

## THE EVOLUTION OF TAX AVOIDANCE



Jo Cleary  
Financial Consultant  
Queensland

Once a legal, acceptable practice, tax avoidance evolved into being illegal and unacceptable. This article discusses the alterations to legislation and the changing attitudes of taxpayers, their advisers and the judiciary that facilitated this evolution.

### Introduction

During the 1970s a tax avoidance industry evolved in Australia, facilitated by a free market and by the changing attitudes of taxpayers, their advisers and the judiciary. This evolution gave rise, in turn, to changes in the approach and methods of the Australian Taxation Office (ATO) to tax collection, complemented by specific alterations to legislation and severe penalty provisions for non compliance. Over time, these measures curbed the growth of tax avoidance.

In general terms, taxpayers' attitudes changed from acceptance of the responsibility to pay tax at the start of the 1970s, to rebellion and ridicule by 1980, to general compliance and fear by the end of the 1980s. The change in attitude of taxpayers was influenced, at least in part, by economic factors. It was also influenced by the apparent acceptance, by the authorities, of blatant tax avoidance schemes put forward by tax advisers. Their use was apparently condoned by the judiciary and it took changes in legislation finally to compel many taxpayers and their advisers to observe and to comply with the law.

The legislative changes reflected the new methods and approaches taken by the other players in the tax system, namely the government and the bureaucracy, whose attitudes towards tax avoidance remained generally constant throughout this period. These attitudes were reflected in the change over time in the use of the term "tax avoidance", which was used to describe something acceptable and legal, but which came to be used, over this period, to describe something unacceptable and illegal.

This article examines the evolution of tax avoidance in the hands of taxpayers and their advisers and the responses of the judiciary and government in checking that evolution. The article first looks at the background in which tax avoidance became acceptable and distinguishes avoidance from evasion. It then proceeds to examine the evolution of tax avoidance up to the 1970s in the context of a weak s 260 and judicial and taxpayer response to initial anti-avoidance legislation. A review is then made of the legislative reform process of the 1980s, with the concomitant change in approach of the judiciary, and covers the reinstatement of s 260 and the introduction of Part IVA. The article concludes with a suggestion for the need for further changes in attitudes in maintaining an appropriate balance between taxpayers and the revenue collecting authorities.

## Background

Taxation is a form of compulsory contribution from the private to the public sector in order to support intended government expenditure.<sup>1</sup> It is, as Holmes J in *Compania de Tabacos v Collector De Filipinas*<sup>2</sup> puts it, the price paid for civilised society. An Australian government's priority is to raise sufficient revenue to cover expenditure with an equitable and efficient allocation of the tax burden. In determining the form and level of taxation, the individual and collective rights of taxpayers, the demands of lobby groups, the economic conditions in Australia and the effect that tax decisions could have on Australia's international and the government's own political position, are all taken into account.

The Income Tax Assessment Act (1936) (the Act) provides the basis for the collection of income tax for a very broad range of entities, activities and transactions. As a result of this breadth of application, it has general provisions that can be interpreted in different ways. These general provisions have led to numerous cases in which the judiciary were responsible for the interpretation of how the provisions should apply in particular situations.<sup>3</sup> The interpretations have been further coloured by the fact that in the eyes of the courts a

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<sup>1</sup> Waincymer J, *Australian Income Tax Principles and Policy* (1991 Butterworths) 2.

<sup>2</sup> (1927) 275 US 87.

<sup>3</sup> See, eg, *NZ Flax Investments Ltd v FCT* (1938) 61 CLR 179 (definition of "incurred"); *FCT v Kowal* 84 ATC 4001 (apportioning of deductions); *FCT v Blake* 84 ATC 4661 (income or capital?); *Nilsen Development Laboratories Pty Ltd v FCT* 81 ATC 4031 (accrued long service leave and annual leave entitlements allowed as outgoings incurred when provided for under s 51(1)?).

requirement that individuals and entities must pay tax and the possible imposition of penalties under the Act give taxpayers certain rights as to the operation of the law. Taxpayers can expect that laws will be clear, stable, efficient, fair and equitable.<sup>4</sup>

The attitude of taxpayers is to pay the least amount of tax possible. Evidence of any administrative unfairness encourages individual taxpayers to start looking for ways to avoid or evade tax. Tax advisers interpret the law for taxpayers and assist them in structuring their affairs to comply with the law and to minimise tax liability.

Early judicial views encouraged taxpayers to take an anti-tax attitude. Lord Esher MR described revenue officials as “unpleasant, tyrannical, monsters” in *Grainger & Sons v Gough*.<sup>5</sup> He said in *CIR v Angus & Co*<sup>6</sup> that “the Crown ... must make out its right to the duty and if there be a means of evading the duty, so much the better for those who can evade it”. In 1936, Lord Tomlin asserted in *IR Commrs v The Duke of Westminster*,<sup>7</sup> “every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be”.<sup>8</sup> The growth of the tax avoidance industry was further encouraged by the advice of the Privy Council in *Europa Oil (NZ) Ltd (No 2) v CIR (NZ)*<sup>9</sup> that it is only the legal results of a transaction that should determine how facts are to be analysed and not the economic motivations.

Section 260 of the Act was the general anti-avoidance provision prior to its replacement by Part IVA on 27 May 1981. Section 260 stated that every agreement shall, so far as it has or purports to have the purpose or effect of altering the incidence of any income tax or defeating, evading, or avoiding any duty or liability, be absolutely void, as against the Commissioner. However, the judiciary by literal interpretation, as discussed later, rendered s 260 ineffective.

A number of factors combined to form the basis on which the tax avoidance industry evolved. These factors included the economic climate in a free market, various judgments,<sup>10</sup> the public attitude to

<sup>4</sup> Sir Harry Gibbs, “The Tax System: Seriously Wrong in Principle” (1993) 28 *Taxation in Australia* 31.

<sup>5</sup> (1896) 3 TC 311.

<sup>6</sup> (1889) 23 QB 579.

<sup>7</sup> [1936] AC 1; 19 TC 490.

<sup>8</sup> Cases referring to this principle include *FCT v Westtraders Pty Ltd* (1980) 54 ALJR 461; *Mullens v FCT* (1976) 135 CLR 290; *Slutzkin v FCT* (1977) 140 CLR 314; *Brambles v FCT* (1977) 8 ATR 108.

<sup>9</sup> (1976) 1 WLR 464.

<sup>10</sup> *W P Keighery Pty Ltd v FCT* (1957) 100 CLR 66 (choice principle);

the payment of tax, and the government's lack of political courage to address the problem of avoidance aggressively.

In economic terms, Australia is a free market. Broadly, a market consists of the buyers and sellers of a good or service. The essential element of the market is competition, which in turn promotes efficiency. A market will ascertain the price a buyer is willing to pay for the good or service and the price for which a seller is willing to sell the good or service. It is equitable because all processes in a market are based on freedom of choice. The private ownership of property is the greatest incentive for the continuity of a market system. A free market is supposed to maximise the satisfaction of consumer demands.

Between 1955 and 1971 prices, as measured by the consumer price index, rose by 54.6%,<sup>11</sup> wages by 116.6%<sup>12</sup> and income tax collections by 332.14%,<sup>13</sup> the last being more than a threefold increase in real terms. This disproportionate increase in tax liability led to the use of artificial vehicles to minimise taxation. As early as 1959, companies, partnerships, trusts and assignments of income were being used to minimise taxation of the wealthy. By the late 1960s and early 1970s, tax havens and other tax planning devices allowed people with high incomes and assets to reduce their tax liabilities to what they considered to be an equitable amount, or even less. The public at large was unaware of this activity and the government on the whole ignored it, making only token efforts to control avoidance and evasion.

Specific anti-avoidance provisions were enacted for the 1964-1965 financial year as a result of a committee chaired by Sir George Ligertwood.<sup>14</sup> These amendments did little but encourage a new generation of more sophisticated and technically artful schemes which were mostly successful.

It was within the environment of a free market that the tax avoidance industry evolved. The culture of the 1970s and 1980s allowed the market of tax avoidance to flourish. There was demand, supply and

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*Newton v FCT* (1958) 98 CLR 1 ("ordinary business or family dealing" test); *Cecil Bros Pty Ltd v FCT* (1964) 111 CLR 430 (s 260 had no application to deductions otherwise allowable under s 51(1)).

<sup>11</sup> *Year Book Australia* (1955 AGPS); *Year Book Australia* (1971 AGPS), CPI six state capital cities - 1954-1955: 74.0 and 1970-1971: 114.6.

<sup>12</sup> Australian Bureau of Statistics, *Year Book Australia* (19xx AGPS).

<sup>13</sup> *Ibid.*

<sup>14</sup> Ligertwood Committee, *Commonwealth Committee on Taxation, Report* (1961 AGPS) - anti-avoidance provisions directed at the use of companies, partnerships, trusts and assignments of income.

established legal precedents. The price that the taxpayers paid their tax advisers for their services produced an efficient industry and a cost effective benefit in the form of tax saved to the taxpayer.

### Tax evasion

Tax evasion is defined as "criminal falsification or non-disclosure as a means of reducing tax".<sup>15</sup> It should be distinguished from tax avoidance, which lacks the criminal intent, but which can cover a broad range of activities from artificial and contrived schemes through to carefully constructed, legal arrangements.

Blatant examples of tax evasion occur in the cash economy. The cash economy involves taxpayers evading their liability to pay tax by simply "pocketing" a cash payment for work performed and not declaring the receipt as income. This practice was identified particularly with certain industries in which tax evasion was widespread. The provisions that existed in the Act were inadequate to prevent this.

To counter this, in 1983, the government introduced the Prescribed Payments System (PPS) provisions (Part IV Div 3A: s 221 YHA - s 221 YHZ). The PPS applies where there is a payment in respect of specified work<sup>16</sup> carried out within specified industries<sup>17</sup> for a prescribed person.<sup>18</sup> Payers must complete the appropriate registration forms and lodge them with the ATO, deduct the tax at the appropriate rate and forward the tax with the duly completed deduction, reconciliation and other forms to the ATO within the prescribed time.

Whilst this has decreased the incidence of tax evasion within the industries to which the PPS provisions apply, there is still a very large number of traders who do not fall within the PPS provisions and who only deal in cash, eg fruit markets. The Reportable Payments System, a watered down version of the PPS, was introduced in 1994 in an attempt to cover more cash transactions and applies at present to

<sup>15</sup> Lehmann G and Coleman C, *Taxation Law in Australia* (1994 Butterworths) 877.

<sup>16</sup> Specified work is defined in Income Tax Regulation 126(2).

<sup>17</sup> Specified industries include building and construction, road transport, architectural services, surveying services, engineering services, other professional building and construction services, joinery and cabinet making, motor vehicle repairs, and cleaning.

<sup>18</sup> A prescribed person is defined separately in relation to each industry and generally refers to a person operating in the same industry category (reg 126(4)).

certain payments in the fishing and clothing industries. However, it is impossible either precisely to quantify revenue lost through tax evasion, or to eliminate it.

### Tax avoidance - within the Act

Prior to and during the 1970s, three common areas of tax avoidance were manipulation of the capital/income distinction, dividend stripping and income splitting. Provided the documentation established the legal effect of a transaction, the courts supported the taxpayers. Paper arrangements were entered into which often bore little or no relationship to the real economic gain or loss resulting from the transaction.

#### *Capital/income distinction*

The definition of "income" evolved from the concepts of income and capital in trust law. There was no relation to economic gains, ability to pay or liability to tax. Tests were adopted by the courts to differentiate between income and capital gains - was the asset sold in the course of a profitmaking scheme or was it sold in a manner that would return capital gains to the seller? If there was no clearly defined answer then the primary test was based on the taxpayer's acquisitory intention - was the acquisition of an asset for profit by resale or was it acquired for other purposes? The government adopted these tests and incorporated the tests regarding intention and the manner of dealing with the asset into the Act.<sup>19</sup> The Commissioner's task of determining whether a receipt was income or capital was sometimes difficult: firstly, in interpreting the intention of a taxpayer at the time of acquisition of an asset, because of the subjective nature of intention; secondly, in assessing the quantum of tax liability under these tests, especially when attempts at avoidance involved the transfer of assets to facilitate the application of the appropriate sections;<sup>20</sup> and thirdly, in establishing that gains in the course of "profit making" schemes were income.<sup>21</sup>

Accordingly, the rearrangement of taxpayers' affairs to show gains from transactions as being capital instead of income was actively and

<sup>19</sup> Section 26(a).

<sup>20</sup> For example, if an asset originally purchased for resale at a profit was gifted to family members, would the profit be the difference between the final proceeds of disposition and the original price paid or between the amount received and the value of the property when it was gifted? See also, *Steinberg v FCT* (1975) 5 ATR 565 and *FCT v Williams* (1972) 3 ATR 283.

<sup>21</sup> *Milne v FCT* (1976) 5 ATR 785, *FCT v Bidencope* (1978) 8 ATR 639 and *Burnside v FCT* (1977) 8 ATR 305.

effectively pursued by taxpayers with the help of their advisers. It took the introduction by the government of the comprehensive capital gain and loss provisions in Part IIIA of the Act in 1985 to remove much of the impetus for this form of avoidance and evasion. By bringing capital profits into the tax net, for assets acquired after 19 September 1985, their tax free status was largely removed.

### *Dividend stripping*

The double taxation of company profits, by taxing profits first when earned in the company and then taxing the dividends in the hands of the shareholders, created an incentive for exploitation. As long as the profits were retained by the company, no further tax was payable, but as soon as they were paid out, the dividends were taxed. To access these profits, the taxpayer's shares in the company were sold. The price of the shares reflected the value of the company's assets, which included significant retained profits not yet distributed as dividends. By selling the shares in the company including the dividends, the purchase price was received as a tax-free capital gain.

If the sale to a third party involved use of funds from the acquired company or an associated party, this extraction of company profits was known as dividend stripping. The proceeds of the sale were then received through a circuitous distribution of company profits via a third party instead of directly.

The ATO implemented procedures to curb the use of this tax avoidance method and the gains, when detected, were treated as taxable dividends in the seller's hands. These procedures were undermined by High Court decisions,<sup>22</sup> which led directly to the development of the "bottom of the harbour" schemes.<sup>23</sup> The High Court had said that the taxpayers would not be liable for taxes because of acts carried out by the purchasers after the sale of a company was completed. On these grounds advisers suggested that the sellers could walk away from the transaction free of any tax liability, even knowing that the buyers may strip the profits out of the company without paying taxes that would be due soon after the sale was completed. It required government legislation to counter the effects of these decisions.<sup>24</sup>

<sup>22</sup> *Patcorp Investments Ltd v FCT* (1976) 10 ALR 407 and *Slutzkin v FCT* (1977) 7 ATR 166.

<sup>23</sup> Krever R, "Avoidance, Evasion and Reform: Who Dismantled and Who's Rebuilding the Australian Income Tax System?" (1987) UNSW Law Journal 229 at fn 33.

<sup>24</sup> Sections 46A and 46B ensured that dividends extracted from companies by purchasers were fully taxed. Sections 36, 36A and 52A were modified or

“Bottom of the harbour” schemes were seen by the government as being criminal in nature. The definition in s 86 of the Crimes Act 1914 (Cth) provides, inter alia, that:

- (1) A person who conspires with another person -
  - (a) to commit an offence against a law of the Commonwealth;... or
  - (e) to defraud the Commonwealth or a public authority under the Commonwealth,shall be guilty of an indictable offence.  
  
Penalty: Imprisonment for 3 years.
- (2) Notwithstanding the penalty set out at the foot of the last preceding sub-section -  
  
...
  - (b) where the offender conspired with another person to commit an offence against a law of the Commonwealth that is punishable by imprisonment for a greater period than 3 years - the offender is punishable as if he had committed that offence.

The Crimes (Taxation Offences) Act 1980 created a number of criminal offences relating to the fraudulent evasion of various federal taxes. The Act is directed, inter alia, against stripping arrangements entered into on or after 4 December 1980 which are designed to render a company or trust incapable of paying tax.<sup>25</sup> It is also an offence to aid, abet, counsel or procure another person to enter into such an arrangement.<sup>26</sup> The maximum penalty is five years gaol, or a \$50,000 fine, or both. The person convicted may also be ordered to pay some or all of the tax involved.<sup>27</sup>

### *Income splitting*

The rationale for a progressive income tax system is the appropriation and redistribution of increases in taxpayers' economic wealth. The

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added to deny purchasers any offsetting deductions if newly acquired shares were later sold. Section 177E prohibited dividend stripping.

<sup>25</sup> Crimes (Taxation Offences) Act 1980, s 5 and s 13.

<sup>26</sup> Ibid at s 6, s 7 and s 13.

<sup>27</sup> Ibid at s 9, s 12 and s 13.



success of the system depends upon the correct tax unit being identified and taxed at the appropriate rate. Diversion of income to or splitting income with parties who pay tax at a lower rate undermines the system. Income splitting offers taxpayers the opportunity to pay tax at the rate of their choice.

The Australian judiciary allowed the transfer of income by the assignment of the right to income with two exceptions, the transfer of contingent property income<sup>28</sup> and the transfer of income from labour. Attempts to prohibit income splitting were piecemeal and counter-productive.<sup>29</sup> The 1961 Ligertwood Tax Committee<sup>30</sup> recommended comprehensive reform. In 1964, the Downing study<sup>31</sup> advocated a complete pooling of a family's property income while the 1975 Asprey Report<sup>32</sup> similarly called for measures to counteract any income transfers leading to income splitting. Legislation then enacted simply voided tax avoidance transfers made for less than seven years.<sup>33</sup> The acceptance by the High Court of the use of trusts for the redirection of income<sup>34</sup> and the inactivity of the legislature paved the way for the proliferation of tax avoidance and tax evasion schemes in this area of tax law.

### The fall of s 260

It was difficult for the courts to reconcile the provisions of the Act that gave taxpayers the choice to organise their affairs to obtain a tax benefit with those provisions that were directed at nullifying schemes of tax avoidance. This uncertainty in the law allowed the exploitation of the system. The ineffectiveness of s 260, which developed because of the court's failure to apply the section in the manner in which it was intended, but for which it was not well drafted, led to tax avoidance and evasion.

The tests that were developed to apply to cases that may have fallen under s 260 of the Act included:

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- <sup>28</sup> *Norman v FCT* (1963) 109 CLR 9. In *Shepherd v FCT* (1965) 113 CLR 385, the Barwick High Court allowed the transfer of the right to future royalties, even though there was no guarantee that the product on which royalties were to be paid would ever be manufactured.
- <sup>29</sup> Krever, above n 23 at 230, fn 37.
- <sup>30</sup> Ligertwood Committee, above n 14.
- <sup>31</sup> Downing, Arndt, Boxer and Mathews, *Taxation in Australia - an agenda for reform* (1964 Melbourne University Press).
- <sup>32</sup> *Taxation Review Committee Report* (KW Asprey, Chairman) (1975 AGPS).
- <sup>33</sup> Section 102A, inserted in 1964.
- <sup>34</sup> *Truesdale v FCT* (1970) 1 ATR 582.

(i) **the predication test -**

This test was established in *Newton v FCT*<sup>35</sup> and s 260 was found to apply. Lord Denning said that for the provision to apply:

you must be able to predicate – by looking at the overt acts by which it was implemented – that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealings, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section.

This case was also the origin of the “ordinary business or family dealing” test. That test was later used in *Peate’s case*<sup>36</sup> to declare void an arrangement between an incorporated medical practice and service company and to allow the application of s 260.

(ii) **the choice principle -**

Taxpayers have the right of choice between alternatives, which the Act itself provides, to arrange their affairs to take advantage of particular tax consequences. This principle<sup>37</sup> was established in *W P Keighery Pty Ltd v FCT*.<sup>38</sup> *FCT v Casuarina Pty Ltd*<sup>39</sup> confirmed the application of the choice principle. It was further extended in *Cridland v FCT*,<sup>40</sup> where Mason J indicated that a taxpayer who deliberately creates a situation to take advantage of tax consequences specifically provided by the Act is not caught by s 260. In *Mullens v FCT*,<sup>41</sup> Stephen J said that “s 260 of the Act in performing its task of ‘protecting the general provisions of the Act’ cannot be allowed to negative the Act’s specific and particular provisions”. In the same case, Barwick CJ referred to “altering the incidence of any income tax” and indicated that if a transaction:

being effective and not in breach of the Act,  
reduced the amount of tax which the taxpayer

<sup>35</sup> (1958) 98 CLR 1.

<sup>36</sup> (1964) 9 ATR 355; 111 CLR 443.

<sup>37</sup> Significant and influential cases dependent on this principle include *Slutzkin v FCT* (1977) 140 CLR 319 and *Patcorp Investments Ltd v FCT* (1976) 140 CLR.

<sup>38</sup> (1957) 100 CLR 66; 11 ATD 359.

<sup>39</sup> (1971) 127 CLR 62.

<sup>40</sup> (1977) 8 ATR 169.

<sup>41</sup> (1976) 6 ATR 504.

otherwise would pay, it did not alter in any relevant sense the incidence of tax ...the court has made it quite plain in several decisions that a taxpayer is entitled to create a situation to which the Act attaches taxation advantages for the taxpayer. Equally, the taxpayer may cast the transaction into which he intends to enter in a form which is financially advantageous to him under the Act.

This reasoning extended the choice principle even further. Provided that taxpayers applied the provisions of the Act in a legally valid form, they could arrange their affairs in such a way as to be able to choose whether to pay tax or not. In *Slutzkin v FCT*,<sup>42</sup> Aickin J indicated that in his view the choice principle applied equally to provisions involving receipt as well as those involving expenditure. He further stated that s 260 was not intended to catch a transaction which avoids the scope of the Act entirely, even though it was done "with a conscious intention that the proceeds should not fall within the operation of the Act".

- (iii) **the antecedent transaction doctrine -** Barwick CJ developed this doctrine in *Mullens* to justify the continuing existence of s 260. The antecedent transaction doctrine depends upon a taxpayer altering the incidence of tax liability under a prior arrangement to a lesser amount by altering the form of the original transaction. If there is evidence of this alteration of form and a resulting reduction in the tax liability, then s 260 will operate.

### The influence of the government of the day

The Whitlam Labor Party won government in 1972 on the promise of more acceptable levels of social justice. This promise required increased revenue. The successor Fraser Liberal government was able to make only limited cuts in popular social programmes. An extended period of increasing inflation following the low inflation and low unemployment period of the 1960s and an unindexed tax rate structure pushed those with median incomes into the higher tax brackets.<sup>43</sup> The public became increasingly aware of the narrow

<sup>42</sup> (1978) 7 ATR 166.

<sup>43</sup> By 1984-1985, almost 40% of full-time employed persons faced a marginal tax rate of 46% or greater, compared with 1% of taxpayers in that group three decades earlier. The top marginal rate cut in at 1.6 times average yearly earnings compared to 18 times in 1954-1955. That top rate cut in at \$35,000, while in 1954-1955 it applied to incomes \$400,000 and over (when translated

income tax base. The government's efforts at legislative change during the 1970s focussed on those sections of the Act subject to blatant abuse (see Table 1). The tactic used by the government in the late 1970s, to announce changes in legislation without detail and later to gazette the changes back to the date of the announcement, was seen as unfair. It was unsettling to the public at large and business decision making in particular, creating uncertainty in the law and a perception of retrospective legislation. The intention of the government was not clearly defined in relation to taxation law so that the judiciary was sympathetic to the plight of the taxpayer. It was the fundamental flaws in the tax system that gave rise to an escalation in tax avoidance schemes during this period.

### The taxpayers' response

The public's growing awareness of the narrowness of the income tax base, the "exemption" of many eligible taxpayers from tax obligations by using artificial means and the government's apparent acceptance of this situation, led to resentment and attempts by taxpayers themselves to neutralise inequities in the system. These attempts took various forms. The extraction of receipts in the form of capital gains, the payment of personal exertion income in the form of untaxed fringe benefits, the taking of remuneration as employment termination and ex gratia payments or as consideration for negative covenants, were all methods employed successfully and legally in the avoidance of tax. These techniques were not seen as schemes but as the clever application of the law as it stood. Taxpayers saw it as their right to minimise their tax in this way and the success of their advisers depended upon their ability to provide alternatives to minimise taxpayers' taxation obligations. Indeed, some would argue that advisers would have been negligent if they had failed to advise their client of all legal possibilities.<sup>44</sup>

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to 1984-1985 dollars). *Reform of the Australian Tax System*, quoted by Krever, above n 23 at 218.

<sup>44</sup> Justice M McHugh, "Jeopardy of Lawyers and Accountants in Acting on Commercial Transactions" (1988) 22 *Taxation in Australia* 544.

**Table 1**  
**Loopholes closed by legislation after cases and prolonged abuse**

| Year                            | Section             | Subject  |
|---------------------------------|---------------------|--|
| <i>Pre 1970</i>                 |                     |  |
| 1966                            | s 65(1) & (1A)-(1F) | To give the Commissioner discretion to limit deductions in relation to payments to relatives and associated persons  |
| <i>Post 1970 and pre Pt IVA</i> |                     |  |
| 1972                            | s 46(7A)            | To prevent "misuse" of the rebate by the "manufacture" of income through the trading stock valuation options available under the Act   |
| 1973                            |                     | To limit the writing off of bad debts by companies:  |
|                                 | s 63A               | substantial continuity of ownership test   |
|                                 | s 63B               |  |
|                                 | s 63C               | same business test   |
| 1977                            | s 31(C)             | The purchase of trading stock not at arm's length  |
| 1978                            | s 46(6A)            | Dividends deemed to be included in taxable income  |
| 1978<br>1979                    | s 6BA               | Deemed cost of shares issued to a shareholder<br>Amendment   |
| 1978                            | s 82KH<br>s 82KJ    | Definitions and other interpretative provisions<br>Denies a deduction under certain tax avoidance schemes involving prepayments and the acquisition of property by the taxpayer or an associate    |
|                                 | s 82KK              | Denies a deduction under certain tax avoidance schemes where a deduction is available to one party in respect of an amount which is not assessable to the other party until a later year of income |
|                                 | s 82KL              | Denies a deduction under certain expenditure recoupment schemes where the taxpayer or an associate receives a compensatory benefit together with a tax saving.                                     |
| 1979                            | s 52(A)(3)(e)       | Dividend stripping   |
| 1979                            | s 100A              | Trust stripping  |

### The advisers' response

The influences of morality, equity and fairness had limited application or a particular interpretation for some advisers.<sup>45</sup> The endorsement of the courts was a defence adopted by advisers who relied on High Court precedents. Provided the appropriate formalities were carried out, the courts sanctioned the actions of the taxpayers and their advisers. The fact that the real economic consequences of the transaction were unrelated to the transaction reported for taxation purposes was ignored. One example of this application is in *Cridland v FCT*.<sup>46</sup> The Full High Court held that the taxpayer was entitled to the benefits of the income averaging provisions available to primary producers, even though he was a university student holding only one unit in a trust, which carried on a business of primary production, and he received distributions of \$1 of income from the trust in one of three years. About 5,000 other students had also acquired units in trusts to obtain the benefit of income-averaging.

A flourishing industry, seemingly justified by the attitude of the courts and the government's non-activity in the area, emerged from this perceived responsibility of advisers.

### The judiciary's response

In 1980 in *FCT v Westradlers Pty Ltd*,<sup>47</sup> Deane J, in a majority in the Federal Court, upheld what he described as "sophisticated tax avoidance procedures", so condoning tax avoidance. He exonerated the courts from any blame in making the decision as,

If there be in truth, such contrariety or unfairness, the fault lies with the form of the legislation at the relevant time and not with the courts whose duty is to apply the words which the Parliament enacted.

Barwick CJ endorsed Deane J's opinion when the case went on appeal to the Full High Court.<sup>48</sup>

Parliament having prescribed the circumstances which will attract tax, or provide occasion for its reduction or

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<sup>45</sup> Leibler M, "Should the Law Institute of Victoria Take a Public Stand Against Artificial and Contrived Tax Avoidance Schemes? - The Case Against" (1980) 54 *Law Institute Journal* 562.

<sup>46</sup> (1977) 140 CLR 330.

<sup>47</sup> (1979) 38 FLR 306.

<sup>48</sup> *FCT v Westradlers Pty Ltd* (1980) 8 ATR 43; 144 CLR 55.

elimination, the citizen has every right to mould the transaction into which he is about to enter into a form which satisfies the requirement of the statute... The freedom to choose the form of transaction into which he shall enter is basic to the maintenance of a free society.

Murphy J, in dissent, suggested that the Act was "intended to apply to commercial reality...in a commercial and realistic way, not in artificial and contrived circumstances". He further added that a strict literal interpretation was "a less than ideal performance of the judicial function" and, if it continued to prevail, "the legislature may have no practical alternative but to vest tax officials with more and more discretion". He said that this may well lead to tax laws capable, if unchecked, of great oppression. The increase in discretion available to tax officials did occur in the 1980s and has, together with provision for harsher penalties, produced not only respect for the tax laws, but also fear because of uncertainty associated with the application of the law.<sup>49</sup>

The courts reduced the Act to a mire of inconsistencies and anomalies by relying on the precedents of the earlier years, through the application of pedantic literalism, and by ignoring the purpose of the legislation. The lack of equity that developed led to the reform of the 1980s.

### The 1980s - the turning point and a programme of tax reform

Encouraged by the exposure of the "bottom of the harbour" schemes in the early 1980s and the awareness by the public of the enormity of the tax avoidance and evasion industry, the government was able to introduce general anti-avoidance provisions. In 1980, the government commenced a programme of reform aimed at curbing tax avoidance. Some of the items of reform include:

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|------|---|
| 1980 | The Crimes (Taxation Offences) Act 1980   |
| 1981 | Section 15AA(1) of the Commonwealth Acts Interpretation Act   |
| 1981 | Part IVA of the Income Tax Assessment Act - Schemes to Reduce Income Tax  |
| 1983 | Part IVA Div 3A of the Income Tax Assessment Act - Prescribed Payments System   |
| 1985 | <ul style="list-style-type: none"> <li>• Part IIIAA of the Income Tax Assessment Act - Franking of Dividends</li> </ul> |

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<sup>49</sup> Bentley D, "The Commissioner's Powers: Democracy Fraying at the Edges?" (1994) 4 Revenue LJ 85.

- Part IIIA of the Income Tax Assessment Act - Capital Gains and Capital Losses
  - Fringe Benefits Tax Assessment Act
- 1988 Cash Transaction Reports Act (renamed in 1992 as the Financial Transaction Reports Act 1988)
- 1990 Part X of the Income Tax Assessment Act - Attribution of Income in Respect of Controlled Foreign Companies

The Crimes (Taxation Offences) Act became operational from 4 December 1980. This Act covers both sales tax and income tax and includes not only those involved in certain arrangement to evade tax, but also those who, directly or indirectly, aid, abet, counsel or procure another person to enter into a scheme. It allows for criminal charges to be laid for taxation offences, with custodial sentences, if the parties to the arrangement are convicted.

Section 15AA(1) of the Commonwealth Acts Interpretation Act was introduced in 1981.<sup>50</sup> This general provision requires judges to look to the purpose of legislation where ambiguity exists. If there is no ambiguity, this section cannot apply to the interpretation, as was the case in *Gray v FCT*.<sup>51</sup>

However, the purposive approach as opposed to the literal approach made it difficult for taxpayers and their advisers to accurately interpret legislation and solve problems through analysis of the law alone. It also tended to downgrade the role of precedent and make judicial decision-making more difficult. For example, the High Court's decisions in *Gulland, Watson and Pincus*<sup>52</sup> went against pre-existing authorities on s 260 and *John v FCT*<sup>53</sup> overturned a clear precedent.

The High Court, in *Cooper Brookes (Wollongong) Pty Ltd v FCT*,<sup>54</sup> departed from an unambiguous literal interpretation to give effect to what was clearly found to be the intention of the legislature. Mason and Wilson JJ said of the literal rule of construction:

In some cases in the past, these rules of construction have been applied too rigidly. The fundamental object of

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<sup>50</sup> It states that: "In the interpretation of a provision of an Act a construction that would promote the purpose or object underlying the Act (whether that purpose or object is expressly stated in the Act or not) shall be preferred to a construction that would not promote that purpose or object".

<sup>51</sup> (1989) 20 ATR 649.

<sup>52</sup> (1984) 15 ATR 422.

<sup>53</sup> (1989) 20 ATR 1.

<sup>54</sup> (1981) 11 ATR 949; 147 CLR 297.



statutory construction in every case is to ascertain the legislative intention by reference to the language of the instrument viewed as a whole.

They said that departing from the literal interpretation:

extends to any situation in which for good reason the operation of the statute on a literal reading does not conform to the legislative intent as ascertained from the provisions of the statute, including the policy which may be discerned from those provisions.

Further major tax reform was initiated by the Hawke Labor government, commencing in 1985 with a Treasury paper known as the Draft White Paper.<sup>55</sup> This attempted to broaden the income tax base and included a capital gains tax, the adoption of a separate fringe benefits tax (section 26(e) was not working), the introduction of a lump sum superannuation payments tax regime, a company/shareholder imputation system, a foreign tax credit system and the revision of some tax subsidies for the Australian Film industry. A consumption tax was included in the Draft White Paper but for political reasons, mainly as a result of pressures from lobby groups, it was not adopted.

In 1988, the Financial Transaction Reports Act 1988 (known until 1992 as the Cash Transaction Reports Act) was introduced to combat the problems of the "cash economy" by attempting to create a "money trail", identifying cash transactions (and the participants) which might otherwise not have been reported for taxation purposes.

The Tax Policy Division of the Commonwealth Treasury, from the early 1980s, has been involved with the details of tax reform. It was this division of the Treasury which produced the influential Draft White Paper. In the late 1980s, it was responsible for the business and superannuation tax changes of 1988-1989 and the controlled foreign corporations legislation.

The Commissioner's position of tax collection enforcement was difficult because of the poorly structured system and the lack of support by the judiciary. Wider discretion was given to the Commissioner in relation to interpretation of the tax law as early as the late 1960s.<sup>56</sup> This gradually increased, particularly with the recognition of the authority of rulings given by the ATO (commencing in December 1982). In Taxation Ruling IT 2500, issued on 18 August 1988, the Commissioner stated that a published ruling

<sup>55</sup> *Reform of the Australian Tax System*, Draft White Paper (1985 AGPS).

<sup>56</sup> *Giris Pty Ltd v FCT* (1969) 1 ATR 3; 119 CLR 365.

in respect of a transaction entered into on the faith of that ruling will be applied, even though the Commissioner may subsequently change his view of the law. In 1992, the Taxation Laws Amendment (Self Assessment) Act gave recognition at law to a taxpayer's right to rely on certain of the Commissioner's public and private rulings. This gave statutory authority to the Commissioner's interpretations of the tax laws. The Commissioner currently has very wide powers in relation to the determination and application of the Act.<sup>57</sup>

### The reinstatement of s 260

The introduction of Part IVA of the Act and s 15AA(1) of the Acts Interpretations Act (1981) and, perhaps, the change within the membership of the judiciary (Sir Garfield Barwick retired as Chief Justice of the High Court on 11 February 1981) brought about a change in judicial attitudes. The decisions in s 260 cases from 1984 to 1989 were decided largely in favour of the Commissioner.<sup>58</sup> In *Davis v FCT*,<sup>59</sup> s 260 would have been applied if argument as to the application of the specific section (s 102B) had not been successful. The court was criticised for failure to follow the pre-existing authorities on s 260, but the decisions in *Newton*,<sup>60</sup> *Peate*,<sup>61</sup> *Keighery*<sup>62</sup> and *Slutzkin*<sup>63</sup> (to name a few) do not have logical consistency. In *Newton*, the Privy Council held that s 260 can apply to an arrangement, even if avoidance of tax is not its sole purpose; it is sufficient if one of its purposes or effects is to avoid liability to tax. In *Peate*, the Privy Council held that s 260 did apply and that the diversion of income through family company arrangements to avoid tax was impermissible. In *Keighery*, the Full High Court held that s 260 did not apply to render void the rearrangements of the taxpayer's affairs to avoid tax and that the section does not operate to deny taxpayers any right of choice between alternative ways of arranging their affairs which the Act itself specifically offers. In *Slutzkin*, the Full High Court held that a taxpayer is entitled to choose a form of transaction which does not subject the taxpayer to tax and that s 260 is "no more than an annihilating section. It does not itself impose tax, nor does it construct or reconstruct any transaction. The

<sup>57</sup> See for a fuller discussion Bentley, above n 49.

<sup>58</sup> *Tupicoff v FCT* (1984) 15 ATR 655; *FCT v Gulland*, *Watson v FCT*, *Pincus v FCT* (1985) 17 ATR 1; *FCT v Greghorn Investments Pty Ltd* (1987) 19 ATR 457; *Bunting v FCT* (1989) 20 ATR 1579.

<sup>59</sup> (1989) 20 ATR 548.

<sup>60</sup> *Newton v FCT* (1958) 98 CLR 1.

<sup>61</sup> *Peate v FCT* (1966) 116 CLR 38.

<sup>62</sup> *WP Keighery Pty Ltd v FCT* (1957) 100 CLR 66.

<sup>63</sup> *Slutzkin v FCT* (1977) 140 CLR 314.

avoidance is of no consequence unless, if the transaction were swept aside, a factual situation involving the payment of tax is exposed."

In the 1970s, the interpretation of the application of s 260 and other provisions of the Act by the courts was influenced by the rights of taxpayers to choose how they arranged their business and family affairs. The High Court, commencing in 1984, focussed rather on the purpose of specific sections of the Act and redefined the meaning of the choice principle and the predication test.

Cases tested s 260 against a trust stripping transaction,<sup>64</sup> a depreciation scheme,<sup>65</sup> an undistributed profits tax scheme<sup>66</sup> and income splitting by a consultant.<sup>67</sup> In *John v FCT*,<sup>68</sup> the Full High Court overturned a clear earlier precedent (*Curran*). These cases all helped to redefine the parameters of s 260. They set strong precedents for later s 260 and Part IVA cases and took a firmer stance against tax avoidance and evasion.

## Part IVA

Part IVA received the Royal Assent and came into operation on 24 June 1981. The provisions of Part IVA are intended as "general anti-avoidance measures to replace section 260".<sup>69</sup> They were enacted to overcome the deficiencies in the old general anti-avoidance provisions of s 260. It did overcome the annihilation process of s 260 and allows the Commissioner to reconstruct a taxable situation. There still remain uncertainties in the application which may eventually require judicial interpretation.

Part IVA is contained in s 177A - s 177G of the Act. It is the provision of "last resort". If an arrangement is found not to be a sham,<sup>70</sup> is not set aside by some other specific anti-avoidance provision and was entered into after 27 May 1981, then the appropriate tests of Part IVA can be applied. It has three main elements. After establishing that the arrangement was entered into after 27 May 1981, the following questions must be answered in the affirmative for Part IVA to apply.

<sup>64</sup> *Evans v FCT* (1988) 19 ATR 1784.

<sup>65</sup> *F and C Donebus Pty Ltd v FCT* (1988) 19 ATR 1521.

<sup>66</sup> *Oakey Abattoir Pty Ltd v FCT* (1984) 15 ATR 1059; 55 ALR 291.

<sup>67</sup> *Bunting v FCT* (1989) 20 ATR 450.

<sup>68</sup> (1989) 20 ATR 1.

<sup>69</sup> Treasurer's Second Reading Speech: House of Representatives, *Hansard*, 27 May 1981, 2682.

<sup>70</sup> The Commissioner is not required to rely on any statutory provision to disregard such a transaction; see *Jacques v FCT* (1924) 34 CLR 328 and *Hancock v FCT* (1961) 12 ATD 312.

- 1 Is there a scheme?
- 2 Was the scheme entered into or carried out with the sole or dominant purpose of obtaining a tax benefit?
- 3 Was a tax benefit obtained?

The Treasurer, in his Second Reading speech when Part IVA was introduced, indicated that the section was aimed to “strike down blatant, artificial or contrived arrangements”, but was not aimed at inhibiting “normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for the arrangement of their affairs”. In *AAT Case 5219*,<sup>71</sup> a Tribunal refused to adopt such an approach.<sup>72</sup> It considered that Part IVA was sufficiently plain in its meaning and applied the actual wording.

“Scheme” is defined widely in s 177A(1) and any transaction entered into could fall within this definition. Section 177C provides a definition of tax benefit. Briefly, a tax benefit is either:

- (i) an amount not being included in assessable income that would have been included or might reasonably be expected to be included ; or
- (ii) a deduction being allowable where the whole or a part of that deduction would not have been allowable or might reasonably be expected not to have been allowable,

if the scheme had not been entered into.

The definition of tax benefit was limited, to overcome one of the perceived problems of s 260, that it was defined too broadly. *Case V160*<sup>73</sup> has shown the inadequacy of the section in dealing with discretionary trust situations. As the trustee determines the distribution of assessable income, the question arises as to whether a beneficiary can have a benefit in connection with a scheme involving distributions from a trust and whether it can be said with certainty that he or she would have obtained such a benefit but for the annihilating effect of s 177F.

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<sup>71</sup> (1989) 20 ATR 3777.

<sup>72</sup> Waincymer, above n 1 at 378-383.

<sup>73</sup> 88 ATC 1058.

The application of Part IVA rests on whether the sole or dominant purpose of the scheme was to obtain a tax benefit. In *Case W58*,<sup>74</sup> the arrangements entered into were not in their own right caught by Part IVA as a scheme, but when they were coupled with the fact that the dominant purpose of the arrangement was to obtain a tax benefit within s 177C(1)(a) and a tax benefit was obtained, the Administrative Appeals Tribunal held that Part IVA applied to the transaction entered into by the taxpayer. Special reference was made to the application of the factors listed in s 177D(b), which outlines when a transaction will be a scheme to which Part IVA applies. The matters outlined include the manner in which the scheme was entered into or carried out, the form and substance of the scheme, the time at which the scheme was entered into and the length of the period during which it was carried out, the result in relation to the operation of the Act that, but for Part IVA, would be achieved by the scheme and any change in the financial position or other consequence to the taxpayer or any connected person.

In *Case Y4*,<sup>75</sup> s 177D was again applied to establish that the dominant purpose of the arrangement was to obtain a tax benefit as defined in s 177C(1)(b). In *Case Y13*,<sup>76</sup> in addition to s 177D's application, the Administrative Appeals Tribunal held that on the balance of probabilities, considering s 177C, the income would have been earned by the taxpayer had the scheme not been entered into.

Whilst the broad inadequacies of s 260 may have been rectified by Part IVA, uncertainties remain as the Commissioner has to interpret the application of Part IVA and is given discretionary powers of cancellation and reconstruction of the taxpayer affairs in s 177F. Section 177D refers to parts of schemes and is concerned with persons who enter into all or part of the scheme. The extent to which a wider transaction can be broken up has not been clearly established. When analysing a transaction to establish a dominant purpose, a dominant tax-avoidance purpose is less likely to be found if the entire scheme is examined. In *FCT v Peabody*,<sup>77</sup> it was stated that, if the Commissioner has identified a wide scheme, he can rely on a narrower scheme within that scheme as meeting the requirements of Part IVA.

The difficulties of application of Part IVA for the taxpayer were further highlighted in the decision by the High Court in *Peabody*.<sup>78</sup>

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<sup>74</sup> 89 ATC 524.

<sup>75</sup> 91 ATC 114.

<sup>76</sup> 91 ATC 191.

<sup>77</sup> 94 ATC 4663.

<sup>78</sup> *Ibid.*

The onus of proof is confirmed as resting with the taxpayer under s 14ZZK(b) of the Taxation Administration Act 1953 and the Commissioner's wide discretionary powers were also confirmed.<sup>79</sup>

The implementation of Part IVA and the penalties associated with the self-assessment of taxation have made the public aware of the dangers of incorrect interpretation of the Act, even if the intentions are completely innocent. The liability for advisers has been increased, placing upon them responsibility for incorrect returns or interpretations.

### "Tax avoidance"

During the 1970s and earlier, "tax avoidance" was understood to be simply the successful outcome of successful tax planning. Transactions were entered into which had legal consequences but had little or no real relationship to commercial activities. By creating "artificial" transactions, the contingent liability of tax, which otherwise would have been payable, was reduced or expunged. This was considered to be legal and acceptable practice. *Cridland v FCT*<sup>80</sup> is an example of such an arrangement.

Part IVA and the associated anti-avoidance legislation has changed that meaning. If Part IVA were applied to the facts of *Cridland*,<sup>81</sup> not only would the scheme be set aside, but additional tax would apply.

### Conclusion

During the 1970s, the public, and perhaps the government, was unaware of the extent of the avoidance and evasion industry. The Act did not clearly define the terms for implementation of its provisions. The judiciary took on the task of establishing tests and setting precedents for the interpretation of the Act by the taxpayers, their advisers, the bureaucracy and themselves. The use of literalism by the judiciary and the exploitation of their decisions by enterprising tax advisers led to the development of a sophisticated tax avoidance and evasion industry. Avoidance became accepted practice for taxpayers and their advisers. The government appeared to be able to do little, if indeed they wanted to. The changes to the Act were

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<sup>79</sup> For a full analysis of *Peabody* see Cassidy, "*Peabody v FCT* and Part IVA" (1995) 5 Revenue LJ.

<sup>80</sup> (1977) 140 CLR 330.

<sup>81</sup> *Ibid.*

piecemeal and almost a token effort to attend to the government's duty to maintain an equitable tax system.

In the early 1980s, with the exposure of the "bottom of the harbour" schemes, the attitude of the public became hostile to tax avoidance, not only because of the publicity attached to the exposure of more elaborate schemes, but more especially because it had been allowed to happen. The government commenced a programme of reform. They systematically implemented laws and procedures to halt the leakage of revenue by artificial transactions and to broaden the tax base. The government made it clearer to taxpayers, the judiciary and the bureaucracy what their policies were, and the result was a diminution of the flagrant abuses that marked the 1970s.

"Tax avoidance", once a legal acceptable practice, evolved into being illegal and unacceptable with specified penalties. The penalties for "tax evasion", which was always illegal, with criminal consequence if pursued under the Crimes Act, were specifically legislated for and widened to include all parties to the transactions, including advisers, and imposed substantial penalties.

By the end of the 1980s, the attitude of taxpayers was changing back to that of the early 1970s. There was a general feeling that paying tax is a necessary evil but there was little widespread ridicule of the tax system.

By using the "big stick" approach in combination with a broadening of the tax base and an improvement in flawed legislation, the government appears to be controlling the tax avoidance industry successfully. It can be argued that the end result justified the means. The cost of this approach was to permeate the improving attitudes of taxpayers with confusion and fear. Confusion arose from the proliferation of changes to the Act, the lack of clarity in some provisions and the occasional inscrutable judgment from the Courts. There was fear of the potential for the imposition of serious penalties where many provisions are open to interpretation, and fear of inadvertently infringing the Act.

The confusion and fear that has resulted from the evolution of remedies in the attempt to wipe out the tax avoidance industry must be removed by a process of major law reform and education. These challenges lie ahead.