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BY EMAIL: partIVA@treasury.gov.au

Chief Adviser
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Dear Chief Adviser

Submission on the Exposure Draft to amend the Part IVA provisions

Thank you for the opportunity to comment on the exposure draft to amend the Part IVA provisions contained in the *Income Tax Assessment Act 1936* Cth (the **"1936 Act"**).

We are aware and have participated in some of the submissions made in respect of the Exposure Draft of the Schedule to be included in *Tax Law Amendment (2013 Measures No. 1) Bill* 2013 (the **"ED"**) and the accompanying Explanatory Materials.

We will only briefly comment further on:

- an apparent drafting anomaly in the ED concerning its use of the term "tax"; and
- whether, on one view, the proposed amendments in the ED can be validly enacted as a law "in respect to ...taxation..." within the meaning of placitum 51(ii) of the Commonwealth of Australia Constitution Act (the **"Constitution"**) either because the purported tax liability is imposed in an "arbitrary or capricious manner" referred to in the majority in *MacCormick v Federal Commissioner of Taxation* (1984) 52 ALR 52 at [63] (**"MacCormick"**) or because the proposed amendments in the ED make Part IVA of the 1936 Act "uncontestable" in the manner discussed by the High Court in *Giris Pty Ltd v Federal Commissioner of Taxation* 69 ATC 4015 (**"Giris"**).

1. THE USE OF "TAX" IN PROPOSED SECTIONS 177AA AND 177CB

It would appear to us that "tax" is not defined in the ED nor the existing Part IVA of the 1936 Act nor in subsection 6(1) of the 1936 Act. The term "tax" is defined in section 995-1 of the *Income Tax Assessment Act 1997* Cth (the **"1997 Act"**). However, subsection 995-1(2) of the 1997 Act provides, in effect, that a defined term in the 1997 Act, "does not also have effect" for the purposes of the 1936 Act. As a result, when "tax" is defined in the 1997 Act for the purposes of "this Act", which is defined for the purposes of the 1997 Act to include the 1936 Act, arguably subsection 995-1(2) of the 1997 Act overrides the meaning of "this Act".

The matter is made more confusing because "withholding tax" is defined in subsection 6(1) of the 1936 Act by reference to the definition in the 1997 Act and the phrase "tax or the withholding tax" is used several times in proposed sections 177AA and 177CB.

The practical effect of the above, if the ordinary meaning of tax – which would include an exaction imposed by a foreign power outside Australia – is relevant, is that proposed section 177CB becomes very difficult to interpret and may accentuate the doubt about the legislative power of the Commonwealth to enact the ED validly.

2. TAXATION POWER

The Constitution establishes the Commonwealth Parliament's power to make laws with respect to taxation. Section 51(ii) of the Constitution states:

> The Parliament shall, subject to this Constitution, have power to make laws for the peace, order, and good government of the Commonwealth with respect to:
>
> ...
>
> (ii) taxation; but so as not to discriminate between States or parts of States;
>
> ...

Latham CJ considered the definition of "taxation" in *Matthews v Chicory Marketing Board (Vic)* (1938) 60 CLR 263 at 276 having regard to section 90 of the Constitution (which considered the power of the Commonwealth Parliament to impose duties of customs and of excise and to grant bounties on the production of export of goods).

> "The levy is, in my opinion, plainly a tax. It is a compulsory exaction of money by a public authority for public purposes, enforceable by law, and is not a payment for services rendered."

The definition espoused by Latham CJ had its origins from the Privy Council case of *Lower Mainland Dairy Products Sales Committee v Crystal Dairy Ltd* [1933] AC 168, but Latham CJ's statement was not an exhaustive statement of what the essence of a tax is.[1]

The breadth and limits of the taxation power in the Constitution has been challenged on a number of occasions by taxpayers and the States. As Gaudron and Hayne JJ pointed out in *Luton v Lessels* (2002) 187 ALR 529 at [541]:

> It is necessary, in every case, to consider all the features of the legislation which is said to impose a tax.

On the basis of comments by the High Court in MacCormick and Giris, a law made under the tax power in placitum 51(ii) of the Constitution may be invalid (among other things) as "arbitrary or capricious" or if the law in uncontestable.

3. GENERAL COMMENTS ON ARBITRARINESS AND LEGISLATION

It is not disputed that legislative change is required where the law is not operating in the manner intended. This applies to all subject matters of law, including taxation law.

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[1] *Luton v Lessels* (2002) 187 ALR 529 at 532

The Commonwealth Parliament's power to make laws with respect to taxation can only be validly exercised if it complies with some basic principles including one of the key principles that English jurist Albert Venn Dicey noted:

> ...the absolute supremacy or predominance of regular law as opposed to the influence of arbitrary power, and excludes the **existence of arbitrariness**, of prerogative, or even wide discretionary authority on the part of the government.
>
> **[emphasis added]**

We submit that **some** of the criteria contained in the proposed amendments to the Part IVA provisions raises doubt as to whether Parliament would be exercising the taxation power outside the limits of the Constitution.

4. WHEN IS A TAX CONSIDERED TO BE ARBITRARY?

When will a tax be considered to be arbitrary? The question of whether a tax was "arbitrary" in nature, was considered in *MacCormick*.

The majority in *MacCormick* elaborated on the limits as to what is considered to be tax and noted at [64]:

> "For an impost to satisfy the description of a tax it must be possible to differentiate it from an arbitrary exaction and this can only be done by reference to the **criteria by which liability to pay the tax is imposed**. Not only must it be possible to point to the criteria themselves, but it must be possible to **show that the way in which they are applied does not involve the imposition of liability in an arbitrary or capricious manner**."
>
> **[emphasis added]**

What can be gleaned from the passages above can be summarised as follows:

1. There must be criteria that creates a liability to pay tax; and

2. The criteria must be sufficiently general in their application.

Assuming all conditions are satisfied, it is then necessary to ensure that when applying the criteria, the taxpayer's liability to pay tax is not imposed in an "arbitrary" or "capricious" manner.

5. IS THE TAXPAYER'S LIABILITY TO PAY TAX IMPOSED IN AN "ARBITRARY" OR "CAPRICIOUS" MANNER?

Assuming the conditions above are satisfied, it is then necessary to ensure that when applying the criteria, the taxpayer's liability to pay tax through the application of the proposed amendments to Part IVA is not imposed in an "arbitrary" or "capricious" manner.

We submit that the requirement to identify the alternative postulate by reference to the assumptions contained in proposed section 177CB impose a tax liability on a taxpayer in an arbitrary manner. The alternative postulate that is ultimately identified by the Court (ie, the most reasonable alternative to the scheme undertaken) is constrained to the alternative postulate that has the same non-tax effects of the scheme undertaken by the taxpayer. The inclusion of the assumptions as to actions of the participants – without regard to any person's liability (or potential liability to tax or withholding tax) and the reference to "same non-tax effect" could reduce the number of alternative postulates which would otherwise by "reasonable expectations" based on would actually have occurred and in some cases, result in a single alternative postulate to the scheme undertaken. As an example, a situation could arise where the highest tax liability is

arbitrarily imposed on the taxpayer because there is only a **single** alternative postulate which a Court can identify (as a result of the assumptions circumscribing any potential for the Court to identify other reasonable alternative postulates).

The arbitrariness appears to be magnified if, in applying the purpose test in proposed 177D, the comparison of the scheme and the alternative postulate is required in inferring objective purpose as suggested by Gummow and Hayne JJ in *Federal Commissioner of Taxation v Hart* 2004 ATC 4599. This is because purpose is to be inferred by comparing something which happened – the scheme – with something which is no longer a reasonably expected alternative but with an arbitrary hypothetical alternative.

6. UNCONTESTABLE TAXES AND GIRIS PTY LTD V FEDERAL COMMISSIONER OF TAXATION

The taxpayer is Giris failed in the High Court on the argument that section 99A of the 1936 Act was "uncontestable" because the Commissioner was given a discretion, which must be exercised reasonably, as to whether or not it was reasonable not to apply section 99A. The exercise of the discretion was reviewable by the Courts.

In relation to the application of the proposed section 177D, given proposed section 177CB, the former proposed section applies by reason of an uncontestably identified "tax benefit" based on assumptions which do not have regard to the facts of the scheme and to what is reasonable as an alternative hypothesis. In this sense, it is not possible to contest the existence of a tax benefit.

If you have any questions, please call Tim Loh on (03) 9679 3076 or Paul O'Donnell on (02) 9258 5734.

Yours sincerely

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