CONSEQUENCES OF ANTI-AVOIDANCE PROVISIONS FOR BANKERS

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SYNOPSIS

1. What are the "anti-avoidance provisions"? In one sense, practically the whole Act! But especially, perhaps, sections 46A-46E, 50A-N, 51(6), 80-80F, 82HK-KL, 121F-L, 136AA-AG, 159GZA-GZX, 160APHA and 160AQT(1)(d), 177A-G, 221YHAAA-YHAAE, 254-7, and section 260, for a start.

2. Strangely enough, most of these provisions were enacted when it was thought that section 260 was a dead letter, and the recent judicial resurrection of that section would have made them largely unnecessary if section 260 had not been terminated as from 27th May, 1981.

   Part IVA has of course replaced section 260 in relation to schemes entered into or carried out after that date. Its principal limits are:

   (a) it only applies where obtaining a tax benefit was the sole or dominant purpose;

   (b) it is concerned only with tax benefits being either failing to derive assessable income or obtaining allowable deductions.

3. Section 257 is the only one referred to above which in terms relates to bankers. I have never come across it in practice. And there is no authority on it.

4. Section 254 could theoretically have most draconian effects on bankers and others. In practice the Commissioner tempers its width with common sense.

5. In their own affairs, bankers must no doubt pay particular regard to Division 13 (transactions with non-residents otherwise than at arm's length), Division 16E (accruals assessability), Part IVA (tax avoidance arrangements) and sub-section 51(6) (deductions in earning foreign income limited to the income). To these must be added Division 16F (thin capitalisation) for banks controlled by non-residents.

6. As far as customers are concerned, a bank needs to ensure that it:

   (a) does not rely on a security that can be set aside because of tax aspects;

   (b) does not become liable to pay money to a liquidator, etc. in relation to a transaction to do with tax (e.g. under section 129 of the Companies Code: see Re Gasbourne (1984) 8 A.C.L.R. 618; and see Brindle and Hooley, Does Construction Knowledge Make a Constructive Trustee (1987) 61 A.L.J. 281);

   (c) does not lend money to taxpayers without ample security in circumstances where the customer may become insolvent because of tax liabilities. (The numerous provisions under which penalties of up to 200% may be imposed - e.g. sections 224-6 - and the possibility that with self-assessment some or many years may go by before a tax issue comes to a head, are factors to bear in mind here.)

   (d) does not give advice or make representations concerning tax which are negligent - or alleged to be so. See Allan, Bankers' Liability for Financial Advice (1987) 16 M.U.L.R. 213.

7. Obviously, no banker can hope to analyse each customer's true tax position. The best that can be done is the exercise of general banking prudence and extending to the tax field a keen sixth sense (some say it is one of the original five senses, namely that the "smell" test has come back into fashion).

8. Particular things to watch for, however, are:

   (a) round robins;

   (b) transactions that seem to be "pure paper";

   (c) transactions without any commercial purpose; and

   (e) things that seem to be "too good to be true".

   Since the early 1980s there has been a wave of judicial decisions which overturn the accepted wisdom of the 1970s, namely that the features mentioned above were not ordinarily inconsistent with compliance with the legislation which was to be read literally and technically.

9. The difficult contemporary problem is not to identify the outrageous, but to know where the line between "tax-effective" structuring and "avoidance" is to be drawn. Illustratons can be drawn from:

(a) The financing of property so as to "stream" depreciation and like benefits.

(b) Corporate arrangements (e.g. new floats) where large dividends (usually bonus shares) are involved, and preservation of the rebate is essential to viability. (See section 46E and compare with section 177D.)

(c) The organisation of a corporate group so as to "stream" franked dividends to taxpayers who can use them.

(d) Debt defeasance (a term which covers a great variety of quite different situations).

(e) Overseas "non-resident" subsidiaries.

10. A banker need not logically be concerned to inquire as to the tax consequences to its customers of such matters, but in practice it will often be exceedingly difficult for a bank to escape involvement when things go wrong for the customer in a big way: Catt v. Maral Australia (1987) 9 N.S.W.L.R. 639.

PAPER

Thank you Mr Chairman, ladies and gentlemen. The topic "Consequences of Anti-Avoidance Provisions for Bankers" raises immediately, of course, the question of what are the anti-avoidance provisions? And to answer that question I thought something I ought to do is to run through the table of sections at the beginning of the Income Tax Assessment Act and to just see which of them could be said to be anti-avoidance provisions. It was a useful exercise. I really think I know the Act reasonably well, but I came across a number of sections the existence of which I had not previously known, and I also came to the conclusion that really a very large part of the Act can be said to be anti-avoidance in one sense. Of course it all depends on what you mean by "avoidance" and there has been a continuing philosophical question for a long time as to what is bringing yourself within the primary tax law and what is avoiding the application of the primary tax law. It is a question to which there will never be any satisfactory firm answer, it must always be a question of degree and to some extent it is a matter of instinct.

But clearly there are a lot of provisions there that could be said to be anti-avoidance provisions. So many and so wide-ranging that when the Treasurer said, as he did on one occasion: "Well, we are going to have an imputation system, here are the provisions about the law and we will tell you what the anti-avoidance provisions are going to say later", it gave everybody the horrors because the anti-avoidance provisions according to one, at least one approach, and perhaps all approaches, are so much integrated into the substance of the law that it is very difficult to know where one begins and the other ends.

Anyway in paragraph 1 of the synopsis I have set out a range of sections which might be said to be anti-avoidance provisions of one kind or another. I certainly do not intend to deal in any detail with any of them, let alone all of them, but it is useful as an exercise to go through them. And many of those provisions are effectively dead letters - I would hope the ones that I either did not know about or had entirely forgotten about are effectively dead letters, although it may be that that is not right. But certainly some of them are. Many of them one thinks were the whim of a particular period and were enacted for a particular reason and either changes in practice or changes in the law have entirely by-passed them and one need not worry about them any longer. It is trite that tax law changes very rapidly indeed.

One measure of that is that one of the sections I was going to say something about is s.46E which was only enacted very recently, and it is a very complicated and difficult section to deal with and it is certainly an anti-avoidance provision. Broadly speaking it is directed at the problem or at the situation where a company revalues assets and makes a bonus issue out of the revaluation of assets reserve. Now that of course is the standard thing that all public companies and many private companies used to do. In the old days the bonus issue was deemed not to be a taxable dividend because there was a special sub-section in s.44 saying so, but these days it is deemed to be a dividend. However, with the absence of division 7, known as the undistributed profits tax, and the width and expansion indeed of s.46, if company A revalued its assets and made a bonus issue to its shareholders, being companies B and C, the shareholders got a dividend which was taxable but rebateable; and under the capital gains tax provisions they were deemed to have a cost of the bonus shares equal in effect to the amount of the bonus issue and subsequently if they sold those shares they had a cost base and they did not pay tax, in effect, on the amount of the bonus.

Now s.46E has got some very complicated provisions saying that if it is a scheme, then in certain circumstances, you cannot do that any more, and we will deny the s.46 rebate. And one of the interesting things about s.46E is that it does follow the general pattern of Part IVA, the operative sub-section really is sub-s.(12) which is very similar indeed to s.177D. But s.177D says that you are only caught if the purpose, and that is defined to mean the sole or predominant purpose, is to get a tax benefit. Section 46E goes much further because it uses almost all the same words as s.177D but it applies wherever it would be concluded that the arrangement was carried out for the purpose or for purposes that <u>included the purpose</u> of getting a tax benefit. And obviously it is one thing to say schemes where the dominant purpose is a tax benefit will be caught and another thing to say that a thing will be caught wherever one of the purposes is a tax purpose. However, I am inclined to think that s.46E is a dead letter already within a few months of its enactment because the announcement on the 25th of May that unfranked dividends will no longer attract a rebate in the hands of a recipient private company means that a bonus issue out of a revaluation of asset reserve to a private company will be taxable in the hands of the private company anyway, and it would appear that all those elaborate provisions probably no longer have much application. But we will have to wait for the legislation to see, and there may be some other cases that fit within it.

Well that is a graphic illustration of how changeable tax law is but the point is still important to note that there is a big difference between provisions which attack because you have a primary purpose of tax avoidance and provisions which apply even although tax avoidance is merely a subsidiary or partial purpose. Are there many commercial transactions, one may say, of any individual nature, where those engaged do not take into account the tax ramifications of what they are doing? The answer must surely be no, and accordingly there may not be very many things that could pass the scrutiny of a test saying if any part of your purpose was to get a tax benefit then we are going to strike out what you have done.

Section 260 is an interesting example of this question of primary purpose and subordinate purpose. Section 260, of course, was one of those sections which for a while was thought to be a dead letter, the High Court almost expressly said so in Cridland's Case (1977) 140 C.L.R. 330, but it has suffered a surprising and startling resurrection. And its resurrection has gone so far as to say that s.260 properly interpreted applies wherever any substantial purpose, not the dominant purpose, but wherever any substantial purpose, is a purpose of tax avoidance. And one of the remarkable things about the ups and downs of tax law is that we went through various phases. First of all s.260 was thought to be quite a useful tool for the tax man and Newton's case gave it a fairly well settled meaning and most people thought they knew, on either side of the fence, what it meant. Then we had the era in the mid-1970s when first of all I think the Privy Council in the Europa Oil Case 76 ATC 6001, and then the High Court cut down s.260 to the point where in Cridland's Case it was said that "well really, it is about time the Commissioner stopped relying upon it". Then we had a period when nothing happened and everyone assumed that it was too difficult to have a general anti-avoidance provision and that was the era in which we had the proliferation of specific sections such as ss.50A-N, 82KH-82KL and a number of the others that I mention in paragraph 1. Then we had Part IVA come along and Part IVA, I think, from the beginning has been thought to be a very sensible solution to the problem. Thus, of course, when it was first enacted, people said that it was very wide and very broad. However, Part IVA does say that it applies only where the sole or dominant purpose is tax avoidance. Since then we have had the judicial resurrection of s.260 and lo and behold we find that s.260 is and always was far more draconian than Part IVA because s.260 applies where any significant part of the purpose is a tax avoidance purpose. So, it is a very remarkable cycle that indicates that really more is involved than black letter law, to say the least.

Incidentally, Part IVA is seven years old this very day! It applies to any scheme entered into after the 27th of May 1981. It may be due for a seven year itch but so far it has not had very much judicial attention and people who read the law reports might say, "well, perhaps it does not have much effect". But I can reassure Ron Mills and his colleagues, who I am sure know it anyway, that Part IVA is a very important operative practical provision because it is something that has to be considered and is considered over and over again in daily professional life and leads to a knockback being given to all kinds of proposals that are suggested.

Part IVA is, of course, the first provision that comes to mind when dealing with anti-avoidance provisions. I shall not go into the details apart from the general sketch I have given of its background, and I will pass instead to some specific provisions which are of particular interest to bankers.

One of those is s.257 which is one of the sections that I have mentioned that I only found out about for the first time when I read the index of the Act for the purposes of this address. It is a section that deals specifically with the position of a banker. And it says (it was written in the old days so it is quite short): "Where any income of any person out of Australia is paid or any proceeds of the disposal of an asset of any person out of Australia are paid into the account of that person with a banker the Commissioner may by notice in writing to the banker appoint him to be the person's agent in respect of the money so paid so long as the banker is indebted in respect thereof and thereupon the banker shall accordingly be that person's agent."

Now I suspect that is one of the sections that is a dead letter, I have never heard of its application but it might be applied sometimes. What it says, of course, is simply that the Commissioner can tell the banker that that banker is the agent of his customer.

Now one of the questions that I have grappled with from time to time concerns the definition of "agent" in s.6, because from time to time people such as shipping companies have said to me, "well, what is the position of our tax liability in Australia as far as the mechanics of enforcement are concerned, because we really have nothing to do with Australia except that we happen to carry goods there and carry them away and we have somebody called a ship's agent in Australia" (and of course there are special provisions about that). And mining companies have said to me "well we deal with these shipping companies and we pay them money but surely we do not have to vet their tax obligations before we pay them anything do we?".

And one of the things one looks at in this respect is the definition of "agent" in sub-s.6(1). It says there that "agent" includes (a) every person who in Australia for or on behalf of any person out of Australia holds or has the control receipt or disposal of any money belonging to that person and (b) every person declared by the Commissioner to be an agent or the sole agent of any person for any of the purposes of this Act. You may say, well, having regard to paragraph (b) of that definition, which says that the Commissioner can declare anyone to be the agent of somebody else, why do you need s.257 which specifically enables him to declare a banker to be an agent? It may be that the definition of agent in s.6 has to be read down, but in any event it is clear that the Commissioner can say to a banker, "you are the agent for your overseas customer".

Now if in some way or another a banker becomes agent for an overseas customer he is under the obligations contained in s.254 which says that any agent and any trustee basically has to make sure that he keeps in his hands any tax to which the Commissioner is entitled and if he pays it out to his principal without the Commissioner getting the tax then he becomes personally liable to the Commissioner for what he should have retained. It is a very sweeping provision. And s.255 adds to it by saying that with respect to every person having the receipt control or disposal of money belonging to a non-resident who derives income or profits from a source in Australia, the following provisions shall apply: he shall when required by the Commissioner pay the tax due and payable by the non-resident; he is hereby made personally liable for the tax payable by him on behalf of the non-resident to the extent of any amount that he has retained or should have retained; and he is indemnified.

Now the difficulty about all that is that somebody like a banker who has got money owing to non-residents simply does not know all the ins and outs of a non-resident's tax position and he cannot possibly be expected to inquire into them and what really is he to do? I said in paragraph 4 of the synopsis that in practice the Commissioner tempers the width of s.254 with common sense and indeed he does so but it looks as if in this respect as in some other respects he is gradually widening the scope of how he looks at ss.254 and 255. There is a ruling IT354 originally dealing with stockbrokers who are in some respects analogous to bankers in that they owe money to overseas principals and they enter into transactions on behalf of their overseas principals and this ruling says well, we are not going to say that every stockbroker is liable to us under s.254 for not making sure that his customers who become liable to tax, s.26AAA tax or s.26(a) or s.25 income, we are not going to say that they are liable to pay us the tax unless we have actually issued an assessment and given them notice.

Now that is a very reasonable position and one can say that gives clarity and certainty and it means that the stockbroker (or if applied to a banker) does not have to get embroiled in all the arguments about the tax position between his customer and the Commissioner. And that would seem to be a very suitable practical compromise.

But in recent times I gather that s.255 in particular is being applied in many cases where no assessment is issued but well in advance of an assessment. Now I am not saying that the application is unreasonable but one just does not know how far it goes and how far the liability under it, which on the face of the statute can attract in almost any transaction where a banker pays a non-resident an amount due to him, will go. For example, foreign entertainers who come to Australia become liable to Australian tax on their Australian source income and there is quite an efficient system, as I understand it, by dint of co-operation between the immigration authorities and the Commissioner by which the promoters of the concert or whatever it happens to be, get a notice under s.255 saying "well, you must retain so much money for the tax". And that is done before the concert is given so the Commissioner does not wait for an assessment, he does not indeed wait until the income is derived, he gets in first, which is a very sensible approach from his point of view. But one may say if he is authorised to do that, and the words of the section suggest it, then isn't a banker, who pays any amount to any non-resident in any circumstances whatever, liable to be lumbered technically if at the end of the day it is determined that that non-resident owed the Commissioner some tax? So far it is a theoretical problem, but it might one day be a real practical problem.

I pass on in the synopsis from those administrative points to deal with some groups of sections that impact upon a bank's own tax liabilities, but they are so manifold that it might be better to turn without discussing them to a bank's position vis-a-vis its customers, which arises because of what those customers have done in relation to their tax position.

Here a banker is faced with a very difficult situation because, on the one hand, the banker can say to a customer, "my function is to lend you money, what you do with it is your business, what your tax situation is is your business, I want to get on with the business of being a banker, I am not your nursemaid, I am not your tax adviser, you do what ever you like about that, but do not worry me about it because I do not want to get involved". And that would be in many ways a very reasonable approach. But it is a very difficult thing in practice because there are two things to consider which stop it working in practice. The first is the practical point that if a banker says, "I leave the whole of your tax to you, I want to know nothing at all about it", then he is at risk all the time of dealing with somebody who is an incipient insolvent. This is because tax is a terribly important part of everybody's income, cash flow and nett worth, and a banker who is concerned with drawing up, at any particular time, a list of assets and a list of liabilities, has to turn his attention to tax in one way or another. And the second thing is that the courts who ultimately say whether the banker has done something wrong, whether a banker is liable to his client, whether a banker can recover from his client or from some third party, take a rather strict, and in some respects unrealistic, approach. And they say, "well if you knew everything about the customer, you are in the same position as he, if you deliberately refrain from enquiry, that is terribly suspicious and we assume all the worst against you, and if you did not even think about enquiring then that was grossly negligent on your part and once again you must pay the penalty."

So in one way or another the banks hardly ever get anywhere as a result of saying "well, that was all our customer's business and it was none of our business".

To some extent banks are inextricably involved in what their clients do from a tax point of view. And it is clear that many lending projects which the banks are asked to participate in depend in one way or another upon tax. It may be because they will only go into something if it is shown to be financially viable, and it will only be financially viable upon the basis that certain tax deductions or credits are available. They may be engaged in the tax because the whole scheme depends upon selling something to the public in circumstances in which the public who subscribed can get tax benefits. Or it may be that the tax is relevant because a question arises about whether somebody is going to be lumbered with tax arising from a long time ago. And self-assessment, as probably all of you know, means that you put in your return, it is virtually rubber stamped on a tentative basis and it is not for some years that you can have any confidence that, if there is any doubtful item in it, it will surface; and it is not for some years that you can be sure, if it is an arguable point, as to what side of the line the taxman will come down upon. You can ask for special rulings and that takes a long time and there is a disinclination, where something is probably OK, but one can imagine arguments against it, to say to the Commissioner, "we want a special ruling" because obviously there is certain defensive flavour about such a course.

So a banker trying to assess what his client's tax obligations are has quite a difficult task ahead. One illustration of how tax can impact upon a banker's liability is to be found in the <u>Marac Australia</u> case mentioned at the end of the synopsis. It is an interesting case as illustrating how far the courts can go in lumbering a poor old bank for something that is really primarily the responsibility of somebody else. That was a case where people promoted an aircraft purchase scheme six or seven years ago, the promotors got together some syndicates of doctors, dentists etc. who wanted some tax relief, and together they bought some aircraft, they got the investment allowance, the paid interest, they got depreciation and the plan was that the value of the aircraft would go up anyway, and they would end up making a large capital non-taxable commercial gain. And as usually happens with such schemes, everything went wrong - well not quite everything, it is not suggested that there was anything wrong with the tax lurk, and at least on this occasion the tax advantages seem to have worked quite well, but everything else went wrong - and the members of the syndicate complained basically because they had been sold the aircraft at too high a price and the aircraft at the end of the day was not worth what they hoped, so they wanted to get their money back and the only person who had any money was the bank. In financing the transaction the banker had taken some short cuts and had got so involved in the planning of the scheme that it was ultimately held that the banker was in the position of a principal and the banker had to pay. So that is the sort of thing that bankers must avoid.

Now Mr Chairman, you asked me in a letter to address the question, or you asked somebody hopefully to address the question, what should a prudent banker do? A prudent banker would never lend any money at all, he would keep it in his safe deposit box! It is a very difficult question. There is a trade-off between risk and reward, and this is something that the courts, especially the entrepreneurial judges, seize upon. They say "you were in it to make money, you were a go-go banker, you have got to pay the price". Everyone has their own temperamental view as to what is conservative, as to where they should stand on the conservative/go-go entrepreneurial side. If you want to be relatively safe from the courts you have to be cautious and conservative. When in doubt, be cautious and conservative, and often when not in doubt, be cautious and conservative.

Now there are times, there are stodgy times, when it is a good thing to give assistance to the bright spark. And there are times when there is a predominance of the bright sparks and in those times it is better to be conservative. My feeling is that the present times are times of a predominance of the bright sparks. Therefore be cautious and conservative!