



Sham, Fraud & Evasion

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Sham and fraud allegations

Increasingly in disputed tax cases, the ATO is alleging sham and fraud in order to ignore an arrangement (sham) and avoid the four year limit on amended assessment (fraud). This presentation looks at the meaning of these terms in the tax context and will suggest how taxpayers advisers when faced with creative allegations of this nature.

- *What is the meaning of sham – a review of the Commissioner’s approach and the decided cases*
- *Some examples of common transactions which are shams*
- *How to ensure that tax structures are not shams*
- *The meaning of fraud and evasion – what is the difference between the two?*
- *How to avoid transactions being classed as evasion*
- *Dealing with ATO allegations of sham and fraud – what is the best strategy?*

1. Overview – tax evasion, tax avoidance and tax planning¹

1.1 Before the concepts of ‘sham’ and ‘fraud or evasion’ are explored, regard should be given to the concepts of ‘tax evasion’, ‘tax avoidance’ and ‘tax planning’. Broadly speaking:

1.1.1 **tax evasion** – is the non-payment of tax which would properly be chargeable to a taxpayer if the taxpayer made a full and true disclosure of assessable income and allowable deductions. Tax evasion can be described as the fraudulent misstatement of taxable income so as to avoid the payment of tax (for example, the failure to declare amounts of cash income, or over-stating deductible expenses);

1.1.2 **tax avoidance** – which is the entry into artificial and contrived schemes by a taxpayer seeking to avoid tax. A taxpayer entering into a transaction which (whilst having legal consequences) have very little or no impact on a taxpayer’s financial position or the financial position of the taxpayer and any associates taken as a group; and

1.1.3 **tax planning** – which is concerned with the organisation of a taxpayer’s affairs (or the structuring of transactions), with the result that there is minimum tax liabilities within the law, without being an artificial tax avoidance arrangement.

1.2 It should be noted that Part IVA of the *Income Tax Assessment Act 1936* (Cth) (**‘the 1936 Act’**) is concerned with ‘tax avoidance’ schemes, and not ‘tax evasion’ (of which fraud or evasion would include).

¹ References: GT Pagone, *Tax Avoidance in Australia*, 2010. Woellner et al, *Australian Taxation Law 2012*, and Kobetsky et al, *Income Tax – Text, Materials and Essential Cases*, 2008.

1.3 It is said that the distinction between tax avoidance and tax evasion is easier to determine as compared with the distinction between tax avoidance and tax planning. Denis Healy, a former Chancellor of the Exchequer (in the UK) once quipped that '*... the difference between tax avoidance and tax evasion is the thickness of the prison wall*'.

1.4 In *Australasian Jam Co Pty Ltd v FC of T* (1953) 88 CLR 23, Fullagar J distinguished 'avoidance' from 'evasion' on the basis that avoidance (unlike evasion) does not require any active or passive fault. Unlike tax avoidance, tax evasion involves some element of fault, or illegality (see *R v Mears* (1977) 37 ATR 321). Tax evasion involves a failure to discharge an obligation which has arisen, whilst tax avoidance is directed at preventing the obligation from arising in the first place.

1.5 However, it is more difficult to distinguish between (legitimate) tax planning, and tax avoidance.

1.6 Lord Nelson in *IR Commrs v Willoughby* [1997] 4 All ER 65 at 73, observed that:

The hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequence that Parliament intended to be suffered by any taxpayer qualifying for such reduction in his tax liability. The hallmark of tax mitigation, on the other hand, is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation, and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option. Where the taxpayer's chosen course is seen upon examination to involve tax avoidance (as opposed to tax mitigation), it follows that tax avoidance must be at least one of the taxpayer's purpose in adopting that course, whether or not the taxpayer has formed the subjective motive of avoiding tax.

1.7 It may be said that tax planning considers both the letter and the spirit of the law, whereas tax avoidance only considers the letter of the law.

2. Anti-avoidance provisions

2.1 Anti-avoidance legislation may be considered either specific, or general, in nature. Specific provisions are enacted to clamp-down on particular abuses of the tax system. Examples of specific anti-avoidance provisions include the alienation of personal services income provisions contained in Divisions 84-87 of the *Income Tax Assessment Act 1997* (Cth) (**the**

1997 Act'), and the non-commercial loss provisions contained in Division 35 of the 1997 Act.

2.2 Part IVA of the 1936 Act contains Australia's general anti-avoidance provisions. Part IVA of the 1936 Act has operated since 1981, and applies where:

2.2.1 a taxpayer enters into a 'scheme';

2.2.2 the taxpayer obtains a 'tax benefit' from the scheme; and

2.2.3 the circumstances indicate that the obtaining of the tax benefit was the 'dominant purpose' of one of the parties.

3 Sham

3.1 Hill J in *Faucilles Pty Ltd v FC of T* considered that a 'sham' transaction is one which is intended to have no legal effect, if there is a common intention of the parties that the transaction should be a 'cloak' or 'disguise' for another transaction, or no transaction at all. Lockhart J in *Sharrment Pty Ltd & Ors v Official Trustee in Bankruptcy* (1988) FCR 449 at paragraph 16 defined the term 'sham' as:

... something that is intended to be mistaken for something else or that is not what it really purports to be. It is a spurious imitation, a counterfeit, a disguise or a false front. It is not genuine or true, but something made in imitation of something else, or made to appear to be something which is not. It is something which is false or deceptive.

3.2 That is, a sham will be found where the acts or documents executed by a taxpayer (and other parties) are intended to give the appearance of legal arrangements which differ from the actual legal rights and / or obligations created by the taxpayer.

3.3 That is, a transaction is a sham when the parties to a transaction have a common intention that their acts or documents are not to create the legal rights and obligations which they give the appearance of creating (*Bayly v FC of T* (1997) 15 SASR 446). Whilst a sham transaction is legally ineffective, not all ineffective transactions will be shams (*Commissioner of Taxation v Just Jeans Pty Ltd* (1987) 16 FCR 110), even if illegality is involved (*Lau v FC of T* (1984) 54 ALR 167).

3.4 As noted in *Jaques v FC of T* (1924) 34 CLR 328 at 325, a transaction of itself is void, has no legal effect, and does not require a statutory provision to nullify such a transaction.

- 3.5 As discussed in Kirby J in *Raftland Pty Ltd v FC of T* 2008 ATC 20-029, when considering whether a transaction is a sham, one must consider whether the arrangement is (according to the parties to the transaction) to have legal reality, or whether the purported transaction is a mere pretence.
- 3.6 It should be noted that just because a transaction is ‘artificial or contrived’ (which is a hallmark of tax avoidance), does not mean that the transaction is a ‘sham’ (see *Oakey Abattoir Pty Ltd v FC of T* 84 ATC 4406). Some cases in which the courts have considered that a transaction is a ‘sham’ includes:
- 3.6.1 *Alloyweld* 84 ATC 4328 – where a prepaid interest scheme was considered to be a ‘sham’ because of an admission by a director of the taxpayer company that he ‘... regarded the arrangement as not being a loan at all and did not consider the company to be under any obligation other than to complete the circularity of the transaction in time’.
- 3.6.2 *Richard Walter Pty Ltd v FC of T* (1996) 67 FCR 243 – where a loan transaction was held to be a sham, because there was no intention as between the relevant parties to a loan, that the loan would in fact be repaid (with the result that the ‘loan’ was a taxpayer’s ordinary income); and
- 3.6.3 *Hickman v FC of T* [2005] AATA 339 where interest with respect to a loan was not considered to be deductible, as the taxpayer did not use its own money in any of the transactions – which were also held to be not on arm’s length or on a commercial basis. It was held that a round robin transaction was a façade for an overriding purpose of obtaining tax advantages.
- 3.7 A result of a transaction being a sham (or indeed legally ineffective) is that the transaction may be disregarded without regard to (for example) any anti-avoidance provisions (see *FC of T v Newton* (1957) 96 CLR 577). However, the application of the principles of sham to part of a transaction will not prevent the application of any anti-avoidance provisions to the whole of an arrangement (*Richard Walter Pty Ltd v Commissioner of Taxation* (1996) 67 FCR 243).

4. Fraud and evasion

- 4.1 In practice, the concepts of ‘fraud’ and ‘evasion’ are used by the Commissioner of Taxation to amend assessments of taxpayers. The basic time period in which the Commissioner can

amend an assessment is two years. Some taxpayers have a four year time limit period in which the Commissioner may amend.

4.2 It should be noted that the Commissioner has a four year time period in which to amend assessments in situations where it is reasonable to conclude that the general anti-avoidance provisions (i.e. Part IVA of the 1936 Act) might apply. That is, in situations where any person entered into or carried out a scheme (either alone or with others) for the sole or dominant purpose of the taxpayer obtaining a tax benefit in relation to income tax from the scheme for that year.

4.3 However, there is an unlimited period in which the Commissioner can amend an assessment in the case of fraud or evasion.

4.4 Item 5 of the table contained in subsection 170(1) of the 1936 Act, where in the opinion of the Commissioner of Taxation, there has been an avoidance of taxation as a result of 'fraud' or 'evasion' by the taxpayer, or a taxpayer's agent or someone working on a taxpayer's behalf, then the Commissioner may amend the taxpayer's assessment at any time.

4.5 It should be noted that a taxpayer may be liable for fraud or evasion of their tax agent. This is notwithstanding that the taxpayer may not have authorised, or known of the acts or omissions which are fraudulent or constitute evasion (see *Weyers v FC of T* 2006 ATC 4523).

4.6 That is, if there is an 'avoidance of tax' as a result of either 'fraud' or 'evasion', then the Commissioner has an unlimited time in which to amend assessments.

4.7 Essential for the application of item 5 of the table contained in subsection 170(1) of the 1936 Act is:

4.7.1 the avoidance of tax;

4.7.2 fraud; and

4.7.3 evasion.

(a) Avoidance of tax

4.8 In order for item 5 of subsection 170(1) of the 1936 Act to be enlivened, there must be an 'avoidance of tax', which may be described as (see *Mynott v FC of T* 2011 ATC 10-195) '*... without any active or passive fault on the part of the taxpayer, less tax has been paid than ought to have been paid*'.

4.9 However, if a taxpayer pays the correct amount of tax, for whatever reason, then there will not be an avoidance of tax. For example, in *FC of T v Maurice's Estate* 77 ATC 4462, the administrators of an estate had failed to disclose certain assets of the estate. However, the administrator had also failed to disclose debts which exceeded the value of the undisclosed assets. As a result, if the undisclosed assets and debts had been properly disclosed, then the estate would have paid less estate duties than it actually did. As a result the Court considered that there was no 'avoidance'.

(b) Fraud

4.10 The 'fraud' considered in item 5 of the table contained in subsection 170(1) of the 1936 Act involves a statement made:

4.10.1 knowing it to be false;

4.10.2 without belief in its truth; and

4.10.3 with reckless indifference as to whether it is true or false

4.11 Fraud is considered to be a serious allegation. It needs to be proved on the balance of probabilities.

4.12 It has been held that fraud does not occur where a taxpayer has formed a genuine, subjective belief in the truth of a particular statement. This is notwithstanding that the belief may have been formed on inadequate grounds.

4.13 However, if a person has a reason for suspecting that they have not paid the correct amount of tax, but deliberately refrain from making adequate inquiries in case such inquiries were to discover the truth, then there may be fraud involved. This is because the person's actions may raise an inference that they did not have a genuine belief in the truth of their statements.

(c) Evasion

4.14 The term 'evasion' is not defined in tax legislation. Further, the Courts have been reluctant to define that term. In *Denver Chemical Manufacturing Co v C of T (NSW)* (1949) 49 SR (NSW) 195, Jordan CJ considered that the term 'evasion' in a taxation context is behaviour which is tantamount to keeping the Commissioner 'in the dark'.

4.15 At 199, Jordan CJ observed that:

Even where a taxpayer is firmly of opinion that his view is the correct one, he may be guilty of evasion by seeking to prevent the Commissioner from applying his mind to some debateable question, e.g. whether a particular item of income should be assessed: the evasion in such cases consist in the attempt to preclude the presentation of any opposing view or to exclude its application.

- 4.16 On appeal to the High Court, Dixon J in *Denver Chemical Manufacturing Co v C of T (NSW)* (1949) 79 CLR 296 developed the observations of Jordan CJ. Dixon J at 313 observed that:

*... necessary to consider what relevant conduct amounts to evasion and whether the Board correctly applied their minds to the question of evasion. I think it is unwise to attempt to define the term 'evasion' ... It means more than avoid and also more than mere withholding of information or the mere furnishing of misleading information. It is probably safe to say that some blameworthy act or omission on part of the taxpayer or those for whom he is responsible, is contemplated. **An intention to withhold information lest the Commissioner should consider the taxpayer liable to a greater extent than the taxpayer is prepared to concede is conduct which, if the result is to avoid tax, would justify finding evasion.** [emphasis added]*

- 4.17 The observations by Dixon J in *Denver Chemical Manufacturing Co* formulated the commonly quoted definition of 'evasion'. It is said that 'evasion' is:

4.17.1 something more than avoidance, or the mere fact of non-payment; and

4.17.2 more than mere withholding of information or furnishing of misleading information.

- 4.18 'Evasion' falls between innocent mistake, and the intention to defraud. Evasion involves some blameworthy act or omission. Evasion will typically involve omitting income from a return, or wrongly claiming a deduction (intentional or otherwise) without any credible or excusable explanation for either.

- 4.19 Evasion involves some 'blameworthy act or omission' by a taxpayer (or someone acting on behalf of the taxpayer), such as an intention to withhold information which (if the Commissioner obtained it), would see the imposition of more tax than what the taxpayer is prepared to concede.

- 4.20 In *Wilson v Chambers & Co Pty Ltd* the Court observed that the question of whether there is 'evasion' requires one to ask whether a taxpayer has '*... acted honestly and reasonably in*

relation to his public obligations'. Higgins J observed that 'evade' connotes at least a conscious act of will by the taxpayer in relation to avoiding a payment, whereas a mere failure to pay may be due to an accident or mistake. Similarly, in *Mano v FC of T 2010 ATC 10-134*, it was held that because a taxpayer had not acted deliberately, a taxpayer's failure to include foreign income in her returns was held not to constitute 'evasion'.

4.21 Evasion involves a blameworthy act or omission. Whether a taxpayer's acts or omissions may be characterised as blameworthy is an objective test, based on what a reasonable person would do in a given situation. Further, it should be noted that a person is usually presumed to intend the natural consequences of their own acts (*Lloyds Bank Ltd v Marcan* [1973] 2 All ER 359).

4.22 In order to assert evasion, the material facts need to establish whether the relevant conduct is 'blameworthy'. Without any admissions, it is necessary to consider the facts and draw conclusions (or inferences) as to whether a taxpayer engaged in evasion. Reasons provided by a taxpayer (or an adviser) may be relevant – but are not determinative.

4.23 In *Australasian Jam Co Pty Ltd v FC of T* (1953) 88 CLR 23, the taxpayer adopted incorrect valuations for closing stock. Fullagar J observed that the taxpayer's arguments as being '*... based on a foundation that is not really tenable ...*'. It was observed by Fullagar J that:

There has been says the Commissioner, no deliberate attempt to deceive, and therefore the case is not one of fraud. On the other hand, it would be unreasonable to suppose, and it has not really been suggested that those responsible for the taxpayer's income tax returns were ignorant of the requirements ... I think, says the Commissioner, that there has been here more than a mere withholding of information which might or might not be relevant; I think that there has been an intentional withholding of information lest I should hold the taxpayer liable to tax to a greater extent than it was prepared to concede, and I regard this as evasion.

4.24 Some situations in which there has been 'evasion' include where a taxpayer has:

4.24.1 *Denver Chemical Manufacturing* - Intentionally omitting income from a tax return, without a credible explanation for the non-disclosure of the income;

4.24.2 *Case D47*, 72 ATC 272 – failure to disclose relevant matters in circumstances where the taxpayer's knowledge and experience were '*... such that he must be taken to have realised that a different view was tenable and that the*

Commissioner or Tribunal might well have decided that the ... [relevant] ... amounts were assessable ...'; or

4.25.3 *Bottzaai v FC of T* 2008 ATC 10-053 – where there was a failure to disclose an amount of capital gains tax which arose from the sale of a rental property.

5. Dealing with the ATO – shams, fraud and evasion

5.1 I consider that most competent professionals would not be involved in sham transactions, fraud or evasion.

5.2 However, if a professional knows of a transaction which is a sham, or a client being involved in fraud or evasion, the professional may have professional obligations to discharge (e.g. to cease acting), or to provide clear advice to the client regarding the transaction and its consequences.

5.3 Regard should also be given to whether a transaction will have criminal consequences. It should be noted that whilst a taxpayer has the onus of proof in the context of a tax audit, in the event of criminal charges, the prosecutor has the onus of proving guilt. As a result, an adviser must consider a taxpayer's exposures when making representations regarding such transactions.

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