

PRACTITIONER ARTICLES

[1092] High Court lets the "sham" genie out of the bottle

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Striking down transactions as a "sham" has severe tax and criminal consequences. The High Court in the *Raftland* case [2008] HCA 21 (reported at 2008 WTB 22 [859]) has let the "sham" genie out of the bottle and given significant impetus to the Tax Office push to strike down a wide range of transactions as "shams".

The decision is, in my view, the most important tax decision in the last decade because of its practical implications for taxpayers and tax practitioners (both professionally and personally).

The facts

For present purposes, the relevant facts in the case were that as part of an arrangement to shelter the taxable income of an income trust against the losses of an unrelated loss trust, a series of transactions were entered into. One part involved providing that the trustee of the loss trust was presently entitled to income of the income trust.

The ATO issued assessments to *Raftland*, as trustee of the income trust, on the basis there was no beneficiary presently entitled to the trust income.

ATO withdrew Pt IVA claim

Shortly prior to the date for hearing in the Federal Court, the ATO advised that it no longer relied upon Pt IVA as justifying the assessments but solely upon the argument that entitlement provision was a sham.

Kiefel J held that the entitlement provision was a sham

Kiefel J heard the dispute at first instance in the Federal Court (*Raftland Pty Ltd v FCT* (2006) 62 ATR 49, reported at 2006 WTB 9 [383]) and held that the trustee's resolution to distribute the trust income to the loss trust was a sham and therefore ineffective to create an entitlement to the income. She also held that the default income provision in the income trust trust

deed, whereby the loss trust was expressed to be entitled to the trust income, was also a sham.

Full Federal Court held provision not a sham

The Full Federal Court reversed the decision of Kiefel J and held that the provision was not a sham: *Raftland Pty Ltd v FCT* (2007) 65 ATR 336, reported at 2007 WTB 5 [164].

Edmonds J in the lead judgment applied the well-known passage from the decision of Lockhart J in *Sharrment Pty Limited v Official Trustee in Bankruptcy* (1988) 18 FCR 449 at 454:

"A 'sham' is therefore for the purposes of Australian law, something that is intended to be mistaken for something else or that is not really what it purports to be. It is a spurious imitation, a counterfeit, a disguise or a fake front. It is not genuine or true, but something made in imitation of something else or made to appear to be something which it is not. It is something which is false or deceptive."

High Court decision holds provision was a sham

In the High Court, the joint judgment of Gleeson CJ, Gummow and Crennan JJ contains the following statement:

*"The presence of an objective of deliberate deception indicates fraud. This suggests the need for caution in adoption of the description 'sham'. However, in the present litigation it may be used in a sense which is less pejorative but still apt to deny the critical step in the appellant's case. The absence of a present entitlement within the meaning of s 100A(1)(a) of the Act may appear from an examination of the whole of the relevant circumstances, and these are not confined to the terms of the *Raftland Trust instrument*." (para [36])*

After considering the evidence, the joint judgment concluded there was a sham and stated:

"The primary judge was fully justified in finding that the entitlement under the Raftland Trust deed was not intended by the settlor or the trustee or the 'tertiary beneficiary' [eg loss trust], to have substantive, as opposed to apparent, legal effect". (para [58])

Kirby J considered that in accordance with established Australian legal doctrine, there was a sham and then went on to state that the doctrine should be extended:

"Doing so would not cut across the language and purpose of the explicit tax avoidance provisions enacted as Pt IVA of the Act. On the contrary, such an approach would be compatible with that contained in Pt IVA and the purposes that led to the enactment of that Part. It would demonstrate, once again, that in the present age, the doctrines of the common law evolve in the orbit of statute". (para [159])

Heydon J, in his judgment, posed the question: had the loss trust sued the income trust for the income in question, what answer would the income trust have made? The answer that he gave was that apart from sham, there was a defence to such an action as the attempted enforcement would be dishonest and fraudulent.

Relevance of the intentions of the legal advisers

The solicitor for the taxpayer gave evidence as to the intentions of his client and in the High Court joint judgment, the following passage appears:

"Edmonds J referred... that many tax schemes are intended to have an otherwise inexplicable legal effect precisely because of the fiscal objectives that are pursued. That is undoubtedly true, but it does not deny the possibility that, in a particular case, documents might not be intended by the parties to have legal effect according to their tenor. The conclusion of Edmonds J was that, far from being a façade or sham, the nomination of the E & M Unit Trust as a tertiary beneficiary of the

Raftland Trust 'was at the forefront of the intentions of those charged with responsibility for establishing the Raftland Trust'". (para [56])

Implications of Raftland case

In my view, the practical implications of the *Raftland* case are:

- Sham is an everyday word, and like beauty, is in the eye of the beholder. The High Court has not laid down the content or boundaries of what is a sham but left it open.
- The assertion of sham is a much greater weapon for the ATO than Pt IVA. None of the carefully drafted legislative provisions in that Part need to be considered.
- Sham has overtones of "fraud" or "dishonesty" which could give rise to criminal offences of money laundering and conspiracy to defraud, as well as the removal of time limits to amend an assessment, and increased penalties. This will put tremendous pressure on taxpayers and their advisers who advised on the transaction.
- The uncertainty about the scope of sham creates a strong bias in favour of the ATO. Only a handful of tax disputes reach the courts; many are "sorted out" by agreement or concession by taxpayers. Despite believing there was no sham, few taxpayers will have the luxury of having the High Court determine whether it thinks sham applies.
- The High Court has introduced a new specie of sham; namely, whether the parties intended the transaction to have "substantial legal effect". But what do those words mean? What is the difference between intending a transaction to have "legal effect", but not intending it to have "substantive legal effect"?
- The High Court effectively "quarantined" the intentions of the solicitor (and apparently senior counsel) who advised the taxpayer in carrying out the transaction. With respect, that is an unreal and artificial approach and would result in many transactions being shams. The law, including trust law, is

often so complex that non-specialists, whether lawyers or not, have frequently

no relevant intentions except those of advising on the transaction.