Doing your research – managed investment scheme avoids the application of Part IVA.

LENZO V COMMISSIONER OF TAXATION [2007] FCA 1402

INTRODUCTION

In the case of *Lenzo v Commissioner of Taxation*[1] the Federal Court of Australia heard an appeal made by Gino Lenzo ("the taxpayer") against the decision of the Commissioner of Taxation ("the Commissioner") disallowing deductions claimed by the taxpayer in relation to a managed investment scheme in the 1998, 1999 and 2000 income years. The Commissioner disallowed the deductions on the basis that they constituted a scheme entered into to derive taxation benefits under Part IVA of the *Income Tax Assessment Act 1936* (Cth) ("*ITAA 1936*") and the taxpayer subsequently appealed to the Federal Court. The Court held that Part IVA of the *ITAA 1936* did not apply to the taxpayer's investment because, despite the investment scheme providing many tax benefits to the taxpayer, it could not be concluded that the taxpayer entered into the investment scheme for the dominant purpose of acquiring a tax benefit.

The case highlights that Part IVA does not necessarily apply to an investment scheme under which investors derive taxation benefits where the investment is considered to be commercially viable. It should be noted that the managed investment scheme in this case was commenced prior to the introduction of the product ruling scheme and so did not have the protection of a product ruling that other schemes may now have. This result should be considered in light of *Taxation Ruling 2007/8* ("Ruling")[2] released on 17 October 2007, which will apply to agricultural managed investment schemes entered into after 1 July 2008. This Ruling provides that investor contributions should "more properly be characterised according to the substance of the schemes in question"[3]. The Commissioner contends that contributions made by investors are likely to be considered as capital in nature because they are the capital cost of the investor's interest in the scheme, and hence not deductible under s 8-1 of the *Income Tax Assessment Act 1997 (Cth)* ("*ITAA 1997*"), regardless of whether those investors are beneficiaries of a trust where the responsibile entity of the scheme is the trustee.

FACTUAL BACKGROUND

The taxpayer is a certified practicing accounting with 24 years experience and has operated as a sole practitioner for the past 10 years. In 1997 the taxpayer began to investigate investment options to ensure that he was provided with the best possible options for wealth accumulation in his retirement. During 1997 and 1998 the taxpayer was made aware of three separate managed investment schemes under which investors became growers in commercial Indian sandalwood plantations. Although the taxpayer decided not to take up these opportunities after his initial research into the projects, the taxpayer remained interested in this type of investment scheme and continued to independently research similar investment projects.

At the end of May 1998 the taxpayer received a prospectus from the East Kimberley Sandalwood Company Ltd ("EKS") relating to a plantation of Indian sandalwood in Western Australia ("Project"). In addition to outlining the operation of the Project, the prospectus contained an independent taxation opinion. This opinion identified various tax deductible outgoings that resulted from investment in the Project, based on the assumption that investors maintained their investment until the sandalwood was harvested and sold, in approximately 15 years.

As he had with the other investment projects, the taxpayer considered the prospectus carefully, particularly the opinions provided by persons within the industry that had been included. These opinions related to the merits of the Project, the expected commercial returns, crop benefits and risks, and an analysis of expected supply and demand trends for the harvested sandalwood crop. At this time the taxpayer remained undecided as to whether the Project would satisfy his wealth accumulation objectives, or whether he should instead contribute his available funds into a self-managed superannuation fund. Although both options were fully tax deductible, the taxpayer ultimately decided to invest in the Project, intending to make a profit.

Taxpayer's funding and insurance arrangements

The taxpayer signed the necessary application forms on 30 June 1998 and appointed EKS to manage his sandalwood lots. A full recourse loan facility provided by Arwon Finance Pty Ltd ("Arwon") (a related company of EKS) was available to Project investors. Investors who took out a loan with Arwon were given the opportunity to enter into an indemnity agreement with Intersure Services Pty Ltd ("Intersure") (another related company of EKS) which provided indemnity for any liability arising under the loan agreement to the extent that proceeds from the investment were insufficient to repay the borrowed monies.

The taxpayer opted to finance his investment by taking the loan offered by Arwon for the amount of $36,982, which was to be advanced in two principal sums. The taxpayer also elected to enter into the indemnity agreement with Intersure. On 14 July 1998 the taxpayer was informed by EKS that the application had been accepted retrospectively on 30 June 1998, which enabled the taxpayer to make a deduction of $20,850 for the 1998 income year to be claimed in accordance with figures contained in the prospectus.

The first principal sum of $20,850 was advanced to the taxpayer on 30 June 1998 of which the taxpayer repaid $7,506 on 31 October 1998. The second principal sum of $16,660 would not be advanced until 1 July 1999, and was due for repayment by the taxpayer upon the harvest of the sandalwood crop or 30 June 2014, whichever occurred first.

Before the second principal sum could be advanced, the taxpayer was advised by Arwon of an option to refinance his loan with the ANZ Bank. On 25 June 1999 the taxpayer received approval from the ANZ Bank for an independent loan of $16,660 (the amount of the second principal sum) to pay for the maintenance, management and rent fees for the remainder of the Project. As a result, Arwon never advanced the second principal sum. The taxpayer repaid the full amount of the loan to ANZ on 21 September 2000. The taxpayer's only remaining liability was the balance of the Arwon loan, being $12,810, and the annual insurance premiums payable to Intersure.

Taxpayer's deductions

The taxpayer claimed losses from business in respect of participation in the Project, being $20,850, $3,884 and $5,203 for the 1998, 1999 and 2000 income years respectively. These deductions related to maintenance fees, rent (in relation to each plantation lot), interest and indemnity fees.

On 8 August 2001 the Commissioner made determinations pursuant to Part IVA *ITAA 1936* that the structure and payment arrangements relating to the sandalwood Project were entered into by the taxpayer for the dominant purpose of gaining a tax benefit. Subsequently, the Commissioner issued amended assessments to the taxpayer for the 1998, 1999 and 2000 income years. The Commissioner disallowed the taxpayer's objections to the amended assessments and on 3 May 2005, the taxpayer appealed to the Federal Court, which appeal is the subject of the present case.

> "The Court held that the taxpayer had not received a tax benefit by using the Arwon loan facility, as similar loan facilities were available from independent financiers."

RELEVANT LEGISLATION

Section 177F(1)(b) of the *ITAA 1936*, allows the Commissioner to disallow deductions made by a taxpayer, having determined that the taxpayer has obtained tax benefits in connection with a scheme to which Part IVA applies.

Section 177C(1)(b) provides that, subject to this section, a reference in [Part IVA] to the obtaining by a taxpayer of a tax benefit in connection with a scheme shall be read as a reference to…

> "a deduction being allowable to the taxpayer in relation to a year of income where the whole or a part of **that deduction** would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out".

Section 177D(b) identifies eight objective factors to consider, in determining whether there is a scheme to which Part IVA applies;

(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) …

ISSUES ON APPEAL TO THE FEDERAL COURT

The issue before the Court was whether Part IVA applied to the Project such that the deductions claimed by the taxpayer in the 1998, 1999 and 2000 income years should have been disallowed by the Commissioner.

Taxpayer's submissions

Counsel for the taxpayer submitted that, for the purposes of the factors to be considered in s 177D(1):

1. The Project entered into by the taxpayer was viable and commercial. As a result of the commerciality of the Project, the taxpayer contended that the objective purpose of the Project was to obtain a profit, rather than obtain a tax benefit.
2. Had the taxpayer not invested in the Project, the taxpayer would have obtained a similar tax benefit by making additional contributions to his self managed superannuation fund ("SMSF"). This contention is supported by the fact that the taxpayer:

a. had established a SMSF and had made non-deductible contributions to that SMSF prior to 1998;
b. had funds available to make a contribution in the 1998 year of approximately the same amount as he invested in the Project;
c. was unable to access the funds contributed into his SMSF for a further 14 years, being a similar time to which he would be able to access his returns from investment in the Project.

3. A private ruling had been obtained on 10 May 2000 by another investor in the Project, indicating that certain amounts of deductions could be claimed in each of the 2000 and 2001 income years for initial expenditure, interest, lease and management fees. However, the Court did not find this ruling to be relevant as the Project before the Court differed to that considered in the private ruling. The differences included lack of opportunity to refinance with an independent lender, the lack of indemnity agreements and requirement to make regular interest repayments on investor loans.

Commissioner's submissions

Counsel for the Commissioner submitted that;

1. A scheme existed for the purposes of s 177A ITAA 1936 to which Part IVA could apply, comprising of the prospectus, loan and indemnity agreements, application forms, lease and management documents, and a trust deed. In the alternative the Commissioner submitted that the scheme may be comprised of the above documentation excluding the prospectus or the trust deed.
2. The taxpayer obtained a tax benefit from entering into or carrying out the scheme.
3. The taxpayer's financial position was improved by entering into the scheme. The initial outlay made by the taxpayer was small in relation to the large deduction claimed in the 1998 year.

DECISION

The Federal Court upheld the taxpayer's appeal, holding that the scheme entered into by the taxpayer was not one to which Part IVA applied.

Did the taxpayer, by entering into the relevant scheme, obtain a tax benefit in relation to it?

The Court held that the taxpayer, by entering into the scheme, did not obtain a tax benefit in relation to it. Section 177C refers to a deduction being allowable to the taxpayer where the whole or part of **that deduction** would not have been allowable if the scheme had not been entered into or carried out[4]. It was reasoned that the deductions claimed by the taxpayer were relevant to the Project (being for prepayment of lease and management fees and indemnity fees) but were not relevant in the event that the taxpayer had instead made additional contributions to his SMSF.

However, the Court also considered it to be relevant that the particular structures set up within this Project (for example the financing arrangements) were not unique, and similar results could have been achieved by the taxpayer, if he had not entered into the scheme, by using independent loan facilities. In this case, although investors were given the opportunity to use a full-recourse loan facility provided by Arwon, a similar loan facility was instead obtained by the taxpayer in 1999 from an independent lender. As a result, the Court held that it did not consider that the taxpayer gained, by entering into the scheme, a tax benefit in respect of his borrowings that he could not reasonably have been expected to obtain otherwise.

Can it be concluded that the taxpayer entered into the scheme for the purpose of obtaining a tax benefit in relation to the scheme?

Assuming that tax benefit existed, the Court held that although the taxpayer would obtain tax benefits by entering into the scheme, it cannot be concluded that the taxpayer, the manager or the promoteer entered into this scheme for the dominant purpose of enabling the taxpayer to obtain a tax benefit in connection with that scheme.

In this regard the Court considered the eight factors listed in s 177D(b) holistically. Firstly, the Court considered the Project to be a "serious commercial project" in light of expert evidence before the Court in relation to the Project's management and operations (including reasonableness of fees), industry trends, pricing and projected demands[5]. The Project did not need to rely upon tax benefits in order to provide a sufficient financial return to qualify as an investment grade product. As a result of this commerciality, the time at which the taxpayer entered into the transaction (ie 30 June 1998) became less important in determining the purposes for which the taxpayer entered into the transaction.

Similarly, the court found that the "round-robin" financing arrangement and the small cash outlay/large and immediate tax benefit is not determinative, merely indicative of the existence of a dominant tax purpose.

> "As the Project was considered to be commercially viable in its own right, it could not be said that the taxpayer invested in the Project for the dominant purpose of obtaining a tax benefit."

Secondly, the form and substance of the Project were consistent. There was no suggestion that the agreements entered into by the taxpayer were a sham, nor were the arrangements complex or artificial (save for the financing "round robin"). In fact, the Court considered these arrangements to be consistent with the arrangements found in other managed

investment schemes, and no alternative forms were offered by the Commissioner for consideration by the Court.

Thirdly, although timing may be indicative of a tax purpose, the existence and use of loan (and similar) agreements to obtain such benefits within a particular income year does not necessarily indicate a dominant tax purpose.

Fourthly, the mere fact that a taxpayer claims a deduction does not mean that Part IVA should apply.

Lastly, despite submissions by Counsel for the Commissioner that the taxpayer's financial position would be improved by the immediate receipt of tax savings, the Court held that any change in position should be considered not only in light of the tax benefit, but also in light of the commercial return. Expert evidence was also put before the Court that an investment of this nature was appropriate for the taxpayer in light of his financial position.

In this case, there was a real prospect that the taxpayer's financial position would be improved by the returns he received from the investment, despite the usual risks associated with this type of agricultural investment. The connection between the taxpayer another other parties involved in the Project were not indicative of a tax purpose.

COMMENT AND CONCLUSION

The *Lenzo* case concerned an appeal by the taxpayer against the Commissioner's decision to disallow deductions claimed in relation to a managed investment scheme in the 1998, 1999 and 2000 income years. The Commissioner disallowed the deductions on the basis that they constituted a scheme entered into to derive taxation benefits under Part IVA of the *ITAA 1936*. On appeal, the Federal Court held that Part IVA did not apply to the taxpayer's investment because the it was a "serious and commercial" venture, which could reasonably be expected to make significant returns upon investment, despite otherwise providing many tax benefits to the taxpayer. As a result, the Court held that it could not be concluded that the taxpayer entered into the investment scheme for the dominant purpose of acquiring a tax benefit.

Readers should be aware that the Commissioner has appealed the Court's decision to the Full Federal Court[6].

The decision of *Lenzo* should be considered in light of *Taxation Ruling 2007/8*, released on 17 October 2007, which will affect management investments schemes entered into from 1 July 2008. This Ruling provides that investor contributions should "more properly be characterised according to the substance of the schemes in question"[7]. This approach means that contributions made by investors are likely to be considered as capital in nature because they are the capital cost of the investor's interest in the scheme, and hence not deductible under s 8-1 of the *ITAA 1997*. Importantly, the Ruling foreshadows a shift by the Commissioner in relation to agricultural management investment schemes to disallow deductions made by investors based on their capital and not revenue nature instead of relying on Part IVA.

The Commissioner argues that investors may either be passive investors (and do not carry on business in relation to the scheme), or carry out a profit making scheme, or make contributions that will be affected by the prepayment rules. In any event, the Tax Office has stated[8] that they expect to present a test case in the near future, so that the Commissioner may be required to clarify, amend or even withdraw this new Ruling, should the Court find in favour of the taxpayer. In any event, a test case will be important to provide investors and stakeholders in the management investment scheme with certainty about the taxation consequences of investor contributions.

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Reference notes:

1 *[2007] FCA 1402 (7 September 2007)*

2 *Replacing withdrawn Taxation Ruling 2000/8.*

3 *TR 2007/8 at [6].*

4 *Ibid note 1, at [118].*

5 *Ibid note 1, see further evidence of Underwood, Sammon, Padmanabha and Begley.*

6 *At the time of writing, the outcome of the appeal is unknown.*

7 *TR 2007/8 at [6].*

8 *ATO Media Release 2007/50 dated 17 October 2007.*