# PART IVA & THE RELEVANCE OF SUBJECTIVE INTENTION

# – THE SECOND INSTALMENT

Paper by
Domenic Carbone
Lecturer, School of Business
The University of Adelaide

Presented at the 20th Annual Conference
of the Australian Tax Teachers Association
24 January 2008

This paper is essentially a "second instalment" to the paper presented at the 19th Annual Conference of the Australian Tax Teachers Association held in 2007.[1] That paper discussed the relevance of subjective purpose or intention in drawing the conclusion under s 177D of the general anti-avoidance provisions in Pt IVA of the *Income Tax Assessment Act 1936* (Cth) (the 1936 Act). The main focus of this paper is to discuss the relevance of subjective intention in deciding whether or not a taxpayer has obtained a tax benefit in connection with a scheme for the purposes of the definition in s 177C of Pt IVA. The paper also discusses the obviously related issue of what other factors may be relevant to the operation of the definition.

At the outset, it must be acknowledged that there is a degree of uncertainty as to how subjective intention is to be determined. The position taken in the paper presented at last year's conference was that regard can be had to a person's actual state of mind, as well as to all the known circumstances in determining subjective intention. A conclusion as to subjective intention can therefore be drawn from direct evidence given by a person, as well as by inference from the known circumstances. However, a person's testimony is not decisive

[1] A revised version of the paper titled "Part IVA: The relevance of subjective purpose in drawing the conclusion under section 177D" is being published in the forthcoming *Journal of The Australasian Tax Teachers Association*.

of that conclusion and must be examined against and judged in light of the known circumstances of a case. Put in this way, subjective intention could more accurately be referred to as subjective intention determined objectively.[2]

It may also be noted at the outset that a leading textbook[3] adopts the proposition that it appears that subjective intentions of the parties who enter into or carry out a scheme may be taken into account in determining what might reasonably be expected to occur for the purposes of s 177C(1). As support for this proposition the authors cite the High Court case of *FCT v Spotless Services*.[4] The issue of the relevance of subjective intention in determining whether a taxpayer has obtained a tax benefit has also been dealt with in other cases but not in a consistent way. Before undertaking a review of those cases, an outline of Pt IVA is provided and some observations are made on the definition in s 177C.

## OUTLINE OF PT IVA

The application of the general anti-avoidance provisions in Pt IVA is governed by s 177D. Basically, the provisions can apply to a scheme where:

(a) a taxpayer has obtained a tax benefit in connection with the scheme, and

(b) having regard to the factors listed in s 177D(b), it would be concluded that a person who entered into or carried out that scheme, or a part of it, did so for the purpose of enabling the taxpayer to obtain a tax benefit in connection with the scheme.

The provisions of Pt IVA are not, however, self-executing and do not simply apply of their own force. To enliven the provisions the Commissioner of Taxation must first exercise the discretion under s 177F to make a determination to, broadly speaking, cancel a tax benefit to

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[2] See further the forthcoming article "Part IVA: The relevance of subjective purpose in drawing the conclusion under section 177D" at 4-7.
[3] *Australian Taxation Law*, Woellner, Barkoczy, Murphy and Evans, 17th ed 2007, CCH at page 1,579 para 25-620.
[4] [1996] HCA 34; (1996) 186 CLR 404 at 424.

which Pt IVA applies. The making of such a determination is therefore the "pivot" upon which the operation of Pt IVA turns.[5]

Under s 177F(1), there are two prerequisites to the Commissioner being able to exercise the discretion to make a Pt IVA determination. The two prerequisites are:

1 A tax benefit has been obtained by a taxpayer in connection with a scheme; and

2 The scheme is one to which Pt IVA applies.

It is the first of these prerequisites that is relevant to this paper.

## TAX BENEFIT OBTAINED BY A TAXPAYER IN CONNECTION WITH A SCHEME

Section 177C(1) defines the expression "the obtaining by a taxpayer of a tax benefit in connection with a scheme" (which expression is now referred to in the short form "tax benefit") as:

> (a) an amount not being included in the assessable income of the taxpayer of a year of income where that amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out;[6] or
> (b) a deduction being allowable to the taxpayer in relation to a year of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out; or
> (ba) a capital loss being incurred by the taxpayer during a year of income where the whole or a part of that capital loss would not have been, or might reasonably be expected not to have been, incurred by the taxpayer during the year of income if the scheme had not been entered into or carried out;[7] or
> (bb) a foreign income tax offset being allowable to the taxpayer where the whole or a part of that foreign income tax offset would not have been allowable, or might

[5] *FCT v Spotless Services Ltd* [1996] HCA 34; (1996) 186 CLR 404 at 413.
[6] To avoid doubt, s 177C(4) provides that s 177C(1)(a) applies to a scheme if an amount of income is not included in a taxpayer's assessable income in an income year, and an amount would have been included, or might reasonably be expected to have been included, in the assessable income if the scheme had not been entered into or carried out, but instead the taxpayer or any other taxpayer makes a discount capital gain for that or any other income year.
[7] The scheme must have been entered into after 3 pm AEST on 29 April 1997.

reasonably be expected not to have been allowable, to the taxpayer if the scheme had not been entered into or carried out;[8]

and, for the purposes of this Part, the amount of the tax benefit shall be taken to be:

(c) in a case to which paragraph (a) applies—the amount referred to in that paragraph; and

(d) in a case to which paragraph (b) applies—the amount of the whole of the deduction or of the part of the deduction, as the case may be, referred to in that paragraph; and

(e) in a case to which paragraph (ba) applies—the amount of the whole of the capital loss or of the part of the capital loss, as the case may be, referred to in that paragraph; and

(f) in a case where paragraph (bb) applies—the amount of the whole of the foreign income tax offset or of the part of the foreign income tax offset, as the case may be, referred to in that paragraph.

Section 177CA has the effect of also including within the definition of "tax benefit" an amount of withholding tax that a taxpayer would have, or could reasonably be expected to have, been liable to pay.[9] There are further provisions in s 177E that apply to tax benefits obtained in connection with dividend stripping schemes.[10]

If a tax benefit is attributable to the making of an agreement, choice, declaration, election, selection or choice, the giving of a notice or the exercise of an option that is expressly provided for by the Act, then the tax benefit is excluded from the definition by virtue of s 177C(2). This will be so, however, only if the relevant scheme was not one entered into or carried out for the purposes of creating any circumstance or state of affairs the existence of which is necessary to enable the declaration, agreement, election, selection, choice, notice or option to be made, given or exercised: s 177C(3).

Central to each paragraph of the definition of "tax benefit" in s 177C(1) are what may be described as two limbs that are worded as alternatives. The two alternative limbs encompass the concepts of:

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[8] The scheme must have been entered into after 4 pm AEST on 13 August 1998.
[9] The withholding tax must not have been payable on an amount paid after 7.30 pm AEST on 20 August 1996.
[10] There are also provisions in s 177EA that apply to imputation benefits from franking credit schemes.

(1) What "would have happened" if a scheme was not entered into or carried out (the first limb); or

(2) What "might reasonably be expected to have happened" if the scheme was not entered into or carried out (the second limb).

Although worded as alternatives, it would seem that the operation of the second limb, by incorporating a criterion of "might reasonably be expected to have happened", covers whatever ground is covered by the first limb. This is because something that "might reasonably be expected to have happened" would surely be encompassed within that which "would have happened".[11] On this view, the first limb could be regarded as being otiose although this is an outcome that is unlikely to find favour with the courts.[12] Further, the use of the words "might" and "expected" in the second limb suggests that it does not require as much a degree of certainty to be satisfied, and is therefore not as restrictive, as the first limb that uses the word "would". The inclusion of the word "reasonably" in the second limb, however, adds a qualification to this more expansive operation of the limb.

It has been accepted in the cases on Pt IVA that the operation of the two limbs requires that a prediction or hypothesis be made as to what would or might reasonably be expected to have happened if the scheme in question had not been entered into or carried out. The outcome of this prediction or hypothesis has been described as an "alternative postulate", with the result that the inquiry directed by Pt IVA requires a comparison to be made between the scheme and this "alternative postulate" to determine whether a tax benefit has been obtained.[13]

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[11] It may be noted that the *Macquarie Dictionary* includes "may be expected or supposed to" as one of the meanings of the word "would".

[12] See for example *Tourism Holdings Australia Pty Ltd v CofT(NT)* [2005] NTCA 3; 2005 ATC 4177 at 4204 [136]; *FCT v Consolidated Press Holdings Ltd* [2001] HCA 32; (2001) 207 CLR 235 at 276 [137]; 2001 ATC 4343 at 4367 [137].

[13] *FCT v Hart* [2004] HCA 26; (2004) 217 CLR 216 at 243 [66] per Gummow and Hayne JJ.

However, despite the two limbs being central to the definition of a "tax benefit" in s177C(1), the section itself is silent and does not provide any indication on what it is that must or may be taken into account in making the prediction or hypothesis required by each limb. This can be readily contrasted with s 177D that specifically lists eight factors in subparagraphs (i) to (viii) of s 177D(b) to which regard must be had in drawing the required conclusion about a person's purpose in entering into or carrying out a scheme or any part of it. Having noted this, it must also be pointed out that none of those eight factors expressly refer to subjective intention as being able to be considered in drawing that conclusion.

Further guidance on the issues of the operation of the two limbs, of what must or may be taken into account in answering the question posed by each of the limbs, and of the relevance (if any) of a person's subjective intention is provided by the High Court in the two cases of *FCT v Peabody*[14] and *FCT v Spotless Services*[15].

## THE RELEVANT HIGH COURT CASES: *PEABODY* & *SPOTLESS*

### *Peabody*

*FCT v Peabody*[16] basically involved the application of Pt IVA to a scheme involving a conversion of purchased shares that resulted in their value shifting to other shares already held by the trustee of a family trust of which the taxpayer was a beneficiary. The trustee, TEP Holdings Pty Ltd (TEP) held 62% of the shares in the Pozzolanic group of companies. The only directors and shareholders of TEP were the taxpayer and Mr Peabody. The remaining 38% of the shares in the group were held by Mr Kleinschmidt. Mr Peabody planned to float the group to the public and to facilitate the float, Mr Kleinschmidt agreed to sell his 38% shareholding to Peabody interests. The sale price of $8.6m was based on the

[14] (1994) 181 CLR 359.
[15] [1996] HCA 34; (1996) 186 CLR 404.
[16] (1994) 181 CLR 359.

group having a net worth of about $24m. It was estimated that the public float would be capitalised at a figure well in excess of $24m.

The parties thought that commercial difficulties might arise if the float prospectus disclosed that the price of the shares offered to the public was well in excess of the price for which the Peabody interests had recently bought Mr Kleinschmidt's shares. To circumvent this problem, TEP acquired a shelf company Loftway Pty Ltd (Loftway) to purchase Mr Kleinschmidt's shares. The purchase was financed by Loftway issuing redeemable preference shares that considerably reduced the cost of finance. Special resolutions were then passed converting the shares bought from Mr Kleinschmidt to "Z" class preference shares that had no voting rights. The effect of this was that the shares acquired from Mr Kleinschmidt, that previously had a value of at least $8.6m, became preference shares with a total value of less than $500, and TEP's interest in the group increased from 62% to 100% without any change in the number of shares it held.

Another effect of what was done was to avoid the possible application of the former s 26AAA of the 1936 Act. This section would have included in assessable income a profit arising from a sale by TEP into the public float of the unconverted shares, if the sale had happened within 12 months of their purchase. The Commissioner relied on the former s 26AAA and made a Pt IVA determination that included in the taxpayer's assessable income one-third of the profit that would have been made from such a sale.

In a unanimous decision of all seven justices, the High Court[17] upheld the decision of the Full Federal Court that the taxpayer had not obtained a tax benefit. In the Full Federal Court,[18]

[17] (1994) 181 CLR 359 at 385.

Hill J (with whom Ryan and Cooper JJ agreed) concluded that no tax benefit was obtained by the taxpayer because it could not be reasonably expected that any amount would have been included in her assessable income if the scheme identified had not been entered into or carried out. The hypothesis that in the absence of the scheme the purchaser of the Kleinschmidt shares would have been TEP was unreasonable.[19] Rather, the only reasonable expectation that could be formed was that a company would have been the purchaser of the shares and not TEP as trustee.

In reaching this conclusion, Hill J relied on the fact that the method actually used to finance the share purchase involved the issue redeemable preference shares that, in turn, resulted in a lower cost of financing. This financing method required a company to issue the redeemable preference shares to a financier, and the payment of a dividend by the borrowing company to the financier that would be received by it as a rebatable dividend. To achieve this financing outcome, the purchaser of the Kleinschmidt shares had to be Loftway or some similar company, and not TEP as trustee as the dividend rebate was not available to a trustee of a trust.[20]

Although the High Court agreed with Hill J's conclusions, the Court specifically pointed out that the difficulty for the Commissioner was not in establishing that a tax benefit was obtained, but in establishing that the tax benefit was obtained by the taxpayer in the relevant income year.[21] The High Court said it was apparent that Loftway or some other company had to be the purchaser of the shares to obtain the cheaper finance for the purchase through redeemable preference shares. The Court noted that it was not contested that the decision to

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[18] *Peabody v FCT* (1993) 40 FCR 531.
[19] (1993) 40 FCR 531 at 548.
[20] (1993) 40 FCR 531 at 547-548.
[21] *FCT v Peabody* (1994) 181 CLR 359 at 384.

finance the purchase in this way was other than a "rational, commercial decision"[22], and that this financing method was found below to be "entirely explicable upon a commercial basis".[23]

In rejecting the Commissioner's contention that the purchaser might reasonably be expected to have been TEP had there been no devaluation of the Kleinschmidt shares, the High Court said of the second limb in s 177C(1)(a):[24]

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

The High Court took the view that since the purchase of the Kleinschmidt shares had to be financed, regardless of whether or not they were subsequently converted and devalued, any uncertainty as to the entitlement to a rebate in respect of dividends paid on the redeemable preference shares made it unlikely that TEP would have been chosen as the purchaser of the Kleinschmidt shares.[25] Instead, the Court found that any profit obtained from the sale of the Kleinschmidt shares, had their devaluation not taken place, would have been made by Loftway.[26]

Indeed, the High Court went further and pointed out that there was no reason to suppose that, had the devaluation not taken place and had the profit been made by Loftway, the profit would have flowed, or might reasonably be expected to have flowed, to TEP and hence to the taxpayer in the relevant income year. In other words, there was no reasonable expectation

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[22] (1994) 181 CLR 359 at 384-385.
[23] (1994) 181 CLR 359 at 386.
[24] (1994) 181 CLR 359 at 385.
[25] (1994) 181 CLR 359 at 385.
[26] (1994) 181 CLR 359 at 385-386.

that Loftway would have declared dividends that would have reached the family trust in that income year.[27]

It is of particular interest that in making the required prediction to identify a reasonable expectation, the approach of the High Court was to determine predicted events against the background of the evidence led by persons connected with the scheme and the assumption that "rational, commercial" decisions were made by those persons. In deciding whether the prediction being made is sufficiently reliable, the High Court also indicated a preparedness to take into account the tax implications of the predicted events by considering the entitlement to a tax rebate in the predicted circumstances.

The High Court and the Full Federal Court reached their conclusions without expressly referring to any evidence of the subjective intention of any of the persons involved in the share devaluation scheme. However, in interpreting the second limb of s 177C(1)(a) at first instance, O'Loughlin J relied on a passage from the judgment of the Full Federal Court in *FCT v Arklay*[28]. In that case, the Full Court was concerned with the meaning to be given to the expression "circumstances existed by reason of which it was reasonable to expect" in s 82AAS(2)(a) of the 1936 Act. In a joint judgment, the Full Court said:[29]

> We are of the opinion that the phrase with which we are concerned in the context of sec. 82AAS of the Act requires a determination whether or not circumstances exist by reason of which the decision-maker is able to expect on reasonable grounds that superannuation benefits would be provided as stipulated in the section. That test is an objective one. However, in applying the test the decision-maker, in considering the circumstances, should have regard to any relevant matters concerning the taxpayer personally. Put another way our understanding of the meaning of the expression is one which involves the application of an objective test, but, as one of the concomitant elements of that test, the subjective intentions of the taxpayer may be relevant.

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[27] (1994) 181 CLR 359 at 386.
[28] 89 ATC 4563.
[29] 89 ATC 4563 at 4567.

Although O'Loughlin J's decision in *Peabody* that the taxpayer had obtained a tax benefit was overturned, neither the Full Federal Court nor the High Court indicated any disapproval of his Honour J's reliance on this passage. The statement supports that while the operation of the second limb involves an objective test, the subjective intentions of persons involved in a scheme is a relevant factor that can be considered in applying the test.

***Spotless***

The taxpayers in *FCT v Spotless*[30] were Australian resident companies with approximately $40m in surplus funds available for short-term investment. They considered a number of proposals for investing "off-shore", including in the Cook Islands. After rejecting the other proposals, the taxpayers decided to invest the surplus funds in the Cook Islands. They made the investment by sending an officer to the Cook Islands who drew a cheque there for the amount invested and delivered it to a Cook Islands bank. On maturity the invested funds plus interest (less Cook Islands withholding tax levied at 5%) were paid to the taxpayers in Australia.

In making the investment in this way, the taxpayers sought to achieve an increased after tax return by taking advantage of the former s 23(q) of the 1936 Act. Under that section, the interest income would be exempt from tax in Australia if it was sourced in the Cook Islands and was not exempt from tax there. Even though the Cook Islands interest rate actually payable was about 4% below the Australian bank bill rate, the after tax return would have been greater than that achievable by investing in Australia because of the Cook Islands interest being exempt from tax in Australia. The Commissioner made determinations under

[30] [1996] HCA 34; (1996) 186 CLR 404.

Pt IVA and issued amended assessments that included in the taxpayers assessable income the amount of the Cook Islands interest less the withholding tax levied on it.

The High Court held that the taxpayers had obtained a tax benefit in connection with a scheme to which Pt IVA applied. The tax benefit was an amount equal to the Cook Islands interest less withholding tax, and the scheme consisted of the particular means adopted by the taxpayers to obtain the maximum return on the invested funds after paying all applicable costs, including tax. Having regard to the factors in s 177D(b) as "objective facts", the Court found that the taxpayers' dominant purpose in entering into and carrying out that scheme was the obtaining of a tax benefit.[31]

Before the High Court, the taxpayers contended that the Full Federal Court had erred in holding that, if the scheme had not been entered into or carried out, an amount of income from the use of the surplus funds would have been, or could reasonably be expected to have been, included in the assessable income of the taxpayers for the income year. The taxpayers submitted that had they chosen not to make the investment they made there was no possible way of knowing whether the amount actually derived from the investment, or any other particular amount, would have been included in their assessable income. Therefore, if they had not entered into the scheme, there would have been no interest and no amount would have been included in their assessable income.

In a joint judgment, Brennan CJ, Dawson, Toohey, Gaudron, Gummow and Kirby JJ rejected the taxpayers' submission. Their Honours noted that it relied on the use in s 177C(1)(a) of the expression "an amount not being included" where, but for the scheme, "that amount"

[31] [1996] HCA 34; (1996) 186 CLR 404 at 422-423.

(being the amount of interest actually received from the Cook Islands) would or might reasonably have been expected to have been so included. Their Honours' response was as follows:[32]

> In our view, the amount to which par (a) refers as not being included in the assessable income of the taxpayer is identified more generally than the taxpayers would have it. The paragraph speaks of the amount produced from a particular source or activity. In the present case, this was the investment of $40 million and its employment to generate a return to the taxpayers. It is sufficient that at least the amount in question might reasonably have been included in the assessable income had the scheme not been entered into or carried out.
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> Section 177D presents the question whether, having regard to the eight categories of matter identified in par (b), posited as objective facts, in the present case a reasonable person would conclude that the taxpayers entered into the scheme for the dominant purpose of enabling each to obtain a "tax benefit" in the necessary sense. A particular application of the definition provision of "tax benefit" in s 177C(1) thus involves consideration of the particular materials answering the various categories in par (b) of s 177D.

Their Honours pointed out that the taxpayers were determined to place $40m in short-term investment. In the absence of any other acceptable alternative proposal for off-shore investment at interest, the reasonable expectation was that the taxpayers would have invested the funds in Australia. The amount then derived from that Australian investment would have been included in the taxpayers' assessable income.[33]

The context of the second paragraph in the passage quoted from their Honours' judgment indicates that determining whether a tax benefit exists involves considering the eight factors listed in s 177D(b) "as objective facts". It seems clear from this that a person's subjective intention cannot be considered, at least directly, in determining the existence of a tax benefit because it is not a factor explicitly included in the listed factors. However, this is not entirely free from doubt as a result of their Honours' reference to the taxpayers being "determined" to

[32] [1996] HCA 34; (1996) 186 CLR 404 at 424.
[33] [1996] HCA 34; (1996) 186 CLR 404 at 424.

make a short term investment of the $40m. Such a state of "determination" would seem to be based on a person's actual state of mind and subjective intention.

## OTHER RELEVANT CASES

With the exception of *WD & HO Wills (Australia) Pty Ltd v FCT*[34], all the other cases to be discussed were decided after *Spotless*. Included in those cases are three decisions of the Administrative Appeals Tribunal. One of these decisions, *Ryan v FCT*[35] resulted from a "test case" that was heard by a justice of the Federal Court sitting as the Presidential Member of the Tribunal.

### *WD & HO Wills*

The taxpayer in *WD & HO Wills (Australia) Pty Ltd v FCT*[36] carried on the business of manufacturing and marketing tobacco products. It was unable to obtain insurance cover on the open market against the health risks arising from the consumption of its products, and so it decided to set up a wholly owned subsidiary to provide such cover as a "captive insurer". The subsidiary was incorporated in Singapore and was managed by a third party management company. The taxpayer paid insurance premiums to the captive insurer subsidiary for the insurance cover and claimed deductions under s 51(1) of the 1936 Act for the amounts paid. The subsidiary made substantial profits because no claims were made against its insurance policies by the taxpayer. The Commissioner disallowed the deductions claimed by the taxpayer and, in the alternative, relied on Pt IVA to support the disallowance.

Before the Federal Court, the taxpayer contended that Pt IVA did not apply because, inter alia, it had not obtained a tax benefit in connection with any scheme. The taxpayer submitted

[34] (1996) 65 FCR 298; 96 ATC 4223.
[35] 2004 ATC 2181.
[36] (1996) 65 FCR 298; 96 ATC 4223.

that had the health risks not been insured with the Singaporean captive insurer subsidiary, it was reasonable to expect that cover would have been obtained through some other means, such as a captive insurer located elsewhere, even in Australia. Alternatively, it was submitted that another course the taxpayer may have taken was to self insure and claim deductions for insurance liabilities incurred but not reported.[37]

Sackville J dismissed the taxpayer's appeal and held that, although the taxpayer had obtained a tax benefit consisting of the deductions for the premiums paid and this tax benefit was connected with a scheme, the scheme was not one to which Pt IVA applied. This was because the scheme was not entered into or carried out for the dominant purpose of enabling the taxpayer to obtain a tax benefit.

In view of this, Sackville J dealt only briefly with the issue of whether the taxpayer had obtained a tax benefit in connection with the scheme. His Honour did this by pointing out that the difficulty in the case was that the evidence did not explore the question of what would have happened had the scheme not been entered into or carried out. He considered that to a large extent the answer to that question must be speculative. Of the various alternatives posed by the taxpayer's counsel, his Honour said:[38]

> are all possibilities, but I could not regard any of them as a reliable prediction, at least in the absence of further evidence. It must be remembered that the options available to [the taxpayer] were limited, because the health risk was not insurable on the open market. … Moreover, s 14ZZO of the *Taxation Administration Act 1953* (Cth) imposes upon an appellant the burden of proving that the taxation decision under challenge is excessive.

[37] (1996) 65 FCR 298 at 326; 96 ATC 4223 at 4245.
[38] (1996) 65 FCR 298 at 339; 96 ATC 4223 at 4256.

On the evidence before him, Sackville J would have concluded that a reasonable prediction, had the scheme not been entered or carried out, was that the taxpayer would have simply taken the risk of claims being made against it by persons claiming to be adversely affected by its products.[39] However, the evidence did not show the taxpayer would have claimed deductions for insurance liabilities incurred but not reported. In the absence of such further evidence, his Honour would have held that the taxpayer obtained a tax benefit.[40]

***CC (New South Wales)***

The absence of evidence on what would or might have happened in the absence of a scheme was also significant in the taxpayer's failed challenge to Pt IVA determinations in *CC(New South Wales) Pty Ltd (in liq) v FCT*.[41] The taxpayer was a construction company that was appointed to manage the construction of a multi-storey residential apartment building project being undertaken by Quay Apartments Pty Ltd (QA) as trustee of a unit trust. The principal unit holder and financier of the unit trust went into receivership and the taxpayer's parent, Concrete Constructions Pty Ltd (CC), acquired the units in the trust and the shares in QA, and assumed all of QA's liabilities. At that time, the unit trust had accumulated tax losses of $50,000. The apartment building project was completed and at the end of the income year the accounts of the unit trust showed accumulated tax losses of $6.427 million.

The taxpayer then secured other construction management contracts and purported to enter into those contracts as agent for QA, in that company's capacity as trustee of the unit trust, under an undisclosed principal-agent agreement. The taxpayer claimed that the income paid to it under the contracts over four income years was derived by QA and could be offset against the past year tax losses of the unit trust. The Commissioner made determinations

[39] (1996) 65 FCR 298 at 339; 96 ATC 4223 at 4256.
[40] (1996) 65 FCR 298 at 339; 96 ATC 4223 at 4256.
[41] *CC (New South Wales) Pty Ltd (in liq) v FCT* 97 ATC 4123.

under Pt IVA and issued amended assessments that included the construction management contract income in the assessable income of the taxpayer.

The taxpayer's appeal challenging the amended assessments was dismissed by Sackville J in the Federal Court. His Honour upheld the Commissioner's argument that the agency agreement made between the taxpayer and QA was ineffective in law to create the relationship of agent and principal. Although it was not strictly necessary to do so, his Honour also decided that, had the agency agreement been effective, the appointment of the taxpayer as agent of QA and the performance of the construction management contracts was a scheme to which Pt IVA would have applied.[42] His Honour further concluded that the tax benefit obtained by the taxpayer was the amount of the construction management contract income. This conclusion was based on the ground that it could reasonably be expected that, in the absence of the scheme which (if effective) diverted that income to QA , the taxpayer would have continued to derive the income from the contracts.[43]

In reaching his conclusion, Sackville J rejected a submission by the taxpayer that, had the scheme not been entered into, other steps would or might have been taken by the taxpayer to reduce the assessable income derived by it from the construction management contracts. The taxpayer would thereby have achieved a similar result to that achieved by the scheme. His Honour pointed out that there was no evidence before the Court that any such steps would have been taken by the taxpayer had the scheme not been entered into. Furthermore, there was nothing in the evidence to suggest that a conclusion should be reached other than that the

[42] However, Sackville J's reasons for holding that Pt IVA would have applied were stated more briefly than if the application of Pt IVA had been the only live issue in the case.
[43] 97 ATC 4123 at 4149.

taxpayer would have continued to derive the construction management contract income if the scheme had not been entered into.[44]

***Essenbourne***

The Court in *Essenbourne Pty Ltd v FCT*[45] adopted what appears to be a more lenient approach to the issue of what would or might have happened in the absence of a scheme, when compared with the approach of Sackville J in both *WD & HO Wills* and *CC (New South Wales)*. In *Essenbourne*, the taxpayer was the owner of a motor dealership business and employed three sons of the family of its shareholders. Since about 1983 the taxpayer paid the sons an annual salary of $25,000 each, which was less than salaries likely to be paid in other dealerships. The low salaries enabled the taxpayer to make contributions to a superannuation fund and an employee share plan that had been established by the taxpayer. In each income year from 1992 to 1996 (except 1994), the taxpayer made contributions to the superannuation fund that ranged from $180,000 to $215,000 a year on behalf of family members, including the three sons. In 1994, the taxpayer made contributions of $225,000 to the employee share plan.

On 30 June 1997, the taxpayer established an "employee incentive trust" in which the three sons and the trustee of the superannuation fund were unit holders. On that day, the taxpayer made of contribution of $252,000 to the incentive trust. It claimed a deduction under s 51(1) of the 1936 Act for the contribution and this deduction was disallowed by the Commissioner. The Commissioner subsequently made a Pt IVA determination to support the disallowance of the deduction and the taxpayer subsequently appealed to the Federal Court to challenge that disallowance.

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[44] 97 ATC 4123 at 4149.
[45] [2002] FCA 1577; 2002 ATC 5201.

Kiefel J allowed the appeal and held that the taxpayer had not obtained a tax benefit in connection with a scheme. His Honour rejected the Commissioner's submission that, if the scheme had not been entered into, the reasonable expectation was that the taxpayer could not have claimed a deduction for the $252,000 contributed to the incentive trust.[46] Instead he was of the view that it was not possible to conclude that the taxpayer would have done nothing and retained the substantial profits made in 1997, particularly given its history of contributions for the family members as employees.

In Kiefel J's view, alternative steps that might have been taken by the taxpayer were the payment of increased salaries or superannuation contributions and these all involved deductions for the taxpayer. Of these alternatives, his Honour considered that the taxpayer would likely have paid superannuation contributions as it had before.[47] He therefore accepted the taxpayer's submission that, if the scheme had not been carried out, it could reasonably be expected a contribution to the superannuation fund would have been made with a consequent tax deduction.[48]

***MacArthur***

The taxpayer in *FCT v MacArthur*[49] had been employed by the Department of Main Roads (the DMR) as a civil engineer from 1972 until 1982 when he resigned and started contract work overseas. He returned to Australia in 1986 and acquired a shelf company in which he and his wife were the directors and shareholders. The company was to be used to get engineering consulting work and to facilitate superannuation for the taxpayer and his wife.

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[46] [2002] FCA 1577; 2002 ATC 5201 at 5211 [40].
[47] [2002] FCA 1577; 2002 ATC 5201 at 5212 [45].
[48] [2002] FCA 1577; 2002 ATC 5201 at 5212 [44].
[49] 2003 ATC 4826.

During the relevant income years, the company entered into contracts with the DMR for the provision of professional services to be supplied by the taxpayer. The Commissioner made Pt IVA determinations including in the assessable income of the taxpayer the income derived by the company under the contracts with the DMR.

On a review before the Administrative Appeals Tribunal[50] it was held that, even though there was a scheme involving the use of the company, the taxpayer had not obtained a tax benefit in connection with the scheme. The Tribunal was of the view that there was no basis for finding that an amount would have been included in the taxpayer's assessable income if the scheme had not been entered into or carried out.[51] In this regard, it was influenced by the fact that there had not been a pre-existing contract of employment between the taxpayer and the DMR.[52] The Tribunal was therefore not satisfied that, if the company had not entered into the contracts with the DMR, the taxpayer would or might reasonably be expected to have entered into a contract with the DMR whereby the taxpayer derived fees payable under that supposed contract.[53]

The Commissioner's appeal to the Federal Court[54] was allowed on the ground that there was every reason to expect that the taxpayer would have continued to practise his profession in his own name in the absence of the company. Dowsett J thought it was clear that the Tribunal did not consider whether the taxpayer "might reasonably" have been expected to contract with the DMR as an alternative to what "would have" happened in the company's absence. In view of this error, his Honour ordered the case be remitted to the Tribunal for further consideration.

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[50] *MacArthur v FCT* 2002 ATC 2212.
[51] 2002 ATC 2212 at 2215 [13].
[52] 2002 ATC 2212 at 2215 [11].
[53] 2002 ATC 2212 at 2215 [14].
[54] *FCT v MacArthur* 2003 ATC 4826.

In his reasons, Dowsett J made the following observation on the alternative "might reasonably be expected" second limb in s 177C(1)(a):[55]

> Specific evidence of that possibility was not necessary. It was an available inference from the evidence…

Whilst his Honour's decision recognises the second limb as having an alternative and broader operation than the first limb, this observation suggests that a "possibility" can be sufficient to satisfy the operation of the second limb. This would seem to overlook and be in conflict with what the High Court said in *Peabody* that a reasonable expectation requires more than a possibility.[56] What is involved is a prediction that is sufficiently reliable to qualify as reasonable.[57]

Dowsett J's approach in finding that an alternative postulate existed for the second limb even in the absence of specific evidence on the issue, but rather by drawing an inference from the evidence, can also be contrasted with the approach taken by Sackville J in *WD & HO Wills* and *CC (New South Wales)*. Although not addressed by Dowsett J, the difference between these approaches could be justified by bearing in mind the party seeking to rely on the alternative postulate. In *WD & HO Wills* and *CC (New South Wales)* the party was the taxpayer who, as Sackville J pointed out, bears the onus of proving that an assessment is excessive. However, in *MacArthur* the party was the Commissioner who does not bear such an onus.[58] As a result of Dowsett J's approach, it seems that any evidentiary burden on the

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[55] 2003 ATC 4826 at 4834 [25].
[56] (1994) 181 CLR 359 at 385
[57] It is perhaps worth pointing out that the *Peabody* prediction approach was not expressly approved, applied or even mentioned by the High Court in the subsequent cases of *Spotless*, *FCT v Consolidated Press Holdings Ltd* [2001] HCA 32; (2001) 207 CLR 235; 2001 ATC 4343, or *FCT v Hart* [2004] HCA 26; (2004) 217 CLR 216.
[58] See *FCT v Dalco* (1990) 168 CLR 614 at 624-625, *Macmine Pty Ltd v FCT* (1970) 53 ALJR 362 at 366, 371 & 381, *McCormack v FCT* (1970) 143 284 at 303, 306 & 323, and *Gauci v FCT* (91975) 135 CLR 81 at 89.

Commissioner with respect to the issue can be satisfied by an inference drawn from other available evidence.

***Ryan***

In *Ryan v FCT*,[59] the taxpayer and his wife were shareholders and directors of a company that carried on a business of providing information technology services to clients for a fee. The skills and expertise that lay behind those services were provided by the taxpayer and his wife provided some secretarial assistance. The company was also the trustee of a superannuation fund of which the taxpayer and his wife were members. In the three income years in question, the company's fee income was paid partly to the taxpayer and his wife and the rest was paid as superannuation contributions made on their behalf. The Commissioner made Pt IVA determinations for the three income years that included in the taxpayer's assessable income the difference between the fees received by the company, and the income paid to the taxpayer by the company.

The taxpayer challenged the Pt IVA determinations before the Administrative Appeals Tribunal, presided over by Downes J, on grounds that included that he had not obtained a tax benefit within s 177C(1)(a). The major area of contention was the superannuation contributions made on behalf of his wife. In this regard, the taxpayer gave evidence that if those contributions had not been paid by the company, it would have paid similar amounts of superannuation contributions on his behalf.[60] In opposing the taxpayer's challenge, the Commissioner made two significant concessions that proved crucial to the outcome in the case.

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[59] 2004 ATC 2181.
[60] 2004 ATC 2181 at 2185-2186 [25-26].

The first concession was that the Commissioner did not contend that amounts received by the company would or might reasonably be expected to have been included in the taxpayer's assessable income. This was because he accepted that Pt IVA scheme did not include the agreements made between the company and its clients.[61] The second concession made was that the Commissioner accepted that if all the superannuation contributions made had been applied to the taxpayer's behalf there would have been no grounds to apply Pt IVA.[62] Despite these concessions, the Commissioner contended the taxpayer had obtained a tax benefit consisting of all or most of the company's fees since all of the visible services provided by the company were the product of the efforts or personal exertion of the taxpayer. Therefore, the amounts of those fees would or might reasonably have been paid by the company to the taxpayer in the absence of the scheme.[63]

Downes J rejected the Commissioner's contention and decided that Pt IVA did not apply because the taxpayer had not obtained a tax benefit. At the outset, his Honour stated his approach to the issue as follows:[64]

> Although Part IVA is concerned more with objective determinations of what might have happened and the purpose for what did happen, rather than the states of mind of the actors involved, it is nevertheless appropriate to consider these matters in their context …

Accordingly, his Honour considered and accepted the taxpayer's evidence about what would have happened if the company had not made the superannuation contributions on behalf of his wife. His Honour found that the primary consideration of the company, through its directors, was to deal with its income by dividing it between the taxpayer and his wife and superannuation contributions on their behalf. Downes J therefore concluded that if the

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[61] 2004 ATC 2181 at 2183 [6].
[62] 2004 ATC 2181 at 2184 [12].
[63] 2004 ATC 2181 at 2184 [16].
[64] 2004 ATC 2181 at 2183 [8].

superannuation contributions paid for the taxpayer's wife were not made then they would have been made on the taxpayer's behalf rather than paid to him as income. There was no reason to think that any of the parties would have even contemplated that the amount would be paid as the taxpayer's income.[65]

***McCutcheon***

*McCutcheon & Anor v FCT*[66] was also decided by the Administrative Appeals Tribunal but the approach taken by the Tribunal differs considerably from that taken by the Tribunal in *Ryan*. The case involved husband and wife taxpayers who were the primary beneficiaries under a discretionary trust that had sold two businesses resulting in the trust having a net income of approximately $3.2m. The taxpayers and their related trusts then entered into a series of steps and transactions to reduce the tax payable on the sale proceeds of the businesses.

The steps and transactions were undertaken pursuant to a "New Venture Income" scheme that, unbeknown to the taxpayers, had been promoted by their lawyers. Basically, the steps and transactions included the taxpayers' related trusts making distributions to entities associated with the lawyers, which had carry-forward tax losses that would offset the assessable income resulting from the distributions. Amounts equal to the distributions, less the lawyers' fees and costs, were then gifted back to the taxpayers' related trusts. The Commissioner made Pt IVA determinations that included in the assessable incomes of each of the taxpayers one-half of the discretionary trust's net income of $3.2m.

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[65] 2004 ATC 2181 at 2186 [28].
[66] 2006 ATC 2280.

The taxpayers sought a review of the Pt IVA determinations in the Tribunal. They did not dispute the existence of a scheme but contended, inter alia, that they had not obtained a tax benefit in connection with the scheme. The taxpayers argued that in view of the pattern of previous distributions made by the discretionary trust, which included distributions to other entities and persons, it was not reasonable to expect that they would have been the only recipients of the trust's $3.2m net income in the relevant income year, if the scheme had not been entered into.[67] In their evidence in chief, it was asserted that the trust would never have distributed to either of them a substantial portion of that income.[68]

The Commissioner's responding contention was that the $3.2m might reasonably have been expected to have been included in the assessable income of each taxpayer in equal shares since they ultimately owned and controlled the discretionary trust and related entities, and also ultimately retained the use and enjoyment of that amount.[69] The Commissioner argued that a consideration of the pattern of previous trust distributions did not require a different conclusion.[70]

The Commissioner also contended that the onus on the taxpayers under s 14ZZK(b) of the *Taxation Administration Act 1953* (Cth), of proving the assessments made were excessive, had not been discharged by them. More specifically, the Commissioner argued that in the case of s 177C, the existence of the onus required evidence to be led by the taxpayers as to what would or might reasonably be expected to have happened had the scheme not been carried out. Subjective statements on the part of the taxpayers made in hindsight, that the trust would never have distributed a substantial portion of the trust's net income to the

[67] 2006 ATC 2280 at 2297 [54-55] & 2299 [67].
[68] 2006 ATC 2280 at 2292 [34].
[69] 2006 ATC 2280 at 2301 [80]
[70] 2006 ATC 2280 at 2302 [80].

taxpayer, did not amount to such evidence. Further, such statements represented an inadmissible opinion concerning an ultimate issue to be determined by the Tribunal and should be disregarded. The Commissioner also argued that in any event such evidence amounted to no more than speculation as to various "possibilities", which was not a sufficient discharge of the onus of proof in the case of s 177C.[71] Finally, it was argued that the taxpayers had led no evidence as to what distributions would have been made by the trust, had the scheme been entered into. The taxpayers' assertions of what might have happened were no more than statements of a possible alternative of the kind rejected by Sackville J in *WD &HO Wills.*[72]

The Tribunal decided that the taxpayers had obtained a tax benefit but rejected the Commissioner's initial contention that the full amount of the $3.2m would have been shared equally by the taxpayers. This was on the basis that the previous distribution history of the trust indicated that there were persons besides the taxpayers personally who received distributions from it. Despite this, the Tribunal further decided that there was no evidence before it on which it could act to determine what the taxpayers would have done had the scheme not been entered into. The Tribunal agreed with the Commissioner that evidence of subjective intention on the part of the taxpayers in their evidence in chief went to the ultimate issue and should be disregarded. This meant there was no evidence in the nature of the requisite *facta probantia* – facts that proved the ultimate issue – of what the taxpayers would have done if the scheme had not been entered into.[73]

The Tribunal took the view that evidence of prior year distributions from the trust did not, of itself, show what the taxpayers would have done in the relevant income year in the absence of

[71] 2006 ATC 2280 at 2302 [80].
[72] 2006 ATC 2280 at 2302 [80].
[73] 2006 ATC 2280 at 2322 [146].

the scheme. This was because those distributions involved significantly lower amounts than the $3.2m that mainly resulted from the sale of two businesses in the income year. The Tribunal therefore concluded that it would be speculative to adopt the taxpayer's argument, based on the pattern of previous trust distributions, to negate or reduce the amount of the tax benefit obtained as a result of entering into the scheme.[74] As a result, decided that the taxpayers had not discharged the onus of proof as it applies when the existence of a tax benefit under s 177C is challenged.

***Epov***

The taxpayer in *Epov v FCT*[75] was the managing director and shareholder of a company, Australia China Business Bureau Pty Ltd (ACBB). Over the 1996 to 1998 income years, ACBB made payments totalling approximately $3.5m to various entities, including the taxpayer and entities related to him. Of relevance was a payment of $71,000 in the 1996 year supposedly paid as a deposit for the purchase of a property, and payments totalling $999,000 in the 1998 year supposedly as loans to a related entity. The Commissioner included the $3.5m in the taxpayer's assessable income under original assessments and, in the alternative, relied on Pt IVA determinations.

The taxpayer's appeals to the Federal Court were partly allowed in respect of the 1996 and 1998 income years. Edmonds J held that the taxpayer had not obtained tax benefits within s 177C in those income years.[76] His Honour rejected the Commissioner's contention that it was a reasonable expectation that ACBB would have paid the amounts to the taxpayer or to someone else on behalf of, or for the individual benefit of, the taxpayer, if the scheme alleged had not been entered into or carried out.

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[74] 2006 ATC 2280 at 2322 [146].
[75] 2007 ATC 4092.
[76] 2007 ATC 4092 at 4102 [62] & [71].

Of the alleged tax benefit in the 1996 year, Edmonds J said the Commissioner's argument could not be accepted because there was no evidence to support it. He continued:[77]

> indeed, there is no evidence which would enable one to draw any inference of such a reasonable expectation. Whatever may be taken into account in determining the conclusion to be drawn under s 177D(b) as to the dominant purpose of a person in entering into or carrying out a scheme – the joint judgment of Gummow and Hayne JJ in *Commissioner of Taxation v Hart* (2004) 217 CLR 216 at [66] suggests that it goes beyond the matters in (i) – (viii) inclusive and extends to the tax benefit obtained by reference to the hypothetical construct upon which that tax benefit is quantified – that hypothetical construct is not determined by the matters in (i) – (viii) of s 177D(b), but rather by the evidence, and the inferences and judgments to be drawn therefrom.

What his Honour says here, about the tax benefit "hypothetical construct" not being determined by the eight matters in s 177D(b)(b), may be compared and contrasted with what was said on the issue by the High Court in *Spotless*.[78] There the Court stated that a particular application of the definition of "tax benefit" in s 177C(1) "involves consideration of the particular materials answering the various categories in par (b) of s 177D." While the High Court did not go further to say that the eight factors listed in s 177D(b) are the only matters that can be considered in applying the "tax benefit" definition, there is still an apparent inconsistency between the two statements.

Edmonds J similarly concluded of the alleged tax benefit in the 1998 year that there was an absence of any evidence that would enable one to hypothesise what would be reasonably expected had the alleged scheme had not been entered into, and no evidence that enabled one to draw any inference of such a reasonable expectation.[79] An appeal to the Full Federal Court

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[77] 2007 ATC 4092 at 4102 [62].
[78] *FCT v Spotless Services Ltd* [1996] HCA 34; (1996) 186 CLR 404 at 424.
[79] 2007 ATC 4092 at 4104 [71].

against his Honours' decision involved other issues and did not extend to the non-application of Pt IVA.[80]

***Lenzo***

In *Lenzo v FCT*,[81] the taxpayer was an accountant who invested in a sandalwood plantation project and claimed general deductions over the 1998 to 2000 income years for expenses incurred in making the investment. The expenses included prepaid management, lease and indemnity fees totalling $20,850 in the 1998 income year, and management and indemnity fees and interest and loan fees totalling $3,884 in the 1999 income year and $5,203 in the 2000 income year. The interest and loan fees were incurred in respect of a borrowing that was made by the taxpayer to fund his first contribution to the project, and that was sourced from a company related to the promoters of the investment. Before making his second contribution, the taxpayer refinanced the borrowing with the ANZ Bank which advanced an amount to pay for his contributions for the remainder of the project. The Commissioner made Pt IVA determinations disallowing the deductions claimed by the taxpayer and he appealed to the Federal Court.

The Federal Court allowed the appeal and held that Pt IVA did not apply because it could not be concluded that the taxpayer (or the manager or promoter) entered into the scheme for the dominant purpose of enabling the taxpayer to obtain tax benefits in connection with it.[82] On the appeal the taxpayer contended, inter alia, that he had not obtained any "tax benefit" in the 1998 income year. He submitted that had he not invested in the plantation project, he would have obtained a similar tax benefit by putting money into his self-managed superannuation fund. Based on what he argued was his "categorical evidence", including objective facts, that

[80] *Epov v FCT (No 2)* 2007 ATC 5009.
[81] [2007] FCA 1402; 2007 ATC 5016.
[82] [2007] FCA 1402; 2007 ATC 5016 at 5043 [137-138].

he would have invested in his superannuation fund an amount that would have resulted in a deduction of the same amount, it was reasonable to expect that he would have obtained the same tax benefit had the scheme not been carried out.[83]

The Commissioner's response to this submission was to point to the terms of s 177C(1)(b) that refer to a deduction being allowable to the taxpayer where the whole or a part of "**that deduction**" would not have been allowable if the scheme had not been entered into or carried out. The relevant deduction for this purpose, argued the Commissioner, was the deduction for prepayment of management, lease and indemnity fees.[84] French J agreed with the Commissioner's submission and held that the "superannuation counterfactual" was extraneous to the alternatives that were to be considered for the purposes of s 177C(1)(b).[85]

French J then went on to point out that a relevant counterfactual in the case involved the taxpayer borrowing the money needed to finance his involvement with the scheme from a source other than the company related to the promoter.[86] His Honour accepted that the taxpayer could have borrowed from the ANZ Bank from the outset and, on this basis, the deduction claimed in the 1998 year would have been allowable or might reasonably be expected to have been allowable in relation to that year of income if the scheme had not been entered into or carried out.[87] His Honour therefore concluded that by entering into the scheme the taxpayer did not obtain a tax benefit in respect of his borrowings that he could not reasonably have been expected to otherwise obtain.

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[83] [2007] FCA 1402; 2007 ATC 5016 at 5038 to 5039 [116-117].
[84] [2007] FCA 1402; 2007 ATC 5016 at 5039 [118].
[85] [2007] FCA 1402; 2007 ATC 5016 at 5039 [118].
[86] [2007] FCA 1402; 2007 ATC 5016 at 5039 [119].
[87] An alternative put forward by French J was that the taxpayer could have used his own funds and obtained the same deduction. However, while this alternative could result in deductions for the payment of the management, lease and indemnity fees, it is submitted that the alternative does not explain how deductions would have been allowable for interest and loan fees.

The approach of French J and his conclusions on these matters may not be the final say as the taxpayer has lodged an appeal to the Full Federal Court. If French J's conclusions are upheld on the appeal, then it would seem to follow that *Essenbourne* must be regarded as being incorrectly decided. This is because in holding that the taxpayer had not obtained a tax benefit, Kiefel J in *Essenbourne* accepted a "superannuation counterfactual" as an alternative postulate or hypothesis to an actual general deduction claimed.

In this respect, it will be of interest to see if on the appeal the taxpayer will point to the apparent incongruity between the approach of French J to identifying the whole of part of the deduction that would not have been allowable to a taxpayer for the purposes of s 177C(1)(b), and the approach of the High Court in *Spotless* to identifying the amount that would or might reasonably be expected to have been included in a taxpayer's assessable income for the purposes of s 177C(1)(a). French J's approach is a strict one in which the particular type of deduction allowable was important to ruling out the "superannuation counterfactual" as an alternative postulate or hypothesis. In contrast, the High Court's approach seems to be less strict in identifying more generally the assessable income tax benefit as an amount produced from a particular source or activity.

It may be noted that the less strict approach by the High Court in *Spotless* could be justified by virtue of the wording s 177C(1)(a) simply referring to "an amount" not being included in assessable income, rather than "an amount of assessable income" not being so included. It

may also be noted that courts in the past have rejected arguments based on the existence of symmetry in the Act's treatment of, at least, ordinary income and general deductions.[88]

***Trail Bros Steel & Plastics***

The outcome of the appeal in *Lenzo* could also reflect on the correctness of *Trail Bros Steel & Plastics Pty Ltd v FCT*,[89] a decision of the Administrative Appeals Tribunal. The case involved a taxpayer company that had entered into written employment contracts with two of its directors under which, in addition to paying the directors modest remuneration, it was required to make superannuation contributions to a self-managed superannuation fund controlled by the directors. Each employment contract required that a total of $297,000 be paid for the benefit of each director during the first four income years of trading after a restructure of the taxpayer's business operations had taken place. The first income year was 1996 in which the taxpayer paid $120,000 to the superannuation fund for the benefit of the directors.

During the 1997 income year amendments were made to the Act that abolished the complete deductibility of superannuation contributions and introduced age-based limits for deductibility. The effect of the amendments was to severely limit the deductibility of the amounts that the taxpayer had agreed to pay as superannuation on behalf of the directors over the following three years. The taxpayer and the directors then agreed to vary the employment contracts so that the contributions were instead paid to a newly created "employee welfare fund". The taxpayer claimed general deductions for those contributions that were disallowed by the Commissioner. One of the grounds relied on by the Commissioner to disallow the deductions was the application of Pt IVA.

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[88] See for example *Mount Isa Mines v FCT* [1992] HCA 62; (1992) 176 CLR 141; 92 ATC 4755 & *Rowe v FCT* [1997] HCA 16; (1997) 187 CLR 266; 97 ATC 4317.
[89] 2007 ATC 2648.

On the taxpayer's request for review before the Tribunal,[90] it was accepted by the parties that the taxpayer had entered into a scheme that consisted of the agreements to vary the employments contracts and the implementation of that variation, including the establishment of the employee welfare fund and the contributions made to it. Despite this, the Tribunal decided that Pt IVA did not apply because the taxpayer had not obtained a tax benefit within the terms of s 177C(1). In so deciding the Tribunal took the view that, absent the scheme, the payments claimed as deductions would still have been made, and would have been made in a way that would have entitled the taxpayer to deduct the amounts from its assessable income.[91]

In making the hypothesis or prediction required for the purposes of s 177C(1) to determine what might reasonably be expected to have happened if the scheme had not been entered into, the Tribunal took as the starting point the fact that the taxpayer, by virtue of the employment contracts, was bound to make payments totalling $237,000 for the benefit of the directors in the remaining three income years.[92] The Tribunal then found that it was impossible to conclude that the taxpayer would have discharged its obligations to the directors in a way that was not fully tax deductible. Further, it was contrary to the interests of all involved for the taxpayer to discharge that obligation in a way that did not allow for complete deductibility of all payments.[93]

As part of these findings, the Tribunal accepted a submission advanced by the taxpayer's counsel that the payments would have been deductible to the taxpayer even if the directors

[90] 2007 ATC 2648 at 2652 [22-23].
[91] 2007 ATC 2648 at 2653 [32].
[92] 2007 ATC 2648 at 2653 [28].
[93] 2007 ATC 2648 at 2653 [29].

had "asked for those payments to be made to themselves, or to their wives, or even to unrelated third parties". Any adverse tax consequences for those potential recipients did not detract from the Tribunal's conclusions about the position of the taxpayer.[94] While this may be so, it appears the Tribunal ignored at least the potential application to the taxpayer of s 109 of the 1936 Act that would limit the deduction for excessive remuneration paid by a private company to associated persons, and perhaps even Division 7A of the 1936 Act.

***Star City***

In *Star City Pty Ltd v FCT*,[95] the taxpayer company had been granted a casino licence by the New South Wales Casino Control Authority. The Authority also granted to Sydney Harbour Casino Properties Pty Ltd (Casino Properties) leases of land on which the casino was to be built. Both the taxpayer and Casino Properties were subsidiaries of Sydney Harbour Casino Holdings Pty Ltd (Casino Holdings). The grant of the casino licence required a once only up front payment of $256m, and the leases provided that the rent for the first 12 years was $15m a year and required that this rent would be prepaid by a payment of $120m. This was in accordance with the Authority's commercial concern to receive the payment of as much money as soon as it could from the transactions.

The prepayment of the $120m in rent was made by Casino Holdings to the Authority. Casino Properties then granted to the taxpayer a non-exclusive licence to occupy and use the casino premises. It was a term of the licence that the taxpayer was responsible to ensure the payment of rent under the leases. The taxpayer claimed the prepaid rent as a deduction and the Commissioner disallowed the deduction relying, inter alia, on the application of Pt IVA.

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[94] 2007 ATC 2648 at 2653 [31].
[95] [2007] FCA 1701; 2007 ATC 5216.

On the taxpayer's appeal to the Federal Court, it was held that the taxpayer had neither obtained a "tax benefit" and nor did it have a dominant purpose of obtaining any such tax benefit from any scheme. Gordon J rejected a submission made by the Commissioner that only one "alternative postulate" was available for the purposes of s 177C and this involved the payment of a nominal rent in addition to the $256m paid for the grant of the casino licence.[96] This submission was rejected on the ground that it did not take proper account of the facts that indicated from the outset it always remained the case that the casino would operate on leased land owned by the State and rent would be paid for the use of the casino premises. A further fact of which the submission also did not take proper account, his Honour said, was the Authority's commercial concern that required payment of as much money as could be obtained as soon as it could.[97] His Honour therefore concluded that the only alternative postulate relied on by the Commissioner was not something that might reasonably be expected to have happened if the scheme had not been entered into or carried out because it was not supported by the "objective facts".[98]

Gordon J continued to observe that what might reasonably be expected if the scheme had not been entered into or carried out was to be "determined objectively".[99] His Honour added:[100]

> The alternative postulate must be reasonable. It must be demonstrated that it was reasonable to expect not only that Star City could have structured the alternative in the manner contended but also that the [Authority] would have accepted that alternative. Only if both conditions are satisfied, might it reasonably be expected that that other arrangement might have happened. In the present case, neither condition is satisfied. The Star City Consortium did not offer it and, no less importantly, the [Authority] did not seek it or choose it.

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[96] [2007] FCA 1701; 2007 ATC 5216 at 5240 [136].
[97] [2007] FCA 1701; 2007 ATC 5216 at 5240 [137].
[98] [2007] FCA 1701; 2007 ATC 5216 at 5241 [145].
[99] [2007] FCA 1701; 2007 ATC 5216 at 5241 [145].
[100] [2007] FCA 1701; 2007 ATC 5216 at 5241 [146].

These observations and the Court's decision are not, however, final as the Commissioner has lodged an appeal to the Full Federal Court.

## CONCLUSION

It can be seen from this discussion that the issue of the relevance of a person's subjective intention to determining whether or not a taxpayer has obtained a tax benefit has been dealt with inconsistently in the case authorities. One the one hand, the authorities that clearly support the proposition that subjective intention can be considered in determining the issue are O'Loughlin J at first instance in *Peabody* and Downes J in *Ryan*. Other authorities that could be read as supporting the proposition are Sackville J in both *WD & HO Wills* and *CC (New South Wales)*, Kiefel J in *Essenbourne*, Edmonds J in *Epov* and the Tribunal decision in *Trail Bros Steel & Plastics*. On the other hand, the Tribunal decision in *McCutcheon* is clearly against the proposition. And at first glance, the High Court in *Spotless* could be read as weighing against the proposition, although this is by no means beyond doubt.

The resulting confusion is clearly undesirable given that the definition of "tax benefit" in s 177C(1) forms one of the prerequisites to the operation of the Pt IVA anti-avoidance provisions that obviously have a general application, and given the attendant risk of considerable penalty where the provisions are found to apply.[101] The issue, as well as the operation of the two limbs of the paragraphs of s 177C(1), warrants clarification either by clear judicial pronouncements directly on point and preferably by the High Court or at least the Full Federal Court, or by amending legislation. In this latter respect, there is of course still outstanding the proposal of the former federal government to amend the "reasonable expectation" test in s 177C(1) along the lines identified by the Ralph *Review of Business*

[101] The base penalty amount is 50% of any underpaid tax but this may be reduced in some circumstances: see s 284-145 to s 284-160 in Schedule 1 to the *Taxation Administration Act 1953* (Cth).

*Taxation*.[102] Recommendation 6.4 of the Review Report was that the operation of the "reasonable hypothesis" test be improved by ensuring the counterfactual to a tax avoidance scheme reflects the commercial substance of the arrangement.[103] If that proposal still proceeds it will remain to be seen to what extent the amendments made resolve the confusion that presently exists.

[102] See the Federal Treasurer's Press Release No: 16 (22 March 2001) following on from the Ralph Review "New Business Tax System" – Stage 2 announcements.
[103] An indication of what this amending provision could look like is perhaps found in s 165-10(3) of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) that forms part of the goods and services tax general anti-avoidance provisions.