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Peabody v FCT and Part IVA

Abstract

The courts were only recently given their first opportunity to consider the substantive operation of Part IVA of the Income Tax Assessment Act 1936 (Cth) in the trilogy of *Peabody v FCT*. Given the potential scope of Part IVA, an understanding of the Courts' appraisal of the legislation's breadth is crucial for all taxation practitioners.

Whilst aspects of the High Court's judgment particularly its view as to the Commissioner's discretion under s 177F, may cause taxpayers concern, other aspects of the judgment affirm the existence of significant limits upon Part IVA's scope. When coupled with Hill J's acceptance that transactions entered into for commercial reasons are not caught by Part IVA, it is submitted that *Peabody* provides an appropriate balance between preventing tax avoidance and not discouraging business and family transactions.

Keywords

Income Tax, Australia, law

PEABODY v FCT AND PART IVA

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The courts were only recently given their first opportunity to consider the substantive operation of Part IVA of the Income Tax Assessment Act 1936 (Cth) in the trilogy of *Peabody v FCT*. Given the potential scope of Part IVA, an understanding of the Courts' appraisal of the legislation's breadth is crucial for all taxation practitioners.

While aspects of the High Court's judgment, particularly its view as to the Commissioner's discretion under s 177F, may cause taxpayers concern, other aspects of the judgment affirm the existence of significant limits upon Part IVA's scope. When coupled with Hill J's acceptance that transactions entered into for commercial reasons are not caught by Part IVA, it is submitted that *Peabody* provides an appropriate balance between preventing tax avoidance and not discouraging business and family transactions.

1 Introduction

While the anti-avoidance provisions contained in Part IVA of the Income Tax Assessment Act 1936 (Cth) were introduced in May 1981 to replace s 260,¹ the recent trilogy of considerations in *Peabody v FCT*² (*Peabody*) provided the courts³ with their first opportunity to

¹ Judicial interpretations and extrapolations had rendered s 260, to a large extent, ineffective. See further the comments of Hill J of the Full Federal Court in *Peabody*, below n 2 at 4110. See also *John v FCT* (1989) 89 ATC 4101 at 4108; *Davis and Anor v FCT* (1989) 89 ATC 4377 at 4399 per Hill J and *Case W58* (1989) 89 ATC 524 at 533. Such judicial limitations included the choice principle and the antecedent transactions test.

² (1992) 92 ATC 4585 (Federal Court, finding in favour of the Commissioner); (1993) 93 ATC 4104 (Full Court of the Federal Court, finding in favour of the taxpayer); (1994) 94 ATC 4663 (Full Court of the High Court, finding in favour of the taxpayer).

³ There have been earlier decisions by the Administrative Appeals Tribunal, most notably *Case W58* (1989) 89 ATC 524.

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consider its substantive⁴ operation. This article critically analyses each of the three Courts' approaches to five key issues underlying the operation of Part IVA, concentrating on the impact of the High Court's approach.

It is ultimately submitted that while aspects⁵ of the High Court's judgment may cause taxpayers concern, the judgment⁶ also significantly limits Part IVA's scope, ensuring that Part IVA combats tax avoidance without discouraging business and family transactions.

2 Facts

The facts in *Peabody* were complex. The shares in the Pozzolanian group of companies⁷ were held by two controlling interests:

- TEP Holdings Pty Ltd (T Co) as trustee of the Peabody Family Trust: 62%; and
- Mr Kleinschmidt (Mr K) and his associates: 38%.

The beneficiaries of the trust were the taxpayer (Mrs P) and her two children. The taxpayer and her husband (Mr P) were the sole shareholders and directors of T Co.

Mr P sought to purchase the interest of Mr K to enable a public float of 50%⁸ of the group. Mr K agreed to sell his interest, but two problems were identified. First, the sale price would have to be disclosed in the prospectus for the public float. This was problematic because the shares would probably be offered to the public at a higher price than that agreed between Mr K and Mr P. Second, if T Co on-sold Mr K's interest to the public within 12 months, as was intended, the transaction would be subject to considerable "capital gains tax" under s 26AAA.

⁴ As opposed to procedural matters that were considered in *FCT v Jackson* (1990) 27 FCR 1.

⁵ Particularly its view as to the Commissioner's discretion under s 177F.

⁶ More specifically, the High Court's definition of "scheme", the rejection of the sub-scheme approach and the Court's interpretation of "tax benefit" considerably confine the Commissioner's ability to invoke Part IVA.

⁷ Pozzolanian Enterprises Pty Ltd, Pozzolanian (Queensland) Pty Ltd, Pozzolanian Bulk Carriers (Queensland) Pty Ltd, Coastal Bulk Haulage Pty Ltd and subsidiaries of these four companies.

⁸ The intention being that the "Peabody interest" would retain the other 50%.

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These problems were avoided by the Peabodys using another company, Loftway Pty Ltd (L Co), to purchase Mr K's shares and then transforming those shares into virtually worthless "Z-class" shares. This would have the effect of making those shares held by T Co in the Pozzolan group represent 100% of the real value of the group. The purchase was financed by the group's banker, Westpac Banking Corporation, in a manner that effected a considerable reduction in financing costs.⁹ The subsequent public float of 50% of the shares in P Co was a great financial success.

The Commissioner¹⁰ included \$888,005 in Mrs P's income. This amount represented one third of the net capital gain Mrs P would have realised if T Co had bought and then on-sold Mr K's shares within 12 months.

3 Issues

For Part IVA to apply there must be:

- a "scheme" as defined in s 177A(1) and (3);
- the scheme must provide the "relevant taxpayer";
- with a "tax benefit" as defined in s 177C; and
- the person must enter into the scheme for the "sole or dominant purpose" of enabling the relevant taxpayer to obtain a tax benefit: s 177D.

In relation to these elements, the dispute in *Peabody* raised, inter alia, five important issues:

- (i) the meaning of "scheme";
- (ii) did the Commissioner or the Court identify the relevant scheme;
- (iii) was it sufficient if tax avoidance tainted only a step in the scheme;
- (iv) how is a tax benefit identified under s 177C;
- (v) how is the dominant purpose determined.

⁹ The bank paid an amount equal to the loan sought to purchase redeemable preference shares in L Co. The bank then received dividends equal to the after-tax amount that would have been payable under a loan arrangement and thereby obtained the benefit of a 100% rebate for the tax in respect of the dividends under what was then s 46. In time the "principal" of the loan would be paid by redeeming the shares.

¹⁰ Exercising his powers under s 177F.

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Each of these issues is considered in turn in light of the three Courts' approaches and with a critical evaluation of their impact.

4 Meaning of "scheme"

(i) Introduction

"Scheme" is defined in exceptionally broad terms in s 177A(1):

- (a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable by legal proceedings and;
- (b) any scheme, plan, proposal, action, course of action or course of conduct.

This definition is extended by s 177A(3) to include unilateral schemes.¹¹ Given the breadth of the definition in s 177A, in most cases the existence of a "scheme" will be satisfied easily.

(ii) High Court

Of the three Courts, only the High Court made substantive comment on the meaning of this notion. The Court required that the circumstances of the purported scheme be capable "of standing on their own without being 'robbed of all practical meaning'".¹²

(iii) Evaluation

It is submitted that this requirement significantly limits the scope of s 177A(1) by excluding the identified transaction/scheme if it is an integral part of a broader scheme. Where the transaction would not have occurred but for the broader scheme, it only constitutes part of the scheme or a "sub-scheme", as discussed below.

This view is not, however, shared by Australian Taxation Office representatives. Mr Michael D'Ascenzo, Chief Tax Counsel for the

¹¹ O'Loughlin J found that the subject course of action involved a unilateral scheme in so far as it was implemented by a single body, "Mr Peabody: he and his advisers, Mr Dutney, Mr Wruck and others" being viewed by O'Loughlin J as a single force: above n 2 at 4594.

¹² Above n 2 at 4670, quoting *IRC v Brebner* [1967] 2 AC 18 at 27.

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Australian Taxation Office, suggests that as long the particular transaction is not explicable by commercial reasons it is a separate scheme that may be examined in isolation of any broader scheme.¹³

It is submitted that this interpretation in effect embodies the “sub-scheme approach”, discussed below. This view suggests that it is sufficient if a step in a scheme is based on tax considerations, even though the scheme as a whole has commercial concerns as its overall purpose(s). As will be seen below, this was rejected by both the Full Court of the Federal Court¹⁴ and the High Court.¹⁵

5 Who must identify the scheme?

(i) Introduction

More controversial is whether the court is limited to the scheme as identified by the Commissioner or can it identify a new scheme to which Part IVA may apply? In *Peabody*, the Commissioner identified the scheme as including everything from the purchase of Mr K’s shares through to the public float.

(ii) First instance

O’Loughlin J, at first instance, did not adopt the Commissioner’s formulation of the scheme, but rather referred to two different narrower scenarios as being “the” scheme:

- the conversion of the shares to worthless Z-class shares and certain consequential transactions;¹⁶ and
- the financing arrangement underlying the purchase of Mr K’s shares and the conversion of the shares.¹⁷

These were used interchangeably, rather than in the alternative.

¹³ Paper presented at “Peabody and Part IVA” Seminar, Deakin University Commercial Law and Policy Centre, Law Institute of Victoria, 3 November 1994. Cf Waincymer, “Peabody and Part IVA”, paper presented at the same seminar.

¹⁴ Above n 2 at 4111.

¹⁵ Above n 2 at 4670.

¹⁶ Above n 2 at 4594. Note that the High Court stated that O’Loughlin J’s view was that this was the offending scheme, which was in turn separate from another scheme, the financing arrangement, which was based on commercial reasons: *ibid* at 4669.

¹⁷ *Ibid*.

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(iii) Full Court of the Federal Court

Hill J¹⁸ was critical of O'Loughlin J's failure "to bear steadily in his mind what the scheme was which the Commissioner had taken into account in making the determination under s 177F".¹⁹ He noted that in the course of his judgment O'Loughlin J seemed to include different transactions in the scheme.²⁰

More importantly, the Court declared that it was impermissible for O'Loughlin J to identify a different scheme to which Part IVA might apply. "When an objection decision is referred by a taxpayer to this Court", the court is confined to the scheme as identified by the Commissioner.²¹ Part IVA's operation is dependent upon the Commissioner's exercise of discretion under s 177F(1), which includes identifying the scheme.²² As this function had been committed by the legislature to the Commissioner, "the Court cannot stand in the shoes of the Commissioner" and usurp that function.²³ Hill J declared, however, that the Commissioner might support an amended assessment by a different scheme, "subject to the limits contained in s 170 of the Act".²⁴

(iv) High Court

The High Court's approach to this matter is not clear. The judgment contains the following suggestions:

- the operation of Part IVA is not based upon the Commissioner exercising a discretion under s 177F(1);
- a court may replace the Commissioner's formulation of the scheme with its own scheme;
- the Commissioner is required to identify the scheme and provide particulars of such; and
- the Commissioner may rely on alternative formulations of the scheme.

¹⁸ Who wrote the Court's primary judgment.

¹⁹ Above n 2 at 4114.

²⁰ Ibid.

²¹ Ibid at 4116.

²² Ibid, citing *Federal Commissioner of Taxation v Jackson*, above n 4 at 13.

²³ Ibid, citing *Federal Commissioner of Taxation v Jackson*, ibid.

²⁴ Ibid.

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As to the first of these points, contrary to Hill J's view, the Court held that Part IVA depends on the factual existence of a scheme that provides the taxpayer with a tax benefit, rather than the Commissioner's opinion as to its existence.²⁵ Hence the Court was not bound by the Commissioner's formulation of the scheme and, in turn, the Commissioner might rely on any alternative scheme identified by the Court.

The Court acknowledged, however, that the Commissioner was "required to supply particulars of the scheme relied on"²⁶ as an "erroneous identification" might lead to the "wrongful exercise of the discretion conferred by s 177F(1)".²⁷ Where "the error goes to the mere detail of the scheme", however, this would not have such grave consequences.²⁸

While the Commissioner must so identify the scheme, the High Court asserted that the Commissioner could justify an assessment on an alternative basis,²⁹ which might include a narrower scheme³⁰ that was part of a broader scheme.³¹

(v) Evaluation

Despite the High Court's diminution of the importance of the Commissioner formally identifying the relevant scheme, it is submitted that this continues to play a crucial part in Part IVA's application as:

- the tax benefit must be in connection with that scheme;³² and
- the person must have entered into that scheme with the dominant purpose of enabling the relevant taxpayer to obtain a tax benefit.³³

²⁵ The crucial fact, the Court held, was "whether a tax benefit which the Commissioner has purported to cancel is in fact a tax benefit obtained in connection with a Pt IVA scheme and so susceptible to cancellation at the discretion of the Commissioner": *ibid* at 4670. (Emphasis added)

²⁶ *Ibid*, citing *Bailey v FCT* (1977) 77 ATC at 4096.

²⁷ *Ibid* at 4669.

²⁸ *Ibid*.

²⁹ *Ibid* at 4670.

³⁰ Subject to the purported scheme meeting the above definition of a scheme: *ibid*.

³¹ *Ibid*, citing *XCo Pty Ltd v Federal Commissioner of Taxation* (1971) 71 ATC 4152 at 4155.

³² Sections 177D and 177F.

³³ Section 177D.

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Given the importance of identifying the scheme, it is contended that it would be remiss of the Commissioner or the courts to refer to different schemes interchangeably³⁴ or simply to fail to identify the scheme.³⁵

Moreover, the High Court's assertion that the court may substitute the Commissioner's scheme for its own reformulation³⁶ may be criticised for five reasons:

- First, one of the crucial differences between s 260 and Part IVA is that, while the former operates automatically, Part IVA is dependent upon the Commissioner making a determination under s 177F(1), which includes identifying the subject scheme.
- Second, in practice this approach would allow the courts to effect a considerable surprise on a taxpayer who challenges a Commissioner's decision on the basis of a scheme that may be dramatically different from that reconstructed by the court.³⁷
- Third, as the exercise of the Commissioner's discretion is an administrative function, the doctrine of the separation of powers prevents the courts usurping this power. While this may be avoided by suggesting that the Commissioner is adopting the court's formulation of the scheme as part of his exercise of discretion, in substance this process involves the courts usurping the Commissioner's administrative function, as the Commissioner is required to exercise his discretion to identify a scheme.

³⁴ As O'Loughlin J did in *Peabody*, above n 2 at 4594. See also *Case Y4* (1991) 91 ATC 114 where Dr Gerber (Deputy President) referred to three different arrangements as "the" scheme:

- * the execution of the mortgage by the doctor and his wife;
- * the incorporation of the company and the execution of the mortgage agreement, inclusive of all steps therein; and
- * the mere incorporation of the medical practice.

³⁵ As the High Court failed to do in *Peabody*. Waincymer suggests that, by asserting that the Commissioner was entitled to accept the narrower scheme identified by O'Loughlin J, the High Court was adopting this scheme as being the relevant scheme: above n 13. It is submitted, however, that the High Court's comment was intended to merely confirm that the Commissioner could suggest to the Court that this narrow formulation of the facts constituted a scheme and that the correctness of that suggestion would then be determined in light of, inter alia, the definition of a scheme. The comment does not mean that the Court accepted the narrow formulation as being "the" scheme.

³⁶ Above n 2 at 4670.

³⁷ While the High Court believed this could be cured by amendment (*ibid*), it is submitted that amendment does not provide a sufficient safeguard of taxpayers' rights.

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- Fourth, while clearly not intended,³⁸ the High Court's finding that the legislation's operation is not dependent upon an exercise of the Commissioner's discretion suggests that the Commissioner need not identify any scheme, leaving this task to the courts.
- Finally, as the High Court's approach potentially³⁹ facilitates a court confining its formulation of "the" scheme to those transactions/courses of conduct which give rise to tax benefits, it would more readily allow a court to ignore the commercial/financial considerations involved in the overall scheme.

More importantly, it is unclear that the High Court intended to depart significantly from Hill J's sentiments. If the High Court is suggesting that "cosmetic" errors may be "rectified" by the court, the statement is no more than a gloss on Hill J's approach. Moreover, it may be reconciled with Lockhart J's suggestion⁴⁰ that the Commissioner's determination may be set aside for failing to identify a "critical part" of the scheme.⁴¹

If, however, the High Court is suggesting that a Court may substitute its own characterisation of the scheme, as long as the "relevant taxpayer" is the same person⁴² under both schemes, it is submitted it is inappropriate for the reasons detailed above.

It is contended, however, that even the latter view would have little impact in practice for four reasons:

- First, the High Court's limited definition of "scheme"⁴³ will significantly constrain the courts' ability to identify an alternative, narrower scheme to which Part IVA may be applied.

³⁸ In so far as the High Court recognised that the Commissioner may be required to provide particulars which purportedly support the application of Part IVA and that an erroneous identification of the scheme may make an exercise of discretion wrongful: *ibid* at 4669 and 4670.

³⁹ This should not occur in practice as the High Court confined the notion of a scheme to those fact scenarios which are capable "of standing on their own without being 'robbed of all practical meaning'": *ibid* at 4670, quoting *IRC v Brebner*, above n 12 at 27.

⁴⁰ In *Spotless Services Ltd v Federal Commissioner of Taxation* (1993) 25 ATR 344.

⁴¹ *Ibid* at 366.

⁴² See in particular the Court's comment at above n 2 at 4669 - 4670.

⁴³ Requiring the scheme to be capable of standing on its own "without being 'robbed of all practical meaning'": *ibid* at 4670, quoting *IRC v Brebner*, above n 12 at 27.

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- Second, a narrow formulation of the scheme often will not satisfy the other prerequisites for the operation of Part IVA, outlined above.⁴⁴
- Third, the Commissioner's error will usually involve a failure to clearly identify the scheme or the inconsistent reference to a variety of schemes. It is submitted that such failures would be contrary to the High Court's requirement to provide particulars⁴⁵ and constitute "an error of a more fundamental kind" that could render the exercise of discretion as wrongful.⁴⁶
- Finally, it is submitted that it will be rare for a court to "come to the Commissioner's rescue" by identifying an alternative scheme to which Part IVA may operate.

6 Is it sufficient if a step in the scheme is "tainted"?

(i) Introduction

Perhaps the most controversial issue arising out of *Peabody* was whether it was sufficient for the operation of Part IVA if tax considerations were the dominant purpose(s) underlying a step/part of the scheme - a "sub-scheme". Commentators were divided on the matter.⁴⁷

The matter became controversial as a result of the decision in *Case W58*.⁴⁸ Briefly, this case involved the creation of a company to enable the taxpayer to gain employment with a computer company. In addition, however, the taxpayer used a trust to distribute the

⁴⁴ For example, if in *Peabody* the scheme was the simple conversion of Mr K's shares into Z-class shares, as suggested by O'Loughlin J, it is difficult to find the necessary causal relationship between the scheme and the tax benefit. Without the on-sale, the conversion of the shares to worthless Z-class shares provided the taxpayer with no tax benefit.

⁴⁵ Above n 2 at 4670.

⁴⁶ Ibid at 4669.

⁴⁷ While the author believed that it was illegitimate to determine the relevant purpose by examining a step in the overall scheme (Cassidy, "Observations on the Application of Part IVA: *Peabody v FCT*" (1993) 21 ABLR 424 at 430 - 431), other commentators were equally adamant that Part IVA authorised this approach (Rosenblum RI, "Part IVA of the Income Tax Assessment Act", presented at the First National Taxation Institute Retreat, Port Douglas, 15-18 July 1993 at 9 - 10; Rosenblum, "Anti-avoidance: Part IVA of the ITAA" (1994) 29(1) *Taxation in Australia* 24 at 42-43; Murphy T, "Part IVA: Back to the Beginning" (1993) 2 *Taxation in Australia* 75 at 77 and 78).

⁴⁸ Above n 1.

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proceeds of the business to his family. It has been suggested⁴⁹ that Hartigan J believed that it was sufficient for the application of Part IVA that part of the scheme, namely the creation and use of the trust, was for tax reasons, this illegitimate part of the scheme tainting the whole arrangement.

(ii) First instance

Implicitly, O'Loughlin J adopted the sub-scheme approach by accepting a narrow selection⁵⁰ of the broader facts as being the relevant scheme. He did not, however, discuss the legitimacy of his approach.

(iii) Full Court of the Federal Court

The Full Court of the Federal Court rejected the sub-scheme approach, declaring it was not sufficient that "an element of [the] scheme had a tax advantage".⁵¹ The dominant purpose must be determined "in relation to the scheme as a whole".⁵² The Commissioner could not "isolate out of a course of action one step and classify that as a scheme".⁵³ Rather, these steps had to be examined in the context of the scheme as a whole.⁵⁴ On the facts, the Court concluded that the dominant purpose underlying the overall scheme was the public floating of the company which, in turn, was commercial in nature.⁵⁵

(iv) High Court

While the High Court accepted that the Commissioner may identify alternative schemes, which may include a narrower scheme that is part of a wider scheme,⁵⁶ it stressed that the narrower

⁴⁹ Dabner, "The First Part IVA Cases and Rulings - Worst Fears Realised" 24 *Taxation in Australia* 665. It is submitted that Hartigan J did not adopt the subscheme approach, but rather believed there to be two independent schemes (creation and use of the company and the creation and use of the trust) to which Part IVA might apply.

⁵⁰ That is, confining the scheme to the conversion of Mr K's shares: above n 2 at 4594.

⁵¹ Above n 2 at 4111.

⁵² Ibid.

⁵³ Ibid.

⁵⁴ Ibid, citing *IRC v Brebner*, above n 12.

⁵⁵ Ibid.

⁵⁶ Above n 2 at 4670.

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scheme must satisfy the above definition of a scheme.⁵⁷ If the purported scheme fails this test "it is not possible to say that those circumstances constitute a scheme rather than part of a scheme".⁵⁸ In turn, that part of the scheme may not be isolated from the overall scheme.⁵⁹

The High Court rejected the Commissioner's suggestion that ss 177D and 177A(5) enabled Part IVA to "cover not only a scheme, but any part of a scheme".⁶⁰ While ss 177A(5) and 177D ensure that the dominant purpose under s 177D may be that held by a person who carries out only part of the scheme, it does not "enable part of a scheme to be regarded as a scheme on its own".⁶¹

(v) Evaluation

The preferable approach is found in the judgments of the Full Court of the Federal Court and the High Court. The language used in Part IVA and judicial interpretation of other anti-avoidance provisions suggest that tax considerations must underlie the scheme as a whole before Part IVA will be applicable.

It is contended that the High Court correctly rejected the Commissioner's submission that ss 177D and 177A ensure that it is sufficient if tax considerations underlie part of a scheme. While certain provisions in Part IVA make reference to "part of the scheme", these references are included for specific reasons, unrelated to the ultimate question of whether the dominant purpose for entering into the scheme was to obtain a tax benefit.

Section 177D provides that, inter alia, Part IVA will only apply if "it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit". As noted above, this merely ensures that the dominant purpose may be held by a person who carries out only part of the scheme. It does not detract from the ultimate obligation under s 177D of establishing that the scheme was entered into "for the

⁵⁷ Ibid. The facts must be capable "of standing on their own without being 'robbed of all practical meaning': ibid, quoting *IRC v Brebner*, above n 12.

⁵⁸ Ibid.

⁵⁹ Ibid.

⁶⁰ Ibid.

⁶¹ Ibid.

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purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with *the scheme*".⁶²

Similarly, s 177A(5)'s inclusion of persons who have entered into "the scheme or the part of the scheme ... for 2 or more purposes" merely ensures that the person with the relevant purpose may enter into only part of the scheme. Hence, as long as the tax consideration(s) held by that person is the dominant purpose underlying the scheme as a whole, it does not matter that tax related purposes do not permeate every aspect of the scheme. The reference also ensures that the person may have more than one underlying purpose. It does not negate the requirement that one of those purposes must be the dominant purpose underlying the scheme as a whole.⁶³

Further, if the references in Part IVA to a "scheme", particularly the need for the person to enter into the scheme "for the purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with *the scheme*",⁶⁴ were intended to extend to sub-schemes, there would be no reason for ss 177D and 177A(5) to expressly refer to "part of the scheme". These express references, for the specific purposes outlined above, must be to the exclusion of any implicit extension in the word "scheme" to sub-schemes in other parts of the legislation.

Both the Full Court of the Federal Court and the High Court relied on *IRC v Brebner*⁶⁵ in rejecting the sub-scheme approach. In that decision Lord Pearce declared:⁶⁶

it would be quite unrealistic and not in accordance with the subsection to suppose that [the taxpayer's] object has to be ascertained at each step in the arrangements. ... The subsection would be robbed of all practical meaning if one had to isolate one part of the carrying out of the arrangement, namely, the actual resolutions which resulted in the tax advantage, and divorce it from the object of the whole arrangement.

A similar approach was adopted by the Australian courts with respect to more specific anti-avoidance legislation, namely what is

⁶² Section 177D (emphasis added). The section also states that "This part applies to *any scheme*".

⁶³ See also the Explanatory Memorandum which accompanied the Bill introducing Part IVA. This states, at p 13, that the relevant purpose is to be tested "having regard to the scheme as a whole".

⁶⁴ Section 177D. (Emphasis added) This would be equally applicable to the statement that "This part applies to *any scheme*".

⁶⁵ Above n 12.

⁶⁶ Ibid at 27.

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known as the “bottom of the harbour” legislation.⁶⁷ Lockhart J declared that the subject course of conduct could not be severed into distinct events and the shareholder’s state of mind with respect to each transaction examined.

Hence the language used in Part IVA and previous judicial comment on other anti-avoidance legislation confirms that the scheme must be viewed as a whole, not isolated into distinct sub-schemes. Consequently, when a course of conduct involves a number of steps, some based on tax considerations, others with purely commercial consequences, the steps that may be spurred by tax reasons may only be isolated if they may satisfy the High Court’s definition of a scheme. Unless they may exist independently, and retain their importance and meaning once so isolated, they may not be treated as a separate scheme.

7 How is a tax benefit identified under s 177C?

(i) Introduction

As noted above, before a scheme may be held to be subject to Part IVA it must provide the relevant taxpayer with a “tax benefit”.⁶⁸ Section 177C defines “tax benefit” in terms of an amount not included in the relevant taxpayer’s assessable income where that amount would or might reasonably be expected to have been included in the taxpayer’s income, or the allowance of a deduction which would or might not have been allowable, but for the scheme.⁶⁹ The most controversial aspect of this definition is the interpretation of the phrase an amount that “would have been included, or might reasonably be expected to have been included” in the taxpayer’s assessable income.

⁶⁷ *FCT v Greghron Investments Pty Ltd* (1987) 87 ATC 4988 at 5007. Lockhart J declared that the subject course of conduct could not be severed into distinct events and the shareholder’s state of mind with respect to each transaction examined.

⁶⁸ Section 177D.

⁶⁹ Note that the narrow interpretation of the “choice principle” is entrenched in s 177C(2) in so far as a tax benefit attributable to a declaration, election or option expressly provided for by the Act is excluded from the definition of tax benefit: cf *Case W 58*, above n 1 at 536-537.

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O'Loughlin J asserted that s 177C required the Court to determine whether "the decision maker could properly postulate that it 'might reasonably be expected' that the [subject profits] ... would have been included in the assessable income of [the relevant taxpayer] 'if the scheme had not been entered into or carried out'".⁷⁰ He believed that this was "not very demanding; it merely calls for a reasonable expectation"⁷¹ as distinct from "something that is irrational, absurd or ridiculous".⁷² The ease of identifying a reasonable expectation, he stated, made the taxpayer's burden of showing an assessment to be excessive "very onerous".⁷³

Applying this test, O'Loughlin J held that there was a reasonable expectation that Mrs P might have received as assessable income one third of the capital gain from the sale of the shares.⁷⁴ But for the scheme, he stated, the Peabody Family Trust would have purchased Mr K's shares, on-sold them to the public within 12 months and passed on the capital gain to the beneficiaries, including Mrs P.⁷⁵ The scheme, therefore, provided Mrs P with a tax benefit within s 177C.

(iii) Full Court of the Federal Court

The Full Court of the Federal Court required a greater degree of probability that the income would have been derived, or the deduction not obtained, by the taxpayer but for the scheme. Hill J declared that s 177C(1)(a) required a "reasonable expectation" in the sense of a reasonable "supposition or hypothesis" that the taxpayer would otherwise derive the income.⁷⁶ While he agreed with O'Loughlin J that "reasonable" should be interpreted in contradistinction to "irrational, absurd or ridiculous",⁷⁷ he stressed that a reasonable expectation was more than a "mere possibility".⁷⁸ It requires a "reasonable probability".⁷⁹

⁷⁰ Above n 2 at 4595.

⁷¹ Ibid at 4596.

⁷² Ibid at 4597, quoting in support *Attorney-General's Department v Cockcroft* (1986) 64 ALR 97 at 106; *FCT v Arklay* (1989) 89 ATC 4563.

⁷³ Ibid.

⁷⁴ Ibid at 4596-4597.

⁷⁵ Ibid at 4597.

⁷⁶ Above n 2 at 4111.

⁷⁷ Ibid at 4112, citing *AG v Cockcroft*, above n 72 at 106.

⁷⁸ Ibid.

⁷⁹ Ibid, citing *Davies v Taylor* [1974] AC 207 at 212 and 219.

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Applying this test, Hill J concluded that the scheme as identified by the Commissioner did not provide Mrs P with a tax benefit within s 177C.⁸⁰ While it was clear that Mr K's shares would have been acquired and that it was the parties' initial intention that T Co would be the purchaser, the "matter remained quite fluid until the question of financing the purchase arose".⁸¹ Given the benefits that flowed from the financing scheme, Hill J ultimately concluded that the only reasonable expectation was that another company (L Co), not the trustee company (T Co), would have purchased Mr K's shares.⁸² Consequently it could not reasonably be expected that the subject amount would have been included in Mrs P's assessable income but for the scheme.⁸³ Hill J believed O'Loughlin J's conclusion to the contrary to be "unreasonable or irrational".⁸⁴

(iv) High Court

The High Court agreed with Hill J that a "reasonable expectation requires more than a possibility."⁸⁵ It involves a prediction of what may have occurred if the scheme had not been entered into and the "predication must be sufficiently reliable for it to be regarded as reasonable".⁸⁶

Applying this test to the facts before it, the High Court agreed with Hill J that it could not reasonably be expected that T Co would purchase Mr K's shares.⁸⁷ First, T Co faced considerable difficulties in financing the purchase of Mr K's shares.⁸⁸ Second, as T Co was a trustee company, it was "far from clear that it could have established any entitlement to a rebate in respect of dividends paid on" Mr K's shares and this rebate entitlement constituted an integral part of the financing arrangement.⁸⁹ Even if T Co was able to avoid this difficulty by purchasing Mr K's shares beneficially, Mrs P would not be presently entitled to any of the profits arising from the on-sale of the shares.⁹⁰

80 Ibid at 4116-4117.

81 Ibid.

82 Ibid.

83 Ibid.

84 Ibid.

85 Above n 2 at 4671.

86 Ibid, citing *Dunn v Shapowloff* [1978] 2 NSWLR 235 at 249.

87 Ibid.

88 Ibid.

89 Ibid.

90 Ibid.

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The only reasonable expectation was, therefore, that L Co would make the profit⁹¹ and there was no reasonable expectation that this would flow to T Co and, in turn, to Mrs P.⁹² While the Commissioner tried to establish that even if L Co was the purchaser Mrs P might nevertheless have obtained a tax benefit, the Court believed this had not been proven “as a matter of reasonable expectation”.⁹³

(v) Evaluation

It is submitted that the approach of the Full Court of the Federal Court and the High Court is preferable to that reflected in O’Loughlin J’s judgment for two reasons.

First, the Commissioner would be able to establish this element too readily if all that was required was that the assumption was outside the realm of the “irrational, absurd or ridiculous”.⁹⁴ This would allow the Commissioner to arbitrarily pick and choose from possible taxpayers, targeting a particular taxpayer even though he/she is an unlikely recipient of the subject tax benefit.

Second, it is submitted that by prefacing the phrase “might reasonably be expected” with the words “would have been included”, the legislation suggests the need for a definite expectation, rather than a mere possibility.

The practical effect of the High Court’s interpretation remains to be seen. Depending upon the degree of probability that the Commissioner must establish, identifying a tax benefit may prove to be considerably difficult. This may be particularly so with respect to new streams of income, as establishing the taxpayer’s entitlement to them but for the scheme will generally be arduous.⁹⁵ The High Court’s finding may in effect incorporate into Part IVA the same limitations that the antecedent situation test imposed on s 260.⁹⁶

As to the High Court’s factual conclusion, apart from the three bases outlined in the Court’s judgment, three further reasons suggest that it

⁹¹ Ibid.

⁹² Ibid at 4671 and 4672.

⁹³ Ibid at 4672.

⁹⁴ As per O’Loughlin J, above n 2 at 4597.

⁹⁵ That is, in the absence of a previous like receipt, the Commissioner may not be able to establish that the taxpayer would, or reasonably might be expected to, obtain the taxable income and hence obtain a tax benefit from the arrangement.

⁹⁶ See, for example, *Rippon v FCT* (1992) 92 ATC 4186 and *Osborne v FCT* (1995) 95 ATC 4323.

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could not reasonably be expected that Mrs P would have derived the subject income:

- First, if the scheme had not been carried out and T Co had bought the shares, it is more likely that the company would have refrained from selling the shares for 12 months in order to avoid the application of s 26AAA.⁹⁷
- Second, the evidence adduced only established that income receipts were normally distributed equally between the three beneficiaries. This may have been inapplicable to capital receipts, such as those stemming from the sale of these shares.⁹⁸
- Finally, where a discretionary trust is involved, it is difficult to say that funds would or might be distributed in a certain way. As Deputy President Todd stated in *Case V160*,⁹⁹ as the trustee has a discretion as to distribution, it is impossible to determine whether one beneficiary or another would receive the subject income within s 177C.

Whilst O'Loughlin J believed that this difficulty was overcome by referring to the trustee's past practice,¹⁰⁰ there was still the possibility that the trustee would vary that practice.

8 How is the dominant purpose determined?

(i) Introduction

The final issue to be considered is how the dominant purpose underlying the scheme is determined. Despite the absence of substantive comment by the High Court on this matter, in light of its importance, it is nevertheless briefly examined to complete the "picture" that the *Peabody* trilogy paints as to Part IVA's operation.

As noted above, Part IVA only applies where, having regard to the eight factors listed in s 177D(b),¹⁰¹ it would be concluded that a

⁹⁷ Cf Murton, "Cases, Legislation and Rulings: Crayfish and Yachts," (1992) *Taxation Institute of Australia Tasmanian State Convention Papers* 3 at 8.

⁹⁸ Murton, *ibid*, notes that the capital beneficiaries of the trust were not identified. They may, for example, have been Mr P, rather than the three income beneficiaries.

⁹⁹ (1980) 88 ATC 1058.

¹⁰⁰ Above n 2 at 4597.

¹⁰¹ The eight factors to which reference is to be made are:

(i) the manner in which the scheme was entered into or carried out;

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person entered into or carried out a scheme for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit: s 177D.

The application of s 177D has raised two primary questions. First, how should the factors listed in s 177D(b) be approached? Second, does s 177D and, in particular, the reference to business or family connections in s 177D(b)(viii), incorporate the “predication test”, espoused by Lord Denning in *Newton v FCT*?¹⁰² According to the predication test, schemes that may be predicated as being entered into for the dominant purpose of, inter alia, commercial and/or family reasons fall outside the scope of the relevant anti-avoidance provisions.

(ii) First instance

As to the first issue, O’Loughlin J declared that there need not be an adverse finding with respect to each of the eight matters specified in s 177D(b) before Part IVA could apply.¹⁰³ It was sufficient if one factor suggests that the dominant purpose underlying the scheme was to obtain the tax benefit.¹⁰⁴

As to the second issue, for two reasons O’Loughlin J did not incorporate the predication test into Part IVA. First, he refused to refer to extrinsic materials which indicated that Part IVA was intended to incorporate this test.¹⁰⁵ Second, he was loathe to use case law¹⁰⁶ pertinent to s 260 to interpret Part IVA.¹⁰⁷

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- (ii) the form and substance of the scheme;
 - (iii) the time when the scheme was entered into and the length of the period during which the scheme was carried out;
 - (iv) the result achieved but for Part IVA;
 - (v) any change in the financial position of the taxpayer as a result of the scheme;
 - (vi) any change in the financial position of any person who has a connection (whether family or business) with the taxpayer as a result of the scheme;
 - (vii) any other consequences for the relevant taxpayer or any other person referred to in sub-paragraph (vi);
 - (viii) the nature of any connection (whether family, business or other) between the taxpayer and a person referred to in sub-paragraph (vi).

¹⁰² (1958) 98 CLR 1 at 9.

¹⁰³ Above n 2 at 4597.

¹⁰⁴ Or two as in this case: *ibid*.

¹⁰⁵ *Ibid* at 4593.

¹⁰⁶ Which would seemingly include *Newton v FCT* (1958) 98 CLR.

¹⁰⁷ Above n 2 at 4593.

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On the facts, O'Loughlin J held that the substance of the scheme (s 177D(b)(ii)) and the advantageous change in Mrs P's financial position effected by avoiding the payment of tax on the capital gain (s 177D(b)(v))¹⁰⁸ indicated that the dominant purpose underlying the scheme was tax avoidance.

(iii) Full Court of the Federal Court

While the Full Court of the Federal Court agreed with O'Loughlin J that an adverse finding need not be attributable to each of the eight factors,¹⁰⁹ Hill J believed that particular factors should not be considered in isolation. Rather, regard must be had "to each and every one of the matters referred to in s 177D(b)" and the relevant purpose should be evaluated by examining those factors for and against the taxpayer.¹¹⁰

Hill J declared that these eight factors provided an exhaustive list of matters relevant to determining the dominant purpose. Hence this was to occur solely through an objective application of these factors without reference to "the actual subjective purpose of any relevant person".¹¹¹

Most importantly, Hill J rejected O'Loughlin J's suggestion that the predication test was inapplicable to Part IVA. He examined the explanatory memorandum and concluded that Part IVA was intended "to restore the law to what it was thought to be after the decision of the Privy Council in *Newton v Federal Commissioner of Taxation*".¹¹² Hill J concluded his judgment by echoing the sentiments underlying the predication test, assuring that Part IVA would "seldom, if ever, ... [apply] 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."¹¹³

On the facts, Hill J rejected O'Loughlin J's finding that Mr P's dominant purpose was to enable Mrs P to obtain a tax benefit as being absurd.¹¹⁴ Rather, he believed that the scheme as a whole was

¹⁰⁸ Ibid at 4597-4598.

¹⁰⁹ Above n 2 at 4113.

¹¹⁰ Ibid.

¹¹¹ Ibid.

¹¹² Ibid at 4110.

¹¹³ Ibid at 4118.

¹¹⁴ Ibid at 4117 and 4118.

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entered into by Mr P with a dominant commercial purpose of acquiring Mr K's shares and floating the company.¹¹⁵

(iv) High Court

While the application of s 177D was not in issue, it is nevertheless relevant to note that the High Court accepted that as the subject circumstances, apart from the devaluation of Mr K's shares, were explicable upon a commercial basis, this ensured that the arrangement did not fall within Part IVA.¹¹⁶

(v) Evaluation

Hill J's approach to the factors listed in s 177D(b) is appropriate. By requiring each factor to be considered, this view ensures that the relevant purpose will not be determined by isolating a number of negative features and adjudging the arrangement by those aspects. Tax considerations must be weighed against other non-tax considerations, the court ultimately determining which dominates.

It is submitted that Hill J's adoption of the predication test accords with the legislative intent underlying Part IVA. That s 177D embodies the predication test has previously been confirmed by both the then Commissioner of Taxation, Mr Boucher,¹¹⁷ and the then Treasurer, Mr Howard. The latter stated that "arrangements of a normal business or family kind, including those of a tax planning nature" were beyond the scope of Part IVA. Part IVA should not "cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of the opportunity available for the arrangement of their affairs".¹¹⁸ It is submitted that these comments reflect a sensible policy designed not to

¹¹⁵ Ibid.

¹¹⁶ Above n 2 at 4672.

¹¹⁷ At a seminar conducted by the Taxation Institute of Australia Mr Boucher stated that any family connection between the taxpayer and other parties to the scheme, and/or family or commercial reasons underlying the scheme, were relevant to the exclusion of Part IVA. See also Second Commissioner Nolan's address of 15 June 1990.

¹¹⁸ Second Reading Speech. Cf also IT Ruling 2330. The Treasurer also gave a number of important examples of arrangements outside the purview of Part IVA: i) "a husband and wife who chose to run a business as a partnership will need have no fear of having their arrangements affected by Part IVA" and ii) "[t]here will be no question ... of the new provisions impeding a parent who wished to pass to a spouse or to children the use or enjoyment of some income producing asset."

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discourage business and family dealings that are structured tax effectively.

9 Conclusion

While the High Court's apparent revision of the basis of Part IVA is disturbing, it has also been submitted that this change of approach will not impact upon taxpayers in practice. Perhaps more importantly, the High Court has imposed appropriate limits on the scope of Part IVA by confirming Hill J's rejection of the "sub-scheme approach", by strictly construing s 177C and by implicitly confirming that transactions entered into primarily for commercial reasons are not caught by Part IVA.