Greenwoods
& Freehills

The Hon David Bradbury MP
Assistant Treasurer
Minister Assisting for Deregulation
Parliament House
CANBERRA ACT 2600

19 December 2012

Dear Minister

**Re: Exposure Draft – Tax Laws Amendment (2013 Measures No 1) Bill 2013**
**Proposed amendments to Part IVA – general anti-avoidance rules**

Thank you for the opportunity to make this submission on the Exposure Draft *Tax Laws Amendment (2013 Measures No 1) Bill 2013* ('the ED').

## 1 Introduction

Whilst Greenwoods & Freehills is supportive of the Australian income tax regime incorporating a robust and generally applicable anti-avoidance rule, we are concerned that any adoption of the proposed changes in the ED will result in significant changes in the application of Part IVA at the expense of the certainty, predictability and taxpayers' ability legitimately to have regard to their tax affairs when undertaking commercial transactions that the current body of court decisions provides to taxpayers.

There are obvious negative consequences of such an approach in terms of:

- the likely substantial increase in required administration of the private binding rulings system by the ATO and inevitable delays in providing taxpayer certainty when dealing with new legislation with no precedent to guide decisions;
- the resulting increased likelihood of the deferral or cancellation of new transactions and projects by the Australian business community, due to the perceived uncertainty of tax outcomes under the ED and particularly a perception that it will force the adoption of the least tax advantageous alternative form of a transaction in order to gain an acceptable level of confidence on the future non-application of Part IVA to a project or transaction; and
- possible perceptions of increased sovereign risk in Australia by potential international investors who may already hold this concern following the approaches taken to the Australian tax treatment of gains on disposal of certain private equity investments in Australia and the unanticipated doubling of the MIT withholding rate under changes only announced in the 2012 Federal Budget which has only been partially ameliorated by the introduction of the limited green buildings MIT regime.

Without in any way discounting the concerns expressed above, this submission proceeds on the basis that there is little prospect of the Government either abandoning the changes due to the concerns expressed above or substantially abandoning its insistence that there are technical deficiencies in the current operation of Part IVA.

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Accordingly, the main concern of this submission is to highlight that what is written already in the ED will so significantly eliminate existing safeguards, i.e. that the 'tax benefit' notion provides to taxpayers, such that some additional safeguards need to be written back into the ED to reflect a proper balancing of community standards in the application of Part IVA. This is also required as a basic matter of fairness to taxpayers who will suffer significant changes to a regime which has been in operation for over 30 years with no significant legislative amendment.

This submission then argues for four important general safeguards to be included before the ED is finalised. This elaboration will ensure that the ED does not cause further and unnecessary uncertainty, or afford the ATO powers which can lead to unsatisfactory tax outcomes. The four safeguards are as follows:

- that the amount of any 'tax benefit' must be limited to an amount that is reasonable in the circumstances;
- that where more than one plausible 'tax benefit' exists, the ATO is expected to assess on the basis of the least expensive option (in tax terms);
- that the ATO cannot insist on a 'tax benefit' by pointing to a substitute transaction that would never be undertaken and which generates an amount of tax that would never be suffered; and
- that the ATO cannot generate a 'tax benefit' when the taxpayer is undertaking a transaction by the only feasible way of accomplishing it, even if the transaction appears contrived.

## 2 'Tax benefit' operated as a curb on ATO practice

The jurisprudence reveals many cases where the ATO asserts tax avoidance in circumstances which, from the taxpayer's perspective, were innocuous.

The decisions in *BHP-Billiton* [2010] FCAFC 25 and *Ashwick* [2011] FCAFC 49 are examples. In both of these cases, the ATO argued that the taxpayers had engaged in tax avoidance, seemingly on the basis that the relevant arrangements had been entered into with the dominant purpose of generating tax deductions in connection with lending with no reasonable expectation (or possibly even belief in the ATO's view) of the derivation of income from the activities of an in-house finance company.

Part IVA was relied on by the ATO to prevent the taxpayers from obtaining a tax deduction for bad debts. The taxpayers had anticipated receiving income and had paid tax on that amount. When it became apparent that the income would not be received and they asked for a refund of that tax (by claiming a tax deduction), the ATO's response was to assert that making this claim was tax avoidance.

With respect, it was not evident why Part IVA should apply to this set of facts where a tax deduction was otherwise available and the facts disclosed nothing more than these deductions reflecting a loss incurred by an in-house finance company in the ordinary course of its business.

To some extent, the impression was created that the ATO had a philosophical objection to the establishment of an in-house finance company and had possibly predetermined that the parties must have entered into the relevant arrangements for the dominant purpose of securing favourable tax outcomes that would not otherwise be available in the absence of forming an in-house finance company, a view espoused in a number of speeches given by an ATO officer in previous years. Assuming this to be so, this is extremely concerning for corporate groups in Australia where in-house finance companies are common and established for a range of commercial (non-tax) reasons.

The outcomes in both cases represented very definite rejections of the ATO's position but came at a significant cost to taxpayers in terms of the time and resources dedicated to lengthy litigation on a set of facts that was not evidently susceptible to an application of Part IVA.

Secondly, some of the cases run by the ATO on Part IVA have created the impression that the ATO uses Part IVA to defeat policies on (non-Part IVA provisions) that it does not like. This is not simply our interpretation – it is a view that has been expressed by the Federal Court. For example, in *Macquarie Bank* [2011] FCA 1076, the Federal Court expressed the view that the ATO were simply trying to use Part IVA to defeat a clearly articulated government policy:

> However, the real problem for the Commissioner in the present case is that he seeks to cancel, in reliance on the provisions of Pt IVA, tax consequences intended by Parliament to be conferred on a company, such as Mongoose, joining a consolidated group irrespective of whether it, or other persons, had as its or their purpose in joining, taking advantage of those consequences.

The same impression has been created in cases involving s.23AJ dividends and deductions for related funding costs under s.25-90, an impression that surfaced publicly in the *Noza Holdings Pty Ltd v Commissioner of Taxation [2011] FCA 46* litigation.

Again, the impression has been created in these cases that the ATO has a philosophical objection to deductions being available where the corresponding income is non-assessable non-exempt. This results in the ATO pressing a forced analysis of common fact situations in an attempt to apply Part IVA to overcome the intended policy outcome of s.25-90.

The public statements of the ATO in this area (TA 2009/9 and Taxation Determination TD 2011/22) reflect fact situations that are clearly susceptible to Part IVA but do not represent what the ATO's approach to more common (and commercially driven) situations may be.

Furthermore, the ATO's withdrawal of any arguments based on Part IVA in *Noza* on appeal is essentially stated to be a reflection of *Noza* being confined to its facts (refer Decision Impact Statement on the ATO's website). However, the ATO's approach in that case essentially was to suggest that the adoption of preference shares in place of ordinary shares in finalising the structure of a transaction (resulting in a s.25-90 deduction for dividends paid on those shares) must be treated as being for the dominant purpose of obtaining that deduction. Gordon J ultimately found as a matter of fact that US tax reasons were the more significant explanation for the adoption of preference shares over ordinary shares and did not have to deal with the substantive reasoning underlying the ATO's approach as a result.

One explanation of the ATO's approach in *Noza* may have been the **change** from ordinary to preference shares in the course of designing a transaction structure demonstrated a dominant purpose to obtain a tax benefit by way of a s.25-90 deduction where it may not otherwise have been available.

However, another explanation is a more substantive concern with a taxpayer (even at the outset of a transaction) choosing one form of shareholding over the other and an implication that this must be attended with a dominant purpose of obtaining a s.25-90 deduction.

Indeed, the experience of taxpayers in other disputes involving s.25-90 has been that the ATO will challenge either:

- such a choice of funding by way of preference shares or another debt interest; or
- an investment related to that funding being in shares that result in the derivation of non-assessable non-exempt income;

as reflecting a dominant purpose to obtain a tax benefit from s.25-90 deductions under Part IVA, despite the outcomes being reflective of the policy evident in s.25-90 (and s.23AJ), and other aspects of the transaction demonstrating substantial commercial reasons for funding in a manner that results in deductions being available under s.25-90 (or making the related investment in shares rather than legal form debt).

In short, recent experience demonstrates difficulties with the administration of Part IVA: the ATO seeing tax avoidance where none exists and using tax avoidance to challenge what appear to be intended outcomes.

In these circumstances taxpayers have had to resort to two lines of defence – an argument that the 'purpose' element of Part IVA was not satisfied and an argument that no 'tax benefit' existed. As a result of the proposed amendments, the second defence will now be eliminated entirely or at least become far less feasible. This is a cause for serious concern.

## 3 'Tax benefit' operated as a limit on unreasonable substitutes

One role of the 'tax benefit' notion in the legislation is to identify and quantify the transaction which the ATO is entitled to tax, instead of the transaction which the taxpayer actually undertook. Again, the jurisprudence reveals cases where the construction of what should happen instead is unrealistic.

In the cases referred to above the courts rejected the ATO's claim of tax avoidance. But in all of these cases where an abusive purpose was alleged, the ATO also argued for an implausible substitute to be taxed instead of what the taxpayer actually did.

For example, in the *Ashwick* case, the ATO argued that the relevant taxpayer should have switched off any claim for interest on money that it had lent to related companies, even though it was paying interest on the money it had lent. Not asking for interest was the proper non-abusive course of action:

> The tax benefits ... that the Commissioner contended on the appeals were obtained by each of the respondent taxpayers in connection with the scheme or schemes the Commissioner identified are predicated on the following counterfactuals:
>
> (1) That after July 1990 [lender 1] would not have charged any interest on debts owed to it ...
>
> (2) that after July 1990 [lender 2] would not have charged interest on debts owed to it ...;
>
> (3) that after October 1991 [lender 3 ]would not have charged any interest on debts owed to it ...;
>
> (4) that after October 1991 [lender 4] would not have charged any interest on debts owed to it ...; and
>
> (5) that after April 1991 [lender 5] would not have charged any interest on debts owed to it ...;

It was argued that companies should simply decide to bear the expenses of other companies and should be taxed on that basis – a proposition which the Full Federal Court dismissed:

> why is it a reasonable prediction [to assert] that [lender 1] would not charge interest on loans to ... when [it] was still being charged interest ... on those borrowings?

Not charging interest on loans could then expose taxpayers to adverse tax consequences under transfer pricing rules or value-shifting rules – apart from being commercially irresponsible.

The same kind of substitute was proposed in *BHP-Billiton*. In the ATO's view, the lender should have:

> released the debt before writing it off with the result that Finance would not have been entitled to a bad debt deduction ...

Essentially, it was argued that taxpayers should be expected to take actions to deny themselves tax deductions.

This same insistence that taxpayers should take – and be taxed on – uncommercial actions can be seen in *Futuris* [2012] FCAFC 32. In that case, the taxpayer re-arranged the ownership of assets inside a corporate group prior to a public float. The ATO put to the Court that the taxpayer should have restructured its operations in such a way as to double the amount of tax payable:

> The effect of the [ATO's] Presumed Counterfactual is that there would be two sales: an internal sale of the bulk of the Building Products Division and an external sale of the Division. The effect of the two sales would be a doubling up of capital gains in respect of essentially the same assets.

If this argument had been successful the taxpayer would have paid more in tax than the profit it made from the transaction.

These cases show the ATO arguing for amounts that are not reasonable.

This is very concerning given that the ED [s. 177CB] in effect overrules the constraint in the current law [s. 177C] that any substitute transaction must be one which 'is reasonably likely' – a constraint which the Courts have in effect read to mean, a transaction which gives rise to a reasonable amount of tax.

## 4 The need for express safeguards, given the imponderable impacts of the draft

The notion of 'tax benefit' created some safeguards for taxpayers in disputes with the ATO on the proper boundaries of Part IVA– in particular, disputes over whether a transaction demonstrated improper structuring that reflected tax avoidance, and the ATO insisting that an implausible substitute triggering an unreasonable amount of tax be taxed instead. Given that this project is intended to remove or curtail the role of 'tax benefit' and its function as safeguard for taxpayers, other safeguards must be established to perform that role.

While it might be argued that adequate safeguards are in fact implicit in the text or subtext of the ED, in our view the effects of the ED are so difficult to predict that such a view cannot be assumed with any confidence. The adjustments made to current law by s. 177CB are more than bewildering; no-one can be sure what they will accomplish when tested before a court.

In our submission, the most sensible approach is to insist on four express qualifications – in addition to whatever else is accomplished by the text. If the safeguards turn out to be implicit in the text of the ED, then no harm will have been done by expressing them.

## 5 Four express safeguards

In our submission, the following four propositions should be expressly included to qualify the effects of the ED:

1. that the amount of any 'tax benefit' must be limited to an amount that is reasonable in the circumstances. There needs to be express protection against the kind of uncommercial outcomes which the ATO put forward, apparently without embarrassment, in *BHP-Billiton*, *Ashwick* and *Futuris*;
2. that where more than one plausible 'tax benefit' exists, the ATO is expected to assess on the basis of the least expensive option (in tax terms). Again, taxpayers need express protection against the over-reaching approach of the ATO evident in *Futuris*;
3. that the ATO cannot insist on a 'tax benefit' by pointing to a substitute transaction that would never be undertaken and which generates an amount of tax that would never be suffered. Again, a more expensive way (in tax terms) of accomplishing any transaction can always be found. Taxpayers need protection against an over-reaching ATO being able to succeed based upon proposing an implausible substitute; and

4 that the ATO cannot generate a 'tax benefit' when the taxpayer is undertaking a transaction by the only feasible way of accomplishing it, even if the transaction appears contrived. The issue here is the idea of 'purpose' could be seen an absolute notion, not a relative one (that is, purpose is demonstrated by showing the transaction is contrived, rather than showing the transaction that is more contrived than another with the same commercial effect). If purpose is an absolute notion, then a taxpayer should not be subject to Part IVA if the complex transaction is, in fact, the most commercially sensible.

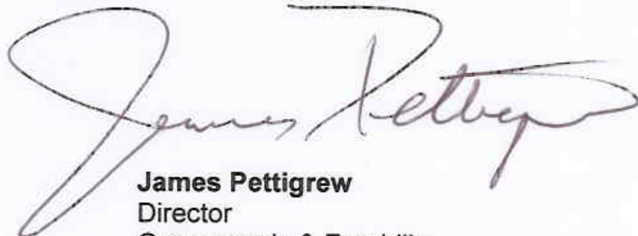
These are simple and reasonable limits. None of these propositions should be regarded as problematic in themselves. Indeed, the ATO might want to adopt them – and claim that it acts in just this way already, and will continue to do so. But the lesson of the jurisprudence is that statutory limits are necessary. In our submission these propositions should be added to the text of the ED so that – whatever else it may accomplish – it cannot produce outcomes that are inconsistent with these safeguards.

Indeed, this approach could be extended to reduce the level of concern that is currently being expressed in boardrooms around that country – expressly acknowledging that:

- choosing to a fund a subsidiary with debt rather than equity is not amenable to Part IVA (and controlled by the thin capitalisation rules);
- choosing to a operate in Australia or abroad by a branch or subsidiary is not amenable to Part IVA; and
- internal restructuring which simply moves assets between onshore subsidiaries or between offshore subsidiaries is not amenable to Part IVA.

If you wish to discuss this submission, please contact James Pettigrew, per the contact details below.

Yours sincerely



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