Institute of Chartered Accountants Australia

20 December 2012

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By email: partIVA@treasury.gov.au

Dear Sir or Madam,

General anti-avoidance rules exposure draft legislation

The Institute of Chartered Accountants in Australia (**Institute**) welcomes the opportunity to comment on the exposure draft legislation (**ED**) and accompanying explanatory material (**EM**) to amend the general anti-avoidance rules in Part IVA of the *Income Tax Assessment Act 1936* (**ITAA 1936**), which was released on 16 November 2012 (**Part IVA Proposals**).

The Institute is the professional body for Chartered Accountants in Australia and members operating throughout the world. Representing more than 70,000 current and future professionals and business leaders, the Institute has a pivotal role in upholding financial integrity in society. Members strive to uphold the profession's commitment to ethics and quality in everything they do, alongside an unwavering dedication to act in the public interest.

Part IVA is a core provision of the income tax system which has the potential to impact negatively on significant commercial activity. Where the provision is appropriately drafted it can be applied to counter egregious tax avoidance activities with no, or little, impact on genuine commercial endeavour. However, where the provision is inappropriately drafted it has the potential to stifle economic activity and render commercially legitimate transactions stillborn.

It is therefore of critical importance that the amendments to Part IVA be limited to the scope of the Government's original policy announcement and to be precisely and clearly drafted.

The Government's original policy intent has been stated in the media releases of the Assistant Treasurer on 1 March and 15 May this year. The 16 November release by the Assistant Treasurer itself does not state any new matters of policy intent but attaches the ED and EM. However, the scope of the amendments in the ED, and as explained by the EM, regrettably goes well beyond the policy intent of the first two media releases. The attachment of these documents to the 16 November media release means it is not entirely clear whether the Government has changed and expanded the policy intent of the amendments, or merely whether the drafters have failed to accurately reflect the previously stated policy intent in the ED and EM. Given the significance of the proposed amendments the Institute considers that, on balance, the latter is the correct situation and its comments are based on this understanding.

The Institute is of the view that where the scope of the drafting exceeds that of the stated policy intent of the amendments the excess is objectionable. An example of this excess is that the Australian Taxation Office (**ATO**) will, if the amendments are enacted, have a legislated capacity to advance alternative postulates which are patently unreasonable and predicated on taxpayers paying the maximum amount of tax conceivable in relation to a transaction. The ATO may, or may not, in practice do so. However, the legislative conferral of this capacity on the ATO will of itself likely reduce economic activity as businesses refrain

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from entering legitimate commercial transactions due to this additional material and/or increase transaction costs as businesses seek to mitigate this risk.

The Institute is of the strong view that the draft amendments should be redrafted to accord with the scope of the Assistant Treasurer's original policy announcement and that a further version should be released for public comment before the amendments are introduced to parliament. Sufficient time should be allowed for meaningful consultation. This would mean that the current plan of introducing the amendments to Parliament in the Autumn sittings is unlikely to be met.

Alternatively, if the Government does intend that the scope of Part IVA be extended in this way it should clearly articulate that intent in a further media release. In any event, a redraft of the amendments will be required in our view.

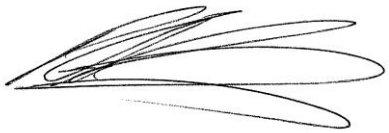
The Institute also considers that it would be of significant benefit to the operation of Part IVA if it was stated in the proposed objects clause section 177AA that the object of this part is to counter schemes that are artificial, blatant or contrived as stated in the explanatory memorandum to the original statute enacting Part IVA.

Our detailed comments on the ED and EM set out in the attachment.

The Institute was represented in the roundtable consultative process relating to the Part IVA Proposals and various issues have been raised in that process. For convenience, therefore, this submission is presented in a summary form highlighting strategic issues.

If you have any queries regarding the content of this submission, please do not hesitate to contact me on 02 9290 5609 or Karen Liew 02 9290 5750.

Yours sincerely



Paul Stacey
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Submission

GENERAL COMMENTS

1. The current Part IVA structure works well

The Institute considers that Part IVA has worked reasonably well since its introduction in 1981 and continues to do so. There is now a strong body of judicial precedent on Part IVA. The ATO, tax advisors and taxpayers alike have a reasonable understanding of how the whole structure of Part IVA works together. As a result egregious tax avoidance is prevented, or caught, by Part IVA without the provision stifling legitimate economic activity. The Institute remains unconvinced that it is necessary to amend Part IVA in the manner proposed. Specifically:

a) Part IVA works appropriately in relation to artificial, blatant and contrived cases as illustrated below; and

b) the Courts have had no difficulty in applying Part IVA where there is a tax benefit determined by comparing what a taxpayer would otherwise be reasonably expected to have done.

We accept, however, that policy decisions fall within the purview of Government. Accordingly, the focus of this submission is on whether the draft legislation implements the Government's original policy decision as clearly indicated in the Assistant Treasurer's media releases of 1 March 2012 and 15 May 2012. The Institute submits that particular care should be taken to ensure that the proposed Part IVA amendments only give effect to the Government's clear policy intent and do not exceed the scope of that policy pronouncement.

2. The scope of the Part IVA Proposals goes beyond the stated Government policy intent

The Institute's understanding of the Government's original policy intent to amend Part IVA is based on the Assistant Treasurer's media releases dated 1 March 2012 and 15 May 2012. The Assistant Treasurer's media release dated 1 March 2012 sets out the scope of the amendments to Part IVA. In that media release, the then Assistant Treasurer, Senator Mark Arbib, stated:

> '"In recent cases, some taxpayers have argued successfully that they did not get a 'tax benefit' because, without the scheme, they would not have entered into an arrangement that attracted tax," Senator Arbib said.
>
> "For example, they could have entered into another scheme that also avoided tax, deferred their arrangements indefinitely or done nothing at all. Such an outcome can potentially undermine the overall effectiveness of Part IVA and **so the Government will act to ensure such arguments will no longer be successful**. (emphasis added)
>
> "The Government amendments will confirm that Part IVA always intended to apply to commercial arrangements which have been implemented in a particular way to avoid tax. This also includes steps within broader commercial arrangements."'

Accordingly, the Government's original policy intent to amend Part IVA is to:

- ensure that a Court's decision that Part IVA does not apply to a scheme cannot be founded on an argument that the taxpayer could have entered into another scheme that also avoided tax, deferred their arrangements indefinitely or done nothing at all;
- confirm that just because an arrangement is commercial this does not mean that Part IVA cannot be applied to that arrangement if the commercial arrangement has been implemented in a particular way to avoid tax; and
- also applies to steps within broader commercial arrangements.

The Assistant Treasurer's media release dated 15 May 2012 affirmed the scope of the announced changes to Part IVA in the March 2012 media release and clarified the process for implementation. The 16 November media release by the Assistant Treasurer itself does not state any new matters of policy intent but attaches an ED and EM containing the Part IVA Proposals.

However, the Part IVA Proposals go considerably further than the original policy intent indicated in the first two Assistant Treasurer's media releases. Paragraph 1.85 of the EM, which explains why the start date of the changes has been delayed, states that this was in part 'to recognise that the amendments are being proposed in a form the public may not have readily anticipated when the measure was first announced'. More correctly the form in which the amendments have been proposed exceeds the scope of the stated policy intent.

In this circumstance either:

- the form of the amendments needs to be redrafted to conform with the scope of the original policy announcement; or
- the Government needs to make a further policy announcement clearly articulating how and why it is further extending the scope of the Part IVA amendments to correspond with that of the released draft amendments.

A summary of the effects of the Part IVA Proposals is provided in paragraph 1.89 of the EM which is summarised below:

- to allow Part IVA to operate as an integrated whole, by:
    - restoring the dominant purpose test in section 177D to be the 'fulcrum' or 'pivot' for Part IVA; and
    - ensure that subsection 177C(1) is construed with paragraph 177D(b);
- ensure that when performing a hypothetical reconstruction of what would have happened absent the scheme, so as to determine if a tax benefit arises, the hypothesis focuses on other ways in which the taxpayer might reasonably be expected to have achieve the same non-tax effects as the scheme. (The Institute notes a disconnect between the EM and the ED in that there is no reasonable requirement in the draft provisions); and
- ensure that no consideration is given to tax implications in considering alternatives to the scheme.

Based on the EM's summary of the effects of the Part IVA Proposals, it is clear that the intended intent underlying the ED and EM goes beyond the Government's original policy as announced in the first two media releases of the Assistant Treasurer.

In particular, the original policy scope of the amendments only requires that Part IVA be amended to the extent that it prevents taxpayers from successfully arguing that Part IVA does not apply because 'they could have entered into another scheme that also avoided tax, deferred their arrangements indefinitely or done nothing at all'. However, the enquiry contemplated by the EM is what the taxpayer would have done to achieve the same commercial effect, absent any consideration of the tax impact of that, or those, alternatives.

This is a different enquiry to that contemplated in the first two media releases of the Assistant Treasurer and the scopes of the two enquiries do not overlap, or align, precisely. For example, it is perfectly foreseeable that a business, absent the tax benefit, would have entered into an alternative arrangement which would have substantially, largely or partly achieved the same commercial outcome. It will seldom be the case that the taxpayer could foreseeably and reasonably enter an alternative arrangement which would achieve exactly the same commercial effect. This is because the intended commercial effect is necessarily an amalgam of commercial objectives, some of which will be competing, and the extent to which any is achievable is dependent upon a process of negotiation with other parties, whom will have their own objectives. The original purpose of the amendments, per the Assistant Treasurer's first two media releases, is not to require taxpayers to have been able to achieve the same commercial effect absent the tax outcome to defeat the application of Part IVA, only that entering into another scheme that

also avoided tax, deferring that arrangement indefinitely or doing nothing at all should not defeat the operation of Part IVA.

The discrepancy between the scope of the amendments as originally announced, and as drafted, highlights the absence of an explicit legislative requirement in the Part IVA Proposals that the alternative postulate be reasonable. Alternatively expressed, the effect of the current drafting is to define the alternative postulate as one which achieves the same commercial effect, but with the maximum tax payable and regardless of how reasonable that alternative is.

3. The key principles fundamental to the current design of Part IVA

In designing the appropriate amendments to Part IVA, the Institute submits that the following principles fundamental to the current design of Part IVA must be adhered to.

1. When the 'tax benefit' inquiry in section 177C depends on a hypothetical reconstruction of what would have happened absent the scheme, the alternative postulate must be reasonable. We are concerned that the Part IVA Proposals will operate unfairly as the assumptions in the proposed section 177CB operate to restrict the reconstruction and therefore, potentially compromise the fundamental requirement of a comparison with a reasonable alternative postulate.
2. The 'tax benefit' inquiry in section 177C determines the identity and the quantity of the tax avoided and then the 'dominant purpose' test in section 177D is applied. The Part IVA Proposals seek to change the order of application of these tests to make it one holistic inquiry which has resulted in uncertain and convoluted drafting.
3. The application of the 'dominant purpose' test in section 177D should not change. The Government has clearly stated that it does not propose to change the core operation of the 'dominant purpose' test. However, the Institute is concerned that the Part IVA Proposals, particularly, subsection 177CB(2) could practically impact the core operation of the 'dominant purpose' test in section 177D.
4. Part IVA should be a provision of last resort in that it should only apply in exceptional cases. Part IVA should not be redrafted as to interfere with the straight forward operation of the ITAA 1936 and the *Income Tax Assessment Act 1997* (**ITAA 1997**). A taxpayer getting a favourable tax result under ITAA 1936 and/or ITAA 1997 does not necessarily mean that tax has been avoided such as to achieve a tax benefit.

DETAILED COMMENTS

4. Deficiencies in the drafting of the ED

The desire to change the way an alternative postulate is formulated and to make the application of Part IVA one holistic inquiry has resulted in uncertain and convoluted drafting.

Firstly, we recommend further clarification for the following:

- More clarification is required to illustrate what is the 'same' non-tax effect in proposed subparagraph 177CB(1)(b)(i). We have already experienced issues with interpreting what is the 'same' for the purposes of applying the same business test to claim company losses. We envisage that there will be similar interpretive challenges to determine what is the 'same' non-tax effect.
- More clarification is required to explain the meaning of 'effect' in proposed section 177CB. We also recommend that the EM includes more examples that consider more complex legitimate commercial planning.
- More clarification is required to explain the meaning of 'incidental' in proposed paragraph 177CB(3)(b). We also recommend more examples be included to illustrate the meaning of 'incidental' in situations with more complex commercial planning.

Secondly, we have listed below drafting issues in the ED:

- The proposed new objects clause refers to schemes undertaken for relevant objective purposes. This oversimplifies the focus of the law on the purpose of a person who entered into or carried out the identified scheme. Furthermore, it does not acknowledge the difference between legitimate tax planning and tax avoidance arrangements that are blatant, artificial or contrived. In fact, it is stated in the explanatory memorandum to *Income Tax Laws Amendment Act (No. 2) 1981* (the Act that introduced Part IVA) that:

  > '[t]he proposed new Part IVA, which this Bill will insert into the Principal Act, is designed to overcome these difficulties and provide - with paramount force in the income tax law - an effective general measure against those tax avoidance arrangements that - inexact though the words be in legal terms - are blatant, artificial or contrived.'

  We believe the objects clause needs adjustment and the original purpose of Part IVA, as stated above in the explanatory memorandum to *Income Tax Laws Amendment Act (No. 2) 1981*, should be reflected in the objects clause.

- Conceptually, the cumulative operation of paragraphs 177CB(1)(a), (b) and (c) is difficult to apply. In particular, it appears paragraphs 177CB(1)(b) and (c) are intended to operate in the alternative. We recommend that section 177CB(1) be redrafted.

- The application of Part IVA is based on an objective inquiry. However, the new terms used in paragraphs 177CB(1)(a) and (b) involve elements of intent which is a subjective inquiry. These include:

  - Proposed paragraphs 177CB(1)(a) and (b) reference to 'refrain' may suggest intent, which is difficult to conceptualise in a negative hypothetical assumption.

  - Proposed paragraph 177CB(1)(b) – reference to 'intending' to achieve for the taxpayer lends itself to a subjective enquiry.

- Another new term is introduced in proposed paragraph 177CB(1)(a). Part IVA operates by reference to a 'person'. The introduction of the term 'participant' in a scheme may cause interpretation issues for taxpayers, the Commissioner and the Courts. We recommend the reference to '(whether or not a participant in the scheme)' be removed.

- The drafting of proposed subsection 177CB(2) is problematical.

  - In formulating the assumption under paragraph 177CB(1)(b) (broadly, the alternative postulate achieve the same non-tax effects as the scheme) regard must be had to the matters in subsection 177D(2). Included in the list of matters in subsection 177D(2) is the tax result achieved by the scheme. It is not clear how subsection 177CB(2) operates coherently with the assumption in paragraph 177CB(1)(b).

  - Furthermore, it is difficult to apply the assumption in paragraph 177CB(1)(a) (i.e. have no regard to any person's tax liability) together with the assumption in paragraph 177CB(1)(b) which requires that regard to be had to the abovementioned matters, one of which includes the tax result of the scheme.

  - If a conclusion is formed in reliance on proposed subsection 177CB(2) that there is a tax benefit, it is unclear how section 177D will be applied on its own. It appears that the conclusion under section 177D is effectively prejudged by the application of section 177CB(2).

5. Drafting style or conceptual difficulties underlying policy intent?

It may be that the drafting style, which is highly prescriptive, causes difficulty with the Part IVA Proposals. But going to the other end of the spectrum, principles based drafting, may simply cause difficulties.

Key terms will necessarily be subject to the normal principles of statutory interpretation and the risk the judges, faced with outcomes they consider unjust, will be inclined to analysis which serves the interests of justice despite legislative terminology. Examples of drafting uncertainty noted above are prime candidates for such judicial behaviour, with judges having available legislative resources outside the amendment such as the scheme definition, the reasonableness test in section 177C and the dominant purpose test in section 177D.

Further, the Commissioner will be under increased pressure to exercise his discretion either not to make a Part IVA determination or to make compensating adjustments in cases where unfair or unreasonable outcomes occur.

The deeper problem is whether any drafting can give effect to the policy intent or whether further work is required to identify a clear intent capable of being given appropriate legislative effect. This deeper problem is illustrated by the question of unintended consequences below.

6. Unintended consequences from the Part IVA Proposals

The Institute is concerned that the proposed section 177CB seems to be prone to several areas of unintended consequence. These difficulties essentially are exposed because of a tension between at least three principles for the operation of the alternate postulate concept – annihilation of the putative scheme transaction, reconstruction of an alternative postulate and speculation inherent in these processes and the prescriptive proposed assumptions.

To illustrate the concerns, consider the facts of *RCI Pty Ltd v Commissioner of Taxation* [2011] FCAFC 104 (**RCI**). The Part IVA Proposals presumably hope to annihilate the dividend from the scheme so that the alternate postulate would be a sale of the relevant US subsidiary to another subsidiary of the taxpayer's group. The capital proceeds would be increased because the value of the subsidiary would be greater by including the profits otherwise paid by dividend. However, the dividend and the scheme had a significant level of commercial purpose which could not be described as merely incidental. Under the Part IVA Proposals, proposed paragraph 177C(1)(b) would apply and it is conceivable that some other payment or indebtedness could at least conceptually be postulated equal to the amount of the dividend, with the result that no tax benefit is obtained by the taxpayer.

That said, the RCI facts illustrate another problem – how could the statutory assumption in proposed paragraph 177CB(1)(b) operate in a real case, and what would this mean for taxpayers and indeed the ATO to give effect to the proposals. In RCI, the series of transactions collectively involved in excess of 30 documents spread over an eight month period, raising the question of how it could be sensibly reconstructed such that the parties would still achieve the same non-tax effects (including the payment of a dividend), but result in a different tax outcome.

In relation to the facts for *Commissioner of Taxation v AXA Asia Pacific Holdings Ltd* [2010] FCAFC 134, again an annihilation of the intermediate steps is intended to be achieved under the Part IVA Proposals such that there is a direct sale to the ultimate purchaser rather than the various transactions before that sale. The difficulty is that the intermediate steps may not be incidental from a commercial perspective and not incidental to the tax effects, with the result that again proposed paragraph 177CB(1)(b) may apply. On a same non-tax effect comparison it may be that actually a transaction other than a direct sale will be the alternate postulate.

So, while the Part IVA Proposals may be intended to operate to annihilate the putative scheme in the above examples, proposed section 177CB may result (and perhaps always requires) a conclusion involving reconstruction of the transaction which might have otherwise taken place. This would, in the view of the Institute, probably be an appropriate outcome, but we highlight that the judicial interpretation of the Part IVA Proposals might take years, illustrating the uncertainty in this drafting.

No doubt the Part IVA Proposals seek to stop unconstrained speculation in applying section 177C. However, in seeking to do so in the manner proposed will lead to a new cycle of speculative reconstruction by the ATO and by taxpayers requiring consideration in the Courts.

The above examples are in relation to income tax benefits.

In relation to deduction tax benefits, it is likely proposed paragraph 177CB(1)(b) will apply as there will always be commercial factors in play. We envisage that the debate in financing cases will be between the different types of financing. This will test the requirement of the 'same non-tax effects' as no form of financing is ever literally the same. Again, the uncertain application of the Part IVA Proposals is unacceptable.

It may be that proposed paragraph 177CB(1)(c) will have a greater role than anticipated: however the focus of that assumption is primarily on schemes of no or limited non-tax effects. Nevertheless, under the current law, the Commissioner has no difficulty winning cases involving aggressive tax planning, whether in the area of mass marketed investment schemes or extreme forms of structured finance[1].

Example 1.3 in the EM poses an example of a transaction that is so structured as to make its tax effects dominate so its commercial effects are treated as incidental to the tax effect and to be ignored. The Institute is concerned that, not only might such an example already be caught by the existing provisions, more significantly the proposed wording may go further and may apply to strike down ordinary commercial arrangements, such as a sale and lease back (versions of which have been found by the Federal Court not to attract Part IVA in the decisions of *Eastern Nitrogen Ltd v Commissioner of Taxation* [2001] FCA 366 and *Commissioner of Taxation v Metal Manufactures Ltd* [2001] FCA 365).

If the result is that a non-tax effect (such as a legal transaction) is deemed not to have its legal effect in the analysis (because it is considered incidental to a tax effect and to be ignored) then proposed paragraph 177CB(1)(c) is highly debatable.

The conceptual problem with the analysis underlying proposed paragraph 177CB(1)(c) is that the tax law does not allow a tax benefit to be obtained in respect of a nullity such as a sham. Under the current architecture of Part IVA, the question of substance versus form is dealt with in the dominant purpose analysis in section 177D. In the Institute's view, the aggressive tax planning that proposed paragraph 177CB(1)(c) is trying to address is not one that can be addressed under section 177C or proposed section 177CB but is correctly and appropriately addressed under the current law in section 177D. The current attempt to address this in proposed section 177CB creates significant uncertainty for all taxpayers.

This analysis demonstrates why the Institute recommends further redrafting, as there is not a clear overarching intent evident in the Part IVA Proposals sufficient to enable taxpayers, their advisors and indeed the ATO as administrator to operate under the proposals.

[1] For example, the ATO won in the complex structured financing case, *Commissioner of Taxation v Citigroup Pty Ltd* [2011] FCAFC 61.