HIGH COURT OF AUSTRALIA

GLEESON CJ,
McHUGH, GUMMOW, HAYNE AND CALLINAN JJ

COMMISSIONER OF TAXATION APPELLANT

AND

TRUDY AMANDA HART & ANOR RESPONDENTS

Commissioner of Taxation v Hart [2004] HCA 26
27 May 2004
S159/2003

ORDER

1. *Appellant's application for special leave to appeal on the ground set out in paragraph (2) in his draft notice of appeal filed with that application refused.*

2. *Appeal allowed.*

3. *Set aside the orders made by the Full Court of the Federal Court of Australia on 26 November 2002 and, in their place, order that the appeal to that Court be dismissed with costs.*

4. *Appellant to pay respondents' costs in this Court.*

On appeal from the Federal Court of Australia

Representation:

B J Shaw QC and G T Pagone QC with J Davies for the appellant (instructed by Australian Government Solicitor)

R F Edmonds SC with M Richmond for the respondents (instructed by Gadens Lawyers)

Notice: This copy of the Court's Reasons for Judgment is subject to formal revision prior to publication in the Commonwealth Law Reports.

CATCHWORDS

Commissioner of Taxation v Hart

Income tax – Avoidance of tax – Tax benefit under *Income Tax Assessment Act* 1936 (Cth) – Whether scheme entered into for the dominant purpose of obtaining a tax benefit – Meaning of "scheme" – Split loan facility – Where money borrowed in part to purchase a principal place of residence and in part to refinance investment property used to produce assessable income – Where expenditure in relation to producing assessable income deductible – Where repayments on loan applied solely in satisfaction of that part of the loan not used to produce assessable income.

Words and phrases – "scheme".

Income Tax Assessment Act 1936 (Cth), ss 177A, 177C, 177D, 177F.

1 GLEESON CJ AND McHUGH J. The issues in this appeal, and the relevant facts, are set out in the reasons of Gummow and Hayne JJ. We agree that the Commissioner's appeal on the Pt IVA issue should succeed, and that the question relating to the deductibility, in the circumstances, of interest upon interest (which was answered by all four members of the Federal Court in favour of the respondents) does not arise.

2 It is convenient to begin a consideration of Pt IVA, in its application to the present problem, by reference to a matter on which Gyles J, at first instance, and all the members of the Full Court were in agreement. It relates to the tax benefit that was obtained by the respondents. An accurate understanding of that benefit is important to a resolution of the difference of opinion between Gyles J and the Full Court on the ultimate outcome.

3 It is part of the scheme of the *Income Tax Assessment Act* 1936 (Cth) that, as a general rule, interest on money borrowed to finance the purchase of a taxpayer's private dwelling house is not an allowable deduction, and interest on money borrowed to finance an investment property, such as a dwelling house to be let for rental purposes, is an allowable deduction[1]. That being so, other things being equal, it may make commercial sense for a taxpayer who is considering the relative levels of borrowing to be undertaken for the purposes of acquiring a residential property, and an investment property, respectively, to arrange for the latter to be more highly geared than the former. If such a taxpayer took out two separate loans, and the terms of the loan for the investment property were different from the terms of the loan for the residential property in that they provided for a higher ratio of debt to equity, and for payments of interest only, rather than interest and principal, during a lengthy term, then ordinarily that would give rise to no adverse conclusion under s 177D. It may mean no more than that, in considering the terms of the borrowing for investment purposes, the taxpayer took into account the deductibility of the interest in negotiating the terms of the loan. How could a borrower, acting rationally, fail to take it into account?

4 The argument for the respondents is that, stripped of immaterial complexities, in essence there is little more to the present case than that. The respondents wanted to borrow money for two purposes: to buy a new house; and to finance the retention of their former home as an income-producing property. They simply arranged for the second part of the borrowing to be more highly geared than the first, and it would not be concluded that their dominant purpose was other than to borrow money to enable them to buy a new house and retain their old house as an investment.

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1 cf *Steele v Deputy Commissioner of Taxation* (1999) 197 CLR 459.

5 The appellant says there is much more to it than that. The tax benefit cancelled by the appellant in the s 177F determination (putting to one side the compound interest question) was a benefit of the kind referred to in s 177C(1) as "a deduction being allowable to the taxpayer ... where ... a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer ... if the scheme had not been entered into or carried out". As Hill J correctly pointed out[2], the definition of the scheme is important, because any tax benefit identified must be related to the scheme, as must any conclusion of dominant purpose, and also the ultimate determination. The significance of the definition of the scheme extends beyond a question of procedural fairness to the taxpayer. It is central to the application of ss 177C, 177D and 177F. However, the identification of the tax benefit is also of central importance. In this case, the benefit in question was not the deduction for interest on that part of the loan referable to the investment property (referred to in the evidence as loan account 2). It was part of that deduction. It was described by Hill J[3] as "the amount of interest representing the difference between the interest payable on the principal sum applied to refinancing Jerrabomberra [the sum the subject of loan account 2] calculated as if there had been rateable principal and interest payable on that sum and the interest in fact claimed as a deduction".

6 In the Federal Court, there were concurrent findings that such a tax benefit had been obtained by the respondents. Hill J, with whom the other members of the Full Court agreed, said that the finding of Gyles J on the point should not be disturbed[4]. That finding turned upon what was found to be a reasonable expectation as to what deduction would have been allowable if the relevant scheme had not been entered into or carried out. Gyles J based his finding as to that expectation on the information given to the respondents about the proposed loan, which invited them to compare the financing of a home loan and an investment/business loan using "standard financing arrangements", on the one hand, with the "wealth optimiser structure" that was ultimately adopted, on the other[5]. The identification of the tax benefit, and the identification of the scheme, are inter-related. The benefit was not the whole of the interest on loan account 2 (the investment part of the borrowing); it was that part of the interest which resulted from the special, or non-standard, features of the arrangements between

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2 *Hart v Commissioner of Taxation* (2002) 121 FCR 206 at 221 [41].

3 (2002) 121 FCR 206 at 223 [49].

4 (2002) 121 FCR 206 at 222-223 [49].

5 *Hart v Commissioner of Taxation* (2001) 189 ALR 584 at 603 [41].

the lender and the borrowers. Those were the features to which the respondents were invited to pay attention in deciding whether to enter into the *particular* transaction. Those features, which defined the "wealth optimiser structure" and distinguished it from "standard financing arrangements", were definitive of the scheme in connection with which the tax benefit, identified by all four members of the Federal Court, was obtained.

7 Gyles J found that there was no evidentiary basis for accepting, as a realistic possibility, that, if the respondents had not taken up the offer of the "wealth optimiser structure", they could have arranged finance, on the terms applicable to loan account 2, for their investment property. He said[6]:

> "There is no support in the evidence for the proposition that the [respondents] would have financed the home by a credit foncier arrangement, and the investment property by a separate interest only loan for a fixed term in relation to which no capital repayments are made and where the only payments which are made are interest payments. There is no evidence as to the availability of such interest only loans on terms which would suit [the respondents] or any similar borrower. Indeed, there is no evidence that interest only loans are made for periods of 25 years or anything like it. Having in mind inflation, it is most unlikely that any such loan would be available. Furthermore, there is not any evidence as to precisely how a package of that sort would be tailored to suit the budget of the [respondents]. A feature of a credit foncier loan is the certainty of the periodic payments for the whole of the period, subject to some variation if interest rates change. This is a feature of the Austral loan as well as the posited 'ordinary financing arrangements' with which it was compared [by Austral]. The actual loan was a credit foncier arrangement with fixed periodic payments over 25 years. It was only one loan with one interest rate. This is the true comparison. The contractual provisions involving the split between loan accounts 1 and 2 are an artificial feature of the arrangements."

8 Hill J, in the Full Court, with whom Hely J and Conti J agreed, described the finding of Gyles J on the question of the tax benefit as a finding that, but for the "wealth optimiser structure", the respondents would have borrowed on the basis that (whether there was one borrowing or two) the borrowing would be on terms that the respondents would have made monthly repayments of principal and interest, so that interest would have been spread rateably over the total of the borrowed moneys in the proportion that these moneys were used to purchase the

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6 (2001) 189 ALR 584 at 603 [43].

new home and refinance the Jerrabomberra property[7]. This finding, Hill J held, should not be disturbed[8].

9 The point of departure between the reasoning of Gyles J and that of the Full Court concerned the application of s 177D to the facts of the case. In that respect, the Full Court accepted an argument that Gyles J appeared to have found that the scheme was to be defined in a way that omitted the actual borrowing[9]. The members of the Full Court were correct to insist that it is inappropriate to exclude the fact of borrowing from the putative scheme. The tax benefit in question was the obtaining of part of a deduction of interest on borrowed money. A taxpayer is not allowed such a deduction for agreeing to a term in a contract of loan, or giving a direction about allocation of payments, or taking some other step in the exercise of rights conferred under the contract. The definition of "scheme" in s 177A is wide, but it must be related to the tax benefit obtained. The deduction here was for the incurring of a liability to pay interest on borrowed money. The tax benefit in connection with the relevant scheme was part of an allowable deduction for interest. This, it seems to us, is what was meant by references in the judgments in the Full Court to the scheme being capable of standing on its own feet. The judges were making the point, which is undoubtedly correct, that, where the tax benefit in question is part of an allowable deduction for interest, a search for the purpose of a scheme, identified in a manner that does not include the borrowing, is not an undertaking that conforms with the requirements of the legislation. In a given case, a wider or narrower approach may be taken to the identification of a scheme, but it cannot be an approach which divorces the scheme from the tax benefit. Here, the borrowing was an indispensable part of that which produced the tax benefit. A description of the scheme that did not include the borrowing would make no sense.

10 However, we do not accept that Gyles J made the error attributed to him. Nor is such an error implicit in the appellant's argument in this Court. While the fact of the borrowing cannot be left out of consideration, it was what the mortgage broker described as the "wealth optimiser structure" of the loan arrangements that secured the tax benefit, that is, not the deduction of the interest on loan account 2, but part of that deduction.

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7 (2002) 121 FCR 206 at 222 [47].

8 (2002) 121 FCR 206 at 222-223 [49].

9 (2002) 121 FCR 206 at 226 [64].

11 Gyles J said[10]:

> "In one aspect, the gist of the scheme lies in the availability of the unencumbered residential property to act as security for the grossly inflated investment loan account after the period of capitalisation of interest and, for that matter, to provide a margin of security during the period of capitalisation as the investment loan account principal increases. Put another way, the scheme depended upon interest being deferred (although incurred and deductible for tax purposes) in order to enable what purported to be capital payments to be made in relation to the other loan. ... Thus, the real effect and substance of the arrangements was to make the payment of interest on the capital sum paid in reduction of the residential loan deductible for taxation purposes."

12 That description of the commercial substance of the transaction is closely related to what the appellant submitted, and Gyles J and the Full Court accepted, was the tax benefit obtained by the respondents. It was the tax benefit so obtained, and applied in reduction of the home loan, that was the wealth optimising aspect of the structure. It was the wealth optimising aspect of the structure, not divorced from the borrowing, but giving the borrowing its distinctive character, that constituted the scheme.

13 In applying s 177D, Hill J said[11]:

> "While the scheme did permit the borrowing of moneys for the two purposes indicated, one private and the other income producing, the manner in which the scheme was formulated and thus entered into or carried out is certainly explicable only by the taxation consequences. By 'manner' here I refer to splitting what might commercially be seen as one advance into the two separate advances with interest on the income producing advance being permitted to remain unpaid, to be capitalised and the capitalised amount then attracting the compound interest with the amount which would otherwise have gone towards payment of that interest being directed towards the repayment of the capital outstanding on the private advance."

14 Notwithstanding that finding, the Full Court, after taking account of all the factors listed in s 177D, held that it would be concluded that the dominant purpose of the respondents in entering into or carrying out the scheme was the

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10 (2001) 189 ALR 584 at 604 [47].

11 (2002) 121 FCR 206 at 226 [65].

obtaining of borrowed money to purchase a new home and refinance what was to become a rental property[12]. We are unable to share that opinion.

15 As Hely J correctly observed in the Full Court[13], the fact that a particular commercial transaction is chosen from a number of possible alternative courses of action because of tax benefits associated with its adoption does not of itself mean that there must be an affirmative answer to the question posed by s 177D. Taxation is part of the cost of doing business, and business transactions are normally influenced by cost considerations. Furthermore, even if a particular form of transaction carries a tax benefit, it does not follow that obtaining the tax benefit is the dominant purpose of the taxpayer in entering into the transaction. A taxpayer wishing to obtain the right to occupy premises for the purpose of carrying on a business enterprise might decide to lease real estate rather than to buy it. Depending upon a variety of circumstances, the potential deductibility of the rent may be an important factor in the decision. Yet, if there were nothing more to it than that, it would ordinarily be impossible to conclude, having regard to the factors listed in s 177D, that the dominant purpose of the lessee in leasing the land was to obtain a tax benefit. The dominant purpose would be to gain the right to occupy the premises, not to obtain a tax deduction for the rent, even if the availability of the tax deduction meant that leasing the premises was more cost-effective than buying them.

16 Even so, a transaction may take such a form that there is a particular scheme in respect of which a conclusion of the kind described in s 177D is required, even though the particular scheme also advances a wider commercial objective. In *Federal Commissioner of Taxation v Spotless Services Ltd*, Brennan CJ, Dawson, Toohey, Gaudron, Gummow and Kirby JJ, after noting that revenue law considerations influence the form of most business transactions, and that the presence of a fiscal objective does not mean that a person entered into or carried out a scheme for the dominant purpose of obtaining a tax benefit, said[14]:

> "Much turns upon the identification, among various purposes, of that which is 'dominant'. In its ordinary meaning, dominant indicates that purpose which was the ruling, prevailing, or most influential purpose. In the present case, if the taxpayers took steps which maximised their after-tax return and they did so in a manner indicating the presence of the

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12 (2002) 121 FCR 206 at 228 [73].

13 (2002) 121 FCR 206 at 230 [81].

14 (1996) 186 CLR 404 at 416.

'dominant purpose' to obtain a 'tax benefit', then the criteria which were to be met before the Commissioner might make determinations under s 177F were satisfied."

17 Their Honours went on to say of the facts of that case[15]:

> "In those circumstances, a reasonable person would conclude that the taxpayers in entering into and carrying out *the particular scheme* had, as their most influential and prevailing or ruling purpose, and thus their dominant purpose, the obtaining thereby of a tax benefit, in the statutory sense. The scheme was the particular means adopted by the taxpayers to obtain the maximum return on the money invested after payment of all applicable costs, including tax. The dominant purpose in the adoption of the particular scheme was the obtaining of a tax benefit ... It is true that the taxpayers were concerned with obtaining what was regarded as adequate security for an investment made 'off-shore'. However, the circumstance that the Midland Letter of Credit afforded the necessary assurance to the taxpayers does not detract from the conclusion that, viewed objectively, it was the obtaining of the tax benefit which directed the taxpayers in *taking steps they otherwise would not have taken by entering into the scheme*." (emphasis added)

18 Let it be assumed that, in the present case, even if the "wealth optimiser structure" had not been available, the respondents would have borrowed money to buy their new home, and also borrowed money in order to retain their former home as an income-earning investment. The "wealth optimiser structure" depended entirely for its efficacy upon tax benefits generated by arrangements between the respondents and the lender that had no explanation other than their fiscal consequences. What "optimised" the respondents' "wealth" was the tax benefit earlier described: not the deductibility of interest as such; but the deductibility of additional interest on loan account 2 contrived by the particular form of the borrowing transaction.

19 It is for those reasons that we would allow the appeal. We agree with the consequential orders proposed by Gummow and Hayne JJ.

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15 (1996) 186 CLR 404 at 423.

GUMMOW AND HAYNE JJ.

The issue

20 The principal issue in this appeal is whether the general anti-avoidance provisions of Pt IVA of the *Income Tax Assessment Act* 1936 (Cth) ("the 1936 Act") may be applied to disallow tax benefits obtained by taxpayers under what have become known as "split loan facilities". If that issue were to be resolved against the appellant ("the Commissioner") the Commissioner would seek special leave to raise a further issue about whether amounts charged as interest on interest could be claimed by the respondents as deductions where both the interest, and the interest on interest, were charged under an agreement to lend money which was applied by the respondents in purchasing an asset used to gain or produce assessable income. The application for special leave to appeal on a ground raising that issue was referred to this Court.

21 Under a "split loan facility" a taxpayer borrowed money, applied part to a private or domestic venture (often, as in this case, the purchase of a principal place of residence), and applied the balance to the acquisition (here the refinancing) of an asset to be used for the purpose of gaining or producing assessable income. The loan agreement provided for the borrower to direct the application of the whole of the periodical payments required under the loan agreement to the satisfaction of that part of the loan used for private or domestic purposes. Interest on the balance of the loan was allowed to accrue and be capitalised and compounded.

22 Because the periodical payments required under the loan agreement would suffice to repay the whole of the capital sum lent, and the whole of the interest which would accrue during the term of the loan, the application of periodical payments to only part of the sum lent (and the interest accruing on that part) would repay that part of the loan quickly. In the meantime, the amount of interest charged on the balance of the loan would increase, and the capital sum owing on that account would rise, as interest was capitalised and then compounded. On the basis that this second part of the sum lent was applied to acquiring an asset used for the purpose of gaining or producing assessable income, the taxpayer claimed the amount of interest charged on this account as a deduction against assessable income pursuant to s 51 of the 1936 Act or, later, s 8-1 of the *Income Tax Assessment Act* 1997 (Cth) ("the 1997 Act").

23 These reasons will seek to demonstrate that the Commissioner was entitled to make the determinations under Pt IVA which he made in relation to each of the respondents. The subsidiary issue about the deductibility of interest on interest does not arise.

The particular facts

24 In 1996, the respondents borrowed $298,000 from Permanent Custodians Limited. Austral Mortgage Corporation Pty Ltd ("Austral") acted as agent for the lender and negotiated the terms on which the respondents borrowed the money. The respondents applied $95,112 of that sum to repay the amount outstanding on the mortgage of a house which they then owned and which they intended to hold for the purposes of letting and thus gaining assessable income. It is convenient to refer to this house as "the investment property". The balance of the amount borrowed ($202,888) was applied to pay the purchase price of a house which the respondents intended to occupy, some expenses they incurred, and an amount owing on a property which the first respondent's mother owned which was to be provided as an additional security for the transaction.

25 The rate of interest payable on the loan could be varied by the lender. Interest accrued daily but was to be debited to the borrowers' loan account monthly. The respondents were bound to repay the loan by 300 monthly payments. The amount of each payment was calculated according to the prevailing interest rate at an amount which would repay the whole of the loan, and interest, over its term.

26 The loan agreement provided that upon request by the respondents, the lender would split the loan balance into a maximum of four separate loan accounts, and allocate the loan balance between those loan accounts in accordance with the respondents' request. It went on to provide that, while the loan amount was split into loan accounts, the loan agreement applied to each account as if the balance of each account was a separate loan and that, provided that the lender was not entitled to require the respondents to repay the loan in full immediately, the lender would credit all payments received by it among the loan accounts in accordance with the respondents' directions.

27 Pursuant to these provisions the respondents requested the lender to split the loan amount and requested that payments which they made should be allocated all to an account having as its opening balance $202,888. That is, the respondents directed that their monthly repayments be applied in satisfaction of that part of the loan which they had used for purposes other than their refinancing the investment property.

28 In consequence, the monthly repayments which the respondents made were credited to that part of the loan which they had used for private or domestic purposes. Interest charged on the part of the loan which the respondents had used to refinance the acquisition of an income-producing asset accrued and was capitalised and compounded.

29 In their amended returns for the year ended 30 June 1997, and again for the year ended 30 June 1998, the respondents claimed as deductions from assessable income interest which was charged on that part of the loan which had been applied to the investment property. In 1999, the Commissioner made determinations that amounts which, but for the operation of Pt IVA, would have been allowable to the respondents as deductions in the 1997 and 1998 tax years not be allowable. The Commissioner issued amended assessments for the 1997 tax year and assessments for the 1998 tax year which reflected the determinations. The respondents objected against these assessments; those objections, so far as now relevant, were disallowed.

30 Pursuant to Div 5 of Pt IVC of the *Taxation Administration Act* 1953 (Cth) the respondents appealed to the Federal Court of Australia against the Commissioner's decision disallowing their objections. At first instance, the respondents' appeals were dismissed[16]. They appealed to the Full Court of the Federal Court. That Court (Hill, Hely and Conti JJ) allowed[17] the appeals and ordered that the Commissioner's objection decisions be set aside, the respondents' objections be allowed and the matters be remitted to the Commissioner to assess in accordance with law.

The tax benefits disallowed

31 It is important to notice the way in which the Commissioner calculated the amount of the deduction which was disallowed. The amount disallowed was *part* of the amount of interest claimed by each respondent as a deduction in each of the 1997 and 1998 tax years. The Pt IVA determinations made by the Commissioner did not state how the amounts disallowed were calculated.

32 The reasons given for the Commissioner's objection decisions did reveal the basis of the calculations. Those reasons drew a distinction between what was called "additional interest" and what was called "the further interest amount". The former (the "additional interest") was identified as the difference between the interest incurred on that part of the loan which related to the investment property, and "the interest that would have been incurred if the borrower had applied the payments to the separate accounts". The interest that accrued on unpaid interest was referred to as "the further interest amount", which we will refer to as the "compound interest amount". It is important to note that the additional interest ($96 and $365 for each of the respondents in the 1997 and 1998 financial years respectively) included the compound interest amounts ($67

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16 *Hart v Commissioner of Taxation* (2001) 189 ALR 584.

17 *Hart v Commissioner of Taxation* (2002) 121 FCR 206.

and $315 for each of the respondents in the 1997 and 1998 financial years respectively). The Commissioner's reasons, having distinguished between these two types of interest, went on to conclude that the interest on interest (the compound interest amount) was not deductible under the general deduction provision (s 51 of the 1936 Act, which applied in the 1997 tax year, and s 8-1 of the 1997 Act, which applied in the 1998 tax year). But the Commissioner concluded that Pt IVA should be applied to disallow the additional interest which, as noted, includes the compound interest. (That is why the deductibility of interest on interest is a question which arises only if the Pt IVA issue is resolved against the Commissioner.) The amount of tax benefit identified, and disallowed, was calculated by taking the difference between the interest which the respondents claimed to be deductible (all interest charged to that part of the loan used for the investment property) and the interest which would have been charged on that part of the loan had it been a loan requiring periodical payments sufficient to pay both principal and interest over the term of the loan which the respondents had taken.

Part IVA

33 Part IVA is engaged only where a tax benefit has been obtained, or would but for s 177F(1) be obtained. The tax benefit must be one obtained by a taxpayer in connection with a scheme to which the Part applies. In those circumstances the Commissioner may exercise the power given by s 177F to determine that either an amount is to be included in the taxpayer's assessable income or a deduction is to be disallowed in whole or in part.

34 The schemes to which Pt IVA applies are identified in s 177D. Leaving aside what s 177D says about the time and place at which a scheme is entered into or carried out, there are two elements that must be satisfied. First, it must be shown that the relevant taxpayer has obtained, or would but for s 177F obtain, a tax benefit in connection with the scheme. Secondly, it must be shown that having regard to eight matters "it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme" or enabling the relevant taxpayer and one or more other taxpayers to obtain a tax benefit in connection with the scheme.

35 The "person" whose purpose is to be identified under s 177D is the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme. Section 177D makes plain that the person whose purpose is to be identified may be (but need not be) the relevant taxpayer or one of the other taxpayers mentioned in the section.

36 The meaning of some of the expressions found in s 177D is amplified by some other provisions of the Part. Particular reference will be necessary to three

of those provisions: first, the elucidation in s 177C of how a reference to "the obtaining by a taxpayer of a tax benefit in connection with a scheme" should be read; secondly, the definition of "scheme" in s 177A(1); and, thirdly, the elucidation in s 177A(5) of how a reference to a scheme or a part of "a scheme being entered into or carried out by a person for a particular purpose" should be read. Although it will often be convenient to begin any consideration of the application of the Part by attending to the operation of these elucidating and definitional provisions, approaching a particular case in this way must not be allowed to obscure the way in which the Part as a whole is evidently intended to operate.

37 Taking Pt IVA as a whole, it is clear that ss 177D and 177F(1) are the two provisions about which the Part pivots. Section 177F(1) provides:

> "Where a tax benefit has been obtained, or would but for this section be obtained, by a taxpayer in connection with a scheme to which this Part applies, the Commissioner may—
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> (a) in the case of a tax benefit that is referable to an amount not being included in the assessable income of the taxpayer of a year of income — determine that the whole or a part of that amount shall be included in the assessable income of the taxpayer of that year of income; or
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> (b) in the case of a tax benefit that is referable to a deduction or a part of a deduction being allowable to the taxpayer in relation to a year of income — determine that the whole or a part of the deduction or of the part of the deduction, as the case may be, shall not be allowable to the taxpayer in relation to that year of income;
>
> and, where the Commissioner makes such a determination, he shall take such action as he considers necessary to give effect to that determination."

Part IVA falls for consideration only where the Commissioner has made a determination under s 177F(1). A determination can be made only where a tax benefit has been obtained (or, but for s 177F(1), would be obtained) by a taxpayer in connection with a scheme to which Pt IVA applies. It follows, of course, that the concepts of "tax benefit", "scheme" and "scheme to which this Part applies" all have their part to play in deciding whether the power given to the Commissioner by s 177F(1) can be exercised. But it is important to consider what the Act says about those concepts having regard to two considerations. First, the various defined terms must be given operation in the interrelated way which s 177F(1) requires. Each of the defined terms takes its place in a single provision permitting the making of a determination. Secondly, each of the definitions must be understood bearing in mind that the inquiry required by

Pt IVA is an objective, not subjective, inquiry. The objective nature of the inquiry required is evident from s 177D, which identifies the schemes to which Pt IVA applies. It provides:

> "This Part applies to any scheme that has been or is entered into after 27 May 1981, and to any scheme that has been or is carried out or commenced to be carried out after that date (other than a scheme that was entered into on or before that date), whether the scheme has been or is entered into or carried out in Australia or outside Australia or partly in Australia and partly outside Australia, where—
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> (a) a taxpayer (in this section referred to as the '**relevant taxpayer**') has obtained, or would but for section 177F obtain, a tax benefit in connection with the scheme; and
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> (b) having regard to—
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> (i) the manner in which the scheme was entered into or carried out;
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> (ii) the form and substance of the scheme;
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> (iii) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;
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> (iv) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;
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> (v) any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;
>
> (vi) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme;
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> (vii) any other consequence for the relevant taxpayer, or for any person referred to in subparagraph (vi), of the scheme having been entered into or carried out; and

(viii) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in subparagraph (vi),

it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme or of enabling the relevant taxpayer and another taxpayer or other taxpayers each to obtain a tax benefit in connection with the scheme (whether or not that person who entered into or carried out the scheme or any part of the scheme is the relevant taxpayer or is the other taxpayer or one of the other taxpayers)."

"Scheme" is defined in s 177A(1) as meaning:

"(a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and

(b) any scheme, plan, proposal, action, course of action or course of conduct".

It includes a reference to a unilateral scheme, plan, proposal, action, course of action or course of conduct[18]. A reference to a scheme or a part of a scheme being entered into or carried out by a person for a particular purpose is to be read[19] as including a reference to the scheme, or part of the scheme, being entered into or carried out by the person for two or more purposes of which the particular purpose is the dominant purpose.

38 The last of the definitional provisions which must be noticed is s 177C(1) which describes how a reference in Pt IVA to the obtaining by a taxpayer of a tax benefit in connection with a scheme is to be read. It is to be read as a reference to

"(a) an amount not being included in the assessable income of the taxpayer of a year of income where that amount would have been

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18 s 177A(3).

19 s 177A(5).

included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out; or

(b) a deduction being allowable to the taxpayer in relation to a year of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out".

The limitations on the reference that are identified in s 177C(2) were not said to be relevant and their detail need not be noticed.

Identifying the "scheme"

39 It has become customary in Pt IVA cases to begin the inquiry by identifying what is said to be the "scheme". And often enough the Commissioner has sought to identify, as he did in these cases, both a "wider scheme" and a "narrower scheme".

40 This practice can be traced to what was said, both in this Court, and in the Full Court of the Federal Court, in *Federal Commissioner of Taxation v Peabody*[20]. And because what was said in this Court's decision in *Peabody* appears to have been taken to decide more than it did, it is necessary to pause to identify what was at issue in that appeal. In *Peabody*, the Full Court of the Federal Court decided that the Commissioner should be held to the "scheme" which he had identified at trial and that, in an appeal against the disallowance of an objection to an assessment, the Commissioner could not seek to rely on only some of the steps or elements which had been identified as constituting the scheme, as themselves constituting a scheme. The Commissioner succeeded on this point in his appeal to this Court.

41 This Court, in its joint reasons, pointed out[21] that "Pt IVA does not provide that a scheme includes part of a scheme". Noting that the Commissioner might be required to supply particulars of the scheme upon which he relied[22] the Court

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20 (1994) 181 CLR 359; on appeal from *Peabody v Commissioner of Taxation* (1993) 40 FCR 531.

21 (1994) 181 CLR 359 at 383.

22 *Bailey v Federal Commissioner of Taxation* (1977) 136 CLR 214.

said[23] that the Commissioner was entitled to put his case in alternative ways and that:

> "[i]f, within a wider scheme which has been identified, the Commissioner seeks also to rely upon a narrower scheme as meeting the requirements of Pt IVA, ... there is no reason why the Commissioner should not be permitted to do so[24], provided it causes no undue embarrassment or surprise to the other side."

42 The actual decision in *Peabody* was that the Commissioner was not bound to the precise way in which he had identified the relevant scheme in that case. The Court said[25]:

> "The erroneous identification by the Commissioner of a scheme as being one to which Pt IVA applies or a misconception on his part as to the connexion of a tax benefit with such a scheme will result in the wrongful exercise of the discretion conferred by s 177F(1) *only* if in the event the tax benefit which the Commissioner purports to cancel is not a tax benefit within the meaning of Pt IVA. That is unlikely to be the case if the error goes to the mere detail of a scheme relied upon by the Commissioner. An error of a more fundamental kind, however, may have that result – where, for example, it leads to the identification of the wrong taxpayer as the recipient of the tax benefit. But *the question in every case must be whether a tax benefit which the Commissioner has purported to cancel is in fact a tax benefit obtained in connexion with a Pt IVA scheme* and so susceptible to cancellation at the discretion of the Commissioner." (emphasis added)

As the Court pointed out[26] in *Peabody*, this conclusion follows from the fact that the discretion given to the Commissioner by Pt IVA does not depend upon the formation of an opinion; it depends upon objective facts.

43 Moreover, it is important to notice that "scheme" is defined, in s 177A(1), in terms that may not always permit the precise identification of what are said to be all of the integers of a particular "scheme". So much follows from the

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23 (1994) 181 CLR 359 at 382.

24 See *XCO Pty Ltd v Federal Commissioner of Taxation* (1971) 124 CLR 343 at 349 per Gibbs J.

25 (1994) 181 CLR 359 at 382.

26 (1994) 181 CLR 359 at 382.

inclusion, within the statutory meaning, not only of arrangements that are not and are not intended to be enforceable by legal proceedings, but also of "any scheme, plan, proposal, action, course of action or course of conduct". This definition is very broad. It encompasses not only a series of steps which together can be said to constitute a "scheme" or a "plan" but also (by its reference to "action" in the singular) the taking of but one step. The very breadth of the definition of "scheme" is consistent with the objective nature of the inquiries that are to be made under Pt IVA.

44 Nothing in subsequent decisions of the Court detracts from these conclusions about the operation of the definition of "scheme". In *Federal Commissioner of Taxation v Consolidated Press Holdings Ltd*, the Court held[27] that part only of the total plan or course of conduct involved in the corporate arrangements that had been made within a group of companies could be identified as a scheme to which Pt IVA applied. Nor do we understand subsequent decisions of the Court as having sought to elevate the Commissioner's identification of the scheme upon which he relies beyond the purpose identified in *Peabody*: the purpose of preventing embarrassment or surprise to the opposite party in the conduct of the proceedings[28]. The fundamental question remains whether, having regard to the eight matters listed in s 177D(b), "it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling the relevant taxpayer [alone or with others] to obtain a tax benefit in connection with the scheme".

45 Against this background it is necessary to come to one other aspect of what was said in *Peabody* which appears to have loomed large in the argument of the present matters below. The Court said[29] that it was possible, despite the very wide definition of a scheme, to conceive of a set of circumstances which constitutes only part of a scheme and not a scheme in itself. That will occur, the Court continued[30], "where the circumstances are incapable of standing on their own without being 'robbed of all practical meaning'[31]".

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27 (2001) 207 CLR 235 at 254 [52], 264 [96].

28 *Federal Commissioner of Taxation v Peabody* (1994) 181 CLR 359 at 382.

29 (1994) 181 CLR 359 at 383.

30 (1994) 181 CLR 359 at 383-384.

31 See *Inland Revenue Commissioners v Brebner* [1967] 2 AC 18 at 27.

46 This statement must be understood as having been directed to the issues of procedural fairness which underlay the issue presented in that case. Could the Commissioner, at trial or on appeal, point to some steps (narrower than those first identified by the Commissioner as the relevant scheme) and say that those steps constituted a scheme? As the Court went on to say[32], immediately after its reference to circumstances being incapable of standing on their own feet without being robbed of all practical meaning:

> "In that event, it is not possible in our view to say that those circumstances constitute a scheme rather than part of a scheme merely because of the provision made by ss 177D and 177A. The fact that the relevant purpose under s 177D may be the purpose or dominant purpose under s 177A(5) of a person who carries out only part of the scheme is insufficient to enable part of a scheme to be regarded as a scheme on its own. *That, of course, does not mean that if part of a scheme may be identified as a scheme in itself the Commissioner is precluded from relying upon it as well as the wider scheme.*" (emphasis added)

The last sentence of this passage reveals that the Court's focus, not surprisingly, was upon the question raised in the appeal: was the Commissioner precluded from advancing a particular argument.

47 The reference to circumstances being "robbed of all practical meaning" appears to have been understood in the Full Court[33] in the present matters as a criterion which must be applied in deciding whether there is a scheme to which Pt IVA applies. That is not right. First, it is far from clear what legal test is intended by saying that a scheme must "stand on its own feet". It is not clear how the metaphor is to be translated into legal principle. Secondly, as the Full Court pointed out[34] in the present matters, the words "robbed of all practical meaning", which were adopted in *Peabody*, were taken from *Inland Revenue Commissioners v Brebner*[35]. There they were used in a very different context and with a clearly intended meaning. The legislation in question in *Brebner* required comparison with what the statute[36] called "bona fide commercial reasons". Part IVA, of course, contains no equivalent expression. What Lord Pearce said

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32 (1994) 181 CLR 359 at 384.

33 (2002) 121 FCR 206 at 221 [42].

34 (2002) 121 FCR 206 at 221 [42].

35 [1967] 2 AC 18 at 27.

36 *Finance Act* 1960 (UK), s 28(1).

would be "robbed of all practical meaning", if one part of an arrangement were to be isolated from other parts, was the sub-section, not the arrangement. Thirdly, and most importantly, there is no basis to be found in the words used in Pt IVA for the introduction of some criterion additional to those identified in the Act itself. There is no reference to a scheme having some commercial or other coherence. Far from the Part requiring reference only to the purpose of those who carry out *all* of whatever is identified as the scheme, s 177D(b) specifically refers to it being concluded "that the person, or one of the persons, who entered into or carried out ... *any part of the scheme*" did so for the purpose of enabling the relevant taxpayer (alone or with others) to obtain a tax benefit in connection with the scheme (emphasis added).

Identifying the scheme in the present matters

48 At the trial of these matters the Commissioner had identified[37] a "wider scheme" and a "narrower scheme". The wider scheme was said to be "all the steps leading to, and the entering into, and the implementation of the loan arrangements" between the lender's agent and the respondents, including five particular steps. Those steps were: (a) the marketing of the loan to the respondents; (b) splitting the loan; (c) acceptance by the lender's agent of capitalisation of interest on that part of the loan used for investment purposes on the basis that it received another predetermined amount in reduction of the home loan portion; (d) the respondents' election to allocate all repayments to the home loan portion until that portion of the loan was paid; and (e) the consequential incurring of additional interest (including compound interest) on the investment loan portion. The narrower scheme was said to be "the provision in the loan for the division into two portions and the direction of the repayments to one or other portion and the direction by the [respondents] of the repayments to the home loan portion".

49 In the Full Court, emphasis was given[38] to whether the narrower definition of the scheme could "stand on its own feet". It was said that it could not, because it "did not include the loan itself". And because it was said that the narrower scheme could *not* stand on its own feet, the Full Court concluded[39] that the wider scheme should be considered. The wider scheme was said to be *all* the steps leading to, and the entering into, and the implementation of the loan

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37 (2001) 189 ALR 584 at 594 [29].

38 (2002) 121 FCR 206 at 221 [44].

39 (2002) 121 FCR 206 at 222 [45] per Hill J, 229 [76] per Hely J, 232 [94] per Conti J.

arrangements. It therefore included, among its elements, the making of the loan to the respondents. This in turn led the Full Court to conclude[40] that, because the borrowing was for use in financing and refinancing the two properties, the dominant purpose conclusion required by s 177D(b) could not be reached. It will be necessary to notice some aspects of the way in which these conclusions were reached and expressed. But before doing that it is necessary to stay a little longer with the question of identifying the relevant scheme.

50 The scheme to be identified must, of course, meet the definition of "scheme" set out in s 177A(1). But, in addition, the scheme to be identified must be a "scheme to which this Part applies": one which is entered into or carried out by a person for a purpose of the kind identified in s 177D(b) where a taxpayer has obtained, or would but for s 177F obtain, a tax benefit in connection with the scheme.

51 It is important to bear steadily in mind that, as was pointed out in the joint reasons of six members of the Court in *Federal Commissioner of Taxation v Spotless Services Ltd*[41], "Part IVA is to be construed and applied according to its terms, not under the influence of 'muffled echoes of old arguments' concerning other legislation[42]". That applies to all aspects of Pt IVA. Whether considering what is a "scheme", or considering other provisions of Pt IVA, it is necessary to eschew arguments that proceed from unstated premises about choice[43] or the drawing of false dichotomies[44] between "rational commercial decisions" and obtaining a tax benefit. It is important to identify why that is so.

52 There is no doubt that "tax laws affect the shape of nearly every business transaction"[45]. But as was said in the joint reasons in *Spotless*[46]:

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40 (2002) 121 FCR 206 at 228 [73] per Hill J, 229 [76], 231 [85]-[88] per Hely J, 232 [94] per Conti J.

41 (1996) 186 CLR 404 at 414.

42 *Ex parte Professional Engineers' Association* (1959) 107 CLR 208 at 276.

43 *W P Keighery Pty Ltd v Federal Commissioner of Taxation* (1957) 100 CLR 66.

44 *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 186 CLR 404 at 415.

45 *Frank Lyon Co v United States* 435 US 561 at 580 (1978) cited in *Spotless* (1996) 186 CLR 404 at 416.

46 (1996) 186 CLR 404 at 416.

> "A particular course of action may be, to use a phrase found in the Full Court judgments, both 'tax driven' and bear the character of a rational commercial decision. *The presence of the latter characteristic does not determine the answer to the question whether, within the meaning of Pt IVA, a person entered into or carried out a 'scheme' for the 'dominant purpose' of enabling the taxpayer to obtain a 'tax benefit'*." (emphasis added)

Always the question must be whether the terms of the Act apply to the facts and circumstances of the particular case.

53 The bare fact that a taxpayer pays less tax, if one form of transaction rather than another is made, does not demonstrate that Pt IVA applies. Simply to show that a taxpayer has obtained a tax benefit does not show that Pt IVA applies. With these considerations in mind, it is sometimes said that it is necessary to read Pt IVA in a way that will not bring "ordinary" transactions to tax. It is obvious that the content of such a proposition turns entirely upon what is meant by "ordinary".

54 Similar considerations can be seen to lie behind contentions that it is necessary to read the definition of "scheme" more narrowly than the terms used in the Act would require. In the present matters, Hely J said[47] that "[t]he more the scheme can be confined to the essential elements by which the tax benefit is obtained, the more likely it will be that the conclusion will be drawn that the dominant purpose for a person entering into a scheme so defined was to obtain the tax benefit". Whether or not that proposition is universally true may be open to debate. Even if, however, it is true, the solution to the difficulty which would be revealed lies not in attempting to seek some additional criterion of completeness or coherence which would inform or restrict the otherwise general terms of the definition of "scheme". As has been pointed out earlier, the words of the provisions give no basis for doing so. If there is a difficulty, its solution must be found in the construction and operation of other provisions of the Part, most particularly s 177D(b).

55 What the Commissioner identified in these matters as the wider scheme falls within the definition of "scheme". That is, all of the steps leading to, and the entering into, and the implementation of the loan arrangements can be understood as together constituting a "scheme". Those steps were a scheme, plan, or course of action. One of the purposes of that scheme was, of course, to provide money for the financing and refinancing of the two properties. But so,

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47 (2002) 121 FCR 206 at 231 [85].

too, the steps said by the Commissioner to have constituted the narrower scheme (the provision of the loan permitting both the division of the loan and the direction of repayments to one portion, coupled with the respondents' direction of their repayments to the home loan portion of the loan) can also be identified as a course of action, scheme, plan or action. Not only is that so, the steps identified as constituting the narrower scheme can be seen to have formed a part of the wider scheme.

56 The central question then becomes, would it be concluded, having regard to the eight matters listed in s 177D(b), that a person who entered into or carried out the wider scheme, the narrower scheme, or any part of either scheme, did so for the dominant purpose of enabling the respondents to obtain a tax benefit in connection with the scheme?

The application of s 177D(b)

57 It is convenient to consider the application of s 177D(b) in these matters by reference to the discussion of that subject in the Full Court. Hill J, with whose reasons in relation to Pt IVA the other members of the Court agreed, directed chief attention to three aspects of s 177D(b). They were, first, the manner in which the scheme was entered into or carried out (s 177D(b)(i)); secondly, changes in the financial position of the respondents, the lender and the lender's agent (s 177D(b)(v) and (vi)) and other consequences (s 177D(b)(vii)); and, thirdly, the conclusion that was to be reached having regard to those features.

58 Of the first of these matters, Hill J said[48] that "the manner in which the scheme was formulated and thus entered into or carried out is certainly explicable *only* by the taxation consequences" (emphasis added). No doubt this single aspect of the matter could not be treated as decisive. The Act requires that *all* of the eight matters listed in s 177D(b) be considered in deciding what conclusion would be reached about the purpose of the relevant persons. Yet it is important to notice the strength of the conclusion which Hill J reached about this matter: "the manner in which the scheme was formulated ... is ... explicable only by the taxation consequences". It will be necessary to return to consider what other considerations could be seen as denying the conclusion to which the manner in which the scheme was entered into or carried out pointed.

59 Of the second group of considerations (those referred to in s 177D(b)(v), (vi) and (vii)) his Honour noted[49] that, as a result of the scheme, the respondents

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48 (2002) 121 FCR 206 at 226 [65].

49 (2002) 121 FCR 206 at 227 [69].

had obtained and applied the funds in the manner earlier described. He said that there was no suggestion that the interest rate charged by the lender was other than a commercial rate. He noted that the respondents paid off the home loan faster than they otherwise would. No other financial or other kind of consequence was mentioned.

60 In this Court, the Commissioner submitted that there were three other relevant changes in the financial position of the respondents that had been brought about by the scheme. Those changes were, first, that, if the respondents were entitled to deduct all of the interest (including compound interest) attributed to that part of the loan used in connection with the investment property, they would pay less tax and would have more disposable income than they would have had if they had taken a loan on other terms. The second change, so the Commissioner submitted, was that, because interest would continue to accrue and be capitalised on that part of the loan used for the investment property, the amount owing on that account would increase to an amount well above the value of the investment property. Thirdly, as noted above, although the interest rate charged was commercially competitive, it was nevertheless marginally higher than would have been charged under the Austral standard principal and interest loans (for both home and investment financing) that were available to the respondents. In other words, so the Commissioner submitted, the respondents willingly agreed to pay a higher rate of interest than was available to them. No doubt account can and should be taken of these consequences of the scheme.

61 Hill J said that taking what, in substance, was a single advance and permitting its division into two parts might, "[t]o some extent"[50], support the conclusion that the obtaining of the additional tax deduction was the dominant purpose of the scheme. But this consideration, too, was evidently not treated as decisive. Any other considerations of form and substance, timing, and the nature of any connection between the respondents and any other relevant persons were not regarded as important.

62 Having said[51] that there was no doubt that the respondents and others involved in the transactions were aware of, and wanted the respondents to have, the tax deductions that were available for interest incurred on that part of the loan used for investment purposes, Hill J held[52] that "a reasonable person would [not] conclude that any person entered into or carried out the scheme or any part of it with the dominant purpose of ensuring that [the respondents] *merely* obtained a

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50 (2002) 121 FCR 206 at 227 [66].

51 (2002) 121 FCR 206 at 228 [73].

52 (2002) 121 FCR 206 at 228 [73].

higher deduction for interest" (emphasis added). (It is by no means clear why the word "merely" was added.) He went on:

> "On any view of the matter the dominant purpose of the *scheme* which included the borrowing by [the respondents] of funds used to finance and refinance the two properties was the obtaining of funds to permit them to do so. ... The *scheme* was directed to a *commercial end*, the borrowing of money for use in financing and refinancing the two properties. That is what a reasonable person would conclude was the ruling, prevailing or most influential purpose of [the respondents] in entering into or carrying out the scheme." (emphasis added)

63 Several points must be made about this reasoning. First, if some distinction was intended to be drawn between identifying the dominant purpose of *a relevant person* and the dominant purpose of *the scheme*, the latter inquiry is not required by s 177D and is irrelevant. Section 177D requires consideration of the purposes to be attributed to relevant *persons* who entered into or carried out the scheme or any part of the scheme.

64 Secondly, as his Honour had earlier noted[53], "[t]here is a false dichotomy between obtaining the maximum after tax return on money invested after payment of tax and obtaining a tax benefit". But so too, as was held in *Spotless*[54], there is a false dichotomy between a "rational commercial decision" and "the obtaining of a tax benefit as 'the dominant purpose of the taxpayers in making the investment'". Pointing to the "commercial end" of the scheme reveals the adoption of the same, or at least a substantially similar, false dichotomy. The presence of a discernible commercial end does not determine the answer to the question posed by s 177D. As Hely J rightly said[55]:

> "A particular course of action may be both tax driven, and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine in favour of the taxpayer whether, within the meaning of Pt IVA, a person entered into or carried out a 'scheme' for the dominant purpose of enabling a taxpayer to obtain a tax benefit."

65 In these matters, it is, of course, true that the money was borrowed to finance and refinance the two properties. Of course the loan was structured in the way it was in order to achieve the most desirable taxation result. But those

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53 (2002) 121 FCR 206 at 223 [54].

54 (1996) 186 CLR 404 at 415.

55 (2002) 121 FCR 206 at 230 [81].

are statements about why *the respondents* acted as they did or about why the lender (or its agent) structured the loan in the way it was. They are not statements which provide an answer to the question posed by s 177D(b). That provision requires the drawing of a conclusion about purpose from the eight identified objective matters; it does not require, or even permit, any inquiry into the subjective motives of the relevant taxpayers or others who entered into or carried out the scheme or any part of it.

66 In the present matters, the respondents would obtain a tax benefit if, in the terms of s 177C(1)(b), had the scheme not been entered into or carried out, the deductions "might reasonably be expected not to have been allowable". When that is read with s 177D(b) it becomes apparent that the inquiry directed by Pt IVA requires comparison between the scheme in question and an alternative postulate. To draw a conclusion about purpose from the eight matters identified in s 177D(b) will require consideration of what other possibilities existed. To say, as Hill J did, that "the manner in which the scheme was formulated and thus entered into or carried out is certainly explicable only by the taxation consequences" assumes that there were other ways in which the borrowing of moneys for two purposes (one private and the other income producing) might have been effected. And it further assumes that those other ways of borrowing would have had less advantageous taxation consequences.

67 In these matters, demonstrating that there was another way in which the money might have been borrowed was very easy. Austral (the lender's agent) went to great lengths to give to the respondents (and presumably anyone else interested in similar proposals to borrow money for two purposes) material that identified the advantages that would be obtained by taking a split loan instead of other forms of loan. Much of this material was tendered in evidence at trial. It included elaborately worked examples illustrating how quickly the home loan could be paid off and how large were the tax benefits which could be obtained. As one of the brochures published by Austral, and given to the respondents, put it (by reference to a "working example"):

> "By structuring your loan using Wealth Optimiser you obtain these potential benefits:
>
> - Your home loan portion is paid off in 4 years, 6 months ... This is approximately 20 years less than the old way, and
>
> - You obtain increased deductible interest on your investment loan portion ...
>
> All by paying **exactly the same monthly amount as you would have normally**."

68 There could be no doubt in these matters that the terms on which the loan was made available were explicable *only* by the taxation consequences for the respondents. If the scheme was identified as "all the steps leading to, and the entering into, and the implementation of the loan arrangements" the manner in which that scheme was entered into strongly suggested that the respondents (each a relevant taxpayer) entered into *that* scheme for the dominant purpose of obtaining a tax benefit. Further, if the scheme was identified in this way, the respondents, by giving the directions they did, carried out the scheme for that same dominant purpose. But so too, if the scheme is identified more narrowly (as the making of the relevant provisions in the loan agreement and the giving of directions under those provisions) the like conclusion would be reached. Both the manner in which that (narrower) scheme was entered into, and the manner in which it was carried out, strongly suggested the conclusion described.

69 It is then important to return, for a moment, to an aspect of the issues discussed earlier concerning the identification of the scheme. The conclusions just described, as being indicated by the manner in which the scheme was entered into or carried out, are indicated by a consideration of how else the loan might have been arranged. They are not conclusions which depend upon identifying the scheme in one of the ways put forward by the Commissioner rather than another.

70 As has already been pointed out, it would be wrong to treat any conclusion drawn from the first of the eight matters mentioned in s 177D(b) as determinative. All eight must be considered. When the remaining seven are examined in these matters it will be seen that either they tend to point to the same conclusion as the manner in which the scheme was entered into or carried out, or they are neutral. None points against the conclusion that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling each respondent to obtain a tax benefit in connection with the scheme.

71 As Hill J rightly pointed out, the form and substance of the scheme (s 177D(b)(ii)) also point to the purpose of a relevant person obtaining a tax advantage. What was one advance, to be repaid by 300 instalments, was treated as if it were two separate loans. The only persons obtaining any advantage from the treatment were the respondents. And the only advantages which they obtained depended upon the taxation treatment resulting from the application of payments and accumulation of interest for which the scheme (however identified) provided. It was these results in relation to the operation of the Act (but for Pt IVA) which would be achieved (s 177D(b)(iv)) and these results would improve the financial position of the respondents (each a relevant taxpayer) (s 177D(b)(v)). The only other consequence for them would be the compounding of interest attributable to the investment portion of the loan (s 177D(b)(vii)). No other person (in particular, neither the lender nor the lender's agent) would gain

or suffer financially (s 177D(b)(vi)) or sustain any other consequence (s 177D(b)(vii)). And the *only* connection between the lender, the lender's agent and the respondents was that created by the loan arrangement, apart, of course, from the relationship of marriage between the respondents.

Conclusion and orders

72 It follows that the conclusion required by having regard to the eight identified matters was that asserted by the Commissioner. Having regard to those matters it would be concluded that the dominant purpose of the respondents in entering into and in carrying out the scheme was to obtain the tax benefit which the Commissioner's determination cancelled.

73 It is, therefore, not necessary to consider the further question which the Commissioner sought to raise about allowing a deduction for interest on interest. The Commissioner's application for special leave to appeal on the ground that the Full Court erred in its treatment of this question should be dismissed.

74 The appeal should be allowed. The Commissioner agreed that he should pay the respondents' costs in this Court in any event. The orders made by the Full Court on 26 November 2002 should be set aside and the appeal to that Court be dismissed with costs.

75 CALLINAN J. The Court has before it an appeal and an application for special leave to appeal by the appellant. The former raises questions as to the nature of a scheme under the *Income Tax Assessment Act* 1936 (Cth) ("the Act") and the identification of the dominant purpose of it. The latter relates to the basis of an assessment of a taxation benefit claimed in respect of compound interest. If the appellant succeeds on his appeal, the issue sought to be resolved by the application for special leave to appeal need not be.

Facts

76 The respondents owned a residential property at Jerrabomberra that was mortgaged to the ANZ Banking Group Ltd ("ANZ"). They decided to buy another residence at Fadden and to make their current residence available for rent. On 21 August 1996 the respondents paid a holding deposit on the Fadden residence. Only then did they explore ways and means of financing the purchase. They obtained a brochure from a mortgage broker, Austral Mortgage Corporation Pty Ltd ("Austral") which promoted a particular arrangement of lending and repayment which it described as a "Wealth Optimiser". The inescapable purpose of the Wealth Optimiser was, as will appear, to facilitate the repayment of a loan to be used not exclusively for the derivation of income but so as to derive the maximum tax benefits possible.

77 The accurate description by the broker of the arrangements and terms of a Wealth Optimiser in this way, which it provided in its promotional material, almost alone establishes this:

> "*'Lets you better manage your after tax dollars'*
>
> ...
>
> Under the Wealth Optimiser way, your loan is split into two portions, a home loan portion and an investment loan portion. You have the choice of allocating the repayments to either the home loan portion, the investment loan portion, or both. By choosing to allocate all of your repayments to your home loan portion, the home loan portion is paid off quickly, usually in around 5 or 6 years instead of 15 to 25 years. During this period, interest continues to accrue and is capitalised monthly on your investment loan portion.
>
> ...
>
> Once your home loan portion is paid off, all of your repayments are allocated to paying off your investment loan portion. Your home remains as security for your investment loan portion. The size of your repayments remains the same throughout the loan (unless you wish to increase them, or interest rates vary).

...

HOW DOES WEALTH OPTIMISER WORK?

The home loan portion needs to be used for financing residential real estate, which will be security for both loan portions. The investment loan portion can be used for investment in shares, managed funds, etc. However for Wealth Optimiser to work most effectively, you need to be paying off a home loan and also a loan used to finance an income producing investment."

78 On 23 August 1996 the respondents were provided with a schedule of the benefits of a Wealth Optimiser compared with a standard loan. It showed that the financing of a borrowing for the purchase of a residence of $145,023, and a loan of $120,592 to finance the purchase of an investment property over 25 years would generate for the borrower $169,470 in increased income tax deductions above those that the borrower would have been entitled to receive under a conventional borrowing if the loan were to extend to its full term. It showed that the amount of interest paid under a Wealth Optimiser and under a conventional loan was the same. It also showed that, after eight years, the amount owing in respect of the property bought for the derivation of income would have increased from $120,592 to $233,085. A likely consequence would be that the amount outstanding in respect of the investment property would come to exceed its value.

79 The respondents were offered a Wealth Optimiser loan of $298,000. Approximately $95,000 and $203,000 were to be respectively utilized to discharge the mortgage on the respondents' current residence which was then to be let and in purchasing the respondents' proposed replacement of it. Permanent Custodians Limited ("the lender") was a legal personality quite separate from Austral. Principal and interest were to be repayable in full 25 years from the date of settlement. Interest would be payable at a variable rate. It was then 9.15%, a slightly, but not significantly higher rate than the respondents had been paying on their current loan by ANZ (8.69%). The respondents were informed that:

"If you ask us to, we will split this amount into a maximum of 2 separate loan accounts. We will calculate interest on each loan account separately and give you a separate statement for each loan account."

80 Interest was to be calculated daily on the unpaid balance of the loan ("or if applicable on the unpaid balance of each loan account") and was to be debited monthly in arrears. Repayments would be $2533 per month, subject to variations of interest rates. On 2 October 1996, the respondents confirmed that they wished to accept the offer. On 4 September 1996 they had entered into a contract to purchase the Fadden property. On 7 October 1996 the respondents made a request to Austral to split the loan into two accounts, one for $202,888 (to be applied to the purchase of the new residential property) ("loan account 1") and the other for $95,112 (to be applied to the refinancing of the investment property)

("loan account 2") with payments to be allocated to loan account 1 (until the balance in that account was paid off). The terms providing for the splitting of the loan into separate loan accounts and the capitalization of all interest accruing on the loan balance were cll 4.3 and 8.6.

> "**4.3 Loan Accounts**
>
> If you ask us to, we will:
>
> (a) split the Loan Balance into a maximum of four separate Loan Accounts; and
>
> (b) allocate the Loan Balance between those Loan Accounts in accordance with your request.
>
> ...
>
> **8.6 Capitalisation of Interest**
>
> On each Payment Date, we will capitalise all interest accrued on the Loan Balance during the immediately preceding Interest Period by debiting your Loan Accounts. Capitalising interest means that interest is added to the amount on which the interest is accruing, and interest then accrues on the total amount."

81 Because the respondents had nominated that the whole of their repayments should be allocated to loan account 1, all payments of principal and interest were applied in reduction of that account, while interest on the amount owing on loan account 2 was capitalized, and compound interest was debited. The consequence was that, as no reductions of the principal outstanding on loan account 2 occurred in the 1997 or 1998 financial years, interest accrued on the whole of the amount of that account. Nor were any payments of interest made in respect of loan account 2 in those years. Compound interest accordingly accrued. The respondents claimed deductions for the whole of the unpaid interest accruing in loan account 2. The appellant was of the opinion that the compound interest was not deductible on any view and disallowed it. He also made determinations under Pt IVA of the Act disallowing as a deduction the interest which would not have accrued on loan account 2 had the agreed periodical payments made by the respondents been allocated proportionally to the two accounts.

First instance in the Federal Court

82 The respondents objected. The appellant rejected their objections. The respondents appealed pursuant to Pt IVC of the *Taxation Administration Act* 1953 (Cth) to the Federal Court. There, the appellant contended that on any view there was a scheme in place and that it was possible to characterize it as such,

either broadly or narrowly. The primary judge (Gyles J) summarized the appellant's contentions which are maintained in this Court in these ways[56]:

> "The [appellant] contends that the scheme is all the steps leading to and the entering into and the implementation of the loan arrangements between Austral and the [respondents], including:
>
> (a) the marketing of the 'wealth optimiser' loan to the [respondents];
>
> (b) the splitting of the loan into the home loan portion and the investment loan portion;
>
> (c) the acceptance by Austral of capitalisation of interest on the investment loan portion, on the basis that it receives another predetermined amount in reduction of the home loan portion;
>
> (d) the election by the [respondents] to allocate the whole of the repayments to the home loan portion until that portion of the loan has been paid; and
>
> (e) the consequential incurring of an amount of additional interest and further interest on the investment loan portion.
>
> Alternatively, the scheme is said to be the provision in the loan for the division into two portions and the direction of the repayments to one or other portion and the direction by the [respondents] of the repayments to the home loan portion. The parties to the scheme are alleged to be the [respondents], and/or Austral and/or its directors, and/or [the lender] and/or its directors.
>
> The [appellant] contends that the tax benefit is either of the following:
>
> (a) if all the interest on the investment loan portion is deductible (including the additional interest and the further interest), the tax benefit is the difference between:
>
> (i) the interest incurred on the investment loan portion; and
>
> (ii) the interest that would have been incurred on the investment loan portion if the [respondents] had allocated the total minimum payment proportionally across both accounts.

---

56 *Hart v Commissioner of Taxation* (2001) 189 ALR 584 at 594-595 [29]-[30].

Under this scenario, the tax benefit for each of the [respondents] would be $96 for the 1997 year and $365 for the 1998 year;

(b) if the additional interest is not deductible but the further interest is deductible, the tax benefit is the difference between:

(i) the interest the [respondents] would have incurred on the investment loan portion if the [respondents] had a conventional interest only investment loan; and

(ii) the interest the [respondents] would have incurred on the investment loan portion if the [respondents] had operated the accounts as separate conventional principal and interest loans.

Under this scenario the tax benefit for each of the [respondents] would be $29 for the 1997 year and $50 for the 1998 year."

83 His Honour held that compound interest was deductible under s 51(1) of the Act (for the 1997 year) and under s 8-1 of the *Income Tax Assessment Act* 1997 (Cth) for the 1998 year[57], but that the appellant was entitled to apply the provisions of Pt IVA to disallow the deductions for the compound and further interest[58].

The appeal to the Full Court of the Federal Court

84 On appeal, the Full Court of the Federal Court (Hill, Hely and Conti JJ) affirmed the decision of the primary judge as to the deductibility of the compound interest under s 51(1) and s 8-1, but held that the provisions of Pt IVA did not apply to disallow the deductions for either the compound interest or the further interest. Its opinion was that the narrower scheme was not a scheme for the purposes of Pt IVA, and that the scheme had to be the wider one, if any. Their Honours held that the wider "scheme [as suggested by the appellant] was directed to a commercial end, the borrowing of money for use in financing and refinancing the two properties" and "[t]hat is what a reasonable person would conclude was the ruling, prevailing or most influential purpose of the [respondents] in entering into or carrying out the scheme"[59].

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57 *Hart v Commissioner of Taxation* (2001) 189 ALR 584 at 592 [26].

58 *Hart v Commissioner of Taxation* (2001) 189 ALR 584 at 609 [59].

59 *Hart v Commissioner of Taxation* (2002) 121 FCR 206 at 228 [73] per Hill J.

The appeal to this Court

85 In almost every respect the language of the legislature is expressed in the widest possible terms. The sections with which the Court is particularly concerned are:

"**177A Interpretation**

(1) In this Part, unless the contrary intention appears:

…

'scheme' means:

(a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and

(b) any scheme, plan, proposal, action, course of action or course of conduct.

...

(3) The reference in the definition of 'scheme' in subsection (1) to a scheme, plan, proposal, action, course of action or course of conduct shall be read as including a reference to a unilateral scheme, plan, proposal, action, course of action or course of conduct, as the case may be.

(4) A reference in this Part to the carrying out of a scheme by a person shall be read as including a reference to the carrying out of a scheme by a person together with another person or other persons.

(5) A reference in this Part to a scheme or a part of a scheme being entered into or carried out by a person for a particular purpose shall be read as including a reference to the scheme or the part of the scheme being entered into or carried out by the person for 2 or more purposes of which that particular purpose is the dominant purpose.

...

177C Tax benefits

(1) Subject to this section, a reference in this Part to the obtaining by a taxpayer of a tax benefit in connection with a scheme shall be read as a reference to:

(a) an amount not being included in the assessable income of the taxpayer of a year of income where that amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out; or

(b) a deduction being allowable to the taxpayer in relation to a year of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out;

and, for the purposes of this Part, the amount of the tax benefit shall be taken to be:

(c) in a case to which paragraph (a) applies – the amount referred to in that paragraph; and

(d) in a case to which paragraph (b) applies – the amount of the whole of the deduction or of the part of the deduction, as the case may be, referred to in that paragraph.

...

177D Schemes to which Part applies

This Part applies to any scheme that has been or is entered into after 27 May 1981, and to any scheme that has been or is carried out or commenced to be carried out after that date (other than a scheme that was entered into on or before that date), whether the scheme has been or is entered into or carried out in Australia or outside Australia or partly in Australia and partly outside Australia, where:

(a) a taxpayer (in this section referred to as the 'relevant taxpayer') has obtained, or would but for section 177F obtain, a tax benefit in connection with the scheme; and

(b) having regard to:

(i) the manner in which the scheme was entered into or carried out;

(ii) the form and substance of the scheme;

(iii) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;

(iv) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;

(v) any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;

(vi) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme;

(vii) any other consequence for the relevant taxpayer, or for any person referred to in subparagraph (vi), of the scheme having been entered into or carried out; and

(viii) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in subparagraph (vi);

it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme or of enabling the relevant taxpayer and another taxpayer or other taxpayers each to obtain a tax benefit in connection with the scheme (whether or not that person who entered into or carried out the scheme or any part of the scheme is the relevant taxpayer or is the other taxpayer or one of the other taxpayers).

...

177F Cancellation of tax benefits etc.

(1) Where a tax benefit has been obtained, or would but for this section be obtained, by a taxpayer in connection with a scheme to which this Part applies, the Commissioner may:

(a) in the case of a tax benefit that is referable to an amount not being included in the assessable income of the taxpayer of a year of income – determine that the whole or a part of that amount shall be included in the assessable income of the taxpayer of that year of income; or

(b) in the case of a tax benefit that is referable to a deduction or a part of a deduction being allowable to the taxpayer in

relation to a year of income – determine that the whole or a part of the deduction or of the part of the deduction, as the case may be, shall not be allowable to the taxpayer in relation to that year of income;

and, where the Commissioner makes such a determination, he shall take such action as he considers necessary to give effect to that determination.

(2) Where the Commissioner determines under paragraph (1)(a) that an amount is to be included in the assessable income of a taxpayer of a year of income, that amount shall be deemed to be included in that assessable income by virtue of such provision of this Act as the Commissioner determines.

…

(2C) Notice of the determination must be given to the taxpayer and … to the person who paid the amount.

(2D) More than one determination may be included in the same notice.

(2E) A failure to comply with subsection (2C) does not affect the validity of a determination.

…

(3) Where the Commissioner has made a determination under subsection (1) … in respect of a taxpayer in relation to a scheme to which this Part applies, the Commissioner may, in relation to any taxpayer (in this subsection referred to as the 'relevant taxpayer'):

(a) if, in the opinion of the Commissioner:

(i) there has been included, or would but for this subsection be included, in the assessable income of the relevant taxpayer of a year of income an amount that would not have been included or would not be included, as the case may be, in the assessable income of the relevant taxpayer of that year of income if the scheme had not been entered into or carried out; and

(ii) it is fair and reasonable that that amount or a part of that amount should not be included in the assessable income of the relevant taxpayer of that year of income;

determine that that amount or that part of that amount, as the case may be, should not have been included or shall not be included, as the case may be, in the assessable income of the relevant taxpayer of that year of income; or

(b) if, in the opinion of the Commissioner:

(i) an amount would have been allowed or would be allowable to the relevant taxpayer as a deduction in relation to a year of income if the scheme had not been entered into or carried out, being an amount that was not allowed or would not, but for this subsection, be allowable, as the case may be, as a deduction to the relevant taxpayer in relation to that year of income; and

(ii) it is fair and reasonable that that amount or a part of that amount should be allowable as a deduction to the relevant taxpayer in relation to that year of income;

determine that that amount or that part, as the case may be, should have been allowed or shall be allowable, as the case may be, as a deduction to the relevant taxpayer in relation to that year of income;

and the Commissioner shall take such action as he considers necessary to give effect to any such determination.

(4) Where the Commissioner makes a determination under subsection (3) by virtue of which an amount is allowed as a deduction to a taxpayer in relation to a year of income, that amount shall be deemed to be so allowed as a deduction by virtue of such provision of this Act as the Commissioner determines.

(5) Where, at any time, a taxpayer considers that the Commissioner ought to make a determination under subsection (3) in relation to the taxpayer in relation to a year of income, the taxpayer may post to or lodge with the Commissioner a request in writing for the making by the Commissioner of a determination under that subsection.

(6) The Commissioner shall consider the request and serve on the taxpayer, by post or otherwise, a written notice of his decision on the request.

(7) If the taxpayer is dissatisfied with the Commissioner's decision on the request, the taxpayer may object against it in the manner set out in Part IVC of the *Taxation Administration Act 1953*."

86 In the Explanatory Memorandum to the Income Tax Laws Amendment Bill (No 2) 1981 (Cth) which introduced Pt IVA (in which the relevant sections appear) into the Act, the Treasurer said this[60]:

> "The proposed new Part IVA, which this Bill will insert into the Principal Act, is designed to overcome [limitations on the scope of s 260, as exposed by judicial decisions] and provide – with paramount force in the income tax law – an effective general measure against those tax avoidance arrangements that – inexact though the words be in legal terms – are blatant, artificial or contrived. In other words, the new provisions are designed to apply where, on an objective view of the particular arrangement and its surrounding circumstances, it would be concluded that the arrangement was entered into for the sole or dominant purpose of obtaining a tax deduction or having an amount left out of assessable income.
>
> That test for application of the new provisions is intended to have the effect that arrangements of a normal business or family kind, including those of a tax planning nature, will be beyond the scope of Part IVA.
>
> In this respect, Part IVA may be seen as effectuating in general anti-avoidance provisions of the income tax law a position akin to that which appears to emerge from the decision of the Privy Council in *Newton v Federal Commissioner of Taxation* (1958) 98 CLR 1. The essence of the views expressed in that case was that a tax avoidance situation covered by section 260 exists only if it can be predicated from looking at an arrangement that it was implemented in that particular way so as to avoid tax.
>
> In coming to a conclusion about the application of Part IVA in particular situations, it will be necessary to examine all relevant external evidence of the purposes for which a person entered into an arrangement and carried it out in the way it was carried out. The manner in which the scheme was entered into, its form and substance, timing aspects, its practical results, including changes in the financial positions of the taxpayer and connected persons and the nature of those connections (eg, business, family) are all to be considered.

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60 House of Representatives, Income Tax Laws Amendment Bill (No 2) 1981, Explanatory Memorandum at 2-18.

It will be necessary, if Part IVA is to apply, that a taxpayer has obtained a 'tax benefit'. A tax benefit will have been obtained by a taxpayer in connection with a scheme if, after applying the other provisions of the Principal Act to the taxpayer, either an amount is not included in assessable income of the taxpayer that might reasonably be expected to have been included if the scheme had not been entered into, or a deduction is allowable to the taxpayer the whole or a part of which might reasonably be expected not to have been allowable if the scheme had not been entered into.

The relevant purpose, already referred to, that is to be enquired into is a purpose of obtaining a tax benefit, in the sense just mentioned. Specification of what constitutes a tax benefit and that the relevant purpose is one of obtaining such a benefit is designed to eliminate the uncertainties associated with the use in section 260 of less precise expressions, eg, 'altering the incidence of any income tax' and 'defeating, evading or avoiding any duty or liability imposed on any person by this Act' and which appear to be at the root of the development by the courts of the 'choice principle' …

Section 177A: Interpretation

This section contains a number of provisions of a definitional nature.

By sub-section (1), 'scheme' is to be defined in a way that covers the various forms in which tax avoidance arrangements may be found. It is to mean any agreement, arrangement, understanding, promise or undertaking whether it is express or implied and whether or not legally enforceable. Any scheme, plan, proposal, action, course of action or course of conduct is also to be treated as a 'scheme'. Under sub-section 177A(3) 'scheme' in the sense just referred to is to include such arrangements when they are of a unilateral kind.

...

Proposed sub-section (4) is addressed to the fact that schemes of the kind to which Part IVA is directed usually involve a number of parties. Accordingly, references to the carrying out of a scheme by a person are to be taken as including references to the carrying out of a scheme by a person together with others.

Sub-section (5) is a provision of some consequence and is designed as part of the measures necessary to give effect to the intention that the relevant tax-motivated purpose that may bring Part IVA into operation is a sole or dominant purpose. Sub-section (5) relates principally to the words at the end of proposed section 177D which refer to a person having acted

for 'the purpose' of enabling a taxpayer to obtain a tax benefit. That language refers to a person's sole purpose but, by reason of sub-section 177A(5) the expression is in the case of a scheme with more than one purpose to include also a dominant purpose, ie, a purpose that outweighs all other purposes put together.

...

Section 177C: Tax benefits

The significance of the term 'tax benefit', which this section defines, is that it represents the kind of tax consequence which a person must have the sole or dominant purpose to achieve, and which must have been achieved, if Part IVA is to apply by reason of section 177D. In brief, a 'tax benefit' represents the non-inclusion in assessable income of an amount that, but for the scheme, might reasonably be expected to have been included and a deduction being allowable that, but for the scheme, might reasonably be expected not to have been allowable.

A tax consequence other than non-inclusion of an amount in assessable income or allowance of a deduction will not be a 'tax benefit', and will thus be outside the scope of Part IVA. In other words, Part IVA applies only in relation to things that go to make up a person's taxable income, and not to rebates of or credits against the tax on a person's taxable income. Withholding taxes, being taxes that are not based on the difference between assessable income and allowable deductions will also be outside the scope of Part IVA.

The main part of section 177C is in sub-section (1). Taking assessable income and allowable deduction items separately, the sub-section is designed as follows.

First, a 'scheme' (see sub-section 177A(1)) must be identified. Then, it has to be found that an amount would have been included, or might reasonably be expected to have been included, in assessable income of a taxpayer but for the scheme. For the purposes of answering the twin questions posed by section 177D, viz, whether a tax benefit has been obtained, and whether a person has a purpose of obtaining a tax benefit, that amount, to the extent that it is not, or is not to be, included in assessable income, is to represent a tax benefit in relation to the taxpayer concerned.

It follows that if there is a scheme designed so that an amount is not included in assessable income and another provision of the Principal Act operates to counter that scheme by requiring that it be so included, the amount cannot be a tax benefit obtained by the taxpayer concerned, and

Part IVA will be inapplicable. In other words, Part IVA is a 'last resort' measure.

...

Section 177D: Schemes to which Part applies

This section will identify schemes to which Part IVA is to apply. Supplemented by section 177E in the particular area of the stripping of company profits it will provide the basis on which action is to be taken under section 177F to cancel the relevant tax benefit.

In brief, section 177D makes Part IVA applicable as a matter of law to a scheme if a taxpayer has obtained a tax benefit under it and, on the basis of an objective view of features of the scheme and its surrounding circumstances, it would be concluded that the scheme was, in tax terms, a 'blatant' one, that is, it was entered into by a person for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit.

In more detail, for a scheme to be one to which Part IVA applies by reason of section 177D it must be a scheme entered into after the date of introduction of the Bill or a scheme that technically is not 'entered into' (eg, one constituted by a unilateral course of action) but is carried out or commenced to be carried out after that date. …

Under paragraph (a) it is a condition for the application of Part IVA that a taxpayer has obtained, or would otherwise obtain, a 'tax benefit' (section 177C) in connection with the scheme concerned.

Paragraph (b) sets out the range of matters to which regard is to be had in coming to a conclusion whether a relevant person had the degree of taxation purpose that must exist if section 177D is to make Part IVA apply.

These are –

- the manner in which the scheme was entered into or carried out;
- its form and substance;
- the particular time at which the scheme was entered into and the period during which it was carried out;
- the tax result that, but for Part IVA, would be achieved by the scheme;
- any change resulting from the scheme in the financial position of the taxpayer;

- any such change in the financial position of a person with whom the taxpayer has business, family or other connections;

- any other consequence of the scheme for the taxpayer or a connected person;

- the nature of any connections between the taxpayer and a connected person whose financial position changes as a result of the scheme.

Against this background, the remaining provisions of sub-paragraph (b) of section 177D operate so that Part IVA will effectively strike down a scheme that on its face, and considered in the light of the designated surrounding circumstances just outlined, is one of which it is appropriate to say that it must have been engaged in for tax purposes.

In more detail, if on the basis of the matters to which regard is to be had it would be concluded that the person or one of the persons who entered into or carried out the scheme, or any part of it, did so for the sole or (by reason of sub-section 177A(5)) dominant purpose of enabling the taxpayer or any taxpayer concerned to obtain a tax benefit then (the other tests of section 177D having been satisfied), Part IVA will apply.

...

Section 177F: Cancellation of tax benefits, etc.

Section 177F is the 'reconstruction' provision of Part IVA and will come into play once section 177D, together with section 177C (for the general run of cases), or section 177E (for dividend stripping and similar schemes) has done its work of both exposing for annihilation a sought-for 'non-taxable' position and quantifying the amount of the 'tax benefit' that stands to be cancelled. The essential function of section 177F is to enable the Commissioner of Taxation, against the background of the other sections mentioned, to determine precisely what tax adjustments should be made in the assessments of the taxpayer concerned and of other taxpayers affected by the scheme.

Sub-section (1) effectively calls on the Commissioner to make a formal determination as to how much of the amount of the identified tax benefit is to be cancelled and directs him, where he has made such a determination, to take such assessing and other action as he considers necessary to give effect to it. There are two kinds of determination possible – under paragraph (a), that the whole or a part of an amount that is not otherwise included in assessable income be so included and, under

paragraph (b), that the whole or a part of a deduction or of a part of a deduction that is otherwise allowable be not allowable.

By sub-section (2), the Commissioner is required, where a determination has been made under paragraph (1)(a), to further determine the appropriate provision of the Principal Act under which the amount in question is to be included in assessable income. A corresponding provision is not called for in relation to a determination that is made under paragraph (1)(b) because the process of cancelling a tax benefit (by disallowing a deduction) under the latter paragraph does not involve the same degree of positive reconstruction to a taxable position as will be necessary where, under a scheme, an amount has not been included in assessable income.

An example of where a determination of the provision under which an amount is to be included in assessable income would be relevant is where there is a question of whether or not an amount to be included in the assessable income of a company has the character of a dividend on which the rebate of tax on intercorporate dividends (section 46) is allowable.

Where the Commissioner has made a determination under sub-section (1), he is also authorised, by sub-section (3), to make a compensating adjustment in favour of either the taxpayer against whom the determination has been made, or any other taxpayer, if he is of the opinion that the person concerned has suffered a taxation disadvantage as a result of the scheme and that it is fair and reasonable that the adjustment be made. The Commissioner again is empowered to take whatever action is necessary to give full and proper reconstructive effect to the determination.

Paragraph (a) deals with a disadvantage in the form of an amount having been included in a person's assessable income that would not have been included if the scheme had not been entered into. The Commissioner is empowered, if it is fair and reasonable to do so, to determine that the amount or part of the amount should not be included in the taxpayer's assessable income. Correspondingly, under paragraph (b) the Commissioner is empowered, if it is fair and reasonable to do so, to make a determination to reverse either wholly or partially a disadvantage in the form of a deduction not having been allowed to a taxpayer that would have been allowable if the scheme had not been entered into.

Where the Commissioner is to make an adjustment in favour of a person under paragraph (3)(b) by allowing a deduction not otherwise allowable, sub-section (4) will have the effect that the reconstruction of the taxpayer's taxation position is to be effected by allowing a deduction

under such provision of the Principal Act as the Commissioner determines.

This serves a purpose corresponding with that served by sub-section (2) in the reconstruction process accompanying the cancellation of a tax benefit attributable to the exclusion of an amount of assessable income.

The next four sub-sections (5) to (8), are designed to extend the benefit of the ordinary objection and appeal provisions to a taxpayer who is dissatisfied with any decision of the Commissioner to not make a determination under sub-section (3) in favour of the taxpayer.

As background, any assessment action by the Commissioner in reliance on section 177F – whether adverse to or in favour of the taxpayer – will be subject to the usual rights of objection, review by an independent Taxation Board of Review and appeal to a Court. These procedures include the power of a Board of Review to substitute its determinations and decisions for those of the Commissioner. However, these procedures may not be available to a taxpayer in a situation where Part IVA has been applied against another taxpayer and the Commissioner considers that the case is not one calling for him to make a compensating adjustment under sub-section (3) in favour of the first taxpayer, ie, an adjustment which that taxpayer considers should be made.

Under proposed sub-section (5) such a taxpayer may ask the Commissioner to make a determination under sub-section (3). By sub-section (6) the Commissioner is to consider the request and give written notice of his decision. If the taxpayer is dissatisfied with the decision he may, under sub-section (7), and within 60 days, lodge a formal objection with the Commissioner. By sub-section (8) the objection, review and appeal provisions of the Principal Act are to apply in relation to such an objection."

87 Read literally, the definition of a scheme is easily wide enough to include something much less than an agreement or arrangement: indeed to include an "action", or "course of action", or a promise made pursuant to, or as part of an agreement or arrangement, or of a scheme. A scheme, however it is to be described, must nonetheless be something which is, or can be the object of a particular, that is to say, a dominant purpose as required by s 177A(5). Further requirements are that what is sought to be identified as a scheme, must be something to which the matters referred to in s 177D(b) can or may be relevant.

88 Those matters, especially those of relevance here, do not operate, however, to narrow the meaning of a scheme. The reference in s 177D(b)(ii) to the "substance of the scheme" invites attention to what in fact the taxpayer may achieve by carrying it out, that is to matters whether forming part of, or not to be

found within the four corners of an agreement or an arrangement. They also require that substance rather than form be the focus. And s 177D(b)(v) requires reference to the financial position, actual or prospective, of the taxpayer before and after the scheme.

89 The first step is to ascertain whether the transactions, or any action taken in relation to, or as part of them, are capable of constituting a scheme within the meaning of s 177A(1). In my opinion there is no doubt that there was a scheme here within that meaning, and that there is more than one way in which what passed between the respondents, Austral and the lender, can be seen to answer the statutory definition of a scheme. The arrangement that the respondents might elect to have interest debited exclusively to one account was each of, an "agreement", "understanding", "promise" or "undertaking", and although the definition does not require as an element of it, legal enforceability, each was legally enforceable as such. The election as to the application of the payments also answers the description of an "action" or "course of action" within the meaning of those words in s 177A(1)(b). This was so despite that the Court said in *Federal Commissioner of Taxation v Peabody*[61], that "Pt IVA does not provide that a scheme includes part of a scheme". An action or course of action undertaken in the course of, or as part of a transaction or series of transactions, is not the same as part of a scheme. The use of the singular, narrow words, proposal, action or course of action in s 177A(1)(b) in juxtaposition with, for example, agreement or arrangement in s 177A(1)(a) indicates that something done which is less than the whole of an arrangement or agreement may be capable of itself being a scheme. This view is I think not only consistent with, and a true reflection of the statutory language, but also with the legislative intention discernible from the Explanatory Memorandum. It is also consistent with the approach of this Court in *Federal Commissioner of Taxation v Consolidated Press Holdings Ltd*[62] in which the Court looked to part only of the activity of the corporate taxpaying group. Furthermore, there is no reason why the promotion of the Wealth Optimiser, its utilization by the respondents, the agreements and mortgages giving effect to it, and the election as to the repayments and debiting of interest, should not be collectively regarded as an arrangement, a course of action or a course of conduct. The arrangement was in fact a tripartite one, involving the broker, the respondents and the lender. Under s 177A(3) a unilateral course of action, for example, the giving of notice of election and payment according to it, by the respondents would have been sufficient to constitute a scheme.

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61 (1994) 181 CLR 359 at 383.

62 (2001) 207 CLR 235 at 254 [52], 264 [96].

90 The respondents sought to emphasize, in attacking the appellant's submissions, that the election by them, or their splitting of the loan in the way in which they did could constitute a scheme, a statement of the Court in *Peabody*[63] in effect that, if "the circumstances are incapable of standing on their own without being 'robbed of all practical meaning'" then those circumstances although they may be a part of a scheme, cannot constitute a scheme itself. All that I would take the Court to mean in making this statement is that it is not for the appellant to attempt to seize upon and isolate one event, or a series of events, which, standing alone may appear to have a complexion which it or they cannot truly bear when other, relevant, connected events are taken, as they should be, into account.

91 Nor is there any doubt that the respondents obtained a tax benefit under s 177C "*in connection with a scheme*". The use of the word "connection" is significant. It is a word of wider import than, for example, "result". The benefit is obvious: a deduction from each respondent's taxable income of the whole of the interest payable in respect of a loan to finance not just the acquisition or holding of an investment property but of both it and a residence, the interest on the financing of which is not tax deductible.

92 The next question, which is of purpose, is whether under s 177D the scheme is one to which Pt IVA applies. This will, in my view, in most cases be the critical question. The answer to it, both as a matter of statutory interpretation and as the Explanatory Memorandum indicates, was intended to be the fulcrum upon which most Pt IVA cases will turn, because the definition of a scheme, being as wide as it is, will relatively easily be satisfied, and the presence or absence of a tax advantage will also usually be readily apparent. The Act requires that questions raised by s 177D be answered by reference to the indicia stated in the section. It is not necessary of course that every one of them be relevant to every scheme. Indeed the presence or overwhelming weight of one factor alone may of itself in an appropriate case be of such significance as to expose a relevant dominant purpose.

93 The first of the indicia is "the manner in which the scheme was entered into" (s 177D(b)(i)). The [wider] scheme was entered into by a transaction between arms length parties who were agreed that its manner of operation, by the making of the election, would lead to maximum tax deductibility. A narrower scheme was the election itself and payment in accordance with it, these being actions of the respondents.

94 The "form and substance" (s 177D(b)(ii)) of the scheme were to this end and effect: tax deductibility. It is also relevant that the scheme, however it is to

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63 (1994) 181 CLR 359 at 384.

be defined, was apparently tax neutral for the lender. And it was not suggested that the broker would be disadvantaged financially by the form it took. The contrary was probably the case but it is unnecessary to decide whether that is so. An aspect of the question to which s 177D(b)(ii) gives rise, is whether the substance of the transaction (tax implications apart) could more conveniently, or commercially, or frugally have been achieved by a different transaction or form of transaction. At least arguably it could have been. If it had, compound interest would have been avoided. Non-recourse by the lender to both (on default by the respondents), rather than to one of the properties only, may have been able to be negotiated. The absence of adversion by the respondents to such a consideration is itself some indication of the purpose to be inferred from the circumstances. The scheme was intended to endure for many years. Its duration had this significance. Although the debt in respect of the residence would be relatively quickly discharged, the mortgage on it would have to remain as security for the outstanding debt because of the very real chance that the sum of the principal owing on the investment property and the accumulating interest, would come to exceed the latter's value and would provide insufficient security for the debt. This, it may be observed, was a matter to which the Full Court did not have sufficient regard in identifying the respondents' dominant purpose. Each of ss 177D(b)(iii), (iv) and (vii) require that all of these matters be taken into account in determining whether Pt IVA applies.

95 From the matters to which I have referred it is easy to conclude, inevitable in fact that a court do so, that the respondents entered into a scheme for the [dominant] purpose of obtaining a tax benefit. What other purpose or purposes could have made commercial or other sense? There was no material before the Court to show that the purchase of the investment property was in fact a good investment in the sense that even if it did not yield a rental sufficient to cover interest and other outgoings there was a reasonable chance that it would appreciate in value. Repayment of the principal owing in respect of the residence did not make it immune to recourse by the lender in the event of default or shortfall in payment or value of the investment property.

96 It may be that the respondents did wish to make an investment and to change their residence. These were entirely irreproachable and proper objectives. But the means adopted to achieve these results could readily, and should be objectively concluded to be a scheme for the [dominant] purpose of enabling the respondents to obtain a tax benefit, and that is so no matter which of the alternative definitions as to the width of the schemes, within which what occurred here falls, is preferred.

97 I would allow the appellant's appeal. The appellant agreed that he should pay the respondents' costs in this Court in any event. The orders made by the Full Court of the Federal Court on 26 November 2002 should be set aside and the appeal to that Court be dismissed with costs.

98 Having reached this conclusion, it is unnecessary to resolve the questions which the appellant's application for special leave raises. That application should therefore be dismissed.