TAX UPDATE - THE NEW ENVIRONMENT

KEITH JAMES

Touche Ross & Company
Melbourne

The paper presented by Messrs Thompson and Marshall of Morris Fletcher and Cross is commended to you all. The three key points of the reduction in tax benefits, the back to basics and the reliance in Part IVA are strongly supported.

Rather than comment on all the issues raised in the paper I would like to comment on the main underlying issue of the justification or otherwise of the policy underlying the attack on tax based financing.

Tax based financing has changed over the years. In its early days there were arrangements which were designed to create tax deductions or benefits that were not inherent in the transaction. Examples of these arrangements include double dips where, for example, the same deductions were obtained by two taxpayers through cross border arrangements, the transfer of tax concessions from exempt taxpayers to taxpayers, especially in regard to investment allowance claims for equipment used by State Governments and their authorities, offshore arrangements especially those involving preference shares in arrangements like that subject to investigation in the Citibank raid. There are many other examples including recoupment schemes and schemes where the two parties to a transaction were taxed in different years.

In most of these cases the finance structure was designed to create what accountants term "permanent differences", that is, the combined income tax expense of the parties to the transaction was diminished.

On policy grounds there can be no major objection to the government's gradual clamp down on these arrangements. Over the last ten years there have been many changes to the Income Tax Assessment Act aimed specifically at eliminating these "abuses". For example, we have seen the recoupment provisions enacted in 1978, leverage lease changes in 1984, Division 16E in 1986 and Double Dipping legislation in 1987.

From the Revenue's perspective the finance industry's willingness to be involved in these arrangements has inevitably drawn suspicion to everything the industry does. At the current time there are still arrangements being marketed where permanent advantages are sought.

Of all industry groups there can be no doubt that the finance industry has the most aggressive attitude to tax planning. In no other industry that I am associated with can there be said to be the same competitive forces at work.

In more recent times tax based finance has, but for one or two minor aberrations, taken on the more legitimate face of being nothing more than the transfer of deductions from one taxpayer who cannot currently utilise them, to a lender who can. As mentioned in the previous paper the transaction does not create new tax deductions or benefits. In this sense, there is what accountants call a simple timing difference. The cost to the revenue is that there is an acceleration of the claiming of the deduction. Importantly, there is not the creation of an artificial deduction nor is a deduction inflated in value. The Revenue's attack in these arrangements has its roots in a view that everything the industry now does should be seen in the bad light of the schemes of the past. In the absence of any self regulation from the industry all of its products are to be regarded with suspicion.

Taxpayers needing finance to acquire plant and equipment have been able to enter into leasing arrangements that have traditionally been structured in such a way that the lessor has been able to benefit from the acceleration of deduction flowing from asset ownership. Over the years a series of public and private rulings have been issued that have sanctioned these arrangements within what may be termed "safe harbour rules". Tax based leasing arrangements are, it would seem, acceptable to the authorities.

In his December announcement, the Treasurer has again stated that tax based leasing was not under threat. In the statement he said: "This review has confirmed the need to act against tax effective financing. Tax effective financing relies upon the ability to transfer, or share, tax benefits. The Government considers that the broad scheme of the tax law requires that tax losses be carried forward by the taxpayer who in substance incurs them and that, in general, such losses should not be available for transfer to other parties, including financiers. An exception, long accepted by revenue authorities, has been in respect of genuine leasing transactions for plant and equipment but the Government believes that other forms of tax benefit transfer should not be accepted."

However, many of the big ticket items of plant and equipment are items that are integral with buildings. The simple leverage lease arrangement becomes technically inappropriate in that it is difficult to separate the ownership of the plant from the land and, in any event, expensive from a stamp duty aspect.

The unit trust financing techniques that developed especially with building developments were designed in broad terms to offer no more than the benefits available through leveraged leases. With both a lease and a trust the purpose is to enable the lenders to obtain the tax benefits as owners, and transfer these benefits to borrowers in the form of reduced finance charges.

To the tax authorities a transfer of a benefit in relation to plant unconnected with buildings is acceptable, but transfers with the same objects with plant integral with buildings is not.

This simple inconsistency of approach raises two issues.

Firstly, is there a justification for attacking arrangements that simply transfer timing differences?

Secondly, if the answer is yes, is there a justification for a selective attack?

In relation to the first question, there will obviously be a wide range of views depending upon the political or economic context of the question. Governments, however, bring down budgets that are only concerned with one year's revenue and expenditure.

The transfer of benefits clearly affects one year's revenue raising. However, there must be a strong case that tax benefit transfer is an efficient way of stimulating investment and economic growth which will, in the longer term, lead to an unencased tax base.

Tax benefit transfers could be argued to be an important incentive for longer term investment strategies. To outlaw such market driven initiatives acts to encourage short term as opposed to longer term investment strategies. In my view the tax neutrality argument works equally in favour of benefit transfers as it does against it.

The Treasurer has announced that a review of this position is to take place and it will be interesting to see how much foresight the government is prepared to be shown on this issue.

In relation to the second question it is perhaps obvious by now that I cannot see an economic justification for any tampering with tax neutrality. However, the more interesting question is whether the inconsistency is justified on terms of taxation law. In relation to leases the unanimous decision of the High Court in FCT v. South Australia Battery Workers 78 ATC 4412 stands as strong authority that a form over substance approach applies to lease transactions.

Further, the specific anti-avoidance provisions in s.82KJ will generally have no application in that tax transfer deals usually have high, rather than low, residuals. However, that section should not be forgotten where leasing deals are structured to give the borrower, rather than the lender, accelerated write offs.

Neither the Commissioner nor the government seem interested in pursuing the approach of distinguishing finance leases from operating leases which is adopted in Accounting Standard AAS 17 (ASRB 1008) and has been contained in the New Zealand Income Tax Act for many years.

The question therefore remains as to whether the Commissioner's approach to finance trusts and the like is valid.

As discussed in the previous paper, the Commissioner has a double-barrelled attack in these arrangements. Firstly, he argues that the ordinary income provisions apply, and as a fall back position Part IVA, the general anti-avoidance provision, can be called upon.

A ruling is nothing more than a public pronouncement by the Commissioner of his interpretation of the law. There is an increasing tendency for rulings to take on the form of an "ambit claim". If you take as a base the Commissioner's success rate in arguing law before the courts, in theory approximately one-third of his "interpretation" should be wrong. The main points of the ruling are:

(a) Section 25

Section 25 is the general assessment section; it simply states that the assessable income of a taxpayer shall include (where the taxpayer is a resident) "the gross income derived directly or indirectly from all sources whether in or out of Australia". The section does not apply to income which is "exempt income". "Exempt income" is defined to mean income which is exempt from income tax and includes income which is not assessable income.

The Taxation Office considers that s.25 applies because it believes that the nature of the trust distribution in a financier's hands is assessable income. The Taxation Office states:

> "The main question in financing unit trusts is whether payments made by way of distributions by the trustee constitute assessable income in the hands of the finance unitholder(s). This question must be determined by reference to the nature of the receipt in the recipient's hands (cf. Scott v. FC of T (1966) 14 ATD 286, 293 per Windeyer J.), and having regard to the nature of the arrangements which ensure that the payments represented by the trust distributions are made to the financier."

The Taxation Office further states:

> "Participation by banks, insurance companies and other financial intermediaries in financing unit arrangements form part of their commercial activities and profits from these arrangements are to be taxed accordingly. For example, the sale of investments in the course of carrying on a business of banking or insurance have been held to be taxable in cases such as the Colonial Mutual Life Insurance Society Ltd. v. FC of T (1946) 73 CLR 604, London Australia Investment Co. Ltd. v. FC of T (1976-1977) 130 CLR 106 and Chamber of Manufacturers Insurance Ltd. v. FC of T 84 ATC 4315; 15 ATR 499.

None of these cases cited are directly relevant. Scott's case concerned the assessability of a gift received by a solicitor, from a long standing client. Windeyer J. observed:

> "I return to the general concept of income. Whether or not a particular receipt is income depends upon its quality in the hands of the recipient. It does not depend upon whether it was a payment or provision that the payer or provider was lawfully obliged to make."

On the facts of that case, Windeyer J. held that the gift was not assessable to the solicitor.

The insurance company cases all involve what might, to a non-insurance company, be regarded as a capital receipt. For example, in the latest of the cases cited by the Taxation Office, the Federal Court agreed that the profits made by an insurance company, on the sale of its investments, formed a normal incidence of that company's business and were thus assessable. Here the issue simply involved that of determining whether profits were of a capital or revenue nature.

(b) Exclusivity of Division 6

The Taxation Office rejects out of hand the proposition that Division 6 (which deals with trust income) is an exclusive taxing provision for beneficiaries/unitholders in respect of shares of income of a trust estate. It states that "the correct view" is that Division 6 is not an exclusive taxing provision in respect of a beneficiary's share of the income of a trust estate.

As a matter of the law, the Taxation Office is being somewhat cavalier in stating that its conclusion is "the correct view".

The Taxation Office justifies this conclusion, in part, by referring to the Explanatory Memorandum accompanying the Income Tax Assessment Bill (No 5) 1987. Specifically, it appears that it relies on that part of that Memorandum, which states:

> "Other amendments proposed to be made by the Bill are designed to ensure that Division 6 will be the dominant source for the liability of beneficiaries or trustees to tax on the income of trust estates. Consequently upon, and supporting those amendments, sub-clause (1) of clause 5 will alter section 26(b) so that, while it will continue in conjunction with section 25 to require the inclusion in assessable income of amounts representing a beneficial interest in assessable income derived under a will, settlement, deed of gift or instrument of trust, there will be specifically excluded from its operation, amounts included in the assessable income of the beneficiary of a trust estate under section 97 and proposed section 99B and amounts in respect of which a trustee of a trust estate is assessable under section 98, 99 or 99A of that Act."

As will be observed, however, that passage does not clearly indicate what Parliament intended. Further, it does not assist in overcoming the basic conflict between Division 6 and other provisions of the Act.

(c) Section 25A

The Taxation Office also seeks to rely on s.25A of the Act. This section is best known as the successor to the former s.26(a) (which, in particular, assessed profits made on the sale of the property acquired for the purpose of profit-making by sale). While it no longer applies to such property (all property transactions now being subject to the capital gains tax), it still applies to any "profit-making undertaking or scheme". Normally, one would not apply s.25A to ongoing commercial transactions.

Further, one can query how any "profit" for s.25A purposes should be calculated; for example, is it before or after interest (or notional interest) costs? Should it reflect the difference between amounts subscribed and amounts received on redemption? And, if s.25A is the appropriate section, it would most probably be inappropriate for the Taxation Office to attempt an assessment until termination of the unit trust arrangement.

(d) Division 16E

The Taxation Office also states that "there is an argument that Division 16E applies to the guaranteed return of income at the end of the contractual period". This view appears to conflict with previous Rulings given by the Taxation Office; for example, in respect of the NSW Rental Property Trust.

In relation to Part IVA it should be noted that neither ruling 2512 or 2519 contain any arguments to support the proportion that an anti-avoidance provision has application.

In my view there is a case that where two arms length parties enter into a new arrangement which, when reduced to basics, is nothing more than one party foregoing, in favour of the other, the benefits of the incidence of ownership of property, there can be said to be the artificial, blatant and contrived arrangement to which Part IVA was directed.

Tax based deals that do nothing more than permit a lender to become the owner of property in my view fail the "artificial" test.

In conclusion, I agree that there is a new tax environment for the finance industry to go about its business. In the swing and roundabout world of tax the industry is, at the moment, very much on the back foot. The future deviation will be very much dependent upon the instance of any challenge in the courts of the Commissioner's rulings and the outcome of the policy review announced by the Treasurer on the 20th December 1988.