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[Insert Client Name]

[Insert Client Position]

[Insert Company Name]

[Insert Client Address]

[Suburb State Post Code]

Dear [Insert Client Name]

**Re:** **Part IVA: General anti-avoidance provisions**

The general anti-avoidance rules contained in Part IVA of the *Income Tax Assessment Act 1936 (****ITAA 1936****)* may be applied by the Australian Taxation Office (**ATO**) to deny a taxpayer the tax benefit of a scheme they have entered into in certain circumstances.

**Executive Summary**

The key features of Part IVA include the following:

1. Is there a scheme?
2. Has a tax benefit been obtained?
3. What was the taxpayer’s sole or dominant purpose?
4. What happens when Part IVA is applied?

Each of these issues is explored further below.

1. **Is there a scheme?**

It is important to identify the scheme as it sets the framework for determining if a taxpayer has obtained a tax benefit in connection with the scheme, and whether the dominant purpose of the taxpayer of entering into the scheme was to obtain the tax benefit.

Part IVA provides a broad definition of "scheme”, which includes any agreement, arrangement, promise or undertaking, whether express or implied and whether or not enforceable or intended to be enforceable by legal proceedings. It also includes any unilateral scheme, plan, proposal, course of action or course of conduct.

As a scheme includes any unilateral action, it is not generally difficult to establish the existence of a scheme, however, this must be based on fact and reality and not determined by reference to a desired outcome[[1]](#footnote-1).

1. **What is the tax benefit?**

A ‘tax benefit’ is defined in section 177C of the *ITAA 1936* as one of the following amounts:

* an amount not being included in assessable income,
* a deduction being claimed,
* a capital loss being incurred,
* a foreign income tax offset being allowable,
* an innovation tax offset being allowable,
* exploration credits being issued,
* a taxpayer not being liable for withholding tax,
* a loss carry back offset being allowable,[[2]](#footnote-2) or
* a refundable Research & Development tax offset or a non-refundable tax offset being allowable.[[3]](#footnote-3)

Furthermore, section 177C of the *ITAA 1936* specifies that a taxpayer will have obtained a tax benefit in connection with a scheme if the tax benefit would not have arisen if the scheme did not occur, or would reasonably not have arisen if the scheme did not occur.

In 2013, the Federal Government implemented amending legislation[[4]](#footnote-4) to tighten the rules applicable to determining whether a tax benefit has been obtained under Part IVA. These changes have a retrospective application to schemes entered into from 16 November 2012, and may have significant impact on business transactions.

1. Schemes entered into before 16 November 2012

In making a determination of tax benefit and purpose, the Commissioner was required to make a comparison of the tax consequences between the scheme in question and an alternative postulate[[5]](#footnote-5). Whilst the alternative postulate was not codified in the statute, it had been determined by the judiciary to be the most appropriate analysis used in order to reach a conclusion about the purpose(s) of the participants in the scheme and whether a tax benefit had arisen in connection with the scheme.

In light of an increasing trend in court decisions in favour of the taxpayer, the Federal Government became concerned that the ‘tax benefit’ test was too easily undermined by an alternative postulate that without the tax benefit the scheme would not have been implemented at all (i.e. the “do nothing” argument). As a consequence, revised legislative provisions were introduced to remedy the perceived shortcomings of the law.

1. Schemes entered into on or after 16 November 2012

The legislative amendments remodelled the working of Part IVA and, amongst other things, codified the alternative postulate used to determine if there is a tax benefit in connection with the scheme under two limbs set out under section 177CB of the *ITAA 1936*. Satisfaction of either limb (together with the other requirements of Part IVA of the *ITAA 1936*) can trigger the application of Part IVA to deny a tax benefit obtained by a taxpayer. Furthermore, these changes effectively eliminate the ability of a taxpayer to mount a successful Part IVA defence that relies on an argument which is a “do nothing” alternative postulate.

1. The first limb is satisfied if the tax effect (e.g. a denial of a deduction or the inclusion of income) *would not have occurred* but for the scheme. This is determined based on a postulate that comprises only the events and/or circumstances that actually happened or existed (excluding those that form part of the scheme). The first limb is described as the ‘annihilation approach’ as it requires a postulate that considers what would have occurred in the absence of the scheme i.e. the scheme must be assumed not to have happened and is annihilated.

*Example[[6]](#footnote-6) – ‘annihilation approach’*

Junie, a foreign resident, enters into an arrangement under which her assessable income, which she would otherwise derive from Australian sources, is instead derived from foreign sources. The result of the arrangement is that the income is not assessable to her in Australia. In this regard, the tax benefit is the reduction in Junie’s assessable income. If the arrangement had not been entered into, the income ‘would have’ been included in Junie’s assessable income because the only operation of the scheme was to change the source of income for taxation purposes.

1. The second limb is satisfied if the tax effect *might reasonably be expected to have occurred* if the scheme had not been carried out. This is determined based on a postulate that is a reasonable alternative to carrying out the scheme. The second limb is described as a ‘reconstruction approach’ as it requires a postulate that could reasonably take the place of the scheme (i.e. this will involve a reconstruction of the state of affairs that would have existed if the scheme had not been entered into or carried out, such as theoretical modifications of a transaction). Of particular relevance is the requirement that the reasonable alternative must disregard any potential tax results and consequences. As a corollary, it is not possible for a taxpayer to put forward a “do nothing” postulate to avoid the application of Part IVA where the reconstruction approach is applied.

*Example[[7]](#footnote-7) – ‘reconstruction approach’*

Chloe borrows money to acquire a family home and a property for use in her business. Chloe enters into a borrowing arrangement whereby the repayments are applied exclusively to the borrowings in relation to the family home, so that the deductible interest payments are increased for the business property borrowing and the non-deductible interest payments for the family home borrowing are minimised. If the ‘annihilation approach’ is applied, this would not leave a sensible result as there would be no borrowing at all. Therefore, it is necessary to apply the ‘reconstruction approach’ to consider what might reasonably be expected to have happened if the scheme had not been entered into. In this regard, a reasonable alternative for Chloe is that she could have taken out a separate loan for each property under normal commercial terms.

However, it is important to note that a tax benefit does not arise in connection with a scheme under section 177C(2) of the *ITAA 1936* if the tax benefit is attributable to the making of an agreement, choice, declaration, election or selection which is expressly provided for in the income tax legislation unless a scheme was entered into to create the circumstances where the taxpayer was able to make such an agreement, choice, declaration, election or selection. Accordingly, a taxpayer obtaining a deferral of a net capital gain by electing to apply capital gains tax rollover relief will not have received a tax benefit unless that taxpayer had entered into a scheme whereby the taxpayer had become eligible to apply such rollover relief.

1. **What was the taxpayer’s sole or dominant purpose?**

In determining whether Part IVA applies it is also necessary to determine whether a person entered into or carried out a scheme did so for the sole or dominant ‘purpose’ of enabling a taxpayer to obtain a tax benefit in connection with the scheme.

Accordingly, if obtaining a tax benefit is only an incidental purpose of a taxpayer entering into a scheme, then this is not sufficient for Part IVA to apply.

The purpose motivating the scheme must be determined on a strictly objective basis, taking into consideration the following eight factors listed in section 177D(2) of the *ITAA 1936*:

1. the manner in which the scheme was entered into or carried out,
2. the form and substance of the scheme,
3. the time at which the scheme was entered into and the length of the period during which the scheme was carried out,
4. the result in relation to the operation of the Tax Acts that, but for this Part, would be achieved by the scheme,
5. any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme,
6. any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme,
7. 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, and
8. the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in paragraph (f).

Various cases have clarified how the above eight matters are to be interpreted in practice. Some of the key decisions arising under these cases are as follows:

* the Commissioner of Taxation must consider all eight factors in weighing up whether a tax avoidance purpose exists (*Peabody v FCT* 93 ATC 4104),
* however, it is not relevant that every factor be proven in respect of every scheme. Indeed, it was held by Callinan J in *FCT v Hart* 2004 ATC 4599 that the presence of one factor alone may be sufficient in itself so as to constitute a dominant purpose, and
* the actual subjective purpose of any relevant person is not a relevant matter to be considered in any application of section 177D(2) (*Peabody v FCT* 93 ATC 4104).

It is also worth noting that the relevant purpose does not have to be attributed to the taxpayer who obtained the tax benefit but may be that of any person who has entered into or carried out the scheme or any part of the scheme. This means that the purpose of a tax adviser involved in the implementation of a scheme can be taken into account in determining whether Part IVA is applicable[[8]](#footnote-8).

Whilst a transaction may be entered into based on a rational commercial decision, this does not necessarily mean that the dominant purpose has not been established. A decision to enter into a transaction can be both commercially and tax driven, but the relevant purpose will be the one that is the most influential, ruling or prevailing purpose. Therefore, it is very important to have proper documentary evidence to support a taxpayer’s defence that the provisions of Part IVA do not apply to a transaction.

1. **What happens when Part IVA is applied?**

Where it is determined that the taxpayer entered into a scheme to obtain a tax benefit the Commissioner of Taxation has a discretion under section 177F(1) of the *ITAA 1936* to cancel the relevant tax benefit.

Accordingly, where the tax benefit is in relation to an amount not being included in the assessable income of the taxpayer in an income year, that tax benefit may be cancelled and the amount included in assessable income.

Alternatively, where the tax benefit is in relation to a deduction being allowable in a year of income that tax benefit may be cancelled and the deduction treated as being wholly or partly non-allowable.

Similarly, capital losses, offsets and credits may be cancelled where the tax benefit obtained took the form of a capital loss, offset or credit.

Finally, where the tax benefit took the form of an amount not being subject to withholding tax that tax benefit may be cancelled and the taxpayer will become wholly or partly liable for such withholding tax.

**Multinational Anti-Avoidance Law** [consider deleting if client does not have consolidated accounting income of AUD$1 billion or more]

In 2015 the Federal Government inserted the Multi-National Anti-Avoidance Law (**MAAL**) into section 177DA of Part IVA of the *ITAA 1936* to crackdown on certain tax avoidance practices of multinational groups.

The purpose of the amending provisions in section 177DA of the *ITAA 1936* is to counter the erosion of the Australian tax base by multinational enterprises using artificial and contrived arrangements to avoid the attribution of profits to a permanent establishment in Australia.

Such a tax benefit will be cancelled if:

* the taxpayer is a significant global entity (with annual global income of $1 billion or more) who makes supplies to customers in Australia,
* the activities are undertaken in Australia directly in connection with those supplies by an Australian entity which is associated with or commercially dependent on the global entity, and
* the taxpayer obtains a tax benefit being the avoidance of tax arising from the attribution of income to an Australian permanent establishment that was entered into for the ‘principal’ purpose of obtaining a tax benefit.

The MAAL applies on or after 1 January 2016 in connection with a scheme (even where that scheme commenced to be carried out before that day).

In addition, from 1 July 2017 a diverted profits tax (**DPT**) applies under Part IVA to ensure that significant global entities are not able to obtain a tax benefit by diverting profits generated in Australia offshore. Should this be the case, tax will be potentially levied at a rate of 40% on the amount of profits diverted overseas where the entity has Australian income of more than $25 million.

Further clarity concerning the operation of the DPT is set out in Law Companion Ruling LCR 2018/6. The Commissioner has also released Practice Compliance Guideline 2018/5, which sets out the ATO’s risk assessment, client engagement frameworks and compliance approach when DPT is identified**.**

**Actions to consider**

When considering any proposed transactions, you must carefully consider the transaction’s commercial and economic substance. In particular, you should ensure that this substance can be clearly demonstrated in a reasonable alternative scheme.

Apart from the impact of Part IVA applying to “reverse” the impact of any scheme, the ATO can also impose significant penalties in respect of the tax benefits obtained.

The practical application of Part IVA can be difficult to understand and apply as there is little guidance currently available other than Practice Statement PS LA 2005/24, which was updated for the 2013 amendments, but have yet to be clarified judicially.

Accordingly, if you require assistance in determining whether a proposed or actual transaction may be subject to Part IVA, please contact me on [insert telephone number of Partner].

Yours faithfully

**[Insert name of Partner]**

1. *FC of T v Spotless Services Limited & Anor* 95 ATC 4775. [↑](#footnote-ref-1)
2. Applies on or after 1 July 2021 even if the scheme was entered into or commenced to be carried out before that date. [↑](#footnote-ref-2)
3. Applies on or after 1 July 2021 even if the scheme was entered into or commenced to be carried out before that date. [↑](#footnote-ref-3)
4. *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013.* [↑](#footnote-ref-4)
5. That is, a hypothetical scenario considering whether there were other ways that the participants in the scheme could have achieved the same commercial outcome with different tax consequences. [↑](#footnote-ref-5)
6. Adapted from Example 1.2 of the Explanatory Memorandum to *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013.* [↑](#footnote-ref-6)
7. Adapted from Example 1.3 of the Explanatory Memorandum to *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013.* [↑](#footnote-ref-7)
8. *FC of T v Consolidated Press Holdings Ltd* 2001 ATC 4343. [↑](#footnote-ref-8)