CHAPTER 3

THE ATO'S POSITION AT LAW

3.1 This chapter provides an overview of the legal basis for the ATO's position on a number of points at issue with mass marketed schemes. The general points covered include:

- The general provisions for deductibility;
- Part IVA;
- Section 221D taxation instalment variations; and
- Scheme promoters.

3.2 Reference to the legal underpinning of the ATO's position is important for clarifying questions about the ATO's ability or powers to take certain actions, such as amending tax assessments several years after a tax return or deduction was lodged and paid, for instance. Misunderstanding about the ATO's right to issue amended assessments, apparently retrospectively, is common place in the debate surrounding MMS.

3.3 The Committee emphasises that the chapter reflects the ATO's interpretation of the law. While both taxpayers and their legal advisers contest the ATO's legal position, the chapter does not examine those contending points of view. As stated in several places in this report, the Committee considers that the ATO's position at law is a central matter that the courts must decide upon: that is, the courts are the appropriate fora to resolve the matter. (Chapter 6 addresses the issue of test cases and the importance of the courts ruling upon the issues at law.)

3.4 These points notwithstanding, the Committee notes that the Ombudsman has concluded in relation to two schemes, Budplan and Maincamp, that the Commissioner's interpretation of the law is reasonably open to him.[1] That said, the Ombudsman is also of the view that the ATO's position is ultimately a matter for the courts to rule upon.

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1 Commonwealth Ombudsman, *The ATO and Budplan: Report of the Investigation into the Australian Taxation Office's handling of claims for tax deductions by investors in a tax-effective financing scheme known as Budplan*, June 1999, p.1. Commonwealth Ombudsman, *The ATO and Maincamp: Report of the Investigation into the Australian Taxation Office's handling of claims for tax deductions by investors in a tax-effective financing scheme known as Maincamp*, January 2001, p.27.

Deductibility: general provisions

3.5 Section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) deals with deductible business losses or outgoings. Prior to ITAA 1997, subsection 51 (1) of ITAA 1936 (general provisions) addressed this matter. According to the ATO:

> …a loss or outgoing of a revenue nature is deductible to the extent that it is incurred in gaining or producing assessable income or is necessarily incurred in carrying on a business for that purpose. Critically, a loss or outgoing will not be deductible to the extent that it is of a capital nature.[2]

3.6 In addition, the ATO referred to the High Court case, *Sun Newspaper versus Federal Commissioner of Taxation (FC of T)*, which established three matters for consideration when determining whether an expenditure is revenue or capital in nature:

- The character of the advantage sought;
- The manner in which it is to be used or enjoyed; and
- The means adopted to obtain it.[3]

Taxation Ruling TR 2000/8

3.7 Taxation Ruling TR 2000/8 (Investment Schemes) elaborates upon these general points. Issued on 14 June 2000, TR 2000/8 outlines the ATO's views on investment schemes and 'tax shelters' including primary production, film and franchise schemes.[4] In particular, the ATO indicated with reference to TR 2000/8 the sort of features that would incline it to view an investor as carrying on a business:

- The investor has an identifiable interest in specific growing trees and the right to harvest and sell the timber from those trees. Otherwise the ATO may view the investment as being in someone else's business and therefore on capital account. But the ATO accepts the practice of the manager harvesting the investor's produce and aggregating it with other investors' produce for the purposes of sale. This point is also relevant to other tax effective investments; and
- The activities of the investor have a significant commercial purpose in view of matters such as their nature, size, scale, repetition and regularity and the manner in which those activities are conducted. This factor looks at the manner in which the investor carries on the activity; specifically, whether

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2 ATO Submission No. 845, p.5.

3 Ibid.

4 ATO Media Release Nat00/63, 'Tax Office ruling on investment schemes TR 2000/8'. See Attachment A3, ATO Submission No. 845.

> the investor has a profit making purpose, the activity is carried on in a systematic, business-like manner, and on a consistent and repetitive basis.[5]

3.8 On the other hand, TR 2000/8 also details the features or characteristics that would 'detract from a finding that an investor is carrying on a business':

- The investor's return is guaranteed;
- There are mechanisms to reduce the risks of participating in the scheme, eg, ongoing maintenance costs are being met by the manager;
- The method of sale of the produce ignores the investor's interest in that produce;
- The use of non - or limited recourse financing and the existence of non-commercial rates, fees or charges. Under a non-recourse arrangement, the promoter lends the investor a significant proportion of the 'cost' of the investment. However, the effective liability to repay the loan is limited to the investor's interest in the investment (which may be of limited value). Nevertheless, the investor still claims a tax deduction for the cost of participating in the investment which may significantly exceed the investor's own cash outlay; and
- The promoters undertake to reverse transactions if tax deductions are disallowed.[6]

3.9 Another factor counting against a participant carrying on a business is if their initial investment amounts to no more than completing application forms and providing funds which are held in trust until the minimum subscription is achieved. TR 2000/8 indicates that under this scenario a participant's outgoing would not have been incurred in carrying on a business.[7]

Part IVA

3.10 Part IVA of the ITAA 1936 empowers the ATO to deny or 'cancel' an investor's tax benefit where a 'reasonable person' would conclude that the sole or dominant purpose for entering a scheme was to obtain that tax benefit. According to the ATO:

> The High Court in *FC of T v. Spotless Services Ltd* observed that where a transaction is influenced by tax considerations this will not of itself result in Part IVA being applied. However, the High Court also found that where the shape of a transaction, or means adopted to achieve a transaction, is so

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5 Overview of Taxation Ruling TR 2000/8 (Investment Schemes), Attachment C in ATO Submission No. 845, pp.1-2.

6 Ibid, p.2.

7 Ibid.

> governed or driven by the tax consequences, the commerciality of the transaction may be so overshadowed that Part IVA can be applied.[8]

3.11 Particular features of schemes that might lead the ATO to apply Part IVA include:

- Transactions which do not occur at market rates/values. For example, grossly excessive fees;[9]
- The inflation or artificial creation of deductions. For example, where only a small proportion of the amount of the deduction claimed is actually used on the underlying activity;
- Round robin arrangements. For example, a bank lends moneys to a promoter's finance company, which in turn loans the moneys to the investor; the investor uses the loan funds to discharge the lease and management fee liabilities and the lessor and manager place the funds received on deposit with the promoter's finance company; the finance company then uses the funds to repay the original loan from the bank. The investor has discharged the lease and management fee liabilities but there are no real cash funds available to the lessor or manager to fund the underlying activity. There is no change in the overall level of cash;
- Non-recourse or limited recourse loans which limit the investor's real commercial risk in relation to any debts. For example, the investor is only liable to repay the loan from and to the extent of any sale proceeds;
- Arrangements where the investor is not subject to significant risks when the tax benefit is taken into account. For example, the existence of a put option which gives the investor the right to sell the underlying asset back to the promoter for a pre-agreed price;
- Prepayments shortly before the end of the year of income;
- Arrangements representing a roundabout way of conducting an activity;
- Transactions between related or unrelated parties not at arm's length;
- Arrangements where the transactions or series of transactions produce no economic gain or loss. For example, the whole scheme is self-cancelling; and
- Arrangements which lack economic substance and are not rationally related to any useful non-tax purpose. For example, related party dealings that merely produce a tax result.[10]

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8 ATO Submission No. 845, p.6.

9 For more on this issue, see 'Fee Levels in Projects' and 'Fee Levels and Deductibility' in ATO Supplementary Submission No. 845A.

3.12 Two further points should be noted in the context of Part IVA's application to mass marketed arrangements. First, the ATO states that no single feature necessarily determines whether Part IVA applies. Consideration must be had for all of the eight so-called 'objective factors' listed above (and outlined in paragraph 177D(b) of the 1936 Act).[11] This helps explain the citing of all eight factors in many of the ATO position papers sent to taxpayers, rather than the ATO singling out one or two factors as the reason for its decision to apply Part IVA.

3.13 The second point goes to the issue of Part IVA's application and the individual circumstances of investors/taxpayers. The ATO claims that because Part IVA is an 'objective' test, the individual circumstances – or the 'subjective motives'[12] – behind a taxpayer's decision to invest will not affect whether Part IVA applies.[13] This reflects a key distinction between the initial consideration of whether Part IVA applies, and the next step of the process, the Commissioner's consideration of whether to apply his discretionary powers to reduce the level of tax penalty.

3.14 Individual circumstances come into play when the Commissioner turns his mind to applying the discretion (under subsection 227(3) of the Act).[14] But individual factors do not figure in the initial consideration whether a scheme has features that attract Part IVA.

3.15 The Committee further examines the issue of individual circumstances and Part IVA in Chapter 5.

Penalty tax rate

3.16 As noted in Chapter 2 (paragraph 2.8), Part IVA applies an automatic statutory penalty of 50 per cent. However, in recognition that in 'most cases' the 50 per cent penalty would not be appropriate, the ATO has reduced it by one of two means:

- In many cases, taxpayers who take up the ATO's invitation to make a voluntary disclosure have had the penalty tax reduced to ten per cent; or
- In some cases, the Commissioner has exercised his discretion to reduce the penalty to five per cent.[15]

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10 Overview of Taxation Ruling TR 2000/8 (Investment Schemes), Attachment C in ATO Submission No. 845, pp.5-6.

11 Ibid.

12 Evidence, p.497.

13 Evidence, p.493.

14 In addition to the Commissioner's discretion, the statutory penalty of 50 per cent can be reduced to 25 per cent if the taxpayer has a reasonably arguable position, or under section 226Z can be reduced by 80 per cent if a taxpayer notifies the Commissioner of a tax shortfall prior to an ATO audit.

15 Evidence, pp.18-20 and 486.

221D Tax Instalment Variations

3.17 Under section 221D of the ITAA 1936, the ATO has the discretion to vary the prescribed rate of tax instalment deductions, ie, the tax taken out of taxpayers' salaries and wages. Many participants in mass marketed schemes had tax deductions paid to them using 221D variations, and many assumed that the processing and payment of refunds under 221D (or end of the year tax refunds for that matter) meant that the ATO had investigated the schemes and approved deductions.

3.18 However, under the law this assumption is mistaken. The approval to vary the tax rate for a taxpayer does not amount to the ATO approving the reason or basis (ie, the scheme) for the variation. Tax Determination TD 93/19, issued on 4 February 1993, makes it plain that ATO approval is limited to the variation, not the investment plan or scheme in which the taxpayer has entered. As stated in TD 93/19:

> An approval to vary a taxpayer's instalment deductions does not mean the ATO has expressed an opinion on the taxation treatment of the negatively geared investment plan or any tax deductions that might flow from that plan.[16]

3.19 Furthermore, the ATO indicated that it is not required under the law to express an opinion or grant approval for the investment arrangement or associated tax deduction.[17] This reflects a basic point of Australia's self assessment tax system, that returns are accepted at face value and generally not scrutinised in detail. Under the law the ATO has up to four years to review returns and amend assessments where necessary. The time period is six years in instances involving anti-avoidance provisions.

Promoters

3.20 One of the peculiar features of the MMS issue is that the promoters of schemes the ATO deems to be aggressive or abusive appear, by and large, to have escaped the penalties or 'downside' that scheme participants have experienced. As the Commissioner has stated, 'Presently it is the participants placed in schemes by promoters who suffer administrative penalties. There is no direct penalty to chasten prospective promoters and marketers'.[18]

3.21 According to the ATO, this anomaly reflects the absence of any sanctions in the law for promoters involved in the design or marketing of tax aggressive arrangements. While promoters who make fraudulent, untrue or false or misleading statements may face criminal prosecution under the Trade Practices Act, the Corporations Law and consumer protection laws, no comparable penalties exist under

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16 TD 93/19, 4 February 1993, p.1.

17 ATO Submission No. 845, p.2.

18 Michael Carmody, Commissioner of Taxation, 'Ethics and Taxation', Speech to the Edmund Rice Business Ethics Forum, Sydney, 28 October 1999, p.3.

tax law. In discussing the imbalance in penalties borne by participants and promoters, the Commissioner recently indicated:

> Our experience with these schemes has highlighted that the structure of the income tax law is such that the focus of the downside for participation in schemes is with the participant. We believe this is a position that needs to be rebalanced. We are therefore developing for government options for consideration that would introduce financial penalties for those who profit from promoting and marketing these types of schemes.[19]

3.22 The ATO told the Committee that the Commissioner had foreshadowed providing advice to the Government on options for dealing with promoters by the middle of May 2001.[20] While the Committee discusses this in brief at paragraphs 4.83-84, it reiterates here that it intends to deal with this key issue in detail in its final report.

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19 Michael Carmody, Commissioner of Taxation, 'Taxation…Current Issues and Future Directions', Speech to the Australian Institute of Company Directors, Perth, 1 May 2001, p.6.

20 Evidence, p.503. On the type of options under consideration, see Evidence, pp.35-36, 503-504 and ATO Submission No. 845, p.12.