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Allowable deductions, cost base of CGT assets and the GAAR: a minefield for taxpayers and their advisers

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Introduction

Taxpayers and their advisers have, for decades, struggled to reconcile outgoings that can be considered as allowable deductions under s 8-1 of the Income Tax Assessment Act 1997 (Cth) (ITAA 97), with those outgoings which may be included in the cost base of a Capital Gains Tax (CGT) asset.¹ In this article we briefly examine *Hart's case*² and the subsequent Taxation Determination TD 2005/33 issued by the Australian Tax Office (ATO). This Tax Determination sets out the Commissioner's view regarding the inclusion (or non-inclusion) of non-capital costs of ownership of a CGT asset in its cost base where such outgoings had been previously denied deductibility under the general deduction provisions³ of the ITAA 97 by virtue of the general anti-avoidance rule (GAAR) under Pt IVA of the Income Tax Assessment Act 1936 (Cth) (ITAA 36).

This article argues that the Commissioner's position as outlined in TD 2005/33 is unclear, confusing and its outcome can be unpredictable for taxpayers.⁴ This argument is based on two major reasonings. First, TD 2005/33 refers to a "tax benefit" in its approach to the inclusion (or non-inclusion) of non-capital costs of ownership of a CGT asset in its cost base.⁵ However, under the GAAR, inclusions in the cost base of a CGT asset are arguably not encompassed within the definition of a "tax benefit" under s 177C(1) of the ITAA 36. Second, the interplay and order of the application of the tax rules of the general deduction provision in s 8-1 of the ITAA 97, the cost base elements of a CGT asset under s 110-25 of the ITAA 97, the exclusion provisions of ss 110-40(2) and 110-45(1B) of the ITAA 97, and the applicability of the GAAR under Pt IVA of the ITAA 36 are not clear from TD 2005/33. Depending on the order in which these tax rules apply to a relevant outgoing, there will be a different outcome for taxpayers in the calculation of their tax liability.

In 2009, Pagone J commented:

Tax falls upon us in the ordinary course of our activities as a compulsory taking from us of something that we, by definition, have earned or owned. How and when that may happen should be clear, predicable and free from whim, caprice or chance.⁶

The application of TD 2005/33 presents us with these same issues. It therefore should be remedied either via legislative reforms to the Income Tax Assessment Acts, or through a rewrite of it, or by the introduction of another tax determination or ruling. This will give taxpayers and their advisers more clarity and certainty in determining a taxpayer's tax liability, thus limiting the risk to a taxpayer in attracting the GAAR under Pt IVA of the ITAA 36.

Hart's case, TD 2005/33 and Pt IVA of the ITAA 36 — tax complexity and taxpayer uncertainty

Hart's case in 2004⁷ highlighted the problematic interplay between the general deduction provision and the application of the GAAR under Pt IVA of the ITAA 36. *Hart's case* involved a taxpayer who had borrowed \$300,000 in order to finance the purchase of an investment property and a principal place of residence. At the time of the borrowing, the taxpayer opted to "split" the loan for both properties into two parts. In short, the ATO did not deny the taxpayer the ability to deduct amounts for the normal interest incurred with respect to the investment property, including interest incurred where some of the borrowed funds were used to refinance the investment property. What remained in question, however, was the particular way in which the two parts of the loan interacted, and the deductibility of those outgoings with respect to the investment property that were considered compound interest and further interest. The Federal Court in the first instance found that because these interest outgoings attracted the operation of the GAAR in Pt IVA of the ITAA 36, they were denied deductibility under the general deduction provision under s 8-1 of the ITAA 97.⁸

On appeal from the Full Federal Court,⁹ the High Court did not consider the question as to whether or not the amounts were deductible, however they did find that the GAAR in Pt IVA of the ITAA 36 did apply to these outgoings. As Boccabella noted in 2005, "the full High

Court accepted that the ‘tax benefit’ to the taxpayer under the GAAR was the deduction for the further interest and the compound interest.”¹⁰ The High Court however did not consider whether the same outgoings could be included in the cost base of the investment property, and if to do so, whether they would attract the provisions of Pt IVA of the ITAA 36.

Following *Hart’s* case, the ATO issued TD 2005/33. Under this determination, the ATO aims to preclude the inclusion of non-capital costs of ownership of a CGT asset in an assets cost base, where such outgoings had been previously denied deductibility under the general deduction provisions¹¹ of the ITAA 97 by virtue of the GAAR under Pt IVA of the ITAA 36. In effect, outgoings such as those dealt with in the *Hart* case (compound and further interest accruing from a split loan arrangement) that had been denied deductibility under s 8-1 of the ITAA 97 because of the application of Pt IVA of the ITAA 36 would be unable to be included in the cost base of the investment asset.¹² The ATO argues that to include such outgoings would not be appropriate as it would be akin to giving the taxpayer a compensatory payment for a breach of the GAAR under Pt IVA of the ITAA 36.¹³

TD 2005/33 notes:

Income tax: does expenditure — which is a non-capital cost of ownership of a CGT asset — form part of the cost base of the asset, if it is a tax benefit in connection with a scheme to which the general anti-avoidance rules in Part IVA of the Income Tax Assessment Act 1936 apply?¹⁴

According to TD 2005/33, the answer is no, “...unless the Commissioner has made a determination for a compensating adjustment to that effect under subs 177F(3) of the Income Tax Assessment Act 1936 (ITAA 1936).”¹⁵ In the example given in TD 2005/33 of a split loan arrangement, the ATO indicates the Commissioner’s position, noting that such outgoings do not attract an allowable compensating adjustment under s 177F(3) of the ITAA 36.¹⁶

Applying the GAAR under Pt IVA of the ITAA 36

From *Hart’s* case, a deduction under s 8-1 will be denied if it attracts the GAAR in Pt IVA of the ITAA 36. The question then arises: can a taxpayer include outgoings such as the compound and further interest expenses emanating from a split loan arrangement in the cost base of an investment property when a CGT event occurs at a later date? As noted above, TD 2005/33 says no¹⁷ — however, when examining the actual GAAR in Pt IVA of the ITAA 36, there is no support for this determination.

What is perplexing for taxpayers is the reference to “tax benefit” in both *Hart’s* case and TD 2005/33. In *Hart’s* case, the ATO and the full High Court referred to

the “tax benefit” with respect to the generation of a deduction under the general deduction provisions. At no time was there any mention of excluding the outgoings with respect to the CGT asset cost base provisions.¹⁸ TD 2005/33 is confounding for taxpayers and their advisers, because it refers to a “tax benefit” for the purposes of Pt IVA of the ITAA 36, which precludes the inclusion of non-capital costs of ownership of a CGT asset in its cost base where such outgoings had been previously denied deductibility under the general deduction provisions of the ITAA 97 by virtue of the GAAR under Pt IVA of the ITAA 36.¹⁹ To attract the GAAR under Pt IVA of the ITAA 36, the inclusion of outgoings that relate to the non-capital costs of ownership of a CGT asset in its cost base (such as further interest and compound interest emanating from a split loan arrangement) would need to fall under the categories of a “tax benefit” as set out in s 177C(1) of the ITAA 36. This is very confusing for taxpayers and their advisers because when they examine what a “tax benefit” is for the purposes of the GAAR in Pt IVA of the ITAA 36, they will find that such outgoings are arguably not encompassed within the exhaustive list contained in s 177C(1).

In summary, s 177C(1) provides that “tax benefit” is:

- an amount not being included in the assessable income of the taxpayer;²⁰
- a deduction being allowable to the taxpayer;²¹
- a capital loss being incurred;²²
- a loss carry back tax offset being allowable to the taxpayer;²³
- a foreign income tax offset being allowable;²⁴ and
- the taxpayer not being liable to pay withholding tax.²⁵

Hart’s case dealt with the deductibility of the relevant outgoings under s 8-1 of the ITAA 97, and the application of s 177C(1)(b) of the ITAA 36. When we turn to TD 2005/33 however, and we examine the exhaustive list in s 177C(1) of the ITAA 36, there is no mention of a “tax benefit” with respect to the application of a CGT cost base provision. It is arguable that even the reference to “generation of a capital loss” under s 177C(1)(ba) of the ITAA 36 could not capture such a “tax benefit”. This is because capital losses, when considering the applicable CGT event A1 (disposal of a CGT tax asset)²⁶ which would arise, would be calculated by reference to a “reduced cost base”, of which element 3 of the cost base is excluded.²⁷ Outgoings such as further interest and compound interest emanating from a split loan arrangement, would arguably fall under element 3 of the cost base of a CGT asset,²⁸ and thus they would be excluded from the reduced cost base calculations in any

case. This assessment adds to the uncertainty for taxpayers and their advisers when trying to determine whether or not they can include relevant non-capital costs of ownership of a CGT asset in its cost base where such outgoings had been previously denied deductibility under the general deduction provisions of the ITAA 97 by virtue of the GAAR under Pt IVA of the ITAA 36.

Tax rules and their timing in application

Leaving aside the problematic issues of the applicability of the GAAR in Pt IVA of the ITAA 36 in its interplay with TD 2005/33 and an assets cost base, TD 2005/33 also presents taxpayers and their advisers with a further complexity.

For taxpayers and their advisers, the order in which the tax rules operate is crucially important. *Hart's* case dealt with timing issues, but only with respect to the application of the general deduction provisions and the application of the GAAR under Pt IVA of the ITAA 36. As noted above, the High Court in *Hart's* case did not deal with the cost base provisions at all. TD 2005/33 however, which was issued after *Hart's case*, notes at para 3 that when calculating a “tax benefit in connection with a scheme”, the cost base exclusion provisions in ss 110-40 and 110-45(1B) of the ITAA 97 will play a part. Importantly, TD 2005/33 does not however set out the order in which the provisions should apply. Nor are there any other provisions in the Income Tax Assessment Acts which set out any ordering rules that apply to the tax treatment of relevant outgoings associated with split loan arrangements.

Generally, the exclusion provisions in ss 110-40(2) and 110-45(1B) of the ITAA 97 operate to deny an inclusion of an outgoing in the second or third element of the cost base of a CGT asset, but only where it has been determined that they should be deducted elsewhere. The underlying rationale is that where a deduction can be recouped elsewhere, this should not be used to increase the cost base of an asset and thereby decrease tax liability. From another view however, taxpayers and their advisers expect to include such outgoings in the CGT asset's cost base when such outgoing cannot be deducted elsewhere. Depending on the ordering of the application of the relevant tax rules, TD 2005/33 can deny taxpayers this opportunity.

Timing and the order in which relevant tax rules are applied are important issues for taxpayers and their advisers in their consideration of the interplay of what a taxpayer can claim as an allowable deduction, what outgoings they can include in the cost base of a CGT asset, and the application of the exclusion in ss 110-40 and 110-45(1B) of the ITAA 97. These areas of the tax law are interwoven and contingent upon each other. Depending on the order in which the relevant provisions

of both the ITAA 36 and ITAA 97 apply, there may be significant tax implications for taxpayers, their advisers and the ATO. For example, the ATO may argue that with respect to relevant interest outgoings emanating from a split loan arrangement, these would be dealt with first under s 8-1 of the ITAA 97 and then under the non-capital costs of holding a CGT asset in s 110-25 ITAA 97, but also keeping in mind the application of ss 110-40 and 110-45(1B) of the ITAA 97. Only after these considerations would Pt IVA of the ITAA 36 be considered. Such an approach would be favourable to the ATO, because the ATO would only need to deal with deductibility issues under s 8-1 of the ITAA 97, and the application of Pt IVA of the ITAA 36. The ATO would not be required to consider the CGT cost base provisions in s 110-25 of the ITAA 97 because of the interplay of the exclusion provisions under s 110-40 and s 110-45(1B) of the ITAA 97.²⁹ These two provisions would have excluded the inclusion of the relevant outgoings in the cost base of an investment asset in any case. For a taxpayer and his/her adviser, this approach is not a favourable one, because it completely interferes with any opportunity for them to have included, for example, a relevant outgoing in an investment asset's cost base, where a CGT event has occurred.

Taxpayers and their advisers may argue that, given that there are no express ordering rules, they should be able to arrange their affairs so that a more favourable outcome for the taxpayer is achieved, without necessarily attracting the operation of the GAAR. Indeed, according to Lord Tomlin in *Inland Revenue Commissioners v Duke of Westminster*, “[e]very man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be”.³⁰ In this regard, a taxpayer in organising his or her tax affairs would consider first the applicability of s 8-1 of the ITAA 97. If the relevant outgoings do not attract this section, they would then examine if the GAAR under Pt IVA of the ITAA 36 applies. Where it is determined that it does not, the taxpayer could then seek to include the relevant outgoings in the cost base provisions for a CGT asset under s 110-25(4) of the ITAA 97 (element no 3). Only then would they refer to the exclusion provisions under ss 110-40(2) and 110-45(1B) of the ITAA 97. Such an approach could allow the taxpayer an opportunity to include such outgoings in the cost base of an investment asset, where a CGT event has occurred.

An obvious tension arises as to which approach is to be taken: the ATO's preferred approach or the taxpayers preferred approach? We argue that without any express ordering rules, the taxpayer is nonetheless left in an exposed situation. *Hart's* case gives no guidance, as the cost base provisions were not raised in the litigation.³¹

TD 2005/33 gives no guidance on the issue either. Unless express ordering rules are introduced, “the legal form of a transaction can lead to dramatically different tax consequences”.³² Taxpayers may argue that the lack of express ordering rules can lead to harsh outcomes for them where the ATO’s preferred approach is taken. This could lead to “distorted economic decision making and act[ed] as a disincentive to investment”.³³ In addition, taxpayers may also argue that these uncertainties unnecessarily add to their tax compliance costs.³⁴ The flaws contained in TD 2005/33 expose the ATO as well. Tax preferences and ambiguities can create the opportunity for tax avoidance, which in turn can lead to revenue leakage. We argue that the introduction of express ordering rules can address these issues significantly.

Conclusion

This article has highlighted some of the complexities, uncertainties and unpredictable outcomes³⁵ involved for taxpayers and their advisers in determining what their tax liability should be, in those circumstances where they wish to include relevant outgoings in the non-capital costs of ownership of a CGT asset in its cost base, and where such outgoings had been previously denied deductibility under the general deduction provisions³⁶ of the ITAA 97 by virtue of the GAAR under Pt IVA of the ITAA 36. The apparent flaws contained within TD 2005/33 place taxpayers and their advisers in an uncertain position when attempting to determine a taxpayer’s tax liability. If the Commissioner’s position to exclude relevant outgoings which are subject to the application of TD 2005/33 is to be supported, legislative reform of the GAAR in Pt IVA of the ITAA 36 should be undertaken so that the relevant outgoings are defined as “tax benefit” for the purposes of GAAR under s 177C(1) of the ITAA 36. This will give taxpayers, their advisers and the ATO greater clarity and certainty about how the tax laws should apply.

We have also illustrated that tax legislation is organised in such a way that sections cannot and should not be read in isolation, and that an appreciation of the interplay between the sections is required when determining the correct tax liability of a taxpayer. Express ordering rules which deal with deductibility and CGT cost base inclusion of non-capital costs of ownership of a CGT asset in its cost base will also allow taxpayers and their advisers to address a taxpayer’s tax liability with more certainty and of course lessen the risk of attracting the GAAR. Until ordering rules are incorporated into TD 2005/33 or in another Tax Determination or Tax Ruling, or until legislative reform is made to the Income Tax Assessment Acts, it is important that in advising their taxpayer

clients who have entered into arrangements of this type, tax advisers should also encourage them to lodge a ruling request with the ATO.



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Footnotes

1. Income Tax Assessment Act 1997 (Cth), s 110-25.
2. *Commissioner of Taxation v Hart* (2004) 217 CLR 216; 55 ATR 712; [2004] HCA 26; BC200403006.
3. Above, n 1, s 8-1.
4. K Wilson “More on Hart — disallowed interest forms part of cost base of property?” (2004) 25 *Weekly Tax Bulletin* [1002].
5. Tax Determination 2005/33, at [9].
6. Hon Justice GT Pagone “Tax uncertainty” (2009) 33(3) *Melbourne University Law Review* 886, at 887.
7. Above, n 2.
8. *Hart v Cmr of Taxation* (2001) 189 ALR 584; 48 ATR 317 at 321-2, 326-7; [2001] FCA 1547; BC200106697.
9. *Hart v Cmr of Taxation* (2002) 121 FCR 206; 50 ATR 369; [2002] FCAFC 222; BC200204126.
10. D Boccabella “ATO’s determination on CGT cost base inclusion for interest expenditure denied deductibility under split loans because Part IVA is flawed and misleading” (2005) 15 *Revenue Law Journal* 50 at 58. Also see *Commissioner of Taxation v Hart* (2004) 217 CLR 216; 55 ATR 712 at 716-8; [2004] HCA 26; BC200403006 (Gleeson CJ and McHugh J), 719, 721, 728 and 730-1 (Gummow and Hayne JJ) and 742-3 (Callinan J).

11. Income Tax Assessment Act 1997 (Cth), s 8-1.
12. TD 2005/33.
13. See for example paras 11 and 12 of TD 2005/33.
14. TD 2005/33, Title.
15. TD 2005/33, at [1].
16. TD 2005/33, at [11]. Also refer to Income Tax Assessment Act 1936 (Cth), s 177F(3).
17. TD 2005/33, at [1].
18. Above, n 2. Also refer to Income Tax Assessment Act 1997 (Cth), s 110-25(4) which refers to the non-capital costs of holding a CGT asset.
19. TD 2005/33, at [9].
20. Income Tax Assessment Act 1936 (Cth), s 177C(1)(a).
21. Above, n 20, s 177C(1)(b).
22. Above, n 20, s 177C(1)(ba).
23. Above, n 20, s 177C(1)(baa).
24. Above, n 20, s 177C(1)(bb).
25. Above, n 20, s 177C(1)(bc).
26. Above, n 1, s 104-10.
27. Above, n 1, s 110-55(2), which notes "All of the elements (except the third one) of the reduced cost base of a CGT asset are the same as those for the cost base."
28. Above, n 1, s 110-25(4). Under this section, element 3 of the cost base of a CGT asset is noted to include "...the costs of owning the CGT asset you incurred (but only if you acquired the asset after 20 August 1991). These costs include: (a) interest on money you borrowed to acquire the asset; and (b) costs of maintaining, repairing or insuring it; and (c) rates or land tax, if the asset is land; and (d) interest on money you borrowed to refinance the money you borrowed to acquire the asset; and (e) interest on money you borrowed to finance the capital expenditure you incurred to increase the asset's value."
29. D Boccabella "Inclusion in cost base of investment property of interest denied deductibility under a split loan because of Pt IVA: some follow up analysis" (2007) 17(1) *Revenue Law Journal* 138-60.
30. *Inland Revenue Commissioners v Duke of Westminster* [1936] AC 1; [1935] All ER 259; (1935) 104 LJKB 383; 19 TC 490.
31. Above, n 2.
32. R Krever "Taming complexity in Australian income tax" (2003) 25(4) *Sydney Law Review* 467 at 468.
33. C Evans "Taxing capital gains: one step forwards or two steps back?" (2002) 5(1) *Journal of Australian Taxation* 114 at 123.
34. See J Freebairn "Microeconomic reform and tax simplification" (1993) 10 *Australian Tax Forum* 461 at 462 who argues that compliance costs on Australian taxpayers are already among the highest of all other tax systems all over the world.
35. Above, n 4.
36. Income Tax Assessment Act 1997 (Cth), s 8-1.