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Dear Chief Advisor

Submission on the Exposure Draft of the General Anti Avoidance Rule in Part IVA of the *Income Tax Assessment Act* 1936 and Explanatory Material

We refer to the Assistant Treasurer's release of the Exposure Draft legislation contained in *Tax Laws Amendment (2013 Measures No 1) Bill 2013: General anti-avoidance rules* and Explanatory Memorandum in relation to the previously announced proposed amendments to the general anti-avoidance provisions in Part IVA of the *Income Tax Assessment Act 1936*.

In response to the invitation for comments on the proposed amendments, we welcome the opportunity to provide the following submissions, on behalf of PricewaterhouseCoopers ("PwC"), in connection with the proposed amendments.

Executive Summary

In PwC's view the Government should proceed cautiously in the reform of Part IVA in order to ensure that amendments give effect only to clear policy intent without creating unintended or uncertain consequences or create difficulties in the administration of the law for the Australian Taxation Office (ATO), taxpayers and advisers.

The Government has formed the clear policy intent that a taxpayer should not be able to avoid the conclusion that there is a "tax benefit" by the argument that it is not reasonable to expect, or that they would have not, pursued an alternative to the scheme that exposed the taxpayer to substantial Australian income taxation (the so-called "do nothing" defence).

PwC acknowledges that the Government will have considered representations that such a policy intent is inappropriate but nonetheless considers it is the appropriate policy intent to underlie an amendment of Part IVA. PwC, noting that the Assistant Treasurer's announcement calls for submissions on the proposed amendments, and will not seek to further agitate debate on this aspect of policy intent.

PwC considers that the drafting of proposed s177CB(1)(a) in the Exposure Draft is sufficient and appropriate to achieve the proposed policy intent of the Government. PwC recommends

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that the Government stop there unless and until a clear case for further changes can be demonstrated and coherent policy intent defined for further reform.

The Exposure Draft Legislation (EDL) and Explanatory Memorandum (EM) however, in terms of policy intent, goes considerably further than the Media Releases by the Assistant Treasurer on 1 March and 15 May 2012. This is acknowledged in para 1.85 of the EM, which explains the deferral of the announced date of effect from 2 March to 16 November 2012 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."

PwC is concerned that:

- The matters dealt with as a whole in the EDL and EM are considerable in the breadth and impact but their policy justification has not been convincingly demonstrated in the EM and the drafting of the EDL does not succeed in being clear and without considerable difficulties.
- The current consultation process on the EDL and EM – effectively a month to comment up to 19 December 2012 – is therefore wholly inadequate for the purpose of sound policy development, legislative design and drafting.
- From the perspective of Australia's national interest in having a healthy tax system, PwC is very concerned that the EDL and EM will in their current form be highly detrimental. The drafting has many unintended consequences, is uncertain and convoluted.
- It is likely that a decade at least of practical experience and judicial consideration will be required to understand the proposed amendments. During this time, in respect of a provision which is of general application to the entire tax base, there will be uncertainty and unintended consequences for the ATO in applying the law, tax rulings, tax audits and in litigation. Advisers and taxpayers will also face enormous difficulties. The current requirements of the EDL will simply be beyond the capacity of most small scale tax agents and advisers and their clients.

PwC counsels that deferral of the introduction of legislation pending a longer and more substantial consultation process, including abrogation of the do nothing defence, would be prudent compared to amendment in stages to introduce first the abrogation and later other amendments. This is because the means by which the later stages are drafted may require redrafting of the abrogation provision, with consequent inefficiency and disruption.

PwC is seriously concerned about whether the first 16 pages of the EM is founded on an unimpeachably correct understanding of the current law, policy intent and its history. The Explanatory Materials indeed make it uncertain as to whether the Government's objection and cause for action is premised on the alleged misapplication of good law by the Courts or the correct application of deficient law needing to be rectified. Until such clarification is expressly provided any proposed amendments will remain uncertain as to what and how they seek to address.

In PwC's view, therefore the Government should allow considerably more time for discussion of the policy issues reflected in the EDL and EM. Part IVA has done well for over 30 years and a longer consultation process will be a better way to develop amendments, if necessary, which will be sound and robust for future decades. It could be that that the Board of Taxation should be engaged to further undertake policy discussion and consultation before the Government considers further amendment of Part IVA. Considerable attention needs to be given to real examples, not only in decided cases but in respect of matters on which the Commissioner has considered it necessary to give public guidance.

Reasons for Submission

1. Part IVA has stood the test of time so caution is prudent before undertaking reform

In PwC's view Part IVA, since its introduction in 1981, has generally worked reasonably well and is reasonably well understood by both the Commissioner of Taxation ("the Commissioner") and taxpayers alike. In many, perhaps the majority, of cases, the Commissioner has been well served by both the provisions and the Courts when applying them.

2. The Basic Architecture of Part IVA works well

Great care should be taken before the basic architecture of Part IVA is disturbed. It has objectively stood the test of time very well if one takes a non-partisan view of its history. There are several elements of the architecture which seem intentionally or unintentionally to be at risk in the EDL and EM.

Part IVA already integrates concepts of the scheme, tax benefit and purpose of the parties who enter into or carry out the scheme but the EDL and EM seek to restate the method by which they integrate in a way that has possibly profound consequences. This occurs by principally:

- seeking to constrain the reasonableness tests in s177C (reasonable expectation and would) by the statutory assumptions in proposed s177CB;
- taking into account the dominant purpose factors in s177D in applying the new alternate postulate test in proposed s177CB(1)(b);
- the intent expressed in the EM (paras 1.93-1.94) seek to make dominant purpose in relation to the scheme the first question and then tax benefit a subsidiary question.

Each of these disturbs principles fundamental to the current design of Part IVA:

- Part IVA is a provision of last resort in the statutory sense that it only applies when a tax benefit is obtained. If no tax benefit is obtained, Part IVA cannot apply.
- Part IVA only applies in exceptional cases. Part IVA should not be drafted so as to interfere with the ordinary/straightforward operation of the Act under which a

taxpayer getting a favourable tax result does not necessarily mean that tax has been avoided such as to achieve a tax benefit.

- The tax benefit inquiry in s177C determines the identity and quantity of the tax avoided (making no finding of purpose) and then s177D operates.
- What is a tax benefit is determined by a test of comparison with a reasonable alternative.

PwC is concerned that the proposed amendments are illogical and unworkable as the purpose inquiry in s177D presupposes that a tax benefit has been obtained.

PwC is also concerned that the proposed amendments will operate unfairly as the statutory assumptions will restrict and therefore comprise the fundamental requirement of a reasonable comparison with an alternate postulate. That is the, the statutory assumptions will require that to some degree the comparison is not reasonable. Further the requirement under proposed s177C(2) could practically foreclose the ability of the Court to assess dominant purpose under section 177D despite a stated Government policy intent not to interfere with the operation of that test.

If the Government considers that the fundamental architecture of Part IVA should be changed, such as in these areas, an entirely more suitable process to the month long consultation process announced on 16 November 2012 should be undertaken.

3. Uncertain and convoluted drafting

The drafting of the EDL is extremely convoluted and challenging to interpret and apply. Such outcomes are obviously undesirable and should be avoided.

The following are key examples:

- What is the "same" non-tax effect (proposed s177CB(1)(b)(i))?
- What is an "effect" (proposed s177CB)?
- How does the "incidental" test work (proposed s177CB(3)(b))?
- How does proposed s177CB(2) work?
- If a conclusion is formed in reliance on proposed s177CB(2) that there is a tax benefit, how will s177D be applied on its own? Is the conclusion under s177D effectively prejudged by the application of s177CB(2)?
- Proposed s177CB(1)(a) and (b) reference to "refrain" may suggest intent, which is difficult to conceptualise in a negative hypothetical assumption.
- Proposed s177CB(1)(a) introduces terms foreign to Part IVA and results in a provision which is unclear and ambiguous. That is, Part IVA operates by reference to a "person". The introduction of the word "participant" to a scheme may cause confusion for taxpayers, the Commissioner and the Courts.
- Proposed s177CB(1)(b) – reference to "intending" to achieve for the taxpayer lends itself to a subjective enquiry. Part IVA has always been based upon an objective enquiry.

These drafting difficulties will produce many problems for the Commissioner as well as taxpayers as cases will all turn on their facts as applied by these new concepts.

4. Drafting Errors

There are two potential areas of error in the drafting.

The first is areas of patent mistake. For example, the new objects clause seems to be concerned with schemes undertaken for a sole or dominant tax purpose. This of course is not the current law or presumably the law as is proposed to be amended, which concerns the purpose of a person who entered into or carried out the identified scheme. More bluntly schemes don't have a purpose, people do. As the objects clause is neither correct nor operative it would be appropriate to delete it altogether.

The second concerns unintended consequences (see further below). The problems are so grave (especially for the Commissioner) as to suggest the drafting itself is flawed.

5. Drafting Style or Conceptual Difficulties underlying Policy Intent?

It may be that the drafting style, which is highly prescriptive, causes difficulty. 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 s177C and the dominant purpose test in s177D.

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 that intent is presently requiring further work to arrive at a clear intent capable of being given appropriate legislative effect. This deeper problem is addressed by the question of unintended consequences.

6. Unintended Consequences

Proposed s177CB 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, reconstruction and speculation.

To illustrate, by mandating a comparison with an alternate postulate as it does, the Commissioner may now be prone to losing several categories of case (at least in respect of tax benefits that the Commissioner might currently win under current law).

For example, in relation to the facts of the RCI case, the likely intent is that the amendments are probably hoped to annihilate the dividend from the scheme so that the alternate postulate is a sale from under the US to Malta, with capital proceeds increased because the shares include the profits otherwise paid by dividend. It is hard to see proposed s177CB(1)(c) applying as the dividend and the scheme had a significant level of commercial purpose and could not be described as merely incidental. Proposed s177C(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 – whether the statutory assumption in proposed s177CB(1)(b) can in a real case be given effect. In RCI the transaction collectively involved in excess of 30 documents spread over an 8 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 which result in a different tax outcome.

It would be a very odd result for the Government if, on RCI facts, RCI would still win despite being unable to argue the "do nothing" defence due to its abrogation by proposed s177CB(1)(a).

In relation to the facts for the AXA case, again an annihilation is probably hoped for such that there is a direct sale to the ultimate purchaser rather than the various steps that intermediated before that sale. The difficulty is that intermediated steps may not be incidental and are arguable not incidental to the tax effects, with the result that again proposed s177CB(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.

The point here is that the EDL and EM in these examples may be intended to operate to annihilate but proposed s177CB may result in (and perhaps always requires) a conclusion involving reconstruction.

No doubt the EDL and EM seek to stop unconstrained speculation in applying s177C but in seeking to do so seems to on these examples run the risk of unintended losses for the revenue because instead of annihilation there is speculative reconstruction.

The examples just given are in relation to income tax benefits.

In relation to deduction tax benefits the revenue will be even worse off because the Commissioner will, unless proposed s177CB(1)(c) applies, always be unable to argue that the scheme was to "do nothing" eg no finance would be raised. Here the debate will in financing cases be between 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.

It may be that the route to save the Commissioner is through proposed s177CB(1)(c). Already the Commissioner under the current law has no difficulty winning cases involving aggressive tax planning, whether in the area of mass marketed investment schemes or extreme forms of structured finance. Example 1.3 in the EM poses an example of a transaction that is structured as to make its tax effects dominate so its commercial effects are treated as incidental and to be ignored. Whilst such an example may already be caught by the existing provisions, PwC is concerned that 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 not to attract Part IVA as found by the Federal Court in the decisions of *Eastern Nitrogen* and *Metal Manufacturers*).

If the result is that a non-tax effect (such as a legal transaction) is deemed not to have such an effect then the appropriateness of an amendment is highly debatable.

The conceptual problem with the analysis underlying proposed s177CB(1)(c) is that the tax law does not allow a tax benefit to 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 s177D. In PwC's view the problem that proposed s177CB(1)(c) is trying to addressed is misconceived as one that can be addressed under s177C or proposed s177CB but is correctly and appropriately addressed under the current law in s177D.

Next Steps

If you would wish further discussion or elaboration please do not hesitate to contact me.

Yours sincerely

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