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Chief Adviser
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Dear Sir

Part IVA proposed changes - Draft of the *Tax Laws Amendment (2013 Measures No. 1) Bill 2013*

Ernst & Young provides comments on the proposed changes to Part IVA of the Income Tax Assessment Act ("ITAA") 1936 set out in the Exposure Draft of the *Tax Laws Amendment (2013 Measures No. 1) Bill 2013* (the "Draft").

The Draft continues to be an area of great concern for Ernst & Young due to the significant:

a) uncertainty for business in dealing with problematical drafting in the Draft;

b) risks associated with untested, beyond original scope changes to Part IVA;

c) likely excessive delays in legislating such complex measures and guidance on the proposed changes;

d) difficulties for business tax governance in dealing with the uncertainty; and

e) the consequential negative impacts on business activity and corporate behaviours pending the enactment of legislation.

Consistent with our submission to Assistant Treasurer, David Bradbury MP earlier this year, the purpose of this submission is to encourage more focused, simpler, timely changes to deal with the problems that the Government has identified as requiring attention. We encourage consideration be given to whether the policy objectives of the government could be achieved by specific measures targeting tax outcomes considered to be offensive rather than amendment to Part IVA. This would provide minimal disruption to the general taxpayer base and the tax administration. Further, it would leave Part IVA as an effective general anti-avoidance provision.

Ernst & Young people are assisting various professional organisations in their responses to the Draft, including representing one professional organisation in the confidential consultation roundtable process. For that reason we keep our comments brief in this submission, and focus on strategic issues rather than minute drafting issues.

Appendix A sets out our specific concerns and recommendations in relation to the Draft. Our key comments are:

1. There is a real risk of unintended consequences arising from wide ranging, untested amendments for all stakeholders.

2. The proposed extension of the tax benefit determination to require 'do something else' Alternative Postulates will result in highly complex, unclear and in some cases unworkable rules that will

require a significant body of jurisprudence before taxpayers and the ATO fully understand their operation.

3. The assumption that all parties act in disregard of their Australian income tax consequences is a fundamental problem with the Draft. It will achieve perverse outcomes and will make it very difficult for Directors to understand how they should comply with their corporate governance obligations.

4. There is no requirement that the Alternative Postulate formulated by the Commissioner be reasonable. Therefore, there is a risk that this will result in 'tax-maximised benefits".

5. 'Do nothing' Alternative Postulate concerns are most relevant to tax benefits covered by paragraph 177C(1)(a) of the ITAA 1936 [i.e. schemes to reduce assessable income]. The proposed changes contained in the Draft unnecessarily extend beyond this. If the amendments were more targeted, this might simplify the necessary amendments and limit the risk of unintended consequences.

6. An attempt to apply these provisions to recent cases results in significant debate as to how the provisions work and what the outcomes would be. It should be possible to apply any proposed amendments to the issues of concern and clearly understand how they would work.

7. The explanatory materials ("EM") purport to set out an historic policy basis. There is significant debate as to whether that is correct or even relevant. The EM should focus on the policy today. The policy of yesterday and whether or not the cases since that time reflect that policy are not relevant. That discussion in the EM takes the focus off articulating and achieving the current policy objective: for example, the EM needs more examples and more discussion of how the Draft interacts with businesses making legitimate choices under the income tax legislation to address the uncertainty and governance problems to which we have referred.

8. As a result a further public draft should be issued and any amendments should not apply before the emergence of the final rules, which in our view are unlikely to bear any resemblance to the rules in the Draft: the amendments should not apply earlier than the date of Royal Assent of the legislation.

Should any further information or clarification be required, please do not hesitate to contact Sue Williamson on +61 3 9288 8917 or Howard Adams on +61 2 9248 5601 or Tony Stolarek on +61 2 8650 7654.

Yours faithfully

Ernst & Young

Appendix A

Analysis of Proposed Part IVA Amendments

Ernst & Young has a number of concerns in relation to the substantive proposed amendments contained in the Exposure Draft of the *Tax Laws Amendment (2013 Measures No. 1) Bill 2013* (the "Draft"). Ernst & Young people are assisting various professional organisations in their responses to the draft, including representing one professional organisation in the confidential consultation process. For that reason this submission focuses on strategic issues rather than minute drafting issues.

We challenge the proposition that Part IVA no longer works or risks no longer working appropriately

Before considering the Draft, and accepting that the government has decided to amend Part IVA, we question the need for the amendments.

In our view:

a) Part IVA in its current form has been successfully applied by the ATO and the courts to artificial, blatant and contrived arrangements including those involving commercial arrangements and transactions.

b) Further, the recent jurisprudence in relation to tax benefit is consistent with the plain words of s177C(1), for example the requirement in s177C(1)(a) to identify a tax benefit being "that amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out." The requirement for a comparison with a reasonable Alternative Postulate is unambiguous.

c) A general anti-avoidance provision ("**GAAR**") such as Part IVA should not be used as a tool by the ATO to target tax outcomes that are not considered acceptable unless those outcomes are derived from blatant, artificial and contrived tax avoidance behaviours.

d) Part IVA should not be used to circumvent the need for Government to take ownership of tax policy and legislate accordingly. If certain types of tax planning/structuring are not considered acceptable, but are not the result of blatant, artificial and contrived tax arrangements, they should be dealt with by specific anti-avoidance measures. For example, if the Government is of the view that certain types of pre-transfer dividends should not be paid if they result in a decrease in capital gains tax it should make specific amendments to that effect.

The remainder of this submission looks to the Draft.

Objects clause for Part IVA

Proposed s177AA sets out the object of Part IVA as being to counter schemes ..."entered into or carried out with an objectively ascertainable purpose of reducing the liability of a taxpayer to tax or withholding tax".

We submit that the objects clause should refer to the generally accepted cornerstone of Part IVA, that Part IVA will not apply to ordinary commercial arrangements and that it will be limited in operation to blatant, artificial or contrived arrangements. This is mentioned in the comprehensive analysis in the EM and should be clear on the face of the law to guide the administration of the law.

New assumptions made in identifying a tax benefit

The new proposed s177CB(1) specifies assumptions to be made in deciding whether there is a tax benefit "on the basis of a postulate that is an alternative to the entry into or carrying out of a scheme". The

assumptions mandated by s177CB must be used to determine what would have been or might reasonably be expected to have been included or allowed or incurred to determine the Alternative Postulate under s177C. This drives the identification of the tax benefit, which is the difference between the amount included/allowed/incurred under the scheme in reality, and the amount under the Alternative Postulate. Our concerns and submissions are set out below.

The problem with the assumptions is that they could generate unreasonable Alternative Postulates. Effectively, the result is that we move from what is perceived by some as one unreasonable test (in that allows the do nothing alternative) to another even more unreasonable and flawed test (in that allows Alternative Postulates based on tax not being a consideration and commercial outcomes that would never have been pursued).

We submit that at the very least the Draft needs to specify that the Alternative Postulates that are derived after applying the proposed s177CB factors should be reasonable.

That requirement currently does not exist. Section 177C refers to the income or deductions that might "reasonably be expected". However, it is unclear how that term can be applied in that provision given the nature of the Alternative Postulates that will be derived after applying s177CB.

By way of example, if the Commissioner applies the s177CB assumptions and identifies 3 Alternative Postulates – there is nothing requiring him to identify the lowest tax Alternative Postulate as the one to be used. This is inequitable.

Assumption 1: establish the Alternative Postulate hypothetically disregarding tax liability

The first new assumption is that "each person (whether or not a participant in the scheme) would have acted or refrained from acting, as the case requires, without regard to any person's liability (or potential liability) to tax or withholding tax in any year of income" (s177CB(1)(a)).

We submit that:

- the breadth of this drafting will lead to Alternative Postulates that are not commercially feasible and are not "reasonable". Tax is a relevant commercial cost that influences decisions and there is no reason why it should be excluded. For example, the Commissioner could argue for an Alternative Postulate that would impose an excessive amount of tax on a person other than the taxpayer, even though it would otherwise not be reasonable to expect that the other person would be willing to bear such a burden. That might not otherwise be a commercially feasible Alternative Postulate.

- there is no consideration in the Draft or draft EM about the treatment of rollovers and legitimate tax concessions in this context (we discuss this below in relation to the interaction with section 177C);

- an Alternative Postulate formulated on this basis will have a tendency to magnify the tax benefit beyond a reasonable level, causing a "tax maximiser" alternative postulate. This might influence the determination of the taxpayer's dominant purpose, as discussed below; and

- this assumption will cause Directors significant concerns in terms of their corporate governance obligations. They will need to be educated to the fact that they will be entitled to make proper commercial decisions taking into account all relevant factors including tax, but then, in determining that tax outcome, they will need to exclude tax from their determinations.

For these reasons the first assumption should be removed from the Draft. Alternatively, there should be a requirement for the selection of the Alternative Postulate to be reasonable so as not to result in tax-maximiser benefits.

Assumption 2: consider non-tax (commercial) effects achieved

The second new assumption will apply to schemes where one or more "non-tax effects" are achieved (s177CB(1)(b)). The drafting adds to uncertainty in analysing multiple commercial steps and outcomes.

"Non-tax effect" is defined as an effect other than relating to liability to tax or incidental to such as tax liability. For example, if the transaction involves several steps (one of which is the claimed Part IVA scheme) leading to the transfer of shares from Holding Company to Subsidiary Company, the non-tax effect is that the share transfer occurred. For the purpose of determining the Alternative Postulate, not only the taxpayer, but also all other persons, are assumed to act to achieve the non-tax effect for the taxpayer, to create a "true alternative for the scheme".

We submit that:

- it is inappropriate to formulate the Part IVA test based on an identical Alternative Postulate. Taxpayers often make genuine choices between various ways of achieving an objective. For example, when a company needs funding, a careful consideration will be made as to whether to fund by debt or equity. If debt is chosen because of a tax outcome, and Part IVA is subsequently applied, there is no reason why the tax benefit should not be determined by reference to the real commercial alternative that was considered – which could be an equity investment;

- the Draft is unclear in how to work through this hypothetical analysis of the "non-tax effect" in a series of events. Specifically, how will the taxpayer and ATO determine which of the events was the commercial outcome that drove all of the events combined? For example, if you sell shares in a company, receive cash and then invest the cash – is the non-tax effect the sale of the shares or the investment of the cash? This non-tax effect will drive the Alternate Postulate and all the resulting implications. We anticipate that it will become one of the central focuses of future Part IVA disputes;

- the examples and indeed the draft law need revision to properly explain the intent. For example: EM example 1.1 refers to an investment of $1m made by way of deposit for 12 months for a return of $50,000 payable in arrears and states that the Alternative Postulate would involve the investment of the same amount, for the same period at comparable risk and return, not an investment in ordinary shares. The example fails to recognise that in some instances, the commercial effect sought may simply be a certain level of funding for the taxpayer or another person, or in some instances, the most viable commercial alternative to debt may be a form of equity. There will need to be a significant body of jurisprudence to establish a clear understanding on how this provision is meant to apply.

This second assumption relating to the Alternative Postulate seems to be artificial and contrived. Although the EM complains that the current "enquiry permitted under s177C(1) is a broad ranging enquiry into what might reasonably be expected to have happened absent the scheme, unconstrained either by the limits of the scheme or the matters prescribed under s.177D", that broad ranging enquiry should not be limited in this way. To do otherwise creates artificiality in the Alternative Postulate and affects its reasonableness.

For clarity, we further submit that the EM should refer to the relevance of other relevant tax considerations (for example, state stamp duty impacts and foreign tax impacts) in the analysis: otherwise the relevant analysis is likely to produce totally inappropriate, unrealistic and uncommercial alternative postulate arrangements.

Assumption 3: Alternative Postulate when no non-tax effects achieved

This is relevant for transactions where the non-tax effects (commercial purpose) are not predominant. If this provision applies it is necessary to assume that all events and circumstance that happened, but were

not part of the scheme, did happen. If there is nothing that was not part of the scheme, the scheme is deemed not to have been entered into.

Query in what circumstances an arrangement might not achieve a non-tax effect. Non-tax effects are defined to exclude any which are incidental to tax effects. This adds uncertainty and there are significant differences of opinion on the meaning of this proposition. On one analysis this provision will have a significant role because many commercial non-tax steps will be incidental to a taxpayer's tax liability and set aside and therefore the arrangement will have no non-tax effect. The contrary view is that most transactions will be dealt with under assumption 2.

For example, look at the recent RCI decision. Would it be dealt with by the second or third assumption? On one view the dividend was incidental to the tax outcome and therefore the arrangement falls to the third assumption. However, another view is that the dividend is a non-tax effect in itself and is not incidental to tax outcomes. On this view the second assumption applies. If the case that drove the amendments does not clearly fall within one of the provisions there must be a problem in the drafting.

We submit that the drafting of the third assumption is problematical and quite uncertain: it needs revision.

Dominant purpose test used in tax benefit analysis

The eight factors in determining purpose (the s177D tests) are to be taken into account in determining the Alternative Postulate relating to non-tax effects under s177CB(1)(b). This curious drafting is stated in the EM to ensure that there is a "single, holistic, inquiry into whether a person participated in the scheme with a sole or dominant purpose of securing for the taxpayer a particular tax benefit in connection with the scheme".

We question how this drafting achieves the "single, holistic, inquiry", why such an approach is in fact required, and how it will be achieved. The determination of the tax benefit should be a mechanical step. This approach, of incorporating factors relevant to determining purpose into the earlier step of identifying tax benefits, seems likely to create significant uncertainty unless the draft is clarified.

Dominant purpose test in section 177D

The Alternative Postulate is relevant not only for the identification of the tax benefit in s177C, but also the evaluation as to dominant purpose in s177D.

We submit that the law should be clear on whether the new assumptions required by s177CB(1) apply also to the purpose test in s177D or whether they are limited to the s177C tax benefit issue.

On one view, the Alternative Postulate required under s177D is unaffected by s177CB and the s177CB assumptions. This would be consistent with the media release, EM, etc. that there is no intention to touch the dominant purpose test. If this is correct, then two separate Alternative Postulates will need to be identified and managed:

- one to quantify the tax benefit in s177C(1), using the assumptions in s177CB(1); and
- another to identify the dominant purpose of the parties who entered into or carried out the scheme, which does not take account of the assumptions in s177CB(1).

The alternative view is that the Alternative Postulate required under s177D is the same as under s177C, on the basis that s177D requires consideration of the dominant purpose of the parties by reference to "a tax benefit" obtained by the taxpayer(s). We consider this view unsatisfactory. The Alternative Postulate for the purposes of s177C and s177CB is developed on the assumption that the same commercial effects are achieved but tax is disregarded: it assumes it is possible to get the same commercial effects without

the same tax effects. If that is indeed the case and the only difference between the Alternative Postulate and the scheme is the existence of the tax benefit, it is difficult to see how a taxpayer could disprove that persons entered into the scheme for the dominant purpose of obtaining the tax benefit for the taxpayer.

Interaction with legitimate tax choices and s177C(2)

Briefly, s177C(2) provides that, in identifying tax benefits for Part IVA purposes, "reference ... to the obtaining by a taxpayer of a tax benefit in connection with a scheme shall be read as not including" legitimate choices available under the tax law, in certain designated circumstances. The proposed amendments seem to reduce the possible application of this provision. For example, how will the Draft operate in relation to a taxpayer that takes action to ensure it conforms to the conditions to be eligible for a tax rollover, or eligible for tax concessions for research and development?

We submit that the Draft and EM need a comprehensive discussion on the interaction of s177CB with taxpayer choices and s177C(2).

Impact on Part IVA disputes and litigation

We submit that these provisions will impose a significant economic burden on taxpayers as each transaction will need to be reviewed to determine the Alternative Postulates under the proposed s177CB prior to ruling out the possible application of Part IVA and there will be significant costs and time resources devoted to an increase in disputes and litigation.

One of the touchstones for Part IVA is whether assessable income might reasonably be expected to be greater if the scheme had not been entered into. This requires an objective determination as to what might reasonably be expected to have occurred but for the scheme. The ED requires this determination based on artificial options (the Alternative Postulate after tax being disregarded but the actual non-tax effect being retained).

The difficulties are best considered by way of example. Assume that a taxpayer enters into an arrangement involving several steps ultimately transferring shares held by Holding Company to Subsidiary Company, assume the ATO considers one of the steps to be a Part IVA scheme. If tax was payable the transaction would not have proceeded. The ATO identifies 5 different ways the transaction could have been implemented and selects as the Alternative Postulate Option 5, which gives the greatest tax liability. The taxpayer will have to argue which of options 1 - 5 would be more reasonable (notwithstanding none of the options would have been implemented). Under current law contemporaneous indicia and facts are relevant to the assessment as to what might reasonably be expected to have occurred if the scheme was not entered into. The role of those materials needs to be reconsidered given that cases will be run by reference to an artificial Alternative Postulate rather than a determination of the true alternative.

We submit it would be inappropriate in a self-assessment environment for the law to provide this level of uncertainty as to the correct outcome under Part IVA.

Achieving reasonable outcomes in complex commercial transactions – impact on s177F

The tax-maximised benefits will place increased focus on the statutory discretion granted under s177F to the Commissioner to "determine **that the whole or a part of that amount shall be included in the assessable income** of the taxpayer of that year of income" (emphases added). That provision has no requirement for reasonable outcomes other than implied through the responsibilities of the Commissioner and taxpayers' rights to contest the s177F decision.

In our view the tax-maximised benefits inherent in the Draft, and the likely greater reliance on ATO discretions under s177F, are inconsistent with a self-assessment environment and are likely to lead to significant uncertainty for companies considering any significant or complex restructures.

Date of effect and impact of further clarification needed

The government's decision to defer the start date for the new rules to 16 November 2012 is a step in the right direction given the delay and the proposals are in "a form the public may not have readily anticipated when the measure was first announced".

However we have identified the uncertainty arising from this Draft and the need for refinement and clarification of the concepts. As mentioned, we consider that a further draft will be required.

Consistent with our input to the government in March 2012, we submit that, to provide fairness and certainty to taxpayers it would be reasonable for the start date to be further deferred to the date the final law is enacted.