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ATO's Determination on CGT Cost Base Inclusion for Interest Expenditure Denied Deductibility under Split Loans because Part IVA is Flawed and Misleading

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Abstract

The Full High Court in *FCT v Hart* (2004) 55 ATR 712 found that further interest and compound interest incurred under a split loan facility is not deductible under the general deduction provision, by operation of the general anti-avoidance rule (GAAR)in Part IVA. But can the interest be included in the cost base of a CGT asset, namely, the investment property? In Taxation Determination TD 2005/33, the Australian Taxation Office (ATO) says no. The ATO claims that it would be inappropriate for the ATO to make a compensating adjustment under s 177F(3) to include the interest denied deductibility because of the GAAR in the cost base of the investment property.

This article argues there are many shortcomings in the ATO's technical analysis in TD 2005/33. The ATO's approach is illogical, and much of the focus in TD 2005/33 is on the wrong question. The design of the GAAR is likely to provide an answer unpalatable to the ATO. The failure of the ATO to raise another relevant GAAR argument (ie, taxpayer obtained a tax benefit in the form of an inclusion in the cost base of the investment property) in *Hart's* case does not assist the ATO. Further, the ATO's extraordinary failure to refer to Taxation Ruling TR 98/22 in TD 2005/33 borders on deception. Taxation Ruling TR 98/22 - a binding ruling - states that certain interest (further interest, and arguably compound interest) denied deductibility under a split loan arrangement because of a GAAR determination is included in the cost base of the investment property. This is contrary to the position now asserted by the ATO in TD 2005/33. Is TD 2005/33 being used to 'bludgeon' affected taxpayers into accepting a position that has little merit under the tax law?

Keywords

ATO, taxpayers, general deductions, CGT, taxation determination

ATO'S DETERMINATION ON CGT COST BASE INCLUSION FOR INTEREST EXPENDITURE DENIED DEDUCTIBILITY UNDER SPLIT LOANS BECAUSE OF PART IVA IS FLAWED AND MISLEADING

Dale Boccabella *

The Full High Court in *FCT v Hart* (2004) 55 ATR 712 found that further interest and compound interest incurred under a split loan facility is not deductible under the general deduction provision, by operation of the general anti-avoidance rule (GAAR) in Part IVA. But can the interest be included in the cost base of a CGT asset, namely, the investment property? In Taxation Determination TD 2005/33, the Australian Taxation Office (ATO) says no. The ATO claims that it would be inappropriate for the ATO to make a compensating adjustment under s 177F(3) to include the interest denied deductibility because of the GAAR in the cost base of the investment property

This article argues there are many shortcomings in the ATO's technical analysis in TD 2005/33. The ATO's approach is illogical, and much of the focus in TD 2005/33 is on the wrong question. The design of the GAAR is likely to provide an answer unpalatable to the ATO. The failure of the ATO to raise another relevant GAAR argument (ie, taxpayer obtained a tax benefit in the form of an inclusion in the cost base of the investment property) in *Hart's* case does not assist the ATO. Further, the ATO's extraordinary failure to refer to Taxation Ruling TR 98/22 in TD 2005/33 borders on deception. Taxation Ruling TR 98/22 - a binding ruling - states that certain interest (further interest, and arguably compound interest) denied deductibility under a split loan arrangement because of a GAAR determination is included in the cost base of the investment property. This is contrary to the position now asserted by the ATO in TD 2005/33. Is TD 2005/33 being used to 'bludgeon' affected taxpayers into accepting a position that has little merit under the tax law?

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1 Introduction

Given that large numbers of taxpayers are affected by the issue raised in Taxation Determination TD 2005/33 (TD 2005/33), the determination is extremely disappointing in terms of its technical analysis. Even worse, TD 2005/33 reflects an astounding lack of disclosure by the Australian Taxation Office (ATO) on a matter of importance to numerous taxpayers. The lack of disclosure is misleading, if not 'deceptive'. Indeed, it is hard to escape the conclusion that TD 2005/33 is being used to 'bludgeon' affected taxpayers into accepting a position that has very little merit under the tax law. In light of this, it would not be a surprise if taxpayers (or, more accurately, their advisors) pay little respect to TD 2005/33.

The question raised in TD 2005/33 is whether interest (further interest and compound interest) accruing under a split loan which was denied deductibility under the general deduction provision by operation of the general anti-avoidance rule (GAAR) on the authority of *FCT v Hart*[1] is included in the third element of the cost base of the CGT asset (ie, investment property) that was financed by the relevant borrowing? Not surprisingly, the conclusion in TD 2005/33 is no. Inexplicably, the ATO's view is that the interest denied deductibility because of the Part IVA determination (GAAR determination) is excluded from the cost base of the investment property because of the cost base exclusion rule(s) in ss 110-40(2) and 110-45(1B) of the *Income Tax Assessment Act* 1997 (ITAA 1997). Subsections 110-40(2) and 110-45(1B) state that an expense cannot be included in the cost base of a CGT asset if it can be deducted. The interest denied deductibility cannot be deducted, and yet the ATO states that the exclusion rule(s) in ss 110-40(2) and 110-45(1B) apply. The ATO does not provide any reasoning to support its 'view'. From there, the ATO states that the only way in which the interest denied deductibility can come within the cost base of the investment property is if a compensating adjustment is made under s 177F(3) of the *Income Tax Assessment Act* 1936 (ITAA 1936). In this regard, the ATO concludes that it would not be appropriate to make a compensating adjustment.

This article analyses the approach of the ATO. This analysis is in Section 3. In order to appreciate the ATO's analysis in TD 2005/33, and the response to that analysis in this article, a brief outline of the facts in a split loan situation is set out in Section 2. The overall conclusion in this article is that the ATO's reasoning in TD 2005/33 is flawed. Put shortly, the ATO's approach lacks logic, and much of the focus in TD 2005/33 is on the wrong question. Indeed, it is submitted that it is not in the ATO's interest to address the correct question, as the design of the GAAR provides an answer that is unpalatable to the ATO. The failure of the ATO to raise another

1 *FCT v Hart* (2004) 55 ATR 712.

relevant GAAR argument (ie taxpayer obtained a tax benefit in the form of an inclusion in the cost base of the investment property) in *Hart's Case*[2] does not assist the ATO. Section 3 of the article also points out the ATO's extraordinary failure to refer to Taxation Ruling TR 98/22. Taxation Ruling TR 98/22, which is a binding ATO ruling,[3] states that certain interest (further interest, and arguably compound interest) denied deductibility under a split loan arrangement because of a GAAR determination is included in the cost base of the investment property. This is contrary to the position now asserted by the ATO in TD 2005/33.

2 Split loans/linked loans: an outline

The following outline of a split loan arrangement (or linked loan arrangement) is taken from a previous article by the author, namely, D Boccabella, Does the interest expenditure denied deductibility in *Hart's Case* enter the CGT cost base of the investment property?: An examination of the key issues (2004) 33 *AT Rev* 216, 217-220. That outline, and therefore this outline, is largely based on the facts in *Hart's Case*.[4] The facts in *Hart's Case* would be fairly representative of most split loan arrangements. Further, it is clear that TD 2005/33 is directed at the type of split loan arrangement involved in *Hart's Case*.[5]

2.1 Facts in *Hart's* Case

Briefly, and with some licence to vary non-material facts and the amounts involved in *Hart's Case*, the taxpayer borrowed $300,000 under a variable rate principal and interest loan, with the aim of funding: (1) The purchase of an investment property[6] and (2) The purchase of a new home to live in. At the option of the taxpayer, the loan

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2 Ibid.

3 Section 170BA(3) of the *Income Tax Assessment Act 1936* (ITAA 1936).

4 Above n 1.

5 It can also be noted that the split loan arrangement set out here is not materially different to those dealt with in Taxation Ruling TR 98/22. Taxation Ruling TR 98/22 deals with the deductibility and CGT asset cost base inclusion for certain types of interest incurred under split loans or linked loans. Note, a large number of the paragraphs in Taxation Ruling TR 98/22 were withdrawn by an addendum to Taxation Ruling TR 98/22 issued on 11 August 2004.

6 It should be noted that the taxpayer refinanced an existing home loan previously used for her main residence that, after obtaining the split loan facility, was to be used as an investment property. There is no *in principle* difference between the refinancing of a loan in order to retain ownership of a property which is now to be used for income production and, taking out a loan to purchase a property for income production: *Hart v FCT* (2002) 50 ATR 369, 376 (Full Federal Court: Hill J).

was split into two accounts or parts. One part was dedicated to the purchase of an income-producing asset (hereafter referred to as Loan Account 2). The other part was applied to purchase a new main residence for the taxpayer (Loan Account 1).

The loan(s) is to be fully repaid within 25 years. However, initially, all loan repayments ($2,550 per month/$30,600 per year) made by the taxpayer are applied against the principal outstanding on the non-deductible part of the loan (ie Loan Account 1). Loan Account 1 will be repaid in just over ten years.[7] At this time, the amount outstanding on Loan Account 2 will have 'blown out' to around $250,000 (up from the initial principal of $100,000). The reason for this blow out is that no repayments were directed to Loan Account 2 during those first ten years, so that not only was interest continuing to accrue on the original principal sum (referred to as 'normal interest' and 'further interest' in this article), interest was also accruing on unpaid interest (referred to as 'compound interest' in this article). At the ten year mark, repayments will then be applied against Loan Account 2. The first 12 month period of the loan is used to illustrate the application of the repayments against Loan Account 1, and the accrual of the various types of interest on Loan Account 2.

	Income Producing Use Part of Loan Loan Account 2	Domestic Use Part of Loan Loan Account 1
Loan Principle Advanced	$100,000	$200,000
Repayments/Payments First 12-mths of loan		
Interest	Nil	$17,772
Principal	Nil	$12,828
Total Paid	Nil	$30,600
Accrual of Interest – First 12-month of Loan		

7 Note that on the actual sums borrowed in *Hart's Case*, it would have been around the 7½ year mark when Loan Account 1 is paid off, and payments commence against Loan Account 2: *Hart v FCT* (2001) 48 ATR 317, 335 (Gyles J), *Hart v FCT* (2002) 50 ATR 369, 375 (Full Federal Court: Hill J).

Normal Interest	$9,105	Not relevant, as not deductible
Further Interest	$45	does not arise
Compound Interest	$395	does not arise

Whether or not the taxpayer directed all loan repayments to Loan Account 1 in the early years (as opposed to rateably across both accounts (ie $2,550 per month had been applied rateably between Loan Account 2 (1/3rd ($850 per month)) and Loan Account 1 (2/3rds ($1,700 per month)), it would still take 25 years to discharge the loan(s) or total indebtedness. Thus, the pre-income tax cash flow position of both the taxpayer and the lender is roughly the same no matter which loan repayment structure is chosen. Sections 2.1.1-2.1.3 explain what each type of interest is, and how it arises in regard to Loan Account 2.

2.1.1 Normal Interest[8]

'Normal interest' is the amount of interest - the only amount of interest - that would have been incurred by the taxpayer had the loan repayments ($2,550 per month) been applied rateably between Loan Account 2 and Loan Account 1 ie 1/3 ($850 per month) to Loan Account 2 and 2/3 ($1,700 per month) to Loan Account 1). The amount of normal interest per period will decline over the term of the loan as such interest is based on a diminishing/reducing principal sum.

2.1.2 Further Interest[9]

The description 'further interest' is found in the judgment of Gyles J at first instance in *Hart's* case.[10] This is the amount of interest that accrued on the outstanding principal of the loan as a result of a failure to apply loan repayments rateably between Loan Account 2 and Loan Account 1 (ie 1/3 to Loan Account 2 and 2/3 to Loan Account 1). This is not interest on unpaid interest. Another way to put it is that further interest

8 The terminology used by the Australian Taxation Office (ATO) to describe the various types of interest that arise under a split loan do not correspond with the descriptions used in this article. The ATO's descriptions, along with those used in this article and which appear in brackets, are as follows: (a) Capitalised Interest (Normal Interest, Further Interest and Compound Interest) (b) Additional Interest (Further Interest and Compound Interest) and (c) The Further Interest Amount (Compound Interest): paragraphs 5-7 of Taxation Ruling TR 98/22.

9 Ibid.

10 *Hart v FCT* (2001) 48 ATR 317, 319-22.

equals the amount of interest that would have accrued had the loan been an interest-only loan, less the amount of interest that would have accrued had the repayments been applied rateably between Loan Account 2 and Loan Account 1 (ie difference in interest that would accrue on the following types of loans: (a) A principal and interest loan and (b) An interest-only loan).

Further interest clearly accrues during every year of the loan up till the end of the 10th year (ie, time repayments commence on Loan Account 2). The amount of further interest during these ten years would increase from year to year as the gap between the original principal, and what would have been the reducing principal, widens. After the 10th year, further interest will also continue to accrue. The reason is that the loan repayments commencing from the 11th year would presumably be applied against the interest accruing thereafter on the 'blown out' principal sum ($250,000) on Loan Account 2 and that principal. This means it would still be some time before the principal sum on Loan Account 2 is reduced down to $100,000, which was the original principal sum on Loan Account 2. However, even after the principal sum on Loan Account 2 falls below $100,000, there will still be a further interest amount. The further interest amount will then begin to reduce as the gap between the original principal ($100,000) and the reducing principal shrinks.

2.1.2.1 Numerical example as to how further interest (and normal interest) arises

	Principal and Interest Loan	Interest Only Loan
Original Loan Principal	$500,000	$500,000
Interest Accrued for 12-months	$47,835	$50,000
Repayments/Payments for 12-months	$96,000	$50,000
Principal Repayments for 12-months	$48,165	Nil
Interest Payments for 12-months	$47,835	$50,000

Terms of Loans/Assumptions

The two loans involved a $500,000 principal sum;

On both loans, interest accrued daily;
The principal and interest loan required repayments of $8,000 per month ($96,000 per year);
The interest-only loan involved payments of $4,167 per month ($50,000 per year);
The interest rate on both loans is 10%;
The interest rate remained at 10% for the first 12-months of both loans;
The example deals with the first 12-months of the respective loans; and
All repayments/payments were made on time as agreed with the lender.
'Normal interest' on both loans in the example for the 12-months was $47,835. 'Further interest' on the interest-only loan in the example for the 12-months is $2,165 (ie $50,000 less $47,835).

2.1.3 Compound interest[11]

This is the amount of interest that is attributable to, or arises on or from, the interest that was not paid at or near the time it accrued (ie interest on interest). Compound interest includes: (1) Interest on normal interest that was not paid (2) Interest on further interest that was not paid and (3) Interest on compound interest that was not paid. In the initial year, this amount would be relatively small as the sum on which it accrues is still relatively small. However, it would grow to a substantial annual sum when the loan goes beyond the first couple of years.

Of course, compound interest reaches it peak just before the time that loan repayments commence on Loan Account 2, which is in the 11th year. However, compound interest does not cease to accrue in the 11th year. The reason is similar to that stated above in regard to 'further interest'. That is, the loan repayments commencing from the 11th year would presumably be applied against the interest accruing thereafter on the 'blown out' principal sum ($250,000) on Loan Account 2 and that principal. This means it would still be some time before loan repayments would discharge all of the compound interest that had accrued on Loan Account 2.

2.2 Decision in *Hart's* Case

The ATO did not attempt to deny deductions for normal interest incurred by the taxpayer on the investment part of the loan, it being clear that the borrowed funds were used or applied to purchase (refinance) an assessable income-producing asset. Further, at no stage did the ATO argue that the GAAR should apply to normal interest. However, in regard to the further interest and the compound interest, the ATO argued that these items did not satisfy the tests for deductibility under the

11 Above n 8.

general deduction provision.[12] In the alternative, the ATO argued that the GAAR applied to these two items of interest.[13]

2.2.1 General deduction provision: s 51(1) of the ITAA 1936 and s 8-1 of the ITAA 1997

The High Court did not analyse the question as to whether further interest and compound interest were deductible under the general deduction provision. However, by dismissing the ATO's application for special leave to appeal against the Full Federal Court's decision that further interest and compound interest were deductible under the general deduction provision, the High Court has effectively accepted that these amounts were deductible under that provision.[14] In the Full Federal Court, Hill J said:

There is no reason in principle why there should be any difference between [normal interest and further interest] and compound interest. Both are simply the cost of the funds which are borrowed. It is artificial to treat compound interest as the cost of some new fund divorced from the original borrowing. The compounding of interest is no more than a formula for computing the interest to be paid on the funds originally borrowed. Accordingly, as the learned primary judge held [Gyles J], the compound interest, like the [normal interest and further interest], will take its character from the use to which the original funds borrowed are put.[15]

And later, Hill J said:

> The moneys were borrowed on terms that included the payment of [normal interest, further interest and compound interest]. There is no suggestion that the amounts paid were not interest. The combination of the [normal interest and further interest and the compound interest] on Loan Account 2 were together the cost of borrowing money used to refinance the rental property [former home]….The objective facts suffice to characterise the compound interest payments, as they characterise the [normal interest and the further interest

12 *Hart v FCT* (2001) 48 ATR 317, 321-2 (Gyles J).
13 *Hart v FCT* (2001) 48 ATR 317, 326-7 (Gyles J).
14 *FCT v Hart* (2004) 55 ATR 712, 714 (Gleeson CJ and McHugh J), 719 and 731 (Gummow and Hayne JJ), and 744 (Callinan J).
15 *Hart v FCT* (2002) 50 ATR 369, 378.

> payments] as being incurred in gaining or producing assessable income and not as being of a private or domestic kind.[16]

Other members of the Full Federal Court agreed with Hill J.[17]

2.2.2 General anti-avoidance rule (GAAR) in part IVA of the ITAA 1936

The Full High Court held that the GAAR applied to the further interest and the compound interest that accrued on the investment portion of the loan. The Full High Court accepted that the 'tax benefit' to the taxpayer under the GAAR was the deduction for the further interest and the compound interest.[18] All three substantive elements of the GAAR were present, namely, a scheme, the obtaining of a tax benefit in connection with the scheme, and that a relevant person entered into the scheme with the dominant purpose of obtaining the tax benefit.[19]

Importantly, the tax benefit identified by the Full High Court (and Gyles J and the Full Federal Court) was the 'generation of a deduction' pursuant to s 177C(1) of the ITAA 1936. At no stage did the Full High Court (and Gyles J and the Full Federal Court) identify any other tax benefit amongst those set out in s 177C(1). Further, at no stage in the Hart litigation did the ATO argue that the tax benefit was anything other than the 'generation of a deduction'.[20]

Finally, the Full High Court (and Gyles J and the Full Federal Court) made no mention of a compensating adjustment arising under s 177F(3) of the ITAA 1936 in regard to the taxpayer's scheme. And, at no stage in the Hart litigation did the ATO suggest that a compensating adjustment could arise in regard to the taxpayer's scheme.

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16 *Hart v FCT* (2002) 50 ATR 369, 379.

17 Above n 15.

18 The comment by Callinan J that 'the whole of the interest payable in respect of a loan to finance…the acquisition or holding of an investment property…' is the benefit cannot be accepted, as this would include normal interest within the tax benefit: *FCT v Hart* (2004) 55 ATR 712, 742-743. As Hill J noted in *Macquarie Finance Ltd v FCT* (2004) 57 ATR 115, 143, it can be assumed that this is not what Callinan J meant.

19 *FCT v Hart* (2004) 55 ATR 712, 716-8 (Gleeson CJ and McHugh J), 719, 721, 728 and 730-1 (Gummow and Hayne JJ) and 742-3 (Callinan J).

20 It is worth noting that the investment property is clearly a CGT asset whose ultimate sale will give rise to CGT event A1 under s 104-10 of the ITAA 1997. Further, the gain or loss on the investment property will not be disregarded on the basis of being the taxpayer's main residence.

3 Analysis of taxation determination TD 2005/33

TD 2005/33 only contains 13 paragraphs, including a two-paragraph example. To ensure comprehensive coverage, the approach in this article to analysing the content of TD 2005/33 is to work through each paragraph in order (Sections 3.2-3.13). This allows the reader to follow the ATO's analysis and logic, and the response in this article. First however, the question raised by, or the title of, TD 2005/33 requires considerable comment (Section 3.1).

3.1 Question in TD 2005/33, or title of TD 2005/33

The question in TD 2005/33, or the title of TD 2005/33, is:

Income tax: does expenditure - which is a non-capital cost of ownership of a CGT asset - form part of the cost base of the asset, if it is a tax benefit in connection with a scheme to which the general anti-avoidance rules in Part IVA of the *Income Tax Assessment Act 1936* apply?

The notion of a 'tax benefit' is exhaustively set out in s 177C(1) of the ITAA 1936, it being impossible to read the content of s 177C(1) as anything other than an exhaustive list. That is, to be a tax benefit, the circumstances of the scheme must come within one of the itemised categories.[21] At present, there are four items in s 177C(1). They can be described is summary as: (1) The dropout from, or of, assessable income[22] (2) The generation of a deduction[23] (3) The generation of a capital loss under the capital gains tax (CGT) regime[24] and (4) The generation of a foreign tax credit.[25] As noted at the beginning of Section 2 above, TD 2005/33 is based on the split loan arrangement in *Hart's Case*. The tax benefit identified at all stages in the litigation in *Hart's Case* was the generation of a deduction under the general deduction provision.[26] This was the tax benefit the ATO identified at first instance in the Hart litigation.[27] Further, at no time in the three court cases in the Hart litigation did the ATO assert that the tax

21 It is submitted that the use of the term 'tax advantage' in the course of discussing the notion of 'tax benefit' in the GAAR by Callinan J in *FCT v Hart* (2004) 55 ATR 712, 743 does not extend the notion of a tax benefit beyond the specifically enumerated items in s 177C(1) of the ITAA 1936.

22 Section 177C(1)(a) of the ITAA 1936.

23 Section 177C(1)(b) of the ITAA 1936.

24 Section 177C(1)(ba) of the ITAA 1936.

25 Section 177C(1)(bb) of the ITAA 1936.

26 Section 51(1) of the ITAA 1936 and s 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997).

27 *Hart v FCT* (2001) 48 ATR 317, 327.

benefit was anything other than the generation of a deduction. In other words, the Full High Court did not hold that the interest (further interest and compound interest) was a tax benefit under s 177C(1) of the ITAA 1936 comprised of the 'generation of a capital loss' or the 'dropout from assessable income'.[28]

To exclude an expense (in the case of a split loan, further interest and compound interest) from a cost recognition provision (eg deduction conferral provision, CGT asset cost base provision) by operation of the GAAR, that would otherwise be included in such a cost recognition provision, there must, amongst other things, be a 'tax benefit'. The notion of a tax benefit in s 177C(1) does not expressly encompass inclusion of an expense in the cost base of a CGT asset. The only way in which an expense, otherwise coming within the cost base of a CGT asset, can be a tax benefit is if somehow such recognition leads to: (1) The 'generation of a deduction' (2) A 'dropout of assessable income' or (3) The 'generation of a capital loss'. In other words, just because an expense is a tax benefit in regard to a deduction provision (ie generation of a deduction) does not mean that that same expense is a tax benefit in regard to inclusion in the cost base of a CGT asset. To be a tax benefit in regard to a CGT asset cost base provision, it must positively come within one of the tax benefits set out in s 177C(1). Or, put another way, the notion of a tax benefit in s 177C(1) does not read 'cost recognition per se'.

The problem with the wording of the question in TD 2005/33 is that it opens up the implication that the further interest and compound interest denied deductibility under the general deduction provision in *Hart's Case* is a tax benefit comprising inclusion in the cost base of the investment property. The use of the term, 'non-capital costs of ownership of a CGT asset' in the question provides the offending words. Some support for this comes later in TD 2005/33 where the ATO makes the observation that:

…a Part IVA determination [GAAR determination] under subsection 177F(1) [of the ITAA 1936] to disallow a deduction for a non-capital cost of ownership, such as interest, will not of itself affect the calculation of the amount included in the assessable income for net capital gains unless a compensating adjustment is made under subsection 177F(3).[29]

To be accurate, the question in TD 2005/33 should have specified that the relevant tax benefit for the further interest and the compound interest was comprised of the

28 A tax benefit in the form of the 'generation of a foreign tax credit' (s 177C(1)(bb) of the ITAA 1936) can be ignored for the purpose of this article.

29 Paragraph 9 of Taxation Determination TD 2005/33.

'generation of a deduction' only. Without such a statement, the question in TD 2005/33 may itself lack precision and tends to mislead. Unfortunately, the ATO's lack of precision tends to carry through the rest of TD 2005/33.[30]

3.1.1 Is further interest and compound interest denied deductibility because of the GAAR determination, a tax benefit under the tax benefit items in subsection 177C(1) of the ITAA 1936?[31]

It will become apparent from the analysis later in this article that the key question that will govern the issue raised in TD 2005/33, and the one that the ATO fails to identify and therefore address in TD 2005/33, is whether the further interest and compound interest denied deductibility because of the GAAR determination, comes within any of the items of 'tax benefit' listed in s 177C(1)?[32] In other words, for present purposes, we can assume that further interest and compound interest denied deductibility under the general deduction provision does positively come within the third element of the cost base of the investment property.[33]

The following analysis can be brief as most of the relevant issues have been discussed elsewhere.[34] First, the inclusion of an expense or a cost in the cost base of a CGT asset is not expressly listed as a tax benefit in s 177C(1) of the ITAA 1936 (ie generation of cost base inclusion is not a tax benefit). That means that the only way in which to exclude cost base inclusion by way of a GAAR determination is for the further interest and compound interest to come within the specifically listed tax benefits. Only two have any chance of being relevant, namely, the 'generation of a capital loss' and the 'dropout from assessable income'. The 'generation of a foreign tax credit' cannot exist because inclusion in the cost base of a CGT asset does not give rise to a foreign tax credit. And further, the 'generation of a deduction' as a form of tax benefit also

30 See in particular paras 1 and 9-12 of Taxation Determination TD 2005/33.

31 The ATO will have no trouble identifying a 'scheme' coming within s 177A(1) of the ITAA 1936 in regard to a split loan arrangement that seeks to obtain inclusion of a cost in the cost base of a CGT asset. Accordingly, this article will not discuss this issue.

32 The 'dominant purpose' requirement will also be relevant in regard to the tax benefit identified, assuming one can be identified: ss 177A(5) and 177D of the ITAA 1936. This is discussed in Section 3.1.2 below.

33 Section 110-25(4) of the ITAA 1997. In addition, ss 110-40(2) and 110-45(1B) of the ITAA 1997 do not apply to exclude cost base exclusion. These issues are discussed in Section 3.10 below.

34 See D Boccabella, 'Does the interest expenditure denied deductibility in *Hart's Case* enter the CGT cost base of the investment property?: An examination of the key issues'(2004) 33 *AT Rev* 216, 225-8.

cannot exist because the inclusion in the cost base of a CGT asset cannot be regarded as a 'deduction'.[35]

3.1.1.1 Generation of a capital loss

It is submitted that the further interest and compound interest would not come within the notion of a tax benefit comprising the generation of a capital loss. The following extract, with footnotes omitted, captures the reasoning:

'Subsection 177C(1)(ba) of the ITAA 1997 refers to a "capital loss". The term is defined to mean 'for each *CGT event, a *capital loss* is worked out in the way described in that event.' In regard to interest on a borrowing to purchase an investment property, the only relevant CGT event is CGT event A1 in s 104-10 of the ITAA 1997. A capital loss under s 104-10 is worked out by subtracting the capital proceeds on occurrence of the CGT event (ie disposal of asset) from the reduced cost base of the asset.

Assuming that further interest and compound interest can only come within the third element of the cost base of a CGT asset, such interest is excluded from the reduced cost base of an asset. If the further interest and compound interest cannot even contribute to the making of a capital loss, it is impossible to sustain an argument that such interest amounts to a capital loss. Accordingly, the further interest and compound interest cannot be a tax benefit under s 177C(1)(ba) of the ITAA 1936.

In regard to the time at which the loan(s) were taken out in *Hart's Case* (ie 8 October 1996), the notion of a 'tax benefit' in s 177C(1) of the ITAA 1936 did not even include a 'capital loss' under the CGT regime.'[36] (footnotes omitted).

3.1.1.2 Dropout from, or of, assessable income

It is reasonable to conclude from paragraphs 9 and 10 of TD 2005/33 that the ATO, if it had turned its mind to the issue in the context of a tax benefit, would consider the dropout from assessable income as the form of tax benefit applicable to the inclusion

35 Ibid 226-7 for a fuller analysis.
36 Ibid 227-8.

of an expense or cost in the cost base of a CGT asset.[37] In the first sentence in paragraph 9, the ATO refers to '…the calculation of the amount included in the assessable income for net capital gains…'. In addition, the last three sentences in paragraph 10 read as follows:

A compensating adjustment can only be made if the disallowed amount would have been included in the cost base of the relevant CGT asset had the scheme not been entered into or carried out (and therefore, there is an additional amount included in assessable income that would not have been included, or there would have been a larger capital loss incurred, had the scheme not been entered into or carried out). In some cases it will be reasonable to suppose that the amount might have been included in the cost base of a different CGT asset (or no asset at all). In these cases the net capital gain would not have been less if the scheme had not been carried out. Therefore a compensating adjustment could not be made in respect of the net capital gain included in the assessable income.

Even though paragraph 10 deals with the compensating adjustment mechanism in s 177F(3) of the ITAA 1936, s 177F(3) uses the same concepts that encompass a 'tax benefit' in s 177C(1). The difference of course is that the compensating adjustment mechanism is seeking to provide an 'advantage' or 'correction' in regard to a detriment that arises because of the scheme (eg an inclusion in assessable income that would not have arisen but for the Part IVA scheme). For present purposes, the relevant item is the exclusion from assessable income, of an amount that has been included in assessable income because of the scheme. At no stage in TD 2005/33 does the ATO provide an explanation or reasons to support its view that the inclusion of a cost in the cost base of a CGT asset relates to an 'inclusion in assessable income'. Another view is expressed in the following extract:

At first glance, it seems absurd to attempt to characterise the inclusion of further interest and compound interest in the cost base of a CGT asset as an exclusion from assessable income. However, the ATO's argument may be that including an amount of further interest and compound interest in the cost base of the investment property increases the cost base of the property, which in turn lowers (or eliminates) the capital gain on the disposal (occurrence of a CGT event) of the property. In turn, this lowers the net capital gain (or prevents a net capital gain from arising), which in turn lowers the taxpayer's assessable income inclusion. The argument continues, there does not appear to be any other limb in the notion of a tax benefit that would catch a situation

37 The analysis of the CGT asset cost base provision in Taxation Ruling TR 98/22 supports this analysis: see paragraphs 27-33 of Taxation Ruling TR 98/22. Note that paragraphs 27-33 were withdrawn by an addendum to Taxation Ruling TR 98/22 issued on 11 August 2004.

where a taxpayer seeks to exclude a capital gain that would otherwise be made on a CGT asset. And finally, the notion of a tax benefit does expressly deal with a capital loss on a CGT asset, but it does not deal with a gain situation. While somewhat attractive, the argument cannot be accepted.

First, it is submitted that the tax benefit referable to an exclusion from assessable income contemplates a receipt or a profit being excluded. Certainly, an amount of profit that is included in assessable income can entail the subtraction of expenses and these circumstances might be within the notion of a tax benefit referable to assessable income [profit on sale of a revenue asset where the profit enters assessable income under s 6-5 of the ITAA 1997]. However, the notion of a tax benefit referable to assessable income does not generally focus on an expense per se, which is what is involved with further interest and compound interest when viewed in isolation and distanced from the ultimate (and possible) disposal of the investment property. Secondly, even if the incurring of further interest and compound interest can somehow be viewed as part of a profit/gain calculation made on disposal of the investment property, that profit or gain does not necessarily enter assessable income of a taxpayer. The reason is that a capital gain made on an individual CGT event is aggregated with other gains for an income year, and from there, losses are subtracted to arrive at a net capital gain. It is this latter item or amount (ie net capital gain) that enters a taxpayer's assessable income. Accordingly, the incurring of the interest is somewhat remote from the assessable income inclusion. Further, the presence of a sufficiently large loss for an income year can cancel out a gain (eg $20,000 loss would cancel out an expected gain of $17,000, leaving a net capital loss of $3,000). In these circumstances, it would be difficult to conclude that an amount (ie $17,000) was being excluded from the taxpayer's assessable income.

The author appreciates that if the above analysis is correct, the notion of a tax benefit may need reforming in regard to schemes where a taxpayer has prevented a capital gain from arising on a CGT event. In the end though, the better view is that inclusion of further interest and compound interest in the cost base is quite removed from an assessable income inclusion. Accordingly, this aspect of the notion of a tax benefit should not apply to further interest and compound interest.'[38] (footnotes omitted).

Subsection 177C(2)(a) provides some support for the ATO's view. The effect of s 177C(2)(a) is that certain assessable income exclusions that are attributable to the making of an agreement, choice, election, etc, provided for under the income tax will not give rise to a tax benefit. The CGT rollover election, in Subdivision 126-B of the ITAA 1936, for transfers of CGT assets between companies that are members of the

38 Boccabella, above n 34, 225-6.

same wholly-owned group is excluded from the exempting effect of s 177C(2)(a) (ie such transfers can give rise to a tax benefit). The focus of Subdivision 126-B is clearly on the gain arising on a CGT event,[39] and not the 'net capital gain', which is the item/amount that enters assessable income.[40] The assumption underlying s 177C(2) appears to be that the exclusion of a capital gain on a CGT event does amount to an exclusion from assessable income.

Arguably, a 1999 amendment to s 177C of the ITAA 1936 also provides some support for the ATO's view. Subsection 177C(4) was inserted to have effect from 21 September 1999. It reads:

To avoid doubt, paragraph (1)(a) [tax benefit in the form of a dropout from assessable income in s 177C(1)(a)] applies to a scheme if:

an amount of income is not included in the assessable income of the taxpayer of a year of income; 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; and

instead, the taxpayer or any other taxpayer makes a discount capital gain (within the meaning of the *Income Tax Assessment Act 1997*) for that or any other year of income.

Subsection 177C(4) clearly deals with the 'conversion' of what would have been an income receipt/income profit into a 'discount capital gain' under the CGT regime. A discount capital gain may be treated more favourably that an income receipt/income profit of the same amount.[41] The ATO's argument here might be that s 177C(4) reflects the view that a discount capital gain, which is likely to have replaced an income receipt/income profit because of the scheme, is an item or amount that enters assessable income and that therefore s 177C(4) has a function in making it clear that a tax benefit does accrue/can accrue in the form of a dropout from assessable income even though the discount capital gain itself enters assessable income (ie the inclusion

39 See in particular, ss 126-45(2)(a), 126-55(1)(a) and 126-60(1) of the ITAA 1997.
40 Section 102-5(1) of the ITAA 1997.
41 Assuming there are no CGT current year losses and there are no previous year net capital losses, only half of a discount capital gain will enter the assessable income of an individual: ss 102-5 and 115-100 of the ITAA 1997. However, if losses exceed the amount of a discount capital gain, there is no benefit to the taxpayer of having made the discount capital gain because the gain is absorbed by the losses: see Steps 1-3 in the method statement in s 102-5(1) of the ITAA 1997.

of the discount capital gain in assessable income does not prevent a tax benefit in the form of a dropout from an assessable income provision from arising).

The argument is not compelling. First, s 177C(4) is merely stated to 'avoid doubt'. This hardly amounts to a positive statement, one-way or the other, from the legislature as to its understanding of s 177C(1) of the ITAA 1936. Secondly, the notion of a tax benefit under s 177C(1)(a) is focused on the amount or item that 'drops out of assessable income'. Subsection 177C(1)(a) has nothing to say about what replaced the 'dropped out item'. This has been the ATO's view for some time.[42] In this regard, what s 177C(4) does is to point out what the effect of the scheme for tax purposes would have been if it were not subject to a GAAR determination (ie taxpayer would have made a discount capital gain). Indeed, the character of what replaced (in s 177C(4), a discount capital gain) the item or amount that dropped out of assessable income is more an issue for the compensating adjustment mechanism in s 177F(3).[43] Thirdly, and related to the second point above, s 177C(4) does not deal with the prevention of a capital gain arising (ie a dropout of a capital gain). Subsection 177C(4) only deals with the dropout of an income receipt/income profit (see reference to 'income' in s 177C(4)(a)).[44] Accordingly, s 177C(4) is not even dealing with the conversion of a 'non-discount capital gain' into a 'discount capital gain'. The implication to be drawn from s 177C(4) (or a similar provision) might have been more favourable to the ATO had the legislature also dealt with the conversion of a 'non-discount capital gain' into a 'discount capital gain'. The obvious response is that the legislature did not deal with this type of conversion because the legislature felt that a capital gain did amount to a 'dropout from assessable income'. In the end though, all we are left with in regard to s 177C(4) is the drawing of implications and speculation.

42 This is consistent with the ATO's long held view that the notion of a tax benefit relates to the exclusion of a particular item/amount of assessable income: see Taxation Ruling IT 2456 (in particular, paragraph 5) and paragraphs 18-21 of Taxation Ruling IT 2513. Taxation Ruling IT 2456 was issued on 14 January 1988, and Taxation Ruling IT 2513 was issued on 23 December 1988.

43 There may be problems in providing a compensating adjustment for the discount capital gain to the taxpayer under s 177F(3) of the ITAA 1936. The reasons are the same as those in regard to the inclusion of a CGT gain in the notion of a tax benefit in the form of a dropout from assessable income: see D Boccabella and T O'Sullivan, 'Home loan unit trust arrangements: Analysis of application of Part IVA' (2003) 32 *Australian Tax Review* 236, 269-271 for a discussion of the issue.

44 It can safely be assumed that the reference to 'income' in s 177C(4)(a) of the ITAA 1936 is limited to income on ordinary concepts, and does not extend to a capital receipt/capital profit that gives rise to a capital gain under the CGT regime. These distinctions are now well known to the legislative drafter.

Contrary to assumptions made by the ATO, it is submitted that there is considerable doubt as to whether the 'dropout from assessable income' encompasses the inclusion of an expense or cost in the cost base of a CGT asset.

3.1.2 Dominant purpose of entering into the scheme to obtain 'A Tax Benefit'

Assuming for the moment that the ATO can identify a tax benefit in regard to the inclusion of further interest and compound interest in the cost base of the investment property, a necessary condition for the making of a GAAR determination is that a person (which may include the taxpayer who obtained a tax benefit) must have entered into the scheme for the 'dominant purpose' of enabling the taxpayer to obtain 'a tax benefit'.[45] The indefinite article 'a' is used on all the occasions (three occasions) where the term 'tax benefit' appears in s 177D of the ITAA 1936. In other words, s 177D does not expressly link, or limit, the dominant purpose requirement (test) to the identified tax benefit that arose from the scheme; any tax benefit from the scheme appears sufficient provided that the dominant purpose test is satisfied in regard to any tax benefit. This raises the possibility that a dominant purpose finding in regard to a person that generates one tax benefit in connection with a scheme (eg generation of a deduction) is sufficient for the purpose of s 177D in regard to another tax benefit that arises from the same scheme (eg dropout from assessable income). This interpretation of s 177D would be very helpful to the ATO in a split loan situation because the Full High Court in *Hart's Case* held that the dominant purpose of the relevant person for carrying out the identified scheme was to obtain deductions under the general deduction provision (ie generation of a deduction as the tax benefit).[46] In light of this, it is unlikely that a conclusion can be reached that the dominant purpose of a person or the taxpayer in *Hart's Case*, and in another split loan situation, was to obtain the tax benefit in the form of CGT asset cost base inclusion.

The key question is, what is the correct interpretation of the words 'a tax benefit' in s 177D of the ITAA 1936? Does it mean the tax benefit in regard to which there is a dominant purpose, or does it mean any tax benefit, which may include one where no

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45 Section 177A(5) and s 177D of the ITAA 1936. The purpose of a person is to be determined objectively: *FCT v Spotless Services Ltd* (1996) 34 ATR 183, 192; *FCT v Consolidated Press Holdings Ltd & Ors; CPH Property Pty Ltd v FCT* (2001) 47 ATR 229, 247.

46 *FCT v Hart* (2004) 55 ATR 712, 719 (Gleeson CJ and McHugh J), 730-1 (Gummow and Hayne JJ) and 743-4 (Callinan J). This was also the view of Gyles J at first instance: *Hart v FCT* (2001) 48 ATR 317, 334-335 and 340-341. The Full High Court's decision essentially restored Gyles J's decision at first instance.

dominant purpose exists in regard to the particular tax benefit?[47] There are arguments both ways. First, the legislature has expressly chosen to use the term, or retain the term, 'a tax benefit' three times throughout s 177D. In other words, the legislature even after having first identified the concept of 'a tax benefit' as a broad concept only requiring a connection with a scheme, refused to alter the terminology so as to make the link with the dominant purpose requirement of the relevant person. Instead, the reference to the concept remained 'a tax benefit'. As a matter of sentence structure, one would think that if the legislature required a link between the dominant purpose of a person and a particular tax benefit, subsequent references to a tax benefit in s 177D would have been linked to the purpose requirement, rather than a tax benefit at large. This tends to support the interpretation that there is no requirement to link a dominant purpose conclusion of a person to the tax benefit identified. It appears that any tax benefit will do, a position favourable to the ATO in a split loan situation.

Secondly, if the 'tax advantage', to use a neutral term, involves two or more cost or expense recognition provisions of the income tax, it is hard to see how it can ever be possible to have the GAAR applying to both provisions (tax benefits under both provisions) in regard to a scheme (one scheme). The reason is that on the assumption that the dominant purpose test is a more than a 50% purpose in pursuit of the identified tax benefit, the dominant purpose test can never be satisfied in regard to two tax benefits in the case where the two tax benefits arise from the one scheme. In other words, limiting the GAAR to the tax benefit in regard to which a dominant purpose exists automatically excludes a dominant purpose finding from the other tax benefit that arose from the same scheme.[48] This is an important issue because in many areas, the structure of the income tax is to give recognition for expenditure that has been denied deductibility under the general deduction provision.[49] This could

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47 The tax benefit at large interpretation of s 177D of the ITAA 1936 will generally benefit the ATO, and be detrimental to taxpayers. On the other hand, the requirement for a link between the dominant purpose and the identified tax benefit will generally benefit taxpayers, and be detrimental to the ATO.

48 The judgment of Brennan CJ, Dawson, Toohey, Gaudron, Gummow and Kirby JJ in *FCT v Spotless Services Ltd* (1996) 34 ATR 183, 188 said in regard to the dominant purpose test in the GAAR: 'In its ordinary meaning, dominant indicates that purpose which was the ruling, prevailing, or most influential purpose.' In light of these comments, it is arguable that, in mathematical terms, the dominant purpose test can be satisfied even when the relevant purpose is below 50%, provided of course it is greater than the other purposes individually (eg 40% tax benefit purpose and the other two purposes are 35% and 25% respectively). Even if this is the correct approach to the dominant purpose test, the analysis in the body of the article still stands.

49 The third element of the cost base of a CGT asset is the provision in issue in this article: s 110-25(4) of the ITAA 1997.

undermine the broad policy of the GAAR where cost recognition is involved because cost recognition under, for example, the cost base of a CGT asset can be just as beneficial as a deduction under the general deduction provision.[50] This supports the view that s 177D is referring to any tax benefit, or a tax benefit at large, as opposed to only the tax benefit for which a dominant purpose finding has been made.[51]

Thirdly, the dominant purpose test does not focus on the subjective purpose of the person who entered into or carried out the scheme. Rather, the test is objective.[52] The Full High Court in *FCT v Consolidated Press Holdings Ltd & Ors; CPH Property Pty Ltd v FCT* noted that:

One of the reasons for making s 177D turn upon the objective matters listed in the section, it may be inferred, was to avoid the consequence that the operation of Part IVA [the GAAR] depends upon the fiscal awareness of a taxpayer.[53]

The Full High Court's extract does not deal with the current problem (ie whether there is a requirement for a link between the dominant purpose and the identified tax benefit). The extract focused solely on the dominant purpose test. In spite of this, it may be valid to ask whether fiscal awareness issues should impact on the proper interpretation of s 177D? It is arguable that in *Hart's Case*, both the taxpayer and the ATO were ignorant of the potential tax benefit of cost base inclusion of the further

50 Whether this is the case depends on things such as the timing of a CGT event, compared to the time a deduction is obtained.

51 The ATO could always argue that the secondary tax benefit (eg cost base inclusion of the further interest and compound interest in a split loan situation (*Hart's Case*)) arose from a scheme that was slightly different to the scheme from which the primary tax benefit arose (eg deductions for further interest and compound interest under the general deduction provision). There is clear authority permitting the ATO to argue alternate schemes: *FCT v Peabody* (1994) 28 ATR 344, 351. This is subject to the proviso that the alternate scheme is capable of standing on its own without being robbed of all practical meaning: *FCT v Peabody* (1994) 28 ATR 344, 352. (But note the disapproving comments of Gummow and Hayne JJ in *FCT v Hart* (1994) 55 ATR 712, 725-726 on the position taken in regard to a 'scheme' in *FCT v Peabody* (1994) 28 ATR 344, 352). In this way, a dominant purpose finding in regard to a particular tax benefit would not constrain a dominant purpose finding in regard to another tax benefit. However, this would not be enough to positively establish a dominant purpose finding in regard to the alternate tax benefit. In any event, it is arguable that one should not have to put a strain on one element of the GAAR (ie scheme) to overcome what may be a design flaw in another area of the GAAR (notion of tax benefit).

52 *FCT v Spotless Services Ltd* (1996) 34 ATR 183, 192; *FCT v Consolidated Press Holdings Ltd & Ors; CPH Property Pty Ltd v FCT* (2001) 47 ATR 229, 247.

53 *FCT v Consolidated Press Holdings Ltd & Ors; CPH Property Pty Ltd v FCT* (2001) 47 ATR 229, 247.

interest and the compound interest. Instead, their focus was on the tax benefit comprised of the generation of deductions. It would be more consistent with the downplaying of a taxpayer's fiscal awareness, objectively speaking, in the operation of the GAAR to adopt the tax benefit at large interpretation of s 177D. In that way, the focus would be on the effect and outcome of a scheme, rather than on the means of obtaining a tax benefit, and a person's statement of mind, objectively speaking. Or, put another way, the fact the taxpayer is ignorant of all of the tax benefits that accrue from a scheme would not provide an exemption from the GAAR.

Fourthly, a valid question to ask is, does the tax benefit at large approach prejudice taxpayers? This is a valid question in light of the fact that the ATO did not raise the cost base inclusion issue in *Hart's Case*. It is submitted that the answer should generally be no. In *FCT v Peabody*,[54] the Full High Court stated that there is no reason why the ATO cannot argue for both a wide and a narrow scheme, provided the ATO's alternate scheme argument does not cause undue embarrassment or surprise to the taxpayer. If it does, an amendment to the pleadings can be made, provided the interests of justice allow such a course.[55] While these comments relate to the scheme issue in the GAAR, there is no reason to think the approach is not relevant to the notion of a tax benefit. In other words, there is no reason to let a procedural issue constrain the correct interpretation of s 177D. This is not inconsistent with the proposition that a procedural error may frustrate the application of the GAAR in a particular case.[56]

Finally, there is little judicial guidance on the issue. The main reason is that the courts have not been expressly asked to address the question. The 'guidance' that does exist is not supported by reasons. Accordingly, that guidance cannot carry much weight. From the author's research, the following cases are the only ones where, in the course of providing broad descriptions of the GAAR, the courts have given some indication that the dominant purpose of the relevant person must be present in regard to the impugned tax benefit, rather than a tax benefit at large:

54 *FCT v Peabody* (1994) 28 ATR 344, 351.

55 Ibid.

56 It is worth noting that in the Full Federal Court in *FCT v Sleight* (2004) 55 ATR 555, Hill J would not give the ATO leave to argue the application of the GAAR to a scheme that was formulated differently to the one argued for at first instance: *FCT v Sleight* (2004) 55 ATR 555, 577-578. Part of his Honour's reasoning was that the tax benefit in regard to the alternate scheme may differ from the tax benefit in connection with the original scheme: *FCT v Sleight* (2004) 55 ATR 555, 578.

'…a taxpayer has obtained a "tax benefit" or would obtain such a benefit but for sec. 177F, and the tax benefit has been obtained or would be obtained by the taxpayer "in connection with a scheme" to which Part IVA applies.': *Jackson v FCT* (1989) 20 ATR 611, 618 (Gummow J).

'The prerequisites for the making of a determination under that [s 177F(1)] are that a taxpayer has obtained a tax benefit, or would but for the operation of sec. 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.': *FCT v Jackson* (1990) 21 ATR 1012, 1016 per Hill J.

'It may be observed that the tax benefit that is required by the closing words of s. 177D to be considered, may, but need not be, the same tax benefit as that actually obtained by the relevant taxpayer. In the ordinary case, however, the tax benefit required by the closing words of s. 177D to be considered will be the same as the tax benefit referred to in s. 177D(a).': *Peabody v FCT* (1993) 25 ATR 32, 42 per Hill J.

'…having regard to the eight matters identified in par (b) of s 177D, it would be concluded that there was the necessary dominant purpose of enabling the taxpayer to obtain the tax benefit;…': *FCT v Spotless Services Ltd* (1996) 34 ATR 183, 186 per Brennan CJ, Dawson, Toohey, Gaudron, Gummow and Kirby JJ.[57]

'Part IVA will be satisfied if it was the obtaining of the tax benefit that directed the relevant persons in taking steps they otherwise would not have taken by entering into the scheme…': *Metal Manufactures Ltd v FCT* (2000) 43 ATR 375, 427 per Emmett J.

'…having regard to the factors listed in s. 177D(b), it can objectively be concluded that the person or persons who entered into or carried out the scheme or part of the scheme did so for the sole or dominant purpose of enabling the taxpayer to obtain that tax benefit in connection with the scheme.': *Krampel Newman Partners Pty Ltd & Ors v FCT* (2003) 52 ATR 239, 264 per Ryan J.[58]

While each of the 'authorities' set out above may be seen as a rejection of the 'at large' interpretation, and therefore supporting the 'impugned tax benefit' interpretation of s

57 Some six pages later in the judgment, their Honours use the 'at large' approach in reaching their conclusion: *FCT v Spotless Services Ltd* (1996) 34 ATR 183, 192-193 (Brennan CJ, Dawson, Toohey, Gaudron, Gummow and Kirby JJ).

58 Some five paragraphs later in the judgment, Ryan J uses the 'at large' approach in describing s 177D(b) of the ITAA 1936: *Krampel Newman Partners Pty Ltd & Ors v FCT* (2003) 52 ATR 239, 265.

177D, they cannot be regarded as determinative. In any event, there are a greater number of judicial statements that fail to support the 'impugned tax benefit' interpretation.[59] In the end, there is no clear judicial statement one-way or the other. On balance though, the 'at large' interpretation is preferred. This is mainly on the basis of the failure of the legislature to draft the wording of s 177D in such away as to limit the GAAR's operation to circumstances where the dominant purpose of a person exists in regard to a particular tax benefit, and the potential that the GAAR's operation will be stymied where two cost recognition provisions are involved.

Accordingly, if the tax benefit point can be overcome, and the 'at large' interpretation of s 177D is correct, the ATO may be able to use the GAAR to exclude the further interest and the compound interest from the cost base of the investment property.[60]

3.2 Paragraph 1 of TD 2005/33

This paragraph gives a negative answer (ie no) to the question raised in TD 2005/33. The explanation is that:

It does not form part of the cost base of the CGT asset unless the Commissioner has made a determination for a compensating adjustment to that effect under subsection 177F(3) of the *Income Tax Assessment Act 1936* (ITAA 1936).

Given that the ATO's detailed reasoning regarding the refusal to use the compensating adjustment mechanism in Part IVA is contained in later paragraphs,[61] this article's response is also dealt with later.[62]

3.3 Paragraph 2 of TD 2005/33

This paragraph summarises s 110-25(4) of the ITAA 1997. Subsection 110-25(4) contains a list of costs (eg interest on money borrowed to acquire an asset, interest on money borrowed to refinance the money borrowed to acquire the asset) that may

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59 See for example, *FCT v Peabody* (1994) 28 ATR 344, 348 (Full High Court); *FCT v Hart* (2004) 55 ATR 712, 718 (Gleeson CJ and McHugh J), 721 (Gummow and Hayne JJ) and 743 (Callinan J).

60 Note that the ATO has made binding statements in Taxation Ruling TR 98/22 that further interest (and arguably, compound interest) denied deductibility because of the GAAR, can be included in the cost base of the investment property. Section 3.13 below deals with this issue.

61 Paragraphs 8-10 of Taxation Determination TD 2005/33.

62 Sections 3.10 and 3.11 below.

come within the third element of the cost base of a CGT asset. The list is claimed to be inclusive only. Subject to the qualification below, the paragraph is an accurate statement of the law, and there is nothing controversial about paragraph 2. The qualification is that the paragraph fails to expressly acknowledge the question as to whether a cost that is outside the listed items (eg compound interest perhaps), but which may come within the notion of 'non-capital costs of ownership of a CGT asset', is within the reach of s 110-25(4).[63]

3.4 Paragraph 3 of TD 2005/33

This paragraph states that costs that would otherwise come within s 110-25(4) of the ITAA 1997 do not form part of the cost base to the extent the taxpayer has deducted those costs or can deduct those costs. Subsections 110-40(2) and 110-45(1B) of the ITAA 1997 are cited as the authorities for this proposition. The paragraph is an accurate statement of the law, and there is nothing controversial about this paragraph.[64]

3.5 Paragraph 4 of TD 2005/33

This paragraph reads:

> If any of these non-capital costs of ownership of an asset that are allowable deductions are tax benefits that have been obtained, or which would but for section 177F of the ITAA 1936 be obtained, in connection with a scheme to which Part IVA applies, the Commissioner may make a Part IVA determination under paragraph 177F(1)(b) of the ITAA 1936 in relation to the deductions that they are not allowable to the taxpayer ('the disallowed amount').

On the face of it, and read in isolation, paragraph 4 appears uncontroversial, and contains an accurate statement of the law. However, the problem with paragraph 4, which carries through the rest of TD 2005/33, is that the tax benefit comprised of the 'generation of a deduction' is being described as 'non-capital costs of ownership of an asset'. The description, non-capital costs of ownership of an asset, describes a collection of expenses (including interest) that may receive recognition under the tax rules by way of inclusion in the third element of the cost base of a CGT asset. Inclusion in the cost base of a CGT asset of 'non-capital costs of ownership of an asset' is quite different in character to recognition for such expenses as a deduction under

63 See Section 3.10.2 below. Also, for an even more detailed discussion of this issue, see D Boccabella, above n 34, 230-4.

64 Readers will appreciate that the ATO's interpretation and application of ss 110-40(2) and 110-45(1B) of the ITAA 1997 is quite hard to accept: see Section 3.10 below.

the general deduction provision (eg timing of recognition is likely to always differ). The notion of a tax benefit in s 177C(1) of the ITAA 1936 recognises this by setting out a particular rule for the 'generation of deductions', as opposed to other forms of tax benefits (eg generation of a capital loss, dropout from assessable income).[65] In spite of this, TD 2005/33 chose to intermingle, merge or mix two cost recognition provisions. This can create the impression that a GAAR determination made in regard to deductions also encompasses cost recognition under the CGT asset cost base rules. Admittedly, the reference to s 177F(1)(b) of the ITAA 1936 and the reference to 'deductions' (and not CGT asset cost base inclusion) in the closing part of paragraph 4 can be seen as an attempt to correct the 'initial error' (ie there was no intent on the part of the ATO to intermingle two cost recognition provisions). However, this attempted 'correction' may have been negated by referring to the disallowed deduction as '('the disallowed amount')'. In the end though, on a fair reading of TD 2005/33, the ATO is not intermingling, merging or mixing two cost recognition provisions.[66] In spite of this, the ATO' s approach in paragraph 4 is careless and lacks the precision required of a determination that many taxpayers and tax advisors will be looking to for guidance.

3.6 Paragraph 5 of TD 2005/33

This paragraph contains two bullet points. The first bullet point states that the Commissioner is authorised to take such action as considered necessary to give effect to the GAAR determination (eg amend an assessment) This bullet point is an accurate statement of the law, and it is uncontroversial. The second bullet point states that the Commissioner may make a determination for a compensating adjustment and take such action to give effect to such determination. Again, this bullet point is an accurate statement of the law, and it is uncontroversial.

3.7 Paragraph 6 of TD 2005/33

This paragraph reads:

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65 Note, it is not clear whether the inclusion of expenditure in the cost base of a CGT asset actually comes within any of the tax benefits listed in s 177C(1) of the ITAA 1936. This was discussed in Section 3.1 above.

66 It is clear from paragraphs 9-12 of Taxation Determination TD 2005/33 that the further interest and compound interest is not being excluded from the cost base of a CGT asset because of a general anti-avoidance rule determination (GAAR determination). Rather, such interest is being excluded, according to the ATO, because it is deductible under s 8-1 of the ITAA 1997 and that ss 110-40(2) and 110-45(1B) thereby exclude cost base inclusion because of that deductibility. This 'analysis' is examined in Section 3.10 below.

A determination for a compensating adjustment can be made, where in the opinion of the Commissioner, had the scheme not been entered into or carried out, an amount:

would not have been or would not be included in assessable income;

would have been or would be allowable as a deduction;

would have been or would be incurred as a capital loss; and

would have been or would be allowable as a foreign tax credit.

Putting aside the minor point about the Commissioner's opinion (see below), this is an accurate statement of the law, and there is nothing controversial about this paragraph. The minor point that can be made is that the Commissioner's opinion is subject to the usual rules regarding the proper holding of such opinions (eg opinion is one that is held in good faith and was not formed arbitrarily, only facts relevant to the formation of the opinion can be taken into account).[67]

3.8 Paragraph 7 of TD 2005/33

This paragraph states that the Commissioner must also be of the opinion that it is fair and reasonable that the compensating adjustment be made. This is an accurate statement of the law,[68] and there is nothing controversial about this paragraph.

3.9 Paragraph 8 of TD 2005/33

This paragraph reads:

> The existence of a tax benefit to which Part IVA applies entitles the Commissioner to make a Part IVA determination, to make a compensating adjustment, and to take action to give effect to either. [first sentence]. It [existence of a tax benefit] does not disturb the application of the income tax law unless, and only to the extent that, the Commissioner makes a Part IVA determination, and acts to give effect to it, or to give effect to a compensating adjustment that the Commissioner may also have made. [second sentence]. The scheme of the anti-avoidance provisions is that in the absence of a determination by the Commissioner that law continues to apply on the basis that the scheme has been carried out, and not as if it were not carried out.' [third sentence].

67 See Boccabella and O'Sullivan, above n 43, 236, 272 for a fuller discussion.

68 Sections 177F(3)(a)(ii), 177F(3)(b)(ii) and 177F(3)(c)(ii) of the ITAA 1936.

The first sentence of paragraph 8 appears to be an accurate statement of the law, and it is not controversial.[69] The second sentence of paragraph 8 also contains an accurate statement of the law, and is not controversial.[70] However, it will be appreciated in Section 3.10 below that the ATO appears to fail to give effect to the second sentence.

It is submitted that the third sentence is also an accurate statement of the law. That is, if a GAAR determination has not been issued, the rest of the income tax law (ie the income tax law less Part IVA of the ITAA 1936) applies to the transaction(s) (scheme).[71] For example, the further interest and the compound interest in *Hart's Case* would have been deductible to the taxpayer because the conditions in s 8-1 of the ITAA 1997 are satisfied (eg relevance of the interest to the production of assessable income, the interest is not a capital outgoing), and no deduction denial provision applies,[72] if the ATO did not make a GAAR determination.[73]

3.10 Paragraph 9 of TD 2005/33

This paragraph reads:

> Accordingly, a Part IVA determination [GAAR determination] under subsection 177F(1) to disallow a deduction for a non-capital cost of ownership, such as interest, will not of itself affect the calculation of the amount included in the assessable income for net capital gains unless a compensating adjustment is made under subsection 177F(3). [first sentence] The amount of the capital gain is therefore to be calculated using the cost base of the asset as determined in accordance with Subdivision 110-A of the ITAA 1997. [second sentence] Thus a non-capital cost of ownership of a CGT asset that is ineligible for inclusion in the

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69 It is arguable that this sentence is too broadly worded. It should clearly specify that the ATO can only make a Part IVA determination (GAAR determination) in regard to a tax benefit that has been found to exist. In other words, the fact that an item of expenditure is a tax benefit comprised of the 'generation of a deduction' does not mean that the same item of expenditure is a tax benefit comprised of the 'generation of a capital loss' or the 'dropout from assessable income'. The only tax benefit held to exist in *Hart's Case* was the 'generation of a deduction'.

70 This is certainly the view of Gummow J in *Jackson v FCT* (1989) 20 ATR 611, 618-9.

71 *Jackson v FCT* (1989) 20 ATR 611, 618-9 (Gummow J).

72 Examples of deduction denial provisions are: s 26-20 (Higher Education Contribution Scheme liabilities), s 26-35 (excess payments/liabilities to related entities) and s 32-5 of the ITAA 1997 (entertainment expenditure). The fourth negative limb in s 8-1(2)(d) of the ITAA 1997 captures deduction denial provisions.

73 In *FCT v Spotless Services Ltd* (1996) 34 ATR 183, in the absence of the GAAR determination, the taxpayer would have derived exempt income pursuant to s 23(q) of the ITAA 1936.

> cost base of the asset because it has been or can be deducted will continue to be ineligible for inclusion in the cost base even after an assessment is amended to give effect to a Part IVA determination to deny a deduction for the disallowed amount, unless the Commissioner makes a compensating adjustment and takes action necessary to give effect to that adjustment.' [third sentence]

This is the key paragraph in TD 2005/33. It is submitted that this paragraph contains numerous errors.

Even though there is no express reference to the cost base of a CGT asset, the first sentence is clearly referring to the link between the denial of a deduction and inclusion in the cost base of a CGT asset of the denied deduction amount. Further, in light of the reference to non-capital costs of ownership of a CGT asset, the sentence is clearly referring to the third element of the cost base of a CGT asset.[74] The first sentence asserts that cost base inclusion is not affected by the deduction denial of expenditure by operation of the GAAR. Presumably, this means that the level of cost base inclusion cannot change because of deduction denial. In light of ss 110-40(2) and 110-45(1B) of the ITAA 1997, which the ATO fails to refer to in paragraph 9, it is very hard to see how this can be a correct statement of the law. Subsections 110-40(2) and 110-45(1B) both read:

Expenditure does *not* form part of the second or third element of the *cost base* to the extent that you have deducted or can deduct it.'[75] (emphasis in original)

Clearly, ss 110-40(2) and 110-45(1B) are cost excluding or cost denial provisions. It is equally clear that ss 110-40(2) and 110-45(1B) do not confer recognition for costs (ie they do not include an amount in the cost base of a CGT asset). Accordingly, if an item of expenditure has been deducted or can be deducted, that expenditure cannot form part of the cost base whether or not it positively comes within the cost recognition provision of the third element in s 110-25(4) of the ITAA 1997.

Aside from the operation of the GAAR in *Hart's Case*, the taxpayer could have deducted further interest and compound interest under the general deduction provision.[76] That was the holding of both Gyles J at first instance,[77] and that of the Full

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74 Section 110-25(4) of the ITAA 1997.

75 Section 110-40(2) of the ITAA 1997 applies to assets acquired at or before 7.30 pm on 13 May 1997 (s 110-40(1)), and s 110-45(1B) applies to assets acquired after 7.30 pm on 13 May 1997 (s 110-45(1)).

76 Section 51(1) of the ITAA 1936 and s 8-1 of the ITAA 1997.

77 *Hart v FCT* (2001) 48 ATR 317, 323-5.

Federal Court.[78] The Full High Court did not disturb this conclusion. Accordingly, and again putting aside the operation of the GAAR, the taxpayer would not have been able to include the further interest and the compound interest in the third element of the cost base of the investment property because the taxpayer 'can deduct the amount'.[79]

The Full High Court held that the GAAR applied to the taxpayer's scheme in *Hart's Case*. The identified tax benefit was the generation of deductions under the general deduction provision for further interest and compound interest. As a result of the application of the GAAR, the taxpayer cannot deduct further interest and compound interest. Accordingly, one of the two conditions that provide the basis for denial of third element cost base inclusion is not satisfied. Subject to levels of taxpayer compliance and ATO audit activity, the other condition will also not be satisfied (ie taxpayers will not have claimed a deduction in their tax return for further interest and compound interest contrary to the Full High Court decision in *Hart's Case*). Thus, neither of the conditions that provide for exclusion of costs is satisfied.

In light of the above, how does the ATO justify the conclusion in the first sentence? The second sentence provides no insight. Indeed, it appears to confirm that the ATO has fallen into error, or that it has contradicted itself without knowing it. In the second sentence, the ATO states that the capital gain is to be determined using the cost base of the asset as determined in accordance with Subdivision 110-A of the ITAA 1997. Subsections 110-40(2) and 110-45(1B) are clearly part of Subdivision 110-A of the ITAA 1997. Putting aside the obvious contradiction, the ATO seems to be saying that taxpayers apply Subdivision 110-A, except for ss 110-40(2) and 110-45(1B).

The third sentence in paragraph 9 contains a conclusion that claims to follow on from the earlier sentences. With respect, without an explanation, the conclusion in the third sentence does not follow as a matter of logic. Indeed, the third sentence also appears to contradict the second sentence assuming that the reference to Subdivision 110-A of the ITAA 1997 includes all the sections within that subdivision, and not just those sections aside from ss 110-40(2) and 110-45(1B).

It is submitted that the only plausible explanation for the ATO's view in paragraph 9 of TD 2005/33 is that the application of the GAAR is to be ignored when applying the cost base exclusion provisions of ss 110-40(2) and 110-45(1B). That is, the deduction denial effect of the GAAR applying is to be ignored. If the deduction denial effect of

78 *Hart v FCT* (2002) 50 ATR 369, 376-9 (Hill J), 387 (Hely J) and 389-390 (Conti J).

79 For a discussion of the meaning of expenditure that has been deducted and/or that can be deducted, see Boccabella, above n 34, 229-30.

the GAAR is ignored for the purpose of ss 110-40(2) and 110-45(1B), the taxpayer can deduct the further interest and the compound interest under the general deduction provision. Accordingly, inclusion in the third element of the cost base will then be denied. In effect, the ATO's approach would mean that ss 110-40(2) and 110-45(1B) of the ITAA 1997 would read as follows:

> Putting aside the deduction denial effect of a Part IVA determination [GAAR determination], expenditure does not form part of the second or third element of the cost base to the extent that you have deducted or can deduct it.

In the absence of a reference to a Part IVA determination (GAAR determination) in ss 110-40(2) and 110-45(1B), it is impossible to read those subsections in the suggested manner. If this was the meaning the legislature intended to convey in ss 110-40(2) and 110-45(1B), it would have been a simple task to give effect to that meaning. The legislature failed to make any reference to Part IVA in 110-40(2) and 110-45(1B). Accordingly, a Part IVA qualification cannot be read into, or overlayed on, ss 110-40(2) and 110-45(1B).

The ATO's position in paragraph 9 does not fit comfortably with the second sentence in paragraph 8. The second sentence in paragraph 8 of TD 2005/33 reads:

> It [existence of a tax benefit] does not disturb the application of the income tax law unless, and only to the extent that, the Commissioner makes a Part IVA determination [GAAR determination], and acts to give effect to it, or to give effect to a compensating adjustment that the Commissioner may also have made.

In paragraph 9, the ATO is effectively saying that a GAAR determination denying a deduction does not affect or 'disturb' the operation of s 8-1 of the ITAA 1997 (general deduction provision) in relation to ss 110-40(2) and 110-45(1B). The second sentence in paragraph 8 is stating that the application of the income tax is only disturbed when a GAAR determination is made. One could reasonably ask, does a GAAR determination ever 'disturb' the application of any part of the income tax? With respect, it appears that a GAAR determination only disturbs certain, unidentified parts of the income tax law. Of course, TD 2005/33 does not provide any criteria for identifying the parts that are not disturbed.

Further, the ATO's position in paragraph 9 does not sit comfortably with the third sentence in paragraph 8. The third sentence in paragraph 8 of TD 2005/33 reads:

The scheme of the anti-avoidance provisions is that in the absence of a determination [GAAR determination] by the Commissioner that law [the income tax law] continues to apply on the basis that the scheme has been carried out, and not as if it were not carried out.

If the absence of a GAAR determination to a transaction/scheme means that the rest of the income tax law continues to apply to a transaction (eg an expense remains deductible), the logical consequence of the presence of a GAAR determination is that the income tax law affected by the GAAR no longer applies. For it to be otherwise would mean that the presence of a GAAR determination has no effect, or has no consequence(s). This is clearly not a tenable position. It is submitted that the presence of a valid GAAR determination in regard to a tax benefit comprised of the generation of deductions (ie facts in *Hart's Case*) must, as a matter of logic, mean that those deductions are not allowable. Yet, in paragraph 9 of TD 2005/33, the ATO insists that they are. It is submitted that the difficulty with, if not the absurdity of, the ATO's position is revealed in the following example.

3.10.1 Difficulty or absurdity example

A taxpayer enters into a scheme to prevent the inclusion of a one-off compensation receipt in assessable income by diverting the compensation receipt away from itself to an associated entity. In other words, the facts are similar to those in *Federal Coke Co Pty Ltd v FCT*.[80] Putting aside for the moment the very real possibility that the constructive receipt principle would apply on the facts in the *Federal Coke case*,[81] the taxpayer will have obtained a tax benefit in terms of a 'dropout from assessable income' under s 6-5 of the ITAA 1997 by diverting the compensation receipt to an associated entity.[82] Accordingly, in the absence of a GAAR determination, the compensation receipt would not be ordinary income. However, on the making of a GAAR determination, the compensation receipt is ordinary income.[83]

Assuming that the compensation receipt would be regarded as an indemnity payment, it is likely that the taxpayer will also have obtained a tax benefit in terms of a 'dropout from assessable income' under s 15-30 of the ITAA 1997 by diverting the compensation receipt to the associated entity. Let us also assume that on grounds of

80 *Federal Coke Co Pty Ltd v FCT* (1977) 7 ATR 519.

81 Section 6-5(4) of the ITAA 1997.

82 Note, this example assumes that the taxpayer and the associated entity are not within the entity consolidation regime (Divisions 700-721 of the ITAA 1997).

83 It appears that s 177F(2) of the ITAA 1936 requires the ATO to determine the charging provision under which the amount (otherwise dropped out from assessable income because of the scheme) is included in assessable income by operation of the GAAR determination.

protecting the revenue, the ATO also issues a GAAR determination in regard to the 'dropout from assessable income' under s 15-30.[84] Accordingly, in the absence of a GAAR determination, the compensation receipt would not be within paragraph 15-30(a) of the ITAA 1997. However, on the making of a GAAR determination, the compensation receipt does come within paragraph 15-30(a).[85] Paragraph 15-30(b) excludes the assessable income inclusion under s 15-30 where the receipt is ordinary income. Paragraph 15-30(b) is an obvious anti-double taxation provision.

On the ATO's reasoning in paragraph 9 of TD 2005/33, the diverted compensation receipt will: (1) Enter assessable income of the taxpayer under s 6-5 because of the GAAR applying (2) Enter paragraph 15-30(a) because of the GAAR applying and (3) Not be excluded from s 15-30 because of paragraph 15-30(b), as the diverted compensation receipt is not income if the GAAR did not apply to the diverted compensation receipt. The result appears to be the inclusion of one receipt in assessable income under two charging provisions (ie double taxation). This is the case even when s 15-30 clearly co-ordinates with s 6-5 to prevent double taxation when a receipt comes within their respective charging parts. It may be that the GAAR determination in regard to s 15-30 will be abandoned once it becomes clear that the GAAR determination in regard to s 6-5 is valid, thereby eliminating double taxation. However, it is submitted that ss 15-30 and 6-5 should be able to co-ordinate to prevent double taxation under those provisions no matter what approach is taken in regard to the GAAR (ie ss 15-30 and 6-5 should be able to co-ordinate without the need to abandon a GAAR determination). Another answer is to say that s 6-25 of the ITAA 1997 will overcome the double taxation problem. However, one doubts that s 6-25 was designed to provide for reconciliation in such situations.

It is submitted that ss 15-30 and 6-5 were drafted on the basis of providing an 'internal reconciliation', and that s 6-25 provides for situations where an 'internal reconciliation' was not provided for.[86]

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84 There may be difficulty in reaching the requisite dominant purpose requirement under the GAAR in regard to the dropout from s 15-30 of the ITAA 1997, where a dominant purpose conclusion has been made in regard to the dropout from s 6-5 of the ITAA 1997. This issue was discussed in Section 3.1.2 above.

85 It appears that s 177F(2) of the ITAA 1936 requires the ATO to determine the charging provision under which the amount (otherwise dropped out from assessable income because of the scheme) is included in assessable income by operation of the GAAR determination.

86 The problem set out here in Section 3.10.1 may also arise in regard to other assessable income charging provisions that co-ordinate with s 6-5 of the ITAA 1997 (eg ss 15-10, 15-15, 15-20 and 15-40 of the ITAA 1997). Difficulties or problems can also arise where a specific

In the end, Part IVA of the ITAA 1936 is part of Australia's income tax law.[87] Part IVA clearly has an operation that denies deductions to taxpayers,[88] and includes amounts in taxpayers' assessable income.[89] There is no apparent basis for excluding the effect of the GAAR from the application of other rules in the income tax, in this case, the general deduction provision as it relates to ss 110-40(2) and 110-45(1B) of the ITAA 1997.

3.10.2 Does further interest and compound interest come within the positive requirement(s) of the cost base provision?

At no point in TD 2005/33, does the ATO examine whether further interest and compound interest actually come within the positive requirement(s) of the third element of the cost base of the investment property: s 110-25(4) of the ITAA 1997. Given the problems the ATO will have in:

(1) Characterising further interest and compound interest as a tax benefit in the form of a dropout from assessable income and (2) Satisfying the dominant purpose test in s 177D in regard to such a tax benefit,[90] it is very surprising that TD 2005/33 completely fails to examine positive cost base inclusion under s 110-25(4).

In other words, one would expect the ATO to fully explore options for preventing cost base inclusion, instead of relying on the dubious reasoning concerning the relationship between s 8-1 and ss 110-40(2) and 110-45(1B).[91]

Further interest will clearly come within the cost base as such interest will be regarded as interest on money borrowed to acquire a CGT asset, namely, the investment property.[92] The ATO also concedes this analysis.[93]

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deduction conferral provision co-ordinates with the general deduction provision or another specific deduction provision (eg ss 25-50, 25-55 and 25-105 of the ITAA 1997).

87 'Part IVA is as much a part of the statute under which liability to income tax is assessed as any other provision thereof.': *FCT v Spotless Services Ltd* (1996) 34 ATR 183, 186.

88 *FCT v Consolidated Press Holdings Ltd & Ors; CPH Property Pty Ltd v FCT* (2001) 47 ATR 229.

89 *FCT v Spotless Services Ltd* (1996) 34 ATR 183.

90 See Section 3.1 above.

91 It should be noted that the interest denied deductibility in *Hart's Case* will not, in any event, come within the third element of the cost base of the investment property because the investment property was not purchased after 20 August 1991: s 110-25(4) of the ITAA 1997.

92 Section 110-25(4)(a) of the ITAA 1997.

93 Paragraphs 31 and 32 of Taxation Ruling TR 98/22. Note that paragraphs 31 and 32 have been withdrawn by an Addendum to Taxation Ruling TR 98/22, issued on 11 August 2004.

Compound interest is more problematic, as well as being a far greater threat to the revenue than further interest.[94] Given that the issue has been discussed comprehensively elsewhere, only a brief summary is provided here.[95] Compound interest does not come within any of the listed items in s 110-25(4). In particular, it cannot be said that compound interest is interest on money borrowed to acquire anything. Rather, compound interest is:

(1) Interest on normal interest that was not paid
(2) Interest on further interest that was not paid and
(3) Interest on compound interest that was not paid.

Accordingly, the only way in which compound interest can come within s 110-25(4) is if a couple of conditions are satisfied. First, the itemised costs set out in s 110-25(4) must not be an exhaustive list of costs coming within the third element of the cost base. Secondly, if the itemised costs are not an exhaustive list, then compound interest must come within the expression 'non-capital costs of ownership of a CGT asset' in the introductory words of s 110-25(4).

First, although there are arguments both ways, the better view is that the itemised list is not an exhaustive list.[96] Secondly, and again, there are arguments pointing both ways, the better view is that compound interest will be regarded as a 'non-capital cost of ownership of the investment property' under a split loan. The following extract (footnotes omitted) from an earlier article captures the essence of the reasoning:

> 'It is submitted that the analysis of the Full Federal Court [in Hart's Case] concerning the character of compound interest in the context of the general deduction provision has some persuasive force for the purpose of the general meaning of "non-capital costs of ownership of an asset'. A summary of the overall points made by the Full Federal Court are:
>
> (1) Both normal interest and further interest, and compound interest are simply the cost of the funds which are borrowed;
> (2) It is artificial to treat compound interest as the cost of some new fund divorced from the original borrowing;
> (3) The compound interest, like the normal interest and further interest, will take its character from the use to which the original funds borrowed are put;

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94 See the significant disparity between the two types of interest for just the first 12-months of a split loan in Section 2.1 above.
95 Boccabella, above n 34, 231-235.
96 Ibid 230-1.

(4) The moneys were borrowed on terms that included the payment of normal interest, further interest and compound interest; and

(5) The combination of the normal interest, further interest and the compound interest on the investment loan were together the cost of borrowing money used to refinance the rental property [former home].

The fact that the Full Federal Court's reasoning was rejected as having any persuasive force in the context of s 110-25(4)(a) and s 110-25(4)(d) does not undermine this (See Sections 4.3.1 and 4.3.2 above). The reason is that ss 110-25(4)(a) and s 110-25(4)(d) deal with specifically worded items concerning interest on loans, whereas, the general rule in s 110-25(4) is broadly stated and is more akin to the generality of the general deduction provision, which was of course the context of the Full Federal Court's characterisation comments.

The ATO did hold the view that compound interest does not come within the description 'a cost of ownership of an asset'. However, given that the ATO's view relies on the same characterisation arguments advanced for non-deductibility under the general deduction provision, and that those arguments were not accepted by the Full Federal Court in *Hart's Case*, the ATO's conclusion must be received with caution.'[97]

3.10.2.1 Summary of tax position re further interest and compound interest

Accordingly, on the following four assumptions:

(1) Further interest and compound interest are denied deductibility under s 8-1 because of the GAAR;
(2) Further interest and compound interest come within the positive requirement(s) of s 110-25(4);
(3) Subsections 110-40(2) and 110-45(1B) do not exclude cost base inclusion; and
(4) The GAAR does not apply to further interest and compound interest for failure of a tax benefit or failure of dominant purpose, the taxpayer has achieved cost base inclusion.

3.10.3 Compensating adjustment mechanism

In both the first sentence and the third sentence of paragraph 9, the ATO claims that cost base inclusion depends on the ATO making a compensating adjustment. The references to a compensating adjustment in paragraph 9 suffer from the same defects

97 Ibid 234.

as the other statements in paragraph 9. Given that paragraph 10 deals with the application of the compensating adjustment mechanism, we shall defer our discussion to Section 3.11 below if any reference needs to be made to paragraph 9. However, before doing that, it must be noted that if the analysis in Section 3.10.1.1 is correct, the ATO cannot make a compensating adjustment to exclude the further interest and the compound interest from the cost base of the investment property. The reason is that a compensating adjustment cannot be used to take away a benefit from a taxpayer. The compensating adjustment mechanism can only confer a benefit,[98] after a GAAR determination has taken away a benefit. It is acknowledged that the ATO is not seeking to use the compensating adjustment mechanism in this (incorrect) manner to exclude the further interest and the compound interest from the cost base of the investment property.

3.11 Paragraph 10 of TD 2005/33

This paragraph reads:

> Whether a compensating adjustment can, and should, be made in respect of the calculation of the cost base of a CGT asset needs to be considered on the facts of each case, and the requirements of subsection 177F(3) must be satisfied. [first sentence] A compensating adjustment can only be made if the disallowed amount would have been included in the cost base of the relevant CGT asset had the scheme not been entered into or carried out (and therefore, there is an additional amount included in assessable income that would not have been included, or there would have been a larger capital loss incurred, had the scheme not been entered into or carried out). [second sentence] In some cases it will be reasonable to suppose that the amount might have been included in the cost base of a different CGT asset (or no asset at all). [third sentence] In these cases the net capital gain would not have been less if the scheme had not been carried out. [fourth sentence] Therefore a compensating adjustment could not be made in respect of the net capital gain included in the assessable income.' [fifth sentence].

Aside from a couple of issues, the content of paragraph 10 contains accurate statements of the law. However, paragraph 10, as well as the references to the compensating adjustment mechanism in paragraph 9, is addressing an inconsequential question. Even affected taxpayers are unlikely to argue against the conclusion reached by the ATO in response to the question raised. That conclusion is,

98 Section 177F(3) of the ITAA 1936. For example, an amount will be excluded from assessable income by use of the compensating adjustment mechanism, where broadly, such an amount would not have been so included if the scheme was not entered into: s 177F(3)(a) of the ITAA 1936.

in the absence of the GAAR scheme, further interest and compound interest would not have arisen, and therefore there is no possibility of inclusion in the cost base of the investment property by use of the compensating adjustment mechanism.

The problem for the ATO is that affected taxpayers are largely disinterested in the question asked by the ATO. It is the wrong question. Put shortly, the ATO's focus on the compensating adjustment mechanism is misdirected, and can have the effect of diverting attention away from the relevant question. The relevant question is, what provision or section of Australia's income tax regime fails to include, or excludes, further interest and compound interest from the cost base of the investment property? Clearly, the ATO has not answered this in a persuasive manner in TD 2005/33.

3.11.1 Why is the ATO failing to fully address the relevant question, and instead addressing an irrelevant question?

There may be a number of reasons. First, and as noted in Section 3.1.1, it is arguable that the inclusion of an amount in the cost base of a CGT asset is not a 'tax benefit' within the meaning of that term in s 177C(1) of the ITAA 1936. In other words, the ATO may be 'saddled' with a badly designed GAAR, in particular, the notion of a 'tax benefit'. Secondly, and this may be related to the first point, at no point in the Hart litigation did the ATO argue that further interest and compound interest is a tax benefit in the form of cost base inclusion (which, on the ATO's view, translates to a 'dropout from assessable income'). The focus in the Hart litigation was limited to a tax benefit in the form of the 'generation of deductions'. The ATO has clearly missed an opportunity to obtain an authoritative statement on the scope of the GAAR.[99] Thirdly, and as will be noted in Section 3.13, in summary paragraph 32 of Taxation Ruling TR 98/22, which is a binding public ruling,[100] states that further interest that has been denied deductibility because of the GAAR forms part of the cost base of the investment property. What may be more damaging to the revenue (and therefore the ATO), is that there is an argument that paragraph 32 of Taxation Ruling TR 98/22 also applies to compound interest.[101]

In light of the above, it is little wonder that the ATO does not really want to address the correct issue in TD 2005/33 in regard to split loans. The answer is likely to be

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99 The ATO would also have had to argue the dominant purpose aspect of the GAAR in relation to a tax benefit in the form of cost base inclusion (which, on the ATO's view, translates to a dropout from assessable income).

100 Section 170BA(3) of the ITAA 1936.

101 This is briefly discussed in Section 3.13 below. A fuller analysis of this issue is contained in D Boccabella, above n 34, 235-8.

unpalatable to the ATO, and has the effect of highlighting a number of failings. In these circumstances, it is no surprise as to why the ATO is seeking to arrogate to itself, through its heavy focus on the compensating adjustment mechanism, the 'final decision' on cost base inclusion.

3.12 Paragraphs 11 and 12 of TD 2005/33

These two paragraphs contain an example where a taxpayer enters into a split loan arrangement. Essentially, the facts are materially the same as those in *Hart's Case*. In short, the ATO analysis gives effect to the ATO's understanding of the tax law set out in earlier paragraphs in TD 2005/33. In summary, that analysis is: (1) The further interest and compound interest[102] are allowable deductions obtained in connection with a scheme and therefore such amounts are not included in the cost base of the investment property (2) A GAAR determination disallows a deduction for the further interest and compound interest (3) The interest denied deductibility does not come within the cost base of the investment property unless the ATO makes a compensating adjustment and (4) A compensating adjustment is not available because in the absence of the scheme, the further interest and the compound interest would not have been included in the cost base of the investment property.

3.13 Paragraph 13 of TD 2005/33

Paragraph 13 contains the standard 'Date of Effect' clause that appears in ATO rulings and determinations. The statement is made that this determination (TD 2005/33) applies to years commencing both before and after its date of issue, and that it does not apply to taxpayers to the extent it conflicts with the terms of settlement of a dispute. Arguably, this is the most deceptive paragraph in TD 2005/33.

Paragraph 13 makes no mention of Taxation Ruling TR 98/22. Indeed, the only mention of Taxation Ruling TR 98/22 in TD 2005/33 is by way of citation in paragraph 11, and a reference at the end of TD 2005/33 under '*Related Rulings/Determinations*'. Taxation Ruling TR 98/22 deals with the tax treatment of further interest and compound interest under split loan or linked loan arrangements. In Taxation Ruling TR 98/22, the ATO concludes that further interest and compound interest are to be denied deductibility by operation of the GAAR, assuming such interest is deductible under the general deduction provision.[103] From there, at paragraphs 32 and 33 of Taxation Ruling TR 98/22, the ATO states that the further interest that has been denied

102 The ATO uses the term 'additional interest' to describe further interest and compound interest': paragraphs 5-7 of Taxation Ruling TR 98/22.

103 Paragraphs 15-26 of Taxation Ruling TR 98/22.

deductibility because of the GAAR is included in the cost base of the investment property for CGT purposes under s 110-25(4) of the ITAA 1997. It is arguable that the same statement is made in regard to compound interest. However, the better view is that paragraphs 32 and 33 of Taxation Ruling TR 98/22 do not conclude that compound interest is included in the cost base.[104]

Paragraphs 32 and 33 appear under the heading 'Ruling' in Taxation Ruling TR 98/22. Taxation Ruling TR 98/22 is clearly a 'public ruling' in terms of the rule that provides for the binding effect of rulings where they provide taxpayers' with a more favourable outcome vis-à-vis the law.[105] The scheme or arrangement in *Hart's Case* is clearly an arrangement that comes within the class of arrangement dealt with in Taxation Ruling TR 98/22. Further, it is fairly safe to say that most, if not all, split loan arrangements will come within the class of arrangement set out in Taxation Ruling TR 98/22. The consequence of this is that taxpayers will be able to include further interest in the cost base of the investment property, whether or not the further interest actually comes within the cost base of the investment property by operation of the substantive rules. This will be advantageous to taxpayers should the ATO's reasoning in regard to cost base exclusion in TD 2005/33 be found to be correct. The issue of greater concern to the ATO, and of greater interest to taxpayers, is whether compound interest can somehow be 'squeezed into' paragraphs 32 and 33 of Taxation Ruling TR 98/22. As noted above, the better view is that it cannot.

3.13.1 Withdrawal of numerous paragraphs in Taxation Ruling TR 98/22

On 11 August 2004, some two and a half months after the Full High Court's decision was handed down in *Hart's Case*, the ATO issued an addendum to Taxation Ruling TR 98/22.[106] The addendum withdrew some 55 paragraphs in Taxation Ruling TR 98/22. Paragraphs 32 and 33 were amongst the withdrawn paragraphs. TD 2005/33 makes no mention of the addendum to Taxation Ruling TR 98/22 that withdrew a number of paragraphs. It is clear that the withdrawal of paragraphs 32 and 33 is designed to put a cap on the potential revenue leakage from the binding effect of such paragraphs. The problem the ATO faces is captured in the following extract:

'Section 14ZAAL of the *Taxation Administration Act* 1953, deals with the effect of the withdrawal of a public ruling. Section 14ZAAL essentially states that a public ruling that has been withdrawn continues to apply to arrangements begun to be carried out before the withdrawal. An arrangement is broadly defined to include such things as

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104 Boccabella, above n 34, 235-7 for a full discussion of the issue.

105 Section 170BA of the ITAA 1936.

106 Addendum to Taxation Ruling TR 98/22 issued on 11 August 2004.

a 'course of conduct', 'transaction', 'agreement', etc. It is submitted that the relevant arrangement in *Hart's Case* is the loan(s) and all the attendant rights and obligations including the direction of repayments to the private portion of the loan. This arrangement was entered into on 8 October 1996. Accordingly, the withdrawal is too late to take away any benefit that might accrue to the taxpayer because of Taxation Ruling TR 98/22. Further, the same point can be made in regard to other taxpayers that have entered into split loan facilities before 11 August 2004. Accordingly, if [sic] taxpayers who have entered into split loan facilities before 11 August 2004, there does not appear to be any reason why the further interest incurred after 11 August 2004 should not be included in the cost base of their investment property.'[107] (footnotes omitted)

3.13.2 ATO's lack of disclosure is misleading and borders on deception

The failure to mention Taxation Ruling TR 98/22 in TD 2005/33 borders on deception; at its lowest, TD 2005/33 is a misleading document. The statements in Taxation Ruling TR 98/22 (especially, paragraphs 32 and 33) are clearly relevant to the question raised in TD 2005/33 (ie inclusion of further interest and compound interest that has been denied deductibility in the cost base of the investment property). The relevance is even stronger given the ATO's view in TD 2005/33 that cost base inclusion is not available on application of the substantive law.

4 Conclusion

This article has concluded that nearly all of the content of TD 2005/33 is flawed. Taxpayers and their advisors will pay little respect to TD 2005/33. The ATO states conclusions on issues that are plainly contentious without providing reasons. The ATO completely fails to deal with a number of issues that are plainly relevant to the question asked in TD 2005/33. The ATO spends considerable energy on discussing a matter that has only marginal, if any, relevance to the question asked in TD 2005/33; a matter upon which taxpayers will agree with the ATO. TD 2005/33 highlights the failure of the ATO to raise a particular GAAR determination argument in *Hart's Case*. The ATO also conveniently fails to mention a detrimental statement in a binding public ruling dealing with the question raised in TD 2005/33. In summary, TD 2005/33 will attract little respect from taxpayers and their advisors.

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107 Boccabella, above n 34, 238.