CONSEQUENCES OF ANTI-AVOIDANCE PROVISIONS FOR BANKERS

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Thank you Mr Chairman, ladies and gentleman. I should own up initially, I think, to say I was the one person who put up my hand last night to interrupt your after dinner speech; but I could not resist the temptation!

The topic of course is "Consequences of Anti-Avoidance Provisions for Bankers". I had to check that topic, before I accepted Mr Bostock's invitation. I thought it may have been getting the words mixed up and perhaps the title was "Avoidance of Tax Consequences for Bankers!" But I am very pleased to be able to address you today.

When I mentioned to a colleague that I was going to follow the addresses of two Queens Counsel this afternoon, he suggested I might be able to play the role of a judge. Well, I have given up that idea. I am glad I decided to wear a suit though because I feel more like a defendant!

I thought it would be a good idea for me today to give you some idea of the practical side of tax - some of the things that are happening, and touch on some legal aspects of avoidance. I want to stress that I am talking about tax avoidance rather than tax evasion. And I do see evidence, nearly everyday, that some people regard those terms as being much the same. We have had some good suggestions put forward. Tax planning, tax minimisation. From New Zealand and the Privy Council we have a new introduction - tax mitigation. We have had some ugly hybrids put in - tax evadance, tax avoision, and, heaven help us, tax ploision!

Talking briefly on tax evasion I should keep you up to date, at least on one topic, and today seems to be a crucial date for tax matters - 27 May - as Mr Forsyth has reminded us. Our Commissioner today is announcing a tax amnesty. And those of you who read the Melbourne Herald last Tuesday already know all about it anyway. There is an amnesty and I will mention three things about it very briefly, because it is a bit outside today's topic,

but it may be of interest to you and many of your clients. I don't see anybody here today who is really affected by this, but I have a 008 number if anybody wants to find out more!

Seriously though, from today up until the 31st of October, the tax office is declaring a type of amnesty. It will relate to people who dropped out of the system; basically, those that have not been lodging income tax returns. It refers to non-lodgers only - there will be no penalties and no prosecution. There is a proviso; it has to be five years' returns that come in. Our studies show that there could be something like 400,000 people earning over $10,000 per year, who have not been lodging income tax returns.

To turn to the topic though, let us get a clear distinction between avoidance and evasion for the rest of the talk. I am happy to adopt the fairly straightforward but perhaps very simplistic approach of the OECD. They have adopted a distinction that says basically that evasion is referring to illegal actions, cheating if you like, whereas avoidance refers to actions that are legally open to taxpayers.

Recent developments on the administrative side. First of all let us look at some of those. Most of you would be aware, I think, and this is not necessarily good news for you, of plans that we have to beef up the audits of large companies in Australia. The move to self-assessment in 1986, we have found, has made it essential that we concentrate our audit focus on the top end of the market. And, quite frankly, the experience both here and overseas is that that is really where the money is.

Last year the return on investment, and there is no suggestion that we are going private here (there would be some good bids I think), from our large company audits was something like a return of 1900 percent per annum on every dollar we spent on salary on an audit. And this will mean, of course, for a lot of large companies that a tax auditor or even a team of auditors may well be on the bank's premises virtually full-time. And in the United States, of course, this is now common and it has been accepted. We even heard of one tax official over there who became so much part of the firm that when he retired he received a gold watch! An Australian businessman suggested to me that he could easily avoid that problem - he would find a way to give the auditor a s.27F payment, that is a bona fide redundancy!

Like the banking industry we have had to adapt to the reality that we now live in a global village. You might be interested to know that we have got strong practical links with our overseas counterparts. Our tax treaties have always provided a formal mechanism of co-operation, but in recent years we have ensured that we have made much more regular contact with our treaty partners to discuss common problems that arise. We too need to keep up with the state of the art in particular industries.

And the banking industry has not avoided the limelight. In 1984, the OECD, in an interesting publication - "Transfer Pricing and Multi-National Enterprises" - closely examined banking in particular and the taxation issues identified by OECD member countries. The major item, and that arises from your industry's emphasis on the use of branches, was the problem of applying the arm's length principle to loan interest in the context of banks. As many of you would know, that problem is still well and truly with us today and is indeed the subject of current audits.

More recently the Commonwealth Auditor-General made some criticisms of our approach in the tax office to the taxing of banks. In a 1987 efficiency audit he commented on our handling of international profit shifting. That has provoked some strong reactions from your industry to a parliamentary committee that is still looking at that report. And the Chairman of that committee, by the way, mentioned recently that there is a silence around this area - I think he referred to trying to scale the wall of silence - but I do note that the Australian Bankers Association has made submissions.

Section 255 was mentioned earlier and perhaps I will mention that briefly. The Auditor-General has suggested that we should be taking a very wide view of that section. We have indeed received opinions from several senior counsel over the years. Not surprisingly, they differ. But the audit office is saying to us that we must get much tougher on that section. What it does is, as already pointed out, it gives us wide powers to ask people having the receipt, control or disposal of money belonging to a non-resident, to ask them, and there is an obligation on them, to retain moneys even before any assessment is issued. I think that this whole area needs close examination in the light of s.218 and other sections we have heard about from other speakers.

Let us move then, to some specific legislation dealing with tax avoidance. I do not want to spend a lot of time on those topics - they have been mentioned briefly and they are in my synopsis. One is reminded though of Lord Denning's comments in a 1966 case when he referred to the game of tax avoidance and if I could quote he said: "The lawyers have become magicians who perform conjuring tricks ... It has become indeed a game of chess, played by each side with a subtlety and skill worthy of the schoolmen; but in the long run the legislature is bound to win. It can offset all those devices, it can call off the game." Re Holmden's Settlement Trusts [1966] 2 All E.R. 661, 665.

Now that is what has happened, it seems to me, in Australia in recent years. The legislature is changing the rules. The Income Tax Act when I left Canberra on Wednesday evening had reached a million words, I think, and by the time that we incorporate the announcements made that evening, I do not know what we will be up to.

We have looked at some areas today and I do not really want to go into the details Mr Chairman of things like dividend rebates, discounted securities, thin capitalisation rules, foreign tax credit changes and there are others particularly in the leasing area. In fact, I think, to add to a point, other areas such as capital gains, imputation and fringe benefits tax all could be said to be all avoidance measures. I think that is beyond the scope of today's topic though.

The most difficult areas to define are the generally anti-avoidance provisions. The two leaders in our armoury, if your like, are Part IVA and Division 13, and I thought it would be useful just to see what has happened to those two provisions since they were both introduced in 1981.

Dealing first with Division 13 - that, of course, is about international transfer pricing. No cases have yet got to the courts but that does not mean to say that we have not been invoking the provisions. We still see that as a very effective measure to combat transfer pricing and similar arrangements. And we do still think it adequately overcomes the deficiencies that were disclosed in the previous s.136. We have made determinations under the new division and we expect more activity as we embark on the complex audit program. And we are about to issue a general taxation ruling that discusses our general approach to transfer pricing.

Turning to Part IVA - I thank the previous speaker for pointing out the seven year birthday today; I don't know about a seven year itch, but I can guarantee you it is not going on sabbatical leave! We have had some activity with Part IVA. It replaced, of course, the notorious s.260. And it is ironic that on the litigation front there have been more important cases on s.260 than on its progeny. We see these s.260 decisions though, as being very important in the interpretation of Part IVA. I would not agree with the comment that s.260 had "suffered" a resurrection; I would have thought it "enjoyed" a resurrection!

Neil Forsyth mentioned in his paper the accepted wisdom of the 70s and Malcolm referred to the halcyon days of the Barwick court. I think we are really in a new era. The re-emergence of the Lord Denning predication test from the 1958 Newton case, supports what we see is the general approach required by Part IVA. It has to be interpreted on its own terms, of course, but we think the courts will adopt what we think is a firm and positive attitude. It certainly is far from the attitude both here and in England that the late Professor Wheatcroft noted in 1955, one of "uncensorious admiration". (The Attitude of the Legislature and the Courts to Tax Avoidance (1955) 18 Modern Law Review 209.)

We have made determinations under Part IVA. Some of them are on their way to be considered by the courts. In many other cases we have given advice that we think Part IVA will apply to proposed

transactions. Of course, with that advice, taxpayers do proceed at their own risk and it must be remembered that there is additional tax involved in Part IVA matters and we have issued a taxation ruling that discusses that question. (Ruling No. 2312.)

The only case that has really dealt directly with Part IVA is one that went to the Administrative Appeals Tribunal late in 1987. That case concerned an annuity scheme described by the Tribunal as a complex and highly artificial arrangement. An interesting aspect of the case is that although we did not rely on Part IVA in making the assessment, indeed we did not even argue it at the Tribunal, the Tribunal nevertheless found that Part IVA applied. The taxpayers appealed in that case to the Federal Court.

We see the days (which we referred to as "paper schemes") have definitely passed. Today we are called on to look at far more sophisticated schemes. While they are not all artificial, I think some can definitely be described as blatant in their purported effect, and certainly some seem to be contrived, to be as complex as seems possible. We are often told that Part IVA cannot apply if the transaction is motivated by sound commercial considerations, i.e. to make a commercial profit overall. We do not accept that that is so important.

The purpose of s.177D is clearly an objective one and that the test is whether, on the basis of the specific matters that the section lists, it would be concluded that a taxpayer enters the scheme for the sole or dominant purpose to obtain a tax benefit.

I think a lot more attention will be given in the future to the eight listed matters in s.177D. One of them, of course, is the tax result that would follow but for the operation of Part IVA. Another is the form and substance of the scheme. In adopting this approach we have applied Part IVA to several areas. We have issued tax rulings on a lot of these - leverage leasing, you may be aware of, income splitting arrangements with personal services in particular; we have applied the Part in some film industry schemes, trust stripping, some company re-arrangements, where we have seen s.177E as important.

In 1981, our present Commissioner noted that Part IVA has to operate in the real world and not the world of make believe. I think it is important to keep that in mind today as more sophisticated and complex avoidance schemes emerge. The provisions have to be interpreted and applied having regard to current commercial and accounting practices, as well as changing attitudes of the courts.

The terms of Part IVA, as with any other piece of legislation, have to be interpreted according to the words that Parliament has adopted. The Second Reading Speech, of course, is available to help us there.

One important factor I want to mention under Part IVA is that we do not accept that a tax benefit cannot arise just because the scheme might result in one form of income being substituted for another. Taxation Ruling 2456 addresses this in detail. The inclusion of income, for example, in the form of dividends or trust distributions or any other form, does not mean that there is no tax benefit if some other amount has been left out. As the ruling points out, the crucial test for Part IVA, we see, is whether or not the objective test of s.177D is met. We see Ruling 2456 as breaking new ground - it certainly has caused some controversy already - but we think that it will provide a very effective tool in challenging arrangements, particular those that try to substitute one form of income for another. For example, assume a company faces a liability if it receives payment for assets it owns - perhaps a s.26(a) or s.25 situation.

If a tax avoidance scheme results in the company receiving dividends rebateable under s.46 in lieu of that payment, we say that a tax benefit within the meaning of the section can arise. The reasoning is spelt out in the ruling; the important thing is that paragraph 177C(1)(a) focuses on what has been left out of assessable income, not on what is included. So these are some general considerations that we take into account.

Time constraints, Mr Chairman, mean that I perhaps should start winding up. One point I would like to make about Part IVA is that it emerges clearly that it is a provision of last resort. It is surprising how in many cases the tax result is determined by other provisions of the law, without even getting to Part IVA.

Debt defeasance - we have issued a draft ruling this week for comment to the professions etc. and we do treat a gain on defeasing a debt as assessable and we see the Myer case as supporting that approach. In the recently released exposure draft by the accounting bodies on the standard it is interesting to note that the standard specifies that gains or losses on defeasance should be brought to account immediately in the profit or loss account or its equivalent. But let me stress that it is very difficult to make general rules in this area. The press this week noted that there are as many types of defeasance as there are accountants.

We have looked at margin lending whereby some part of a lender's return for providing finance might be satisfied by the way of dividends on shares that are registered in the lender's name. We see the substance of these arrangements as a lending transaction, in fact a legal mortgage. Depending on the facts the principles in Ruling 2456, as I mentioned, could apply.

A term that causes us some concern is "tax effective financing". If it means the arrangements in question are effective for income tax purposes, it is OK, assuming of course the view is ultimately shown to be correct. On the other hand if it means the

arrangement is not feasible unless the tax savings contemplated are in fact available, then a warning, I think, needs to be sounded. If it so blatantly dependent on tax benefits, perhaps the objective test required by s.177D may not be too difficult to meet.

We are looking closely at some complex arrangements that are designed to trade tax benefits from an entity that cannot use them across to one that can use them. But I think I would have to agree with the comment that was made by Neil Forsyth in his paper/synopsis, that the problem is not so much to identify the outrageous but where to draw the line.

Mr Chairman, I want to mention very briefly details of rulings of proposed transactions. We are about to issue a tax ruling that addresses the question. We are going to insist that Part IVA requests do indeed address the various matters that the legislation requires us to have regard to. In the language of our present locality we would be saying "well, not only must you place the cards on the table, but they have to be placed face up!".

I conclude therefore with a quote. How much easier might it all be for us if in Australia we philosophically accept the attitude of the eminent American jurist, Oliver Wendall Holmes. An incident is reported of a young associate who exclaimed to Mr Justice Holmes: "Don't you hate to pay taxes?" He was rebuked with the hot response: "No, young feller, I like to pay taxes. With them I buy civilisation". (Frankfurter, Mr Justice Holmes and the Supreme Court (2nd ed., 1956) 71.)