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The quandries of the tax adviser

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Today's tax adviser is often faced with many unenviable quandaries. To understand why this is so is an essential precondition to developing a view on how a tax adviser should best approach the role of giving advice to a client, to best assist that client.

Our society is modern, sophisticated and complex. Recently, there has been extra-ordinary proliferation in the quantity and complexity of problems associated with statutory enactments and other related subordinate instruments. This phenomenon is particularly acute with the recent explosion of legislation, explanatory memoranda, rulings and other relevant materials which impact on the taxation affairs of Australians.

To make my point, there is no need for me to take you back to the late 1960s when I commenced legal practice, when the Income Tax Assessment Act was some two or three hundred pages long and accompanied by little in the way of subordinate legislation or rulings. It is sufficient simply to describe what has happened since 1996. Over a period of six years to 2002, the quantity of our tax legislation has more than doubled, increasing by some 5,000 pages. This is a staggering figure. This alone has made the tax system virtually unmanageable, both for tax advisers and also for the Tax Office.

And the quantity of tax legislation is not the only issue. Sad as it is true, its quality is nothing short of appalling. Convoluted and obscure, much of it is unintelligible even to tax experts. Some parts of the legislation are so incomprehensible that they have simply not been applied, either by tax advisers or the tax office.

The tax system is now in danger of total collapse, having reached a point where its nature seriously risks inconsistency with the rule of law in a modern democratic society.

Interestingly, the former Chief Justice of the High Court, Sir Harry Gibbs, in a paper delivered on 5 May 1993, in discussing tax reform, pointed out that:

"An important part of any reform would be to modify the objectionable provisions which are directed at tax avoidance, and in particular those that give the Commissioner a discretionary power to override other provisions of the Act. Provisions such as those of Part IVA themselves amount to abandonment of the rule of law, and the fact that so important a system of legislation is enforced in this way tends to undermine respect for the law generally."

Those words from Sir Harry Gibbs resonate today with even more force than they did when they were first uttered nearly 10 years ago.

The mischief which flows from our dysfunctional tax laws is compounded by the self assessment regime which, in effect, says this to taxpayers – *"It does not matter that major parts of the law are unintelligible or incomprehensible, it is your job to get it right. If you are uncertain about the correct treatment of a particular transaction, then we will provide you with a tax ruling; however, if the transaction is complex, then such a ruling might not issue for many months."*

The Tax Office would then explain that, in the past, it had been prepared to issue informal advice, but now will only do so in exceptional circumstances because advance opinions and private rulings were abused in earlier years. In other words, the onus is really on the taxpayer to get it right.

But it goes so very much further than this. There are additional distinguishing features which make disputes between the Commissioner of Taxation and taxpayers quite unlike commercial disputes between private litigants. First, in tax law, the burden of proof is reversed. Once a Tax Office assessment is issued, the burden is on the taxpayer to demonstrate that it is excessive. Secondly, the penalty regime is quite draconian. If the taxpayer gets it wrong, then the general interest charge is likely to be set at a rate which is close to being double the commercial rate. And, where Part IVA applies, there is an additional automatic penalty of 25%, even if the taxpayer's case is more than reasonably arguable. Finally, any tax assessed becomes payable shortly after the issue of an assessment – and it may take years until a tax dispute is finally resolved by the courts, leaving the taxpayer both out-of-pocket and in a state of considerable uncertainty.

So, with these ever present quandaries, what is the role of the tax lawyer and how does he or she give meaningful tax advice – or at least the best possible tax advice – to the client?

Tax law is becoming highly specialized. The days of the tax generalist are all but gone. Even the specialists risk not having a detailed knowledge of all of the tax law within their specialty areas. But it is essential that a tax adviser is sufficiently familiar with the tax laws generally to be able to identify the critical tax issues which are likely to arise in any given set of circumstances on which advice is being sought.

Once those issues have been identified, the appropriate tax consequences can be researched and resolved.

Traditionally, the role of the lawyer is to seek a client's instructions on the relevant facts and proposals and then to give advice on the law's application. But to suggest that this is an accurate description of a tax lawyer's role is essentially to propagate a fiction. Except in those rare circumstances where the application of the law is clear, the client will really be looking for a sophisticated form of risk assessment and general guidance from a tax adviser. The client will want to know the following:

- (a) How likely is it that the Tax Office will challenge the client's proposed tax treatment of a particular transaction?
- (b) If the Tax Office does so challenge, how likely is it that it will be possible to settle the dispute with the Tax Office on reasonable terms and conditions?
- (c) If a dispute proceeds to litigation, how likely is it that a Full Federal Court or, if special leave is given, the High Court, will decide in favour of the taxpayer. Here, two things in particular should be noted. First the reference is to a Federal Court as distinct from the Federal Court because a Full Court of the Federal Court can be constituted by different judges and this may have an impact on the outcome. Second, making a judgement on what a court is likely to decide if a matter comes before it is quite distinct from seeking an opinion of what the law is.
- (d) What is the potential downside for the client if a dispute with the tax office is lost, in terms of interest, penalties and any promoter's fees?

A principal issue then is the likelihood of the Tax Office mounting a challenge to the tax consequences said to flow from a particular transaction or arrangement. In making such an assessment, it is important to understand that, whatever the theory, in practice, the Tax Office does not sit back objectively, simply look at the facts and then apply the law. Rather, it sees its role as the protector of the revenue. The Tax Office's primary concern will be to ensure that there are no unacceptable leakages of revenue which occur in a manner which is not consistent with its view of government policy. This is why the Tax Office has a particular sensitivity to what it describes as aggressively mass marketed so called tax effective arrangements.

A few examples well illustrate my point. The Tax Office has, for some time, been attacking mass marketed arrangements involving split loans where tax deductible interest has been capitalised to accelerate the repayment of the private part of the loan, thereby maximising income tax deductions. These arrangements were the subject of an adverse tax ruling (TR 1998/22) in 1998. The Commissioner successfully challenged these arrangements in Hart's case before Justice Gyles of the Federal Court on 2 November 2001, but was very recently unsuccessful on appeal to the Full Federal Court, on 26 July 2002.

My own personal view is that this is not the type of scheme that Part IVA was directed against and that it would not have been challenged by the Commissioner of Taxation had it been an individual arrangement entered into by a taxpayer, as distinct from being part of a mass marketed exercise with a potentially substantial adverse impact on the revenue.

Indeed, I know of many individual variations on this type of arrangement, entered into in isolated instances, which have not been subject to challenge by the Commissioner of Taxation.

When asked by a client, at an early stage, and before the Tax Office's view was known, whether he should enter such an arrangement, I advised that, in my view, it was most likely that the arrangement would be unsuccessfully challenged by the Tax Office. However, I also advised that there was room for differences of opinion and much would depend on the constitution of the Federal Court hearing the matter and whether or not the High Court gave special leave to appeal.

On the other hand, if all that the client had wanted to know was my opinion on the applicable law, I would have advised him, quite simply, that, in my view, Part IVA should have no application to the arrangement. Unfortunately, too many tax lawyers have given advice in this way in response to requests from clients. Surely clients deserve more meaningful and practical advice.

Another example is the Tax Office's approach to capital protected products where the Commissioner has sought to disallow a deduction in respect of that proportion of the interest which had been paid to gain the benefit of the limited recourse feature of each relevant loan. The Commissioner was unsuccessful in the Federal Court in Firth's case [2002 FCA 413], both at first instance and before the Full Federal Court. Again, I doubt very much that the Commissioner would have attacked the arrangement had it been a "one off" as distinct from participation in a mass marketed product.

The Commissioner of Taxation's attitude to the mass marketing of equity linked bonds and security lending arrangements is again clearly attributable to his perception of his role in protecting the revenue.

In judging whether an arrangement is likely to be challenged by the Commissioner, there are other factors which also need to be taken into account. Depending on the state of political play, the Commissioner will want to be seen as coming down tough on the top end of town and on high wealth individuals, particularly in circumstances where he is busy attacking mums and dads on work related expense claims, in order to demonstrate that the tax system is operating fairly.

Of course, this overlooks the fact that those who are categorized as high wealth individuals are subject, in effect, to almost continuous audit by reason of the way in which their affairs are scrutinized by the Tax Office. Obviously, this level of scrutiny will impact on high wealth individuals in assessing the likelihood of relevant arrangements being detected and challenged by the Commissioner.

It is almost certain that a challenge will be mounted when the Tax Office has a publicly articulated approach towards a particular type of arrangement under consideration. But, to be fair to the Commissioner, in cases where the law is framed in a way which fairly obviously, and in a manner adverse to the interests of taxpayers, does not reflect the Tax Office's understanding of government policy, the Commissioner will frequently adopt a benign attitude.

Much of this will be equally relevant to assessing the basis upon which a dispute with the Tax Office might be expected to settle. It is most unlikely that the Commissioner will settle an arrangement which he has identified as a mass marketed arrangement other than in accordance with Tax Office guidelines.

But, whether disputes which do not concern mass marketed schemes are capable of being satisfactorily resolved, other than through litigation, will depend on a number of factors. These include the amount of revenue at risk; Tax Office resources available to litigate; whether the proposed settlement provides a reasonable outcome in terms of government policy; the impact of any proposed settlement on future compliance by the taxpayer concerned; and the flow on effect that the settlement is likely to have in relation to other taxpayers.

Setting all of this to one side, it is my contention that those tax advisers who have created the most mischief, who have played a key role in facilitating the successful mass marketing of dubious tax schemes and who have been largely responsible for destabilizing our tax system, are the advisers who have been providing misleading and largely useless pieces of advice to taxpayers who really deserved better.

It is these tax advisers who have been a key factor in the proliferation of the mass marketed agricultural schemes, the controlling superannuation schemes and other similarly dubious tax driven arrangements.

Generally, the advice they have given has been framed in terms of their opinions of the proper application of the relevant provisions of the Income Tax Assessment Act. By and large, those opinions contained no qualitative assessment of the risk of different views being adopted by a Federal Court or the High Court. There was generally nothing in them from which clients could discern whether the opinions were delicately balanced or whether they represented a high degree of certainty in the context of the law's application. There was generally no discussion of the likely attitude of the Tax Office, the potential penalties, immediate demands for payment of tax in dispute, or the financial impact of substantial unrecoverable promoters' fees having been paid for no return.

All too frequently in the past, tax advice has been given from sitting "under a palm tree" in this way. Tax advisers, whether they be solicitors, barristers or accountants, need to understand precisely what it is that their clients are looking for when they seek advice, and to respond to that need.

In this area of the law, particularly when the so-called "smell test" is applied to any arrangement, instinct and experience really count. It is also important to know who to speak to at the Tax Office and when to "escalate" a particular issue to ensure a fair outcome.

During the last few years, particularly from 1995 to 1998, innumerable schemes came across my desk. I advised my clients against participating. I trust you now understand why I gave that advice.

In addition, following the High Court decision in *Spotless*, in Part IVA the Commissioner possesses a powerful weapon to counter tax minimization arrangements. It is one thing to consider that Part IVA is inapplicable in a particular case. It is quite another to be able to advise confidently that there is no significant risk of a court adopting a different view. Furthermore, the circumstances of the marketing of a particular scheme may substantially increase the likelihood of the Commissioner being able to invoke successfully the provisions of Part IVA. Clients are entitled to a balanced assessment of all risks. All too frequently, in the past, they haven't received it.

In the past also, through a combination of inaction and incorrect rulings, the Tax Office unwittingly aided the development of an industry dedicated to the mass marketing of aggressive tax minimization arrangements. But it would be wrong to blame the Tax Office alone. In large measure, the flourishing of these arrangements can be directly attributed to bad professional advice.

To be fair, the Tax Office has clearly learned some valuable lessons from its failure to act pre-emptively and pro-actively when required. It has taken those lessons to heart.

I would also like to think that, by now, most tax practitioners will have developed a clearer insight into what it means and how to deliver sound, competent and balanced professional advice to clients.

Thank you.

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This publication is intended to provide a general outline and is not intended to be a complete or definitive statement of the law on the subject matter covered. Further professional advice should be sought before any action is taken in relation to the matters described in this publication.

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