Senate Economics Legislation Committee

ANSWERS TO QUESTIONS ON NOTICE

Treasury

Australian Taxation Office

Budget Estimates 2004-05, (4 June)

Question: Webber 1

Outcome 2, Output 2.2.1

Topic: Mass marketed projects

Written question on notice-Senator Webber

Senator **Webber** asked:

1(a) At the ATO Pt IVA Panel meeting held over two days at the end of May 1999, how many taxpayers' tax returns were considered during the proceedings, and in how many mass marketed projects?

1(b) Were any minutes taken of the Panel Meeting and can they be made available?

1(c) What ATO action has occurred in relation to the taxpayers in the remainder of the 276 mass marketed projects which the Senate Economics References Committee noted in June 2001, as these were not eligible, as 174 were, for the June 2002 ATO settlement offer?

Answer:

1(a) On 27 and 28 May 1999 the Part IVA Panel considered a number of mass marketed investment schemes. The Panel considered 18 schemes and provided advice as to whether Part IVA would apply to those schemes. It also provided advice on other potential challenges under the primary provisions of the Act.

1(b) A record of the Panel meeting was prepared and a copy is attached apart from the record of discussion of potential criminal offences and aspects of specific investment schemes that may identify taxpayers. Release of this information is considered to be inconsistent with the Tax Office's secrecy responsibilities. The names of panel members have also been deleted from the attached record of discussion.

1(c) Following the February 2002 settlement offer an additional 27 schemes have been determined to be mass marketed investment schemes in accordance with the criteria as stated in the media release issued that day. Participants in the remaining schemes have been invited to either settle their dispute under the Code of Settlement Practice or to continue their dispute through the courts or Administrative Appeals Tribunal.

Part IVA Panel - SB Schemes Workshop
27 and 28 May 1999
Conference Room 36A, Casselden Place Office
REPORT

Panel members present: ---

TCN present: ---

Also present: ---

Auditors and Team Managers.

Matters discussed

1. The Panel considered the 18 schemes, providing specific advice as to whether Part IVA would apply to each scheme. It also provided advice on other potential challenges under primary provisions.
2. In addition, the Panel engaged in general discussion about key elements of schemes in general. This was done in the context of the application of primary taxation provisions and also of Part IVA.
3. The Panel also considered issues of fairness and administrative practice.
4. The Panel discussed four particular questions raised by --- team:

    (i) Using Part IVA to reopen assessments outside the sec 170 time period of 4 years
    (ii) Using electronic signatures on Part IVA determinations
    (iii) Legality of issuing a Part IVA determination after the Notice of Decision on an Objection has issued but prior to any Court or AAT hearing.
    (iv) Whether we can apply the outcome reached on schemes decided by the Panel to other schemes employing essentially the same technique(s).

Panel's general discussion of key scheme elements:

Leveraged management fees

(i) Capital component

There is a possibility where up-front fees are 'leveraged-up' that they might have a *capital component*. This argument is particularly strong where fees in the first year are significantly higher than those in the second year, although the 'services' provided by the Manager are substantially the same. This can also be argued in the context of the specific scheme, for instance with reference to the building of dams, irrigation of land, planting of vines. The problems with this argument are twofold: (i) there will invariably be a legal contract specifying what the fees are for, this contract will only show revenue items; (ii) there will often be difficulties in extracting this sort of information from financial accounts.

(ii) 'Carrying on a business'

It could be argued under section 51(1) that the investor is not 'carrying on a business'. This argument will depend on the individual features of the particular scheme. Factors to consider could include whether the investor has the power to appoint or terminate a manager and whether the investor's own 'share' in the business is readily identifiable. A problem with this argument could be that 'a business' is usually being run by someone, that is, someone is growing grapes or trees. In this case the Commissioner would argue that it was the manager who was carrying on the business.

(iii) Fletcher - type apportionment

If deductions exceed income, a *Fletcher* type analysis could be employed to apportion the initial expenditure, on the basis that not all of the expenditure was incurred in gaining assessable income, part was incurred in gaining a tax deduction. This argument will probably be of little use, since it will most likely be rare for deductions to exceed anticipated income. The apportionment would also be very difficult to effect.
Steele shows that 'assessable income' in section 51(1) is an abstract phrase which includes assessable income which the relevant outgoing 'would be expected to produce'. This would make it difficult for us to prove (from an evidentiary perspective) that the venture was not expected to earn assessable income.

(iv) Part IVA

The 'trick' to this type of scheme is the front-end load, with leveraging in the first year and no concession that any part of the expense is capital. Part of this is that the taxpayer claims a deduction for which they have outlaid no money and for which they are not at risk.
On the other hand, there is no inherent mischief in a taxpayer borrowing to incur an expense for which there is a tax deduction.
However, leveraged management fees are a significant factor in indicating that the dominant purpose was to obtain a tax benefit.
Some members of the Panel raised concerns about Part IVA applying in conjunction with the *Fletcher*-type apportionment. The problem here is that the *Fletcher* analysis will consider a taxpayer's subjective motive. There may be fairness problems in arguing, after a taxpayer has 'passed' the subjective test, that the taxpayer's objective dominant purpose was to obtain a tax benefit. On the other hand, Part IVA is designed to require an objective analysis of purpose.

Risk

The panel discussed the use of the terms 'non-recourse' and 'limited recourse' loans. It was unclear whether there is any recourse to the investor beyond a specified security under a 'limited recourse' loan.
It was also considered that de facto non-recourse loans could be constructed by the making of representations, by the promoter (or another party) that a loan that is full-recourse on its face will not be enforced. This would create an equitable estoppel in the investor, with the practical effect that the loan would be non-recourse. However, it would be very difficult to prove that such a representation had been made, since investors who revealed such a representation would risk their deductions.
It was suggested that for the purposes of these schemes a new term be invoked, 'deferred recourse'. This is a loan that need only be repaid at a later time out of the proceeds of the scheme.

Round robin financing

A round robin, of itself, is not offensive. For example, there is no essential mischief in the purchase of a piece of property where the vendor invests the proceeds of the sale in a trust which lends the money to the purchaser.
However, in many of these schemes the round robin, which facilities an inflated pre-payment, is one of the real problems.
Nonetheless, the panel did not consider that a round robin by itself would be sufficient to make a scheme subject to Part IVA. The round robin may need to be linked to other features, such as no real money being invested, little real money being available to the manager, and an investor not being exposed to risk.

Taxpayer's net cash position

The Panel considered that Part IVA could apply even where the taxpayer was in a negative net cash position. That is, even where the expense incurred by the taxpayer in entering the scheme exceeded the tax refund obtained. It would still be possible to say that but for the tax refund, the taxpayer would not have entered the scheme. In such a situation, however, the taxpayer may have a stronger argument that they hoped to gain assessable income.
In essence, Part IVA is not concerned with weighing up what a particular tax benefit costs a person. Part IVA weighs purposes, not costs.

Arms length dealings

The Panel noted that just because two parties are arms-length, does not mean they *deal* at arms length. Nor is it possible to argue that an arrangement that involves arms length parties is necessarily commercial.

Wash of scheme income

The washing of the income is part of the overall arrangement. Often the scheme will not make sense if the promoter has to return scheme income. However, it may not be necessary to deal with the washing of the income where the scheme that the Commissioner is concerned with relates to the upfront deduction. In that case, the washing will not be an integral part of the s.177A scheme.
Also, a focus on the 'washing' could dilute our argument, since it could indicate that the dominant purpose of the promoters was to enrich themselves, and that the enrichment of the investor was only a subsidiary purpose.

Administration of Schemes cases and Part IVA

General observation by the Panel that Courts and taxpayers will require punctilious adherence to the requirements of Part IVA.

Section 177C: Tax benefits

Where the Commissioner relies on Part IVA, the question will arise how much of the deduction claimed by the investor ought to be disallowed. In particular, ought the investor's actual cash investment to be disallowed as a deduction?
There is an argument that the essential character of the scheme is that the investor 'buys' tax deductions. The cash outlay, then, was also incurred only to gain a tax benefit. In that sense the scheme can be 'wholistically' characterised, and dealt with as a whole. That would mean that the entire deduction would be disallowed.

The problem with this approach could be that there *is* usually, some underlying business. That is: grapes and trees are growing as part of a business, which suggests that someone ought to be allowed a deduction for the expense of growing them.
This emphasises the fact that any attempt to apportion the expense must be very difficult. The general view of the panel was that the whole deduction ought to be disallowed.

The panel was of the view that the Commissioner needs to be very careful about defining the tax benefit correctly, including character and amount. In particular, we need to ensure that determinations show the correct tax benefit. In this context there is a danger that a single determination that covers different elements of the scheme deductions (eg. management fee, loan fee, farm fee, capital fee) could be too uncertain. A taxpayer probably needs to be able to see clearly the case that they have to answer. This means that they need to know precisely which elements of the deduction are being cancelled, and why. The best way administratively to deal with this is probably to make *one determination for each fee*. Section 177F(2D) allows the Commissioner to include more than one determination in the same notice. The notice would provide that it contains three determinations relating to three (say) tax benefits. The advantage of this approach is that it allows the taxpayer to object to specific elements of our application of Part IVA.

Compensating Adjustments

The question arises as to whether the Commissioner ought to make a compensating adjustment by rendering the income from the scheme not assessable income to the promoter. On the one hand there were concerns about perceptions of fairness. On the other hand, it was noted that if the deduction were disallowed on the basis that it was capital, the income from the scheme would still be assessable.
This issue was not decided absolutely. --- is to work together with TCN in cases to seek an appropriate solution.

Penalties

In relation to issues of fairness and justice, tax avoidance penalties are 50%. This needs to be considered in the context of investors who may have been deceived by promoters. For some, the disallowance of the deduction may almost be penalty enough. --- have already implemented a procedure to give investors the opportunity to remit penalties (in the best case, to 5%), by cooperating with the Commissioner in his investigation of the scheme.

Criminal pursuit

The Panel noted that one of the criticisms of the Tax Office in the former 'schemes era' was that it did not adequately pursue the criminal aspect of scheme promotion.
There *are* some criminal offences that could apply here. For instance, money laundering type offences, found in the *Proceeds of Crime Act 1987, Part V, Div. 1 - Money laundering*. There may also be indictable fraud, which would allow the income to be traced to the money launderer. There could also be crimes against the *Crimes (Taxation Offences) Act.*

The panel also noted that part of our strategy for combating schemes needs to be to tackle the promoters.

Discussions of particular schemes

Decisions made on particular schemes, particularly in relation to Part IVA, are necessarily subject to consideration in the light of the individual taxpayer's circumstances.

Four alternative arguments exist:

(i) the expenditure is not deductible under 51(1) because it is not incurred in carrying on a business;
(ii) the expenditure is capital in nature;
(iii) part of the expenditure is disallowable because the taxpayer's subjective purpose was not to earn assessable income (*Fletcher)*
(iv) Part IVA applies.

The whole deduction is to be disallowed.
Separate determinations (in one notice) to be made for each element of the deduction (*eg.* purchase of --- fees, management fees).

Further application of this decision:

It was considered by the Panel that the two schemes --- were in essentials on all fours with ---. As such, the approach outlined above, including the application of Part IVA, for --- would apply equally to those schemes.

It was considered by the Panel that this decision would apply equally where the invested funds were applied to gaining shares in promoter entities (as opposed to being a fee of some sort). There would need to be some sort of tacit arrangement that the promoter buy back the shares and put the money toward the loan.

A notable feature of this scheme is that the upfront payments are for ---. In many other schemes, the upfront payment is for 'management fees'. The panel discussed the issue of whether the --- could comprise a capital component. TR 95/6 and IT 2296 allow seedlings as 'incidental and relevant to carrying on a business and is deductible in the year of income in which it is incurred'.

It is unclear in this scheme whether the loan is non or deferred recourse. Some further investigation will need to be conducted. If it can be shown that the loan is non-recourse, the result is the same as in ---, Part IVA applies.

The panel considered that Part IVA applies.

The arrangement here comes close to being a sham. The round robin is similar to that in ---, so the same arguments apply here.

This is a --- scheme which has non-recourse loan funding using a round robin arrangement. ---

The scheme has involved disagreements --- and is operating at a significantly lower level than forecast.
The audit is already at a fairly advanced stage. The deductions have already been disallowed on the basis of *Fletcher* and Part IVA. We are also arguing sham here.

This scheme is highly artificial. For instance, the business was not yet set up when --- and only commenced at a low level of activity 6 months later. It is still difficult to discern any real underlying business.

It could be possible to argue here that the --- fee is capital, despite the fact that it is paid annually. The argument would be that it goes to the income-producing structure of the business.

Alternatively, it could be argued that the amount is not incurred to gain assessable income, because there can be no reasonable expectation that the 'business' will earn any assessable income (*ie. Fletcher* argument). Alternatively, Part IVA applies.

There was a business already in existence when this scheme was set up. However, actual business activity is minimal. The royalty is meant to be an annual fee, but it is much higher in the first year than in other years.

Again, *Fletcher* type argument and Part IVA.

Main argument here is that investors are not 'carrying on a business'. The loan appears to be de facto non-recourse because of the indemnity.

There was some discussion about methods of extracting income from overseas company ---. Part IVA might be a possibility, but that will depend on what the structure was set up for. Alternatively, we could argue section 255, *Person in receipt or control of money from non-resident.*

We could try arguing sham here. Alternatively, we could argue that there is no 'business', it is only really a paper transaction. Part IVA also applies.

Division 10B allows a capital deduction for a unit of industrial property. One challenge to the deduction is that the expense was not made at arms-length, as there was no 'hard bargaining'.
It could be argued that the initial assignment --- creates an immediate assessable gain (*Myers Emporium).* This argument will require close attention to the terms of the agreement.
Section 102CA could also be argued.

Although the loan is not actually non-recourse, the existence of the deeds combined with the double round robin means that investors would not conceivably have any exposure to recovery action ---. That is, there is no real risk.
There is also an equity of redemption argument around the assignment: argue that the absolute assignment was for security, giving the assigner an equity of redemption. (The assigner does retain some rights under the assignment clause, eg. the right to surplus). Then you have to argue that they are not entitled to that equitable remedy (clean hands doctrine) and that they have abandoned their equitable right by dealing inconsistently with it.
There was a private binding ruling request here, but we refused to rule as we had already commenced audit activity. In terms of litigating issues, it is better for us to have an assessment rather than a PBR. The disadvantage in contesting a PBR is that both parties are confined to the facts detailed in the application.
Part IVA applies also to the interest deductions

The decision in *Victor Gross* is relevant here, and puts us in a strong position.
There was a suggestion that the mischief here could be countered by the simple application of the *James Flood* decision - that you can't have a deduction in year one where the liability is subject to contingencies in later years. The essential question will be whether there is here a future contingent obligation, or a presently existing but defeasible obligation. No legal or business soundness here.
Our assessments have been raised, arguing that --- did not exist.
We could also argue fraud or evasion here, --- at the time they say it existed.

Strategy here is first to argue section 124ZAM: No deduction unless expenditure at risk. If that section fails, Part IVA applies.
However, if a deduction is disallowed under Division 10BA (eg. section 124ZAM), it can still be allowed under Division 10B.
The possibility was considered but rejected that the --- could be a Division 16E security. There could be problems getting around *FCT v Lau.*
Conclusion: no deduction for the --- is properly invested in Australian film and is an allowable deduction.
An issue arose around assessment of income: the entire --- guaranteed return is potentially assessable income. Is it fair to assess that full amount if only --- was allowed as invested in the film? There was an 'underage' clause here, where the investor invests the full amount, --- and if the producer can make the film for less, the producer can keep the excess. In this sense it may not really be relevant that only --- actually went into the film.

The scheme is very blatant, assessments have already been raised. --- Some appeals already on foot in AAT and Federal Court.

The Panel was reluctant to commit itself at this stage to the application of Part IVA. There is real money involved in the round robin here, and the scheme did take place as the documentation suggests. ---
Nonetheless, there was a large up-front deduction and deferral of income. Only about

--- was used in the actual production.
Some discussion of whether it was appropriate to disallow the deductions under section 51.
--- is to see a position paper on Part IVA issues, ---also to see a position paper on section 51 issues.
This scheme requires careful attention because it is more sophisticated than many others.

This scheme is commercially unreal. It was sold to investors on the basis of 'no risk'. However, there was a theoretical possibility at least (if the finance company decided not to enforce the security deposit with the subcontractor) that recourse could be had against the investor.
There is a strong case here based on section 51. Part IVA to apply in the alternative.

The deductions here involve --- provisions as well as other provisions of the Act. The loan is alleged to be full recourse, but there does seem to be an ambiguous sort of reassurance of investors that they won't be pursued beyond scheme income. The tax opinion enclosed in the prospectus uses the term non-recourse ---. There may be an equitable estoppel nonetheless.
There is an argument that the amounts are not deductible under section 51. There are also strong arguments relating to quarantining and the --- entity: that the interest may need to be quarantined, in part at least.
We could also argue that amounts are not allowable under section 330-15 ITAA 1997, not of relevant character.
Part IVA to apply in the alternative.

Panel discussion and advice on general issues

(i) Part IVA Assessments outside the section 170 time period of 4 years

The Panel was of the view that where Part IVA is the only basis to deny a deduction or include an item as income, it will be available after the expiration of the section 170 four year time period. However, it was not appropriate to use Part IVA as a 'backdoor' method of opening assessments that ought clearly to have been challenged under primary sections. As such, we ought to ensure that amended assessments are issued within the four year period in cases where there is doubt as to whether it is necessary to rely on Part IVA.

There is also an issue around the term "allowable" in paragraph 177C(1)(b). There is a risk that the courts may take the view that "allowable" means "properly allowable" (in theory), rather than "actually allowed". If that interpretation is given by the courts, we will be prevented from making Part IVA amendments outside the four year rule if a taxpayer can successfully show the court that the deduction was not "properly allowable".

If these issues are ever litigated, they should be escalated back to the Panel.

(ii) Using electronic signatures on Part IVA determinations

'Electronic signature' is defined in section 6(1) ITAA 1936: it is a unique identifier in electronic form. It is expected that this would be an image in the signature block of a determination.

The Panel was of the view that this was an issue that required further work and research. There are important questions around whether the signature is necessary at all, and if it is, whether an electronic one will suffice.

Because it is important for Part IVA that it be clear that a decision maker has addressed his or her mind specifically to the case at hand, and given the uncertainty around this issue, it was decided for present purposes that the determinations ought to receive individual signatures.

(iii) Legality of issuing a Part IVA determination after the Notice of Decision on an Objection has issued but prior to any Court or AAT hearing

The following is taken from the advice ---:

As indicated previously, we must make all efforts to make determinations at the time we propose to disallow any deductions or make other adjustments in respect of scheme cases.

After the decision of the Full Federal Court in ***Stokes,*** the Chief Tax Counsel has, inter alia, said the following:

- To give effect to a determination under section 177F, an assessment should be issued under section 166 of the Act if no assessment has been issued previously in respect of the relevant year against the taxpayer.

- If an assessment has been issued prior to making the determination but the "tax benefit" was not included, it will be necessary to issue an amended assessment under section 170 of the Act to give effect to the determination.

- If prior to making the determination, the "tax benefit" was included in assessment under sections of the Act other than Part IVA (eg. section 25(1) of Part IIIA), it will not be necessary to issue an amended assessment. As a matter of practice, we should issue and serve on the taxpayer a copy of the determination.

In addition to the above, please note the following in response to the issue:

If the matter is already a Part IVC case either in the Tribunal or the Court and no Part IVA determination has been made up to that stage and if the ATO wishes to rely on Part IVA, a determination must be made and served on the taxpayer as soon as it is practicable. We also need to inform the taxpayer of his or her right to respond to this issue prior to the hearing of the matter. The law after both ***Jackson*** and ***Stokes*** is not quite clear. This issue will be tested and we will get some clarity of the law in the fullness of time.

(iv) Whether we can apply the outcome reached on schemes decided by the Panel to other schemes employing essentially the same technique(s)

The Panel was of the view that where a schemes falls within the broad categories decided on here, TCN could approve the application of Part IVA. However, if a case was different or raised a novel issue, or if taxpayers raised new or novel arguments in response to our position papers, these should be escalated back to the Panel.

This process could be monitored by TCN peer review, which would involve communication and cross sampling to ensure consistency.

This approach was approved by the Second Commissioner.

Where time is the essence of making a Part IVA decision, SES officers in SB can make those decisions subject to a review by the Panel when possible.

In all cases being litigated where Part IVA is an issue, we need to have a Senior Tax Counsel involved.