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**Abstract**
In February 1991, the Federal Commissioner of Taxation (inexplicably withdrew his appeal against the decision of Davies J in Metropolitan Oil Distributers (Sydney) Pty Ltd v FCT (1990). This paper examines whether the arrangements entered into by the taxpayer could have been struck down by the Commissioner had they been entered into after 27 May 1981. In doing so, it provides a useful analysis of the effectiveness of the Part IVA provisions.

**Keywords**
Federal Commissioner of Taxation, tax, tax avoidance

# PART IVA - A TIGER, OR TOOTHLESS?

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**In February 1991, the Federal Commissioner of Taxation (inexplicably) withdrew his appeal against the decision of Davies J in *Metropolitan Oil Distributors (Sydney) Pty Ltd v FCT* (1990). This paper examines whether the arrangements entered into by the taxpayer could have been struck down by the Commissioner had they been entered into after 27 May 1981. In doing so, it provides a useful analysis of the effectiveness of the Part IVA provisions.**

## Introduction

The general provision directed against tax avoidance which applies to a scheme entered into after 27 May 1981 is contained in Part IVA of the Income Tax Assessment Act 1936 (Cth) ("the Act"), comprising s 177A - s 177G. This paper examines recent relevant cases in order to determine whether the Commissioner could strike down the arrangements entered into by the taxpayer, Metropolitan Oil Distributors (Sydney) Pty Ltd ("MOD Sydney") using Part IVA, had the arrangements been entered into after 27 May 1981. It further considers the factors which would result in the Commissioner being unsuccessful under Part IVA.

Davies J in *Metropolitan Oil Distributors (Sydney) Pty Ltd v FCT* ("*MOD Sydney*")[1] held "the burden of tax fell as the Act intended", and that s 260 of the Act, (the general provision directed against tax avoidance prior to 28 May 1981) did not apply.

The Commissioner appealed *MOD Sydney* to the Full Federal Court in October 1990, with hearings to commence in February 1991. An officer "advised that the Commissioner was prepared to take the case to the High Court if necessary...Should the Commissioner be

1 (1990) 90 ATC 4624.

unsuccessful in the Courts, action would be commenced to review the law."[2] The Australian Tax Office ("ATO") inexplicably withdrew its appeal in February 1991.

## Summary of the Tax Arrangement in *MOD Sydney*

The taxpayer company, MOD Sydney, was created as part of a scheme to lessen the tax payable by two family companies. All three companies were controlled by the same three Massington family members.

The arrangement involved the sale of goodwill of a petroleum distributorship owned by Metropolitan Oil Distributors Pty Ltd ("MOD"), and land where the business was conducted, owned by MOD Holdings Pty Ltd ("MOD Holdings"), to MOD Sydney. MOD Sydney claimed deductions for interest payments under s 51(1), on loans which appear to have been created by a series of journal entries. In part, the arrangement was that interest on borrowings by MOD Sydney for the acquisition of goodwill and land from MOD and MOD Holdings, was paid to the Massington Overseas Trust ("MO Trust") settled in Singapore.

Originally the payment for land and goodwill was to be by way of an exchange of cheques. However, this round robin did not occur because of MOD Sydney's bankers' interpretation of a statement from the Treasurer "presumably relating to tax avoidance schemes". The arrangement was instead set up and conducted as described below.

The Singapore company trustee of the MO Trust was to be replaced by an Australian company, Shulwa (No 5) Pty Ltd whose directors were two of the family members. A beneficiary of the trust was to be a company incorporated and resident in Singapore. The Singapore company shareholder was to be a company controlled by two accountants in Hong Kong. That company was to be the trustee of another family discretionary trust, the Massingham Minor Trust.

On 31 March 1980 the trustee of the MO Trust loaned $550,000 to MOD Sydney at 12% interest per annum, a commercial rate of interest, payable at six monthly intervals in advance. MOD Sydney

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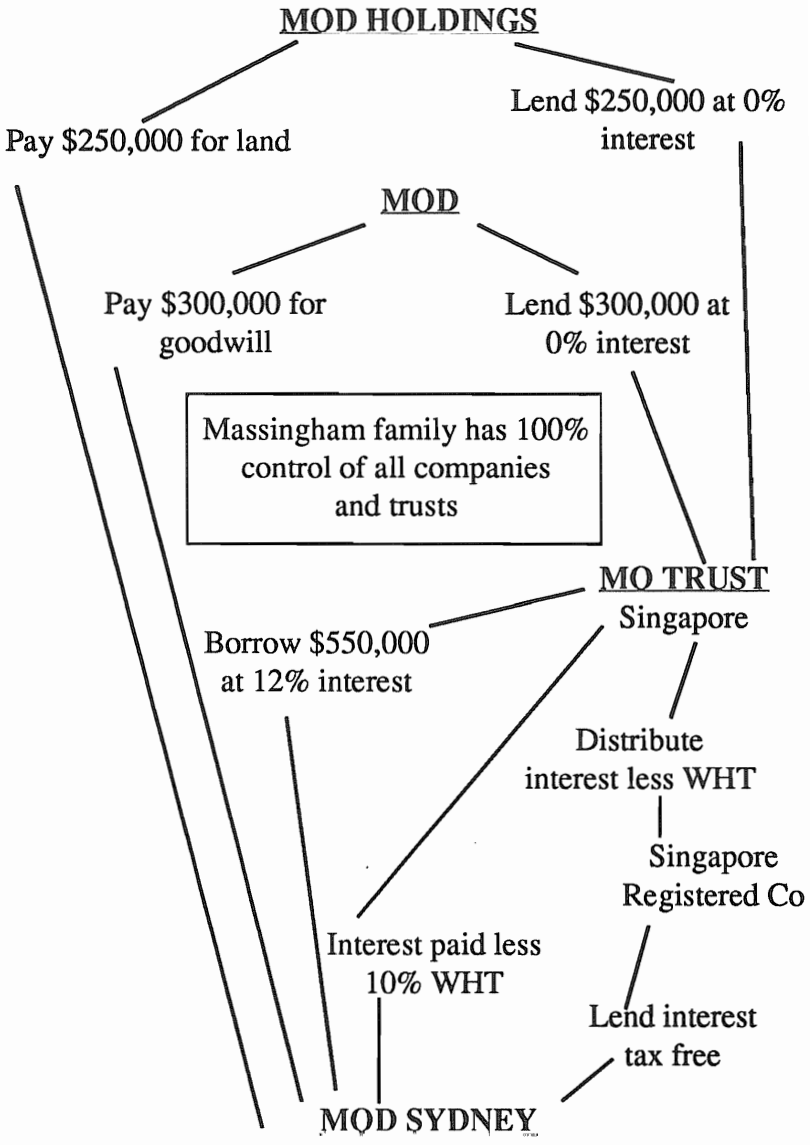
2 Overseas Beneficiary Case Strategy Conference Minutes, Item 9, Appeals and Review Group, 18 October 1990: obtained under the Freedom of Information Act 1982.

*Metropolitan Oil Distributors (Sydney) Pty Ltd v FCT*




**All transactions are notional - no money changes hands**

paid $300,000 to MOD for goodwill, and $250,000 to MOD Holdings for the land. Equivalent sums were loaned to the trustee of MO Trust seemingly interest free.

Interest income paid by MOD Sydney to the trustee of MO Trust was to be distributed by trustee resolution to the Singapore beneficiary company. This arrangement resulted in tax payable on the interest paid off-shore being limited to 10% interest withholding tax by virtue of the Income Tax (Dividends and Interest Withholding Tax) Act 1974. The 90% balance remaining was loaned back to MOD Sydney.

These steps are illustrated in the flowchart of transactions below.

The Commissioner argued that the interest payments made by *MOD Sydney* were not incurred and, if incurred were not deductible under s 51(1) and that, if they were otherwise deductible, the arrangements giving rise to them were struck down by s 260 of the Act.

However, Davies J concluded at 4637 that:

> notwithstanding the disposition of the business from one company to another when there was no commercial reason for doing so, and the establishment of trusts and companies in Singapore and Hong Kong, which could hardly be characterised as ordinary family or business dealings,

the interest payments made by MOD Sydney were deductible under s 51(1) and that s 260 did not apply.

**Why is the interest expense deductible under s 51(1)?**

Section 51(1) of the Act provides that:

> All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions except to the extent to which they are losses or outgoings of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income.

In *MOD Sydney* the loan of $550,000 was to acquire the goodwill of a

business from MOD and land from MOD Holdings. Latham CJ, Rich, Dixon, McTiernan and Webb JJ in *Ronpibon Tin NL and Tongkah Compound NL v FCT* said:[3]

> for expenditure to form an allowable deduction as an outgoing incurred in gaining or producing the assessable income it must be incidental and relevant to that end...

Davies J considered s 51(1),[4] saying it "is not primarily directed to purpose or motive..." The interest paid by MOD Sydney was at a commercial rate on a loan used to pay the price of the goodwill and the land acquired by MOD Sydney. It was "incidental and relevant to the gaining or producing of its assessable income", thus the interest paid by MOD Sydney was not "private" expenditure. "MOD Sydney [was] entitled to the deduction under s 51(1)."

**Section 51(1) as it relates to s 260**

Section 260 of the Act was the general anti-avoidance provision applicable to transactions entered into before 28 May 1981, when it was repealed and replaced by the current anti-avoidance provisions of Part IVA.

Section 260 was designed to defeat tax avoidance schemes not otherwise caught by specific provisions. It gave the Commissioner power to render void every written or oral contract, agreement or arrangement, which had the purpose or effect of:

a) altering the incidence of any income tax;

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

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

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

Despite the fact that s 260 was written in very broad terms, its effect had been diminished by successive decisions of the Australian High

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3 (1949) 8 ATD 431 at 435-436; (1949) 78 CLR 47 at 56-57.

4 Above n 1 at 4634.

Court, at that time led by Barwick CJ, who one writer[5] says "had displayed an intense dislike of the section ever since his defeat as Counsel at the Privy Council" in *Newton v FCT*.[6] Lord Denning had said Barwick's submissions, if accepted would deprive s 260 of any effect.

The section's limitations, summarised in the explanatory memorandum to the introduction of Part IVA of the Act, were:

- the choice principle, which prevented its operation if the Act allowed a taxpayer that form of transaction;
- the motives of the persons entering into an arrangement were not considered, rather the purpose of the arrangement was the relevant issue;
- ambiguity as to the extent (wholly or in part) necessary to eliminate the sought-after tax benefit; and
- no Commissioner's power to reconstruct what was done to arrive at a taxable situation after the section had voided an arrangement.

Hill J in *Davis v FCT*[7] said of s 260 that, in many instances, it had been read down to place "proper perspective vis-a-vis the other provisions of the Act while on the other hand giving the section work to do in an appropriate case..." Section 260 was a self executing section, but Hill J said one of its limitations was that the Commissioner was not permitted "to reconstruct a new and fictitious set of facts creating a liability for a taxpayer."

Davies J in *MOD Sydney*[8] considered "it will be a rare case when expenditure which is an allowable deduction under s 51(1) of the Act can be struck down by s 260 of the Act." He cited Barwick CJ, who he said "put the matter succinctly" in *FCT v Casuarina Pty Ltd*:[9]

> I should merely wish to say that there is, in my opinion, no room for the application of s 260 where the taxpayer

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5 Olms, Tax Avoidance, Paper 18, *Australasian Tax Teachers' Conference*, Sydney, January 1994 at 2.

6 (1957) 96 CLR 578 (HC); (1958) AC 450 (PC).

7 (1989) 89 ATC 4377 at 4400 and 4402.

8 Above n 1 at 4636.

9 71 ATC 4068 at 4070.

> has become liable for the amount of tax appropriate under the terms of the Act for the ascertainment of the taxpayer's liability.
>
> Steps taken to bring about that state of affairs cannot, in my opinion, qualify as action under s 260 to achieve any of the four purposes or effects described in the section.

## Section 51(1) as it relates to Part IVA

With the exceptions of the decision on appeal by the taxpayers in *Peabody v FCT*[10] and the decision in *Spotless Services Ltd v FCT*,[11] Part IVA has not been examined by the Courts in detail.

The Administrative Appeals Tribunal ("the Tribunal"), has considered Part IVA in a few cases. In *Case Y4*,[12] the taxpayer was a medical company, which had been incorporated in 1984 by a general practitioner doctor. One of the reasons for incorporation was to get a deduction for $3,224 interest paid on a $40,000 loan borrowed to purchase the goodwill of the medical practice by the medical company from the doctor in the 1985 tax year.

The Commissioner disallowed the interest expense on the grounds that:

- the expenditure was "private" and hence excluded from deduction pursuant to the exception contained in s 51(1); and
- the arrangements entered into by the taxpayer constituted a "scheme" to which Part IVA of the Act applied.

The Commissioner's first ground was rejected by Deputy President of the Tribunal Dr Gerber:[13]

> on finding that there was an actual loan to acquire the practice, the interest on the loan moneys is classically an outgoing incurred in producing assessable income and

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10 (1992) 92 ATC 4585 (FC); (1993) 93 ATC 4104 (FFC) (on appeal). The decision of the High Court in *Peabody*, which was heard in November 1993 had not been handed down at the time this article was written.

11 (1993) 93 ATC 4397 (FC) (on appeal).

12 (1991) 91 ATC 114.

13 Ibid at 116.

thus qualifies for deduction under s 51(1).

In applying the same deductibility test in *MOD Sydney*, Davies J found the interest expense was deductible by virtue of s 51(1) and the intention to gain a taxation benefit did not preclude deductibility:[14]

> notwithstanding the disposition of the business from one company to another, when there was no commercial reason for doing so, and the establishment of trusts and companies in Singapore and Hong Kong, which could scarcely be characterised as ordinary family or business dealings, s 260 did not apply...the borrowing did not alter the incidence of income tax, for there was no antecedent taxation position which was altered, and the borrowing did not relieve any person from liability to pay income tax or avoid any liability imposed by the Act or prevent the operation of the Act in any respect. The burden of tax fell as the Act intended.

A similar position was taken in *Bailey v FCT*[15] by Barwick CJ, who considered only if some step in the process lacks "the authority of the Act" will an assessment be excessive.

Thus cases support the proposition that the interest in *MOD Sydney* is an allowable deduction under s 51(1), meaning Part IVA would not apply to this part of the arrangement.

## Part IVA

Part IVA comprises s 177A - s 177G of the Act. It is the current general provision directed against tax avoidance. It was introduced to rectify the deficiencies of s 260.

For Part IVA to apply:

- there must be a scheme;
- entered into after 27 May 1981;
- with the sole or dominant purpose of obtaining a tax benefit.

If all these conditions exist and they result in:

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14 Above n 1 at 4637.

15 (1977) 136 CLR 214 at 217.

- an amount not being included in the assessable income of the taxpayer that would have been included or might reasonably be expected to have been included in assessable income;[16] or

- a deduction is allowable to the taxpayer which would not have been allowable, or might reasonably be expected not to have been allowable,[17]

s 177F gives the Commissioner the power to reconstruct the facts and then gives him the discretion to cancel all or part of the tax benefit and either include the relevant income in the taxpayer's assessment,[18] or disallow the relevant deduction.[19]

Part IVA gives the Commissioner wider powers to amend assessments than in other cases not involving fraud or evasion.

Section 177G(1) provides him with the power to cancel a tax benefit within six years after the date on which tax became due and payable if the amendment gives effect to s 177F(1), whereas in other cases of avoidance of tax not involving fraud or evasion, subject to s 170(2) the period is four years from:

- in the case of a company or a trustee of an eligible approved deposit fund, superannuation fund or trust, from the date or deemed date of assessment, or

- in any other case the date that the tax became due and payable under the assessment.

So the question is, would Part IVA act to strike down the arrangements in *MOD Sydney*, had the arrangements been entered into after 27 May 1981?

## The basic questions for Part IVA to apply

### 1 Is there a scheme?

Section 177A(1) says "scheme" means any agreement, arrangement,

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16 Section 177C(1)(a).

17 Section 177C(1)(b).

18 Section 177F(1)(a).

19 Section 177F(1)(b).

understanding, promise or undertaking, whether express or implied, and whether or not legally enforceable. Read broadly, it could cover almost anything done by the taxpayer.

In *Case Y13*[20] a consulting engineer formed a discretionary trust with a corporate trustee to undertake consulting work in his spare time. His rationale was to avoid a conflict of interest with his regular job. This evidence was accepted by the senior member of the Tribunal, Dr Grbich, however the Commissioner assessed the taxpayer personally claiming there was a scheme within the meaning of Part IVA.

Dr Grbich said,[21] "to assert that tax arrangements play a significant part in the structuring of a taxpayer's affairs is not the same as asserting that Part IVA applies", yet he interpreted s 177A widely and found there was a scheme which involved all the steps, including the formation of the trust, distributions, etc.

The judgment in *MOD Sydney* states that "the incurring of the interest by the taxpayer and the payment of that interest to the MO Trust was designed to reduce the overall rate of tax which the members of the family and their structures paid".[22]

Prima facie the complex steps of the arrangement detailed indicate that a scheme existed to reduce the overall rate of tax.

The interest income was paid by MOD Sydney to the trustee of MO Trust and was to be distributed by the trustee by resolution to the Singapore beneficiary company, and this is a relevant factor in light of *Case V160*.[23] This case concerned a complicated series of transactions designed to avoid tax and which were found to be a sham. Tribunal Member Mr Todd formed the opinion that Part IVA did not "apply at all comfortably in a trust situation". The difficulty was who had obtained the tax benefit? The discretion vested in the trustee meant that the tax benefit could not be said to belong to a particular taxpayer who would or might reasonably have been expected to include an amount in assessable income.

Mr Todd considered that if the provisions of s 260 of the Act had

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20 (1991) 91 ATC 191.

21 Ibid at 194.

22 Above n 1 at 4635.

23 (1988) 88 ATC 1058.

been relevant, they would have been applicable, but Part IVA would not apply. He concluded:[24]

> ...it is ironic that the born-again s 260...so often found wanting in times past, was put to sleep only to be replaced by a provision the greater complexity of which can give rise in some circumstances to problems at least as great as those that occurred in relation to its predecessor.

*Case V160* highlights a weakness in Part IVA which could be argued in *MOD Sydney*, had the arrangements been entered into after 27 May 1981, because the interest income was paid to the MO Trust.

## 2 Was the scheme entered into with the sole or dominant purpose of obtaining a tax benefit?

Part IVA focuses on the dominant purpose of a party to a scheme. For Part IVA to apply the scheme must have been entered into with the "sole or dominant" purpose of obtaining a tax benefit.

"Dominant" is not defined in the Act; the *Shorter Oxford English Dictionary* defines "dominant" as meaning "exercising chief authority or rule; ruling, governing; most influential."

The "sole or dominant" requirement of Part IVA could result in the scope of Part IVA being narrower than the former s 260, where in *FCT v Gulland*[25] "sole or dominant" purpose did not appear to be necessary.

In *Case Y13* Dr Grbich did not find a sole or dominant purpose of obtaining a tax benefit, rather he adopted a "substance" approach. He accepted the taxpayer's conflict of interest reason and said[26] he had not got evidence but "incomplete facts".

Dr Grbich inferred there was a purpose of obtaining a tax benefit because the taxpayer decided on a trust. With respect, it is argued that the decision in *Case Y13* was incorrect in finding for the Commissioner. Having found the taxpayer's reason for getting into the trust structure, "was not moved to a significant degree by tax considerations", it is argued that Part IVA should not have applied

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24 Ibid at 1070.

25 (1985) 85 ATC 4765.

26 Above n 20 at 192.

because there is no sole or dominant purpose.

Conversely in *MOD Sydney* Davies J[27] observed that the family members "became dissatisfied with the rewards of the enterprise, which I take to mean the after-tax result" and saw a solicitor who proposed an arrangement "that would provide immediate and ongoing taxation benefit. No attempt [was] made to suggest that what was done was designed for the welfare of the income earning enterprise or of the family save that less taxation would be payable."

The facts in *Peabody* were that the taxpayer Mrs Peabody was a beneficiary of a family trust which owned the majority of shares in a group of companies. In order to facilitate a public float of shares, all outstanding shares were purchased from the other shareholder, Mr Kleinschmidt, for approximately $8.6 million, via a shelf company rather than directly. The shares were converted to "Z" class preference shares, which were virtually worthless, and the purchase was financed through redeemable preference shares. The Commissioner, relying on s 177F, considered the taxpayer had obtained a tax benefit from the scheme and applied Part IVA by including an additional $888,005 in the assessable income of Mrs Peabody under the provisions of s 177F.

In the taxpayer's appeal, O'Loughlin J[28] found that Mr Peabody carried out this scheme for the dominant purpose of enabling the three trust beneficiaries, including his wife Mrs Peabody, to obtain the identified tax benefit. He also had "no difficulty in labelling this scheme as blatant, artificial and contrived." O'Loughlin J identified the conversion of the shares to "Z" class shares as giving rise to the tax benefit and confirmed the amended assessment.

This decision was appealed to the Full Federal Court by the taxpayer, where Hill J took a narrower approach when considering the interpretation of the word "dominant". In allowing the taxpayer's appeal, he looked at the whole of the scheme and concluded it had a dominant commercial purpose, which was the acquisition of shares from a Mr Kleinschmidt and the flotation of a public company. His Honour said it would be "absurd" to decide that the purpose was to exclude the $888,005 from assessable income of the three beneficiaries of the Peabody Family Trust. The fact that an element of the scheme had a tax advantage did not detract from

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27 Above n 1 at 4625 - 4626.

28 Above n 10 at 4598.

the dominant purpose of the scheme as a whole.

In MOD Sydney, Davies J said,[29] "the lending back of 90% of the interest paid is an important matter to consider", but he gives this factor no further consideration. The Commissioner submitted that the obligation to pay interest was not a business matter undertaken for a commercial end, but undertaken to obtain a taxation deduction. There was no commercial necessity for MOD Sydney to pay for the assets.

At the taxpayer's own admission in *MOD Sydney*, it would be difficult to claim that a dominant purpose of entering into the scheme was not to obtain a tax benefit, but was it a tax benefit within the meaning of Part IVA?

In *Ure v FCT*[30] the taxpayer's desire to obtain a taxation advantage played an important role in the rejection by the Court of the claim that interest paid had been incurred in gaining or producing assessable income. An important difference in *MOD Sydney* is that tax was paid on the interest paid to MO Trust in the form of interest withholding tax, as provided for in the Act. It is therefore contended that the Full Federal Court decision in *Peabody* would apply and that, this element of Part IVA would not be effective for the Commissioner.

### 3 Was a tax benefit obtained?

For Part IVA to apply, the taxpayer must, under s 177C, have obtained a tax benefit. A tax benefit can arise in one of three ways. The first two are:

- an amount is not included in the taxpayer's assessable income which would have been included in his assessable income, or might reasonably be expected to have been included, if the scheme had not been entered into or carried out; or

- a deduction is allowable to the taxpayer, and the whole or part of that deduction would not have been allowable, or might reasonably be expected not to be allowable, if the

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29 Ibid at 4434.

30 (1981) 81 ATC 4100.

> scheme had not been entered into or carried out.

A tax benefit arises where the taxpayer earned less assessable income or obtained more allowable deductions than would otherwise have been the case.

Does a tax benefit presuppose there was a stream of income before the present arrangements were entered into? In *Case Y13* the taxpayer argued there were no previous fees, he had never entered into a consultancy arrangement beforehand, it was the trust that earned the consultancy income. If income had been diverted into the trust, it could properly be argued that the taxpayer had earned the income, because he was changing an existing situation by diverting an income stream, but income was not diverted into the trust.

In his discussion on s 177C(1), in *Case Y13*, Dr Grbich compares the actual tax result obtained with steps that might have been expected had "various tax avoidance steps not been undertaken".

The Commissioner was successful on his second ground in *Case Y4*, which was that the arrangement entered into by the taxpayer constituted a scheme to which Part IVA applied. Dr Gerber found that on this ground the establishment of the medical practice company constituted a scheme as defined in s 177A.

For Part IVA to apply a taxpayer must have obtained a tax benefit, which he said[31] "includes a deduction being allowable which would not otherwise be allowable in the absence of the scheme". It followed that because the doctor's previously non-deductible interest was now deductible, this gave rise to a tax benefit as defined in s 177C(1).

Dr Gerber, in applying Part IVA, said:

> put bluntly, the purpose of substituting one mortgagee for another was to create a tax deduction by recourse to an "incestuous" relationship of prohibited degree...Such "incest" creates a tax benefit to which Part IVA applies - in this case the conversion of a non-deductible interest payment on a domestic home into a deductible expenditure in the accounts of the company.

Had the arrangements in *MOD Sydney* been entered into after 27

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31 Above n 12 at 117.

May 1981, the Commissioner may argue that he successfully applied Part IVA in the similar *Case Y4*, where the purpose was, by substitution of loans, an attempt to convert non-deductible interest expense into deductible interest expense under s 51(1), thus giving rise to a tax benefit as defined in s 177C(1). However, as MOD Sydney originally did not replace a private loan with a business loan, arguably its facts can be distinguished from the facts in *Case Y4*.

The interest paid by MOD Sydney was at a commercial rate. As it was paid to an overseas beneficiary, the tax liability was limited to 10% withholding tax by virtue of the Income Tax (Dividends and Interest Withholding Tax) Act 1974, which limits tax on interest paid to non-residents to 10%.

Section 128D provides that income upon which non-resident withholding tax is payable shall not be included in the assessable income of a person. Section 177C says the obtaining by a taxpayer of a tax benefit means an amount not included in assessable income which would have been included or might be reasonable expected to be included.

In the second reading of the Bill introducing Part IVA, the then Treasurer said Part IVA would not apply to ordinary business or family dealings but only to what is blatant, contrived or artificial. A tax benefit would be obtained if after all the other provisions of income tax law had been applied an amount had not been included in the taxpayer's assessable income had the scheme not been entered into.

Since income subject to non-resident withholding tax does not form part of assessable income, and the interest was not previously assessable, MOD Sydney could effectively argue that Part IVA would not apply to the interest paid to the non-resident beneficiary. Part IVA does not apply where non-resident withholding tax is involved, "as a result of the interrelation of s 128D, the definition of "tax benefit" in s 177C and the terms of s 177E(1)(c) of the Act."[32]

In Income Tax Ruling IT 2466 the Commissioner expressed the view that s 51(1) deductions will be disallowed if the arrangement is a sham. "Lack of commercial justification, transactions which are part of an artificial round robin not supported by real funds and no documentation to support the loan and interest transactions are

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32 Hamilton & Deutsch, *Understanding International Taxation* (1988) 194.

considered in this approach." MOD Sydney had documentation, and the Commissioner did not and could not contend that the whole arrangement should be struck down.

The third category of tax benefit was contained in the now repealed s 177C(1)(ba). It related to rebates for superannuation contributions under s 159TL, which have since been changed. It was inserted into the Act because there was concern that when this rebate was introduced it could be abused because, according to the explanatory memorandum, "the description of a tax benefit in Part IVA does not cover a tax benefit, consisting of an entitlement to a tax rebate obtained under a scheme, that is not available apart from the scheme..."

In *Peabody* (FFC)[33] Hill J pointed out that there were no tax benefits in the circumstances of the case, because the benefit obtained was by way of a tax rebate rather than a tax benefit under s 177C.

The inclusion of s 177C(1)(ba) in 1990 and His Honour's decision in *Peabody* provide authority that Part IVA will not apply where non-resident withholding tax is payable. This is because, under the provisions of s 128D, interest paid to a non-resident which is subject to non-resident withholding tax shall not be included in assessable income. Thus it is contended that there was no tax benefit within the meaning of Part IVA in *MOD Sydney*.

**The effectiveness of a determination under s 177F**

If MOD Sydney had objected to the assessment and the scheme had been entered into after the introduction of Part IVA, can the Commissioner make a determination under s 177F(1)?

Section 177F(1) gives a discretionary power to the Commissioner to make certain determinations. The power is conditional on the existence of certain circumstances, which are:

- that a taxpayer has obtained a "tax benefit" or would obtain such a benefit but for s 177F; and
- the tax benefit has been obtained or would be obtained by the taxpayer "in connection with a scheme" to which Part

33 Above n 10 at 4117.

IVA applies.

In *Jackson v FCT*[34] Jackson was an accountant and tax agent who in 1981 changed the vehicle from which he conducted his business from that of a sole practitioner in his own name, to one conducted by the trustee.

For the 1982 and 1983 years, the Commissioner amended assessments so that Jackson was personally assessed on income generated from the trust.

After disallowance of the taxpayer's objections, Jackson requested that the Commissioner refer the decision to disallow the objections to the Court for hearing, pursuant to s 187(b) of the Act. Subsequently the Commissioner referred the matter to the Court in respect of the 1982 and 1983 income years, on 4 January 1988 and 18 January 1988 respectively. On 11 August 1988 the Commissioner made determinations to include additional amounts in Jackson's assessable income for those years, pursuant to s 177F, "Schemes to Reduce Income Tax".

Section 177F did not form part of the Commissioner's amended assessments nor was it part of the objection by the taxpayer. Only after institution of proceedings in the court did the Commissioner attempt to rely on Part IVA. The Commissioner took the view that he could make and rely on a determination at any stage before the evidence was closed; that is after the disallowance of the objection and the institution of the appeal. He relied on the decision of the Full Federal Court in *Fletcher & Ors v FCT*.[35]

Gummow J distinguished *Jackson* from *Fletcher* because in *Fletcher* it was held that:

- following an objection to an assessment, a possible result is for the Commissioner to issue an amended assessment under the now repealed s 186;

- the Commissioner, in determining an objection to an assessment, is entitled to make a determination under s 177F and give effect to it by his decision under s 186;

- the Tribunal has, by force of s 43 of the Administrative

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34 (1989) 89 ATC 4429.

35 (1988) 88 ATC 4834.

> Appeals Tribunal Act 1975 ("AAT Act") all the Commissioner's powers and discretions that were conferred by s 186.

The Tribunal is therefore free to exercise that same discretion if it wishes.

In *Jackson* there had been no amended assessment by the Commissioner, and because the appeal was made directly to the Court, s 43 of the AAT Act had no application.

Gummow J concluded:[36]

> Part IVA played no part in the processes of assessment for the two years in question. To intrude now into the matters of which the Court is seized, the effect of determinations expressed to have been made after the institution of proceedings would be to change the nature of those matters from challenges to the decisions of the (Commissioner) some years ago to disallow the taxpayer's objections to particular amended assessments.

Hill J, in *FCT v Jackson*,[37] the appeal from the decision of Gummow J, said:[38]

> Unlike s 260, Part IVA does not operate of its own force. It is predicated upon the making of a determination by the Commissioner pursuant to s 177F(1).
>
> The prerequisites for the making of a determination under that subsection are that a taxpayer has obtained a tax benefit, or would but for the operation of s 177F(1) have obtained a tax benefit, and that the obtaining of that tax benefit was in connection with a scheme to which Part IVA applies.

The critical factor was that it is the determination that triggers Part IVA.

The judgment of Hill J in *Jackson* is consistent with s 177F and the framework of the former Part V. At that time a taxpayer was bound by his notice of objection, and Jackson's objection contained no

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36 Above n 32 at 4440.

37 (1990) 90 ATC 4990.

38 Ibid at 4993-4994.

ground relating to Part IVA.

Even though there now exists power under ss 14ZZK and 14ZZO of the Taxation Administration Act 1953 ("TAA Act") for the Tribunal or Court to order that the taxpayer is not limited to the grounds stated in his objection, the taxpayer has no automatic right to such an order, so it cannot be taken that these sections have conferred a power upon the Commissioner to make a s 177F(1) determination without proceeding to an assessment, where such power did not exist before.

*Jackson* and *Fletcher* provide authorities that where the Commissioner has failed to exercise his powers under s 177F, and Part IVA could possibly apply to the taxpayer, if the taxpayer appeals an objection decision directly to the Federal Court, and not the Tribunal, the Commissioner will not be able to make a determination under Part IVA.

Additionally, on the authority of *Jackson*, the Commissioner is shut out from significant remedies if his basis is a section that confers a discretion and the taxpayer appeals to the Federal Court against the decision under s 14ZZ of the TAA Act, because the taxpayer can argue the Commissioner cannot rely on any discretions.

The explanation in *Jackson* that unlike the Tribunal, the Federal Court is limited in the way it can deal with an objection is reiterated by Hill J in *Peabody*:[39]

> The Court is confined to deciding whether the Commissioner's decision has been affected by some error of law, whether the Commissioner has addressed himself to the right issue or whether he has taken some extraneous factor into consideration or failed to take into account some relevant factor.

His Honour further suggests that, if the Commissioner were now to form a view that a quite different scheme had been entered into or carried out, he could make a fresh determination and amendment, but not within the present appeal. With due respect, such an approach, if upheld by the High Court, could result in a succession of s 177F determinations and appeals until the Commissioner gets it right and wins the appeal.

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39 Above n 10 at 4116.

## Conclusion

Davies J said that the arrangements entered into in *MOD Sydney* did not avoid any liability to pay tax imposed by the Act.

It is contended that there was a scheme with a purpose to pay less tax but that because income which has been subject to non-resident withholding tax is not included in the assessable income of a person, and the deduction under s 51(1) is an allowable deduction, no tax benefit was obtained within the meaning of s 177C. Thus if the scheme had been entered into after the introduction of Part IVA, the Commissioner would have been unsuccessful in applying Part IVA. The burden of tax had fallen in accordance with the Act.

*Case V160* highlights a defect in Part IVA in relation to identifying the existence of a tax benefit because of the discretion vested in the trustee. In an arrangement similar to that in *MOD Sydney* entered into after the introduction of Part IVA, the taxpayer may be successful in arguing this defect in Part IVA, in that the interest was paid to the trustee of the MO Trust, who has the discretion of distribution. This results in difficulty in identifying the person receiving the tax benefit, meaning Part IVA may not apply.

Division 6 of Part III recognises derivation of income through trusts so MOD Sydney could rely on *Peabody* and argue that the eight tests contained in s 177D cannot apply because s 177A(5) and s 177D refer to part of a scheme. Reference to "scheme" must, on the authority of *Peabody* (1993) be to all the elements of the arrangements and some elements of the arrangement in *MOD Sydney* are clearly within the operation of the Act.

MOD Sydney appealed directly to the Federal Court. A request for a decision to be referred directly to the Court rather than the Tribunal is of critical importance where there is an arrangement which may otherwise fall within the scope of the provisions of Part IVA (or another section which involves the exercise of the Commissioner's discretion).

If the assessment is based on a particular section and the Commissioner disallows an objection and the tax avoidance provisions of Part IVA play no part in his decision, the authority in *Jackson* means that the Commissioner cannot subsequently change his mind and seek to apply those provisions once the matter is before the Federal Court. Similarly, on the authority of *Peabody*, if

the Commissioner fails to identify the correct section of Part IVA the same restriction applies.

Hill J, in allowing the taxpayer's appeal in *Peabody*, concluded:[40]

> Part IVA would seldom, if ever, operate to permit the Commissioner to make a determination...where the overall transaction is in every way commercial, although containing some element which has been selected to reduce the tax payable. Part IVA is no more applicable to such a case than was its predecessor, s 260.

His decision is yet to be confirmed or reversed by the High Court, but in *Jackson* Gummow J said if the determination did not include all or part of the amount in the assessable income, that failure would be to the disadvantage of the revenue rather than the taxpayer. The scheme nominated by the Commissioner and the tax benefit cancelled are the elements examined by the court to determine whether the Commissioner has exercised his discretion properly. The identified scheme in *MOD Sydney* resulted in payment of non-resident withholding tax, and income subject to the withholding tax provisions is specifically excluded from being included in assessable income.

In summary, it is contended that it is unlikely that the Commissioner would have been successful in *MOD Sydney*, even if the arrangements had been entered into after the introduction of Part IVA.

Steps that could be taken to make Part IVA more effective in cases or to prevent arrangements involving similar facts to *MOD Sydney* from exploiting the legislation would be to:

- tax interest streamed through a trust to non-resident beneficiaries at ordinary non-resident rates of tax (29% - 47%) rather than the 10% interest withholding tax rate;
- disallow a deduction for interest paid by an Australian entity as part of an arrangement to convert trading income to an interest stream which ultimately flows through a trust to non-resident beneficiaries;
- tax trusts as companies. (These three measures were

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40 Above n 10 at 4118.

recommended by the 1991 Parliamentary inquiry into the abuse of interest withholding tax provisions. The desirability of taxing trusts as companies was favourably commented upon in the 1993 Parliamentary inquiry into the Australian Taxation Office);[41]

- amend Part IVA to include an additional part to catch schemes designed to take advantage of the non-resident withholding tax provisions; and

- reinstate a revamped version of the "born again" s 260 to operate in conjunction with Part IVA.

Until effective measures are implemented, loopholes will be exploited and the revenue will continue to be at risk.

41 House of Representatives Committee on Finance and Public Administration, "Follow the Yellow Brick Road", March 1991, Recommendations 3, 4 and 5, paras 9.58 and 11.168, *An Assessment of Tax*, November 1993, Joint Committee of Public Accounts.