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Interpretation 'til your Hart is content …

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The difficulty with interpretation is that it is necessarily a subjective, rather than an objective exercise. No matter what claims are made to the contrary, language and its construction will always involve a level of value judgment. Particularly where the construction of language impacts on the economic activity of commercial parties the biases of decision makers will undoubtedly intrude. Nowhere is this more clearly evident than in the varying interpretations given to Part IVA. Although many are unwilling to admit it (for whatever reason), decisions are not based on objectivity, but rather on a decision maker's view of when tax minimization is proper and when it is improper. No matter, how specific or how general, language is in the area of anti-avoidance, judges will always be the true bearers of power. It is the Courts (particularly the higher Courts), with their inherent biases, that decide in each particular fact situation before them whether or not the taxpayer has gone beyond what is allowed by law - into the dreaded, territory labeled tax avoidance. Accordingly, it is not surprising that Part IVA, like its predecessor section 260, has blurred boundaries. Boundaries, which much like the composition of each bench deciding a particular set of facts, vary. The author would suggest that it is with this (surely considered by some radical) view of language and interpretation in mind that the recent High Court's decision in Hart 's case should be viewed.

The issue

The issue before the High Court in Hart's case was whether the general anti-avoidance provisions in Part IVA of the Income Tax Assessment Act 1936 (Cth) (ITAA 36) applied to disallow tax benefits obtained by taxpayers under what has become known as "split loan facilities". In the past, such facilities have generally been marketed to taxpayers by virtue of their associated tax benefits.

The law

In broad terms, Part IVA applies where considering a particular arrangement and its surrounding circumstances, it may be concluded that the arrangement was entered into for the sole or dominant purpose of obtaining a tax benefit. However, the tax benefit must be one obtained by the taxpayer in connection with a scheme to which the Part applies. In reaching the determination regard must be had to the 8 matters listed in section 177D(b).

The facts

In the 1997 income tax year, the taxpayers entered into a split loan facility to finance the acquisition of a new residence and to refinance their existing residence (to be used as a rental property). In broad terms, the facility worked as follows:

- one loan was used to finance the acquisition of the two assets;
- interest payable was calculated on the one principal amount and only one monthly repayment was required to be made;
- the monthly repayments were credited to that part of the loan which they had used for private or domestic purposes;
- interest charged on part of the loan used to refinance the acquisition of an income-producing asset accrued and was capitalised and compounded.

Further, this interest could be accruing on the investment loan account could be claimed as a tax deduction (simple interest). As that interest was not paid at the time that it accrued or capitalised, interest became payable on the capitalised interest (compound interest).

The effect of the arrangement was that the taxpayer could claim a greater tax deduction for interest on the investment component of the loan than would be the case with the conventional loans where two separate loans, one for private purposes and the other for income producing purposes, had been taken out.

For the 1997 and 1998 income tax years, the taxpayers claimed deductions for the simple interest plus the compound interest. The Commissioner, however, only allowed deductions for the interest that would have been incurred if the repayments had been applied rateably against both accounts. He did not allow deductions for the compound interest or the "further interest".

The Commissioner made determinations under section 177F(1) of the ITAA 1936 in respect of the relevant years of income cancelling tax benefits alleged to have been obtained by the taxpayers in connection with a scheme to which Part IVA applied.

The High Court's decision

The High Court unanimously finds in favour of the Commissioner holding that the dominant purpose of the taxpayers' in entering into or carrying out the scheme was to obtain a tax benefit. The Court reaches its decision by delivering 3 different judgments – two joint judgments, one by Gleeson CJ and McHugh and one by Gummow CJ and Hayne J and a single judgment by Callinan J.

The joint judgment of Gleeson CJ and McHugh J

Before proceeding to an analysis of whether the arrangement was entered into for the required dominant purpose, their Honours focus on 2 other aspects of Part IVA, namely:

- the meaning of tax benefit (paragraph 2); and
- the definition of scheme (paragraph 5).

Tax benefit and scheme

According to their Honours, in determining whether a tax benefit was obtained in the case before them the correct comparison to make was between a standard financing arrangement and the wealth optimizer structure. Therefore, in their view, the identification of the tax benefit and identification of the scheme were interrelated (paragraph 6). In particular, the features that distiguished the wealth optimizer

structure and the standard financing arrangement were indicative of the scheme in connection with which the tax benefit was obtained (paragraph 6).

Gleeson CJ and McHugh J resort to the well-known “but for” test to determine the choice the taxpayer would have made absent the availability of the “wealth optimizer structure”.

Their Honours then proceed to note that where the tax benefit in question is an interest deduction, the search for the purpose of the scheme, identified in a manner that does not include the borrowing, is not an undertaking that conforms with the requirements of the legislation (paragraph 9). In a given case, a wider or narrower approach may be taken to the identification of a scheme, but it cannot be an approach that divorces the scheme from the tax benefit. In the case before them, the borrowing was an indispensable part of that which produced the tax benefit. A description of the scheme that did not include the borrowing would not make sense (paragraph 9). In coming to such a view, their Honours are clearly engaging in an interpretative exercise.

It was the tax benefit so obtained, and applied in reduction of the home loan, that was the wealth optimising aspect of the structure. It was the wealth optimising aspect of the structure, not divorced from the borrowing, but giving the borrowing its distinctive character, that constituted the scheme (paragraph 12).

Dominant purpose

Gleeson CJ and McHugh J conclude that the split loan facility depended entirely for its efficacy upon tax benefits generated by arrangements between the taxpayers and the lender that had no explanation other than their fiscal consequences (paragraph 18). They hold that: “What "optimised" the respondents' "wealth" was the tax benefit earlier described: not the deductibility of interest as such; but the deductibility of additional interest on loan account 2 contrived by the particular form of the borrowing transaction.”

The difficulty with such an observation, however, is that it could be made in relation to arrangements that traditionally would not be considered tax avoidance.

Is there any room for tax minimization at all?

In contrast to their view on split loan facilities, in Gleeson CJ and McHugh J's view, if a taxpayer takes out 2 separate loans, and the terms of the loan for the investment property are different from the terms of the loan for the residential property in that they provided for a higher ratio of debt to equity, and for payments of interest only, rather than interest and principal, during a lengthy term, then "ordinarily" such an arrangement would not breach Part IVA (paragraph 3). In other words, in their Honours' (subjective) opinion, tax minimization opportunities arising from such arrangements would "ordinarily" (but perhaps not always) be acceptable.

In fact, their Honours go so far as to suggest that how could a borrower, acting rationally, fail to take it into account the taxation implications of such arrangements? Therefore, by contrast to the judgments of the rest of the High Court, from their Honours judgment it would appear that the rational commercial decisions of a taxpayer have a bearing on whether or not Part IVA applies to a particular fact scenario (paragraph 3).

Moreover, in their judgment, their Honours note that the fact that a particular commercial transaction is chosen from a number of possible alternative courses of action because of tax benefits associated with their adoption does not of itself mean that Part IVA will be breached. Interestingly, their Honours acknowledge that "taxation is part of the cost of doing business, and business transactions are normally influenced by cost considerations" (paragraph 15). This begs the question, why could this not be said of the Harts - weren't the they simply considering all of the costs of doing business of which tax was an important one.

However, even where a scheme advances wider commercial objectives (paragraph 16), there will be tax avoidance where that is the dominant purpose of the transaction (paragraph 17). While this can be easily stated, the difficulty lies in determining before a particular scheme is entered into whether the fact that the scheme carries

with it significant tax advantages means that the dominant reason why it has been chosen is to obtain tax benefits. Particularly also where there are clearly other commercial reasons for entering into the scheme.

The joint judgment of Gummow and Hayne JJ

Gummow and Hayne JJ take a wholistic approach to the interpretation of Part IVA. However, in their view the pivotal sections on which the Part turns are sections 177D and 177F (paragraph 37).

Scheme

According to their Honours, the Commissioner's discretion in Part IVA does not depend on the formation of an opinion (paragraph 42). Their Honours consider the very breadth of the definition of scheme as consistent with the objective nature of the inquiries that are to be made under Part IVA (paragraph 43). With respect, this claim to objectivity for an inherently subjective exercise is rather difficult to comprehend.

Their Honours disagree with the Federal Court that "robbed of all practical meaning" can be treated as a test in deciding whether there is a scheme to which Part IVA applies. In their Honours view:

- it is far from clear what legal test is intended by saying that a scheme must "stand on its own feet". It is not clear how the metaphor is to be translated into legal principle.
- the words "robbed of all practical meaning", were adopted from a very different context and with a clearly intended meaning; and
- most importantly, there was no basis to be found in the words used in Part IVA for the introduction of a criterion additional to those identified in the Part itself (paragraph 47).

In contrast to Gleeson CJ and McHugh J, their Honours completely dismiss the idea of looking at what taxpayers consider in making rational commercial decisions (paragraph 51). However, the approach of Gleeson CJ and McHugh J is to be preferred. An interpretation of Part IVA that ignores commercial decision making has the potential

to stifle economic activity as most commercial decisions necessarily involve an element of tax minimization. More frequently than not also tax minimization will be an important consideration.

Luckily for taxpayers, their Honours acknowledge that the mere fact that a taxpayer pays less tax, if one form of transaction rather than another is made, does not demonstrate that Part IVA applies. Simply to show that a taxpayer has obtained a tax benefit does not show that Part IVA applies. However, their Honours show reluctance to adopt an approach to the interpretation of Part IVA that ensures that "ordinary" transactions do not breach Part IVA. According to their Honours such an approach would turn entirely on the meaning of "ordinary" (paragraph 53). Again, their Honours' fear of subjectivity is concerning and its basis unrevealed.

The Commissioner's wider and narrower scheme

Their Honours agree that the Commissioner's wider scheme was a "scheme" (paragraph 55). The steps involved in the Commissioner's wider scheme were as follows:

- the marketing of the loan to the respondents;
- splitting the loan;
- acceptance by the lender's agent of capitalisation of interest on that part of the loan used for investment purposes on the basis that it received another predetermined amount in reduction of the home loan portion;
- the respondents' election to allocate all repayments to the home loan portion until that portion of the loan was paid; and
- the consequential incurring of additional interest (including compound interest) on the investment loan portion.

Their Honours agree also that the narrower scheme identified by the Commissioner was also a scheme. That is, the "scheme" involving "the provision in the loan for the division into two portions and the direction of the repayments to one or other portion and the direction by the [respondents] of the repayments to the home loan portion". That was because they could be identified as a course of action, scheme, plan or

action. In addition, according to their Honours, the narrower scheme formed a part of the wider scheme.

Having agreed with the Commissioner’s identified schemes, the issue for their Honours then became whether, having regard to the 8 factors listed in section 177D(b), it could be concluded that a person who entered into or carried out the wider scheme, the narrower scheme, or any part of either scheme, did so for the dominant purpose of enabling the respondents to obtain a tax benefit in connection with the scheme? All 8 matters in section 177D(b) were considered, with neither matter being considered by their Honours as determinative.

According to their Honours the fact that a taxpayer can point to a discernible commercial end has no bearing on the application or otherwise of Part IVA. In this regard, their Honours agreed with the following comments made by Hely J:
"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 in favour of the taxpayer whether, within the meaning of Pt IVA, a person entered into or carried out a 'scheme' for the dominant purpose of enabling a taxpayer to obtain a tax benefit."
Their Honours take the view that Part IVA does not require, or even permit, any inquiry into the subjective motives of the relevant taxpayers or others who entered into or carried out the scheme or any part of it (paragraph 65). Taken to its logical conclusion, such an approach would mean that even where taxpayers are completely unaware of the tax benefits associated with a particular scheme they may still be found to be in breach of Part IVA. Is this what their Honours intend?

Their Honours conclude that:
“There could be no doubt … that the terms on which the loan was made available were explicable only by the taxation consequences for the respondents. If the scheme was identified as all the steps leading to, and the entering into, and the implementation of the loan arrangements the manner in which that scheme was entered into strongly suggested that the respondents (each a relevant taxpayer) entered into that scheme for the dominant purpose of obtaining a tax benefit. Further, if the scheme was identified in this way, the respondents, by giving the

directions they did, carried out the scheme for that same dominant purpose." (paragraph 68)

The single judgment of Callinan J

From the outset, Callinan J notes that "the inescapable purpose of the Wealth Optimiser was … to facilitate the repayment of a loan to be used not exclusively for the derivation of income but so as to derive the maximum tax benefits possible" (paragraph 76). One thing made clear from a reading of Callinan J's judgment, is his Honour dislike of the scheme's tax minimization purpose.

To substantiate his judgment, Callinan J begins by quoting extensively (or perhaps over-extensively, as the quote spans an overwhelming 7 pages) the Explanatory Memorandum to the Income Tax Laws Amendment Bill (No 2) 1981 (Cth) which introduced Part IVA.

Scheme

Drawing on the Explanatory Memorandum, and by reference to the legislative provisions, Callinan J concludes that there was a "scheme" on the facts before him. In fact, in his Honour's view, there were a number of different ways that could result in a scheme within the provisions (paragraph 89).

Tax benefit

According to Callinan J, the tax benefit was "obvious". That is, a deduction from each respondent's taxable income of the whole of the interest payable in respect of a loan to finance not just the acquisition or holding of an investment property but of both it and a residence, the interest on the financing of which is not tax deductible" (paragraph 91).

Consistently with the opinion of Gummow and Hayne JJ, Callinan J is also of the view that all 8 of the matters in section 177D(b) need to be considered. Considering in particular the factor in section 177D(b)(ii) his Honour concludes that it was:

"inevitable in fact that a court [would come to the conclusion that it did], that the respondents entered into a scheme for the [dominant] purpose of obtaining a tax benefit. What other purpose or purposes could have made commercial or other sense?"

Although "inevitable", it is surprising that 3 judges of the Federal Court came to a different conclusion on precisely the same set of facts.

Conclusion

While there may be a benefit to having a general anti-avoidance provision in the income tax context, its scope and operation depends entirely on how it is interpreted from time to time and from person to person. For certainty's sake, if for no other reason, aspirations for objectivity are to be admired. However, such aspirations represent little more than deception when quite clearly, judges of different courts and of different socio-political persuasions are inclined to interpret provisions differently. An acknowledgement of the problems in interpreting Part IVA, followed by a genuine attempt to interpret them in a manner that encourages both commercial activity and prevents excessive tax avoidance is to be preferred. Where the line is drawn in each specific case is a matter left for judges. The problem then becomes how decisions that begin as fact specific can be widened into principles of general application. From that problem, stems the dilemma faced by tax practitioners in advising taxpayers before entering into such arrangements. Particularly is this so when such arrangements are not only entered into for tax reasons, but there are also legitimate commercial reasons for entering them.