THE TAX INSTITUTE

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Dear Mr Reid

Exposure Draft: Ensuring the effectiveness of the income tax general anti-avoidance rule

The Tax Institute thanks you for the opportunity to make this submission in response to the exposure draft of legislation ("**ED**") and draft explanatory memorandum ("**Draft EM**") to effect the Government's announced intention to "ensure the continued effectiveness of the general anti-avoidance rule in Part IVA of the *Income Tax Assessment Act 1936*." ("**Part IVA**").

The Tax Institute supports the maintenance of integrity rules within the tax system to ensure that tax is levied fairly, consistently and according to the policy intention of the relevant tax laws. Widespread faith in the integrity of our tax laws is essential to securing taxpayer trust and voluntary compliance.

The general anti-avoidance rule in Part IVA plays a particularly significant role in safeguarding the integrity of the tax system, ensuring compliance with the intention, not just the letter of the tax law. As such, Part IVA should only be applicable in circumstances where the relevant taxpayer has acted in a blatant, artificial or contrived manner in order to pay less tax than would have been the case had tax been appropriately levied on the substance (rather than the form) of the transaction.

Role of Part IVA

The structure and effectiveness of Part IVA needs to be considered in light of the many ways in which the general anti-avoidance rule affects tax liability, taxpayer behaviour and the taxpayer/Australian Taxation Office ("**ATO**") relationship. Part IVA should be drafted in order to ensure that:

- The provisions are only applicable to those taxpayers that are intended to be affected;

- The provisions strike the right balance between deterring tax avoidance behaviour and not adversely impacting on genuine commercial transactions, thereby resulting in intended taxpayer behavioural responses; and

- The provisions maintain the appropriate balance between allowing the ATO to counter integrity concerns, and allowing taxpayers the right to challenge the Commissioner's assessment – an essential right in a self-assessment system to guard against the imposition of arbitrary assessments.

The comments in our submission below are set out with reference to this framework.

Intent of the proposed amendments

The Government's announced intention underpinning these amendments is set out in:

- the then Assistant Treasurer's media release of 1 March 2012;

- the Assistant Treasurer's media release of 15 May 2012;

- the Assistant Treasurer's media release of 16 November 2012; and

- the draft EM.

The comments in our submission below are set out on the basis of our understanding of the Government's concerns in relation to the current effectiveness of Part IVA, which may be summarised as follows:

1. "The breadth of the permissible enquiry [as to the alternative postulate] 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]." (at paragraph 1.58, draft EM)

2. Rejection of alternative postulates put by the Commissioner on the basis 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 … 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." (at paragraph 1.67, draft EM).

3. Recent cases have resulted in confusion as to whether "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." (at paragraph 1.77, draft EM).

Structure of submission

Our submission below is set out in three parts:

- Part I addresses the Government's views on the need for amendment to Part IVA, the structure and nature of the proposed amendments and The Tax Institute's views in relation to the same.

- Part II sets out our comments on the ED and draft EM, in light of the Government's announced intention underpinning these proposed amendments.

- Part III sets out our views on our preferred basis on which to amend Part IVA to address issue 2 as set out above (if considered necessary). This Part also sets out our views on why points 1 and 3 set out above do not constitute shortfalls in the current operation of Part IVA *vis a vis* its role to appropriately counter integrity concerns.

PART I: ARE THE PROPOSED AMENDMENTS TO PART IVA REQUIRED?

We do not consider the current Part IVA to be ineffective in the ways described in the Government's media releases and draft EM, as set out above.

As such, it is our view that the proposed amendments are unnecessarily extensive, place undue and inappropriate reliance on the purpose inquiry and are based on incorrect assumptions about the likely findings of the Courts in circumstances where the "do nothing" counterfactual may have been put by taxpayers in other circumstances.

Current state of Part IVA

The current Part IVA adequately fulfills its purpose of preventing, punishing or obviating the obtaining of a tax benefit, as defined, where the taxpayer has entered into a scheme for the sole or dominant purpose of obtaining that tax benefit. Recent cases have not resulted in the effectiveness of Part IVA being compromised.

This is because:

- The 'three limbs' approach to Part IVA adopted by the Courts is entirely appropriate - though the purpose test should ultimately determine whether Part IVA is applicable in a particular case, it should only properly be relevant where a tax benefit has objectively been found. While we broadly agree that the limbs of Part IVA should be applied in a coherent fashion, so that the purpose test and tax benefit test operate with reference to the same ultimate goal, there is no need to collapse the limbs into a single, holistic inquiry to ensure effectiveness of the provisions. Nor is it the only role of the tax benefit test to support the purpose test. The two safeguards in Part IVA (the tax benefit and purpose tests) were intentionally inserted by the legislature to ensure an appropriate balance in the current structure between the competing concerns of tackling tax avoidance and limiting the power to do so to an appropriate range of circumstances.

- As is the case under current law, a "tax benefit" should only arise where the taxpayer's actions in entering into a scheme with the dominant purpose of tax

avoidance have been adverse to the revenue. Where, in a choice between the commercially different options A and B:

- the taxpayer has chosen Option A which is subsequently found to be a scheme with the dominant purpose of obtaining a tax benefit;
- the taxpayer would have otherwise objectively and reasonably chosen Option B (whether that is another action, or inaction as in the 'do nothing' counterfactual);
- Option B is reasonably open to the taxpayer (i.e. it does not constitute another tax avoidance scheme); and
- the tax payable as a result of Option B is not any less than was actually paid under Option A (i.e. in the absence of a Part IVA assessment);

the revenue is not adversely affected, as even if the taxpayer had refrained from acting in a manner that constituted tax avoidance, no greater amount of tax would or could have been collected. This is the case whenever Option B is an objectively reasonable alternative postulate to Option A, even if it does not achieve the same 'non-tax effects' as Option A.
A "tax benefit" should only arise where if the taxpayer had acted within the bounds of the tax law (including Part IVA), a greater amount of tax would have been payable. In our view, this outcome is in keeping with the original intention of the current law, and remains appropriate today. This is especially so in light of the dual role of the tax benefit test – to identify *and* quantify the loss to revenue as a result of the taxpayer's actions.

- The Courts have applied this test appropriately to find that a tax benefit existed in only those cases where the taxpayer's actions have resulted in a loss to revenue.
- The assertion that decisions in recent cases will allow 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 is incorrect. This is because in order for a "do nothing" counterfactual to be relied upon to calculate the tax benefit, a Court would need to agree that this counterfactual was a reasonable alternative in the circumstances. Under current law, this requirement is unlikely to be fulfilled where the Commissioner is able to put another reasonable alternative postulate, whether or not that alternative postulate results in the same "non-tax effects" as the scheme.

The proposed amendments

The proposed amendments are deeply complex and have resulted in much confusion and debate as to their actual and intended effects (as well as the extent to which these coincide). The scope, breadth and effect of these amendments will likely take much litigation to resolve.

In light of our view that the current law does not give rise to an integrity concern to which the proposed amendments are a response, we do not recommend the introduction of amendments that are likely to cause significant uncertainty and therefore increase compliance costs.

Our high-level comments on the design of the proposed amendments are as follows. As above, the role of the alternative postulate is to establish the circumstances (and therefore the amount of tax that would have otherwise been paid) if the taxpayer had behaved in accordance with the objective standard set by the law (i.e. had the taxpayer not entered into the tax avoidance scheme). The constraining of this query to only consider other ways in which the taxpayer could have achieved the same "non-tax effects" is inappropriate – unless a greater amount of tax would have resulted from any reasonable alternative, no loss to revenue has resulted.

In a significant departure from this intended operation of the law, the proposed amendments change the relevant tax benefit query from "what reasonable alternative would the taxpayer have objectively chosen if the scheme were unavailable?" to "would alternate methods to achieve the same non-tax effects have yielded a higher amount of tax"? Such a change fundamentally alters the role of the tax benefit test – from identifying an inappropriate loss to revenue to merely identifying every situation in which a taxpayer has minimised their tax liability, whether appropriately or not.

This is undesirable because:

- As above, it is not appropriate for a "tax benefit" to result under Part IVA unless a loss to revenue has resulted.

- Where Part IVA does apply, the proposed section 177CB may yield an artificially high tax assessment for the taxpayer. This is because tax may be legitimately taken into account as a commercial consideration when evaluating commercial alternatives (see further below in Part II), and an alternative postulate that is reasonable in the context of the proposed section 177CB assumptions may not be commercially viable outside that narrow context. This issue is of great concern to our membership. From our reading of the ED and draft EM, it appears as though the Commissioner is entitled to choose any alternative postulate that would be reasonable within the confines of the proposed section 177CB assumptions. Such alternative postulates are likely to be unreasonable outside the confines of those assumptions whenever tax considerations have been taken into account when making commercial decisions. Allowing the Commissioner to impose a Part IVA assessment on the basis of an unreasonable alternative postulate without any capacity for taxpayer challenge is inappropriate, disturbs the existing balance of Part IVA and may result in arbitrary taxation in some circumstances.

- Even if the proposed amendments do not result in Part IVA applying where it should not (due to the operation of the purpose test), the purpose test should not be relied upon to overcome an over-reach of the 'tax benefit' test i.e. the purpose inquiry should not be required to save taxpayers that should not have been caught in the Part IVA net at all owing to the absence of a "tax advantage". There should be no need to make a purpose inquiry unless there has been a loss to revenue, because:

    - The tax benefit test can be easier (and therefore more cost-effective) for taxpayers to self-assess against, especially in the small to medium enterprise market.

- Notwithstanding ATO safeguards in relation to the actual application of Part IVA, a diminished capacity for taxpayer challenge and increased capacity for the Commissioner to raise an artificially high assessment will significantly and potentially inappropriately alter taxpayer and ATO behaviours in a range of circumstances – from audit all the way to litigation.

PART II: THE EXPOSURE DRAFT AND DRAFT EXPLANATORY MEMORANDUM

Our views on the ED and draft EM are made not as against our view of the manner in which Part IVA should be amended (if at all), but as against whether the ED achieves the Government's announced intention.

However, as it is our view that these amendments are unnecessary, we have presumed that as few amendments as possible to the current Part IVA would yield the best outcome in the circumstances.

The objects clause (proposed section 177AA)

We do not consider the inclusion of an objects clause necessary, but have no significant comments to make on the objects clause as drafted. In our view the proposed clause neither adds to nor detracts from the proposed amendments.

The recognition of different purpose thresholds within Part IVA as a note to the section is not ideal, but preferable to the insertion of a second objects clause to cover sections 177E, 177EA and 177EB.

The relevance of the 'scheme'

As noted in the draft EM, a 'scheme' can be identified as broadly or as narrowly as considered appropriate.

As the relevant purpose is that of entering into the scheme, and the tax benefit is that yielded by comparison to an alternative postulate to entering into the scheme, the scope of the scheme was always a significant (if not determinative) factor in the application of Part IVA.

In our view this significance will increase following the proposed amendments, as the scheme will also play a significant role in determining the relevant "non-tax effects", and therefore the alternative methods by which the non-tax effects may have been achieved.

Notwithstanding the comments in the draft EM and relevant media releases that steps within a broader commercial transaction can constitute a scheme, we envisage problems with appropriately identifying the non-tax effects to take into account when constructing an alternative postulate, unless the scheme is appropriately wide and takes the commercial intention of the relevant transaction or series of transactions into account.

By this, we do not suggest that the existence of a commercial purpose necessarily precludes the existence of a dominant purpose of obtaining a tax benefit, but that the alternative postulate might not yield a sensible result unless the scheme is defined with reference to the commercial objective.

It is also foreseeable that a narrowly defined scheme may artificially result in a "tax benefit" where a more broadly defined scheme in the same situation would not have yielded such an outcome.

As such, we recommend either:

- A legislative requirement to also consider the non-tax effects of the broader, commercially viable transaction when defining the scheme; and/or

- Additional guidance in the EM on the appropriate manner in which a scheme should be defined the circumstances.

Interaction of the 'tax benefit' test and the 'purpose' test

There remains significant confusion amongst our membership as to the manner and extent to which the proposed amendments alter the current law in relation to the manner in which the tax benefit test and purpose test interact.

The comments in the draft EM suggest that it is the Government's view that:

- the three limbs in Part IVA (of scheme, purpose and tax benefit) are to be applied as a holistic inquiry;

- the role of the tax benefit test is to support that holistic inquiry; and

- the iterative nature of this inquiry is consistent with the Parliamentary intention of the current law.

Furthermore, the draft EM also states that the Courts had historically concurred with this view, but have in recent cases begun to apply Part IVA in a manner that is not consistent with these principles.

In contrast, there remains a perception within the tax community that under the intended and actual operation of the current law, the three limbs of Part IVA (scheme, purpose and tax benefit) each need to be satisfied, whether considered simultaneously or progressively, and that the tax benefit and purpose tests are to be applied in succession, rather than as a single query.

To the extent that divergent views exist, and to the extent that the proposed amendments alter the current law, we recommend that further guidance be included in the EM on the manner in which the three limbs in Part IVA are intended to interact. Additional guidance in this regard may assist in quelling the confusion. Such guidance should specifically address the reference in proposed subsection 177CB(2) to the need to have regard to proposed subsection 177D(1) when deciding whether Part IVA applies to the scheme, and the manner in which this requirement alters the current law in the Government's view.

Proposed section 177CB(1)(a): Regard to any person's liability to tax

It is our understanding that the phrase "regard to any person's liability to tax" in proposed section 177CB(1)(a) will relate only to "tax" as defined in section 6(1) of the *Income Tax Assessment Act 1936* ("**ITAA1936**") (i.e. "income tax imposed as such by any Act, as assessed under this Act, but, except in section 260, does not include

mining withholding tax or withholding tax") and is therefore not intended to refer to liability to other overseas, Federal or State taxes.

A comment in the EM to confirm this intention may be appropriate to avoid any doubt, even if such confirmation may ultimately be superfluous.

Reconstruction of the alternative postulate (subsection 177CB(1)(b))

The capacity to reconstruct an alternative postulate for the purposes of section 177C in light of the assumptions in proposed section 177CB will depend heavily on the manner in which the terms "non-tax effect", "incidental" and "scheme" are interpreted. It is our view that these terms may not necessarily be interpreted by the Courts in the seemingly intended manner.

Furthermore, the broad definitions in the ED (even when read in conjunction with the draft EM) are likely to create significant uncertainty for taxpayers and the ATO.

We also note that many actions are likely to give rise to both tax-effects and non-tax effects. Under the proposed amendments, every action that had non-tax effects (that were not incidental to the tax effects) will be required to be held constant when constructing an alternative postulate comprised of a theoretical set of actions. This will be the case regardless of whether the action/s also had tax effects.

By way of example, the payment of a dividend will not typically be able to be excluded in constructing an alternative postulate, as the payment of the dividend will have both tax effects and non-tax effects.

The resulting integrity concern – that taxpayers may be able to generate a situation where no tax benefit will result as all actions that resulted in tax effects also resulted in non-tax effects that were not incidental to the tax effects – should be carefully considered in light of the policy intention of the proposed amendments.

Excising the scheme (subsection 177CB(1)(c))

As effect refers to the end achieved, there are unlikely to be many situations where a scheme, however defined, has no non-tax effects whatsoever that are not incidental to the tax effects.

Nevertheless, whether a scheme in fact had any non-tax effects will likely constitute a subject of difference of opinion between the ATO and taxpayers. This is likely to be especially the case where the ATO does not have access to full information as to all of the effects of the scheme.

As a result, it is foreseeable that the Commissioner will seek to rely on this subsection in certain circumstances. As such, we recommend that proposed subsection 177CB be amended to include a requirement that the alternative postulate be commercially viable or reasonable, even where that alternative postulate is constructed under subsection 177CB(1)(c) (see our further comments below).

The need to consider the non-tax effects of the "broader transaction" is canvassed in the draft EM (at paragraph 1.123), but is not required by the provisions of the Act. Such a requirement would provide a necessary safeguard against commercially unreasonable or unviable alternative postulates.

Unreasonable alternative postulates

As noted above, when the assumption in proposed subsection 177CB(1)(a) is applied simultaneously with the assumption in either proposed subsection 177CB(1)(b) or (c), the resulting alternative postulate may not be commercially viable. This is because of the manner in which these assumptions interact. The commercial viability of the non-tax effects achieved by a particular scheme is likely to have been determined with reference to the anticipated tax cost of the scheme. Once this tax cost is changed via application of the proposed subsection 177CB(1)(a), the resulting alternative postulate may no longer be commercially viable in light of the revised tax cost.

Notwithstanding the above, it is also foreseeable that application of the assumption in proposed subsection 177CB(1)(a) alone may also yield an unreasonable alternative postulate. What a taxpayer might reasonably be expected to have done on the application of unrealistic assumptions such as acting without regard to any person's tax liability may not be realistic outside that narrow confine.

The application of these assumptions is most likely to yield commercially unviable alternative postulates in circumstances where a taxpayer has minimised the tax cost of a scheme both legitimately and illegitimately (for example, where part of the identified 'tax benefit' is owing to a legitimate deduction, and the remainder is owing to an inappropriately obtained deduction). The application of the proposed section 177CB assumptions will allow for the construction of an alternative postulate that eradicates both the legitimate and illegitimate deduction. As above, this change may render the alternative postulate commercially unviable outside the confines of the applied assumptions.

This problem is not satisfactorily addressed by the requirement in section 177C to consider what a taxpayer might 'reasonably' be expected to have done, as under the proposed amendments this requirement is subject to the unrealistic assumptions in proposed section 177CB.

This issue is of greatest concern where, when objectively considered, the taxpayer had a sole or dominant purpose of obtaining a tax advantage (as that term is used in the draft EM). The tax benefit test will obviously come into consideration at this point in identifying as well as quantifying the tax benefit arising from the scheme.

Our comments on the inappropriateness of using the test set out in the ED to identify a tax benefit are set out above.

Further to those comments we also note that where Part IVA applies, the use of the test in the ED to quantify the tax benefits that may be cancelled is grossly inappropriate and will generate results that are at odds with the intended application of Part IVA. As the ED is currently drafted, the Commissioner will have an unfettered power to cancel all tax benefits arising from the scheme, whether or not those tax benefits were obtained inappropriately.

By way of example, the alternative postulate in Example 1.2 of the draft EM may not have been commercially viable once tax considerations are taken into account because Gadget Co may not have been entitled to a deduction for the $25,000 fee. In this circumstance, Part IVA would apply, but the appropriate tax benefit should be calculated with reference to the amount of the fee that Gadget Co and Banker Co would likely have negotiated in light of the denied deduction, not the whole amount. However, under the ED, the Commissioner would be able to raise a Part IVA

assessment on the basis of the unrealistic alternative postulate described in the example, as the denial of the deduction for the fee is required to be ignored under proposed subsection 177CB(1)(a).

Such an alternative postulate will not be able to be challenged at law, as it is still reasonable in the context of the proposed section 177CB assumptions. The proposed ED provides no comfort or capacity for challenge to taxpayers to guard against the raising of unreasonable Part IVA assessments on the basis of unreasonable alternative postulates.

While we do not intend to suggest that the Commissioner would deliberately apply unreasonable alternative postulates intended to maximise the tax collected, the lack of any capacity to challenge such an assessment tilts the balance of Part IVA significantly and inappropriately in the Commissioner's favour. Such a significant change is likely to affect both the actual application of Part IVA as well as taxpayer and ATO behaviours long before an assessment is raised, or a dispute is escalated.

The risk profile of certain transactions is likely to be heightened as a result of an increase in the potential amount of a Part IVA assessment. Taxpayers will be left with the choice to either bear an unduly high tax risk profile, or cease to undertake a transaction that would otherwise have proceeded. In the context of a dispute, taxpayers may yield to an unreasonable assessment due to a diminished capacity to challenge, as well as the decreased prospects of success for any such challenge.

Proposed solutions

Alternative postulates should be reasonable

We recommend that proposed subsection 177CB be amended to include a requirement that the alternative postulate be commercially viable or reasonable, whether that alternative postulate is constructed under subsection 177CB(1)(b) or (c). Such an inclusion would provide a necessary safeguard against unintended consequences of the proposed amendments.

With respect to alternative postulates constructed under subsection 177CB(1)(c), theoretically the excision of a scheme that has no non-tax effects should not result in an alternative postulate that is not commercially viable or reasonable. However, the application of this subsection is likely to turn on differing views as to whether the scheme in fact had any non-tax effects (that were not incidental to the tax effects). In the event of a dispute on the facts, a requirement that the alternative postulate be commercially viable or reasonable will be at worst, superfluous, and at best the basis on which the appropriate result is reached.

Cancelling the tax benefit

Should this amendment not be considered appropriate, we strongly recommend limiting the Commissioner's ability to cancel all or part of a tax benefit connected with the scheme.

Specifically, the Commissioner's ability to cancel a tax benefit should be limited to only that part of the tax benefit that the taxpayer entered into the scheme with the dominant purpose of obtaining. Without such a restriction, the Commissioner will have the capacity to cancel any and all tax benefits connected with the scheme, whether obtained inappropriately or not.

For the reasons set out above, the requirement that the alternative postulate (and therefore the tax benefit resulting from the alternative postulate) be 'reasonable' within the context of the proposed section 177CB assumptions is an inadequate safeguard against unduly high tax assessments being raised by the Commissioner. Furthermore, even outside the context of litigation, such an imbalance in the structure of the system will likely result in inappropriate ATO and taxpayer behaviours.

Proposed section 177CB(1)(b)(i): The same non-tax effects

The concept of a non-tax effect is central to the operation of the proposed Part IVA. Taxpayer, ATO and judicial understanding and interpretation of this term, will determine whether the amendments are ultimately applied as intended. It is likely that this term will need to be the subject of litigation before its scope and breath is fully defined and understood.

The high-level meaning or intention of this term seems ascertainable from the context of the amendments. However, the relevance and significance of this term, as well as its expected longevity warrant the inclusion of much more detailed guidance in relation to the manner in which the term should be interpreted by taxpayers and the ATO in the first instance, then the Courts as relevant.

The "same" non-tax effects

We strongly advise against the use of the term "same" in this circumstance. This is despite the inclusion of a carve-out for non-tax effects that are incidental to the tax effects of the scheme.

The term "same" has been interpreted rigidly by the Courts in other contexts, most relevantly the application of the same business test in section 165-13 of the *Income Tax Assessment Act 1997*. Such rigidity of application is undesirable in these circumstances, and unnecessary for the structural integrity of the proposed Part IVA.

In addition, the meaning of an "incidental" effect is unclear (see further below). Furthermore, as described in further detail below, the terms "non-tax" and "effect" will also likely prove difficult to define. As such, a rigid requirement to presume the "same" non-tax effects may yield odd and unintended results.

Due to the relevance of the term "non-tax effects" as well as the difficulty that is likely to be encountered in defining the non-tax effects of a particular scheme, we recommend that the clause be drafted to allow a degree of flexibility in determining which 'non-tax effects' should be held constant when determining the alternative postulate.

We instead recommend that the clause be altered to require a presumption that the taxpayer would have acted to achieve either;

- The same material non-tax effects;
- Substantially the same non-tax effects; or
- Effectively the same non-tax effects.

We also recommend the inclusion of further guidance in the EM as to the degree to which non-tax effects need to be the "same" (or any other term if substituted) in order to satisfy this requirement. A series of examples would assist in illustrating the intention of the amendments.

The same "non-tax effects"

The factors taken into account, as well as the effects or purposes achieved by a transaction or series of transactions by the taxpayer are likely to be wide-ranging, interrelated, complex and not entirely financial.

In our view, reference to the factors in subsection 177D(2) allows such relevant considerations to be taken into account from a legislative perspective in determining the non-tax effects of the scheme.

Nevertheless, in order to provide much needed clarity for all relevant parties, we recommend the inclusion of further, detailed guidance and a number of additional, and more complex examples to explain the intention underpinning the use of this term. Such guidance should explain:

- Examples of effects that may be considered to be non-tax effects for the purposes of this section.

- The meaning of an "effect" i.e. an end achieved (as per paragraph 1.110 of the draft EM). In this regard, we note the importance of distinguishing between actual versus intended effects, effects rather than purposes and effects rather than actions.

- The relevance of non-tax effects that were unintended or not envisaged at the time of entering into the scheme. The meaning of an effect achieved "as a result of concerted action to that end" is also unclear. Does the actual effect of a scheme need to have been intended? Does the effect need to result from an action (as opposed to inaction)?

- How to consider effects which are both tax and non-tax (such as for example, the effect of determining that a beneficiary is presently entitled to trust income, which is relevant in the context of determining beneficiary entitlements under trust law as well as tax liability of the beneficiary with respect to the net income of the trust).

- The relevance of non-tax effects achieved by an entity other than the taxpayer.

- The relevance of non-tax effects of the alternative postulate other than those also achieved by the scheme.

Without such detailed guidance, there is significant risk of confusion and unnecessary complexity.

By way of example, we suggest the inclusion of examples that canvass non-tax effects such as:

- Compliance with regulatory requirements other than the income tax acts (such as compliance with other overseas, Federal and State tax obligations, workplace health and safety requirements, documentation required for investors/lenders, corporate, regulatory and reporting requirements and compliance with environmental standards etc.)

- Risk mitigation (such as asset protection considerations).

- Compliance with directors' duties, where the relevant taxpayer is the company.
- The securing of commercial benefits (such as a supply or distribution channel, access to a new market etc) or funding (whether via debt or equity raising).

- Staffing and recruitment considerations.

- Non-financial/business considerations such as the effect on personal or familial relationships.

Proposed subsection 177CB(3)(b): An effect that is incidental

We suggest the inclusion of further guidance and additional examples in the EM to describe the legislative intent of the term "an effect that is incidental" to a tax effect. Such an explanation should also address how this term interacts with the term "incidental purpose" in sections 177EA and 177EB of ITAA1936, especially in light of the recent decision in the case of *Mills v Commissioner of Taxation* [2012] HCA 51.

Role of the explanatory memorandum

We acknowledge the important role that the explanatory memorandum will play in informing Parliamentary debate on the amendments, and subsequently as part of the extrinsic materials that the Courts may take into account in certain circumstances to determine the intention of the legislators.

In our view, the core object and function of the explanatory memorandum to a Bill is to explain the effect of the proposed amendments, including why those effects are desirable.
To the extent that the draft EM contains material to explain the intended operation of the amendments (such as from paragraph 1.86 to 1.130), we are appreciative of Treasury's significant efforts in drafting the document.

However, many sections of the draft EM contain superfluous and in our view, incomplete statements as to the intention of Part IVA when introduced and the need for these legislative amendments.

These statements are not necessary for Parliament to understand the effect of the proposed amendments and may have the effect of guiding judicial deliberations in an inappropriate manner. This is especially the case where the draft EM contains statements as to the principles espoused by and the effect of particular cases which are at odds with the long-held understanding of other members of the tax community.

Such statements should be removed from the draft EM altogether. Examples include:

- Paragraph 1.25
- Paragraphs 1.29 and 1.30
- Paragraphs 1.54 to 1.85

To the extent that such detailed arguments are considered necessary to justify (rather than explain) the amendments, and also contain normative statements as to the desired operation of Part IVA in the present day, rather than the intended operation of Part IVA when first introduced, the statements should either:

- be rewritten to explain the manner in which the intended operation of Part IVA has changed since introduction in 1981; or
- be contained in a document other than the Explanatory Memorandum that is a more appropriate vehicle via which the Government may justify (rather than explain) the proposed amendments, such as for example the Assistant Treasurer's second reading speech on introduction of the Bill.

Application date

The Government's decision to defer the application date of the amendments from date of announcement (1 March, 2012) to date of release of the ED and draft EM (16 November, 2012) is a welcome recognition that "the amendments are being proposed in a form the public may not have readily anticipated when the measure was first announced." (paragraph 1.85, draft EM).

Should the form in which these amendments are introduced into Parliament differ significantly in comparison to the ED (as is recommended in Part III of this submission), we recommend that the application date be set to the date of Royal Assent rather than date of application for the same reasons outlined in the preceding paragraph.

Such a delayed application date should not result in integrity concerns as taxpayers that were concerned about the potential application of Part IVA will have been dissuaded from entering into transactions that may fall foul of the proposed provisions as set out in the ED after the date of its release.

Transitional issues

The ED notes that the amended Part IVA will apply to schemes entered into or commenced to be carried out after 15 November 2012.

It is foreseeable that the amendments could apply to a narrowly defined scheme where all relevant steps in the scheme occurred after the application date, even when the scheme is part of a broader transaction that commenced before the application date. Such an outcome appears to be inconsistent with the policy underpinning the choice of the application date.

As such, we recommend that the draft EM be revised to clearly state that schemes are intended to be excluded from application of the amendments where the broader transaction commenced before the application date i.e. where there is a coherent plan

or course of action which commenced prior to 16 November 2012 and in relation to which the asserted scheme steps are merely a component part, then the new rules should not apply, merely because those steps occurred after 16 November 2012.

PART III: THE PREFERRED AMENDMENT MODEL

As noted in Part I of this submission, it is our view that the current Part IVA does not give rise to an integrity concern which needs to be addressed via legislative amendment. As such, the proposal below should be read subject to our comments in Part I of this submission.

Nevertheless, if such amendments are considered necessary, the amendments should be restricted to only those changes considered necessary to address the perceived integrity concerns. Any more extensive a rewrite of the tax benefit test is unnecessary and bound to result in uncertainty which will likely only be resolved after years of costly litigation.

The only stated Government objective of the proposed amendments (as set out in the draft EM and on page 2 of this submission for ease of reference) that addresses a perceived integrity concern is as follows:

Rejection of alternative postulates put by the Commissioner on the basis 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 … 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." (at paragraph 1.67, draft EM).

Part IVA can be amended to legislatively prohibit the obtaining of a tax advantage from functioning as a shield by a narrower set of amendments that require the alternative postulate to be constructed as follows:

- The alternative postulate satisfies the relevant requirements if it is commercially equivalent in effect to the broader, commercially viable transaction/s that were actually entered into (as distinct from a narrower scheme that may not have a commercial objective).

- Such an alternative postulate should continue to be subject to section 177C, so that the alternative postulate is required to be reasonable.

- Any reasonable alternative postulate that satisfies this requirement should be sufficient – there should be no need to determine whether the posited alternative postulate is the most reasonable. In this regard, we are sympathetic to the information imbalance that may exist between the taxpayer and Commissioner in constructing the alternative postulate.

- The requirement set out in proposed section 177CB(1)(a) of the ED (that each person would have acted without regard to any person's tax liability) should be removed altogether – this requirement (especially when applied cumulatively) is unrealistic, unnecessary and bound to result in commercially unviable

alternative postulates whenever tax considerations have been taken into account but did not amount to a tax advantage.

Such a narrower amendment will resolve many of the issues caused by the current ED and will still effectively tackle the perceived integrity concern set out above.

The requirement that the alternative postulate be commercially equivalent will prevent the argument that the taxpayer would have "done nothing" and would also restrict the construction of the alternative postulate from being an "at large" query.

The difficulty posed by the ED in defining the "non-tax effects" of a narrow and potentially commercially unviable scheme will be dispensed with – as the taxpayer's actions will need to be considered in light of broader, commercial objectives, the definitional problems that exist in the ED in relation to the many of the relevant integers (scheme, non-tax effect, incidental effects) will lessen.

In the context of litigation, the Courts will have greater cause to consider the context of the scheme, which should result in coherence between the objectives of the purpose test and the tax benefit test while lessening the significance of the definition of the specific 'scheme'.

The use of a broader concept such as commercial equivalence, rather than the legalistic, narrow and rigid concept of 'non-tax effects of the scheme' will allow for greater flexibility and more sensible application of Part IVA (including quantification of the tax benefit) in the facts and circumstances that are particular to each situation. Furthermore, the use of a concept that is more readily understandable by the lay population will allow Part IVA to strike the appropriate balance between deterrence and punishment while minimising the impact on genuine commercial transactions.

In this regard, while we understand the temptation to rely on strict, legalistic rules and definitions, it is our view that a principles-based approach to drafting is more appropriate in the context of anti-avoidance legislation, which is not just relevant for the purposes of defining tax liability, but is intended to also elicit the desired behavioural responses from taxpayers.

Such a test would result in the identification of a tax benefit in a manner that is consistent with the current role of the tax benefit test i.e. to identify the loss to revenue caused by the taxpayer's actions. Where the Commissioner is unable to identify a reasonable alternative postulate that is commercially equivalent to the scheme, the absence of any such alternative is indicative that no "tax benefit" exists i.e. there has been no loss to revenue, for the same reasons as set out in the example in Part I above.

In our view, this approach is better suited to achieve the Government's intentions, as the overwhelming majority of instances in which Part IVA is considered in practice is in a practical and not a strict legal sense.

Of course, such principles can only constitute the basis on which the amendments to Part IVA may be constructed, and will require further development via public consultation before the resulting amendments are workable. As such, should Treasury consider this option worthy of pursuing, we would be pleased to discuss the matter further. We also recommend that the resulting legislation be exposed for public consultation prior to being introduced via a Bill. As such an approach would result in

amendments that would be different in many material respects from the ED, we also recommend reconsidering the appropriateness of the proposed application date.

As adoption of the approach outlined above should address the Government's integrity concerns, there should be no requirement to further amend Part IVA to either:

- collapse the purpose test and tax benefit test into a single, holistic inquiry; or

- carve out the "would" query from the "might reasonably be expected to" query with respect to the assumptions i.e. the construction of an alternative postulate subject to the assumptions set out above should be possible regardless of whether the alternative postulate is predicated on the basis that those set of actions "would" have happened or "might reasonably be expected" to have happened. This is because the need to refer to the broader commercially viable set of transactions should allow for consideration of the tax benefit that would result from an alternative postulate that consists of an excision of the scheme. Alternatively, a sensible definition of the "scheme" would also yield appropriate results.

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Should you wish to discuss any of the above, please do not hesitate to contact either me or Tax Counsel, Deepti Paton on (02) 8223 0044.

Yours sincerely

Ken Schurgott
President

CC: The Hon David Bradbury MP, Assistant Treasurer and Minister Assisting for Deregulation