A Question of the Integrity of the Dividend Imputation System When Corporate Tax Rate Changes:

An Australian Study

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Abstract

This study examines the dividend imputation system adopted in Australia, one of a few OECD countries that still operate a full imputation tax system. The Australian government recently announced corporate tax rate cuts, providing an opportunity to study the potential effects that corporate tax rate changes may bring to an imputation tax system. This paper analyses the proposed changes to the imputation system put forward in the *Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016* and suggests that such changes could potentially cause distortions to the existing imputation system in Australia. The potential distortions include the discrepancy between the tax rate used in computing company's tax liability and the tax rate employed as a basis for imputation, the additional tax payment required at domestic shareholder's level upon receiving franked dividends, and the wastage of franking credits arisen from previous corporate tax payments. Furthermore, this paper suggests consideration of an extension period of four or five years, during which companies in Australia can still apply the imputation (franking) rate based on the 30% company tax rate in respect of the dividends paid out of the underlying profits that were previously taxed at the same rate of 30%.

I. Introduction

The literature in corporate taxation has for a long time been concerned about double taxation of corporate profits, which refers to the after-tax dividends getting taxed a second time in the hands of company's shareholders. Under a classical tax system, shareholders' return from investment in companies in reality is not the return received from companies in the form of dividends, which are already taxed at company level. The fact that shareholders are subject to personal income tax on receipt of dividends has resulted in a much lower realised return for these investors. From one perspective, having a classical tax system provides scope for a country to lower their corporate tax rate in order to be competitive in the global market for investments by multinational companies, because in such tax

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jurisdiction on top of the corporate tax the government also collects additional income tax from individual shareholders who are in receipt of dividends.[1]

Parallel to the classical tax system, some countries operate a dividend imputation tax system to address the issue of double taxation. Under a dividend imputation system, shareholders are also taxed on the dividend income distributed out of a company's after-tax retained profits but these shareholders at the same time receive a tax credit for the amount of tax that was already paid by that respective company. Before 2000, a number of countries in the Organisation for Economic Co-operation and Development (OECD) had a dividend imputation system in place; however, many of those either abolished entirely the imputation tax system or changed to a partial imputation system by 2012, such as Finland, France, Germany, Italy and Norway.[2] Until 2016, only five OECD countries operate a full dividend imputation system and these countries are: Australia, Canada, Chile, New Zealand and Mexico.[3]

An imputation tax system operates to benefit domestic shareholders in a way that these shareholders are entitled to a tax credit for the company tax already paid at corporate level and that tax credit reduces the total personal income tax a shareholder is required to pay on the dividend income. In other words, the tax being paid at shareholder's level under an imputation system is the top-up tax after taking into account the tax already paid in respect of the same income source, i.e. the income originating from the corporate profits. As a simple explanation, for an amount of profit denoted P, the company deriving that profit needs to pay tax at corporate tax rate R_C (say, 30%). When the after-tax profit gets distributed to a domestic individual shareholder whose marginal tax rate is R_I (45% for example), under a full imputation system that shareholder is only required to pay the differential in tax, which is $P*(R_I - R_C)$ where $R_I - R_C = 15\%$, instead of paying a personal income tax amount of $P*R_I$ in addition to the corporate tax amount of $P*R_C$.

The question arises here is, what will happen when a country changes its statutory company tax rate? In a globalised environment where countries are in competition of lowering corporate tax rates to attract foreign investments, most governments bear the pressure to follow their peers and to be in line with other tax jurisdictions. As a result, in a fiscal year where R_C reduces, say from 30% down to 20%, the tax rate differential ($R_I - R_C$) is increased by 10% (i.e. from 15% to 25%) in this simple demonstration. What it means is that, if a company paid tax at 30% on its business profit in a prior year but the underlying after-tax profit is later on distributed in the form of franked dividend based on an imputation rate of

1 See Geoffrey Kingston, 'Dividend Imputation or Low Company Tax?' (2015) 2 *JASSA Finsia Journal of Applied Finance* 12. This paper examines the potential for a company tax cut in Australia should the dividend imputation system be abolished.

2 David Richardson, 'The Case against Cutting the Corporate Tax Rate' (Technical Brief No 20, The Australia Institute, December 2012).

3 Andrew Ainsworth, 'Dividend Imputation: The International Experience' (2016) 1 *JASSA Finsia Journal of Applied Finance* 58.

20%, the additional amount of income tax being paid by an individual shareholder is no longer P*15%. Later discussion in this paper suggests that the same individual shareholder is worse off by paying extra tax as a result of the dividend not only being grossed up at a lower R_C but also carrying lower franking credits calculated at the same lower R_C.

This issue faced by an imputation tax system is examined in this paper through an analysis of the Australian tax system. Australia is an appropriate setting for this study for two reasons. First, Australia has a long history of continuous operation of a dividend imputation system, commencing from 1987.[4] Second, Australia recently announced a company tax rate cut from 30% to 27.5% with a timeframe for the rate cut to roll out gradually from smaller-sized to larger-sized corporate entities. The tax rate cut will come into effect from the 2016–17 income year[5] for companies with turnover less than AU$10 million, and will apply to all companies including largest firms by the end of the 2023–24 income year.[6]

The remainder of this paper proceeds as follows. Section II of this paper examines the Australian experience with the dividend imputation tax system. After that, Section III discusses the potential distortions to the imputation system when company tax rate changes. Section IV presents one possible option to retain the integrity of the imputation system when corporate tax cuts occur. A conclusion is provided in Section V.

II. Australian Experience with the Dividend Imputation Tax System

A. *Operation of the Imputation Tax System in Australia*

Australia is one of a few OECD countries that still operate a full dividend imputation system. Australia's history of the imputation tax system spans decades and dated back to 1923.[7] For the period from 1923 to 1940, companies were taxed on corporate profits and shareholders were taxed on dividends received from companies but could receive a rebate for the tax that had already been paid at corporation level.[8] However, from 1940, shareholders in Australia no long received a tax rebate in relation to their dividend income and Australia changed from an imputation tax system to a classical tax system. Under the classical tax system, dividends

4 Garry Twite, 'Capital Structure Choices and Taxes: Evidence from the Australian Dividend Imputation Tax System' (2001) 2 *International Review of Finance* 217.

5 In this paper, the 2016–17 income year is also referred to as 2017 income year, and so on for other income years.

6 See Australian Taxation Office, *Reducing the Corporate Tax Rate* (5 September 2016) <https://www.ato.gov.au/General/New-legislation/In-detail/Direct-taxes/Income-tax-for-businesses/Reducing-the-corporate-tax-rate/>. The *Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016* was introduced to the Parliament on 1 September 2016.

7 Andrew Ainsworth, Graham Partington and Geoff Warren, 'Do Franking Credits Matter? Exploring the Financial Implications of Dividend Imputation' (Working Paper No 058/2015, Centre for International Finance and Regulation, June 2015) 5.

8 Ibid.

received by shareholders are necessarily taxed twice, first at company level and second at shareholder level. Australia moved back to the imputation tax system in 1987. Effective from 1 July 1987, company taxes paid to the Australian Taxation Office (ATO) are distributed to Australian tax residents as a tax credit attached to a dividend declared by the company.[9] Under the Australian tax regime, this tax credit is called a 'franking credit'.

Since 1987, Australia has been continuously operating the dividend imputation system for nearly 30 years. The major change in respect of the operation of this system was the rebate provision, under which the allowable rebate of franking credits before 1 July 2000 was capped at the tax liability of a taxpayer and any excess imputation credit was lost.[10] Under the new provision introduced in July 2000, the entire amount of franking credits is refundable to taxpayers even when franking credits exceed tax liabilities.[11] As such, the shareholders do not incur wastage of excess franking credits and the imputation retains its value for taxpayers with low income and having marginal personal tax rate lower than statutory company tax rate.

Under the present imputation system in Australia, companies are required to keep records of the franking account, which keeps track of the income tax payments made to the ATO.[12] The maximum franking credits distributable to shareholders is the balance reflected in the franking account of a company. In other words, a firm cannot 'frank' the dividends (i.e. attach the imputation credits to the dividends) more than the amount of company income tax that has been paid.

As an example, when an Australian resident company makes a before-tax profit of $100, it is required to pay income tax at statutory corporate tax rate of 30%, being $30. [13] After a corporate tax of $30 is paid by that company to the ATO, the company can record a credit of $30 in its franking account. The retained profit after tax for the company is $70. Subsequent to that, when that company pays a dividend of $70 to its shareholder (assuming an individual sole shareholder in this example), a franking credit worth of $30 is attached to that dividend, which necessarily reduces the balance of the company's franking account to zero.

The individual shareholder, upon receiving a franked dividend of $70, is required to 'gross up' the cash dividend amount to reflect the before-tax corporate profit of $100. The tax liability of that individual shareholder (in respect of the dividend received) is calculated on

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9 Twite, above n 4.

10 John C Handley and Krishnan Maheswaran, 'A Measure of the Efficacy of the Australian Imputation Tax System' (2008) 84 *Economic Record* 82.

11 Ibid.

12 Australian Taxation Office, *Simplified Imputation – The Franking Account* (17 December 2015) <https://www.ato.gov.au/Business/Imputation/In-detail/Simplified-imputation---the-franking-account/>.

13 Corporate tax rate in Australia for companies that are not 'small business entities' is 30% for the 2015–16 Australian income year. A 'small business entity' is one whose aggregated turnover is less than AU$2 million. See Australian Taxation Office, *Company Tax Rates* (17 October 2016) <https://www.ato.gov.au/rates/company-tax/>.

the grossed-up dividend figure of $100. For an individual taxpayer with marginal personal income tax rate of 49%, their personal tax on the dividend income will be $100*49% = $49.[14] Under the dividend imputation system, this Australian resident shareholder is entitled to a franking credit of $30, which is offset against the tax liability of $49. Hence, the net tax required of the individual shareholder in this case is $49–$30 = $19. In this example, under the imputation system, total income tax paid on the original $100 of business profit is $49, consisting of $30 paid at corporate level and $19 paid at individual shareholder level. Contrasting with the classical tax system where no tax credit is provided for the company tax previously paid, total income tax payments on the original profit of $100 would amount to $79 (assuming no other tax relief given to the individual shareholder), being made up by $30 paid by the company and $49 paid by the shareholder.[15]

When an Australian resident company pays tax at a lower rate compared to the statutory corporate tax rate, there will be insufficient franking credits in the company franking account to make the dividends fully franked; in that case, the dividend distributed by the company would be partially franked. Likewise, in a situation where a company does not pay any income tax on its profits after applying available tax offsets (e.g. tax offset for research and development activities carried out by the firm), the dividend distributed will have to be unfranked dividend. Therefore, in Australia, the imputation system can be considered as a system of prepayment of tax on corporate profits because domestic shareholders essentially pay income tax on the distributed company profits (in the form of dividends) at their relevant marginal tax rate.[16] This view is however only applicable for companies of which all of the shareholders are Australian residents for tax purposes.

B. *Australian Experience With Dividend Imputation: Findings of Prior Research*

A dividend imputation system is often referred to as a tax system that addresses the issue of double taxation on dividends encountered in a classical tax system.[17] An imputation system is also viewed as an efficient and equitable tax system.[18] Some researchers argue that an efficient imputation system reduces the biases emerging under the classical tax system, including biases towards debt and retention of earnings as well as bias against the corporation form.[19] Dividend imputation is believed to promote equity because it reduces the tax burden on investors who would otherwise be taxed twice on their return from

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14 Highest marginal individual tax rate in Australia for the 2015–16 income year is 49%, including 2% of Medicare levy and 2% of temporary budget repair levy for the year.

15 For further examples in relation to operations of the Australian tax system, see Twite, above n 4.

16 Catherine Ikin and Alfred Tran, 'Corporate Tax Strategy in the Australian Dividend Imputation System' (2013) 28 *Australian Tax Forum* 523.

17 Handley and Maheswaran, above n 10.

18 Brett Wilkinson and Marcy M Fancher, 'Eliminating 'Double Taxation': The Dividend Imputation Alternative' (2004) 74 *CPA Journal* 15.

19 Ibid.

investment in companies under a classical tax system.[20] In order to further understand the dividend imputation system, this section examines Australia's experience after operating an imputation system for a continuous period of nearly 30 years.

Firstly, a study of the efficacy of the Australian dividend imputation system by Handley and Maheswaran reports significant utilisation of imputation as a means to reduce personal tax liabilities for the period from 1990 to 2004.[21] More specifically, these researchers document that the percentage of distributed franking credits used to bring down personal taxes is 67% during the years 1990–2000 and that percentage increases to 81% for the period 2001–2004.[22] Handley and Maheswaran conclude that the policy shift to a dividend imputation system in Australia delivers the intended result of eliminating double taxation of dividends (for domestic shareholders) which was the major equity issue before 1987 when the classical tax system was still in use.[23]

In addition, prior research into the Australian imputation tax system also study how dividend imputation may be associated with share prices, company cost of capital and corporate behaviours. Some academics attempt to analyse whether franking credits are priced by the stock market and whether the value of imputation credits should be incorporated into a capital asset pricing model.[24] The reported findings in this line of research are inconclusive in respect of the impacts of dividend imputation on share price and cost of capital. For example, studies by Brown and Clarke (1993) and Minney (2010) suggest that imputation credits are priced by the stock market.[25] On the contrary, research carried out by Lajbcygier and Wheatley find that dividend imputation in Australia does not result in lower required returns on equity for investors.[26] A separate study examining Australian hybrid securities shows franking credits are not capitalised into the cum-dividend day prices of these hybrid securities, attributing this finding to the argument that price setting in the Australian market is from a foreign investor's perspective whereas only domestic investors receive the benefit of imputation credits in Australia.[27]

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20 Handley and Maheswaran, above n 10; Wilkinson and Fancher, above n 18.

21 Handley and Maheswaran, above n 10.

22 Ibid.

23 Ibid.

24 Stephen Gray and Jason Hall, 'The Relation between Franking Credits and the Market Risk Premium' (2006) 46 *Accounting and Finance* 405.

25 Phillip Brown and Alex Clarke, 'The Ex-dividend Day Behaviour of Australian Share Prices before and after Dividend Imputation' (1993) 18 *Australian Journal of Management* 1; Aaron Minney, 'The Valuation of Franking Credits to Investors' (2010) 2 *Journal of Applied Finance* 29.

26 Paul Lajbcygier and Simon M Wheatley, 'Imputation Credits and Equity Returns' (2012) 88 *Economic Record* 476.

27 Clinton Feuerherdt, Stephen Gray and Jason Hall, 'The Value of Imputation Tax Credits on Australian Hybrid Securities' (2010) 10 *International Review of Finance* 365.

Mentioned earlier in this Section is a remark about the view that a dividend imputation system reduces two biases often observed in a classical tax system: (a) bias towards retention of profits within the corporation, and (b) bias towards debt usage. Research conducted on Australian dividend imputation system provides some evidences supporting this remark. Pattenden and Twite analyse the period from 1982 to 1997 to examine the effect of the switch from a classical tax system to an imputation system in Australia effective from July 1987.[28] These researchers report a finding that introduction of the dividend imputation leads to an increase in dividend payouts by Australian companies.[29] In addition, with regards to the reduction in the bias towards debt financing following the implementation of dividend imputation, an Australian study documents a decreased level of firm leverage and a corresponding increase in financing using external equity after introduction of an imputation system.[30] However, other researchers cautioned that there could be other significant factors contributing to the observed reduction in debt use and it is difficult to ascertain the impact of dividend imputation in this regard.[31]

In a review of the reported findings in respect of the effects of the dividend imputation on the Australian equity markets and behaviours of investors and corporations, Ainsworth, Partington and Warren contend that overall the Australian economy is believed to benefit from having an imputation tax system.[32] This contention is important in light of the recent debate about the benefits of dividend imputation and whether Australia should continue maintaining this system. Holding similar view, Davis in a recent paper discussing the interaction between the imputation tax system and the Australian financial system believes that the benefits of having dividend imputation are greater than the costs associated with it.[33] Davis' paper argues that there is less distortion to the operation of the financial system under the imputation tax system as opposed to under the former classical tax system.[34] The author also puts forward that the imputation system in Australia enhances 'financial stability, market discipline and corporate governance' through decreased debt uses and increased dividend payouts.[35]

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28 Kerry Pattenden and Garry Twite, 'Taxes and Dividend Policy under Alternative Tax Regimes' (2008) 14 *Journal of Corporate Finance* 1.

29 Ibid.

30 Twite, above n 4.

31 Andrew Ainsworth, Graham Partington and Geoffrey J Warren, 'The Impact of Dividend Imputation on Share Prices, the Cost of Capital and Corporate Behaviour' (2016) 1 *JASSA Finsia Journal of Applied Finance* 41, 47.

32 Ibid, 47–8.

33 Kevin Davis, 'Dividend Imputation and the Australian Financial System' (2016) 1 *JASSA Finsia Journal of Applied Finance* 35.

34 Ibid.

35 Ibid.

Finally, Ainsworth puts it in perspective in his discussion of the Australian imputation tax system after reviewing other countries' experiences with dividend imputation.[36] Through an examination of the motivations behind the removal of the dividend imputation in nine countries, Ainsworth observes that after abolishing the imputation system, these countries go through a number of changes to their tax systems to provide various types of remedy for double taxation of dividends (e.g. changing tax rates for dividend income or taxing only part of the dividend received).[37] The Australian imputation system on the contrary has remained stable for nearly 30 years with the significant revision being the rebate provision effective from July 2000, which allows full refunds of franking credits for Australian resident shareholders.

Summarising the above, the dividend imputation system in Australia has not only brought positive contributions to the Australian financial market but also proved to be a stable and efficient system for Australia. It is therefore important to identify and address any potential adverse impacts that changes in regulations may cause to the imputation system, in order to ensure that a system that has worked reasonably well will continue to work well in the future.

III. Potential Distortions to Dividend Imputation when Company Tax Rate Changes

Australian company tax rate for the 2015–16 financial year is 30% for most corporate entities and 28.5% for 'small business entities' with aggregated turnover of less than AU$2 million.[38] In recognition of Australia's higher corporate tax rate compared to the average of the OECD countries,[39] the Australian government is currently implementing a company tax rate cut. Starting from the 2016–17 income year, companies having aggregated turnover less than AU$10 million will be eligible for a lower tax rate of 27.5%. The threshold of AU$10 million will increase progressively until 2023–24 when all companies irrespective of turnover levels can access the 27.5% tax rate.[40] The flat company tax rate will then continue to drop in the following years until it reaches 25% in 2026–27, as outlined in the *Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016* submitted to the Australia's Parliament on 1 September 2016.[41] Some prior studies examine the potential impacts of corporate tax rate

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36 Andrew Ainsworth, 'Dividend Imputation: The International Experience' (2016) 1 *JASSA Finsia Journal of Applied Finance* 58.

37 Ibid.

38 Australian Taxation Office, above n 13.

39 Australian Treasury, 'Re:Think Tax Discussion Paper' (Discussion Paper, Parliamentary Library, Australian Government, 2015) 74–5.

40 Australian Taxation Office, above n 6.

41 Explanatory Memorandum, *Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016* (Cth) 9–33.

cuts in Australia and analyse the interaction between company tax rate reduction and any potential removal of dividend imputation[42]; however, such discussion is beyond the scope of this paper. Rather, the focus of this paper is at the consequent impacts on dividend imputation in Australia when corporate tax rate changes.

A. *Previous Adjustments in Response to Changes in Corporate Tax Rates 2000–2002*

The latest changes in respect of Australian corporate taxation introduce the first significant tax rate cuts for companies in the last 15 years since the last change in 2000–2002 under John Howard's government. In order to have an insightful examination of the effects of the latest measures on the imputation system, it is worthwhile to review the Australian dividend imputation story when the country last had a company tax rate change.

Following the *1999 Review of Business Taxation* (the *Ralph Report*), the Australian government decided to change corporate tax rate from 36% in 1999–2000 to 34% in 2000–01, and then down to 30% in 2001–02.[43] Together with the reductions in company tax rate, there were also changes to the imputation system to: (a) to reflect the tax rate cuts in the franking account, and (b) to simplify the imputation system. Operation of the imputation tax system in Australia prior to July 2002 is different from what Australia currently has, and the main difference lies in the company's franking account. Before July 2002, the franking account under the former imputation system was not used to record the corporate tax payments made to the ATO; instead, it was used to track the taxed income, i.e. the net income after deducting corporate tax from taxable income.[44] A conversion of the franking account was required in 2002–03, which is explained further below. However, previous study suggests that despite different methods of recording the franking account, the outcomes between the former and the existing imputation systems are similar, and the nature of the dividend imputation retains the same in terms of giving a tax credit to shareholders for the company income tax already paid.[45]

(a) Franking accounts in 2000–01 and 2001–02

Until 1999–2000, Australian corporate entities could have franking accounts of different classes A, B and C reflecting different tax rates.[46] The entries in these franking accounts previously arose based on company tax rates of 39% (class A account), 33% (class B

42 Studies examining this issue include: Geoffrey Kingston, 'Dividend Imputation or Lower Company Tax?' (2015) 2 *JASSA Finsia Journal of Applied Finance* 11; J M Dixon and J Nassios, 'Modelling the Impacts of a Cut to Company Tax in Australia' (Working Paper No G-260, Centre of Policy Studies, Victoria University, April 2016).

43 Business Council of Australia, 'Corporate Taxation An International Comparison' (Research Paper, October 2005) 9.

44 Tom O'Sullivan, 'Australia's Dividend Imputation System: New Rules but Similar Outcomes' (2003) 29 *Tax Notes International* 319.

45 Ibid.

46 Explanatory Memorandum, *New Business Tax System (Miscellaneous) Bill 1999* (Cth) 25–35.

account), and 36% and 34% (class C account).[47] When the tax rate was reduced from 36% in 1999–2000 down to 34% and then 30% in the following two years, the tax rate cuts were accompanied with a requirement to convert the existing franking credits and debits in all class A, class B and class C accounts into one equivalent class C account.[48]

Under the former imputation system in Australia (before July 2002), the franking account operated to keep track of the after-tax income of corporate entities. For example, when a company earned a profit of $100 in 2000–01 and paid tax at the company tax rate of 34% in that year, a taxed income amount of $66 (being $100 less $34) would be recorded as a credit in the company's class C franking account for the year ending 30 June 2001. As such, the franking account under the old system reflects the after-tax income (as opposed to the tax payments under the new system after July 2002). On 1 July 2001, this entry would be converted into an equivalent class C franking account using the legislated formula: 34/66 x 70/30.[49] After applying this factor, the resulting credit entry in the 2001–02 class C franking account becomes a credit of: $66 x 34/66 x 70/30 = $79.33. After being reinstated on 1 July 2001, a credit of $79.33 in the 2001–02 financial year means that the company could distribute a fully franked dividend of $79.33 using the 30% franking rate, which was the new tax rate applicable in 2001–02.

(b) Franking account in 2002–03

After converting franking entries from the old class A, B and C franking accounts into the equivalent class C franking account which reflects the corporate tax rate of 30% in the 2001–02 tax year, at the end of the 2002 income year there should only be one new class C franking account. The Australian government decided to implement new rules in 2002–03 to change the operation of the company franking account. From tracking after-tax income under the old rules before 1 July 2002, the franking account changed to keep track of corporate tax payments under the simplified imputation system effective from 1 July 2002.[50]

The ATO required companies to close off class C franking account at 30 June 2002 and roll over any surpluses into a new franking account established on 1 July 2002 by applying a factor of 30/70.[51] For example, if a company started operation in the 2001–02 tax year and paid $30 of tax on a pre-tax profit of $100, their class C franking account at 30 June 2012 would have recorded a credit (or surplus) of $70. This class C franking account, under the simplified imputation rules, would be closed off on 30 June 2002 and a new franking account would be established on 1 July 2002. In this example, the surplus of $70 in the old class C

47 Revised Explanatory Memorandum, *Taxation Laws Amendment Bill (No. 4)* 2001 (Cth).

48 Ibid.

49 Revised Explanatory Memorandum, above n 47, [1.16]-[1.18].

50 O'Sullivan, above n 44.

51 Australian Taxation Office, *How Are Franking Surpluses Prior to 1 July 2002 Converted?* (17 December 2015) <https://www.ato.gov.au/Business/Imputation/In-detail/Simplified-imputation---the-franking-account/?page=7>.

franking account would be converted into a credit of $30 in the new franking account using this calculation: $70 x 30/70 = $30.

The new franking account established from 1 July 2002 operates on a tax-paid basis. As O'Sullivan contends, 'companies do not need to gross-up franking account entries, or maintain multiple franking accounts when the company tax rate changes from year to year'.[52] The question arises here is, under the new simplified imputation system, what will happen when there is a change in corporate tax rate? Since 2002, there has been no change in statutory tax rate for companies until recently. The latest company tax cuts therefore present challenges to the existing operation of a dividend imputation system in Australia. What should tax policy-makers do in order to implement the transition to lower company tax rates smoothly while still retaining the integrity of the imputation system?

B. *Potential Distortions to the System Resulting from Latest Company Tax Rate Changes*

(a) Proposed corporate tax rate reduction from 2016–2017 and changes to the dividend imputation rules

On 1 September 2016, the Australian government introduced the *Treasury Laws Amendment (Enterprise Plan) Bill 2016* (hereon '*2016 Tax Plan Bill*') which includes the proposed reduction in corporate tax rate.[53] Under this proposal, the company tax rate will decrease from 30% to 27.5% over an eight-year period with the change coming into effect from 1 July 2016 for firms with turnover less than AU$10 million and rolling out for larger companies at different stages. The corporate tax rate in Australia will then further go down, as a flat rate for companies of all sizes, from 27.5% (in 2023–24) to 27% (in 2024–25), 26% (in 2025–26) and then 25% (in 2026–27 and later years).[54] The *2016 Tax Plan Bill* also puts forward an initiative to align the franking rate of 30% for franked dividends with the corporate tax rate being reduced in stages:

> *1.70 During that period [from 2016–17 income year to 2023–24 income year], a greater number of corporate tax entities will be entitled to the 27.5 per cent corporate tax rate each year, reflecting the increase in the aggregated turnover to qualify as a base rate entity.*[55] *Therefore, it is not feasible to continue to operate the imputation system at the headline corporate tax rate of 30 per cent for all corporate tax entities.*[56]

Recognising the potential discrepancy between the current imputation rate of 30% for dividends paid and the reduced statutory tax rate for companies, the *2016 Tax Plan Bill* introduces a new concept of 'corporate tax rate for imputation purposes', suggesting that it

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52 O'Sullivan, above n 44.

53 Explanatory Memorandum, above n 41.

54 Explanatory Memorandum, above n 41, [1.11]-[1.16].

55 Definition of 'base rate entity' is provided in para 1.13 of the *2016 Tax Plan Bill*. See Explanatory Memorandum, above n 41, [1.13].

56 Explanatory Memorandum, above n 41, [1.70].

can be different from the corporate tax rate applied in income tax calculation.[57] Although the definition of 'corporate tax rate for imputation purposes' is not clearly set out in the *2016 Tax Plan Bill*, para 1.73 of the Bill provides an example to demonstrate how this new concept applies from 2016–17. My interpretation of the proposal is that application of the new concept relies on a comparison between the prior year's aggregated turnover and the current year's threshold to be eligible for the lower company tax rate (also the 'base rate entity' threshold). If the prior year's aggregated turnover is less than the current year's threshold, the corporate tax rate for imputation purposes will be the lower rate of 27.5% (if the year falls in the 2017–2024 period), i.e. franking rate of 27.5% will apply to franked dividends paid. Vice versa, if the prior year's aggregated turnover is greater than the current year's threshold, the franked dividends will have the imputation rate of 30%.

(b) Complexity of the proposed changes

A detailed reading of the proposed changes outlined in the *2016 Tax Plan Bill* suggests this proposal may add more complexity to the existing corporate taxation and dividend imputation system in Australia. As part of the proposal, new definitions of 'base rate entity' and 'corporate tax rate for imputation purposes' are introduced in the *2016 Tax Plan Bill*. The way how these new definitions are incorporated into the present imputation tax system is quite complex.

Firstly, while the 'small business entity' test is still in use in determining the applicable corporate tax rate for a company for the 2016–17 year (with aggregated turnover threshold set to be AU$10 million), the relevant test from the 2017–18 year to the 2022–23 year will change to the 'base rate entity' test.[58] A company qualifying to be a 'base rate entity' can access the lower corporate tax rate of 27.5% in those relevant income years from 2017–18 to 2022–23. Paras 1.42 and 1.46 of the Bill jointly define 'base rate entity' as a corporate tax entity that satisfies two requirements: (a) carrying on a business, and (b) having aggregated turnover below the relevant 'aggregated turnover threshold'.[59] While the second limb is straightforward with the annual aggregated turnover thresholds set out in Table 1.1 of the Bill[60], the first requirement of 'carrying on a business' may cause some uncertainty in respect of companies with only passive investments.[61] The proposal however envisages removal of

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57 Explanatory Memorandum, above n 41, [1.73].

58 Explanatory Memorandum, above n 41, [1.11]-[1.13].

59 Explanatory Memorandum, above n 41, [1.42], [1.46].

60 Explanatory Memorandum, above n 41, 11.

61 Subsection 995-1(1) of the *Income Tax Assessment Act 1997* defines 'business' as follows: 'includes any profession, trade, employment, vocation or calling, but does not include occupation as an employee'. Detailed analysis of conditions to for a company to be considered 'carrying on a business' is beyond the scope of this paper. The attention of this paper is at the complexity of the proposed changes in the *2016 Tax Plan Bill*.

the 'base rate entity' test from the 2023–24 income year since all corporate tax entities will be taxed at a flat rate regardless of their turnovers effective from 1 July 2023.[62]

Furthermore, the concept of 'base rate entity' is also integrated into determination of a company's 'corporate tax rate for imputation purposes', another new definition proposed in the *2016 Tax Plan Bill*. Para 1.73 of the Bill states:

> *1.73 As a result of this change, for the purposes of applying provisions in the imputation system, corporate tax entities will use the corporate tax rate for imputation purposes. This is generally defined to mean the entity's corporate tax rate for the income year (the current income year), worked out on the assumption that the entity's aggregated turnover for the income year is equal to its aggregated turnover for the previous income year. [...]*

Operation based on this definition may cause confusion. My reading of the Bill suggests that while the aggregated turnover of a company in the current year is relevant in determining the 'corporate tax rate for income tax calculation', assessment of the 'corporate tax rate for imputation purposes' requires reference back to the company's aggregated turnover in the prior year.

Table 1 summarises my interpretation of *Example 1.1* provided in the *2016 Tax Plan Bill*.[63] As demonstrated in the table, in this example, company A pays franked dividends carrying imputation credits based on the 27.5% tax rate because company A's aggregated turnover in 2016–17 (AU$20 million) is less than the 2017–18 'base rate entity' threshold of AU$25 million. It is important to recognise that the dividends in 2017–18 are most likely distributed from retained earnings accumulated from prior years, which were previously taxed at 30%.

Table 1: Example of operation of the proposed change to imputation rate from 2016–17[64]

Company A	2015–16	2016–17	2017–18
Aggregated turnover	$18mil	$20mil	Note (b)
Small business entity (SBE) or base rate entity (BRE) threshold	$2mil	$10mil	$25mil
Current year's aggregated turnover less than current year's SBE/BRE threshold?	No	No	Note (b)
Corporate tax rate for income tax	30%	30%	Note (b)
Prior year's aggregated turnover less than current year's SBE/BRE threshold?	N/A – Note (a)	No	Yes
Corporate tax rate for imputation purposes	30%	30%	27.5%

Note (a): Imputation rate of 27.5% only starts from 2016–17 income year.

Note (b): *Example 1.1* in the *2016 Tax Plan Bill* does not provide this information.

The complexity of this proposal as discussed above could possibly result in various mistakes inadvertently made by taxpayers and tax agents. Moreover, apart from its complexity issue,

62 Explanatory Memorandum, above n 41, [1.14]-[1.15], [1.51].

63 Ibid.

64 Ibid.

the proposal in the *2016 Tax Plan Bill* may potentially lead to potential distortions to the existing dividend imputation system, which are discussed in detail below.

(c) Potential distortions

The recent changes to corporate tax rates and imputation rules in Australia as proposed in the *2016 Tax Plan Bill* present challenges to retaining the integrity of the imputation tax system. Firstly, the major distortion to the dividend imputation is that from 2016–17 franked dividends paid by several companies will be franked based on the new tax rate of 27.5% while the underlying profits for such dividends were previously taxed at a higher rate of 30%.

Under the latest proposal, a large number of companies eligible for the lower corporate tax rate of 27.5% will be caught under the new imputation rules and have to pay franked dividends with an imputation rate equal to the reduced company tax rate of 27.5%. In that situation, the franked dividends received by domestic shareholders will be grossed up at the imputation rate of 27.5%; at the same time, the respective shareholders also receive franking credits calculated based on the tax rate of 27.5%. *Table 2* provides a comparison between the old imputation rules (before 2016–17) and the proposed new imputation rules (in effect from 2016–17 if legislated), and highlights the difference in the overall taxes paid on the same amount of corporate profit under the old and new provisions. As illustrated in *Table 2*, starting from a company profit of $100 being taxed at 30% in 2015–16, this after-tax underlying profit when distributed to a domestic individual shareholder in 2016–17 will result in different net tax payable amounts required from that individual shareholder under the old and new imputation rules.

Under the old rules where dividend is franked based on a tax rate of 30%, the domestic individual shareholder who is already subject to a top marginal personal income tax rate of 49% will have a personal tax liability of $19. In this situation, total company tax and shareholder's tax amount to $49, or 49% of the original company profit of $100. This example shows that the old rules effectively lead to the intended result for an imputation system where the full amount of company tax paid is passed on to the shareholder in the form of a tax rebate.[65]

In contrast, under the new rules where companies satisfying the 'small business entity' (SBE)/ 'base rate entity' (BRE) threshold can access a lower corporate income tax rate of 27.5%, a large number of those corporations will have a corporate tax rate for imputation purposes of 27.5% while some others may be lucky enough to still be able to frank dividends based on the old tax rate of 30%. The example in *Table 2* assesses the tax liability at the individual shareholder's level if the imputation rate is 27.5%. Calculations in *Table 2* show that the amount of total taxes paid on the original company profit of $100 is $50.76,

65 This is in line with the argument that the dividend imputation tax system acts as a prepayment of personal income tax on corporate profits through taxing at corporate level. See Ikin and Tran, above n 16.

comprising of $30 of tax paid at corporate level and $20.76 of tax paid at domestic shareholder's level. The domestic shareholder in this situation only receives a franking credit worth $26.55 even though the company tax already paid is $30. Due to the shortfall of franking credit distributed to the shareholder, under the new imputation rules, the effective rate of total taxes paid on the original company profit for individual domestic shareholders (who are subject to the 49% top marginal personal tax rate) is 50.76%, which is 1.76% higher than the effective rate under the old set of rules.

Para 1.72 of the *2016 Tax Plan Bill* argues:

> *1.72 This change [referring to the new rules for dividend imputation] does not alter basic operation of the imputation system. Distributions to members who are domestic shareholders will continue to be ultimately taxed at the member's marginal tax rate.*[66]

However, the example illustrated in *Table 2* has highlighted the distortion in the imputation system under the proposed new rules in the *2016 Tax Plan Bill* where the imputation system does not deliver the initially intended result because an individual domestic shareholder is now effectively paying tax on fully franked dividend income at a rate that is higher than their own top marginal personal tax rate. Thus, a small portion of double taxation once again comes back to the tax system, as a result of the recent company tax rate cut.

In addition, a new issue arises in respect of the undistributed franking credits remaining in the company franking account. As demonstrated in the example in *Table 2*, under the new imputation rules, while $30 of company tax paid in 2015–16 is credited in the company franking account, this balance is only reduced by an amount of $26.55 being franking credits distributed to the domestic shareholder. As a result of this distribution, there is a credit of $3.45 remained in the franking account. The proposed changes to the imputation system do not address this wastage of undistributed franking credits.

The remaining franking credits can potentially get trapped in the franking account and may only be used in the future when the company engages in some tax aggressive planning to pay company tax at a rate lower than the statutory tax rate. This can happen when the unused franking credits arising from the 'old' profits are attached to the dividends paid out of the 'new' profits, upon which the company pays little tax (owing to tax aggressive strategies) and as such creates little 'new' franking credits. Hence, unconsciously the proposed new imputation rules create an incentive for companies to look for tax aggressive strategies to lower their effective tax rates in future years in order to utilise the 'trapped' franking credits arisen from the changes associated with company tax rate cuts.

[66] Explanatory Memorandum, above n 41, [1.72].

Table 2: Comparison of taxes paid on corporate profit under the old rules (before 2016–17) and new rules (from 2016–17) of the Australian dividend imputation system

	Old rules: Underlying profit taxed at 30% & dividend with imputation at 30%	New rules: Underlying profit taxed at 30% & dividend with imputation at 27.5%
FY2015–16		
Company before-tax profit (A)	$100.00	$100.00
Corporate tax rate (B)	30.0%	30.0%
Company income tax (C = A*B)	$30.00	$30.00
Company after-tax profit (D = A – C)	$70.00	$70.00
FY2016–17		
Franked dividend paid to shareholder (E = D)	$70.00	$70.00
Corporate tax rate (F)	30.0%	27.5% (assuming meeting SBE threshold)
Corporate tax rate for imputation purposes (G)	30.0%	27.50%
Franking credits attached to dividend paid (H = E*G/(1-G)	$30.00	$26.55
Grossed-up dividend (I = E + H)	$100.00	$96.55
Individual domestic shareholder's marginal tax rate (J)[67]	49.0%	49.0%
Tax on dividend income at individual shareholder's level (K = I*J)	$49.00	$47.31
Franking credits received by individual shareholder (L = H)	$30.00	$26.55
Net tax payable on dividend income by individual shareholder (M = K – L)	$19.00	$20.76
Summary		
Total taxes paid on the original company profit of $100 (N = C + M)	$49.00	$50.76
Effective tax rate on the original company profit of $100 (combined corporate and individual shareholder levels) (P = N/A)	49.0%	50.76%

The wastage of franking credits currently available in companies' franking accounts and the potential of corporations' involvement in tax aggressive planning to utilise all the trapped franking credits can be remarkable issues due to the large balance of franking accounts of Australian firms. According to the *ATO Taxation statistics 2013–14*, the total franking credits available for distribution in all companies' franking accounts amount to over AU$296 billion.[68] Using the latest data provided in the *ATO Taxation statistics 2013–14*, the average

[67] Top marginal individual tax rate in Australia for the 2016–17 year is 49%, including Medicare levy of 2% and Temporary budget repair levy of 2%. See Australian Taxation Office, *Individual Income Tax Rates* (31 October 2016) <https://www.ato.gov.au/rates/individual-income-tax-rates/>.

[68] Australian Taxation Office, *Taxation Statistics 2013–14: Company – Table 1* (February 2016) <https://data.gov.au/dataset/taxation-statistics-2013-14/resource/6217e594-1c2e-4b3e-be66-1c7c502fa28c>.

growth rate of the companies' franking account balance over a ten-year period from 2004 to 2014 is calculated to be 10.66%. Applying this average growth rate to the 2015 and 2016 tax years, it is estimated that the total franking account balance would reach approximately AU$363 billion, which is equivalent to total distributable franked dividends of AU$846 billion (by applying a factor of 70/30, based on current company tax rate of 30%). *Table 3* provides a summary of franking account balances from 2004 to 2014 extracted from *ATO Taxation statistics 2013–14* and estimated franking account balances and equivalent distributable franked dividends in 2015 and 2016.

Since the proposed company tax rate cuts to 27.5% in Australia are to occur in different stages, from smaller to larger companies, over the 2017–2024 period, the more relevant figures are the franking account balances for companies with turnover less than AU$10 million because these are the ones qualifying for the lower tax rate of 27.5% in 2016–17 and hence most likely subject to the 27.5% franking rate. Firms with turnover less than AU$10 million do not have much time to plan for dividend distributions whereas larger firms have more time to review their dividend policies to make the most use of the existing undistributed franking credits. The franking account balance figures for these smaller firms are not available; however, the total franking account balances of all companies reported in *Table 3* suggest Australian companies overall tend to have large undistributed franking credits in their franking accounts.

Moreover, another distortion to the existing dividend imputation system created by the new proposal is in respect of the meaningfulness of the proposed method to determine the 'corporate tax rate for imputation purposes'. As discussed above, pursuing to the *2016 Tax Plan Bill*, a company will be required to frank dividends paid in the current year at the 27.5% rate (any year from 2017 to 2024) if its prior year's aggregated turnover is less than the current year's SBE/BRE threshold; otherwise, an imputation rate of 30% will apply. Explaining for this approach, para 1.71 of the *2016 Tax Plan Bill* contends that 'a corporate tax entity will not know its aggregated turnover for a particular income year (and therefore its corporate tax rate for that income year) until after the end of the income year.'[69] Nevertheless, this paper argues that the proposed operation of the changes to imputation rates delivers little benefit in respect of segregating the underlying profits for which the corporate tax rate equals to the imputation rate.

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69 Explanatory Memorandum, above n 41, [1.71].

Table 3: Summary of franking account balances from 2004 to 2014 extracted from ATO Taxation statistics 2013–14 and estimated franking account balances in 2015 and 2016

Financial year	ATO statistic / Estimate	Franking account balance (AU$)	% Increase in franking account balance (compared to previous year)	Distributable franked dividends at 30% tax rate (AU$)
2003–04	ATO statistic	108,108,909,226		
2004–05	ATO statistic	120,785,640,859	11.73%	
2005–06	ATO statistic	135,127,268,330	11.87%	
2006–07	ATO statistic	153,921,868,636	13.91%	
2007–08	ATO statistic	179,509,795,063	16.62%	
2008–09	ATO statistic	201,380,531,173	12.18%	
2009–10	ATO statistic	217,691,212,752	8.10%	
2010–11	ATO statistic	228,795,702,114	5.10%	
2011–12	ATO statistic	251,971,425,419	10.13%	
2012–13	ATO statistic	276,810,391,705	9.86%	
2013–14	ATO statistic	296,351,149,193	7.06%	
Average % increase in franking account balance over 10 years (2004–2014)			10.66%	
2014–15	Estimate	327,942,181,697	10.66%	765,198,423,960
2015–16	Estimate	362,900,818,266	10.66%	846,768,575,954

As a practical example, let us revisit *Example 1.1* used in the *2016 Tax Plan Bill* to illustrate para 1.73 (with a summary provided in *Table 1* of this paper).[70] In *Table 4*, the original *Example 1.1* is modified by assuming Company A's aggregated turnover for 2017–18 is AU$26 million. Since the BRE threshold in 2017–18 is AU$25 million, company A cannot qualify for lower corporate tax rate of 27.5%. Under the new imputation rules, the 'corporate tax rate for imputation purposes' in 2017–18 is determined by reference to the aggregated turnover in the previous income year, which is 2016–17. Because the previous year's aggregated turnover of AU$20 million is below the BRE threshold of AU$25 million for 2017–18, the applicable imputation rate on dividends paid in 2017–18 becomes 27.5%.

70 Explanatory Memorandum, above n 41, [1.73].

Table 4: Further example of operation of the proposed change to imputation rate from 2016–17

Company A	2015–16	2016–17	2017–18
Aggregated turnover	$18mil	$20mil	$26mil
Small business entity (SBE) or base rate entity (BRE) threshold	$2mil	$10mil	$25mil
Current year's aggregated turnover less than current year's SBE/BRE threshold?	No	No	No
Corporate tax rate for income tax	30.0%	30.0%	30.0%
Prior year's aggregated turnover less than current year's SBE/BRE threshold?	N/A – Note (a)	No	Yes
Corporate tax rate for imputation purposes	30.0%	30.0%	27.5%

Note (a): Imputation rate of 27.5% only starts from 2016–17 income year.

In this new example, a company pays income tax at 30% on the 'old' profits (2016 and 2017 income years) and still pays income tax at 30% on the 'new' profits in the current year (2018 income year). However, the franked dividends in the 2018 income year, which are necessarily paid out of the 'old' underlying profits, carry imputation credits based on the lower tax rate of 27.5%. Essentially, the franking credits distributed to shareholders are reduced to the lower imputation rate while the company has never been eligible to access the lower corporate tax rate, past and present. This example illustrates a situation where the new imputation rules result in unnecessary mismatch between corporate tax rate for income tax calculation and corporate tax rate for imputation purposes, and therefore further distort the existing imputation regime.

Nevertheless, it should also be noted that one potential consequence of the reduction in imputation rate (from 30% to 27.5% and further reduced after 2023–24) is that companies are pushed to distribute the 'old' profits carrying franking credits at 30% tax rate. As a result, we may expect to see a spike in dividend payout trends. A sudden increase in dividend payouts may reduce retained earnings originally planned for business reinvestment and growth, and require capital to fund dividend payments. It is interesting to see what impact this might have on corporate leverage. Besides, for companies with substantial undistributed franking credits, it is possible that domestic investors may demand distribution of the remaining franking credits in the franking account in order to avoid the disadvantage caused by the lower imputation rate of 27.5% imposed on the underlying corporate profits previously taxed at 30%. In that situation, these firms might be expected to pay special franked dividends to reduce (if not fully exhaust) the undistributed franking credits. Another question arises here as to whether this may have any (potentially favourable) effect on share price. However, examination of the effects on the financial market is beyond the scope of this paper.

IV. RETAIN THE INTEGRITY OF THE DIVIDEND IMPUTATION SYSTEM?

New Zealand, one of a few OECD countries that still operate a full dividend imputation system, recently also experienced a company tax cut. Following the introduction of the *Taxation (Budget Measures) Act 2010*, corporate tax rate in New Zealand was reduced from 30% to 28%, effective from the 2011–12 income year.[71] The New Zealand government recognised that the reduction in imputation rate to be aligned with company tax rate would create a disadvantage to shareholders upon receiving franked dividend arising from company profit source which had already been taxed at the higher rate of 30%.[72] Acknowledging that potential disadvantage to shareholders, the New Zealand government provided companies with a transitional period, starting from the first day of 2011–12 income year until 31 March 2013, during which imputation rate of 30% was still applied on dividends paid out of company's underlying profits which were previously taxed at 30%.[73] Australia can consider the experience of New Zealand in tailoring its regulations around changes to the Australian imputation system when corporate tax rate changes.

This paper suggests one approach to minimise the potential distortions to the dividend imputation system when the Australian government implements company tax rate cuts. The ultimate outcome targeted by the alternative recommended here is to achieve the intended result of a full imputation system, which is also restated in para 1.72 of the *2016 Tax Plan Bill*: 'distributions to members who are domestic shareholders will continue to be ultimately taxed at the member's marginal tax rate'.[74] This paper suggests policy-makers consider an extension period, spanning four to five years, for companies to still apply the imputation rate based on the 'old' company tax rate on the corporate profits previously taxed at the same rate. In order words, in the transition from a corporate tax rate from 30% to 27.5%, companies are still allowed to frank dividends at an imputation rate of 30% on the underlying profits that were previously taxed at 30%, for a period of up to four or five years.

This paper puts forward an extension period of four or five years, which is longer than the transitional period adopted by the New Zealand when cutting company tax rate from 30% down to 28%. There are two main reasons for proposing an extension period of this length. Firstly, a period of four to five years would be long enough for companies to plan for dividend

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71 Inland Revenue Department, *New Tax Rates for Companies and Savings* (13 August 2010) <http://www.ird.govt.nz/technical-tax/legislation/2010/2010-27/leg-2010-27-companies-and-savings/>.

72 Chartered Accountants Australia and New Zealand, 'Submission Lodged on Enterprise Tax Plan Bill' (Submission to Senate Economics Legislation Committee, 27 September 2016).

73 Ibid.

74 Explanatory Memorandum, above n 41, [1.72].

payments, including arrangement for capital required for cash payments to shareholders. Since Australia has a rather large franking account balance, which stands at AU$296 billion at the end of the 2013–14 income year,[75] one or two years of extension might not provide sufficient time for companies to exhaust all the undistributed franking credits. A very short extension period can be particularly difficult for firms that previously retained profits to invest in firm's growth and research and development activities; such firms might have to struggle to finance the payments of special dividends if they choose to distribute all of the 'old' franking credits (based on imputation rate of 30%). Secondly, a longer extension period avoids extraordinary surge in dividend payouts. If the extension period is only for one year, distribution of all of the 'old' franking credits means that there will be unusually high special dividends in that extension year, which essentially push individual shareholders to the next income tax bracket if they are not already at the highest marginal individual tax rate. On the other hand, if this extension time is spread over four or five years, the increase in dividend payments can be spread over the length of the extension period.

In order to segregate the underlying profits for which the tax rate for company income tax calculation and the corporate tax rate for imputation purposes are to be the same, companies may be required to report franking credits available for distribution at each applicable franking rate. The 'applicable franking rate' should be understood as the company tax rate based on which the tax payments, i.e. the franking credits, were originally computed. An example is provided in *Appendix 1* to illustrate how this recommended approach can operate in reality.

Under the approach suggested in this paper, corporations have an extension period to pay out the undistributed ('old') franking credits originally arisen from tax payments at the 30% tax rate. At the same time, companies can start having 'new' franking credits from paying corporate tax at 27.5% recorded in the same company franking account. After all the 'old' franking credits are exhausted through dividends (with imputation rate of 30%) paid within the extension period, a company can start distributing the 'new' franking credits which are attached to dividends franked at the new imputation rate of 27.5%. In order to keep track of the 'old' and 'new' franking credits, companies will be required to clarify the imputation rate for each franking entry (either debit or credit). *Appendix 1* presents one possible way this segregation can be incorporated into the existing company franking account. In essence, this is not much different from operating multiple franking accounts during the extension period; however, the suggestion here makes consolidation into one franking account as simple as possible.

Once the extension period of four or five years lapses, if a company has not used up all the 'old' franking credits (imputation rate of 30%), these will be converted to 'new' franking credits (imputation rate of 27.5%) by applying a factor of: 70/30 x 27.5/72.5. This method

[75] Australian Taxation Office, above n 68.

is similar to the conversion to class C franking account back in 2001–02,[76] except that back in 2002 the franking account tracks taxed profits while the franking account post-2002 tracks tax payments made to the ATO. The consequence of this conversion is that domestic shareholders will pay higher top-up tax on dividend income compared to that top-up tax required of the same shareholders before conversion of the 'old' franking credits. This consequence is shown in *Table 5*.

In *Table 5*, it is demonstrated that for a corporate profit of $100 on which $30 of tax is paid to the ATO, if a company distributes $30 of franking credits within the extension period, an individual domestic shareholder subject to the highest marginal tax rate (of 49%) upon receiving a dividend of $70 is required to pay an additional tax (or top-up tax) amount of $19. In contrast, if for some reason this same company does not distribute $30 of franking credits before the end of the extension period, the 'old' surplus of $30 will be converted into a 'new' credit of $26.55 in the company franking account, i.e. the maximum amount of franking credits distributable to shareholders but these franking credits are subject an imputation rate of 27.5%. Following the conversion, when the domestic shareholder receives a dividend of $70, the additional tax in the hands of that shareholder now increases to $20.76. Hence, the 'additional' top-up tax of $1.76 (being $20.76 less $19) can be considered as a penalty to company shareholders when a company does not fully exhaust the undistributed franking credits, which arose from previous tax payments made at 30% tax rate, during the extension period provided by the Australian government.

The above recommendation in respect of the extension period and revision to the franking account in order to keep track of franking credits for corporate profits paid at different tax rates is only one alternative this paper can suggest. There can be other alternatives that should be considered with the overarching aim of retaining the integrity of the dividend imputation system in Australia.

76 Revised Explanatory Memorandum, above n 47.

Table 5: Comparison of taxes paid on corporate profit before and after conversion of franking credits when extension period lapses

	Underlying corporate profit taxed at 30%	Before conversion: 'old' franking credits	After conversion: 'new' franking credits
Company before-tax profit (A)	$100.00		
Corporate tax rate (B)	30.00%		
Company income tax (C = A*B)	$30.00		
Company after-tax profit (D = A – C)	$70.00		
Franking credits			
+ Original 'old' franking credits (E = B)		$30.00	
+ 'Old' franking credits converted to 'new' franking credits after extension period lapses (F = E*70/30*27.5/72.5)			$26.55
Franked dividend paid to shareholder (G = D)		$70.00	$70.00
Imputation rate (H)		30.00%	27.50%
Franking credits attached to dividend paid (I = G*H/(1-H))		$30.00	$26.55
Grossed-up dividend (J = G + I)		$100.00	$96.55
Individual domestic shareholder's marginal tax rate (K)		49.00%	49.00%
Tax on dividend income at individual shareholder's level (L = J*K)		$49.00	$47.31
Franking credits received by individual shareholder (M = I)		$30.00	$26.55
Net tax payable on dividend income by individual shareholder (N = L – M)		$19.00	$20.76

V. CONCLUSION

This article raises a question of the integrity of the dividend imputation tax system when corporate tax rate changes. An analysis of the Australian dividend imputation system is provided in this article since Australia is one of a few OECD countries that still operate a full imputation tax system and the Australian government recently announced corporate tax rate cuts to be more in line with the OECD average company tax rate.

This study starts with an examination of the overall experience that Australia has after operating a dividend imputation system for nearly thirty years, starting from 1987. It is overall suggested that the imputation system in Australia has brought positive contributions to the Australian financial market and the imputation system is generally considered to be stable and efficient. The paper proceeds to examine the potential distortions that the proposed changes in the *2016 Tax Plan Bill* may cause to the existing imputation system.

These potential distortions include: (a) the discrepancy between the tax rate of 30% applied on the underlying corporate profits and the lower tax rate of 27.5% used for imputation purposes; (b) the consequently higher tax payable at domestic shareholders' level on the same underlying corporate profit; (c) the wastage of franking credits which may be trapped in the company franking account; and (d) the induced corporate tax aggressive planning strategies to utilise the trapped franking credits. Besides, it is noted that the new imputation rules put forward by the *2016 Tax Plan Bill* may also lead to an increase in dividend payouts, which may consequently have certain interactions with company borrowings to pay special dividends as well as with company's share price.

This paper suggests one alternative for consideration with a view to achieve the intended outcome of a full dividend imputation system. This article recommends providing companies with an extension period of four or five years during which the corporate tax entities can still apply the imputation rate based on the 30% company tax rate in respect of the dividends paid out of underlying profits that were previously taxed at 30%. The suggestion package also includes a revision to the franking account, which allows companies to keep track of franking credits that arise from tax payments at different tax rates (30% or 27.5%). Under the proposed alternative, any undistributed franking surplus previously subject to the imputation rate of 30% will be converted to 'new' franking credits subject to imputation rate of 27.5% once the extension period lapses.

Furthermore, the recommended alternative in this paper also caters for any further company tax rate changes in the future. As part of the proposal in the *2016 Tax Plan Bill*, after corporate tax rate for companies of all sizes reaches a flat rate of 27.5% in 2023–24, further tax cuts will occur to bring the corporate tax rate down to 27% (in 2024–25), 26% (in 2025–26) and then 25% (in 2026–27 and later years).[77] Therefore, it is now a timely opportunity to consider thoroughly all the alternatives and tailor the changes required in order to retain the integrity of the imputation system in Australia; these changes can set a stepping stone for further variation of corporate tax rate in the future.

[77] Explanatory Memorandum, above n 41, [1.14]-[1.15].

APPENDIX 1

This appendix presents two examples to illustrate how the suggested approach in Section IV of this paper operates in reality and how adoption of this tracking method for the company franking account may address the issues surrounding company tax rate cuts for Australian companies.

In this appendix, it is assumed that a four-year extension period applies and that during the extension period, companies can still apply the imputation rate (or franking rate) based on the 'old' company tax rate on the underlying corporate profits previously taxed at the same rate. Simply put, companies are still allowed to frank dividends at a franking rate (FR) of 30% on the underlying corporate profits previously subject to tax at 30% for the first four years since the companies start becoming eligible for the lower corporate tax rate.

This paper recommends the existing company franking account be revised to allow recording debit and credit entries at relevant FR. Practically the debit column will be split into two categories, being FR of 30% and FR of 27.5%; likewise for the credit column. Consequently, the running balance column in the franking account would reflect: (a) the franking credits available to be distributed based on 30% tax rate; and (b) the franking credits available to be distributed based on 27.5% tax rate.

In both examples, company A and company B are Australian corporate tax entities and are assumed to be eligible for the lower company tax rate of 27.5% from the 2017 financial year (i.e. the year ending on 30 June 2017). These two companies are allowed a four-year extension period. In the first example, company A could exhaust the undistributed franking credits subject to FR of 30% within the four-year extension period. In contrast, company B does not have sufficient cash to pay enough dividends to utilise all the 'old' franking credits. After the extension period lapses, company B is required to convert the 'old' franking credits into 'new' franking credits, which are subject to 27.5% FR.

Company A:
'Old' franking credits subject to FR of 30% are utilised within the four-year extension period

Assuming company A has an opening surplus of $50,000 at FR of 30% in its company franking account at the beginning of the 2017 financial year. During the 2017 year, company A receives franked dividends carrying $10,000 in franking credits at FR of 30%. Company A also pays income tax of $8,000 to the Australian Taxation Office (ATO) in respect of its 2016 income tax return (which is lodged and assessed after 30 June 2016) and its 2016 income tax is calculated based on tax rate of 30%. The two amounts of $10,000 and $8,000 are recorded as credit entries in the FR 30% column. Besides, in the 2017 year, company A pays the ATO income tax instalments totalling $25,000 in relation to the 2017 financial year. Because company A is eligible for the lower tax rate of 27.5% starting from 2017, the instalments worth of $25,000 are recorded as a credit entry for the FR 27.5% column. Under the suggested four-year extension period, company A is allowed to pay dividends franked based on the old tax rate of 30% in the 2017 year. As such, a debit entry of $35,000 is entered in the FR 30% column to reflect the 'old' franking credits distributed by company A in 2017.

Table A: Franking Account of Company A – 'old' franking credits subject to franking rate of 30% exhausted within the four-year extension period

	Debit		Credit		Balance	
Franking rate (FR)	30.0%	27.5%	30.0%	27.5%	30.0%	27.5%
2017 Financial year: First year						
Opening franking credits					50,000	
Dividend received – FR of 30%			10,000		60,000	–
Income tax paid – 2016 tax return			8,000		68,000	–
Income tax instalments in respect of FY2017				25,000	68,000	25,000
Dividend paid – FR of 30%	35,000				33,000	25,000
Closing franking credits					33,000	25,000
2018 Financial year: Second year						
Opening franking credits					33,000	25,000
Dividend received – FR of 30%			10,000		43,000	25,000
Dividend received – FR of 27.5%				5,000	43,000	30,000
Income tax refund – 2017 tax return		3,000			43,000	27,000
Income tax instalments in respect of FY2018				22,000	43,000	49,000
Dividend paid – FR of 30%	35,000				8,000	49,000
Closing franking credits					8,000	49,000
2019 Financial year: Third year						
Opening franking credits					8,000	49,000
Dividend received – FR of 30%			7,000		15,000	49,000
Dividend received – FR of 27.5%				8,000	15,000	57,000
Income tax paid – 2018 tax return				5,000	15,000	62,000
Income tax instalments in respect of FY2019				27,000	15,000	89,000
Dividend paid – FR of 30%	15,000				–	89,000
Dividend paid – FR of 27.5%		20,000			–	69,000
Closing franking credits					–	69,000

An illustration of how the credit and debit entries are recorded for the 2017 financial year is provided in *Table A*. At the end of 2017, company A has closing surpluses of $33,000 (at 30% FR) and $25,000 (at 27.5% FR).

Transactions of similar nature occur for company A in the 2018 and 2019 financial years. In the 2019 year, company A exhausted the franking credits available at FR of 30%. As such, in 2019, company A is considered to have paid dividends in two tranches: the first with attached franking credits of $15,000 subject to imputation rate of 30%, and the second with attached franking credits of $20,000 subject to imputation rate of 27.5%.

Company B:
'Old' franking credits subject to FR of 30% are not utilised within the four-year extension period and the remaining balance is converted to 'new' franking credits

In the second example, company B is assumed to have the same tax payment and dividend payment history as company A in the 2017, 2018 and 2019 financial years, except that in 2019 the cash available in company B only allows it to pay dividends with attached franking credits of $5,000 subject to 30% FR rate (because 2019 is only the third year of the four-year extension period). After crediting $5,000 in the FR 30% column in 2019, the closing balances in company B's franking account for 2019 become $10,000 (at 30% FR) and $89,000 (at 27.5% FR). The calculations are demonstrated in *Table B* of this appendix.

In the 2020 financial year, company B pays the same amount of dividend as that paid in 2019. As such, company B distributes $5,000 in franking credits at the imputation rate of 30% in 2020, leaving a closing franking surplus of $5,000 in the FR 30% column. The closing balance of franking credits subject to FR of 27.5% is $127,000 for 2020. In this example, an assumption is made that the four-year extension period applies, commencing in 2017 and ending in 2020. Hence, the undistributed 'old' franking credits subject to franking based on the 30% tax rate are required to be converted to 'new' franking credits (i.e. subject to an imputation rate of 27.5%) in the beginning of the 2021 income year.

In *Table B*, the first entry for the 2021 year is the conversion entry, in which the opening franking surplus of $5,000 in the FR 30% column is converted to $4,425 franking credits being added to the surplus recorded in the FR 27.5% column by applying this factor: 70/30 x 27.5/72.5. As a result of this entry, the only franking surplus in company B's franking account as at 1 July 2020 (i.e. beginning of 2021 income year) is $131,425.

Starting from 1 July 2020, after the extension period is over, all franking entries – both debits and credits – for the 2021 financial year are recorded in the FR 27.5% column. In this example, as at 30 June 2021, the franking balance of company B shows a zero balance in the FR 30% column and a closing franking surplus of $159,425.

This example has demonstrated how the suggested revision to company franking account can be practically carried out when a company does not exhaust its 'old' franking credits, which are based on company tax rate of 30%, in the four-year extension period.

The examples provided in this appendix only illustrate one of the possible methods to manage company franking account when corporate tax rate changes with minimal distortions to the current imputation system.

Table B: Franking Account of Company A – 'old' franking credits subject to franking rate of 30% not exhausted within the four-year extension period

	Debit		Credit		Balance	
Franking rate (FR)	30.0%	27.5%	30.0%	27.5%	30.0%	27.5%
2017 Financial year: First year						
Opening franking credits					50,000	
Dividend received – FR of 30%			10,000		60,000	–
Income tax paid – 2016 tax return			8,000		68,000	–
Income tax instalments in respect of FY2017				25,000	68,000	25,000
Dividend paid – FR of 30%	35,000				33,000	25,000
Closing franking credits					33,000	25,000
2018 Financial year: Second year						
Opening franking credits					33,000	25,000
Dividend received – FR of 30%			10,000		43,000	25,000
Dividend received – FR of 27.5%				5,000	43,000	30,000
Income tax refund – 2017 tax return		3,000			43,000	27,000
Income tax instalments in respect of FY2018				22,000	43,000	49,000
Dividend paid – FR of 30%	35,000				8,000	49,000
Closing franking credits					8,000	49,000
2019 Financial year: Third year						
Opening franking credits					8,000	49,000
Dividend received – FR of 30%			7,000		15,000	49,000
Dividend received – FR of 27.5%				8,000	15,000	57,000
Income tax paid – 2018 tax return				5,000	15,000	62,000
Income tax instalments in respect of FY2019				27,000	15,000	89,000
Dividend paid – FR of 30%	5,000				10,000	89,000
Dividend paid – FR of 27.5%		–			10,000	89,000
Closing franking credits					10,000	89,000
2020 Financial year: Fourth year						
Opening franking credits					10,000	89,000
Dividend received – FR of 30%			–		10,000	89,000
Dividend received – FR of 27.5%				15,000	10,000	104,000
Income tax refund – 2019 tax return		2,000			10,000	102,000
Income tax instalments in respect of FY2020				25,000	10,000	127,000
Dividend paid – FR of 30%	5,000				5,000	127,000
Closing franking credits					5,000	127,000
2021 Financial year: Fifth year						
Opening franking credits					5,000	127,000
Conversion of opening balance after 4-year extension (factor of 70/30 x 27.5/72.5)	5,000			4,425	–	131,425
Dividend received – subject to 27.5% FR				15,000	–	146,425
Income tax paid – 2020 tax return				4,000	–	150,425
Income tax paid in respect of FY2021				29,000	–	179,425
Dividend paid – FR of 27.5%		20,000			–	159,425
Closing franking credits					–	159,425

WHEN IS THE COMMISSIONER EMPOWERED OR REQUIRED TO NEGATE A GST BENEFIT?

CYRUS THISTLETON*

I. INTRODUCTION

Competently structured tax legislation tends to minimise tax avoidance by putting in place provisions, which may include specific anti-avoidance provisions, to stop the abuse of the intent of each provision in the tax legislation, even when a scheme is devised to enable avoidance. Even though the policy intent of the legislation may be reflected in the wording of the legislation to a greater or lesser degree, it can be open to different interpretations or can be manipulated to suit the taxpayer's preferred outcome. It is impossible for the legislature to foresee all possible tax avoidance arrangements and to enact a tax provision which has no loopholes for an indefinite period. Despite the existence of some specific anti-avoidance provisions[1] to address particular schemes, general anti-avoidance provisions are put in place to prevent artificial schemes which are designed, solely or principally, for the purpose of obtaining tax benefits by using these loopholes in a manner which is inconsistent with the intent of the legislature.

The leading and the most influential High Court decisions on the general anti-avoidance rules in FCT v Unit Trend Services Pty Ltd[2] (Unit Trend), FCT v Spotless[3] (Spotless), FCT v Consolidated Press Holdings[4] (Consolidated Press), FCT v Peabody[5] (Peabody) and FCT v

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1 Specific anti-avoidance provisions of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA) such as s 9-75(1)(b) (the value of taxable supplies not expressed in money), s 29-25 (Commissioner may determine particular attribution rule for particular taxable supplies and creditable acquisitions), s 66-10 (amounts of input tax credit for creditable acquisitions of second-hand goods) and s 72-70 (the value of taxable supplies foe inadequate consideration between associated persons).

2 *FCT v Unit Trend Services Pty Ltd* (2013) 250 CLR 523.

3 *FCT v Spotless Services Ltd* (1996) 186 CLR 404.

4 *FCT v Consolidated Press Holdings Ltd* (2001) 207 CLR 235.

5 *FCT v Peabody* (1994) 181 CLR 359.

Hart[6] (Hart) have acknowledged the importance of the general anti-avoidance provisions. In this regard, Sackville J stated that 'it is becoming increasingly apparent that the general anti-avoidance provisions are central to the operation of the Australian tax system'.[7]

Division 165 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA) contains the general anti-avoidance rules for the GST, the wine equalisation tax and the luxury car tax. The general anti-avoidance provisions in the GSTA give the Commissioner the power under s 165-40 of the GSTA to negate the GST benefit obtained from an artificial or contrived scheme when the GST provisions fail to achieve the result intended by the legislature. Division 165 can be applied to an arrangement when an entity, being the avoider, got or gets a GST benefit from a scheme which has the sole or dominant purpose of getting a GST benefit or, alternatively, the principal effect of the scheme is that the avoider gets the GST benefit from the scheme, directly or indirectly. However, the third element (determining the purpose and the principal effect) is controversial and subject to different interpretations. The principal effect test is an extension of the test in Pt IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936). Once these requirements are satisfied, the Commissioner is empowered to make a declaration negating the GST benefit.

Although the focus of this article is on Division 165, the author refers, in particular, to Pt IVA court decisions because: (1) Division 165 is based on Pt IVA in many aspects, such as structure and purpose;[8] (2) there is a paucity of judicial guidance on Division 165; and (3) there are many more income tax avoidance court cases than there are GST avoidance cases.

Despite being a derivative of Pt IVA, Division 165 was written to address the transactional nature of GST, as well as rectifying Pt IVA deficiencies. In this respect, Gyles J in *McDonald's Australia Ltd v FCT*[9] stated that, Division 165 is 'broadly similar to Pt IVA of the *Income Tax Assessment Act 1936* (Cth), the subject of much litigation, but there are important differences … both from the different terms of the provisions themselves and from the differences between GST and income tax'.

It should be noted that Division 165 should be considered after specific anti-avoidance provisions fail to prevent the GST benefit as the result of the scheme. Accordingly, in this paper, an example is provided which shows how the specific anti-avoidance provisions are considered prior to application of Division 165.

Since Division 165 does not deal with tax evasion, it is important to distinguish between tax avoidance and tax evasion. In this regard, the author explains, in passing, what constitutes tax evasion and what constitutes tax avoidance.

6 *FCT v Hart* (2004) 217 CLR 216.

7 Justice R Sackville, 'Avoiding tax avoidance: the primacy of Part IVA' (FCA) [2004] *FedJSchol* 11.

8 See Explanatory Memorandum to the *A New Tax System (Goods and Services Tax) Bill* 1998, [6.313]

9 *McDonald's Australia Ltd v Commissioner of Taxation* [2008] FCA 37 at [16].

The author then provides a detailed examination of the application of Division 165 and takes into consideration the policy intent of the GSTA to examine the circumstances in which the Commissioner should negate the GST benefit. The author writes this article from both a legal and a tax administrator's perspective.

II. SPECIFIC ANTI-AVOIDANCE PROVISIONS

Specific anti-avoidance provisions are to address possible tax avoidance schemes. However, it is impossible for the legislature to foresee all possible tax avoidance arrangements and to enact a tax provision which has no loopholes for an indefinite period. When considering application of Division 165, it is always considered necessary to consider the specific anti-avoidance provisions prior to considering general anti-avoidance provisions.

The following example describes an arrangement, entered into by an entity, which attempts to increases its entitlement to input tax credit (ITC), however, it triggers the specific provisions that stops the rise of the GST benefit. In the absence of such specific provisions, it is considered appropriate to apply Division 165 to negate the GST benefit.

When looking at the GST chain, some businesses are end users where the GST is, in part, an expense to the business, such as acquisitions that attract reduced input tax credit (RITC) under s 70-5 of the GSTA. This may include entities which provide input taxed supplies, such as authorised deposit-taking institutions like banks. The financial supplies are input taxed and therefore, the bank cannot claim ITC for acquisitions it makes in making those supplies. However, there is provision for a special 75 percent ITC entitlement for certain types of services acquired by financial supply providers such as banks. These are called 'reduced credit acquisitions'.

The example is a hypothetical scenario for the purposes of demonstrating how specific anti-avoidance provisions work, as follows:

1. Ultimate Head Entity (UHE) is a bank which is a financial supply provider.
2. Company A is a member of the broader economic group; however, it is not a member of UHE GST group at the initial stage of the arrangement.
3. Company A is a service provider which is not carrying on an enterprise for the purposes of making financial supplies. This entitles the company to 100 percent of the input tax credit for its acquisitions.
4. Company A, while sitting outside the GST group, buys a business which has the necessary requirements for providing services to UHE, by utilising going concerns provisions and treating the acquisitions as GST free. These acquisitions are intended to be used exclusively by UHE.
5. Immediately afterwards (or some time later), the UHE's GST group representative groups Company A for GST purposes. Subsequently, Company A provides goods and/or services to UHE which is an intra-group transaction. Under the grouping provisions of

GSTA, the supplies and acquisitions made wholly within the group are effectively ignored and not treated as taxable supplies or creditable acquisitions.

6 While UHE attempted to increase its entitlement to ITC from 75 percent to 100 percent by entering into this arrangement, it triggers GST specific anti-avoidance provisions to prevent the bank from getting the GST benefit.

In the above scenario, the GST benefit is the loss of revenue resulting from the intra-group transaction. Had the Company A been outside of the GST group when it supplied UHE with the services, then the GST liability of the UHE Group representative would exceed the RITC entitlement of the UHE such that the Commissioner would be in a revenue positive position.

Prior to considering the application of Division 165, it is important to consider specific anti-avoidance provisions to see if the GST benefit resulting from this arrangement could result in an increasing adjustment.

This arrangement gives rise to an increasing adjustment under s 48-55, Division 135 and 129 of the GSTA. An increasing adjustment, for purposes of GSTA, means that the GST liability of UHE GST group is increased due to the fact that the bank acquired a business GST-free as a going concern but intends to use it wholly or partly in making input taxed supplies. These provisions are specific anti-avoidance provisions.

Section 48-55 of the GSTA requires that GST groups be treated as a single entity for the purposes of working out whether the representative member has any adjustments, in particular:

> *(1A) If:*
>
> *(a) while you were not a * member of any * GST group, you acquired or imported a thing; and*
>
> *(b) you become a member of a GST group at a time when you still hold the thing;*
>
> *Then, when the * representative member of the GST group applies section 129-40 for the first time after you became a member of the GST group, the * intended or former application of the thing is the extent of * creditable purpose last used to work out: (c) the amount of the input tax credit to which you were entitled for the acquisition or importation; or (d) the amount of any * adjustment you had under Division 129 in relation to the thing.*

Division 129 of the GSTA requires an increasing adjustment because of changes in the extent of creditable purpose.

Division 135 of the GSTA applies in relation to any supply of a going concern. Division 135 states that you have an increasing adjustment if you are the recipient of a sale of a going concern and intend that some or all of the supplies, made through the enterprise to which the supply of the going concern relates, will be input taxed supplies. The GST group representative may have an increasing adjustment when the going concern becomes part of the GST group if its use was to make supplies that were neither taxable nor GST free, on the basis that the GST group is now a single entity.

Therefore, the UHE GST group, as the recipient of a supply of a going concern, has an increasing adjustment to take into account the proportion (if any) of supplies that will be made in running the concern and that will not be taxable supplies or GST-free supplies. Later adjustments are needed if this proportion changes over time. The amount of the increasing adjustment is as follows:

$$\frac{1}{10} \text{ x Supply price x Proportion of noncreditable use}$$

The above specific anti-avoidance provisions are in place to address such schemes. However, when such provisions fail, the general anti-avoidance provisions are available to prevent artificial schemes which are designed, solely or principally, for the purpose of obtaining tax benefits by using such loopholes in a manner which is inconsistent with the intent of the legislature.

III. Evasion and Avoidance

General anti-avoidance provisions of Division 165 are not generally directed at tax evasion. The distinction between evasion and avoidance can sometimes be a little unclear and may be difficult to recognise in practice. While both result in tax revenue leakage, one, avoidance, is done lawfully through artificial but legitimate activity and the other, evasion, classically carries a factor of clear illegality or fraud. As they say 'the difference between avoidance and evasion is the thickness of a prison wall'.[10] Although fraud can mean different things in branches of the law, for the purposes of Australian taxation law as a whole, it is common law fraud and not criminal law fraud or equitable fraud. The court in *Kajewski v FCT*[11] held that:

> *Fraud within s 170(2)(a) involves something in the nature of fraud at common law, ie, the making of a statement to the Commissioner relevant to the taxpayer's liability to tax which the maker believes to be false or is recklessly careless whether it be true or false.*

It can therefore be extrapolated that this concept also applies equally to GST law. A good description of fraud in taxation matters was given by Enderby J in *Masterman v FCT; MacFarlane v FCT*.[12] In this case, the taxpayer lodged income tax returns, for a few income years, claiming deductions in respect of employees that did not exist. Enderby J stated that the statements made in these tax returns 'can only be described as frauds on the Commissioner of Taxation'. Taking this approach, in the context of GST, producing invoices for goods which do not exist or claiming GST that was never paid, in order to maximise GST refunds, constitutes fraud and thus evasion.

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10 Former British Chancellor Denis Healey.

11 *Kajewski v FCT* [2003] FCA 258 at [111].

12 *Masterman v FCT; MacFarlane v FCT* (1984) 16 ATR 77.

Evasion also includes conduct which is more than avoidance but less than fraud. In this respect, Lord Hobhouse in *Simms v Registrar of Probate*[13] described evasion as 'nothing more than intentional avoidance of something disagreeable but less than fraud'.

Evasion is best explained by reference to the judgment of Dixon J in *Denver Chemical Manufacturing v FCT*[14] in which his Honour described evasion as a 'blameworthy act or omission on the part of the taxpayer'.

Williams J in *Barripp v FCT (NSW)*[15] explained tax evasion in the following way:

> *Where a taxpayer makes a profit which he knows to be taxable income and wilfully omits this profit from his income tax return, he would be guilty of evasion in the absence of some satisfactory explanation for the omission.*

Accordingly, tax evasion requires the presence of two elements: (1) the act itself such as a false statement or deliberate omission; and (2) the 'guilty' mind of the taxpayer who knows he is doing something wrong and recklessly ignores the true position.

Gleeson CJ in *R v Meares*[16] distinguished between 'avoidance' and 'evasion', in the following way:

'Tax avoidance involves using, or attempting to use, lawful means to reduce tax obligations. Tax evasion involves using unlawful means to escape payment of tax. Tax avoidance is lawful and tax evasion is unlawful … It is sometimes said that the difference may be difficult to recognise in practice. I would suggest that in most cases there is a simple and practical test that can be applied. If the parties to a scheme believe that its possibility of success is entirely dependent upon the revenue authorities never finding out the true facts, it is likely to be a scheme of tax evasion, not tax avoidance.'

Tax avoidance was defined by the *Review of Business Taxation*:[17]

> *Tax avoidance may be characterised as a misuse or abuse of the law rather than a disregard for it. It is often driven by the exploitation of structural loopholes in the law to achieve tax outcomes that were not intended by the Parliament but also includes manipulation of the law and a focus on form and legal effect rather than substance. The way things are done in order to take advantage of structural loopholes, or to dress up something to satisfy form but not substance can also stamp an arrangement as avoidance.*

Characteristics of a tax avoidance scheme would be qualities such as 'artificiality', 'undue complexity' and 'circularity', or 'lack of business reality'.[18]

13 *Simms v Registrar of Probate* (1900) AC 332 at [334].

14 *Denver Chemical Manufacturing v FCT* (1949) 79 CLR 296 at [313].

15 *Barripp v FCT (NSW)* (1941) 6 ATD 69 at [72].

16 *R v Meares* (1997) 37 ATR 321 at [323].

17 *Review of Business Taxation*, A tax system redesigned, July 1999, at [243].

18 *Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes)* [2005] STC 1 at [24], citing Park J in the High Court.

It should be noted that tax avoidance is different from legitimate tax planning or tax mitigation. Legitimate tax planning is a way in which a taxpayer structures his or her business and taxation affairs, in compliance with taxation laws, to arrive at the lowest possible tax cost. This is not against the intent of the legislature. Lord Templeman, in *CIR (NZ) v Challenge Corporation*, stated that there is a difference between acceptable tax mitigation to which the general anti-avoidance rules do not apply and unacceptable tax avoidance to which the general anti-avoidance rules applies.[19]

There is also a situation where taxpayers avoid paying GST liability or other tax liabilities to the Commissioner by phoenixing where the tax liability becomes no longer accessible by means of the systematic liquidation of related entities. The aim of phoenixing is simply to avoid payment of a tax liability, employee entitlements and creditors.

In phoenixing, the directors of the company leave the debts with the old company and place the company into liquidation, leaving no assets to pay creditors. In the meantime, another company is registered and operated by the same 'controlling mind' and continues the same business under a new structure.

For tax purposes, a phoenixing arrangement is concerned with the stripping of assets of companies and trusts before tax liability is due or collected; and schemes under which a tax liability falls on a company or trust that is never intended to have sufficient assets to meet its tax liability. This is neither avoidance nor evasion. It is not avoidance because the GST liability already exists. It is not fraud or evasion as the liquidation is not illegal and it would be difficult to establish the fraudulent intention of the directors to lift the corporate veil. However, director's penalty notices and *Crimes (Taxation Offences) Act 1980* (Cth) could restrict phoenixing. There are cases where the Commissioner has sought to apply the provisions of this Act such as in *R v Ditford*.[20]

GST avoidance could also be in the way of altering the timing of payments of GST or refunds as was decided in *VCE v FCT*.[21] *VCE* concerned an arbitrage opportunity through a transaction exploiting differences in the timing for payment and accounting for GST differently, one on cash and the other on accrual. VCE claimed an input tax credit when it entered into an agreement to purchase a medical centre payable over an approximately 15-year period, while the vendor was only paying GST when consideration was received. The Commissioner disallowed VCE's claim under Division 165. The Administrative Appeals Tribunal (AAT) found that the taxpayer got a GST benefit and Division 165 was applied to negate the benefit.

In the absence of fraud or evasion, GST anti-avoidance provisions, unlike Pt IVA, have a time limit in which they may be applied. The effective time limit for the Commissioner to make a

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19 *Commissioner of Inland Revenue v Challenge Corporation Ltd* [1987] AC 155 at [167]-[168]. See also the decision of the New Zealand Court of Appeal in *Commissioner of Inland Revenue v BNZ Investments Ltd* [2002] 1 NZLR 450 at [39], where the majority drew the line between legitimate tax planning and improper tax avoidance.

20 *R v Ditford* 87 ATC 4678 and 91 ATC 4423.

21 *VCE and FCT* [2006] AATA 821.

declaration under s 165-40 is within four years after the time GST became payable by an entity.[22]

GST is highly susceptible to evasion and not quite so easily susceptible to avoidance. The obvious situation is where a transaction is a sham with fraudulent GST refund claims or where GST is simply not paid, in respect of a taxable supply, by deliberate underreporting of taxable supplies. Legislation can deal with evasion by criminalising it. It can impose penalties on those who are caught in the act. However, detection and prosecution are the problems.

Since the general anti-avoidance provisions are not generally directed at tax evasion, the act of GST minimisation, for the purposes of Division 165, should fall within the scope of tax avoidance.

IV. APPLICATION OF DIVISION 165

Division 165 is aimed at artificial and contrived transactions that are, in themselves, real and lawful but which nonetheless breach the normal or expected operation of the GSTA. Its object is to deter schemes that would produce GST benefits, such as reducing GST, increasing refunds, or altering the timing of payment of GST or refunds where the dominant purpose or principal effect is to get GST benefits.[23] Not all of the GST benefits obtained by taxpayers constitute GST avoidance.[24] An outcome of reduction in GST would hardly seem to be GST avoidance if it comes about accidently as part of ordinary commercial transaction. Although there is no carve-out for commercial transactions, commercial explanation does not negate Division 165. While the legality and commercial reasoning behind the transaction needs to be considered carefully, it should not prevent the application of Division 165 when some provisions are utilised in a manner not intended by the legislature. In this respect, the New Zealand High Court in *Miller v Commissioner of Inland Revenue*[25] held that:

> *It is the very nature of tax avoiders to manoeuvre skilfully around the express rules of the general law and the tax legislation and end with the innocent submission - as I have not infringed them I have succeeded. That is the very reason for generally expressed anti-avoidance provisions which begin their operation when other provisions have had their effect.*

The AAT in *Unit Trend* acknowledged that the fact that a transaction is genuinely commercial does not exclude the application of Division 165:[26]

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22 See *Taxation Administration Act* 1953 (Cth), ss 105-5 and 105-50 in Schedule 1.

23 Explanatory Statement to GSTA, s 165-1. The explanatory statement is quite important. Although they do not have operative force in themselves, they may be considered in determining the purpose or object underlying the legislation (s 182-10 of the GSTA).

24 GSTA, 165-5(1)(b).

25 *Miller v Commissioner of Inland Revenue* (1996) 17 NZTC 13,001.

26 *The Taxpayer and FCT* [2010] AATA 497 at [114].

> *... even if the ultimate objective of the transaction is genuinely commercial or the transaction producing the GST benefit also delivers a desired non tax commercial outcome, Division 165 may still operate. Division 165 might apply if there is enough in the way in which a transaction is entered into or carried out, viewed through the prism of the matters listed in s 165-15(1) of the GSTA, that the purpose of obtaining the GST tax benefit outweighs the commercial objectives. The greater the degree of artificiality or contrivance in the transaction directed to obtaining the GST benefit the greater the prospect that the commercial pursuits of the transaction will not be dominant.*

V. UNIT TREND

Unit Trend, a property developer, was the representative member of a GST group of companies which, at the relevant time, included Simnat Pty Ltd, Blesford Pty Ltd and Mooreville Investments Pty Ltd. Different members of the Unit Trend GST group were allocated different roles in the property development. In this case, when construction of the project was at an advanced stage, Simnat sold the project as going concern to Blesford and Mooreville, which completed the project and sold the completed individual residential units to buyers.

The group members used grouping and going concerns provisions and applied margin scheme which resulted in reducing the amount of GST payable by GST group on the ultimate sales of individual residential apartments. The choices and elections that the GST group made which were specifically allowed under GSTA are:

- The choice to form the GST group;
- The choice of intra-group transactions;
- The choice to treat the sales as a supply of a going concern; and
- The choice to apply margin scheme to final sales of the individual residential apartments which means the GST was payable on the difference between the purchase and sale price, rather than on the sale price alone).

The Commissioner issued a declaration to Unit Trend under the anti-avoidance provisions in Division 165 negating the GST benefit. This declaration was contested by Unit Trend in the AAT which found in favour of the Commissioner. The AAT's decision was subsequently overruled by the Full Court in favour of Unit Trend. The Full Court held that the GST benefit obtained by Unit Trend was attributable to the making of a choice, election, application or agreement expressly provided for by the GSTA and, therefore, Division 165 did not apply. On appeal by special leave to the High Court, the issue before the Court was whether the GST benefit obtained by Unit Trend was not attributable to the making of a choice, election, application or agreement that was expressly provided for by the GST Act.

The High Court in *Unit Trend* considered the purpose of Division 165, and took into account the legislative intent of the supplementary explanatory memorandum to *A New Tax System*

(Goods and Services Tax) Bill 1998.[27] Further, the High Court in *Unit Trend* considered the 'election exclusion' contained in s 165-5(1)(b) GSTA. This saving provision can only be applied to protect the taxpayer where the arrangement is not artificial. The High Court confirmed that Division 165 can still be applied when an entity is taking advantage of an election, which was found in the GSTA, in a way that is not consistent with the policy and object of the provision that grants the choice.

The High Court decision in *Unit Trend* also supports the view that Division 165 is focused on the objective purpose or effect of the arrangement and not the motive or subjective purpose of the taxpayer.[28]

The decision of High Court in *Unit Trend* is important in the application of Division 165 because the High Court acknowledged that the High Court cases such as *Spotless, Consolidated Press, Hart* and *Peabody* that dealt with Pt IVA are important authorities in dealing with Division 165 in relation to identifying the scheme, the tax benefit as well as the dominant purpose of the scheme and should also be applied in the context of Division 165. Moreover the importance of *Unit Trend* is the clarification of the exclusion in 165-5(1)(b). This is the first time that the application of the exclusion has been tested in the High Court.

A. *The elements of Division 165*

(a) GST benefit

A 'GST benefit' is defined in s 165-10(1) of the GSTA. An entity gets a GST benefit by (Any of these effects are a GST benefit):

- reducing GST liability, either by not paying or by paying less;[29]
- obtaining or increasing GST refunds;[30] or
- timing benefits, such as altering the timing of GST payment (eg pays GST later) or GST refunds (e.g. gets a refund earlier).[31]

A taxpayer may obtain a variety of tax benefits from the same scheme. However, for the purposes of Division 165, the dominant target of the scheme should be a GST benefit. The definition of 'GST benefit' for the purposes of Division 165 is different from the definition of 'tax benefits' in Pt IVA. This is because the nature of GST and income tax are different as they have different bases.

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[27] *FCT v Unit Trend Services Pty Ltd* (2013) 250 CLR 523 at [53].

[28] Michael Evans, 'GST — It's Not a Matter of Choice: *Commissioner of Taxation v Unit Trend Services Pty Ltd*' on Opinions on High (5 July 2013) http://blogs.unimelb.edu.au/opinionsonhigh/2013/07/05/evans-unittrend/.

[29] GSTA, s 165-10(1)(a).

[30] GSTA, s 165-10(1)(b).

[31] GSTA, ss 165-10(1)(c) and (d).

An obvious example of what constitutes a GST benefit is an inordinate deferred settlement arrangement while claiming an input tax credit today for the expected future value of the property to be paid in future.[32]

There may be situations where the GST benefit obtained does not attract anti-avoidance provisions:

- offering delivery-inclusive prices rather than charging delivery separately for GST-free goods. In this case, delivery is incidental to the supply of those GST-free goods and, thus, there is no GST payable on the value of the portion attributed to delivery costs as the delivery is not contractually separate from the sale of the GST-free goods. This is a common commercial arrangement and accepted internationally;
- formulating a product to bring the supply of that product within the GST-free category, such as increasing the fruit juice content of a beverage from 85 percent (subject to GST) to 90 percent (GST-free) in order to achieve GST-free status;
- an exporter electing to have monthly tax periods in order to bring forward the entitlement to input tax credits; or
- a supplier of child care applying to register under the *Childcare Rebate Act 1993* (Cth), which makes the supplies of child care GST-free.

Identifying the GST benefit requires an examination of what could reasonably have been expected to be the position when viewed independently from the scheme; a reasonable counterfactual which involves a reasonable expectation test.

(b) What is a 'reasonable expectation'?

The enquiry directed by Division 165 requires comparison between the scheme in question and an alternative hypothesis based on the reasonable expectation test in the context of the definition of tax benefit.

The High Court in *Peabody* explained reasonable expectation as follows:[33]

> *A reasonable expectation requires more than a possibility. It involves a prediction as to events which would have taken place if the relevant scheme had not been entered into or carried out and the prediction must be sufficiently reliable for it to be regarded as reasonable.*

When identifying the GST benefit raised from a scheme, ss 165-10(1)(a), (b), (c) and (d) of the GSTA refers to 'could reasonably be expected'. In other words, what could reasonably be expected to have happened if the scheme had not been entered into or carried out? The use of the word 'could' rather than 'would' appears to set a lower degree of satisfaction.

There are many factors to consider when applying the reasonable expectation test, but a few of them are more reasonable and, in the author's opinion, give more weight to a reasonable counterfactual scenario:

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[32] See cases such as *VCE and FCT* [2006] AATA 821 and *Ch'elle Properties (NZ) Ltd v Commissioner of Inland Revenue* [2007] NZCA 256.

[33] *FCT v Peabody* (1994) 181 CLR 359 at [42].

- the most straightforward and usual way of achieving the commercial and practical outcome of the scheme (disregarding the tax benefit);
- commercial norms, for example, standard industry behaviour; and
- the behaviour of relevant parties before/after the scheme compared with during the period of operation of the scheme.

If the scheme includes some significant commercial effect (ignoring the GST benefit), then it is important to see if another counterfactual scenario can achieve the same result but without the GST benefit. When comparing different counterfactuals, it is possible for different conclusions to be reached as to what could reasonably be expected to have happened if the particular scheme had not been entered into or carried out. According to the explanatory memorandum,[34] 'enquiry will be in relation to the most economically equivalent transaction to the scheme or part of the scheme actually entered into or carried out'.

While it may be difficult to find the most reasonable transaction, the one that creates the most economically equivalent transaction to the scheme and which generates the same commercial result and practical outcome without the GST benefit would be the most reasonable one to choose. Interestingly, unlike Pt IVA, even where there is no other alternative scenario, s 165-10(3) provides that a GST benefit can still arise 'even if there is no economic alternative'. In this respect, the explanatory memorandum states that:[35]

> *'An entity that gets a GST benefit from a scheme, even if the entity claims it would not have entered into any type of transaction had the actual scheme not been entered into can still have that GST benefit negated.'*

Accordingly, s 165-10(3) empowers the Commissioner to apply Division 165 in circumstances where the taxpayer claims that no GST benefit arises from the scheme because in its absence, nothing would have happened.

In the author's opinion, it is reasonable to conclude that it only needs to be found that there is a GST benefit, as the result of the scheme, when the scheme was artificial and had no commercial benefit or outcome other than the obtaining of the GST benefit or perhaps other tax benefits.

(c) What constitutes 'an amount'?

Section 165-10(1)(a), (b), (c) and (d) refers to 'an amount' or 'part of an amount' which is a particular quantum of money, whether cash or equivalent, either payable to or payable by the entity. Amount includes a nil amount.[36]

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34 Explanatory Memorandum to the *A New Tax System (Goods and Services Tax) Bill* 1998, [6.334].

35 Ibid [6.335].

36 GSTA, s 195-1.

(d) Which amount constitutes the GST benefit?

Section 165-10(1)(a) deals with that part of the GST benefit involving the actual amount payable by the entity to the Commissioner (including nil amount) being reduced from the amount that should have been paid.[37] An obvious scenario is where the taxable supply is converted to GST-free supplies, as the result of the scheme, so the liability of the entity to the Commissioner in respect of that transaction is reduced to nil amount. The amount equal to the reduction in GST for that transaction is the GST benefit. It is irrelevant to say that the GST is paid by one entity (third party) and claimed back as a creditable acquisition and therefore there is no GST benefit since it is revenue neutral. But, in fact, when applying s 165-10(1)(a) to calculate the GST benefit, you consider the liability of the avoider, rather than trading it off against the third party input tax credit to the transaction if the acquisition is a creditable acquisition.

Section 165-10(1)(b) deals with that part of the GST benefit involving the actual amount payable by the Commissioner to the entity being increased from the amount that should have been paid.[38] An obvious scenario is where input taxed supplies are converted to GST-free supplies as the result of the scheme so the entity can have a full refund for the GST paid on the acquisitions. The GST benefit in this situation is the increase in the claim for input tax credit.

Section 165-10(1)(c) and (d) deals with the timing benefit which arises from the payment of GST, either in delaying the payment or in claiming it. The GST benefit in these situations will be the time value of the money irrespective of how small it is.

(e) What is the 'net amount'?

According to the explanatory memorandum, the net amount refers to the combined effect of s 165-10(1)(a) and (b) where a net amount payable by an entity to the Commissioner is reduced to nil or converted into a refund payable by the Commissioner to the entity.[38]

(f) Is it important for the GST benefit not to be attributable to the taxpayer making an election that is expressly provided for by the GSTA?

When an entity obtains a GST benefit, following the choices and elections that the entity makes, which is specifically allowed under the GSTA, the question is, can the anti-avoidance provisions apply in this situation? This issue concerns s 165-5(1)(b) and (3) GSTA. The election exclusion rule in s 165-5(1)(b) sets the following conditions, for the Commissioner, in negating a GST benefit:[39]

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37 Explanatory Memorandum to the *A New Tax System (Goods and Services Tax) Bill* 1998, [6.331]

38 Ibid.

39 GSTA, s 165-5(1)(b).

> *(b) the GST benefit is not attributable to the making, by any entity, of a choice, election, application or agreement that is expressly provided for by the GST law, the wine tax law or the luxury car tax law.*

This section was included in the GSTA, when the GSTA was introduced, to ensure that the exercise of an express choice, allowed under the GSTA, would not trigger Division 165.

The High Court in *Unit Trend* examined the election exclusion contained in s 165-5(1)(b). In this case, the High Court emphasised that the real test in s 165-5(1)(b) is not whether a GST benefit is attributable to a statutory choice but, rather, whether the GST benefit was not attributable to a statutory choice. Their Honours took the view that the Federal Court mistakenly focused on the word 'attributable' rather than the phrase 'not attributable to'.[40]

However, this created problems in regard to arrangements which were specifically allowed under the GSTA but where the abuse of these provisions created a situation where the taxpayer may argue that the benefit was received and is attributable to the choice which is specifically allowed under the GST law. The language in s 165-5(1)(b) contrasts with the language in the income tax anti-avoidance rule: s 177C(2)(a)(i) of the ITAA36. This rule provides that a tax benefit that 'is attributable' to the making of the choice is not a tax benefit obtained by a taxpayer in connection with a scheme.

Greenwood J in *Walters v FCT* stated that:[41]

> *The phrase in s 177C(2)(a)(i) 'attributable to' the particular election, choice or event means that there must be a direct relationship between the non-inclusion of the relevant amount and the choice or election made by the taxpayer.*

Despite the 'not attributable to' issue, s 165-5(3) (creating circumstances or states of affairs) was inserted by the *Tax Laws Amendment (2008 Measures No. 5) Act 2008* (Cth) with effect to choices and elections made after 9 December 2008. The insertion of s 165-5(3) was intended to overcome the problems faced by the Commissioner when considering artificial schemes, even though the explanatory memorandum accompanying the amending legislation stated that this is to confirm the existing law. Section 165-5(3) states that:[42]

> *(3) A GST benefit that the avoider gets or got from a scheme is not taken, for the purposes of paragraph (1)(b), to be attributable to a choice, election, application or agreement of a kind referred to in that paragraph if:*
>
> *(a) the scheme, or part of the scheme, was entered into or carried out for the sole or dominant purpose of creating a circumstance or state of affairs; and*
>
> *(b) the existence of the circumstance or state of affairs is necessary to enable the choice, election, application or agreement to be made.*

40 *FCT v Unit Trend Services Pty Ltd* (2013) 250 CLR 523 at [33].

41 *Walters v FCT* (2007) 67 ATR 156 at [83].

42 GSTA, s 165-5(3).

Therefore, if the taxpayer creates circumstances and a state of artificial affairs, which ultimately provides the GST benefit, then the scheme is not taken, for the purposes of Division 165, to be attributable to a choice, election, application or agreement of a kind referred to in that provision. The High Court in *Unit Trend* acknowledged that when applying the election exclusion in s 165-5(1)(b), you do not need to find a causal link between the relevant choice or election and the GST benefit.

It is considered by some GST pundits that Division 165 will not apply to a situation where GST benefit is obtained through grouping provisions in Division 48. It should be noted that certain choices such as the choice to group may be necessary for a scheme to work. Where the grouping is artificial, and mainly for the purposes of tax benefits, it is irrelevant to say that the non-payment of GST is attributable to the making of a choice expressly provided for under the GSTA. In the author's opinion, Division 165 should apply in cases where grouping provisions are used in a scheme to get the GST benefit directly or which enable the entity to also get other GST-related benefits indirectly.

B. *GST wash transactions*

A GST 'wash' transaction is one where a supplier who is registered for GST fails to include GST in the price of a taxable supply and remit it to the ATO; the supply in question is then made to a recipient who is registered for GST, and would have been a creditable acquisition with the entitlement to claim back, from the ATO, a full input tax credit if the transaction had been correctly treated as taxable by the supplier. The term 'wash' refers to the fact that the effect is revenue neutral.

This could, however, be achieved as a result of a scheme in which a supply made by a GST-registered entity, that would otherwise be a taxable supply, is treated as either a GST-free supply or not a taxable supply.[43] The GST-free supply is made to another GST-registered entity. Based on the classification of the transaction, there is no GST liability for the supplier and no ITC entitlement for the recipient. From an ATO perspective, this is a wash transaction as it is revenue neutral. The question arises as to whether the general anti-avoidance rule can be applied in this situation.

It is important to note that Division 165 can still be applied to a GST wash transaction, described above, as you consider the liability of the avoider rather than trading it off against the potential ITCs claimable by the acquirer. That means the GST position of each entity is considered separately to the transaction. It is irrelevant to say that there is no net GST loss to the ATO on the overall net GST position of both entities. However, if this interpretation is

[43] For example, under Division 48 of the GSTA (grouping provisions), the supplies and acquisitions made wholly within the group are effectively ignored and not treated as taxable supplies or creditable acquisitions.

taken, then there will be compensating adjustments under 165-45 on the 'losers' net amount.[44]

The application of a wash transaction only has an impact when considering the application of, or remission to, shortfall penalties and/or general interest charges.

C. *The GST benefit must arise 'from' a 'scheme'*

(a) What is a 'scheme'?

'Scheme' is defined broadly in s 165-10(2) to include any scheme, plan, proposal, action, course of action or course of conduct, whether unilateral or otherwise. In establishing whether there is a scheme, the purpose of the scheme is irrelevant. 'The focus of the enquiry is on the purpose of the persons who entered into or carried out the scheme. It is not an enquiry into any purpose of the scheme.'[45] The term 'from' in Division 165 suggests that the benefits must flow from the scheme, that is, the scheme must result in the tax benefit.

Due to the wide definition of scheme in the context of GST, it would be easy to establish, under any circumstances, that a scheme exists. Obviously, the scheme cannot be a mere proposal. It should include both actions and courses of conduct. Scheme is an essential part of Division 165, as any GST benefit identified must be related to the scheme and flow from the scheme, as must any conclusion of sole, dominant purpose or the principal effect.[46]

(b) What is 'part of a scheme'?

Unlike the Pt IVA provisions, the GST benefit can arise from a single transaction which is part of the scheme. This reflects the nature of GST as being a transaction-based tax.[47] This does not mean that part of the scheme is a scheme itself, but it appears that Division 165 can be applied to part of a scheme and not necessarily to the full scheme. The scheme can be found in individual steps or, more often, in a combination of steps. In *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*,[48] the New Zealand Supreme Court held that:

> *Parliament must have envisaged that the way a specific provision was deployed would, in some circumstances, cross the line and turn what might otherwise be a permissible arrangement into a tax avoidance arrangement ... Thus tax avoidance can be found in individual steps or, more often, in a combination of steps. Indeed, even if all the steps of an arrangement are unobjectionable in themselves, their combination may give rise to a tax avoidance arrangement ... [The GAAR's] function is to prevent uses of the specific provisions which fall outside their*

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44 Section 165-45 of the GSTA provides that where an entity gets a GST disadvantage due to another entity getting a GST benefit, the Commissioner may make an adjustment to compensate the disadvantaged entity.

45 *FCT v Spotless Services Ltd* (1996) 186 CLR 404 at [423]; Hart (2004) 217 CLR 216 at [63] per Gummow and Hayne JJ.

46 *FCT v Unit Trend Services Pty Ltd* (2004) 217 CLR 216 at [41] per Hill J.

47 Explanatory Memorandum to the *A New Tax System (Goods and Services Tax) Bill* 1998, [6.336].

48 *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115 at [104].

> *intended scope in the overall scheme of the Act. Such uses give rise to an impermissible tax advantage which the Commissioner may counteract.*

(c) Territorial application

A scheme may involve international dealings. This does not preclude the operation of Division 165. Section 165-5(2) provides that 'it does not matter whether the scheme, or any part of the scheme, was entered into or carried out inside or outside Australia'.

D. *Sole or dominant purpose, principal effect*

Section 165-5(1)(c) requires the existence of one of the following:

> (i) an entity that (whether alone or with others) entered into or carried out the scheme, or part of the scheme, did so with the sole or dominant purpose of that entity or another entity getting a GST benefit from the scheme; or
>
> (ii) *the principal effect of the scheme, or of part of the scheme, is that the avoider gets the GST benefit from the scheme directly or indirectly*; (emphasis added)

The way in which the sole or dominant purpose is pinpointed has similarities to the way in which the principal effect is pinpointed, albeit with some slight differences.

The inquiry under s 165-5(1)(c) is as to the purpose of the person or persons who entered into or carried out the scheme and it is not to the purpose of the scheme itself.[49] The AAT in *VCE* confirmed this and stated that it is not the purpose of the scheme that should be the focus of the enquiry, but rather the purpose of those who entered into or carried out the scheme. The person or persons may be, but need not be, the taxpayer.[50]

Sole purpose is too narrow in scope and can be hard to quantify. But this is what the law says. If there is more than one purpose, the sole purpose test cannot, by definition, apply. If the scheme has a number of purposes, then all purposes are examined and decide which one is dominant. Each purpose must be tested by reference to the specified factors. But what is important to consider is the fact that what is planned and done should be for the purpose of getting GST tax benefits, providing the GST benefit can be identified and the purpose/effect tested against it. It should be noted that some schemes which may produce a GST benefit may also produce other tax benefits. The taxpayer usually takes actions that have advantageous tax consequences and which are entered into deliberately with a view to gaining those advantages. This can be tested against what is dominant. When the scheme is found to have two or more purposes, or effects, the effect or purpose can be considered in relativity to other purposes or effects, or to a purpose with more than 50 percent dominance. Dominant purpose or principal effect indicates the purpose or effect which is the 'ruling,

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49 *FCT v Spotless Services Ltd* (1996) 186 CLR 404 at [417]; *FCT v Hart* (2004) 217 CLR 216 at [63]; *FCT v Sleight* [2004] FCAFC 94 at [67] per Hill J (with whom Hely J agreed).

50 *FCT v Hart* (2004) 217 CLR 216 at [35].

prevailing or most influential purpose', as was held in *Spotless*[51] by the High Court. If the scheme results in multiple tax benefits and if the GST benefit obtained by the scheme is not the dominant purpose or the principal effect of the scheme, then Division 165 cannot not be applied.

In respect of sole or dominant purpose, where the taxpayer argues that the purpose of the scheme is commercial, a question arises as to what extent the scheme actually achieved the desired commercial outcomes.

The difference between purpose and the effect of a scheme is at times lacking in clarity. The purpose of a scheme can be described as 'the effect which it is sought to achieve'.[52] The ATO in Practice Statement PS LA 2005/24 stated that the effect test focuses on the results of the scheme, rather than the purpose of the participants.[53] The net result is that the focus is on the scheme itself, rather than on the participants.

The Explanatory Memorandum to s 165-5(1)(c) clarifies this state of affairs by saying that 'it applies specifically to the avoider and the GST benefit obtained by the avoider'[54] and it is necessary for the effect to be 'an important effect, as opposed to merely an incidental effect'.[55] The revised explanatory memorandum provides further clarification:[56]

> The principle [sic] effect test only applies to the entity and does not look at the effect on other entities. For this test, principal effect means an important effect, as opposed to merely an incidental effect. This is in contrast to the dominant purpose which is concerned about the prevailing or most influential purpose of the scheme.

Therefore, the purpose test focuses on the participants in the scheme, while the effects test focuses on the result of the scheme.

Where the scheme has a number of purposes or effects, the question will be which appears to be the dominant one or the principal one, that is, to say the one that is most significant. Many schemes which may produce a GST benefit may also produce a tax benefit for income tax purposes.

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51 *FCT v Spotless Services Ltd* [1996] 186 CLR 404 at [416].

52 *Newton v FCT* (1958) 98 CLR 1 at [2]; see also *Insomnia (No. 2) Pty Ltd and Insomnia (No. 3) Pty Ltd v FCT* (1986) 84 FLR 278 at [290] per Murphy J; and Justice G Hill, 'Scheme New Zealand or an example of the operation of Div 165' (2003) 1 *eJournal of Tax Research* 147 at [156].

53 Practice Statement PS LA 2005/24: Application of General Anti-Avoidance Rules, [215]. This Practice Statement provides instruction and practical guidance to the ATO officers on the application of General Anti-Avoidance Rules (GAARs). Officers proposing to make a determination under section 165-40 GSTA should follow this practice statement. This practice statement also outlines the role and operation of the GAAR Panel of the ATO.

54 Explanatory Memorandum to the *A New Tax System (Goods and Services Tax) Bill* 1998, [6.344]; see *The Taxpayer and FCT* [2010] AATA 497.

55 Explanatory Memorandum to the *A New Tax System (Goods and Services Tax) Bill* 1998, [6.345].

56 Explanatory Memorandum to the *A New Tax System (Tax Administration) Bill (No. 2)* 2000, [1.95].

Multiple purpose schemes are usually aimed at a few types of tax and there are usually no rational commercial grounds to enter into such a scheme. A good example of a multiple purpose scheme can be seen in transactions involving property. Transfer of property attracts three types of tax, these being stamp duty, GST and income tax. In a property transaction, taxes such as stamp duty would be applicable to the GST-inclusive value of the property transaction making the application of GST more important. To the best of the author's knowledge, there has not yet been an anti-avoidance case that considers this scenario.

Section 165-15(1) GSTA lists a range of matters which are to be taken into account in determining the entity's purpose in entering into or carrying out the scheme. The factors listed in s 165-15(1) need to be considered objectively. The inquiry into the purpose is not the actual purpose of the relevant person. It is an objective one having regard to, and only to, the 12 matters identified in s 165-15(1).[57]

There are 12 factors that must be objectively considered by the Commissioner. The objective enquiry is not about the purpose of entering into the transaction, but a conclusion based on the application of objective facts into the 12 factors.

Some of the matters may point one way, others may point in the opposite direction and some may be neutral. Each of the 12 factors must be taken into account to make a conclusion concerning dominant purpose.[58]

(a) The manner in which the scheme was entered into or carried out (s 165-15(1)(a))

In *Spotless*, the joint judgment of six of the Justices of the High Court stated that:[59]

''Manner' includes consideration of the way in which and method or procedure by which the particular scheme in question was established.'

The manner in which the scheme is carried out, for avoidance purposes, usually demonstrates some level of unnecessary complexity which is unusual in the ordinary commercial sense.

The transactions may be carried out for commercial purposes; however, the structured way that the scheme is entered into and carried out usually suggests careful planning and should be justifiable mainly for taxation consequences. Where a simple transaction is carried out with a high level of complexity, it is little wonder that questions should be asked regarding why it should be so.

In *Hart*, the High Court held that consideration of the manner in which the scheme was entered into or carried out is important; this involves unusual features designed to confer a tax benefit not otherwise available.

In *Consolidated Press*, the court concluded that the interposed company lacked any reason for being, other

57 *FCT v Hart* (2004) 217 CLR 216 at [65]; *FCT v Sleight* [2004] FCAFC 94 at [67]; *FCT v Zoffanies Pty Ltd* (2003) 132 FCR 523 at [53]-[54].

58 *FCT v Consolidated Press Holdings Ltd* (2001) 207 CLR 235 at [94].

59 *FCT v Spotless Services Ltd* (1996) 186 CLR 404 at [420].

than to create a tax benefit.

The arrangement is usually structured by some tax experts or based on the advice of tax advisers promoting the arrangements.

While this factor in isolation would not be determinative, the Commissioner will give this factor a great weight.

(b) The form and substance of the scheme (s 165-15(1)(b))

Form and substance are probably the most usual indicia of tax avoidance and can include:

- the legal rights and obligations involved in the scheme; and
- the economic and commercial substance of the scheme.

The desired effect of tax planning is to manipulate the form of business transactions in order to maximise the taxpayer's profit. A difference between the commercial and practical effect of a scheme, on the one hand, and its legal form on the other may indicate the scheme has been implemented in a particular form to obtain the GST benefit.

The Full Federal Court's decision in *FCT v Sleight*[60] and *Pridecraft Pty Ltd v FCT*[61] shows the importance of looking at the substance of arrangements, in particular the commercial and financial substance of arrangements, when making a conclusion concerning dominant purpose.

The period over which the scheme was carried out also impacts on form. Generally, the more short-lived the scheme, the more likely it is to lead to the conclusion of avoidance. It can be presupposed that the form of any tax avoidance transaction will be that which results in the desired GST effect.

(c) The purpose or object of the GSTA and any relevant provision of the GSTA whether expressly stated or not (s 165-15(1)(c))

It is necessary to assess the purpose and intent of the relevant legislative provisions in the GSTA which were used by the scheme. It is, therefore, important to consider the legislative purpose of any act. Division 165 is aimed at artificial and contrived schemes that are, in themselves, real and lawful but which nonetheless breach the normal or expected operation of the GSTA and, therefore, that purpose of the Act is, to some extent, frustrated. The policy intent of the Act and the provisions can be manipulated to suit the taxpayer's preferred outcome by entering into an artificial and contrived scheme. In arriving at an appropriate conclusion, the overall intent of the GSTA policy objectives should be considered. This is where the Commissioner should look at the policy intent of the relevant provision to see whether it has been defeated.

60 *FCT v Sleight* [2004] FCAFC 94 at [33]-[36].

61 *Pridecraft Pty Ltd v FCT* [2004] FCAFC 339.

It is contrary to the legislative purposes of the GSTA for an entity to obtain a GST benefit where GST on the transaction is avoided or reduced.

(d) The timing of the scheme (s 165-15(1)(d))

The reference to timing is directed at the question of when the particular scheme is entered into or carried out, as well as considering the GST law at the time.[62]

Consideration of the timing of the occurrence of key steps in the scheme (e.g. immediately or shortly after one another) is also important.

The fact that a scheme is entered into shortly before the end of a tax sensitive date such as the date of a change in the rate of GST (e.g. a future change from 10 percent to 15 percent) and carried out for a brief period may point to the purpose of obtaining a tax benefit.

(e) The period over which the scheme was entered into and carried out (s 165-15(1)(e))

The period over which the scheme is entered into and carried out is an important factor. The more short-lived the scheme, the more likely it is to give rise to the conclusion of avoidance.[63] In *Futuris*, the court considers whether the steps were carried out in a 'flurry of activity'.[64] In this case, the transactions were carried out and completed within minutes of each other leading to a conclusion of a dominant tax purpose.

In *Sleight* and *Vincent v FCT*,[65] the courts considered whether there was a connection between the timing and the flow of funds by the scheme. It was recognised that if the timing and flow of funds of the scheme are needed for a tax benefit to be produced, then the conclusion of a dominant purpose is more likely to be ascertained.

It should be noted that some schemes are carried out over a long period and not a short period. In this situation, this factor has less weight in the anti-avoidance conclusion.

(f) The effect that the GSTA would have in relation to the scheme apart from Division 165 (s 165-15(1)(f))

This factor deals with the effect of the scheme without considering Division 165; whether a GST benefit exists. The GST liability under the arrangement is almost inevitably reduced or nullified.

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62 *The Taxpayer and FCT* [2010] AATA 497 at [115], with reference to *FCT v Mochkin* (2003) 52 ATR 198 at [45]; *Vincent v FCT* (2002) 193 ALR 686 at [93]; *CPH Property Pty Ltd v FCT* (1998) 40 ATR 151 at [42].

63 *FCT v Sleight* [2004] FCAFC 94 at [83].

64 *Futuris Corporation Ltd v FCT* (2010) 80 ATR 330 at [156], and *FCT v Sleight* [2004] FCAFC 94 at [83].

65 *Vincent v FCT* (2002) 193 ALR 686 at [91]-[95].

(g) Any change in the avoider's financial position that has resulted, or may reasonably be expected to result, from the scheme (s 165-15(1)(g))

There is usually no rational commercial benefit, such as any effect on the market value of company's shares or any movement in the net financial position of the company, in a scheme which is structured mainly for GST benefit and, perhaps, for income tax and stamp duty benefits as well. A scheme with no commercial benefit, merely a tax benefit, will often produce no real change in the financial position of the entity except for the tax benefit component. For the purposes of Division 165, the main measurable financial benefit is the saving of GST. In this case, it is more likely that a finding of tax avoidance will be concluded.[66] In *Hart*, the High Court established that the beneficial change in the taxpayer's financial position was wholly dependent on the tax benefit that was obtained.

(h) Any change that has resulted, or may reasonably be expected to result, from the scheme in the financial position of the entity (or a connected entity) that has or had a connection or dealing with the avoider, whether the connection or dealing is or was of a family, business or other nature (s 165-15(1)(h))

The GST benefits, obtained from the scheme, by the related parties, also point to the scheme being entered into for the dominant purpose or principal effect of getting a GST benefit.

The GST benefit, as the result of the scheme, can impact other persons and this falls within the form and substance factor. There are occasions where the scheme may be financially neutral but, in general, a change in the financial position of the entity, or of a connected entity such as an economic group or family, as a result of tax benefits will be sufficient indication of avoidance.

When considering this factor, *The Taxpayer and FCT*[67] identified that there is an overlap with the considerations and conclusions reached in relation to the change in the taxpayer's financial position.

(i) Any other consequences for the avoider or connected entity of the scheme having been entered into or carried out (s 165-15(1)(i))

This is not always relevant and should be considered in each case separately as was held in *The Taxpayer and FCT*.[68] Each case is capable of a broad meaning and can include the subjective purposes, motives and intentions of the participating entities. It is important to check whether the entity has skipped commercial profits by entering into the scheme.

66 See also *The Taxpayer and FCT* [2010] AATA 497 at [115] and [143]; *Futuris Corporation Ltd v FCT* (2010) 80 ATR 330 at [165]-[169].

67 *The Taxpayer and FCT* [2010] AATA 497 at [159].

68 Ibid at [145].

It seems that the fiscal awareness of the taxpayer was of no account when the legislature considered GST anti-avoidance provisions.[69]

(j) The nature of the connection between the avoider and a connected entity, including the question whether the dealing is or was at arm's length (s 165-15(1)(j))

Arm's length dealing has, over time, been discussed in depth in relation to income tax and, more particularly, in relation to capital gains tax. It should be noted that an arm's length dealing between entities which may, or may not, be connected, should be considered and not an arm's length relationship.

In the concept of income tax, Davies J in *Barnsdall v FCT*[70] stated that 'term should not be read as if the words 'dealing with' were not present. The Commissioner is required to be satisfied not merely of a connection between a taxpayer and the person to whom the taxpayer transferred, but also of the fact that they were not dealing with each other at arm's length. A finding as to a connection between the parties is simply a step in the course of reasoning and will not be determinative unless it leads to the ultimate conclusion'.

In *The Trustee for the Estate of the late AW Furse No. 5 Will Trust v FCT*,[71] Hill J said:

> *What is required in determining whether parties dealt with each other in respect of a particular dealing at arm's length is an assessment whether in respect of that dealing they dealt with each other as arm's length parties would normally do, so that the outcome of their dealing is a matter of real bargaining.*

It is important to note that unrelated parties may interact in a non-arm's length manner. Even so, this may lead to the conclusion that their motivation is to avoid GST.

(k) The circumstances surrounding the scheme (s 165-15(1)(k)) and any other relevant circumstances (s 165-15(1)(l))

When considering these two factors, a broad range of enquiries can be considered including, but not restricted to, the prevailing economic conditions, industry practices that are relevant to the scheme,[72] or the nature of the tax advice received by the taxpayer in relation to the scheme.

Deputy President Forgie in *VCE* stated that these two factors may potentially include the subjective purposes, motives and intentions of the participating entities.[73] The same observation was expressed by the court in *FCT v News Australia Holdings Pty Ltd*.[74]

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69 *VCE v FCT* (2006) 63 ATR 1249 at [86]-[90] per Deputy President Forgie.

70 *Barnsdall v FCT* (1988) 81 ALR 173 at [176].

71 *The Trustee for the Estate of the late AW Furse No. 5 Will Trust v FCT* 21 ATR 1123 at [1133].

72 PS LA 2005/24, above n 53, [225].

73 *VCE v FCT* (2006) 63 ATR 1249 at [137] per Deputy President Forgie.

74 *FCT v News Australia Holdings Pty Ltd* (2010) 79 ATR 461, at [472].

E. *Reasonable conclusion after considering the above 12 matters*

Having considered these 12 factors, the application of Division 165 requires a reasonable conclusion as to whether the purpose of an entity in entering into or carrying out the scheme, or the principal effect of the scheme, is to obtain a GST benefit.

In *Peabody*[75], in a passage, Hill J stated that:

> *In arriving at his conclusion, the Commissioner must have regard to each and every one of the matters referred to in s 177D. This does not mean that each of those matters must point to the necessary purpose referred to in s 177D. Some of the matters may point in one direction and others may point in another direction. It is the evaluation of these matters, alone or in combination, some for, some against, that s 177D requires in order to reach the conclusion to which s 177D refers.*

The 12 factors in Division 165 are, more or less, similar to s 177D(2) of the ITAA 1936. However, there are also some important differences which reflect the transaction-based nature of the GST including s 165-15(1)(c), s 165-15(1)(d) and s 165-15(1)(f). Some of these factors provide obvious indicia of avoidance, others less so, and there has not been much discussion on the weight or relevance of any of these factors in a GST context. It is the evaluation of these matters in combination which is critical.

F. *What is the decision-making process?*

Step 1

Once the ATO officer has reached a conclusion of GST avoidance, Aggressive Tax Planning (ATP) and Tax Counsel Network (TCN) are engaged.[76] If the conclusion is supported, in particular, by TCN, the ATO will issue the taxpayer with a position paper setting out its preliminary view.

Step 2

The ATO considers the taxpayer's response (if any) to the position paper.

Step 3

If the ATO officer still considers that Division 165 applies, the case is referred to TCN. If the officer's view is supported (by a submission signed off by TCN), the case is then referred to the General Anti Avoidance Rules Panel (the GAAR Panel).

Step 4

The GAAR Panel, as an independent internal review body, assesses the proposal to apply Division 165 before the formal declaration is made and served.[77] The GAAR Panel has a

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75 *Peabody v FCT* (1993) 25 ATR 32, at [42].

76 See PS LA 2005/24, above n 53, [11]. The ATO officer should disclose to the taxpayer that Division 165 may be in contemplation when requesting additional information from the taxpayer to determine whether Division 165 may apply to the arrangement or an associated arrangement.

77 See PS LA 2005/24, above n 53, [18]-[41].

consultative role and does not make the relevant decision but its advice is taken into account. The GAAR Panel provides its advice on the basis of contentions of fact which have been put forward by ATO officer and by the taxpayer.

The taxpayer has the opportunity to make submissions to the panel. Once the Panel has assessed the applicability of Division 165, the Commissioner may make a Division 165 declaration. Although this is, ordinarily, the course of events, the proposal to apply Division 165 is not always reviewed by GAAR Panel and there are exceptional circumstances where the Commissioner makes a declaration without having the decision assessed by GAAR Panel. This can be due to time constraints or other reasons. However, the application of the GAAR must still be cleared by a Deputy Chief Tax Counsel.

Step 5

A declaration under s 165-40 is required if the Commissioner decides to apply Division 165. The purpose of the declaration by the Commissioner is to negate the GST benefit which has been obtained from the scheme by the avoider. The Division 165 declaration may specify an amount that becomes the net amount for the relevant business activity period.[78] One declaration can relate to net amounts for several tax periods and importations. Under s 165-65, the Commissioner must give copy of the declaration to the entity affected. A failure to comply with this does not affect the validity of the declaration.[79]

Step 6

The Commissioner will issue the taxpayer with an amended assessment for the relevant tax period to reflect the negation of the GST benefit and the applicable penalties and interest charges.

G. *Penalties*

Like Part IVA, the same penalty regime applies to Division 165. The taxpayer is liable to pay an administrative penalty of 50 percent of the scheme shortfall amount.[80]

H. *Objection and Review*

The Division 165 declaration and the subsequent assessment is a reviewable decision.[81] Formal objection must first be made to the Commissioner requesting that he revisit his original decision. The taxpayer may take the objection decision to the Administrative

78 Net amount: the GST liability less the input tax credits attributable to a relevant tax period.

79 GSTA, s 165-65(2).

80 *Taxation Administration Act* 1953 (Cth), s 284-160 of Schedule 1 for *base penalty amount*: scheme. See PS LA 2005/24, above n 53, [179]-[184].

81 *Taxation Administration Act* 1953 (Cth), s 14ZZ. .

Appeals Tribunal or appeal to the Federal Court followed by the Full Federal Court, then, with special leave to the High Court.[82]

The Tribunal may, standing in the shoes of the Commissioner, make a determination including making a new Division 165 declaration and refer the matter back to the Commissioner if AAT or Court thinks the objection decision wrong on some technical point/s, but justified subject to reconsideration in compliance with Division 165. The Court can set the Division 165 declaration aside and can send it back to the Commissioner to reconsider.[83]

In a review under Pt IVC, the onus is on the taxpayer to prove, on the balance of probabilities, that the assessment is excessive.[84] In a Division 165 case, this could be done by establishing that the conclusion to invoke the Division by the Commissioner was not supportable.

A Division 165 case will always be based on a set of facts. However, the taxpayer has to satisfy the Tribunal or court, on a review of an objection decision, that the Commissioner's conclusion that there had been tax avoidance as defined by Division 165 is excessive and the Commissioner's action to negate the GST benefit is objectively wrong.[85]

I. *Taxpayer Alerts, Public Rulings and Tax Determinations on Division 165*

There are 17 Taxpayer Alerts[86] (some covering multiple arrangements) and 12 ATO view products[87] (Public Rulings and Tax Determinations) issued to date on the application of Division 165 by the Commissioner, as follows:

(I) Taxpayer Alerts (TA)

TA 2013/2 – *Wine equalisation tax (WET) producer rebate schemes*. This Taxpayer Alert describes two contrived arrangements that are designed to create additional Wine Equalisation Tax (WET) rebates through non-commercial dealings between entities.

TA 2012/5 – GST – *Acquisition of intangible right for inflated consideration which is financed by supplier.* This Taxpayer Alert describes an arrangement where an entity claims an input tax credit on a purported acquisition (on non-commercial terms) of an intangible right from

82 See *Taxation Administration Act 1953* (Cth), Pt IVC, *Taxation objections, reviews and appeals*.

83 *Fletcher v FCT* [1988] FCA 362.

84 *Taxation Administration Act 1953* (Cth), s 14ZZK(b)(i).

85 *Bai v FCT* [2015] FCA 973 at [34].

86 A Taxpayer Alert is a warning to the community about an emerging aggressive tax planning where the ATO believes taxpayers may not be complying with the law. Practice Statement PS LA 2008/15 provides guidance for initiating and issuing a Taxpayer Alert.

87 The ATO makes known its views about the application of relevant provisions in a number of ways. For example, the ATO issues formal rulings, grouped in different series, on the application of relevant provisions at a general level, in the sense that they do not address particular entity's affairs.

a GST-registered supplier, with the provision of vendor finance under which payments are contingent on a future event.

TA 2010/7 – GST – *Retirement Village operators who on-sell services to residents in an attempt to claim greater input tax credits.* This Taxpayer Alert describes an arrangement in which a retirement village operator ('RVO') increases its claims for input tax credits (or for decreasing adjustments) by assuming the role of a service supplier, such as an electricity retailer. By buying services and on-supplying them to retirement village residents living in independent living units ('ILUs'), the RVO contends that it is making a taxable supply, separate from its input taxed supply of residential accommodation.

TA 2010/1 – GST - *Interposing an associated 'financial supply facilitator' to enhance claims for reduced input tax credits for expenses incurred in the course of a company takeover.* This Taxpayer Alert describes an arrangement that attempts to create or increase an entitlement to a reduced input tax credit (RITC) for an entity that makes a financial supply of acquiring shares in a company as part of a takeover.

TA 2009/7 – *Uncommercial contract manufacture arrangements to claim the wine equalisation tax (WET) producer rebate.* This Taxpayer Alert describes uncommercial and collusive arrangements where one or more growers use a contract winemaker, so each such grower can attempt to claim the WET producer rebate by retaining title to their produce, until a pre-arranged sale to the winemaker.

TA 2009/6 – *Use of uncommercial indirect marketing arrangements to reduce wine equalisation tax (WET).* This Taxpayer Alert describes uncommercial and collusive arrangements that seek to reduce WET liability by using an interposed entity and an agency relationship to shift the point where WET liability is determined and to manipulate which methodology is used in determining it.

TA 2009/5 – *Use of an associate to obtain Goods and Services Tax (GST) benefits on construction of residential premises for lease.* This Taxpayer Alert describes an arrangement where an entity uses an associate in an attempt to secure input tax credits on the construction of residential premises for lease and defers the corresponding GST liability, in some cases indefinitely.

TA 2009/4 – *Land owner's use of a registered associate to maximise input tax credit entitlements and reduce Goods and Services Tax (GST) payable under the margin scheme.* This Taxpayer Alert describes an arrangement that purportedly allows a land owner to register for GST as late as possible to minimise its GST payable under the margin scheme, but still claim a full input tax credit on its acquisition of construction services from its associate.

TA 2008/17 – *Claims for GST refunds beyond four years arising from the reclassification of a previously taxable supply as GST free.* This Taxpayer Alert describes a situation where a taxpayer seeks to claim a refund four years or more after the end of a tax period on the basis that they incorrectly classified a supply as a taxable supply and they now contend it is GST free. In this situation the Commissioner may not be able to recover the input tax credits previously claimed on what are contended to be incorrectly classified supplies. This could lead to a situation where either the supplier or the recipient of the supply obtains a windfall gain.

TA 2007/1 – *Lease by a charitable institution to an associated endorsed charitable institution designed to gain input tax credits.* This Taxpayer Alert describes arrangements designed to gain entitlement to input tax credits by treating otherwise input taxed supplies of residential accommodation as GST-free. These arrangements involve charitable institutions leasing land and buildings to associated endorsed charitable institutions in an attempt to increase the cost of making supplies of accommodation to residents and thereby satisfying a concessional GST provision.

TA 2005/4 – *Creation of Goods and Service Tax (GST) input tax credits by barter exchanges.* This Taxpayer Alert describes arrangements where a barter exchange buys and sells in its own right, effectively acting as a member with its own trading account. The barter exchange has access to unlimited trade dollars to spend on the acquisition of goods and services, often at commercially unrealistic prices, from its members. Consequently, large GST refunds are claimed by ensuring that its acquisitions continually exceed its supplies by significant amounts within the barter operation.

TA 2004/9 – *Exploitation of the second-hand goods provisions to obtain Goods and Services Tax (GST) input tax credits.* This Taxpayer Alert describes arrangements apparently designed in an attempt to exploit the GST second-hand goods provisions resulting in claims for GST input tax credits in relation to second-hand goods sold to an interposed associated entity. A GST registered entity acquires goods (usually of high value) through a non-taxable supply. The acquiring entity sells the goods to an associated entity, thus creating a claim for an input tax credit on its acquisition of the goods under the second-hand goods provisions.

TA 2004/8 – *Use of the Going Concern provisions and the Margin Scheme to avoid or reduce the Goods and Services Tax (GST) on the sale of new residential premises.* This Taxpayer Alert describes an arrangement involving an entity which makes a sale of substantially completed residential units/houses to another entity as a GST-free going concern. The acquiring entity completes the residential units/houses and sells them as a taxable supply to third parties, paying GST only on the margin between this sale price and its acquisition cost, which is designed to set the price to reduce or eliminate the margin for GST.

TA 2004/7 – *Use of the Grouping provisions and the Margin Scheme to avoid or reduce the Goods and Services Tax (GST) on the sale of new residential premises.* This Taxpayer Alert describes an arrangement that uses the grouping provisions and the margin scheme in an attempt to avoid or reduce GST on the sale of new residential premises. Relying on a concession within the grouping provisions, substantially completed residential units/houses are sold within a group and not treated as a taxable supply. The acquiring group member completes the residential units/houses and sells them as a taxable supply to third parties, paying GST only on the margin between this sale price and the intra-group sale price. The effect of the intra-group sale is to avoid or reduce the margin for GST on the sale to the third party.

TA 2004/6 – *Use of the Grouping provisions of the GST Act to avoid Goods and Services Tax (GST) on the sale of new residential premises.* This Taxpayer Alert describes an arrangement that uses the grouping provisions in an attempt to avoid GST on the sale of new residential premises. The parties to the arrangement use a GST group structure for the purposes of creating an 'internal sale' of new home units/houses between GST group members. This is to support a claim that the units/houses are no longer 'new residential premises'. On this basis, any subsequent sale of the residential units/houses is claimed to be input taxed and not subject to GST.

TA 2004/2 – *Avoidance of Goods and Services Tax (GST) on the sale of new residential premises.* This Taxpayer Alert describes an arrangement using the joint venture provisions to attempt to avoid GST on the sale of new residential premises. The parties to the arrangement purportedly form a joint venture for the purpose of creating an 'internal sale' of new home units/houses by the joint venture operator to a participant in the joint venture. This is to support a claim that the units/houses are no longer 'new residential premises'. On this basis, any subsequent sale of the residential units/houses is claimed to be input taxed and not subject to GST.

TA 2004/1 – *Non-arm's length arrangements using Goods and Services Tax (GST) cash/non-cash accounting methods to obtain a GST benefit.* This Taxpayer Alert describes non-arm's length arrangements where an entity makes acquisitions from another entity at commercially unrealistic prices to obtain an inflated input tax credit. The arrangements seek to manipulate a timing advantage between a vendor using a cash basis of accounting and a purchaser using a non-cash basis of accounting.

(m) Public Rulings

WETR 2014/1 Wine Equalisation Tax: provides the Commissioner's views on the arrangements set out in Taxpayer Alert TA 2013/2 Wine Equalisation Tax (WET) producer rebate schemes and whether Division 165 of the A New Tax System (Goods and Services Tax) Act 1999 applies.

GSTR 2010/1 Goods and services tax: application of Division 165 of A New Tax System (Goods and Services Tax) Act 1999 where a land owner engages the services of an associate to arrange construction of residential premises for lease under an arrangement described in Taxpayer Alert TA 2009/5.

GSTR 2005/5 Goods and services tax: arrangements of the kind described in Taxpayer Alert TA 2004/8: use of the Going Concern provisions and the Margin Scheme to avoid or reduce the Goods and Services Tax on the sale of new residential premises.

GSTR 2005/4 Goods and services tax: arrangements of the kind described in Taxpayer Alerts TA 2004/6 and TA 2004/7: use of the Grouping or Margin Scheme provisions of the GST Act to avoid or reduce the Goods and Services Tax on the sale of new residential premises.

GSTR 2005/3 Goods and services tax: arrangements of the kind described in Taxpayer Alert TA 2004/9 - exploitation of the second-hand goods provisions to obtain input tax credits.

GSTR 2004/3 Goods and services tax: arrangements of the kind described in Taxpayer Alert TA 2004/2: Avoidance of GST on the sale of new residential premises.

(n) Tax Determinations

GSTD 2011/3 Goods and services tax: do the acquisitions of the services provided under the arrangement described in Taxpayer Alert TA 2010/1 form part of a reduced credit acquisition made by the financial supply provider under item 9 of the table in subregulation 70-5.02(2) of the A New Tax System (Goods and Services Tax) Regulations 1999?

GSTD 2009/D2 Goods and services tax: are there GST consequences where a land owner engages the services of an associate to arrange construction of residential premises for lease under an arrangement described in Taxpayer Alert TA 2009/5?

GSTD 2007/2 Goods and services tax: what are the results for GST purposes of a charitable institution engaging with an associated endorsed charitable institution in an arrangement described in Taxpayer Alert TA 2007/1?

GSTD 2006/5 Goods and services tax: what are the results for GST purposes of barter exchanges engaging in the arrangement described in Taxpayer Alert TA 2005/4?

WETD 2011/1 Wine equalisation tax: what are the results for entities that engage in an arrangement described in Taxpayer Alert TA 2009/7.

WETD2010/1 Wine equalisation tax: what are the results for Wine Equalisation Tax purposes for entities engaging in an arrangement described in Taxpayer Alert TA 2009/6?

VI. CONCLUSION

The application of GST general anti-avoidance provisions is enhanced by a good understanding of different types of tax, especially income tax, stamp duty and GST, in line with a correct interpretation of the relevant law. It also needs competent experience in business structures and tax administration in order to balance the commercial objectives and particular means adopted by the taxpayer.

In the author’s opinion, it is reasonable to conclude that it only needs to be found that there is a GST benefit, as the result of the scheme, when the scheme was artificial and had no or immaterial commercial benefit or outcome other than the obtaining of the GST benefit or perhaps other tax benefits.

A case which involves GST avoidance may involve other taxes too, but this cannot be caught by general anti-avoidance provisions of the GSTA. This is due to the sole, dominant purpose or principal effect test. It usually follows that, if the dominant purpose was to reduce income tax, then GST or even stamp duty shortfalls cannot be considered. In the author's opinion, it would be of benefit if the Commissioner were to take one such case, where income tax avoidance, GST avoidance and also stamp duty avoidance are in equipoise, to the court in order to obtain a definitive view.

The Commissioner, undoubtedly, has the power to make a declaration to negate the GST benefit when the circumstances for its exercise exist. However, whether the Commissioner has discretionary power to act or in fact is required to act when he has reached a reasonable conclusion about dominant purpose, or principal effect after considering the 12 factors, is not clear. Even though, there are suggestions, in some quarters, that the words in s 165-40 that the Commissioner 'may make a declaration' imply a discretionary power.[88] Such a discretion, if it exists, is not absolute. It must be exercised in compliance with the requirements of Division 165. It is not really clear what the implications of the power being limited discretionary are. It might be argued that if it is a discretionary power that it can only be effectively challenged before the AAT which is in the shoes of the Commissioner. The Court can only supervise the proper exercise of the power, not substitute its own opinion as to how the discretion should have been exercised by the Commissioner. The better view, it is suggested, is that the Commissioner's power is not a true administrative discretion.

[88] *VCE v Federal Commissioner of Taxation* (2006) ATC 187, 63 ATR 1249 at [135] (SA Forgie); cf GT Pagone, Tax Avoidance in Australia (*Federation Press*, 2010), [158-9]; see PS LA 2005/24, above n 52, at [193]: 'It gives the Commissioner the discretion to negate a 'GST benefit' that an entity gets or got from a scheme to which Division 165 of the GST Act applies. This discretion is contained in section 165-40 of the GST Act.' and at [228]: 'If the foregoing elements are satisfied, the Commissioner may exercise the section 165-40 discretion to negate the GST benefit obtained.'