

update

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Star City Pty Ltd & Part IVA – Revisiting “muffled echoes” from the past!

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Introduction

Part IVA of the *Income Tax Assessment Act 1936 (the Act)* was introduced to replace section 260 of the Act. The purpose of the change was ostensibly to better combat tax-avoidance in Australia. Section 260 and its application proved to be complicated and excessively broad, to the point where by the early 1980s, it was essentially struck down following the decision in *Newton's* case. This case represented the beginning of the end for section 260, because it allowed a transaction that was part of an ordinary business or family dealing, to escape the threshold requirements of section 260.

The High Court's seminal decision in *Spotless* clearly said that any interpretation of Part IVA would not be constrained by the “influence of ‘muffled echoes of old arguments’ concerning other legislation”.

Spotless led the way for judicial decisions concerning commercial transactions that appeared as being reasonably explicable according to their circumstances, and not for the sole or dominant purpose of obtaining a tax benefit. In recent times, the courts appear to have increasingly followed this path by ignoring the possibility of legitimate tax planning in relation to commercial transactions.

However, the decision of Her Honour Gordon J. in *Star City Pty Ltd v C of T* [2007] FCA 1701, is a welcome breath of fresh air for Part IVA and heralds the possibility of a distinct change in the judicial reasoning of the threshold requirements of Part IVA.

The Commissioner has recently appealed Her Honour's decision and, no doubt, the Part IVA issue will be considered by a Full Court in the event that the substantive deductibility issue is confirmed.

Part IVA allows the Commissioner of Taxation to make a determination cancelling a tax benefit obtained by a taxpayer in connection with a scheme to which Part IVA applies.

It must be able to be objectively shown that a person entered into or carried out a scheme for the sole or dominant purpose of obtaining a tax benefit. In determining the sole or dominant purpose, the Court must also make an assessment of what might reasonably be expected to have happened if the scheme had not been entered into or carried out. This is commonly referred to as the “counterfactual”, or as Her Honour refers to it, the “alternative postulate”.

The Courts' traditional objective approach

The Courts have held that Part IVA requires an objective approach, rather than an inquiry into the subjective motive of the taxpayer. As the then Second Commissioner Michael D'Ascenzo stated in his paper entitled “Maintaining integrity and confidence in the tax system”:

‘Rather than asking why the taxpayer acted as they did, the inquiry requires a comparison between the scheme in question and an alternative postulate.’

The Second Commissioner then commented that the existence of a legitimate commercial end does not hinder the scope of Part IVA because “[a] particular course of action may be ... both tax driven and bear the character of a rational commercial decision” (citing *FCT v Hart* (2004) 55 ATR 712 at para 52).

In *Calder v C of T* [2005] FCAFC 254, the Court used an objective approach, stating that regard cannot be given to the subjective purpose or state of mind of the applicant. Similarly, the Court in *C of T v Sleight* [2004]

FCAFC 94 also took an objective approach in applying Part IVA.

The High Court's decision in *C of T v Hart* [2004] HCA 26 probably represents the high watermark of the courts' objective approach and has arguably broadened the parameters of Part IVA beyond its intended scope.

In *Hart*, the taxpayer borrowed funds to refinance the purchase of an investment property and to purchase a residential property. Repayments were made to the residential property account, while the other account was left to accrue interest. The taxpayer claimed the interest as a tax deduction on the ground that the funds were applied to acquiring an asset used for the purpose of gaining or producing assessable income. Relying on Part IVA, the Commissioner allowed the deduction for the interest that would have accrued on the investment property funds had the repayments been made to both accounts equally, but disallowed the additional interest as a tax benefit.

The main issue in *Hart* was whether the dominant purpose of the scheme was to obtain a tax advantage. By majority, the Court held that the dominant purpose was not to borrow money to purchase the residential property and refinance the investment property. The manner in which the scheme was entered into implied that the scheme was for the dominant purpose of obtaining a tax benefit. This was evidenced partly by the fact that the taxpayer's agent informed the taxpayer of the tax benefits involved in obtaining this type of split loan facility arrangement, as opposed to other forms of loans. Accordingly, the Court found that the loan was only provided to enable taxation benefits for the taxpayer.

The conclusion reached in *Hart* appears to be at odds with the fundamental object of Part IVA, because transactions of a normal business or family kind were meant to be beyond its scope. The important question to consider is whether Part IVA was designed to apply to a purely commercial transaction, where the transaction is structured in a tax effective way?

In deciding that a tax benefit purpose was present, the High Court disregarded the 'commerciality' of the arrangement and confined the definition of the scheme to how the tax benefits were obtained. An objective approach such as this makes it far more likely that the dominant purpose of entering into a scheme will be for the purpose of obtaining a tax benefit.

The High Court arguably failed to look at the surrounding circumstances and consider what the taxpayer's purpose was in borrowing the funds. Instead, it asked why the taxpayer had borrowed on the terms and conditions that made up the loan arrangement. The Court held that the taxpayer entered the arrangement for the dominant purpose of obtaining a tax benefit.

Star City – A subjective approach?

An assessment of the 'dominant purpose' underlying a transaction based on purely objective grounds has consistently resulted in Part IVA being applied broadly. Although commercial transactions may be structured in a tax effective manner, they are not always designed for tax-avoidance purposes.

The Court's approach in *Star City* arguably reflects a leaning away from a purely objective analysis to an subjective analysis. Such an approach will hopefully pave the way for ordinary commercial business transactions to escape Part IVA's previously wide application.

In *Star City*, the NSW Casino Control Authority (CCA) granted a Casino Licence to the Star City Consortium. The State and CCA also granted a 99 year lease of land on which a casino was to be built. Star City prepaid \$120 million for rent for the first 12 years of the lease term, which represented the present value of the annual rental over that period of \$15 million per annum. The rental would then be reduced to \$250,000 per annum after the first 12 years. Payment was arranged in this way because the State Treasury and the CCA required as much money to be paid as soon as possible. Thus it was in the interests of Star City to propose

such a payment plan. Star City claimed the pre-payment as a deduction.

The Commissioner of Taxation disallowed the deductions and imposed penalties.

A relevant question for the Court was whether Part IVA could apply to disallow the deduction for the prepayment which was held to be deductible.

The Court arrived at this conclusion on the basis that Star City had not entered into a scheme for the purposes of Part IVA, and even if it did, derived no tax benefit from the scheme under which the prepayment was made.

The Court's approach can be seen in its analysis of the three threshold issues of Part IVA:

1. the tax benefit must have been obtained in connection with a 'scheme';
2. there must be a 'tax benefit'; and
3. the 'dominant purpose' of the scheme must have been to obtain the relevant tax benefit.

- Scheme

The Commission identified a number of actions and sought to rely on the combined effect of the actions to justify both a scheme and a scheme within a scheme *C of T v Peabody* [1994] HCA 43.

Gordon J. held that for a scheme to exist for the application of Part IVA, there must be a connection between the actions said to constitute the scheme. A series of "disjointed or unconnected steps could not amount to a scheme" because the existence of a scheme is a question of fact to be determined by the evidence. No inference could be drawn from the facts in *Star City* to illustrate the existence of one continuous scheme.

- Tax Benefit

Even if the actions identified by the Commissioner amounted to a scheme under Part IVA, Star City must have obtained a tax benefit, which was held not to be the case. Section 177C requires an assessment of what might reasonably be expected to have happened if the scheme had not been entered into or carried out. This process has been referred to in previous case law as the identification of the counterfactual.

While previous courts considered whether there was a tax benefit by objectively construing Part IVA according to its terms,

Her Honour turned to a subjective analysis and looked at the surrounding circumstances for guidance.

The Court found that the overall purpose of Star City's arrangement was to be awarded the licence. This involved taking a lease from the State of the Casino premises and paying rent for those premises. The CCA and the Treasury made it clear that the licensee should pay as much money as could be negotiated at the commencement of the Lease. The Court found that any assessment of the counterfactual must take this factor into account.

Star City offered three alternative methods for payment of rent, the CCA electing to receive the payment of rent upfront. Thus, the Court could not be satisfied that Star City could have structured an alternative that would have been acceptable by the CCA. Therefore, no tax benefit was found to have derived from the arrangement.

- Section 177D (b) factors

The Court approached its analysis by ultimately finding that the dominant purpose of the transaction was not to obtain a tax benefit. Her Honour looked at the actual purpose of the transaction.

For Star City, the goal of the arrangement with the CCA was to be the successful bidder and obtain the Casino Licence. As mentioned above, the CCA required the successful bidder to produce as much of the lease payment as soon as possible. Commercial considerations were therefore the driving influence in the arrangement. This consequently required structuring the transaction in a manner acceptable to the CCA, and was not aimed at enabling Star City to obtain a tax benefit.

To suggest that it was structured to obtain a tax benefit would be to ignore the fact 'that the form and manner of the transaction were in large part constrained by considerations not subject to Star City's control'.

Rather than comparing the scheme in question and whether an alternative postulate existed, Her Honour took a subjective approach, asking why Star City acted in the way it did. Thus the Court ultimately found that Star City's actions were not directed at obtaining a tax benefit.

The Court also considered the commerciality of the arrangement, rather than confining its analysis to how the tax

benefits were obtained. It held that while any 'rational economic actor' will attempt to minimise tax duties arising from a business transaction, the 'dominant purpose' of that attempt must be to obtain a tax benefit.

The Court acknowledged that such an arrangement may be for purely commercial reasons and the fact that it allows for a substantial tax deduction should not automatically subject it to the parameters of Part IVA. Consequently, the fact that tax considerations were considered by *Star City* and the CCA should not render it a tax avoidance scheme, because tax laws affect the shape of nearly every business transaction.

Conclusion

Part IVA was introduced to better combat tax avoidance after section 260's application was viewed as being too broad. However, previous decisions have highlighted that the Part IVA threshold has been set too low with many legitimate commercial transactions being unnecessarily caught by its application.

It is submitted that *Star City* demonstrates a more liberal and commercially rational approach to Part IVA, allowing a tax effective commercial transaction not to fall within Part IVA.

It remains to be seen if Gordon J.'s approach and reasoning is upheld on appeal. If it is, then hopefully it may pave the way for a new judicial approach to the interpretation and reasoning of Part IVA to fulfil its original purpose of eliminating tax avoidance schemes that are 'blatant, artificial or contrived'.

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