Avoidance Law Developments

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I am billed in the programme as the bearer both of bad news and of the obvious: that tax avoidance laws are uncertain in their application. That was not always thought to be the case and I do not think it inevitable. However the history of tax avoidance jurisprudence in Australia, and perhaps the more recent jurisprudence in New Zealand, has revealed such uncertainty in tax avoidance legislation that it has made its application difficult to predict with confidence to some commercial transactions.

The Virtues of Certainty and Uncertainty

Every law student is taught that certainty in the law is important and fundamental to the rule of law. An ordered society depends upon certainty of laws and predictability in their application. Commerce cannot function without a confident measure of predictability. Certainty is the foundation of the lawyer's craft and is, perhaps, the only contribution that makes lawyers useful to clients and to society. It is the lawyer's ability to predict the application of the law that helps lawyers arrange relations between people in their personal affairs, in business transactions and in dealings with government. Without a reliable degree of certainty, contracts would be worthless and ordinary relations and dealings would be at the risk of capricious whims and fancies.

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Certainty in the law is fundamental to the rule of law which "should be clear, easily accessible, comprehensible, prospective rather than retrospective, and relatively stable".[1]

Certainty, however, cannot always be achieved in law even when it is attempted. Some uncertainty is an inevitable feature of language.[2] It is a feature of the frequent mismatch between the lawyer's tools and the underlying concepts which legislation seeks to enact.[3] It arises from different views about what legislation is intended to achieve or how it should be applied in a given case.[4] The legal rules of statutory constructions are in part designed to produce, or at least, increase certainty, but some uncertainty remains.

On the other hand, it should not be overlooked that some uncertainty may be intended and thought to be desirable. There are many examples of tax laws drafted with embedded uncertainty as a means of discouraging behaviour. The Australian community's concern with tax avoidance in the latter half of the 20th century led to a significant change in the way in which tax legislation was seen and drafted. The Costigan Royal Commission, and the events uncovered by it, no doubt played a part in an overall rethinking of what had

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1 Melissa Castan and Sarah Joseph, *Federal Constitutional Law, a Contemporary View* (2nd ed, 2006) 5; J Raz, "The Rule of Law and its Virtue" (1977) 93 *Law Quarterly Review* 195, 198-202; A V Dicey, *Introduction to the Study of the Law of the Constitution* (1st ed, 1885; 10th ed, MacMillan, 1960); Butterworths, *Halsbury's Laws of Australia*, vol 4 (at 18 August 2009) 80 Civil and Political Rights, 'Use of International Covenant on Civil and Political Rights' [80-25].

2 *Bourne v Norwich Crematorium Limited* [1967] 1 WLR 691; Roland Barthes, *Criticism and Truth* (Continuum, 2007) 25-28; Umberto Eco, *The Limits of Interpretation* (1990).

3 G.T. Pagone, 'Tax Uncertainty' [2009] 33 *Melbourne University Law Review*, 886.

4 See, for example, *Hepples v Federal Commissioner of Taxation* (1992) 173 CLR 492.

been accepted principles.[5] The Australian government and legislative response to the social evil of tax avoidance was in part the enactment of taxing provisions dependent upon discretionary considerations.[6] Mr PJ Lanigan, then Second Commissioner of Taxation, explained in a conference paper to the Taxation Institute of Australia in 1969 that the legislative response to successful exploitation of loopholes would be a greater reliance upon statutory discretions as the means by which tax would be imposed notwithstanding the uncertainty and lack of predictability that would necessarily come with such provisions.[7] Uncertainty as a desirable objective may seem unpalatable to some of us, but the reality is that uncertainty plays a key part of commerce and social decision making,[8] and its adoption through taxation by discretionary powers is in part a means of combating tax avoidance.[9]

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5 See: The letter to the editor by Arie Freiberg, 'White-Collar Crime Must Be Seen as "Real" Crime', *The Age,* 23 September 1982, 12.

6 PJ Lanigan, "Technical Problems Relating to the Objectives and Consequences of Taxation", in Taxation Institute of Australia (ed), *Taxation Now and in the Future: Papers and Commentaries Presented at the First National Convention of the Taxation Institute of Australia* (1969) 29, 32-3, 38; see also Professor R Parsons "Commentary" in Taxation Institute of Australia (ed), *Taxation Now and in the Future: Papers and Commentaries Presented at the First National Convention of the Taxation Institute of Australia* (1969) 46, 47.

7 PJ Lanigan, "Technical Problems Relating to the Objectives and Consequences of Taxation", in Taxation Institute of Australia (ed), *Taxation Now and in the Future: Papers and Commentaries Presented at the First National Convention of the Taxation Institute of Australia* (1969) 29, 32-3, 38.

8 Philip D Straffin, 'The Prisoner's Dilemma' in Eric Rasmusen (ed), *Readings in Games and Information* (2001); John von Neumann and Oskar Morgenstern, *Theory of Games and Economic Behaviour* (2004).

9 PJ Lanigan, 'Technical Problems Relating to the Objectives and Consequences of Taxation', in Taxation Institute of Australia (ed), *Taxation Now and in the Future: Papers and Commentaries Presented at the First National Convention of the Taxation Institute of Australia* (1969) 27, 29, 32-3, 38; Ross Parsons, 'Commentary' in Taxation Institute of Australia (ed), *Taxation Now and in the Future: Papers and Commentaries Presented at the First National Convention of the Taxation Institute of Australia* (1969) 45, 47.

There are many instances in tax law of intended structured uncertainty. There are, for instance, numerous provisions where the liability of a taxpayer is made to depend upon the exercise of a discretion by the Commissioner. The Australian Parliament may constitutionally enact a law with respect to taxation by reference to which the amount of tax payable is made to depend upon the formation by the Commissioner of an opinion about whether the application of some provision is unreasonable, even when the Commissioner has a discretion to take into account such "matters, if any, as he thinks fit" in forming the opinion.[10] There are many reasons for discretions to be given in tax legislation notwithstanding the desirability for clarity, certainty and predictability.[11] One reason may be to have a tax outcome depend upon commercial, business or economic considerations that non discretionary rules might not allow. It is not hard to see the echo of economic criteria as the determinants in transfer pricing discretions or in the Australian debt/equity rules.

The Tax Avoidance Conundrum

Another reason for discretions is, as I have suggested above, as a response to what may be thought to be the "social evil" of tax avoidance.[12] Provisions directed to preventing tax avoidance are steeped in uncertainty, although the uncertainty embedded in these provisions is conceptually problematic. It is problematic because the anti avoidance provisions are not intended, and

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10 *Giris Pty Ltd v Commissioner of Taxation* (1969) 119 CLR 365.

11 Prof G.S.A. Wheatcroft, "Taxation by Administrative Discretion", *Papers, First National Convention, Taxation Institute of Australia* (TIA, 1969) 1-11; see also K.C. Davis, *Discretionary Justice* (1979, Illinois), Ch 1.

12 Lanigan, above n 1, 29, 32-33, 38; Professor Ross Parsons, 'Commentary', *Papers, First National Convention, The Taxation Institute of Australia*, (TIA, 1969) 47.

ought not, to apply as primary taxing provisions. They are intended to apply, rather, only when the ordinary provisions have failed to achieve the purpose which, somehow, they were intended to achieve but failed to achieve[13]. A moments reflection will reveal an obvious tension between the application of such provisions and a purposive construction of fiscal legislation: how can taxing provisions fail to achieve their proper and intended purpose if they have been construed and applied according to their purpose?

The jurisprudence on anti avoidance, both statutory and judicial, is fundamentally about how to deal with the conundrums which the issue poses. How is a taxpayer to be taxed where the law has been complied with but does not make the taxpayer taxable? What is the jurisprudential basis of any tax if the law has been complied with and imposes no tax? How are anti avoidance provisions to be enacted or applied without making courts legislators of the taxing provision? How does the law reconcile fiscal advantages allowed for, or encouraged, by the legislation itself with those which are not specifically provided? How is a sound anti avoidance provision to be distinguished from a law that imposes tax upon a citizen's diligent compliance with the law according to its letter, terms and purposes?

Avoidance and Abuse of Legislation

Measures to prevent tax avoidance are interlinked with the need to preserve the integrity of legislation when the words themselves, and their purposive construction and application, are found to have failed to achieve their intended

13 ICF Spry, *Section 260 of the Income Tax Assessment Act* (2nd ed, 1978).

effect. In other jurisdictions, typically those which do not have a specific anti avoidance provision, a purposive construction of legislation has been used as the means by which courts have countered tax avoidance. In the United States decision of *Helvering v Gregory*[14] Judge Learned Hand refused to apply a literal reading of a statute which he considered to be contrary to the statutory intention. His Honour said:

> … Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes … Nevertheless, it does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definitions of each term used in the statutory definition … [T]he meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create.[15]

A purposive, or non literal, construction to taxing statutes may, however, be made more difficult as the statute increases in specificity. In the same passage Judge Learned Hand observed that "[A]s the articulation of a statute increases, the room for interpretation must contract".[16]

The courts have also relied upon principles of statutory interpretation in the United Kingdom in developing the doctrine sometimes referred to as the doctrine of fiscal nullity to counter tax avoidance. The doctrine articulated first

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14 69 F. 2d 809 (2nd Cir, 1934), aff'd 293 U.S. 465 (1935).

15 69 F. 2d 809 (2nd Cir, 1934) 810-11; see also Marvin A Chirelstein, 'Learned Hand's Contribution to the Law of Tax Avoidance' (1968) 77 *Yale Law Journal* 440.

16 69 F. 2d 809 (2nd Cir, 1934) 810; aff'd 293 U.S. 465 (1935).

in *W.T. Ramsay v Inland Revenue Commissioners*[17] was said by Lord Wilberforce to be within the function of the courts to apply strictly and correctly the legislation enacted by Parliament. In that context, his Lordship said:

> To force the courts to adopt, in relation to closely interpreted situations, a step by step, dissecting, approach which the parties themselves may have negated, would be a denial rather than an affirmation of the true judicial process.[18]

The question at issue in *Ramsay* was whether there had been a disposal giving rise to a loss under a taxing statute. The issue of construction was whether the particular transaction came within the intended terms of the statute where the disposal was effected by a series of steps, each of which the parties necessarily intended to be effective according to their terms, but the partial legal effect of which had been intentionally undone by some other parts of the transaction. The principle adopted in that case was subsequently formulated by Lord Brightman in *Furniss v Dawson*[19] in these terms:

> First, there must be a pre-ordained series of transactions; or, if one likes, one single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial (i.e. business) end. The composite transaction does, in the instant case; it achieved a sale of the shares in the operating companies by the Dawsons to Wood Bastow. It did not in *Ramsay*. Secondly, there must be steps inserted which have no commercial (business) <u>purpose</u> apart from the avoidance of a liability to tax … not "no business <u>effect</u>". If those two

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17 [1982] AC 300.

18 Ibid 326C-D; cited with approval in *Tower MCashback LLP 1 v Revenue and Customs Commissioners* [2011] 2 WLR 1131, 1144.

19 [1984] AC 474.

> ingredients exist, the inserted steps are to be disregarded for fiscal purposes. The Court must then look at the end result. Precisely how the end result will be taxed will depend on the terms of the taxing statute sought to be applied.[20]

The importance, and limitations, of the statutory construction at play as the foundation and extent of the principle enunciated has been remarked upon in subsequent cases[21] and by commentators.[22] In *Tower MCashback LLP 1 v Revenue and Customs Commissioners*[23] it was criticised as obscuring the force of the earlier view expressed by Lord Wilberforce and imposing a "fairly inflexible prescription".

A series of cases in the UK was said to have given rise to the view that the principle enunciated in *Ramsay* created new jurisprudence applicable to taxing statutes and to the effect that transactions or elements in transactions which had no commercial purpose were to be disregarded.[24] In *Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes)*[25] it was said that such a conclusion from the cases went too far.[26] In that case it was said that it was necessary first to decide (on a purposive construction) what transaction will assume the relevant statutory description and next to decide

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20 Ibid 527.

21 See especially *IRC v McGuckian* [1997] 1 WLR 991, 999-1000 (Lord Stein) and 1005 (Lord Cooke), *MacNiven (HM Inspector of Taxes) v Westmoreland Investments Ltd* [2003] 1 AC 311 per Lord Hoffman.

22 See Lord Walker, 'Ramsay 25 Years On: Some Reflections on Tax Avoidance' (2004) 120 *Law Quarterly Review* 412, 416.

23 [2011] 2 WLR 1131, 1148.

24 *Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes)* [2005] 1 AC 684, 696 (Lord Nicholls of Birkenhead); see also *Tower MCashback LLP 1 v Revenue and Customs Commissioners* [2011] 2 WLR 1131, 1147-8.

25 [2005] 1 AC 684.

26 Ibid 696 (Lord Nicholls of Birkenhead).

whether the transaction in question assumed that description.[27] Lord Nicholls explained that the approach taken in the earlier decisions depended on statutory interpretation, saying:

> The essence of the new approach was to give the statutory provision a purposive construction in order to determine the nature of the transaction to which it was intended to apply and then to decide whether the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) answered to the statutory description. Of course this does not mean that the courts have to put their reasoning into the straitjacket of first construing the statute in the abstract and then looking at the facts. It might be more convenient to analyse the facts and then ask whether they satisfy the requirements of the statute. But however one approaches the matter, the question is always whether the relevant provision of the statue, upon its true construction, applies to the facts as found. As Lord Nicholls of Birkenhead said in *MacNiven v Westmoreland Investments Ltd* [2003] 1 AC 311, 320, para 8: "The paramount question always is one of interpretation of the particular statutory provision and its application to the facts of the case.[28]

Some may see in this passage something of the parliamentary contemplation approach adopted by the New Zealand Supreme Court in *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*[29] with the difference, of course, that under the *Ramsay* principle the taxing provision is never a separate an anti avoidance provision: under the *Ramsay* principle the taxing

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27 Ibid 696-7.

28 Ibid 695-696; see also *Astall v HM Revenue and Customs* [2009] EWCA Civ 1010.

29 (2009) 24 NZTC 23,188, 23210.

provision remains the general provision. In *Barclays* it was held that the taxpayer was entitled to the capital expenditure allowance under s 24(1) of the *Capital Allowances Act 1990* (UK) notwithstanding that some transactions may have had no commercial purpose apart from the tax benefit secured. In that case a company (BGE) had built a pipeline and incurred expenditure which it did not expect to absorb for some time. Transactions were entered into, including a sale and leaseback, which enabled another company to enjoy the capital expenditure allowance and to pass on a benefit to BGE.[30] In contrast, the UK Supreme Court held in *Tower MCashback LLP 1 v Revenue and Customs Commissioner*[31] that a taxpayer's claim to a deduction failed upon a realistic appraisal of the facts. In that case funds borrowed, although not a sham (and therefore legally effective) had in reality been put into a loop invoking no meaningful expenditure.[32]

Limitations on Purposive Interpretation

Amongst the criticisms and difficulties of leaving the battle against tax avoidance only to a purposive interpretation of the taxing provisions is that the revenue authorities lack the ability to "reconstruct" transactions to determine liability. In other words that purposive statutory interpretation would only be effective if the taxing provisions as interpreted managed to impose liability or deny fiscal advantages. Often it will, but is had been a criticism of provisions like Australia's s 260[33] and New Zealand's s 108[34] that they failed to impose

30 Cf: *Bellinz v Federal Commissioner of Taxation* (1998) 84 FCR 154.
31 [2011] 2 WLR 1131.
32 Ibid 1159[75].
33 *Income Tax Assessment Act 1936* (Cth).
34 *Land and Income Tax Act 1954* (NZ).

tax in some cases where the provisions otherwise applied.[35] As against that, however, there must be set the discipline (both structural and analytical) of requiring the basis of taxation to be found in the general provisions intended to create the impost rather than a general anti avoidance rule setting its sights on "avoidance" as the criteria for taxation.

General Anti Avoidance Legislation

The means adopted to deal with tax avoidance in Australia, New Zealand and Canada has been the enactment of special statutory provisions of general application. The general anti avoidance rule in Australia was for many years that found in s 260 of the *Income Tax Assessment Act 1936* (Cth) in much the same terms as existed in s 108 of the *Land and Income Tax Act 1954 (*NZ). An important feature of those provisions was that they did not themselves impose taxation. They operated principally as a deeming provision or as some such provision to that effect. That is an important aspect of the provisions because the avoidance rule by those provisions did not create a separate head or subject matter of taxation apart from or independent of the provision said to be avoided. The rule applied as an adjunct to, or facilitator of, the other taxing provisions and specifically of the provision said to be avoided. It sought only to negate (that is, to render void as against the revenue) the avoidance arrangement so that the taxing provision might operate as it, not so that another taxing provision in the avoidance rule, would operate.

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35 *Mangin v Inland Revenue Commissioner* [1971] AC 739.

The Australian provision, but not the New Zealand equivalent, was thought to be ineffective largely because of a series of cases from which there emerged what was referred to as the choice principle. The problem stemmed from the tension between obtaining a tax advantage to which a taxpayer was entitled to obtain and one to which the taxpayer was not entitled.

Section 260 was much shorter than Part IVA subsequently enacted in Australia. It, similarly to the provision in New Zealand, provided that every contract, agreement or arrangement was absolutely void as against the Commissioner[36] in so far as it had or purported to have the purpose or effect of:

(a) altering the incidents of any income tax;

(b) relieving any person from liability to pay income tax or making any return;

(c) defeating, evading or avoiding any duty or liability imposed on any person by the Act; or

(d) preventing the operation of the Act in any respect.

The words of s 260, like its equivalent in New Zealand, were wide and simple and because of that they carried the risk of a greater ambit of application than intended or desirable. That led to criticism of the section and to various attempts to give it a meaning that would have a reasonable and predictable

[36] The words "as against the Commissioner" appeared for the first time in 1936. The earlier provisions affected private rights and could be relied on by individuals against others in affecting private rights where a contract, agreement or arrangement differed the incidence of tax: *De Romero v Read* (1932) 48 CLR 649. The Privy Council described this as an "unexpected effect" in *Newton v Federal Commissioner of Taxation* (1958) 98 CLR 1, 7 (Lord Denning on behalf of the court).

application. In 1921, Knox CJ in *Deputy Federal Commissioner of Taxation v Purcell*[37] said of the precursor to s 260 in s 53 of the *1916 Act*:

> The section, if construed literally, would extend to every transaction whether voluntary or for value which had the effect of reducing the income of any taxpayer …

For this reason, his Honour sought to construe the terms of the section to curb unintended excesses. His Honour said:

> [B]ut, in my opinion, its provisions are intended to and do extend to cover cases in which the transaction in question, if recognised as valid, would enable the taxpayer to avoid payment of income tax on what is really and in truth *his* income. It does not extend to the case of a *bona fide* disposition by virtue of which the right to receive income arising from a source which theretofore belonged to the taxpayer is transferred to and vested in some other person. The section is intended to protect the revenue against any attempted evasions of the liability to income tax imposed by the Act … and the *bona fide* gift or sale by a taxpayer of assets producing income is therefore in no sense an attempt to evade his liability to income tax.[38]

The case before his Honour, and subsequently on appeal to the Full High Court, concerned the owner of certain income producing property who had declared himself a trustee of the property for himself, his wife and his daughter equally. His Honour found that the declaration of trust created by the taxpayer was not affected by the anti avoidance provisions in s 53 of the *1916*

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37 (1921) 29 CLR 464, 466.

38 Ibid.

Act. The members of the Full Court essentially agreed with the decision of the Chief Justice at first instance.

Criticism of the terms in which the anti avoidance provisions were expressed was sometimes strident. In *Federal Commissioner of Taxation v Newton*[39] Kitto J said:

> Section 260 is a difficult provision, inherited from earlier legislation, and long overdue for reform by someone who will take the trouble to analyse his ideas and define his intentions with precision before putting pen to paper.

In the same case Fullagar J said:

> [T]he 'purposes' or 'effects' which will attract its operation are stated very vaguely. If we interpret it very literally, it will seem to apply to cases which it is hardly conceivable that the legislature should have had in mind.[40]

These doubts and uncertainties saw limitations emerge on s 260 that ultimately led to its replacement with Part IVA.[41] The New Zealand anti avoidance provisions similarly came in for strident criticism from high authority. Lord Wilberforce in his dissenting judgment in *Mangin v Inland Revenue Commissioner* [42] questioned the ability of the provision to confront

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39 (1956) 96 CLR 577, 596.

40 Ibid 646.

41 See *WP Keighery Pty Ltd v Federal Commissioner of Taxation* (1957) 100 CLR 66; *Mullens v Federal Commissioner of Taxation* (1976) 135 CLR 290; *Slutzkin v Federal Commissioner of Taxation* (1977) 140 CLR 314; *Cridland v Federal Commissioner of Taxation* (1977) 140 CLR 330; *Clarke v Federal Commissioner of Taxation* (1932) 48 CLR 56; *Bell v Federal Commissioner of Taxation* (1953) 87 CLR 548; *Rowdell Pty Ltd v Federal Commissioner of Taxation* (1963) 111 CLR 106; Razeen Sappideen, 'Judicial Legislation and the Rationalisation of Section 260 of the Income Tax Assessment Act 1936' (1977) 8 *Federal Law Review* 319.

42 [1971] AC 739.

the problems of modern tax avoidance. In *Commissioner of Inland Revenue v Gerard*[43] McCarthy P described the provision as "notoriously difficult",[44] echoing laments which had been expressed about the equivalent Australian provision.[45]

The Predication Test

The Privy Council had made an attempt in *Newton v Federal Commissioner of Taxation*[46] to enunciate a test to determine when a transaction would fall within the ambit of an anti avoidance provision. The test required an objective observer to look at the impugned arrangement and to be able to predicate that they were implemented in that particular way so as to avoid tax. The test was put in these terms:

> In order to bring the arrangement within the section you must be able to predicate – by looking at the overt acts by which it was implemented – that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealings, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section. Thus, no one, by looking at a transfer of shares *cum* dividend, can predicate that the transfer was made to avoid tax. Nor can anyone, by seeing a private company turned into a non-private company, predicate that it was done to avoid Div. 7 tax … Nor could anyone, on seeing a

43 [1974] 2 NZLR 279.

44 Ibid 280.

45 Ibid 281-3; *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* (2009) 24 NZTC 23,188, 23206-7; see also James Coleman, *Tax Avoidance Law in New Zealand* (CCH, 2009), 15-16.

46 (1958) 98 CLR 1.

> declaration of trust made by a father in favour of his wife and daughter, predicate that it was done to avoid tax …[47]

This dicta served for many years as the basis upon which impermissible tax avoidance was to be determined and the anti avoidance provision to be applied. The Australian legislature appears clearly enough to have intended the enactment of Part IVA to have given legislative effect to the predication test which had been enunciated in *Newton v Commissioner of Taxation*.[48]

The predication test required a consideration of the particular contract, agreement or arrangement which had been identified as an avoidance transaction to determine whether its objectively ascertainable purpose was to avoid tax. The enquiry called for was not into the actual motive or purpose (whether subjective or objective) of the participants to the transaction. What the provision was thought to strike at, therefore, was not an intention to avoid tax but, rather, at arrangements about which nothing could be said of them except that tax avoidance was their predominant purpose. The distinction is less subtle than it might sound, and in that distinction there might be the only sound and principled criterion by which anti avoidance provisions may sensibly, reliably and defensibly apply.

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47 (1958) 98 CLR 1, 8-9 (Lord Denning on behalf of the court).

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

Amongst the many sound reasons why the anti avoidance provisions should not apply to a person's actual intention to avoid tax is that sound tax policy should not make the anti avoidance rules depend upon, and to vary as between, the particular circumstances of identical transactions. A wholly artificial tax avoidance scheme should be struck down whether or not a taxpayer can be shown to have a tax avoidance purpose.[49] The converse is also sound tax policy: tax avoidance rules should not apply where a person takes advantage of a provision in the tax law designed to provide a tax benefit. These simple enough considerations might provide the basic outlines for how a tax avoidance provision must be applied. A focus upon purely artificial steps and transactions should reliably enable taxpayers, revenue officials, and the courts to determine when to apply and when not to apply an anti avoidance rule.

The essence of the predication test was essentially an enquiry into whether something was done which had no substantial objective function or objective explanation other than tax avoidance. That, upon a careful consideration, would exclude from the operation of the anti avoidance rule many transactions which were motivated to reduce tax but about which one could not say there was no explanation other than tax. A few examples may both explain the point and enliven debate about whether tax avoidance provisions should or should not apply in that way. A trustee's resolution to make distributions in a discretionary trust along lines which maximise the tax benefits between the

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

beneficiaries may be motivated wholly, and exclusively, by the tax considerations flowing from the distributions made, but still not be caught by the anti avoidance provisions for the very simple reason that although tax may have been the motivation for the resolution, nonetheless the resolution produced more than the tax consequences: the beneficiaries gain entitlements flowing from the resolutions which they would not otherwise have had. On such a basis the predication test as enunciated in *Newton* would not apply to conduct motivated by taxation (however entirely motivated by tax considerations the conduct may have been) where one looked at the transaction and found that the overt acts did something more than the tax consequence produced and which may have been their motivation. Indeed, that kind of analysis explains the examples found in the famous passage in *Newton*. No one could sensibly say that the private company which had been turned into a non private company in *WP Keighery Pty Ltd v Federal Commissioner of Taxation*[50] was motivated by anything other than the favourable taxation consequences which was produced. The beneficial tax consequences may be why the reconstruction occurred, but the reconstruction did occur in fact and that brought with it other commercial and legal consequences apart from the tax benefits. That situation was given as an example in *Newton* of one where the anti avoidance provision would not operate for the reason that, whatever the motivation may have been, the conversion of a company from a private company to a non private company did effect more than the tax consequences which had motivated the transactions.

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50 (1957) 100 CLR 66.

Seen in this way an anti avoidance provision provides a valuable adjunct to a taxing statute by ensuring that taxpayers do not embellish their transactions with curlicues that have no purpose beyond taxation. Such an approach to the interpretation of the anti avoidance rules also has the highly desirable consequence of confining its operation within predictable bounds. There might still be room for debate in particular cases about how the test is to be applied, but it would confine the debate to a principled one about analysing those elements of a transaction which produced the tax consequence to determine whether those elements had some function other than tax. The anti avoidance provisions could predictably apply where the non tax function was non-existent, immaterial or so overwhelmed by the tax purpose that the commerciality of the element is overshadowed.[51]

The Statutory Solution in Australia: Part IVA

In the late 70s early 80s in Australia it was thought both that s 260 was ineffective to achieve its purpose and that it was possible to enact an alternative that would be effective. The theoretical problem was how to make taxable something which was otherwise not taxable on either a literal or a purposive construction of the provisions and on their application to the facts of a particular case. The legislation could have made the avoidance provision depend upon a finding of fact, or some constructive conclusion, about the primary provisions being abused. That had been the basis of the jurisprudence in the US and appears to have been adopted by the legislation

51 *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 186 CLR 404, 408 (argument by Counsel for the Commissioner).

in Canada and to have found judicial favour recently in New Zealand in *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*.[52]

The Australian legislature in 1981, however, chose to make the anti avoidance provision depend not upon a view that the provisions were being abused but, rather, upon a constructive conclusion that a person to a scheme (where the word "scheme" is not used pejoratively) participated in the scheme for the purpose of enabling a taxpayer to obtain a tax benefit. The critical criterion for application of the anti avoidance provision was the purpose to be attributed to a person.[53] It was a "constructive" conclusion because the conclusion was not to be found in the actual purpose of anyone but, rather, was to be drawn from the objective consideration of specific facts and circumstances.

The statutory test adopted in Part IVA owed much to the predication test in *Federal Commissioner of Taxation v Newton.*[54] That was clearly stated in the extrinsic materials including the treasurer's second reading speech and explanatory memorandum[55]. It is not surprising that the predication test in *Newton* is at the heart of Part IVA because the problem with s 260 had been thought to be in the way in which the so called choice principle had come to

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52 (2009) 24 NZTC 23,188.

53 *Income Tax Assessment Act 1936* (Cth) s 177D.

54 (1958) 98 CLR 1.

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

make the application of s 260 fail in certain cases and rather than any widespread dissatisfaction with what the Privy Council had enunciated as the test to determine its application. The provisions, therefore, show much concern to deal with how choices might be made without application of the anti avoidance rule, but with making its provisions depend ultimately upon what was thought to be a statutory formulation of the predication test.

Peabody, "may" and Part of a Scheme

The enactment of the legislative provisions in Part IVA, however, gave rise to their own and novel interpretative debates which have grown, have modified, have varied, but continue to this day and which some consider threaten the viability of the provision. The first serious debate concerning the operation of Part IVA concerned the role of the scheme identified by the Commissioner. Central to the litigation was the meaning and effect of the three letter word "may" in s 177F. A fundamental issue in *Peabody*[56] was the role of the scheme as identified by the Commissioner in the application of Part IVA. Counsel for the taxpayer argued:

> The power to make a determination is in s. 177F(1)(a). The phrase "a tax benefit has been obtained ... in connection with a scheme" is defined in s. 177C(1). The tax benefit may not be the subject of a determination under s. 177F(1) unless it is obtained in connexion with "a scheme to which this Part applies", which is defined by s. 177D. Central to the operation of these provisions is the scheme in connexion with which the tax benefit the subject of the determination is obtained. It must be the scheme in connexion with which the

56 *Federal Commissioner of Taxation v Peabody* (1994) 181 CLR 359.

> tax benefit in s. 177F(1)(a) is obtained. Accordingly, *that scheme* must be the one in whose absence it is (s. 177C) reasonable to expect that the particular taxpayer would have derived the amount of income assessed. *That scheme* must be entered into with the purpose specified in s. 177D(b). For the purpose of considering an assessment, the Commissioner is entitled to examine and discard a variety of schemes to ascertain whether each exhibits the desired characteristics and in particular whether its absence would reveal a reasonable expectation of derivation by the taxpayer of an amount of assessable income. He may also consider the potential liability of a variety of taxpayers. Such a review comprises the performance by the Commissioner of his duties before making a determination and consequent assessment. Once he has made a determination and assessment, it is the Court's role to consider whether, in respect of the tax benefit *actually* cancelled, the statutory preconditions to the determination are satisfied and whether the Commissioner has had regard to all and only the relevant matters and reached his conclusion unaffected by any mistake of fact or law. That role is to be performed in respect of the tax benefit actually selected and not of alternatives which could have been but were not the subject of a determination.[57]

The High Court rejected the view that Part IVA depended upon the Commissioner's correct identification of a scheme. The court, rather, upheld the contention that Part IVA presupposed the obtaining of a tax benefit in connection with a scheme as an objective fact.[58] The court did not say that the identification of a scheme did not matter but only that the operation of the

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57 Ibid 369.

58 Ibid 382 (Mason CJ, Brennan, Deane, Dawson, Toohey, Gaudron, McHugh JJ).

provisions were not made to depend upon the Commissioner's correct identification of the scheme.

An unexpected consequence for the subsequent application of Part IVA arose from observations made by the court in addressing an argument put by the Commissioner. The Commissioner had argued that the relevant dominant purpose could be found in part of what might have been identified as the scheme. The argument was put, of course, in the context of the jurisprudence before the court gave judgment in *Peabody* and was therefore necessarily without the benefit of the court's reasoning on the other issues in the case. The Commissioner's argument is recorded as having been put in the context of submissions that assumed that the only scheme able to be considered was one which had as its dominant purpose a commercial nature rather than to enable a taxpayer to obtain a tax benefit. It was in that context that the Commissioner had argued that the provisions of Part IVA permitted the requisite conclusion to be drawn from "part of a scheme". The argument, in other words, proceeded upon the hypothesis that the only place left for the Commissioner to point to a requisite dominant purpose was in part only of an otherwise non avoidance scheme.

It was in answer to that argument that the court said that Part IVA could not apply to something as if it were a scheme where the circumstances were incapable of standing on their own as a scheme without being robbed of all practical meaning.[59] That passage subsequently became the basis of

[59] Ibid 383–4 (Mason CJ, Brennan, Deane, Dawson, Toohey, Gaudron, McHugh JJ).

arguments that circumstances identified by the Commissioner as schemes could not be within the contemplation of Part IVA if they were incapable of standing on their own without being robbed of all practical meaning. The court's words were taken out of the context of the hypothesis of the Commissioner being forced to find the dominant purpose in something which was not itself a scheme, and were applied in support of a limitation to Part IVA that the scheme identified by the Commissioner needed to be something which was otherwise capable of identification as a scheme in its own right. An issue in subsequent cases therefore became whether the scheme propounded by the Commissioner was one capable of being a scheme in the sense thought to have been intended by the *Peabody* dicta.

It was not for another ten years before the High Court could reconsider that observation. In the joint judgment of Gummow and Hayne JJ in *Federal Commissioner of Taxation v Hart*[60] their Honours explained the error in treating the earlier observations in *Peabody* as "a criterion which must be applied in deciding whether there is a scheme to which Part IVA applies".[61] Their Honours pointed out that what had been said in *Peabody* had been addressed to a particular argument on which the Commissioner had sought to rely and went on to say:

> Thirdly, and most importantly, there is no basis to be found in the words used in Pt IVA for the introduction of some criterion additional to those identified in the Act itself. There is no reference to a scheme having some commercial or

60 (2004) 217 CLR 216.
61 Ibid 237.

> other coherence. Far from the Part requiring reference only to the purpose of those who carry out *all* of whatever is identified as the scheme, s 177D(b) specifically refers to it being concluded "that the person, or one of the persons, who entered into or carried out ... *any part of the scheme*" did so for the purpose of enabling the relevant taxpayer (alone or with others) to obtain a tax benefit in connection with the scheme …[62]

It would seem now that the identification by the Commissioner of a scheme has lost some of the significance it had in earlier litigation after *Peabody* but the effect of *Peabody* was not without cost and uncertainty. The cost was not only in litigation. It was also in the legal advice which had to be given upon an erroneous understanding of what *Peabody* stood for and the many more hidden costs of actions and decisions by taxpayers, the revenue and their respective advisers which were made upon a basis that was later found to be wrong.

The importance of what is identified as the scheme to the application of Part IVA should not, however, be ignored. Part IVA only applies where a tax benefit has been obtained "in connection with [a] scheme".[63] That requirement is only satisfied where it is the scheme which gives rise to, or produces, the tax benefit which the Commissioner has cancelled. Indeed, the role played by s 177C(1) is to ensure that Part IVA is limited in its application to those schemes which produce the tax benefits. Section 177C(1) statutorily compels that there be a clear and discernable link between the tax benefit

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62 Ibid 238 (emphasis in original).

63 *Income Tax Assessment Act 1936* (Cth) s 177D(a); *Macquarie Finance Ltd v Federal Commissioner of Taxation* (2004) 57 ATR 115, [76] (Hill J).

obtained and the scheme by which it is obtained. It may be that the link can be satisfied by reference to reasonable expectations but the need for the link is important both analytically and as a safeguard for taxpayers.

Dichotomy Between Rational Commercial Decisions and Tax Planning

A fundamental concern for the application of any anti avoidance provision is the extent to which it is applied in the face of commercial tax planning. The particular facts in *Hart* (like those in *Spotless* and *CPH*) showed a wider commercial objective to have been achieved by what the taxpayer had done than merely the obtaining of the tax benefit. In *Hart* the taxpayers secured funds for their properties; in *Spotless* the taxpayers lent money and received interest income. A wider commercial objective apart from tax, however, would not prevent the operation of Part IVA[64] if the commercial objective was achieved in a particular way which showed that the tax benefit was the dominant explanation for the scheme as entered into.

A fundamental consequence of *Spotless* was to have rejected a dichotomy between rational commercial decisions and tax planning.[65] The consequence was to uphold the application of Part IVA in some cases where tax objectives explained the structure of what was otherwise a wholly commercial, and otherwise fiscally permissible, outcome. The fiscal outcome in *Spotless* could conceivably have been obtained without structuring and, indeed, the structuring in that case may be seen to be directed to achieve and secure

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

65 *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 186 CLR 404, 415-6 (Brennan CJ, Dawson, Toohey, Gaudron, Gummow and Kirby JJ).

commercial objectives rather than to manufacture artificial or contrived tax outcomes. These considerations have seen Part IVA apply in that difficult area where genuine commercial objectives and tax considerations meet and influence each other in the structure adopted by taxpayers. In that context there is a genuine concern that Part IVA may have come to apply more broadly than intended and, perhaps, more broadly than fiscal policy would require that it should.

The concern that Part IVA may apply more broadly than it should, or perhaps than was intended, may in part be seen by Justice Hill's lament in *Macquarie Finance Ltd v Federal Commissioner of Taxation.*[66] In that case his Honour upheld the application of Part IVA but expressed the view that its application was unlikely to have been what those drafting the provisions had intended. A similar lament was perhaps made by what his Honour had said some years earlier in *CPH Property Pty Ltd v Commissioner of Taxation.*[67] In that case his Honour considered the potential application of Part IVA in the context of a commercial transaction effected in part by the interposition of a company which, had it been successful, would have had the effect of preserving the tax deductibility of interest payments that would otherwise have been quarantined by operation of s 79D. In that context his Honour said:

> It might perhaps be said that one of the problems in the present case lies in artificially dissecting part of a scheme from the totality of the scheme adopted. The arrangement as a whole was directed to a commercial end much more significant than tax. Part of the structure was devised

66 (2004) 57 ATR 115.
67 (1998) 88 FCR 21.

> because of tax, but the separating out of the tax and non-tax benefit leaves outside the structure both the borrowing of ACP and the subscription of moneys for shares by CPIL(UK). That, however, is a consequence of the decision of the High Court in *Spotless*.[68]

The remark in the last sentence was a reference to what the High Court had said in *Spotless*, namely that the "fact that the transaction was commercial does not require the conclusion that the dominant purpose would fall outside the part, for there is no true dichotomy between schemes which are commercial and those which are tax driven".[69] Perhaps those drafting the provisions had not subjectively intended the provisions to operate in that way, and perhaps that is why Hill J ascribed the result as "a consequence" of the decision in *Spotless* rather than flowing transparently from the statutory provisions themselves. However interesting it may be to pursue these thoughts, the fact is that it is now well established that the application of Part IVA will not be defeated merely because the scheme entered into was directed to, and in fact achieved, a wider commercial purpose than merely the tax benefit obtained.

It has repeatedly been held since *Spotless* that Part IVA may apply to transactions which have overall commercial objectives. *Spotless* was a case in which a taxpayer sought to derive interest income by a deposit of money at interest. The deposit was commercial; the interest received was real. The taxpayer could have achieved the tax benefit it sought to achieve without the

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68 Ibid 42.

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

possibility of the application of Part IVA had it done no more than write and post a cheque to the bank in the Cook Islands for derivation of interest income upon that deposit in the Cook Islands. *Hart* is the flipside of the same coin. In *Spotless* the taxpayer lent money to derive real interest income; in *Hart* the taxpayers borrowed money and paid real interest on which they claimed deductions. In that case it is also probable that the taxpayer could have achieved the fiscal consequences had they been able to secure two loans with two different banks, or perhaps even two loans with the same bank, but which were not linked in the way in which they were in that case. In each case there were aspects of the commercial transactions seeking to secure commercial objectives which were only made necessary to ensure the tax benefits would remain available. In each case it was those factors which explained the way in which the transaction (otherwise commercial) was done to secure the tax consequences in fact secured. The elements of "artificiality" in the schemes were (ironically) in the commercial terms thought necessary or commercially desirable to preserve the commercial objectives. The tax benefits could have been achieved easily (and without the anti avoidance provisions applying) but the schemes were undertaken to secure the commercial objectives that obtaining the tax benefit alone might not preserve.

Tax Benefit

Another area of debate has emerged around the application of s 177C. That section is headed "Tax Benefits" and is often treated as a definition of the tax benefits to which Part IVA may be applied. There appear to be at least two rather different ways of reading s 177C. One way is that it requires the

precise identification of what gave rise to the tax benefit. On that view satisfying s 177C does no more than require the precise and careful identification of the scheme as that which produces the tax benefit.[70] The purpose of the section by that construction is to provide analytical rigour to the application of Part IVA and to ensure that any tax benefit cancelled by the Commissioner is a tax benefit which is analytically, and therefore in fact, produced by the scheme. This reading of the section does not require a consideration of any counterfactual or of any alternative postulate. It simply asks that there be identified that which analytically, and therefore in fact, the scheme either would, or might reasonably be expected, to produce.

A different construction has been adopted in a series of cases which appears to require a different and more complex enquiry. That construction assumes that s 177C excludes from the operation of Part IVA any tax benefit which would have been obtained had the scheme not been entered into. The idea behind this construction may be that Part IVA should not apply where the tax benefit obtained by the taxpayer through the scheme would have been obtained had the scheme not been entered into or carried out. This view has been said to require a consideration of what the scheme produced and its comparison with an alternative postulate.

In *Lenzo v Federal Commissioner of Taxation*[71] the taxpayer submitted at first instance that if Mr Lenzo had not invested in the plantation project on which the Commissioner had applied Part IVA, he would have obtained a similar tax

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

71 (2007) 68 ATR 381; *Federal Commissioner of Taxation v Lenzo* (2008) 167 FCR 255.

benefit by putting money into his self-managed superannuation fund.[72] The answer given to this at first instance by French J was that s 177C(1)(b) sought to identify whether "that deduction", namely the deduction referable to the identified scheme, would not be, or might not reasonably be, allowable if the scheme had not been entered into or carried out.[73] His Honour therefore considered the superannuation "counterfactual" which had been contended for by the taxpayer to be extraneous to the statutory alternatives contemplated by the section.[74] His Honour went on to say, however, that a relevant "counterfactual" was that the taxpayer might have invested in the plantation project using either an alternative source of funds or his own funds.[75] These counterfactuals were challenged on appeal on the basis that they amounted to an erroneous finding at first instance that Mr Lenzo would still have invested in the plantation scheme. The basis of that contention was that the task required by s 177C(1) was to be undertaken by comparing what the scheme produced with what else a taxpayer might have done in the absence of the scheme.

On appeal, the Full Federal Court held that, in assessing the counterfactual, s 177C(1)(b) requires the "entirety" of the scheme identified for application by Part IVA to be ignored.[76] In reaching that conclusion no distinction was to be made between a scheme and its factual components, and the counterfactuals used by the trial judge were criticised on the basis that they dispensed with

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72 (2007) 68 ATR 381, 407 [116] (French J).
73 Ibid 407 [118].
74 Ibid.
75 Ibid 407 [119].
76 *Federal Commissioner of Taxation v Lenzo* (2008) 167 FCR 255, 281 [136] (Sackville J), 263 [42] (Heerey J agreeing), 286 [159] (Siopis J agreeing).

part of the scheme but left the balance intact.[77] In *AXA Asia Pacific Holdings Ltd v Federal Commissioner of Taxation*[78] Jessup J, at first instance, sought to explain the decision of the Full Court in *Lenzo* by saying:

> In my view, *Lenzo* is authority for the proposition that the starting point under s 177C(1)(a) is one which the whole scheme identified by the Commissioner must be assumed out of existence. The question then arises: what then might reasonably have been expected to have been included in the assessable income of the taxpayer? Here the court is engaged in a "prediction as to events which would have taken place" in the absence of the scheme: *Commissioner of Taxation v Peabody* (1994) 181 CLR 359, 385. The exercise thus postulated, in my view, is wholly one of fact-finding. A fact is not disqualified, *a priori* as it were, from consideration merely by reason of it having been an element of the scheme which was in place. To the contrary: what the taxpayer and his or her associates in fact did in the commercial circumstances which existed is likely to shed much light on what they would have done in the absence of the scheme, and in some cases to be, as a matter of prediction, elements of that counterfactual. Nothing in *Lenzo* requires me to hold otherwise. Indeed, the way Sackville J approached the task of prediction was entirely consistent with the counterfactual in any particular case involving elements of the presumptively discarded scheme, assuming always that the facts of the case indicated such an outcome.[79]

The view adopted by Jessup J drew a distinction between the scheme and any facts which may constitute its elements. It is the former, but not the latter,

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77 Ibid 280 [130] (Sackville J).
78 [2009] FCA 1427.
79 Ibid [118].

which the authority of *Lenzo* was seen to require to be entirely "ignored"[80] or "assumed out of existence".[81] Whether that is what had been intended by the Full Federal Court in *Lenzo* may be doubted in view of the observation by the Full Court in *Lenzo* that the difficulty with the counterfactuals adopted by French J at first instance had been "that they apparently dispense[d] with part of the scheme (as found by his Honour), yet leave the balance of the scheme intact".[82]

The approach to *Lenzo* adopted in *AXA* at first instance was endorsed in *Federal Commissioner of Taxation v Trail Bros Steel & Plastics Pty Ltd*[83] where the Court said:

> When assessing the alternative postulate or predicting the events that would or might take place, that question is answered on the assumption that *the scheme* has not been entered into or carried out: *Lenzo* 167 FCR 255 at [121]. Put another way, s 177C does require the entirety of the scheme to be ignored: *Lenzo* 167 FCR 255 at [136]. But that is not the entire question posed by s 177C. The rest of the question involves the objective enquiry of predicting the events that would have, or might reasonably be expected to have, taken place in the absence of the scheme.
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> […]
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> The *particular activity* or the events that would have, or might reasonably be expected to have, taken place in the absence

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80 *Federal Commissioner of Taxation v Lenzo* (2008) 167 FCR 255, 281 [136] (Sackville J).

81 *AXA Asia Pacific Holdings Ltd v Federal Commissioner of Taxation* [2009] FCA 1427, [118] (Jessup J).

82 *Federal Commissioner of Taxation v Lenzo* (2008) 167 FCR 255, 280 [130] (Sackville J).

83 (2010) 186 FCR 410.

of the scheme and which are identified as a result of the objective enquiry are not confined or defined by the scheme. Of course, it cannot be the same complete set of events giving rise to the scheme - that would be the scheme. But at the same time, the identification of the activity or the events does not necessarily preclude any element of *the scheme*. As the High Court has said, "scheme" is a word of wide import: *Peabody* 181 CLR at 383; *Hart* 217 CLR 216 at [87].

A scheme is usually comprised of a number of "steps" or "integers". It is conceivable that a scheme (comprising just some of the integers of a wider scheme to which Pt IVA applies) may be a scheme to which Pt IVA does not apply. If the narrower scheme is the particular activity or the events that would have or might reasonably be expected to have taken place in the absence of the scheme, then that is the alternative postulate. The difference between the deduction claimed in relation to the scheme and the allowable deduction from the narrower scheme is the tax benefit. Similarly, the alternative postulate may comprise some of the integers of the scheme to which Pt IVA applies and other integers which do not form part of that wider scheme. The express words of s 177C require a prediction about what would happen or might reasonably be expected to happen. It is necessarily a hypothetical analysis. But it is a hypothetical analysis directed at ascertaining what particular activity would have been (or might reasonably have been) undertaken if the scheme was not entered into. The "integers" that are relevant to that objective enquiry are not limited and "may not always permit the precise identification of ... all the integers of a particular ‘scheme’": *Hart* 217 CLR 216 at [43]. The integers will be different for each case and the onus is on the taxpayer to identify those integers which establish the alternative postulate.

> It is contrary to the express words of s 177C (including s 177C(2)), its context and its purpose to exclude particular integers from a prediction about what would happen or might reasonably be expected to happen. Put another way, absent particular integers, the enquiry would not be an objective enquiry as required by s 177C but a prediction of what would happen or might happen having regard to only a subset of the integers available to a taxpayer. That is not the object of Pt IVA.[84]

On appeal to the Full Court in *Federal Commissioner of Taxation v AXA Asia Pacific Holdings Ltd*[85] their Honours[86] set out the relevant legal principles concerning the application of s 177C and said:

> Section 177C (read with the other provisions in Pt IVA) identifies that it is an "objective fact" whether a taxpayer obtained a tax benefit in relation to a scheme to which Pt IVA applies: *Commissioner of Taxation v Peabody* (1994) 181 CLR 359 at 382; *Hart* 217 CLR 216 at [37]; *Federal Commissioner of Taxation v Lenzo* (2008) 167 FCR 255 at [119] citing *Commissioner of Taxation v Mochkin* (2003) 127 FCR 185 at [26].
>
> In the case of an amount being included in the assessable income of a taxpayer, s 177C(1)(a) provides that it is an objective inquiry as to what would have been included or might *reasonably* be expected to have been included in the assessable income had the "scheme" not been entered into or carried out: *Epov v Federal Commissioner of Taxation* (2007) 65 ATR 399 at [62] and *Peabody* 181 CLR 359 at 385-6.

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84 Ibid 418-9 [28] – [31] (Dowsett and Gordon JJ).
85 [2010] FCAFC 134.
86 Edmonds and Gordon JJ with Dowsett J agreeing.

> The legislation requires a comparison between the relevant scheme and an alternative postulate, or counterfactual: *Hart* 217 CLR 216 at [66].
>
> The alternative postulate requires a "prediction as to events which would have taken place *if the relevant scheme had not been entered into or carried out* and that prediction must be sufficiently reliable for it to be regarded as reasonable" (emphasis added). "A reasonable expectation requires more than a possibility": *Lenzo* 167 FCR 255 at [122] citing *Peabody* 181 CLR 359 at 385. The question posed by s 177C(1) is answered on the assumption that *the scheme* had not been entered into or carried out: *Lenzo* 167 FCR 255 at [121].[87]

In answering the question posed by s 177C(1) on that construction of the provision their Honours reasoned that the exclusion of particular integers from a prediction is contrary to the express words of s 177C, its context and its purpose. In that regard their Honours said:

> The express words of s 177C require a prediction about what would happen or might reasonably be expected to happen. It is necessarily a hypothetical analysis. But it is a hypothetical analysis directed at ascertaining what particular activity would have been (or might reasonably have been) undertaken if the scheme was not entered into. The "integers" comprising the scheme that are relevant to that objective enquiry are not limited and "may not always permit the precise identification of ... all the integers of a particular 'scheme'": *Hart* 217 CLR 216 at [43] and *Trail Bros* (2010) 186 FCR 410 at [30].

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87 *Federal Commissioner of Taxation v AXA Asia Pacific Holdings Ltd* [2010] FCAFC 134, [126] – [129].

> It is contrary to the express words of s 177C (including s 177C(2)), its context and its purpose to exclude particular integers from a prediction about what would happen or might reasonably be expected to happen. Put another way, absent particular integers, the enquiry would not be an objective enquiry as required by s 177C but a prediction of what would happen or might happen having regard to only a sub-set of the integers available to a taxpayer: see *Trail Bros* (2010) 186 FCR 410 at [31].[88]

The Full Court in *AXA*, like the trial Judge, sought to apply *Lenzo* in reaching its conclusion. The litigation reveals dispute about whether what is set up as the alternative postulate in any given case is permitted by the legislation. The reason for that dispute is the fight over whether what the Commissioner has cancelled as a tax benefit is not a tax benefit for the purposes of Part IVA. It might ultimately be better for disputes about alternative postulate to be confined, as they were probably intended in *Hart*, as illuminating the conclusion about purpose[89] rather than informing the content or identification of the tax benefit.[90]

The Onus and its Discharge

The prevailing reading of s 177C has had a substantial effect upon the way in which both the Commissioner and taxpayers analyse and argue about the application of the anti avoidance provisions. The search for the counterfactual is potentially to the advantage of neither Commissioner nor taxpayer. If the alternative postulate, or the counterfactual, is to be found not in a

88 Ibid [132] – [133].
89 An application of s 177D.
90 An application of s 177C.

consideration of what was done by reference to how the same thing could have been done, but rather by reference to what in fact might have been done or what in fact might reasonably expected to have been done, then both taxpayer and Commissioner are directed to undertake a very complicated analysis by reference to facts and circumstances which did not occur.[91] It would, curiously, place in centre stage an artificially created hypothesis into something that never happened.[92] One ought not to trivialize the seriousness of the issue, but I cannot help but think of the "Counterfactual game" made famous by the "nerdy" characters in the TV show "The Big Bang Theory"[93] where Amy asks Sheldon such questions as "In a world where Rhinoceroses are domesticated pets, who wins the Second World War". Sheldon's correct answer is "Uganda" because "Kenya rises to power on the export of rhinoceroses. A central African power block is formed, colonizing North Africa and Europe. When war breaks out, no one can afford the luxury of a rhino. Kenya whithers, Uganda triumphs".[94]

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91 "Yesterday, upon the stair,
I met a man who wasn't there
He wasn't there again today
I wish, I wish he'd go away …"
Hughes Mearns, *Antigonish ("The Little Man Who Wasn't There").*

92 Some may recall the Monty Python sketch in which the words "nothing happened" assumed the power of mystery and drama when accompanied by strong dramatic music, mysterious looking figures and a prelude of suspense;
see "The Day Nothing Happened" Monty Python at
http://www.wepsite.de/The%20Day%20Nothing%20Happened.htm; "The Adventures of Ralph Mellinsh" in Monty Python *Free Record Given Away with the Monty Python Matching Tie and Handkerchief* (Audio LP Record or CD), 1975.

93 <http://www.youtube.com/watch?v=0lpY0Kt4bn8>.

94 Other examples of the game include:
Question:In a world where a piano is a weapon, not a musical instrument, on what does Scott Joplin play the Maple Leaf Rag?
Answer: Tuned bayonets.
Defence: Isn't it obvious?
Question: In a world where mankind is ruled by a giant intelligent beaver, what food is no longer consumed?
Answer: Cheese Danish.

The practical difficulty occasioned by an inquiry into counterfactuals may be seen in the facts in *Noza Holdings Pty Ltd v Federal Commissioner of Taxation*[95] where Gordon J was called upon by the parties' submissions to analyse in detail whether the commercial objectives achieved by the actual means adopted by a taxpayer were able to be achieved by the counterfactuals relied upon by the Commissioner. Her Honour concluded in that case that they were not.[96] The conclusion was reached by reference, not to whether the transaction itself exhibited signs of tax avoidance but, rather, to whether what was put as an alternative transaction was commercially able to achieve the same commercial outcomes as the one actually adopted by the taxpayer. In *Federal Commissioner of Taxation v AXA Asia Pacific Holdings Ltd*[97] Edmonds and Gordon JJ remarked upon the risk of artificiality occasioned by such enquiries:

> The finding that it *might reasonably be expected* that the alternative postulate was a direct sale to MBF is a further example of the difficulties which now arise in litigation concerning Pt IVA where the focus is on the "scheme" and the "alternative postulate" identified by the parties. Of course, this is a direct result of the adversarial process. The problem is that it does run the risk of creating considerable artificiality often divorced from commercial reality.[98]

Defence: In a world ruled by a giant beaver, mankind builds many dams to please the beaver overlord. The low lying city of Copenhagen is flooded. Thousands die. Devestated, the Danes never invent their namesake pastry. <http://boards.straightdope.com/sdmb/showthread.php?t=581199>.

95 [2011] ATC 20-241.

96 [2011] ATC [20-241], 12,054.

97 (2010) 189 FCR 204.

98 (2010) 189 FCR 204, 243-4 [147].

The taxpayer was successful in *AXA* and *Noza*, but advisers to taxpayers may not be able to take much comfort from the outcome. The outcome in both was achieved by complex, and to some extent (if not largely), artificial analysis about necessarily hypothetical circumstances which did not occur.

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

affirmatively comes within the anti avoidance provisions. In that context the role played by intuitive decision making and the need to reconcile competing policy objectives become particularly significant, critically important and frequently unpredictable.

The complexity and difficulty of the inquiry was considered, but may not have been resolved, by the Full Federal Court decision in *RCI Pty Ltd v Federal Commissioner of Taxation.*[99] In that case the court considered whether it was sufficient to find as a tax benefit that the counterfactual contended by the Commissioner was reasonable. In concluding that it was not their Honours said:

> It is trite that a taxpayer in this Court bears the onus of proving that an assessment is excessive: s 14ZZO(b)(i) of the *Taxation Administration Act 1953* (Cth). It follows that it is the taxpayer who bears the onus to establish that a tax benefit is excessive. It might do that by establishing that there is no tax benefit or by establishing that it is less than that determined by the Commissioner: *Federal Commissioner of Taxation v Trail Bros Steel & Plastics Pty Ltd* [2010] FCAFC 94; (2010) 186 FCR 410 at [35] and [36] per Dowsett and Gordon JJ, Edmonds J agreeing [62]; *Federal Commissioner of Taxation v AXA Asia Pacific Holdings Ltd* [2010] FCAFC 134; (2010) 189 FCR 204 at [134] per Edmonds and Gordon JJ, Dowsett J agreeing [1].
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> It has been said in the past, and the learned primary judge at [88] of her Honour's reasons said below, that the taxpayer carries the onus of establishing that the Commissioner's counterfactual is unreasonable; and that if the taxpayer does

[99] [2011] ATC 20-275.

not establish that the Commissioner's counterfactual is unreasonable, then the taxpayer fails to prove that the assessment is excessive on that ground. (Of course, the taxpayer may establish that the assessment is excessive on some other ground, such as that the conclusion required to be drawn as to the dominant purpose of a party to the scheme under s 177D(b) cannot be drawn, but that is another matter.)

Such an articulation of the onus is erroneous, but if not, certainly unhelpful because it can lead one into error. Even if a taxpayer establishes that the Commissioner's counterfactual is unreasonable, it will not necessarily follow that he has established that the assessment is excessive. *That is because the issue is not whether the Commissioner puts forward a reasonable counterfactual or not; it is a question of the Court determining objectively, and on all of the evidence, including inferences open on the evidence, as well as the apparent logic of events, what would have or might reasonably be expected to have occurred if the scheme had not been entered into.* Thus, even if a taxpayer establishes that the Commissioner's counterfactual is unreasonable, that will not discharge the onus the taxpayer carries if the Court determines that the taxpayer would have or might reasonably be expected to have done something which gave rise to the same tax benefit.

That such an articulation of the onus is at worst erroneous and at best unhelpful, can also be illustrated from the other side of the coin, because it implies that if the Commissioner's counterfactual is reasonable that is the end of the matter; even if the Court were to conclude, on all the evidence, inferences and logic referred to, that if the scheme had not been entered into the taxpayer would have or might

reasonably be expected to have done something which did not give rise to a tax benefit, or which gave rise to a tax benefit less than that thrown up by the Commissioner's counterfactual. In our view, that cannot be correct.

In saying this, we are mindful that when seeking special leave to appeal to the High Court in *AXA* [2011] HCA 63 (11 March 2011), the Commissioner's first ground was that s 177C was 'a gateway provision rather than a major forensic exercise'. He submitted that, to satisfy s 177C –

> "[I]t is enough if it might reasonably be expected that the amount would be included in the assessable income in the sense that there might be a number of reasonable expectations and it is sufficient if, on any one of those, the amount would have been included in the assessable income."

This no doubt explains the submission of senior counsel for the Commissioner towards the end of the hearing of the present appeal:

> "[W]e submit our submission is reasonable... We don't say it is the only counterfactual. We don't even say it is necessar[ily] the most probable counterfactual, but it meets the threshold."

However, we are comforted in the view we have come to by the fact that the Commissioner's special leave application was dismissed without counsel for AXA being called on. Of the first ground, the Court simply said:

> "The first point is a question of construction in relation to which the Full Court of [the Federal Court] had taken a particular approach. We think there are

> insufficient prospects of disturbing this approach on appeal."[100] (my emphasis).

It may readily enough be accepted that a counterfactual is not reasonable merely because the Commissioner says so. What is not clear is why it is not enough to enliven the provisions that the counterfactual propounded by the Commissioner is reasonable as judged independently of it being propounded by the Commissioner. In that case the court held that the taxpayer did not obtain a tax benefit within the meaning of s 177C because whatever may have happened by what occurred the taxpayers either would have abandoned the transaction actually entered into or would have done something else which, in effect, would not have produced the tax consequence by the means actually secured.[101] The basis for that conclusion was the court's analysis of the "underlying or foundation material" before the court.[102] The court did not exclude the potential relevance of other evidence but concluded that in the vast majority of cases it was the court's view about the "underlying or foundational material" which would answer the inquiry called for by s 177C. In that regard the court observed:

> That this may be a recipe for uncertainty of outcome in any given case is to be regretted, but if it is to be criticised as too dependent on the judgment of the Court, that is a criticism to be directed at the architecture of the legislation and not the process of the Court.[103]

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100 Ibid [128] – [132] (Edmonds, Gilmour and Logan JJ).
101 Ibid [150], 12,728.
102 Ibid [140], 12,726.
103 Ibid [140], 12,726.

What is left unresolved, amongst other matters, is the impact in any case of a reasonable counterfactual which happens to be propounded by the Commission. It appears from *RCI* not to be sufficient that the propounded counterfactual is objectively reasonable for it to be a counterfactual which would justify the application of Part IVA. Its effect would seem to depend upon whether it is both objectively reasonable and also that adopted by the court. That may be a defect in the legislation but, if it is, it is a defect that makes the provisions difficult to predict until finally resolved by court decision.

Cautious observation on recent New Zealand developments

It is not surprising to see debates in New Zealand about the proper role and proper approach to anti avoidance provisions. The two cases from the New Zealand Supreme Court in *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*[104] and *Penny and Hooper v Commissioner of Inland Revenue*[105] are illustrations of two aspects of recurrent debates which I venture to suggest are also seen in other jurisdictions. *Ben Nevis* illustrates concerns about the misuse of a statutory provision and the difficulties in the application of those concerns as seen in the US, UK and Canadian cases. *Penny and Hooper* illustrates concerns about non commercial dealings to achieve a favourable tax outcome. Each case carries with it complex issues and each decision gives rise to difficult questions for their future application.

104 (2009) 24 NZTC 23,188.
105 (2011) 25 NZTC 25,635.

Ben Nevis: "Parliamentary Contemplation"

The approach taken in New Zealand in *Ben Nevis* would seem, on one view, to have the anti avoidance provisions operate more broadly than may have been contemplated in *Newton*. In *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*[106] the New Zealand Supreme Court adopted a test requiring a consideration of the purpose contemplated by parliament when enacting the provision which a transaction is said to have avoided. In the joint judgment of Tipping, McGrath and Gault JJ their Honours said:

> When, as here, a case involves reliance by the taxpayer on specific provisions, the first inquiry concerns the application of those provisions. The taxpayer must satisfy the Court that the use made of the specific provision is within its intended scope. If that is shown, a further question arises based on the taxpayer's use of the specific provision viewed in the light of the arrangement as a whole. If, when viewed in that light, it is apparent that the taxpayer has used the specific provision, and thereby altered the incidence of income tax, in a way which cannot have been within the contemplation and purpose of Parliament when it enacted the provision, the arrangement will be a tax avoidance arrangement.[107]

It is understandable that regulators, courts and the community alike will not be eager in the modern world to condone what appears to be the manipulation of the law in a way that was not intended by parliament. It is therefore not surprising to find judges expressing themselves against endorsing a "use" of

106 (2009) 24 NZTC 23,188.
107 (2009) 24 NZTC 23,188, 23211-2.

statutory provisions that was not what the court perceives to have been the use intended by parliament. A difficulty for the courts, however, is how to express a principled test with predictive force that is jurisprudentially more than a final court's expression of disapproval of one given set of facts.

The test enunciated in *Ben Nevis* may not prevent debate and litigation about the application of the New Zealand general anti avoidance provisions to other facts in subsequent cases. There is often fierce debate, at least in Australia, about what was or was not within the contemplation of parliament when enacting a specific provision. It is likely that there will be much debate between revenue authorities and taxpayers about what was within the contemplation of the New Zealand parliament when enacting a specific provision as a prelude to debate about whether the general anti avoidance provision has been engaged on the facts. It is also probable that judges will have different views about whether something comes within the principle. In the field of tax there may still be something to be said in favour of the need for precision in legislative drafting.[108] That need may be stronger in the case of the anti avoidance rules. Courts may have differing views about the law which, once finally stated, is applicable to all. However, differing views about whether a particular transaction is an avoidance transaction is a different matter because it depends upon judgment and impressions. Whether or not something is caught by anti avoidance provisions should be predictable and

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108 *BP Refinery (Westernport) Pty Ltd v Hastings Shire* (1977) 16 ALR 363; *Western Australian Trustee Executor and Agency Co Ltd v Commissioner of State Taxation (WA)* (1980) 147 CLR 119, 126 (Gibbs J).

not be dependent upon judgments about which reasonable jurists may, and frequently do, reasonably differ.

The enquiry called for in *Ben Nevis* is about the underlying policy through which the specific provision is reflected. Taxpayers and revenue authorities may be expected to have different views about what a specific provision means and how it is to be applied. On one view the "parliamentary contemplation" test may confine the application of the general anti avoidance provisions in New Zealand to those situations where it may reliably be said that the application of the anti avoidance rule is to give effect to the policy underlying a specific provision. In that way, the need to link the impugned arrangement with something found to be within the contemplation of parliament in another provision may reveal in *Ben Nevis* the echoes of the abuse of statute jurisprudence developed in the United States and the enactment of the general anti avoidance rule in Canada. However, both taxpayers and the revenue authorities are likely to find different "angles" to the decision in *Ben Nevis*, and each is likely to rely, and to distinguish, the decision for their own ends.

The majority judgment in *Ben Nevis* said that the enquiry into whether a tax avoidance arrangement exists is not confined. Their Honours said:

> The general anti-avoidance provision does not confine the Court as to the matters which may be taken into account when considering whether a tax avoidance arrangement exists. Hence the Commissioner and the courts may address a number of relevant factors, the significance of which will depend on the particular facts. The manner in which the

> arrangement is carried out will often be an important consideration. So will the role of all relevant parties and any relationship they may have with the taxpayer. The economic and commercial effect of documents and transactions may also be significant. Other features that may be relevant include the duration of the arrangement and the nature and extent of the financial consequences that it will have for the taxpayer. As indicated, it will often be the combination of various elements in the arrangement which is significant. A classic indicator of a use that is outside Parliamentary contemplation is the structuring of an arrangement so that the taxpayer gains the benefit of the specific provision in an artificial or contrived way. It is not within Parliament's purpose for specific provisions to be used in that manner.
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> In considering these matters, the courts are not limited to purely legal considerations. They should also consider the use made of the specific provision in the light of the commercial reality and the economic effect of that use. The ultimate question is whether the impugned arrangement, viewed in a commercially and economically realistic way, makes use of the specific provision in a manner that is consistent with Parliament's purpose. If that is so, the arrangement will not, by reason of that use, be a tax avoidance arrangement. If the use of the specific provision is beyond Parliamentary contemplation, its use in that way will result in the arrangement being a tax avoidance arrangement.[109]

The breadth of this enquiry is directed to whether a tax avoidance arrangement exists not into an enquiry into what parliament contemplated. It

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109 *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* (2009) 24 NZTC 23,188, [108]-[109] (Tipping, McGrath and Gault JJ).

may be accepted that parliament can be presumed to have contemplated that the benefit of its specific provisions would not be gained by an artificial or contrived way, but future decisions may need to take care to ensure that these passages are not applied as tautologies. Whether an avoidance arrangement exists cannot depend upon whether it is an avoidance arrangement (since that would be tautologous) but, rather, whether the arrangement can reliably be seen to have been outside what parliament contemplated. It is the latter to which attention is likely to be drawn, and about which there is likely to be fierce debate. The "parliamentary contemplation" test may conceivably be relied upon by taxpayers to narrow the application of the anti avoidance rules by arguing, with some force, that what was in the contemplation of parliament when enacting the specific provision was, and stopped with, the ambit of its actual terms (purposively interpreted, of course).[110] The revenue might rely upon the "parliamentary contemplation" rule to focus upon some broader fiscal policy effected by the language in the specific provision which in terms may not go as far as the revenue would like. No doubt, in an appropriate case, each will adopt the opposite stance to achieve opposite conclusions. The broader the assumed contemplation of parliament, the broader the reach of the anti avoidance rule; the narrower the assumed contemplation of Parliament, the narrower the reach of the anti avoidance rule.

An allied, but more fundamental jurisprudential concern about the approach taken in *Ben Nevis*, is that its application may result in the imposition of

110 *Scott v Cawsey* [1907] 5 CLR 132, 154-5 (Isaacs J).

unlegislated taxation. It is implicit in the *Ben Nevis* approach to the anti avoidance provision that tax will not arise other than through the anti avoidance rule. In other words that the primary provisions, purposively construed and purposively applied, did not go as far as parliament is to be presumed to have contemplated but failed to go. An ability to extend the reach of taxing provisions through the anti avoidance provisions may encourage the application of the anti avoidance provisions by the New Zealand revenue authorities significantly beyond the reach of the primary taxing provisions. The *Ben Nevis* approach, and its application, may also result in the courts being criticised that they have engaged in judicial legislation; that is, that in giving legal effect to the Commissioner's assessments, through the anti avoidance provisions, to something which parliament is presumed to have contemplated but failed to enact in the primary provisions (given a purposive interpretation) involves the courts in making law something that is not law.

In evaluating such concerns it is important to recall that the issue of the application of the anti avoidance rule only arises after the primary taxing provisions have been given a purposive interpretation. In other words the question posed in *Ben Nevis* of parliament's contemplation is a second purposive interpretation which calls to be considered only after the primary provisions are given a purposive interpretation but found not to apply. A practical consequence of the approach may be that the anti avoidance provision becomes a mechanism for filling the actual gaps in tax legislation rather than striking only at what is undoubtedly tax avoidance.

A mechanism which "fills in gaps" may be indistinguishable from a delegation of legislative powers. In the task of applying the principle, however it may be described, it will be difficult for a court (let alone the many taxpayers called upon to make decisions upon the law as it is stated without the benefit of a court decision) to know with sufficient confidence how to go about determining what parliament contemplated. The complex modelling and economic assumptions which form the basis of fiscal provisions will not be easy for a court to ascertain. In one instance in Australia fiscal benefits were introduced in one context upon an unstated assumption that some of the benefits would be wasted.[111] The market which developed to make use of credits by trading in them was subsequently countered in Australia by specific legislative provisions.[112] In New Zealand they might have been met in the first instance by a departmental invocation of the *Ben Nevis* principle followed by courts having to decide whether the parliamentary contemplation principle applied. The application of the principle may be difficult where the legislative provisions in issue are detailed or complicated.[113]

Penny and Hooper: An "uncommercial" artificial step

In *Penny and Hooper v Commissioner of Inland Revenue*[114] the issue in dispute was the simple fixing of a low salary by orthopaedic surgeons with their employers who were companies owned by the surgeons' family trust. A consequence of fixing low salaries was that the company employers derived

111 GT Pagone, *Tax Avoidance in Australia* (2010) 112-4.
112 Ibid.
113 *Helvering v Gregory* 69 F 2d 809, 810 (2nd Cir 1934), aff'd 293 US 465 (1935).
114 (2011) 25 NZTC 25,635.

substantial income through the work undertaken by the surgeons with the economic consequence of the companies (and not the surgeons) deriving the income otherwise referable to the services of the surgeons.

Applying tax avoidance provisions to transactions, or aspects of transactions, which are thought to be uncommercial is not without difficulty. An uncommercial dealing judged by one aspect may appear to be sound commercial judgment by another. It has long been held that it is not for the revenue authorities to determine how a taxpayer is to conduct business or what or how much a taxpayer should incur in doing so.[115] An uncommercially low salary to the principal income earner might permit higher superannuation benefits to that earner's spouse without falling foul of anti avoidance rules.[116] An uncommercial dealing may be sufficient to enable the conclusion that some part of a loss or outgoing was not sufficiently incurred in the gaining of assessable income to deny a deduction.[117] On the other hand an uncommercial rate of interest as between companies may be explained by a broader commercial objective of a holding company[118] or of group activities and group necessities.[119]

The court in *Penny and Hooper*[120] was mindful of such complications and posed the relevant question and inquiry as follows:

> The question to be asked is therefore why the salary was

115 *Ronpibon Tin NL v Federal Commissioner of Taxation* (1949) 78 CLR 47.
116 *Ryan v Federal Commissioner of Taxation* (2004) 56 ATR 1122.
117 *Fletcher v Federal Commissioner of Taxation* (1991) 173 CLR 1.
118 *Federal Commissioner of Taxation v Total Holdings (Aust) Pty Ltd* (1979) 79 ATC 4279.
119 *Federal Commissioner of Taxation v Ashwick (Qld) No 127 Pty Ltd* (2009) 77 ATR 92.
120 (2011) 25 NZTC 25,635 [34], 25,645.

> fixed as it was on a particular occasion. Whether that involved tax avoidance can be answered by looking at the effect produced by the fixing of the level of the salary in combination with the operation of the other features of the structure.[121]

In that case the court concluded against the taxpayers holding that the "taxation advantage produced" by the fixing the salaries of a low level "can fairly be seen as the predominant purpose".[122]

The decision in *Penny and Hooper* will no doubt give rise to lively discussion for some time. Its circumstances are at least about 50 years old as seen from the facts in *Peate v Federal Commission of Taxation.*[123] Critical to its application in the future will be the role of evaluation and judgment in the conclusions fairly to be seen from what arrangements produce. Much will turn upon the evidence and the impression which that evidence will have upon a decision maker. In that context there may still be much room for significant differences of opinions and that raises a significant policy question for the law about the extent to which anti avoidance rules should apply to cases in which there is genuine room for doubt. One such area of difference may be in the application of the anti avoidance rules to husband and wife partnerships where one is the effective income generator but the two share income equally. In that context it may be interesting to see how revenue authorities (and ultimately the courts) distinguish domestic arrangements of that kind from those in which income is shared with an arm's length third party silent partner

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121 Ibid [34], 25,645.
122 Ibid [36], 25,646.
123 (1964) 111 CLR 443.

whose only contribution (typical also in the domestic arrangements) is liability as a guarantor or joint partner if sued. And, if domestic arrangements of that kind are thought exempt from the anti avoidance net (whether on principle or on policy grounds) it will be intending to see why or how similar considerations should not apply to arrangements such as those challenged in *Penny and Hooper*.

One feature in the decision in *Penny and Hooper* that may cause lively debate is whether the question as anticipated by the court calls for a subjective inquiry into the taxpayer's actual reason for doing what was done. The answer to the question was said by the court to lie in looking at the "effect" produced but that is not to exclude looking at other matters in other cases if the inquiry is one into the subjective intention of the taxpayers. It will also be interesting to see how far the "effect" will govern the outcome of the application of the anti avoidance rules. Plainly there are some effects which reduce tax that a taxpayer may legitimately choose to take. And that, of course, is where the downfall of s 260 was thought to have commenced. And on that note I had better stop.

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