Can Part IVA apply to legitimate components of a transaction?

PETER CUMINS V COMMISSIONER OF TAXATION [2007] FCAFC 21

INTRODUCTION

In the case of *Peter Cumins v Commissioner of Taxation*[1] the Full Federal Court heard an appeal from the Federal Court concerning an amended assessment that had been issued to the taxpayer on the basis that the general anti-avoidance provisions in Part IVA of the *Income Tax Assessment Act 1936* (Cth) ("ITAA 1936") applied, so that the taxpayer incurred a capital gain and not a capital loss from the sale of a beneficial interest in shares from one family trust to another. The Full Federal Court, upholding the decision of both the Federal Court and the Administrative Appeals Tribunal ("Tribunal"), held that the amended assessment should apply as the taxpayer had not satisfactorily established that the amended assessment was excessive and should not have been caught by Part IVA.

This case highlights the Commissioner's wide discretion in applying Part IVA to transactions that, on their own, would be legitimate transactions, but together have the effect of providing a benefit to the taxpayer that could be caught under the anti-avoidance provisions in Part IVA of the ITAA 1936.

FACTUAL BACKGROUND

Peter Cumins ("the taxpayer") was the sole trustee and general beneficiary of a discretionary family trust ("Trust 1") created by a deed dated 6 March 1992. In 1995 the taxpayer became the managing director of Cash Converters International Limited, of which the chairman was the taxpayer's brother. In 1997 the taxpayer's brother decided to retire and, between July and October of that year, sold his shares in the company to the taxpayer for 30 cents per share. In order to acquire these shares, the taxpayer entered into a loan agreement with the National Australia Bank ("the Bank") for the amount of $4.3 million. Pursuant to this loan agreement, the taxpayer was required to obtain consent from the Bank before assigning or transferring any of its rights or obligations in relation to the loan or shares.

On 11 June 1998 the taxpayer, in his capacity as trustee of Trust 1 made a capital gain of $787,375 from the sale of shares. This gain was included in the income tax return of Trust 1 for the 1998 income year.

On 12 June 1998 the taxpayer created a second family discretionary trust ("Trust 2") on similar terms to Trust 1, with the taxpayer as sole trustee and the specified beneficiaries being the taxpayer and his family. The taxpayer then, in his capacity as trustee of Trust 1, sold 8 million of the shares that were held in Cash Converters Limited, free from encumbrances, to himself as the trustee of Trust 2. These shares were sold for 20 cents each so that a total consideration of $1,600,000 was to be paid by Trust 2 to Trust 1.

Trust 1 made a capital loss of $800,000 from the sale of the Cash Converters shares to Trust 2 and this loss completely offset the capital gain that Trust 1 had made the previous day.

The sale of shares between Trust 1 and Trust 2 was effected by an executed share transfer form and an unexecuted share sale agreement. This unexecuted share sale agreement included provisions that:

- the vendor had the right to deliver the share transfer form at settlement even if the purchaser did not pay the price at settlement; and
- if the price was not paid at settlement, the purchaser was to pay interest on the price at 8.23 per cent per annum until the price was paid.

On the settlement date Trust 1 did not pay Trust 2 $1,600,000 in consideration for the 8 million shares and no other financial arrangements were entered into facilitate the payment of this amount. Importantly, the taxpayer had not obtained the Bank's prior consent to the transfer of these shares as it was required to do under the loan agreement.

The Commissioner issued the taxpayer with an amended income tax assessment for the year ended 30 June 1998 that increased the taxpayer's net capital gain by $800,000 on reliance of a number of grounds, including a Part IVA determination.

The taxpayer sought a review of the Commissioner's decision by the Tribunal, and then the Federal Court. Both the Tribunal and the Federal Court upheld the Commissioner's amended assessment. The taxpayer then appealed to the Full Federal Court.

RELEVANT LEGISLATION

Section 177F(1)(c) of the ITAA 1936[2] provides the Commissioner with power to make a necessary determination, including cancellation of the tax benefit, where it is found that a tax benefit has been obtained by a taxpayer in connection with a scheme. The section reads:

> (1) Where a tax benefit has been obtained, or would but for this section be obtained, by a taxpayer in connection with a scheme to which this Part applies, the Commissioner may:

…

(c) in the case of a tax benefit that is referable to a capital loss or a part of a capital loss being incurred by the taxpayer during a year of income--determine that the whole or a part of the capital loss or of the part of the capital loss, as the case may be, was not incurred by the taxpayer during that year of income;

Once the existence of a tax benefit in connection with a scheme is established, s 177D(b) gives the Commissioner authority to determine whether Part IVA applies having regard to the following objective factors:

(i) the manner in which the scheme was entered into or carried out;

(ii) the form and substance of the scheme;

(iii) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;

(iv) the result in relation to the operation of [the ITAA 1936] that, but for [Part IVA], would be achieved by the scheme;

(v) 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;

(vi) 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;

(vii) any other consequence for the relevant taxpayer, or for any person referred to in subpara (vi), of the scheme having been entered into or carried out; and

(viii) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in subpara (vi) …

THE TRIBUNAL'S DECISION

The Tribunal was required to consider whether the taxpayer incurred a capital loss of $800,000 under the *Income Tax Assessment Act 1997* (Cth) ("ITAA 1997"), and if so, whether Part IVA of the ITAA 1936 operated to deem that that capital loss had not been incurred.

The Commissioner submitted to the Tribunal that the taxpayer had entered into a scheme to which Part IVA applied. The Commissioner identified the relevant parts of the scheme as:

(a) the creation of Trust 2 on 12 June 1998;

(b) the purported sale of 8 million shares from Trust 1 to Trust 2 for $1,600,000;

(c) the purported realising of a capital loss of $800,000 from the sale of shares that was reported by Trust 1 in its income tax return for the 1998 income year;

(d) the offsetting of the $800,000 capital loss against the capital gain made by Trust 1 on 11 June 1998;

(e) the distribution of the net capital gains of Trust 1 for the 1998 income year; and

(f) the purported reduction by $800,000 of the net capital gain distributed to the taxpayer by Trust 1.

The Commissioner then submitted that the scheme entered into by the taxpayer had resulted in a tax benefit and that there was no reasonable expectation (being more than a possibility) that the taxpayer would have incurred that tax benefit had it not entered into the scheme. The tax benefit identified by the Commissioner was the incursion of the capital loss on 12 June 1998 that completely offset the capital gain made the previous day. The Tribunal agreed with the Commissioner's submission, concluding that it was unreasonable to expect that the taxpayer would have incurred the capital loss had the scheme not been entered into, placing emphasis on the fact that the taxpayer had not sought the Bank's prior consent to the transaction as required by the loan agreement and determining that the Bank would not have consented to any alternative transactions for incurring the loss unless the taxpayer's loan had been repaid.

As the Tribunal had concluded that both a scheme and tax benefit existed, it was then required to determine whether the taxpayer had carried out the scheme for the dominant purpose of obtaining the tax benefit, by considering the eight matters listed in s 177D(b). The Tribunal found that:

(i) The sale of shares was not carried out in an "ordinary" manner due to avoidance of the Bank's consent.

(ii) "Disconnection" existed between the form of the agreement and the transactions implemented by the taxpayer. In form, the transaction appeared to be the sale of shares free from encumbrances. In substance however, the taxpayer only had a beneficial interest in the shares, which was encumbered by a mortgage to the Bank.

(iii) It was relevant that the transactions took place on consecutive days. The taxpayer generated a capital gain of $787,375 on 11 June 1998 before transferring the shares into Trust 2, which had been created that day to result in a capital loss on 12 June 1998.

(iv) It was significant that the transaction caused the taxpayer to change his financial position by way of offsetting the capital loss against the capital gain.

(v)–(viii) It could not be concluded that the taxpayer's purpose, or one of the taxpayer's purposes, in carrying out the scheme was to shelter 8 million of the shares from present or future claims by creditors of Trust 1.

The Tribunal affirmed the Commissioner's determination, finding that a reasonable person would conclude that the taxpayer had carried out the scheme with the sole purpose of obtaining a tax benefit from a capital loss and therefore the scheme was one to which Part IVA applied.

THE FEDERAL COURT JUDGMENT

The taxpayer appealed to the Federal Court on the grounds that the Tribunal had failed to take into account and give proper weight to the correct law, the genuine nature of the transaction, the issue of wash sales and alternatives open to the taxpayer.

The Federal Court rejected the taxpayer's submissions, instead upholding the decision of the Tribunal. It reasoned that:

- The Tribunal's discretion had been properly exercised in finding that a tax benefit associated with the scheme was incurred as a result of the capital loss.
- The matters in s 177D(b) were properly applied: it was irrelevant that the Tribunal considered subss 177D(b)(v) to (viii) holistically as the Tribunal had made proper findings on the facts before it.
- Part IVA was not precluded where the scheme may have been "genuine or directed at crystallising a loss"[3] and,

in any event, the relevant transaction could not be considered as "genuine" because the taxpayer had not suffered any economic loss as beneficial ownership of the shares had remained with him.

- There was no requirement at law for the Tribunal to take into account any "wash sale" rulings relating to the application of Part IVA, as differing circumstances made them irrelevant.
- The Tribunal was not required to consider alternative transactions that were open to the taxpayer in light of the scope and strength of the loan agreement with the Bank and because the taxpayer had made no attempt to obtain the Bank's consent to the transactions.

ISSUES ON APPEAL TO THE FULL FEDERAL COURT

The taxpayer appealed to the Full Federal Court on the grounds that:

1. The Tribunal failed to exercise or properly exercise its discretion under s 177F(1) through failure to apply two distinct stages.
2. The Tribunal's finding of a relevant "tax benefit" failed to consider any alternative transactions available, resulting in a breach of natural justice.
3. Errors of law were made by the Tribunal relating to specific aspects of s 177D(b).
4. The Tribunal failed to properly consider issues of additional (penalty) tax and remission of additional tax.

Each submission was dealt with separately by the Court in its determination.

1. Section 177F(1) and exercise of discretion

The taxpayer argued that the first premise in s 177F(1) required the Commissioner to determine an objective fact[4]; whether a tax benefit was obtained in connection with a relevant scheme to which Part IVA applies. Therefore the Commissioner was only required to exercise "judgment" rather than "discretion". The taxpayer claimed that discretion was only relevant after a tax benefit has been found, and this discretion allowed the Commissioner to consider whether to cancel the tax benefit or not. At this stage the nature of the transaction should have been considered.

The Court confirmed that it is settled law that an objective determination is required for matters in s 177D and that the Commissioner is bound to take account of matters listed in that section. However, the

Commissioner is not required to consider matters outside those listed in s 177D and "once the Commissioner has reached a conclusion under s 177D …as to the purpose of the scheme, there is no super-imposed obligation to take into account other matters"[5].

The Court also reasoned that the Tribunal had not erred in not giving weight to the consideration that there was a "genuine" share sale transaction that crystallised losses actually incurred, as the Tribunal had "…appreciated that the transaction was genuine and expressly did not treat it as a sham"[6] and had correctly observed that in this particular case no economic loss was actually incurred. The argument was thus irrelevant. It noted that ultimately the provisions of Part IVA can apply to "genuine" transactions.

2. The Tribunal's finding of a relevant "tax benefit" failed to consider any alternative transactions available, resulting in a breach of natural justice

The taxpayer argued that it was not within the Tribunal's power to decide that the Bank would have insisted on repayment of the loan before giving its consent to any alternative transactions.

In the Court's opinion the onus lay on the taxpayer to illustrate to the Tribunal that the Bank would have consented to other alternative arrangements. The Tribunal had correctly determined there was not enough evidence to reach a decision that the Bank's consent would be forthcoming, making suggested alternative transactions a nullity. In addition to this, the Court considered it was significant that the loan agreement with the Bank was breached, as the Bank was not informed until after the scheme was implemented so that their prior consent was not obtained.

The Court rejected the taxpayer's argument that the scheme was entered into for asset protection reasons, holding that the scheme's dominant purpose was to obtain a tax benefit in the form of a deduction. There appeared to be no pressure or threats from any of the creditors of Trust 1.

3. Errors of law were made by the Tribunal relating to specific aspects of s 177D(b)

The taxpayer argued that the Tribunal had not considered each aspect of s 177D(b) because subss (v)-(viii) were considered as a whole. The Court rejected this argument and held that the Tribunal had appropriate regard to all matters, particularly as subss (v)-(viii) were interrelated and no express requirement existed for each subsection in Part IVA to be considered independently. The only requirement is that the Commissioner and the Tribunal consider the specified matters to reach a final, global decision, which, in this case, the Tribunal successfully accomplished.

Although the taxpayer also argued that the arrangement was common practice, the Court quickly dispensed with this argument as it is not seen as a required matter for consideration by the Commissioner or the Tribunal under s 177D. Additionally, there was no evidence submitted in relation to this argument, making it vague and irrelevant.

4. The Tribunal failed to properly consider issues of additional (penalty) tax and remission of additional tax

The Court was not persuaded that the Tribunal had incorrectly applied the approach set out in *Walstern v Commissioner of Taxation*[7] in relation to the additional tax. Instead, the Court considered that the Tribunal was correct in its findings that it was not reasonable for the taxpayer to contend that he was legally permitted to take steps to realise capital losses under the scheme. Therefore the fixing of additional tax payable was properly imposed.

COMMENT AND CONCLUSION

The Full Federal Court delivered a joint judgment dismissing the appeal, and upholding the findings of the Tribunal and the Federal Court, to allow the amended assessment issued by the Commissioner, which disallowed the capital loss claimed in relation to the 1998 financial year. The capital loss in question resulted from the sale of listed shares by the taxpayer as trustee of one trust to himself as trustee of another trust to crystallise a loss and entirely offset a capital gain made the previous day. The general anti-avoidance provisions of Part IVA were correctly applied to deny the capital loss claimed by the taxpayer.

The Full Federal Court held that under s 177F(1) the Commissioner is empowered and entitled to cancel a tax benefit if the requirements in s 177D are satisfied. Once the requirements of s 177D are satisfied, no further exercise of discretion is required. Accordingly, the decision to cancel a tax benefit under s 177F(1) does not involve two stages. Rather discretion is only necessary in the sense that it is not compulsory for the Commissioner to exercise the power. There is no over-arching or final discretion to be exercised by the Commissioner independently of that required in s 177F.

Part IVA can apply to genuine transactions. Genuine transactions will be caught if, as a whole, they result in a scheme that falls within Part IVA, giving rise to a tax benefit that would not otherwise have been gained by a taxpayer, after consideration of the elements in s 177D. Although s 177D contains several elements that go to the nature of the transaction, taxpayers should not be disillusioned by the genuine nature of each part of the transaction as this is not a safeguard against the operation of Part IVA. Short time periods, transfer of property without consideration and failure to comply with mortgagee's requirements all point the Commissioner towards a scheme to which Part IVA may be applied.

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Reference notes:

1 *[2007] FCAFC 21 (2 March 2007)*

2 *Note that all references are to the ITAA 1936 unless otherwise indicated*

3 *[2007] FCAFC 21 at [28]*

4 *Ibid at [34]*

5 *Ibid at [36]*

6 *Ibid at [39]*

7 *(2003) 137 FCR 1*