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- an amount was deducted from the taxpayer's assessable income where it would not, or might reasonably have been expected not to be deducted otherwise.[2]

There is no qualification on the word "amount," so it is not limited to tax advantages which are contrived or artificial, or have been created by self-cancelling paper transactions. A tax benefit is any tax advantage.

The tax benefit must, however, arise out of a scheme to which ITAA applies. A scheme is:-

- any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable by legal proceedings; and
- including any unilateral scheme, plan, proposal, action, course of action or conduct.[3]

This definition is wide. In fact, it is so wide, that it can relate to any course of action, or any single act, including a unilateral act. So broad is the definition of the concept of a scheme, that a tax benefit could arise out of any course of action so long as a purpose, which is a dominant purpose, to obtain the tax benefit, can be ascertained.

What has become apparent from the cases which have come before the courts to date is that the definition of the scheme is critical to the finding relating to the purpose of the taxpayer in entering into the scheme. The more narrowly the scheme can be defined just by reference to the facts which generate the tax benefit, the easier it will be for a dominant purpose of obtaining that tax benefit to be established. In fact, it is this issue which is at the heart of the current tussle between the Commissioner and the courts, as manifest in the appeal in *Hart v FCT*[4] at present before the High Court.

If the Commissioner is able to convince the High Court that schemes can be identified just by reference to the tax benefit – ignoring the context in which the tax benefit was obtained – then the Commissioner will have achieved the power to annihilate any commercial or family transaction where a tax advantage is found, which is something which no general anti-avoidance measure has succeeded in doing to date. So far, the courts have held the line by ensuring that:

- the purpose test is assessed in relation to the factual context in which the taxpayer operated; and that
- the scheme whose purpose is relevant is not so narrowly defined that it ignores the factual basis of the transaction which th1.9(e context 3.5c0dowla-3.taxpay0. conte0003.9(sse)0(h)9

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just the identified tax benefit, or whether it must take into account the substance of the transaction which the taxpayer entered into.

This is the very issue which is central to *Hart v FCT*, which is currently before the High Court on appeal. This case involved an attack by the Commissioner on a home loan product which has been marketed in Australia by financial institutions with great success. The product - in this instance known as a wealth optimiser loan - provided for a loan in two facilities. One facility related to the loan in respect of the taxpayer's residence; the other related to the loan for

There are observations to be found which tend to suggest otherwise. In 1999 the Full Federal Court in *FCT v Consolidated Press Holdings Ltd* said that the exercise of the Commissioner's discretion does not depend on the correct identification of a scheme by the Commissioner. The Commissioner's discretion is enlivened so long as there is a Part IVA scheme.[19] The basis of this view must be that the identification of the scheme is posited as one of objective fact and therefore it would follow that so long as a scheme can be identified as a matter of objective fact, Part IVA applies.

But this view is not borne out by what has been said in more recent cases. Nor would it appear to be sustained by the provisions of Part IVA[20] or fundamental principles of due process.

In 2002 in Hart v FCT Hill J. said that if the Commissioner can re-identify schemes it is only initially and only between narrowly and widely defined schemes. The Commissioner may change his mind, but only subject to considerations of fairness.[21] This appears to be directed to his ability to choose between the narrowly and widely defined schemes which he has identified. His Honour's observation simply confirms the narrow way in which the High Court in Peabody expressed itself.

Nor does the High Court decision in Peabody support the proposition that the Court can itself identify a scheme as the Full Federal Court did in Spotless. If the Court were to formulate its own scheme at the hearing or on appeal, then the discretion vested in the Commissioner would not have been exercised.

As Hill J. observed in delivering the unanimous judgment of the Court when Peabody v FCT was before the Full Federal Court, the determination which the Commissioner makes must be made in relation to the scheme he idenitifies. The scheme which then has to be considered by the Court is the scheme in respect of which the Commissioner made his determination. As His Honour said:-

> …this Court cannot stand in the shoes of the Commissioner and exercise discretions which the legislature has committed to the Commissioner. This Court is confined to deciding whether the Commissioner's decision has been affected by some error of law, whether the Commissioner has addressed himself to the right issue or whether he has taken some extraneous factor into consideration or failed to take into account some relevant factor.[22]

Hill J. then went on to address the possibility that the Commissioner could formulate a new scheme, but came to the conclusion that in this situation the Commissioner would have to make a fresh determination and make an amended assessment. Those observations were not commented on or criticised in the High Court.

This approach also appears to be supported by the way in which the Full Federal Court last year in *FCT v Mochkin*[23] handled an attempt by the Commissioner to reformulate the scheme. The Commissioner attempted, before the Full Federal Court, to advance a wider scheme which had not been put to the first instance judge. The Full Federal Court took the view that the Commissioner could not rely on this wider scheme, as the

[19] 1999 ATC at 4967
[20] FCT v Peabody [1993-94] 181 CLR 359,382
[21] 2002 ATC at 4619
[22] 93 ATC 4101, 4116
[23] 2002 ATC 4465

taxpayer would have been prejudiced by not being able to call additional evidence relating to this scheme.

That approach accords with the principle established by *Peabody* and is consistent with the thrust of the principles formulated in the Full Federal Court subsequently.

The Third Identification Principle

The third principle is that in identifying schemes, the Commissioner must ensure that they exist in fact and reality, and are not simply figments of the Commissioner's imagination. This was referred to by the Full Federal Court in Spotless in the following way:-

> It is not sufficient to identify a scheme by reference to a hoped for fiscal outcome [Part IVA] requires that a scheme has an existence in fact and reality and is not something based on the Commissioner's view of the facts or their legal effect.[24]

This was illustrated in *Spotless.* When the case was before the Full Federal Court, the fact that the scheme, which the Commissioner had identified, was said to be a scheme to capture a tax benefit in the form of a special exemption from tax was criticised as being a reflection of the Commissioner's perception of the arrangement.

The Fourth Identification Principle

There is another issue regarding identification and that is whether a scheme can be identified only by what was in fact done, as distinct from what might otherwise have been done.

The issue was raised in Mochkin. In Mochkin, the taxpayer, who was a stockbroker, had been sued by a firm of stockbrokers

has now been established that by dominant purpose is meant that purpose which is "the ruling, prevailing or most influential purpose."[26]

The legislation refers to the conclusion about purpose being the purpose of the person, or one of the persons, who entered into or carried out the scheme – not the purpose of the scheme.[27]

In so far as the meaning of "entered into or carried out the scheme" is concerned, Hill J. in *Peabody's* case, when it was before the Full Federal Court, equated the expression with the word "participate". His Honour also emphasised that the relevant purpose is that of enabling the taxpayer to obtain the necessary tax benefit. In this context His Honour said that the expression "enabling" carried its ordinary meaning of "make able" or "make possible" and probably also meant "assist in making able or possible" or "contribute to making able or possible".[28]

The legislation refers to the conclusion about purpose being the purpose of the person, or one of the persons, who entered into or carried out the scheme. Therefore, the relevant purpose may be contributed by someone who is not the taxpayer. That does not mean that the purpose of the taxpayer is irrelevant, since the taxpayer may be a person who entered into or carried out the scheme. But, it does mean that anyone connected with the scheme can taint it, even if the taxpayer's purpose is totally untainted, which was the position in *Vincent v FCT*.[29]

It is also apparent that the requisite purpose may be contributed by someone who is not a party to the scheme. This is borne out by the *Peabody* case itself. There, the person whose purpose was relevant was Mr Peabody, yet he was not a party, in any legal sense, to any of the transactions. He was, however, a participant, in the sense of being the controlling mind behind the scheme.

The legislation highlights another problem. The purpose which is relevant is the purpose of the person, or one of the persons, who entered into or carried out, the scheme. As a scheme for Part IVA purposes can only be a stand-alone scheme, this raises the question of whether the inquiry must relate to the purpose of a person concerned with the stand-alone scheme, or whether the purpose of someone connected with part of a stand-alone scheme will suffice.

The High Court in *Peabody's* case held that if a person participates in only part of a stand-alone scheme, the purpose of that person can be taken into account, but that purpose must be ascertained in relation to the whole of the stand-alone scheme, not just that part of it with which the person was associated.[30] Therefore, it would follow that while a person may participate in only part of a scheme (which will be sufficient to provide the physical nexus) the purpose must relate to the whole scheme. The purpose which is relevant to this inquiry, however, is the dominant purpose.

[26] FCT v Spotless Services Ltd [1996] 186 CLR 404 at 416
[27] S177D; Hill J. Peabody v FCT 93 ATC 4104 at 4113
[28] Hill J. Peabody 93 ATC at 4113
[29] 2002 ATC 4490
[30] 181 CLR at 424

Ascertaining Purpose

If it is the dominant purpose which is relevant, the question is then, how the dominant purpose is to be ascertained. The legislation refers to the conclusion about purpose being drawn from the purpose of the person, or one of the persons who entered into or carried out the scheme. This tends to suggest that the conclusion about purpose can be ascertained from the subjective intention of the taxpayer, or anyone else who was connected with the scheme. However, the High Court has clarified that the relevant purpose is an objective purpose ascertained by having regard to objective facts. Thus, in the main judgment, in the High Court in *Spotless*

balancing exercise. All of the factors may not be relevant. The evidence relevant to each factor may not be equally important. But, the more significant factors and the evidence which supports them could be expected to carry more weight in the balancing process. However, what may be underpinning the observations which Hill J. has consistently made is a desire to ensure that a dominant purpose is not determined primarily by reference to the first few criteria. Some flexibility may be a useful tool in such determinations, particularly since the principles for determining dominant purpose are still evolving.

But, even if manner, form and substance and timing are more significant, this still leaves open the question of how an evaluation is to be made once a tax benefit has been identified as arising from the scheme. Tax benefits do not arise in a vacuum. They arise in a commerci Tw[nare st009 Tcx 1e schem

commercial purpose could cause a problem in future cases. His Honour's comments to this effect (they were not endorsed by the majority in that case, but nor were they rejected) were as follows:-

> … However, Pt IVA does not authorise the Commissioner to make a determination …merely because a taxpayer has arranged its business or investments in a way that derives a tax benefit. More is required before the Commissioner of Taxation can lawfully make a determination under that paragraph. First, the scheme must be examined in the light of the eight matters set out in para (b) S177D. Second, that examination must give rise to the objective conclusion that the taxpayer or some other person entered into or carried out the scheme or a part of the scheme for the sole or dominant purpose of enabling the taxpayer or the taxpayer and some other person to obtain a tax benefit in connection with the scheme. That conclusion will seldom, if ever, be drawn if no more appears than that a change of business or investment has produced a tax benefit for the taxpayers.
>
> The facts of the present case show much more than a switch of investments resulting in a tax benefit. The elaborate nature of the scheme and its attendant circumstances lead inevitably to the conclusion that the scheme was not merely tax driven but that its dominant purpose was to enable the taxpayer to obtain a tax benefit by participating in the scheme.[43]

The *Spotless* principles unsettled the established perception of the operation of Part IVA, because it was obvious that even if a transaction were an ordinary commercial transaction, this would no longer save it from being annihilated by Part IVA. Yet, it was difficult to see how the High Court's adoption of the view that a tax dollar saved was as good as any other sat comfortably with the decision on the facts.

The *Spotless* case arose out of a commercial transaction where a decision had been made to adopt a particular investment strategy to take advantage of a tax concession

the High Court, is equally able, if not better able, to support the Full Federal Court decision.

The Commercial Context

The decision in *Spotless* has raised two difficulties:

1. How can a commercial transaction, in which a tax benefit has been identified, survive on the basis that obtaining the tax benefit was not the dominant purpose?
2. How can any transaction, where it has been structured to obtain a tax benefit, specifically provided by ITAA, survive on the basis that obtaining the tax benefit was not the dominant purpose?

Some assistance regarding the interpretative approach which should be taken by the courts in addressing these two issues, is afforded by the Treasurer's statement in the second reading speech at the time the Bill for introducing Part IVA into ITAA was before Parliament, where the Treasurer said:-

> The proposed provisions – embodied in a new Part IVA of the Income Tax Assessment Act – seek to give effect to a policy that such measures ought to strike down blatant, artificial or contrived arrangements, but not cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for the

transactions which would not have been entered into, but for the tax benefit, in a manner consistent with the *Spotless* principles, yet maintaining consistency with the approach outlined in the Treasurer's second reading speech.

In *Eastern Nitrogen* the taxpayer had sold plant affixed to the taxpayer's premises to a financier and then leased the plant back at a commercial rental. This has been a familiar method of financing in Australia for decades. The transaction took the form of a lease. The rental payments under the lease gave a higher tax deduction than interest would have done. That was the identified tax benefit. This arrangement was held, by a unanimous decision, not to be a scheme to which Part IVA applied, notwithstanding that the transaction would not have been structured as a lease, but for the tax advantage.

The tax question confronting the Court was clear - whether the financing transaction, which provided a better after-tax return, could be said to have been entered into for the dominant purpose of obtaining the tax advantage.

The judgments in this case clearly show that the inquiry was directed, at least initially, to a consideration of the manner, form and substance of the transaction. In other words, the approach adopted in Spotless was followed. The approach to be adopted was outlined by Lee J. in the following statement:-

In *Eastern Nitrogen*, it was also at the heart of the matter and the Court specifically addressed the *Spotless* principles in relation to tax-driven transactions. Lee J., with whom Sundberg J. concurred, maintained that proper business management requires the net cost of financing to be taken into account. Furthermore, where a business relies on borrowings to provide circulating capital, the net cost of that finance, after taking into account any deductions that are available under ITAA, is a relevant consideration, and to adopt one form of financing over the other on such a basis, does not, by itself, lead to a conclusion that a dominant purpose to obtain that tax advantage exists.

> To show that a business which depends upon financiers to provide the recirculating capital needed for the operation of the business, has obtained that finance at a net cost, after taking into account provisions of the [ITAA], that is less than the net cost of obtaining finance by another method, will not, in itself, show that the dominant, ruling or supervening purpose of the operator of the business is to obtain the tax benefit constituted by the extent to which deductible outgoings incurred in respect of that borrowing will be

which enabled the tax advantage to be available, nor that the substance of the transaction was a single advance; nor the fact that the scheme brought about the obtaining of a greater amount of interest than would otherwise have been available, or the manner in which the transaction was entered into or carried out.

No, the importance of *Hart's* case lies in the fact that it has reconfirmed the necessity to identify the scheme by reference to the commercial reality of what the parties did and then to test dominant purpose against that. Hill J. said:-

> It is obvious enough, however, that so long as the scheme is found to include the making of the loan or loans, that one of the objectives of the scheme and indeed an important objective of it, was the financing of the acquisition of the (new house) and the refinancing of the (existing house).[50]

In other words, unless the scheme is identified by reference to what the taxpayer actually did, it is robbed of all practical meaning and cannot be considered to be a Part

accept that subjective intention may be relevant to one of the eight factors prescribed by S177D, e.g. the manner in which the scheme was carried out. The observation was not developed.[53] But, if subjective intention might be relevant to some of the S177D factors, it might equally be a relevant circumstance concerning the identification of the scheme itself.

The issue on appeal in *Zoffanies* was whether the Tribunal had applied the correct test, not the broader issue of what evidence may be admissible to support various S177D factors, or the aspect of commerciality. The ground on which the appeal ultimately succeeded was that the Tribunal had applied the wrong test. The Tribunal was found to have substituted the taxpayer's subjective motive or purpose for the objective test required by Part IVA, using subjective evidence of the taxpayer to do so.

The courts have also indicated that commerciality is not relevant to the identification of a scheme. This emanates from the decision of the Full Federal Court in *Spotless*.[54]

However, what the Full Federal Court said in *Spotless* on this issue needs to be examined. The observations of the majority were directed to criticism that the scheme identified by the Commissioner stated certain terms of the scheme were not normal commercial terms.[55] The majority judgment does not state that the ambit of what the parties were entering into or carrying out was irrelevant, or that it was irrelevant whether it was of a commercial nature. The Court only said that whether the terms were commercial was a matter to be considered in determining the purpose of the scheme. It said nothing about the commerciality of what the parties did, which is necessarily of critical importance to the identification of the scheme.

The importance of *Hart's* case is that it establishes that there are two tests to be applied in relation to ascertaining whether obtaining the tax benefit is the dominant purpose. First, the eight factors need to be considered with an assessment being made about the impact of tax in relation to each. Then the commercial side of the transaction needs to be weighed against the assessment made under S177D in order to establish whether there was a legitimate commercial objective, which is the overriding purpose of the transaction or, whether within the context of that commercial objective, tax considerations are all encompassing. At present, it appears that the commerciality of what the parties did is to be ascertained from the identification of the scheme and evidence relevant to that issue. If that is the correct reading of the effect of *Hart's* case, then the evaluation required under Part IVA is only two degrees of separation removed from the old Newton predication test.

CONCLUSION

What has emerged is that the way in which the scheme is identified in large measure determines the finding of purpose.

If the scheme is identified as those facts by which the tax benefit was obtained, then the purpose of such a narrowly defined scheme is a foregone conclusion and the inquiry required by S177D to establish the dominant purpose is irrelevant. It is only if

[53] 2003 ATC at 4954
[54] Spotless 95 ATC 4805
[55] Ibid at 4805

the scheme is identified by reference to the practical reality of what the taxpayer did, that the S177D considerations have a role to play and it becomes possible to make a determination about whether tax is the dominant purpose of the taxpayer's actions.