HIGH COURT OF AUSTRALIA

GLEESON CJ,
GUMMOW, KIRBY, HEYDON AND CRENNAN JJ

RAFTLAND PTY LTD AS TRUSTEE OF THE
RAFTLAND TRUST APPELLANT

AND

COMMISSIONER OF TAXATION RESPONDENT

Raftland Pty Ltd as trustee of the Raftland Trust v Commissioner of Taxation
[2008] HCA 21
22 May 2008
B39/2007

ORDER

1. *Appeal dismissed.*

2. *Special leave to cross-appeal granted.*

3. *Cross-appeal treated as instituted, heard instanter and allowed.*

4. *Set aside the orders made in paragraphs 2 and 3 of the order of the Full Court of the Federal Court of Australia made on 31 January 2007 and, in their place, order that the appeal to that Court in respect of the year ended 30 June 1996 be dismissed.*

5. *Appellant to pay the respondent's costs of the appeal and cross-appeal.*

On appeal from the Federal Court of Australia

Representation

D G Russell QC with H L Alexander for the appellant (instructed by Tobin King Lateef)

A Robertson SC with J H Momsen and P A Looney for the respondent (instructed by Australian Government Solicitor)

CATCHWORDS

Raftland Pty Ltd as trustee of the Raftland Trust v Commissioner of Taxation

Income tax – Trust income – Present entitlement – Trust deed provided that beneficiaries entitled under default provision had immediate and indefeasible vested interest in income – Income never paid to or demanded by appellant as trustee of Unit Trust – Whether appellant as trustee of Unit Trust presently entitled to trust income – Whether entitlement of appellant under default provision reflected legal entitlements intended by parties creating trusts – Application of parol evidence rule – Whether entitlement of appellant under default provision a "sham".

Income tax – Trust income – Present entitlement – Reimbursement agreement – *Income Tax Assessment Act* 1936 (Cth), s 100A provided that beneficiary otherwise presently entitled to income of trust estate deemed not to be presently entitled where entitlement arose out of, or arose by reason of act, transaction or circumstance that occurred in connection with, "reimbursement agreement" – Whether transactions between building companies and Development Trust "reimbursement agreement" – Whether other income of Development Trust distributed to Raftland Trust but not derived from agreement between building companies and Development Trust arose out of, or arose by reason of act, transaction or circumstance that occurred in connection with, "reimbursement agreement" – Whether, by operation of s 100A, appellant as trustee of Raftland Trust and not tertiary beneficiaries of Raftland Trust presently entitled to trust income.

Income tax – Avoidance or minimisation of liability to tax – Proper analysis of documents and actions of appellant and other persons – Suggestion that certain actions constitute a "sham" – History and meaning of "sham" for the purposes of Australian law – Utility for legal purposes of conclusion that transactions constitute a "sham" – Whether in present case propounded documents expressed purposes and intentions of parties with legal consequences determined accordingly – Whether documents were a "sham" and may be disregarded with legal obligations of parties determined otherwise – Whether primary judge erred in references to and conclusions of "sham" – Whether Full Court erred in giving effect to different conclusion as to existence of "sham".

Trusts – Trust income – Whether losses borne by capital in previous tax years must be recouped before trust income is available for distribution – Relevance of existence of successive interests, where interest in income followed by interest in capital – Relevance of *Upton v Brown* (1884) 26 Ch D 588.

Words and phrases – "present entitlement", "reimbursement agreement", "sham".

Income Tax Assessment Act 1936 (Cth), ss 99A, 100A, 226H, 260, Pt IVA.

1 GLEESON CJ, GUMMOW AND CRENNAN JJ. This appeal concerns assessments to income tax of the appellant, Raftland Pty Ltd ("Raftland") in its capacity as trustee of the Raftland Trust, for the years ended 30 June 1995, 30 June 1996, and 30 June 1997. Although the respondent at one time relied upon Pt IVA of the *Income Tax Assessment Act* 1936 (Cth) ("the Act"), by the time of the hearing at first instance such reliance had been abandoned. The appeal turns upon the application of Div 6 of Pt III of the Act, and, in particular, ss 99A and 100A. The issue is whether, having regard to those provisions, the appellant has established that the assessments were excessive.

2 The appellant failed both at first instance in the Federal Court before Kiefel J[1] and (subject to one minor qualification) in the Full Court (Dowsett, Conti and Edmonds JJ)[2]. The qualification concerns an amount of $57,973 relating to the year ended 30 June 1996. It is the subject of an application for special leave to cross-appeal. It is convenient to leave that application to one side until the conclusion of these reasons. Save for that, the questions to be determined are the same for each of the three years of income. It is unnecessary to deal separately with the second and third years, other than briefly to note the material facts.

3 There was a difference between the reasons for decision of Kiefel J and those of the Full Court, although ultimately they agreed that the net income derived by the appellant fell to be assessed pursuant to s 99A of the Act, which provides that in certain circumstances trust income is to be taxed in the hands of the trustee at a special rate. Section 100A affects the question of present entitlement to trust income. If s 100A(1) applies to a beneficiary, the beneficiary is deemed not to be presently entitled to income, thereby rendering the trustee liable under s 99A. Section 100A(3A) provides that, in certain circumstances, s 100A(1) does not apply. In order to give effect to ss 99A and 100A, it is necessary to identify the legal rights and liabilities arising from the facts, the decisive question being one concerning present entitlement to income of a trust estate, bearing in mind s 95A, which extends the concept of entitlement to cover the case of a beneficiary who has a vested and indefeasible interest (s 95A(2)).

4 There was also a matter of penalties under Pt VII of the Act. Kiefel J and the Full Court, having concluded that the appellant's challenge to the assessments had not been made out (subject to the minor qualification earlier mentioned), and that there was, therefore, a "tax shortfall" as defined by s 222A, accepted that, in

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1 *Raftland Pty Ltd v Commissioner of Taxation* (2006) 227 ALR 598.

2 *Raftland Pty Ltd v Federal Commissioner of Taxation* (2007) 65 ATR 336.

the circumstances of the case, the shortfall was caused by recklessness within the meaning of s 226H. On the view of the case taken by Kiefel J, the reason for that conclusion was clear. On the other hand, the appellant strongly resists such a conclusion on the approach taken by the Full Court. The appellant also complains that the Full Court gave inadequate reasons for its decision on the point. This is a matter to which it will be necessary to return.

The statutory provisions

5 Division 6 of Pt III of the Act deals with trust income. Section 96 provides that, except as provided in the Act, a trustee shall not be liable as trustee to pay income tax upon the income of the trust estate. Where there is a beneficiary of a trust estate who is not under any legal disability and is presently entitled, s 97 provides that the beneficiary's share of the net income of the trust estate is part of the assessable income of the beneficiary. Later provisions deal with various circumstances in which the trustee will be liable to pay income tax on the income of the trust estate, or some part of it. Section 98 is one such provision. Section 99A relevantly provides:

> "(4A) Where there is a part of the net income of a resident trust estate:
>
> (a) that is not included in the assessable income of a beneficiary of the trust estate in pursuance of section 97;
>
> (b) in respect of which the trustee is not assessed and is not liable to pay tax in pursuance of section 98; and
>
> (c) that does not represent income to which a beneficiary is presently entitled that is attributable to a period when the beneficiary was not a resident and is also attributable to sources out of Australia;
>
> the trustee shall be assessed and is liable to pay tax on that part of the net income of the trust estate at the rate declared by the Parliament for the purposes of this section."

6 The rate referred to in s 99A(4A) is what was earlier described as the special rate. Section 100A includes the following:

> "(1) Where:
>
> (a) apart from this section, a beneficiary of a trust estate who is not under any legal disability is presently entitled to a share of the income of the trust estate; and

(b) the present entitlement of the beneficiary to that share or to a part of that share of the income of the trust estate (which share or part, as the case may be, is in this subsection referred to as the '**relevant trust income**') arose out of a reimbursement agreement or arose by reason of any act, transaction or circumstance that occurred in connection with, or as a result of, a reimbursement agreement;

the beneficiary shall, for the purposes of this Act, be deemed not to be, and never to have been, presently entitled to the relevant trust income.

(2) Where:

(a) apart from this section, a beneficiary of a trust estate who is not under any legal disability would, by reason that income of the trust estate was paid to, or applied for the benefit of, the beneficiary, be deemed to be presently entitled to income of the trust estate; and

(b) that income or a part of that income (which income or part, as the case may be, is in this subsection referred to as the '**relevant trust income**') was paid to, or applied for the benefit of, the beneficiary as a result of a reimbursement agreement or as a result of any act, transaction or circumstance that occurred in connection with, or as a result of, a reimbursement agreement;

the relevant trust income shall, for the purposes of this Act, be deemed not to have been paid to, or applied for the benefit of, the beneficiary.

...

(3A) Where:

(a) apart from this section, a beneficiary (in this subsection referred to as the '**trustee beneficiary**') of a trust estate is presently entitled to a share of the income of the trust estate in the capacity of a trustee of another trust estate (in this subsection referred to as the '**interposed trust estate**');

(b) apart from this subsection, the trustee beneficiary would, by virtue of subsection (1), be deemed not to be, and never to have been, presently entitled to that share or a part of that share of the income of the first-mentioned trust estate

(which share or part is in this subsection referred to as the '**relevant trust income**'); and

(c) apart from this section, a beneficiary of the interposed trust estate is or was, or beneficiaries of the interposed trust estate are or were, presently entitled, or deemed to be presently entitled, to any income of the interposed trust estate (in this subsection referred to as the '**distributable trust income**') that is attributable to the relevant trust income;

subsection (1) does not apply, and shall be deemed never to have applied, in relation to the trustee beneficiary, in relation to any part of the relevant trust income to which the distributable trust income is attributable.

(3B) Where:

(a) apart from this section, a beneficiary (in this subsection referred to as the '**trustee beneficiary**') of a trust estate would, by reason that income of the trust estate was paid to, or applied for the benefit of, the trustee beneficiary, be deemed to be presently entitled to income of the trust estate in the capacity of a trustee of another trust estate (in this subsection referred to as the '**interposed trust estate**');

(b) apart from this subsection, that income or a part of that income (which income or part is in this subsection referred to as the '**relevant trust income**') would, by virtue of subsection (2), be deemed not to have been paid to, or applied for the benefit of, the trustee beneficiary; and

(c) apart from this section, a beneficiary of the interposed trust estate is or was, or beneficiaries of the interposed trust estate are or were, presently entitled, or deemed to be presently entitled, to any income of the interposed trust estate (in this subsection referred to as the '**distributable trust income**') that is attributable to the relevant trust income;

subsection (2) does not apply, and shall be deemed never to have applied, in relation to the trustee beneficiary, in relation to any part of the relevant trust income to which the distributable trust income is attributable.

...

(7) Subject to subsection (8), a reference in this section, in relation to a beneficiary of a trust estate, to a reimbursement agreement

shall be read as a reference to an agreement, whether entered into before or after the commencement of this section, that provides for the payment of money or the transfer of property to, or the provision of services or other benefits for, a person or persons other than the beneficiary or the beneficiary and another person or other persons.

(8) A reference in subsection (7) to an agreement shall be read as not including a reference to an agreement that was not entered into for the purpose, or for purposes that included the purpose, of securing that a person who, if the agreement had not been entered into, would have been liable to pay income tax in respect of a year of income would not be liable to pay income tax in respect of that year of income or would be liable to pay less income tax in respect of that year of income than that person would have been liable to pay if the agreement had not been entered into.

(9) For the purposes of subsection (8), an agreement shall be taken to have been entered into for a particular purpose, or for purposes that included a particular purpose, if any of the parties to the agreement entered into the agreement for that purpose, or for purposes that included that purpose, as the case may be.

...

(13) In this section:

'**agreement**' means any agreement, arrangement or understanding, whether formal or informal, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings, but does not include an agreement, arrangement or understanding entered into in the course of ordinary family or commercial dealing;

'**property**' includes a chose in action and also includes an estate, interest, right or power, whether at law or in equity, in or over property."

7 Kiefel J and the Full Court, by different paths, came to the conclusion that s 100A applied, in conjunction with s 99A(4A), to bring about the result that the appellant was liable to tax at the special rate on the income of the Raftland Trust. The appellant, in order to succeed, must make good its challenge to both lines of reasoning. The primary difference concerned the legal effect of the transactions to be described below and, in particular, the matter of present entitlement to certain trust income. In that respect, Kiefel J concluded that the entitlement was not as the appellant claimed it to be. The Full Court, on the other hand, accepted the appellant's case as to the nature of the relevant legal rights, but held that, notwithstanding those rights, s 100A defeated the appellant's attack on the assessments.

8 The transactions giving rise to the assessments were acknowledged to have been aimed at securing a fiscal benefit by enabling accumulated tax losses, incurred in earlier years by a trust estate called the E & M Unit Trust, to be set off against the income of previously unrelated, profitable, businesses controlled by what were described in argument as the Heran interests. The appeal does not directly concern the offsetting of past losses against present income, although both parties attach evidentiary importance, in one way or another, to that fiscal objective. It is Div 6 of Pt III of the Act that is of direct relevance to the assessments, and the challenge to them. This is not a Pt IVA case, and the tax avoidance purpose of the arrangements to be described below, while of significance in the identification of the legal rights created by those arrangements, should not distract attention from the ultimate issues that must be decided in order to measure the assessments against the provisions of the Act. The assessments are founded upon an acceptance, at least to a substantial extent, of the legal efficacy of the arrangements. The differences between the appellant and the respondent as to the legal relations created by the transactions, upon which the Act operates, although important, are relatively confined. It is necessary to bear this in mind because, although the respondent relied, with good effect before Kiefel J, upon an argument that invoked the concept of "sham", that argument was not aimed at the entire complex of arrangements. A wider and less carefully directed argument might have threatened the assessments themselves.

The background to the 1995 transactions

9 The fiscal objective of the 1995 transactions which are said to have given rise to the tax liabilities in dispute was to enable the Heran interests, identified in more detail below, to obtain the benefit of tax losses previously incurred by the E & M Unit Trust. It is convenient to begin by identifying the E & M Unit Trust, the Heran interests, and two trusts (including the Raftland Trust) that were constituted on 30 June 1995.

10 The E & M Unit Trust was settled on 8 July 1986. The original trustee was E & M Investments Pty Ltd ("E & M Investments"), whose directors were, until August 1991, Mrs Thomasz (formerly Mrs Carey) and Mr Thomasz. The beneficial interest in the trust fund, comprising initial sums together with any additional sums accepted by the trustee, was held by unit holders in proportion to their units. Clause 22 of the trust deed obliged the trustee to pay, apply or set aside the net income from investment of the trust fund for the benefit of the unit holders in proportion to their units. Ten units were divided equally between Mrs Thomasz, as trustee of the ECK Family Trust, and Thomasz Enterprises Pty Ltd, as trustee of the Thomasz Family Trust.

11 The business of the trust was the acquisition and sale of real property. The business failed. The 1991 tax return for the E & M Unit Trust (prepared in 1994 and lodged in 1997) disclosed carried forward tax losses of $4,014,738. Mr and Mrs Thomasz became bankrupt, but they had been discharged by the time of the 1995 transactions. The bulk of the losses incurred by the E & M Unit Trust resulted from the sale (by a mortgagee) of trading stock (land), the proceeds of sale being insufficient to discharge secured liabilities.

12 Pursuant to documents executed in July 1991, E & M Investments ceased to be the trustee of the E & M Unit Trust and Mr Carey, the son of Mrs Thomasz, became trustee. At that time, it seems that Mr Carey also became trustee of the Thomasz Family Trust and the ECK Family Trust. There is no suggestion that Mr Carey had any role independent of that of a representative of the interests of Mr and Mrs Thomasz. The draft balance sheets for the 1992, 1993 and 1994 tax years were substantially the same as the financial statements prepared for 1991, except that after the sale of the security property in February 1992, a loan to Mr Thomasz appeared in place of (and in the same amount as) the loan from the mortgagee. Between July 1991 and June 1995, Mr Thomasz engaged in some modest trading in shares and options on behalf of the trust.

13 Until the 1995 transactions, the Heran interests had no contact or association with the E & M Unit Trust, or Mr and Mrs Thomasz. Heran Projects Pty Ltd ("Heran Projects"), Northbank Homes Pty Ltd ("Northbank") and Southbank Homes Pty Ltd ("Southbank") were building development companies controlled by one or more of the Heran brothers – Mr Brian Heran, Mr Martin Heran and Mr Stephen Heran. Northbank was trustee of the Northbank Trust, constituted by deed of settlement dated 11 July 1995, the primary beneficiaries of which were the three Heran brothers. Southbank was trustee of the Southbank Trust, constituted on the same date with the same primary beneficiaries.

14 Mr Brian Heran and, until May 1996, Mr Stephen Heran also controlled Maggside Pty Ltd ("Maggside"), which, as trustee of the Brian Heran Discretionary Trust, carried on a business of renting properties owned by the trust. The Brian Heran Discretionary Trust was constituted in April 1990; the primary beneficiaries included any trust or partnership in which any of the Heran brothers had a vested or contingent interest and any company in which any of them held shares or of which any of them was an office holder.

15 Heran Developments Pty Ltd ("Heran Developments") was a company incorporated in February 1993 and controlled, at the relevant time, by one or more of the Heran brothers. On or before 30 June 1995, two companies, Raftland and Navygate Pty Ltd ("Navygate"), were acquired. The three Heran brothers became the directors of those companies, and the shares were held by Brian and Stephen Heran.

16 The Raftland Trust was settled on 30 June 1995, with Raftland as the trustee. The trust was established on the advice of Mr Brian Heran's solicitor, Mr Tobin; the settlor, Ms Sommerville, was Mr Tobin's employee. She had no relevant intention independent of that of her employer's client. The trust was constituted by deed poll, executed by Ms Sommerville. The trust fund, which included a nominal settlement sum and any other property or income to be received by the trustee on the trusts of the deed, was to be held on behalf of beneficiaries, who were divided into classes described as primary, secondary and tertiary. The three Heran brothers were the primary beneficiaries of the Raftland Trust; the secondary beneficiaries included relatives of the Heran brothers, as well as any trust or partnership in which any of the Heran brothers had a vested or contingent interest, any company in which any of them held shares or of which any of them was an office holder and any person or company that had granted a power of attorney to any primary beneficiary. According to the terms of the trust instrument, the tertiary beneficiaries were the trustee for the time being of the E & M Unit Trust, together with any person the principal (Mr Brian Heran) determined to be a beneficiary before the perpetuity date.

17 Clause 3(b) of the Raftland Trust deed gave the trustee a discretion to pay, apply or set aside all or any part of the net income of the trust (after allowing for all expenses of the trust fund) for the benefit of one or more of the primary, secondary and tertiary beneficiaries, or to accumulate the income. Clause 3(b) further provided that, if that discretion was not exercised by 30 June in any year in respect of all or any part of the income, the trustee was obliged to hold that income as set aside or accumulated for such of the tertiary beneficiaries as were then living or in existence, absolutely and as tenants in common in equal shares and, absent tertiary beneficiaries, for one of the other classes of beneficiaries. Clause 3(c)(iii) provided that a determination in exercise of that discretion could be made in writing or by resolution of the trustee, while cl 3(f) provided that any beneficiary becoming entitled to share in the income of the trust under cl 3(b) had an immediate and indefeasible vested interest in that income. The trust was to terminate and vest absolutely on the perpetuity date and the capital was to be held for such one or more of the primary beneficiaries then living in such proportions as the trustee should in its absolute discretion think fit.

18 On 30 June 1995, Mr Carey executed a deed acknowledging, as trustee of the E & M Unit Trust, his acceptance of appointment as a beneficiary of the Raftland Trust and undertaking not to disclaim that interest or distributions from the Raftland Trust. In the same document, Mr Carey amended cl 34(a) of the E & M Unit Trust deed (relating to the period of notice required to be given before a trustee could retire), removed himself as trustee, and appointed Raftland as trustee of the E & M Unit Trust with effect from 2 July 1995.

19 The Heran Developments Trust was also constituted on 30 June 1995, with Heran Developments as trustee. The beneficiaries were of three classes, cast in the same terms as those of the Raftland Trust; as with the Raftland Trust, the settlor was Ms Sommerville. Clause 3 was the same as cl 3 of the Raftland Trust deed.

The 1995 transactions

20 In May 1995, management reports prepared for Heran Projects and Northbank forecast taxable profits of approximately $2.7 million and $284,000 respectively. Mr Brian Heran contacted Mr Tobin about the possible "acquisition" of a trust with accumulated tax losses. Pursuing Mr Heran's instructions, Mr Tobin obtained information about the E & M Unit Trust from Mr Adcock of Harts Accountants ("Harts"). Mr Adcock informed Mr Tobin that the E & M Unit Trust had tax losses of approximately $4 million, and nominated a "price" of $250,000 to be paid with respect to the E & M Unit Trust.

21 On 22 June 1995, Mr Tobin wrote to Harts, suggesting that the E & M Unit Trust be paid $250,000. Mr Tobin suggested that the E & M Unit Trust dispose of the distribution that would be made to it in a way which did not fall foul of the income injection test (referred to in a press release of the Commonwealth Treasurer dated 9 May 1995, entitled "Trafficking in Trust Losses"), giving as examples a distribution to its unit holders or part payment of debts. Mr Tobin also acknowledged that further steps might be necessary once amendments to the Act had been passed. He stated his expectation that Harts' clients would cooperate with his own clients' reasonable requests, but averred that he was "not seeking to impose any contractual obligation on them to do so." Mr Heran never met, spoke or wrote to Mr Carey, Mr or Mrs Thomasz or their agents.

22 The availability of the accumulated tax losses having been to that extent secured, it was then necessary to take steps to direct into a convenient channel the income against which the losses would be offset. On 22 June 1995, Heran Projects entered into an agreement with Maggside, by which Maggside, as trustee of the Brian Heran Discretionary Trust, was to be paid the sum of $2,915,000 for granting Heran Projects the right to sell a number of investment properties of the Brian Heran Discretionary Trust and retain the sale proceeds. The dealings between Heran Projects and Maggside involved the payment of $2,915,000 by Heran Projects to Maggside, and a payment by Maggside to Heran Projects in the same sum. The payment to Heran Projects was funded partly by way of repayment of an earlier loan, and partly by a further loan to Heran Projects.

23 On 30 June 1995, Maggside resolved to distribute all of the income of the Brian Heran Discretionary Trust for that year ($2,849,467 after carrying forward

trust losses of $43,295) to the Raftland Trust. There is no challenge to the power of Maggside to apply the income of the Brian Heran Discretionary Trust in that way. It is accepted that Raftland as trustee of the Raftland Trust was an eligible beneficiary under the Brian Heran Discretionary Trust. The distribution and receipt were recorded in the internal accounts of the Brian Heran Discretionary Trust and the Raftland Trust respectively. This was the derivation of income by the appellant on which the 1995 assessment was based.

24 Also on 30 June 1995, the directors of Raftland passed two resolutions: that the Raftland Trust distribute $250,000 to Mr Carey in his capacity as trustee of the E & M Unit Trust; and that the Raftland Trust distribute the balance of its income for 1995 to Mr Carey in his capacity as trustee of the E & M Unit Trust.

25 The moneys for a bank cheque for $250,000 payable to Mr Carey came from Heran Projects, Northbank and Southbank. Mr Carey directed in writing that payment be made to Harts, and the bank cheque was handed over at a meeting on 3 July 1995. Harts deducted $30,000 (evidently for fees) and the balance of $220,000 was paid to Mr Carey, who in turn paid it to Mr Thomasz. Mr Thomasz decided to have the $220,000 paid to the Thomasz Family Trust. The Thomasz Family Trust income tax return for the 1996 year showed the sum of $220,000 as "business income".

26 The internal balance sheet of Raftland as trustee of the Raftland Trust shows in handwriting the figure of $2,849,467 against "other debtors" under "current assets", a non-current liability being "loan other entities" of $250,000 and a current liability of $2,642,762 ("other creditors"). In a notation against a journal entry, the sum of $250,000 is shown as "drawings to G Carey". The tax return of the Raftland Trust for the 1995 tax year asserted the distribution of net income of $2,849,467 to the E & M Unit Trust.

27 Raftland did not pay, and at the time the appeal was heard had not paid, the balance of $2,599,467 (after deduction of the $250,000 paid to Mr Carey) to the E & M Unit Trust. The E & M Unit Trust has never called for or received those moneys, and no distribution of those moneys to unit holders is proposed. Instead, as will appear, the amount was applied for the benefit of the Heran interests, in a manner calculated to diminish any risk that Mr and Mrs Thomasz might evince some further interest in it.

28 The internal accounts of the E & M Unit Trust for 1995 show current assets at $2,892,762 with a loan due from "other entities" of $250,000, and the balance of the assets owed by "other debtors". The tax return for the E & M Unit Trust for 1995 shows a distribution to it from the Raftland Trust of $2,849,467, against which losses brought forward from previous years were set off. The net income was nil. Losses of $1,165,271 were carried forward.

29 Mr Brian Heran's legal advisers were aware that income would be "sheltered" by the losses of the E & M Unit Trust only to the extent that the trustee of the E & M Unit Trust was presently entitled to the income of the Raftland Trust. It was not disputed that the attainment of a fiscal objective motivated the participants in the 1995 transactions. There was, however, a dispute as to whether the legal rights created by the transaction conformed with that objective. That was the point on which Kiefel J and the Full Court differed.

30 On 3 July 1995, there was a meeting of directors of Raftland as trustee of the Raftland Trust. The chairman reported that, apart from $250,000 to be distributed to the trustee of the E & M Unit Trust for immediate payment to creditors and/or beneficiaries, Raftland did not expect to require the funds to which it was entitled under the resolution of Maggside as trustee of the Brian Heran Discretionary Trust made on 30 June 1995. The basis of that expectation, or lack of expectation, will require further examination. What is clear is that no requirement to pay the money to the E & M Unit Trust was envisaged. The Thomasz interests had taken the $250,000 and departed. They were not expected to return. The directors of Raftland resolved that the moneys be applied in subscribing for shares in Navygate, to be paid as soon as alterations to the Memorandum and Articles of Association and to the authorised capital of Navygate had been effected. Also on 3 July 1995, the directors of Navygate resolved to accept Raftland's offer and to do what was necessary for the issue of the additional shares.

31 On 6 July 1995, in the context of Raftland subscribing for shares in Navygate, senior counsel provided a written advice to Mr Tobin, which said that, as the E & M Unit Trust would not be calling upon the balance of funds to which it was entitled from the Raftland Trust, the funds were to be reinvested in the group for the benefit of the group. The only sense in which the E & M Unit Trust was part of the group was that Raftland had become the trustee. The unit holders remained the same. The brief to counsel was not in evidence. The basis of his knowledge that the E & M Unit Trust would not be calling on the funds to which it was entitled is a matter of inference. The group for whose benefit the funds were to be reinvested did not include the beneficiaries of the E & M Unit Trust.

32 On 7 July 1995, at an extraordinary general meeting, the members of Navygate resolved to increase Navygate's share capital by three million shares of $1 each and to alter the Memorandum and Articles of Association accordingly. The directors of Raftland resolved to apply in writing for 3,999,998 shares in Navygate, and the chairman reported that Raftland as trustee of the Raftland Trust had received funds by way of income, which were not required for use in the business of the trustee, and that other companies related to Raftland had offered to provide additional loan funds to enable Raftland to subscribe for

3,999,998 shares in Navygate. The minutes recorded cheques tabled for $3,999,998, but no cheques were in fact tabled. Also on 7 July 1995, Navygate resolved to issue the shares. The Navygate share register did not record this further issue of shares, but the Navygate shareholding is recorded in the accounts of Raftland.

33 It was not contended by the appellant that the amounts referred to above were misappropriated. Yet it is central to the argument for the appellant that they were amounts to which the E & M Unit Trust and, through that trust, its beneficiaries were entitled. The apparent discrepancy between the entitlements appearing on the face of the documents and the way in which the funds were applied gave rise to a question whether the documents were to be taken at face value. In various situations[3], the court may take an agreement or other instrument, such as a settlement on trust, as not fully disclosing the legal rights and entitlements for which it provides on its face. If that be so, the parol evidence rule in Australia identified with *Hoyt's Pty Ltd v Spencer*[4] does not apply.

34 One such case is where other evidence of the intentions of the relevant actors shows that the document was brought into existence "as a mere piece of machinery" for serving some purpose other than that of constituting the whole of the arrangement[5]. That, in essence, is the respondent's case with respect to the alleged existence of the "present entitlement" of the trustee of the E & M Unit Trust to the income of the Raftland Trust.

35 The term "sham" may be employed here, but as Lockhart J emphasised in *Sharrment Pty Ltd v Official Trustee in Bankruptcy*[6] the term is ambiguous and uncertainty surrounds its meaning and application. With reference to remarks of Diplock LJ in *Snook v London and West Riding Investments Ltd*[7], Mustill LJ later

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3 See *Equuscorp Pty Ltd v Glengallan Investments Pty Ltd* (2004) 218 CLR 471 at 484 [36]; [2004] HCA 55; *Hadjiloucas v Crean* [1988] 1 WLR 1006 at 1019; [1987] 3 All ER 1008 at 1019.

4 (1919) 27 CLR 133 at 144; [1919] HCA 64.

5 *Hawke v Edwards* (1947) 48 SR (NSW) 21 at 23 per Jordan CJ. See also the remarks of Windeyer J in *Scott v Commissioner of Taxation (No 2)* (1966) 40 ALJR 265 at 279.

6 (1988) 18 FCR 449 at 453.

7 [1967] 2 QB 786 at 802.

identified[8] as one of several situations where an agreement may be taken otherwise than at its face value, that where there was a "sham"; the term, when "[c]orrectly employed", denoted an objective of deliberate deception of third parties.

36 The presence of an objective of deliberate deception indicates fraud. This suggests the need for caution in adoption of the description "sham". However, in the present litigation it may be used in a sense which is less pejorative but still apt to deny the critical step in the appellant's case. The absence of a present entitlement within the meaning of s 100A(1)(a) of the Act may appear from an examination of the whole of the relevant circumstances, and these are not confined to the terms of the Raftland Trust instrument.

The 1996 and 1997 transactions

37 In July 1995, Heran Developments and Heran Projects entered into an agreement by which Heran Developments as trustee of the Heran Developments Trust took over the assets and liabilities of Heran Projects. Heran Developments distributed all of its trust income for 1996 to the Raftland Trust, as did Maggside, as trustee of the Brian Heran Discretionary Trust, and Northbank, as trustee of the Northbank Trust. Raftland as trustee of the Raftland Trust then resolved to distribute its income for that year to the E & M Unit Trust. Subject to what appears in the next paragraph, it is not suggested that these arrangements, or the transactions carried out in 1997, produce any consequence different from that which obtains for the year ended 30 June 1995.

38 Of the moneys that came into the Raftland Trust for the year ended 30 June 1996, $57,973 came from the Brian Heran Discretionary Trust, which, the Full Court found, was not sourced from the agreement described above between Heran Developments and Heran Projects. Instead, it appeared to derive from rental and interest income. This is the matter the subject of the proposed cross-appeal.

The amended assessments

39 By letter dated 15 July 2002, the Commissioner informed Raftland that determinations had been made under Pt IVA of the Act. On 19 July 2002, the Commissioner issued notices of amended assessment for the 1995, 1996 and 1997 tax years. For 1995, the taxable income was stated as $2,849,467; the total tax assessed was $2,973,766.28, which included $689,571.01 in penalty tax and

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8 *Hadjiloucas v Crean* [1988] 1 WLR 1006 at 1019; [1987] 3 All ER 1008 at 1019.

$905,051.25 in interest. For 1996, the taxable income was stated as $779,705; the total tax assessed was $837,610.43, which included $25,820.10 in additional tax for late return, $189,078.76 in penalty tax and $244,544.65 in interest. For 1997, the taxable income was stated as $386,035; the total tax assessed was $393,693.59, which included $10,819.45 in additional tax for late return, $93,999.58 in penalty tax and $100,875.50 in interest.

40 On 13 September 2002, Raftland lodged objections to the amended assessments. The Commissioner informed Raftland that its objections had been disallowed by letters dated 29 October 2002 (in relation to the 1995 and 1996 tax years) and 4 October 2002 (in relation to the 1997 tax year).

41 Shortly before the hearing before the Federal Court, the Commissioner advised that he no longer relied on the provisions of Pt IVA in relation to this appeal.

Entitlement to the income of the trust estate

42 The first question to be addressed was that of the legal entitlement to the income of Raftland as trustee of the Raftland Trust. As noted earlier, it is convenient to confine attention to the income for the year ended 30 June 1995. The answer, according to the appellant, was that the trustee of the E & M Unit Trust was so entitled, either by force of the resolutions to distribute such income passed by Raftland as trustee of the Raftland Trust on 30 June 1995 or by force of the default provisions of the Raftland Trust deed. This argument was accepted by the Full Court, but not by Kiefel J.

43 It was argued by the respondent, and accepted by Kiefel J, that, notwithstanding the appearance of legal entitlement created by the Raftland Trust deed and the resolutions for distribution, such appearance did not reflect accurately the intentions of either Mr Brian Heran or Mr and Mrs Thomasz, who were the parties to the transactions constructed by Mr Tobin and Harts, and that those intentions were truly reflected in the application of the funds that in fact occurred.

44 The appellant bore the onus of establishing that the assessments were excessive. Although Mr Brian Heran, and his two brothers, Mr Tobin, Mr and Mrs Thomasz and Mr Carey were called as witnesses, the evidence of the intentions of the Herans and Mr and Mrs Thomasz was somewhat oblique, and much depended upon inference. The settlor of the Raftland Trust, Ms Sommerville, had no relevant evidence to give on the matter of intention. She was the only person who executed the trust deed. It may be inferred that she had no intention independent of that of the Herans, who were her employer's

clients. It also may be inferred that Mr Carey had no intentions independent of those of Mr and Mrs Thomasz.

45 The legal relevance of the intentions of Mr Tobin was a matter of dispute in argument, but an attempt in cross-examination to elicit clear evidence on the subject was unsuccessful. The following exchange occurred:

"Q. Now, the Raftland Trust, was that set up by you?

A. Yes.

Q. Ms Sommerville who was the settlor, did she work in your office?

A. Yes.

Q. And I take it you determined the terms of the Raftland Trust?

A. Yes.

Q. And one of the matters in particular was that the trustee of the E & M Unit Trust was named as the tertiary beneficiary?

A. Correct.

Q. That was what you had intended?

A. Yes.

Q. Perhaps was advised that that was a deliberate step?

A. Yes.

Q. I take it that Mr Brian Heran played no part in the determination of what the terms of the trust should be?

A. He simply would have been advised by me.

Q. That is, he was advised what was necessary?

A. Yes.

Q. And the Heran Developments Trust was settled on the same day?

A. I think that's right, yes.

HER HONOUR: I'm sorry, which trust was that?

MR HACK: Heran Developments Trust.

Q. The purpose of naming E & M Unit – or the trustee of the E & M Unit Trust as a beneficiary of the Raftland Trust was to enable it to receive distributions from the Raftland Trust?

A. Correct.

Q. And in that way use up the losses that it had?

A. Correct.

Q. It was a mechanism for injecting funds from the Heran entities in a tax effective manner?

A. Yes.

Q. I take it that it was – you never intended that – leaving aside the question of the purchase price, that the trustee of the E & M Unit Trust ever benefit from these arrangements?

A. Well, in fact, the trustee would have benefited from the arrangements. That's how it was set up.

Q. In what way?

A. Well, that's what the document said.

Q. Sorry. It may say it but it was never the intention that there be real distributions to it, was there?

A. We recognised that the unit holders of that trust could call up those funds.

Q. And you created a mechanism to prevent that from happening?

A. Well, we did some things such as we took control of the trustee of the E & M Unit Trust, which was Raftland, and we did some other things which involved Navygate, and I suppose those things were done because we had a concern that the unit holders could call up those funds.

Q. And you wanted to ensure that they were not in a position to do so?

A. Well, there was a commercial risk that they could have.

Q. Well, by naming it as a beneficiary, it was not then in contemplation that anything other than a purchase price would have been paid to the trustee of the E & M Unit Trust?

A. Sorry, can you just repeat that?

Q. The trustee of the E & M Unit Trust was named as the tertiary beneficiary of the Raftland Trust?

A. Yes.

Q. At that time it was never in contemplation, leaving aside the question of $250,000, that any amount would be paid to the trustee of the E & M Unit Trust?

A. Do you mean physically paid?

Q. Well, let's start with physically paid?

A. Well, that's probably right, yes.

Q. And what was in contemplation at best was a distribution on paper only?

A. I think that sells it a bit too short because we recognised that there was a real risk that the unit holders could call up those funds."

46 It may be observed that "a commercial risk" is a curious way to describe a legal entitlement. When Mr Tobin said that "there was a real risk that the unit holders could call up those funds" he was giving less than enthusiastic endorsement to the theory that the money belonged to them.

47 As has been noted, the settlor of the Raftland Trust, Ms Sommerville, had no intention separate from that of Raftland. The directors of Raftland were the Heran brothers, and two of them were the shareholders. It is the intention of the Heran brothers that is specifically relevant to a question whether the trusts apparently created by the Raftland Trust deed were wholly or partly a pretence. The creation of such an express trust depends upon the intention of the person alleged to have created it[9]. A part of an instrument may be a pretence[10]. The

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9 *Commissioner of Stamp Duties (Qd) v Jolliffe* (1920) 28 CLR 178 at 181; [1920] HCA 45.

10 *A G Securities v Vaughan* [1990] 1 AC 417 at 462-463.

respondent argued that in this case the pretence was that part of the trust instrument which made the E & M Unit Trust a tertiary beneficiary. The corollary of that argument was that the document signed by Mr Carey as trustee of the E & M Unit Trust, insofar as it accepted appointment as a beneficiary of the Raftland Trust, also was a pretence. As has been noted, Mr Carey had no intention independent of Mr and Mrs Thomasz, and it was their intention that was relevant to that question.

48 The Heran brothers, and Mr and Mrs Thomasz, were business people, not lawyers. It is unlikely that they applied their minds with care to the detail of the documents that were prepared by Mr Tobin. That does not mean, however, that their intentions were irrelevant. It may mean, as a matter of factual inference, that they had no intentions inconsistent with the documents prepared by Mr Tobin and that, therefore, there is no reason to take those documents other than at face value. It may mean (as the Full Court, in substance, found) that they intended to do whatever was regarded by Mr Tobin as necessary to secure the fiscal objective of the exercise. On the other hand, the respondent argued, and Kiefel J held, that the Heran brothers and Mr and Mrs Thomasz had a common intention that was inconsistent with the creation and the enforcement of the entitlement of the E & M Unit Trust as a beneficiary of the Raftland Trust. It is, therefore, necessary to examine the findings of fact made by Kiefel J. Central to her Honour's reasoning was the $250,000 paid to the Thomasz interests as the "price" for the E & M Unit Trust. It was, her Honour held, the intention of the Herans, and Mr and Mrs Thomasz, that the Thomasz interests were to receive that amount *and no more*. Following such receipt, they were to make no further claim on the Raftland Trust.

49 The conduct of the parties after 30 June 1995 is evidence of their intention on and before that date. Kiefel J said:

> "Raftland has not in fact paid the balance sum of $2,642,762 to the E&M Unit Trust and it is not intended to do so. I do not understand Raftland to suggest that it ever held that intention. Mr Tobin conceded as much and in any event its intention not to do so may readily be inferred ... The E&M Unit Trust has not called for or got in those monies and has recorded no intended distribution to its unitholders. Mr Thomasz said that apart from the purchase price of $250,000 he had no expectation of receiving any further benefits from the transactions. He considered that control had been relinquished by the E&M Unit Trust. In answer to a question put by the Commissioner, he agreed that he understood the transaction to involve entities with which he or his wife were associated being owed a purchase price and from that point [they] would have no further dealings with the trust."

50 The evidence showed that the business people looked upon the transaction as the purchase, for a price of $250,000, by the Heran interests from the Thomasz interests, of control of a trust with accumulated tax losses. In legal terms there was no sale and purchase of property. The sum of $250,000 was not consideration for rights of property. It does not follow, however, that for the parties to regard it as a price was wholly incorrect. It was the amount that the Heran interests (specifically, Heran Projects, Northbank and Southbank) were willing to pay to Mr and Mrs Thomasz for "control" of the E & M Unit Trust. In the context "control" included the assumption of trusteeship, and the capacity to direct its future affairs. It had a negative as well as a positive aspect, involving the exclusion of Mr Carey and Mr and Mrs Thomasz, or their respective trusts, from any future involvement. It would have been inconsistent with this "sale" of "control" for the Thomasz interests subsequently to seek an accounting from Raftland for the purported distributions.

51 Kiefel J pointed out that the $250,000 was not paid from income of the Raftland Trust; it was provided by other entities associated with the Herans. She found as a fact (and her finding was amply supported by the evidence) that it was to be "a one-off payment with nothing further to take place between the parties."

52 Kiefel J went on:

> "So far as concerns the second resolution to distribute, Raftland had no intention of ever paying it and Mr and Mrs Thomasz had no expectation that the E&M Unit Trust would [ever] receive those monies or any further benefits. Mr Thomasz knew that that income was to be applied against the Trust's losses. He knew that whilst a debt was to be recorded as owed to the E&M Unit Trust, in its books of account, he and his wife would be having no further dealings with the Trust. Those controlling Raftland and the E&M Unit Trust well understood that the only transaction which was to take place between them was that relating to the control of the Trust. There is no direct evidence that Mr and Mrs Thomasz promised never to seek any further monies. I infer however that they had no intention of doing so, consistent with their understanding of the transaction."

53 Kiefel J concluded that the provisions of the Raftland Trust deed which purported to create an entitlement in the E & M Unit Trust as tertiary beneficiary, and the resolutions which purported to reflect that entitlement, were a façade and were contrary to the intentions of the Herans and Mr and Mrs Thomasz. Consistently with that, if, having received the $250,000, the Thomasz interests had attempted to restrain Raftland from applying the trust income as it did or to seek an accounting, or otherwise to assert any rights, they would have been unsuccessful. They had no entitlement to the income. Under the default

provisions of cl 3(b) of the Raftland Trust deed the primary beneficiaries were entitled to the trust income. Her Honour went on to consider and apply s 100A on that basis. That is a matter to which it will be necessary to return.

54 In the Full Court, the principal judgment was that of Edmonds J. Dowsett J substantially agreed, subject to certain qualifications which are not presently material. Conti J agreed with Edmonds J.

55 Edmonds J disagreed with Kiefel J's conclusion that the E & M Unit Trust was not entitled to the income of the Raftland Trust, and that it was contrary to the intentions of the parties that the E & M Unit Trust (and, through it, the Thomasz interests) should be entitled to such income. He quoted, and relied upon, the passage from the evidence of Mr Tobin set out above. He said:

> "Those who advised Mr Brian Heran, notably Mr Tobin, but there were others such as senior counsel retained by Mr Tobin, were well aware that, only to the extent that the trustee of the E & M Unit Trust was presently entitled to the income of the Raftland Trust, would that income be sheltered by the losses in the E & M Unit Trust. The attainment of that fiscal objective drove the transaction from the point of view of its participants. Hence, if it was not achieved by a determination to pay to or apply or set aside the income of the Raftland Trust to the trustee of the E & M Unit Trust pursuant to cl 3(b)(i) of the Raftland Trust deed, it was to be achieved by the default provisions of the proviso to cl 3(b), reinforced by the provisions of cl 3(f)".

56 Edmonds J referred to a passage in the reasons of Lehane J in *Richard Walter Pty Ltd v Commissioner of Taxation*[11], where that learned judge observed that many tax schemes are intended to have an otherwise inexplicable legal effect precisely because of the fiscal objectives that are pursued. That is undoubtedly true, but it does not deny the possibility that, in a particular case, documents might not be intended by the parties to have legal effect according to their tenor. The conclusion of Edmonds J was that, far from being a façade or sham, the nomination of the E & M Unit Trust as a tertiary beneficiary of the Raftland Trust "was at the forefront of the intentions of those charged with responsibility for establishing the Raftland Trust."

57 The reference to "the intentions of those charged with responsibility for establishing the Raftland Trust" appears to be a reference to the intentions of Mr Tobin. As earlier explained, the relevant intentions are those of the Heran

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11 (1996) 67 FCR 243 at 267-268.

brothers, and Mr and Mrs Thomasz. Furthermore, the reasoning does not reflect the complexity of Mr Tobin's position. In the passage from his evidence set out above, which Edmonds J quoted, it was put to him directly that it was not in contemplation that anything other than the "purchase price" ($250,000) would be paid to the trustee of the E & M Unit Trust. His response was evasive. He said it was probably right that nothing would be "physically paid" (an expression of unclear meaning). He then remarked that to say that what was in contemplation was a distribution on paper only "sells it a bit too short". He said that "we recognised that there was a real risk that the unit holders could call up those funds." He had earlier explained the steps that were taken to diminish that "risk", including the application for shares in Navygate. Mr Tobin's intentions were, no doubt, more subtle than those of his clients, but he was unable to give a direct answer to the suggestion that it was the intention of the parties that the Thomasz interests, and the E & M Unit Trust, were to receive $250,000 and nothing more.

58 There was an inconsistency between the fiscal and the financial objectives of the transaction, although they overlapped. It is accurate, as a proposition of law, to say that for the tax scheme to succeed it was necessary for the E & M Unit Trust to be entitled to the income of the Raftland Trust. Yet Kiefel J found as a fact, on the basis of compelling evidence, that it was the intention of the Herans, and of Mr and Mrs Thomasz, that $250,000 was all the beneficiaries of the E & M Unit Trust were ever to receive or to seek. It is little wonder that Mr Tobin found it difficult to distinguish between a legal entitlement and a commercial risk that the entitlement would be invoked. The primary judge was fully justified in finding that the entitlement under the Raftland Trust deed was not intended by the settlor or the trustee, or the "tertiary beneficiary", to have substantive, as opposed to apparent, legal effect.

59 On this issue, the conclusion of Kiefel J should be upheld. It was on the question of the operation of s 100A that the appellant failed in the Full Court. However, because Edmonds J was willing to accept that, subject to s 100A, the E & M Unit Trust was entitled to the income of the Raftland Trust for each of the three income years in question, whereas Kiefel J found that it was the primary beneficiaries who were entitled, they began their respective analyses of s 100A from different starting points. In view of the conclusion expressed above, the correct starting point is that adopted by Kiefel J.

The application of s 100A

60 Having held that the primary beneficiaries of the Raftland Trust were presently entitled to the income of the Raftland Trust, within the meaning of s 100A(1)(a) (a matter that followed from her earlier reasoning), Kiefel J considered whether that present entitlement arose out of a reimbursement agreement or arose by reason of any act, transaction or circumstance that

occurred in connection with, or as a result of, a reimbursement agreement, bearing in mind the definition of "agreement" in sub-s (13), and the terms of sub-ss (7) and (8).

61 The transactions, her Honour held, were clearly not in the ordinary course of commercial dealings. Following *Commissioner of Taxation v Prestige Motors Pty Ltd*[12] and *Idlecroft Pty Ltd v Commissioner of Taxation*[13] she observed that an "agreement" does not have to be legally enforceable and it is not necessary that the beneficiary be a party to it. It is, however, necessary that a reimbursement agreement provide for the payment of money, transfer of property or the provision of services or other benefits to a person other than the beneficiary. Kiefel J said:

> "A benefit in this case was gained by the Brian Heran Discretionary Trust and by Heran Projects. The benefit accrued so long as Raftland did not make the payment of trust income to the E&M Unit Trust. In turn Maggside did not have to pay Raftland and it did not have to call upon the monies it had loaned Heran Projects. At the same time they enjoyed tax benefits.
>
> …
>
> Raftland submitted that, whilst there may have been a connexion to the E&M Unit Trust's entitlement and the reimbursement agreement, this is not so with respect to the Primary Beneficiaries whose entitlement arises because of the operation of the default clause. A similar argument was raised and rejected in *Idlecroft*. It was held ... that the requisite connexion is present in such a case. The connecting circumstance is that the entitlements of the default beneficiaries came about because the appointment of income was invalid. That appointment was made pursuant to the reimbursement agreement. But for the existence of the agreement, the appointments would not have been made. The same analysis applies in the present case."

62 The reference to "appointment" in that passage is a reference to the facts of *Idlecroft*, and to a passage in the joint reasons of Ryan, Tamberlin and Kiefel JJ in that case[14]. In the Full Court, Edmonds J also found that the

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12 (1998) 82 FCR 195.

13 (2005) 144 FCR 501.

14 *Idlecroft Pty Ltd v Commissioner of Taxation* (2005) 144 FCR 501 at 512 [45].

agreement of 22 June 1995 between Heran Projects and Maggside was a "reimbursement agreement", providing for the payment of money to a person other than the beneficiary, namely Maggside, and that but for that reimbursement agreement there would have been no income of the Raftland Trust for the year ended 30 June 1995. Although they had different views on the identity of the relevant beneficiary, the approach of Kiefel J and Edmonds J to s 100A(1) was otherwise consistent.

63 Kiefel J was correct to conclude that s 100A(1) applied, subject to the question whether s 100A(3A) denied that result. She held that s 100A(3A) did not apply to deny the application of s 100A(1) because the primary beneficiaries were not beneficiaries in the capacity of trustees of other trust estates. Upon the hypothesis that (subject to s 100A(1)) the primary beneficiaries were presently entitled to the income of the Raftland Trust for each of the income years, the reasoning of Kiefel J on s 100A(3A) was correct. This was accepted by the Full Court.

64 It is strictly unnecessary further to examine the reasons for the Full Court's conclusion, on a different hypothesis, that is to say, entitlement of the E & M Unit Trust, that s 100A applied adversely to the appellant. Nevertheless, one of those reasons involves a question of general principle that was fully argued in this Court, and it should not be allowed to pass.

65 Save for the matter of the $57,973 in the 1996 year which is the subject of the proposed cross-appeal, the Full Court found that there was a reimbursement agreement and that the present entitlement of the trustee of the E & M Unit Trust arose out of that reimbursement agreement, so that, subject to s 100A(3A), s 100A(1) was satisfied. The Full Court held that s 100A(3A) did not deny the application of s 100A(1), because there was, in the circumstances of the case, a failure to satisfy the condition that, apart from s 100A(3A), the beneficiaries (Mr Carey in his capacity as trustee of the Thomasz Family Trust and Mr Carey in his capacity as trustee of the ECK Family Trust) of the E & M Unit Trust were presently entitled to the whole of the income of the E & M Unit Trust in each of the years of income, the whole of such income in each of those years being wholly attributable to the relevant trust income.

66 The primary reason given for that conclusion was that, for each of the three years, the E & M Unit Trust had no net income for trust purposes because of the losses of previous years. Edmonds J said:

> "The losses of previous years had been incurred by the trustee at the time in carrying on a business of buying and selling real property. The general rule is that such losses in one year must, in the absence of any contrary direction in the trust instrument, be made up out of profits of subsequent

> years and not out of capital ... There can be no profits properly distributable in cash until all past losses are paid".

67 The authority for this proposition was said to be *Upton v Brown*[15]. That case concerned a settlement by which a business was assigned to trustees for successive tenants for life (a wife, a husband, and their children) and then to be held in trust absolutely for remaindermen[16]. A receiver and manager was appointed to carry on the business. During the life of the first tenant for life, the business was carried on at a loss. During the life of the second tenant for life, profits were earned. The question was whether the loss must be made good out of the subsequent profits, or out of capital. The former was held to be the case.

68 The principle is stated in the current edition of *Lewin on Trusts*[17] as follows:

> "Where a business is held in trust for successive life tenants and remaindermen and is carried on by a receiver at a loss during the life of the first life tenant, the loss must be made good out of the profits during the life of the next life tenant and not out of capital, unless payment out of capital is expressly directed. In every case the adjustment of the relative rights of life tenant and remainderman in such a case necessarily depends to some extent on the construction of the particular will."

69 The principle is a particular application of the general requirement that a trustee who has two or more beneficiaries is under a duty to deal with each of them impartially[18]. The question whether a loss should be borne by capital or made good out of the income of later years, or, to put it another way, whether capital should be recouped before income is regarded as available for distribution, like the question whether benefits flowing from the use of trust property should be to the advantage of life tenant or remainderman, may arise where "a testator or settlor creates successive interests, with an interest in income followed by an interest in capital"[19]. In the case of the E & M Unit Trust, however, where there was one class of unit holders in a unit trust, with co-

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15 (1884) 26 Ch D 588. Reference was also made to *In re Reynolds* [1942] VLR 158 and *Jacobs' Law of Trusts in Australia*, 7th ed (2006) at 480 [1945].

16 The trusts are described in *Upton v Brown* (1879) 12 Ch D 872.

17 *Lewin on Trusts*, 18th ed (2008) at 888 [25–60] (references omitted).

18 *Scott and Ascher on Trusts*, 5th ed (2007), vol 4 at 1462-1472 §20.1-§20.2.

19 *Sinclair v Lee* [1993] Ch 497 at 506.

extensive interests in income and capital, the rationale for the application of *Upton v Brown* did not exist[20].

70 It is unnecessary to say anything further about the reasons given by the Full Court for deciding that s 100A(3A) did not deny the application of s 100A(1).

71 Subject to the question raised by the proposed cross-appeal, the conclusion of Kiefel J on this issue should be upheld.

Penalties

72 The argument in this Court on the question of recklessness raised by the terms of s 226H challenged the Full Court's approach, bearing in mind that, unlike Kiefel J, the Full Court held that the parties intended to create, and effectively created, a present entitlement in the E & M Unit Trust. On that hypothesis, all that was involved, so the argument ran, was an erroneous appreciation of the operation of s 100A and an understandable error supported by competent legal advice. The hypothesis having been rejected, the argument falls away. On the basis on which Kiefel J decided the case, which should be upheld, her decision as to recklessness and her finding that no case for remitter of part of the penalties was made out must also be upheld.

The application for special leave to cross-appeal

73 Although the Full Court, for reasons different from those of Kiefel J, concluded that s 100A applied, and dismissed the appeals in respect of the years ended 30 June 1995 and 30 June 1997, its order in relation to the appeal in respect of the year ended 30 June 1996 was that such appeal be allowed so as to exclude the sum of $57,973 from the application of s 100A but otherwise be dismissed. The respondent seeks special leave to appeal against that order.

74 Edmonds J, when examining the question of the identification of the reimbursement agreement for the purposes of the application of s 100A, and in particular the connection between the reimbursement agreement and the entitlement of the beneficiaries, considered that there was a difference between an amount of $57,973 which came into the Raftland Trust from the Brian Heran Discretionary Trust during the year ended 30 June 1996 and the remainder of the income for that year and for the other two years, which was distributed as part of the arrangements identified as a reimbursement agreement. That was an amount

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20 cf *In re Bridgewater Navigation Co* [1891] 2 Ch 317 at 327.

of rental and interest income derived by the Brian Heran Discretionary Trust and regarded by the Full Court as distinct from the agreement of 22 June 1995 between Maggside and Heran Projects or from the later rearrangements under which the former business of Heran Projects was carried on by other entities.

75 Edmonds J said:

> "The $57,973 which came into the Raftland Trust from the Brian Heran Discretionary Trust for the year ended 30 June 1996 appears to be sourced in rental and interest income. In other words, it is not sourced in the 'reimbursement agreement' between Heran Projects and Maggside, as trustee of the Brian Heran Discretionary Trust".

76 What his Honour meant by "sourced" is explained by a passage a few paragraphs earlier in his reasons where he was dealing with the connection required by s 100A(1). He said:

> "I am also of the view that the present entitlement of [the relevant beneficiary, which he regarded as the trustee of the E & M Unit Trust] to the income of the Raftland Trust for the year of income ended 30 June 1995 'arose out of' that reimbursement agreement as identified, in the sense that 'but for' that reimbursement agreement there would have been no income of the Raftland Trust to which [the beneficiary] would have been presently entitled".

77 He went on to say that the position in relation to the 1996 and 1997 years was not so clear, and finally reached the conclusion that, as to $57,973, s 100A(1) did not apply. The problem is that, on the approach his Honour took to the matter of connection, the difference between that amount and the other amounts in question is not material. If the reimbursement agreement had not been entered into, the $57,973 would not have been distributed to the Raftland Trust. There would have been no income of the Raftland Trust. The respondent's challenge to this part of the reasoning of the Full Court has been made good.

78 Although the point is relatively minor in the larger context of the case, it is integral to the matter of the application of s 100A(1), which had to be considered in order to deal with the arguments of the parties on the appeal. In that sense it would not do justice to the parties if this Court were to refuse to deal with it[21].

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21 cf *Director of Public Prosecutions v United Telecasters Sydney Ltd* (1990) 168 CLR 594 at 602; [1990] HCA 5.

Special leave to cross-appeal should be granted and the cross-appeal should be allowed.

Conclusion and orders

79 The appeal should be dismissed. Special leave to cross-appeal should be granted, and the cross-appeal should be allowed. The orders made in paragraphs 2 and 3 of the order of the Full Court of the Federal Court should be set aside, and in their place it should be ordered that the appeal to that Court in respect of the year ended 30 June 1996 be dismissed. The appellant should pay the respondent's costs of the appeal and cross-appeal.

80 KIRBY J. As argued in this Court and in the Federal Court of Australia, a critical issue in these proceedings was whether certain dealings affecting the liability of a taxpayer under the *Income Tax Assessment Act* 1936 (Cth) ("the Act") amounted to a sham, and, as such, were to be ignored in determining that liability.

81 In Australia and in other countries with comparable revenue laws, issues of this kind have given rise to debate and sharply differing views[22]. Nearly forty years ago in *Paintin and Nottingham Ltd v Miller Gale and Winter*[23], Turner J, in the New Zealand Court of Appeal, warned against allowing the word "sham" to become a "legal shibboleth" so that "on its mere utterance it [is] to be expected that contracts will wither like one who encounters the gaze of a basilisk".

82 The anxiety that lay behind this judicial warning has been influential. The law ordinarily operates upon documents and other evidentiary materials that attempt to express intended legal consequences according to the words used and the statutes or legal doctrines that those words enliven. Fear of over-reaction should not, however, prevent courts, where justified, from calling a sham what it is. That is what the primary judge in the Federal Court (Kiefel J) did in this case[24].

83 The Full Court of the Federal Court disagreed. It held that the impugned transaction was "not a sham, but rather was at the forefront of the intentions of those charged with responsibility for establishing the Raftland Trust"[25]. This difference of view produced a different legal analysis, although it ultimately resulted in almost identical orders on the principal issues.

84 In this Court, Raftland Pty Ltd as trustee of the Raftland Trust ("the appellant") challenged the approach and orders of the Full Court. The Commissioner of Taxation ("the respondent"), by notice of contention, sought, primarily, to restore the approach, findings and conclusions of the primary judge. The respondent also sought special leave to cross-appeal against the Full Court's modification of the primary judge's orders. He asked for their restoration.

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22 Tiley, *Revenue Law*, 5th ed (2005) at 107.

23 [1971] NZLR 164 at 175.

24 *Raftland Pty Ltd v Commissioner of Taxation* (2006) 227 ALR 598 at 618 [90].

25 *Raftland Pty Ltd v Federal Commissioner of Taxation* (2007) 65 ATR 336 at 359 [83] per Edmonds J; cf at 343 [8] per Dowsett J ("for slightly different reasons"), 343 [9] per Conti J.

85 I agree with the conclusions of Gleeson CJ, Gummow and Crennan JJ ("the joint reasons"). The orders of the primary judge should be restored. In large part, I agree with the joint reasons. Specifically, I agree that[26]:

> "The primary judge was fully justified in finding that the entitlement under the Raftland Trust deed was not intended by the settlor or the trustee, or the 'tertiary beneficiary', to have substantive, as opposed to apparent, legal effect."

86 In my opinion, this conclusion means that the primary judge was right to ignore the transaction characterised as a sham, and to have regard instead to what she identified as the "real transaction"[27]. The primary judge's conclusions and orders, but also her reasoning, should be upheld. The Full Court erred in so far as it decided otherwise. The appellant's challenge to the orders made below fails. I agree with the joint reasons that the respondent's cross-appeal should succeed[28].

The facts

87 *Complex transaction*: The dealings the subject of this appeal are summarised in the joint reasons in terms that I accept. Further details are recorded in the reasons of the primary judge[29].

88 As the joint reasons make clear, the facts of the matter are not without complexity. However, complexity is sometimes a deliberate feature of sham dealings. This is because their purpose is to disguise the real nature of a transaction, so as to avoid undesired taxation or other consequences[30].

89 Complex transactions may also be involved in taking proper advantage of provisions of the Act in order to minimise taxation liability. Often, the identification of sham dealings is a difficult task. However, from the start, the respondent contended that essential elements of the transactions here at issue

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26 Joint reasons at [58].

27 (2006) 227 ALR 598 at 618 [90].

28 Joint reasons at [73]-[78].

29 See (2006) 227 ALR 598 at 600-614 [2]-[74].

30 See, for example, *R v Inland Revenue Commissioners; Ex parte Matrix-Securities Ltd* [1994] 1 WLR 334 at 345; [1994] 1 All ER 769 at 780 where Lord Templeman referred to "[t]he trick of circular, self-cancelling payments with matching receipts and payments".

represented a sham[31]. Those elements had no real business or commercial explanation or justification. Moreover, there was a demonstrated discordance between the real intentions of the participants and the apparent purposes of the constituent documents on which the appellant relied.

90 *Explicit reliance on sham*: Lest there be any doubt that, before this Court, the respondent sought to support the primary judge's invocation of sham, in the course of oral argument his counsel made it plain that "[t]he primary submission is that Justice Kiefel's analysis was correct with the consequences that her Honour found"[32]. Only as a fall-back position did the respondent support the alternative route to substantially similar orders adopted by the Full Court. Respectfully, therefore, I cannot agree with Heydon J that the trial judge did not make a finding of sham and "does not seem to have been explicitly invited to do so"[33]. Such conclusions are not consistent with the record.

91 The primary judge noted that one of the issues that the respondent's arguments presented was whether or not the "purported distributions" amounted to a "sham"[34]. In consequence, a significant part of her Honour's reasoning proceeded to address that issue under the heading "Whether the distributions to the E&M Unit Trust were a 'sham'"[35]. In the relevant section of her reasons, the primary judge referred to the decision of this Court in *Equuscorp Pty Ltd v Glengallan Investments Pty Ltd*[36], and decisions of the Full Court of the Federal Court on sham which were binding on her[37]. She did so immediately before expressing her findings and conclusions[38].

92 *Evidence supporting conclusion of sham*: In this Court, the respondent pointed to a number of considerations as supporting the primary judge's finding

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31 Joint reasons at [8].

32 [2008] HCATrans 009 at 94 [4222].

33 Reasons of Heydon J at [173].

34 (2006) 227 ALR 598 at 611-612 [59]-[61].

35 (2006) 227 ALR 598 at 614-618 [75]-[91].

36 (2004) 218 CLR 471 at 487 [48]-[49]; [2004] HCA 55 cited (2006) 227 ALR 598 at 615-616 [79].

37 (2006) 227 ALR 598 at 615 [76]-[77] citing eg *Sharrment Pty Ltd v Official Trustee in Bankruptcy* (1988) 18 FCR 449 at 454 per Lockhart J.

38 (2006) 227 ALR 598 at 618 [89]-[90].

that the written documents did not express the true intentions of the participants, and therefore amounted to a sham. Without repeating all of her Honour's findings in this respect, the following can be noted[39]:

(1) The appellant bore the burden of proving a distribution of trust income of the Raftland Trust to the E & M Unit Trust[40]. However, it failed to discharge that burden[41];

(2) The appellant and the other Heran entities having an interest in the impugned dealings were not concerned to create a real relationship of trustee and beneficiary between the appellant and the E & M Unit Trust. They had no business, commercial, family or other reason to benefit that trust or its unit-holders, aside from the object of enabling income to be channelled to a trust which had accumulated tax losses. Mr Brian Heran was candid in this respect, agreeing in his evidence that, had the E & M Unit Trust not been available for that purpose, he would not have had Heran Projects and Maggside enter into the initial transaction[42];

(3) The $250,000 paid to the E & M Unit Trust was not income of the Raftland Trust. It was provided by related Heran entities in the sole and obvious expectation of deriving income tax benefits from doing so. The parties understood it to be "the *price* for control of the [E & M Unit Trust], access to the accumulated losses and the co-operation of Mr Carey and Mr and Mrs Thomasz". It was not expected that there would be any further, still less ongoing, dealings between the parties. According to its true character, the transaction involved the transfer of interests for an identified, limited and valuable consideration[43];

(4) In respect of the year ended 30 June 1995, the appellant did not make, and at no time intended to make, payment of the balance of the income of the Raftland Trust ($2,599,467[44]) to the E & M Unit Trust[45]. It was the disparity between the documentation and the inferred intention of the

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39 The same abbreviations are used as in the joint reasons.

40 (2006) 227 ALR 598 at 616 [81].

41 (2006) 227 ALR 598 at 618 [89].

42 (2006) 227 ALR 598 at 616 [83].

43 (2006) 227 ALR 598 at 616-617 [84]-[85] (emphasis in original).

44 See joint reasons at [27].

45 (2006) 227 ALR 598 at 606 [35], 616-617 [84].

participants in this connection that led to the "curious" evidence of Mr Tobin, the Herans' solicitor, recounted in the joint reasons[46];

(5) Not only did the appellant have no intention of ever paying the balance, but Mr and Mrs Thomasz had no expectation that the E & M Unit Trust would ever receive it or, indeed, any further benefits whatever. Mr Thomasz was aware that the balance was to be applied against the E & M Unit Trust's losses, but he did not expect that he and his wife would have any future dealings with that trust. Whilst there was no direct evidence that Mr and Mrs Thomasz promised never to claim any further moneys, the primary judge was clearly right to infer that they never had any intention of doing so, consistent with their understanding of the true nature of the transaction that had taken place[47];

(6) The appellant considered that there was no real risk that the unit-holders of the E & M Unit Trust would or could require the trustee of that trust to seek the balance. The Navygate transaction could therefore be seen as nothing more than an attempt to encourage the opposite impression[48]; and

(7) For the years ended 30 June 1996 and 30 June 1997, payment by the appellant of $779,705 and $386,035 respectively was not in fact made to the E & M Unit Trust. Nor was it intended to be made. The purported further distributions from the appellant were not, in reality, further distributions at all. The parties did not intend them to have effect as such[49].

The legislation

93 The relevant provisions of the Act, including ss 97, 98, 99A and 100A, are described, or set out, in the joint reasons[50]. The provisions of s 226H, governing liability to additional tax having regard to alleged "recklessness" in connection with the under-statement of income, are also explained there[51]. I agree with what the joint reasons say on the issue that arises in respect of s 226H.

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46 Joint reasons at [45]-[46].

47 (2006) 227 ALR 598 at 617 [86].

48 (2006) 227 ALR 598 at 617 [87].

49 (2006) 227 ALR 598 at 607 [41]-[42].

50 Joint reasons at [5]-[6]. See also (2006) 227 ALR 598 at 607-611 [46]-[57].

51 Joint reasons at [72]. See also (2006) 227 ALR 598 at 621 [105].

94 It is unnecessary for me to explain the unique Australian provisions of Pt IVA of the Act[52]. Those provisions amount to one legislative response to the significant problem of the use of complex transactions to facilitate tax avoidance that arose in Australia in the context of the narrow scope afforded by this Court to s 260 of the Act[53]. Originally, the respondent notified the appellant that he was making his determination of under-payment of income tax under Pt IVA of the Act. However, shortly before the hearing before the primary judge, the respondent advised that he did not rely on Pt IVA[54]. It was on that footing that the application of ss 95A, 99A and 100A of the Act fell to be determined.

The reasons of the Federal Court

95 *The primary judge*: After considering the character of the purported distributions to the E & M Unit Trust, the primary judge stated[55]:

> "The true nature of the distributions is to be determined by reference to all of the evidence. [The appellant] is required to prove that there were distributions of trust income and there is evidence which strongly suggests that this was not the parties' common intention. Rather, [the appellant] was to pay and the E&M Unit Trust was to receive a sum for control of the trust and access to its losses. No further dealings were intended to take place. The onus then shifts to [the appellant] to show that these inferences, concerning the parties' intentions, are not correct. It might have done so by direct evidence from the parties or [*scil* as] to what had taken place between them, if that had been helpful. Having not done so it has not established that there were distributions of income.
>
> A conclusion that a transaction is a sham means that it may be ignored and regard had to the real transaction. In the present case, I conclude that there were no distributions of income to the E&M Unit Trust. The appointment of the E&M Unit Trust as a tertiary beneficiary was made only as part of the facade and should also be disregarded."

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52 cf joint reasons at [8].

53 cf *Cridland v Federal Commissioner of Taxation* (1977) 140 CLR 330 at 337-338 per Mason J; [1977] HCA 61 ("the very restricted operation conceded to s 260 by the course of judicial decision and the generality of the language in which the section is expressed stand in high contrast").

54 (2006) 227 ALR 598 at 607 [45].

55 (2006) 227 ALR 598 at 618 [89]-[90].

96 This finding can only be understood against the background of the primary judge's earlier explanation of the preconditions to a determination that what appear to be effective legal transactions amount to a sham, and of the legal consequences that follow when the sham elements are disregarded.

97 It was, therefore, on the basis of a finding of sham that the primary judge proceeded to her ultimate conclusion that the appellant held the income on trust for the primary beneficiaries, obliging consideration of s 100A[56]. In the result, the primary judge held that s 100A(1) of the Act applied, so that the primary beneficiaries were not to be taken as presently entitled to the income, and the appellant was liable to be assessed pursuant to s 99A[57]. Section 100A(2), (3A) and (3B) had no application[58]. These conclusions applied to the assessable income of the Raftland Trust for each of the relevant taxation years[59].

98 In the premises, the conclusion that the appellant's under-statement of its income amounted to "recklessness" was inevitable. As the primary judge remarked[60]:

> "In the context of a *sham* transaction, a conclusion of recklessness is clearly open."

99 *The Full Court*: The principal reasons in the Full Court were delivered by Edmonds J. After detailed reference to the evidence and to decisional authority, his Honour concluded[61]:

> "With respect to the conclusion of the primary judge … I am of the view that the nomination of the trustee of the E & M Unit Trust as a tertiary beneficiary of the Raftland Trust [was] not a sham, but rather was at the forefront of the intentions of those charged with responsibility for establishing the Raftland Trust. In other words, to establish it in such a way that the income of the Raftland Trust passed to the trustee of the E & M Unit Trust, to be sheltered by the losses of that trust, if not by distribution – in the sense of payment to, application or setting aside of

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56 (2006) 227 ALR 598 at 618 [91].

57 (2006) 227 ALR 598 at 621 [101].

58 (2006) 227 ALR 598 at 621 [102]-[103].

59 (2006) 227 ALR 598 at 621 [104].

60 (2006) 227 ALR 598 at 621 [105] (emphasis added).

61 (2007) 65 ATR 336 at 359 [83].

> such income for the E & M Unit Trust – then by the default provisions of the proviso to cl 3(b), reinforced by the provisions of cl 3(f)."

100 In the result, Edmonds J took the view that the trustee of the E & M Unit Trust was entitled to the income of the Raftland Trust for each of the relevant years[62]. He further concluded that s 100A(3A) of the Act did not operate to deny the application of s 100A(1)[63]. This led Edmonds J to his conclusion and to the orders favoured by the Full Court.

The threshold issue

101 In my view, it is essential for this Court to grapple with the issue of sham. It should do so in light of:

- The specific difference that emerged between the reasoning of the primary judge and that of the Full Court;
- The submissions of the parties before this Court;
- The particular submission of the appellant that it was difficult or impossible to reconcile the Full Court's rejection of the finding of sham with its limited disturbance of the parties' transaction and the imposition of additional tax by the Full Court by way of penalty for "recklessness"; and
- The respondent's explicit argument, expressed in his notice of contention, that the Full Court had erred in disturbing the primary judge's factual conclusions, analysis and orders, which included her Honour's express invocation and application of the concept of sham.

102 The foregoing considerations render it impossible (and certainly undesirable) for this Court, without facing up to the sham issue, to resolve the question defined by Dowsett J in the Full Court as[64]:

> "whether or not the parties intended that legal or equitable rights and obligations be created by the various transactions into which they entered. … In a case such as this the question to be addressed is whether the parties intended that the various transactions take effect, or whether they were really trying to camouflage the true nature of the dealings between

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62 (2007) 65 ATR 336 at 359 [84].

63 (2007) 65 ATR 336 at 368 [114].

64 (2007) 65 ATR 336 at 342 [4].

them. In such a case the court must decide where reality stops and camouflage starts."

103 There is a further and final reason for this Court to address the issue of sham. The resolution of the question in this appeal is not without importance for the approach of the Commissioner, his officers, administrative bodies and courts to complex transactions designed to achieve minimisation of tax obligations. As Dowsett J suggested, such matters will often present difficult problems of characterisation and judicial line-drawing. Clearly, Turner J was correct to state in *Paintin and Nottingham*[65] that the mere invocation of sham does not render a transaction suspect, still less ineffective. In one sense, the sham classification is one to be applied in retrospect, when all of the evidence is understood.

104 Nevertheless, in the present case, there are strong reasons for supporting the approach of the primary judge and affirming the conclusion of a sham transaction and the orders to which that conclusion led.

Emergence of the concept of sham

105 *The problem of tax avoidance*: As revenue law in developed countries became more complex and the stakes larger both for the revenue and for taxpayers, it was inevitable that taxpayers would seek expert advice on how they might order their affairs so as to reduce their liability to tax. Courts cannot "ignore the [fact] that … tax laws [now] affect the shape of nearly every business transaction"[66]. Businesses plan their affairs around the realities of competition and tax liability[67]. Subject to the law, that is a taxpayer's right.

106 However, over the years, endeavours to diminish tax obligations have given rise to minimisation "schemes" of varying degrees of artificiality, and to legislative responses both of a general[68] and a particular[69] kind. It is important to keep such responses in mind, for they afford the context within which distinctive judicial approaches have emerged in other countries, as in this, to render the more artificial "schemes" ineffective as against the revenue.

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65 [1971] NZLR 164 at 175. See above these reasons at [81].

66 *Frank Lyon Co v United States* 435 US 561 at 580 (1978) cited *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 186 CLR 404 at 416; [1996] HCA 34.

67 *Commissioner of Internal Revenue v Brown* 380 US 563 at 579-580 (1965); cf *Spotless* (1996) 186 CLR 404 at 415-416.

68 The Act, s 260.

69 The Act, Pt IVA. See also s 100A.

107 *United States response to artifice*: In the United States of America, the Supreme Court has developed a doctrine akin to sham to enhance the ability of a decision-maker to disregard artificial transactions of ostensible legal regularity and effect. In 1935, in *Gregory v Helvering*[70], the Supreme Court observed of a corporate reorganisation which it judged to be sham and unrealistic:

> "The whole undertaking … was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. … To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."

108 Similar views were expressed by the same Court ten years later in *Commissioner of Internal Revenue v Court Holding Co*[71]:

> "To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress."

109 *Murphy J's dissent in Westraders*: In the heyday of tax avoidance schemes that found favour in this Court, according to a literal interpretation of the impugned documentation, Murphy J, in dissent in *Federal Commissioner of Taxation v Westraders Pty Ltd*[72], cited the foregoing United States decisions. He expressed a preference for their approach. He favoured it over the kind of "strict literalism" that he regarded as prone to defeat the obvious purpose of revenue legislation. Murphy J applied the United States approach to the case in hand. However, he was alone in doing so. Although Wilson J agreed in reading the legislation in a "broad way" so as to achieve its purposes[73], he did not embrace the basic change of doctrine and approach favoured by Murphy J.

110 Looking back at *Westraders*, some of the remarks of Murphy J appear to herald the general change that was later to emerge in this Court in the interpretation of federal legislation – a move from the "literalist" approach of earlier times to the more "purposive" approach now generally followed[74].

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70 293 US 465 at 470 (1935).

71 324 US 331 at 334 (1945); cf *Frank Lyon* 435 US 561 at 580 (1978) cited *Spotless* (1996) 186 CLR 404 at 416.

72 (1980) 144 CLR 55 at 79; [1980] HCA 24.

73 (1980) 144 CLR 55 at 81-82.

74 See eg *CIC Insurance Ltd v Bankstown Football Club Ltd* (1997) 187 CLR 384 at 408; [1997] HCA 2; *Newcastle City Council v GIO General Ltd* (1997) 191 CLR

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Murphy J's search was for the purpose and object of the applicable statutory provisions. He declared that it was "an error to think that the only acceptable method of interpretation is strict literalism"[75]. He went on[76]:

> "In tax cases, the prevailing trend in Australia is now so absolutely literalistic that it has become a disquieting phenomenon. Because of it, scorn for tax decisions is being expressed constantly, not only by legislators who consider that their Acts are being mocked, but even by those who benefit. In my opinion, strictly literal interpretation of a tax Act is an open invitation to artificial and contrived tax avoidance. Progress towards a free society will not be advanced by attributing to Parliament meanings which no one believes it intended so that income tax becomes optional for the rich while remaining compulsory for most income earners."

111 *A refined doctrine of sham*: After *Westraders*, the notion of sham in the context of commercial transactions was invoked in a number of decisions of the Federal Court. In influential reasons in *Sharrment Pty Ltd v Official Trustee in Bankruptcy*[77], Lockhart J reviewed the authorities on the concept of sham to that time. He said:

> "A 'sham' is … for the purposes of Australian law, something that is intended to be mistaken for something else or that is not really what it purports to be. It is a spurious imitation, a counterfeit, a disguise or a false front. It is not genuine or true, but something made in imitation of something else or made to appear to be something which it is not. It is something which is false or deceptive."

112 Important to this description is the idea that the parties do not *intend* to give effect to the legal arrangements set out in their apparent agreement, understood only according to its terms. In Australia, this has become essential to the notion of sham, which contemplates a disparity between the ostensible and the real *intentions* of the parties[78]. The courts must therefore test the intentions of

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85 at 112-113; [1997] HCA 53; *Project Blue Sky Inc v Australian Broadcasting Authority* (1998) 194 CLR 355 at 381 [69], 384 [78]; [1998] HCA 28.

75 (1980) 144 CLR 55 at 79.

76 (1980) 144 CLR 55 at 80.

77 (1988) 18 FCR 449 at 454 cited (2006) 227 ALR 598 at 615 [76].

78 *Scott v Commissioner of Taxation (Cth) (No 2)* (1966) 40 ALJR 265 at 279; cf *Re State Public Services Federation; Ex parte Attorney-General (WA)* (1993) 178 CLR 249 at 290 per Toohey J; [1993] HCA 30.

parties, as expressed in documentation, against their own testimony on the subject (if any) and the available objective evidence tending to show what that intention really was.

Comparative approaches to sham transactions

113 *Differing approaches*: A review of comparative law on the identification of sham transactions reveals that, in several jurisdictions whose legislation is relevantly comparable to our own, the sham concept is well-entrenched. Indeed, judges elsewhere have indicated some degree of willingness to consider the development of a broader and more robust approach to the identification of sham. Such willingness demonstrates the disinclination of judges to accept, at face value, documents devised and executed by the parties in purported expression of their legal rights where there is reason, as a matter of evidence and common sense, to believe that their real intentions lie elsewhere.

114 *United Kingdom*: In *Bridge v Campbell Discount Co Ltd*[79], a case involving a suggested penalty in a hire purchase agreement, Lord Devlin proposed the following test for discerning sham[80]:

> "[W]hen a court of law finds that the words which the parties have used in a written agreement are not genuine, and are not designed to express the real nature of the transaction but for some ulterior purpose to disguise it, the court will go behind the sham front and get at the reality."

115 The sham concept was then further refined by Diplock LJ in *Snook v London and West Riding Investments Ltd*[81]:

> "[I]f it has any meaning in law, ['sham'] means acts done or documents executed by the parties to the 'sham' which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create. … [F]or acts or documents to be a 'sham', with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations which they

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79 [1962] AC 600.

80 [1962] AC 600 at 634.

81 [1967] 2 QB 786 at 802 citing *Yorkshire Railway Wagon Co v Maclure* (1882) 21 Ch D 309 and *Stoneleigh Finance Ltd v Phillips* [1965] 2 QB 537. See also *W T Ramsay Ltd v Inland Revenue Commissioners* [1982] AC 300 at 337.

> give the appearance of creating. No unexpressed intentions of a 'shammer' affect the rights of a party whom he deceived."

116 Although Diplock LJ's definition was offered in connection with hire purchase documents, his analysis has been accepted as generally applicable to revenue cases in the United Kingdom[82], Australia[83] and elsewhere[84]. Critics have suggested that it "means nothing more than that the label given by the parties to a transaction is not conclusive in determining [their] legal rights"[85]. However, as will be demonstrated, the maintenance of sham as an independent legal concept is useful from both a terminological and a procedural point of view.

117 Courts in the United Kingdom have insisted that they will not treat an act or a document as a sham simply because they conclude that it is uncommercial or even economically artificial[86]. They have drawn a distinction between[87]:

> "the situation where parties make an agreement which is unfavourable to one of them, or artificial, and a situation where they intend some other arrangement to bind them. In the former situation, they intend the agreement to take effect according to its tenor. In the latter situation, the agreement is not to bind their relationship."

118 Attempts have been made, however, to broaden the bases on which transactions manifesting characteristics of sham might be disregarded, and thus to ameliorate the strictness of the *Snook* definition. Hence, courts in the United Kingdom have developed a concept of "fiscal nullity" which applies where steps having no commercial or business purpose other than tax avoidance are inserted into a composite transaction[88]. It has been suggested that this should be viewed

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82 See eg *MacNiven v Westmoreland Investments Ltd* [2003] 1 AC 311 at 319 [4].

83 See *Sharrment* (1988) 18 FCR 449 at 453-454.

84 See eg *Stubart Investments Ltd v The Queen* [1984] 1 SCR 536 at 572.

85 Tiley, "Judicial Anti-avoidance Doctrines: The US Alternatives", (1987) *British Tax Review* 180 at 196; cf Lehmann and Coleman, *Taxation Law in Australia*, 5th ed (1998) at 1321.

86 *Hitch v Stone* [2001] STC 214.

87 *Hitch* [2001] STC 214 at 230 [67] per Arden LJ (Kay LJ and Sir Martin Nourse concurring). See also *Revenue and Customs v Dempster (t/as Boulevard)* [2008] EWHC 63 (Ch) at [12] per Briggs J.

88 *Ramsay* [1982] AC 300; *Inland Revenue Commissioners v Burmah Oil Co Ltd* [1982] STC 30; *Furniss v Dawson* [1984] AC 474. Later decisions suggest that the

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as "a species of the sham concept"[89]. However, so far, "fiscal nullity" has not been accepted in other jurisdictions[90]. In Australia, this Court has held it to be inapplicable, assigning as a reason the lack of necessity because of the existence of the specific anti-avoidance provisions enacted as Pt IVA of the Act[91].

119 Another development in the United Kingdom has involved the elaboration of the concept of "pretence", which permits courts to override contractual terms that have been inserted solely to avoid a public policy expressed in a statute[92]. Some observers have regarded the concept of "pretence" as extending the law's response to "sham devices" and "artificial transactions"[93].

120 Notwithstanding these developments, the basic doctrine as explained in *Snook* continues to govern the law's response in the United Kingdom when a transaction is alleged to be a sham[94]. The parties must have *intended* to create rights and obligations different from those appearing in their documents. They must have *intended* to give a false impression of those rights and obligations to third parties. Only then will the label of sham be applied, with the legal consequences that it attracts[95].

121 *Canada*: In *Minister of National Revenue v Cameron*[96], the Supreme Court of Canada adopted the approach to sham expressed in *Snook*. However,

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"principle" may be a technique of statutory interpretation rather than a common law doctrine of anti-avoidance: see *Craven v White* [1989] AC 398 at 520 per Lord Goff of Chieveley.

89 Lee, "The Concept of Sham: A Fiction or Reality?", (1996) 47 *Northern Ireland Legal Quarterly* 377 at 387.

90 See eg *Stubart* [1984] 1 SCR 536.

91 *John v Federal Commissioner of Taxation* (1989) 166 CLR 417 at 434-435; [1989] HCA 5.

92 *Street v Mountford* [1985] AC 809; *A G Securities v Vaughan* [1990] 1 AC 417.

93 *A G Securities* [1990] 1 AC 417 at 462 per Lord Templeman. See Bright, "Beyond Sham and into Pretence", (1991) 11 *Oxford Journal of Legal Studies* 136 at 140.

94 Tiley, *Revenue Law*, 5th ed (2005) at 107.

95 *Hitch* [2001] STC 214 at 230 [66].

96 [1974] SCR 1062 at 1068 per Martland J.

shortly afterwards, in *Minister of National Revenue v Leon*[97], the Federal Court of Appeal felt entitled to hold that:

> "If [an] agreement or transaction lacks a *bona fide* business purpose, it is a sham."

122 The "business purpose" criterion was subsequently rejected by the Supreme Court of Canada in *Stubart Investments Ltd v The Queen*[98]. In that case, Estey J, using the language of "deceit", explained that lack of business or commercial purpose was insufficient to evidence a sham. An additional, subjective, element was needed[99]:

> "This expression ['sham transaction'] comes to us from decisions in the United Kingdom, and it has been generally taken to mean (but not without ambiguity) a transaction conducted with an element of deceit so as to create an illusion calculated to lead the tax collector away from the taxpayer or the true nature of the transaction; or, simple deception whereby the taxpayer creates a facade of reality quite different from the disguised reality."

123 In her reasons in the same case, Wilson J noted that[100]:

> "A transaction may be effectual and not in any sense a sham … but may have no business purpose other than the tax purpose."

124 During the ensuing decade, other Justices of the Supreme Court of Canada hinted at an attempt to revitalise an "economic realities" rule. Thus, in *Bronfman Trust v The Queen*[101], Dickson CJ concluded:

> "If … the Trust had sold a particular income-producing asset, made the capital allocation to the beneficiary and repurchased the same asset, all within a brief interval of time, the courts might well consider the sale and repurchase to constitute a formality or a sham designed to conceal the essence of the transaction, namely that money was borrowed and used to fund a capital allocation to the beneficiary."

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97 [1977] 1 FC 249 at 256.

98 [1984] 1 SCR 536.

99 [1984] 1 SCR 536 at 545-546.

100 [1984] 1 SCR 536 at 540.

101 [1987] 1 SCR 32 at 55.

125 For some time, it was unclear whether these observations indicated the emergence of a broader approach to sham in Canada[102]. However, in *McClurg v Canada*[103], the Supreme Court again endorsed the approach stated in *Snook*. Subjective deception, rather than alleged objective unreality, was affirmed as the essential criterion. Hints of the alternative theory still appear in Canadian case law from time to time[104]. But for the moment, the *Snook* test prevails.

126 *New Zealand*: In *Paintin and Nottingham*[105], Turner J made it clear that, in New Zealand, "[t]he word 'sham' has no applicability to transactions which are intended to take effect, and do take effect, between the parties thereto according to their tenor". In an earlier decision in *Bateman Television Ltd v Coleridge Finance Co Ltd*, his Honour had remarked, to like effect[106]:

> "[T]he occasions on which Courts have set aside the form of a transaction as a 'sham' are confined to cases in which, really doing one thing, the parties have resorted to a form which does not fit the facts in order to deceive some third person, often the revenue authorities, into the belief that they were doing something else."

127 Later, in *Mills v Dowdall*[107], Richardson J postulated, as a test for sham, whether "the [documents do] not reflect the true agreement between the parties". Later still, in *Marac Life Assurance Ltd v Commissioner of Inland Revenue*, Richardson J emphasised that[108]:

> "The true nature of a transaction can only be ascertained by careful consideration of the legal arrangements actually entered into and carried out: not on an assessment of the broad substance of the transaction measured by the results intended and achieved or of the overall economic consequences."

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102 Nitikman, "Preparing for NAFTA: Canadian Judicial Anti-Avoidance Doctrines – Part 2", (1993) 19(4) *International Tax Journal* 47 at 52.

103 [1990] 3 SCR 1020.

104 See eg *Faraggi v The Queen* [2008] 1 CTC 2425.

105 [1971] NZLR 164 at 175.

106 [1969] NZLR 794 at 813.

107 [1983] NZLR 154 at 160.

108 [1986] 1 NZLR 694 at 706.

128 This approach has laid the ground for a narrow operation of the doctrine of sham in New Zealand[109]. So much was reaffirmed in the recent decision of the New Zealand Court of Appeal in *Accent Management Ltd v Commissioner of Inland Revenue*[110]:

> "[A]rtificiality and lack of commercial point (other than tax avoidance) are not indicia of sham. And the concepts of sham and tax avoidance are not correlatives. As well, while there are elements of pretence (and certainly concealment) associated with [the] transactions [here at issue], these are explicable on bases other than sham".

Authority of this Court

129 The effort of Murphy J to develop a broader doctrine of sham, capable of dealing with "artificial and contrived transactions for tax avoidance purposes"[111], has not, so far, found favour in this Court. Nor, despite early support in other Australian courts[112], has this Court accepted the principle of "fiscal nullity" adopted by the House of Lords in *W T Ramsay Ltd v Inland Revenue Commissioners*[113], citing the presence in the Act of statutory provisions enacted "for the purpose of inhibiting tax avoidance"[114]. This is so despite a number of legal trends that might have been taken as supporting the adoption of a more ample doctrine of sham:

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109 Prebble, "Criminal Law, Tax Evasion, Shams, and Tax Avoidance: Part II – Criminal Law Consequences of Categories of Evasion and Avoidance", (1996) 2 *New Zealand Journal of Taxation Law and Policy* 59 at 63-66.

110 [2007] NZCA 230 at [59]. See also *Accent Management Ltd v Commissioner of Inland Revenue* (2005) 22 NZTC 19,027 at 19,059-19,061 [215]-[225].

111 *Westraders* (1980) 144 CLR 55 at 79.

112 *Federal Commissioner of Taxation v Ilbery* (1981) 38 ALR 172; *Federal Commissioner of Taxation v Kelly Ford Pty Ltd* (1984) 3 FCR 469; *Oakey Abattoir Pty Ltd v Federal Commissioner of Taxation* (1984) 54 ALR 595. But see *Oakey Abattoir Pty Ltd v Federal Commissioner of Taxation* (1984) 55 ALR 291.

113 [1982] AC 300.

114 *Federal Commissioner of Taxation v Patcorp Investments Ltd* (1976) 140 CLR 247 at 292 cited *John* (1989) 166 CLR 417 at 434-435.

- The retreat from past decisions upholding schemes involving artifice[115], which decisions led to professional and public criticisms[116], and produced both legislative[117] and judicial[118] responses;

- The strong tendency of current legal doctrine, across a wide range of areas (except perhaps the criminal law), to give preference to substance over form, that is, to the real and intended meaning of a law or a legal instrument, understood in its context, in preference to the meaning suggested by a strictly literal verbal analysis[119];

- The strong general trend towards a "purposive" interpretation of legislation and other written texts, aimed at giving effect to the imputed purpose of contested words[120];

- The increased recourse by courts to extrinsic materials, in order to clarify the purposes of legislation[121]; and

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115 See eg *Curran v Federal Commissioner of Taxation* (1974) 131 CLR 409; [1974] HCA 46.

116 cf Marr, *Barwick*, (1980) at 228-229, 293-294.

117 The Act, Pt IVA. See *Spotless* (1996) 186 CLR 404 at 416.

118 *Cooper Brookes (Wollongong) Pty Ltd v Federal Commissioner of Taxation* (1981) 147 CLR 297 at 313, 320; [1981] HCA 26; cf *Ramsay* [1982] AC 300.

119 See eg *Fish v Solution 6 Holdings Ltd* (2006) 225 CLR 180 at 206 [86], 214 [112]; [2006] HCA 22; *Federal Commissioner of Taxation v Citylink Melbourne Ltd* (2006) 228 CLR 1 at 20-21 [51]; [2006] HCA 35; *Bodruddaza v Minister for Immigration and Multicultural Affairs* (2007) 228 CLR 651 at 671 [54]; [2007] HCA 14; *General Motors Acceptance Corporation Australia v Southbank Traders Pty Ltd* (2007) 227 CLR 305 at 313 [23]; [2007] HCA 19; *Tofilau v The Queen* (2007) 81 ALJR 1688 at 1727-1728 [188]; 238 ALR 650 at 699; [2007] HCA 39; *Telstra Corporation Ltd v The Commonwealth* (2008) 82 ALJR 521 at 530 [43]; 243 ALR 1 at 13; [2008] HCA 7.

120 *Kingston v Keprose Pty Ltd* (1987) 11 NSWLR 404 at 423-424; *Bropho v Western Australia* (1990) 171 CLR 1 at 20; [1990] HCA 24; *Project Blue Sky* (1998) 194 CLR 355 at 381-382 [70].

121 See *Acts Interpretation Act* 1901 (Cth), s 15AB. See also *Cooper Brookes* (1981) 147 CLR 297 at 321; cf Hill, "A Judicial Perspective on Tax Law Reform", (1998) 72 *Australian Law Journal* 685 at 688-689.

- The appreciation that income tax legislation, although having some special features, is not to be isolated from general interpretative trends, such as those described above[122].

130 A narrow approach to sham thus prevails in Australia. This was affirmed in the recent decision of this Court in *Equuscorp*[123]. That was a case where investors, alleged to have entered improvident loan agreements for the purpose of obtaining tax deductions, themselves later sought to avoid enforcement of the agreements on the basis of sham, giving evidence of earlier oral agreements to limit the operation of the written documents. They submitted that the transactions involved no true loans because no "real money" was ever actually lent.

131 This Court held that, having executed the written loan agreements, the investors were bound by them in the absence of proof of their invalidity or of rectification of the written documents. Although the primary judge in *Equuscorp* (Helman J) had concluded that the agreements were "book entries … made to create an 'audit trail'" resulting in transactions that were a sham, in the sense of "a complete artifice or facade" or a "charade"[124], this Court held that each of the written agreements was legally effective on its face and not a sham. The Court said[125]:

> "'Sham' is an expression which has a well-understood legal meaning. It refers to steps which take the form of a legally effective transaction but which the parties intend should not have the apparent, or any, legal consequences[126]."

132 To the complaint that no "real money" had been lent (in the sense of no actual capital being brought into the partnership), and that there had therefore been no "loan", this Court said[127]:

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122 *Federal Commissioner of Taxation v Ryan* (2000) 201 CLR 109 at 146 [84]; [2000] HCA 4.

123 (2004) 218 CLR 471.

124 *Equuscorp Pty Ltd v Glengallan Investments Pty Ltd* [2001] QSC 464 at [28]-[29].

125 (2004) 218 CLR 471 at 486 [46].

126 *Sharrment* (1988) 18 FCR 449.

127 (2004) 218 CLR 471 at 487 [48].

> "As the expression 'real money' might suggest, the point which the respondents sought to make in these matters appeared to be one about the economic rather than the legal effect of the transactions in question."

133 *Equuscorp* thus stands for the proposition that, where parties express their rights and obligations in what appear to be binding legal instruments, courts will accord such instruments their purported legal effect, according to their tenor, even if the transactions described do not appear to "have been commercially sensible"[128] (that is, entered into with an economic motive in mind other than tax avoidance).

134 However, *Equuscorp* does not deny the existence of sham as a legal category. On the contrary, this Court expressly accepted that sham has a well-understood legal meaning, and that whether a sham is established or not depends on whether the parties intend their respective rights and obligations to derive from what appears to be a legal instrument.

135 It could hardly be supposed that *Equuscorp* had written the sham classification out of revenue law in Australia. The place of sham in legal analysis has been acknowledged since the early days of this Court[129]. Its continuing relevance has been repeatedly recognised over the years[130]. There is thus no reason for this Court to avoid either the concept or the word. The word "sham" derives from Old English. It may probably be traced to the same root as the similar Old English word "shame", with which its core notions of duplicity and deceit are connected[131]. One of its dictionary meanings ("something that is not what it purports to be"[132]) is the primary meaning assigned to it by current legal doctrine in Australia.

136 It follows that it is perfectly proper for Australian courts, and other decision-makers, to invoke the concept of sham in legal analysis, as acknowledged in *Equuscorp*. It may be helpful in revenue cases so long as the need for *intentional* deception is kept in mind. And because what is intended, in

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128 (2004) 218 CLR 471 at 488 [53].

129 See eg *Jaques v Federal Commissioner of Taxation* (1924) 34 CLR 328 at 358 per Isaacs J; [1924] HCA 60.

130 See eg *Scott* (1966) 40 ALJR 265 at 279 per Windeyer J.

131 *The Shorter Oxford Dictionary*, 3rd ed (rev) (1965), vol 2 at 1863-1864. In Dr Johnson's *Dictionary of the English Language*, (1755), "sham" is defined as "[f]alse; counterfeit; fictitious; pretended".

132 *The Macquarie Dictionary*, Federation edition (2001) at 1731.

the context of a sham, may itself be disguised, the objective facts are by no means irrelevant. They may assist to prove the relevant intention of the participants where (as will usually be the case) a forthright admission by those who have resorted to the sham is lacking.

The utility and content of sham in legal analysis

137 *Utility of sham analysis*: The foregoing survey demonstrates that the use of the notion of sham in legal analysis, including in revenue cases, is to some extent controversial. In the opinion of some, it is merely a conclusory label. For others, it is irrelevant and likely to mislead.

138 On the other hand, as noted above, this Court has recognised that the concept of sham has a "well-understood legal meaning"[133]. Where that meaning is applicable, invocation of the expression is preferable to the use of other descriptive words with no necessary legal consequence, such as "charade", or "facade", or "artifice". It is not useful to state that "in the present litigation" it is legitimate to use the word "sham" in a "less pejorative" sense than that indicating fraud unless consideration is given to the meaning and outer limits of the concept which that word indicates[134].

139 The challenge is to give the word "sham" more precise content, and to confine its use to cases that fit within the resulting definition. Mr Malcolm Gammie is right to conclude that there is only a "limited scope for the sham concept in a straightforward contractual dispute"[135]. In such a case, more useful tools of legal analysis, and more appropriate relief, may often be found by invoking remedies of rectification[136], the doctrine of *non est factum*[137] and invalidation for deceit.

140 The particular utility of sham analysis, especially in revenue cases, is that it permits courts to send a clear signal that they will not be deceived into giving effect to unreal transactions, just because such transactions are expressed in

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133 *Equuscorp* (2004) 218 CLR 471 at 486 [46].

134 cf joint reasons at [36].

135 Gammie, "Sham and Reality: the Taxation of Composite Transactions", (2006) *British Tax Review* 294 at 312.

136 Bright, "Beyond Sham and into Pretence", (1991) 11 *Oxford Journal of Legal Studies* 136 at 140, fn 33.

137 Conaglen, "Sham Trusts", (2008) 67 *Cambridge Law Journal* 176 at 202.

documents that, to a greater or lesser extent, observe legal forms and give effect to apparent legal objectives.

141 Dr Matthew Conaglen points out that, in the course of conventional legal analysis, courts ordinarily feel obliged to interpret documents according to the meaning that they "would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract"[138]. Evidence concerning previous negotiations, declarations of subjective intent and the parties' subsequent conduct is normally excluded from consideration. Where sham is invoked, however, examination of such evidence may be required. Dr Conaglen explains[139]:

> "[T]he relevance of the sham doctrine is that it justifies the court in stepping outside of the normal construction process in order to ascertain 'the truth of the matter' by reference to material which would normally be excluded as irrelevant to that process."

142 In other words, where it is legally warranted, sham analysis affords the court a ground for ignoring, instead of merely construing, the primary documentary material in determining the rights and obligations of the parties[140]. It follows that the prerequisites for sham analysis are important because they provide a filtering process by which courts may decide which cases are to be dealt with *outside* the normal rules of documentary construction and which must be decided *within* those rules. An important policy justification for this approach is that it helps to ensure that "the normal rules of construction are not circumvented without justification"[141].

143 Without recourse to otherwise excluded materials, a sham transaction might achieve the purposes behind the parties' conduct and documentation. The fact that sham transactions normally involve an element of deceit will ordinarily support a conclusion that cases of sham can be set apart from the remedy of

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138 Conaglen, "Sham Trusts", (2008) 67 *Cambridge Law Journal* 176 at 180 citing *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896 at 912 per Lord Hoffmann; [1998] 1 All ER 98 at 114.

139 Conaglen, "Sham Trusts", (2008) 67 *Cambridge Law Journal* 176 at 182.

140 cf joint reasons at [33].

141 Conaglen, "Sham Trusts", (2008) 67 *Cambridge Law Journal* 176 at 182.

rectification[142]. In such circumstances, this will also provide a strong ground for the application of the label of sham to the proved acts and documents.

144 *Content of sham analysis*: Although, therefore, courts will ordinarily give legal effect to documents according to their language, sham analysis is an exception to that conventional approach. That is why it requires exceptional circumstances to enliven a conclusion that documents and acts amount to a sham, with the legal results that such a conclusion justifies.

145 The key to a finding of sham is the demonstration, by evidence or available inference, of a disparity between the transaction evidenced in the documentation (and related conduct of the parties) and the reality disclosed elsewhere in the evidence. Where, for example, the evidence shows a discordance between the parties' legal rights or obligations as described in the documents and the actual intentions which those parties are shown to have had as to their legal rights and obligations, a conclusion of sham will be warranted[143].

146 The test as to the parties' intentions is subjective[144]. In essence, the parties must have intended to create rights and obligations different from those described in their documents. Such documents must have been intended to mislead third parties in respect of such rights and obligations[145].

147 Where a court is considering a suggestion of sham that has a reasonably arguable evidential foundation, the court will not be confined to examining the propounded documentation alone. It may examine (and draw inferences from) other evidence, including the parties' explanations (if any) as to their dealings, and evidence describing their subsequent conduct[146].

148 To justify a conclusion that documents constitute a sham, the requisite intention to mislead must be a common intention of the parties[147]. An exception may exist where the acts and documents reflect a transaction divisible into

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142 cf Bright, "Beyond Sham and into Pretence", (1991) 11 *Oxford Journal of Legal Studies* 136.

143 *Snook* [1967] 2 QB 786 at 802.

144 *Snook* [1967] 2 QB 786 at 802; *Hitch* [2001] STC 214 at 230 [66].

145 *Hitch* [2001] STC 214 at 230 [66].

146 *Hitch* [2001] STC 214 at 230 [65]; *Sharrment* (1988) 18 FCR 449 at 461.

147 *Snook* [1967] 2 QB 786 at 802; *Hitch* [2001] STC 214 at 230 [69].

separate parts, such that a transaction is a sham as to part only of the transaction[148].

149 Neither the complexity nor the artificiality of a transaction[149], nor any circularity evident in it[150], nor the apparent lack of commercial or economic sense[151] will of themselves, alone or in combination, necessarily warrant a conclusion that a transaction constitutes a sham[152]. Nor does a departure by the parties from the terms of their original agreement necessarily indicate that they never intended that agreement to be effective and binding according to its tenor[153]. Nevertheless, a sham can develop over time if there is a departure from the original agreement and the parties knowingly do nothing to alter the provisions of their documents as a consequence[154].

150 *Sham as a tool of analysis*: When the foregoing considerations are kept in mind, it is obvious that the analysis of documentation by reference to such criteria can be useful so long as it is remembered that the focus is upon the mutual intentions of the parties as to their respective rights and obligations. The focus is not, as such, upon an assessment of the "broad substance of the transaction measured by the results intended and achieved or of the overall economic consequences"[155].

151 It follows that the primary value of sham analysis is that, where justified, it may rescue the decision-maker from being led by the nose into the artificial task of defining the legal rights and obligations of the parties by reference to their proved documents and related conduct alone, where extrinsic evidence

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148 See New Zealand Commissioner of Inland Revenue, "Sham – meaning of the term", (1997) 9(11) *Tax Information Bulletin* 7 at 7-8.

149 *Sharrment* (1988) 18 FCR 449 at 454-455; *Oakey Abattoir* (1984) 55 ALR 291 at 297.

150 *Sharrment* (1988) 18 FCR 449 at 458.

151 See *Case X10* (2005) 22 NZTC 12,155 at 12,171 [116].

152 cf *Accent Management* [2007] NZCA 230 at [59].

153 *Hitch* [2001] STC 214 at 230 [68].

154 See *Marac Finance Ltd v Virtue* [1981] 1 NZLR 586 at 588.

155 *Marac Life Assurance Ltd v Commissioner of Inland Revenue* [1986] 1 NZLR 694 at 706 per Richardson J.

demonstrates that they constitute a sham and were not intended to be effective or have their "apparent, or any, legal consequences"[156].

152 For a court to call a transaction a sham is not just an assertion of the essential realism of the judicial process, and proof that judicial decision-making is not to be trifled with. It also represents a principled liberation of the court from constraints imposed by taking documents and conduct solely at face value. In this sense, it is yet another instance of the tendency of contemporary Australian law to favour substance over form. As such it is to be welcomed in decision-making in revenue cases.

Conclusion: sham established, transaction ineffective

153 When the foregoing principles are given effect in this appeal, the present was a case where it was clearly open to the primary judge to conclude, as she did, that arrangements described in the impugned written documents amounted to a sham.

154 The primary judge made findings as to the intentions of the participants. There was no error in those findings. To the contrary, her findings were fully sustained by the evidence. They reflected sensible and rational inferences drawn from that evidence. They supported the primary judge's conclusion that a sham was demonstrated.

155 In the Full Court, Edmonds J departed from the primary judge's findings by deciding that the nomination of the trustee of the E & M Unit Trust as a "tertiary beneficiary" of the Raftland Trust was not a sham[157] and that, consequently, the trustee of the E & M Unit Trust was entitled to the whole of the trust income of the Raftland Trust for the taxation years ended 30 June 1995, 1996 and 1997. In so deciding, Edmonds J and the Full Court erred. Focusing on the state of mind of the Herans' solicitor, Mr Tobin, did not demonstrate that the findings and conclusion of the primary judge were wrong. Whatever may have been the purpose of the professional adviser, the proper subject of attention was the intention of the parties with regard to the impugned transaction. It was with this in mind that the primary judge correctly addressed the question that she had to decide.

156 The conclusion of the primary judge as to the common intention of the parties ought not to have been disturbed. There was no demonstrated or proper ground for such disturbance. Because of the reimbursement agreement,

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156 *Equuscorp* (2004) 218 CLR 471 at 486 [46].

157 (2007) 65 ATR 336 at 359 [83].

s 100A(1) of the Act applied in relation only to the primary beneficiaries. Section 100A(3A) did not apply to the primary beneficiaries because they were not trustees.

157 The analysis of the primary judge was therefore correct. It should be restored. And this Court should not be diffident to invoke the tool of reasoning that sham provides in cases of this kind. Nor should it be hesitant in utilising the word "sham" when explaining its reasons. So long as the legal preconditions are established, the decision-maker should call a spade a spade – and a sham a sham.

158 If the documents evidencing a transaction are shown to be intentionally deceptive, false and misleading, they are "inherently worthless, and … no enactment [is needed] to nullify [the transaction]"[158]. In other words, when the documents amount to a sham, they are ignored. They fail to achieve their purported objectives. The law then gives consequence to the true transactions, as revealed by the evidence – just as the primary judge did in this case.

159 There is an orthodox approach to sham, accepted and expressed in Australian legal doctrine, as in the law of other, similar jurisdictions. There have also been suggestions of the emergence of a broader approach to the notion of sham, particularly in revenue cases. I accept that the "narrower" approach to sham, explained by this Court in *Equuscorp*, is applicable to this case. It was correctly applied by the primary judge. However, in my view, the idea of sham could be broadened somewhat. Doing so would not cut across the language and purpose of the explicit tax avoidance provisions enacted as Pt IVA of the Act. On the contrary, such an approach would be compatible with that contained in Pt IVA and the purposes that led to the enactment of that Part. It would demonstrate, once again, that in the present age, the doctrines of the common law evolve in the orbit of statute[159].

Orders

160 The orders of the primary judge should be restored. I agree in the orders proposed in the joint reasons.

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158 *Jaques* (1924) 34 CLR 328 at 358 per Isaacs J.

159 cf *Roads and Traffic Authority v Royal* [2008] HCA 19 at [93].

161 HEYDON J. The circumstances are set out in the judgment of Gleeson CJ, Gummow and Crennan JJ.

162 The central question is whether the Tertiary Beneficiary under the Raftland Trust Deed was "presently entitled" to the income of the Raftland Trust in the tax year ended 30 June 1995 within the meaning of s 100A of the *Income Tax Assessment Act* 1936 (Cth).

163 The Heran interests – that is the brothers Brian, Martin and Stephen Heran – being the principals of the Heran group of companies, which were profitable, desired to obtain the benefit of tax losses incurred by the E & M Unit Trust and to obtain control of the E & M Unit Trust. The principals of the E & M Unit Trust, Mr and Mrs Thomasz – the Thomasz interests – desired to gain whatever financial advantage they could out of the transfer of control. The solicitor for the Heran interests, Mr Tobin, devised a plan to effectuate these desires, and prepared the documents thought necessary to implement them.

164 The Raftland Trust was created by a Deed executed by the Settlor, Mrs Sommerville, on 30 June 1995. It was executed in the presence of, and witnessed by, Mr Tobin.

165 The Trustee, who was not party to the Raftland Trust Deed, was Raftland Pty Ltd. The directors of Raftland Pty Ltd were the three Heran brothers. The shareholders of Raftland Pty Ltd were Brian and Stephen Heran. The three brothers were the Primary Beneficiaries of the Raftland Trust, and various of their relatives and associated entities were the Secondary Beneficiaries.

166 Clause 1(u) and the Schedule of the Raftland Trust Deed appointed the Trustee of the E & M Unit Trust as a Tertiary Beneficiary of the Raftland Trust. In the events which happened, the effect of cl 3(b) was that if by 30 June 1995 the Trustee of the Raftland Trust had not decided to pay out or accumulate the income of the Trust Fund for that year, it was to be held in trust for the only Tertiary Beneficiary – the Trustee of the E & M Unit Trust. On 30 June 1995 the directors of Raftland Pty Ltd passed a resolution proposing that in its capacity as Trustee of the Raftland Trust it distribute as income an amount of $250,000 to Mr Carey as Trustee of the E & M Unit Trust. On the same day those directors also passed a resolution that Raftland Pty Ltd, in its capacity as Trustee of the Raftland Trust, distribute the balance of its income to Mr Carey as Trustee of the E & M Unit Trust.

167 The appellant's case was that if matters stood there, contrary to the assessment made by the respondent, the sum of $2,849,467 would not have been taxable in the hands of Raftland Pty Ltd, the Trustee of the Raftland Trust, because it had no present entitlement to it. It would have had no present entitlement to it because the Trustee of the E & M Unit Trust would have had a present entitlement under the Raftland Trust Deed.

168 However, the respondent contended that matters did not stand there. It contended that the following three things should be "disregarded". The first was the Raftland Trust Deed so far as it appointed the Trustee of the E & M Unit Trust as a Tertiary Beneficiary of the Raftland Trust (cl 1(u) and the Schedule). The second was the first resolution on 30 June 1995. The third was the other resolution passed that day.

169 It may be inferred that, so far as the intention of the Settlor, Mrs Sommerville, was relevant, that intention was to be found in the minds of the Heran brothers, the principals of Mr Tobin, who was Mrs Sommerville's employer. So far as the intention of the Trustee, Raftland Pty Ltd, was relevant, the same was true in view of its directors and shareholders. In assessing that intention any evidence by Mr Tobin, the architect of the transactions, could be taken into account, particularly if it were adverse to the interests of his principals. It may also be inferred that the intention of Mr Carey as Trustee of the E & M Unit Trust was the intention of Mr and Mrs Thomasz, the controllers of that Trust, and that that intention was the same as that of the Heran brothers.

170 The trial judge made the following findings. The Heran interests desired to obtain control of the E & M Unit Trust, with its carried forward losses. The Thomasz interests desired to relinquish that control for the price of $250,000. The Heran interests did not desire to benefit the E & M Unit Trust to any extent greater than $250,000. The Thomasz interests had neither any expectation of that benefit nor any intention of seeking it: any risk that the unit holders of the E & M Unit Trust might require the Trustee of that Trust to seek payment of the income of the Raftland Trust pursuant to cl 3(b) of the Raftland Trust Deed was "commercial" only – a risk of no significance, "little more than a mere possibility". Hence both the Heran interests and the Thomasz interests did not contemplate that there would be any distributions of income from the Raftland Trust, and the only payment to pass from the former interests to the latter was to be the $250,000 payable as the price for control of the E & M Unit Trust.

171 Those findings are crucial to considering the question of whether, as at 30 June 1995, the Trustee of the E & M Unit Trust had a present entitlement to the income of the Raftland Trust.

172 A person of full capacity who has a present beneficial entitlement to trust income can vindicate that entitlement by curial action, and a person of full capacity who cannot do that has no present beneficial entitlement. The position in relation to the income of the Raftland Trust thus may be tested by posing a hypothetical inquiry. As shown below, if the event hypothesised took place, criticism of the Trustee of the E & M Unit Trust would be merited. Accordingly, it is desirable to stress that the event hypothesised has never happened and is never likely to happen. The inquiry is: had the Trustee of the E & M Unit Trust sued the Trustee of the Raftland Trust for the income of the Trust in its operation

for the year ended 30 June 1995, pursuant to cl 3(b) of the Raftland Trust Deed, what answer could the Trustee of the Raftland Trust have made?

173 It does not appear possible for the Trustee of the Raftland Trust to answer that there was a "sham" in the sense of a transaction aimed at deceiving third parties. The trial judge did not make a finding to that effect, and does not seem to have been explicitly invited to do so. In these circumstances it would be difficult in this Court to make that finding in this case.

174 In some cases it would be possible to hold that a beneficiary apparently entitled under a trust was not presently entitled because that beneficiary had contracted to give up the relevant beneficial interest in whole or in part. That is an unlikely analysis for the Trustee of the Raftland Trust to proffer here, because it is difficult to find any consideration flowing to the E & M Unit Trust or from any other party for that contract. In any event it is erroneous to characterise the parties' dealings as first causing beneficial interests to spring up in the Tertiary Beneficiary and then leading to a contract in which the Tertiary Beneficiary gave up those beneficial interests: the question is rather whether their dealings, despite the form of cl 3(b) of the Raftland Trust Deed, prevented any beneficial interest arising at all.

175 For the same reason it would not be possible for the Trustee of the Raftland Trust to contend that the Tertiary Beneficiary had waived its beneficial interests. "'Waiver' implies that you have something, and that you are throwing it away."[160] On the trial judge's findings of fact, the question is rather whether the Tertiary Beneficiary as such ever had anything.

176 Nor, if the Trustee of the E & M Unit Trust insisted on its apparent rights under the Raftland Trust Deed, is the case one where rectification is available to forestall that claim. Rectification is a remedy granted where the parties are in complete agreement as to the terms of their dealings, but by an error wrote them down wrongly. Here they were in complete agreement, and one of the terms of that agreement was that in part they be written down as they were written down in the Raftland Trust Deed.

177 However, the Trustee of the Raftland Trust could give an answer in the words which Lord Selborne LC, James and Mellish LJJ used in *Jervis v Berridge*[161]. It is not the case that cl 3(b) of the Raftland Trust Deed was

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160 Ewart, *Waiver Distributed*, (1917) at 13.

161 (1873) LR 8 Ch App 351 at 359. The passage was quoted with approval by Hope JA in *Air Great Lakes Pty Ltd v K S Easter (Holdings) Pty Ltd* (1985) 2 NSWLR 309 at 318.

"valid and operative between the parties, but omitting (designedly or otherwise) some particular term which had been verbally agreed upon". Rather it was "a mere piece of machinery obtained by the [Heran interests] from the [Thomasz interests], as subsidiary to and for the purposes of the verbal and only real agreement, under circumstances which would make the use of it for any purpose inconsistent with that agreement dishonest and fraudulent."

178 A court of equity, asked by a person claiming a present beneficial entitlement under a purported trust to enforce it, would not do so if that attempted enforcement of the purported trust would be dishonest and fraudulent. That is the position in which the Trustee of the E & M Unit Trust would be if an attempt to enforce cl 3(b) had been made. If the Thomasz interests acting through the Trustee of the E & M Unit Trust could not use cl 3(b) of the Raftland Trust Deed to claim a present entitlement to the income of the Raftland Trust, it follows that they did not have that entitlement.

179 The conclusion of the Full Court of the Federal Court cannot stand with the findings of the trial judge, and those findings have not been shown to be wrong. While in one sense the Full Court was correct to say that the nomination of the Trustee of the E & M Unit Trust as a Tertiary Beneficiary of the Raftland Trust was at the forefront of the intentions of those who established the Raftland Trust, their intentions taken as a whole were inconsistent with the existence of any capacity in the Trustee of the E & M Unit Trust to enforce a beneficial entitlement, and that Trustee did not have a beneficial entitlement.

180 It follows, as the respondent submitted, that the nomination of the Trustee of the E & M Unit Trust as a Tertiary Beneficiary of the Raftland Trust should be "disregarded". It further follows that the two resolutions of the directors of Raftland Pty Ltd on 30 June 1995 purporting to distribute the income of the Raftland Trust to the Trustee of the E & M Unit Trust as a Tertiary Beneficiary should also be disregarded. There having been no payment of income to the Secondary Beneficiaries, the proviso to cl 3(b) has the result that Raftland Pty Ltd held the income on trust for the Primary Beneficiaries within the meaning of s 100A.

181 On other issues I agree with Gleeson CJ, Gummow and Crennan JJ, and with the orders they propose.