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1 Introduction

1. The rapidly changing and complex business environment presents both opportunities and challenges for corporate taxpayer groups. One of the most striking challenges is managing the reputational and brand risks that are closely linked to a corporate group's tax profile. To manage these, many corporate groups may consider restructuring to align with their stakeholders' expectations and to seek to protect their reputations by ensuring that they do not fall foul of various recent legislative amendments that adversely affect a group's Australian tax profile.

2. However, there is the potential for a restructuring itself to trigger the operation of the general anti-avoidance rule (**GAAR**), i.e. the provisions in Part IVA of the *Income Tax Assessment Act 1936* (**ITAA 1936**). Taxpayers are potentially in a catch-22 situation. There is an irony in this: in 1989 in *John v Commissioner of Taxation*[1] the High Court rejected the so-called fiscal nullity doctrine developed in the UK, which did not then have a GAAR, and which enabled courts applying revenue legislation to ignore particular steps of transactions that were pre-ordained and had no commercial purpose other than avoiding tax.[2] In doing so, the High Court relied on the fact that Australia has a GAAR. Because of the GAAR there is no scope to construe the ordinary provisions of the Act by reference to a statutory interpretation principle that would imply into the ordinary provisions an anti-avoidance purpose. The High Court said:

> "If any such or similar principle is to be applied in relation to the Act, it is one that must be capable of implication consonant with the general rules of statutory construction. One such general rule, expressed in the maxim *expressum facit cessare tacitum*, is that where there is specific statutory provision on a topic there is no room for implication of any further matter on that same topic. The Act, in s 260 and now Part IVA, makes specific provision on the topic of what may be called tax minimization arrangements and thereby excludes any implication of a further limitation upon that which a taxpayer may or may not do for the purpose of obtaining a taxation advantage. We would respectfully adopt as correct that which was said by Gibbs J in *Patcorp*:
>
> > 'The presence of s 260 makes it impossible to place upon other provisions of the Act a qualification which they do not express, for the purpose of inhibiting tax avoidance.'"

3. In addition to the GAAR the legislation now includes, and continues to include, many specific anti-avoidance or so-called integrity measures. One might think that the existence of specific provisions should by implication exclude the general: *expressio unius est exclusio alterius*. Thus the sorts of arrangements to which the specific provisions are applicable are those that in many cases would not trigger the GAAR. By extension, arguably, organising one's affairs so as to avoid adverse consequences arising under newly introduced specific anti-avoidance or integrity provisions should be perfectly legitimate – if entering into the arrangements in the first place does not trigger the GAAR, then unwinding them should not either.

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[1] (1989) 166 CLR 417.

[2] See e.g. *Ramsay v Inland Revenue Commissioners* [1982] AC 300; *Inland Revenue Commissioners v Burmah Oil* [1982] STC 30; and the discussion of the concept of tax avoidance in Australia and the United Kingdom in "Tax Avoidance – A View from the Dark Side", David Bloom QC vol 39 Melbourne University Law Review 950.

4. In other words, if particular kinds of arrangements entered into by taxpayers are perceived as tax mischief that deserve the application of specific anti-avoidance provisions - then restructuring to avoid committing the mischief should, so the argument goes, not attract the operation of the GAAR.

5. The Commissioner however does not accept that Part IVA cannot be applied in such a restructuring context. It is certainly possible in my view that such aversion to perceived tax mischief that would fall foul of the specific provisions, might be able to attract the operation of the GAAR: particularly where the restructure involves more than just avoiding the operation of the specific provisions. It needs to be borne in mind that although practitioners commonly speak of a purpose of tax-avoidance being necessary to attract Part IVA, s 177D in fact requires a finding that the person, or one or more persons, who entered into or carried out the relevant “scheme” or any part of it, did so for the purpose of enabling a taxpayer to obtain a “tax benefit” (as defined) in connection with the scheme, or for the purpose of enabling the relevant taxpayer and another taxpayer each to obtain a tax benefit in connection with the scheme. That conclusion as to purpose needs to be reached having regard to the eight factors listed in s 177D(2) (formerly s 177D(b)). To conclude generally that unwinding arrangements that trigger specific anti-avoidance provisions cannot trigger the GAAR is unduly simplistic – not least because the “scheme” under which the arrangement is unwound needs to be considered. As in any case involving Part IVA, a conclusion one way or the other can only be reached after a very careful examination of the facts of the case.

6. This paper seeks to consider the potential application of the general anti-avoidance provisions when focussed on restructures of the kind that might be contemplated by groups operating in the resource industry, in light of recent or proposed amendments to the corporate tax landscape. I have focussed on the deductibility of debt finance costs and the challenges presented by reason of changes to the taxation of arrangements known as hybrids. Thin-capitalisation considerations are also a factor that may lead some taxpayers to wish to restructure their affairs. Several example transactions are considered: not with a view to providing legal advice or a definitive answer in relation to the application of Part IVA in relation to any particular transaction, but to try and identify the sorts of considerations to be taken into account when considering the potential application of Part IVA.

7. I would like at the outset, to acknowledge the assistance that I have had in preparing this paper and developing the examples, from Jacqueline McGrath (KPMG Law Brisbane) and Gareth Redenbach (Barrister Victorian Bar), and from David Wood (King and Wood Mallesons) and Caitlin Murdoch (Holding Redlich) by whom this paper was checked prior to finalisation. Thanks to all of you for your help. Errors and omissions are mine and, as always, this conference paper should not be relied on as advice but is intended as general educational information.

2 Part IVA

2.1 Recent amendments

8. Comparatively recent amendments to Part IVA include the Multinational Anti-Avoidance Legislation (**MAAL**) (in operation from 1 January 2016) which inserted new s 177DA into the ITAA 1936 and the Diverted Profits Tax provisions (177H – 177R effective from 1 July 2017) directed to significant global entities that enter into or carry out arrangements whose principal purpose is to obtain a tax benefit through the diversion of profits offshore.

9. While these developments are significant, the kinds of restructuring arrangements that are the subject of this paper are unlikely to engage those provisions.

10. Accordingly, the focus of this paper is on the pre-existing general anti-avoidance provisions contained within Part IVA.

2.2 Part IVA – Overview of provisions (other than MAAL and DPT)

11. The relevant provisions, broadly, have three statutory criteria that must be satisfied before, as a fourth step, the Commissioner can make a determination under s 177F to cancel a “tax benefit” as defined.

12. The first criterion is the existence of a “scheme”; the second is the existence of a “tax benefit” as defined; and the third is that having regard to specific factors to be taken into account under s 177D, it must be able to be said that there was a sole or dominant purpose, assessed objectively, of obtaining a tax benefit attributable to one or more persons who entered into or carried out the scheme or any part thereof.[3]

13. Where there is a scheme, a tax benefit, and the conclusion as to purpose under s 177D can be reached, the fourth step for the application of Part IVA is for the Commissioner to make a determination under s 177F to cancel the whole or part of the relevant tax benefit.

14. The 2013 amendments mentioned below arguably suggest that the purpose inquiry under s 177D is to be undertaken as a second step, rather than the tax benefit inquiry: the extrinsic materials state that.[4] Nevertheless, the provisions make clear (in s 177D(3)) that Part IVA will only apply to a scheme if the relevant taxpayer has obtained, or would obtain but for s 177F, a tax benefit in connection with the scheme. In the author’s view it makes little difference whether the tax benefit inquiry is undertaken as a second step (as suggested above) or as a third step, after purpose under s 177D is assessed, because it remains the case that all three elements (scheme, purpose and tax benefit) need to be present.

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[3] Section 177A(5) has the effect that if there are two or more purposes, the dominant purpose is the one that matters.

[4] See the Explanatory Memorandum to the Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013 at paras [1.56]-[1.58].

2.2.1 Requirement for a scheme

15. The definition of "scheme" in s 177A is very broad, and refers to any agreement, arrangement, understanding, promise or undertaking etc. Since any tax benefit must be connected with a scheme, as must be the conclusion as to dominant purpose, the identification of the scheme to which Part IVA is said to apply is of central importance: *Lenzo v FCT*.[5] In practice, although identification and definition of the scheme is important because it needs to be linked to the tax benefit sought to be impugned, the kinds of restructures that are the focus of this paper would inevitably result in a conclusion that there is a "scheme" in each case.

2.2.2 Requirement for a tax benefit: s 177C

16. The second (or arguably the third) statutory prerequisite to the operation of Part IVA is that there must be "tax benefit". The concept of "tax benefit" is defined in s 177C(1), which as relevant to consideration of the below restructuring examples (which all involve deductions, rather than non-inclusion of income) provides as follows:

> "Subject to this section, a reference in this Part to the obtaining by a taxpayer of a tax benefit in connection with a scheme shall be read as a reference to:
>
> (a) [not reproduced]
>
> (b) a deduction being allowable to the taxpayer in relation to a year of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out."

17. This requires a consideration of a counterfactual, alternative hypothesis, or alternative postulate. It is clear from the text of the legislation[6] that the "would not have been" and "might reasonably be expected not to have been" inquiries are alternatives. They are often referred to as the first limb and the second limb respectively.

18. Further instruction as to the manner in which the hypothetical inquiry under s 177C is to be undertaken, is contained in s 177CB (introduced in 2013), which informs the consideration under s 177C of what would or might reasonably be expected to have happened if the scheme had not been entered into.

19. The effect of s 177CB(2) is that in determining that a tax effect (in the examples under consideration, a deduction not being allowed) <u>would</u> have arisen but for the scheme, it is permissible only to take into account events or circumstances that actually happened or existed, other than those that form part of the scheme. This is sometimes referred to as an "annihilation" approach to the tax benefit inquiry, because the actual scheme or transaction entered into is

[5] (2008) 167 FCR 255 at 277 (para [120]).

[6] And from the extrinsic materials accompanying the 2013 amendments that introduced s 177CB, for what this is worth: it is highly unlikely that a Court would consider the 2013 extrinsic materials in construing s 177C. Even under the legislation prior to the amendments the Full Court of the Federal Court had made clear that the two limbs were alternatives: *RCI v Federal Commissioner of Taxation* (2011) 84 ATR 785 at 842 [126].

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required wholly to be ignored.[7] This is the approach taken under former s 260, which has limitations in some cases: as the High Court said in *John v FCT*:[8]

> "[Section] 260 effects a fictitious annihilation of contracts, agreements and arrangements. It does not proceed to substitute an alternative basis on which tax should be calculated. Of course, in some cases the annihilation of a legal form will itself reveal a basis for the calculation of tax."

20. Now, the effect of s 177CB(3) in application of the second limb, is that a decision that a tax effect, e.g. a deduction being disallowed, might reasonably have been expected to have occurred but for the scheme, must be based on a postulate (sometimes referred to as a counterfactual, or alternative hypothesis) that was a reasonable alternative to entering into or carrying out the scheme. In determining whether the postulate is a reasonable alternative to the scheme, under s 177CB(4), one is required to have particular regard to the substance of the scheme, and any result or consequence that is or would be achieved by the scheme other than a result arising in relation to the operation of the income tax legislation, and one is also required to disregard any result in relation to the operation of the income tax legislation that would be achieved by the postulate for any person, whether or not a party to the scheme. This is sometimes referred to as a "reconstruction" approach because it enables consideration of alternative events that were reasonable alternatives to what in fact happened, although significantly post the 2013 amendments the tax consequences of the alternative hypotheses are required to be disregarded.[9] The application of this provision has not yet been considered by a Court so it is difficult to see what practical effect it will have. What is clear however is that it makes it not viable to advance an argument that there is no tax benefit because an alternative transaction should be accepted as a reasonable alternative, and it would have resulted in the availability of an alternative deduction (or a non-inclusion of income) in circumstances where the consequence of the application of Part IVA is to deny a deduction (or require an inclusion of income). That is not to say, however, that the availability of an alternative deduction is irrelevant: the availability of an alternative deduction might well be relevant to the purpose inquiry under s 177D and may point strongly to a conclusion that the purpose required by s 177D is not present – it is difficult to argue that there is a purpose of tax avoidance if e.g. an alternative and "legitimate" deduction was always going to be available under an alternative transaction, for example in a case where debt finance is required and in circumstances where the costs of debt finance are generally deductible.[10]

21. In 2016 the Commissioner updated his Policy Statement – *Law Administration Practice Statement PSLA 2005/24* to take into account the introduction of s 177CB. This is an internal

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[7] See the discussion in the Explanatory Memorandum to the Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013 which introduced s 177CB, at [1.37] discussing the so-called annihilation approach and at [1.39] discussion the so-called reconstruction approach under the second limb.

[8] 166 CLR at 432.

[9] This extremely confusing provision was introduced in 2013 following a series of cases that the Commissioner lost, some of which were lost because it was concluded that there was no tax benefit because under the alternative hypothesis, the non-derivation of income said to represent a tax benefit was concluded, based on the particular facts of each case, not to have been a reasonable alternative: eg *RCI Pty Ltd v Federal Commissioner of Taxation* (2011) 84 ATR 785 at 846-848 [141]-[150]; *Federal Commissioner of Taxation v Axa Asia Pacific Holdings Ltd* (2010) 189 FCR 204 at 242-243 [141]-[146] per Edmonds and Gordon JJ with whom Dowsett J agreed.

[10] The fact that alternative transactions that could have been carried out may be relevant to the purpose assessment was recognised in *FCT v Hart* 217 CLR 216 at 243, referring to the reasons of Hill J in the Full Federal Court.

document used to guide Australian Taxation Office (**ATO**) exmployees in the administration of the Act, but it also contains expressions of opinion on matters such as whether pre-2013 case law on the concept of "tax benefit" remains relevant. There is room for debate about this and the position will not be clear until a set of facts falls to be assessed by the Federal Court.

22. Finally, in relation to the "tax benefit" issue it is worth bearing in mind the exclusion in s 177C(2), the effect of which is to negate a conclusion as to the existence of a tax benefit where it arises by reason of certain choices permitted by the ITAA 1936 or the *Income Tax Assessment Act* 1997 (**ITAA 1997**).

23. It is sufficient for the purposes of this paper to extract part of the provision insofar as it applies to choices resulting in tax benefits arising by reason of non-inclusions of income or availability of deductions:[11]

> "The reference in this Part to the obtaining by a taxpayer of a tax benefit in connection with a scheme shall be read as not including a reference to:
>
> (a) the assessable income of the taxpayer of a year of income not including an amount that would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer if the scheme had not been entered into or carried out where:
>
> (i) the non-inclusion of the amount in the assessable income of the taxpayer is attributable to the making of a declaration, agreement, election, selection or choice … expressly provided for by this Act or the Income Tax Assessment Act 1997 …; and
>
> (ii) the scheme was not entered into or carried out by any person for the purpose of creating any circumstance or state of affairs the existence of which is necessary to enable the declaration, agreement, election, selection, choice …to be made … as the case may be
>
> (b) a deduction being allowable to the taxpayer in relation to a year of income the whole or a part of which would not have been, or might reasonably be expected not to have been, allowable to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out where:
>
> (i) the allowance of the deduction to the taxpayer is attributable to the making of a declaration, agreement, election, selection or choice … expressly provided for by this Act or the Income Tax Assessment Act 1997 …; and
>
> (ii) the scheme was not entered into or carried out by any person for the purpose of creating any circumstance or state of affairs the existence of which is necessary to enable the declaration, agreement, election, selection, choice …to be made … as the case may be;"

[11] It applies also to capital losses, foreign tax offsets and innovation tax offsets. Note, the section is only extracted in part.

24. This provision is potentially relevant to restructures where part of the "scheme" involves, for example, an election to consolidate. It is to be noted also that the purpose test in s 177C(2)(a)(ii) and (b)(ii) is potentially a different purpose test from that under s 177D.[12] Whereas s 177D identifies the factors to which regard must be had in order to assess purpose, s 177C does no such thing. Moreover s 177C speaks of the purpose of creating a circumstance or state of affairs, whereas under s 177D the task is to attribute the necessary purpose to one or more persons who entered into or carried out the scheme or part of it.

25. An argument that a right to a deduction was incurred by a taxpayer due to an election to consolidate (in that case, in the form of a multiple entry consolidated group) was considered by Gordon J in *Noza Holdings Pty Ltd v Commissioner of Taxation* (2011) FCA 46 at [286]-[292]. Her Honour concluded on the facts that the deduction in that case was not due to the election to form a consolidated group but did not otherwise suggest that the argument may not have been valid. That case went on appeal, but in the appeal, the Commissioner did not rely on Part IVA: see *FCT v Noza Holdings Pty Ltd* (2012) 201 FCR 445. A similar argument was sought to be advanced by the taxpayer, before the Full Federal Court in *FCT v Macquarie Bank Ltd* (2013) at 210 FCR 164, a case concerning the derivation of income rather than the availability of deductions. However, the argument was only put after the close of the case on appeal and upon the Court inviting submissions from the parties in relation to the application of s 177C(2), whereupon the taxpayer for the first time submitted that there was no tax benefit on the basis that the tax benefit was ultimately attributable to an election or choice to form a consolidated group: see 210 FCR at 196 [121]. In circumstances where the argument had not been put previously, the Court declined to consider it and so the issue was not determined; and the Commissioner lost the appeal for other reasons.

2.2.3 Requirement for a sole or dominant purpose of tax avoidance: s 177D

26. The third (or second) statutory prerequisite is (in summary) that it must able to be concluded, objectively, 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 sole or dominant purpose of enabling a relevant taxpayer to obtain a tax benefit in connection with the scheme – see the full text of s 177D(1).

27. Section 177D(2) then identifies a range of factors that are required to be taken into account, in determining whether or not the requisite sole or dominant purpose is present in any particular case. Those factors (in summary) are:

    a. the manner in which the scheme was entered into or carried out;
    b. the form and substance of the scheme;
    c. the time at which the scheme was entered into and the length of the period during which the scheme was carried out;
    d. the result in relation to the operation of the Act that, but for Part IVA, would be achieved by the scheme;
    e. any change in the financial position of the relevant taxpayer that resulted, will result, or may reasonably be expected to result from the scheme;

[12] See further GT Pagone, "Tax Avoidance in Australia", Federation Press 2010 at p.67.

f. any change in the financial position of any person who has, or who 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;
g. any other consequence for the relevant taxpayer, or for any person referred to in paragraph (f) of the scheme having been entered into or carried out; and
h. the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in paragraph (f).

28. In *FCT v Spotless Services Ltd* (1996) 186 CLR 404 at 421 the High Court emphasised, referring to *FCT v Peabody* (1994) 181 CLR 359 at 382 that the matters to which regard is to be had under s 177D are "posited as objective facts". Further, according to the High Court in *FCT v Hart* (2004) 217 CLR 216 at 227 (per Gleeson CJ and McHugh J) the fact that a particular commercial transaction is chosen from a number of possible alternative courses of action because of tax benefits associated with it does not of itself mean that Part IVA will apply. The mere fact that a transaction minimises tax is not sufficient to attract the operation of Part IVA: as Gleeson CJ and McHugh J went on to say in *Hart*:

> "...even if a particular form of transaction carries a tax benefit, it does not follow that obtaining the tax benefit is the dominant purpose of the taxpayer in entering into the transaction."

29. Notwithstanding that, and as appears from the discussion below in considering the examples, it has been much more difficult for the Commissioner to successfully apply Part IVA in cases where transactions were influenced by broader commercial considerations, than in circumstances where the transactions made no sense, absent the tax outcomes. A theme in several Part IVA cases in which the Commissioner has been successful, particularly cases concerning derivation of income rather than deductions,[13] is that the schemes made little or no commercial sense absent the tax benefits: that is, the tax advantages attributable to the particular form of the transactions resulted in the commercial advantages.

30. In practice, assessing the potential application of s 177D requires a very detailed examination of the particular transaction and the surrounding circumstances, and consideration of each of the factors identified. Some factors may in any given case point towards the conclusion that the necessary purpose exists; others may be neutral or tend against such a conclusion. Overall it is an evaluative task and in litigation, the outcome will depend on the evidence available to support the case. Although purpose is assessed objectively, contemporaneous documents identifying – as factual matters – the non-tax related considerations and advantages that flow from a transaction, can be critical in supporting a conclusion that Part IVA does not apply.

[13] Although *FCT v Hart* was a case involving deductions.

3 Hybrids and anti-hybrid measures

3.1 Hybrid arrangements, and the new legislation

31. So-called hybrid arrangements allow groups to drive down their global tax rate using arrangements that are compliant with existing domestic laws, but which arbitrage differences between domestic tax laws of different countries. Anti-hybrid measures have been introduced in Australia following the OECD's Base Erosion and Profit Shifting initiative and in particular following its October 2015 report, "Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report" (**the OECD Report**) and the Board of Taxation's report, "Implementation of the OECD Hybrid Mismatch Rules" in March 2016 (**the Board of Taxation Report**).

32. An example of a hybrid: the issue to a foreign related corporation of redeemable preference shares (**RPS**) or bonds carrying a fixed return, may be classified by an Australian taxpayer as the issuing of debt, with a deduction being permissible in Australia for the payments liable to be made over the term of the instrument. In such a case the entitlement to a deduction arises annually as the liability is progressively incurred notwithstanding that a cash payment obligation may not arise until the expiry of the instrument. In the domestic jurisdiction of the foreign holder of the instrument, the arrangement may be classified as an equity investment with the payments when received being classified as non-taxable dividends or capital returns; or, if the arrangement does give rise to a derivation of income, that may not occur until an entitlement to payment arises, in which case there will be a timing mismatch between the incurrence of deductions in Australia and the corresponding derivation of assessable income overseas. See further **Examples 2 and 3** discussed below.

33. In other circumstances a payment can give rise to deductions being available in two places. For example, an entity that one jurisdiction may regard as transparent for tax purposes may be regarded as taxable in another jurisdiction: see **Example 1** discussed further below.

34. The *Australian Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Act 2018* (**the Anti-Hybrid Act**) passed the Parliament on 16 August 2018 and received Royal Assent on 24 August 2018. It takes aim at these types of arrangements by measures that (among other things) include:

    - denying deductions, where a deductible payment is not taxed elsewhere or where the term of an instrument is more than 3 years and a derivation of income is deferred: the description used to characterise such arrangements is that of a "deduction/non-inclusion mismatch";
    - including an amount in assessable income, where a payment gives rise to two deductions: the description used to characterise such arrangements is that of a "deduction/deduction mismatch".

35. Further, intra-group multinational financing arrangements may be affected by the Integrity Rule in Subdivision 832-J denying a deduction in Australia if there is evidence of:

- routing funds through payments to foreign interposed entities; that
- results in an Australian income tax deduction; and
- the imposition of foreign income tax on the payment at a rate of 10% or less; and where
- it is reasonable to conclude (having regard to specified matters) that the entity or one of the entities that entered into or carried out all or part of the scheme did so for a purpose including a purpose of enabling a deduction to be obtained in respect of the payment, and enabling foreign income tax to be imposed on the payment at the rate of 10% or less.

36. An example of where the Integrity Rule might potentially apply can be seen in **Example 4** discussed below. There, an Australian operating company is funded by a related foreign finance company located in a jurisdiction that imposes tax at <10%.

37. It should be noted that the latest International Dealings Schedule (**IDS**) required to be completed in conjunction with preparation of corporate tax returns includes questions on hybrid arrangements. Taxpayers will need to have made sufficient inquiries about the affairs of their shareholders/financiers to enable completion of the IDS. This is a potential issue for entities that may not have adequate visibility over the arrangements of entities "further up the chain".

38. In some instances, the consequences of the application of the hybrid rules could be such that they result in existing structures being unviable, e.g. by denying a deduction in Australia for financing costs which may render funding arrangements prohibitively expensive on an after-tax basis. The Explanatory Memorandum to the bill that became the Anti-Hybrid Act (**the Anti-Hybrid EM**) anticipates specifically that many taxpayers may wish to restructure their affairs to avoid such consequences:

> "1.20 It is likely that, where possible, many taxpayers will restructure out of hybrid arrangements that would otherwise be subject to the OECD hybrid mismatch rules (including arrangements subject to the integrity rule) and enter into alternative arrangements that do not attract the operation of the hybrid mismatch rules. It is possible that restructures which remove a hybrid mismatch could result in:
>
> - retaining a deduction in a foreign jurisdiction with a greater amount being included in the Australian income tax base — either because of the elimination of an Australian income tax deduction or an increase in assessable income;
> - retaining an exemption in a foreign jurisdiction with a greater amount being included in the Australian income tax base because of the elimination of an Australian income tax deduction;
> - retaining a deduction with a greater amount being included in a foreign income tax base; or
> - retaining an exemption in Australia with a greater amount being included in a foreign tax base because of the elimination of the foreign deduction.
>
> 1.21 These alternative arrangements would satisfy the objective of the hybrid mismatch rules."

39. The acknowledgment of the fact that taxpayers may wish to restructure is in my view recognition of the fact that it is legitimate to do so.

3.2 Examples of the application of the new rules

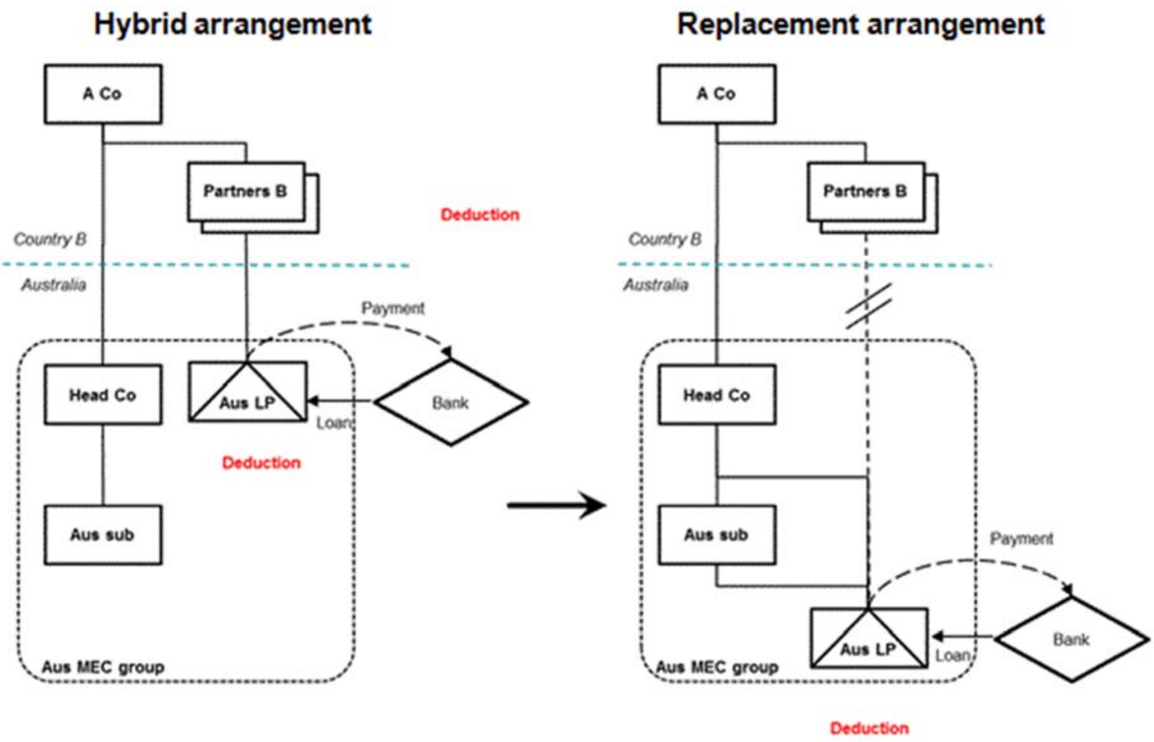
40. Both the Anti-Hybrid EM and the ATO publication Practical Compliance Guideline 2018/D4 (published 21 June 2018) give numerous examples of the kinds of situations in which the anti-hybrid mismatch rules may apply.

41. It is well beyond the scope of this paper to cover all of the kinds of circumstances in which the anti-hybrid rules may apply: I note that there is another session at this conference that specifically covers the anti-hybrid measures.

42. What I have sought to do is identify four examples of where the anti-hybrid rules could apply to financing transactions, for the purposes of the consideration of Part IVA that follows, on the assumption that the transactions were to be restructured in the manner set out further below.

43. Before considering Part IVA however it is necessary to identify the consequence under the anti-hybrid rules that would follow, in the absence of a restructure. That is because a critical inquiry under Part IVA is to ask what would have happened, or what might reasonably have been expected to have happened, but for the transaction to which Part IVA may be applicable.

3.2.1 Example One



44. **Example 1** is an Australian Limited Partnership with foreign and Australian members that is a member of an Australian multiple entry consolidated group (**MEC Group**), where the overseas members are also subsidiaries of the overseas based ultimate holding company that holds the shares in the head company of the Australian group.

45. This scenario is based on Example 1.3 of the ATO's draft Practical Compliance Guideline PCG 2018/D4.

46. Interest on a bank loan payable by the partnership gives rise to a deduction available to the head company of the group in Australia in respect of the entirety of the interest incurred; while the foreign members of the limited partnership are entitled to a deduction in respect of their share of the interest on the loan under the law of the relevant foreign jurisdiction, by reason of the foreign jurisdiction treating the limited partnership as a transparent entity. Thus, under the current law both Head Co and the country B resident partners in Aus LP can claim a deduction in respect of the same outgoings.

47. The hybrid arrangement gives rise to the consequence under new s 832-530 of the ITAA 1997, that unless the foreign country has foreign hybrid mismatch rules, the deduction in Australia would be disallowed, in an amount not exceeding the deduction available in the foreign country.

48. The amount disallowed, known as the neutralising amount, is calculated under s 832-560 by allowing for any "dual inclusion income", that is, income that is taxed in both jurisdictions.

3.2.2 Restructuring of Example 1

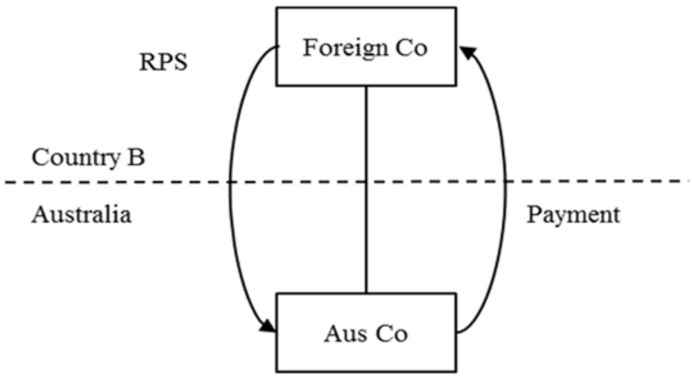
49. **Example 1** can be restructured to neutralise the hybrid (deduction/deduction) outcome and thereby avoid triggering the denial of the tax deduction in Australia.

50. Assume that, as depicted in the "Replacement Arrangement", an internal reorganisation of the group is carried out, with steps taken to replace Aus LP's existing partners in Country B (for instance through equity contribution of the Aus LP interests) with Australian resident partners, being existing members of the Aus MEC Group.

51. Under the replacement structure Head Co will continue to be entitled to a deduction for interest on the bank loan owed by Aus LP, and a deduction for interest will no longer be available in Country B. The deduction/deduction outcome has been neutralised by the elimination of the deduction in Country B.

52. This restructuring is regarded by the recently published "Practical Compliance Guideline" released by the ATO, PCG 2018/D4, published 21 June 2018, as low risk in relation to Part IVA.

3.2.3 Example Two



53. Example 2 assumes AusCo has issued RPS to Foreign Co that are treated as debt for Australian tax purposes. This scenario draws on examples 1.11 and 1.12 from the Anti-Hybrid EM.

54. Assume Aus Co has operated as a wholly owned subsidiary of Foreign Co for many years, funding resource projects by issuing RPS and that successive tranches have been issued, with various redemption timeframes from (say) 5 to 15 years.

55. Dividends (and deductions in Australia for the cost of the debt finance) accrue progressively and to the extent unpaid are treated as part of the redemption price. Under the current law, Aus Co gets a deduction each year in Australia but there is no derivation of income overseas until payment, at which time an amount will be assessable to Foreign Co for tax purposes (assuming that there is no participation exemption in the foreign jurisdiction).

56. Although in the example there is a tax consequence on derivation to Foreign Co, the new law deems a deduction/non-inclusion mismatch to arise under s 832-220 unless (in summary) the mismatch primarily relates to a deferral in the recognition of income and the term of the interest or arrangement is 3 years or less. The consequence is that the deduction available to AusCo is denied under s 832-180. There are several steps to this analysis: the deduction denied under s

832-180 is the deduction component of a "hybrid financial instrument mismatch". Under s 832-200 there is a "hybrid financial instrument mismatch" if there is a "hybrid mismatch" and (in summary) the parties are related, as is the case in the example, or the payment is made under a "structured arrangement". There is a "hybrid mismatch" under s 832-215 if there is a deduction/non-inclusion mismatch (as defined in s 832-105) and the mismatch meets a "hybrid requirement" in s 832-220 or s 832-225.

57. Here the hybrid requirement under s 832-220 is met because the payment that gives rise to the mismatch is made under a debt interest, the mismatch is attributable to differences in the treatment of the interest arising from the terms of the interest, and the exception in s 832-220(2) does not apply because although the difference in treatment primarily relates to a deferral in the recognition of income under the debt interest, the term of the arrangement is not 3 years or less.

58. On redemption, if there is an amount included in Foreign Co's income then a deduction is generally allowable to AusCo by way of an adjustment under s 832-240. The effect is to defer the availability of the deduction to AusCo until the corresponding amount is required to be included in Foreign Co's income.

3.2.4 Restructuring of Example 2

59. **Example 2** could be restructured by altering the terms of the RPS, or redeeming them and replacing them with further RPS, to ensure that the RPS on issue after the restructure have terms of 3 years or less.

60. Although based on OECD recommendations, one of the features of the way the Australian implementation of anti-hybrid measures has differed from the OECD recommendations, is that the rules will not apply where the term of the arrangement is 3 years or less and the issue is one of timing: s 832-220(2).

61. This was one of the recommendations of the Board of Taxation Report concerning implementation of the OECD Report. Recommendation 5 of the Board of Taxation Report was a suggestion that the provisions should not apply to financial instruments with a term of 3 years or less where the hybrid mismatch is merely one of timing. It was considered desirable that there should be a "safe harbour" period of some kind, and the Board of Taxation Report noted that the UK had adopted a 12-month safe harbour, but with flexibility for a longer period if taxpayers could provide the revenue authorities with evidence to justify that the timing difference was reasonable.

62. The Board of Taxation Report noted that submissions did not comment specifically on this matter but concluded that a 12-month safe harbour period would be too short as financing instruments would typically have terms that extend beyond a 12-month period. It also noted that although that the OECD Report contemplated a 12-month safe harbour, with the possibility of an extension in particular cases (as adopted by the UK), this was considered likely to result in an administrative burden on the ATO to provide guidance, which would create significant uncertainty for taxpayers.

63. The critical recommendation made by the Board of Taxation Report appears at [3.41]:

> "3.41 The Board considers that a three year safe harbour period strikes the right balance between ensuring long term deferral arrangements are no longer possible, and

reducing compliance costs and uncertainty for taxpayers. It would also relieve the administrative burden on the ATO. The Board also considers that a permanent denial of a deduction should not arise for timing differences beyond the three year safe harbour period. Instead, the deduction or relevant part of the deduction should be delayed until such time that the equivalent amount of income is recognised for tax purposes in the counterparty jurisdiction. Also, where the defensive rule is triggered in the case of an Australian lender, an amount would be included in the assessable income of the Australian payee each year an accruals deduction is claimed in the counterparty jurisdiction (with such assessable income being credited against any actual receipt, or the actual receipt being treated as non-assessable in the year of receipt)."

64. In this respect, it is worth noting what was said in the Anti-Hybrid EM, at [1.13] - [1.16]:

"1.13 Hybrid mismatch arrangements can reduce the collective tax base of countries around the world even though it can be difficult to determine which country has lost tax revenue.

1.14 The principal objective of the hybrid mismatch rules is to neutralise the effects of hybrid mismatches so that unfair tax advantages do not accrue for multinational groups as compared with domestic groups.

1.15 In this regard, the OECD Action 2 Report concludes that hybrid mismatch arrangements are widespread and result in a substantial erosion of the tax bases of countries concerned, with an overall negative impact on competition, efficiency, transparency and fairness ...

1.16 The OECD Action 2 Report sets out comprehensive rules for dealing with, hybrid mismatch arrangements. The amendments in Schedule 1 and 2 to this Bill closely follow the recommendations in the OECD Action 2 Report. Some departures occur to take into account recommendations of the Board of Taxation and to allow for unique features of the Australian tax system that were not specifically contemplated by the OECD recommendations. In this regard, key departures from the recommendations in the OECD Action 2 Report are:

- a modification to the hybrid financial instrument mismatch rule so that (as recommended by the Board of Taxation) the rule does not apply where, broadly:

  — the term of the arrangement is three years or less; and

  — the mismatch is merely one of timing…"

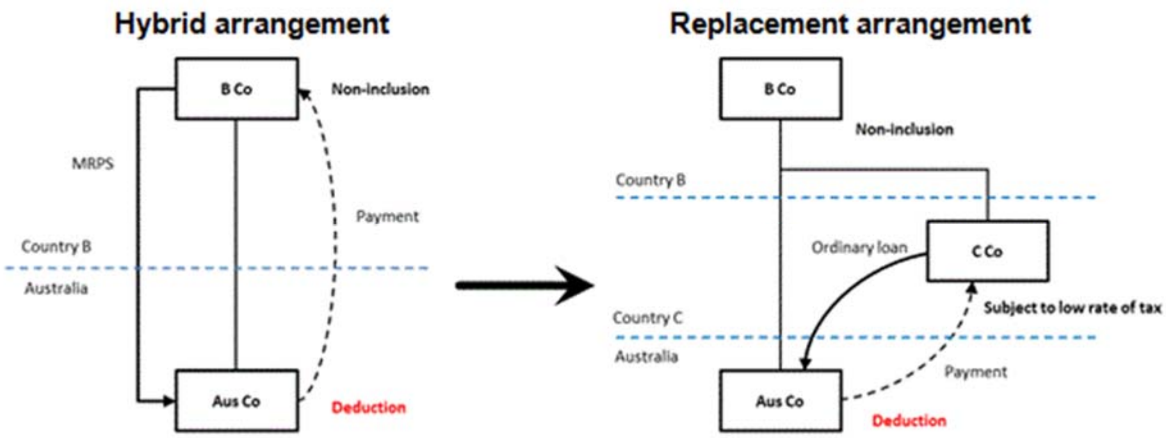
65. It being the case that so-called "unfair tax advantages" should not be permitted for multinational groups as compared with domestic groups, it might be thought to be curious as to why the rules should not apply where the term of an arrangement is 3 years or less and the issue is one of timing. Nevertheless, it is abundantly clear that the anti-hybrid mismatch rules are not intended to apply, at all, in these circumstances.

66. Thus, the transaction in Example 1, which concerns RPS with various redemption timeframes from (say) 5 to 15 years could be restructured, so as to replace the RPS on issue with one or more tranches of shares having redemption timeframes of 3 years or less.

67. There are of course a number of ways in which the RPS could be restructured, either in a single transaction or series of transactions altering the terms of all the RPS on issue, or in successive transactions issuing new RPS over a period of years as each tranche of RPS on issue expires.

68. It is to be noted that under this proposed restructure, there would still be a deduction/non-inclusion mismatch under the definition in s 832-105, but the hybrid requirement in s 832-220 would not be satisfied due to the exception applicable to instruments with terms of 3 years or less.

3.2.5 Example Three



69. **Example 3** shows an equivalent structure to Example 2 as the hybrid arrangement and assumes that it is restructured under the "replacement arrangement". This scenario draws on Scenario 2.2 of the ATO's draft PCG 2018/D4. Instead of AusCo being financed by RPS, a loan is advanced from C Co to Aus Co, in circumstances where C Co is subject to a low rate of tax.

70. Regardless of whether the replacement arrangement was implemented as a restructure or was simply the status quo, if the rate of tax applicable to C Co was 10% or less, the Integrity Rule in Subdivision 832-J would be of potential application (subject to the matters set out in s 832-725).

71. If the rate of tax in C Co's jurisdiction was lower than the Australian rate but more than 10%, and the structure assumed in Example 1 were to be restructured so as to remove the RPS and replace them with a loan from C Co, Part IVA considerations might arise, as discussed further below: and see example 4.

3.2.6 Restructuring of Example 3

72. Example 3 draws from Example 2 but, rather than changing or refinancing the existing RPS to result in 3 year terms, it is assumed that further funds are advanced by a subsidiary of the ultimate holding company operating in a low tax jurisdiction, the proceeds of which are used to

redeem the RPS and in turn, the holding company uses the funds received from Aus Co to capitalise the borrower. This could effectively be carried out by paper transactions/book entries.

73. For the purposes of the example, it is assumed that the rate of tax in the new lender's jurisdiction is more than 10%, so the Integrity Rule in Subdivision 832-J could not apply.

74. However, one would then have replaced a situation where a deduction would have been denied in Australia (under the facts assumed in Example 2) by operation of the anti-hybrid rules, with a situation where Aus Co would be entitled to a deduction in Australia for the interest payment made to C Co. The situation might arise where the ultimate holding company does not require that entity to include the interest income received by C Co in its tax base on accruals basis (for example, under a controlled foreign company regime) and as a result, interest payments are not subject to tax in country B. It may also be assumed, for the purposes of the example, that dividends paid by C Co to B Co (the holding company) are exempt from tax in country B under a dividend participation exemption.

75. Under the transaction as restructured, there is no longer a deduction/non-inclusion mismatch, as defined by s 832-105, because the deduction available to Aus Co does not exceed the amount of the payment in the hands of C Co that is subject to foreign income tax: that is, for the purposes of the example it is assumed that the full amount of the interest payments liable to be made by Aus Co are taxable in the hands of C Co, albeit that they are taxable at a lower rate.

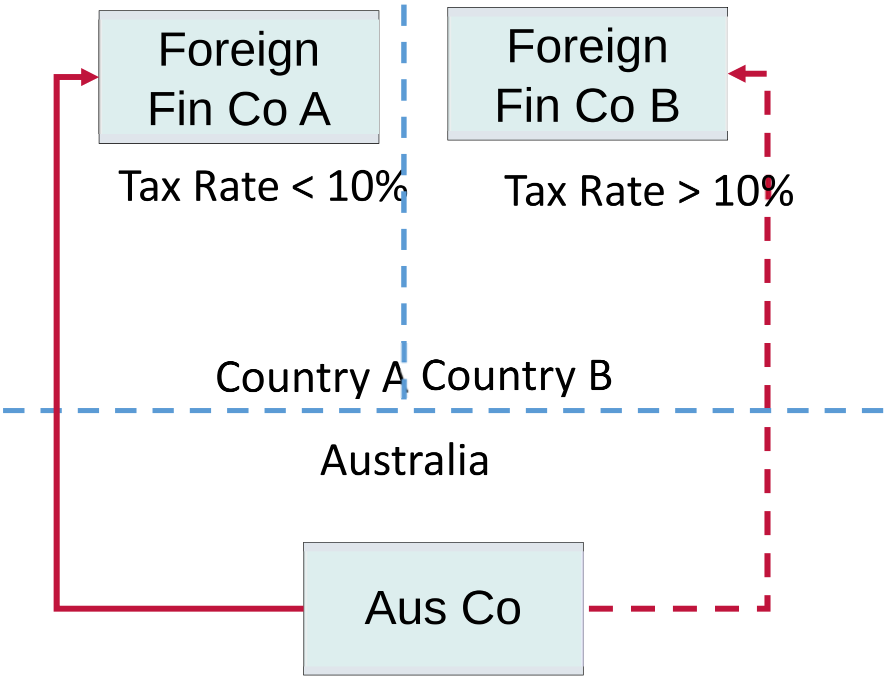
76. This is in fact one of the examples given (scenario 2.2) in the PCG 2018/D4, published 21 June 2018. Leaving aside Part IVA there is no suggestion in that publication, that the replacement arrangement would not be successful to preserve the benefit of the tax deduction in Australia available under the existing structure that would, but for the anti-hybrid rules, be available.

77. PCG 2018/D4 is of course a non-binding draft document and has been released in light of the potential for the Commissioner to apply Part IVA to cancel all or part of a tax benefit, where a taxpayer restructures an existing hybrid arrangement to avoid the potential application of the hybrid mismatch rule. The PCG states that it is designed to assist taxpayers to manage their compliance risk, where their intention is to eliminate hybrid outcomes, and that it does so by outlining restructuring "that the Commissioner considers to be of 'low risk' and to which he would not seek to apply Part IVA of the ITAA 1936."

78. This restructure is not considered "low risk" by the ATO: while this might suggest that the ATO would like to be able to apply Part IVA, it gives little comfort to taxpayers as to whether Part IVA would be held by a Court to be applicable.

79. The reason given by the ATO for the transaction not being low risk is that the PCG assumes that to be low risk, a transaction should not result in any change, under the restructured arrangement, to the jurisdictions of the entities involved in the hybrid arrangement: see para [16] and [65]. As discussed below, and as the contemplated restructuring of Example 4 is suggested to demonstrate, I consider this approach to be simplistic and arbitrary, and this criterion to be unhelpful to demonstrate of itself, whether a transaction should be regarded as low risk.

3.2.7 Example Four



80. Example 4 is a situation where Aus Co is funded by a related finance corporation (Foreign Fin Co A) operating in a jurisdiction with a tax rate of less than 10%. Assume both Foreign Fin Co A and Foreign Fin Co B are both interposed subsidiaries of the same ultimate holding company.

81. For the purposes of the example it is assumed that AusCo could have been financed by another related finance company operating in a different jurisdiction (Foreign Fin Co B), with a tax rate of more than 10% (but still less than the Australian corporate tax rate).

82. Under the anti-hybrid legislation, the Integrity Rule in Subdivision 832-J would potentially apply to deny the deduction. There needs to be a payment of interest or an amount under a derivative financial instrument made by an entity to a foreign entity under a scheme; and the parties relevantly related: see s 832-725(1)(a) to (g) for the detailed threshold requirements.

83. The Integrity Rule would potentially apply if under s 832-725(1)(h) it were found reasonable to conclude, having regard to the matters set out in s 832-725(2), that the entity or one of the entities who entered into or carried out the scheme or any part thereof did so for a *principal purpose*, or for more than one principal purpose that includes a purpose of:

- enabling a deduction to be obtained in respect of the payment; and
- enabling foreign income tax to be imposed on the payment at a rate of 10% or less, or enabling foreign income tax not to be imposed on the payment.

84. The matters required to be considered under s 832-725(2) are:

- the facts and circumstances that exist in relation to the scheme;

- if the payment is an amount of interest – the source of the funds used by the interposed foreign entity to provide the paying entity with the loan or other debt interest;
- whether the interposed foreign entity engages in substantial commercial activities in carrying on a banking, financial or other similar business.

85. While each separate set of facts needs to be considered separately, it is apparent that in many cases it may not be straightforward to reach the required purpose conclusion under s 832-725.

86. From the point of view of the borrower, it may be difficult to conclude that there was a sufficient purpose of obtaining a deduction in Australia and enabling foreign tax to be imposed at a rate of 10% or less: the purpose ordinarily in incurring an obligation to pay interest might be thought to be one of obtaining access to funds, and the tax consequence of the receipt would ordinarily be of no consequence to the borrower. The borrower's dominant purpose in any given situation might be, for example, a purpose of funding a new mining or petroleum operation. A comparison can perhaps be drawn with the sale and leaseback cases, discussed below at para [130].

87. Equally from the lender's point of view, it might be difficult to conclude that there was a purpose of enabling the borrower to obtain a deduction or to enable foreign tax to be imposed at a rate of 10% or less. The lender's dominant purpose might be a purpose of earning a return on the money advanced.

88. Interesting questions would potentially arise if purposes of other entities were to be considered: could it be said, for example, that the ultimate parent company had a sufficient purpose of enabling a deduction and avoiding foreign income tax, because the combination of those two features of the original loan enable it to drive down its global tax rate? Further, could it be said that the parent company "carried out" the scheme? It is conceivable perhaps that if the scheme were defined as one entered into merely between AusCo, Foreign Fin Co A and Foreign Fin Co B that the ultimate parent would not be a participant. Whether it could be said to have carried it out might depend on the extent of the involvement of it, or its employees, in the affairs of those entities: if the transaction was devised by parent company employed tax managers on secondment to AusCo, for example, or if the restructure was carried out as part of a series of global financing transactions centralising previous arrangements into a single group financing vehicle. In such circumstances the Commissioner might seek to define the scheme as one in which the parent company was in fact a participant.

89. Different facts could lead to different outcomes – a refinancing where the lender is merely an interposed entity, its sole source of funds is equity from the parent company, and the transaction is a "one-off", might well be regarded differently from a case where the lender is a group finance company that accesses a range of funding sources, including external third parties, and its core business is lending money to operating companies within the group in various different parts of the world.

3.2.8 Restructuring of Example 4

90. Example 4 can readily be restructured by refinancing the loan through Foreign Finance Co B, which is assumed to be in a jurisdiction where the tax rate is greater than 10% (but, for the purposes of the example, assumed to be lower than the Australian rate).

91. This is a very straightforward transaction and would readily avoid the potentially draconian consequences of the Integrity Rule in Subdivision 832-J (denial of the entirety of the deduction in Australia).

92. However, it does involve a change of jurisdiction in that Foreign Finance Co B is a tax resident of a country other than the countries of which the original transaction participants were resident.

93. As mentioned above PCG 2018/D4 suggests that one of the assumptions applicable to all scenarios that the ATO regards as low risk, is that "[t]here is no change to the jurisdictions of the entities involved under the replacement arrangement".

94. The change of jurisdiction is the feature that is identified in respect of the restructure in example 3, which results in the conclusion that the restructure is not "low risk". As discussed further below in the author's opinion this is unduly simplistic and it would arguably be a perverse outcome if Part IVA could be applied in facts such as those indicated by Example 4, simply because of the change of jurisdiction of the lender and in particular where the change is from a low (<10%) tax jurisdiction to a higher tax jurisdiction. As discussed below, whether or not Part IVA could be applied requires consideration of very many further matters beyond the fact that there has been a change in jurisdictions.

4 Part IVA and Restructure Examples

4.1 Scheme, and tax benefit consideration

95. In any restructuring transaction that avoids a specific anti-avoidance provision, it seems to me that it is inevitable that there will be a scheme, as defined. Accordingly it is convenient to move to identifying the relevant tax benefit of each restructure.

4.1.1 Examples one to three – a tax benefit is clearly identifiable

96. In the case of examples one to three above, and the contemplated restructures that avoid the hybrid outcomes involving denial of deductions that are presently available, there is also (it seems to me) almost certainly a tax benefit:

    a. Under example one (as restructured) the deduction to HeadCo is available but would not have been available under the anti-hybrid rules if the scheme (assumed to consist of the removal of the foreign members of the partnership and the replacement with resident partners) had not been entered into;
    b. Under example two (as restructured) the deduction to AusCo is available but would not have been available under the anti-hybrid rules if the scheme (assumed to consist of the alteration or replacement of the RPS so as to ensure that the RPS on issue post-restructure have terms of 3 years or less) had not been entered into;
    c. Under example three (as restructured) Ausco obtains a deduction under the scheme (assumed to consist of the refinancing of the RPS with a loan from C Co in a low tax jurisdiction) that would not have been available under the anti-hybrid rules if the scheme had not been entered into.

97. In each of examples one to three above it is unnecessary to consider the "reconstruction" approach to determining whether there is a tax benefit, by making an assessment of what might reasonably be expected to have happened, if the scheme had not been entered into. That is because it is clear that once the restructure is disregarded under the "annihilation" approach of disregarding the scheme, the anti-hybrid rules would deny a deduction. If it were not already the case, s 177CB makes clear that "would have occurred" and "might reasonably be expected to have occurred" are alternatives and in most deduction cases, it will be clear that in the absence of the scheme the deduction would not have been allowable. The real focus therefore is on purpose under s 177D.

98. However, the conclusion that there is a tax benefit is far less clear in respect of examples four and five (example five is discussed further below). That is because the application of the specific anti-avoidance provision that would deny the deduction is far from clear.

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4.1.2 Example four – tax benefit?

99. Under example four, it is assumed that the scheme consists of the substitution of Foreign Fin Co B as lender in lieu of Foreign Fin Co A.

100. The first inquiry is whether there is a deduction allowable that "would not" have been allowable, had the scheme not been entered into or carried out. The deduction is for the interest payable on the loan to Foreign Fin Co B.

101. This raises a significant issue - if it is assumed for the sake of the argument that the Integrity Rule in Subdivision 832-J would not in fact have applied to deny the deduction in respect of the interest payable to Foreign Fin Co A under the original structure, e.g. because it would not be reasonable to reach the purpose conclusion required under new s 832-725, is it viable to contend that that the requirement that the deduction would not have been allowable, if the scheme had not been entered into or carried out, is not satisfied?

102. In other words, if a restructure undertaken out of an abundance of caution to avoid the possible application of Subdivision 832-J was in fact unnecessary, and a deduction would have been allowable under the original structure, can there be a tax benefit?

103. Under the pre-2013 legislation, in my view, the answer would clearly have been no. Although (as the Commissioner notes in PSLA 2004/24) there may be some divergence in the pre-2013 authorities about whether an alternative deduction needed to be of the same kind as that sought to be cancelled, the availability of an alternative deduction could result in a conclusion of no tax benefit:

   a. *FCT v Lenzo*[14] establishes that there will be no tax benefit if the taxpayer can establish that what would have happened, but for the scheme, would have resulted in a deduction of the same kind as the deduction claimed by the taxpayer in consequence of the scheme;
   b. *FCT v Trail Bros Steel & Plastics Pty Ltd*[15] endorsed that approach.

104. As Edmonds J said in *Trail Bros*:

> "[W]hen [s 177C(1)(b)] speaks of 'a deduction being allowable to a taxpayer … where the whole or a part of that deduction … might reasonably be expected not to have been allowable, to the taxpayer', it is speaking quantitatively and is not requiring symmetry between the provision under which the deduction is allowable under the impugned scheme and the provision under which a deduction is allowable under the alternative postulate, before the latter can reduce the quantum of the tax benefit."

105. Post 2013, the issue becomes whether the requirement in s 177CB(2) to conclude that a deduction would not have been allowed "based on a postulate that comprises only the events or circumstances that actually happened or existed (other than those that form part of the scheme)" results in a different outcome.

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[14] (2008) 167 FCR 255: see per Sackville J at 279 [128], with whom Sipois J agreed at 286 [160].

[15] (2010) 186 FCR 410: see per Dowsett and Gordon JJ at 418 [28]; and see Edmonds J at 427 [65]. In my view the Commissioner is wrong in PSLA 2005/24 where he states at [67] that the Full Court decision in *Trail Bros* did not follow *Lenzo*.

106. In the example, ignoring the scheme, the original loan from Fin Co A would have been in place and interest would have been deductible (assuming the non-application of Subdivision 832-J). Under both the scheme and the original transaction, the deduction would have been a deduction of the same kind, i.e. a deduction under s 8-1 for interest. It seems to me that in this instance, there is no tax benefit.

107. Of course, to establish that, the taxpayer would need to negate the hypothetical application of Subdivision 832-J to the original structure. In many cases, because Subdivision 832-J requires an assessment of purpose to be made having regard to a range of factors, the answer may not be clear. If 832-J would have applied, however, it seems clear that there is a tax benefit.

4.2 Assessment of purpose – section 177D

4.2.1 Example 1 – no purpose of tax avoidance?

108. As mentioned above, the Commissioner accepts that the contemplated restructure of example 1 is “low risk”.

109. In PCG 2018/D4 the Commissioner states that the following assumptions apply to all low risk restructuring scenarios:

a. There is no change to the jurisdictions of the entities involved under the replacement arrangement.
b. The original arrangement makes commercial sense for the parties involved (in that prior to the restructure it would not have attracted the application of Part IVA of the ITAA 1936).
c. The replacement arrangement makes commercial sense for the parties involved.
d. The restructure and replacement arrangement are effected in a straightforward way having regard to the circumstances.
e. The restructure and replacement arrangement are implemented on arm's length terms.
f. The replacement arrangement is otherwise tax effective. That is, disregarding the potential application of Part IVA of the ITAA 1936, the replacement arrangement preserves a tax benefit. Whether a tax benefit actually exists under a replacement arrangement depends on whether an amount remains deductible or non-included.

110. With respect to the authors of PCG 2018/D4, those criteria bear no necessary resemblance to the criteria that a Court required to assess purpose under s 177D would be required to apply. The criteria that Courts and Tribunals considering Part IVA are required to apply, and the criteria that the Commissioner is required to apply, are those set out in s 177D(2) of the ITAA 1936. If a judge were to take the factors identified in PCG 2018/D4 into account, in substitution for those in s 177D, there would be little difficulty in persuading an appellate court that he or she had misdirected himself or herself.

111. In addition, it is clear that, but for the “scheme” comprising the restructure, the deduction in Australia available to Head Co would be disallowed under the anti-hybrid rules. That deduction, subject to the application of Part IVA, is preserved by a restructure carried out between related

parties that results in no changes to the ultimate beneficial ownership of any assets. Those sorts of features might in other circumstances lead the Commissioner to conclude that Part IVA does apply.

112. In particular, at least some of the factors identified in s 177D(2) might point to a dominant purpose of obtaining the tax benefit in the form of the preservation of the Australian deduction to Head Co:

   a. *the manner in which the scheme is entered into or carried out (s 177(2)(a))*: as mentioned, the "scheme" is carried out by altering the interests held in Aus LP in a manner that effects no change to the ultimate beneficial ownership of the underlying assets. Presumably the "scheme" would be carried out in a series of pre-ordained carefully planned steps. On the other hand, the scheme involves changing the assets held by the Australian head company;
   b. *the result in relation to the Act that, but for Part IVA, would be achieved (s 177(2)(d))*: the "scheme" preserves an Australian deduction that would be eliminated, but for the restructure, unless Part IVA applies to deny it.

113. However, the restructure is consistent with the apparent objective of the anti-hybrid rules and as noted above, the Anti-Hybrid EM recognises that parties may wish to restructure their arrangements.

114. Overall it would be a perverse outcome for Part IVA to be applied to the restructure of Example 1, where at a macro level the tax consequence of the restructure to avoid application of the anti-hybrid rules is that globally the group's effective tax rate is likely to be increased due to the loss of the deduction in Country B. However if, as seems intuitively correct (and as the Commissioner accepts) the restructure is in fact low risk, it cannot be so for the reasons suggested in PCG 2018/D4. Rather in the author's opinion, application of Part IVA and in particular assessment of purpose under s 177D must be determined having regard to the criteria in s 177D itself. Significantly, those criteria include, in s 177D(2)(f) and (g):

> "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"
>
> and
>
> "any other consequence for the relevant taxpayer, or for any person referred to in paragraph (f), of the scheme having been entered into or carried out".

115. Consequences and changes in financial position would include:

   a. Head Co would remain entitled to its deduction for financing costs, which ordinarily are deductible;
   b. Head Co would avoid triggering the specific anti-avoidance rules;
   c. The non-resident partners in Aus LP lose a deduction in Country B (but they also lose an interest in the partnership, which is acquired by the Australian Head Co);
   d. The ultimate holding company's effective global tax rate may go up; and consequently its cost of business goes up.

116. The factors identified in paras (c) and (d) above are interesting in that they have tax consequences: but they are probably neutral in relation to whether there is a relevant purpose of tax avoidance, bearing in mind that the purpose question requires consideration of whether there is a purpose of obtaining the <u>relevant</u> tax benefit, i.e. the deduction <u>in Australia</u>, in connection with the scheme. The fact that a deduction overseas is lost, and that the head company's overall tax rate goes up, arguably does not shed any real light on whether there was a purpose of obtaining a tax deduction in Australia. Having said that, the consequence to the ultimate head company of its overall tax rate going up, is a factor that would be pointed to in order to argue that the consideration of consequences for persons other than the taxpayer, tends against the conclusion that there was a dominant purpose of any entity of obtaining a tax benefit in connection with a scheme. Further, in Australia, the Head Co acquires new property.

117. In the author's view, on the basis that this transaction is low-risk in relation to Part IVA, a significant reason for that being the case is that the transaction maintains the availability of a legitimate, existing deduction, results in no change to the underlying ultimate ownership of the group's assets, and is carried out in a manner that avoids triggering the anti-hybrid rules.[16]

4.2.2 Example 2 – no purpose of tax avoidance?

118. As mentioned above, in the author's view it would be wrong to apply the criteria identified in PCG 2018/D4 in order to determine whether Part IVA applies, to the exclusion of the factors identified in s 177D. However, if the Commissioner is intending to apply such criteria then they ought to result in the conclusion that the restructure involving the substitution of 3-year bonds for longer term instruments that would result in the denial of a deduction in Australia, is low risk. Taking each criterion identified by the Commissioner individually:

a. There is no change in jurisdictions;
b. The original arrangement makes commercial sense, i.e. prior to the restructure Part IVA would not have applied: the transaction was a simple provision of finance to a wholly-owned subsidiary by means of RPS;
c. The replacement arrangement makes commercial sense – this criterion is highly subjective. However, the replacement arrangement continues the provision of finance from the parent company, albeit with a preference for shorter term funding;
d. Whether the restructure and replacement arrangement are effected in "a straightforward way" would need to be considered. However, it would certainly be possible to do so;
e. Whether the restructure and replacement arrangement are effected on arm's length terms would also need to be considered. Three-year interest rates may differ from longer term rates, so the terms would need to reflect that, but it would certainly be possible to implement the arrangement on arm's length terms;
f. The replacement arrangement is otherwise tax effective: in this instance, that is the case because leaving aside questions as to the application of Part IVA, interest on RPS in a funding arrangement such as this would ordinarily be deductible.

119. Thus, adopting the approach in PCG 2018/D4, the application of Part IVA should be "low risk".

[16] This could also be considered under s 177D(2)(a), "the manner in which the scheme was entered into or carried out".

120. Without going through each of the criteria in s 177D(2) (which of course, one would need to do in the event of needing to consider an actual transaction), it seems to the author that at least some of the same features as identified above in relation to example 1 as tending against a relevant purpose of tax avoidance are also present. In particular:

   a. Aus Co would remain entitled to its deduction for financing costs, which ordinarily are deductible;
   b. Aus Co would avoid triggering the specific anti-avoidance rules.

121. What differs from example 1, however, is that whereas the restructure under example 1 resulted in the loss of the overseas deduction, and thus the hybrid "double deduction" outcome was eliminated, adopting 3-year terms in example 2 enables the deduction/non-inclusion mismatch to be maintained, albeit for a lesser period of time than may previously have been the case. However, both the legislation and the extrinsic materials make perfectly clear that instruments with 3-year terms or less, are not intended to result in the application of the anti-hybrid rules notwithstanding the fact that there might be a deduction/non-inclusion mismatch. Moreover, the fact that there is an ability to ensure that Foreign Co is not required to include an amount in its assessable income overseas until expiry of the three-year term is not a factor that would point in favour of a conclusion that there was a purpose of obtaining the relevant tax benefit, namely, the deduction in Australia.

122. In circumstances where there are specific provisions directed at perceived tax mischief that do not apply to instruments with terms of 3-years or less, where the Commissioner's criteria in PCG 2018/D4 all appear to be satisfied and where, arguably, the purpose of the arrangement is either:

   a. to ensure the continuity of the non-inclusion requirement in Country B; or
   b. to ensure the availability in Australia, of a deduction for legitimate financing costs, in circumstances where specific legislative provisions targeted at hybrid arrangements intentionally do not apply to instruments with terms of three years or less, and where it is recognised (in the Anti-Hybrid EM) as legitimate to restructure so as to avoid the adverse consequences of the new legislation,

   the better view, it is suggested, is that Part IVA should not apply. Naturally, the specifics of any particular transaction would need to be considered on their merits, but that outcome would seem to follow.

123. Where the legislation contemplates three-year terms as being perfectly legitimate, it seems to me that the choice to adopt three-year terms is one that should not attract the operation of Part IVA simply because the deduction remains available, any more than a choice to lease property because of the availability of a deduction for rental expenses could attract Part IVA. As Gleeson CJ and McHugh J said in *Commissioner of Taxation v Hart*:[17]

> "… the fact that a particular commercial transaction is chosen from a number of possible alternative courses of action because of tax benefits associated with its adoption does not of itself mean that there must be an affirmative answer to the question posed by s 177D. Taxation is part of the cost of doing business, and business transactions are normally influenced by cost considerations. Furthermore, even if a particular form of transaction

[17] (2004) 217 CLR 216 at 227 (paragraph [15]).

> carries a tax benefit, it does not follow that obtaining the tax benefit is the dominant purpose of the taxpayer in entering into the transaction. A taxpayer wishing to obtain the right to occupy premises for the purpose of carrying on a business enterprise might decide to lease real estate rather than to buy it. Depending upon a variety of circumstances, the potential deductibility of the rent may be an important factor in the decision. Yet, if there were nothing more to it than that, it would ordinarily be impossible to conclude, having regard to the factors listed in s 177D, that the dominant purpose of the lessee in leasing the land was to obtain a tax benefit. The dominant purpose would be to gain the right to occupy the premises, not to obtain a tax deduction for the rent, even if the availability of the tax deduction meant that leasing the premises was more cost-effective than buying them."

4.2.3 Examples 3 and 4 – no purpose of tax avoidance?

124. These examples are considered together, because both involve the substitution of a lender, with a new lender in a different jurisdiction; assumed to be a jurisdiction with a tax rate of more than 10%, which ensures that the Integrity Rule in Subdivision 832-J does not apply to the arrangement as restructured.

125. In relation to the fact pattern from example 3, according to the Commissioner's PCG 2018/D4, at [65]:

> "[T]the restructuring is not straightforward and goes further than merely removing the hybrid element of the existing arrangement. In particular it does not accord with one of the assumptions outlined in paragraph 16 of this draft Guideline that there is no change under the replacement arrangement to the jurisdictions of the entities involved in the hybrid arrangement. Accordingly, the arrangement would be considered a higher risk from a compliance perspective."

126. No reason is given as to why a change in jurisdictions is said, of itself, to require a conclusion that a transaction is of a higher risk from a Part IVA perspective than would otherwise be the case. As mentioned previously, whether there is a change in jurisdiction is not one of the matters required to be taken into account in s 177D, although, the fact of the change of jurisdiction might be able to be considered, for example, in considering the manner in which the scheme was entered into or carried out: s 177D(2)(a).

127. It seems to me, that a number of the factors are suggested to lead to examples 1 and 2 being unlikely to attract the operation of Part IVA are present in examples 3 and 4 and the proposed restructures. In particular:

   a. Aus Co (like Head Co in the earlier examples) would remain entitled to its deduction for financing costs, which ordinarily are deductible;
   b. Aus Co would avoid triggering the specific anti-avoidance rules.

128. Restructuring to maintain an entitlement to a deduction for an outgoing that is ordinarily deductible, and doing so by ensuring that the anti-hybrid rules are not infringed, while not otherwise having any consequence on the amount of tax paid in Australia does not – without more – seem to the author, to point to a sole or dominant purpose of obtaining a tax benefit in the form of the deduction. Part IVA requires consideration, under s 177(2)(d), of the result in relation

to the operation of the income tax legislation that, but for Part IVA, would be achieved by the scheme. The result would be that Aus Co would be entitled to a deduction for the cost of debt finance to obtain the use of monies to apply in its business – but in circumstances where an express anti-avoidance provision has recently been enacted that would, if triggered, deny deductions for funding costs that are ordinarily deductible, and where the legitimacy of restructuring has been identified expressly in the extrinsic material, the fact that a deduction is able to be maintained arguably does not have the significance that it might have in other cases. Perhaps this feature may point to a purpose of obtaining a tax benefit, but such a purpose seems to the author to be likely to be regarded by a Court as being outweighed by other factors.

129. Overall it seems to the author that the factors identified in s 177D(2) point to the conclusion that the dominant purpose, objectively assessed, of the persons entering into or carrying out the schemes, was that of providing funding to Aus Co for the purpose of refinancing its existing RPS or facilities, to assist it in funding its Australian operations. Given that deductions may have been denied under the pre-existing arrangements, it might (depending on the facts) be viable to argue that the dominant purpose assessed objectively was to obtain finance on the best terms reasonably available: the fact that the schemes may have resulted in a lower after tax cost of funds than would have been the case if the anti-hybrid measures were applied to deny the deductions altogether does not alter that.

130. A similar analysis in relation to sale and leaseback transactions was adopted in two separate decisions of the Full Federal Court, namely *Eastern Nitrogen Ltd v Commissioner of Taxation*[18] and *Commissioner of Taxation v Metal Manufactures Ltd*.[19] Although the transactions considered in these cases involved the sale and leaseback of assets rather than the refinancing of loans, the following observations of Lee J in *Eastern Nitrogen* 108 FCR at 31-2 are significant and permit argument by analogy:

> "On the facts found by his Honour the 'after-tax cost' of finance was always of importance to the appellant in the conduct of its business, whatever line of finance was under consideration. Due and proper management of the business required assessment to be made of the net cost of finance after taking into account the extent to which any outgoings associated with that cost were allowable deductions from assessable income...
>
> To show that a business which depends upon financiers to provide the recirculating capital needed for the operation of the business, has obtained that finance at a net cost, after taking into account provisions of the Act, that is less than the net cost of obtaining finance by another method, will not, in itself, show that the dominant, ruling or supervening purpose of the operator of the business is to obtain the tax benefit..."

131. Two factors that perhaps attract the interest of the Commissioner to the arrangements are that first, the replacement lender's income is taxed at a low rate; and secondly, it may not be required to account in its income tax return on an accruals basis for the replacement lender's interest income, and dividends paid by the lender to the parent company may be exempt from tax under a participation exemption.

[18] (2001) 108 FCR 27.
[19] (2001) 108 FCR 150.

132. Both of these factors would be able to be taken into account under either or both of s 177D(2)(f) and (g) referred to in para [114] above.

133. It is difficult to generalise, in the abstract and with hypothetical examples, about the conclusions that might be reached on questions such as purpose, which are highly dependent on the particular facts of each case. However, neither factor identified above, alone, points to a sole or dominant purpose – in the author's view – of obtaining a tax benefit in connection with a scheme. It is to be recalled that the tax benefit, if there is one, is "a deduction being allowable to **the** taxpayer". The taxpayer, in example 3, is Aus Co. While it might be said that there was a purpose of ensuring a non-inclusion of income by B Co, that would not be enough. While the Commissioner would be likely to argue that the manner in which the scheme was entered into, involving a low-tax jurisdiction, points to the existence of a necessary purpose, it does not seem to the author that, of itself, the use of a low tax jurisdiction suggests a purpose in this case of obtaining a tax benefit in Australia. The transaction fundamentally involves the provision of finance, and, while there is no necessary dichotomy between "commercial" transactions and transactions that attract the operation of Part IVA, the transaction is not one about which it could be said – unlike the transactions considered in cases such as *FCT v Citigroup*[20] and *FCT v Spotless Services Pty Ltd*[21] - that it does not make sense, absent the tax considerations.

134. Further additional facts may enhance, or detract from, the conclusions that one may reach about the application of Part IVA in any given case. In the facts of example 3, for example:

a. Assume that C Co was in the same country as B Co (so the ATO's concern about changes of jurisdiction could have no possible relevance), but had a carried-forward loss position, or a high base for fixed deductions available to it e.g. depreciation deductions on plant and equipment;
b. Assume, alternatively, that C Co was a group finance company that had a history of lending to other group companies elsewhere in the world, and that it had as its core business, lending money;
c. Further to (b), assume that the re-financing was part of a series of global re-financing transactions, centralising various intra-group company loans into C Co as a single group financing vehicle.

135. In reality, these sorts of considerations and other transaction specific facts are likely to be important.

[20] (2011) 193 FCR 380.
[21] (1996) 186 CLR 404.

5 Thin capitalisation regime and proposed changes

136. Although the focus of this paper has been on restructures of transactions affected by the anti-hybrid legislation, I thought it might be worth providing a further example of a transaction that may have consequences in relation to the use of carried forward losses and under the thin-capitalisation provisions. Before turning to Part IVA it is useful to review briefly the features of the thin-capitalisation regime that are salient for the purposes of the example.

5.1 Thin capitalisation – short overview

137. In very general terms the thin capitalisation regime, which is contained in Division 820 of the ITAA 1997, operates to regulate the amount of debt used to fund the Australian operations of both foreign entities who invest in Australia and Australian entities who invest overseas. The regime operates against a background in which (subject to the operation of the thin capitalisation rules) an income tax deduction is generally allowable for the cost of debt finance (usually interest) but a deduction is not generally allowable for costs associated with raising equity or paying dividends on equity interests. In this environment, all other things being equal, the tax deduction available for debt finance would favour the use of debt rather than equity to fund operations and new projects.

138. The objective of the thin capitalisation rules in Division 820, insofar as they are applicable to Australian taxpayers that carry on business or own subsidiaries overseas,[22] is to ensure that taxpayers do not allocate what the legislature regards as excessive amounts of debt (for which finance costs such as interest would generally be deductible) to their Australian operations, as opposed to their overseas operations for which finance costs such as interest may (also) be deductible, notwithstanding the fact that a derivation of foreign income earned from those operations may not give rise to a tax liability in Australia.[23]

139. The statutory mechanism that was adopted to achieve the objective of limiting the permissible level of debt was to prescribe an amount of “maximum allowable debt” which is calculated by way of comparison with the value of the taxpayer’s Australian assets.[24] If the amount of a taxpayer’s debt referrable to Australian assets (in general, debt other than debt used to fund foreign operations) exceeds the “maximum allowable debt”, then a proportion of the taxpayer’s deduction for financing costs that would otherwise be allowable for income tax purposes is disallowed.

140. As applicable to foreign corporations operating in Australia, the legislation seeks to ensure that foreign owned Australian resident taxpayers do not allocate what the legislature regards as

[22] The Division does not apply to Australian entities that operate only in Australia.

[23] In this respect it is worth noting that at the time that the thin capitalisation rules in Division 820 were introduced, the same amending legislation enacted s 25-90 of the ITAA 1997 which generally permits a deduction for a loss or outgoing incurred in deriving non-assessable non-exempt income from a foreign source (e.g. foreign source non portfolio dividend income that is neither assessable nor exempt, by reason of former s 23AJ of the ITAA 1936 and now s 768-5 of the ITAA 1997).

[24] The Division operates differently from the manner described in respect of Approved Deposit Taking (ADI) institutions, but for the purposes of this paper directed to the resource industry, that may be ignored.

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excessive levels of debt to their Australian operations, which by reason of the deduction for funding costs would have the effect of reducing taxable income in Australia. Again, the legislation operates by imposing an amount of “maximum allowable debt” calculated by way of comparison with the value of the taxpayer’s Australian assets. If the amount of a taxpayer’s debt referrable to Australian assets exceeds the “maximum allowable debt”, then a proportion of the taxpayer’s deduction for financing costs that would otherwise be allowable for income tax purposes is disallowed.

141. In both scenarios the provisions are engaged when the entity's debt-to-equity ratio exceeds prescribed thresholds. By reason of the fact that the maximum allowable debt is able to be calculated by reference to asset values, if a taxpayer relies on what is known as the “safe harbour debt amount” method to calculate its maximum allowable debt,[25] increasing the value of assets held by an Australian taxpayer (or an Australian tax consolidated group), would be expected to increase that group’s maximum allowable debt. In turn this would enable the group to borrow more money without exceeding the maximum allowable debt, leading to the denial of deductions under the thin capitalisation regime, than would otherwise be the case.

5.2 Thin capitalisation – proposed changes

142. The so-called “manipulation of thin capitalisation calculations” was one of the topics focused on by the ATO its 2017 submission to the Senate Inquiry into Corporate Tax Avoidance[26]. The areas of concern identified by the ATO included:

- Taxpayers increasing the value of their total assets by undertaking revaluations of certain assets either for accounting purposes or for thin capitalisation purposes only; and
- Inappropriate calculation of debt values for safe harbor calculation purposes.

143. On 1 August 2018, Treasury released draft legislation[27] said to be concerned with “Improving the integrity of the thin capitalisation rules” by ensuring that Australian entities align the value of their assets for thin capitalisation purposes with their value in their financial statements. If enacted, these rules will come into effect from the income years on or after 1 July 2019.

144. Also on 1 August 2018 the ATO released *Draft Taxation Ruling TR 2018/D4* which states that the “debt capital” of an entity for thin capitalisation purposes means any debt interests issued by the entity that are still on issue at that time. This means that an entity’s debt capital must be valued in its entirety in the manner required by the accounting standards.

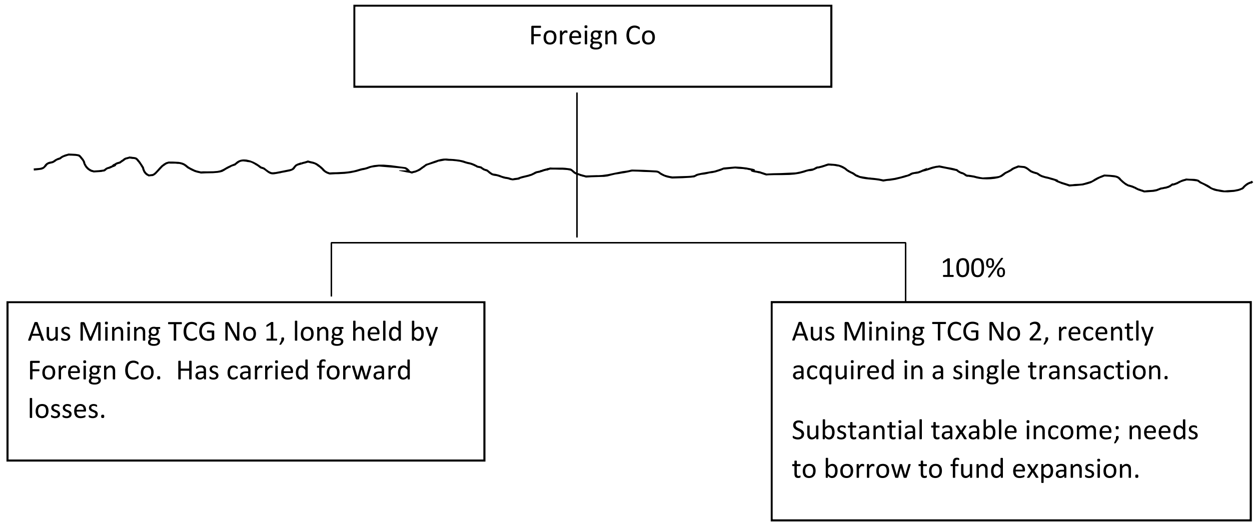
[25] Under s 820-90 and s 820-190 of the ITAA 1997 the safe harbour debt amount, and the calculation thereof, is one of three alternative permissible means by which the maximum allowable debt is reached. The safe harbour debt amount is commonly relied upon and is intended to reflect, broadly speaking, 60% of a taxpayer’s Australian assets.

[26] Senate Standing Committees on Economics, Corporate Tax Avoidance, ATO Submission 139.2, page 14, available at https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Corporatetax45th/Submissions.

[27] Exposure Draft *Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018* No. , 2018.

5.3 Example 5 - thin capitalisation example, and a potential restructure

145. It should be noted in advance that this example isn't strictly concerned with a restructure to avoid the proposed thin-capitalisation changes. It is a more general example of a restructure giving rise to benefits under the thin-capitalisation regime.



146. In this example Foreign Co holds two separate tax consolidated groups both carrying on mining operations for the same commodity in the same part of Australia. Group No 1 was acquired progressively over the last 15 years and is now 100% owned. It has substantial assets and tax losses. Group no 2 was acquired as to 100% in a single transaction more recently (but before Group no 1 was 100% owned, so it could not have been acquired as a 100% subsidiary of Group no 1). It has substantial taxable income.

147. Now that both groups are 100% owned it is proposed to combine the groups into a single consolidated group under a structure with the head company of TCG No 2 holding 100% of the shares in the head company of TCG No 1. Thus, TCG No 1 will be subsumed into TCG No 2 and will cease to exist.

148. This is expected to enable the overall gearing of the group to be able to be increased because TCG No 1's assets (assumed to be purchased for market value) will be able to be considered for thin capitalisation calculation purposes; TCG No 2 needs to take on additional debt to fund expansion and is currently restricted under the thin cap regime.

149. In addition, TCG No 1 tax losses will be available (assuming satisfaction of the same business test) to offset against income generated by TCG No 2.

5.3.1 Example 5 – tax benefit?

150. In example 5 there is a real issue as to whether or not there is a tax benefit, and if so what it is.[28] With TCG No 2 acquiring TCG No 1 and becoming the head company of the new group then arguably there would be, in the form of the deduction for carried forward losses from TCG No 1 that would become available on consolidation (assuming satisfaction of the same business test) to the new group. The scheme in such a scenario would probably need to include the formation of the new consolidated group, and, the making of a choice under s 36-17 of the ITAA 1997 to claim the deduction. Both the choice to consolidate and the choice to claim the deduction are choices expressly provided for under the ITAA 1997. Moreover there might be sound commercial reasons for wanting to streamline the shareholding structure (and doing so would probably facilitate streamlining the management structure) and merge the two wholly-owned groups into one – among other things only one tax return would need to be filed as compared to two previously and there may be commercial synergies able to be realised by having the two previously non-wholly owned groups become a single group with one head company. This would be a conventional transaction, and, although the circumstances would need to be considered, it might be very difficult for the Commissioner to contend successfully under s 177C(2)(b)(ii), that the scheme was entered into or carried out for the purpose of creating the state of affairs necessary to enable the choice(s) to be made.

151. Similarly if TCG No 1 were to acquire TCG No 2 there would also be a real issue as to whether or not there is a tax benefit: the consequence that income from TCG No 2 is now required to be included in the income of TCG No 1 as head company is an intended outcome of the consolidation provisions. TCG No 1 was always entitled to deduct carried forward losses, subject to having sufficient income to enable it to do so. And again, if the tax benefit is assumed to be the deduction attributable to carried forward losses, there would seem to be a strong argument that it was attributable to either or both of the choice to consolidate, or the choice to claim the deduction under s 36-17, both of which are expressly provided for under the ITAA 1997.

152. Alternatively on either scenario, if the tax benefit were said to be the availability of an increased deduction by reason of the combined value of the two groups' assets being available to be considered for the purposes of the application of the thin-capitalisation rules to the newly formed group, there would seem prima facie to be a strong argument that the availability of such an increased deduction is attributable to the choice to consolidate.

153. Examples 4 and 5 are intended to indicate that whereas in most cases, the tax benefit analysis will be straightforward, it should not be assumed to be the case. It is not clear from the judgments in the *Macquarie Bank* decision referred to above, why the taxpayer did not raise the tax benefit issue until the Full Court stage of the litigation – perhaps a decision was taken early on to focus on the other available arguments, which were successful for the taxpayer. In several cases decided before the 2013 amendments, the "tax benefit" analysis was decisive and,

[28] There may also be an issue in the context of consolidation as to which company should receive the Part IVA determination and assessment and arguably there are conflicting authorities on this point: the *Macquarie Bank* Full Court decision (2013) 210 FCR 164 is probably inconsistent with the Full Court decision (comprising a 5 member bench) in *Channel Pastoral Holdings Pty Ltd v FCT* (2015) 232 FCR 162. It is beyond the scope of this paper to consider that issue.

notwithstanding the amendments it is suggested that in circumstances such as Examples 4 and 5, depending on the facts, the tax benefit analysis may still be decisive.

154. Notwithstanding that, in most cases, Part IVA will turn on the purpose assessment under s 177D. The extrinsic material to the 2013 amendments states expressly that the purpose assessment is intended to be “the fulcrum” around which Part IVA operates.

5.3.2 Example 5 – no purpose of tax avoidance?

155. In example 5, combining the two groups, electing to consolidate and choosing to claim a deduction for carried forward losses would need to be regarded as part of the “scheme”, because it is those activities that result in the potential tax benefits.

156. However, those acts of themselves (which would be considered in assessing the manner in which the scheme was entered into or carried out under s 177D(2)(a), and/or under s 177D(2)(e), (g) and (h) in considering changes in financial position, other consequences, and the nature of connections between the entities), are not all acts that could necessarily be said to point to a dominant purpose of obtaining a tax benefit: for example, there is nothing untoward of itself, in choosing to form a tax consolidated group. This may have the consequence that tax losses can be used (or that a higher deduction becomes available for financing costs without infringing the thin-capitalisation limits) but the consequence of a transaction is a fundamentally different thing, in many cases, from the purpose of it. One of the fundamental objects of the consolidation regime is to reduce compliance costs and remove complexity: the manner in which the scheme is assumed to have been carried out would be consistent with a dominant purpose of reducing compliance burden, as only one tax return would be required moving forward. Combining the two groups in the manner suggested may also, for example, facilitate streamlining management functions, and, potentially, rebranding or otherwise integrating the operations; or simplifying accounting practices.

157. In this respect the restructuring transaction is one that might be regarded as reflecting broader commercial objectives, unlike Part IVA cases that have concerned restructures that are explicable only by tax outcomes. An example of such a case, where the taxpayer lost, is *British American Tobacco Services Australia Limited v FCT*.[29] Interestingly, that was a case where tax losses were able to be used by the transferee of certain assets that attracted a CGT roll-over. The tax-benefit however that the Commissioner relied on was not the ability to use the tax losses, but the non-inclusion of a capital gain on the disposal of the assets that attracted the roll-over.[30]

158. The disposal of the brands by BATAS was necessary, i.e. it had to happen, because as part of a merger of the British American Tobacco group of companies and the Rothmans group of companies, BATAS was required by undertakings given to the ACCC to divest certain tobacco brands. Following the merger, it sold the brands to a member of the Rothmans Group with which it had merged, which then on-sold the brands for the same price to companies within Imperial

[29] (2010) 189 FCR 151.

[30] The trial judge had taken into account the ability to utilise tax losses in the assessment of purpose in the context of considering changes in financial position, other consequences, and the nature of connections between the entities under s 177D(b)(vi), (vii) and (viii), now s 177D(2)(d), (g) and (h). The Full Court held that the trial judge had been correct to do so.

Group (which was unrelated to the British American Tobacco group or to the Rothmans group). BATAS obtained rollover relief for the capital gain made on the sale to Rothmans; the Rothmans company which on-sold the brands was able to offset its capital gain by utilising tax losses.

159. The Commissioner contended that Part IVA applied, identifying as the scheme, a number of steps including the decision to interpose the Rothmans company between BATAS and the Imperial company which ultimately acquired the brands. The tax benefit alleged was the non-inclusion in the assessable income of BATAS of a net capital gain of some $118 million due to the availability of rollover relief.

160. The Full Court unanimously upheld the trial judge's conclusion that the relevant parties who entered into the scheme, did so for the purpose of enabling BATAS to obtain the tax benefit afforded by the rollover. The Full Court said:

> "A comparison between the Scheme carried out and the counterfactual was important in the present case because it revealed that the manner in which the Scheme was formulated and carried out was, when compared with the counterfactual, explicable only by taxation consequences: s 177D(b)(i). Next, that under the Scheme, and the counterfactual, the merger and its commercial benefits (facts relied upon by the Appellant as noted in [49] and [50] above) would have been achieved. Put another way, as the trial judge concluded, it was unnecessary to implement the Scheme to achieve both those objectives – the merger and the commercial benefits identified..."

161. This was consistent with the view that had been taken by the trial judge, that:[31]

> "There was no commercial or legal reason why the disposition to the Imperial subsidiaries of both the 9 Wills Brands and the Rothmans Brands should have been effected from a single vendor, transferor or disposer rather than disposition from separate vendors, transferors or disposers. Precisely the same commercial and legal object could have been achieved without the transfer, sale or disposal by the Taxpayer to Rothmans followed by transfer, sale or disposal by Rothmans to the Imperial subsidiaries."

162. Had there not been an obligation to dispose of the brands,[32] or had there been evidence of a particular commercial or legal explanation (other than to attract a benefit of rollover relief) for the structure involving the sale and immediate on-sale, the result may well have been different.

163. Coming back to example 5, an ability to demonstrate broader commercial considerations such as reducing compliance costs or streamlining reporting structures or accounting procedures or facilitating rebranding would result in the example clearly being distinguishable from the *BATAS* case or other transactions, including *Spotless* and *Citigroup* where, as the courts observed, the transactions made no sense absent tax considerations.

164. It is significant also, in the case of example 5, that the "form and substance" are likely to be identical: s 177D(2)(b). Again, this tends against a conclusion as to the existence of a relevant

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[31] *British American Tobacco Australia Services Limited v Commissioner of Taxation* [2009] FCA 1550 at [89].

[32] The counterfactual relied on was that had BATAS not entered into the scheme, the brands would have been sold by way of a direct disposal to the Imperial Group.

purpose of obtaining a tax benefit. The form and substance are both features that may enable broader commercial objectives to be achieved, i.e. reduced compliance burdens, etc.

165. In *FCT v Macquarie Bank Ltd*, Middleton and Robertson JJ (with whom Emmett J agreed on this issue), said at 235 [263] that:

> "We understand this criterion to relate to whether there are material differences between the form and substance of a scheme – one example might be where a comparison of the form and substance of a scheme reveals that despite its form, in reality, it is effectively a sham… We consider that this criterion requires a direct evaluation of the extent to which the form of the scheme adopted matches the outcome achieved."

166. Clearly, depending on the facts of the transaction and the surrounding circumstances, different conclusions might be reached as to the relevance of the factors required to be considered under s 177D(2)(c) to (h). And as already noted, the fact that a transaction may have "commercial" outcomes does not preclude a conclusion that Part IVA can apply. This was made clear in *Spotless* itself, where the High Court said:[33]

> "A particular course of action may be … both 'tax driven' and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine the answer to the question whether, within the meaning of Pt IVA, a person entered into or carried out a 'scheme' for the 'dominant purpose' of enabling the taxpayer to obtain a 'tax benefit'."

167. That passage is well known and often cited. What is less frequently recalled, however, is that the High Court had earlier said that in that case:[34]

> "[W]hat might be seen as the commercially unattractive aspects of [the transaction] would be more than offset if the interest were exempt from income tax in Australia. As will appear, it was this collateral tax advantage which provided the key to the whole transaction and gave it its particular commercial attraction."

168. In other words, the transaction did not make sense, commercially, absent the tax advantages. The case was one in which the taxpayer company was investing funds on deposit for the first time in a low tax jurisdiction (the Cook Islands), where it otherwise would have invested the funds in Australia, where the interest rates applicable in the Cook Islands were lower than in Australia (so the pre-tax return would be lower) and where various costs that would not have been incurred had the investment been made in Australia, were incurred, and security arrangements were negotiated. However, the interest from the Cook Islands was exempt in Australia under s 23(q) of the ITAA 1936 and the low withholding tax imposed in the Cook Islands made the after-tax return higher than it would have been, had the funds been invested in Australia at higher rates of interest. That scenario made a conclusion as to a dominant purpose of obtaining a tax benefit, relatively easy to reach: the Court appears to have accepted the Commissioner's submission that "[w]hat was done was a series of acts explicable on an objective basis only by a purpose of obtaining a tax benefit. The commercial advantage … is the obtaining of a tax benefit".

[33] (1996) 186 CLR 404 at 416.

[34] 186 CLR at 412.

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6 Conclusions

169. In restructures carried out that have objectively verifiable commercial advantages or expected advantages, that arise independently from tax advantages, it is likely to be difficult to conclude that the relevant dominant purpose was that of obtaining a tax benefit. While each case of course needs to be considered on its own facts, this is a sensible outcome: Part IVA as introduced was only ever intended to apply to arrangements that are blatant, artificial or contrived.[35]

170. The line may be difficult to draw where the perceived tax benefit arises from a restructure that results in the non-occurrence of an adverse outcome, that arises under new legislation and where the "scheme" involves unwinding a pre-existing transaction that otherwise would be treated differently and more unfavourably than when it was entered into. In circumstances where the legitimacy of restructuring to avoid adverse outcomes has been recognised, and where doing so enables, for example, legitimate pre-existing deductions for funding costs to be maintained, and the commercial status quo as to the after-tax cost of funds to be continued, it would be perverse in many cases to apply Part IVA where a transaction ensures that specific anti-avoidance provisions are not triggered. It needs to be borne in mind that the concept of a tax benefit, and the inquiry as to a purpose of obtaining a tax benefit, is concerned with a tax benefit in Australia.

171. Finally, irrespective of the complexity of the restructure or responses following implementation of any future so-called integrity measures; what remains enduring is the power of contemporaneous documentation to draw upon when a dispute arises. In particular, what often prove most decisive are robust and tested tax risk governance policies, records (such as board minutes and supporting papers) evidencing a very clear understanding of the transactions concerned by those key decision-makers in the organisation, together with contemporaneous business records recording an explanation of the business environment and the specific commercial objectives against which the transactions were implemented. Such evidence is likely to be highly probative to resist a submission that the commercial benefits of a transaction are in fact referrable to the obtaining of a tax benefit.

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16 October 2018

[35] As identified in the Explanatory Memorandum to the Income Tax Laws Amendment Bill (No 2) 1981.

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