Whose sham to prove? – Millar in the Full Federal Court

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Abstract: In *Millar v FCT* (4 July 2016), the Full Court of the Federal Court found that a loan transaction was a sham. The result was that tax had been avoided through fraud or evasion, and the taxpayers were liable to pay an administrative penalty for intentional disregard of the tax law. The decision addresses two substantive legal issues. The first is the meaning of the term "sham" as used in Australian law and the elements comprising that concept. The second is whether interest that has been capitalised can be considered "paid" for withholding tax purposes. In addition, the court was required to consider the manner in which a taxpayer can discharge the onus of proof in taxation litigation and the statutory interpretation principles that apply when construing legislative provisions that have been rewritten. This article considers the decision and its implications in detail.

Introduction and background

On 4 July 2016, the Full Federal Court (comprising Logan, Pagone and Davies JJ) handed down its decision in *Millar v FCT*.[1] As well as the immediate substantive legal issues arising from the facts of this case, the decision addresses a number of more general legal questions of interest.

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Facts

The taxpayers sought to purchase an apartment on the Gold Coast. The purchase price was $1.1m. The taxpayers were able to raise $600,000 of this amount using their own efforts, but required assistance in raising a further $600,000 to pay the balance of the purchase price and meet incidental costs, such as stamp duty.[2] Their accountant of several decades, Mr Vanda Gould, offered to arrange financing through a bank based in Samoa — Hua Wang Bank Berhad (HWBB). Mr Gould informed the taxpayers that a precondition for HWBB to provide the loan was that they had to place $600,000 on deposit with HWBB. This amount was to be taken from the taxpayers' self-managed superannuation fund. The taxpayers entered into a loan agreement with HWBB for $750,000 (to be drawn down as required) for a period of five years and, as arranged, placed $600,000 on deposit with HWBB in the name of their superannuation fund. The deposited funds were to earn interest at a rate of 5% per year. It was noted in the course of the decisions that it was an unusual feature to be required to deposit the entire desired loan amount with the lender as a precondition for the loan.[3]

Importantly, the taxpayers never dealt directly with anyone from HWBB. Instead, all their dealings were conducted through Mr Gould, who had a relationship with HWBB and, in fact, HWBB was permitted to deal only with Mr Gould's clients.[4]

The loan attracted interest under the terms of the loan agreement, which was payable on 30 June of each year, although clause 5.4 of the loan agreement permitted HWBB to capitalise any interest payable that had not been paid by that due date. Clause 5.4 was interpreted as being permissive — it gave HWBB a discretion, but not an obligation, to capitalise interest payable.[5] All interest accumulated under the loan was, indeed, capitalised in accordance with this term such that the taxpayers never made a transfer in payment of interest owing. When the original loan was rolled over just before its maturation, the loan facility was increased to $1m.[6] By the time of the Administrative Appeals Tribunal (AAT) hearing, the amount outstanding had grown to approximately $1.5m due to this capitalisation practice.[7]

Despite being the sole conduit through which the taxpayers dealt with HWBB, the taxpayers did not call on Mr Gould to provide evidence at the AAT. As discussed below, this proved to be crucial in the relevant findings of fact and especially in the context of determining whether the taxpayers had discharged their onus of proof.

Legal issues

Two substantive legal issues arose from these facts. The first of these stemmed from the Commissioner characterising the deposit-loan structure as a sham. Resolving this issue required the court to consider the meaning of sham and then determine whether the taxpayers' arrangement was a sham.

As noted above, the Commissioner regarded the arrangement that the taxpayers entered into with HWBB as a sham. In brief, a sham is a transaction that is, in truth, something other than what it purports to represent (this is discussed in significantly more detail below). The Commissioner had concluded that, rather than being a genuine loan and deposit structure, the arrangement was, in truth, a cloak through which the taxpayers could

gain access to their superannuation funds in an unauthorised manner. Adopting that view enlivened s 26AFB of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), which had the effect of including the superannuation funds transferred to HWBB in the taxpayers' assessable income.

As discussed in the following section, in alleging that the arrangement was a sham, the taxpayers had the burden of proving that the arrangement was not a sham.[8] Therefore, the court not only considered the meaning of "sham" closely (including imputed intention based on third party roles), but also the manner in which the taxpayers needed to discharge their burden of proof.

The second substantive issue was whether the taxpayers were under a withholding tax obligation through the payment of interest to a non-resident. The importance of this issue was that, as the taxpayers had not withheld tax on any interest payments found to have been made to HWBB, they would be denied a deduction for any interest that they incurred under s 26-25 of the *Income Tax Assessment Act 1997* (Cth). Whether a withholding obligation arose turned on whether it could be said that, in capitalising interest payments, the taxpayers had "paid" those amounts.

This second issue stemmed from s 11-5 of Sch 1 to the *Taxation Administration Act 1953* (Cth) (TAA), which is the successor provision of s 221YK ITAA36. Section 11-5 requires that a taxpayer withhold tax when an amount of interest is "paid" to a non-resident. Section 221YK imposed the same requirement in the same terms, but also included a series of examples in which interest would be regarded as having been paid, which included the case where interest had been capitalised (as was the situation here). These examples are not replicated in s 11-5. Thus, the court was required to consider whether the terms of the former s 221YK influenced the interpretation of s 11-5.

The Commissioner won on both issues in the AAT and before Griffiths J in the Federal Court. In the Full Federal Court, the Commissioner won by majority, with Pagone and Davies JJ (in separate judgments) holding that the arrangement did constitute a sham. As a result of this finding, it was not necessary for their Honours to consider the withholding tax issue, rendering their comments on that issue obiter. However, their Honours both found in favour of the Commissioner on this matter as well. Logan J held in favour of the taxpayers on the matter of sham and then found in their favour on the withholding tax issue.

The court's analysis

Sham

While necessary to consider the meaning of the term "sham", there is little in the judgments that extends or clarifies the meaning of that phrase. Logan J, quoting the High Court in *Equuscorp Pty Ltd v Glengallan Investments Pty Ltd*,[9] stated that "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."[10] Pagone J, in noting the central role of the parties' intentions, quoted Diplock LJ in *Snook v London and West Riding Investments Ltd*,[11] where it was said that:[12]

> "['Sham'] means acts done or documents executed by the parties to the 'sham' which are intended 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."

Davies J noted the similar formulation of sham that Kiefel J put forward at first instance (and accepted by the High Court) in *Raftland Pty Ltd v FCT*[13] that "a 'sham' refers to steps which take the form of a legally effective transaction, but which the parties do not intend should have the apparent, or any, legal consequences".[14]

As is evident from all these definitions, the concept of sham centres around the parties' intentions. Of relevance to this case was the role (if any) that the intention of a third party, namely an adviser, has in determining the taxpayer's shamming intention. Mr Gould was the conduit between the taxpayers and HWBB, with no communication occurring directly between the parties.

The taxpayers adopted the position that they genuinely believed in the legitimacy of the arrangement and, therefore, the arrangement could not be a sham. In other words, the taxpayers genuinely believed that a loan for the amount of $600,000 was obtained from HWBB and an equal amount was placed on deposit with HWBB. As a question of fact, the AAT accepted the taxpayers' evidence on the point of their subjective belief.[15]

However, in these circumstances, the taxpayers' subjective belief was insufficient to determine the issue of whether the transaction constituted a sham. Critical to the outcome of this element of the case was that the taxpayers had the onus of proof in Pt IVC proceedings.[8] Consequently, it was for the taxpayers to disprove that the arrangement constituted a sham. As Pagone J explained, "[to] rebut the shamming intention, they needed, at least, to establish that they had entered into a legally effective loan with [HWBB] and not merely that they believed Mr Gould that they had done so by accepting the arrangement he had put to them".[16]

Much was made of the taxpayers' decision not to call Mr Gould to give evidence, as he was regarded as being in a unique position to shed light on the intentions underlying the arrangement. The AAT identified some 14 specific questions to which Mr Gould could have given evidence[17] but did not.[18] Merely by establishing that they believed that the arrangement was genuine was insufficient for the taxpayers to discharge their burden of proof and it was open to the AAT to so find.[19]

It was on this point that Logan J differed from the majority. His Honour interpreted the authorities on the definition of sham as being focused on the intentions belonging to the parties to the arrangement in question and not that of some intermediary. The only circumstances in which another party's intention could be imputed to a principal is when that other party is acting as that party's agent.[20] Further, the parties to the arrangement need a mutual intention that the transaction be a sham.[21] Once the AAT had found as a question of fact that the taxpayers held a genuine subjective belief in the arrangement's legitimacy, then it was not open to the AAT to find that the arrangement was a sham.[21]

On this question of imputed intention, there was a clear difference of opinion as to the state of the authorities, which will be an interesting issue to watch should the case be appealed. Logan J interpreted the authorities as focusing on the parties' intentions and no further, with the majority (upholding the decisions below) regarding the relevant principles as permitting such imputation. Stated directly, it would appear that these interpretations are irreconcilable. Further, the majority's position may be difficult to sustain, since, on the surface, the authorities, particularly those preceding *Raftland*,

do not seem to contemplate imputing a third party's intentions in characterising an arrangement as a sham (except, of course, where the third party is an agent). However, a degree of consistency may be identified if the majority's approach is qualified with an unstated requirement that intention is imputed only "in appropriate circumstances". It is evident that the majority here were uncomfortable with the arrangement, not least being the lack of communication between the parties, but especially the discrepancy between the purported arrangement as represented in the legal documents and the parties' subsequent behaviour.

This was highlighted by Pagone J[21] and stated somewhat more directly by Davies J, who stated "[t]he apparent discrepancies between the transaction documents and what the parties actually did invited inquiry into whether the transaction documents were a pretence".[22] Commencing at para 37, the AAT identifies several gaps and inconsistencies in the evidence before it, such as the non-recording of interest expenses in the superannuation fund's financial statements.[23] Subject to resolution from the High Court, it would seem that the door is open for third party intentions to be used in characterising a sham where the parties' behaviour is inconsistent with the rights and obligations set out in the legal documentation.

Withholding tax

As with the sham issue, Pagone and Davies JJ separately held in favour of the Commissioner, with Logan J finding in favour of the taxpayers. As noted earlier, having found in favour of the Commissioner on the sham issue, it was not necessary for Pagone and Davies JJ to consider this issue, whereas it was a necessary component of Logan J's judgment.

The withholding issue was whether the (resident) taxpayers were required to withhold tax from the interest payments due to HWBB (as a non-resident). Having not withheld tax during the course of the arrangement, if there was such a requirement, then the taxpayers would be denied a deduction for the interest payable under the loan agreement.

In actuality, though, this issue was one of statutory interpretation, in particular, the use of predecessor provisions when construing rewritten legislation.

The obligation to withhold tax from such interest payments is imposed under s 12-245 of Sch 1 TAA. This provision is clarified by s 11-5 of the same schedule, which is expressed in the following terms:

> "(1) In working out whether an entity has paid an amount to another entity, and when the payment is made, the amount is taken to have been paid to the other entity when the first entity applies or deals with the amount in any way on the other's behalf or as the other directs.
>
> (2) An amount is taken to be payable by an entity to another entity if the first entity is required to apply or deal with it in any way on the other's behalf or as the other directs."

Section 11-5 succeeded the former s 221YK. Of particular importance was s 221YK(3)(a), which stated:

> "(3) For the purposes of this Division:
>
> (a) interest or a royalty shall be deemed to have been paid by a person to another person although it is not actually paid over to the other person but is reinvested, accumulated, capitalized, carried to any reserve, sinking fund or insurance fund however designated, or otherwise dealt with on behalf of the other person or as the other person directs;"

> *"... the door is open for third party intentions to be used in characterising a sham where the parties' behaviour is inconsistent with the rights and obligations set out in the legal documentation."*

As noted earlier, the loan agreement between the taxpayers and HWBB permitted HWBB to capitalise interest payable on the loan where no transfer had taken place. Such capitalisation took place in respect of all the interest that had accrued on the taxpayers' loan.

The basic issue at hand was whether interest that had been capitalised would be regarded as paid for the purposes of s 12-245. If yes, then the taxpayers faced a withholding obligation that had not been met and they would be denied deductibility for such incurred interest expenditure as a result.

Logan J, in finding for the taxpayers, held that provisions should be read as they stand in their present state, rather than by reference to any predecessor provisions.[24] Looking at the wording of s 11-5 on its face, Logan J stated "that a person does not deal with an amount by doing nothing in respect of that amount".[25] With the taxpayers not having taken any overt action and in the absence of any absurdity arising from the text,[26] the taxpayers could not be regarded as having paid any interest and, therefore, s 12-245 did not have any application.

The majority, on the other hand, placed significant weight on the terms of s 11-5's predecessor, specifically the list of examples provided in the former s 221YK(3)(a). Davies J noted that the general terms used in the current provision are "substantially similar" to those used in its predecessor.[27] Her Honour went on to state that "[a]s a matter of construction of s 11-5, the absence of an express deeming that interest is paid if it is capitalised does not mean that the section was not intended by Parliament to apply to capitalised interest at all".[28] Given the freedom to consider capitalised interest as having been paid in the sense that it had been dealt with according to direction, it was held that s 12-245 did apply to impose a withholding obligation.[28] Pagone J also considered the capitalisation to be a dealing within the meaning of s 11-5, thereby triggering the withholding requirement under s 12-245.[29]

Conclusion

This case raised two interesting questions that may come before the High Court should it be appealed. Of primary importance is the question of whether a third party's intention is relevant when characterising an arrangement as a sham. For any decision that permits looking to such third party intentions to be consistent with established precedent, it would seem that the approach needs to be qualified so that such examination takes place when the observed conduct is at odds with the legal documentation involved.

The second question, as to how rewritten provisions should be interpreted in light of

their predecessors has particular relevance for income tax statutes, given the modern efforts to simplify the language used in taxing legislation. While the transition from the ITAA36 to its 1997 successor would seem to be covered by s 1-3 of the latter statute (at least to a certain extent), the absence of such clarification provisions in other statutes, such as the TAA, imports a greater significance to such construction principles.

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References

1 *Millar v FCT* [2016] FCAFC 94 (*Millar*). This was an appeal from the decision of Griffiths J in the Federal Court ([2015] FCA 1104), which was an appeal from the Administrative Appeals Tribunal decision in *Morrison and FCT* [2015] AATA 114 (*Morrison).*
2 *Morrison* at [12].
3 *Morrison* at [29].
4 [2015] FCA 1104 at [13].
5 See, for example, *Millar* at [49] (Pagone J).
6 *Morrison* at [26].
7 *Morrison* at [22].
8 S 14ZZK of the *Taxation Administration Act 1953* (Cth).
9 [2004] HCA 55.
10 *Millar* at [1].
11 [1967] 2 QB 786.
12 *Millar* at [42].
13 [2006] FCA 109.
14 *Millar* at [79].
15 *Morrison* at [69].
16 *Millar* at [45].
17 The AAT was informed that Mr Gould did not give evidence as he was facing criminal charges at the time of the hearing; *Morrison* at [48].
18 *Morrison* at [49].
19 *Millar* at [46] (Pagone J), [84] (Davies J).
20 *Millar* at [10].
21 *Millar* at [46].
22 *Millar* at [84].
23 *Morrison* at [41].
24 *Millar* at [27].
25 *Millar* at [31].
26 *Millar* at [35].
27 *Millar* at [94].
28 See application of these principles in *Millar* at [95].
29 *Millar* at [50].