THE TAX INSTITUTE

10 March 2011

The General Manager
Business Tax Division
c/- The Treasury
Langton Crescent
PARKES ACT 2600

Attention: Mr Michael Wilson

Email: sbtr@treasury.gov.au

Dear Sir,

Improving the operation of the anti-avoidance provisions in the income tax law

The Tax Institute (**Tax Institute**) welcomes the opportunity to comment on the Treasury's "*Improving the operation of the anti-avoidance provisions in the income tax law*" discussion paper (**Discussion Paper**) which was released on 18 November 2010.

Terms not otherwise defined in this submission take their meaning from the terms defined in the Discussion Paper. All legislative references in this submission are to the *Income Tax Assessment Act 1936* (**ITAA 1936**) and the *Income Tax Assessment Act 1997* (**ITAA 1997**) unless otherwise stated.

Summary

The Tax Institute welcomes the Government's decision to review the operation of the anti-avoidance provisions in the income tax law. This review has been long anticipated, and is in our view, overdue. The Discussion Paper represents an opportunity to review the approach taken in both the general anti-avoidance rules (**GAAR**) and specific anti-avoidance provisions (**SAAPs**) with the aim of simplifying and streamlining the law.

Importantly, our submission takes a broader view of the reforms that are needed to clarify the law than anticipated in the Discussion Paper. We consider that some aspects of the Discussion Paper are too narrowly framed and merely focus on issues of integrity. We would prefer a more wholesale review of the provisions, with the aim of introducing policy considerations that should be taken into account before the GAAR or SAAPs are applied. We consider that such amendments to the provisions would ensure they are properly targeted to tax mischief, and deliver greater certainty to taxpayers in respect of their potential application.

Level 10, 175 Pitt Street
Sydney NSW 2000
Tel: 02 8223 0000
Fax: 02 8223 0077
info@taxinstitute.com.au
taxinstitute.com.au
ABN 45 008 392 372

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Comments on the review of the GAAR

Consultation Question 1

Which of the three approaches to amending the definition of the term 'tax benefit' in Chapter 2 would be most effective? What other options should be considered?

This is the most important question raised in the Discussion Paper. In our view, however, the question in the first part is too narrowly framed. Hence we set out here what we consider the core problem to be in answer to the second part of the question and then move onto the first part of the question.

The aim of the review is identified as "*to improve the integrity, certainty and simplicity of the income tax laws*" but the discussion of the general anti-avoidance rules seems to be concerned solely with integrity "*ensuring that the general anti-avoidance rule contained in Part IVA of the ITAA 1936 is able to deal with existing and emerging risks.*" We consider that the most pressing problem in the current application of Part IVA is the large amount of uncertainty it creates which has received unfavourable media attention internationally.[1]

The definition offered in the paper of what is the appropriate trigger for the GAAR is "*a series of artificial or contrived transactions undertaken with the objective of reducing a taxpayer's tax liability without committing either criminal or taxation offences*." The only substantive content here is the reference to artificial or contrived transactions and that is the core of the problem. In a modern market economy with complex corporate, accounting, regulatory and tax laws, many dealings in both the small/medium and large business context will inevitably involve a series of complex transactions which will try to weave their way through this maze of rules and will certainly not be seeking to maximise the tax payable as a result.[2] Hence it will depend on the perspective of the observer whether the line has been crossed and different observers will have different perspectives. In other words despite the many pages of legislation in Part IVA we still essentially have a "smell test" as the current Commissioner of Taxation recognised in a speech when he was Second Commissioner and Chief Tax Counsel.[3]

In our view, the GAAR needs to have more content if it is to provide some certainty along with integrity. The Ralph Review of Business Taxation which is one of the sources for the Discussion Paper discussed this issue as follows:[4]

> *The objects clause of the GAAR should clarify that the general anti-avoidance powers are to be exercised in a manner consistent with, and supportive of, the tax policy principles embodied in other provisions in the tax law. It should also make clear that the GAAR will not apply to the mere use in a straight-forward and ordinary manner of structural features of the*

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1 The situation which has received the most coverage overseas is the taxation of private equity. The point here is not whether the approach of the Australian Taxation Office (ATO) to private equity is correct in relation to Part IVA but that it has been the cause of a great deal of uncertainty. A related uncertainty issue was addressed by the Assistant Treasurer in a Press Release No 27 of 17 December 2010, "Government Provides Investment Certainty by Addressing 'FIN 48' Issue" which covers several issues including the potential use of Part IVA.

2 When the transactions have a cross border element, the complexity rapidly multiplies depending on the number of countries involved.

3 D'Ascenzo, "Part IVA – the Stewards' Inquiry – A Fair Tax System" (2003) available at http://www.ato.gov.au/corporate/content.asp?doc=/content/31980.htm&page=1#P20_4181 "*But it does not mean the end of the smell test which, historically, has probably been a better predictor of outcomes than any quantity of logic*."

4 Review of Business Taxation, *A tax system redesigned* (1999) 241.

law to best advantage -- for example, the use of an election or an entity structure (as opposed to the use of such features as part of a wider tax avoidance arrangement) does not in itself bear the stamp of avoidance.

Such a statement of policy should confirm the circumstances in which the GAAR could be applied and reduce the perception that valid business practices could unintentionally be subject to the application of the GAAR.

In other words tax avoidance should be understood for the purpose of the GAAR as a case where the letter of the law does not match the policy of the law and the GAAR should only be applied where such a disparity can be identified.[5] This is the real distinction between Canadian, Irish and South African rules on the one hand and the Australian (and New Zealand) rules on the other.[6] The Discussion Paper recognises that the "election" exception in the Australian GAAR has a similar effect but the problem is that the exception is confined only to cases of elections and not to other cases not involving elections where the actions of the taxpayer are consistent with the policy of the law. In such cases the taxpayer has to rely on the Commissioner of Taxation not exercising the discretion in section 177F to apply Part IVA and that, without more, cannot produce certainty in the sense of predicting in advance what the tax outcome of the proposed transaction is.

The ATO, without usually identifying the problem in this way, seeks to deal with it in a number of cases by issuing guidance on how it will apply Part IVA including acknowledging that it is not applying the provisions in such cases to its full extent. Thus, in the consolidation context the ATO provides guidance on what it sees as the policy of the consolidation regime and how this affects whether a determination will be made under Part IVA. Moreover the ATO notes that in consolidation cases which give rise to tax avoidance within Part IVA, the amount of the adjustment will not be for the full amount of deductions obtained by the head company or assessable income not taxed to the subsidiary member, but only to the overall difference even though Part IVA could be applied to the full amount.[7]

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5 Professor Parsons put the distinction thus, *Income Taxation in Australia* (1985) available at http://setis.library.usyd.edu.au/oztexts/parsons.html para [16.8]

> *"Tax avoidance, as the phrase is used in discussion about tax, is a phrase of shifting meaning. It is at times used as a synonym for tax evasion, though a distinction between evasion and avoidance is a fundamental one. Evasion is the non-payment of tax when the law requires payment. The phrase tax avoidance is also used in a sense that is the one preferred in this Volume: the non-payment of tax when the law does not say that tax should be paid, though the policy of the law says that it should. The phrase is used in other senses. It is sometimes used in a sense that makes it a judgment on the policy in fact embodied in the law, a judgment made by someone who does not agree with that policy and would want to see a different policy embodied in the law. Thus the view is held by some people that capital gains should be subject to tax. That view may lead them to describe the sale of shares in a company that has accumulated profits as tax avoidance. In this instance the meaning of tax avoidance shades into yet another meaning which would identify tax avoidance with actions of the kind that will attract the general provisions of Pt IVA of the Assessment Act. This last meaning would say that there is tax avoidance if a person acts in a way that justifies an inference that he acted as he did because he wanted, for himself or for another, the relief from tax that would attend his actions. There is tax avoidance in this sense even though neither the words of the law nor the policy of the law would say that his actions should give rise to a greater tax liability."*

The last meaning is effectively the one adopted by the Discussion Paper. As Parsons argues it has little content and only the second meaning can make the line of unacceptable tax avoidance have any real content, para [16.41]

> *"Pt IVA lacks any rational justification. The presence of a purpose to enable a person to obtain a tax benefit may make some sense as a basis of selection of occasions when a tax benefit will be denied, if it is not within the policy of the law to grant that tax benefit. But it makes no sense whatever as a selector of occasions when a tax benefit will be denied, if that benefit is to be denied even though it is within the policy of the law to grant it."*

6 We note that the Australian GST law adopts a policy based approach (refer to Subdivision 165 of the *A New Tax System (Goods and Services Tax) Act 1999*).

7 ATO, *Consolidation Reference Manual* (2008) Part C9-1-220. Aware that the reference to policy is not directly mandated by Part

While it is possible for the ATO to deal with policy in fairly standard transactions after a period of experience (and considerable uncertainty) with them, as has occurred for agriculture tax shelters and various corporate capital management issues, it is not possible for many one-off transactions. The alternative of seeking a private ruling for such transactions is often not feasible given the complexity of the issues and the timeframes that have to be met in carrying them out. Moreover, the tax consequences of such transactions should not be left to the ATO to determine without being required to give consideration to the underlying policy of the legislation.

The problems that are caused by not having explicit regard to policy are demonstrated by the spate of Part IVA cases in the last year dealing with corporate reogranisations and acquisitions (many of them still on-going).[8] The major debate in each case is what is the tax benefit and whether the criteria in section 177D lead to the conclusion that the dominant purpose was to obtain the identified tax benefit by the identified taxpayer but the analysis gives no sure grounds for predicting how future reorganisation and acquisition transactions will be dealt with as the underlying policy concerns are not identified and the results in the cases are fairly evenly divided between ATO and taxpayer wins. For example, in the *British American Tobacco* case one suspects that the ATO concern was the use of rollovers and loss transfer rules to obtain the utilisation of losses from one side in an acquisition on the other side of the acquisition although generally the policy of the tax law is that ownership of losses cannot be transferred outside the same underlying ownership. It is not possible to know, however, as the policy issue receives no discussion in the case.

In our view it should be a requirement in the application of Part IVA to identify what underlying policy of the tax law has been contravened, or to put it in terms of the onus of proof being on the taxpayer, that the taxpayer should be able to prevent the application of Part IVA by showing that the transaction is not a breach of the underlying policy of the tax law.

In turn, this would require development of criteria for identifying the policy of the tax law. The object clauses referred to by the Ralph Review are one possible source but in view of the development of the current tax law over many decades under different drafting and policy practices, the legislation should direct that the broadest scope of material available on the public record be able to be used in identifying the policy and that the literal terms of the specific provisions in issue should not have any priority in identifying the underlying policy.[9]

IVA, the ATO seeks to deal with policy as part of the factual matrix

> *"Each of the scenarios includes a section that discusses the policy context that is considered relevant to the issues raised in that scenario. The discussion of policy is not intended to indicate the operation of Part IVA is determined by reference to the policy underlying a particular provision. It simply indicates that such underlying policy is part of the contextual matrix that should be considered when analyzing the potential operation of Part IVA."*

We consider that the underlying policy must be part of the analysis and accordingly should be directly incorporated into Part IVA.

8 *AXA Asia Pacific Holdings* [2010] FCAFC 134, *British American Tobacco Australia Services* [2010] FCAFC 130, *News Australia Holdings* [2010] FCAFC 78, *Futuris Corporation* [2010] FCA 935, *RCI* [2010] FCA 939 and *Noza Holdings* [2011] FCA 46.

9 As the discussion paper notes, the Canadian cases have been uneven in applying the Canadian GAAR. It is considered that the fundamental problem has been the judicial position that the policy of the provisions has to be found in the literal terms of the provisions themselves which is effectively a return to literalism in the interpretation of tax legislation. The Tax Institute is not advocating such an approach. For a strong criticism of some of the Canadian decisions, see Arnold "Confusion Worse Confounded: The Supreme Court's GAAR Decisions" (2006) 54 *Canadian Tax Journal* 167 (the author was closely involved in the development of the Canadian GAAR).

Further, as proposed by the Ralph Review,[10] this approach should not be applied in isolation. To ensure that decisions on the GAAR are indeed reflecting the underlying policy of the law, there should be a framework for regular analysis of policy issues thrown up by ATO positions and court decisions and, if necessary, corrective action taken to deal with inconsistent underlying policy. It is very difficult for the ATO and taxpayers to apply the law, including Part IVA, when it reflects inconsistent underlying policies.

Two of the recent court decisions mentioned above, *Futuris* and *RCI*, demonstrate the issue. Previous tax law treated dividends received on shares very differently from capital gains made by companies on the sale of the same shares, with dividends receiving more favourable tax treatment. Taxpayers not surprisingly structured transactions to give rise to dividends and the ATO argued that in the circumstances they should have received capital gains with the result that Part IVA applied. The decisions are split one in favour of the taxpayer and one in favour of the ATO and both are on appeal. Since the income years in question the law has been amended to produce much more consistent treatment of dividends and capital gains in such cases. Such systemic reform of policy is a necessary adjunct to the application of Part IVA whatever form it takes and largely avoids such problems of inconsistent underlying policy for the future in this particular instance.

Hence in answer to the second part of consultation question 1, the Tax Institute considers that there should be reform of Part IVA by basing it on underlying tax policy in a way which can contribute at the same time to integrity and certainty in the tax system, and also a framework for regular review of that policy.

Provided that this approach is adopted and subject to the discussion below, it is considered in answer to the first part of the first consultation question that Part IVA could be broadened to encompass all forms of reducing the bottom line tax to be paid rather than identifying a series of intermediate steps in the calculation process. Drafting such an approach is not trivial – the Discussion Paper refers to tax payable but that term may not be appropriate as it generally refers in the 1936 Act to tax payable before offsets. The difficulty is demonstrated by section 45B(9) which is intended to be a bottom line approach but in our view does not clearly get to that result in either its original[11] or amended form. The detail of any drafting to this end is an issue that can be discussed after initial decisions are made.

The benefit of such an approach is that it avoids arguments about the exact scope of Part IVA that can currently arise. For example, and drawing on the *Futuris* case referred to above, the tax benefit was the “conversion” of an assessable capital gain to an assessable dividend of essentially the same amount. At first sight, it is difficult to see how this could be a tax benefit as the same amount was included in assessable income under the scheme as under the counterfactual. The real concern of the ATO was that the dividend attracted a section 46 inter-corporate dividend rebate (offset) which meant that it was effectively untaxed rather than an amount not being included in assessable income at all or for a much smaller amount as a result of the scheme. The ATO has long taken the position in ruling IT 2465 that the reference to an amount in Part IVA included the character of the income so that a change in character could attract the assessable income limb of the tax benefit definition. This position has been regarded as controversial but had been untested. The judge in *Futuris* accepted the ATO position more or less without argument as presumably the taxpayer was not concerned to run this argument (as it had what for the present is another winning

10 Note 4, 242-245.

11 Vann, “The new definition of dividend” in Taxation Institute of Australia, *1998-99 Convention Papers* vol 1 p 1.

argument). The second or third approach in the Discussion Paper to defining tax benefit would overcome such issues.

On the other hand, Part IVA should continue to be treated as a provision of last resort and only utilised in significant cases. For a period Part IVA included within its definition of tax benefit a very minor (in individual amount) superannuation rebate. Presumably the concern was that many thousands of individuals might enter into schemes to take advantage of the rebate but where multiple assessments are concerned and amounts are very small, there must be questions about applying Part IVA on a cost benefit basis. Accordingly we consider that there is a case for limiting Part IVA amendments to some minimum amount (which could vary by class of taxpayer). The recent experience with running multiple Part IVA test cases for agricultural tax shelters (with general but not universal success for the ATO) indicates that Part IVA even with the test case approach is not a very suitable vehicle for many small cases.

If there had been processes in place for identifying and escalating integrity/avoidance concerns to Government in the agricultural tax shelter area, then a great deal of costs could have been avoided. The Commissioner of the day made a series of speeches in the mid 1990s noting the trend that was emerging but it was some five years before significant action was taken and the clean up process took another five years with very significant ATO and taxpayer costs (apart from tax, interest and penalties) and it was found necessary for the ATO to soften its normal approach in Part IVA cases considerably. As already noted it is very important not to view Part IVA in isolation but consider its amendment against a background of other measures that will enhance integrity and certainty, thus taking pressure off the ATO having to constantly apply Part IVA.

Hence our approach to the first part of the first question is that changes to Part IVA should be made in a broader context and that provided that context includes making the operation of Part IVA more certain, including procedures to identify areas of tax law that require policy and legal clarification and appropriate measures to reduce the economic costs of widespread application of Part IVA it would be appropriate to include a more all embracing definition of tax benefit. Without such broader consideration we consider that the already significant costs of uncertainty caused by Part IVA would increase and not justify a broadening of the definition of tax benefit purely for largely unspecified integrity concerns.

We address some more specific issues in relation to this question in our response to the second consultation question. We also address there some issues in relation to dividend stripping which belong more naturally with our response to that question.

It follows from our submission that the election rule exceptions in Part IVA would need to be rethought if the underlying tax policy is adopted as a condition to the application of Part IVA. Currently these rules operate differently in the capital gain rollover area than for other elections, see section 177C(2A). The capital gain provision is particularly obscure in its expression and differs from the other election provisions in the test applied. If the current structure of Part IVA is retained, then we submit that consideration should be given to clarifying the operation of section 177C(2A) and making it consistent with the other election provisions.

Consultation question 2

Is it appropriate to expand the definition of a 'tax benefit' to include obtaining a tax offset?

We have already noted in our response to the first consultation question that the interpretation adopted by the ATO in relation to the assessable income component of the tax benefit definition

that tax offsets may be included even if that is not obvious on the face of the legislation. A similar point can be made about the *International Tax Agreements Act 1953*, under which treaty reductions in tax are effected by a tax rebate (offset) for tax by assessment and by reduction in the amount of tax for withholding tax, see sections 16, 17A. It is not clear from reading the definition of tax benefit generally and in relation to withholding tax that these methods of reducing tax are intended to be covered by the tax benefit definition.

Accordingly the answer to this question in our view depends in part on how the first question is answered. If it is decided to retain the list approach then in relation to tax offsets it should be made clear that Part IVA can only be applied to deny a tax offset directly and not indirectly through interpretation of another tax benefit provision where the result is not obvious. Again this will provide more certainty to taxpayers as to which kinds of tax benefits are covered. If for integrity purposes it is considered that particular offsets should be covered then that should be clear and not a matter of inference or less than obvious interpretation of the provisions.

If on the contrary it is considered that a comprehensive generic definition of tax benefit is appropriate based on the bottom line of tax required to be paid, then as noted above, offsets would be covered if the drafting were done appropriately. We would support such an approach subject to the conditions outlined above in relation to our submission on consultation question 1.

Although it does not seem directly to be the subject of a consultation question, we would strongly submit that the same objective tests and the same condition of dominant purpose should be applied to all tax benefits within Part IVA whatever approach is taken to the basic question of list versus generic definition of tax benefit. This comment applies most directly to the provisions on franking/imputation credits (offsets) in sections 177EA and 177EB. These differ from the rest of Part IVA in two important respects. Firstly, they have a lower threshold than dominant purpose and, secondly, they have a list of factors to consider that considerably expand the range of factors applied to normal tax benefits. In other words, although bolted onto Part IVA they are quite different in operation. In our view these provisions should be removed from Part IVA and considered along with the SAAPs dealing with imputation and corporate distribution issues discussed below in relation to SAAPs.

Apart from the different tests to be applied we consider that the current approach is inappropriate because of the last resort nature of Part IVA. At the moment section 177EA is routinely applied as a systemic measure in class rulings on share buybacks. This approach sends conflicting messages to taxpayers about the purpose and operation of Part IVA – is it an exceptional measure for egregious cases or is it a measure to be routinely applied to a wide variety of transactions. Because of the economic costs and taxpayer angst that attends the application of Part IVA in our view it should be truly a last resort rather than a first resort measure. While the specific issue of application of section 177EA to share buybacks has been dealt with by the Board of Taxation Report on the subject and the Government response,[12] the place of sections 177EA and 177EB in Part IVA was not part of the Board's recommendations nor the Government response. Nonetheless the tenor of the Board report supports our view that these provisions should become part of the SAAPs as discussed below.

If it is decided to include tax offsets within Part IVA, then it would still be possible to apply the Part to schemes to obtain franking offsets. If that approach is taken then this may impact on how many

[12] Refer to the Board of Taxation's report to the Treasurer "*Review of the Taxation Treatment of Off-Market Share Buybacks*" and the Government's response contained in Attachment B of the (then) Assistant Treasurer's Media Release 48 of 2009 (dated 12 May 2009).

SAAPs there are in the area of imputation and corporate distributions but not with the general point made here of removing these specific provisions from Part IVA.

To similar effect, if Part IVA is written as a generic provision applying to all schemes to obtain a reduced tax bottom line including tax offsets, then in our view the same "one test" approach should apply to dividend stripping which is currently the subject of a special rule in section 177E. That is, it should be removed from Part IVA to become (part of) a SAAP dealing with dividend stripping. That provision in effect modifies the definition of tax benefit to remove the reasonable expectation counterfactual for the reason that in many dividend stripping cases it is not possible to predicate that anything would have occurred if dividend stripping were not a possible option. That is, this is one case where the "do nothing argument" is likely to prevent a tax benefit arising under the general tax benefit definition as attested by the large number of redundant companies still in existence because of section 47. They remain in existence and do nothing because of the tax consequences of a liquidation.

Even if Part IVA is retained as applying to only certain schemes to obtain tax benefits we consider that dividend stripping is appropriately dealt with in a SAAP. One justification for a SAAP is to deal with cases that are not dealt with by the GAAR without specific modification (see below). In our view this applies to dividend stripping. The main case where the ATO sought to apply section 177E, *Consolidated Press*,[13] was unsuccessful and in our view indicates that the issues posed by the provision are quite specific and separate from the general issues under Part IVA.

We note that one important difference of rules in Part IVA compared to SAAPs is that they explicitly take precedence over Australia's tax treaties whereas arguably treaties take precedence over SAAPs. We do not, however, consider that removal of sections 177E, 177EA or 177EB from Part IVA would have any detrimental effects so far as tax treaties are concerned. Moreover, tax treaties increasingly contain their own SAAPs dealing with dividends to which these provisions in Part IVA are directed.

Consultation question 3

Would re-enacting Part IVA in the ITAA 1997 be useful or beneficial to users of the income tax laws? What mechanism should be used to effect a re-enactment, that is, should the movement of Pt IVA of the ITAA 1936 to the ITAA 1997 merely move the provisions, or make more extensive use of drafting tools, and what risks may such a re-enactment create?

Our response to this question depends very much on decisions made in relation to the issues canvassed above. If it is decided to tackle a number of the fundamental issues which arise under Part IVA as discussed above, then we consider that it would be worthwhile to transfer the GAAR in a substantially rewritten form to the ITAA 1997 using the drafting conventions of that Act. Given that substantive changes were being made the general uncertainty risks from new provisions would necessarily be present, but that would be a cost worth paying if in the longer term certainty is improved as we consider would occur under the suggestions above. If, however, the status quo is largely to be retained then we see no advantage in a transfer now for the sake of achieving one Act.

In view of the residual but fundamental role that Part IVA performs in tax integrity issues, it is important that the fate and structure of the many SAAPs particularly in the ITAA 1936 be settled

[13] (2001) 207 CLR 235; it has been applied in a subsequent case, *Lawrence* [2009] FCAFC 29, but the point made in the text remains valid in our view.

before the redrafting of Part IVA as part of a transfer exercise occurs, for example, in relation to rules on imputation and dividend stripping as discussed above. Only after the majority of SAAPs have been dealt with can the precise form of the new GAAR (in the case largely of a simple transfer) be settled.

More importantly we consider that the costs of the new drafting style in the case of a simple transfer of Part IVA may create uncertainty without increasing tax integrity and that would be a detrimental outcome. At this stage the attitude of courts to the "same ideas in different language" approach of the ITAA 1997 has not been significantly tested and it would be a potential concern if the courts regarded some fundamental concepts of Part IVA as up for grabs in a simple transfer case – better the devil you know for both taxpayers and tax administrators.

Consultation question 4

Should section 260, the previous general anti-avoidance rule for the ITAA 1936, be repealed or retained?

Section 260 has a residual operation as applying to arrangements pre May 1981. It does, in part, provide some context to the interpretation of the words used in the specific anti avoidance rules. If the Government decides to repeal section 260, we recommend that there be a comment in the amending legislation that its repeals should not in any way affect the interpretation of any other provision in the Income Tax Assessment Act 1936.

If Part IVA is retained for the present in the ITAA 1936 then there is little to be gained in dealing with section 260 issues. Even if Part IVA is transferred to the ITAA 1997, it does not seem pressing to deal with the section 260 transitional issue while the ITAA 1936 remains partly operative if there are no significant changes in the new version. Once the ITAA 1936 is entirely repealed then the matter could be addressed. At that point we would be even further from the 1981 operative date of Part IVA and so the risks would be even smaller. On the other hand we consider that the risks of immediate repeal of section 260 should be quite small and would be surprised if there were residual cases in which it could apply.

Comments on the review of SAAPs

General observations

Our responses to the following questions are selective. That does not mean that we do not consider questions to which we have not responded in full detail as unimportant. Rather we consider that the current process is not the appropriate context for discussion because other processes are already in train or (more commonly) that the range of issues raised is so wide that we are unable to provide a detailed commentary in the time available and consider it more important to provide a clear process for dealing with such provisions in a systematic way over time rather than a one size fits all generic approach. To the extent that generic issues and approaches can be identified we have sought to elaborate them, again without necessarily providing comments on every provision referred to in the discussion draft.

As discussed specifically in relation to the GAAR above we consider that there should be a process in place to consider policy issues on a rolling and ongoing basis. In the context above we were concerned with the application of the GAAR in particular but we consider that the process should be wider than just integrity issues and that there should be a rolling program of real (as opposed to rewrite) review of the whole tax legislation, generally starting with the oldest provisions

first (which will facilitate the overall desire to reunite the income tax legislation in one Act). In effect this process is already underway given the broad ranging and on-going debate and review around the income tax system but in our view it should be more formal and systematic in the form of a forward work-plan that encompasses the domain of the income tax. Of course as governments identify their priority areas, other areas will fall back in the list but in principle the rolling review should be a tax policy objective. This can ensure that systemic provisions of the income tax remain current and obviate the need for SAAPs or the application of the GAAR.

We accept, however, that there will be an ongoing need for SAAPs and the GAAR. Our comments above and below should be understood in the light of an objective, consistent with the Ralph Review, of relying on systemic provisions where possible but recognising that integrity may require more urgent and specific solutions while systemic solutions are developed and that some integrity measures will always be necessary if for no other reason than that, due to international constraints, it will not always be possible to adopt systemic solutions to every issue.

Consultation question 5

Do you agree with the following principles for identifying unnecessary SAAPs discussed in this paper?

(a) Principle 1: Where the mischief for which a SAAP was introduced is no longer relevant due to the mischief only being available at a certain historical time, the SAAP should be repealed.

(b) Principle 2: Where the purpose for which a SAAP was introduced is served by another provision, in particular the GAAR, it should be repealed.

(c) Principle 3: Where two SAAPs cover substantially the same mischief, one of the SAAPs should be amended so that the other SAAP can be repealed.

We generally agree with Principle 1 and consider that it should be applied more broadly than in the Discussion Paper. In particular we consider that what we have called below “relics” of the 1970s should generally be eliminated from the tax legislation. Most of these provisions were introduced at a time when the High Court of Australia seemed to have rendered the former GAAR in section 260 effectively inoperative in many cases giving rise to many detailed and very specific SAAPs. In view of the introduction of Part IVA which has proved very successful in dealing with integrity issues (which should not change if the submissions made above are accepted), the general change adopted by the courts in relation to the interpretation of tax legislation, the wide range of subsequent systemic changes to the tax system such as the capital gains tax and the various systems in place in the ATO to identify integrity issues in real time, we consider that most of these provisions can be repealed without any adverse impact on the operation of the tax system – indeed there seem to have been virtually no examples of the provisions being applied in recent times. Repeal would not adversely impact on integrity and would improve certainty in the operation of the tax legislation.

In regard to Principle 2 we consider that a balanced approach is necessary. As noted above we consider that the GAAR should indeed be a provision of last resort which does not need to be applied on a frequent and widespread basis. SAAPs can contribute to this goal in two ways. First, they can deal with specific situations that are not fully dealt with under the GAAR, especially if, as proposed above, the GAAR is rewritten as a generic rule without specific and detailed application

rules for specific cases that in various ways depart from or modify its general operation (see the discussion of imputation, corporate distribution and dividend stripping issues below).

Secondly, SAAPs can deal with specific integrity issues in a clearer and more specific way than the GAAR while leaving room for a residual operation of the GAAR. In such cases it should be recognised that the room for the GAAR is limited – the GAAR should not be viewed as a route to the same result as often appears to be the current approach of the ATO where every possible argument from interpretation of specific provisions, to SAAPs, to GAARs, is run in a case which often detracts from getting clear and reasoned decisions on the operation of particular provisions. While the approach in chapter 1 of the Discussion Paper to the analysis of tax problems is accepted (consider specific rules including sham, then SAAPs, then GAARs), it is considered that ATO litigation policy should be selective on which issues it runs and should generally follow the same hierarchy to achieve a sense of order in clarifying the law.[14]

We strongly agree with Principle 3 in the sense that overlapping SAAPs should be avoided so far as possible especially where they are directed to the very same issue, rather than overlapping only at their margins. In the 1970s and early 1980s the apparent attitude of the courts to tax avoidance may have invited an approach of the more anti-avoidance rules the better but that is now a legacy that can be reconsidered.

In deciding whether SAAPs do indeed substantially overlap, it is not just similarity of language or concept that should determine the matter. As discussed below we consider that the various arm's length/market value rules in the legislation need to be sorted carefully in deciding whether they overlap or can be incorporated into a more general rule. We also consider that this is a different question to that which is being stated in Principle 3 and involves replacing a large number of SAAPs with a very broad generic rule that is well on the way to being an alternative GAAR rather than a SAAP. On the other hand if this possible change is intended to be an example of dealing with a tax policy issue as a systemic matter, then as noted above we consider that this is an appropriate question to raise as part of rolling review of tax legislation, though for the reasons stated below we consider that considerable caution is required in the particular instance of arm's length/market value rules.

There are other circumstances where a SAAP may now be redundant, in particular where judicial decisions have confirmed that the SAAP is unnecessary. Examples are section 82KJ and section 102CA.

The timeline for section 82KJ can be summarised broadly as follows:

- The relevant interest and rent prepayment schemes were common in the late 1970s (when the facts in Creer and Gwynvill Properties occurred);
- On 17 April 1978 amendments were announced and enacted as section 82KJ and related provisions by the Income Tax Laws Amendment Bill 1978;
- In 1986 *Creer* and *Gwynvill Properties* were both won by the Commissioner without the need for 82KJ, yet section 82KJ remains in force.

[14] Compare *Virgin Holdings* [2008] FCA 1503 and *Undershaft* [2009] FCA 41 where this approach was taken to test a specific and long standing issue with *BHP Billiton Finance* [2010] FACFC 25 where the whole of Act (every possible argument) approach was adopted. The High Court sensibly sorted the issues in deciding the leave to appeal application in the last case (with leave only given on one issue involving a SAAP).

Likewise when the Commissioner lost in the Full Federal Court in the Myer Emporium case in 1985, section 102CA was enacted by the Taxation Laws Amendment Bill 1986, and in 1987 the Commissioner won in the High Court without the section being needed 87 ATC 4363), yet the section remains in force.

Consultation question 6

Are there SAAPs in the list at Appendix A or elsewhere in the law that may be considered unnecessary using the above principles and, if so, why?

We consider that many of the provisions listed may be repealed. We do not deal with all of them but rather try to provide discussion of the issues to be considered and specific comments on what in our view are some of the more important provisions.

As noted in the Discussion Paper, SAAPs are often reviewed when an area of the tax law is being reformed (as opposed to simply rewritten). A number of the identified provisions are already the subject of such processes, for example, provisions in ITAA 1936 Pt III Divs 6, 6AAA, 6B, 6C (trusts), Part X (controlled foreign companies). In such cases we consider that the reconsideration of SAAPs should be done in the context of those other processes, informed by the outcome of the current review of SAAPs (so far as possible without delaying those other processes).

Although in part covered by those other processes, we would highlight two SAAPs for repeal, ITAA 1936 sections 94, 102. These provisions are directed at income splitting and diversion that has since been dealt with in a variety of ways (for example, ITAA Pt III Div 6AA, ITAA 1997 Divs 84-87, not to mention the application of Part IVA). In our experience they are not used by the ATO and operate as traps for the unwary, for example, in setting up trusts. They date back to the original 1936 enactment (although amended since) and indeed in the case of the former further back in time, and have not received any detailed policy consideration for many years.

We consider that the SAAPs enacted in response to the tax avoidance schemes of the 1970s and early 1980s should receive particular scrutiny, in part because of their age which make them relics of a long gone and very different era, but mainly because they have been overtaken by so many events that most of them are nowadays redundant and rarely relied upon by the ATO. In cases where the ATO does refer to the provisions, they usually rely (successfully) on other provisions to produce the same result. The provisions are often the cause of unnecessary compliance (for example, in class and product rulings and advice on complex transactions).

Although there are many reasons why these SAAPs are outdated, we would highlight three. First, the enactment of Part IVA has very successfully dealt with the kind of round robin, often collapsing schemes at which the provisions were directed. Secondly, the change in judicial interpretation of tax legislation generally to a much more purposive approach often means that the schemes do not get past first base of the general income tax rules, for example, Fletcher's case. Thirdly, the enactment of the CGT often generates a tax liability in implementing the schemes to which they were directed. In this category we would include at least ITAA 1936 sections 52A, 82KH-82KL, Pt III Div 9C, ITAA 1997 section 70-20 (as to the last of which see also below on arm's length rules).

Imputation and corporate distribution tax law is particularly rife with SAAPs which have grown up over many years but which largely relate to the late 1990s. We have argued above that three which currently appear in Part IVA do not really belong there because they depart from the basic structural elements of the GAAR (sections 177E, 177EA, 177EB). We consider that considerable simplification of the law can be achieved in this area with improved certainty, reduction in

compliance costs and no loss of integrity. As these issues arise on a daily basis for the ATO, advisers and taxpayers, this is probably the area of reform of SAAPs where the greatest benefits are available for all stakeholders in the income tax system. To fully explain why would require an extensive submission of its own but we sketch here an outline of the possibilities and our reasons for making substantial changes. There is already a long delayed project to transfer one of the areas of the law from the ITAA 1936 to the ITAA 1997 (the qualifying shareholder rules) as well as some recommendations of the Review of Business Taxation whose fate is unclear and we would suggest these could all be considered as part of a single and significant SAAPs simplification project.

The main provisions concerned are ITAA 1936 sections 6(4), 6BA(5), (6), 45-45D, 52A, 177E, 177EA, 177EB, Pt IIIAA Divs 1A, 7-BA (repealed but still apparently intended to be in force), ITAA 1997 section 202-45(e), Divs 197, 204, 207-F, 208. In broad terms these cover three areas, dividend stripping, dividend streaming and trading, and capital streaming and trading. The dividend stripping rules relate back to the 1970s tax avoidance era (sections 52A, 177E) and the beginning of the imputation system in 1987 (sections 207-145(1)(d), 207-150(1)(e), 207-155). The other rules emerged from two separate policy initiatives of the late 1990s, one arising from changes to corporate law maintenance of capital rules and the other from the 1997 Budget announcements about imputation credit streaming and trading. A plethora of rules was enacted but, in the light of experience since, it is possible to reduce the needed integrity rules considerably in our view (including with no significant change in current policy settings). The Ralph Review suggested some changes in policy settings which might be considered in a review but we submit that a review is worthwhile for simplification of the law in any event.

In relation to dividend stripping, we consider that rules are still necessary to ensure that conversion of dividends to capital gains in cases where dividends are treated less favourably than capital gains is prevented (a matter unlikely to be solved for a variety of reasons by a systemic policy change) but this outcome can be achieved by one rule rather than three. A version of section 177E could remain in a SAAP but not the other rules – the dividend streaming and trading concerns that underlie the imputation rules can be dealt with differently while the rules in section 52A which adopt a different approach to the same problem can be repealed as another 1970s relic.

In terms of dividend and capital streaming and trading, experience since the late 1990s suggests that only two sets of basic SAAP rules are necessary. The very specific rules in relation to qualifying shareholders and exempting companies (to use shorthand descriptions) could be maintained as relatively bright line indicators to sophisticated investors as to the difference between acceptable and unacceptable practices. Both areas are in need of technical consideration apart from more substantive policy issues (neither of which we elaborate here) but as relatively specific SAAPs they can be helpful.[15] Apart from this, relatively broad SAAPs based on ITAA 1936 sections 45B and 177EA/177EB (the latter outside Part IVA as discussed above) would seem to deal with the all various issues that were the concerns in the late 1990s policy changes. In our experience these are generally the rules that are defaulted to by the ATO in these areas. In terms of Policy Principle 3 above we consider that this would be a considerable simplification that would allow taxpayers, their advisers and the ATO to avoid the large compliance costs of dealing with the current multiple overlapping regimes. In this process, however, section 45B should be carefully considered as in our view it is so broad in its operation that any significant capital distribution in

[15] At the same time one very unfortunate transitional problem from the 1990s changes could be dealt with – the fact that the previous rules currently apply to companies with shares that have a par value, even though those rules do not appear in the current legislation. Many, particularly foreign, companies still fall within the old rules and should be able to discover their tax treatment by reading the current legislation.

effect requires a class or private ruling before it can be effected and such rulings usually take six months or longer to issue.

It would be necessary to deal more specifically with dividend reinvestment and dividend bonus plans but that can be done within current policy parameters if the main objective is to simplify current overlapping SAAPs as opposed to major policy change. The Tax Institute considers that the current policy on some of these issues is questionable. The Henry Review affirmed current policy settings while the imputation system is maintained and the current Government has generally confirmed its commitment to the imputation system. Hence we do not pursue policy changes in this context but will continue to argue for policy changes within the imputation system in broader contexts.

Consultation question 7

Are there other groups of SAAPs not identified in Appendix B that could be grouped? If so, please identify the relevant provisions and explain why it is appropriate for them to be grouped.

Apart from our discussion of corporate/shareholder tax issues in response to the previous consultation question and the discussion of 'arm's length' rules in relation to the following consultation question we query whether the groupings suggested in the Discussion Paper are helpful in the sense of suggesting consolidation of such SAAPs. We do not consider that there are other groupings which are appropriate. The main objective in terms of grouping policy issues should be in terms of systemic approaches to the tax system rather than development of SAAPs.

We very strongly support the view that SAAPs which rely on purpose tests should be limited to (at a maximum) two expressions of the purpose – dominant purpose and a main purpose (that is, not an incidental purpose). The dominant purpose test of Part IVA should be the standard test even where it is found necessary to express a SAAP in purpose terms because the GAAR (revised as suggested above) does not deal directly with specific situations (such as dividend stripping), unless there is a strong policy reason for adopting the lesser standard. We note that the UK Institute for Fiscal Studies which has studied the introduction of a GAAR in the UK suggests that a GAAR would not cover many of the very specific situations covered by SAAPs.[16]

A decision to adopt less than a dominant purpose test should in the longer term in our view require justification why the lower standard in necessary. In the short term we consider that all purpose based SAAPs should be standardised around the two expressions of the purpose. In the longer term they should be reviewed under two policy based standards: is there a continuing justification for a purpose based SAAP and, if there is, what is the appropriate purpose standard given the basic standard of dominant purpose.

In relation to at risk and income injection rules we consider that there is no emerging systemic principle at this stage which could provide a general rule for the tax system. While it is appropriate to be aware of different approaches to these issues and to consider alignment in appropriate cases, we consider that the rules identified in the Discussion Paper are generally so discrete that broad grouping is not a viable option. There are possibilities of grouping in specific areas such as partnerships and R&D but we consider that this should be the current likely limit of grouping of SAAPs.

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[16] Institute for Fiscal Studies, *Tax Avoidance: A Report by the Tax Law Review Committee* (1997), *A General Anti-Avoidance Rule for Direct Taxes* (1999), *Countering Tax Avoidance in the UK: Which Way Forward?* (2009).

Consultation question 8

Would there be a benefit to replacing the SAAPs that use an 'arm's length' substitution with any of the options discussed?

We consider that there are strong reasons for being very cautions in relation to generalising of arm's length/market value rules found in current law. The Ralph Review of Business Taxation suggested such a general approach but that was never clearly endorsed by Government. We put forward four reasons for this caution.

First, we consider that the compliance costs of a general market value rule for either associated/related parties or more extensively (parties not dealing at arm's length) are not justified. Unfortunately the Ralph Review assumed that market valuation is not a cost intensive issue. Given the requirements of market valuations for cost setting and available fraction purposes in consolidation, it is not surprising among other reasons that there is a very small uptake of consolidation in the small and medium business sector. The Government and the Board of Taxation has identified this as a major problem but without realising the compliance imposition of such market valuations and possible challenges by the ATO (not to underestimate the other compliance intensive aspects of consolidation).

Secondly, current rules reflect clear targeting of market value rules (consider the fact that some relate to only upside or downside issues). Policy makers in such cases realised that problems only occurred in particular situations and that the compliance obligations should only be imposed in cases where tax problems were relatively clear. In our view that is a further support for the current approach. The Discussion Paper refers to current Canadian law in this regard but we consider that recent Canadian case law shows that general market value rules are not without their problems.[17]

Thirdly, current Australian case law is careful to draw a distinction between being at arm's length and dealing at arm's length in the sense that unrelated parties can for various reasons not deal at arm's length even though they are at arm's length in the sense that overall they will impose market prices between themselves. Fourthly, and relatedly, we consider that two different standards of pricing are in fact involved in the law in this area. When parties are related (associated), market prices do not always provide an explanation of outcomes as there are additional profits that may not be explained by general market prices. Where, however, parties are unrelated overall they will deal at market prices even though particular transactions may not be at market prices for tax reasons. It is vital to distinguish these two cases as different standards are intended to be applied by the law. The fact that current law in Australia (and overseas) does not make the distinction clear leads to considerable confusion. It is suggested that this confusion explains the difference of the positions of the taxpayers and the tax administration in cases in Australia and overseas without realisation of the issues involved.[18]

To resolve this confusion (which is much more important for tax administrations and taxpayers than developing consistent terminology for arm's length and market value tests), we consider that Australian law should be modified to make this difference clear. Such an approach requires an extensive revision of current tests in Australian law apart from any unification issue and we do not pursue it further here other than to suggest that the "arm's length" standard of the OECD Guidelines on Transfer Pricing for Multinational Enterprises and Tax Administrations should be

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17 *GlaxoSmithKline* [2010] FCA 201, *General Electric Capital Canada* [2010] FCA 344 (both Canadian Federal Court of Appeal). This issue is further elaborated in the third and fourth points below.

18 Refer to *Roche Products Pty Ltd* (2008) 70 ATR 703 and *SNF (Australia)* [2010] FCA 635 and cases in previous footnote.

mandated in Australian law for international dealings of related parties as a systemic rule[19] and that a market value test should be applied in other specific cases as a SAAP unless there are compelling reasons to the contrary. The language for the two cases should be sufficiently distinguished (which does not currently occur) to prevent the confusion.

Consultation question 9

Do you support any of the outlined approaches to standardising SAAP[s]?

Our responses to consultation questions 5 to 8 indicate general support for the proposed approach to SAAPs with the reservation that we do not think a lot is to be gained now trying to group existing SAAPs in relation to arm's length/market value, at risk or income injection areas. We support the standardisation of purposes tests with only two basic standards, dominant purpose and a main purpose, with dominant purpose as the basic standard and main purpose requiring specific justification before it is adopted. See also our response to the next question.

Consultation question 10

Are there any SAAPs that create particular compliance cost issues? If so, please identify which SAAPs fall into this category and explain why.

We consider that the SAAPs having to do with private company dividends, especially as recently amended by Government and interpreted by the ATO, create onerous compliance obligations and costs as well as results out of all proportion to the mischief. As the Tax Institute has made detailed submissions on these issues in the recent past, we do not repeat them here but consider that this issue should receive further attention from Government with a view to a significant reduction in compliance costs.

In addition we would make one specific suggestion, the repeal of the deemed dividend rule ITAA 1936 section 109. This provision deals with excessive payments for services (such as salaries) or retirement allowances to individuals who are associates of the private company making the payment. Such payments are made non-deductible (and hence are taxed at the company level) and treated as unfranked dividends of the recipient individual leading to full tax on them at the individual level without the benefit of imputation credits. Repeal is recommended as the provision is not being applied by the ATO for the very good reason that it is now not necessary in light of the imputation system. The provision was aimed at excessive payments being made before the introduction of imputation in 1987 to avoid the double taxation of distributed company profits that then applied.

In view of the various taxes and charges attracted by payroll (payroll tax, superannuation contributions, workers compensation etc), it is highly unlikely that companies will seek to make excessive payments of these kinds to associates, and to the extent they do there is no income tax mischief as the overall income tax treatment is the same in the absence of application of section 109 whether moneys leave the company as deductible salary etc or as franked dividends. In relation to excessive retirement payments, the superannuation system is now the appropriate control mechanism.

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[19] The Review of Business Taxation included a number of recommendations to make international transfer pricing systemic but does not draw the distinction discussed here. We consider that both issues should be pursued but do not provide further details as these are for a future stage of policy development.

As alluded to earlier in this submission, section 45B poses significant difficulties from a compliance perspective, due to the practical need to obtain a binding ruling before proceeding with a transaction that involves a possible capital payment.

Consultation question 11

Do you agree with the principles to assist with the future development of SAAPs discussed in Chapter 3 of this paper? What other principles might be adopted?

For convenience we set out the principles below:

> *Principle 1: A SAAP should only be introduced into the law if there is not an existing provision that could deal with the mischief targeted by the SAAP.*
>
> *Principle 2: SAAPs should, where possible, be self-executing, not requiring the Commissioner to make a determination or to form an opinion or state of mind or exercise a discretion.*
>
> *Principle 3: Explicit policy conditions (such as criteria for a provision to apply relating to person, place, time or amount) should be clearly expressed by the SAAP.*
>
> *Principle 4: Common elements of SAAPs should use consistent terminology.*
>
> *Principle 5: SAAPs that apply to specific avoidance behaviours for a single legislative context should be located within the relevant provision, or in an adjacent part of the relevant division or subdivision.*
>
> *Principle 6: Where a single consolidated SAAP affecting multiple provisions is created, signposts should be inserted into those affected parts of the legislation where the consolidated SAAP will apply.*
>
> *Principle 7: Where the mischief for which a SAAP was introduced is no longer relevant, due to the mischief only being available at a certain historical time, the SAAP should be repealed.*
>
> *Principle 8: Where the mischief for which a SAAP was introduced is now appropriately dealt with by another provision or case law, the SAAP should be repealed.*

We generally agree with the principles as appropriate for design of SAAPs going forward and only wish to make two comments on them. In relation to principle 1, we consider that there are two reasons why a SAAP may be introduced: first, that the particular avoidance activity will not be adequately handled by the GAAR because of specific features of the activity concerned (see our earlier discussion on dividend stripping); and secondly, even where the GAAR could apply, that it is helpful in the particular case to have a more objective SAAP to more closely define the policy intended to be implemented and/or to cover common situations where abuse might occur to ensure that the GAAR does operate as a last resort rule.

In relation to principles 5 and 6 it follows from our previous discussion that there will be few cases where a SAAP ranges across a wide variety of different situations. Given the caution that we have expressed about grouping, in our view principle 6 would have little scope for operation except in relation to closely allied but different rules that can be made the subject of a single SAAP.

THE TAX INSTITUTE

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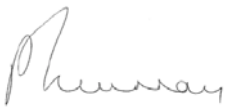
If you require any further information or assistance in respect of our submission, please contact me on 03 9288 6677 or the Tax Institute's Tax Counsel, Tamera Lang, on 02 8223 0011.

Yours sincerely



Peter Murray
President