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The Schemes Continue

The Commissioner continues to take an aggressive stance in applying the general anti-avoidance provisions, particularly with respect to mass marketed primary product schemes structured in a tax effective manner

INTRODUCTION

On 26 August 2003, the Full Court of the Federal Court handed down its decision in *Puzey v Commissioner of Taxation* [2003] FCAFC 197, which dealt with the application of the general deduction provisions and the operation of the general anti-avoidance provisions of Part IVA of the *Income Tax Assessment Act 1936* ("the 1936 Act").

BACKGROUND

Mr Puzey ("the taxpayer") invested in an Indian Sandalwood project ("the project") which was marketed as a "tax investment project". The project involved the purchase and planting of sandalwood seedlings, the leasing of plots of land, and engagement of a project manager.

In the 1997 income tax year, the taxpayer acquired an option for $100 to purchase $40,000 of seedlings, with the option to be exercised on 30 June 1997. On 15 July 1997, the taxpayer paid another $100 for another option to purchase a further $40,000 of seedlings on 30 June 1998. Between May 1997 and October 1998, the taxpayer actually paid two amounts of $14,000, representing deposits for the $40,000 for the seedlings. As a result of a series of "round robin" bank transactions, the taxpayer was paid an amount of $39,900 owing by the taxpayer in respect of the purchase of the seedlings by a company associated with the project, with the amount being treated as a loan for the taxpayer.

The taxpayer entered into a lease starting 1 May 1998 and ending 30 November 2013 in respect of a plot of land on which the seedlings were to be planted. The rental for the plot of land was $1,200 pa, reviewed annually.

The taxpayer also entered into a management agreement. Under the agreement, the manager would plant the sandalwood seedlings and maintain the plots of land. As consideration, the taxpayer was required to pay a $2,000 "preparation and establishment fee", and a $800 "annual plantation management fee".

In the 1998 income year, the Australian Securities Commission ("ASC") determined that the "prescribed interests" provisions of the Corporations Law should have applied to the project. As a result, the project was modified such that the taxpayer became a beneficiary of a trust which carried out the project.

In respect of the 1997 income tax year, the taxpayer received a substantial refund as a result of participating in the project, and applied for a variation of PAYG instalments under s 221D of the 1936 Act for the 1998 income year on the basis of the deductions the taxpayer received in the 1997 income year.

The seedlings were planted in the 1998 income year. However, the seedlings planted on the taxpayers plot did not perform and required replacing by October 1999.

In respect of the 1997 income year, the taxpayer claimed $40,000 of deductions, being for the seedlings. In respect of the 1998 income year, the taxpayer claimed a total of $42,575, being for seedlings, plantation establishment costs, management fees and other charges.

On 24 January 2000 the Commissioner issued amended assessments disallowing the deductions relating to the project claimed by the taxpayer, and imposing penalty tax on the amounts disallowed. On 31 January 2000, the Commissioner issued Part IVA determinations in respect of the relevant years of income, which the taxpayer argued could not be relied upon as they post-dated the 24 January 2000 amended assessment. On 8 November 2001, the Commissioner issued a new Part IVA determination and amended assessment. The taxable income and tax payable on the new amended assessment was the same as that on the amended assessment dated 24 January 2000.

ISSUES TO BE DETERMINED

The issues which were to be determined in the appeal included:

1. whether in each of the years of income the sums claimed by the taxpayer were allowable deductions;
2. whether Part IVA of the 1936 Act applied such that the Commissioner could disallow the deductions; and

3. the implications of the taxpayer receiving two sets of each of the determinations and amended assessments from the Commissioner.

WHETHER THE TRANSACTION WAS A SHAM

At first instance, the Commissioner contended that the transaction constituted a sham. The Commissioner argued that the agreement by the taxpayer to purchase the seedlings, and the loan by which the seedling purchase was financed were "… both shams or disguises for some other real transaction…" [para 33]. That is, the taxpayer purchased the seedlings ostensibly for $28,000 when the amount actually paid was $14,000. Further, the Commissioner argued that the taxpayer did not incur the $40,000 sums each year as claimed by the taxpayer.

The Court agreed with the judgement at first instance that the transaction was not a sham given that the agreements were entered into were intended to actually take effect.

WHETHER A BUSINESS WAS CARRIED ON BY THE TAXPAYER

The Court recognised that to the extent that the taxpayer was carrying on a business, then the amounts paid in respect of the seedlings would be an allowable deduction, and not characterised as capital.

The Court stated that in determining whether a business is being carried on, all the relevant facts and circumstances are to be taken into account. The Court stated at paragraph 46 that:

> … every business must have a first transaction. And there may be a business, even if that business is small in scope … A person may carry on a business, notwithstanding that the person had some other activity, such as full time employment. It is not necessary in concluding that a business is carried on that the acts to be undertaken are acts of the person seeking to establish he or she is carrying on a business. So a person may appoint another to take the steps which constitute the business activity…

In characterising an activity as a business, it was recognised that the activity should be engaged upon "on a continuous and repetitive basis". However, for activities which continue over a relatively long period of time but where there will be significant periods of inactivity, such as a plantation operation, such periods should not disqualify the activity from being a business. It was recognised that a "..[b]usiness does not mean busy."

The Court considered United Kingdom case law for the purposes of defining a "business", which included the "badges of trade" indicia. The indicia included:

> … the profit motive (although a non profit company may still carry on a business), acting in a business like way, (although many businesses may be found which operate in a non-business like way), the keeping of books of account and records, (although the fact that there are none will not necessitate the conclusion that a business is not carried on) and repetition (although a fixed term project may still be a business). [para 48]

After considering the characterisation of a business, the Court considered the issue was:

- whether the taxpayer was a mere passive investor, notwithstanding the agreements surrounding the transaction which sought to give the mere appearance of a business being conducted; or
- whether legitimate commercial transactions were conducted, despite the taxation benefits which the taxpayer would receive.

Further, the Court found that no principal/agency relationship existed. Rather, work was undertaken by contractors via legitimate contractual relations on the land which the taxpayer leased.

The 1997 Income Tax Year

With respect to the 1997 income tax year, the Court concluded that the taxpayer was conducting a business by stating at paragraph 54:

> The fact that the physical activity of clearing and planting had not commenced at the time …[the taxpayer] … entered into the arrangements does not require the conclusion that the business had not commenced. Rather, it seems to us that the correct analysis is that …[the taxpayer]… committed himself to a business with the first step of entering into the relevant agreements and that in so doing …[the taxpayer] … commenced a business.

The 1998 Income Tax Year

The Court found that for the 1998 income tax year, after the ASC inspired restructure of the project, the taxpayer was not conducting a business. The Court considered that notwithstanding that the lease and management agreement entered into by the taxpayer continued in operation, the Court considered that taxpayer made his lot available to the Trustee, after which time the planting, tendering and harvesting activities were activities of the Trustee and not the taxpayer. That is, the taxpayer became a passive investor in a managed investment scheme.

The Court conceded that the rent associated with the leasing of the lot and the management fee payable to the manager of the scheme was deductible because they were incurred "for the purpose of gaining and producing assessable income." [para 58]

However, in respect of the seedlings by the taxpayer, to the extent that the taxpayer was not carrying on a business, the Court stated at paragraph 58 that:

> … it can no longer be said that the seedlings are trading stock (or as it is sometimes called, the circulating capital) of his business for there is no business. It is obvious enough that the outgoings in question were incurred to gain or produce at the end of the project assessable income … [which would represent] … the net profit of the trustee's business but after deducting the capital outlaid by … [the taxpayer].

Further, at paragraph 61 the Court stated:

> … if no business is carried on by the taxpayer then the seedlings really become the fixed capital of the taxpayer's business with which the taxpayer will earn income by pooling them with seedlings similarly acquired by other investors and permitting the trustee (or manager) to carry on business with them and after a lengthy period of time receive a pro rata distribution of the net proceeds.

Therefore, in respect of the 1998 income tax year, the amounts paid by the taxpayer for the seedlings were not deductable.

APPLICATION OF PART IVA OF THE 1936 ACT

The Court summarised the requirements for the application of Part IVA of the 1936 Act, being that there be a "scheme" and a "tax benefit" that is obtained by the taxpayer in connection with the scheme, with the requisite purpose.

Identification of the "Scheme"

The scheme was [at paragraph 88]: "…the presentation and execution of a seedling purchase agreement under which the cost

of seedlings was calculated to provide to a participant in the project an outgoing in an amount able to provide a tax benefit…" so that the tax saved would cover payments to be made by the taxpayer, and the payments for the seedlings. The alternative scheme proposed by the Commissioner was the entire set of agreements entered into by the taxpayer and the steps taken under them.

The Court considered that the alternative scheme was the relevant "scheme" for the purposes of Part IVA of the 1936 Act.

Procedural Fairness and Identification of the Scheme

The Court rejected the taxpayer's submission that the Judge at first instance, by adopting a "scheme" which was not one of the two alternatives put forward by the Commissioner, breached of procedural fairness. In rejecting the taxpayer's submission, Court stated at paragraph 65 that:

> The scheme must be identified by reference to the arrangement actually entered into. This is not to say that the scheme as represented is irrelevant to the conclusion that has to be reached under Part IVA. It is. However, it suffices here to say that there was certainly no denial of natural justice on the part of the Primary Judge in selecting as a scheme something that had not been put to …[the taxpayer] … for this is not what the learned Judge did.

Identification of the "Tax Benefit"

The Court identified the "tax benefit" as the deductions to which the taxpayer was entitled as a result of entering into the scheme. It was submitted by the Commissioner that, had the taxpayer not entered into the scheme, he would not have had the deductions which became available to him.

Whilst the Courts held that the amount outlaid for the seedlings were not deductible in the 1998 income year because the taxpayer was not carrying on a business, the Court considered that if it was wrong, then the deduction for seedlings would be available in both the 1997 and 1998 income years and would therefore form part of the "tax benefit" for the purposes of Part IVA of the 1936 Act. Furthermore, the outgoings relating to the rent and management fees formed the tax benefit which the taxpayer obtained as a result of the scheme.

> **"The Court recognised that '... the task is to weigh the totality of ... [the matters in s177D(b)] ... in reaching the conclusion as to dominant purpose.'"**

DETERMINING THE PURPOSE OF ENTERING INTO THE SCHEME

The Court recognised that in order to ascertain the purpose of entering into a scheme, the matters set out in s 177D(b) of the 1936 Act were to be considered so as to determine whether it would be concluded that either the taxpayer or a person who had entered into or carried out the scheme did so for the purpose or the dominant purpose of obtaining the relevant deductions.

While the Court considered each of the matters separately, the Court recognised that "..the task is to weigh the totality of these matters in reaching the conclusion as to dominant purpose."

In ascertaining the "manner in which the scheme was entered into or carried out", it was noted by the Court that "… taxation deductibility was an essential ingredient in funding the participation in the arrangement." [para 68]. The project was not promoted by those "interested and expert in sandalwood timber" to finance plantation as a business investment, but by financial advisers, canvassers and others on behalf of promoters as "tax effective". The Court stated at paragraph 69:

> … unlike what may be seen to be an ordinary investment project, the scheme was to be entered into by a participant signing a series of documents which were pre-prepared and there were instructions to the participant to take the necessary steps to have the PAYE instalments varied.

Further, whilst the tax advantages were promoted to be certain, the project's investment consequences were uncertain. Indeed, the project was considered highly speculative.

A further factor considered by the Court was the "grossly excessive amount" paid for the seedlings by the taxpayer. The Court considered that:

> … it was this excessiveness which enabled … [the taxpayer] … to obtain a cash refund in a sufficient sum to finance the initial cash payment of $14,000 and likewise to obtain a PAYE variation to fund the payment in the 1998 year of income of the same amount. [para 71]

The Court considered both the "form and substance" of the project, with the difference being the resulting tax benefit. The Court considered the substance of the scheme, which was that which appeared in the promotion documents, as [para 72]:

> A participant was to pay two cash amounts of $14,000. These, with other minor (and deductible payments), were to entitle the participant to a return when the timber was harvested.

The Court identified the form of the scheme at paragraph 72, being the requirement that the taxpayer:

> … was to make a payment of $40,000 in each of the first two years of income. An advance was to be made to the participant to fund the participation which was repayable at whichever was the first to occur of the sale of the timber or 30 December 2012. The outgoings which the participant contracted to make were for seedlings, rent, and management.

In discussing "the time the scheme was entered into and length of the period during which it was to be carried out," it was

recognised that the scheme was entered into at the end of the 1997 income year, allowing a refund of tax after the lodgement of the 1997 tax return, and a variation of the PAYG instalments for the 1998 income tax year.

However, the fact that the scheme was to continue until 2012, and that there was no intention to bring the scheme to a premature end favoured the taxpayer, because it could not be viewed as a "… short term taxation arrangement." [para 74]

The "result in relation to the operation of the Act" was the deductions for the 1997 income year, and the application by the taxpayer for the PAYG tax instalment variation for the 1998 income year.

In respect of the "change in financial position of taxpayer and others", the Court accepted that the transaction was "not just a paper scheme" [para 76]. However, the Court recognised that the funding of the scheme was done via the tax benefits obtained in the form of the taxpayer's tax deductions, and the resulting PAYG instalment variations.

As for the "other consequences for the taxpayer and others", the Court recognised that there was a mere speculative possibility that the project would be successful.

In respect of the "nature of any connection between the taxpayers and others", it was recognised that, apart from the commercial relationship, there was no relationship between the taxpayer and the other parties involved with the project.

In coming to its conclusion as to the requisite purpose, the Court weighed the issues and concluded that the taxpayer entered into and carried out the scheme "… for at least the dominant purpose of obtaining … the tax deductions" [para 79]. Further, "…[t]axation was the prevailing purpose; any returns from the sale of sandalwood was both speculative and secondary" [para 79].

VALIDITY OF THE ASSESSMENTS

In respect of the second set of amended assessments, the taxpayer argued that:

- they were invalid because the assessments were "tentative" and did not fix an amount of tax payable by the taxpayer; and
- a Part IVA of the 1936 Act determination could only have been made by the Commissioner if he was of the view that the deductions claimed were not allowable under the general deductions provision.

Tentative Assessments

The Court rejected the taxpayers submission that the second set of assessments were "tentative". The Court cited *Commissioner of Taxation v S Hoffnung & Co Ltd* (1928) 42 CLR 39, in defining a "tentative" assessment as [para 85]:

> … an assessment that was not definitive, and thus such as not to bind the taxpayer. Such a tentative assessment, that is to say, an assessment which did not put the taxpayer under an obligation to make payment within thirty days of notice of it, would not be an assessment at all, so that the time would not run in which the taxpayer could object to it.

Further, *F J Bloemen Pty Ltd v Federal Commissioner of Taxation* (1981) 147 CLR 360 was cited for the proposition that a provisional or tentative assessment is not assessment. However, the Court recognised at paragraph 86 that:

> The mere fact that what on its face was a regular notice of assessment was accompanied by an adjustment sheet which intimated that the Commissioner would review the assessment in a certain event did not have the result that the assessment was tentative.

The Court recognised the decision in *Cadbury-Fry-Pascall Pty Ltd v Commissioner of Taxation* (Cth) (1944) 70 CLR 362 which stood for the proposition that the issue of two assessments made under two separate powers of assessment against the same taxpayer in respect of the same year of income was not "tentative," as each assessment definitively fixed a liability to tax.

The Court distinguished the decision of *Commissioner of Taxation v Stokes* (1996) 72 FCR 160, on which the taxpayer relied, where two assessments made against the same taxpayer in the same year of income both made under the same assessment power was considered to be invalid.

Further, in finding that the assessments issued to the taxpayer were valid, the Court agreed with the Primary Judge that an amended assessment need not increase or reduce the taxable income of the taxpayer for it to be valid.

Whether the Commissioner Had the Power to Issue a Part IVA of the 1936 Act Determination

The second argument put forward by the taxpayer was that the Commissioner could not issue a Part IVA of the 1936 Act determination after denying the deductions under the general deduction provisions. In rejecting the taxpayer's submission, the Court at paragraph 94 stated that the taxpayer's:

> argument is misconceived. Part IVA is not predicated upon the Commissioner forming the opinion that a deduction is allowable before making a determination that operates to disallow the deduction. All that is necessary for the power in the Commissioner to make a determination under Part IVA to disallow a deduction is that there is a deduction which is allowable to a taxpayer in the year of income which would not have been allowable to the taxpayer in the year of income if the relevant scheme has not been entered into or carried out… It is only once the Part applies that is to say, it is only once there is objectively a tax benefit, that any question of discretion or power to make a determination …arises.

CONCLUSION

The stance which the Commissioner took in the case demonstrates its aggressive approach in respect to the application of Part IVA of the 1936 Act, particularly with respect to mass marketed primary product schemes structured tax effectively for potential participants.

Even though the project failed, it seems that in cases such as this the Commissioner will not take into account the potential viability of the project. Assuming that the project did become profitable for the taxpayer, the Commissioner would no doubt subject the profits of the project to taxation, whilst limiting the initial deductions. This approach is questionable, particularly considering that the Commissioner disallowed the full amount of deductions for both the income years, notwithstanding that the taxpayer actually paid amounts for participation in the project, and was considered as carrying on a business at least in the 1997 income tax year.

It is submitted that the precedence value of the statements in the judgement in respect of Part IVA of the 1936 Act outside the confines of mass marketed schemes is limited. ◆

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