

26 March 2013

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Senate Standing Committees on Economics
P O Box 6100
Parliament House
CANBERRA ACT 2600

Attention: Senator Bishop

Dear Senator Bishop

Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013

1. Thank you for the opportunity to make this submission. We have had the benefit of some further time to consider the proposed amendments to be introduced by *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013 (The Bill)* and have identified some potential legislative drafting anomalies in the manner in which section 177C of the *Income Tax Assessment Act, 1936* is to be applied. We welcome the opportunity to raise these issues for your consideration.
2. We consider these anomalies are unintended but if not corrected, potentially raise material and significant 'revisions' in the administration of Part IVA, which are adverse to taxpayers. As you are no doubt aware, taxpayers bear the burden of proof in respect of any taxation dispute and accordingly these anomalies, further disadvantage taxpayers in such taxation disputes. We have not set out a full explanation of the operation of Part IVA for these purposes but have identified relevant background to help demonstrate the issues and for your information.

Settled Law of the High Court of Australia

3. The Full Federal Court in *RCI Pty Limited v Commissioner of Taxation* [2011] FCAFC 104 cited and applied the High Court decision in *Commissioner of Taxation v Peabody* (1994) 181 CLR 359 to confirm that the reasonable alternative postulate for the purposes of applying section 177C is to be determined as an objective (that is, evidenced based) enquiry after considering all the available and surrounding evidence. The relevant extract is as follows:

In Commissioner of Taxation v Peabody (1994) 181 CLR 359 at 382, the High Court made it clear that the existence of a tax benefit is to be established as an objective fact

and is not a matter of the Commissioner's opinion or satisfaction that there is a tax benefit. Moreover, where at 385 the High Court said –

'A reasonable expectation requires more than a possibility. It involves a prediction as to events which would have taken place if the relevant scheme had not been entered into or carried out and the prediction must be sufficiently reliable for it to be regarded as reasonable [see Dunn v Shapowloff [1978] 2 NSWLR 235 at p. 249, per Mahoney J.A.]'

the reference to 'prediction can be read as a prediction based on objective enquiry and determination.

4. We understand that this is not a 'perceived weakness' in the application of Part IVA that the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013* is seeking to remedy. This is evidenced in paragraph 1.20 of the Explanatory Memorandum to The Bill, which provides:

Although the Commissioner is entitled to put his case in relation to the scheme and the tax benefit in alternative ways, the existence of the Commissioner's discretion to cancel the tax benefit does not depend upon the Commissioner's opinion or satisfaction that there is a tax benefit or that, if there is a tax benefit, it was obtained in connection with a scheme. The existence of a scheme and a tax benefit must be established as matters of objective fact (see Peabody v Commissioner of Taxation (1994) 123 ALR 451 (Peabody) at pp 458-459).

5. In the RCI case the Court went on to explain the position as follows (**emphasis added**):

It is trite that a taxpayer in this Court bears the onus of proving that an assessment is excessive: s14ZZO(b)(i) of the Taxation Administration Act 1953 (Cth). It follows that it is the taxpayer who bears the onus to establish that a tax benefit is excessive. It might do that by establishing that there is no tax benefit or by establishing that it is less than that determined by the Commissioner: Federal Commissioner of Taxation v Trail Bros Steel & Plastics Pty Ltd (2010) 186 FCR 410 at [35] and [36] per Dowsett and Gordon JJ, Edmonds J agreeing [62]; Federal Commissioner of Taxation v AXA Asia Pacific Holdings Ltd (2010) 189 FCR 204 at [134] per Edmonds and Gordon JJ, Dowsett J agreeing [1].

It has been said in the past, and the learned primary judge at [88] of her Honour's reasons said below, that the taxpayer carried the onus of establishing that the Commissioner's counterfactual is unreasonable; and that if the taxpayer does not establish that the Commissioner's counterfactual is unreasonable, then the taxpayer fails to prove that the assessment is excessive on that ground. (Of course, the taxpayer may establish that the assessment is excessive on some other ground, such as that the conclusion required to be drawn as to the dominant purpose of a party to the scheme under s 177D(b) cannot be drawn, but that is another matter).

*Such an articulation of the onus is erroneous, but if not, certainly unhelpful because it can lead one into error. Even if a taxpayer establishes that the Commissioner's counterfactual is unreasonable, it will not necessarily follow that he has established that the assessment is excessive. That is because the issue is not whether the Commissioner puts forward a reasonable counterfactual or not; **it is a question of the Court determining objectively, and on all of the evidence, including inferences open on the evidence, as well as the apparent logic of events, what would have or might reasonably***

be expected to have occurred if the scheme had not been entered into. Thus, even if a taxpayer establishes that the Commissioner's counterfactual is unreasonable, that will not discharge the onus the taxpayer carries if the Court determines that the taxpayer would have or might reasonably be expected to have done something which gave rise to the same tax benefit.

That such an articulation of the onus is at worst erroneous and at best unhelpful, can also be illustrated from the other side of the coin, because it implies that if the Commissioner's counterfactual is reasonable that is the end of the matter; even if the Court were to conclude, on all the evidence, inferences and logic referred to, that if the scheme had not been entered into the taxpayer would have or might reasonably be expected to have done something which did not give rise to a tax benefit, or which gave rise to a tax benefit less than that thrown up by the Commissioner's counterfactual. In our view, that cannot be correct.

In saying this, we are mindful that when seeking special leave to appeal to the High Court in AXA [2011] HCA 63 (11 March 2011), the Commissioner's first ground was that s 177C was 'a gateway provision rather than a major forensic exercise'. He submitted that, to satisfy s177C –

'[I]t is enough if it might reasonably be expected that the amount would be included in the assessable income in the sense that there might be a number of reasonable expectations and it is sufficient if, on any one of those, the amount would have been included in the assessable income'.

This no doubt explains the submission of senior counsel for the Commissioner towards the end of the hearing of the present appeal:

'[W]e submit our submission is reasonable... We don't say it is the only counterfactual. We don't even say it is necessary[ily] the most probably counterfactual, but it meets the threshold.'

However, we are comforted in the view we have come to by the fact that the Commissioner's special leave application was dismissed without counsel for AXA being called on. Of the first ground, the Court simply said:

'The first point is a question of construction in relation to which the Full Court of [the Federal Court] had taken a particular approach. We think there are insufficient prospects of disturbing this approach on appeal'.

Anomalies arising from The Bill

6. New section 177CB, which applies 'to deciding, under section 177C', allows a postulate that is a reasonable alternative to entering into or carrying out the scheme to be considered for the purposes of applying section 177C. In our opinion, this seems to alter the nature of the enquiry for the purpose of applying section 177C. That is, 177CB(3) seems to allow any postulate that is a reasonable alternative to entering into or carrying out the scheme to be considered for the purposes of applying section 177C. This departs from the principle laid down in Peabody's Case, as noted above. The proposed drafting arguably permits any reasonable alternative and not relevantly the alternative that was reasonably most likely based on a prediction (by the Courts) and having regard to all the surrounding facts and evidence. Accordingly, it leaves open the possibility that the

Courts' assessment of what is a reasonable alternative may be substituted or replaced with an assessment by the Commissioner of Taxation.

7. As noted in the extract from the RCI Case (refer paragraph 5 above), this was the legislative construction that the Australian Taxation Office unsuccessfully advanced in the application for special leave to the High Court of Australia in *FCT v AXA Asia Pacific Holdings Ltd* as follows

Counsel for the ATO

We submit that the hypothetical fact-finding approach adopted in this line of Full Federal Court cases distorts the whole operation of Part IVA. In our submission, section 177C, the obtaining by a taxpayer of a tax benefit in connection with the scheme, is intended to be a gateway provision rather than a major forensic exercise.

Ruling of the HCA

The first point is a question of construction in relation to which the Full Court of Australia has taken a particular approach. We think there are insufficient prospects of successfully disturbing that approach on appeal. Accordingly, special leave is refused with costs.

8. The Explanatory Memorandum to The Bill confirms at paragraph 1.20 that the principle outlined in *Peabody's Case* is correct and accordingly, we infer there is no intention to disturb this position.
9. However, as a matter of statutory construction, a Court may nevertheless consider the text of the statute is clear without resort to the Explanatory Memorandum for clarification. We submit that the drafting presented in the Bill potentially represents an unintended material and significant departure from how Part IVA is intended to operate.
10. Where this anomaly is not corrected, then potentially the ATO (and not the Court) would be in a position to determine the reasonable alternative postulate. This has potential flow on effects, where the taxpayer's purpose under section 177D is determined having regard to the reasonable alternative postulate and the related tax benefit arising therefrom.
11. A question that therefore arises is where a reasonable alternative postulate (not determined objectively but instead speculatively and disregarding tax costs) results in the maximum amount of tax, will the taxpayer be disadvantaged in discharging its onus of proof - that is, proving that its sole or dominant purpose (which clearly remains to be determined objectively) was not to obtain a relevant tax benefit.

Submissions

12. We submit that the Committee should carefully consider the text of The Bill (and not simply rely upon the Explanatory Memorandum), to confirm the plain reading and meaning of section 177CB and its interaction with sections 177C and 177D, since this is the approach required to be adopted by the Courts.
13. We consider that where it is intended that section 177C remain an objective test then the drafting in section 177CB should confirm that intention. That is, that the reasonable alternative postulate should indeed (as was stated by the High Court in *Peabody's Case*),

be an objective factual enquiry for the Courts to determine and a prediction based on all the surrounding evidence. We submit that this approach should be expressly stated in the text of the Act. For example, insert new section 177CB(4)(c) to confirm that:

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

(c) it must be sufficiently reliable to be reasonable and must be determined [objectively], having regard to the facts and circumstances surrounding the scheme.

14. We trust these submissions are of assistance to the Committee in their review of The Bill. Please do not hesitate to contact Karen Payne on +61 2 9921 8719 should you require any further information or clarification.

Yours faithfully
MINTER ELLISON

Karen Payne
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