FEDERAL COURT OF AUSTRALIA

Mission Accomplished? – A Perspective on Part IVA of the Income Tax Assessment Act 1936 delivered at The Tax Institute 2012 Queensland Corporate Tax Retreat Hyatt Regency, Sanctuary Cove, Gold Coast Thursday 6 September 2012

The Honourable Justice Logan RFD
A Judge of the Federal Court of Australia

Who am I? I am a car dealer. More accurately, my immediate family and I control by share ownership a private company which deals in motor cars. My motor company is spectacularly profitable. So much so that, towards the end of the 2011 financial year, I am facing the dilemma of either causing the motor company to declare a dividend and thus visit me and my fellow shareholders with a massive personal tax liability or not do so and so see the company incur a massive tax liability in respect of undistributed profits.

Later in time another Australian would summarise his attitude to tax in a way which would accord with mine:

> *"I pay the tax I am required to pay, not a penny more, not a penny less. If anybody in this country doesn't minimize their tax, they want their heads read because, as a Government, I can tell you they're not spending it that well that we should be donating extra."*[1]

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[1] Evidence of Mr K B Packer in 1991 before the Senate Select Committee on Certain Aspects of Foreign Ownership Decisions in Relation to Print Media, quoted in Sydney Morning Herald 18-19 February 2006 p 41, sourced from: http://www.kerrypacker.com/kerry-packer-stories-and-directory.html (accessed 6 September 2012).

Being of that mind, I approach my tax advisers. They come up with the following plan which I implement before the end of the financial year.

My motor company amends its articles of association so as to give special dividend rights to 80,000 ordinary 1 dollar shares, which entitled the holders of the shares to a dividend of $285 on every 1 dollar share. That comes to a total of $22.8 million as special dividend. After the payment of that dividend, those shares were to carry only a five per cent fixed dividend. The original shareholders then sold these shares to a company called Pactolus Limited (which was a private company controlled by my tax advisers) at a price of $22.8 million, equal to the anticipated dividend. The Pactolus company paid to the original shareholders the price by cheque, and at about the same time received from the motor company a cheque for the special dividend. The two cheques were for the same amount - $22.8 million. The Pactolus company was only able to pay for the shares because of the special dividend it received on them.

The Pactolus company also applied to the motor company for 400,000 five per cent preference 1 dollar shares (freshly issued) and paid for them by a cheque in favour of the motor company for $19.83 million. On the next day the Pactolus company sold these 400,000 shares to the original shareholders (from whom they had bought the 80,000 ordinary shares) at a price of $19.83 million. The original shareholders paid this sum, by cheque in favour of the Pactolus company, out of the $22.8 million they had received for the 80,000 ordinary shares.

All the cheques in the above transaction were banked simultaneously, with the result that by the end of June 2011 the motor company had distributed $22.8 million as special dividend. This had found its way back to the original shareholders who had received $22.8 million, of which they had reinvested $19.83 million as capital in the company and kept $2.97 million in cash. The Pactolus company had received 80,000 shares on which it was thenceforward only entitled to a fixed dividend of five per cent. These were now worth $3.965 million, and the Pactolus company sold them to a subsidiary company for that sum in cash.

The Pactolus company was, of course, liable to pay tax on the special dividends it received: but it was a company dealing in stocks and shares and as such it was entitled to deduct losses on its deals from the dividends it received. On the purchase and resale of the shares it had made a loss. It had bought the shares for $22.8 million and sold them for $3.965 million - a loss of $18.835 million. That loss could be set against the special dividend which it had received of $22.8 million, leaving it with a net profit of only $3.965 million on which it had to pay tax.

The answer to who I am is, of course, that I am the car dealer named Mr Lauri Joseph Newton. The facts just recited are those related by Lord Denning when delivering the advice of the Judicial Committee of the Privy Council in *Newton v Federal Commissioner of Taxation* (*Newton's Case*),[2] adjusted for inflation and the advent of decimal currency since the transactions described occurred in 1949.[3]

Putting aside the operation of any specific anti-avoidance provisions and capital gains tax, could it seriously be contended that a scheme such as this would now survive the making of a determination under Part IVA of the *Income Tax Assessment Act 1936* (Cth) (*1936 Act*) by which a total of $22.8 million was rateably included in the assessable incomes of Mr Newton and his family, according to the extent of their shareholding in the motor company? There is an obvious scheme, an obvious tax benefit in terms of s 177C and, having regard to s 177D, an equally obvious purpose on the part of Mr Newton to obtain that tax benefit.

It will be recalled that the conclusion reached in *Newton* was that s 260 of the *1936 Act* applied to the arrangement just described such that it was void as against the Commissioner with the result that the special dividends came to be assessed as income in the hands of the shareholders in the motor company. In contrast, s 260 was held not to apply to the schemes described in *Curran v Federal Commissioner of Taxation*,[4] *Slutzkin v Federal Commissioner of Taxation*[5] and *Federal Commissioner of Taxation v Westraders Pty Ltd*.[6] Can anyone though imagine that

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[2] [1958] AC 450
[3] Using Reserve Bank of Australia Pre-Decimal Inflation Calculator: http://www.rba.gov.au/calculator/annualPreDecimal.html
[4] (1974) 131 CLR 409
[5] (1977) 140 CLR 77
[6] (1980) 144 CLR 55

such schemes would now enjoy similar success in the face of a determination made by the Commissioner under Part IVA of the *1936 Act*?

The purpose of this perhaps overlong introduction is to suggest that, on any view, Part IVA is a potent, effective riposte to such blatant, artificial, contrived schemes. None of the cases concerning Part IVA thus far finally determined decided in either the High Court or the Federal Court would support a contrary conclusion. In this sense, its mission truly has been accomplished.

It is suggested in light of cases such as *RCI Pty Ltd v Federal Commissioner of Taxation*[7] (*RCI*) and *Federal Commissioner of Taxation v Futuris Corporation Ltd*[8] that Part IVA is in need of "reform".[9]

I was a party to the Full Court's judgments in these cases. In the former the Commissioner was refused special leave to appeal to the High Court; in the latter it was not sought by him. It is a longstanding and prudent rule of conduct that judges do not comment publicly in respect of cases in which they have delivered a judgment.[10] The judgment delivered must speak for itself. I intend to adhere to that rule.

As it happens though, the broad background to one of those tax cases gave rise to other litigation. That I can talk about. Especially for a conference such as this, the linkages between that other litigation and the tax case have, I think, some importance in reflecting on the operation and application of Part IVA. Those linkages are best approached by going back in time to an era when Part IVA first received judicial examination. I am also permitted to speak about judgments given in that era, for it was prior to my appointment to the bench.

It is now just over 20 years ago since Bob Gotterson QC (as he then was) and I appeared for Mary Peabody before O'Loughlin J in the Federal Court[11] on her

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7 [2011] ATC 20-275; special leave refused - *Commissioner of Taxation v RCI Pty Ltd* [2012] HCA Trans 29

8 [2012] ATC 20-306

9 Press Release of 1 March 2012 of the then Assistant Treasurer, The Hon Mark Arbib, Maintaining the Effectiveness of the General Anti-Avoidance Rule: http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2012/010.htm&pageID=003&min=mva&Year=&DocType

10 Australian Institute of Judicial Administration, Guide to Judicial Conduct, section 5.6.2.

11 *Peabody v Federal Commissioner of Taxation* 92 ATC 4585 (O'Loughlin J).

appeal against her assessment to income tax. The then Susan Kiefel QC led Chris Newton for the Commissioner. Though Part IVA had formed part of the *1936 Act* for over a decade it had yet to receive judicial examination. Mrs Peabody's tax appeal was the first case in which it did.[12]

It is in the nature of litigation and the conclusive quality of final judgments that the outcomes of some cases can have clarity in hindsight that they never had in prospect. I can assure you that, in prospect and notwithstanding what by today's standards was an unusually informative Explanatory Memorandum[13] which had accompanied the introduction of Part IVA,[14] there was considerable uncertainty in the legal and accounting professions, not to mention the wider commercial community, as to exactly what was the reach of this new anti-avoidance measure. It was thought that it would not apply and would not be sought to be applied to ordinary commercial transactions. After all, it had been expressly stated in the Explanatory Memorandum that, "Part IVA may be seen as effectuating in general anti-avoidance provisions of the income tax law a position akin to that which appears to emerge from the decision [in *Newton's Case*]."[15] That complacent thinking was challenged when the Commissioner came to make a Part IVA determination in respect of Mrs Mary Peabody. There could be no suggestion that the Commissioner acted in bad faith in making his determination in respect of Mrs Peabody. He, too, was feeling his way.

The facts in of the case are well known. They included these essential features:

(a) Control of the fly ash business conducted by the Pozzolanic Group as to 62% by TEP Holdings representing Peabody family interests and as to 38% by interests controlled by a Mr Kleinschmidt.

(b) TEP Holdings was the trustee of a trust of which Mrs Peabody was a beneficiary.

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[12] Hartigan J had examined Part IVA, but in his capacity as President of the Administrative Appeals Tribunal in *AAT Case 5219* (1989) 20 ATR 3777. His Honour upheld the use of Part IVA to assess a scheme to disperse what was in substance personal exertion income via the interposition of a discretionary trust.

[13] Explanatory Memorandum to the Income Tax Laws Amendment Bill (N0 2) 1981, circulated by the then Treasurer, The Hon J Howard, MP (Part IVA EM)

[14] Inserted by the Income Tax Laws Amendment Act (N0 2) 1981, s 11, commenced 24 June 1981.

[15] Part IVA EM, p 3.

(c) An appreciation by Mrs Mary Peabody's husband, Mr Terrence Peabody of the value which stood to be realised by a public float of half of the shares in the Pozzolanic Group.

(d) A desire by Mr Kleinschmidt to dispose of his interest but that the price received by him not become public knowledge.

(e) Willingness on the part of Mr Peabody to acquire Mr Kleinschmidt's interest in a way which did not involve public disclosure of the price. This was not just to accommodate Mr Kleinschmidt's desire but also because of the effect that disclosure might have on the price able to be sought on a public float for shares representing half of the Pozzolanic Group.

(f) An understanding by Mr Peabody and those advising him of the disclosure requirements in respect of a prospectus for a public float.

(g) Absence of any certainty as to whether TEP Holdings could itself finance an acquisition of the Kleinschmidt shares.

(h) Availability of cheaper finance from Westpac Bank if special purchase vehicle (which became the shelf company, Loftway) undertook the purchase of the Kleinschmidt shares.

(i) Use of the issuing of preference shares by Loftway to Westpac as part of the financing transaction.

(j) Conversion of shares in the Pozzolanic Group to preference shares carrying special dividend rights and then the exclusion of these shares from the float as part of the means by which disclosure of the Kleinschmidt share acquisition and price was kept from disclosure.

(k) An understanding by Mr Peabody and his advisers that, if TEP Holdings were to acquire the Kleinschmidt shares within and sell them into the planned float, that the sale would occur within 12 months of acquisition such that the anticipated profit would fall for inclusion in the assessable income of TEP Holdings by virtue of the operation of s 26AAA of the *1936 Act*.

The trial judge, I am sure, thought this was all too clever by half. He saw the share conversion step in what was a closely co-ordinated series of steps which culminated in a successful share float as having the dominant purpose of avoiding the application of s 26AAA. I took judgment when Mrs Peabody's taxation appeal was dismissed. Our instructing solicitors, Neil Dutney and Geoff Hancock, made the telephone call to Mr Peabody advising the result from my chambers at the Inns of Court. It was not an easy call.

In the result, no other judge took a similar view of the facts. An appeal to the Full Court was unanimously upheld[16] and, though the Commissioner secured a grant of special leave to appeal, his resultant appeal was dismissed 7-0.[17] There is no more emphatic outcome than that.

Both in the Full Court and in the High Court, the main reason why the Commissioner lost *Peabody* was that, viewed objectively, the dominant purpose of Mr Peabody (the only relevant person) was not to obtain a tax benefit for Mrs Peabody, although that was *a* purpose but a purpose of a commercial nature relating to the acquisition and the camouflaging of the purchase price in respect of the acquisition of the Kleinschmidt shares for the purpose maximising value in a public float. Another reason why the Commissioner failed was that it was held to be impermissible to isolate but part of a whole scheme if that part made no sense in isolation.

The next Queensland case in which a taxation appeal challenging a Part IVA based assessment was heard was *Eastern Nitrogen Ltd v Federal Commissioner of Taxation (Eastern Nitrogen)*. On this occasion, I was led by David Bloom QC and Tony Slater QC. In this case also the taxpayer lost at first instance[18] but triumphed unanimously in the Full Court.[19] On this occasion, the Commissioner was refused special leave to appeal to the High Court.

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16 *Peabody v Federal Commissioner of Taxation* (1993) 40 FCR 531. David Bloom QC and Tony Slater QC appeared on the appeal and in the High Court. Lest it be thought that Bob Gotterson QC and I were completely out of favour, I should record that I was offered the brief to junior David Bloom QC to respond to the commissioner's special lave application but could not accept it because of a prior commitment.

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

18 99 ATC 5163 (Drummond J)

19 (2001) 108 FCR 27.

Eastern Nitrogen concerned a sale and leaseback transaction, a very large and undoubtedly innovative sale and leaseback transaction. The subject of the sale was the company's ammonia plant. In his Part IVA determination, the Commissioner cancelled what he saw as the tax benefit of the lease rental deductions and allowed instead by way of a compensating adjustment only a proportion of them on the basis of interest on a loan of economic equivalence to the sale price.

Contrary to the conclusion of the trial judge, the Full Court held that the sale was effective in equity to pass ownership of the plant to the financier. Further, the Full Court pointed to evidence of the constant need for the company to have access to working capital on the best available terms for its ammonia product related business to the advantages to the company of the lease in terms of liberating capital tied up in the plant and the length of the facility compared with other funding options hitherto used by it – rolling over of short term bills of exchange with interest rate fluctuation risks and risk of market disinterest. The evidence from the financiers was that the lease arrangement gave them more commercial leverage than if they were but secured creditors. Though, again, a purpose of the company was the tax advantage found in the deductibility of the whole of a rent instalment against the background mentioned that was held not to be the dominant purpose.

In between *Peabody* and *Eastern Nitrogen* was Federal *Commissioner of Taxation v Spotless Services Ltd* (*Spotless*).[20] *Spotless* is a good example of the potency of the present Part IVA as an anti-avoidance measure. As will be recalled, it was decided against the background of a placement for investment of surplus capital in the Cook Islands. The interest rate available there was about 4% lower than prevailing bank bill rates in Australia. Interest income derived there was subject to a 5% withholding tax. The Cook Islands had no double taxation agreement in Australia. The taxpayer contended that the income was exempt from tax in Australia pursuant to s 23(q) of the *1936 Act* on the basis that it was derived in the Cook Islands and not exempt from tax there. The Commissioner on the other hand made a determination under Part IVA the effect of which was to include in the taxpayer's assessable income the amount of the interest less the amount of the withholding tax. The taxpayer

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[20] (1996) 186 CLR 404.

succeeded in the original jurisdiction[21] and, by majority, at intermediate appellate level[22] but lost 7-0 in the High Court (with McHugh J delivering a notable separate concurrence), an end result every bit as emphatic as *Peabody*. On this occasion, the objective scrutiny of the facts led to the conclusion that the dominant purpose was that of obtaining a tax benefit. The scheme represented by the placing of the funds in this off-shore location made no sense but for the securing of exemption under s 23(q).

For today, *Spotless* is noteworthy for the adoption with approval by the High Court[23] of an observation made in the United States Supreme Court by Harlan J in 1965 in *Commissioner of Inland Revenue v Brown*:

> *[T]he tax laws exist as an economic reality in the businessman's world, much like the existence of a competitor. Businessmen plan their affairs around both, and a tax dollar is just as real as one derived from any other source.*[24]

The High Court also referred approvingly to a later statement by the United States Supreme Court that it could not, “ignore the reality that the tax laws affect the shape of nearly every business transaction.” [25]

Having so done, the High Court observed that, “Much turns upon the identification, among various purposes, of that which is ‘dominant’.”[26]

It is on these notes that I return to the wider background against which *RCI* was decided. *RCI* was part of the James Hardie Group.

That wider background included a plan by the James Hardie Group to move its corporate headquarters off-shore. Because companies in the group were subject to asbestos exposure related damages claims and to the contingency of further such claims in Australia, that move had to be accompanied by the creation in Australia of a compensation fund sufficient to meet the anticipated amount of such claims.

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[21] 93 ATC 4397 (Lockhart J).
[22] (1995) 63 FCR 244 (Beaumont J dissented from Northrop and Cooper JJ)
[23] *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 186 CLR 404 at 415-416.
[24] (1965) 380 US 563 at 579-580.
[25] *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 186 CLR 404 at 416, referring to *Frank Lyon Co v United States* (1978) 435 US 561 at 580.
[26] *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 186 CLR 404 at 416.

In a proceeding brought by the Australian Securities and Investments Commission (ASIC) alleging a breach of director's duties, the board of the holding company was found at trial to have approved the release to the Australian Stock Exchange (ASX) of a statement which was misleading as to the sufficiency of provision in the compensation fund by describing it as "fully funded". In the High Court, *ASIC v Hellicar*, (*Hellicar*), [27] the result turned on the overturning of the erroneous conclusion by the NSW Court of Appeal[28] that the minutes of a board meeting recording the approval by the board of the release to the ASX concerned was not evidence that the board had approved that release. The High Court also corrected another error made by the Court of Appeal, which was that the ASIC was under a duty to call a particular witness.

The result in the High Court restored the findings made at trial by Gzell J[29] of contravention by the James Hardie directors of the statutory duty of care and diligence to which they were at the time subject pursuant to s 180 of the *Corporations Act 2001* (Cth) (*Corporations Act*), a duty which, in amended form, remains to this day. The judgment of Gzell J contains a noteworthy summary[30] of the jurisprudence concerning the nature of that duty. It is beyond the scope of this paper to explore that jurisprudence in detail.

For present purposes, the importance of recalling the recognition of "economic realities" in *Spotless* and reading *RCI* and *Hellicar* together is what that discloses as to the breadth of subjects dealt with by directors in the course of working through the business agenda of the board of a major public company – changes in sources and patterns of income and product demand as between the USA and Australia, the impact of exchange rate differences and tax regimes in each place, where best to centre the group's headquarters, exposure to common law and workers' compensation liabilities to name but the more obvious.

What this emphasises is the enduring truth of the observation made by Harlan J of the economic realities of a businessman's world. A director subject to the duties found in s 180 of the *Corporations Act* would breach that duty if the tax

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[27] *ASIC v Hellicar* (2012) 86 ALJR 522.
[28] *Morley v ASIC* (2010) 247 FLR 140.
[29] *ASIC v MacDonald (No 11)* (2009) 230 FLR 1 (Gzell J).
[30] *ASIC v MacDonald (No 11)* (2009) 230 FLR 1 at [236] to [257].

consequences of particular corporate business activities and proposals were not taken into account.

The governance of a corporation's business involves the administration of multifactorial issues of which tax is but one. To look at the reports of *Peabody* and *Eastern Nitrogen* in the law reports, one might think that this proposition was trite. Evidencing that proposition did not though occur by happenstance, osmosis or judicial notice. It required a very thorough understanding of the transactions concerned and the business environment in which they arose, good corporate governance practices in terms of presentation and preservation of board minutes and supporting papers and the explaining of the same by witnesses be they those with contemporary transactional knowledge or those with expertise in relation to the market in which the company operated or contemporary corporate finance practices. In the gathering together the requisite evidence, Mrs Peabody was well served by her solicitors (Messrs Dutney and Hancock[31]) as was Eastern Nitrogen by its (Mr William Thompson[32]).

In contrast, the Commissioner has but one role, the administration of taxation laws.[33] The singularity of that role carries with it a commensurate risk of insularity of thinking. The business world, unlike that of the Commissioner, does not revolve around tax. Further, the Commissioner has the disadvantage of not being a party to the activities he comes to examine. That is why the onus of proving an assessment to be excessive is consigned to the taxpayer.[34]

In both *Peabody* and *Eastern Nitrogen* it was, inevitably, for the reasons set out above, the case that the obtaining of a tax benefit was *a* purpose in the business activities designated by the Commissioner as "schemes". There is a very considerable risk, of which *Peabody* and *Eastern Nitrogen* are eloquent proof, that the presence of such a purpose will, given the narrow role consigned to the Commissioner, appear to him to be the dominant purpose. That risk is not diminished if the Commissioner chooses to undertake his solicitor's work in-house.

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[31] Of the Brisbane firm, Cannan & Petersen which, after a number of mergers, forms part of Norton Rose.

[32] Of Minter Ellison.

[33] s 3A, *Taxation Administration Act 1953 (Cth)* (TAA).

[34] ss 14 ZZM and 14ZZR, TAA.

Adverse outcomes for the Commissioner in Part IVA cases are not just a victory for a taxpayer. They are also an independent, external assessment of the efficacy of the process that led to the making of the determination and the related assessment. Those adverse outcomes may serve as an indication not of a deficiency in Part IVA but rather of a deficiency in particular public administration practices which led to the use of Part IVA or the pressing of a case in which it was used.[35]

In cases where there is never even an intention to honour the transactions which constitute the scheme concerned, there is no role or need for Part IVA. The doctrine of sham will apply: *Raftland v Federal Commissioner of Taxation*.[36] Where there is no sham, Part IVA has and will continue to stop blatant, artificial or contrived tax avoidance.

In business, doing nothing is always an opportunity cost. Not to do nothing may, in given circumstances, entail a breach of a director's duties. In cases involving schemes to which corporations are a party and as Part IVA presently stands, both in examining whether there is a tax benefit and in examining purpose actions which would manifestly entail a breach of a director's duties under s 180 of the *Corporations Act* are, I suggest, unlikely to give rise to a reasonable expectation that they would occur. Modifying s 177C in a way which would eliminate a "do nothing" postulate would be therefore be a major change to the present anti-avoidance regime.

Whether or not so to do is a matter for the value judgment of Parliament. It would be unfortunate if that value judgment were based on the flawed premise that cases in which the Commissioner's use of Part IVA failed inevitably point to a deficiency in the legislation, as opposed, perhaps, to a deficiency in case selection. At least in hindsight, *Peabody* and *Eastern Nitrogen* are examples of that.

It should be appreciated also that in certain cases, faced with a quite different general anti-avoidance regime, the boards of companies dealing with the economic

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[35] As to the matters discussed in this paragraph, see also the helpful and thorough discussion of subject by the Inspector-General of Taxation in his recent report, Review of the Australian Taxation Office's Use of Early and Alternative Dispute Resolution, especially the section, "ATO Management of Tax Litigation", paragraphs 6.17 to 6.32: http://www.igt.gov.au/content/reports/ATO_alternative_dispute_resolution/ADR_Report_Consolidated.pdf

[36] (2008) 238 CLR 516.

reality of having to take into account taxation and in order to discharge duties specified in or akin to those in s 180 of the *Corporations Act*, might consider other “do nothing” options. Those options might well be either do nothing further in Australia or do not invest here in the first place.