Navigating the whole new world of Part IVA disputes involving trusts

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The application of the tax law to trusts is notoriously complex. In recent years, the Commissioner has frequently invoked general and specific anti-avoidance regimes to challenge trust arrangements and distributions that were previously considered low risk. This article analyses Pt IVA, s 100A and s 45B of the *Income Tax Assessment Act 1936* (Cth), through the lens of key recent decisions in *Minerva*, *Guardian*, *Ierna*, *Collie*, *Grant*, and *Merchant*. These decisions reinforce the paramount importance of robust evidence to discharge the taxpayer's burden of proof around tax benefit and dominant purpose, particularly when taxpayers are pursuing legitimate commercial objectives. As the Commissioner continues to explore the boundaries of anti-avoidance rules, advisers and taxpayers will need a thorough understanding of the evolving jurisprudence to effectively navigate the intricate landscape of trust taxation.

Overview

After a period of relative quite during the COVID-19 period, the Commissioner of Taxation (Commissioner) has engaged in a number of significant disputes concerning the application of general and specific anti-avoidance regimes to arrangements involving trusts and trust distributions. Given the dearth of reform in the taxation of trusts, the Commissioner appears eager to test the limits of these anti-avoidance regimes, particularly in relation to transactions that were once considered low risk. This article seeks to make sense of how the general and specific anti-avoidance regimes apply in the context of trusts.

The article begins with a consideration of the decisions of the Federal Court and the Full Court of the Federal Court of Australia in *Minerva Financial Group*.[1] At first instance, the Federal Court made factual findings consistent with the taxpayer's submissions; the court upheld the taxpayer's objection against the application of Pt IVA to a scheme essentially comprising the establishment of a stapled structure on the basis that the structure was adopted for commercial reasons associated with the planned initial public offering (IPO). On appeal, the Full Court upheld the taxpayer's objection against the application of Pt IVA to decisions made by a trustee to exercise its discretion to distribute only relatively small amounts of income to special unitholders.

Next, the decisions of *Guardian*[2] and *Ierna*[3] are considered. Each of these decisions provide useful guidance on the identification of tax benefits in relation to schemes involving trusts. In addition to the Pt IVA analysis, *Guardian* addressed the application of s 100A, and *Ierna* dealt with s 45B.

The decisions in *Collie*[4] and *Grant*[5] are considered together since they address almost identical schemes under which professional practice income was streamed through chains of trusts and tax-preferred entities, with the result that profits were effectively received tax-free and minus only some minor commissions for the tax-preferred entities.

Finally, the decisions in *Merchant*[6] and *MJH Trading Trust*[7] are considered. The former concerns the dividend stripping regime in Pt IVA, while the latter concerns a specific anti-avoidance provision aimed at preventing dividend stripping arrangements related to franking credits. Both cases provide useful guidance on the scope of transactions that fall under the rubric of dividend stripping, while *Merchant* also gave the Commissioner an opportunity to test the general anti-avoidance regime on a "wash sale" arrangement.

These cases demonstrate the importance of paying careful attention to the evidence that is adduced, and the use to which that evidence can be put.

Legislative references in this article are to the *Income Tax Assessment Act 1936* (Cth) (ITAA36) unless otherwise stated.

Minerva Financial Group

The genesis of the Commissioner's dispute with Minerva was the decision to restructure so as to reap the greatest possible benefit in an IPO.

Material facts

The taxpayer, Minerva Financial Group Pty Ltd (MFG) was a member of a group of companies and trusts that carried on a non-bank financial services business broadly known as "Liberty Financial" (the group of entities are defined as "Liberty Group" for present purposes).

Unlike a bank, which could rely on deposits to support its lending activities, the Liberty Group obtained capital for its business through a process called "securitisation". The trial judge described securitisation as "a process called securitisation, which involves the pooling of loan receivables and related securities (usually mortgages) into securitisation trusts, in order to fund loans it arranges for customers".

The Liberty Group's business has at all times involved Liberty Financial Pty Ltd (LF) and Secure Funding Pty Ltd (Secure Funding). LF was, and remains, the principal operating entity of the Liberty Group's business, providing services to Secure Funding (as trustee) as well as to other members of the Liberty Group, including loan origination, management, financing and administrative services. Secure Funding acted as trustee of Liberty's securitisation trusts, raising funds from financiers and institutional investors to

acquire financial assets, and was the lender on record for every loan originated by LF.

Between 2004 and 2008, the Liberty Group explored various funding and growth opportunities, including a planned IPO. The directors believed, consistent with external professional advice received throughout the period, that it would be advantageous to offer stapled securities (ie shares in a company stapled to units in a unit trust) rather than simply offering shares in a company. Accordingly, in 2007 and 2008, the Liberty Group restructured to permit the formation of a stapled structure (noting that the shares and units were not stapled until an IPO was imminent in 2020) with:

- a group of companies to undertake activities including loan origination, underwriting and servicing of financial assets, and treasury management (the Corporate Silo); and
- a group of trusts that held the group's wholesale and securitisation trusts, and received interest income and fee income from borrowers (the Trust Silo).

To address a concern that the yields on stapled securities should not exceed 4% to 5%, which would have caused yield fluctuation and valuation issues, and to ensure that the Corporate Silo had funds to meet its cashflow requirements to carry on its business, two companies in the Corporate Silo were each issued with a discretionary unit in the Minerva Holding Trust (MHT). The MHT owned all the securitisation trusts in the Trust Silo. The discretionary units provided the trustee of the MHT with the discretion to distribute an amount of trust income to the corporate unitholders from time to time.

A simplified diagram of the Liberty Group following the restructure is shown in Diagram 1.

Although the restructure had placed the group in the most efficient form to IPO, in the course of July or August 2007, the Liberty Group decided to postpone the IPO; factors contributing to that decision included:

- a downturn in global financial markets (later referred to as the global financial crisis or "GFC");
- feedback received from potential investors that the market did not support the IPO with an external management structure; and
- a dispute with Macquarie.

The Liberty Group operated in the "stapled" form between 2008 and the present, and after several thwarted attempts, was able to successfully IPO in December 2020.

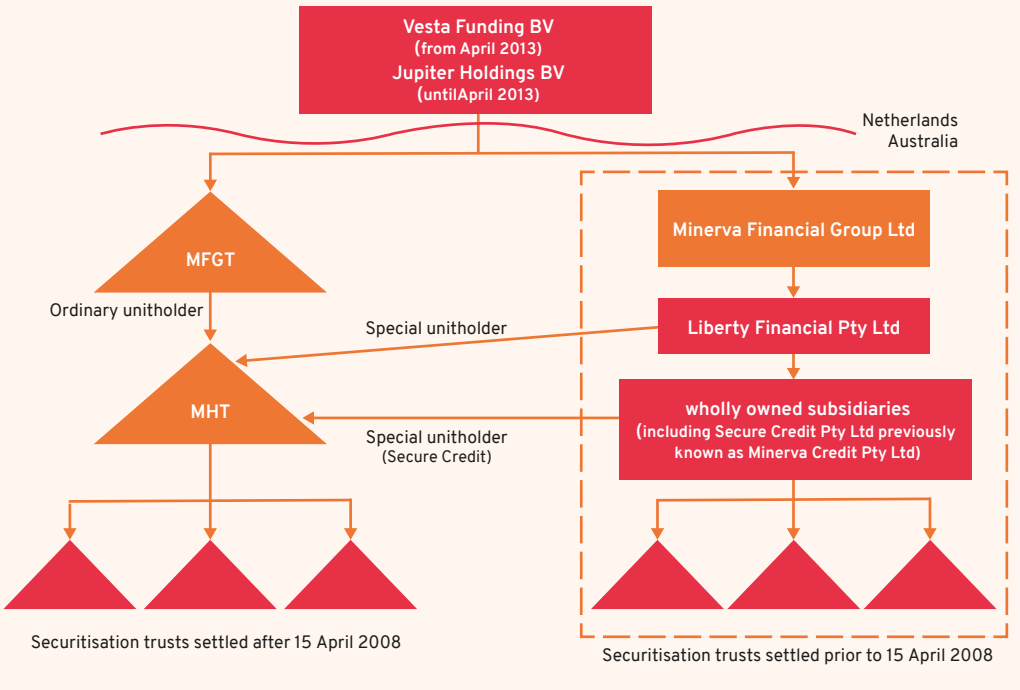
Key issues

One of the consequences of the restructure was that interest income that had previously been derived by a company (and thus subject to tax at the corporate rate of 30%) was instead derived by trusts that distributed that income to a non-resident beneficiary (with withholding tax of 10% being applied). Although this obviously fails to describe anything answering the description of a "tax benefit" for the purposes of s 177C, it was nevertheless apparent that it was at the forefront of the Commissioner's mind when formulating his case.

At trial, the Commissioner advanced three schemes. On appeal, the Commissioner introduced a fourth scheme, which was a variation on schemes two and three described below.

The first scheme (the Restructure Scheme) related to the establishment of the Trust Silo in 2008, with MHT being the holder of interests in the securitisation trusts that were

Diagram 1. The Minerva Group post-restructure



established from 2009 and onwards, and the distribution of income through MHT and ultimately to the Liberty Group's non-resident unitholders.

The second, third and fourth schemes (the Distribution Schemes) related to the decision by the trustee of the MHT not to distribute income to the holders of the special units at the levels that the Commissioner believed to be necessary and appropriate.

The Restructure Scheme

Central to the dispute in relation to the Restructure Scheme was the commercial benefits of the stapled structure, and whether those outweighed the income tax advantages that flowed from its operation. The taxpayer identified the following commercial benefits that were expected to flow from the restructure:[8]

- a higher IPO listing price;
- increased opportunity for private equity capital raising (for the same reasons as the IPO or stapled securities would result in a higher listing price);
- enhanced flexibility and access to sources of debt funding;
- advantages when acquiring other financial services businesses or assets; and
- improved operational efficiency.

The Commissioner did not accept that there were any commercial benefits associated with the stapled structure,[9] believing instead that it could only be explained by the tax consequences of its operation. Further, the Commissioner argued that by adopting the stapled structure, the group had not changed its business operations but had deprived the business "of a major source of its income and that was replaced with unwritten, interest-free cash loans".[10]

In addition to the lay evidence of three senior executives from the Liberty Group, the taxpayer called Mr Moz Ali as an expert witness to provide evidence regarding the commercial benefits that were expected to flow from the restructure. Mr Ali's expertise was based on the following experience:[11]

> "I have over 25 years of experience within the financial services industry, including 18 years across two top tier global investment banks. I am currently Managing Director of Theorem Consulting, an independent consulting firm established in 2018, that specialises in advising on mergers and acquisitions, acquisition financing, capital raisings and capital structuring."

The Commissioner's expert witness was Mr FitzGerald, who described his qualifications in the following terms:[12]

> "Over 45 years of experience, focused on credit markets and credit risk management in both the origination and investment areas of the market and as a member of a major superannuation fund investment committee and as advisor to fixed interest asset manager [sic]."

Given the commercial benefits identified by the taxpayer, the Commissioner's choice of an expert whose expertise was so firmly in the debt capital markets might be seen as surprising. What is less surprising is that the Commissioner "did not ultimately place any particular reliance on Mr FitzGerald's opinions in respect of matters relating to equity capital transactions, whether in the context of an IPO or a private capital raising". Although the Commissioner's counsel maintained that Mr FitzGerald had "adequate expertise" to be regarded as an expert, the relevance of his experience was relevant to the weight the court could give to his opinions. Indeed, the court ultimately did not have regard to Mr FitzGerald's opinions about matters relating to equity capital markets, and the court specifically rejected Mr FitzGerald's assertion that there were essentially no IPO benefits from the stapled structure.

Mr Ali's evidence, which was entirely consistent with the lay evidence adduced by the Liberty Group, was embraced by the court. Indeed, all of the advantages proffered by the taxpayer's were accepted by the court.

The court also expressly rejected the Commissioner's argument on the viability of the Australian business following the restructure, finding that it was contrary to the evidence that showed that LF continued to remain profitable in each of the relevant years and continued to derive income. The Commissioner's submission that the Australian group suffered by virtue of being deprived of income from the securitisation trusts was rejected as being inconsistent with the evidence, which showed that the Corporate Silo remained profitable throughout the period under consideration.

Having regard to the conclusions reached in respect of each of the eight matters set out in s 177D, O'Callaghan J found that a reasonable person would not conclude that the taxpayer entered into or carried out the first scheme for the dominant purpose of enabling it to obtain a tax benefit in connection with the scheme. In particular, the court found that the "manner" in which the first scheme was carried out was not "artificial and contrived" as contended by the Commissioner.

The Commissioner did not appeal from the decision of O'Callaghan J on the Restructure Scheme, which is not particularly surprising given the factual findings made in relation to the obvious commercial advantages of the stapled structure and the absence of any cogent evidence of disadvantages incurred.

The Non-Distribution Schemes

At first instance, O'Callaghan J held that Pt IVA applied in relation to the Non-Distribution Schemes. The court accepted that the evidence established that MHT considered its power to distribute its distributable income in each of the income years in dispute, and that it made a determination in each of those income years regarding the extent to which amounts were to be distributed to the special unitholders. However, the court went on to make the following observations:[13]

> "563 The applicant could only proffer one *reason* why a greater distribution of income from MHT to LF would not be desirable, that is, the so-called return on equity 'metric'. As I also explained, the applicant was unable to provide any evidence as to how the metric was calculated, what assumptions underpinned it, whether or why a lower return on equity metric would not be desirable or how that consideration outweighed the negative consequences of LF not receiving the income…
>
> 564 The applicant was unable to provide any *cogent reason*, other than the tax benefit, why the decision was taken in each of the relevant years to direct no more than 2% of MHT's net income to the special unitholders." (emphasis added)

This underpinned the court's conclusion that the choice of which beneficiary income would be distributed to was "driven by the tax benefit of directing income away from LF". The taxpayer appealed from O'Callaghan J's decision on the application of Pt IVA to the Non-Distribution Schemes.

On appeal, the Full Court identified these paragraphs as the crux of the difficulty with the primary judge's reasoning, explaining:[14]

> "… The primary judge concluded that because the appellant did not proffer a commercial reason why the appellant only distributed nominal amounts of income from MHT to the special unitholders, both the manner in which the [Non-Distribution Schemes] were carried out and the timing of the schemes were indicative of the dominant purpose of obtaining a tax benefit.
>
> By the way in which the primary judge approached the consideration of the first and third s 177D factors, the primary judge's reasoning elides the question posited by s 177D with an inquiry as to whether the trustee's discretion would have been exercised differently but for the tax benefit. The question posited by s 177D is not addressed by a consideration of the subjective purpose of a party to the scheme. It is not addressed by testimony of a person as to their reasons for taking a particular action or step. The statutory question is to determine purpose by an objective assessment of objective facts. A person's subjective understanding of a commercial reason or motive does not answer the question posited by Part IVA."

With respect, there can be no doubt that the trial judge's reasoning did not follow the established jurisprudence in relation to Pt IVA when it embarked on a quest to discover the "reason" that certain steps were taken. Paragraph 60 of the Full Court's decision contains a restatement of the key principles regarding Pt IVA, which should be read and re-read by tax practitioners since it distils over 30 years of jurisprudence; in sub-para (3), it cites the decision of the High Court's decision in *Hart* as authority for the proposition that "[t]he inquiry required by Pt IVA is an objective, not subjective, inquiry".[15]

The explanatory memorandum to the Bill that introduced Pt IVA explained that the general anti-avoidance regime was intended to apply if the dominant purpose of obtaining a tax benefit was made out "on an objective view of the particular arrangement and its surrounding circumstances". The High Court observed that one of the reasons for making the Pt IVA turn on an objective inquiry into the purpose of a scheme was to "avoid the consequence that the operation of Pt IVA depends upon the fiscal awareness of a taxpayer".[16] By directing the inquiry to the "object or aim" of the scheme, the purpose test is focused on "the reason why something has occurred or been allowed to occur".[17]

The Full Court summarised the eight factors of s 177D as follows:[18]

> "The s 177D factors are directed at examining what was done (the scheme's substance and form), how it was done (the manner in which the scheme was entered into and carried out), when it was done (timing) and the consequences of what was done."

Although the Commissioner appeared eager to direct the inquiry towards the forbidden ground of subjective motive, his counsel did nevertheless raise some arguments that touched on the purpose of the Non-Distribution Schemes.

It was put that the requisite conclusion about purpose could be derived from the fact the distributions from the Trust Silo to the ultimate shareholders were not paid in cash. However, although it was true that cash was not transferred from the Trust Silo (or even from MHT to the head trust of the Trust Silo), the distributions from MHT to the head trust, and from the head trust to the ultimate shareholders "were paid and/or satisfied through a series of offsets of intra-group loans and the issue of units".[19] The Full Court, unlike the Commissioner, recognised that "the ledger accounts recording the loas were recording a real liability of the debtor and a real asset of the creditor", and that movements in the loan balances "had a real economic and financial effect". It was the "real commercial consequences"[20] of the distributions through the Trust Silo that were relevant to the inquiry into the purpose of the Non-Distribution Schemes, not the subjective motive of the trustee in making those distributions.

The Commissioner also argued that distributions from the Trust Silo to the Corporate Silo were required for a variety of reasons. However, as noted in the foregoing in relation to the trial judge's decision on the Restructure Scheme, the evidence demonstrated that "revenues derived by LF during the relevant years were sufficient to meet its expenses and generate a profit and that it did not suffer a capital deficiency". The Full Court accepted that the financial evidence led by the taxpayer (which included financial statements and testimony from the Chief Financial Officer) discharged its burden of proof in relation to the financial position of the Corporate Silo.

Although there may be circumstances in which a trust distribution may arguably not give rise to real commercial consequences, they are surely rare. Ordinarily, it would be expected that when a trustee decides to create for a beneficiary an entitlement to income, then such an entitlement exists and would be a significant non-tax consequence of the trustee's decision. In *Minerva*, the taxpayer was able to lead compelling evidence that

demonstrated that the beneficiaries actually benefitted from the distributions to which they were made entitled.

The Commissioner elected not to seek special leave from the High Court to appeal the Full Court's decision in respect of the Full Court's decision that Pt IVA did not apply to the Non-Distribution Schemes.

Guardian

Material facts

Background

Mr Alexander Springer had a number of business ventures in Australia through private companies under his control (the Springer Group). Although an arborist by trade, Mr Springer's business ventures extended beyond forestry to encompass property development and property investment activities. Around 2007, Mr Springer had decided to transition to retirement, and after taking up residence in Vanuatu in late 2007, he became a tax resident of that country from the 2009 income year. Although Mr Springer resigned as director of each of the companies in the Springer Group, he continued to have a keen interest in the business of these entities and retained effective control of their activities. By 2012, the business activities of the Springer Group were being wound down and the companies deregistered.[21]

After Mr Springer's resignation as director of companies in the Springer Group, his son Eric was appointed as director in his place. During the time of his directorship, Eric relied on assistance from a Mr Shafferman, a long-standing business associate of Mr Springer. Mr Shafferman was appointed as a co-director of the companies in the Springer Group when Eric moved to the United States in November 2012. The evidence, which was not challenged, was that Mr Shafferman acted on instructions from Mr Springer.

The taxpayer, Guardian AIT Pty Ltd (Guardian), was the trustee of the Australian Investment Trust (AIT), a discretionary trust settled on 25 June 1998. Mr Springer was at all times the "Principal" of the AIT, in which capacity Mr Springer had the power to appoint "any person or corporation (not being the Settlor) determined … to be a Beneficiary for the purposes of this Deed". The trustee had an equivalent power under the trust deed.

By the end of the 2010 income year, AIT had accumulated a commercial investment property portfolio, consisting of properties in Queensland and Tasmania, and was deriving net rental income from those properties; AIT's other main source of income was interest income and franked dividends from companies in the Springer Group.

In the 2011 and earlier income years, the AIT made distributions of income to companies in the Springer Group depending on their cash requirements. The primary judge accepted Mr Springer's evidence that distribution decisions were predominantly made on an "as needs" basis (ie depending on which operating entity was expected to require funds and at what level). It was also found that Mr Springer never had any pre-determined plans for distributions, and this was consistent with the absence of forward budgets.

On 27 June 2012, Mr Springer caused AIT Corporate Services Pty Ltd (AITCS) to be incorporated, with the AIT holding 100% of the issued shares. The decision to incorporate AITCS was informed by a series of discussions with advisers from Pitcher Partners, who recommended that a new corporate beneficiary "would insulate the future wealth accumulation in a separate legal entity by providing protection from any litigation that might be commenced against the former operating entities involving the businesses they carried on". The primary judge found that the incorporation of AITCS was also consistent with Mr Springer's desire to utilise "clean skin" companies, rather than to reuse one with a trading history. The trial judge accepted that there was no expectation AITCS would "declare a franked dividend in relation to the income that it had received from the trust back to the trust".

Income of the 2012 income year

In June 2012, Mr Springer exercised his power as Principal of the AIT to determine that AITCS would be a beneficiary of the AIT.

On 30 June 2012, AIT distributed approximately $8.2m, of which around $2.6m was distributed to AITCS and left unpaid (the 2012 UPE).

In November 2012, Pitcher Partners drew to Mr Springer's attention a risk that the Commissioner would treat the 2012 UPE as a loan from a private company to a shareholder, thereby triggering the operation of Div 7A, with the result that a deemed dividend would arise to the AIT. In March 2013, Pitcher Partners suggested that the amount of the 2012 UPE could be transferred to AITCS, but Mr Springer expressed discomfort with the prospect of transferring that amount "into an account that I have no control over".

Accordingly:

- on 17 April 2013, AITCS drew on the 2012 UPE to pay its income tax liability, leaving it with an entitlement to approximately $1.8m;
- on 1 May 2013, AITCS declared a fully franked dividend of $1,848,145 to the AIT, which was an amount equal to the remaining balance of the 2012 UPE, with the effect of reducing the 2012 UPE to nil; and
- on 23 June 2013, Guardian as trustee for the AIT appointed the net income of the 2013 income year attributable to franked dividends to Mr Springer. This included the fully franked dividend declared by AITCS on 1 May 2013.

The primary judge accepted Mr Springer's evidence that, at that time, the payment of a dividend by AITCS seemed to be the simplest way of dealing with the matter, and that one reason Mr Springer was happy with the proposal "may well have been an apprehension on his part of a personal need at that time for money".

Income of the 2013 income year

On 23 June 2013, the AIT distributed all of its net income for the 2013 income year other than franked dividends to AITCS, this amount was not paid and created an unpaid present entitlement (2013 UPE); the net income attributable to franked dividends were distributed to Mr Springer. After drawing on the 2013 UPE to pay its tax liability, AITCS declared a fully franked dividend equal to the balance of the 2013 UPE on 27 February 2024.

On 23 June 2014, Guardian as trustee for the AIT appointed the net income of the 2014 income year attributable to franked dividends to Mr Springer. This included the fully franked dividend declared by AITCS on 27 February 2014.

The primary judge accepted Mr Springer's evidence that he had "no express recollection of his involvement in decisions as to the allocation of income for the 2013 income year" save for one immaterial particular. Mr Springer's evidence was also that he had not been informed by Pitcher Partners about the prospect of a dividend being paid by AITCS out of the proceeds of the 2013 distribution, or that he would ultimately receive it, consistent with prior years, nor did he suggest that it should be paid.

Key issues

Key to understanding the mischief perceived by the Commissioner in this instance is the tax implications of trust distributions to non-residents:

- franked dividends distributed to a non-resident beneficiary of a trust are non-assessable non-exempt income;[22] and
- other amounts of net income other than franked dividends distributed to a non-resident beneficiary are subject to tax at the top marginal rate.[23]

Accordingly, Australian tax on the net income of the AIT was effectively capped at 30% by virtue of it being distributed to Mr Springer after having been distributed to AITCS, whereas it would have been subject to tax at 45% had the net income of the AIT (other than franked dividends) instead been distributed directly to Mr Springer.

The Commissioner sought to challenge this outcome by applying s 100A and Pt IVA. Although the dispute yielded important guidance on the application of s 100A, that lies beyond the boundaries to be traversed by this article and so will be noted only in passing.

Section 100A

The primary judge held that s 100A did not apply to the distributions in the 2012 or 2013 income years, but that it did apply in respect of the 2013 UPE. On appeal, the Commissioner accepted the Federal Court's decision that s 100A did not apply in respect of the 2012 and 2014 income years, but sought to defend the application of s 100A in respect of the 2013 income year.

The Full Court accepted that s 100A requires a reimbursement agreement to exist at or prior to the time by which a beneficiary is made presently entitled to net income of the trust, in this case being the date the 2013 UPE was created. The Full Court went on to discuss what must exist at that date to constitute a reimbursement agreement, observing that enforceability was not required, but that there must nevertheless be an understanding reflecting "a common intention, or consensus existing between at least two parties".

In considering what was required for the court to be satisfied that there was a reimbursement agreement, the Full Court explained that the scope to impute in the context of s 100A is far more limited than in the context of Pt IVA.

The Full Court found on the evidence that, although a dividend by AITCS was not objectively "wholly conjectural", it was not sufficient for the purposes of s 100A that the parties might have anticipated that an arrangement might be reached at some later date for a dividend to be paid by AITCS to the AIT. Rather, s 100A would only be satisfied if, when the 2013 UPE was created, there had to be an arrangement or understanding between two or more parties that AITCS would pay a dividend to the AIT. The evidence relied on by Hespe J, which was unchallenged, included:

- Mr Springer's oral evidence that any advice or recommendation by Pitcher Partners was not communicated to him before creation of the 2013 UPE. Absent a finding that there had been some communication of a plan or recommendation prior to creation of the 2013 UPE, it would have required a finding that Pitcher Partners had authorisation to act on or behalf of the relevant entities to conclude that there was consensus or adoption of the supposed agreement between Guardian and Mr Springer; and
- when the 2013 UPE was created, there was no understanding that it would be cleared by the payment of a subsequent dividend from AITCS.

The Full Court unanimously dismissed this appeal on the basis that there was no "reimbursement agreement" between Guardian and AITCS because there was no "agreement" as of the date of the 2013 UPE involving the payment of a dividend. The absence of evidence of an agreement was critical to the conclusion that s 100A did not apply.

Part IVA

Decision at first instance

The tax benefit identified by the Commissioner was the non-inclusion in Mr Springer's assessable income of the amount of the net income of the AIT attributable to unfranked income, which was in fact distributed to AITCS. Curiously, neither the Commissioner nor Mr Springer referred to s 177CB, which the primary judge observed was in operation during the relevant years.

Similar to the conclusions reached in respect of s 100A, the primary judge held that there was no "tax benefit" because, if the schemes had not been entered into, AITCS would have received and retained its UPEs in cash or it would have invested those amounts with Guardian through a loan agreement complying with the terms stipulated in

s 109N. The primary judge found that the Commissioner's alternative postulate would "never, ever have occurred", and that there is "emphatic evidence" to that effect. Thus, in relation to s 177C, where Mr Springer bore the onus of proving that he did not obtain a tax benefit, the primary judge concluded that Mr Springer had indeed discharged that onus.

The primary judge also found that an analysis of the eight factors in s 177D did not lead to a conclusion that the dominant purpose of a person who entered into or carried out the scheme was to obtain the tax benefit identified by the Commissioner. Rather, the purpose of the schemes were risk minimisation, which was achieved by having a new corporate beneficiary to which distributions might be made, and which could thereafter serve both as a vehicle for wealth accumulation and asset protection.

Decision on appeal

On appeal, the Commissioner focused on the steps involving the appointment of income to AITCS, and the subsequent dividend paid by AITCS to AIT in the 2012 and 2013 income years. The Commissioner argued that, if the schemes had not been entered into or carried out, it might reasonably be expected that Mr Springer would have been made presently entitled to the amounts of net income of the AIT in each of the 2012 and 2013 income years without any "diversion" to AITCS.

Consideration of the Full Court's analysis of the tax benefit obtained by the taxpayer must begin from the interpretation placed on s 177F by the High Court in *Peabody* ([1994] HCA 43), where it observed:

> "Under s.177F(1), the Commissioner's discretion to cancel a tax benefit extends only to a tax benefit obtained in connection with a scheme to which Pt IVA applies. The existence of the discretion is not made to depend upon the Commissioner's opinion or satisfaction that there is a tax benefit or that, if there is a tax benefit, it was obtained in connection with a Pt IVA scheme. Those are posited as objective facts. The erroneous identification by the Commissioner of a scheme as being one to which Pt IVA applies or a misconception on his part as to the connection of a tax benefit with such a scheme will result in the wrongful exercise of the discretion conferred by s.177F(1) only if in the event the tax benefit which the Commissioner purports to cancel is not a tax benefit within the meaning of Pt IVA … the question in every case must be whether a tax benefit which the Commissioner has purported to cancel is in fact a tax benefit obtained in connection with a Pt IVA scheme and so susceptible to cancellation at the discretion of the Commissioner."

Although not explicitly cited for this purpose by the Full Court in *Guardian*, it follows from this that the taxpayer "bore the onus of proving that he did not obtain a tax benefit in connection with a scheme for the purposes of s 177C".[24] However, how the taxpayer discharges that burden is critically important, because merely proving that the tax benefit identified by the Commissioner is not a tax benefit (whether it is something that could not possibly have happened absent the scheme, or for some other disqualifying reason) will not discharge the taxpayer's burden, because the court might still determine that a tax benefit has been obtained. The taxpayer must therefore prove to the court that not only has the Commissioner failed to identify a tax benefit, but also that the court has not identified a tax benefit either. This proposition was expressed by the Full Court in *RCI* in the following terms:[25]

> "Even if a taxpayer establishes that the Commissioner's counterfactual is unreasonable, it will not necessarily follow that he has established that the assessment is excessive. That is because the issue is not whether the Commissioner puts forward a reasonable counterfactual or not; it is a question of the court determining objectively, and on all of the evidence, including inferences open on the evidence, as well as the apparent logic of events, what would have or might reasonably be expected to have occurred if the scheme had not been entered into. Thus, even if a taxpayer establishes that the Commissioner's counterfactual is unreasonable, that will not discharge the onus the taxpayer carries *if the court determines* that the taxpayer would have or might reasonably be expected to have done something which gave rise to the same tax benefit." (emphasis added)

Here, the Full Court posited a circumstance where the court has before it some evidence from which it could determine that the same tax benefit would, or might reasonably be expected to, have been obtained. This is consistent with the decision of the Full Court in *Trail Bros*:[26]

> "In the end, the Court will decide what would have been done, or might *reasonably* be expected to have been done, in lieu of the scheme having regard to *all* of the evidence that is led. If a taxpayer has given evidence of what he or she would have done but for entering the scheme, that evidence will be relevant and useful to the extent to which it reveals facts or matters that bear upon the objective determination of the alternative postulate." (emphasis in original)

Accordingly, identification of the tax benefit will form part of the court's fact-finding process. Returning to the High Court's decision in *Peabody*, the taxpayer was able to establish the absence of a tax benefit by demonstrating the illogicality of the taxation consequences upon which the Commissioner's counterfactual was predicated and, implicitly, the High Court's inability to identify any tax benefit itself.

In *Guardian*, the Full Court followed this course of analysis, and made the following statement:

> "… for Mr Springer to discharge his onus, it was not sufficient for him to show that the Commissioner's alternate postulate was not reasonable. *He had to satisfy the Court of what might reasonably be expected to have happened in the absence of scheme*." (emphasis added)

With respect, this appears to leave the taxpayer in a precarious position since it suggests that, even where the Commissioner and the court has failed to identify a tax benefit obtained by the taxpayer in connection with the

scheme, the taxpayer has nevertheless failed to discharge its burden. It is not clear how the additional burden arises, or why the taxpayer has not fully discharged the burden by successfully establishing that a statutory condition to the application of Pt IVA has been shown not to exist. It ought to be sufficient for the taxpayer to prove on the evidence that the Commissioner has failed to identify a tax benefit, unless the court can identify on the evidence that the taxpayer would have, or might reasonably be expected to have, done something that gave rise to a tax benefit.[27]

Leaving this potential issue to one side, the court did find as a fact that an alternative postulate consisting of a direct distribution from the AIT to Mr Springer was not rendered so unreliable by the facts in the case for it not to satisfy the test for a tax benefit. With respect, this must be correct; the evidence established that Mr Springer did not want to have funds held by AITCS and preferred to receive those funds personally, and that the AIT would not accumulate those funds (since to do so would trigger tax at the top marginal rate). Accordingly, the Full Court held that Mr Springer obtained a tax benefit in each of the 2012 and 2013 income years being the non-inclusion of an amount in Mr Springer's assessable income in those years. Since the taxpayer had not challenged the trial judge's finding that the dominant purpose of the scheme was to obtain the tax benefit, this effectively determined the proceeding.

Ierna

Material facts

Before 20 September 1985, Mr Carmelo Ierna and Mr Melville Hicks started a fashion retailing business that was conducted by an Australian resident company in its capacity as trustee of the City Beach Trust (CBT). At the end of each income year, the profits of the CBT were distributed through interposed trusts, and were ultimately received by corporate beneficiaries:

- in the 2011 and earlier income years, Mastergrove Pty Ltd; and
- in the 2012 and later income years to Ierna Beneficiary Pty Ltd (a company associated with Mr Ierna) and to Hicks Beneficiary Pty Ltd (a company associated with Mr Hicks).

Before 2012, Mastergrove lent money to Mr Ierna, Mr Hicks, the Hicks Property Trust and the Ierna Property Trust on terms that complied with s 109N (Div 7A compliant loans). From 2012, similar Div 7A compliant loans were made by Ierna Beneficiary and Hicks Beneficiary Pty in the later income years. Over time, the loan balances grew considerably.

In 2010, the Commissioner published TR 2010/3 (Income tax: Division 7A loans: trust entitlements) (TR 2010/3), in which he opined that UPEs arising on or after 16 December 2009 would be treated as loans to which Div 7A could apply; if left outstanding, such loans would trigger deemed dividends unless converted to Div 7A compliant loans. The court accepted evidence from the tax agent to the parties to the effect that the Commissioner's views in TR 2010/3 severely disadvantaged trusts such as the CBT that were conducting business operations. The evidence was that running a business through a trust resulted in UPEs that would need to be subject to interest and minimum repayments in compliance with Div 7A to prevent those UPEs being treated as deemed dividends.

In response to the challenges presented for the continuation of the business carried on by the CBT as a result of the Commissioner's views set out in TR 2010/3, as well as the inability to accumulate profits in a trust structure in a tax effective manner, a restructure of the CBT and its related parties was implemented in 2016 (the 2016 restructure). The 2016 restructure involved the interposition of Methuselah Holdings Pty Ltd (Methuselah) between the existing unitholders and the CBT to create a corporate structure; the unitholders applied a roll-over under Subdiv 615-A of the *Income Tax Assessment Act 1997* (Cth) (ITAA97), which resulted in the shares in Methuselah being treated as pre-CGT interests to the extent the units exchanged for those shares were also pre-CGT interests.

The 2016 restructure also resulted in Methuselah undertaking a selective share capital reduction pursuant to which 10.4 million ordinary shares in Methuselah held by Mr Ierna, and the same number of shares held by a trust associated with Mr Hicks, were cancelled for consideration of $2.50 per share, resulting in total proceeds of around $26m for each shareholder.

No cash payments were made to either shareholder in respect of this selective capital reduction; instead, the amounts were left outstanding as loan receivables. These loans were subsequently assigned and offset against certain Div 7A compliant loans. The loan receivables, assignments and repayments were recorded in the financial accounts of the relevant entities via accounting entries. In practical terms, the selective capital reduction allowed the shareholders to realise part of the value of their deemed pre-CGT shares in Methuselah, and to use the proceeds to repay outstanding loans.

Key issues

The Commissioner assessed the taxpayers on the basis that the restructure resulted in either:

- the taxpayers receiving a capital benefit of $26m as a result of the selective capital reduction that was taken to be an unfranked dividend pursuant to ss 45B and 45C; or, in the alternative
- the taxpayers received a tax benefit arising in connection with a scheme to which Pt IVA applied in the amount of approximately $33.7m, referable to the amount that would have been included in their assessable income had a fully franked dividend sufficient to settle the outstanding Div 7A compliant loans been paid, rather than having $26m returned by way of the selective share capital reduction.

The Commissioner filed a notice of appeal against the Federal Court's decision on 4 July 2024, though, as of

the date of this article, the matter has not been listed for hearing, nor is it clear which judges will sit on the appeal.

Application of section 45B

The primary contentions in relation to the application of s 45B concerned whether the CBT was an associate of Methuselah, and the extent to which the capital benefit was attributable to the profits of the CBT.

The court expressed a preference for a construction of the word "associate" as defined in s 318 that included the trustee of the CBT as an associate of Methuselah, but which did not render the CBT an associate of Methuselah. However, as the court was able to decide that s 45B did not apply for other reasons, it decided that it was unnecessary to reach a concluded view on this issue.

One of the elements necessary for the application of s 45B is that a conclusion about the purpose of obtaining a tax benefit be drawn having regard to "the relevant circumstances of the scheme". Broadly, because Methuselah was a newly formed company with no accumulated profits, and neither Methuselah nor any of its associates had a "pattern of distributions of dividends, bonus shares and returns of capital or share premium", it was not possible to reach the necessary conclusion. Rather, the payment to the shareholders was wholly "attributable to" the share capital account, and the particular scheme was held not to have been adopted as a mechanism to avoid the payment of a dividend. As articulated by Logan J:[28]

> "On no objective view could the return of capital from that account to its shareholders be regarded as a substitute for the payment of a 'dividend', as defined, to them. The payment to the shareholders was wholly "attributable to" (actually sourced in or caused by) Methuselah's share capital account. The method chosen had nothing to do with dividend substitution but was explicable by a purpose of taking advantage of Division 615-A rollover relief."

Accordingly, the court found that s 45B did not apply to the scheme postulated by the Commissioner.

Application of Part IVA

The Commissioner alleged that the tax benefit obtained by the taxpayer in connection with the scheme was the non-inclusion of a dividend and associated franking credits in the taxpayer's assessable income for the 2016 income year. The alternative postulate identified by the Commissioner was that Mastergrove would have paid a fully franked dividend to its shareholders to enable them to repay their outstanding loans.

The first difficulty the court identified with the Commissioner's alternative postulate was that it failed to address how the payment of the dividend would result in repayment of the relevant loans—the missing step being a set-off or other method through which the shareholders would apply the amount of the dividend in reduction of their loans. Although as discussed in relation to *Guardian*, the court could remedy a defect of this kind if it could identify for itself a tax benefit obtained in connection with the scheme.

The second difficulty identified by the court was:[29]

> "Mastergrove has never, on the evidence, paid dividends in order to provide for any repayments by Ierna Beneficiary and Hicks Beneficiary. So there is nothing in any past course of conduct which might support an objective conclusion that this would have occurred, or might reasonably be expected to have occurred, if the 'scheme' as identified had not been entered into or carried out.
>
> At most, this postulate is a theoretical possibility, and one unconsidered (save *ex post facto* within the Commissioner's office) at that. For the purposes of Part IVA, more is required in relation to an alternative postulate. What is necessary is a prediction based on evidence."

It is unsurprising that the payment of a dividend by a company was considered a "theoretical possibility", given that it is entirely orthodox for ordinary shares to carry the right to share in the profits of the company by way of dividends. However, it is not clear on the face of the judgment why a history of not paying dividends renders a hypothesis incorporating the payment of a dividend unreasonable.

Although a taxpayer is obviously not required to choose the scheme that results in the highest possible tax liability, it is nevertheless open to question whether the identification of an alternative postulate that triggers a lower tax liability necessarily proves that any higher tax alternative postulate is unreasonable. Here, it was proved on the evidence that Mastergrove had sufficient profits to pay the dividend to its shareholders as postulated by the Commissioner, and it may be that, on appeal, the Commissioner will suggest that the court is not required to identify the one scheme that is either what "would" have happened or the most likely among those things which "might reasonably be expected" to have happened, but for the scheme.

The court also accepted the taxpayer's evidence that an alternative means by which the Div 7A loans could be repaid, namely through a tax-free disposal of pre-CGT units in the CBT. The court found this to have the advantage of "featuring the substance of the 'scheme' and its non-tax results", and thus concluded that no tax benefit had been obtained in connection with the scheme.

This case again demonstrates that Pt IVA does not require a taxpayer to choose the option that involves paying the most tax. In particular, the case highlights that, despite s 177CB (which Logan J considered), tax-based reasoning for the infeasibility of an alternative postulate can be legitimate if it reflects the actual financial constraints faced by the entities involved.

Although not strictly necessary given its finding in relation to tax benefit, the court also considered the application of the dominant purpose test in s 177D. It was held that there was no change in financial position for the taxpayers, and

that it was unnecessary to interrogate the other factors in detail given the analysis of the "relevant circumstances" in s 45B and when the conclusion flowing from a global assessment of the factors is "so stark".

The decision highlights the importance of meticulous record-keeping by taxpayers and their advisers; the court had the benefit of detailed evidence in relation to the financial position of the business spanning several decades, and a compelling explanation of the need for the 2016 restructure and how the options considered led to the structure ultimately adopted, which enabled it to make the findings on which the taxpayer's success was based.

Collie and Grant

In March 2024, O'Loughlin DP handed down his decisions in *Collie v FCT*[30] and *Grant v FCT*,[31] each dealing with schemes involving the alienation of professional services income that had very similar fact pattens and, consequently, decisions. The taxpayers were associates of the taxpayer in *Hart v FCT*,[32] where the Full Court of the Federal Court of Australia upheld Pt IVA assessments, and there was "a degree of overlap" between the facts and considerations in that case. On appeal, each of the taxpayers were successful, and each matter was remitted to the Administrative Review Tribunal for rehearing.

Material facts

Messrs Collie and Grant were at one time connected to a Brisbane law firm that has received considerable scrutiny from the Commissioner in relation to the affairs of its clients and its partners. Both taxpayers faced the potential of personal financial risks by reason of various legal and regulatory proceedings they were involved in, leading them to take steps to avoid deriving income or accumulating assets in their own names. Significantly, the tribunal found each of the taxpayers were able to adduce undisputed facts that provided "a contextual foundation for the asserted need to take steps directed to asset protection goals".[33]

The Commissioner identified two broad classes of schemes, the Practice Trust NVI Scheme and the IET NVI Scheme, to which he applied Pt IVA. The schemes differed year by year, and involved 10 to 12 entities, and often in excess of 50 steps. In the interests of concision, I will not attempt to even paraphrase the tribunal's explication of the schemes, which spanned several hundred paragraphs and dozens of intricate diagrammatic representations (a Herculean accomplishment on the part of the Deputy President).

Very broadly, the schemes enabled the taxpayers to access money from the professional practice through a structure whereby income was distributed through a chain of newly established trusts, received by an entity with either substantial tax losses or tax-exempt status, and then gifted or distributed as capital contributions by that entity. The loss companies and tax-exempt entities received a small fee for their participation in the schemes. Ultimately, the taxpayers' share of the untaxed profits wound up in entities controlled by them, and from which the funds were applied for their personal use by way of loans.

Key issues

The taxpayers argued that, because the relevant trusts did not have a history of making distributions, no taxpayer obtained a tax benefit in connection with the schemes because it was not possible to identify a taxpayer who would have, or might reasonably be expected to have, received distributions of income absent the schemes.

Further, the taxpayers argued that the dominant purpose of the schemes was to "secure or further the asset protection strategies and benefits" they each sought, and not to obtain a tax benefit (if a tax benefit was found to exist).[34]

Decisions of the Administrative Appeals Tribunal

Tax benefit

The argument that a lack of distribution history renders it impossible to identify a reasonable alternative postulate in which a tax benefit exists is quite risky because, although it could reduce the reliability of the Commissioner's alternative postulate, it necessarily also reduces the likelihood of any alternative postulate advanced by the taxpayer. Another risk is that the absence of a history of distributions arguably makes it impossible to describe any alternative postulate involving a distribution to a beneficiary as unreasonable, because it is in the nature of a discretionary trust that distributions can be made to any of the beneficiaries. This situation could be contrasted with the position of a trust with a well-established pattern of distributions to members of a particular family group, where an alternative postulate in which a distribution is made to a distant and unknown relative might be so unlikely as to be unreasonable.

In both *Collie* and *Grant*, the taxpayers argued that income would have been distributed to family members rather than the taxpayers;[35] and in both cases, the tribunal found that these were no more than speculative contentions with no reliable support in the evidence. Further, the tribunal considered that the connection between the activities of the taxpayers and the profits of the business (which were the subject of the schemes) rendered it more likely that they would derive all, or at least some, of the profits personally.

Another challenge that the taxpayers failed to overcome was the decision in the related case of *Hart*. In that case, the Full Court concluded that the taxpayer had obtained a tax benefit, and that it was not enough to displace this conclusion for the taxpayer to assert that other entities might have been more likely to derive the assessable income than the taxpayer.[36] This further demonstrates that when a taxpayer claims that it is not possible to predict the recipient of a taxable amount by way of the alternative postulate, it is necessarily more difficult for that taxpayer to also contend that it would not have received those taxable amounts.[37]

The tribunal concluded that the tax benefits identified by the Commissioner were sufficiently reliable to be reasonable expectations of what would have, or might reasonably be expected to have, happened but for the schemes.

Dominant purpose

The tribunal accepted that asset protection was an important motivation for each of the taxpayers. However, the tribunal referred to the High Court's dictum in *Spotless* that it is a false dichotomy to draw a distinction between a "rational commercial decision" on the one hand and the obtaining of a tax benefit as "the dominant purpose of the taxpayer" on the other. In a passage that has become a shibboleth of the tax profession:[38]

> "A person may enter into or carry out a scheme, within the meaning of Pt IVA for the dominant purpose of enabling the relevant taxpayer to obtain a tax benefit where that dominant purpose is consistent with the pursuit of commercial gain in the course of carrying on a business."

Although a common factual matrix might require subtle distinctions between a scheme's taxation and commercial advantages, the tribunal did not consider that such subtleties arose in the present case. The reason for this conclusion can be gleaned from the tribunal's *in globo* analysis of the dominant purpose of the schemes, expressed below in memorable terms:[39]

> "For present circumstances a blatant artificial and contrived means was designed and executed to ensure that amounts having their origins in the [relevant businesses] were not taxable in the hands of anybody in the Years in which they otherwise would be. The contrivance and artificiality reach their zenith in paper distributions to tax exempt charitable entities or loss companies with the charity or loss company receiving and enjoying a very small proportion of the distribution purportedly made to it while providing shelter from Australian taxation in respect of the whole distribution. The contrivance associated with these steps in the scheme reveal a dominant purpose of tax avoidance or securing the tax benefit as opposed to asset protection."

The tribunal went on to analyse each of the eight factors individually, and drew attention to the importance of the factors concerning the "manner in which the scheme was entered into or carried out", and the "form and substance of the scheme". The analysis of these factors is set out below:

> "(a) The manner of execution involving the choreographed and orchestrated steps taken, insertion of multiple trusts and creating entitlements in the shelter entities never intended to enjoy the entitlement created, using negotiable instruments by-passing the shelter entities removing any ability for them to take any step to frustrate the planned arrangements and allowing them to participate with minimal steps and actions, leads to the tax avoidance purpose conclusion.
>
> (b) The form of each scheme was an entitlement of the loss company or exempt entity to the sheltered trust income. The substance of each scheme was that it was never intended that that income be enjoyed. This difference leads to the same tax avoidance purpose conclusion."

The taxpayer in *Collie* also argued that the dominant purpose might be found in the commissions paid to the tax-exempt entities. However, the tribunal found that the commissions represented a "very small proportion of the income to which they were legally entitled but were never to enjoy", and that this "suggests tax avoidance purposes".[40] Given the distinction drawn by the tribunal between the legal entitlement and the "actual" entitlement of the tax-exempt entities, it is curious that the Commissioner did not allege that those transactions were shams.[41]

It is also noteworthy that the tribunal observed that tax-exempt entities that participated in arrangements of this type could jeopardise their tax-exempt status. Whatever the outcome of the future conduct of these cases, this comment could lead to further interesting developments in the not-for-profits space.

Decisions of the Full Court of the Federal Court of Australia

In decisions handed down on 19 December 2024, the Full Court criticised the tribunal's decisions in *Collie* and *Grant* for failing to properly consider material evidence, for failing to weigh competing submissions, and for failing to provide adequate reasons "for any of its conclusions";[42] the Full Court in *Collie* also criticised the tribunal for the delay in handing down its decision.[43] Interestingly, the scope of the remitter differs:

- in *Collie*, the Full Court allowed the taxpayer's appeal and remitted to the tribunal the question whether the taxpayer obtained a tax benefit afresh;[44] and
- in *Grant*, the Full Court allowed the taxpayer's appeal and remitted to the tribunal the question of whether Pt IVA applied in the 1997 through 2002 income years.[45]

Significantly, in both cases, the tribunal's hearing "is not to be a continuation of the hearing which has already occurred before the Tribunal" and neither party is bound by the prior conduct of the proceedings.[46] Given the matters will be reheard, it will be fascinating to watch the further conduct and development of these cases, though a brief consideration of the Full Court's analysis of tax benefit is warranted.

In *Collie*, the Full Court grappled with an issue similar to the one discussed in relation to *Guardian* earlier in this article, being the process by which a court or tribunal must evaluate evidence and submissions to identify whether a tax benefit has been obtained.[47] The Full Court explained the task by reference to the following extract from *RCI*:

> "the issue is not whether the Commissioner puts forward a reasonable counterfactual or not; it is a question of the court determining objectively, and on all of the evidence, including inferences open on the evidence, as well as the apparent logic of events, what would have or might reasonably be expected to have occurred if the scheme had not been entered into. Thus, even if a taxpayer establishes that the Commissioner's counterfactual is unreasonable, that will not discharge the onus the

taxpayer carries if the court determines that the taxpayer would have or might reasonably be expected to have done something which gave rise to the same tax benefit."

The Full Court thus considered that "it was incumbent on the Tribunal to ask and answer that question by reference to the competing evidence and submissions which were before it". One difficulty in applying this to the tribunal's reasoning was the different way the taxpayer's case was described:

- in para 96, the tribunal stated the taxpayer "contends that the income *would* have been distributed to loss vehicles or companies" (emphasis added); and
- in para 16, the core of the taxpayer's case was described as being that "it *could not reasonably be expected* that any income would be appointed [to the taxpayer]" (emphasis added).

The tribunal appeared to reach a conclusion based on the "would" limb of tax benefit, such that the taxpayer's failure to positively identify what *would* have happened but for the scheme was fatal to their argument that no tax benefit had been obtained. Contrarily, the Full Court analysed the tribunal's decision on the basis that the taxpayer's case was that the tax benefit identified by the Commissioner was not something that could reasonably be expected. On this basis, it is hardly surprising that the Full Court reached the conclusion it did.

In *Grant*, the taxpayer's case with regard to tax benefit was identified by the tribunal as being a challenge to the reasonableness of the Commissioner's counterfactual, and expert evidence was led in by the taxpayer on this question. The Full Court did not consider that it was open for the tribunal to reject this evidence on the basis that it was "not assisted by it [sic]",[48] citing the decision in *Futuris* as grounds for the proposition that evidence may be relevant in analysing a counterfactual while being speculative without being "merely speculative".[49] However, in reaching this conclusion, the Full Court did not address the decision in *Hart*[50] that was critical to the tribunal's reasoning. In that case, Bromberg J, in a decision upheld on appeal,[51] found that a counterfactual that is "unpalatable" or undesirable to a taxpayer will not "render it unreasonable, nor a mere possibility".[52] Whether the decisions in *RCI* and *Hart* can be or need to be reconciled was not addressed by the Full Court, though may be relevant when the matter is reheard.

The Full Court in *Grant* also criticised the tribunal for dismissing the taxpayer's "submissions and evidence about how he managed his tax affairs",[53] in particular, the submission that income would have been distributed to other individuals or companies.[54] Assuming that the individuals and companies identified by the taxpayer were in fact beneficiaries of the relevant trust, it is difficult to avoid the Full Court's conclusion that the proposition that distributions might be made to them was more than a mere "speculative contention" with no reliable support.

Merchant

At a high level of generality, the decision of the Federal Court of Australia in *Merchant v FCT*[55] concerned two schemes:

- what is colloquially known as a "wash sale" (ie the sale of shares to realise a tax loss without any change in the ultimate economic ownership of the shares); and
- a scheme involving dividend stripping.

An appeal against this decision was heard by the Full Court on 6 and 7 November 2024, and the decision reserved.

Material facts

In 1973, Mr Merchant co-founded the Billabong brand of surfing apparel and associated paraphernalia. The business ultimate changed its name to Billabong Limited (BBG) and was listed on the Australian Securities Exchange on 11 August 2000.

Through related entities, Mr Merchant remained a shareholder in BBG. Mr Merchant wanted to maintain a significant interest in BBG. His interests in BBG were ultimately purchased by the time BBG was delisted from the ASX in August 2018.

Mr Merchant was the director and controlling mind of a number of Australian corporate entities (the Merchant Group), which in 2010, acquired all the shares in what was then a start-up company known known as Plantic Technologies Ltd (Plantic). Although Plantic was a successful business, it was capital intensive, requiring entities in the Merchant Group (GSM and Tironui) to extend credit in the order of $55m. This level of funding displeased Mr Merchant, and by May 2014 (at the latest), Mr Merchant was considering the sale of Plantic. Sealed Air Corporation, a company listed on the New York Stock Exchange, expressed an interest in acquiring Plantic.

In anticipation that the sale might result in a substantial capital gain, on 4 September 2014, a trust in the Merchant Group disposed of shares in BBG, triggering a capital loss of $56.6m, the purchaser was the Gordon Merchant Superannuation Funds (GMSF). Further, it was necessary to reduce Plantic's debt load to enable the shares to be sold on a "cash free and debt free" basis; this was achieved by lenders in the Merchant Group forgiving the loans to Plantic, which had the effect of increasing the value of Plantic's shares and thereby increasing consideration paid for those shares.

Although the sale to Sealed Air Corporation did not eventuate, Plantic was eventually sold to Kuraray Co Ltd (Kuraray), resulting in a capital gain in the order of $85m.

Key issues

In 2008, the Commissioner issued TR 2008/1, which addressed situations where shares are sold for a tax loss in circumstances where the taxpayer and its related entities do not "genuinely" dispose of their economic exposure to the asset being sold. The ruling concludes that the Commissioner may make a determination to apply Pt IVA

to cancel the tax benefit of any capital loss realised as a result of a wash sale. In line with this position, the Commissioner made a determination under s 177F(1)(c) to effectively disallow the capital loss of $56.6m incurred by the MFT on the basis that there was a scheme that had been entered into with the dominant purpose of enabling the capital loss to be realised.

Additionally, the Commissioner made a determination under s 177F(1)(a) that the forgiveness of debts by GSM and Tironui were schemes by way of, or in the nature of, dividend stripping. In consequence, amended assessments were issued to Mr Merchant to include the forgiven amounts in his assessable income as dividends for the 2015 income year.

The "wash sale" scheme

The taxpayer did not dispute that a tax benefit had been obtained by the scheme identified by the Commissioner; specifically, the capital loss incurred in consequence of the sale of the shares in BBH to GMSF. The only issue in dispute in relation to the Wash Sale Scheme was whether it could be concluded under s 177D that a person who entered into or carried out the scheme did so for the dominant purpose of obtaining the tax benefit.

The court accepted that Mr Merchant "did not want to sell, and would not have sold, BBG shares to unrelated third parties". It is not obvious form the decision how the taxpayer sought to marshal this fact in its submissions, it may have been to demonstrate that a sale to a third-party was not considered or that there was no other way for cash to be injected into MFT. This fact was likely adduced by the taxpayer to support the conclusion that Pt IVA did not apply. The court nevertheless held that the unwillingness to sell to third parties in fact emphasised the point of the sale as being to realise a capital loss while maintaining the Merchant Group's shareholding in BBG. Even if the court had accepted the taxpayer's argument on this point, it may not have had a significant impact on the ultimate decision, because the taxpayer's subjective intention is not a matter on which the application of Pt IVA turns.

The taxpayer also argued that the sale of shares in BBG was motivated, at least in part, by a desire to free up cash so that the vendor could meet its expenses, including the funding needs of Plantic. The taxpayer led evidence that Plantic's funding needs were onerous, and that the Merchant Group had sold various assets (a such as a helicopter and land in Hawaii) to raise the necessary cash, rather than having to borrow to meet those needs. However, other evidence, including oral evidence of Mr Merchant, contemporaneous emails and other inferences concerning the roles played by various advisers, did not support the proposition that the sale was to free up cash. Ultimately, the court was not persuaded that there was a particular need to free up cash to fund Plantic shortly prior to the sale of the BBG shares. Since this is evidence was probative of a significant non-tax purpose of the scheme, its acceptance by the court may have made a significant difference to the conclusion ultimately reached.

In relation to the eight factors:

- The manner in which a scheme was entered into or carried out requires consideration of the "way in which and method or procedure by which the particular scheme in question was established".[56] The court held that this factor weighed in favour of the dominant purpose being to obtain the tax benefit because the scheme was not conceived of for commercial purposes but for the purpose of crystallising a capital loss on sale of the BBH shares.
- The form and substance of the scheme were said to be the same, though the court also observed that the form of the scheme was an off-market share transfer, while the substance of the transaction included the retention of economic ownership of the shares by Mr Merchant. It is not clear why the form and substance were the same, since a transaction in the form of a sale of shares might not typically have the substance of a transaction where there is no change in economic ownership. Nevertheless, the court held that this factor weighed in favour of the dominant purpose being to obtain the tax benefit.
- The time the scheme was entered into plainly weighed in favour of the dominant purpose being to obtain the tax benefit because it was undertaken at a time when a significant capital gain was anticipated and there were no non-tax consequences proved on the evidence.
- The result but for the application of Pt IVA, which "almost invariably weighs in favour of a conclusion that the dominant purpose was to obtain a tax benefit", was described as not weighing against a conclusion that the dominant purpose was to obtain the tax benefit.
- The court held that the change in financial position of the taxpayer, and other parties to the scheme, weighed in favour of the dominant purpose being to obtain the tax benefit because of the significant tax savings it triggered (in the order of $56.5m in capital losses), while it resulted in only a nominal infusion of cash (around $5.8m).
- Under the rubric of "any other consequence of the scheme", the court identified that the transfer of the BBG shares to GMSF was contrary to its documented investment strategy and resulted in a diminution to its expected future income streams (because the shares were not expected to pay dividends). This too weighed in favour of the conclusion that the dominant purpose was obtaining the tax benefit.
- Finally, the connection between the relevant entities was found to support the conclusion that the dominant purpose was obtaining the tax benefit. This conclusion seems inescapable given all of the entities were "controlled" by Mr Merchant, and there was no evidence accepted by the court as to why he might not be indifferent to which entity within the Merchant Group owned the BBG shares.

Ultimately, the conclusion that the dominant purpose of the scheme was obtain the tax benefit (ie the capital loss incurred on disposal of the BBG shares) appears inescapable given the difficulty the taxpayer faced in

convincing the court of an evidentiary basis for any non-tax consequences of the scheme.

Dividend stripping schemes

Part IVA includes a "supplementary code" to address dividend stripping schemes, capturing both schemes "by way of or in the nature of dividend stripping", and schemes "having substantially the effect of a scheme by way of or in the nature of a dividend stripping".[57]

The explanatory memorandum to the Bill introducing Pt IVA explained the phrase "dividend stripping" in the following relatively uncontroversial terms:[58]

> "Schemes within the category of being, or being in the nature of, dividend stripping schemes would be ones where a company (the "stripper") purchases the shares in a target company that has accumulated profits that are represented by cash or other readily-realisable assets, pays the former shareholders a capital sum that reflects those profits and then draws off the profits by having paid to it a dividend (or a liquidation distribution) from the target company."

At a high level, "dividend stripping" can be seen as an operation by which the economic value of an otherwise taxable dividend is obtained free from the tax consequences ordinarily associated with a dividend. The Full Court in *Consolidated Press Holdings* identified six characteristics of dividend stripping schemes:[59]

- a target company with substantial undistributed profits;
- the sale or allotment of shares in the target company;
- the payment of a dividend to the purchaser or allottee of the shares out of the target company's profits;
- the purchaser escaping Australian income tax on the dividend;
- the vendor shareholders receiving a capital sum in an amount the same as or very close to the amount of the dividends paid to the purchasers; and
- the scheme was carefully planned, with all the parties acting in concert, for the predominant if not the sole purpose of the vendor shareholders avoiding tax on a distribution of dividends by the target company.

In *Lawrence*, Jessup J concluded that a scheme could not constitute dividend stripping absent a disposal of shares.[60] The Full Court (hearing an appeal instituted by the taxpayer on other grounds) observed that it was not surprising that the Commissioner did not seek to appeal from this finding, and implicitly affirmed that the scheme did not possess the characteristics required to be one "by way of or in the nature of dividend stripping".[61]

In the category of "schemes having substantially the effect of dividend stripping", the explanatory memorandum identified:[62]

> "… schemes in which the profits of the target company are not stripped from it by a formal dividend payment but by way of such transactions as the making of irrecoverable loans *to entities that are associates of the stripper*, or the use of the profits to purchase near-worthless assets from such associates." (emphasis added)

The phrase "to entities that are associates of the stripper" was held to include not only transactions where the economic value of a company is extracted by a method other than a "formal dividend payment", but also where the result of the extraction resulted in the economic value being passed (to adopt a neutral term) to associates of existing shareholders.[63] From this, it appears that the essence of a scheme having substantially the effect of dividend stripping is the extraction of economic value from a company and that amount passing to an entity connected with the shareholder (I eschew the term "associate" as that phrase carries significant baggage from its compendious definition in s 318).

In *Merchant*, the Commissioner identified what were described as the "Debt Forgiveness Schemes", which consisted solely of the forgiveness of the relevant debts.[64] This may have been a reflexive position for the Commissioner to adopt, because it is widely believed that it is harder for taxpayers to challenge a narrower scheme under s 177D. Yet, this position had the fatal flaw of omitting essential elements of a dividend stripping scheme, such as a shareholder accessing corporate profits in a tax-free form. In opening submissions, the Commissioner foreshadowed the adoption of broader schemes, a move the court suggested was "[p]erhaps in recognition of the weakness of his position on this issue".[65]

The taxpayer argued that the Debt Forgiveness Schemes served "an obvious commercial objective, namely to facilitate the sale of MFT's shares in Plantic".[66] The court accepted that the forgiveness of debts was "consistent with the commercial purpose of selling the shares in Plantic", yet this was to draw the false dichotomy identified in the High Court's dictum in *Spotless* (discussed under the heading "Decisions of the AAT" above). As it would have been entirely possible for the forgiven loans to have been repaid as part of the sale, the court held that there was "no sensible commercial objective from the point of view of either GSM or Tironui in forgiving the substantial debts".[67]

The taxpayer also argued that the sale of shares in MFT was not driven by a desire to obtain a tax benefit from the Debt Forgiveness Schemes.[68] The court did not accept this submission, and held that a discernible commercial end does not preclude a finding that the "particular form of a transaction was selected for the dominant purpose of tax avoidance".[69]

The taxpayer's failure to lead evidence demonstrating non-tax benefits associated with the forgiveness of debts ultimately resulted in the court accepting that the purpose of the forgiveness was to transfer undistributed profits from GSM and Tironui to MFT, so that they could be realised via the disposal of shares in MFT.

MJH Trading Trust

In *FCT v Michael John Hayes Trading Pty Ltd*,[70] the Full Court of the Federal Court of Australia considered whether

a scheme (entered into and carried out by each of four taxpayers) fell within the meaning of the phrase "dividend stripping operation" as defined in s 207-155 ITAA97. Although this case did not concern Pt IVA, because the phrase "dividend stripping operation" overlaps with the phrase "dividend stripping" as it appears in s 177E, it is instructive to consider the Full Courts decision in this article.

Material facts

The taxpayers were corporate trustees of public trading trusts, each controlled by one of four brothers (the Hayes Brothers). The trustee companies were acquired in February 2010, and shortly thereafter became trustees of trusts that were formed so as to satisfy the requirements to be "trading trusts" for the purposes of Div 6C. As a result of being "trading trusts", the taxpayers were treated as companies for certain income tax purposes and, relevantly, "[t]rading trusts are public trading trusts and not subject to Div 7A of the [*Income Tax Assessment Act 1936* (Cth)]".[71]

The Hayes Brothers were associated with four operating companies, each of which had profits available for distribution to their shareholders (the Operating Companies). The Operating Companies also had franking account balances that would have enabled the dividends that were paid to be franked.

Three months after the taxpayers were formed, the Operating Companies issued Z class shares to the taxpayers for $1 per share (I omit the details concerning the specific number of shares acquired by each of the four taxpayers in each of the four Operating Companies as those details are not relevant for present purposes). On the very day the taxpayers acquired the Z class shares, the four Operating Companies declared and paid fully franked dividends of just over $8m on the Z class shares (no dividends were declared in favour of the ordinary shares). The dividends represented almost all the retained earnings of the Operating Companies.

The taxpayers included the franked dividends and the associated franking credit amounts in their assessable income and claimed tax offsets on account of those franking credits. The franking credit offsets effectively "sheltered" the franked dividends from tax, which were thus effectively received by the taxpayers tax-free.

Key issues

Relevantly, a "dividend stripping operation" is defined as follows:[72]

> "A distribution made to a member of a corporate tax entity is taken to be made as part of a ***dividend stripping operation*** if, and only if, the making of the distribution arose out of, or was made in the course of, a scheme that:
>
> (a) was by way of, or in the nature of, dividend stripping; or
>
> (b) had substantially the effect of a scheme by way of, or in the nature of, dividend stripping."

The consequence of a franked distribution being made as part of a "dividend stripping operation" includes that the amount of the franking credit on the distribution will be excluded from assessable income.[73] The Full Court considered whether the Administrative Appeals Tribunal erred in deciding that dividends paid to the taxpayers were not taken to be made as part of a dividend stripping operation.

Decision of the Full Court

Dividend stripping operations

Since the phrase "dividend stripping" is not defined for the purposes of the definition of the phrase "dividend stripping operation", the correct construction of its meaning raises a question of law.[74]

The Full Court referred to the decisions of the Federal Court, the Full Court of the Federal Court and the High Court in the "*Consolidated Press Holdings* taxation litigation", which considered the concept of "dividend stripping" in the context of Pt IVA.[75] However, the Full Court observed that the description of the common characteristics of dividend stripping schemes set out in the "*Consolidated Press Holdings* taxation litigation" are not "a legislative prescription" and should not be treated as such.[76]

At first instance, the tribunal based its decision on two principal factual matters:[77]

- that profits were not removed from the Australian income tax system; and
- that a majority of the dividends were ultimately loaned back to the Operating Companies.

In relation to the tribunal's first point, the Full Court held that having regard to whether profits were removed from the Australian income tax system "suggests that the wrong question was asked and/or … applied" because the test is actually whether tax on dividends that would have been payable by the original shareholders has been avoided.[78] The Full Court also observed that if tax is payable by an entity other than a shareholder in the same amount and in the same income year, the fact that no tax is avoided "may be probative of whether there was a dominant purpose of tax avoidance on the dividends".[79]

In relation to the tribunal's second point, the Full Court held that the loans back to the Operating Companies would not preclude the scheme being one by way of, or in the nature of, dividend stripping. The Full Court gave weight to the fact that a dividend stripping operation can take place between members of the same group without the need for an "outsider".[80]

Finally, the Full Court concluded that the facts had not been fully found and that it could not be satisfied that only one conclusion was reasonably open to it. The matter was thus remitted to the tribunal for redetermination.

The Commissioner's new argument regarding purpose

On appeal, the Commissioner also sought leave to raise a submission not run before the tribunal, being that it is sufficient if tax avoidance was an "incidental purpose"—being a purpose less than a dominant purpose, but more than a trivial or *de minimis* purpose—of a scheme, and that a scheme did not need to have a dominant tax avoidance purpose in order for it to be found to be a scheme by way, of or in the nature of, dividend stripping.[81]

The Full Court rejected leave to appeal on this point, and emphatically rejected the Commissioner's proposition; it identified that the concept of "dividend stripping" is "rooted in the history of tax avoidance", which necessitated the conclusion that it is an essential characteristic of "dividend stripping" that a purpose of tax avoidance be the sole or dominant purpose.[82] This conclusion is entirely consistent with the High Court's reasoning in *FCT v Consolidated Press Holdings Ltd*.[83]

It is noteworthy that the Commissioner sought to have the bar lowered so that a merely "incidental purpose" could enliven dividend stripping provisions. Even in s 177EA, parliament was only willing to set the purpose test as low as "a purpose (whether or not the dominant purpose but not including an incidental purpose)". Although this decision may not be binding on a later court considering the application of s 177E, one can hope that the Commissioner will not need to seek judicial guidance on the appropriate purpose test under that provision, and that this does not herald a desire to apply a lower threshold for all purpose tests throughout the general and specific anti-avoidance regimes.

Conclusion

Navigating through Pt IVA issues involving trusts requires a comprehensive understanding of both recent cases and jurisprudence spanning several decades. The cases discussed in this article highlight the complexities and nuances involved in considering whether the general anti-avoidance regime might apply to arrangements involving trusts. As the Commissioner continues to challenge arrangements that were previously considered low risk, it is imperative for practitioners to remain vigilant and informed. Ultimately, a thorough understanding of these developments will be crucial when navigating the complexities of trust taxation, even when pursuing legitimate commercial objectives.

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