How many times can the Commissioner tax one income stream?

MCCUTCHEON V COMMISSIONER OF TAXATION [2008] FCA 318.

On 12 March 2008 the Federal Court handed down its decision in *McCutcheon v Commissioner of Taxation*,[1] relating to determinations made by the Commissioner of Taxation ("Commissioner") under Part IVA of the *Income Tax Assessment Act 1936 (Cth)* ("ITAA 1936") to tax benefits derived by the taxpayers as a result of entering into a scheme for the purposes of Part IVA. Importantly, in bringing an appeal to the Federal Court, the taxpayers questioned whether it was possible for the Commissioner to make the determinations, in the alternative, against more than one taxpayer with respect to one amount of income. The Federal Court dismissed the taxpayers' appeal, holding that on these facts there was sufficient evidence before the Tribunal on which to find that each taxpayer could properly be assessed for tax, in the alternative, on the income that the Commissioner identified.

FACTUAL BACKGROUND

Towards the end of 1997 Mr McCutcheon and Mrs McCutcheon (collectively the "taxpayers") entered into an agreement to sell a Townsville based wholesale fuel distribution business ("distribution business") and a related fuel retail business ("retail business") to a purchaser. The distribution business was conducted by Northern Oil Pty Limited as trustee for the P&A Trust ("P&A"). The retail business was conducted by Oil Services Pty Ltd as trustee for the Pine Grove Unit Trust ("PGUT"). Pursuant to a contract of sale, P&A and PGUT contracted to sell their respective businesses to the purchaser with an expected completion dated of 1 December 1997.

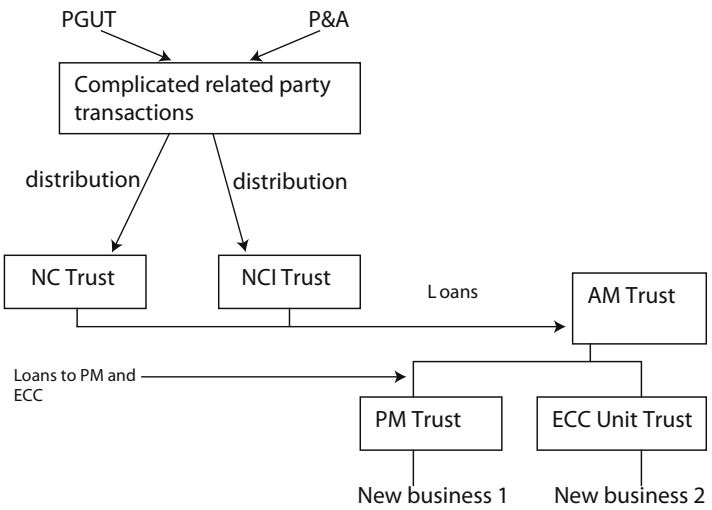
The taxpayers were motivated to sell the two businesses to finance the acquisition of two further businesses known as the East Coast Printed Circuits Business and the Primemovers Business. However, the taxpayers would only have enough money if they were able to extinguish the capital gains tax liability arising from the sale of the distribution and retail businesses.

As a result, the taxpayers acquired Retail Technology Holdings Pty Ltd. This entity had sufficient carry forward losses to offset the gains made by the taxpayers upon the sale of the distribution and retail businesses. Between 27 November 1997 and 30 June 1998 the taxpayers entered into a complicated string of transactions to achieve their objectives.

Between 27 November 1997 and 30 June 1998 the taxpayers entered into a complicated string of transactions to achieve their objectives. Amongst these transactions:

- Three trusts – the AM Trust, the NC Trust and the NCI Trust – were established. Each of these trusts had the same beneficiaries, being the Australian Red Cross Society (primary), the National Heart Foundation Queensland Division (secondary) and any corporation, trustee corporation or superannuation fund in which the trustee or specified beneficiary has any interest (tertiary); and
- Farrago (NQ) Pty Ltd was incorporated and appointed the trustee of the AM Trust. At all material times the taxpayers controlled Farrago.

At the risk of oversimplifying very complicated facts, the ultimate effect of the scheme found by the Court was that P&A and PGUT advanced funds that were obtained from the sale of the fuel and retail business to two related entities in order to purchase the Primemovers and East Coast Printed Circuits businesses as follows:



At all material times the taxpayers controlled the entities involved in each stage of the transaction and were beneficiaries of each of the trusts.

The Commissioner made three determinations, with respect to the income of PGUT and P&A, under s 177F of Part IVA of the ITAA 1936 to cancel the tax benefit of a scheme as follows:

1. To Mrs McCutcheon in regard to $1,616,406.00 (this being half the income of the P&A Trust) pursuant to s 97 of the ITAA 1936.
2. To Mr McCutcheon in regard to $1,616,406.00 (this being half the income of the P&A Trust) pursuant to s 97 of the ITAA 1936.
3. In the alternative to AM Trust on the basis that the amount of $3,232,813.00 should be included in its assessable income and to Mr McCutcheon in the same amount as the presently entitled beneficiary.

Only the first and third determinations resulted in amended assessments being issued.

The taxpayers unsuccessfully lodged objections against these decisions to the Commissioner and then appealed to the Tribunal. In the case of Mr McCutcheon, the taxpayers attacked the amended assessments on the basis that two determinations were made against Mr McCutcheon under s 177F of the ITAA 1936.

RELEVANT LEGISLATION

Section 97(1): Beneficiary not under legal disability:

Subject to Div 6D, where a beneficiary of a trust estate who is not under any legal disability is presently entitled to a share of the income of the trust estate:

(a) the assessable income of the beneficiary shall include:

(i) so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was not a resident and is also attributable to sources in Australia; and

…

177C Tax benefits

(1) Subject to this section, a reference in this Part to the obtaining by a taxpayer of a tax benefit in connection with a scheme shall be read as a reference to:

(a) an amount not being included in the assessable income of the taxpayer of a year of income where that amount 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;

…

177F Cancellation of tax benefits etc.

(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:

(a) in the case of a tax benefit that is referable to an amount not being included in the assessable income of the taxpayer of a year of income –determine that the whole or a part of that amount shall be included in the assessable income of the taxpayer of that year of income;

…

and, where the Commissioner makes such a determination, he shall take such action as he considers necessary to give effect to that determination.

TRIBUNAL DECISION

The Tribunal upheld the Commissioner's determination in respect to Mrs McCutcheon but set aside the larger of the two determinations in respect to Mr McCutcheon on the basis that Part IVA did not enable the Commissioner to make two separate determinations under s 177F directed at two different taxpayers (the AM Trust for $3.2m and Mr McCutcheon for $1.6m) in regard to the one stream of income, and then rely on the determination made against the AM Trust to issue an amended assessment against Mr McCutcheon for the $3.2m (remembering that he was presently entitled to the whole of the income of AM Trust).

In the interests of administrative efficiency, the Tribunal stood in the place of the Commissioner and ordered the Commissioner issue a further assessment to Mr McCutcheon that included only half the amount of the disputed income in his assessable income (in relation to the second determination of the Commissioner noted above).

> "The primary question before the Court was whether the determinations made by the Commissioner were invalid because they related to the same amount of income"

ISSUES BEFORE THE FEDERAL COURT

The taxpayers appealed to the Court on a number of grounds. The primary question put before the Court was whether the determinations made by the Commissioner in respect of each taxpayer were invalid on the basis that the Commissioner had made simultaneous determinations under the same provisions of the ITAA 1936 for the same year, and in relation to the same income, which were inconsistent with each other. In other words, if the Commissioner was to hypothesise that the whole amount of $3,232,813 formed part of the assessable income of the AM Trust, and was deemed to be the income of Mr McCutcheon pursuant to s 97 of the ITAA 1936, the Commissioner could not also make a determination that that the same amount formed part of the income of Mr and Mrs McCutcheon as beneficiaries of the PGUT and P&A Trusts on the grounds that, but for the scheme, it might reasonably be expected that these taxpayers would have shared the capital gain upon disposal of the two fuel distribution businesses 50/50.

The taxpayers argued that:

(a) the determination to include $3,232,813 in the income of Mr McCutcheon as well

as to include $1,616,406 in the income of Mrs McCutcheon was not a proper exercise of the power conferred on the Commissioner by s 177F of the ITAA 1936;

(b) the only rationally probative evidence before the Tribunal going towards the prediction required when making a determination under s 177F of the ITAA 1936 did not support this outcome;

(c) evidence presented by Mr McCutcheon about what would NOT have happened had the scheme not been entered into was incorrectly ignored.

The taxpayers submitted that the Commissioner also failed to identify "a tax benefit" obtained by each taxpayer, instead identifying multiple benefits obtained by the taxpayers and Farrago separately. In this regard the taxpayers contended that the Commissioner has a "statutory obligation in acting in reliance of s 177F to define the scheme by which a taxpayer has obtained a tax benefit and then determine in respect of the stream of assessable income comprising the tax benefit, the particular taxpayer that obtained that particular benefit".[2] As a result, the Commissioner cannot, in relation to the single sum of $3,232,813 make simultaneous determinations for the whole amount and parts of that whole amount in relation to the same scheme.

The Commissioner submitted that the Tribunal erroneously decided that:

(a) the reviewable objection decision made by the Commissioner in respect of Mr McCutcheon should be set aside;

(b) the determination against the AM Trust was invalid and therefore could not support the $3.2m assessment issued to Mr McCutcheon; and

(c) the alternative determination issued to Mr McCutcheon under s 177F was invalid and therefore could not support the amended assessment made by the Commissioner; and

(d) the issue of whether Mr McCutcheon obtained a tax benefit for the purpose of s 177C of the ITAA 1936 was a matter for the Commissioner to demonstrate before the Tribunal.

FEDERAL COURT DECISION

The Federal Court dismissed the taxpayers' appeal holding that there was an adequate relationship between the AM Trust and the taxpayers to support the alternative amended assessment issued to the taxpayers. Furthermore, the Federal Court held that the Tribunal did not err in its conclusion that the taxpayers had obtained a tax benefit on the evidence before it.

> "There was a necessarily symetrical relationship between the alternative determinations made by the Commissioner"

Validity of determinations

The question of law before the Federal Court concerned the lack of symmetrical treatment between the alternative and multiple determinations made to the particular taxpayers and the issue of amended assessments to different taxpayers in respect of what is described as one stream of income.

The Court examined the wording of each of s 177C(1)(a), s 177D and s 177F(1)(a) – highlighting that the wording of these provision referred to concepts in the singular. Section 177F(1)(a) in particular refers to a tax benefit, obtained by a taxpayer and to a tax benefit that is referable to **an** amount not being included in a taxpayer's assessable income.

Nevertheless, the Court also highlighted the requirement of the Commissioner to make a prediction as to what might "reasonably be expected" to have occurred if the relevant scheme had not been entered into or carried out when determining whether a taxpayer had obtained a tax benefit. The scope of what the Commissioner is required to consider is widened by the very nature of this question.

The Court reasoned that the Commissioner had completed all of the necessary steps required to make a valid determination under s 177F – identifying a taxpayer within reach of the section, finding a tax benefit obtained in connection with an identified scheme and satisfying himself that it was a scheme to which Part IVA could apply.

The Commissioner hypothesised that, had the scheme not been entered into or carried out, that income distributed by NOPL as trustee of the P&A Trust would have been distributed to Mr and Mrs McCutcheon equally. The alternative hypothesis was that had the scheme not been entered into or carried out, the whole amount of $3,232,813 would have been included or might reasonably have been expected to be included in the assessable income of the AM Trust.

The Court held that the Commissioner was able to make alternative determinations to Farrago as trustee of the AM Trust and Mr McCutcheon in relation to the same sum of income because there was a necessarily symmetrical relationship between Farrago in its capacity as trustee of the AM Trust and Mr McCutcheon as a person who fell within the tertiary class of beneficiaries of the AM Trust who was, at the relevant time, presently entitled to 100% of the income of the AM Trust.[3] The Court reasoned that Farrago, in its capacity as trustee of the AM Trust, had obtained a tax benefit in the amount of $3,232,813.00 and because there was a beneficiary that was presently entitled to 100% of that income (Mr McCutcheon) it was allowable for the Commissioner to make alternative determinations against Mr McCutcheon. In regard to the relationship that existed between Farrago and Mr McCutcheon the Court reasoned that it was improper to describe the alternative assessment to Farrago as being "foreign to Mr McCutcheon" in the sense it was described by the Tribunal.

Evidence before the Tribunal

The taxpayers submitted that the Tribunal erred in excluding particular evidence sought to be given by Mr McCutcheon. The Court reasoned that the issue of whether the proper evidence was considered went to the question of whether the determinations made by the Commissioner were properly founded upon

a prediction that an amount of $1,616,406 might reasonably have been included in the assessable income of the taxpayers had the scheme not been entered into or carried out. The Court held that the Tribunal erred by excluding additional evidence which may have assisted the Tribunal to understand the context of the other material facts before them. However, the Court held that it was not open to Mr McCutcheon to now provide affidavit evidence as to these facts as the relevant issue went to the ultimate question that was before them

Tax benefit

The taxpayers submitted that there was no evidence before the Tribunal to support the conclusions that as a "as a reasonable prediction of events, absent the scheme, that Mr and Mrs McCutcheon would have been likely to receive an equal distribution of the income stream". The Court looked at the many issues that Tribunal did consider, noted that the "burden of proof falls upon the appellants to demonstrate that the assessments issued to each taxpayer is excessive" and held that there was no demonstrated error in the methodology adopted by the Tribunal in identifying the existence of a tax benefit. Therefore, it was open to the Tribunal to predict that, had the scheme not been entered into, the amount of $1,616,406 could reasonably have been expected to be included in each of the taxpayers' assessable income, as beneficiaries of the P & A Trust.

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Reference notes:

1 *[2008] FCA 318.*

2 *Above n 1 at [23].*

3 *Pursuant to s 97 of the ITAA 1936*