Further notes on recent Part IVA cases

Introduction

There have been several cases recently that have dealt with Part IVA ITAA 1936, some of which are on appeal. Nonetheless, a number of tentative conclusions can be reached as to what these cases mean for planning purposes. Part IVA includes the original 1981 provisions of s177D (schemes entered into with a dominant purpose of tax avoidance) and s177E (schemes in the nature of dividend stripping). More recently s177EA (scheme to secure a franking credit advantage -2003) and s177J (the Diverted Profits Tax – relevant only to Significant Global Entities -2017) were introduced into Part IVA. There are no cases yet on the MAAL (s177DA) also only relevant to Significant Global Entities, inserted into Part IVA in 2015.

A related issue is the Commissioner's alternative recent use of s 207-150 ITAA 1997, introduced 2002, to deny franking credits where there is asserted to be a scheme in the nature of dividend stripping, rather than s177E. The use of s207-150 will deny franking credits to the recipient of the dividend, whereas s177E, and the further alternative of s177D, may result in a different party being liable to tax as having received a tax benefit e.g. who would have got the dividend if the scheme had not been implemented.

There is nothing to stop the Commissioner choosing alternative approaches, but another issue is whether he can, or should, run only a case on Part IVA (the general anti-avoidance provision), when there is a more targeted specific anti-avoidance provision, which may be applicable i.e. is Part IVA truly a provision of last resort in view of the primacy given to Part IVA by s177B(1)? Sections 177B(3) & (4) only require the Commissioner to *disallow deductions* rather than apply Part IVA in cases where a specific provision would have that effect.

In contrast to the PSI provisions which expressly note that Part IVA may still apply even if the PSI provisions don't, e.g. the "income injection test" for trust losses does not apply to injections by members of the family group if the trust has made a family trust election, but there is nothing necessarily to stop the Commissioner alleging that the family member who injects the income has received a tax benefit by no longer being assessable on the income now derived by the loss trust, even though the specific provision has provided an exemption to the trust. The issue of whether the application of the anti-value shifting provisions prevented the Commissioner from applying s177D arose at first instance in the *Futuris* case, but was rejected by the trial judge and was not appealed: see *Commissioner of Taxation v Futuris Corporation Limited* [2012] FCAFC 32 at [29] & [47].

The *Mylan* case is one where transfer pricing and thin capitalisation provisions (as they then were), did not limit interest deductions in favour of offshore related parties, so the Commissioner only ran a Part IVA case.

The recent cases often involved multiple other issues (such as s45B, s100A, s230-45), but only the decision in *Merchant* covers two of the Part IVA provisions.

The fact that several cases have been overturned on appeal, highlights the problem for advisors, as clearly the judiciary has trouble with dominant purpose and what is dividend stripping. Clearly caution is the watchword when working with these issues, and the Commissioner will always levy significant penalties if he asserts Part IVA applies.

Recent s177D Cases

FC of T v Guardian AIT Pty Ltd ATF Australian Investment Trust [2023] FCAFC 3 (not appealed) 24 Jan 2023

Collie v Commissioner of Taxation [2024] FCAFC 172; *Grant v Commissioner of Taxation* [2024] FCAFC 173 (both 19 Dec 2024 matters remitted to ART for proper finding of material facts) (potentially leading to different fortunes from their partner Mr Mick Hart (now deceased) reported at *Hart v F. C. of T. No* 4 [2018] FCAFC 61 (from which special leave to High Court was denied)). It is of particular importance that these cases were about the law before the 2013 amendments to Part IVA, and the focus was on whether the taxpayers got a "tax benefit", and so the outcome may not be relevant to schemes implemented after 2013.

Mylan Australia Holding Pty Ltd v FC of T [2024] FCA 253 (not appealed) 20 March 2024

Merchant & Anor v FC of T [2024] FCA 498 (the "Billabong" case) in relation to the triggering of a capital loss on a "wash sale" (on appeal by taxpayer) 14 May 2024

Ierna & Ors v FC of T [2024] FCA 592 (the "City Beach" case) (on appeal by taxpayer) 6 June 2024

Of these, only *Guardian* applied the 2013 amendments to Part IVA, whereas in *Minerva* and *Merchant* the taxpayer conceded the effect of s177CB on the "tax benefit" but rather, argued about the dominant purpose.

Recent s177E Case

Merchant & Anor v FC of T [2024] FCA 498 in relation to whether a debt forgiveness constituted a dividend stripping scheme (on appeal by taxpayer)

Recent s177EA Case

BSKF and FCT [2024] AATA 3377 (said to be on appeal)

Recent s177J Case

PepsiCo Inc & Anor v FC of T [2024] FCAFC 86 (special leave granted to the Commissioner by the High Court)

It is noted that s177CB was relevant to this case.

Recent s207-150 Cases

B&F Investments Pty Ltd ATF Illuka Park Trust & Anor v FC of T ("the BBlood case") [2023] FCAFC 89 (not appealed)

FC of T v Michael John Hayes Trading Pty Ltd ATF MJH Trading Trust & Ors [2024] FCAFC 80 (remitted to AAT, special leave denied by High Court)

In an Arnold Block Leibler article set out more fully in the Appendix hereto, **"Part IVA - Taxpayer succeeds in Minerva appeal"**, Thomson Reuters Weekly Tax Bulletin 2024-012 (28 March 2024), referring to the Full Court decision, it was said:

> ***"Relevant principles***
>
> Relying on what the High Court said in *FCT v Hart* [2004] HCA 26; (2004) 217 CLR 216 (and other decisions), the Full Court reiterated a number of principles (at [60]-[65]), including:
>
> *"The inquiry required by Part IVA is an objective, not subjective inquiry: Hart at [37]."*
>
> *"The bare fact that a taxpayer pays less tax, if one form of transaction rather than another is made, does not demonstrate that Part IVA applies: Hart at [53]."*
>
> *"Simply to show that a taxpayer has obtained a tax benefit does not show that Part IVA applies: Hart [53]."*
>
> *"Part IVA does not apply merely because the Commissioner can identify another means of achieving the same or similar outcome which would have resulted in more tax being payable."*
>
> *"Statements about why the taxpayer acted as they did or about why a party to the transaction structured the transaction the way they did are not statements which are an answer to the question posed by s 177D(2). That section requires a conclusion about purpose to be drawn from the eight objective matters; it does not require or even permit any inquiry into the subjective motives of the taxpayer or others who entered into or carried out the scheme or any part of it: Hart at [65]."*

I would say in relation to these extracts from the Full Court, "Part IVA does not apply merely because the Commissioner can identify another means of achieving the same or similar outcome which would have resulted in more tax being payable", the underlining I have added is the key. I think there is an issue over this statement post the 2013 amendments if it didn't contain the word "merely". The Full Court in *Minerva* was not required to consider the effect of introduction of s177CB (as the taxpayer conceded they had received a "tax benefit"). The section reads as follows:

> **"177CB The bases for identifying tax benefits**
>
> (1) This section applies to deciding, under section 177C, whether any of the following (***tax effects***) would have occurred, or might reasonably be expected to have occurred, if a scheme had not been entered into or carried out:
>
> (a) an amount being included in the assessable income of the taxpayer;..

(2) A decision that a tax effect would have occurred if the scheme had not been entered into or carried out must be based on a postulate that comprises only the events or circumstances that actually happened or existed (other than those that form part of the scheme).

(3) A decision that a tax effect might reasonably be expected to have occurred if the scheme had not been entered into or carried out must be based on a postulate that is a reasonable alternative to entering into or carrying out the scheme.

(4) In determining for the purposes of subsection (3) whether a postulate is such a reasonable alternative:

(a) have particular regard to:

(i) the substance of the scheme; and

(ii) any result or consequence for the taxpayer that is or would be achieved by the scheme (other than a result in relation to the operation of this Act); but

(b) disregard any result in relation to the operation of this Act that would be achieved by the postulate for any person (whether or not a party to the scheme)." (underlining added)

I relation to the Arnold Bloch Leibler extract from the Full Court: "... s 177D(2). That section requires a conclusion about purpose to be drawn from the eight objective matters; it does not require <u>or even permit any inquiry into the subjective motives</u> of the taxpayer or others who entered into or carried out the scheme or any part of it: Hart at [65]" (underlining added), I have to say:

Looking at what the taxpayer considered as alternatives will surely inform what at least some of the alternative postulates might be. The background as to how the scheme was put in place ("foundational facts": see *Collie* FFC at [43]; *Grant* FFC at [62], [63], [65], [66]), will aways be relevant evidence of what was being sought to be achieved. It would be an enquiry in a vacuum to do otherwise. A taxpayer will always want to lead evidence as to the non-tax purposes of a transaction. *Contra*, a taxpayer with a tax avoidance subjective purpose would not be inclined to lead such evidence. That the Commissioner is always looking to go behind the taxpayer's legal professional privilege is because it will reveal the subjective intentions of the taxpayer. If Part IVA was entirely dependent on an objective analysis, he wouldn't need to know what the taxpayer's subjective intentions were.

PS LA 2005/24

Do the [2013] amendments require taxpayers to pay the highest possible amount of tax they could have incurred, had a scheme not been entered into or carried out?

91. No. Section 177CB says nothing to this effect.

92. In theory, the following scenario might arise. A scheme results in a certain commercial objective being met without incurring any tax liability. Absent the scheme, the same non-tax objective might have been met in two different ways: one resulting in a $100 tax liability and the other in a $200 tax liability. Assume that neither alternative would itself have attracted Part IVA, had it been carried out. Under the pre-amendment law, the question would be, as a matter of reasonable prediction, which of those two alternatives (if either of them) is it most reasonable to predict would have happened absent the scheme? The taxpayer would be entitled to suggest that the lower tax liability for the first alternative is a reason to expect that course would have been taken rather than the second. Other things being equal, a court may well have agreed with this.

93. Under the new law, the identification of a reasonable alternative to the scheme must be done disregarding these hypothetical tax effects. As between the two possible alternatives, it is not permissible to give weight to their relative tax costs.

94. In this somewhat theoretical scenario, section 177CB does not require the higher or the lower of the two hypothetical tax liabilities necessarily to be chosen. If the two truly were equally 'reasonable' by the lights of section 177CB, the law does not say which to choose. On the other hand, **it behoves the Commissioner to administer Part IVA (and indeed the whole of the tax law) with common sense and reasonableness**. Besides, the Commissioner's case under section 177D might well be more attractive to a court in practice if the lower of the two is the correct reference point. For the enquiry as to purpose under section 177D requires consideration of what other possibilities existed, **and the tax effects of the scheme are still relevant to that enquiry: paragraph 177D(2)(d).**

95. In any event, the Commissioner may choose to cancel only part of a tax benefit in appropriate cases. And, in the final analysis, the compensating adjustment mechanism in subsection 177F(3) remains available to ameliorate any unfair or unreasonable result: refer paragraphs 174 to 176." (underlining added)

Whilst Villios et al referred to PS LA 2005/24 in the paper **"My spidey sense is tingling-Navigating the Part IVA web"**, TTI Barossa Convention 7-9 August 2024, they did not refer to [94] thereof, nor that s177CB's first sentence, say it applies for the purpose of s177C. The authors are concerned that s177CB constrains the alternatives to be considered also for s177D, and not just to determine whether there is a "tax benefit" for the purpose of s177C:

"Another question not yet decided by the courts is whether Part IVA now requires two alternative postulates – one for the purposes of s 177C affected by s 177CB, and another for the purposes s 177D, unaffected by s 177CB. This overlooked issue, is not addressed directly in either *Minerva* or *Guardian*, and may prove to be a significant issue in future disputes. An analysis of this issue requires an exploration of the extent to which s 177C and s 177D have been read together.

"It has long been clear that s 177C requires a consideration of an alternative postulate. The view that s 177D's dominant purpose test requires a consideration of an alternative postulate(s) emerges first from the joint judgement of Gummow and Hayne JJ in *Hart*, where their honours stated "to draw a conclusion about purpose from the eight matters identified in s 177D(b) will require consideration of what other possibilities existed". In this paragraph, their honours appear to be reading s 177C and s 177D together. The Full Court in *British American Tobacco Australian Services Ltd v FCT* applied this statement, stating it was "usually required" under s

> 177D to compare the scheme with a "counterfactual" because this may reveal the scheme's purpose is "explicable only by taxation consequences". Despite occasional doubts about the "legislative foundation" of Gummow and Hayne JJ's statements, their honours comments have been consistently upheld. In *Minerva*, the Full Court noted also directly the passage from above. Further, *Minerva* appeared to apply this principle in its "conclusion on dominant purpose" by noting that the "commercial outcome (of the Commissioner's postulate) was different from the outcome obtained" and after noting in the same paragraph stating "s 177D factors are to be considered in light of the counterfactual or other possibilities". This raises an intriguing question – is the alternative postulate that assists the analysis of the eight factors in s 177D affected by s 177CB, especially s 177CB(4)(b)?
>
> "Two possibilities exist. Courts may adopt a "two alternative postulates approach", determining one for s 177C constrained by s 177CB, and a separate one for s 177D, unaffected by s 177CB. The trial judge in *Minerva* indirectly supports this view where O'Callaghan J, citing the Explanatory Memorandum, stated that the amendments were not intended to have other effects besides those his honour discussed. This approach risks undesirable implications, compelling the court to entertain evidence and arguments on two distinct postulates, increasing the time and cost for both the ATO and the taxpayer.
>
> "However, some practitioners raise an even more alarming consideration for the taxpayer – the same postulate, as determined for s 177D, applies for s 177C (the "one postulate approach"). This approach may be possible based on the established practice of reading s 177D and s 177C together.
>
> "Adopting the established practice of reading s 177D and s 177C together, the courts might hold that s 177CB affects both s 177C and, indirectly, s 177D. Section 177CB would therefore constrain, or at least significantly influence, the alternative counterfactual(s) that inform the analysis under s 177D. There is some support for this approach." (citations omitted)

When Villios et el say this question has not been considered directly, I do note that the Full Court in *Guardian* only referred to s177CB under the heading "Tax Benefit" (at [172]), and did not refer to it under the heading "Dominant Purpose". However, in considering various alternative postulates for "Dominant Purpose" the Full Court seems to have focused more on the commercial effect of them, rather than the tax effect of them, in rejecting those put forward by the taxpayer. Having said that, at [211] there is a general statement of principle, in relation to s177D(1)(e), rather than s177D(1)(d):

> "A consideration of this factor without taking into account the other possibilities that may have been open to the parties at the relevant time risks the analysis being artificial and sterile: *Macquarie* 210 FCR at 224 [211] (Middleton and Robertson JJ)."

This followed (Full Court in *Guardian*):

> "181.In considering the s 177D matters, it may be appropriate and necessary to have regard to the possibilities that existed outside of the scheme entered into or carried out. The various alternatives that were in fact considered may cast light on the conclusion to be drawn from the application of a particular s 177D matter: *Hart* 217 CLR at 244 [69] (Gummow and Hayne JJ); *Spotless Services* 186 CLR at 422 (Brennan CJ, Dawson, Toohey, Gaudron, Gummow and Kirby JJ); *Macquarie* 210 FCR at 223–4 [210]–[211] (Middleton and Robertson JJ)."

As to whether the Commissioner is restrained not to choose the maximum tax alternative, to which the above extract from PS LA 2005/24 is directed, Villios et al, in suggesting potential further reform, said:

> 'First, as has been argued elsewhere, the amount of "tax benefit" under s 177C should be capped to a "reasonable amount". Using *Futuris* as an example, the Commissioner should be precluded from arguing a tax benefit exceeding the commercial transaction's benefit. Relying on the Commissioner's discretionary powers to "cancel only part of a tax benefit" under s 177F of the ITAA 1936 leaves the taxpayer in a precarious situation. Indeed, in *Futuris*, the Commissioner not only asserted a tax benefit exceeding the proceeds from the IPO, but they even sought penalties. Accordingly, any "tax benefit" argued by the Commissioner should not be able to exceed the commercial benefits of the scheme or transactions.' (citations omitted)

I note that in *Mylan*, the Commissioner argued a reasonable alternative was to fund the acquirer entirely by equity, which would have not created any interest deduction. Again, in that alternative, he was going for the maximum tax outcome.

In introducing the 2013 amendments to Part IVA, the EM said:

> "1.16 As the High Court has confirmed on a number of occasions, Part IVA will apply to an arrangement if the particular form in which the arrangement is implemented evinces the requisite tax avoidance purpose (see Federal Commissioner of Taxation v Spotless (1996) 141 ALR 92 (Spotless) at 103 and 105, and Hart (2004) 206 ALR 207 at [16][52]and [94]).
>
> "1.17 More particularly, as Callinan J observed in Hart (2004) 206 ALR 207 at [94], 'an aspect of' the direction in Part IVA to consider the 'form and substance' of a scheme 'is whether the substance of the transaction (tax implications apart) could more conveniently, or commercially, or frugally have been achieved by a different transaction or form of transaction.'" (underlining added)

Some tentative comments on the recent Part IVA cases

Whilst the cases often say that complexity alone is not a Part IVA *indicia*, Callinan J's observation above is highly influential behind those denials. Using artificial structures such as dividend access shares; designed mismatches with trust and tax law income; designed mismatches with entities such as Div 6C trusts, must ring alarm bells. However, restructuring to avoid the commercial burden of Div 7A loans is apparently acceptable if achieved without artifice.

Merchant ("Billabong")

From the perspective of purely domestic arrangements, perhaps the *Merchant* case is most informative, even though it is on appeal to a Full Court. It confirms that a "wash sale" will be subject to s177D as the Commissioner warned years before in a Taxpayer Alert. It also highlights that debt forgiveness in a sale of company situation may be questioned when paying out the debt is the more commercially likely alternative. Also, the 2013 amendments to Part IVA (particularly s177CB) had the effect of the taxpayer conceding that they had received a "tax benefit" and only contesting the dominant purpose of the scheme. See Appendix p30 ff.

Guardian

The Full Court held that the taxpayer will lose on the onus of proof after the introduction of s177CB if they can't put forward a reasonable hypothetical to what they actually did. With respect, the Full Court's rejection of what most advisors

would have thought were reasonable hypothetical alternatives was not convincing. See Appendix p12 ff.

Minerva

Setting up a business structure years before is unlikely to be part of a Part IVA scheme. A trust's failure to exercise discretion to distribute income to other than default beneficiaries should not be subject to Part IVA according to the Full Court. I note that Hespe J was the only Justice in the Full Court in both *Guardian* and *Minerva*. See Appendix p33 ff.

Pepsi

Whilst the facts of the case are not likely to come up often, what is important is that the Full Court held that if there is no reasonable hypothetical alternative, to what they actually did, the taxpayer can satisfy the onus of proof, setting up a special leave application to the High Court due to the contrary *Guardian* case. See Appendix p23 ff.

Collie

The AAT held that the *Peabody* argument ((1994) 181 CLR 359), that the Commissioner has assessed the wrong taxpayer won't satisfy the onus unless the applicant can "definitely" show who would have got the income absent the scheme. At [57] the Full Federal Court said this was not consistent with authority. Nor was the AAT correct to consider it was bound by the decision in *Hart*, at [56]. The Full Court remitted the matter to the ART as taxpayer had lead evidence that he had loss entities available to deal with the income, and the AAT failed to deal with that evidence. See Appendix p16 ff.

Grant

The Full Federal Court said at [86] that the AAT should have admitted the expert evidence for the taxpayer of Mr Laxon (a former partner of EY). This is particularly interesting as a differently constituted Full Court found the trial judge in *Hart* was not in error in excluding the expert evidence for the taxpayer by Mr McNaulty (a partner of a well know Brisbane law firm), as being speculative: FFC at [70]-[71]. The Full Court in *Grant* said all expert evidence about what might have happened but for the scheme actually undertaken, may to a certain account, be speculative, but this does not exclude its consideration. Again, the Full Court found that the outcome was not bound by the decision in *Hart*, at [94], and that it was not necessary that the taxpayer show "definitely" who would have got the income, at [93]. See Appendix p19 ff.

Mylan

Contrary to PS LA 2005/24, the Commissioner will argue for a maximum tax reasonable hypothetical when he gets to court. Using a mixture of debt and equity

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to fund an acquisition is commercially expedient and taking it up to the "safe harbour" level is not itself an *indicia* of a dominant purpose of seeking to achieve a tax benefit. It is interesting that the Commissioner has not appealed to a Full Court. The use of promissory notes rather than cash was not of itself, a Part IVA problem. See Appendix p20 ff.

<u>Ierna ("City Beach")</u>

The Federal Court held that realising pre-CGT capital gains to fund the payout of Div 7A loans will not be subject to Part IVA. The commercial burden of the terms of Div 7A loans may necessitate a restructure. In this case it was done by a buy-back of pre-CGT shares but it could have been more simply done by a sale of those pre-CGT shares, meaning that the reasonable hypothesis was itself not a Part IVA scheme. See Appendix p38 ff.

<u>BSKF</u>

A complex scheme to use franking credits and artificially created (dubious) tax deductions so as to get a refund of those credits was subject to s177EA by the AAT. The arrangements were highly contrived, just like in *Collie* & *Grant*. See Appendix p41 ff.

<u>B&F Investments Pty Ltd ("BBlood")</u>

Another highly contrived case promoted to a client, involving the conscious mismatch of trust and tax law income, and a share buy-back creating a deemed dividend which was not ordinary income, and so not distributable for trust law purposes.

Whilst it was not necessary to decide the dividend stripping issue, as s100A applied, the Full Court said: "there is room to doubt whether a scheme can be in the nature of dividend stripping where the scheme involves a payment of a deemed dividend between a company and long-standing shareholder". The reference to a "long-standing shareholder" is important because such a shareholder could not be described as a "dividend stripper". See Appendix p43 ff.

<u>Michael John Hayes Trading</u>

The Full Court held that dividend stripping could potentially involve the dividend being loaned back to the operating company that paid the dividend, which is a surprise to orthodox thinking. However, the battleground, is still the dominant purpose of the arrangement. Asset protection needs to be demonstrated to be a dominant purpose. The presence of complex features such as Div 6C trusts deemed to be companies but not subject to Div 7A, and dividend access shares must be likely to trigger the Commissioner's interest in Part IVA. This complexity also occurred in another Cleary Hoare scheme in *D. Marks* [2016] FCAFC 86, where a limited partnership then deemed to be a company for purposes other Div 7A, and again, the use of dividend access shares. See Appendix 46 ff.

Guardian

I have previously commented (in 2023) on the *Guardian* decision in the Full Federal Court and the first instance decision of the Federal Court in Minerva:

https://www.robertgordontax.com/uploads/SOME_NOTES_ON_PART_IVA_22_03_23.pdf

In that article, I concluded:

> "One cannot help feel that after the Guardian appeal, Part IVA is a real threat to making trust distribution decisions (even where there is actual payment, not just creation of a UPE), based on the tax profile of the beneficiaries, unless there is a strong commercial purpose or personal need for the income by that beneficiary[30], although there is nothing "blatant, artificial or contrived" nor complexity, in a trust making actual distributions within a family group (as defined in the legislation).
>
> "After Minerva, a restructure to allow non-resident owners to obtain 10% interest withholding tax rather than 30% corporate tax rate is a real risk, even though if that structure was in place from day one (i.e. no antecedent transaction), the choice to set up a trust structure rather than a company structure would probably be unassailable.
>
> > 30 Especially since the Victorian Court of Appeal decision in the Owies case [2022] VSCA 142: see "Owies – is this the end of trustees' unfettered discretion", Sladen Legal website 10.08.22."
>
> After the *Minerva* appeal to the Full Court was allowed, I would still exercise caution about allocating income to a non-resident beneficiary, except in a case such as *Minerva*, where the "owner" of the whole structure was a non-resident, so it would be entirely natural for that owner to have the trust distribution made in their favour. Further, if the beneficiary to obtain the benefit is in any event, a default beneficiary, the non-exercise of a discretion becomes even less important. The allowing of the appeal in *Minerva* sits uncomfortably with the decision in *Guardian,* where, after all, Mr Springer was the ultimate "owner" of the structure, and at the relevant time, a non-resident.

See Appendix p12 ff.

<u>TD95/4</u>

Often a "restructure" will include a rollover. In this regard Taxation Determination TD 95/4 is important, as it seems that if the rollover company is to continue to "invest" after the rollover to it, the Commissioner's attitude is that it is not just being used to reduce the tax on an outright sale of the rolled over asset:

"Does the simple disposition of an income producing asset by a natural person to a wholly owned private company constitute the carrying out of a scheme to which Part IVA of the Income Tax Assessment Act 1936 will be applied?

1. No. Of itself, the simple disposition of an income producing asset by a natural person to a wholly owned private company is not an arrangement to which the Commissioner will seek to apply Part IVA...Examples are outlined below.

2. It should be noted however that where there are other associated transactions, transfers or arrangements, whether antecedent or subsequent, the disposition will be examined within that broader context, and it may be concluded that Part IVA... should be applied.

Example 1:

Geoff holds a significant portfolio of shares in a number of public companies. Most of these pay out fully franked dividends. Geoff disposes of his shares to a wholly owned private company which has been newly incorporated for that purpose. The intention is that the earnings from the shares will be retained in the company **until such time as it is considered appropriate to declare and pay a dividend to Geoff.**

Example 2:

Anna holds a rental property. The initial intention was that the property would be negatively geared. However, because of an unexpected reduction in interest rates a net profit is now being returned. Anna disposes of the property to a wholly owned private company which has been newly incorporated for that purpose. The intention is that the rental earnings from the property will be retained in the company **until such time as it is considered appropriate to declare and pay a dividend to Anna**.

Example 3:

Karl holds a parcel of shares in XYZ Pty Ltd which currently have an indexed cost base of $10,000, and a market value $15,000. The shares were acquired by Karl after 19 September 1985. Karl wishes to sell the shares to finance another investment, and prior to arranging the sale, he disposes of the shares to his wholly owned family company (or alternatively disposes of them to a wholly owned private company which has been newly incorporated for that purpose). The company sells the shares, retains the gain, and **makes the new investment**. The Commissioner will not seek to apply Part IVA to these facts alone.

However, if for example there were objective evidence of an antecedent arrangement to sell the shares, suggesting that the use a private company was no more than a **late contrivance** the dominant purpose of which was simply to reduce the level of tax on that sale, it is likely that Part IVA would be applied."

In the exception to Example 3, it must be assumed that the rollover company would not pay a dividend to "Karl" any time soon after the sale by the company? What if the rollover happened a year before the rollover company sold the shares?

It needs to be noted that the TD issued in 1995. After the general 50% CGT discount was introduced in 1999, even if the individual in Example 3 was on the top marginal

rate, and the corporate tax rate was 30%, it would only be if "Karl" held the shares for less than 12 months, that the company tax rate would be more attractive than the individual rate.

Another observation on the TD, is that the Commissioner seems comfortable in the ruling with the income from the rolled over asset continuing to be taxed at the company tax rate rather than the individual rate "until such time as it is considered appropriate to declare and pay a dividend". That is, tax deferral using rollovers to companies is available in those Examples.

I note that in *Guardian*, the Full Court thought the timing of the dividend to Mr S by AITSC after only months earlier, AITSC got the trust distribution, was particularly relevant to Part IVA applying.

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<u>APPENDIX</u>

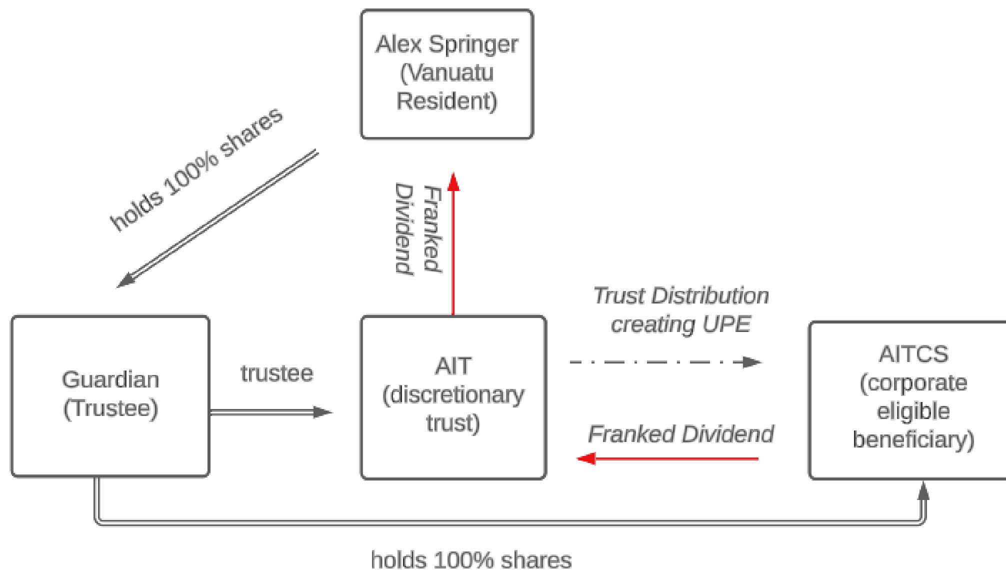
In what follows I have edited and annotated headnotes from reported cases to better explain what the cases really involved from the perspective of a tax advisor trying to understand the significance of the case for future planning purposes. I have also extracted some other commentaries.

<u>Recent s177D Cases</u>

FC of T v Guardian AIT Pty Ltd ATF Australian Investment Trust; FC of T v Springer

[2023] FCAFC 3

Before: Perry, Derrington and Hespe JJ.



Adapted from headnote in 2023 ATC ¶20-850:

> "In 2007 Mr S decided to transition to retirement. For that purpose he took up residence in Vanuatu. It was not part of the Commissioner's case, that going to Vanuatu (said by the headnote to be a known tax haven but this was not part of the judgement) was part of a Part IVA scheme.
>
> On 23 June 2013, Guardian appointed the income of AIT (other than franked dividends) for the 2013 year to AITCS and appointed the net income attributable to franked dividends to Mr S. Mr S's status as non-resident meant that he was not liable to any tax in respect of the trust distributions attributable to fully franked dividends derived by AIT (including the fully franked dividends AIT received from AITCS).
>
> Commissioner's position was that Guardian (as trustee) and Mr S had reached an understanding that AITCS would be incorporated for the purpose of being made presently entitled to the income of AIT, that Guardian would benefit from the amount to which AITCS was made presently entitled, and that Mr S would <u>ultimately</u> benefit from the amount to which AITCS was made presently entitled.
>
> The taxpayers argued before Logan J. that, for s 100A to have application, the reimbursement agreement must precede "the payment of money or the transfer of property to, or the provision of services or other benefits" and the present entitlement of the beneficiary. It was also argued that the Commissioner's counterfactual (that the trust income would have gone directly to Mr S instead of AITCS) would never have occurred. <u>It was submitted that the only 2 rational and reasonable counterfactuals as to what would have occurred were either that AITCS would have received and retained in full its UPE in cash, as it in fact did in respect of the 2014 UPE, or it would have invested it with Guardian in accordance with a Div 7A compliant loan agreement, as it did (tentatively) on 12 April 2013, before the dividend was paid in that income year.</u>

The Full Court held that for s 100A to be satisfied as at 23 June 2013 (which would result in Guardian (as trustee) being assessable under s99A, there had to be an arrangement or understanding between two or more parties that AITCS would pay a dividend to AIT. Thus even though the payment of a dividend by AITCS to AIT as at 23 June 2013 was not "wholly conjectural", there was no "agreement" as at that date within s 100A(13) that involved payment of that dividend. Therefore, there was no "reimbursement agreement" for the purposes of s 100A. (This conclusion made it unnecessary to consider the issues of purpose and the scope of the phrase "ordinary commercial or family dealing" in s100A.)

Assessments were also issued to Mr S on the basis that Pt IVA of ITAA 1936 applied, ie that the steps taken each year constituted a scheme within the meaning of s 177A(1). The Commissioner's position was that, if the primary scheme had not been entered into or carried out, Mr S would, or might reasonably be expected to, have included in his assessable income the amounts that were included in AITCS's assessable income from the trust distribution by AIT, but rather AIT would have made Mr S presently entitled to those amounts, pursuant to s 98A(1) of ITAA 1936. In addition to a primary scheme, the Commissioner also identified narrower schemes (the 2012, 2013 and 2014-related schemes) said to have served the same purpose. It was submitted that, but for the operation of Pt IVA, Mr S obtained a tax benefit within the meaning of s 177C(1) to the extent of the assessable income of AITCS for the relevant years not included in his assessable income, and that Pt IVA applied to negate the tax benefit obtained.

The Full Court held that 2012 and 2013-related schemes were each a scheme as defined in s 177A. <u>Absent the scheme, it could not reasonably be expected that AITCS would have received and retained in full its UPE in cash</u>. Such an alternate postulate was inconsistent with the concerns Mr S expressed to Pitcher Partners about leaving a large amount of funds in a bank account over which he had no control.

But what about a hypothetical that included Mr S also obtaining control over that bank account?

<u>Absent the scheme, it could not reasonably be expected that AITCS would have invested the funds representing its present entitlement with AIT in accordance with a Div 7A compliant loan agreement</u>, for three reasons:

First, the investment agreement in fact entered into in 2013 was to operate only <u>to the extent</u> that the Commissioner's views as expressed in PS LA 2010/14 would characterise any unpaid present entitlement of AITCS as a loan.

Second, the <u>commercial substance</u> of such an arrangement involving AITCS investing the funds representing its present entitlement with Guardian is quite different from the scheme carried out because, under that alterative arrangement, AITCS would retain an asset (in the form of its investment in Guardian) whereas, under the scheme, the asset is owned directly by Mr Springer. A prediction that has a different commercial outcome from the scheme entered into and carried out is not readily accepted as reliable.

I would comment that it would certainly be a different commercial outcome if Mr S had real asset protection concerns and so would not want the cash to come to him personally.

Third, the very <u>commercial outcome</u> which would result from an investment or loan agreement by AITCS was in fact rejected by Mr Springer when he proposed the payment of

a dividend by AITCS. The taxpayer's rejection of an alternative at the relevant time is important evidence in determining what would have occurred in the absence of the scheme.

I would ask, does a reasonable hypothetical cease to be so as it was rejected by the taxpayer. Any proposal other than the one that is implemented would usually be "rejected" by the taxpayer.

For Mr S 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. Mr S had not satisfied that onus. Accordingly, he obtained a **tax benefit** in 2012 and 2013 in the form of the non-inclusion of an amount in his assessable income in those years.

The conclusion in relation to the existence of a tax benefit in respect of the 2013-related scheme was further supported by s 177CB(4). By reason of s 177CB(4)(b), it was not open to the primary judge to have regard to the higher Australian income tax cost that would have applied had the income been distributed directly to Mr S in determining what might reasonably be expected to have happened had the 2013-related scheme not been entered into or carried out. Mr S received a tax benefit in the 2013 year on the basis that, in the absence of the scheme, it might reasonably be expected that Mr S would have been made presently entitled to the net income of AIT attributable to unfranked income.

The dividend that was declared and paid by AITCS out of its 2012 AIT trust distribution was entirely referable to objective circumstances that came to exist after the creation of its present entitlement. There was nothing in the way in which the chronology of events unfolded in relation to the 2012 AITCS UPE that would support a conclusion that the dominant purpose of any party to those steps carried out the scheme for the dominant purpose of enabling Mr S to obtain a tax benefit in the 2012 year.

At the time that the 2013 AIT trust income was appointed to AITCS, the objective circumstances were quite different. The form of the 2013-related scheme was not the product of an evolving set of circumstances but the implementation of a strategy that had been developed with the evolution and implementation of the 2012-related scheme. The manner in which the 2013-related scheme was entered into and carried out supported a conclusion that Mr S, Guardian or AITCS entered into or carried out that scheme for the dominant purpose of enabling Mr S to obtain a tax benefit (ie the benefit of the unfranked income of AIT derived by it at a tax cost limited to the corporate tax rate).

A comparison of the form and substance of the 2012 and 2013-related schemes, as well as the change in financial position of Mr S that resulted from the schemes, also supported a conclusion that a party carrying out the schemes did so for the dominant purpose of enabling Mr S to obtain a tax benefit. The form of the schemes involved making AITCS presently entitled to net income of AIT. However, the substance of the schemes was that Mr S would enjoy direct ownership and control of the value of that present entitlement (after AITCS paid its resulting tax liability) within a few months of AITCS becoming so presently entitled. The outcome achieved by the schemes was the direct enrichment of Mr S. His financial position was improved by receiving a distribution in the form of franked income rather than a direct distribution of unfranked income.

Having regard to all the matters in s 177D, Pt IVA applied to enable the Commissioner to make a determination to include an amount in Mr S's assessable income for the 2013 year."

Whereas the Court needs to rely on facts as found by the AAT, a Full Court can go behind the findings of fact by a trial judge, in relation to documentary evidence (Full Court in *Guardian* at [105]). The findings of fact may be insufficient to identify reasonable hypotheticals. At trial, Logan J did not make a finding of fact that Mr S would not pay any tax in Vanuatu. He must have been relying on common knowledge. The Full Court seems to have assumed the same.

Nor did Logan J. make findings about who controlled AITCS's bank account, or why Mr S did not control it, or whether he could have taken control of it. As a reasonable hypothesis was that he could have taken control of it might have been open, but as there are no finding of facts on this issue, this caused a problem for the taxpayer's case. The Full Court makes a lot of the lack of reasonably hypothetical that AITCS may have kept the cash, but AITSC did that in the 2016 tax year (Logan J at [118]) and there was no finding of fact of why it could hold the cash in 2016 but not earlier e.g. did control of the bank account change by 2016?. More curious still is the Full Court looked at the evidence to conclude that as at 28 June 2012, Mr S had expressed no discomfort with AITCS hold cash in its bank account (Full Court at [189]), but at [160] says he had expressed discomfort with AITCS holding a lot of cash at bank, and at [190] that Mr S expressed discomfort only after AITCS became presently entitled in the 2012 tax year. All of this without making a finding of fact as to who controlled AITCS's bank account at the relevant times, or whether this could have changed. My surmise is that whoever was the director of AITCS at the relevant time was a signatory to its bank account. This would have been Mr S's son Eric and later, Mr Schafferman.

Testing the soundness of the reasoning in *Guardian*, it is worthwhile to consider, if Mr S had not lived in a known tax haven, surely it would have been necessary to identify how much tax Mr S would have paid on a fully franked or unfranked dividend. If a case comes up with the same factual pattern but the principal lives in a country with some tax liability, surely this must affect the s177D analysis of dominant purpose to avoid Australian tax and so require a finding of fact. (I note the unlegislated May 2023 Budget announcement that Part IVA is to be amended to overcome an argument that the dominant purpose of a scheme is to avoid foreign tax, and so the dominant purpose can't be to avoid Australian tax). If the foreign tax liability equalled the Australian tax avoided, could the dominant purpose of the taxpayer be to avoid the Australian tax? There must be a non-Australian tax reason or indeed no tax reason why this has happened – perhaps the taxpayer just wanted the money and tax wasn't the issue.

Often the pattern of distributions from a trust will be relevant. Logan J found that from the time AIT was formed in 1998 till just before the 2012 tax year, companies in the Springer Group got distributions on a need arising basis (at [94]). The Full Court went behind that and referred to evidence of Mr S's sons Eric and Richard getting some distributions as well. However, there was no pattern of Mr S getting distributions before Mr S becoming a non-resident in 2007.If he had always received distributions before 2007, surely it is less likely that he had a dominant purpose of avoiding Australian tax by getting distributions thereafter?

Collie v FC of T (No 2)

[2024] FCAFC 172

Before: O'Callaghan, McEvoy and Needham JJ.

Adapted from headnote to 2024 ATC ¶20-940:

The taxpayer was a solicitor who, in October 1993, became a director of a company established by Michael Hart and the then partners of the legal firm Cleary Hoare. In 2002 he became a principal of Cleary Hoare Practice Trust (CHPT), which had taken over the Cleary Hoare practice in 1993.

The taxpayer was issued income tax assessments for the 1997 to 2001 years in respect of the taxable income of trusts that derived income from consulting services promoting tax minimisation and avoidance structures. The trusts were established between 1994 and 2000 by the CHPT principals, the taxpayer and Hart to facilitate a scheme that filtered income through a sequence of trusts to a company that had available current or carried forward losses or to a tax-exempt entity, and through that company or entity to other entities. Ultimately the money representing the trust income, less commissions paid for the use of accumulated company losses or other shelter, was filtered back to entities connected with the Cleary Hoare principals and the taxpayer. Corresponding penalty assessments were issued that imposed penalties at the rate of 50%.

The taxpayer objected to all assessments then sought review by the AAT of the Commissioner's decision to disallow his objections. The disputed assessments involved similar facts and circumstances dealt with by the Full Federal Court in *Hart* v *FC of T* 2018 ATC ¶20-653. The AAT proceedings (commenced in 2010) were put on hold pending the outcome in *Hart* and only reactivated once the High Court refused the taxpayer's application for special leave to appeal from the full court decision in 2018. As with the *Hart* decision, the disputed assessments here involved consideration of:

- how the consulting trusts' business profits were moved through a complex scheme without any tax burden being borne ultimately to those involved in those businesses and/or their related or connected entities, and
- who should pay tax on the taxable income referable to those profits and distributions.

Primarily in issue before the AAT was whether the taxpayer had assessable amounts in respect of the trusts' taxable income for the 1997 and later years pursuant to Pt IVA of ITAA 1936 and whether the penalty rate of 50% was appropriate. The taxpayer's case was essentially that, for asset protection reasons, he did not derive any of the disputed income, he was not entitled to any trust income, and Pt IVA did not apply to him. He claimed that, due to litigation he was involved in during the 1990s with the ATO, Australian Securities Commission and ANZ Bank, he was exposed to a significant risk of adverse outcomes both as to results and costs, which influenced his thinking as to the various arrangements the subject of these proceedings.

The taxpayer claimed that he had good reason not to own any assets or earn any income personally and had taken steps to ensure he did not derive or otherwise become responsible for any assessable or taxable income of any trust through the substantive provisions of s 25(1) of ITAA 1936 (or s 6-5 of ITAA 1997), or s 97 of ITAA 1936. Those steps involved a system of arranging for distributions by trust entities that did not have any pattern of distribution, so that it could not be predicated who, apart from the actual recipient or beneficiary, would have been such a recipient or beneficiary. The taxpayer contended this meant there was no relevant tax benefit within the meaning of s 177C of ITAA 1936 as it stood at the time. The subsidiary Pt IVA rebuttal argument advanced was that the dominant purposes of the schemes identified were not to enable the taxpayer to have the tax benefit contended for.

At first instance the AAT set the objection decisions aside and remitted them to be remade in accordance with its reasons. The AAT considered that, in circumstances where profits of an enterprise sheltered from tax through a scheme were profits from an enterprise relying on the

taxpayer's acumen and knowledge, it was not unreasonable to expect that some or all of that profit would have come back to the taxpayer. The taxpayer had not definitively shown that a different taxpayer would have included the relevant amounts in their assessable income. It could be predicted with sufficient reliability to meet the reasonable expectation threshold that an architect of the scheme would be a recipient of the taxable income representing the business profits apart from the scheme having been entered into or carried out. However, the Commissioner's calculation of the tax benefits was flawed in regard to the inclusion of interest.

The AAT rejected the taxpayer's argument that the dominant purpose of the scheme was to secure or further asset protection strategies. It said there could be concurrent commercial and tax avoidance purposes associated with the scheme; the relevant question was which one was dominant. Here a blatant, artificial and contrived means was designed and executed to ensure that amounts having their origins in the consulting services businesses were not taxable in the hands of anybody in the relevant years. The contrivance associated with the steps in the scheme revealed a dominant purpose of tax avoidance or securing the tax benefit (being the trust taxable income not being included in the taxpayer's assessable income) as opposed to asset protection. The Pt IVA determinations were confirmed subject to the amount of the tax benefit being restated. The AAT also concluded that the penalty set at the 50% rate was appropriate.

From that decision the taxpayer appealed to the Full Federal Court, primarily on the grounds that the AAT:

- failed to comply with s 43(2B) of the *Administrative Appeals Tribunal Act 1975* (AAT Act) by not making reference to relevant evidence in respect of its findings in relation to material questions of fact and thereby not providing proper reasons
- made material findings of fact not based on any rational evidence, and
- failed to have regard to relevant material and submissions that were put by the taxpayer.

Held: appeal allowed; matter remitted to the Administrative Review Tribunal for rehearing of the question whether the taxpayer obtained a tax benefit in each relevant year of income.

1. The AAT failed to comply with s 43(2B) of the AAT Act. There was a wholesale failure of the AAT to have regard to material evidence, to weigh in the balance competing submissions, and to provide adequate reasons for any of its conclusions. The question posited by s 177C(1)(a) was a critical issue in dispute before the AAT. It was incumbent on the AAT to ask and answer what would have or might reasonably be expected to have occurred if the scheme had not been entered into by reference to the competing evidence and submissions that were before it. The AAT did neither.

2. The AAT was also wrong to consider itself bound by the decision of the full court in *Hart*. It was axiomatic that each case was to be decided on its facts and, on any view, the facts in the taxpayer's case were not the same — or anywhere near the same — as in *Hart*.

3. The AAT's assertion that it was necessary for the taxpayer definitively to show that a different taxpayer would have included the relevant amounts in their assessable income was obviously wrong. That was not what the section said and nothing in *Hart*, or any other case, supported that proposition."

At first instance, the AAT had said:

85. In his witness statement, the appellant asserted that he would not have taken any action which might have given rise to any entitlement on his part to a share of income produced by the Practice Trust. This was speculation and rightly ruled inadmissible by the primary judge [in Hart]. As the Full Court observed in RCI at [134]:

> [A taxpayer]...may, for example, lead evidence that the taxpayer would have undertaken a particular activity, or adopted a particular course, in lieu of the scheme; or it may lead evidence that the taxpayer would not have undertaken a particular activity, or adopted a particular course, in lieu of the scheme: see, for example, *Commissioner of Taxation v News Australia Holdings Pty Ltd* [2010] FCAFC 78. Generally, such evidence is unlikely to be sufficient to discharge the onus unless it is supported by objective indicia to be gleaned from the context and matrix of underlying or 'foundation' facts, as they have been called (see *McCutcheon v Federal Commissioner of Taxation* [2008] FCA 318; (2008) 168 FCR 149 a [37-[39] per Greenwood J) as well as the logic of the taxpayer's counterfactual having regard to the commercial or financial aspirations and limitations of the parties to the scheme; without such support, such evidence is likely to be regarded as no more than purely speculative.

110. … 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. It is useful to see whether the contended for asset protection objectives (and therefore purposes) could be achieved by other means. Clearly, they could have been achieved without the number of trusts and paper distributions involved in the scheme which produce the tax benefit." (underlining added)

These comments were also relevant in the associated case of *Grant*.

Grant v FC of T (No 2)

[2024] FCAFC 173

Before: O'Callaghan, McEvoy and Needham JJ.

Adapted from headnote to 2024 ATC ¶20-939:

Held: appeal allowed; matter remitted to Administrative Review Tribunal for rehearing of (1) whether taxpayer had assessable amounts in respect of CHPT taxable income for 1997 to 2002 tax years pursuant to Pt IVA, and (2) whether taxpayer had assessment amounts in respect of IET taxable income for the 1997 to 2000 tax years pursuant to Pt IVA.

1. The AAT failed to comply with s 43(2B) of the AAT Act. There was a wholesale failure of the AAT to have regard to material evidence, to weigh in the balance competing submissions, and to provide adequate reasons for any of its conclusions. In particular, it was plainly insufficient in the face of the submissions made by the taxpayer about evidence given by an experienced accountant for the AAT to first recognise that the evidence was supportive of the taxpayer's case and then reject it because it was "not assisted by it". Nor was it open to the AAT to dismiss out of hand, as "a speculative contention", the taxpayer's evidence about how he managed his affairs after 2004. His evidence on this was not "wholly irrelevant" and it had to be considered, not brushed aside without explanation. Further, the AAT's finding that the conducting of the IET business involved his "acumen and knowledge" made no mention of, let alone gave proper consideration to, the taxpayer's evidence that he had no role to play in that business and that, given that he did not contribute to its profit-making activities, it was most unlikely that the persons who did would share it with him.

2. The AAT was also wrong to find that *Hart* decided that it was necessary for a taxpayer "definitively" to show that a different taxpayer would have included the relevant amounts in their assessable income. That was not what the case said, and was not what s 177C(1)(a) contemplated.

3. The AAT was also wrong to consider itself bound by the decision of the full court in *Hart*. Its conclusion that the taxpayer's case did not involve any material difference to *Hart* was a proposition that did not emerge from any finding of fact made by the AAT. More fundamentally, the AAT never posed, let alone answered, the question posited by s 177C. It was incumbent on the AAT to ask and answer that question with reference to the competing evidence and submissions, but it did neither." (underlining added)

Mylan Australia Holding Pty Ltd v FC of T

[2024] FCA 253

Before Button J.

Adapted from the headnote to 2024 ATC ¶20-900:

The taxpayer (MAHPL) was the head company of a tax consolidated group, which included Mylan Australia Pty Ltd (MAPL). MAHPL was the immediate parent company of MAPL. The ultimate holding company of MAPL and MAHPL was Mylan Inc (a US company), which was the head of the Mylan group of companies.

MAPL acquired all of the shares in Alphapharm Pty Ltd in October 2007. Alphapharm was one of the operating subsidiaries of Merck KgaA which, together with its related entities, carried on a global generics pharmaceutical business (Merck Generics). Merck Generics was acquired by members of the Mylan group in October 2007 for USD7 billion.

These proceedings concerned the application of s 177D to the funding arrangements associated with MAPL's acquisition of the shares in Alphapharm. In short, MAPL was funded with a mix of interest-bearing debt and equity at a 3:1 ratio. The debt component was constituted by an intercompany promissory note (PN A2) issued by MAPL to Mylan Luxembourg 1 S.a.r.l. (Lux 1). By determinations issued under s 177F the Commissioner disallowed MAHPL's deductions for interest expenses under PN A2 and consequential carry forward losses.

In applying Pt IVA, the Commissioner identified a wider scheme (also referred to as the primary scheme), and a narrower scheme (also referred to as the secondary and tertiary schemes). The Commissioner considered that the entry into the wider scheme (which included the incorporation of the local Australian holding company structure (MAPL and MAHPL)) generated a tax benefit, being all the interest deductions on PN A2 (and on a promissory note entered into in 2014, ie PN A4).

The Commissioner's view was that, had the wider scheme not been pursued, the shares in Alphapharm would not have been separately acquired through a local Australian holding company structure. Rather, Alphapharm would have remained a subsidiary of the Netherlands company, Merck Generics Group B.V. (MGGBV) and would have become part of the Mylan group with the acquisition of MGGBV. In this scenario (described as the primary counterfactual), MAPL would not have acquired the shares in Alphapharm and would not have incurred interest expenses under PN A2. On this primary counterfactual, MAPL would not have incurred any debt, therefore there would have been nothing to refinance and PN A4 would not have come into existence.

MAHPL relied on the following two counterfactuals to the wider and narrower schemes:

- • Counterfactual A — that MAPL might be expected to have funded the acquisition of Alphapharm using 25% equity injected by its parent and 75% debt borrowed from Mylan (or a US subsidiary, rather than Lux 1) on the same, or similar, terms as those set out in PN A2
- • Counterfactual B — that MAPL might be expected to have funded the acquisition of Alphapharm using 25% equity injected by its parent and 75% debt borrowed from an external lender or lenders.

In relation to whether MAHPL had the dominant purpose of obtaining a tax benefit, the Commissioner claimed that Mylan's failure to cause MAPL to refinance (or renegotiate its interest obligation on PN A2) when economic circumstances changed, indicated that the scheme was carried out in a manner so as to maximise MAPL's interest outgoings. To this MAHPL responded that:

- a failure to renegotiate the interest rate was a matter of commercial judgment that was not the concern of Pt IVA
- MAPL had no unilateral power of amendment under PN A2, and
- as a failure to refinance is an event that never occurred, the failure to refinance can have no relevance to "manner" under s 177D(b)(i).

MAHPL submitted that the manner in which the acquisition was structured was appropriate and commercially expedient as it provided a flexible and straightforward means of repatriating cash from Australia. It also contended that there would not be a "tax benefit" for the purposes of s 177C(1) unless, *at the time the scheme was entered into*, its proponents could foresee that the course they were embarking on would be more advantageous from a tax perspective than an alternate course. MAHPL contended that the reference in s 177C(1)(b) to whether a deduction (or part of a deduction) "might reasonably be expected" not to have been allowable meant that the "expectation" must be assessed at the time of entry into the scheme.

Held: appeal allowed.

1. The Commissioner's primary counterfactual did not constitute a prediction of the events that might have taken place (had the primary scheme not been entered into) that was sufficiently reliable such that it could be regarded as reasonable. First, the primary counterfactual would inflexibly have tied up funds equivalent to the purchase price of Alphapharm as equity when debt was significantly more flexible than equity and a mix of debt and equity was generally the preferred means of funding subsidiaries. Secondly, Mylan's overall foreign loss position in the US was such that it would have been unable to claim any foreign tax credits for income taxes paid in Australia, exposing it to an effective worldwide tax rate of 65% on Australian-generated earnings. That effect was so extreme as to be intolerable.

2. The distinguishing characteristic of the primary counterfactual was the proposition that the acquisition of Alphapharm would be 100% equity funded. As a 100% equity funded acquisition was not a sufficiently reliable prediction of what would, or might reasonably be expected to, have occurred, there would be no utility in considering whether a variation of the primary counterfactual might be devised. Given that the 100% equity funding assumption was the basis of the proposition that no debt funding would have occurred in Australia at all, and hence there would have been no interest deductions in Australia, MAHPL had discharged its onus of showing that it did not receive a tax benefit calculated by reference to the primary counterfactual.

3. In coming up with a "preferred counterfactual", the facts that would have (or might reasonably be expected to have) occurred in the absence of a scheme were closest to MAHPL's counterfactual B and the Commissioner's tertiary counterfactual. Although MAHPL did not obtain a tax benefit in connection with the primary scheme that could be calculated by reference to the primary counterfactual, it did obtain a tax benefit, being the difference between the deductions it in fact claimed for interest expenses incurred by MAPL and the deductions that MAHPL would have, or might reasonably be expected to have, claimed had it proceeded according to the preferred counterfactual put forward by the court.

4. There was no basis on which it could be concluded that the preferred counterfactual was itself a Pt IVA scheme. The fundamental features of the counterfactual involved an Australian holding company subsidiary being established to acquire a valuable business (Alphapharm) for cash and borrowing from external lenders to do so. The fact that the borrowing that MAPL would have taken out correlated with Australia's thin capitalisation ratio was not, of itself, a factor that rendered the preferred counterfactual a Pt IVA scheme.

5. Section 177C(1)(b) did not require that, in order for there to be a tax benefit, the specific advantage gained through entry into the scheme — which was objectively determined at a later point in time — be anticipated and expected at the time of entry into the scheme. In referring to reasonable expectation, s 177C(1) directed attention to the qualitative likelihood of the prediction put forward as a counterfactual.

6. MAHPL's response to criticism of Mylan's failure to refinance did not hold water. A matter was not insulated from, and put beyond the reach of consideration under, Pt IVA simply because it was a "commercial judgment". Further, while MAPL did not have a unilateral right of amendment under PN A2, it was able to pay out the note early if it obtained finance from elsewhere and could have at least sought to renegotiate the rate on the note. The claim that the examination of "manner" in relation to a scheme could not include considering steps that could have been but were not taken was also to be rejected. MAPL's failure to refinance PN A2 to take advantage of lower interest rates, or to use declining interest rates as an occasion on which to renegotiate the interest rate attached to PN A2, tended to support the existence of the requisite dominant purpose in relation to how the scheme was carried out.

7. Having regard to all 8 matters in s 177D(b), it could not be concluded that Mylan or any other entity who entered into or carried out the schemes or any part of the schemes did so for the purpose of enabling MAHPL to obtain a tax benefit in connection with the schemes. Only one matter supported a contrary conclusion: the failure to refinance PN A2 or otherwise revisit the interest rate paid on PN A2. The other matters addressed were neutral or pointed to purposes other than obtaining a tax benefit in connection with the schemes. MAHPL had discharged its onus in relation to the dominant purpose enquiry of s 177D and thus established that the assessments issued to it were excessive.

8. As Pt IVA did not apply to the interest deductions, it followed that the carry forward losses should not have been disallowed.

At [418], her Honour refers to Part IVA being introduced to deal with "blatant artificial and contrived" schemes.

The insertion of MAPL under the head company MAHPL, for MAPL to acquire the Alphaphama Austco apparently had no particular tax purpose, and was not like the insertion of the holding company in

Consolidated Press Holdings, to overcome s79D, nor like the artificial creation of a consolidated group to acquire another consolidated group to get a tax base uplift.

PepsiCo Inc & Anor v FC of T

[2024] FCAFC 86

Before Perry, Jackman & Colvin JJ

This was an appeal from a decision of the Federal Court (Moshinsky J.)

It is necessary to point out that the Diverted Profits Tax (DPT) in s177J of Part IVA only applies to Significant Global Entities (SGEs). It applies at the rate of 40% rather than at the marginal rate applicable to the taxpayer under s177D or 177E. Its operation is not constrained by double tax agreements due to Part IVA being “carved out” by s4(2) of the International Agreements Act. Also, to have application in requires the foreign tax rate to be less than 80% of the Australian tax rate on the income and the scheme in question needs to have a foreign associate of an Australian taxpayer as a party. As well as a “penalty” rate of tax, the ordinary rates of penalties for intentional disregard, recklessness, and lack of reasonable care are all doubled for SGEs

Note that under the DPT, it applies if the ‘principal purpose or more than one principal purpose’ is to achieve a tax benefit, which threshold is lower than the ‘sole or dominant purpose threshold’, which is used in subsection 177D. That a foreign tax benefit may also be achieved by the scheme does not prevent its application.

The Commissioner’s position was that the payments for beverage concentrate contained a component of royalty subject to royalty withholding tax, at the rate of 5% under the US / Australia double tax agreement. Alternatively, the Commissioner sought to rely on the DPT. Clearly, the taxpayers would be better off to be subject to royalty withholding tax rather the DPT.

The disputes related to the 2018 and 2019 tax years and so s177CB introduced in 2013 was relevant.

My overall impression from the DPT perspective was that his expert evidence did not conclude what part of the payment for the concentrate was referrable to the licence to use the IP, which left the conclusion that nothing was paid for the IP, and in fact, the only payments were to the provider of the concentrate, rather than the taxpayer.

Section 177H (1) specifies:

> “The primary objects of the DPT provisions are:
>
> “(a) to ensure that the Australian tax payable by significant global entities properly reflects the **economic substance of the activities** that those entities carry on in Australia; and
>
> “(b) to prevent those entities from reducing the amount of Australian tax they pay by diverting profits offshore through **contrived arrangements** between related parties.”

This is particularly interesting as the words “blatant, artificial or <u>contrived</u>” didn’t make their way into the original Part IVA provisions whilst they were used in the EM and the Treasurer’s second reading speech.

It is noteworthy that the Commissioner didn't raise an alternative s177D case. In this regard the following is also interesting from the EM introducing the DPT:

> "1.18…Although the DPT is not a provision of last resort, consistent with the operation of Part IVA, it is expected that the DPT will be applied only in very limited circumstances. It is intended that the Commissioner would apply the DPT only after he or she has given consideration to the operation of the ordinary provisions in the income tax law."

It is not possible to describe the case relating only to the DPT components.

Adapted from the headnote to 2024 ATC ¶20-918:

The taxpayers, PepsiCo Inc and Stokely-Van Camp Inc (SVC) were United States companies. At all relevant times the PepsiCo group of companies operated a global beverage business. PepsiCo was the owner of a world-wide portfolio of trademarks, designs and other rights and assets relating to the Pepsi and Mountain Dew brands. SVC was the owner of a world-wide portfolio of trademarks, designs and other rights and assets relating to the Gatorade brand.

The taxpayers (collectively "PepsiCo/SVC") entered into either an Exclusive Bottling Appointment or an Exclusive Bottling Agreement ("the EBAs") with Schweppes Australia Pty Ltd ("the bottler") in relation to the Australian market. Under the EBAs:

- PepsiCo or SVC agreed to sell beverage concentrate to the bottler, which was to be mixed by the bottler with other ingredients in accordance with formulas, specifications and other information provided by the PepsiCo group to produce finished beverages for retail sale in Australia, and
- PepsiCo or SVC granted the bottler the right to use in Australia trademarks and other intellectual property to enable the bottler to manufacture, bottle, sell and distribute the finished beverages in branded PepsiCo group packaging.

The EBAs provided for the bottler to pay for the concentrate but did not expressly provide for the payment of a royalty for the right to use intellectual property. It was common ground that, although the PepsiCo EBA did not expressly licence the bottler to use the relevant trademarks and other intellectual property, it contained an implied licence to that effect and could not have operated otherwise. The SVC EBA contained an express "royalty-free" licence of the intellectual property.

The arrangements entered into between the parties included that CMSPL (a member of the PepsiCo group incorporated in Singapore) produced concentrate according to a highly secret recipe or formula provided by PepsiCo and SVC. CMSPL supplied the concentrate to PBS (a member of the PepsiCo group that was incorporated in Australia). PBS, which was nominated as the "seller" by PepsiCo and SVC under the relevant EBA, supplied concentrate to the bottler and invoiced the bottler for the concentrate that had been supplied. The bottler paid PBS for the concentrate in accordance with those invoices, and PBS transferred almost all money received from the bottler to CMSPL, retaining only a small margin.

The Commissioner issued PepsiCo/SVC with royalty withholding tax notices (calculated at a rate of 5% of the royalties) and diverted profits tax assessments (calculated at a rate of 40% of the royalties) in respect of the years of income ended 30 June 2018 and 2019. The taxpayers challenged those assessments before the Federal Court, where the Commissioner's primary contention was that they were each liable for royalty withholding tax pursuant to s 128B of ITAA 1936 and Art 12 of the

Convention between the United States of America and Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion (US DTA). The Commissioner's alternative contention was that the diverted profits tax provisions of Pt IVA of ITAA 1936 applied.

The key issues to be determined in relation to royalty withholding tax were:

- whether the payments made by the bottler under the EBAs were, to any extent, consideration for the use of, or the right to use, the items set out in para (4)(a) and (b) of Art 12 of the US DTA and the items set out in para (a) to (d) of the definition of "royalty" in s 6(1) of ITAA 1936
- if so, whether the relevant portions of the payments were income derived by either taxpayer for the purposes of s 128B(2B)(a) and amounts to which they were beneficially entitled for the purposes of Art 12 of the US DTA, and
- if so, whether the relevant portions of the payments were paid, or taken to have been paid, to either taxpayer for the purposes of s 128B(2B)(b)(i) as affected by s 128A(2).

The key issues to be determined in relation to diverted profits tax were whether: (i) either taxpayer obtained a tax benefit in connection with the scheme for the purposes of s 177J(1)(a) of ITAA 1936, and (ii) it would be concluded, having regard to the matters in s 177J(2), that the scheme was entered into or carried out for a principal purpose of enabling the relevant taxpayer (or others) to obtain a tax benefit and to reduce any of the taxpayer's liabilities to tax under a foreign law in connection with the scheme.

The Commissioner's alleged scheme in relation to diverted profits tax was the entry into the relevant EBA on terms whereby no royalty was paid for the use of intellectual property, technical knowledge and/or assistance. It was contended that, had the relevant scheme not been entered into or carried out, the alternative postulates were either:

- the relevant EBA would or might reasonably be expected to have expressed the payments to be made by the bottler to be for **all of the property provided by (and promises made by)** the PepsiCo group entities (rather than for concentrate only), or
- the relevant EBA would or might reasonably be expected to have expressly provided for the payments to be made by the bottler to include a **royalty** for the use of, or the right to use, the relevant trademarks and other intellectual property (whether or not the amount of the royalty was specified).

Consequently, a royalty would or might reasonably be expected to have been paid by the bottler to the relevant taxpayer, or to another entity on their behalf or as they directed.

The taxpayers contended that the Commissioner's postulates were not reasonable alternatives for the purposes of s 177CB(3) of ITAA 1936, with the consequence that there was no tax benefit for the purposes of s 177C(1)(bc). It was submitted that the postulates represented a departure from the substance of the schemes (s 177CB(4)(a)(i)) and did not achieve the same commercial results or consequences as the schemes (s 177CB(4)(a)(ii)).

At first instance the Federal Court rejected the challenge by PepsiCo/SVC to the imposition of royalty withholding tax (and, in the alternative, to diverted profits tax) in respect of the EBAs and found in favour of the Commissioner.

According to Moshinsky J, it was apparent from the terms of the EBAs that the payments were, to some extent, consideration for the use of, or the right to use, the relevant trademarks and other intellectual property. It was significant, he said, that the parties to the EBAs were PepsiCo/SVC; the seller of the concentrate was not. In each case, the licence of the trademarks and other intellectual property was fundamental to the agreement. The payments made by the bottler were, to an extent, consideration for the use of, or the right to use, the items set out in para (4)(a) and (b) of Art 12 of the US DTA and the items set out in the definition of "royalty" in s 6(1).

The primary judge found that PepsiCo/SVC were entitled to receive the payments made by the bottler under the EBAs. This followed as a matter of contract from the fact that they were the parties to the EBAs and the bottler's payment obligations under the EBAs were owed to them. PepsiCo/SVC's nomination of PBS to be the seller of the concentrate under the EBAs for the relevant years constituted a direction to the bottler to pay PBS rather than PepsiCo or SVC (as applicable).

In these circumstances, the relevant portions of those payments "came home" to PepsiCo/SVC by being applied as they directed. They were therefore income derived by PepsiCo/SVC for the purposes of s 128B(2B)(a) and amounts to which they were beneficially entitled for the purposes of Art 12 of the US DTA. The relevant portions were also deemed to have been paid by the bottler to PepsiCo/SVC for the purposes of s 128B(2B)(b)(i) by virtue of s 128A(2). It followed that the payments made by the bottler under the EBAs in the relevant years were, to an extent, "royalties" and PepsiCo/SVC were liable to pay royalty withholding tax at the rate of 5% on those royalties.

In *obiter dicta*, Moshinsky J went on to state that, if the royalty withholding tax provisions did not apply, the diverted profits tax provisions did. Having regard to the matters in s 177J(2), it would be concluded that one of the principal purposes of each taxpayer in entering into or carrying out the relevant scheme was to obtain a tax benefit (namely not being liable to pay Australian royalty withholding tax) and to reduce foreign tax (namely, US tax on their income). The terms of the EBAs were said to be contrived, in that payments that were ostensibly for concentrate alone were in substance for both concentrate and the licence of valuable intellectual property.

From that decision the taxpayers appealed to the Full Federal Court, while the Commissioner cross-appealed in relation to the diverted profits tax issue (which technically was dismissed once the Commissioner succeeded on the royalty withholding tax issue). The cross-appeals were predicated on the success of the taxpayers' appeals.

In relation to whether the payments made by the bottler to the seller were in part "consideration for" the right to use intellectual property (so that they were a royalty) the Commissioner submitted that the EBAs should not be construed in accordance with their ordinary language (ie that what was to be paid was a price being paid for the concentrate and therefore "as consideration for" the sale of the concentrate) but rather should be seen as including a component for the price for the concentrate together with a component for the bottler's contractual entitlement to use the relevant trademarks and other intellectual property. It was pointed out that the EBAs did not stipulate that the price was being paid only in consideration for the concentrate, and it was unlikely that PepsiCo/SVC were giving away something so valuable for nothing.

In relation to whether the payments were income derived by PepsiCo/SVC, the Commissioner submitted that the moneys had been paid to PepsiCo/SVC because there had been a payment by direction.

In respect of the application of Pt IVA, the Commissioner sought to rely only on the second limb of s 177C(1)(bc), ie what "might reasonably be expected to have happened but for the scheme". This required the court to assess the commercial and economic substance of the scheme and the commercial and economic substance of each postulate put forward and then reach a conclusion as to whether they corresponded.

Held: taxpayers' appeals allowed; by majority (Colvin J dissenting) Commissioner's cross-appeals dismissed.

Per Perram and Jackman JJ:

1. The payments made by the bottler to the seller were for concentrate alone and did not include any component that was a royalty for the use of PepsiCo/SVC's intellectual property. The payments were in no part made in "consideration for" the use of that intellectual property and they did not therefore include a "royalty" within the definition of that term in s 6(1).

2. The Commissioner's submission that the licence to the bottler for the use of the trademarks and other intellectual property was otherwise being granted for nothing was to be rejected. It proceeded on the overly simplistic assumption that the grant of the licence right to the bottler was only of benefit to the bottler. In fact, it was also a benefit to PepsiCo/SVC. The licence did not operate as an assignment of the goodwill from PepsiCo/SVC to the bottler. On the contrary, the goodwill at all times remained with PepsiCo/SVC. PepsiCo/SVC obtained the benefit of having their goodwill sustained and enhanced and the bottler obtained the benefit of being able to exploit PepsiCo/SVC's goodwill to its own advantage.

3. There was nothing in the Commissioner's submission that the sale clauses of the EBAs did not specify that the price paid was the consideration for the purchase of the concentrate. Since it was not shown that the licences in this case were given in exchange for nil value there was no occasion to embark on an exercise of contractual interpretation. It followed that, on their proper construction, the EBAs fixed a price for future sales of concentrate alone that did not include a component for the licence to use trademarks and other intellectual property. The consideration for the purchase of the concentrate was the price the parties stipulated for such in the EBAs.

4. Obiter. It was well-established that a direction by a creditor to a debtor to pay a third party constituted a payment to the creditor. However, there could be no payment by direction unless there was an antecedent monetary obligation owed by the bottler to PepsiCo/SVC. PepsiCo/SVC had neither possession of nor title to the concentrate and did not deliver the concentrate either actually or constructively. There was no sale of concentrate by PepsiCo/SVC, and the bottler was not obliged to pay them for something they were not selling. It followed that the EBAs did not give rise to any monetary obligation on the part of the bottler to PepsiCo/SVC to pay them for the sale of concentrate by the seller. The payments were received by the seller on its own account; the amounts were not paid to PepsiCo/SVC. The payments could not constitute "income derived" by PepsiCo/SVC within the meaning of s 128B(2B)(a).

5. The Commissioner's contention that the commercial and economic substance of the scheme was that the amount of money paid by the bottler was for the concentrate and for the licence granted to the bottler to use the trademarks and other intellectual property was to be rejected. Neither the scheme advanced by the Commissioner nor any of the evidence provided material from which it could be inferred that the commercial and economic substance of the scheme was that the concentrate price included a royalty for the licence of the intellectual property. The commercial and

economic substance of the scheme was that the price agreed for concentrate was for concentrate, which was quite different from both the first and second postulates put forward by the Commissioner.

6. If the scheme included elements from which it could be inferred as a matter of commercial and economic substance that the payments for concentrate included a royalty then it might well be that, in the absence of the scheme, PepsiCo/SVC would have sought to recoup the value of that royalty. However, where the scheme did not permit the conclusion that the concentrate price included a royalty, this conclusion was not reasonably open. Thus neither postulate was a reasonable alternative to the scheme for the purposes of s 177CB(3).

7. As there were no other reasonable postulates in addition to those put forward by the Commissioner, the taxpayers had discharged their burden under s 14ZZO(b)(i) of the Taxation Administration Act 1953. PepsiCo/SVC did not obtain a tax benefit "in connection with a scheme" for the purposes of s 177J(1)(a). On the evidence before the court and the terms of the scheme advanced by the Commissioner, PepsiCo/SVC had demonstrated that the payments for concentrate were not to be brought to tax under s 177P(1) and (2)(a).

8. Obiter. Having regard to the matters to be taken into account in assessing whether the scheme was entered into for the purpose of obtaining a tax benefit, and on the highly artificial assumption that the price of concentrate included a royalty, it could be concluded that the requisite purpose under s 177J(1)(b)(i) had been established. Had the Commissioner's postulates been shown to be reasonable alternatives to the scheme, it would be concluded that s 177J(1)(b)(i) was engaged.

Per Colvin J (dissenting on the DPT):

1. Regard to the whole of the terms of the EBAs revealed that the EBAs were not properly characterised as agreements for the supply of concentrate needed to make beverages. They were agreements to bottle, sell and distribute branded products. If the amount required to be paid under the EBAs was for the concentrate alone then the right to distribute the branded products was being afforded without any part of the monetary consideration being attributable to the licence to use the valuable brands of PepsiCo/SVC. That was a commercially unreasonable view of the terms of the EBAs considered as a whole. It followed that the amounts provided for by the EBAs as the prices for units of concentrate were partly amounts in consideration for the use of the trademarks that the bottler was licensed to use.

2. The amounts paid by the bottler to the related entity (ie seller) were not "owed" to PepsiCo or SVC. The payments made by the bottler and received by the related entity did not result in the derivation of income by PepsiCo or SVC. It followed that the taxpayers had demonstrated that the primary judge was in error in concluding that the terms of s 128B(2B) were met.

3. The diverted profits tax appeal should be upheld on the basis of the conclusions reached above to the effect that the EBAs provided for the payment of amounts that were, in part, consideration for the use of the trademarks. The mechanism by which the related entity could be nominated as the seller (and be the party to whom payment would be made) meant there was no income in the form of a royalty that could be the subject of a withholding tax liability on the part of PepsiCo or SVC (as the case may be). That postulate was consistent with the second alternative put forward by the Commissioner. In accordance with the analysis undertaken by the majority as to purpose (on the basis of the assumption that the EBAs provided for payments that were, in part, consideration for

the use of the trademarks), it was to be concluded that the scheme was entered into for the purpose of obtaining a tax benefit." (underlining added)

In a Corrs Chambers Westgarth article in Thomson Reuters "Weekly Tax Bulletin" **Commissioner orders one last round in PepsiCo - delving into the grounds of appeal**" no 34 published 20 August 2024, it was said:

Summary of key takeaways

In the High Court special leave application, The Commissioner has also contended that the majority judgment of the Full Court, and the approach taken to determining the construction of the 'tax benefit' criteria of Part IVA of the ITAA 1936, is directly inconsistent with recent decisions of the Full Federal Court in *FCT v Guardian AIT Pty Ltd ATF Australian Investment Trust* (2023)115 ATR 316 (**Guardian**) and *RCI Pty Ltd v FCT* (2011) 84 ATR 785 (**RCI**).

In the view of the Commissioner, a number of high value tax disputes will be impacted by the special leave application and requested resolution of the associated issues, with every anti-avoidance case affected by a High Court determination and resolution of the perceived inconsistencies in relevant Full Federal Court Part IVA authorities - the critical question being whether a taxpayer can discharge its onus where no postulate that is a reasonable alternative to the scheme has been identified.

Issue 2 - Diverted Profits Tax
Special leave question 2:

Can a taxpayer discharge its onus of proving that an assessment under Part IVA of the ITAA 1936 is excessive where the taxpayer does not establish any postulate that is a reasonable alternative to entering into or carrying out the scheme (and the other criteria for the application of the DPT are otherwise satisfied)?

The Commissioner's DPT contention in the special leave application relates to the Commissioner's alternative argument, namely that if no royalty was paid by Schweppes under the Agreements on which royalty withholding tax was payable by PepsiCo and SVC, then PepsiCo and SVC obtained a DPT tax benefit under Part IVA of the ITAA 1936.

The majority judgment of the Full Court placed large emphasis on considering the concepts of 'scheme' and the determination of a reasonable alternative postulate for the purposes of Part IVA, within the context of the conclusions drawn from the specific factual and evidentiary circumstances associated with the PepsiCo and SVC arrangements. In particular, the absence of any evidence showing that the value of the intellectual property licences granted to Schweppes under the Agreements was being recovered through the concentrate price, was an important factor to the majority in their reasoning and was noted on a number of occasions.

As contended by the Commissioner, the error made by the majority of the Full Court in relation to this aspect, and in particular the conclusions drawn by the majority in respect of the interpretation of the Agreements entered into by PepsiCo and SVC with Schweppes, and the determination of the consideration payable for the transfer of property under the Agreements, "infected" their reasoning in relation to the alternative DPT arguments.

Importantly, the Commissioner contends that the focus placed by the majority of the Full Court on the Commissioner's' lack of evidence' resulted in an inverting of the onus of proof required to be discharged by PepsiCo and SVC for the purposes of Part IVA. Rather than demonstrating and "satisfying the Court of what might reasonably be expected to have occurred in the absence of [a] scheme" (with the Commissioner specifically referencing the decision of Hespe J of the Full Federal Court in Guardian in this regard), the Commissioner contends that in the view of the majority of the Full Court, this onus was characterised and limited to PepsiCo and SVC showing that there was "no postulate which [was] a reasonable alternative to the scheme".

In the view of the Commissioner, the position taken by the majority of the Full Court in PepsiCo directly contradicts earlier judgments of the Full Federal Court and the approach to onus, as endorsed in RCI and Guardian.

Concluding observations

Specifically in the context of the amendments made to Part IVA in 2013 which saw the introduction of s 177CB of the ITAA 1936, the Commissioner notes in the special leave application that these provisions have not previously been considered by the High Court.

In particular, the Commissioner draws attention to the perceived division between decisions of the Full Federal Court as to whether a taxpayer can discharge its burden in a Part IVA case where they fail to advance any reasonable alternative postulate, noting that more is required under Part IVA than merely showing the Commissioner's counterfactual was unreasonable, and concluding that the High Court's "determination of the onus point will affect every anti-avoidance (Part IVA) case".

Whether Part IVA mandates the identification of an alternative postulate is a fundamental question which has remained unanswered since the amendments to Part IVA in 2013. The heart of the amendments was to ensure that the 'might reasonably be expected to have' ('reconstruction') limb is based on a postulate that is a reasonable alternative to the scheme, having particular regard to the substance of the scheme and its effect for the taxpayer, but disregarding any potential Australian income tax costs - in effect, eradicating the 'do nothing' argument.

However, PespiCo raises the question, *what if there is no reasonable alternative to the scheme?* Or framed in the circumstances of PepsiCo, *how might it reasonably be expected that PepsiCo / SVC and Schweppes would have contracted on a basis that included a royalty payment for the licence of intellectual property, when no part of the actual concentrate price included a royalty for the licence of intellectual property?* In our view, the counterfactual must still be 'reasonable', so this opens up the possibility that such a counterfactual may not exist. The Commissioner's alternative postulates address this issue, but also give rise to a significant point of difference as between the majority and minority judgments of the Full Court.

In arriving at a conclusion as to whether an alternative postulate is reasonable, s 177CB(4) of the ITAA 1936 mandates that regard must be had to the substance of the scheme and any non-tax outcomes for the taxpayer. In practice, this requires:

First, the identification of the financial or other non-tax consequences for the taxpayer that would be accomplished or achieved as an end result of the scheme having been entered into and carried out for the taxpayer; and

Second, an evaluation of whether the alternative postulate is capable of fulfilling these commercial / non-tax objectives of the transaction." (underlining added)

I note that the High Court has indeed recently granted special leave on 7 November 2024, simply saying: "Special leave to appeal is granted" without elaboration.

Merchant & Anor v FC of T ("Billabong case")

[2024] FCA 498

Before: Thawley J.

In September 2014 the Merchant Family Trust (MFT) sold high-cost base shares in Billabong (ASX listed) to the Merchant Super Fund (MSF), crystallising a capital loss of over $56M. By a share sale agreement in March 2015, MFT sold all its shares in Plantic to an unrelated entity. In April 2015, as a condition precedent to the completion of the agreement, loans made by 3 Merchant Group entities (two companies owned by Mr Merchant and a trust), to Plantic of $55 million, were forgiven under a deed.

The forgiveness of the debts boosted the value of Plantic, which increased the capital gain on the sale of its shares which was intended by the scheme to be partly protected by the loss on the Billabong share sale. MFT's capital gain on the sale of its shares in Plantic was around $85M.

The Commissioner applied s177D to the Billabong share sale that gave rise to the capital loss, on the basis that the dominant purpose of that sale was to crystalize the capital losses so as to shield the gain on the sale of Plantic, and that <u>there was no "economic loss" to the Merchant group on the Billabong share sale</u>. Accordingly, that loss was not available to shield the capital gain on the sale of Plantic, and Mr Merchant was the beneficiary of MFT's revised net income.

He also applied s177E to the <u>forgiveness of the debts</u> by two of the three Merchant Group entities, being companies (GSM $50M and Tironui $4.215M) as being schemes having substantially the effect of a scheme by way of or <u>in the nature of dividend stripping, and on the basis Mr Merchant would have ultimately received the accumulated profits of those companies as dividends</u>; and he included the amount of those forgiven debts in Mr Merchant's assessable income as unfranked dividends under s177F (rather than as a capital gain subject to a 50% CGT discount, as would have occurred under the scheme).

Adapted from the headnote to 2024 ATC ¶20-918:

> There was no dispute that the Billabong share sale was a scheme for the purposes of s 177A(1), that the scheme resulted in a tax benefit for the purposes of 177CB(2), and that Mr Merchant was properly assessed to 100% of the net income of MFT. The primary issue in the s 177D proceeding was whether it would be concluded under s177D(1) that a person who entered into or carried out the Billabong share sale scheme did so for the dominant purpose of obtaining the tax benefit that resulted. The taxpayers argued that the sale of the Billabong shares to MSF "freed up" the super fund's cash to MFT, but this was held only to a minor purpose.
>
> Section 177E did not require a complete, or a substantially complete, avoidance of tax to apply. <u>Section 177E was capable of applying where the tax avoidance purpose was to avoid the higher tax that would have been payable on dividends</u>, albeit a lower amount of tax was still payable as a result of the scheme. It was clear that the objective purpose of the loan forgiveness was to permit the amounts forgiven to be accessed in a way in which substantially less tax would be paid than if those amounts were repaid to GSM and Tironui and received by Mr Merchant by way of dividends
>
> A dividend stripping scheme did not cease to be one simply because the purchaser of the shares did not have a tax avoidance motive or was indifferent. It was not necessary for every party who played a role in a scheme that had the effect of a scheme in the nature of dividend stripping to be involved in "careful planning" or to act "in concert" with the others. The more important issue was the purpose of the person who received the dividend.
>
> The taxpayers had not established that the debt forgiveness was not motivated predominantly because of the tax benefit it would deliver and so they had not discharged the onus of proving that the broader scheme did not have substantially the effect of a scheme by way of or in the nature of dividend stripping.

I note that Mr Merchant is suing EY for negligence over his tax liability: *Merchant & Ors v Ernst & Young (a firm) & Anor* [2023] QSC 259 (15 November 2023). The Commissioner had years before the transactions

the subject of the case, issued a Taxpayer Alert TA 2008/7 concerning “wash sales”. The Commissioner also considered that the arrangement of Mr Merchant’s superannuation fund purchasing listed shares from his family trust to crystallise capital losses in the family trust to offset an upcoming large capital gain in the trust contravened the *Superannuation Industry (Supervision) Act 1993* (SISA). However, the AAT determined that a risk of future non-compliance by Mr Merchant was unlikely and he should not be disqualified from being director/trustee of his super fund: *Merchant v FC of T* [2024] AATA 1102.

The application of s177D to the “wash sale” in *Merchant* was predictable, but the application of s177E is somewhat surprising without any finding of fact as to any past dividend policies of GSM and Tironui. I surmise that GSM was a corporate beneficiary of MFT due to its large accumulated profits, and if so, it was unlikely to pay dividends as a matter of course as Mr Merchant was the shareholder in GSM. I surmise that the whole point of the corporate beneficiary is to avoid Mr Merchant receiving even fully franked dividends, at least not in the foreseeable future.

I also note that in the *Michael John Hayes Trading* case, the Full Court seemed to be confident that beneficiaries might be able to find a way to avoid tax in the future, in discounting the Tribunal’s conclusion that tax would invariably be paid sometime in the future.

Whilst the obtaining of a tax benefit is defined in s177A(1)(a) so as to include the deferral of tax from a year of income, if the deferral is longer term than short term, this must tend against a dominant purpose of tax avoidance if there are commercial purposes served by the structure that allows deferral. After all, the decision to derive income through a corporate structure that provides limited liability, cannot be predicated on the basis of avoidance of tax by the deferral of any “top-up” liability which might be occasioned by the payment of a dividend. People close to retirement often defer the receipt of dividends from companies they own, until they have no other income.

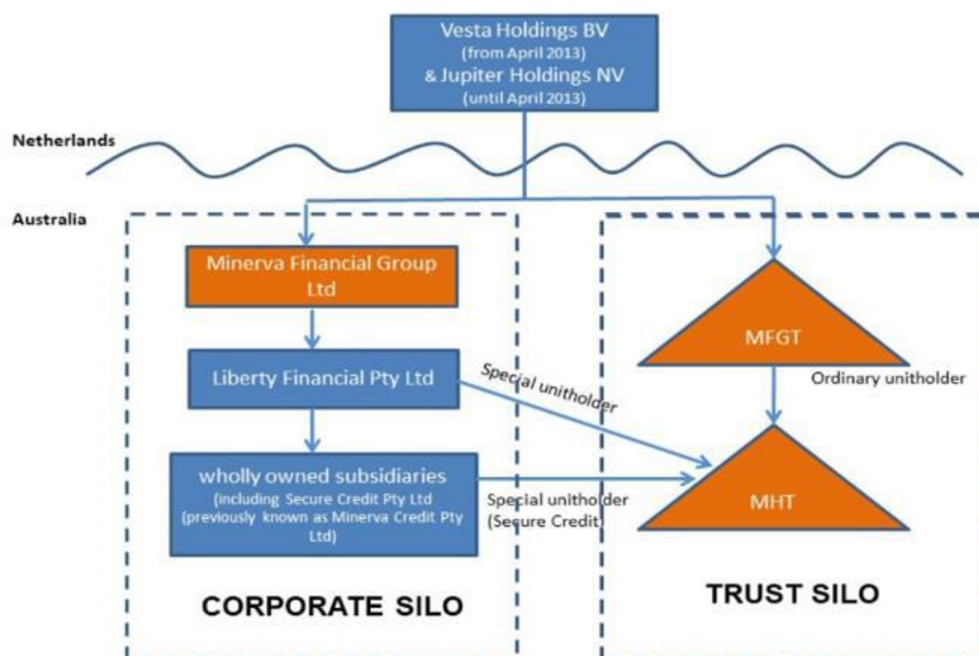
Thawley J. in *Merchant* made highly relevant comments on the Commissioner’s Part IVA preference for narrow schemes:

> “470.` The Commissioner submitted that his identification of the scheme as consisting solely of the debt forgiveness was permissible. This was said to follow from the decision of Jessup J in *Lawrence FC*. The Commissioner’s position was presumably adopted in an attempt to secure the forensic advantage of focussing solely on the debt forgiveness when examining the dominant purpose of the scheme.
>
> 471. The forensic advantage comes about because various elements of the transaction as a whole have a clear commercial purpose, whereas the debt forgiveness viewed in isolation provides the Commissioner a stronger case. This is a tactic commonly employed by the Commissioner with respect to the general anti-avoidance provision: the more narrowly one can define the scheme, the more likely one can force a conclusion that the dominant purpose was one of obtaining the tax benefit. The tactic does not readily translate to s 177E which does not turn on an identification of a “tax benefit”, or a purpose of obtaining a “tax benefit”. Section 177E (a specific anti-avoidance provision) is structurally very different from the general anti-avoidance provisions in Part IVA. Section 177E(1) turns on identification of a scheme which falls within s 177E(1)(a) as a dividend stripping scheme or one of that nature or of that effect. One cannot – as the Commissioner sought to do in this case – select one component of what is in fact the scheme and argue that the other components are not part of the scheme but must be considered as part of the context which must be taken into account in assessing the single component of the scheme. No doubt that would provide a forensic advantage when it comes to assessing dominant purpose, but it would be an unfair one and inconsistent with the terms of s 177E.

472. The applicants' criticisms of the Commissioner's position on this issue are good ones. The debt forgiveness, viewed in isolation, is not a dividend stripping scheme. Nor, viewed in isolation, is it either a scheme in the nature of or having substantially the effect of a dividend stripping scheme. The debt forgiveness as a scheme is a scheme to forgive debts and nothing more. Contrary to the Commissioner's submissions, the point was not addressed in *Lawrence FC*. It does not follow from the decision in *Lawrence FC* that, in the present context, the single step of forgiving debts could be substantially in the nature of a dividend stripping scheme."

An issue not explored in *Merchant* was the company law aspects of companies forgiving debts which were worth their face value i.e. were the director(s) acting the companies' best interests (s180 Corporations Act 2001). In the *Binnetter* litigation, the directors of companies who caused companies they controlled to be involved in tax avoidance/evasion, were found to have breached their directors' duties and were therefore, personally liable for the companies' debts: *BCI Finances Pty Limited (in liq) v Binetter (No 4)* [2016] FCA 1351.

Thomson Reuters "Weekly Tax Bulletin" [201] Part IVA - Taxpayer succeeds in Minerva appeal



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ARTICLE
by Paul Sokolowski, Partner, and Mark Macrae, Senior Associate - Arnold Bloch Leibler*

On 8 March 2024, the Federal Court handed down its decision in *Minerva Financial Group Pty Ltd v FCT* [2024] FCAFC28.

In a unanimous judgment, that Court (comprising Besanko, Colvin, and Hespe JJ) allowed the taxpayer's appeal from the decision of O'Callaghan J. The Court held, in the circumstances, that choosing not to exercise a discretion to distribute income to the holders of special units in a unit trust was not a scheme to which Pt IVA of the ITAA 1936 applied.

Background

The taxpayer was the head entity of a corporate group ("MF Group"), the members of which carried on a financial services business. Broadly, as a "non-bank" provider of financial services, the MF Group obtained capital through the process of securitisation, which involves the pooling of loan receivables and related

securities (typically mortgages) into special-purpose securitisation trusts which in turn issued notes to investors to finance the MF Group's lending activities.

The trustee of the securitisation trusts issued units to a related entity in the form of a residual income unit (RIU) and a residual capital unit. Relevantly, the holder of the RIU was entitled to receive the balance of the interest income of the securitisation trust remaining after interest was paid to the noteholders (and other expenses paid).

A corporate subsidiary of the taxpayer ("LF") was the main operating company within the MF Group, providing services and loans to other members of the MF Group and performed a treasury and cash management function. It was also the provider of subordinated debt to the securitisation trusts. Prior to 2007 it was the holder of RIUs in the securitisation trusts. Distributions received by LF from the securitisation trusts were the principal source of LF's gross income for the 2004 to 2007 income years.

The issues in dispute had their genesis in a pre-IPO reorganisation undertaken in 2007 and 2008, when the MF Group reorganised itself into what the primary judge described as a "trust silo" and a "corporate silo". The reorganisation was undertaken on advice over many years that the optimal way to go to market was to offer stapled securities consisting of a share in the taxpayer, which would hold the group's active assets, and a unit in a trust ("MFGT") which would hold the group's passive financial assets. Units in the securitisation trusts were to be held by Minerva Holding Trust ("MHT"); MHT was to issue ordinary units to MFGT and a discretionary special unit ("Special Unit") to LF and another subsidiary in the "corporate silo" ("SC"). While the IPO was postponed due to market conditions and other concerns during the GFC, the reorganisation proceeded and from 2008 the RIUs in the securitisation trusts were owned by MHT within the "trust silo". The RIUs of pre-2008 securitisation trusts continued to be held by LF within the "corporate silo".

The reorganisation was not the only change to the way in which the finance business was conducted within the MF group. As the Full Court found (at [28]), the very considerable growth in the business required new sources of funding to be secured. In consequence, the role of LF changed. LF was remunerated by the payment of management and administration fees for the services that it was providing in relation to the securitisation trusts and other aspects of the business, including in conducting its role as central treasury.
Under MHT's constitution: (a) the trustee had a power to determine, at its sole discretion, to distribute all or any proportion of the income of MHT (called "Special Distributions") to the holders of Special Units (ie LF and SC); and (b) the holder of ordinary units (ie, MFGT) was entitled to all of MHT's income not distributed to the Special Unit holders. In the 2012 year, the trustee of MHT did not exercise the discretion to make Special Distributions to the Special Unitholders, and MFGT was entitled to and was paid all of MHT's distributable income. In the 2013 to 2015 years, the trustee of MHT exercised the discretion to make Special Distributions of nominal amounts to the Special Unit holders and MFGT was entitled to and was paid the bulk of MHT's distributable income.

Although LF did not receive Special Distributions from MHT in the relevant years, it continued to derive income from the securitisation trusts settled prior to April 2008, management fees from related entities (including MHT) and interest on subordinated loans it made to the securitisation trusts and on other intercompany receivables.

Under MFGT's constitution, MFGT's unit holder ("Parent", a non-resident of Australia) was entitled to all of the income of MFGT. In each of the relevant years, all of MFGT's distributable income was distributed and paid to the Parent, on which withholding tax of 10% was with withheld and paid to the ATO.

The decision at first instance

The schemes and tax benefits

The Commissioner made Pt IVA determinations and issued amended assessments to the taxpayer on the basis that the taxpayer, as the head entity of a consolidated group, had received tax benefits in the 2012 to 2015 years in connection with 3 alternative schemes, each being progressively narrower.

The first scheme

The first scheme related to the establishment of the "trust silo" and with MHT being nominated as the RIU holder in new securitisation trusts ("Scheme 1"). The asserted "tax benefit" for the taxpayer under Scheme 1 was all the residual income from new securitisation trusts established from 2008.

The second scheme

The second scheme advanced by the Commissioner comprised 3 steps: (1) the transfer of units in MFGT to the Parent;(2) the non-exercise by the trustee of MHT of its discretion to distribute income to LF and SC; and (3) MHT lending funds to LF in the "corporate silo" ("via interest free, unwritten loans") and not satisfying the present entitlements to MHT's and MFGT's income "by the payment of cash" ("Scheme 2").

The asserted "tax benefit" for the taxpayer under Scheme 2 was all the net income of MHT (being, essentially, the residual income from new securitisation trusts established from 2008 less expenses of MHT, which included fees paid to LF).

The third scheme

The third scheme related to the "failure" by the trustee of MHT to distribute any more than nominal amounts of income to LF and SC. This scheme comprised the second and third steps of Scheme 2 ("Scheme 3"). The asserted tax benefit was the same as for Scheme 2.

Outcome at first instance

The existence of a "scheme" and a "tax benefit" were not issues in dispute. The proceedings before the primary judge turned on whether, based on the 8 factors set out in s 177D of the ITAA 1936, a reasonable person would conclude that a party entering into or carrying out any part of the scheme (in this case, the taxpayer) did so for the dominant purpose of enabling the taxpayer to obtain a tax benefit.

In *Minerva Financial Group Pty Ltd v FCT* [2022] FCA 1092, the primary judge held that Pt IVA did not apply, and found for the taxpayer, in relation to Scheme 1. Having regard to each of the 8 s 177D factors, his Honour concluded (at [556]) that a reasonable person would not conclude that the taxpayer entered into or carried out Scheme 1 for the dominant purpose of enabling it to obtain a tax benefit in connection with the scheme.

However, the primary judge held that Pt IVA did apply, and found against the taxpayer in relation, to Schemes 2 and 3. In so finding, the primary judge was of the view (at [498]) that the "true gist" of these 2 schemes was the MHT trustee's *"failure to exercise its discretion to distribute, or to distribute more, to MHT's special unitholders"* (ie LF and SC). In relation to Scheme 2, the primary judge separately considered the 2 parts of that scheme, holding that the first part (comprising only step 1 of that scheme) was not suggestive of a dominant purpose to obtain a tax benefit. As to the second part of Scheme 2 (comprising the second and third steps of that scheme), the primary judge considered that there was no evidence from the taxpayer as to the commercial reasons why only nominal amounts of income were distributed from MHT to the special unitholders in the relevant years (at [563]-[564]). The primary judge concluded that the first factor (manner in which the scheme was entered into and carried out) and third factor (the time at which the scheme was entered into and the length of the period during which the scheme was carried out) supported a conclusion that the taxpayer entered into or carried out Scheme 2 for the dominant purpose of enabling it to obtain a tax benefit.

The primary judge concluded that the second factor (form and substance) did not support a conclusion that the taxpayer entered into Scheme 2 for the dominant purpose of obtaining a tax benefit. The remaining s 177D factors were considered by the primary judge to be neutral in relation to Scheme 2.
For similar reasons, the primary judge held that Pt IVA applied to Scheme 3 (at [592]).

The taxpayer's successful appeal to the Full Court

The taxpayer appealed the decision at first instance, contending that his Honour erred in concluding that Schemes 2 and 3 were schemes to which Pt IVA applied, and he ought to have found, having regard to the 8 matters set out in s177D, that the non-exercise by the trustee of MHT of a discretion to distribute income to the special unitholders *"did not attract the operation of Part IVA"*.

The Commissioner did not appeal the primary judge's conclusion that Pt IVA did not apply to Scheme 1. In particular, as the Full Court noted (at [49]), the Commissioner did not seek to impugn the reorganisation of the MF Group into a "trust silo" and a "corporate silo". Rather, the Commissioner relied on Schemes 2 and 3, and also advanced a fourth scheme during oral submissions which consisted only of the non-exercise of the discretion of the trustee of MHT to make Special Distributions to the holders of the Special Units (Scheme 4). Further, by notice of contention, the Commissioner argued that the judgment of the primary judge should have been affirmed on 2 grounds other than those relied upon by his Honour.

Relevant principles

[Set out earlier]

Dominant purpose

The Full Court noted (at [67]) that the difficulty in the primary judge's reasoning on Schemes 2 and 3 was the reliance on the failure to proffer a "commercial reason" why the trustee of MHT did not distribute all or most of its income to the "corporate silo". The Full Court observed (at [68]) that a search for a party's "subjective purpose" or "motive" for entering into or carrying out a transaction was not what s 177D called for. The exercise was to identify purpose by an objective assessment of objective facts; testimony of a person as to their reasons for taking a particular action or step does not address this question.

After observing (at [69]) that the "essence" of each of the alternative Schemes 2, 3 and 4 *"was the same, focussing on the exercise of the appellant's discretion as trustee of MHT to make distributions"*, the Full Court analysed each of the matters set out in s 177D.

First factor - manner in which the scheme was entered into or carried out

The Full Court held (at [70]) that the manner in which the trustee of MHT came to exercise its powers of distribution did not support the conclusion that any party entered into or carried out any of the schemes for the dominant purpose of enabling the taxpayer to obtain a tax benefit. The Full Court said (at [76]) that the "objective facts" were that LF/SC as holders of the Special Units had no entitlement to the income of MHT absent the exercise of the trustee's discretion; the "default position" was that income would be distributed to MFGT as the ordinary unit holder and there was *"nothing extraordinary about distributions flowing in accordance with the terms of the trust constitution."*

The Full Court (at [81]) expressed difficulty with the Commissioner seeking to *"draw upon a diversion from the pre-restructure course of conduct"* to assert that the manner in which the schemes were carried out supported the requisite purpose. The Full Court pointed out that LF was in a very different position after the reorganisation and it was *"too simplistic to conclude that LF ought to be entitled to the same returns post-restructure as it had been pre-restructure"*. Further, the Court noted that the evidence demonstrated that LF's financial position did not suffer as a result of not receiving Special Distributions (explored further in the 5th and 6th factors).

Second factor - form and substance of the scheme

The primary judge found (at [152]) that distributions from MHT to MFGT were paid and/or satisfied through a series of offsets of intra group loans and the issue of units, and observed that the Commissioner accepted that this was the case in the years in dispute. The primary judge also found (at [386]) that there was *"nothing unorthodox about recording loans in general ledgers ... or about loans being repaid by set-off or by ledger entries"*.

The Full Court agreed with the Primary Judge that this factor did not support a conclusion that the taxpayer entered into Schemes 2 and 3 for the dominant purpose of obtaining a tax benefit. As the Full Court noted (at [86]), the Primary Judge concluded that there was no material difference between the form and substance of the Schemes 2 and 3; the substance was that MFGT benefitted from its ownership of the ordinary units in MHT and the form was the same. The Full Court added that the same might equally be said of the additional Scheme 4.

On appeal, the Commissioner argued that while the form of the transactions were distributions of MHT's income to MFGT and from MFGT to the Parent, the substance of the transactions was said to be the funds associated with MHT's net income having *"flowed predominantly to LF in the form of"* loans to MF, which was said to have "replaced" LF's income stream.

The Full Court (at [89]) rejected the Commissioner's contentions as they conflated *"the concept of cash or funds with the concept of income"*, noting that cash *"is a fungible asset"* and *"[c]ash is advanced; income is not"*. The result of the centralised treasury and cash management function performed by LF for the MF Group was that all cash to which MHT was entitled from the securitisation trusts was deposited with (or loaned to) LF; all cash was to flow to LF. Further, the Full Court accepted (at [90]) that any increases in LF's indebtedness to MHT as a result of MHT depositing its cash entitlements with LF was temporary. LF was not relying on the MHT loan to finance its operations, nor was it relying on the MHT loan as a permanent or long-term part of its capital structure.

The Full Court (at [74]) accepted that *"the ledger accounts recording the loans were recording a real liability of the debtor and a real asset of the creditor" and that movement in those balances had "real economic and financial effect"*. The Full Court also accepted that the distributions by MHT to MFGT and the subsequent distributions by MFGT to the Parent "had real commercial consequences". The Full Court concluded (at [93]) that the role of LF as a centralised treasury entity, rather than tax benefits, *"explains the cash flows"*.

Third Factor - the time at which the scheme was entered into and the length of the period during which the scheme was carried out

The Full Court held (at [96]) that the primary judge had erred in finding that the third factor was indicative of a party having a dominant purpose of obtaining a tax benefit. The Full Court found (at [97]) that this factor was neutral, stating that the time at which the decision was made not to exercise the discretion (or to exercise it only to the extent of a nominal amount) - ie at the end of the financial year - was reflective of the terms of the MHT constitution and that *"tells one nothing about the dominant purpose of a party in this case."*

Fourth factor - the result in relation to the operation of the ITAA 1936 that, but for Part IVA

The Primary Judge concluded that the fourth factor was neutral in relation to Schemes 2 and 3. The Full Court agreed.

On appeal, the Commissioner argued that this factor supported the dominant purpose being the obtaining of the tax benefit because less tax was paid on MHT's income (ie 10% withholding tax on distributions from MFGT to the Parent as against 30% tax if distributed to LF). The Full Court observed (at [100]) that the Commissioner's argument said no more than that a tax advantage was obtained, which *"casts no useful light on the dominant purpose"* of the parties to the scheme. The Full Court (at [101]) rejected the Commissioner's contention that the only benefit to the Parent was attributable to the tax consequences of MHT distributing income to MFGT and, in turn, MFGT distributing income to the Parent, rather than MHT distributing income to LF. As the Full Court had explained, the distribution of income to the Parent *"had real economic and financial consequences to them that would not have flowed had the income been distributed to LF"*.

Fifth factor - any change in the financial position of the relevant taxpayer
[The WTB article contained no content under this heading}

Sixth factor - any change in the financial position of any person who has, or has had, any connection with the relevant taxpayer

The Full Court (at [105]) also rejected the Commissioner's challenge to the Primary Judge's conclusion that the fifth and sixth factors were neutral, for reasons including:

The Commissioner's submissions entirely discounted the financial consequences to the Parent of distributions made to it by MFGT, which distributions would not have happened if MHT's income had been distributed to LF; the distribution of income by MFGT had real economic and financial advantages to Parent.

The Commissioner's submissions failed to have regard to the totality of the circumstances including the fact that the MF Group's business was growing, and that additional debt and equity capital were raised by the group from 2016 to support that growing business. The evidence did not support a conclusion that if LF had been paid Special Distributions, it would have been able to fund the future growth its business came to experience without the need for further financing.

The Commissioner's contention that the non-exercise of the discretion to distribute income to LF adversely affected LF's capital adequacy ratio and thereby put LF's credit rating at risk was not supported by the evidence. The evidence was that the non-payment of distributions to LF in the relevant years did not affect the solvency, profitability or credit rating of LF.

At first instance, and on appeal, the Commissioner accepted that the financial position of the Parent *"improved as a result of the scheme"*. However, in explaining how and why it improved, the Full Court accepted that the distribution of income to MFGT resulted in MFGT distributing that income to the Parent, that then effectively applied the distributions due to it from MFGT to increase its investment in MFGT. As the Court noted, this had the "corresponding effect of increasing the capital base of MFGT" and that there was *"no objective basis on which it might be said that the choice by [Parent] to increase its investment in the 'trust silo' was not commercially rational*".

LF continued to be profitable, solvent and maintained its credit rating in each of the relevant years. Its capital needs grew because its business grew and not because it had been deprived of distributions by MHT, and at the same time, the schemes had real economic and financial consequences to the Parent. The Full Court concluded (at [113]) that this pointed away from a party having the requisite dominant purpose.

Seventh factor - any other consequence for the relevant taxpayer, or for any person referred to in paragraph (f), of the scheme having been entered into or carried out

The Full Court (at [115]) concluded that this factor was *"of no assistance in the present case in forming a conclusion as to the dominant purpose of any party to any of the schemes"*.

Eighth factor - the nature of any connection between the relevant taxpayer and any person whose financial position is affected as a result of the scheme

In was not disputed that all the entities in the "corporate silo" and the "trust silo" were ultimately owned by the same entities. The Primary Judge considered this factor to be neutral. The Full Court (at [118]) did not accept the Commissioner's challenge to that finding. The Full Court concluded (at [120]) that:
"[O]*nce it is accepted that the trust silo was established as part of a legitimate restructure, the question becomes whether the particular way in which distributions within that structure were made thereafter attracts the operation of PartIVA. The schemes identified by the Commissioner and the possible alternatives all necessarily involved connected parties. To point to the fact that the entities affected were all connected casts no light on whether a party to any of the schemes had the requisite dominant purpose."*

Conclusion

The Full Court noted that distributions were made to MFGT as the ordinary unitholder in accordance with the trust constitution, and that this enabled MFGT to make distributions to its unitholder "which resulted in a real benefit to those unitholders". The Full Court concluded by stating (at [123]):

"If distributions had been made differently more Australian tax would have been payable. But the identification of a tax benefit does not answer the question posited by s 177D. Nothing in the surrounding context objectively supports a conclusion that any party to any of the schemes either entered into or carried out any of the schemes for a dominant purpose of enabling the appellant to obtain a tax benefit."
[*Arnold Bloch Leibler were the instructing solicitors for the taxpayer in the Federal Court proceedings at first instance and on appeal.]

Ierna & Ors v FC of T ("City Beach" case)

[2024] FCA 592

Before: Logan J.

The "City Beach" street wear business was carried on by the City Beach Unit Trust (CBT), which was commenced pre-CGT. Its founders were Mr Ierna and Mr Hicks.

By 2016, the unit holders in CBT were:

(a) 14 units were held by Mr Ierna (pre-CGT);
(b) 1 unit was held by the Ierna Family Trust (post-CGT); and
(c) 15 units were held by the William Hicks Family Trust (pre-CGT).

It was not a finding of fact by the Court, but strangely, income that would have been expected to flow from CBT on Mr Ierna's unit holding found its way to the Ierna Family Trust. The terms of the CBT deed were not set out in the judgment but if this income flow was allowed, then the CBT trust must have in fact been a hybrid trust. This has led Dale Boccabella to conclude that the rollover in

the restructure referred to below was not available under Div 615: "*Ierna* case restructure: Was the Division 615 rollover really available?" Thomson Reuters Weekly Tax Bulletin 2024-037 (11/9/2024).

Be that as it may, the discretionary trusts various corporate beneficiaries were presently entitled to the trust net income, which built up large Unpaid Present Entitlements (UPEs) and Div 7A loans totalling just under $26M until 2016.

The trigger for a restructure was TR 2010/3 (taking the position that UPEs would become loans subject to Div 7A over time), which made the burden of the required repayments a severe cash flow problem. As it has recently become apparent, the Commissioner position in the ruling was incorrect: *Commissioner of Taxation v Bendel* [2025] FCAFC 15, Logan, Hespe and Neskovcin JJ, 19 February 2025.

Steps were subsequently taken to achieve the restructure, involving:

- a transfer of the units in CBT to a new company (Methuselah, of which Messrs Ierna and Hicks were directors) in consideration for new shares in Methuselah under a Div 615 rollover. The pre-CGT units in CBT thereby translated into deemed pre-CGT shares in Methuselah.
- the undertaking of a selective share buy-back creating a debt to shareholders, being in substance, a realisation of pre-CGT capital gains to the shareholders in Methuselah
- the assignment of the buy-back debt to the corporate beneficiaries in extinguishment of their Div 7A loans, and
- an election by Methuselah to form a consolidated group with CBT.

In the 2016 year CBT distributed 100% of its income and capital gains (a net profit of $4,642,780) to Methuselah.

The Commissioner asserted that the buy-back of the deemed pre-CGT shares in Methuselah was in substitution of dividends, under s45B. Also in issue was whether Pt IVA of ITAA 1936 applied. The tax benefit identified by the Commissioner was the non-inclusion of a dividend and the franking offset in the assessable income of Messrs Ierna and Hicks for the 2016 income year (rather than the proceeds of the selective share buyback by Methuselah being the proceeds of the realisation of pre-CGT shares).

Adapted from the headnote to 2024 ATC ¶20-918:

> Held: the share buy-back was not in substitution of any pattern of dividend distributions. Methuselah had never paid a dividend before as it was a new company so s45B did not apply.
>
> Under Part IVA the Commissioner alternative postulate that Methuselah would pay a dividend was not reasonable.
>
> Had the scheme not been entered into or carried out, the unit holders in CBT would have transferred their units to Methuselah for market value in consideration for shares worth $23 million and cash of $52 million payable on the terms of the loan agreements. In turn, that loan receivable would have been assigned to the creditor companies in repayment of the Div 7A loans. It followed from an application of s 177CB to the taxpayers' alternative postulate that neither Mr Ierna nor Mr Hicks obtained a tax benefit in connection with the scheme.

It was noted that the scheme left Mastergrove's (one of the corporate beneficiaries), net assets available for future distribution to shareholders (and related taxing, when received). It also left them available for the provision of security in the meantime.

Objectively, the dominant purpose was always to use pre-CGT assets, namely units in CBT, to repay the commercial detriment of the Div 7A loans.

Again, the Court was prepared to assume that the accumulated profits of the corporate beneficiaries would end up being taxable, unlike the Full Court in *Michael John Hayes Trading*.

In an article published on The Tax Institute website, "**Ierna v Commissioner of Taxation – section 45B and Part IVA**" (12 July 2024), it was said:

> "… the Court determined that Part IVA did not apply. Interestingly, a large part of the evidence was adduced by the Applicants' professional advisers. The advisers were able to give critical supporting detail with respect to the financial position of the business at historical points in time, as well as how that position impacted on advice given and therefore the course of action ultimately adopted."

This evidence was ultimately crucial because it allowed the Court to conclude that the Applicants would be unable to repay certain Division 7A loans, and those loans were a central plank of the Commissioner's Part IVA counterfactual. The Court stated, for the purposes of the alternate postulate under Part IVA, a theoretical possibility is not sufficient and that 'what is necessary is a prediction based on evidence.' The Court relevantly made the following findings with respect to facts adduced into evidence:

- the Commissioner did not identify a basis on which the Applicants would have been able to fund the Division 7A loans required by his alternate postulate; and
- the entities that might have provided the funding for any repayment of the loans were required to meet the significant ongoing demands for cash in the business.

Significance of the decision

The significance of this decision will become apparent only once it is known if there is to be an appeal, and if so, once the outcome of such an appeal is determined. In the interim, it is possible to make a few brief remarks.

First, Part IVA cases continue to result in successful outcomes for the Taxpayer. Part IVA matters are notoriously dependent on their facts, and so the significance of these decisions can be difficult to ascertain. That said, a key component of the finding with respect to Part IVA was a forensic examination of the capability of the evidence to support the Commissioner's alternate postulate. The inability of the evidence to do so weighed against the Commissioner with respect to Part IVA.

Second, the decision highlights the importance of meticulous record-keeping by taxpayers and their advisers. The facts as described in the judgment gave rise to a compelling narrative arc.

The witnesses for the Applicants were able to give detailed and cogent evidence as to:

1. the historical financial position of the business;

2. the need for the restructure;

3. the various options that were considered; and

4. the basis for the form of the restructure that was ultimately adopted.

The Court was able to make those factual findings only because the evidence adduced by the Applicants allowed those findings to be made.”

Recent s177EA Case

BSKF and FCT

[2024] AATA 3377

Adapted from Thomson Reuters Weekly Tax Bulletin 2024-040 [751] ATO determination cancelling imputation benefit upheld:

> The taxpayer (BSKF), who was both a lawyer and an accountant, was a former tax partner in a Big 4 accounting firm. He controlled a number of entities (the BSKF group), including SOPL through which he provided his professional services and HGYT which acted as the financier for the BSKF group. HGYT was majority owned by the trustee of a trust for the benefit of the taxpayer's children and grandchildren.
>
> In April 2009, the taxpayer settled a dispute with the ATO concerning the tax treatment of substantial sums paid by two public companies to SOPL. Under a settlement deed, SOPL was required to pay $3.9m plus GIC to the ATO. Another member of the BSKP group (PBPL) was also a party to the settlement deed.
>
> SOPL fell into dispute with one of the public companies to which it had previously provided the services of BSKF. SOPL commenced legal proceedings against the that public company. The litigation which was funded by HGYT pursuant to a Credit Facility Agreement (CFA). Over the period of the litigation, SOPL became indebted to HGYT in an amount of approximately $3M.
>
> As SOPL could not meet its obligations under the settlement deed or the CFA, the following events occurred in June 2009:
>
> On 19 June, the taxpayer caused two ordinary shares in SOPL to be transferred to him, such that he became SOPL's sole shareholder;
>
> On 20 June, SOPL, HGYT and the taxpayer entered into Deeds of Assumption under which the taxpayer assumed the obligations of SOPL to pay principal and interest to HGYT under the CFA (the Assumption Obligations);
>
> On 26 June, PBPL cancelled 24,476,464 options to purchase T-class preference shares in PBPL that had been issued to the taxpayer. This was said to increase PBPL's retained earnings for the 2009 income year by just over $24.47m. I surmise that this was necessary for to increase PBPL’s retained earnings as part of a scheme.

On 28 June 2010, SOPL paid just over $3.45m due for payment under the notice of assessment issued pursuant to the settlement deed, thus generating a franking credit in SOPL's franking account;

On 30 June 2010, PBPL executed a Deed of Subvention Payment under which PBPL undertook to pay the subvention payment to SOPL on demand, which was said to result for accounting purposes in a corresponding increase of just over $24.86m in SOPL's sundry income and receivables at 30 June 2010, which I again surmise was only possible due to the increase in PBPL's retained earnings by the cancellation of the options referred to above; and

On 30 June 2010, SOPL declared the previously envisaged fully franked dividend of just over $3.49m per share ($6.98M) payable to the taxpayer as SOPL's sole shareholder.

The consequences of this sequence of events were that the taxpayer had the benefit of an imputation credit of just over $2.99m attached to the dividend and, consequent upon his claiming deductions for the Assumption Obligations and carried forward losses, received a refundable tax offset for the same amount.

Subsequently, the ATO made a determination under s 177EA of the ITAA 1936 to negative the benefit of the imputation credit.

At trial, the taxpayer abandoned his claim for deductions for the Assumption Obligations.

Bearing in mind the above background, interestingly the AAT made introductory comments about the task of considering the s 177EA determination:

250. The issue for determination is whether BSKF has discharged the burden of proving the Commissioner's s 177EA determination denying the benefit of the imputation credit attached to the SOPL dividend should not have been made or should have been made differently.

251. The imputation system is well known. As discussed below, the object of s 177EA is to prevent abuse of that system. However, it must be applied according to its terms, not by reference to perceptions of whether the circumstances may be regarded as indicating abusive conduct.

Adapted from Thomson Reuters Weekly Tax Bulletin 2024-040 [751] **ATO determination cancelling imputation benefit upheld**:

The AAT was not persuaded that the s 177EA determination denying the benefit of the imputation credit attached to the SOPL dividend should not have been made or should have been made differently.

The AAT rejected the taxpayer's submission that the s 177EA determination should not have been made because the dividend was contemplated by the settlement deed and the determination was not given effect by an assessment.

The AAT rejected the taxpayer's contention that the purpose test in s 177EA(3)(e) was not satisfied. A conclusion that the purpose of the scheme was to enable the taxpayer to obtain the benefit of the franking credit in accordance with the settlement deed, as contended by the taxpayer, was not inconsistent with a conclusion that a not incidental purpose of the

scheme was, in terms of s 177EA(3)(e), "enabling the ... taxpayer to obtain an imputation benefit". Indeed, in the AAT's view, they were one and the same. It would be "quite artificial" to separate the purpose of obtaining the dividend and franking credit as contemplated by the settlement deed from a purpose of obtaining the franking credit. Whether or not contemplated by the deed, the purpose was the same.

Furthermore, the transfer of the SOPL shares was "precisely the type of scheme" envisaged by s177EA(3)(a) ("a scheme for a disposition of membership interests"), with its purpose to be determined, not in a tunnel-vision way confined to a scheme articulated as s 177EA(3)(a) requires, but by reference to the relevant circumstances". In the AAT's view, there were facts that may be determined from objective evidence "from which an inference that a frankable dividend was expected to be paid at the time of the transfer of the SOPL shares to [the taxpayer]".

Nor could it be said that the obtaining of the imputation credit was incidental to another purpose of transferring the shares. No other commercial purpose is suggested by the objective evidence.

In particular, it was said:

291. In my view, because of the contrived circumstances relating to the dividend, this is a case where the relevant circumstances listed in s 177EA(17) being not exhaustive assumes some importance. Many of the listed circumstances do not apply in this case. However, the combination of the various agreements and transactions carried out or caused to be carried out as discussed above, in my view point firmly to the conclusion that the scheme, considered in the context of these agreements and transactions, and the absence of a rational alternative commercial explanation, was entered into for at least a not-incidental purpose of BSKF obtaining the imputation benefit and the refundable tax offset. BSKF's submissions, because they start from the proposition that one looks only to the scheme as articulated, do not confront this fundamental issue.

Recent s207-150 Cases

B&F Investments Pty Ltd ATF Illuka Park Trust & Anor v FC of T ("BBlood case")

[2023] FCAFC 89

Before: Moshinsky, Colvin and Hespe JJ.

Adapted from the headnote to 2023 ATC ¶20-850:

"The taxpayers were a corporate beneficiary (BE Co) of a discretionary trust (IP Trust) and the trustee (IP Trustee) of that trust. As part of a plan, the trust deed of IP Trust was amended to ensure that the net income of the trust was as per trust law rather than as per s95.

In the 2014 income year a company with retained earnings (IP Co) bought back shares held in it by IP Trustee. The proceeds of the buy-back (about $10 million) paid by IP Co to IP Trustee were deemed by s 159GZZZP of ITAA 1936 to be a dividend for tax purposes. Although it had never previously received a dividend, IP Trust received a dividend in the

amount of approximately $300,000. BE Co, a newly incorporated beneficiary, was made presently entitled to the income of IP Trust. The consequence of BE Co being presently entitled to the trust income was that it was assessable on the trust's net income, which included the share buy-back dividend. The tax payable by BE Co in relation to the share buy-back dividend was wholly offset by the franking credits attached to the deemed dividend. The trustee was not liable to pay income tax because all of the trust income had been distributed.

Because the buy-back proceeds were not income of the IP Trust according to ordinary concepts, BE Co was not entitled to payment of the proceeds of the deemed dividend. The buy-back proceeds were retained by IP Trustee and treated as an accretion to the corpus of the IP Trust for the purposes of the IP Trust deed."

The taxpayers had the scheme brought to them a firm of accountants who had "promoted" the scheme to several other taxpayers. It is not known if the Commissioner has considered apply the promoter penalty provisions relying on the promotion of a Part IVA scheme, but they didn't bring their case against the taxpayers in this case, on the basis that the scheme was promoted to the taxpayers.

"The Commissioner assessed IP Trustee in respect of the relevant trust income on the basis that s 100A of ITAA 1936 deemed BE Co not to be presently entitled to that income. In the alternative, the Commissioner assessed BE Co on the basis that s 207-150(1) of ITAA 1997 applied to deny the entitlement of BE Co to a tax offset equal to the franking credits. Both IP Trustee and BE Co objected and, upon their objections being disallowed, appealed.

At first instance, Thawley J held that s 100A applied with the consequence that BE Co was deemed not to be presently entitled to the income of the IP Trust to the extent of the deemed dividend. As a result, the IP Trustee was liable to tax on that amount. In the alternative, s 207-150 of ITAA 1997 applied because the deemed dividend was paid as part of a dividend stripping operation as defined in s 207-155 of ITAA 1997. The primary judge also concluded that BE Co's application should be dismissed notwithstanding it was an alternative assessment to IP Trustee's assessment that had been affirmed.

On appeal, IP Trustee claimed that s 100A(8) did not permit the identification of an alternate postulate based on a reconstruction. Further, if s 100A(8) did permit a consideration of alternative hypothetical transactions, the primary judge erred in concluding that, if the agreement had not been entered into, IP Co would have paid an actual dividend to the IP Trust and IP Trustee would have distributed that income to an individual or individuals. In addition, the primary judge erred in concluding that one or more parties to the agreement entered into the agreement for a purpose of facilitating access to IP Co's profits in later years without further tax becoming payable or with less being payable.

The appellants argued the primary judge ought to have concluded that if the agreement had not been entered into, IP Co would not have distributed retained earnings and would have continued to retain those earnings or, if IP Co had paid a dividend to the IP Trust, IP Trustee would have distributed that dividend to BE Co.

Held: appeal by IP Trustee dismissed; appeal by BE Co allowed.

1. The task under s 100A(8) was not one of identifying the effect of an agreement; it was one requiring a view about the purposes of a person. The relevant purpose was that a party intended that, by entering into the agreement, someone — "a person" — was liable to pay "less tax" or no tax in a year of income.

2. The time at which the relevant purpose was to be ascertained was the time of entry into the agreement. It was not part of the statutory task to establish what the parties to the agreement would have done if the agreement had not been entered into.

In this respect, the Full Court said in reference to s100A(8), however:

51. Although the identification of an alternative postulate is not part of the statutory task of investigating purpose, drawing a conclusion about the purpose of doing something may require a consideration of any non-tax outcome sought to be achieved by what was done and what other *possibilities* existed that might have achieved that outcome: see *Hart v Commissioner of Taxation* [2002] FCAFC 222; (2002) 121 FCR 206 at 226–7 [66], [69] (Hill J), albeit in the context of Pt IVA. A focus on annihilating or deleting what was done (here, entering into an agreement) without such a consideration may be a sterile and meaningless exercise in the context of assessing purpose. But the consideration of such other means is relevant only to the extent it casts light on the purpose of a party in adopting the means in fact adopted. Simply pointing to another means to achieve the same commercial objective does not, of itself, address the statutory question: PJ [179]; *Prestige Motors* at 222 (Hill and Sackville JJ).

3. On the facts as found by the primary judge, s 100A applied. As a result, IP Trustee was liable to tax on the net income of the IP Trust that was attributable to the deemed dividend.

4. While it was open to the Commissioner to issue alternative assessments which were necessarily inconsistent, once the true state of facts was determined and the liability of the correct taxpayer had been established, the alternative inconsistent assessment was necessarily excessive. The true state of affairs here was that s 100A was found to have applied. This necessarily entailed a conclusion that the assessment issued to BE Co was excessive because s 207-150(1) could not be satisfied.

5. It was not necessary to decide whether the deemed dividend paid by IP Co was made as part of a dividend stripping operation for the purpose of s 207-150(1), although the Full Court made some comments which would tend to throw doubt on the finding by Thawley J on that count:

111…(1) In characterising a scheme as being by way of or in the nature of dividend stripping, it is necessary to look at the content, purpose and effect of the scheme. A scheme is not characterised as being by way of or in the nature of dividend stripping by looking only at the purpose of the scheme. Whilst the purpose of avoiding tax on a dividend is the typical characteristic of a dividend stripping scheme, perhaps an essential characteristic, it is not the only characteristic. The High Court in *Consolidated Press Holdings* referred to "the particular taxation purpose" as "the hallmark of such a scheme", but it also observed that, in that case, a "number of characteristics common to schemes that have been regarded as typical dividend stripping schemes were absent": at 275 [133].

(2) In so far as the content of the scheme is concerned, whilst it may be accepted that the term "in the nature of dividend stripping" is capable of encompassing schemes that depart from the paradigm of a dividend stripping operation, the term cannot be so protean as to be meaningless. It may be doubted that a scheme can be by way of dividend stripping without a participant in the scheme acting as a dividend stripper. Although it is not necessary to express a concluded view, there is room to doubt whether a scheme can be in the nature of dividend stripping where the scheme involves a payment

> of a deemed dividend between a company and long-standing shareholder. This conclusion would be consistent with the reasoning of the Full Court in *Lawrence v Federal Commissioner of Taxation* [2009] FCAFC 29; (2009) 175 FCR 277, where the concession that the scheme was not "by way of or in the nature of dividend stripping" within the first limb of s 177E(1) was said by the Full Court to have been correctly made in the context of a scheme that involved no dividend or deemed dividend, no vendor shareholder and no purchaser of shares: at 286 [29]–[30].
>
> (3) In so far as the effect of a scheme by way of or in the nature of dividend stripping is concerned, such schemes historically resulted in the receipt by the vendor shareholder of a sum that was not income for tax purposes. The receipt by the vendor shareholder was described as a "capital sum" in contradistinction to an income receipt for income tax purposes. In this context, "capital" was not used in a trust law sense but in the tax law sense. It is observed that the Illuka Park Steps resulted in the existing vendor shareholder receiving a tax law deemed dividend that was taxable as a dividend. The retained earnings of IP Co were not moved from IP Co to the shareholder in a form that was recognised for tax law purposes as capital.

Whilst not exceptional in its exact expression, Thawley J said at first instance:

> "248 To the extent that the income from those dividends was distributed to beneficiaries, those distributions would have resulted in additional tax being paid above the corporate rate given that relevant discretionary objects are likely to have had a marginal rate above 30%. If the income from those dividends was not distributed, then additional tax would have been payable by the trustee. It was suggested that the retained earnings would not have been paid by dividend to IP Trust because of these potential additional tax liabilities. However, there is nothing unusual about 'additional tax' or 'top-up tax' being paid by recipients of company distributions. The payment of tax on the distribution of company profits (and the obtaining of a tax offset in respect of tax paid on those profits by the company, represented by franking credits) reflects the ordinary intended operation of Australia's imputation system. In simple terms, the imputation system operates to prevent what might be thought to be an undesirable form of double taxation: if a company is taxed on its profit at 30% and the shareholder receives a distribution of that taxed profit, the shareholder should only pay tax at a level which takes account of the fact that 30% tax has already been paid on the profits underlying the distribution."

The above passage does not recognise the reality, of the common practice of attempting to constrain the immediate tax liability to the corporate rate for those that can do so, was in effect, acknowledged by the Commissioner in ATO website material published in 2015 (suspended in 2017), being the predecessor to PCG2021/4 on professional service firms and Part IVA, where the Commissioner only regarded arrangements where the average rate of tax paid by the professional person's group, was less than 30% as being at risk, mirroring the company tax rate at the time. The current PCG also takes the effective tax rate into account with anything less than 30% being higher risk of Part IVA.

It is also worth noting that the Full Court in *Grant* said Mr Laxon's evidence should have been admitted. He opined about limiting the tax to the corporate rate, and the relevance of asset protection: FFC at [54]. He didn't expressly mention it, but since the AAT thought it must follow (Mick) *Hart*, it is worth remembering that the Full Court in (Mick) *Hart* mentioned *FC of T v Mockhin* [2003] FCAFC 15, with approval of the asset protection dominant purpose in the appropriate case.

FC of T v Michael John Hayes Trading Pty Ltd ATF MJH Trading Trust & Ors

[2024] FCAFC 80

Before: Bromwich, Thawley and Hespe JJ.

The Full Federal Court had remitted to the AAT for redetermination (involving making findings of fact necessary to determine the dominant purpose of the scheme), of a series of transactions that resulted in the profits of the operating companies in a family group (the Hayes Group) being distributed to newly formed trading trusts did not constitute a dividend stripping operation.

The Hayes Group was controlled by the Hayes family, which included 4 brothers. The Group had 4 operating companies. In 2010, the Group was restructured on professional advice. Four fixed trusts, 4 trading trusts and 4 rural unit trusts were formed in February that year. Each brother was separately identified with one of the fixed, trading and rural unit trusts. The taxpayer companies were the trustees of the trading trusts. The unitholders of each trading trust were the relevant brother's family trust (as to 80%) and the relevant fixed trust (as to 20%). The trading trusts were set up so as to be “public trading trusts” under Div 6C, and treated for some purposes as companies e.g. Div 7A did not apply to loans made by them.

Adopted from Thomson Reuters Weekly Tax Bulletin 2024-031 [585] Appeals update - Michael John Hayes Trading Pty Ltd (Dividend stripping):

> In May 2010, after the existing shareholders (the Hayes brothers) had declined an offer to acquire Z class shares (shares with special rights – commonly called Dividend Access Shares) in the 4 operating companies:
>
> Two of the trading trusts each acquired 10 Z Class shares for $1 per share in 3 of the 4 operating companies; and the other 2 trading trusts each acquired 10 Z Class shares for $1 per share in each of the 4 operating companies.
>
> The 4 operating companies had profits available for distribution. Later on the same day the trading trusts acquired the Z class shares, the 4 operating companies declared and paid fully franked dividends totalling just over $8M to the trading trusts as the holders of the Z Class shares. The proceeds of the dividends were lent by the trading trusts either to the operating companies or to the pre-existing shareholders (the Hayes brothers). In percentage terms, the proportion of the dividends that made their way to the pre-existing shareholders in the form of loans was 30.46%. Those amounts were then used to retire or repay debt owed to Hayes Group entities.

Adapted from the headnote to 2024 ATC ¶20-916:

> The Full Federal Court said that the AAT's decision was “determinatively influenced" by two principal factual matters:
>
> (a) the profits were not removed from the Australian income tax system at all; and
>
> (b) a majority of the dividends were ultimately loaned back to the operating companies (such that it could not be said that the original shareholders received a capital sum that substantially represented the profits distributed) and there was "no compensating non-taxable receipt" (implicitly by the pre-existing shareholders) as "usually found in dividend stripping operations".

As regards (a) above, the Full Court said that tax on the dividends which would have been payable by the pre-existing shareholders had been avoided. The dividends were paid to associates of those shareholders and the majority of the proceeds lent back to the operating companies where they might be accessed in the future by the original shareholders in a tax-free way. The fact that the profits did not leave the Australian tax net (in the tax year in which the scheme was undertaken) was not determinative of whether the purpose of the scheme was for the pre-existing shareholders "to avoid a tax liability on a distribution of profits" had the distribution been made to them.

As regards (b) above, the Full Court said that the fact that the operating companies' profits were paid to associates of the pre-existing shareholders and a majority then paid back to those companies (by way of loans) did not preclude the scheme from being one "by way of, or in the nature of, dividend stripping". Further, the fact that there was an absence of" a compensating non-taxable receipt usually found in dividend stripping operations" did not necessitate a conclusion that the scheme was not "by way of, or in the nature of, dividend stripping". Nor was a scheme necessarily denied the character of a dividend stripping scheme by reason of the fact that a non-taxable receipt was not received by the pre-existing shareholders directly.

The Full Court observed at [10] that the "trading trusts" were set up such as to attract the operation of Div 6C, and be treated for some purposes as a company, such that Div 7A did not apply to them (as they are not "private companies"), so non-commercial loans could be made by them, either to companies or individuals. Also, the fact that the "trading trusts" became entitled to dividends by the use of Z class dividend access shares is important. The use of dividend access shares (DAS) was flagged as potential application of the anti-dividend streaming rules (TA 2012/4). The scheme was put together by Cleary Hoare, as was the failed attempted use of a limited partnership to avoid Div 7A some years earlier: *D Marks Partnership by its General Partner Quintaste Pty Ltd v Commissioner of Taxation* [2016] FCAFC 86 (that case also involved Z class shares; also see TA 2007/5; closely held LPs were made subject to Div 7A in 2010). Taken together, the Div 6C trusts and DAS in Michael John Hayes Trading are hardly the features of a "normal" restructure, such as "top hatting" a trading company with a holding company, paying a fully franked dividend, and then lending the money back to the trading company as a secured debt, for asset protection purposes (as on an insolvency of the trading company, the parent company will be a secured creditor). The Full Court did say something quite troubling from that traditional point of view:

> "50….There is no good reason why a dividend stripping scheme could not involve the target company receiving a capital sum, rather than the original shareholders receiving a capital sum. Once it is appreciated that a dividend stripping operation may involve an allotment of new shares rather than a sale of existing shares, there is no logical basis for denying a scheme the character of a scheme "by way of, or in the nature of, dividend stripping" merely because all or part of the capital sum is received by the target company rather than the original shareholders themselves. In the present case, the amount received by the target company would seem to have been received at the direction of, or pursuant to arrangements set by, the original shareholders."

In the end, it is the non-tax avoidance purpose which saves the situation. The alleged asset protection and structure simplification purpose of the restructure in that case was, accordingly to the Full Court, not made out as a finding of fact, with the result that they remitted that aspect (and the question of the rights on the Z class shares and the question of who controlled the target

companies after their issue), to the AAT to make further finding so fact, which would go to the question of whether there was in fact, a tax avoidance purpose. The Full Court said:

"38….What Hill J stated (*CPH PJ* at 47 – 48) was:

> Obviously not all sales of shares, even if cum dividend, are in the nature of dividend stripping. Nor is the sale of 100 per cent of shares in a company necessarily dividend stripping, even if the company has accumulated profits. What is missing in the first case and may be missing in the second is the conclusion that an objective observer would reach as to why the scheme has taken place. For a scheme will only be a dividend stripping scheme if it would be predicated of it that it would only have taken place to avoid the shareholders in the target company becoming liable to pay tax on dividends out of the accumulated profits of the target company. It is that matter which distinguishes a dividend stripping scheme from a **mere reorganisation**.

"39.In place of the word "predicated", his Honour could equally have used the word "said". The word "predicated", in the context in which it was used, should be taken to be referring to the basis or purpose of the scheme." (underlining added)

Another interesting feature of the *Michael John Hayes Trading* case, was that the Commissioner did not run s177D or s177E. The unusual use of Div 6C trusts and DAS would then have drawn more attention.

As I understand Deputy President O'Loughlin KC has not joined the Administrative Review Tribunal (ART - the replacement of the AAT), so the determination of facts required by the Full Court will fall to someone else. It might also be observed that the Deputy President's alleged failure to make findings of facts as to tax avoidance purpose because he found that the scheme was not one in the nature of dividend stripping, is unfortunate for the taxpayer, occasioning more costs. There is a chance that this case could turn into another *Richard Walter* saga, where returning to the Tribunal happened twice. I also understand that the taxpayers led considerable evidence at trial about the asset protection features and commercial benefits of the restructure. The appeal went straight from the AAT to the Full Court as the AAT was constituted by a Deputy President and the Chief Justice of the Federal Court decided it was appropriate to have the appeal heard by a Full Court, rather than a single judge.

The High Court denied special leave on 10 Oct 2024 as "the application does not raise a question of law of public importance sufficient to warrant a grant of special leave to appeal and otherwise advances no ground of appeal from the unanimous decision of the Full Court with sufficient prospects of success."

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