

# Chaire de recherche en fiscalité et en finances publiques

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## Effective Responses to Aggressive Tax Planning

## What Canada Can Learn from Other Jurisdictions

## Instalment 3: Australia – General Anti-Avoidance Rule

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This instalment is the third in a series that presents a detailed study on aggressive tax planning. It underpins the issuance of *Tax Paper No. 112* published in July 2009 by the Canadian Tax Foundation (CTF). As mentioned in the preface of the book in order to keep publishing costs reasonable and to avoid delaying its publication, the CTF has given us permission to publish this document in French and English on our Website.

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 UNIVERSITÉ DE  
SHERBROOKE

## The Mission of the Research Chair in Taxation and Public Finance

The **Research Chair in Taxation and Public Finance** (RCTPF) was formed on April 15, 2003 via an unconditional grant from the Québec Government, to whom we are grateful. We are specifically thankful to the Government for having given us total freedom in selecting topics we thought were important, thus expressing its confidence in the selection of our projects. In Québec, there are few official forums where practitioners, public-sector executives and researchers can discuss new issues in taxation and public finances. In addition, research in these fields generally focuses on a single discipline to the detriment of the multi-disciplinary aspect of relations between the state and its taxpayers. The **Research Chair in Taxation and Public Finance** was formed in response to these two realities. Its primary mission is to stimulate interdisciplinary research and training by bringing together professors and researchers interested in the political economy of taxation. For more information on the **Research Chair in Taxation and Public Finance**, visit its official Website at: <http://www.usherbrooke.ca/adm/recherche/chairefiscalite/>.

Gilles Larin holds the RCTPF. Robert Duong<sup>1</sup> contributed to this instalment while he was a research professional with the RCTPF. Diane Benoît was a consultant with the RCTPF.

We wish to express our gratitude for their observations and suggestions to Gilles Paré, who acted as outside adviser, and to other readers who wished to remain anonymous. Of course, we assume full responsibility for the comments and interpretations in this study.

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<sup>1</sup> Robert Duong, who is a lawyer, was a research associate with the Research Chair of Taxation and Public Finance at the University of Sherbrooke when this study was done. He is now working with the federal Department of Finance as a policy officer in the area of income tax. The views expressed in this publication are those of the authors and do not in any way represent the position of the Department of Finance of Canada. The material contained in this publication is not intended to be advice on any particular matter. No subscriber or other reader should act on the basis of any matter contained in this publication without considering appropriate professional advice. The publisher, and the authors and editors, expressly disclaim all and any liability to any person, whether a purchaser of this publication or not, in respect of anything and of the consequences of anything done or omitted to be done by any such person in reliance upon the contents of this publication.

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## Abstract

### Instalment 3: Australia – General Anti-Avoidance Rule

In 2005, the Research Chair in Taxation and Public Finance initiated studies on aggressive tax planning in light of concerns expressed by tax administrations, the courts, taxpayers and tax advisers (“**stakeholders**”). The studies analyze the tools developed by some of Canada’s major trading partners in response to aggressive tax planning schemes put into effect by taxpayers and tax advisers.

**This study aims to spark thinking among the various stakeholders in Canada by taking a comprehensive and pragmatic approach to several issues inherent in aggressive tax planning. In view of the scope of the subject, its complexity and the specific features of the taxation systems of foreign jurisdictions, our study should be seen as a reflection on aggressive tax planning rather than an exhaustive analysis of each of the tools examined and all the associated issues. This project was written over a more than a two year period. As the underlying logic was the key element we wished to convey, we wish to emphasise that these documents do not necessarily represent the state of tax legislation or jurisprudence.**

As part of this project, the Chair held a symposium in 2006 on the risks inherent in aggressive tax planning for all stakeholders and published a discussion paper detailing the major issues of these schemes.

This project is being pursued here by a study of the tools developed by Australia, United States, United Kingdom and European Union. Our goal is to assess whether it would be worthwhile for Canada to adopt one or more of these tools to safeguard its tax system. The assessment was carried out taking into consideration the point of view of each stakeholder, according to generally recognized principles of tax administration.

This study consists of ten instalments detailing the study framework that guided our analysis of the tools developed in other countries and our study of each of the selected tools. Our conclusions in relation to all of these tools and possible solutions for Canada were destined to become instalment No. 10. However, it is not published here, because it was recast and augmented to become Tax Paper No. 112, published in July 2009 by the Canadian Tax Foundation: *Effective Responses to Aggressive Tax Planning – What Canada Can Learn from Other Jurisdictions*.

We refer the reader to instalment 1, “Study Framework” for an overview of our thinking throughout the instalments.

This instalment deals with Australia’s general anti-avoidance rule (GAAR) included in *Part IVA* of the *Income Tax Assessment Act 1936*. This tool has similarities with Canada’s general anti-avoidance rule. We begin by describing the general context of the GAAR. We identify the rule’s criteria as well as the issues stemming from their application for each group of stakeholders. In this instalment, we formulate conclusions on the application of the GAAR.

Application of the Australian GAAR illustrates the usefulness of defining objective parameters in the tax legislation based on economic substance that can be used to decide whether the dominant purpose of an arrangement is the claiming of a tax benefit for the taxpayer. Defining such parameters in the legislation should provide all stakeholders with a greater degree of predictability, flexibility and consistency in the enforcement of a GAAR. The general scope of these parameters carries the risk that opinions may significantly differ on their respective importance and practical application. Accordingly, the tax administration must exercise its extensive audit powers in a reasonable way to reconcile the principles mentioned above.

Because of the absence of the criterion of abuse of the law taken as a whole in the GAAR, there is the risk that the distinction between legitimate arrangements and those carried out for tax avoidance purposes will be made mainly on the basis of the purposes pursued by taxpayers at the expense of the objects of the law. In our view, it is important that a general anti-avoidance rule apply according to the objects of the tax law read as a whole in order to strike a balance between protection of the tax system and taxpayers’ privilege to minimize their tax payable. Despite the lack of such a criterion, the Australian courts have nonetheless, on certain

occasions, applied the law according to these objects to conclude that an arrangement constituted tax avoidance.

The application in Australia of a penalty for under-stating tax payable on taxpayers who implemented a tax avoidance scheme certainly increases the risk of aggressive tax planning. However, we are of the view that the tax law must allow taxpayers who put forward a reasonable interpretation of the law to avoid such a penalty to the extent that it is almost impossible to draw a clear line between legitimate arrangements and those entered into for tax avoidance. In view of the uncertainties attending the GAAR and the penalty rates that apply, the tax administration must be transparent and consistent in applying this rule and demonstrate flexibility. Above all, it must define the objects of the tax law more clearly.

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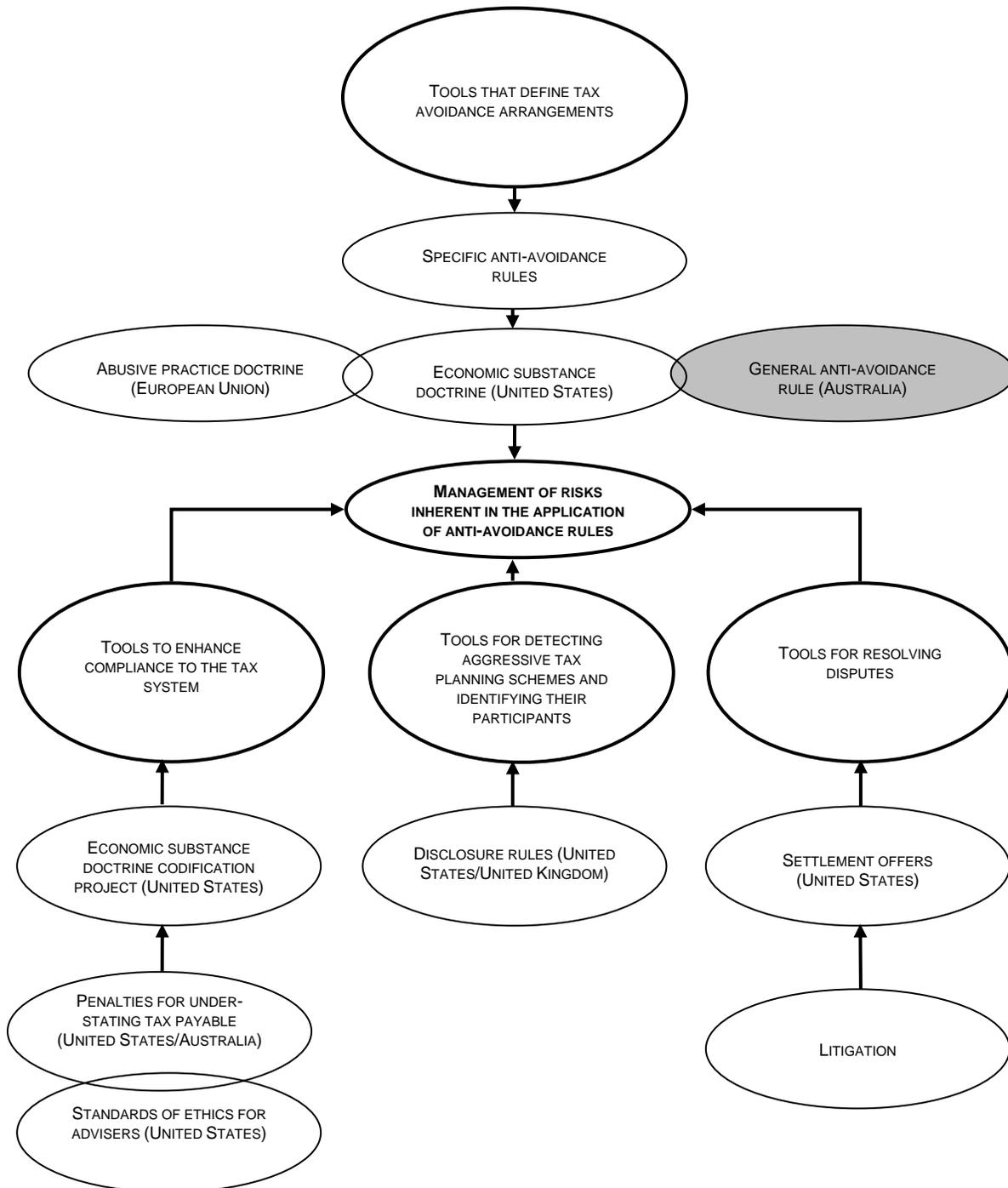
## General Context

As discussed in Instalment 1, “Study Framework”, of this study, there are a number of tools available to the tax administration to better curb tax avoidance arrangements and increase the risk for aggressive taxpayers and advisers. These tools can be divided into four spheres of intervention of the tax administration:

- Tools that define tax avoidance arrangements.
- Tools to enhance compliance to the tax system.
- Tools designed to detect aggressive tax planning schemes and identify their participants.
- Tools that focus on resolving disputes.

Figure 1.1 on the following page provides a concise illustration of the relation between these spheres of intervention in managing the risks inherent in aggressive tax planning. Each sphere of intervention is shown in the chart using a bold border. The foreign tools selected for the purposes of the study are inserted in the appropriate spheres of intervention. The tool considered in this instalment, the Australian GAAR, is indicated by a grey background to situate its role in the tax administration’s management of the risks inherent in aggressive tax planning.

**FIGURE 1.1**  
**SPHERES OF INTERVENTION OF THE TAX ADMINISTRATION REGARDING AGGRESSIVE TAX PLANNING:**  
**SELECTED TOOLS USED BY SOME OF OUR TRADING PARTNERS -**  
**PART IVA OF ITAA 1936 OF AUSTRALIA**



Our Chart.

Like other countries, Australia's tax administration is trying to reduce its tax gap. In its simplest form, this is estimated by the tax administration as the difference between the amount of tax that taxpayers should bear under the tax laws and the amount they have actually reported and paid. There are many reasons for this gap, in particular where the taxpayer does not file his tax return, omits certain categories, or makes undue use of deductions or exemptions.<sup>2</sup>

Australia's tax administration cannot provide an exact measure of the gap associated with aggressive tax planning. In October 2003, the tax administration estimated the value of notices of assessment issued in cases of mass marketed investment schemes between 1999 and 2003 at AUS\$1.7 billion.<sup>3</sup> By comparison, this amount equals roughly 37.5% of the value of notices of assessment issued by the tax administration regarding amounts of income tax and penalties payable by taxpayers during fiscal year 2002-2003.<sup>4</sup> In relation to income tax collected by the Australian tax administration, this amount equals 1.3% of the \$128 billion collected for the same fiscal year.<sup>5</sup>

Australia's income tax act<sup>6</sup> acknowledges taxpayers' privilege to organize their affairs to minimize their tax payable. The law includes specific anti-avoidance rules as well as a general anti-avoidance rule (GAAR) that attempt to limit this privilege.

Briefly, the purpose of the GAAR is to withdraw the tax benefits claimed by a taxpayer who implements a plan whose dominant purpose is of a tax nature. The rule is intended to prevent taxpayers from claiming a tax benefit that does not comply with the objects of the law. The tax administration has prevailed before the courts in a number of cases relating to the application of the GAAR. However, the courts have been unable to completely remove the ambiguity over its scope, for the following reasons, among others:

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<sup>2</sup> For a discussion on the relevance and difficulties in measuring the tax gap, see Jacqui McManus, Neil Warren, "The Case for Measuring Tax Gap", (2006) 4:1 *eJournal of Tax Research* 61 [McManus, "Tax Gap"].

<sup>3</sup> Austl., Australian National Audit Office, *The Australian Taxation Office's Management of Aggressive Tax Planning*, Audit Report No. 23, 2003-2004 Performance Audit (29 January 2004) [ANAO, *ATO Management of Aggressive Tax Planning*], pages 25 and 110.

<sup>4</sup> Austl., Australian Taxation Office, *Commissioner of Taxation Annual Report 2005-2006* (Canberra: Australian Taxation Office, October 2006) [ATO, "Annual Report 2005-2006"].

<sup>5</sup> Austl., Commonwealth Treasury, *2003-2004 Budget Paper No. 1* (Canberra: Commonwealth, 13 May 2003), pages 5-7.

<sup>6</sup> *Income Tax Assessment Act 1936* (Cth.) [ITAA 1936].

- The rule does not lay out precise parameters for determining arrangements that do comply with the tax law.
- The rule does not define what constitutes a “dominant purpose”.
- The dominant purpose criterion does not ensure consistent application of the tax law in accordance with its objects.

The tax administration set up a committee to improve the efficiency of the tax system as a whole and, in 1999, this committee proposed changing the GAAR to have it apply according to the objects of the tax law. The tax administration is continuing to study the merits of adopting this approach.

Along with efforts to more clearly distinguish in the legislation legitimate arrangements from those entered into for tax avoidance purposes, the tax administration is stepping up its audit activities, in particular regarding tax advisers. It required the filing of 395 tax returns from 88 promoters that, in its view, exhibited a high risk of tax avoidance. In addition, it required that 168 entities controlled by these promoters file supplementary returns.<sup>7</sup> The tax administration has also introduced a system of penalties targeting promoters of aggressive tax planning schemes with a risk of avoidance. The tax administration will soon adopt ethical standards in taxation to provide taxpayers with the assurance of greater predictability and consistency in the opinions of their tax advisers, and to better protect the integrity of the tax system.

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<sup>7</sup> See ATO, *Annual Report 2005-2006*, *supra* note 4, pages 158-159 under the heading *Risks in specific focus areas: Aggressive tax planning*.

## Context of the GAAR

Under a self-assessment system, taxpayers are responsible for determining their tax payable. Generally, they must demonstrate due care to apply the tax law in a reasonable way, in light of case-law and the documents published by the tax administration.

The multiplicity and the complexity of tax rules create grey areas in the application of the law. Taxpayers could be of the view that an interpretation of the law allows them to reduce their tax. In particular, taxpayers could organize their affairs to benefit from disparities and inconsistencies among various rules. However, obtaining tax benefits established according to a literal interpretation of these rules could run counter to the objects of the law taken as a whole.

In the view of the Australian Taxation Office, tax planning schemes entered into by taxpayers that abuse the objects of the tax law undermine the trust of other taxpayers in the fairness and integrity of the tax system.<sup>8</sup> A tax reform committee set up by the Australian government described tax avoidance in these terms:

*Tax avoidance may be characterised as a misuse or abuse of the law rather than a disregard for it. It is often driven by the exploitation of structural loopholes in the law to achieve tax outcomes that were not intended by the Parliament but also includes manipulation of the law and a focus on form and legal effect rather than substance. The way things are done in order to take advantage of structural loopholes, or to dress up or characterise something to satisfy form but not substance can also stamp an arrangement as avoidance. Tax avoidance represents a serious threat to the integrity of the tax system and to the revenue. It is also a form of subsidy from those paying their fair share of tax according to the intention of the law to those shirking their similar obligations.<sup>9</sup>*

[our extracts and italics]

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<sup>8</sup> Austl., Australian Taxation Office, *Updated Compliance Program 2005-2006*, NAT 7769-10.2005 (Canberra: Australian Taxation Office, August 2005, updated 13 October 2005) [ATO, *Compliance Program 2005-2006*], pages 83-88.

<sup>9</sup> Austl., Commonwealth, Review of Business Taxation, *A Tax System Redesigned* (Canberra: Commonwealth of Australia, July 1999) [Review of Business Taxation, *A Tax System Redesigned*], page 243.

The tax law contains specific anti-avoidance rules as well as a GAAR to limit aggressive tax planning. The difficulties raised by the courts in applying the 1936 GAAR prompted the tax administration to change it on 27 May 1981. The tax administration wanted to resolve four major problems in applying the 1936 GAAR, in particular because of the broad scope of the terms used in it. These problems are:

- Recognition by the courts of taxpayers' privilege to organize their affairs to obtain a result that complies with the law.
- The 1936 GAAR applied depending on the consequences arising from an arrangement without taking into consideration the purposes that the taxpayers sought to achieve.
- Ongoing uncertainty as to whether the 1936 GAAR applied to an arrangement as a whole or solely to part of it in order to eliminate the tax benefit sought.
- The rule did not give the tax administration the power to re-qualify the arrangement where it was to be cancelled.<sup>10</sup>

Table 2.1 shows extracts from the 1936 GAAR and the GAAR in force since 28 May 1981.

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<sup>10</sup> Austl., Commonwealth, House of Representatives, *Explanatory Memorandum, Income Tax Laws Amendment Bill (No. 2), 1981 Income Tax Law Amendment Act (No. 2) 1981* [House of Representatives, 1981 *Explanatory Memorandum*].

**TABLE 2.1: SHORT COMPARISON OF THE GENERAL ANTI-AVOIDANCE RULE IN FORCE FROM 1936 UNTIL MAY 27, 1981 WITH THE ONE IN FORCE SINCE THEN**

| <p><b>SECTION 260 ITAA 1936</b><br/> <b>CONTRACTS TO EVADE TAX VOID</b><br/> <b>APPLICABLE TO ARRANGEMENTS IMPLEMENTED FROM 1936 UNTIL MAY 28, 1981</b></p>  | <p><b>SCHEMES TO REDUCE INCOME TAX - PART IVA – ITAA 1936</b><br/> <b>SECTION 177D</b><br/> <b>APPLICABLE TO ARRANGEMENTS IMPLEMENTED AFTER MAY 27, 1981</b></p>   |
|--|--|
| <p>Every contract, agreement, or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly:</p> <ul style="list-style-type: none"> <li>(a) altering the incidence of any income tax;</li> <li>(b) relieving any person from liability to pay any income tax or make any return;</li> <li>(c) defeating, evading, or avoiding any duty or liability imposed on any person by this Act; or</li> <li>(d) preventing the operation of this Act in any respect,</li> </ul> <p>be absolutely void, as against the Commissioner, or in regard to any proceeding under this Act, but without prejudice to such validity as it may have in any other respect or for any other purpose.</p> | <p>This Part applies to any scheme that has been or is entered into after 27 May 1981, and to any scheme that has been or is carried out or commenced to be carried out after that date (other than a scheme that was entered into on or before that date), whether the scheme has been or is entered into or carried out in Australia or outside Australia or partly in Australia and partly outside Australia, where-</p> <ul style="list-style-type: none"> <li>(a) a taxpayer (in this section referred to as the "relevant taxpayer") has obtained, or would but for section 177F obtain, a tax benefit in connection with the scheme; and</li> <li>(b) having regard to-                             <ul style="list-style-type: none"> <li>(i) the manner in which the scheme was entered into or carried out;</li> <li>(ii) the form and substance of the scheme;</li> <li>(iii) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;</li> <li>(iv) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;</li> <li>(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;</li> <li>(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;</li> <li>(vii) any other consequence for the relevant taxpayer, or for any person referred to in subparagraph (vi), of the scheme having been entered into or carried out; and</li> <li>(viii) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in subparagraph (vi),</li> </ul> </li> </ul> <p>it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme or of enabling the relevant taxpayer and another taxpayer or other taxpayers each to obtain a tax benefit in connection with the scheme (whether or not that person who entered into or carried out the scheme or any part of the scheme is the relevant taxpayer or is the other taxpayer or one of the other taxpayers).</p> |

Table prepared by the authors from extracts of the relevant sections taken from the *ITAA 1936*.

## 3

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### Description

#### 3.1 Criteria

Where specific anti-avoidance rules do not apply,<sup>11</sup> the tax administration can, under the GAAR, deny a taxpayer the tax benefits arising from a scheme when it is reasonable to consider, from an objective standpoint, that the dominant purpose of the taxpayer who implemented the scheme or of any other participant in the scheme is to obtain a tax benefit for the taxpayer.<sup>12</sup>

First, a tax benefit for a taxpayer consists of an amount that is not included in the calculation of income, or a deduction in the calculation of income, a capital loss or a foreign tax credit, which benefit it is reasonable to believe that the taxpayer would have been unable to claim without the tax planning scheme.<sup>13</sup> The taxpayer may claim the tax benefits arising from an election specifically stipulated by the tax law without being targeted by the GAAR. However, the rule can apply to schemes carried out by a taxpayer who organizes his affairs to satisfy the criteria stipulated by the rules relating to such election.<sup>14</sup>

Second, a scheme is defined as any arrangement, agreement, understanding, promise or undertaking, express or implied, that may or may not be legally enforceable, and any scheme, plan, proposal, action, or conduct<sup>15</sup> of one or more persons.<sup>16</sup> A scheme can be carried out in Australia and abroad, in whole or in part.<sup>17</sup>

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<sup>11</sup> 177B(3) *ITAA 1936*. For greater clarity, the law stipulates that the specific anti-avoidance rules must apply prior to the GAAR.

<sup>12</sup> As we point out in subsection 4.3, this criterion does not explicitly take into consideration the notion of abuse of the law taken as a whole.

<sup>13</sup> 177C *ITAA 1936*. Note that the tax benefits covered include amounts subject to the rules for withholding tax at source: 177CA *ITAA 1936*.

<sup>14</sup> 177C(2), (2A) and (3) *ITAA 1936*.

<sup>15</sup> 177A(1) “*Scheme*” *ITAA 1936*.

<sup>16</sup> 177A(4) *ITAA 1936*.

<sup>17</sup> 177D *ITAA 1936*.

Where a tax benefit arises from a scheme, the tax administration must determine whether the dominant purpose of the taxpayer or of any other participant in the scheme was to obtain such benefit for the taxpayer. To that end, the rule stipulates eight so-called objective criteria for determining whether the dominant purpose in a scheme was of a non-tax nature.<sup>18</sup> The courts must determine whether the GAAR applies taking all the criteria into consideration and depending on the importance they attach to them in a given situation.

The eight criteria can be grouped into three categories, namely the manner in which the scheme was carried out, the impacts arising from the scheme on the parties involved and the nature of their connection.<sup>19</sup> The eight criteria are:

- The manner in which the scheme was entered into.
- The form and substance of the scheme.
- The time at which the scheme was entered into and the length of the period during which it was carried out.
- The result achieved by the scheme under the income tax law if the GAAR did not apply.
- Any change in the financial position of the taxpayer, as well as any reasonably predictable additional change.
- 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 taxpayer, as well as any change that could reasonably affect his financial position.
- Any other consequences of the scheme for the taxpayer or for any person who is or was connected to him.
- The nature of the connection between the taxpayer and any other party to the scheme.

[our adaptation]

Other rules apply on top of the GAAR to delimit specific forms of schemes for which there is a risk that the GAAR may not apply.<sup>20</sup> Essentially, these rules are designed to remedy difficulties

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<sup>18</sup> 177D ITAA 1936.

<sup>19</sup> Austl., Australian Taxation Office, *Part IVA: The General Anti-Avoidance Rule For Income Tax*, NAT 14331-12.2005 (Canberra: Australian Taxation Office, December 2005) [ATO, *GAAR Brief*].

<sup>20</sup> See 177E ITAA 1936 (*Stripping of Company Profits*); 177EA ITAA 1936 (*Creation of Franking Debit or Cancellation of Franking Credits*); 177EB ITAA 1936 (*Cancellation of Franking Credits – Consolidated Groups*).

in the application of the GAAR relating to the identification of a tax benefit in certain circumstances.<sup>21</sup>

### 3.2 Penalty for under-stating tax payable

Taxpayers who under-state their tax payable may be subject to a monetary penalty. Briefly, the penalty rates stipulated in the tax law range from 25% to 75% of the amount of tax under-stated, depending on the nature of the act giving rise to the under-statement.

Taxpayers may be subject to a penalty for under-stating tax payable if such under-statement arises, among others, from a false or misleading statement, failure to file a document with the tax administration, negligence or reckless disregard in the application of the tax rules, or an unreasonable application of the tax law. Because of grey areas in the law, taxpayers who carry out aggressive tax planning schemes are likely to be subject to a monetary penalty because they have applied the tax law in an unreasonable way.

More specifically, a taxpayer who implements a tax avoidance scheme covered by the GAAR is liable for a monetary penalty corresponding to an amount equal to 25% or 50% of the value of the tax benefit that is denied, depending on the level of the scheme's compliance with the tax law.<sup>22</sup>

A taxpayer must pay a penalty of 25% of the amount of the tax benefit denied by the application of the GAAR if he can demonstrate that at the time the scheme was implemented, it was reasonable to believe that the GAAR did not apply to the scheme. Otherwise, the taxpayer is liable for a penalty equal to 50% of the withdrawn tax benefit.<sup>23</sup> The tax administration has discretion to cancel all or part of the penalty.<sup>24</sup>

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<sup>21</sup> The purpose of one of these rules, namely section 177E *ITAA 1936*, is explained in subsection 4.2.

<sup>22</sup> See sections 284-145 to 284-160 in the *Schedule I* of the *Taxation Administration Act 1953* (Cth.) [*TAA 1953*] relating to the application of the tax avoidance penalty, and sections 284-70 to 284-90 of that act for the other penalties for under-statement of tax payable. For an explanation of the structure of tax penalties in Australia, see Austl., Commonwealth Treasury, *Report on Aspects of Income Tax Self-Assessment*, (Canberra: Commonwealth of Australia, August 2004) [*Treasury, ROSA*], pages 39-47.

<sup>23</sup> The tax administration is seeking to make its policy on the application of penalties more transparent, among others by publishing an administrative policy. It will be publishing other similar information documents, including one dealing specifically with the application of penalties arising from the application of the general anti-avoidance rule. See Austl., Australian Taxation Office, *ROSA in Brief-Penalties: A quick reference tool explaining the*

The taxpayer's opinion will be considered reasonable if a court can conclude that despite the application of the GAAR to the tax planning arrangement, that opinion is about as likely to be correct as incorrect, in light of an objective analysis of the circumstances of the arrangement and recognized sources of interpretation.<sup>25</sup>

These recognized sources of interpretation include the tax law, case-law (Australian or foreign) and decisions or interpretations issued by the tax administration. Any document that can help to clarify the scope of the law and avoid an unreasonable or clearly absurd result must also be consulted. Such documents include international agreements, explanatory notes of bills, parliamentary debates and reports of government commissions.<sup>26</sup>

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*changes to the Review of Self Assessment (ROSA) recommendations relating to penalties*, (September 2005) [ATO, *ROSA-Penalties*].

<sup>24</sup> See sections 298-5, 298-20 and 298-40 *TAA 1953* and Austl., Australian Taxation Office, PS LA 2005/24, *Application of General Anti-Avoidance Rules*, (13 December 2005) [ATO, *GAAR Practice Statement*], paragraph 144. The tax administration has not published guidelines on the exercise of its discretionary power to cancel all or part of a penalty resulting from the application of the GAAR: see Austl., Australian Taxation Office, *ROSA In Brief – Part IVA*, JS 4861-04.2006 (Canberra: Australian Taxation Office, April 2006), page 12. As we shall see in subsection 4.6, the tax administration and the courts could consider the taxpayer's purposes in a scheme as well as his level of tax expertise in order to cancel all or part of a penalty for under-stating tax payable.

<sup>25</sup> Section 284-15 in *Schedule 1*, under Part 4-25 *TAA 1953*.

<sup>26</sup> Section 15AB *Acts Interpretation Act 1901* (Cth.) [*Interpretation Act*].

## 4

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### Observations

The GAAR seeks to reconcile the taxpayers' privilege to minimize their tax with the integrity of the tax system faced with tax-avoidance arrangements. The GAAR specifies that taxpayers can claim tax benefits arising from making elections expressly allowed by the tax law. However, the GAAR does not allow taxpayers to benefit from these elections if they organize their affairs to take undue advantage of them. The main issues relating to aggressive tax planning emerge where taxpayers organize their affairs, among other things, to take advantage of these elections to minimize their tax payable.<sup>27</sup>

The courts have focused the discussion on the distinction made in the law between legitimate arrangements and avoidance transactions. In their view, the discussion must be based on the law rather than strictly on principles of interpretation established in the past, including the principle recognizing the taxpayers' privilege to organize their affairs to minimize their tax.<sup>28</sup> In our view, the GAAR offers the following advantages:

- It maintains flexibility in drawing out this distinction since it applies depending on the importance of the tax purposes in the taxpayer's arrangement.

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<sup>27</sup> The tax administration is of the view that aggressive tax planning schemes are generally developed as part of financing packages that seek to boost the value of tax deductions or take advantage of tax benefits expressly allowed by the tax law regarding certain forms of investment: see ANAO, *ATO Management of Aggressive Tax Planning*, *supra* note 3, pages 25-27 and in *Appendix 2: The ATO's Indicators of Aggressive Tax Planning*. For a discussion on the scope of the exception stipulated by the GAAR in relation to elections expressly allowed the taxpayer by the tax law, see Nicole Wilson-Rogers, "Coming Out of the Dark? The Uncertainties that Remain in Respect of Part IVA: How does Recent Tax Office Guidance Help?" (2006) 4:1 *eJournal of Tax Research* 25 [Wilson-Rogers, "Uncertainties in Respect of Part IVA"], pages 36-37. The issues relating to elections by taxpayers in regard to aggressive tax planning are dealt with in subsection 4.6 that covers the penalty for understatement of tax payable.

<sup>28</sup> See *FC of T v. Hart & Anor* (2004), 2004 A.T.C. 4599, [2004] HCA 26 [*Hart*], paragraph 51. In Maurice Cashmere, "Part IVA After Hart" (2004) 33 *Austl. Tax Rev.* 131 [Cashmere, "Hart"]: "This was underscored by observations that Part IVA was to be construed and applied according to its terms and not by reference to "muffled echoes of old arguments". This is a reference to cases such as *Inland Revenue Commissioner v. Duke of Westminster* (1936) AC 1 and *Newton's Case*."

- It sets out that distinction predictably and consistently by laying down objective criteria for measuring the importance of the various purposes of an arrangement.
- It helps to identify a tax benefit in an arrangement through a comparison of the arrangement with alternative arrangements.
- The taxpayer must show that he entered into his arrangement to achieve a commercial purpose.
- The penalty significantly increases the risk for aggressive taxpayers.

In recent years, the tax administration has generally prevailed before the courts in applying the GAAR. In principle, the courts' decisions can contribute to setting a sharper distinction between legitimate arrangements and avoidance transactions. However, case-law has not succeeded in clearly establishing this distinction. Uncertainties and concerns persist concerning the Australian Taxation Office's application of the GAAR and its use of case-law. These concerns bear on the following aspects:

- Identification of tax benefits and the purposes pursued in an arrangement on the basis of pre-established objective criteria.
- Measurement of the relative weight of the tax purposes compared with any other purposes in an arrangement.
- The degree to which an arrangement complies with the objects pursued by the tax law read as a whole.
- The reasonableness of the taxpayer's interpretation for the purposes of the application of a penalty for under-statement of tax payable.
- The responsibility of tax advisers regarding aggressive tax planning.
- The strategy of the tax administration faced with courts' decisions that could counter its interpretation of the law.
- The tax administration's capacity to carry out its audit activities within the assessment period.

The following subsections deal with the advantages of the GAAR and the concerns voiced by stakeholders regarding it.

#### **4.1 A GAAR formulated according to objective rather than subjective criteria results in an application of the rule that is more predictable and consistent**

The GAAR applies to the extent that a reasonable person can conclude in light of the eight objective criteria defined therein that the dominant purpose of an arrangement is to obtain a tax benefit, whether such purpose is attributable to the taxpayer or to any other party to the scheme.

In our view, an application of a rule according to objective criteria defined in the tax law helps improve its predictability and consistency. Criteria expressed in general terms can provide the courts with some flexibility in the application of the tax rules based on the facts and circumstances of each arrangement. Nonetheless, various stakeholders can express diametrically opposed opinions on the application of these criteria, in particular to assess the financial impacts for taxpayers.

For the tax administration, the possibility of objectively identifying a dominant purpose improves its chances of applying the GAAR compared to a rule that applies based on a subjective assessment of the taxpayer's intentions. Should the courts uphold a subjective approach, they should possibly grant equal if not preponderant importance to the taxpayer's intentions compared to the facts and circumstances submitted by the tax administration as evidence.<sup>29</sup> Taxpayers generally argue that their primary purpose is not of a tax nature. In that case, there is a high risk that the courts will apply an anti-avoidance rule based on the taxpayer's credibility and will be unable to apply it consistently.

The tax administration also has a better chance of applying the GAAR by identifying the dominant purpose through the application of the eight criteria in regard both to the taxpayer and any participant in the scheme.<sup>30</sup> Indeed, it may be in the monetary interest of any of the parties

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<sup>29</sup> The courts and the tax administration can nonetheless assess the taxpayer's intentions subjectively for the purposes of the penalty for under-statement of tax payable: see subsection 4.6.

<sup>30</sup> See House of Representatives, *1981 Explanatory Memorandum*, *supra* note 10 under *Clause 7*: "Further, the relevant purpose is, having regard to the scheme as a whole, to be tested in relation to the involvement of a person in either a part of the scheme or the whole of it. It has been a feature of tax avoidance schemes of the kind that Part IVA is directed against that a considerable number of parties and of connected transactions are

involved in a scheme, among others the tax advisers or the promoters, that the taxpayer obtain a tax benefit.<sup>31</sup> Nonetheless, there is the risk with this possibility that the taxpayer may be deprived of the tax benefits, or even assessed a penalty for under-statement of tax payable even though he is not in a position to be aware of the existence of such a purpose among other participants.<sup>32</sup>

## 4.2 Comparing an arrangement with alternative arrangements helps identify a tax benefit and a dominant purpose, but stakeholders may differ on their characteristics

The courts have concluded that under the terms of the GAAR, the tax benefit and the dominant purpose in an arrangement must be identified in light of alternative hypothesis (counterfactual).<sup>33</sup> However, the GAAR does not expressly lay down parameters for identifying an alternative hypothesis. In our view, applying the GAAR according to the taxpayer's purposes in a scheme increases the likelihood that the court will select a counterfactual that fits into the taxpayer's commercial context without considering the objects of the law read as a whole.<sup>34</sup>

A taxpayer could argue that only his scheme enabled him to achieve his non-tax purposes in a reasonable way, the tax benefits being merely incidental to the achievement of the said purposes.<sup>35</sup>

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involved, and provisions against such schemes would fail in their purpose if limited to purposes of persons who were involved in the schemes in their entirety.”

<sup>31</sup> See *FC of T v. Consolidated Press Holdings Ltd & Anor, CPH Property Pty Ltd v. FC of T* (2001), 2001 A.T.C. 4343, [2001] HCA 32 [*Consolidated Press*], paragraphs 93-95; G.T. Pagone, “Part IVA: The General Anti-Avoidance Provisions in Australian Taxation Law” [2003] MULR 30 [Pagone, “Hart”]; ATO, “GAAR Brief”, *supra* note 19 paragraphs 84-85.

<sup>32</sup> In *Cashmere*, “Hart”, *supra* note 28 on page 133: “The legislation refers to the conclusion regarding purpose, being that of the purpose of the person, or one of the persons, who entered into or carried out the scheme. It does not refer to the purpose of the scheme. It follows that the relevant purpose may be contributed by someone who is not the taxpayer. That does not mean that the purpose of the taxpayer is irrelevant, since the taxpayer may be a person who entered into or carried out the scheme. However, it does mean that anyone connected with the scheme can taint a scheme with an unacceptable purpose, even if the taxpayer is totally innocent, which was the position in *Vincent v. FCT* (2002) 50 ATR 20.” The scope of *Vincent* will be described in subsection 4.6 for the purposes of the application of the penalty for under-statement of tax payable.

<sup>33</sup> See ATO, *GAAR Practice Statement*, *supra* note 24, paragraph 92, quoting the decision reached by the High Court of Australia in *Hart*, *supra* note 28; Pagone, “Hart”, *supra* note 31.

<sup>34</sup> Dominic Carbone, John Tretola, “FCT v Hart: An Analysis of the Impact of the High Court Decision on the Application of Pt IVA” (2005) 34 *Austl. Tax Rev* 196 [Carbone, “Hart”], pages 207-208.

<sup>35</sup> *Ibid.* See also *Cashmere*, “Hart”, *supra* note 28, pages 147-148.

For its part, the Australian Taxation Office will seek to establish that the characteristics of the taxpayer's scheme diverge from those of current arrangements contemplated by the tax law by demonstrating:

- the artificial nature of an arrangement;
- the lack of genuine commercial purposes;
- a disproportion between the tax benefits and the total return on the investment in the arrangement; and
- the total or partial lack of economic risk for the taxpayer.<sup>36</sup>

Uncertainty over the characteristics of tax avoidance arrangements leads to further uncertainty in the tax administration's exercise of its power to apply the GAAR to an arrangement. The discretionary aspect of this power carries a risk that the courts will hesitate to overturn a decision of the tax administration in relation to the counterfactual it has approved.<sup>37</sup>

Without being bound by the tax administration's conclusions,<sup>38</sup> the courts could, like the tax administration, retain a counterfactual that would have enabled taxpayers to achieve the non-tax purpose of the arrangement more simply and more directly, without obtaining the tax benefit.<sup>39</sup> The courts could retain a counterfactual if it is reasonable to believe that it could actually have taken place notwithstanding the arrangement entered into by the taxpayer. The courts' use of

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<sup>36</sup> ANAO, *ATO Management of Aggressive Tax Planning*, *supra* note 3 pages 25-27 and in *Appendix 2*, "The ATO's Indicators of Aggressive Tax Planning".

<sup>37</sup> Differences of opinion have been expressed over the tax administration's power to apply the GAAR. For some, the tax administration exercises a discretionary power to apply the GAAR. According to others, the tax administration must apply the GAAR when faced with a dominant purpose of a tax nature. Others attribute a discretionary power to the tax administration to apply the GAAR within the parameters set therein: see Wilson-Rogers, "Uncertainties in Respect of Part IVA", *supra* note 27 pages 44-53. In light of the decision reached in *Cumins*, *infra* note 77, in particular at paragraph 41, the tax administration can apply or not apply the GAAR where it objectively concludes that this rule applies in light of the eight determined criteria, and can exercise a discretionary power to withdraw all or part of the tax benefits claimed by taxpayers. See Austl., Australian Taxation Office, *Peter Cumins v. Commissioner of Taxation*, Decision Impact Statement, Reference No. WAD53 of 2006 (28 May 2007), online at the ATO Website <<http://law.ato.gov.au/atolaw/view.htm?DocID=LIT/ICD/WAD53of2006/00001>>.

<sup>38</sup> G.T. Pagone, "Tax Planning or Tax Avoidance" (2000) 29 *Austl. Tax Rev* 100 [Pagone, "Tax Planning"], pages 106-108.

<sup>39</sup> See *Hart*, *supra* note 28, paragraphs 66-71 and 94.

criteria such as current commercial standards<sup>40</sup> would help support a counterfactual that is compliant with the objects of the tax law. However, uncertainty remains as to the criteria that they can apply to retain one of the counterfactuals in a given situation in the absence of specific criteria in the tax law.<sup>41</sup>

A government committee had proposed changing the GAAR to specify that the counterfactual must be defined according to the commercial substance of an aggressive arrangement, in accordance with the non-tax purpose achieved by the arrangement. Essentially, this change sought to prevent taxpayers from alleging that the GAAR does not apply where the reasonable alternative is that the taxpayer would have implemented no other arrangement. Under such a scenario, the taxpayer would therefore have derived no tax benefit, so that the GAAR could not apply. We reproduce below an extract from the report tabled by the government committee that proposed the change:

Operation of the 'reasonable hypothesis' test: That operation of the existing reasonable hypothesis test (in section 177C) be improved by ensuring the counterfactual to a tax avoidance scheme reflects the commercial substance of the arrangement. Currently, in order to demonstrate the existence of a tax avoidance scheme, the Commissioner of Taxation is required to construct a reasonable alternative transaction or counterfactual which does not give rise to the tax benefit. In some tax avoidance cases promoters of the scheme have argued that the reasonable alternative to the scheme may be that the taxpayer would not have done anything. The recommendation will confirm that this is not the case. For example, if the sale of property had an attached tax benefit, the alternative transaction would be constructed on the basis that the sale of property, without the tax benefit, would have taken place<sup>42</sup>.

[our extracts]

To illustrate, the rule related to the GAAR regarding dividend stripping is designed to overcome the difficulties in identifying a counterfactual to such an arrangement. The following extract from

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<sup>40</sup> ATO, *GAAR Practice Statement*, *supra* note 33, paragraph 69. Paragraph 80 of the decision reached by Justice Hill having concluded that the GAAR applies in *FC of T v. Sleight* (2004), 2004 A.T.C. 4477, [2004] FCAFC 94 [*Sleight*], refers to the usual financial structures that an investor seeking a commercial purpose could have preferred objectively to the detriment of the tax planning arrangement in dispute that maximized the tax deductions claimed by a taxpayer.

<sup>41</sup> Michael Bersten, Daniel McInerney, "Why Does Part IVA Matter?" *PricewaterhouseCoopers' TaxTalk* (October 2005) [Bersten, "Part IVA"], online: PwC Website <<http://www.pwc.com/extweb/manissue.nsf/docid/105B82A208B3C3BBCA25709D0018B947>>.

<sup>42</sup> Review of Business Taxation, *A Tax System Redesigned*, *supra* note 9, under recommendation 6.4.

the explanatory notes illustrates the difficulties of applying the GAAR according to an alternative hypothesis:

Section 177 E Stripping of Company Profits. In brief, this section is a self contained code within the framework of Part IVA designed to apply to schemes of a dividend stripping kind which would otherwise effectively place company profits in the hands of shareholders in a tax-free form.

Schemes of the kind to which section 177 E is directed could on occasions come within the general ambit of section 177 D, but section 177 E is needed for situations where, for example, although profits are in fact stripped from a company, it may not be a reasonable hypothesis that, but for the scheme, the profits would have been paid as dividends. But for the scheme they would formally have remained in the company, at least for the time being. If that were so in a particular case, the situation would not fall within section 177D because there would not, under section 177C, be a « tax benefit » - i.e., an amount not included in assessable income that but for the scheme would have been, or might reasonably be expected to have been, included<sup>43</sup>.

[our extracts]

Where a taxpayer carries out a scheme that enables him to deduct an amount in calculating his income or tax payable, the tax administration will want to prove that the taxpayer would not have developed it were it not for the tax benefit of the scheme.

The decision of the courts in *Cumins*<sup>44</sup> involves such a case of an alternative hypothesis intended to cancel the deductibility of a capital loss. The taxpayer had realized a taxable capital gain following the sale of a fraction of the shares he held in a company. The day after the sale, he transferred another fraction of shares to a related transferee for an amount corresponding to their market value. The taxpayer thus suffered a capital loss because this amount was less than the adjusted cost base of the shares. He applied this loss against the taxable capital gain. The legal ownership of the shares lay with the corporation that had made a loan to the taxpayer enabling him to acquire them. The taxpayer transferred the shares without the consent of the lender and without repaying the loan, but declared to the transferee that they were not encumbered by any charge. The transferee did not pay the sales price to the taxpayer.

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<sup>43</sup> House of Representative, *1981 Explanatory Memorandum*, *supra* note 10, under *Clause 7*. Moreover, in Review of Business Taxation, *A Tax System Redesigned*, *supra* note 9, under recommendation 6.6, the government committee charged with reviewing Australia's tax system questioned the need to change or even maintain a number of specific rules, including section 177E *ITAA 1936*, provided the GAAR and the tax rules were changed in light of its proposals.

<sup>44</sup> See *Cumins v. FC of T* (2007), 2007 A.T.C. 4303 (F.C.F.C.A.), [2007] FCAFC 21, affirming the decision handed down in 2006 A.T.C. 4084, [2006] FCA 43 [*Cumins*]. Both the Federal Court and the Full Federal Court upheld the decision reached by the Administrative Appeals Tribunal at the trial level.

The courts concluded that it was reasonable to believe that the taxpayer could not have claimed a deduction for a capital loss but for the tax planning scheme. In light of the facts, the lender would not have allowed the taxpayer to carry it out. The taxpayer's allegation that the essential purpose of the operation was to protect his shares from creditors was groundless. We reproduce certain passages of the decision reached by the Full Federal Court in this case that illustrate the issues relating to the identification of the purposes of an arrangement:

[...] the Court must give consideration as to whether the deduction might reasonably be expected to have been allowable if the scheme had not been carried out. [...] The Commissioner must compare the consequences of the scheme and those of alternative postulates. [...]

It is submitted by the appellant that the Tribunal should not have determined that the Bank would have insisted on repayment of the loan before giving its consent to the alternative transactions. [...] In our opinion, because the statutory onus lay on the appellant, he had to satisfy the Tribunal that the Bank would have consented to the form and substance of the alternative arrangements. This consideration was required in the context of each alternative. [...] In our view, the Tribunal was therefore entitled to reach the conclusion that the suggested alternative arrangements could not have been expected to take place as contemplated as it was not satisfied on the evidence that the Bank would have given the required consent.

[...] The main advantage as submitted by the appellant was that that the scheme would protect the beneficiaries of the trusts from creditors. This is a vague and generalised assertion. The main creditor - by a large margin - was the Bank, and it held security over the shares. At the time of the transaction, the debt to the Bank was over \$4 million. The amount of debt to third party creditors was substantially less. It was therefore open to the Tribunal on the evidence to reach the conclusion that protection from creditors was not a significant factor in carrying out the scheme, and that the scheme's dominant purpose was to obtain a tax benefit in the form of a deduction. [...] [...] The way the scheme was implemented was in breach of the appellant's obligation under the Loan Agreement to inform and obtain the consent of the Bank in relation to any transaction concerning the shares. [...]

[...] the Tribunal noted that the share sale was not carried out in an ordinary manner because (i) the shares were encumbered to the Bank's subsidiary; and (ii) Mr Cumins, as trustee, was contractually obliged to obtain the Bank's consent and this was not obtained. The Tribunal noted [...] that whereas the share sale agreement referred to a sale of shares "free from encumbrances," the transaction as effected was a sale of the beneficial interest in the shares, meaning that they were in fact encumbered.

[...] Counsel for the appellant also advanced the proposition that many other people regularly entered into transactions similar to the scheme implemented by Mr Cumins. It was contended that it is a common practice to enter into such transactions. It was open to the Tribunal, however, to conclude that this proposition was not proven by the appellant and that it was a matter of pure assertion. In any event, this is not one of the matters required to be taken into account by the Commissioner or the Tribunal under s 177D. Similarly, the appellant's contention that holders of share portfolios regularly enter into transactions near the end of the

financial year is a vague generalisation, and as such is unhelpful. There was no evidence put to the Tribunal or the Court in relation to this proposition or its relevance.<sup>45</sup>

[our extracts]

### 4.3 Stakeholders' opinion on the relative weight of the purposes of a scheme may differ

The courts can reach diametrically opposed conclusions as to the presence of a dominant purpose of a tax nature where parameters defining “dominant purpose” are lacking.

According to the explanatory notes to the law, a dominant purpose is one that proves to be more important than any other purpose pursued in a tax planning scheme.<sup>46</sup> The courts have interpreted this term to mean “the ruling, prevailing or most influential purpose.”<sup>47</sup> These terms convey the idea that the dominant purpose for a person is the one that predominates in his decision to implement the scheme.

The analysis must be performed objectively from the perspective of a reasonable person. It must take into consideration all eight criteria stipulated by the GAAR. These criteria are similar to general parameters for qualifying the nature of the dominant purpose of an arrangement. Consequently, many reasonable points of view can confront each other in the interpretation and application of any of the eight objective criteria or all of them to qualify the nature of the dominant purpose.<sup>48</sup> In particular, changes in the financial position of one of the participants in an arrangement can be assessed from a temporal, actuarial or economic perspective.<sup>49</sup>

The courts consider all the facts that give rise to the tax benefit to decide whether the dominant purpose of one of the participants in the tax planning scheme was of a tax nature. However, the nature of the dominant purpose test carries the risk that the courts may reach diverging

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<sup>45</sup> *Ibid.*, paragraphs 42-44, 46 and 51. Also see paragraphs 45 to 55 of the decision reached by the Federal Court in this case.

<sup>46</sup> House of Representatives, *1981 Explanatory Memorandum*, *supra* note 10 under *Clause 7*: “That language refers to a person’s sole purpose but, by reason of sub-section 177(A)(5) the expression is in the case of a scheme with more than one purpose to include also a dominant purpose, i.e. a purpose that outweighs all other purposes put together.”

<sup>47</sup> *FC of T v. Spotless Services Ltd & Anor* (1996), 96 A.T.C. 5201 (H.C.A.) [*Spotless*], page 5206.

<sup>48</sup> Wilson-Rogers, “Uncertainties in Respect of Part IVA”, *supra* note 27, pages 41-42.

<sup>49</sup> Pagone, “Hart”, *supra* note 31; ATO, *GAAR Practice Statement*, *supra* note 33, paragraphs 84-85.

conclusions on the application of the GAAR depending on whether they isolate the portion of the scheme that creates the tax benefit or retain the scheme as a whole. A reasonable person could examine the aggressive arrangement as a whole rather than just part of it to highlight a dominant purpose that is not of a tax nature. For its part, the tax administration will isolate the steps of a scheme whose only objective is to achieve tax benefits from those seeking a legitimate purpose.

The diverging opinions expressed by the courts in *Macquarie*<sup>50</sup> illustrate the difficulties in applying the GAAR to a scheme that has multiple purposes. In this case, the courts had to decide whether a corporation could deduct, in calculating its income, interest paid in the course of an issue of financial instruments by another corporation of the same group.<sup>51</sup> The judges were split on the application of the GAAR:

- Some judges concluded that the taxpayer's tax planning arrangement served no purpose in achieving the intended commercial purpose, in light of counterfactuals that could achieve this commercial purpose without the tax benefits claimed.
- On the other hand, other judges assigned preponderant weight to the intended commercial purpose.

The following passages taken from the decision by Justice Hely of the Appeal Court in *Macquarie* illustrate the differences of opinion among the judges:

The primary judge concluded as follows (at ATC 4892-4893 [120]; ALR [120]): 'It follows, therefore, that if, contrary to my view, the 'interest' payable on the notes was an allowable deduction to MFL in the year of income, then that deduction constituted a tax benefit which MFL obtained from a scheme to which the provisions of Part IVA applied and in respect of which the Commissioner was entitled to make a determination under s 177F disallowing to MFL the deduction. I might add that I reach this conclusion with some reluctance. I doubt if the legislature would have regarded the present 'scheme' as involving the application of Part IVA when the

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<sup>50</sup> *Macquarie Finance Limited v. FC of T* (2005), 2005 A.T.C. 4829 (F.C.A.F.C.), [2005] FCAFC 205, permission to appeal denied by the High Court on 10 February 2006 [*Macquarie*].

<sup>51</sup> In this case, the courts concluded that the amounts paid were not deductible in calculating the taxpayer's income since they were connected to the issue of financial instruments of the parent company and the amounts paid were capital in nature. Nonetheless, the trial court and the appeal court expressed their view on the application of the GAAR to this arrangement. For the purposes of our study, the differing opinions illustrate the difficulties in the application of the dominant purpose criterion of the GAAR.

Part was enacted in 1981. However, it seems to me that the approach of the High Court in *Hart* requires me to reach the conclusion I have.'

With respect to his Honour, I am of a different opinion. In my view, addressing the question posed by his Honour in ATC 4891 [110]; ALR [110] of his reasons, a reasonable person would conclude, having regard to the eight factors listed in s 177D(b), that the dominant purpose of those engaged in the issue of the MIS on the particular terms on which that issue was made was to secure to the MBL Group all of the commercial advantages associated with debt financing (including, but not limited to tax deductibility of interest) whilst at the same time qualifying as Tier 1 capital.

There is force in MFL's submission that ultimately the Commissioner's case is that MFL borrowed money, thereby incurring deductible interest, and that if another party (MBL) had done something different (issued shares) MFL would not have incurred the deductible outgoing. The fallacy in this case is that - contrary to the direction in s 177D(b) - it confines attention to the tax consequences of the actual and "counterfactual" transactions and leaves out of account the commercial advantages and consequences obtained and flowing from what was done.<sup>52</sup>

[our extracts]

Such differences of opinion can become even more marked if there are many parties in an arrangement. While the taxpayer's dominant purpose is commercial in nature, any of the other parties involved, including the tax advisers and the promoters may have as its dominant purpose an interest that the taxpayer obtain a tax benefit.<sup>53</sup> The courts could hold differing opinions on the presence of such a purpose among the other parties. The following passage taken from *Vincent* illustrates this possibility:

The second matter argued concerned the question whether his Honour erred in considering whether it would be concluded that the promoter had carried out the scheme for the dominant purpose of obtaining for Ms Vincent the tax benefit. It is clear both from the language of s 177D and the decision of the High Court in *FC of T v Consolidated Press Holdings Ltd & Anor* 2001 ATC 4343; (2001) 179 ALR 625 that a determination can be made if there is any person, be it the taxpayer, a promoter of a tax scheme or a legal or accounting adviser of whom it would be concluded that he, she or it entered into or carried out the scheme or any part of it for the dominant purpose of securing for the taxpayer a tax benefit. In considering the question of purpose by reference to the promoter his Honour did not err. We may doubt, however, whether we would reach the same conclusion as to the purpose of the promoter in this case. Indeed, we would be inclined to the view that the dominant purpose of the promoter here was to obtain the profits that clearly would have flowed to the various companies associated with him. However, it is not necessary to reach a concluded view on this question.<sup>54</sup>

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<sup>52</sup> See the decision of Justice Hely in *Macquarie*, *supra* note 50, paragraph 241.

<sup>53</sup> *Consolidated Press*, *supra* note 31, paragraphs 93-95; Pagone, "Hart", *supra* note 31; ATO, *GAAR Practice Statement*, *supra* note 33, paragraphs 84-85.

<sup>54</sup> See *Vincent v. FC of T* (2002), 2002 A.T.C. 4742 (F.C.A.F.C.), [2002] FCAFC 291 [*Vincent*], paragraph 100.

#### 4.4 The dominant purpose criterion does not ensure consistent application of the tax law in accordance with its objects

Since the GAAR should apply on the basis of the purposes of an arrangement, it may be feared that the outcome depends chiefly only on the taxpayer's commercial context without taking into account the objects of the tax law read as a whole. Although the criterion of the abuse of the objects of the law is absent from the GAAR, some judges have taken these objects into consideration in their decisions. Such an interpretation complies with the Interpretation Act in Australia, under which an interpretation that allows the underlying objects of a law to be achieved – whether such objects are mentioned explicitly or not – should prevail over an interpretation that would be contrary to them.<sup>55</sup>

By taking the objects of the tax law into consideration, it is easier for the courts to identify whether a tax benefit is present in an arrangement by comparing it with another arrangement that complies with these objects.<sup>56</sup> *Hart* illustrates this possibility. In the case, the High Court concluded that the taxpayer could not claim the tax benefits arising from an arrangement allowing him to deduct, in calculating his income, interest paid on a mortgage loan contracted to acquire his principal residence. The court reached this conclusion on the grounds that the law does not allow individuals to deduct such amounts in calculating their income:

It is part of the scheme of the Income Tax Assessment Act 1936 (Cth) (the ITAA 1936) that, as a general rule, interest on money borrowed to finance the purchase of a taxpayer's private dwelling-house is not an allowable deduction, and interest on

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<sup>55</sup> Section 15AA *Interpretation Act*: "Regard to Be Had to Purpose or Object of Act. 15AA In the interpretation of a provision of an Act, a construction that would promote the purpose or object underlying the Act (whether that purpose or object is expressly stated in the Act or not) shall be preferred to a construction that would not promote that purpose or object."

<sup>56</sup> In the opinion of Justice Hill expressed at the trial court in *CPH Property Pty Ltd & Ors v. FC of T* (1998), 98 A.T.C. 4983 (F.C.A.) [*CPH*], page 4995, laws should generally be interpreted and applied according to their objects even in the absence of section 15AA *Interpretation Act*: "However, it must likewise be said that even without provisions such as ss 15AA and 15AB of the *Acts Interpretation Act* 1901, it is fundamental that the statutory construction proceed to give effect to the manifest or expressed intention of Parliament. As McHugh J pointed out in *CAC of NSW v Yuill & Ors* (1991) 9 ACLC 843 at 861; (1991) 65 ALJR 500 at 511 the literal or grammatical meaning may not be the meaning which Parliament intended to enact. Hence there will be a need to depart from the literal meaning where there is good reason so to do: *Cooper Brookes* at ATC 4306; CLR 321. As Mason and Wilson JJ there said: "... It [ie the propriety of departing from a literal interpretation] extends to any situation in which for good reason the operation of the statute on a literal reading does not conform to the legislative intent as ascertained from the provisions of the statute, including the policy which may be discerned from those provisions." For a discussion on the interpretation of the tax laws and the role of section 15AA *Acts Interpretation Act*, see John Tretola, "The Interpretation of Taxation Legislation by the Courts – A Reflection on the Views of Justice Graham Hill" (2006) 16:1 *Revenue Law Journal* Article 5 [Tretola].

money borrowed to finance an investment property, such as a dwelling-house to be let for rental purposes, is an allowable deduction<sup>57</sup>.

[our extracts]

An aggressive arrangement could be found valid where there is a dominant commercial purpose among all the participants, even if doubt remains as to whether it complies with the objects of the tax law. The courts could conclude that the GAAR applies to an arrangement pursuant to the dominant purpose criterion even though in their view, the tax administration did not necessarily contemplate that such arrangement be likened to tax avoidance at the time of the changes made to the GAAR in 1981.<sup>58</sup>

Taxpayers could then argue that standard commercial arrangements comply with the objects of the tax law. A simple statement that an arrangement is consistent with the objects of the tax law is, however, insufficient. Taxpayers must prove that the arrangement carried out is a standard arrangement on the basis of the eight objective criteria, including those relating to the impact on the economic situation of the parties. Below are extracts taken from the decision of the courts in *Cumins* to illustrate this point:

In this ground the application raises the issue of whether the Tribunal erred in its interpretation of Pt IVA by failing to find that it was not intended to apply and does not apply to a genuine transaction which crystallises losses actually incurred on the value of listed shares, being the circumstances of the current case.

The applicant's argument on this ground commences by reference to the fact that Pt IVA was not intended to apply and has not been applied in the context of capital gains tax ("CGT") where the essence of the relevant transaction is a genuine sale of an asset like a listed share, at a proper value, where the value has fallen since acquisition. It is said that in the case of the listed shares, it is not the taxpayer who creates, generates or even stimulates the loss at the time of sale. The loss is "part and parcel" of the share-trading price, crystallised for, and recognised by, the CGT system when a sale occurs.

[...]

[...] The fact that the scheme may have been "genuine or directed at crystallizing a loss" does not preclude the application of Pt IVA. In the present case, the Tribunal considered the matters it was required to have regard to by s 177D(b) and found that it would be concluded that the applicant entered into the scheme for the purpose of obtaining the tax benefit. On its findings the Tribunal was correct to affirm the respondent's determination under s 177F.

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<sup>57</sup> See *Hart*, *supra* note 28, paragraph 3. For an illustration as to the identification of a dominant purpose of a tax nature in an arrangement in regard to the objects of a tax rule, see also *Consolidated Press*, *supra* note 31.

<sup>58</sup> The opinion of the trial court judge in *Macquarie*, *supra* note 50 illustrates the possibility that the courts reach such a conclusion. See the extract of such opinion in the decision of Justice Hely of the Appeal Court in this case, *supra* note 52.

I also agree that the scheme in the present case would hardly be described as a “genuine transaction which crystallises losses actually incurred on the value of listed shares”. No economic losses was suffered as a result of the scheme. [...] The scheme was such that it was open for it to be found that it was in the character of a contrivance to create a capital loss for the purpose of the income tax legislation in order to reduce the amount of the net capital gain that the Trust would otherwise be required to return by reason of other sales that had given rise to capital gains.<sup>59</sup>

#### 4.5 Taxpayers must demonstrate that, based on the weight of probabilities, their position complies with the law

Taxpayers bear a significant portion of the risk regarding tax avoidance because they must convince the courts that the notice of assessment issued under the GAAR is excessive.<sup>60</sup> Otherwise, the courts could uphold the notice of assessment issued by the tax administration, even if the latter provides no piece of proof in support of it.<sup>61</sup>

Taxpayers thus assume the onus of proving, based on the preponderance of probabilities, that their tax payable is less than that determined by the tax administration.<sup>62</sup> Taxpayers must then convince the courts that a reasonable person would conclude objectively that the dominant purpose of each participant in the tax planning scheme was of a non-tax nature.<sup>63</sup> However, taxpayers may find it difficult to convince the courts of the validity of their arrangement where a multitude of alternative hypotheses are present,<sup>64</sup> especially if these counterfactuals are

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<sup>59</sup> See *Cumins*, *supra* note 44, paragraphs 33 to 36 of the decision reached by the Federal Court, affirmed on appeal by the Full Federal Court.

<sup>60</sup> See sections 14ZZK(b) and 14ZZO(b) TAA 1953. See also *Rio Tinto Ltd v. Federal Commissioner of Taxation*, [2004] FCA 335 [*Rio Tinto*], paragraph 31: “At all material times the income tax legislation has included a provision imposing on the taxpayer the burden of proving that the assessment is excessive. At the time of Bailey it was s 190(b) of ITAA 1936. The more expansive form of s 14ZZO(b) is not relevantly different [...] The section is concerned with the ultimate disposition of the appeal. Unless the court otherwise orders, the appellant is limited to the grounds stated in its objection, and has the burden of proving that the assessment is excessive or incorrect. [...]”.

<sup>61</sup> For a succinct summary of the allocation of the burden of proof between taxpayers and the tax administration, see Austl., Inspector-General of Taxation, *Review of Tax Office Management of Part IVC Litigation*, Report to the Minister for Revenue and Assistant Treasury (Canberra: Commonwealth of Australia, 28 April 2006) [IGT, *ATO Management of Litigation*], paragraphs 3.15 to 3.17.

<sup>62</sup> See the decisions reached by Justices Brennan, Toohey and Deane in *FC of T v. Dalco* (1990), 90 A.T.C. 4088 (H.C.A.) [*Dalco*].

<sup>63</sup> See the decision of Justice Carr in *Eastern Nitrogen Ltd. v. FC of T* (2001), 2001 A.T.C. 4164 (F.C.A.F.C.), [2001] FCA 366 [*Eastern Nitrogen*], paragraph 86: “In the terms of s 14ZZO(b)(i), the appellant had the burden of proving that the respondent’s assessments were *excessive*. In evidentiary terms, I think that means that if the appellant failed to establish objective facts, under the various categories set out in par (b) of s 177D, from which a reasonable person would not conclude that its dominant purpose in entering or carrying out the scheme was to obtain a tax benefit, it failed to discharge its statutory onus of proof.”

<sup>64</sup> Pagone, “Hart”, *supra* note 31; Bersten, “Part IVA” *supra* note 41.

consistent with applicable commercial standards and the objects of the law. The extracts of the *Cumins* decision quoted at the end of subsection 4.2 illustrate these difficulties.

## **4.6 Risk for taxpayers to be subject to a penalty for understating tax payable**

In addition to withdrawing the tax benefits claimed, the Australian tax administration can levy a penalty for understating tax payable (subsection 3.2 describes its main features).

In the tax administration's view and in light of the submissions it received, the penalties taken as a whole, including the one for understating tax payable, seem to be considered reasonable in general.<sup>65</sup> The tax administration is carrying out studies to measure the effectiveness of these penalties on taxpayers' behaviour.<sup>66</sup> We wonder whether the penalties imposed appear fair to stakeholders in Australia considering the grey areas around the application of the GAAR and case-law.

### ***4.6.1 Function of the reasonableness of the application of the tax law by the taxpayer***

As far as aggressive tax planning is concerned, taxpayers must exercise reasonable care to check that a tax planning arrangement complies with the tax law and with case-law. With the prospect of a penalty for understating tax payable, the taxpayer must apply the tax law in a way that is as likely to comply with the law as to breach it. Consequently, a higher penalty rate (50% rather than 25%) where the taxpayer is found to have applied the tax law unreasonably could help improve his level of care in implementing such arrangements, or even dissuade him from doing so.<sup>67</sup>

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<sup>65</sup> See Treasury, *ROSA supra* note 22, pages 43-44.

<sup>66</sup> Austl., Inspector-General of Taxation, *Review into the Tax Office's Administration of Penalties and Interest Arising from Active Compliance Activities*, Report to the Minister for Revenue and Assistant Treasurer (Canberra: Commonwealth of Australia, 18 May 2005) [IGT, *ATO Administration of Penalties*], pages 31-32.

<sup>67</sup> As we mentioned in subsection 3.2, a taxpayer must exercise reasonable care in applying the tax law and be sure to claim tax benefits according to a reasonable interpretation of the tax law and case-law. Accordingly, a taxpayer who exercises reasonable care may avoid the penalty stipulated for negligence. Without being negligent, he could nonetheless be liable for a penalty for understating tax payable if his interpretation of the tax law and the GAAR prove unreasonable. See Austl., Australian Taxation Office, PS LA 2006/2, *Administration of Shortfall Penalty for False and Misleading Statement* (6 March 2006) [ATO, *Penalty for Misleading Statement*], paragraphs 66 to 78.

However, stakeholders may hold diametrically opposed opinions on the reasonableness of a tax interpretation. Neither the tax law nor the interpretation documents published by the tax administration provide specific parameters for determining the degree to which an interpretation is reasonable for the purposes of the GAAR. According to a review of the tax system carried out by the Australian government, the tax administration would stand to gain from publishing guidelines concerning the application of the penalty, as well as the circumstances in which it could cancel it in whole or in part.<sup>68</sup>

In the view of the tax administration, a position could be considered reasonable if the taxpayer has a reasonable chance of winning his case before the courts, even if that probability is less than 50%.<sup>69</sup> The taxpayer could then avoid a penalty of 50% if there is uncertainty either in the scope of a tax rule or in its application to the facts and circumstances of the arrangement.<sup>70</sup> Without specific parameters, taxpayers could invoke a variety of grounds that could be considered reasonable by the courts to avoid the maximum penalty rate.

Even if, under the GAAR, a court withdraws the tax benefits claimed by the taxpayer, it must still objectively assess the reasonableness of the treatment claimed by the taxpayer to determine the applicable penalty rate. The courts determine this rate according to the following principles and criteria laid down in the *Walster* decision:

- The court must apply the penalty objectively.
- It must identify the grounds supporting the tax benefits claimed by the taxpayer.
- It must weigh the grounds supporting its decision with those supporting the taxpayer's position.
- It must determine whether the taxpayer's position, while incorrect according to the court's decision, is as likely to satisfy the tax law as to run counter to it, in light of recognized sources of interpretation of the tax law.

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<sup>68</sup> See IGT, *ATO Administration of Penalties*, *supra* note 66, paragraphs 3.48 to 3.52; ATO, "ROSA-Part IVA", *supra* note 24.

<sup>69</sup> See Austl., Australian Taxation Office, TR 94/5, *Income Tax: Tax Shortfall Penalties: Reasonably Arguable* (6 January 1994) [ATO, *Reasonably Arguable*], paragraph 9(a).

<sup>70</sup> Austl., Commonwealth, House of Representatives, Revised Explanatory Memorandum (REPS), *A New Tax System (Tax Administration) Bill (No. 2) 2000, A New Tax System (Tax Administration) Act (No. 2) 2000* [House of Representatives, *2000 Revised Explanatory Memorandum*], paragraphs 1.20 to 1.29.

- The level of compliance with the tax law required for the purposes of the penalty for under-stating tax payable is lower than that of the preponderance or equality of probabilities.
- Taxpayers must have shown reasonable care to substantiate the grounds for the tax benefits claimed on the basis of the facts and circumstances of the arrangement, as well as recognized sources of interpretation and their respective importance.
- The court must decide whether the penalty applies by recognizing that reasonable persons could express differing opinions as to the compliance of the position of the tax administration or the taxpayer in light of recognized sources of interpretation.<sup>71</sup>  
[our extracts and adaptation]

A structured interpretation of the tax law by the taxpayer regarding the application of various rules could be likened to reasonable grounds in the absence of case-law that can clarify a contentious aspect of a tax planning arrangement.<sup>72</sup> Taxpayers could try to avoid a 50% penalty by establishing that an arrangement complies with the letter of the tax law without regard to the objects of the law read as a whole. The fact that the GAAR lacks the criterion of abuse of the tax law read as a whole could, in our view, lead to such a result.

A decision reached by the courts illustrates this possibility.<sup>73</sup> In this case, the tax administration had withdrawn, under the GAAR, the tax benefits obtained by a taxpayer and had imposed a penalty of 50%. The taxpayer argued that the GAAR did not apply to his arrangement because the tax benefit, namely the non-taxation of the capital gain arising from the sale of stock, resulted from making an election explicitly stipulated by the tax law. The court concluded that the benefit arose from the application of other tax rules to transactions carried out by the

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<sup>71</sup> See *Walstern Pty Ltd v. FC of T* (2003), 2003 A.T.C. 5076 (F.C.A.), [2003] FCA 1428 [*Walstern*], paragraph 118; ATO, *GAAR Practice Statement*, *supra* note 33, paragraphs 142-144. For a summary of these parameters, see Michael Bersten, "Reasonably Arguable Position" *PricewaterhouseCoopers' TaxTalk* (July 2006) [Bersten, "Reasonably Arguable"], online: PwC Website <<http://www.pwc.com/extweb/manissue.nsf/docid/431E850541D5BB7ECA2571A7001FDCE1>>.

<sup>72</sup> See House of Representatives, *2000 Revised Explanatory Memorandum*, *supra* note 70. See also Austl., Commonwealth, House of Representatives, Explanatory Memorandum, *Taxation Laws Amendment (Self Assessment) Bill, 1992 Taxation Laws Amendment (Self Assessment) Act 1992*. For the purposes of the penalty, taxpayers must give consideration to case-law from countries other than Australia. In view of the specific features of the tax and legal systems of each country, there is uncertainty as to the level of care that the taxpayer and the tax adviser must exercise to identify and understand foreign case-law, and the importance they must give to it. Logically, the level of care should vary depending on the nature of the arrangement in dispute and the circumstances, as well as the compatibility of the foreign case-law with Australia's tax system.

<sup>73</sup> *Case 1/2006*, [2006] A.T.C. 101 (A.A.T.A.), [2005] AATA 1251 [*Case 1/2006*], in particular paragraphs 65-68.

taxpayer after the election previously mentioned was made.<sup>74</sup> The court concluded that the dominant purpose of the taxpayer in the series of transactions was to obtain a non-taxable capital gain, but that the penalty for under-stating tax payable should be reduced to 25%. In the court's view, the taxpayer's argument concerning making an election explicitly allowed by the law could be considered reasonable in the circumstances, although it was incorrect.

The courts could also cancel the 50% penalty imposed by the tax administration where the taxpayer shows that it is reasonable to believe that the dominant purpose of an arrangement is of a commercial nature in light of the facts and circumstances of the arrangement, and notwithstanding the withdrawal of the tax benefits under the GAAR. The courts must then compare the importance of a general commercial purpose pursued by the taxpayer in a tax planning arrangement and that of the tax purpose. We quote below extracts from the *Pridecraft* decision to illustrate the possibility that a taxpayer can avoid a 50% penalty by proving that he pursued a general commercial purpose:

The primary Judge in the present case made a judgment that the competing arguments on the application of Part IVA of the ITAA were sufficiently finely balanced to warrant *Pridecraft's* position being characterised as "reasonably arguable" for the purposes of ss 226 and 226L of the ITAA. There was no suggestion that his Honour misunderstood or misapplied the propositions stated by Hill J in *Walstern v FC of T*, which both parties accepted as correct. I do not think that his Honour's reasoning or conclusion reveals any errors justifying appellate intervention.

*Pridecraft's* contentions, made to the Commissioner, the primary Judge and this Court, rested on the proposition that the Part IVA Scheme had a clear commercial purpose. The fundamental reason this argument has not been accepted is that an element of the Part IVA Scheme [...] warranted the conclusion that *Spotlight* entered or carried out that part of the scheme for the purpose of enabling it to obtain a tax benefit. It must be remembered that the inquiry required by s 177D(b) of the ITAA is an objective one. Given the undisputed evidence that the [...] Scheme as a whole was prompted by a desire to restructure *Spotlight's* Profit Share Bonus Scheme and had a genuine commercial objective, I think it fair to say that there was room for a rational argument that, viewed objectively, *Spotlight's* dominant purpose in entering the Part IVA Scheme was not to obtain a tax benefit. Accordingly, the Commissioner's cross-appeal on this issue should be dismissed<sup>75</sup>.

[our extracts]

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<sup>74</sup> Applying these rules cancelled virtually all the taxable capital gain that the taxpayer would have realized from the sale of the stock in the absence of the tax planning arrangement.

<sup>75</sup> See *Pridecraft Pty Ltd v. FC of T; FC of T v. Spotlight Stores Pty Ltd* (2004), 2005 A.T.C. 4001 (F.C.A.F.C.), [2005] FCAFC 339 [*Pridecraft*], paragraphs 109-110, confirming the decision reached by the trial judge in *Spotlight Stores Pty Ltd & Anor v. FC of T*, 2004 A.T.C. 4674 (F.C.A.), [2004] FCA 650.

In light of the divided opinions of judges on the application of the GAAR in various decisions, the courts could cancel a 50% penalty<sup>76</sup> where taxpayers succeed in showing the presence of a general commercial purpose underlying a tax planning arrangement. Otherwise, the latter could be subject to a penalty rate of 50%. Here we again quote from the *Cumins* decision to illustrate the possibility that a taxpayer might be subject to a 50% penalty if he cannot reasonably demonstrate that he sought to achieve a general commercial purpose:

Fourth, his Honour was of the view that there had been no failure by the Tribunal to adequately consider the alternative transactions open to Mr Cumins. It was noted by his Honour that having regard to the scope and strength of the Loan Agreement and the fact that Mr Cumins had made no attempt to inform the Bank of the scheme in question, it was open to the Tribunal to find that the consent of the Bank would have been required for Mr Cumins to pursue the alternative transactions, unless the loan was repaid. *His Honour also accepted the proposition that there was no inconsistency between the Tribunal's reasons and its findings that no part of the purpose of the scheme was referable to commercial purposes.* His Honour did not agree with the appellant's contention that the scheme achieved a commercial advantage due to its protection of the shares from creditors of Trust 1. This is because the Bank, both before and after the scheme, retained legal title to the shares as security for the debt. In addition, his Honour noted that the debt created by the scheme between the two trusts was one which was open to the creditors of Trust 1 to access at some point in the future.

[...]

There is a general assertion put forward by the appellant that the Tribunal erred in its application of the relevant principles in deciding the issue of additional tax, having regard to the decision in *Walstern v Commissioner of Taxation* 2003 ATC 5076 ; (2003) 137 FCR 1. However, we are not persuaded that the Tribunal incorrectly applied the approach as set out in [108] of *Walstern*.

The appellant further contends that he was legally permitted to take steps to realise genuine capital losses, and therefore that Part IVA should not apply. It is maintained that the scheme consisted of a regular sale of a beneficial interest in a parcel of shares, and that a reasonable person would not reach the conclusion that such a transaction would fall within Part IVA. The Tribunal found against the appellant on these issues and considered that Part IVA did not support the position taken by the appellant in any material sense. The Tribunal made a finding that it was not reasonably arguable that Part IVA does not apply to the scheme implemented by the appellant. In our view, this approach was in accordance with settled principle and was open to the Tribunal. We are not persuaded that this order should be vacated. It was also submitted that the Tribunal did not take into account the existence of the Taxation Determination 95/4 or Taxation Ruling IT 2643, referred to earlier, which were said to have led Mr Cumins to believe that the scheme would be effective. These considerations were expressly rejected by the Tribunal as being

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<sup>76</sup> Michael Bersten, "Macquarie Finance – A Win For The ATO On Deductibility, but the Anti-Avoidance Rule Did Not Apply" *PricewaterhouseCoopers' TaxTalk* (October 2005) [Bersten, "Deductibility"], online: PwC Website <<http://www.pwc.com/extweb/manissue.nsf/docid/824F1998612233AECA25709D001B7BD6>>.

irrelevant, and no error was disclosed by the Tribunal's failure to take these matters into account when fixing the additional tax payable<sup>77</sup>.

[our extracts and italics]

The tax administration could find it difficult to justify the application of the maximum penalty rate even in cases of tax planning arrangements for which solicitation has been carried out by tax advisers. According to the information published by the Australian tax administration on its Website, the courts have upheld the application of the GAAR in six of seven decisions involving mass marketed schemes sampled by the tax administration, but upheld the application of a 50% penalty only once.<sup>78</sup>

#### ***4.6.2 Function of taxpayers' intentions assessed subjectively***

Even if the eight GAAR criteria apply objectively, the penalty for under-stating tax payable could apply by taking the taxpayer's subjective intention into consideration. For the purposes of the penalty, the courts should then measure the relative weight of the subjective intention of the taxpayers concerned and of the eight objective criteria of the GAAR:

*It is to be recalled that s 226L was a penalty provision. The fact of entry into a tax avoidance scheme was a necessary condition of the imposition of the penalty for which it provided. If the purpose of penalties is to secure compliance with the tax laws, they may ordinarily be expected to be concerned with the conduct and purposes of defaulting taxpayers. That is to say their actual conduct and actual purposes. It is difficult to see why if two constructions of s 224(2) be available that construction should be adopted which would permit the imposition of a penalty by reference to a purpose which the taxpayer never had. Of course, purpose could be assessed even under s 224(2) by reference to objective factors. It may also be that the statements of individual taxpayers about their purposes relevant to the imposition of penalty would be given little weight. But the relative weight and extent of subjective and objective evidence relevant to that determination will be an*

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<sup>77</sup> See paragraphs 30 and 53-54 of the decision reached by the Full Federal Court in *Cumins*, *supra* note 42. In that case, the courts upheld the application by the tax administration of a penalty for under-stating tax payable at the rate of 50% because the taxpayers could not reasonably argue that the purpose underlying the arrangement as a whole was of a commercial nature, i.e. the protection of shares held by the taxpayers from creditors.

<sup>78</sup> See [www.ato.gov.au](http://www.ato.gov.au), *Mass marketed scheme cases*, updated to January 18, 2006.

*accident of the particular proceedings in which the question arises.* In this case the evidence of the taxpayers and the advisors was unchallenged<sup>79</sup>.

[our extracts and italics]

Under its discretionary power, the tax administration could consider various factors specific to the taxpayer, including his intention, to cancel all or part of a penalty arising from the application of the GAAR. To encourage compliance with the tax system, it could impose a penalty taking into consideration the facts and circumstances of each taxpayer as well as the tax compliance profile. The tax administration must exercise its discretionary power consistently regarding taxpayers.<sup>80</sup> Taxpayers have voiced the view that in some aggressive tax planning cases, either the tax administration did not allow them an opportunity to submit their arguments on the inapplicability of a penalty for under-stating tax payable, or it did not take into consideration their circumstances and the tax compliance profile.<sup>81</sup>

In our view, an application of the penalty for under-stating tax payable according to subjective criteria could, for fairness' sake, allow taxpayers to avoid a 50% penalty provided the dominant purpose of a tax nature in an arrangement is attributable to their tax advisers. As we observed in subsection 4.1, the GAAR applies objectively provided the dominant purpose in an arrangement is to obtain a tax benefit – whether such purpose is attributable to the taxpayer or to any other party to the arrangement. If the penalty applies regardless of the taxpayer's purpose, he could be subject to a penalty when the dominant purpose of a tax nature in an

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<sup>79</sup> See *Starr & Anor v. FC of T* (2007), 2007 A.T.C. 4080 (F.C.A.), [2007] FCA 23 [*Starr*], paragraph 52, overturning the trial decision reached in *Starr & Anor v. FC of T* (2005), 2005 ATC 2285 (A.A.T.), [2005] AATA 797, and appealed by the tax administration on February 12, 2007. The appeal was heard on 31 July 2007. While the decision bears on the penalties applicable up to June 30, 2000, it could possibly broaden the criteria applicable for the purposes of the application of the penalty currently in force. Briefly, prior to the tax law being amended in 2000, it included various sections applying a penalty for under-stating tax payable depending on whether the under-statement stemmed from the application of specific anti-avoidance rules, the GAAR or any other rule (i.e. in the latter case, section 226L in question in *Starr*). In 2000, the tax administration consolidated all these penalties within a single penalty applicable in tax avoidance cases, i.e. in TAA 1953 under *Subdivision 284-C – Penalties relating to schemes*. The wording of the section that defines the taxpayer subject to this penalty – i.e. section 284-145 TAA 1953 – shows similarities with the wording of section 226L. In particular, section 284-145 TAA 1953 stipulates that for the purposes of the penalty, all the relevant items must be taken into consideration to determine whether the dominant purpose in an arrangement is the obtaining of a tax benefit by the taxpayer. In our view, such wording allows the possibility contemplated by the Federal Court judge in *Starr* to the effect that the courts must analyze the purposes of the taxpayer both subjectively and objectively.

<sup>80</sup> See House of Representatives, *2000 Revised Explanatory Memorandum*, *supra* note 70, paragraphs 1.139 to 1.142.

<sup>81</sup> See IGT, *ATO Administration of Penalties*, *supra* note 66, paragraphs 4.79 to 4.83.

arrangement is attributable to another person that participated in the arrangement, including a tax adviser.<sup>82</sup>

Taxpayers who did not obtain a fair picture of the risks inherent in the GAAR because of the negligence or reckless disregard of their tax advisers could ask the tax administration to reduce the penalty for under-stating tax payable.<sup>83</sup> The tax administration must then reconcile the responsibilities of the aggressive taxpayer and those of his adviser with the integrity of the tax system. A reduction of the taxpayer's penalty based on the degree of responsibility of his adviser may be fair to the taxpayer. Such a reduction does not necessarily encourage compliance with the tax system by the adviser unless he must compensate his client for any loss arising from the application of the GAAR or is otherwise subject to a tax penalty for negligence or reckless disregard. Consequently, the tax administration could be enticed to adopt tools that focus on advisers' compliance with the tax system.

#### **4.7 The tax administration attributes responsibilities to tax advisers regarding aggressive tax planning schemes**

Because of the uncertainty surrounding the application of the GAAR, taxpayers could seek the opinion of tax advisers concerning the extent to which their arrangements comply with the tax law.

A taxpayer can have a fair picture of the risks of an aggressive tax planning arrangement to the extent that:

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<sup>82</sup> In *Vincent*, *supra* note 54, the trial court had upheld a penalty for under-stating tax payable imposed on the taxpayer arising from the application of the GAAR. In the view of this court, the GAAR applied even though the dominant purpose of the taxpayer was of a non-tax nature, because in light of the eight objective criteria of the GAAR, the dominant purpose of the tax advisers who were parties to the arrangement was that the taxpayer obtains a tax benefit. However, the federal appeal court cancelled the penalty relating to the GAAR because, briefly, this penalty was applied by the tax administration after the expiry of the assessment period; moreover, the appeal court expressed, as an *obiter dictum*, that in its view the dominant purpose among the tax advisers was possibly to achieve a commercial purpose.

<sup>83</sup> See Austl., Commonwealth Treasury, Draft Explanatory Memorandums, *Tax Laws Amendment (Tax Agent Services) Bill 2007, Exposure Draft (7 May 2007)* [Treasury, *Tax Agent Bill Draft Explanatory Memorandum*], in "Chapter 6, Relief from certain tax shortfall penalties for taxpayers who engage tax practitioners", paragraph 6.10.

- the taxpayer provides his tax adviser with all the relevant facts and circumstances of an arrangement;
- the adviser exercises reasonable care in the application of the tax law and case-law to the facts and circumstances of the arrangement; and
- the latter opines that the arrangement is at least as likely to comply with the tax law as to run counter to it, so that the taxpayer avoids the penalty corresponding to 50% of the tax benefit if such benefit is withdrawn under the GAAR.

To provide taxpayers with greater predictability and consistency in the opinions of their advisers, the tax administration announced, on 9 May 2006, the creation of a new professional board for tax advisers, the Tax Practitioners Board, along with ethical standards. The law was to be passed no later than during the last quarter of 2007, but would become effective no earlier than February 2008 to enable stakeholders to become acquainted with the ethical standards.<sup>84</sup> On 7 May 2007, the Australian government published a bill and draft regulations to implement these measures.<sup>85</sup> Tax advisers will have to be accredited by this professional board to represent taxpayers before the tax authorities, and in compliance with the ethical standards, with the risk of being subject to disciplinary sanctions.

An exhaustive analysis of the ethical standards proposed in Australia lies beyond the scope of our study. Briefly, the standards are based on general principles such as impartiality, honesty, integrity and responsibility of tax advisers in the exercise of their profession.<sup>86</sup> The following standards could apply to tax advisers regarding aggressive tax planning schemes:

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<sup>84</sup> See Austl., Minister for Revenue, “New Tax Practitioners Regime”, n° 016 (May 9, 2006). These measures stem from proposals made in this regard some years ago and on which discussions were held between tax advisers and the tax administration: see Treasury, *ROSA*, *supra* note 22, pages 43-44.

<sup>85</sup> See Austl., Commonwealth Treasury, *Exposure Draft Tax Agent Services Bill, Related Regulations and Explanatory Material* (May 7, 2007). Public hearings on this bill ended on 13 July 2007: see Austl., Commonwealth Treasury, *Treasury’s Consultation Process on Announced Tax Measures as at 30 June 2007* [Treasury, *Consultation Processes as at 30 June 2007*] under “Policy Proposal, New Legislative Regime for Tax Agents”, page 22.

<sup>86</sup> See Treasury, *Tax Agent Draft Explanatory Memorandum*, *supra* note 83 in “Chapter 3, Obligations of registered tax practitioners”, paragraph 3.25.

- Tax advisers must act lawfully in the best interests of their client and have regard to their responsibilities owed to the community.<sup>87</sup>
- They must not allow their interests to conflict with those of their client.<sup>88</sup>
- They must take reasonable care to ensure the accuracy and completeness of the information provided by their client.<sup>89</sup>
- They must take all reasonable steps to apply the tax law to their client's facts and circumstances. In case of uncertainty, advisers must consult the tax law as well as related extrinsic material, case-law, technical interpretations and other interpretation documents published by the tax administration. If need be, tax advisers must seek the views of other advisers, even the tax administration to remove uncertainty as to the application of the tax law or the case-law.<sup>90</sup>
- They must purchase professional liability insurance to compensate a client for a loss stemming from opinions they supplied to him.<sup>91</sup>
- The sanctions stipulated by the ethical standards allow the national professional board to levy a sanction that is proportional to the severity or repetitive nature of a professional act. That may go as far as suspension or termination of a tax adviser's registration if he displays serious disregard causing damage to his client or to the integrity of the tax system.<sup>92</sup> [our extracts and adaptation]

In addition to ethical standards, on 6 April 2006 the tax administration implemented a regime of penalties targeting promoters of aggressive tax planning schemes.<sup>93</sup> The regime seeks to protect taxpayers from the risks inherent in certain arrangements for which tax advisers engage in solicitation activities. The arrangements targeted are similar to those covered by the GAAR and for which the tax treatment claimed is unlikely to be considered reasonable under the rule.

Under this regime, the tax administration can ask the courts to impose a monetary penalty on a promoter within four years of the day when the promoter began his solicitation activities. The penalty can reach \$550,000 for individuals and \$2.75 million for promoting companies or an amount corresponding to double the revenue they collect, whichever is greater. The tax

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<sup>87</sup> *Ibid.*, paragraph 3.34.

<sup>88</sup> *Ibid.*, paragraph 3.35.

<sup>89</sup> *Ibid.*, paragraphs 3.43, 3.75-3.77.

<sup>90</sup> *Ibid.*, paragraphs 3.45 to 3.48.

<sup>91</sup> *Ibid.*, paragraph 3.56.

<sup>92</sup> *Ibid.*, paragraph 3.64.

<sup>93</sup> See Division 290 – Promotion and implementation of schemes in *Schedule 1, TAA 1953*.

administration can obtain an injunction from the courts to prevent promoters from continuing their activities.<sup>94</sup>

The courts consider the value of the tax benefits at stake, the nature of the promoter's conduct and the losses sustained by investors. A promoter can avoid the penalty if he exercised reasonable care to ensure not to carry out a solicitation activity. An adviser acts with reasonable care if, in particular, he relies on the opinion expressed by the tax administration concerning the application of the penalty. The tax administration has issued preliminary guidelines concerning the application of penalties for solicitation.<sup>95</sup>

The tax administration expects to collect revenue of some \$15 million in 2007-2008, \$25 million in 2008-2009, and \$35 million in 2009-2010. These estimates are established solely on the basis of the deterrent effect this tool will have on promoters.<sup>96</sup> The tax administration fears that uncertainty surrounding the GAAR will undermine the effectiveness of measures targeting promoters.<sup>97</sup>

#### **4.8 The tax administration must apply the GAAR and case-law consistently and fairly to all taxpayers**

In case of uncertainty over the scope of application of the tax law and case-law, the tax administration could issue a notice of assessment that in all likelihood would be appealed by the taxpayer to the courts. Such a situation could arise in particular if the taxpayer's obtaining of tax benefits pursuant to a literal application of the tax law ran counter to the objects of the tax law, as argued by the tax administration. If need be, the courts will be called on to clarify the scope of application of the tax law for the benefit of all taxpayers.

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<sup>94</sup> See ATO, *Annual Report 2005-2006*, *supra* note 7, pages 158-159, under the heading *Risks in specific focus areas: Aggressive tax planning*.

<sup>95</sup> See Austl., Australian Taxation Office, Draft Practice Statement, *Administration of Division 290 of Schedule 1 to the Taxation Administration Act 1953: Promotion and implementation of schemes (the promoter penalty laws) – application in relation to tax exploitation schemes*, PS LA 2007/x (March 15, 2007). The tax administration expects to finalize these guidelines by 28 September 2007: see the ATO Website <<http://www.ato.gov.au/corporate/content.asp?doc=/content/00098629.htm>>.

<sup>96</sup> See Austl., Commonwealth, House of Representatives, Explanatory Memorandum, *Tax Laws Amendment (2006 Measures No. 1) Bill 2006, Tax Laws Amendment (2006 Measures No. 1) Act 2006* [House of Representatives, 2006 Explanatory Memorandum], in "Chapter 3 – Deterring the promotion of tax exploitation schemes", paragraph 3.135.

<sup>97</sup> See Austl., Australian Taxation Office, *Promoter Penalty Co-Design Subcommittee Minutes – 31 August 2006* [ATO, *Promoter Penalty Subcommittee*].

These uncertainties arise in the application of the GAAR. To ensure predictable and consistent application of this rule, the tax administration has set up a review committee as part of its audit activities. For the sake of transparency and fairness, taxpayers involved in a contentious arrangement can come before this committee and substantiate the grounds for the tax treatment claimed. In the same vein, the tax administration publishes the guidelines issued to its auditors concerning the application of the GAAR.<sup>98</sup>

These measures enable taxpayers to better manage the risk inherent in aggressive tax planning. In spite of that, taxpayers and their tax advisers as well as the tax administration can have diametrically opposed views on the application of the GAAR to a given arrangement, according to the facts and circumstances of the arrangement, as well as on the scope of the decisions reached by the courts, depending on whether they are favourable or unfavourable. Taxpayers' management of the risk inherent in aggressive tax planning therefore depends on the tax administration's reasons in support of a notice of assessment based on the GAAR, on how the tax administration handles the taxpayers' notices of objection and, ultimately, the decisions reached by the courts.

According to a report tabled by the Inspector-General of Taxation, the Australian Taxation Office generally applies the tax law fairly, predictably and impartially, as it has been formulated in keeping with the decisions reached by the courts.<sup>99</sup> However, it has at times applied the tax law and case-law in a way that, from the point of view of taxpayers and tax advisers, appears to run counter to the above-mentioned principles.<sup>100</sup>

To illustrate, the tax administration was able to issue notices of assessment to taxpayers solely for the purpose of having the courts confirm its interpretation of the tax law regarding one or more aggressive tax planning schemes – whether the case-law complies with this interpretation

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<sup>98</sup> ATO, *GAAR Practice Statement*, *supra* note 33.

<sup>99</sup> For an overview of the principles and issues relating to the tax administration's role in disputes, see IGT, *ATO Management of Litigation*, *supra* note 61. For a short explanation of the role of the executive power of the Australian tax administration in tax litigation, see paragraphs 3.28 to 3.42 of that document. Australia's tax administration publishes its administrative policies regarding tax litigation: see in particular Austl., Australian Taxation Office, *Conduct of Tax Office Litigation in Courts and Tribunals*, PS LA 2007/12 (Canberra: Australian Taxation Office, 21 June 2007) as well as *Management of Decisions of Courts and Tribunals*, PS LA 2007/2 (Canberra: Australian Taxation Office, 15 February 2007).

<sup>100</sup> IGT, *ATO Management of Litigation*, *ibid.*

of the tax law or not. This strategy is contrary to the principle of predictability in the application of the tax law and case-law and tends more towards bolstering its audit and collection activities than towards a clarification of the tax law – the objective that should guide its conduct in tax litigation. Below is an extract from the report mentioned above that illustrates the conflict among the duties of the tax administration:

From this entire review, the Inspector-General has concluded that there are a number of aspects of the Tax Office's conduct with respect to litigation which strongly suggest that the Tax Office's principal philosophy on litigation is that it is a means of validating the Tax Office view and ensuring that taxpayers comply with its view of the law. This compliance approach is, in certain circumstances, overriding law clarification aims for litigation. These features of the Tax Office's conduct, when coupled with the absence of cost/benefit approaches by the Tax Office in terms of assessing the benefits of litigation against the total internal and external costs of litigated cases (which is discussed further in the next chapter), mean that community perceptions that at times the Tax Office has a 'win at all costs' approach to litigation are justified.<sup>101</sup>

[our extracts]

The tax administration could give the impression that it allows an unduly restrictive scope to a decision in favour of taxpayers, that it delays recognizing the impact of such a judgement on, among others, technical interpretations or prior decisions it has issued, or that it refuses to recognize certain conclusions of a decision in favour of taxpayers. It could argue that it is justified in behaving this way regarding decisions unfavourable to it if, in its view, this proves necessary to protect the objects of the tax law. However, this strategy infringes on the principle of predictability in the application of the tax law to the extent that:

- its objects are not clearly expressed therein;
- the courts have confirmed the application of the tax law made by taxpayers; and
- the tax administration does not clearly express the reasons why it limits the scope of a decision reached by the courts.<sup>102</sup>

On the other hand, the tax administration could extrapolate the conclusions of a decision in its favour to other situations similar to the one giving rise to the decision. This strategy, if it were

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<sup>101</sup> *Ibid.*, in "Chapter 4: Tax Office's Philosophy On and Approach To Litigation", paragraph 4.26. This chapter describes the role and the approach of the tax administration regarding tax litigation as well as the conflicts between its duties of impartiality in enforcing the tax law and of collection of tax revenues.

<sup>102</sup> *Ibid.*, in "Chapter 7: Tax Office's Application of the Outcome of Finalised Decisions", pages 141-172. For an illustration of the issues regarding a case where the tax administration sought to apply the GAAR, see paragraphs 7.138 to 7.149. See also "Chapter 4: Office's Philosophy On and Approach to Litigation", especially paragraphs 4.27 to 4.31; 4.35 to 4.47.

applied, would appear to infringe on the principle of fairness in the application of the tax law to the extent that the tax administration attributes a restrictive scope to decisions in favour of taxpayers.<sup>103</sup>

The tax administration could amend a notice of assessment, nullify or settle a dispute with taxpayers to prevent the courts from reaching a decision that is unfavourable to it or which limits the scope of the favourable decision reached by the High Court in *Hart*.<sup>104</sup> Such a strategy is more consistent with the tax administration's risk management regarding aggressive tax planning at the expense of a clarification of the tax law.

Because of the diverging opinions expressed by taxpayers and the tax administration as to the scope of application of the case-law and the tax law, the courts must decide disputes between these parties. In light of statistics published by the tax administration for the period from 1 July 2003 to 30 June 2005 and shown in Table 4.1 on page 43, 2,197 of the 3,200 notices of assessment of all types appealed by taxpayers involved aggressive tax planning, i.e. approximately 69% of these appeals.

Of these 2,197 cases, the tax administration nullified or amended a notice of assessment in only 0.4% of them. This low rate could be attributable to, among other things, the fact that the tax administration considers that the taxpayer is not able to provide the evidence supporting the claim of tax benefits or is not able to demonstrate that the tax administration applied the law and case-law in error in his regard. The vast majority of taxpayers must then deal with the likelihood of proving the validity of the tax benefits obtained to the court.

For taxpayers, the costs inherent to litigation can be high.<sup>105</sup> To the extent that a clarification of the tax law proves necessary and in the interest of the public or of a given activity sector, the tax administration may accept to cover the taxpayers' costs regarding a dispute before the trial

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<sup>103</sup> *Ibid.*, in "Chapter 7: Tax Office's Application of the Outcome of Finalised Decisions", pages 141-172.

<sup>104</sup> *Ibid.*, paragraphs 4.32 and 6.46-6.48. The *Hart* case was discussed in subsection 4.4.

<sup>105</sup> *Ibid.*, paragraph 3.48: "Submissions made to this review have estimated that the current minimum costs of running a tax case in the Federal Court are in the order of \$100,000 with an additional cost of \$50,000 to \$75,000 to run any appeal from that decision."

courts to obtain such clarification.<sup>106</sup> Still, the tax administration may refuse to cover the legal expenses of taxpayers where it appeals a decision reached by the trial court that is unfavourable to it if, in its view, the case involves a tax avoidance scheme.<sup>107</sup> Moreover, the tax administration may agree to cover the legal expenses of taxpayers with the objective of having the court confirm its application of the GAAR to a specific aggressive tax planning scheme rather than to obtain a clarification of the scope of the tax law.<sup>108</sup> The tax administration's arbitrary management of a reimbursement program for legal fees carries the risk that it could use this tool unfairly to bolster its audit and collection activities.

To guard against the consequences of an unfavourable decision by the courts and for financial reasons, the tax administration and taxpayers could focus on reaching settlements regarding aggressive tax planning.<sup>109</sup> Again for the period from 1 July 2003 to 30 June 2005, the tax administration and taxpayers settled roughly 73% of aggressive tax planning cases at the objection stage. The settlement rate for aggressive tax planning cases is decidedly higher than the settlement rate obtained by the tax administration in other tax cases (approximately 25%).

A high settlement rate may indicate that both taxpayers and the tax administration are able to reach agreement on their respective risks regarding tax litigation.<sup>110</sup> The high settlement rate

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<sup>106</sup> For an overview of the measures adopted by the tax administration to pay the taxpayers' costs in disputes that mainly would help clarify the scope of the application of the tax law, see *ibid.*, "Chapter 6: The Test Case Litigation Program and Other Tax Office's Funding Arrangements for Cases", pages 105-140.

<sup>107</sup> *Ibid.*, paragraphs 6.26-6.27, 6.83 and 6.210-6.216. In light of the Inspector-General of Taxation's report, the tax administration will agree to refund the legal costs taxpayers must incur when it appeals a decision reached by the trial court in favour of the taxpayer, if such refund is otherwise fair and in the public's interest: see paragraphs 6.210 to 6.216.

<sup>108</sup> *Ibid.*, paragraphs 6.36-6.60 and 6.98-6.99.

<sup>109</sup> *Ibid.*, in "Chapter 3: Nature and Circumstances of Tax Litigation" especially paragraphs 3.104 and 3.105, as well as in "Appendix 3B: Tax Office's Detailed Reply to Chapter 3", paragraphs A.3b.30 to A.3b.38. The tax administration published its administrative policy regarding settlement offers regarding groups formed generally of at least 20 taxpayers in a similar situation, in particular considering a given aggressive tax planning arrangement: see Austl., Australian Taxation Office, *Guidelines for Settlement of Widely-Based Tax Disputes*, PS LA 2007/6 (Canberra: Australian Taxation Office, 21 February 2007). These offers are made in light of the recommendations made by a committee with the tax administration known as the Widely-Based Settlement Panel. The tax administration's objective is to make offers where justified by the circumstances, transparently and fairly. To that end, it could make offers by reducing the amount of tax payable as well as the penalties and interest, depending on the uncertainty surrounding the application of the tax law to a given situation and the extent to which the participants have complied with the tax system.

<sup>110</sup> IGT, *ATO Management of Litigation*, *supra* note 61. The tax administration could be inclined to settle disputes with taxpayers involving tax avoidance arrangements that feature complex circumstances and facts. However, it might not settle with taxpayers where they are not able to provide evidence in support of the tax benefits claimed where it is seeking to obtain a clarification of the tax law or where it is seeking to obtain confirmation of its application of the tax law.

may also be attributable to the tax administration's relatively high success rate before the courts regarding aggressive tax planning. Of the aggressive tax planning cases not settled during the period from 1 July 2003 to 30 June 2005, roughly 73% were decided in favour of the tax administration in whole or in part.<sup>111</sup>

The decisions reached in favour of the tax administration in two types of schemes known as mass marketed schemes probably contributed to the high settlement rate for aggressive tax planning cases since a fairly considerable number of taxpayers accepted a settlement offer from the tax administration following these decisions.<sup>112</sup> Out of seven decisions involving mass marketed schemes, the courts upheld the application of the GAAR in six cases; in one of them, the courts upheld the application of a 50% penalty against a taxpayer.<sup>113</sup> In the past, the tax administration has obtained an apparently satisfactory success rate before the courts: during the period from December 1996 to October 2002, it prevailed in 11 of 17 disputes relating to the application of the GAAR.<sup>114</sup> The volume of decisions reached by the courts in favour of the tax administration exerts additional pressure on taxpayers to reach a settlement with it.

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<sup>111</sup> Out of 588 unsettled cases for the period from 1 July 2003 to 30 June 2005, the courts confirmed the notice of assessment in part in 282 cases and in whole in 132, and 14 decisions reached in favour of the tax administration were upheld upon judicial review. On the other hand, the courts nullified all or part of the notice of assessment issued by the tax administration in only eight cases.

<sup>112</sup> IGT, *ATO Management of Litigation*, *supra* note 61, "Chapter 3: Nature and Circumstances of Tax Litigation" and "Appendix 3B: Tax Office's Detailed Reply to Chapter 3", paragraphs A.3b.22 to A.3b.27.

<sup>113</sup> See [www.ato.gov.au](http://www.ato.gov.au), *Mass marketed scheme cases*, updated to 18 January 2006.

<sup>114</sup> See ANAO, *ATO Management of Aggressive Tax Planning*, *supra* note 3, "Appendix 4: Application of Part IVA Anti-Avoidance Provisions", note 312.

**TABLE 4.1**  
**TAX DISPUTES BETWEEN TAXPAYERS AND THE AUSTRALIAN TAXATION OFFICE**  
**NUMBER OF APPEAL AND JUDICIAL REVIEW CASES BEFORE THE COURTS FINALIZED DURING THE PERIOD FROM**  
**1 JULY 2003 TO 30 JUNE 2005 FOR THE TAX LAWS AS A WHOLE**

| Outcome  | Category                      |         | Total |
|--|-------------------------------|---------|-------|
|  | Aggressive Tax Planning (ATP) | Non-ATP |       |
| Settled  | 1 609                         | 249     | 1 858 |
| Part favourable to the Tax Office              | 282                           | 44      | 326   |
| Favourable to the Tax Office                   | 132                           | 184     | 316   |
| Withdrawn by taxpayer                          | 72                            | 185     | 257   |
| Conceded by Tax Office                         | 3                             | 84      | 87    |
| Affirmed on review in favour of the Tax Office | 14                            | 55      | 69    |
| Unfavourable to the Tax Office                 | 8                             | 39      | 47    |
| Abandoned by the Tax Office                    | 5                             | 37      | 42    |
| Other  | 72                            | 126     | 198   |
| Totals   | 2 197                         | 1 003   | 3 200 |

Source: Table taken from IGT, *ATO Management of Litigation*, *supra* note 61, page 26.

#### **4.9 The presence of the GAAR does not of itself reduce the number of specific anti-avoidance rules: a reform of the tax rules is necessary**

Uncertainty in the application of the GAAR and in the identification of the objects of the tax law read as a whole means that a clear distinction cannot be drawn between legitimate arrangements and tax avoidance schemes. Granting discretionary power to the tax administration to apply anti-avoidance rules reasonably depending on the circumstances would help to establish a flexible and fair demarcation between them. Australia's tax law has almost 212 specific anti-avoidance rules that grant the tax administration the power to withdraw tax benefits arising from arrangements that, in its view, can be likened to tax avoidance.<sup>115</sup> The discretionary application by the tax administration of specific rules is difficult to reconcile with the principle of predictability of the law.

<sup>115</sup> See Austl., Commonwealth Treasury, *Review of Discretions in the Income Tax Laws Discussion Paper* (Canberra: Commonwealth, 21 June 2007).

A clearer formulation of the objects of the tax law based on general parameters together with the case-law established under the GAAR would help eliminate certain specific anti-avoidance rules.<sup>116</sup> In particular, these objects could be formulated according to the principle that arrangements with similar economic substance are taxed the same way, regardless of their form.<sup>117</sup> That would help reconcile the principles of predictability and flexibility in the application of the tax law for all stakeholders. The challenge is to delimit these parameters precisely enough to enable the courts to reach more informed decisions and, where necessary, limit the discretionary power granted to the entity in charge of audit activities and enforcement of the law.

#### **4.10 The efficiency of the tax administration's audit resources shortens the assessment period**

The risk associated with aggressive tax planning for taxpayers and the tax administration depends on the resources available to the latter to carry out its audit activities within the new assessment period. Australia reduced this period from six to four years regarding anti-avoidance. This period corresponds to the minimum time within which the tax administration is able to identify tax returns in which there is a risk of avoidance and take appropriate measures.<sup>118</sup> It seems reasonable that the time allowed for re-assessment should enable the tax administration to complete its examination of tax returns without unduly prolonging the taxpayer's uncertainty.

However, specific rules can stipulate an assessment period extending over a longer period, or even indefinitely.<sup>119</sup> These exceptions illustrate the tax administration's difficulties in completing an audit of tax returns with a high risk of avoidance within four years. An indefinite new assessment period may be necessary for the tax administration to protect the integrity of the tax

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<sup>116</sup> See John Taylor, *Beyond 4100: A Report on Measures to Combat Rising Compliance Costs Through Reducing Tax Complexity* (Australia: Taxation Institute of Australia, May 2006); Review of Business Taxation, *A Tax System Redesigned*, *supra* note 9, recommendation 6.6.

<sup>117</sup> See Review of Business Taxation, *A Tax System Redesigned*, *supra* note 9, page 113, point P12 *Economic Substance Over Form*.

<sup>118</sup> Section 170 *ITAA 1936*. See the recommendations formulated in this regard in Treasury, *ROSA*, *supra* note 22, page 10, as well as Austl., Commonwealth House of Representatives, Explanatory Memorandum, *Tax Laws Amendment (Improvements to Self Assessment) Bill (No. 2) 2005 Tax Laws Amendment (Improvements to Self Assessment) Act (No. 2) 2005* [House of Representatives, 2005 Explanatory Memorandum] in "Chapter 2: Amendment of assessments".

<sup>119</sup> See 170(10) *ITAA 1936*; Austl., Australian Taxation Office, *ROSA In Brief – Period of Review*, JS 5200-04-2006 (Canberra: Australian Taxation Office, April 2006) [*ROSA-Period of Review*].

system, but it infringes on the principle of fairness and predictability in the administration of the law where there is no fraud or evasion. In our view, the tax administration should bolster its tax avoidance detection activities rather than unduly prolong this period.

## Conclusion

According to Australia's tax administration, the GAAR is an effective tool to apply to taxpayers who carry out aggressive tax planning arrangements or who may be tempted to do so. However, the GAAR as such is not a complete tax avoidance solution. Still, the parameters of the GAAR and their application by the courts in Australia could provide suggestions for adjustments to Canada's GAAR (GAAR-CAN) given that the two tools are based on the identification of the purposes pursued by a taxpayer in an arrangement and the comparison of the relative importance of the tax purpose with that of other purposes.

Like the GAAR-CAN, the GAAR applies based on the relative importance of the tax benefit claimed by a taxpayer in an arrangement, compared with the relative importance of any other purpose achieved by the arrangement. While the GAAR applies if the dominant purpose of an arrangement is of a tax nature, the GAAR-CAN applies if, among other things, the primary purpose of an arrangement is of a tax nature. In itself, the GAAR criterion of the dominant purpose, taken in isolation, poses the same application challenges as the GAAR-CAN criterion of the primary purpose. These challenges arise essentially from differences of opinion among stakeholders on how to identify and measure the importance of the various purposes in an arrangement.

We note that the Australian courts have applied the dominant purpose criterion objectively in light of the GAAR's eight objective criteria. This approach increases predictability and consistency in the application of the rule for all stakeholders. These criteria reduce the chance that a general rule is applied solely according to the subjective intentions of taxpayers. A distinction between legitimate arrangements and tax avoidance schemes on the basis of general parameters enables the tax rules to be applied with more flexibility.

There is the risk with applying the eight general criteria of the GAAR to an arrangement from the standpoint of a reasonable person that stakeholders will have different opinions as to the characteristics of a tax avoidance scheme, particularly concerning the respective importance of

the tax purposes and the commercial purposes. The courts ultimately must question the taxpayer's decision to implement a given arrangement rather than another one he could have considered. The tax administration must therefore apply its powers to conduct audits and apply the tax rules so as to reconcile the principles of predictability, flexibility and consistency.

In our view, an application of a general anti-avoidance rule strictly according to the criterion of the dominant purpose in an arrangement does not result in establishing a distinction that is sufficiently fair and consistent between legitimate and abusive arrangements. Faced with the variety of arrangements a taxpayer could implement, a court could decide that the taxpayer simply exercised his privilege to minimize his tax payable according to the commercial context he found himself in. We believe that this privilege must be exercised within the range of possibilities allowed by the tax law. We believe that a general anti-avoidance rule must be based primarily on a criterion based on the compliance to the objects of the tax law.

Without the criterion of abuse of the tax law read as a whole in the GAAR, the dominant purpose criterion carries a risk that the courts will assign greater importance to taxpayers' purposes rather than to the objects of the law.<sup>120</sup> A government committee had proposed that the GAAR apply taking into consideration the objects that emerge from the provisions of the tax law.<sup>121</sup> Application of the GAAR according to the objects of the law would help to identify arrangements recognized for tax purposes. In our view, application of the tax law according to the economic substance of arrangements would bolster the application of the GAAR and, by the same token, would make it possible to eliminate specific discretionary rules that become obsolete. It remains to be seen whether the tax administration will act on the recommendation made in this sense in the past.<sup>122</sup> In the meantime, as in *Hart*, the courts play an important role in enforcing the tax law according to its objects.

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<sup>120</sup> See Carbone, *supra* note 34, pages 207-208. See also Cashmere, "Hart", *supra* note 28.

<sup>121</sup> See Review of Business Taxation, *A Tax System Redesigned*, *supra* note 9 under recommendation 6.1. For a commentary on the scope of this proposal, see Nabil Orow, "Structured Finance and the Operation of General Anti-Avoidance Rules" (2004) 4 *British Tax Review* 410, pages 420-421.

<sup>122</sup> The tax administration continues to study the merits of adopting this approach, but as yet has taken no action. See Treasury, *Consultation Processes as at 30 June 2007*, *supra* note 85 in "Policy Proposal: *General Anti-Avoidance Rule*", page 21. Note that the preference of the Review of Business Taxation is that the taxation principles underlying the tax system be changed or, where this solution is not appropriate, that the GAAR be used rather than specific anti-avoidance rules: see Review of Business Taxation, *A Tax System Redesigned*, *supra* note 9 in "Section 6: Tax System Integrity".

The lack of more detailed parameters as to the application of the GAAR leads to uncertainty in the decisions of the courts regarding the reasonable nature of the application of the tax law by the taxpayer. The application of a minimum penalty of 25% by the tax administration adds significantly to the financial risks for aggressive taxpayers. This rate seems high to us at first sight in view of the uncertainties surrounding the tax law and to the extent that the taxpayer is truly pursuing a non-tax purpose. The tax administration's fair and transparent exercise of its discretionary power to reduce a penalty mitigates the impact of a relatively high penalty rate.

We believe that the parameters of the penalty should be set in the tax law and that the penalty rate should be lower. This way, the risk that the tax administration will be strict in applying the penalty to bolster its collection and audit activities is minimized in comparison with a penalty applicable according to an extended discretionary power. A penalty should apply if the taxpayer is seeking solely to achieve a tax benefit or if the arrangement is clearly contrary to the objects of the tax law. The subjective application of a penalty would, in the interests of fairness, allow the penalty to be reduced based on the taxpayer's degree of tax expertise in circumstances where he acts in good faith and does not have the expertise required to grasp the nuances of his advisers' opinions.

Along with the analyses of the parameters of the GAAR, all the measures adopted by the tax administration focused on transparency of its application allow various stakeholders to better manage the risks inherent in aggressive tax planning. Ultimately, the tax administration must develop a consistent, impartial, timely and transparent approach to disputes regarding aggressive tax planning in accordance with the principle of fairness and predictability in the application of the law.<sup>123</sup> Increasing the number of auditors and the effectiveness of audit procedures can reduce the period of uncertainty of taxpayers regarding their tax situation.

In light of our study of the GAAR, we note that the strategy of the Australian tax administration regarding aggressive tax planning leans towards adopting tools in each of its spheres of intervention, applicable to both taxpayers and tax advisers. We question the responsibility of tax advisers towards the state regarding aggressive tax planning in the context of a self-

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<sup>123</sup> For a summary of the observations and conclusions reached by the tax administration regarding tax litigation, see IGT, *ATO Management of Litigation*, *supra* note 61 in "Chapter 2: Overview, Summary and Key Recommendations", pages 3-15.

assessment system. The application of these measures by the tax administration over the coming years could shed light on how to fairly reconcile the duties of tax advisers to their clients and the protection of the integrity of the tax system.

Beyond the GAAR's parameters and their application by various stakeholders, its effectiveness depends on that of the tax administration in collecting information on aggressive arrangements carried out by taxpayers both in Australia and abroad. During 2005-2006, Australia's tax administration provided information to 42 countries and received information from 21 countries. These exchanges occurred under agreements designed to curb aggressive tax planning.<sup>124</sup> The future will tell whether Australia, like the United Kingdom and the United States, is successful in strengthening its tools for detecting aggressive tax planning arrangements and their participants. We will also see how successful groups of stakeholders are in delimiting the acceptable from the unacceptable in tax planning without unduly reducing either the collection of taxes by the state or the privilege of taxpayers to conduct business in a global market economy.

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<sup>124</sup> See ATO, *Annual Report 2005-2006*, *supra* note 7.

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