Chapter 24

ANTI-AVOIDANCE PROVISIONS

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A case for reform

There is over-reliance on specific anti-avoidance provisions

24.1 Overall, tax avoidance and evasion have an adverse effect on incentive through their effects on the level of tax required from complying taxpayers. They run counter to the objective, expressed in the Review's terms of reference, of lowering the company tax rate.

24.2 Specific anti-avoidance provisions have been added continually to the law seeking to prevent taxpayers being able to take advantage of gaps and flaws in the tax law. This continual growth in the number of specific anti-avoidance measures has added to complexity and compliance costs.

24.3 Reliance on specific anti-avoidance provisions is a poor substitute for addressing structural flaws in the law. Anti-avoidance provisions often have a broader application than originally intended, thereby increasing taxpayer uncertainty. They, themselves, create further avoidance opportunities.

A strategy for reform

Adopt a more systematic approach to dealing with avoidance issues

24.4 Tax law that was developed consistently with the policy, legislative and administrative design principles in *A Strong Foundation* would provide a fair, non-distorting system with integrity. Particularly relevant in this regard are the principles concerning taxation of comprehensive income, economic substance over form, policy transparency and anti-avoidance provisions.

24.5 With full adherence to such principles, general anti-avoidance provisions would handle blatant avoidance activities. The structure and design of the law would subsume the need for specific anti-avoidance provisions. Cost of compliance and complexity in the application and administration of the code would be significantly reduced. Taxpayers would respond by entering into transactions and arrangements on the basis of their economic substance. Perceived tax incentives to enter into contrived and artificial arrangements would be removed.

24.6 In practice, full adherence to these principles is not possible. Thus, some specific anti-avoidance provisions are inevitably required. A rigorous and disciplined approach to assessing the need for such provisions is, however, necessary to avoid repetition of current problems.

24.7 A systematic evaluation of the need for specific anti-avoidance provisions would identify problem areas and establish whether structural solutions are available to address the structural flaws that are likely to underlie those problems.

24.8 Options outlined in Chapters 15 to 23 aim to correct some of the structural flaws that have given rise to the current anti-avoidance provisions. Consideration of those options provides an opportunity to revisit the current anti-avoidance provisions, and other areas of possible concern, to determine whether specific anti-avoidance provisions are needed.

24.9 Such an evaluation should be part of a better structured approach to dealing with avoidance issues, including through a reformed, robust general anti-avoidance provision, and achieving integrity via sound design principles.

24.10 This approach is consistent with the announcement in *A New Tax System* that the general anti-avoidance rules are to be modernised and that a review would be undertaken to identify those specific anti-avoidance provisions that can be either removed or consolidated and harmonised.

Key policy issues

What should be the general approach to anti-avoidance issues?

Examine what underpins tax avoidance activity

24.11 Investors make their decisions on views about how the value of assets and liabilities may change and on the likelihood of making profits or losses after tax.

24.12 Where the tax law does not reasonably reflect the changing values of assets or liabilities — or does not treat losses symmetrically with gains — investors will be advantaged or disadvantaged by the law. Where advantage exists, some will seek to arrange their investment portfolios or use particular business structures to access that advantage. Where disadvantage exists, some of those adversely affected will attempt to off-load that disadvantage.

24.13 Inevitably specific anti-avoidance provisions are introduced in response to investors' seeking advantage or seeking to off-load disadvantage — particularly when extreme or blatant practices are employed.

24.14 Tax exempt investors undertake their investment decisions on the basis of a range of expected future profits or losses, incorporating the effect of

possible changes in the value of assets and liabilities. If the tax base reflects this same view of profit and loss in the range of possible outcomes, the tax exempt investors will not be advantaged or disadvantaged in their decision-making compared to those being taxed. This would be so regardless of the tax rates applying with those being taxed. Taxed investors would lose a slice of profit or would have their losses lessened according to the tax rate facing them. Regardless of that tax rate they would view alternative investments and their value as much as they would if they were tax exempt themselves.

24.15 This world where tax avoidance provisions would be unnecessary is changed where the tax base varies from this ideal such that tax value is misaligned with commercial value and losses are not treated symmetrically with gains. This may be illustrated using the circumstances of tax exempt investors, taxpayers facing a tax loss and non-resident investors. (See Examples 24.1 — 24.3 overleaf.)

Look for structural solutions

24.16 Against these considerations, two basic conclusions may be drawn. First, where possible, underlying structural flaws in the tax base should be addressed with structural improvement. This should minimise the need for specific anti-avoidance provisions. In this regard, *A New Tax System* noted that a review of specific anti-avoidance provisions will be undertaken to identify those provisions which can be consolidated and harmonised and those which can be removed. Reform of the business base should assist in such harmonisation and, in particular, the removal of unnecessary provisions.

24.17 An income tax system turns on capturing changing *tax values* of taxpayers' assets and liabilities. Crucial to the integrity of such a tax system is the requirement that all the business assets and liabilities of a particular taxpayer be taken into account — and the changing tax value of those assets and liabilities is assessed to that taxpayer. Depreciation allowances estimate the reduction in value in a taxpayer's plant item. But any liabilities of the taxpayer associated with that item — such as the right of access to it by another taxpayer — need to be factored in. For that taxpayer, what needs to be captured is the net changing tax values of the plant item, of the right that someone else has over it and of any stream of future payments for that right.

24.18 Secondly, where a flaw cannot be addressed with appropriate structural change there is the question whether that flaw can be better addressed by either specific anti-avoidance measures or general anti-avoidance provisions. This question needs to be assessed on a case-by-case basis. In this regard also, *A New Tax System* noted that the general anti-avoidance rules would be modernised to ensure that they deal with existing and emerging risks.

Example 24.1: Tax exempt investors

In some situations tax value is out of line with commercial value because taxpaying investors are able to access accelerated write-off allowances for their capital expenditure. In the early years of the life of their investments the tax allowances are higher than the actual reduction in value of the investments. Questions of the justification for the tax exemption (or, more generally, for different marginal rates) aside, this gives the taxable investor an advantage over the tax exempt investor. Tax exempt investors continue to base their decisions on the expected actual change in value of an investment. But the taxpayer is advantaged by the reduction in tax value exceeding the actual decline in value.

Not surprisingly, the tax exempt investor will seek out ways to try to gain the same benefits from the investment as are offered to the taxpayer. With accelerated depreciation, this is typically sought through leasing or similar arrangements. By leasing the asset the tax exempt investor can share in the accelerated depreciation allowances by way of lease rentals that the lessor is able to reduce because of the accelerated write-off.

As a result of this scope to transfer the tax benefit, provisions in the law — section 51AD and Division 16D — were introduced to deny tax exempt bodies indirect access to the benefits of concessional capital allowances, such as accelerated depreciation (in the face of aggressive tax planning schemes by some tax exempt bodies and taxable persons). These anti-avoidance provisions, in turn, spawn their own administrative complexities — with matching compliance costs imposed on the taxpayer. For example, the distinction between finance leases, as opposed to operating leases, is in part driven by measures of the degree of ownership risk that the lessee assumes over the asset. This dividing line is difficult to administer. Moreover, to avoid the necessary definition of finance lease, the anti-avoidance provisions need to encompass substitute arrangements whereby assets are not formally leased but the tax exempt investor retains control over the asset. This boundary line is again difficult to maintain and police. In any case, the tax exempt investor can always benefit indirectly by acquiring goods and services produced by taxpayers who benefit directly from accelerated depreciation on their plant. Thus, the boundary line can never be drawn comprehensively.

Chapter 9 discusses these issues in more detail.

Example 24.2: Taxpayers facing a tax loss

Another example of anti-avoidance provisions arising from underlying structural flaws in the law is in the general area of losses. The symmetrical treatment of profits and losses would be met completely by paying the taxpayer the value of the loss in the year incurred times the taxpayer's tax rate — or, in economic parlance, providing 'full loss offset'. Losses would be reduced in the same proportion (the tax rate) that profits are reduced. That is equivalent to the outcome for taxpayers who incur a loss on one activity and have sufficient income from other activities against which to fully offset that loss. Thus, 'full loss offset' would maintain neutrality between taxpayers with plenty of income producing projects and those with none — as well as between investments with a higher risk of possible losses compared to investments with little risk. However, where revenue needs to be raised from the income tax system, providing full loss offset could only be contemplated where annual accrued gains were also fully assessed.

Given the lack of generalised full loss offset many taxpayers try to get around the impact of that by a range of activities, such as the use of redeemable preference shares and loss trafficking. Taxable persons have adopted aggressive tax planning to purchase losses to offset against taxable income. Again, the law has a wide range of anti-avoidance provisions designed to stop or hinder these practices. The same business test which allows, in specific circumstances, the transfer of losses in a company being sold is discussed in Chapter 28.

Example 24.3: Non-resident investors

In the international arena, a range of complex anti-avoidance provisions exist to stop the selected indirect transfer of tax benefits to non-residents. The complex franking credit trading provisions are the most recent example of this. Those provisions are designed to stop non-resident share investors (as well as certain residents, such as tax exempts) who cannot access the benefits of franking credits and capital losses on those shares from selling those benefits to residents who can make use of them. They seek to prevent high income residents from arranging their affairs to pay little tax.

In practice, the dividing line between those who can transfer those benefits and those who cannot is difficult to draw and administer and imposes compliance costs. The franking credit trading provisions are another example of where the degree of risk faced by taxpayers is used to help to draw this dividing line.

24.19 These conclusions suggest that evaluations of the need for specific anti-avoidance provisions should address the following questions:

- What is the problem?
- Is the problem caused by a structural flaw in the law?
- Can the structural flaw be addressed directly?
- If a structural flaw cannot be addressed directly, is it justifiable to attempt to address the flaw indirectly via specific anti-avoidance provisions?
  - What are the revenue implications of the problem?
  - Should those seeking to access tax advantage provided by the flaw — or seeking to off-load tax disadvantage — be denied that opportunity? The discussion of leasing and accelerated depreciation in Chapter 10 is an illustration of this question being posed in practice.
  - What are the costs of compliance and the greater complexity that attach to the provisions?
  - Are there second round effects that need to be considered? One dimension of this question is the effects of market adjustments to the underlying structural flaw. Taxpayer response to the anti-avoidance provisions themselves is another.
  - Can reformed general anti-avoidance provisions (see below) be relied upon to deal with the issue — by addressing blatant taxpayer action?

Introduce a robust general anti-avoidance rule

24.20 In deciding what form anti-avoidance measures could take, there is a tension between general and specific measures. A very robust general anti-avoidance rule would eliminate the need for specific anti-avoidance measures. However, the content and scope of a general anti-avoidance rule needs careful consideration to diminish unintended consequences and promote certainty.

24.21 Regardless of how well the tax law is designed, there will be taxpayers at the margin who conceive of schemes that are in essence inconsistent with the scheme of the law and the purpose of the relevant provisions. There is therefore a need for a general anti-avoidance provision to address, for example, schemes entered into which produce a result contrary to the underlying principle and purpose of the income tax law. This would encompass arrangements to reduce or delay the correct amount of tax or to increase or bring forward a refund of tax, and to ensure that credits, rebates

and losses are only available to reduce the tax payable of those taxpayers who are properly entitled to them.

24.22 A general anti-avoidance rule should never assume the role of a primary taxing provision. This would be administratively inefficient and would often leave intact the underlying causes of a lack of integrity. Its proper function is that of a provision of last resort, to be applied in extraordinary circumstances and not in everyday situations.

24.23 A soundly structured general anti-avoidance rule would be consistent with, and support, the fabric of an income tax system but could not be so broad as to encompass a taxpayer's comprehensive income in all circumstances. As noted, an excessively broad general anti-avoidance rule would reduce taxpayer certainty. In a self-assessment environment, it is essential that taxpayers have as much certainty as possible.

What specific issues require further examination?

24.24 A range of issues require examination concerning the need for specific anti-avoidance circumstances. Some of these issues relate to existing specific anti-avoidance rules. The assessment of many depends on the direction ultimately taken with particular reform options.

Debt/equity issues

24.25 Under a redesigned imputation system with full franking and with refunds of excess imputation credits, taxable resident individuals would be taxed once on distributed profits from entities at their marginal tax rates. This is consistent with the treatment of returns from debt.

24.26 However, debt might be more attractive than equity for taxpayers who cannot fully benefit from franking — for example, non-residents, tax exempt organisations and entities with carry-forward losses. In other cases, equity may be more attractive than debt (for example, to provide taxable residents access to a franked dividend stream). These issues are discussed at greater length in Chapter 7.

24.27 The use of debt may also provide a means by which the members of closely held entities could avoid the operation of the profits first rule canvassed in Chapter 19. Loans from members to entities could be substituted for contributed capital, and returned ahead of retained profits.

Tax exempt transactions

24.28 As explained in Chapter 3 of *A Strong Foundation*, there is a wide range of inconsistent provisions currently in the law dealing with non-arm's-length transactions.

24.29 There is a need for consistency, based on a principled approach, and there is scope for a general provision to handle asset transfers for non-arm's-length consideration.

24.30 One approach to be considered in analysing this issue would be adopting a high level principle to provide for the substituting of commercial value. Despite the diverse and inconsistent treatment across various provisions in the current law, this substitution underpins those provisions. The analysis would need to take into account the wide range of exemptions under the various provisions that currently substitute market value.

Transfer of entity losses

24.31 There is a company income injection test in the current law. That provision essentially denies a deduction to the company for previous year losses if the company enters into transactions that would not have been entered into had the loss not been available.

24.32 Currently, there is also an income injection test in the trust loss provisions. In broad terms, the test applies where, in connection with a scheme, losses or deductions are used to shelter from tax the assessable income of an outsider to the trust.

24.33 The need for an income injection test should be assessed given the taxation of trusts like companies and reform options for the treatment of unfranked dividends in Chapter 15 and the options for new and comprehensive value shifting rules in Chapter 29.

24.34 If an income injection test were retained, in order to achieve consistent taxation treatment, the same test should apply to companies, trusts and limited partnerships.

Unfranked dividend streaming

24.35 Unfranked dividend streaming involves providing unfranked dividends to shareholders who receive little or no benefit from franking credits so that a greater proportion of franking credits can be directed to those who benefit most from them. For example, a high tax rate resident taxpayer can make full use of franking credits but an exempt investor, or a non-resident portfolio investor, may have no use for them.

24.36 Relevant to the future of the current unfranked dividend streaming provisions would be the options considered in Chapter 15 for treating unfranked dividends. If deferred company tax was adopted, specific integrity measures would be unnecessary to deal with the streaming of unfranked as against franked dividends. If either the resident dividend withholding tax or the unfranked inter-entity distribution option were adopted instead, it would be necessary to consider whether a reformed general anti-avoidance provision could adequately deal with the problem in the absence of the specific provisions.

Franking credit trading

24.37 Franking credit trading is closely related to unfranked dividend streaming as described above. In unfranked dividend streaming, the distributing entity seeks to ensure that franking credits are provided to those members who will benefit from them most. In franking credit trading, the members act independently of the entity to ensure that franking credits end up with those who will benefit from them most — franking credit trading is a form of do-it-yourself streaming.

24.38 While none of the options considered in this paper would address the incentives and means to engage in franking credit trading, the development of a reformed general anti-avoidance provision would be of relevance to deciding the shape of specific franking credit trading provisions. Relevant to this assessment (and that of dividend streaming) is the threshold policy issue relating to the revenue implications of the 'wasting' of franking credits in the hands of some members.

Dividend stripping

24.39 Dividend stripping involves the purchase of an entity with a large amount of retained income, the distribution of those profits in a tax-free manner (for example, if the 'dividend stripper' is a company, and benefits from the inter-corporate dividend rebate) and obtaining a tax loss on the subsequent disposal of the shares.

24.40 Where the income of the target entity has been taxed at the entity level, and the disposal of the entity to the dividend stripper gives rise to a capital gain in respect of the retained profits, double taxation does not arise. The distribution of profits in a tax-free manner and the capital loss that arises ensure (as discussed in Chapter 20) that only a single tier of taxation applies to the income earned by the target entity.

24.41 However, where the capital gain on disposal of the target entity is not taxed, or the retained income has not been taxed at the entity level and can be distributed tax-free, allowing the capital loss to the dividend stripper would

result in the avoidance of even just a single tier of taxation. Where the dividend stripper is a company or similarly taxed entity, that tax avoided would only be clawed back upon distribution of the tax-preferred income to members.

24.42 The introduction of any of the options considered in Chapter 15 for taxing unfranked profit distributions through the domestic entity chain would raise the question of the need for dividend stripping provisions. Relevant also are the options in relation to consolidation and capital loss duplication (Chapters 25 to 29).

Dividend substitution

24.43 Dividend substitution involves returning capital to members rather than profits. It allows for deferral of the taxation of profits at the personal level, with capital distributed while profits are retained.

24.44 Relevant to examining the need for dividend substitution provisions would be the adoption of a profits first rule together with a slice approach where there is an extinguishment of an ownership interest (see Chapter 19). These arrangements would provide only limited opportunity for returning contributed capital ahead of retained profits.

Capital streaming

24.45 Capital streaming involves the streaming of capital distributions to members with a relative preference for capital gains as against other members, and of profit distributions to those other members.

24.46 Introduction of a profits first rule and the slice approach for buy-backs, liquidations and equivalent distributions would place practical limits on the ability of entities to stream contributed capital. The alternative treatment of created ownership interests (for example, bonus share plans) outlined in Chapter 18 would limit their use for capital streaming.

24.47 However, even if these options were adopted some scope for capital streaming would remain (for example, by buying back shares from non-resident shareholders on-market and from resident shareholders off-market). The applicability of a reformed general anti-avoidance provision would be a relevant consideration in assessing the justification for specific provisions to address the remaining scope for capital streaming.

Capitalisation of profits

24.48 Companies are permitted by Corporations Law to convert profits into capital amounts, potentially allowing profit distributions to be disguised as contributed capital distributions. Certain profits — for example, capital gains — may also be trust capital for trust law purposes.

24.49 If the option discussed in Chapter 19 to require companies (and trusts and limited partnerships) to maintain separate contributed capital accounts was adopted, specific provisions aimed at preventing the capitalisation of profits would be unnecessary.

Redeemable preference shares

24.50 There are currently anti-avoidance provisions aimed at substituting interest payments between entities with dividends on redeemable preference shares. The substitution is a result of the borrower of funds not being able to get immediate benefit from the deductibility of interest payments (because of, say, being in a tax loss position). The section 46 rebate on inter-corporate dividends allows a tax-driven substitution of dividends.

24.51 Any of the three options considered in Chapter 15 for treating unfranked profit distributions would address this issue.