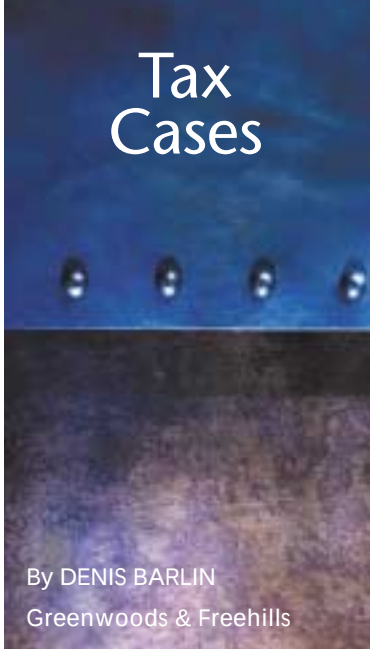

Howland-Rose v Commissioner of Taxation [2002] FCA 246 (18 March 2002)

Budplan: Victory for the Commissioner but hope for other taxpayers?

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The decision of Conti J, handed down on March 18, 2002 in *Howland-Rose v Commissioner of Taxation* ("Budplan") [2002] FCA 246, was the first of a number of test-case decisions which generally will decide the efficacy of so called "mass marketed schemes".

The principal issues addressed in the *Budplan case* were the availability of deductions pursuant to Section 51(1) of the *Income Tax Assessment Act 1936* (Cth) ("the 1936 Act") and the application of Part IVA of the 1936 Act.

BACKGROUND

The Applicants in Budplan were four out of a total of 2,371 investors in the Budplan Personal Scheme ("BPS.") The BPS was established to carry out research and development in respect of tea tree oil ("TTO") products, with the purported ultimate aim of manufacturing and selling such products.

Participation in the BPS required an initial investment of $24,000, effected by a "round robin" and non-recourse loan. The transaction centred on syndicate participation in the BPS. The BPS had the purpose of [para 12]:

> Engag[ing] … in the business of development for potential manufacture and sale of specified tea tree oil based products including all necessary scientific research.

The main issue to be determined was the deductibility of the $24,000 initial investment, along with the incidental interest expenses and loan fees, under the former Section 51(1) of the 1936 Act. If the deductions were allowable, then the issue of whether Part IVA would apply to deny the deductions would be relevant.

SECOND LIMB OF SECTION 51(1) OF THE 1936 ACT

The Applicants argued that the BPS had the purpose of merging, on the one hand, TTO product research and development, and TTO product manufacture and sale. The Applicants argued that the combination of the two activities essentially allowed deductions for the Applicants pursuant to the second limb of the former general deductions provision, being Section 51(1) of the 1936 Act. That is, they were losses or outgoings which the Applicants "… necessarily incurred in carrying on a business for the purpose of gaining or producing … [assessable] … income…".

As a starting point, Conti J, in applying *FCT v Lau* (1984) 6 FCR 202 and *FCT v Brand* (1995) 31 ATR 326, found that notwithstanding that the management of a business has been delegated to an agent, still a business may be carried on. An issue raised by the Court and left undecided was whether in substance the Applicants carried on business in partnership, and not as individuals and the possible taxation and legal consequences which might follow if in fact there was a partnership.

The threshold issue to be determined, in order to determine the application of Section 51(1) of the 1936 Act, was whether the Applicants were carrying on a business. The Applicants relied on *Lau's case* and *Brand's case* to argue that the outgoings they incurred were for a "real and genuine commercial purpose" and therefore deductible.

Conti J distinguished between research and development expenditure on the one hand, which he held does not lead to the earning of assessable income, and expenditure on manufacturing and sale which may lead to the earning of assessable income. In citing *Goodman Fielder Wattie Ltd v FCT* (1991) 29 FCR 376, Conti J referred to three stages of a business, being:

1. Investigating whether a proposed or possible line of business is viable;
2. Deciding whether to make a commitment to the activity, and,
3. Entering into the activity.

Expenditure incurred "too soon" before the business actually commences may not be characterised as expenditure expected to produce assessable income.

Conti J found at paragraph 102, that:

> The difficulty confronting the Applicants … [was] … that the expenditure… was in substance and reality the undertaking of research and expenditure which would not necessarily lead to any assessable income ever being derived from [TTO] …products which might subsequently be manufactured upon the basis of the results [from the research and development] …

STATE OF MIND IN RESPECT OF CONDUCTING A BUSINESS

Conti J laid down a test to be satisfied in order for expenditure to be deductible by virtue of the second limb of Section 51(1) of

the 1936 Act. His Honour stated that there needs to be an objective appraisal of the circumstances in which the expenditure is made, and the objective purpose of making the expenditure. Relevant to the objective purpose may be the taxpayer's subjective purpose.

The Applicants argued that whilst ultimately the test is objective, unchallenged evidence as to a taxpayer's subjective purpose would be "conclusively persuasive as to the objective purpose". Conti J, in dismissing the Applicants argument found at paragraph 106 that the "… interaction between a taxpayer's subjective purpose and contemporaneous objective circumstances…" led to the conclusion that the circumstances, objectively viewed, characterised the outgoings in the Applicants hands as not for a "real and genuine commercial purpose" and therefore not deductible by virtue of Section 51(1) of the 1936 Act

REQUIREMENT FOR PERMANENT CHARACTER OF A BUSINESS

Conti J applied the test in *Hope v Bathurst City Council* (1980) 144 CLR 1 insofar as "for a business to be carried on the activities must possess something of a permanent character".

Conti J found that the BPS Prospectus purported to merge into the notion of carrying on the business of manufacturing and distributing TTO products the activities of the research and development required successfully to bring into existence such products. However, it was stated at paragraph 110 that the Applicants:

> Ignore[d] the reality that without successful research and development, there can be no feasible manufacture and marketing of the products the subject of the research and development, and it cannot be realistically contended that the Prospectus predicated otherwise.

Therefore it was found that the Applicants never reached the stage of carrying on business activities, much less activities having a permanent character.

Whilst the Applicants attempted to apply the *Lau, Emmakell and Brand cases*, Conti J distinguished those cases from the BPS. His Honour at paragraph 112 stated:

> The Applicants' purported emphatic reliance upon Lau, Emmakell and Brand cannot … be justified … The subscribers to the schemes in those cases were not depending on the viability of the proposed growing activities being first established by research and development, but instead committed themselves from the outset to the growing activities of businesses immediately being launched as ongoing concerns, and to production from growing activities, in contrast to activities of research …

Consequently it was held that the expenditures of the Applicants were in the nature of, and related to, steps anterior to carrying on business. That is, given that there was a lack of nexus between research and development expenditure, and the potential for earning assessable income, the losses and outgoings incurred by the Applicants were not allowable by virtue of the second limb of Section 51(1) of the 1936 Act.

FIRST LIMB OF SECTION 51(1) OF THE 1936 ACT

After rejecting the deductibility of the Applicants' expenditure under the second limb of Section 51(1) of the 1936 Act, Conti J explored the availability of deductions by virtue of the first limb, that is, whether it was "incurred in gaining or producing the assessable income". Conti J observed at paragraph 116:

> There have been a number of statements made by the High Court as to the scope of operation of the first limb … It may be observed that the first limb tends to provide a narrower base to which a taxpayer might seek recourse, in contrast to the wider base of the second limb.

Conti J held that *prima facie*, expenditure on research and development is regarded as of a capital nature as opposed to a revenue nature. As a result, normally expenditure on research and development would not meet the operation of the first limb of Section 51(1) of the 1936 Act.

In applying a test for the first limb of Section 51(1) of the 1936 Act, Conti J stated at paragraph 117:

> … for an outgoing to qualify for deductibility under the first limb involves a question of characterisation, and that the subjective motivation of a taxpayer in making an outgoing is sometimes a relevant factor in the task of characterisation, though not ordinarily so where the outgoing gives rise to the receipt of a larger amount of assessable income.

As a result, the deductions were disallowed under the first limb of Section 51(1) of the 1936 Act because they related wholly to the cost of research and development and were not capable of being identified with the derivation of any assessable income.

ASSESSING THE VIABILITY OF THE PROJECT FOR THE PURPOSES OF ASSESSING DEDUCTIBILITY

Because the deductions were denied due to failing either limb of Section 51(1) of the 1936 Act, Conti J found that strictly it was unnecessary to decide upon the viability of the project for the purposes of assessing the availability of the deductions, that is, whether the Applicant had a "real and genuine commercial purpose".

However, Conti J at paragraph 120 stipulated the evidentiary test to be applied in determining whether the taxpayer had a "real and genuine commercial purpose", by stating:

> That test does not necessarily require a taxpayer to establish that the venture he or she determines relevantly to pursue or become involved in would necessarily have been productive of assessable income, based on the information available at the time of financial commitment … Obviously enough there are graduations of risk of loss in any business venture, in relation to events which may subsequently happen, and reliance upon the benefit of hindsight will often be questionable.

In applying the test, Conti J distinguished between the role of the Court in ascertaining the fulfilment of the evidentiary test, and the role of the expert witnesses in ascertaining whether the financial and other business objectives of a taxpayer can be met as a matter of fact. It was stated at paragraph 124:

> I do not think that in the context of resolving taxation issues, it is appropriate for the Court to resolve what I think boil down to largely conjectural, albeit bona fide, professional opinions. The Court should not, in circumstances such as the present, venture beyond inquiry as to fulfilment or otherwise of the kind of evidentiary test exemplified by Beaumont J in Lau …, namely whether moneys have been outlaid by a taxpayer for a real and commercial

> purpose. …[otherwise]… the cost of resolution of tax deductibility disputes may become prohibitive.

In applying the test, His Honour found that at the time that the Applicants subscribed for their interests in the BPS, it could not have been foreseen that the projections of the Prospectus as to the length of time sufficient to achieve the productivity objectives could have been fulfilled.

LEGITIMACY OF "ROUND-ROBINS" AND LIMITED RECOURSE LOANS

In respect of the financing of the participation in the BPS by the Applicants through so called "round-robins" of unpresented bills of exchange, the Commissioner contended that the funds were never actually subscribed for the gaining or producing of assessable income, in respect of which deductions were claimed. As a result, it was argued by the Commissioner that there was an absence of "commercial value" in the arrangement.

Conti J rejected the Commissioner's arguments. His Honour held that the bills of exchange were actually drawn and circulated, and the relevant book entries were made by "counterbalancing set-offs of credit and debit amounts", which effected the payment of all obligations by participants in the BPS.

Conti J discussed the effect of limited recourse loans. Conti J held that a participation in a limited recourse loan arrangement did not necessarily mean that a transaction has no "commercial value". However, the BPS was structured such that whilst the participants may have made commercial losses, still they would have derived financial benefits such that the transaction made "commercial sense", as was explained by Conti J at paragraph 141:

> Given the circumstances that the Prospectus demonstrated … participation would result in a cash surplus to participants … notwithstanding an entire loss of the participant's invested funds in research and development which might be wholly unsuccessful, there was in my opinion no commercial rationale … for participation … without being able to underwrite the "no cash loss" situation held out by the terms of the Prospectus.

APPLICATION OF PART IVA OF THE 1936 ACT

The Court addressed the issue of the application of Part IVA of the 1936 Act in respect of participation in the BPS, in the event that the deductions under Section 51(1) of the 1936 Act were not disallowed.

After summarising the authorities pertaining to Part IVA of the 1936 Act, Conti J at paragraph 133 summarised the test as:

> … an objective analysis of relevant facts, and drawing conclusions therefrom as to the existence of a dominant purpose of enabling a participant in the BPS … to obtain a tax benefit.

The applicants relied on the recent New Zealand Court of Appeal decision of *Commissioner of Inland Revenue v BNZ Investments Ltd* (2001) 20 NZTC 17, to argue that in order to apply Part IVA of the 1936 Act, there needs to be established the existence of consensual conduct on behalf of the participants. The Court rejected the Applicants argument, on the basis that the statutory requirements for the application of the New Zealand anti-avoidance provisions differ from the Australian provisions.

In analysing the surrounding facts, including the BPS Prospectus, it was held that, disregarding the tax deductions which the Applicants claimed, there was no commercial rationale for entering into the arrangement. Conti J stated at paragraph 143:

> …… the Applicants acquired their respective syndicate participations objectively for the dominant purpose of obtaining the benefit of the taxation deductibility opportunities so predominantly featured in the Prospectus. … [The Applicants] … participat[ed] in the process of research and development at no, or virtually no, ultimate cash shortfall, by reason of the excess or likely excess of the monetary benefits flowing in principle from the incidents of taxation deductibility over the cost of participation outlaid in cash.

CONCLUDING REMARKS

Given that Budplan centred on a research and development scheme, which is not typical of mass marketed tax schemes, the strict precedence value of the case may be questioned. However, the statements in respect of Part IVA of the 1936 Act illustrate the wide ranging nature of the anti-avoidance provisions, and the willingness of the Court to take a systolic view as to its application.

Whilst the decision was a victory for the Commissioner, the decision should be viewed on its particular facts. Accordingly, despite the fact that Budplan centred on a so called "mass marketed tax scheme", caution should be taken not to interpret the decision as a victory against "mass marketed schemes" as a whole. There may be "mass marketed schemes", even those with limited recourse finance, where "commercial value" in participation is to be found. Particularly will this be so for proven business ventures where the relevant prospectus projects an after-tax positive result for the participant.

In a media release dated 18 March 2002, the Commissioner of Taxation, Mr Carmody, "welcomed" the Budplan decision, stating that it:

> "confirms [that] arrangements typically employed in mass marketed tax schemes in an attempt to artificially create tax deductions do not succeed".

It seems that Mr Carmody has extracted more from the decision than is evident in his Honour's judgement. ■

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