

*Mochkin v Commissioner of Taxation [2002] FCA 675*  
(28 May 2002)

## Wicked Witch fails to stop progress down the yellow brick road

The decision in *Mochkin v Commissioner of Taxation* [2002] FCA 675, involved:

- the question of whether personal services income was being diverted to interposed entities;
- the application of Part IVA of the *Income Tax Assessment Act 1936* (Cth) ("the 1936 Act") to purported personal services arrangements; and
- administrative matters involving the validity of determinations under of Part IVA of the 1936 Act.

### BACKGROUND

Levi Mochkin ("the Applicant") appealed to the Federal Court following the disallowance by the Commissioner of objections to amended assessments.

The Applicant migrated to Australia in 1985. In 1987 the Applicant personally entered into an arrangement with Bridges Son & Shepherd Limited ("Bridges") for the provision of stockbroking services. Under the arrangement the Applicant introduced clients to Bridges, who executed orders on behalf of the Applicant. The Applicant received a commission in respect of the clients which had their orders executed by Bridges.

In May 1987 Bridges terminated the arrangement and demanded the Applicant indemnify it for unpaid commissions in respect of clients which the Applicant had introduced. Initially the Applicant refused to indemnify Bridges on the grounds that he was an employee of Bridges. However, after receiving legal advice, the Applicant

accepted that he would be characterised as an independent contractor, and negotiated a settlement with Bridges.

The Applicant subsequently [para 4]:

... decided to take steps to avoid thereafter attracting personal liability for similar defaults by his clients and to ensure that his stockbroking business was carried on through a limited liability company "for the benefit of my family, related entities and charities".

On 1 February 1988, the Applicant set up a company, Daccar Pty Ltd ("Daccar"), the trustee of the Applicant's family trust which contracted with Pembroke to provide stockbroking services in a manner similar to that which was provided under the Bridges arrangement. On 20 June 1989, the Applicant set up another company, Ledger Holdings Pty Ltd ("Ledger") which was another trustee company in respect of another family trust of the Applicant. Ledger became the contracting party with Pembroke instead of Daccar.

Subsequently Ledger terminated and entered into a number of similar agreements with other stockbroking houses. Relevantly, Ledger referred clients to the stockbroking houses and received commissions in respect of the references. Further, the Applicant at no time gave personal undertakings in respect of liabilities which may arise as a result of the stockbroking business after the establishment of Daccar and Ledger.

In mid-1991 the Applicant was offered an opportunity to make a large placement in Great Central Mines NL ("Great Central"). It became apparent that clients of

Ledger were interested in subscribing to the placement. However, the broker whom Ledger was working through at the time declined to be involved in the placement. As a result, and due to a placement being made to clients of Ledger, the Applicant took the view that neither the Applicant personally, as the holder of the stockbrokers' proper authority, nor Ledger were entitled to receive the placement fee. Consequently, the Applicant agreed with Great Central that the fee in respect of the placement, amounting to \$564,270 be paid to Daccar.

### PERSONAL SERVICES INCOME ISSUE – APPLICATION OF SECTIONS 25(1) AND 19(1) OF THE 1936 ACT

The Commissioner argued that the fees and commissions received by both Daccar and Ledger were income derived by the Applicant within the meaning of s 25(1) of the 1936 Act, which provides:

The assessable income of a taxpayer shall include:

- (a) where the taxpayer is a resident: the gross income derived directly or indirectly from all sources whether in or out of Australia; and
- (b) where the taxpayer is a non-resident: the gross income derived directly or indirectly from all sources in Australia;

which is not exempt income, an amount to which s 26AC or 26AD applies or an eligible termination payment within the meaning of Subdiv AA.

Further, the Commissioner argued that s 19 of the 1936 Act had application given that the amounts paid to Daccar and Ledger were done so according to the Applicant's

directions. Section 19(1) of the 1936 Act states:

Income or money shall be deemed to have been derived by a person although it is not actually paid over to him but is reinvested, accumulated, capitalised, carried to any reserve, sinking fund or insurance fund however designated, or otherwise dealt with on his behalf or as he directs.

In finding that s 19(1) of the 1936 Act had no application, Ryan J held that both Daccar and Ledger could have sued in their own names to recover unpaid fees and commissions, and each were responsible to the relevant broking houses for client defaults. Ryan J stated at para 38:

No payment could have been made to him [the Applicant] "as he directed" in his personal capacity which, I consider, is what is required by s 19(1). Any directions which he gave, either in the conduct of the broking consultancy business or for distribution to beneficiaries, were given in his capacity as a director or employee of Daccar, and later Ledger.

The Court held that the Applicant was not providing personal services to the broking houses. This was the case because the broking houses did not have the capacity to direct the Applicant as to how to conduct his business. Further, other employees of Ledger were capable of undertaking the services which the Applicant undertook in advising or obtaining instructions from clients in respect of the share trading transactions. Ryan J at para 40 stated:

... on the analysis which I favour, no personal services were provided by Mr Mochkin to any of the various broking houses. None of them had the right to direct him personally in advising or obtaining instructions from clients. Rather, it was a matter of indifference to the broking houses, I infer, how or by whom those instructions were obtained. Of necessity, during Mr Mochkin's many and extended absences from the office, they must have been obtained and relayed to the relevant broking houses by ... some other member of the Ledger "team" without any reference to Mr Mochkin.

Further, Ryan J found that, putting aside the Great Central fee, the Applicant did not derive income from the provision of personal services. The clients of Daccar and Ledger paid the broking houses the commissions in respect of their trades, therefore, it was the broking houses, not

the Applicant, Daccar or Ledger which earned the personal services income. Ryan J at para 45 stated:

... Mr Mochkin did not receive income from the provision of personal services to the clients of the business. Those clients did not attract any liability to pay Mr Mochkin or Daccar or Ledger for any services. Their contracts were with the broking house from time to time which issued them with "bought" and "sold" notes. It is true that the making of those contracts created an entitlement in Daccar, and later Ledger, to a share of commission and attracted to one or other of those companies a secondary liability for any default by the clients. However, those incidents of the arrangement do not permit a conclusion that any person other than the broking house derived income from the provision of personal services to the clients.

In relation to the Great Central fee Ryan appeared to consider that it was income of the Applicant on the analogy of cases of "gifts" made in an employment or business context, and that s 19 applied to the payment of the fee to Daccar but concluded in any event that Part IVA applied (see below).

#### **APPLICATION OF PART IVA OF THE 1936 ACT TO THE DACCAR AND LEDGER SCHEMES**

The Commissioner identified two schemes within the meaning of Part IVA of the 1936 Act, being the Ledger Scheme consisting of the income which Ledger earned from the broking houses, and the Daccar Scheme, consisting of income received by Daccar in respect of the Great Central placement.

#### **Part IVA of the 1936 Act – Ledger Scheme**

It was contended by the Commissioner that but for the establishment of Ledger it might reasonably have been expected that there would have been included in the Applicant's assessable income the income actually derived for that year by Ledger from the broking houses.

In dismissing the Commissioner's argument, Ryan J looked to the purpose of the Applicant establishing Ledger.

Ryan J accepted that a purpose of the Applicant establishing Ledger and conducting business through it was to obtain a tax benefit, by stating at para 50:

... I am prepared to accept that one of the purposes of Mr Mochkin in entering into the scheme was to obtain a tax benefit namely the ability to have the net income to be generated by the stockbroking consultancy business distributed in a tax effective way to the beneficiaries of a discretionary trust.

However, Ryan J recognised that there were other purposes for the conducting of business through Ledger. In particular, it was emphasised that the Applicant's desire to limit his personal liability which may arise from the stockbroking business. Ryan J at para 51 stated:

However, the manner in which the scheme was entered into or carried out points, in addition, to other purposes having actuated Mr Mochkin. Without attempting an exhaustive catalogue of those other purposes, one which springs most readily to mind was to immunise Mr Mochkin personally and the separate assets of himself and Daccar against being required to discharge liability for "client defaults" or other debts or obligations of the business. Support for the imputation of that purpose is afforded by Mochkin's steadfast refusal, at various points of carrying out the scheme, to provide personally, or through Daccar, any form of guarantee of Ledger.

The Applicant did not want to be sued personally for client defaults as happened in respect of the agreement between the Applicant and Bridges. Therefore, the dominant purpose of the Applicant in entering the schemes involving Daccar and Ledger was not to obtain a tax benefit, but rather to avoid attracting personal liability from his stockbroking business.

Ryan J found that another reason for running the business through Ledger was to allow Ledger to establish its own goodwill independent of the Applicant. Ryan J stated at para 51:

Another such purpose, I consider, was to allow the business to build up goodwill which would be detached, at least to an extent, from the personality and continued participation in it of Mr Mochkin himself.

Ryan J stated that whilst the Applicant, through Ledger and ultimately via the discretion held under the family trust could avoid the inclusion of amounts in the Applicant's assessable income, at the time of entering into the Ledger scheme the tax result was potentially neutral. This was

because Ledger as trustee of the family discretionary trust, could have distributed income to beneficiaries liable to pay tax at the same marginal rate of tax as the Applicant. Alternatively, amounts could have been paid to charities as donations for which if the Applicant had made the donations personally, he could have obtained deductions.

The Commissioner contended that as stated in *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 186 CLR 404 at 415, the fact that a scheme is undertaken for a commercial outcome does not preclude a dominant purpose of obtaining a tax benefit being imputed. Ryan J distinguished between pursuing a commercial gain in which a tax benefit is received and pursuing a commercial gain which entails a dominant purpose of obtaining a tax benefit. Ryan J at para 66 stated:

It is true ... that the fact that a scheme is consistent with the pursuit of commercial gain does not preclude a dominant purpose of obtaining a tax benefit ... However, that obviously does not mean that the pursuit of commercial gain entails a dominant purpose of obtaining a tax benefit. Rather, it is "the taking of steps which would not otherwise have been taken by entering into the scheme" despite the pursuit of commercial gain, which points to the objective conclusion that obtaining a tax benefit was the dominant purpose ... Essentially the step which the Commissioner here identifies as one which would not otherwise have been taken is the conduct of the business through Daccar, and then Ledger, which was each the trustee of a discretionary trust. However... it is the totality of the steps taken by entering into the scheme which has to be considered. When that is done, there remains undisturbed the conclusion already indicated, that Mochkin's dominant purpose was to achieve a limitation of liability for the future conduct of the business and to eliminate altogether his own personal exposure to that liability.

Therefore, in finding for the Applicant that Part IVA of the 1936 Act was not applicable to the Ledger scheme, Ryan J at para 65 stated:

... I have concluded that Mr Mochkin's dominant purpose in entering into it and carrying it out was to avoid personal exposure to the liabilities and debts which would be incurred

in the conduct of the business ... It is true that he was also probably actuated by other purposes related to the conduct of the business and the potential to reduce his own taxable income, but those were, I find, subordinate to the dominant purpose which I have imputed to Mr Mochkin.

### Part IVA of the 1936 Act and the Daccar Scheme

In respect of Daccar, the Commissioner contended at para 68 that "the payment of the "finder's fee" of \$564,270 to Daccar in circumstances where there was no connection between Great Central and Daccar to warrant the payment" resulted in excluding the amount from his personal income.

Ryan J found that the Applicant requested a "finders fee" on the basis that it was the Applicant's efforts in securing the placement that imposed a moral, if not legal obligation on Great Central to pay him. It was held that the payment had been made to the Applicant at his direction in the course, or as a result, of his vocation as a stockbroker or investment adviser

In finding for the Commissioner, that the Applicant obtained a tax benefit by channelling the "finders fee" in respect of the Great Central placement through Daccar, Ryan J stated at para 71 that:

...the Daccar Scheme, as identified by the Commissioner, involved the taking of steps, principally by directing payment of the fee to Daccar, for which no other purpose can objectively be ascribed to Mr Mochkin than that of excluding the amount from his personal income and thereby obtaining a tax benefit.

### VALIDITY OF PART IVA OF THE 1936 ACT DETERMINATIONS

The Applicant submitted that the Part IVA determinations made were not valid:

- either because the person who made the determinations was not authorised to do so;
- in making the determinations there was either irrelevant considerations or a failure to take into account relevant considerations; and
- the amended assessments were not served on the Applicant on time.

### The validity of the Part IVA of the 1936 Act Determinations – Issue of Delegation of Authority

The Part IVA determinations made by the ATO actually were made by an ATO Officer on behalf of the Acting Deputy Commissioner of Taxation.

The Applicant argued that the Acting Deputy Commissioner of Taxation never properly authorised the ATO officer to make the determination under s 177F of the 1936 Act. Further, the Applicant contended at para 78 that:

unlike a delegation of power, the relationship of "authority" is a personal relationship and can only be made expressly or by necessary implication.

However, in citing *O'Reilly v The Commissioners of the State Bank of Victoria* (1982) 153 CLR 1, Ryan J held at para 77 that:

the nature of the powers reposed in the Commissioner by s 177F entails that those powers "were not intended to be exercised only by the Commissioner or his delegate personally but may be exercised through a properly authorised officer" ...

Therefore, in dismissing the Applicant's argument that the ATO officer was not properly authorised to make the determination, Ryan J found that the Acting Deputy Commissioner of Taxation's power was delegatable and had been delegated properly.

### Was there an effective exercise of discretion under Section 177E?

The Applicant contended that the Commissioner did not lawfully exercise his discretion under s 177F of the 1936 Act. That is, in making the decision either irrelevant considerations were taken into account, or relevant considerations were not taken into account.

However, Ryan J, in dismissing the Applicant's argument stated at para 87:

I have been unable to discern on the face of the instrument embodying the determinations that irrelevant considerations [were taken into account] or ... [that there was a failure] ... to take into account some relevant consideration. ... [T]here is no evidence to support an inference ... that he took into account some extraneous consideration or failed to take into account a

relevant matter. Nor is this a case where an unreasonable result was arrived at so as to create a presumption that an error occurred in the exercise of the discretion or statutory power, notwithstanding the inability of the court to identify the error.

### Service of the Amended Assessment

The Applicant contended that the service for the amended assessment in respect of the income year ended 30 June 1992 occurred outside the time limit imposed by s 177G(1) of the 1936 Act. Section 177G(1) of the 1936 Act provides:

Nothing in s 170 prevents the amendment of an assessment at any time before the expiration of 6 years after the date on which tax became due and payable under the assessment if the amendment is for the purposes of giving effect to subs 177F (1).

The amended assessment in respect of the income year ending 30 June 1992 was issued on 14 April 1999 and served on the Applicant on 15 April 1999.

The Commissioner argued that in determining time limits provided for in legislation, s 36(1) of the Acts Interpretation Act 1901 (Cth) ("AIA") was applicable, which states:

Where in an Act any period of time, dating from a given day, act, or event, is prescribed or allowed for any purpose, the time shall, unless the contrary intention appears, be reckoned exclusive of such day or of the day of such act or event.

In applying s 36(1) of the AIA, Ryan J at para 93 stated:

The period of time here dated from the day on which the tax assessed by the original assessment became due and payable, ie 15 April 1993. If that day be excluded, as required by s 36(1), the period of six years allowed by s 177G expired at midnight on 15 April 1999

Therefore, Ryan J found that the service of the amended assessment to the Applicant was within the time limit imposed by s 177G(1) of the 1936 Act.

### CONCLUSION

It could be argued that the failure of the Court to support the Commissioner's assessment of the Applicant as having personal services income vindicates the Government's decision to enact the Alienation of Personal Services Income

regime contained in Part 2-42 of the 1997 Act, although it is likely that the Applicant would not be caught by those provisions as there appears to have been a personal services business conducted by Ledger.

However, the stance which the Commissioner took in *Mochkin's case* highlights the determination of Commissioner to apply Part IVA of the 1936 Act in situations where there is alienation of services income in contexts outside Part 2-42 of the 1997 Act. Although that Part was not in effect in the relevant years, still it is clear that Part IVA may be applied to a much wider variety of service situations than those covered by Part 2-42.

It is often the case that asset protection is a significant reason for setting up a discretionary trust to hold assets or conduct a business. The asset protection operates in two basic ways. First, there is the case where an individual cannot avoid personal liability in a business context (such as partners in many professional service firms) and family assets are held in a discretionary trust to shelter them from this unavoidable personal liability. Secondly, there is the more common case where the business can be conducted other than by an individual directly and a company or discretionary trust with a corporate trustee can shield individuals who effectively run the business from liabilities arising out of the business. In this second case it is not uncommon to have a second discretionary trust to hold family assets which are not part of the business to protect them from both liabilities of the business and liabilities of the individual that may arise apart from the business. (In the current case the creation of the second discretionary trust was done to separate different activities with different risks.)

Often setting up discretionary trusts will involve these motives but also be used for income splitting and tax planning within the family. In a Part IVA context it is important to know which is the dominant purpose in setting up the trust – liability protection or tax benefits. *Mochkin's case* is a good illustration of this issue. The judge came down on the side of liability protection as the dominant purpose (while also noting a number of other purposes including business issues and tax benefits). No doubt the Commissioner will want to argue that

this is a special case. The Applicant had in fact been sued and held personally liable before doing business through the trusts and had refused to sign guarantees which would have brought back personal liability. However, especially in the current environment when personal liabilities have been highlighted in a number of large business failures and insurance is becoming increasingly costly and difficult to obtain, the argument for a dominant purpose of liability protection will be a strong one in many situations where discretionary trusts are set up. It will all depend on the facts of each case.

Also the case is a good illustration of problems which can arise when taxpayers do not observe the legal position that is created. The Great Central fee was not dealt with through the trust structure and as a result the individual ended up with liability for tax on the fee. It was the case here that the trust structure could not be used for the fee for good business reasons but it is not uncommon in practice for taxpayers to ignore the structures they have created and act directly in transactions. In that event a discretionary trust may not be successful in protection against Part IVA, or even general taxation principles.

The case is on appeal so whether this *Mochkin* gets all the way down the yellow brick road to the Emerald City remains to be seen. ♦

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