CGT cost base uplift – taxpayer caught by Part IVA

WALTERS V COMMISSIONER OF TAXATION [2007] FCA 1270

INTRODUCTION

On 20 August 2007 the Federal Court handed down its judgment in the case of *Walters v Commissioner of Taxation*[1] which considered whether a series of transactions entered into by the taxpayers, resulting in a uplift of the cost base of shares in a company for CGT purposes was a sham and could be caught by the general anti-avoidance provisions in Part IVA of the *Income Tax Assessment Act 1997* ("ITAA 1997"). The Administrative Appeals Tribunal ("Tribunal") had allowed the Commissioner of Taxation's ("Commissioner") amended assessment that included the amount of $349,999 in the assessable income of each taxpayer. The Federal Court upheld the Tribunal's decision in relation to Part IVA finding that, whilst none of the transactions were a sham, the taxpayers had entered in the transactions in order to obtain a tax benefit that could be caught by Part IVA. This case serves a timely reminder that advisors should be aware that transactions entered into by taxpayers resulting in a uplift of the CGT cost base of an asset are subject to the general anti-avoidance provisions in Part IVA.

MATERIAL FACTS

Dart Trading Co Pty Ltd ("Company") was incorporated on 19 November 1991 and conducted a supermarket business in Queensland. The first directors of the Company were David Walters and Rhondda Walters (collectively referred to as the "taxpayers") and Terrence and Annette Walters. Upon their appointment as directors, each individual was issued one ordinary share of $1.00 in the Company. There were no other shareholders.

In 1998 the shareholders of the Company entered into discussions to sell their business to Franklins. Although nothing came from these discussions the taxpayers continued to be interested in selling their interest in the business, by selling their shares in the Company. David Walters was particularly interested in restructuring his affairs to protect his assets and sought advice from his legal advisers in relation to the best way to go about such a restructure.

In April – May 1999 there was a flurry of activity in relation to the shares held by the taxpayers:

1. The Adelong Trust and the Adelong Trust No 2 were created on 13 April 1999. Adelong Hills Pty Ltd was appointed as trustee of each trust, and the taxpayers were each appointed as directors of Adelong Hills Pty Ltd.

   The Adelong Trust was established for the benefit of its absolute beneficiary, Sailpeal Pty Ltd ("Sailpeal") . Adelong Trust No 2 was established for the benefit of Bracknell Pty Ltd ("Port Bracknell"). The deeds of each trust contained similar terms, namely that the trustee must hold the net income of the trust fund for the benefit of the absolute beneficiary unless the absolute beneficiary, in conjunction with the trustee determine, that the net income can be applied to the primary, secondary or tertiary beneficiaries of the trust, respectively being the Australian Red Cross, Royal Flying Doctor Service or any trustee in which the trustee of the trust, is a beneficiary.

2. Each taxpayer entered into a share sale agreement on 13 April 1999 in respect of their share in the Company.

   David Walters entered into an agreement with Sailpeal. Pursuant to that agreement, Sailpeal satisfied the purchase price by issuing 2,000 $1.00 shares to David Walters. Rhondda Walters entered into an agreement with Port Bracknell. Pursuant to that agreement, Port Bracknell satisfied the purchase price by issuing 2,000 $1.00 shares to Rhondda Walters. There were no other shares on issue for either company.

   Each of the taxpayers executed a document for the purposes of subdiv 122-A of the ITAA 1997 by which they chose to obtain a roll-over in respect of the CGT trigger event being the disposal of each share in the Company, one to Sailpeal and the other to Port Bracknell. As a result of this election, the capital gain made by each of the taxpayers from the trigger event was disregarded.

3. Each of Sailpeal in relation to the Adelong Trust and Port Bracknell in relation to the Adelong Trust No 2 declared that, as the beneficial owners of the Company shares, that those shares were to be held "upon and subject to the trusts of the [relevant trust]". The taxpayers as directors of each trustee company resolved that the declarations of trust be accepted.

4. The Dart Trust, Dart Trust No 2 and Adelong Trust No 3 were created on 14 April 1999, all on similar terms to the Adelong Trust. The trustees of the trusts were Port Bracknell Pty Ltd, Sailpeal

and Peachbronze Pty Ltd respectively. The taxpayers were appointed as the directors of these companies.

5. Also on 14 April 1999, Adelong Hills Pty Ltd in its capacity of each of the Adelong Trust and Adelong Trust No 2 entered into a share sale agreement with Port Bracknell as trustee of the Dart Trust and Sailpeal as trustee of the Dart Trust No 2 respectively. The agreements stated that each share would be sold to their respective purchaser for $35,000.
6. The taxpayers, as directors of Adelong Hills Pty Ltd and Port Bracknell Pty Ltd made the appropriate resolutions to give effect to the share sale agreements.
7. Each of the taxpayers exercised their power as Principal (David Walters in relation to the Dart Trust and Rhondda Walters in relation to the Dart Trust No 2) to remove the respective trustee companies (Port Bracknell and Sailpeal) and personally assume the role of trustee of the relevant trusts, declaring that they held the trust fund on the same trusts that existed prior to their appointment.
8. On 15 April 1999 the taxpayers as directors of Adelong Hills Pty Ltd in its capacity as trustee of each of the Adelong Trust and Adelong Trust No 2, resolved to pay, apply and set aside the net income and additional tax income of the Adelong Trust and Adelong Trust No 2 for the 1999 income year to and for the benefit of Peachbronze in its capacity as trustee of the Adelong Trust No 3.
9. At the end of May 1999 Terrence Walters told the taxpayers that the Company was putting aside money to assist the purchaser of the shares from the taxpayers. On 15 June 1999 the taxpayers resigned as directors of the Company and ASIC approved a loan by the Company's remaining directors, Terrence and Annette Walters to purchase the Company's shares from the taxpayers for $700,000, being their current market value. The taxpayers had each sold their shares to the purchasers in their capacity of the Dart Trust and Dart Trust No 2.

These transactions had the effect of uplifting the cost base of each share from their par value of $1 to $350,000 being their current market value. This occurred when the shares were sold by Adelong Hills to each of Sailpeal and Port Bracknell for substantially less than their market value. Because of this under valuing, the market substitution rules in s 116-30 of the ITAA 1997 would be applied so that the cost base would be deemed to be the current market value of the shares, instead of the agreed price which was substantially less.

The Commissioner issued amended assessments to each taxpayer to take account of the income said to be derived by them in the 2000 income year. The Commissioner issued the amended assessments on the basis that the taxpayers had entered into a series of transactions in April 1999 for the purpose of increasing the cost base of each share they held in the Company to $350,000. The taxpayers appealed against the amended assessments to the Tribunal, where the Commissioner's amended assessments were upheld. The taxpayers appealed the decision of the Tribunal to the Federal Court, which is the subject of the present case.

RELEVANT LEGISLATION

Section 177C(1)(a) provides that a reference to a taxpayer obtaining a tax benefit in connection with a scheme shall be read in reference to an amount that has not been included in the income of the taxpayer where that amount would or might reasonably be expected to have been included in the assessable income of the taxpayer had the scheme not been entered into or carried out.

However, s 177C(2) provides that a reference… to the obtaining by a taxpayer of a tax benefit in connection with a scheme shall be read as not including a reference to:

(a) the assessable income of the taxpayer of a year of income not including an amount that would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out where:

(i) the non-inclusion of the amount in the assessable income of the taxpayer is attributable to the making of an agreement, choice, declaration, agreement, election, selection or choice, the giving of a notice or the exercise of an option (expressly provided for by [the ITAA 1936] or the [ITAA 1997]) by any person, except one under subdiv 126-B, 170-B or 960-D of the ITAA 1997.

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 after consideration is given to the eight listed objective factors, including:

(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) …

TRIBUNAL DECISION

The Tribunal found that the transactions entered into by the taxpayers were not a sham. The taxpayers had intended the transactions to have their full effect according to their terms so that they would be able to achieve the desired taxation result.

The Tribunal was satisfied that the taxpayers had entered into a scheme to which Part IVA could be applied. The Tribunal considered that the taxpayers did more than engage in the sale of a share to a wholly owned company in return for shares in that company. Instead, the taxpayers set in motion a series of steps beginning with disposition of their shares and ending with the gains being distributed to them by the trust which received the proceeds from sale that would give rise to the uplift in each share's cost base.

Although it was important to consider the consequences that had arisen for the taxpayers as a result of the operation of the scheme, it was equally important to examine the consequences for the taxpayers had the scheme not been entered into. The Tribunal considered that the scheme entered into by the taxpayers gave rise to a tax benefit within the meaning of Part IVA because the scheme resulted in an amount not being included in the taxpayer's assessable income that would otherwise have been included. Importantly, if the taxpayers had not entered into any of the transactions in the scheme, they would have incurred a substantial capital gain.

For the purposes of s 177D the Tribunal held that the taxpayers had entered the scheme for the dominant purpose of obtaining a tax benefit in connection with that scheme. The Tribunal did not accept that the activities occurring between 13 and 15 April 1999 was part of a separate process of estate planning or restructuring as submitted by David Walters. Instead, it was clear to the Tribunal that the flurry of activity was a reflection of the taxpayer's desire to obtain a tax benefit up the sale of shares.

The Tribunal rejected the taxpayer's contention that no tax benefit arose because s 177C had the effect of excluding circumstances where an amount has been excluded from the taxpayer's assessable income arises because of a choice or election expressly provided for by the ITAA 1997. In this regard the Tribunal held that the tax benefit arose from the subsequent steps in the scheme that led to an uplift in the cost base of the shares, and this could not be restricted to only to the election by each taxpayer to roll over any gain under subdiv 122-A.

ISSUES

The taxpayer appealed the Tribunal's decision in relation to Part IVA to the Federal Court. The Commissioner also appealed, but in relation to the amount of penalty tax imposed by the Tribunal, which is outside the scope of this paper.

The taxpayer submitted that:

(a) the Tribunal erred in law in applying s 177C of the ITAA 1936, particularly that any tax benefit arising from the uplift in the cost base of the shares in the hands of the parties was not obtained by either taxpayer but the trustee of the relevant trust;

(b) it was not correct for the Tribunal to conclude that the taxpayers were unable to bring themselves within the exemption provided for in s 177C(2)(a)(i). The taxpayers contended that no tax benefit arose because the amount was not included in their assessable income as a result of an election or choice allowable under the ITAA 1997 and so the exemption provided for under this section would apply;

(c) the Tribunal misconstrued the meaning and effect of s 177D of the ITAA 1936;

(d) it was not correct for the Tribunal to conclude that the taxpayer's sole or dominant purpose for entry into the scheme was the obtaining of a tax benefit.

DECISION

The Federal Court upheld the Tribunal's findings that the taxpayers had entered into a scheme for the dominant purposes of obtaining the tax benefit by way of an uplift in the CGT cost base of the Company's shares in the hands of the parties, and that Part IVA could be applied to this series of transactions.

(a) the Tribunal did not err in law in applying s 177C of the ITAA 1936;

The Court rejected the taxpayer's submissions that the Tribunal erred in its application of s 177C in relation to the election made by each taxpayer to roll over any gain, with the result that the gain be disregarded for the purposes of the taxpayer's assessable income. Although this result is contemplated by the wording of s 177C(2)(a)(i) the inclusion of the phrase "attributable to" the election, choice or event means that there must be a direct relationship between the non-inclusion of the relevant amount and the choice or election made by the taxpayer. This may have been the case where each part of the transaction was to be considered separately. However, the Tribunal found that it was the series of transactions that constituted the relevant scheme meaning that the gain of $349,999 representing the capital gain is not attributable to the choice made by the taxpayer under subdiv 122-A. The non-inclusion is instead attributable to the entire scheme, rather than the election under subdiv 122-A in relation to one step in the series of transactions.

(b) the taxpayers did not fall within the exception in s 177C(2)(a)(i);

As a result of their findings above, the Court also confirmed that the taxpayers did not fall within the exception in s 177C(2)(a)(i), as they failed to satisfy the first limb of the exclusion.

(c) the Tribunal did not misconstrue s 177D;

The Federal Court held that Part IVA could apply to "any scheme" and it was open to the Tribunal to identify the relevant scheme as all of the dealings up to but not including the actual sale of the shares to Terrence and Annette Walters. In this regard the relevant scheme comprised the sequence of steps "taken together"[2] that resulted in the uplift of the CGT cost base of each share in the Company.

(d) sole or dominant purpose correctly identified.

The Federal Court confirmed the question to be answered was whether a reasonable person would conclude that each taxpayer in entering into and carrying out the particular scheme had, as his or her "most influential and prevailing, ruling or dominant purpose, the obtaining thereby of a tax benefit, in the statutory sense"[3].

In answering this question, the Court found that the taxpayers had acquired a package solution from their advisers that required execution over a short period of time. An integral part of the solution was the creation

of the discretionary trusts in which the taxpayers continued to control ownership of the trustee companies and the relationship between these trustee companies and each of the taxpayers was important. The end result of the transaction improved the financial position of each of the taxpayers, by $349,999, and also that of their advisers, who were paid for their advice.

Section 177D operates on a hypothesis that a taxpayer has obtained a tax benefit in connection with the scheme and the dominant purpose informing the scheme is one of enabling the taxpayer to obtain that benefit. The Court found that this hypothesis was clearly supported as the capital gain that would have otherwise been realised by the taxpayer would have been included in their assessable income for the appropriate year.

CONCLUSION AND COMMENT

On 20 August 2007 the Federal Court handed down its judgment in the case of *Walters v Commissioner of Taxation* which examined whether a series of transactions entered into by the taxpayers, resulting in a uplift of the cost base of shares in a company for CGT purposes was a sham and could be caught by the general anti-avoidance provisions in Part IVA of the ITAA 1997. The Tribunal had allowed the Commissioner's amended assessment that included the amount of $349,999 in the assessable income of each taxpayer. The Federal Court upheld the Tribunal's decision in relation to Part IVA finding that whilst none of the transactions were a sham, the taxpayers had entered in the transactions in order to obtain a tax benefit that could be caught by Part IVA.

This case serves a timely reminder that advisors should be aware that transactions entered into by taxpayers resulting in a uplift of the CGT cost base of an asset are subject to the general anti-avoidance provisions in Part IVA. This is particularly the case where the transactions are wider than a taxpayer's election or choice to roll over a capital gain to give effect to that tax result. In those circumstances the Federal Court has clearly stated that the exemption in s 177C(2)(a)(i) will not be available to taxpayers to exclude the application of Part IVA.

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Reference notes

1 *[2007] FCA 1270*

2 *At [59].*

3 *Federal Commissioner of Taxation v Spotless Services Limited (1996) 186 CLR 404 at 423.*

VICTORIA SUPER CLUB