Deloitte.

12 July 2016
2016/13

Tax Insights

Commissioner of Taxation v Ludekens (No. 2) [2016] FCA 775

Snapshot

Following the introduction of the civil penalties colloquially referred to as the 'promoter penalties', there was significant uncertainty as to how they would be applied in practice, and in particular the likely quantum of the penalty that might result given the discretion afforded to the Court under the regime. *Commissioner of Taxation v Ludekens (No. 2)* [2016] FCA 755 (***Ludekens (No. 2)***) sheds light on this and confirms that the Courts will take a considered approach in deciding penalty quantum. This is in stark contrast to the Commissioner who requested significantly larger penalties, revealing a harsher stance. The Court has also narrowed the factors to be considered in applying the penalty.

KEY TAKEAWAYS

Factors to be considered have been narrowed

The Court in *Ludekens (No. 2)* commented directly on the submissions of the Commissioner and, in doing so, narrowed the factors to be considered when determining penalty amounts. Specifically:

- **The maximum penalty**: This is not the starting point when determining penalty amounts.
- **Alternative offences**: Conduct which is not prosecuted under the promoter penalty provisions but could form a separate offence under the Tax Acts should not be allocated much weight when determining penalty amounts.
- **The nature of the contravention**: The commercial viability of the scheme is irrelevant. The actual conduct and actions taken as part of the contravention are important.

A substantial penalty, but a just and fair result

Ludekens (No. 2) also revealed that the Courts will impose substantial penalties on contraventions of the promoter penalty provisions. The Court in *Ludekens (No. 2)* ultimately enforced a penalty of $180,000. In the light of the desperate financial position of the Taxpayers (a result, in large, due to the conduct in question), the relatively small loss to the investors in the scheme in question and its lack of commercial viability, the severity with which the promoter penalty provisions will be enforced is clear

However, in reaching this result, the Court also allocated significant weight to the personal circumstances of the Taxpayers, a clear indication of the Court's intention to nevertheless reach a just and fair result.

LUDEKENS (NO. 2)

All that remained to be determined in *Ludekens (No. 2)* was the amount of the penalties to be imposed following the decision in *Commissioner of Taxation of the Commonwealth of Australia v Ludekens & Anor* (2013) 92 ATR 301 (***Ludekens***) that the Taxpayers were guilty of the civil offence of promoting tax exploitation schemes.

Recap

The *Taxation Administration Act 1953* (**TAA**) prohibits entities (including individuals and body corporates) from promoting tax exploitation schemes. Tax exploitation schemes have the following characteristics:

- The sole or dominant purpose of carrying out or entering into a scheme is to obtain a scheme benefit. A scheme benefit includes a lower tax-related liability, or a greater amount of credits receivable from the Commissioner; and
- It is not reasonably arguable a scheme benefit is available under law.

"Conduct which is not prosecuted under the promoter penalty provisions, but could form a separate offence under the Tax Acts, should not be allocated much weight when determining penalty amounts"

Where an entity is found guilty of promoting a tax exploitation scheme, the Federal Court may order that the entity pay a civil penalty. In determining the amount of the penalty, the Court may have regard to all matters it considers relevant and, in particular, the factors listed in section 290-50(5) of Schedule 1 to the TAA.

In *Ludekens,* the Taxpayers acquired "woodlots" which were the subject of a favourable ATO product ruling. Specifically, income tax deductions and GST refunds would be available to investors who were accepted into the scheme by 30 June 2007.

As at 30 June 2007, the Taxpayers had acquired signatories to enter into a partnership carrying on a business in relation to the "woodlots" to temporarily satisfy the ATO product ruling. The intention was to swap out these signatories for investors at a later point in time (and backdate those documents). On entering the scheme, the investors would be able to claim the benefits of the income tax deductions and GST refunds for the 30 June 2007 income year.

Penalty Proceedings

The Court began by outlining that the prescribed maximum penalty for the Taxpayers was approximately $10 million each. However, the Court stressed that in the process of determining the appropriate penalty *"it is incorrect to commence with the maximum penalty and engage in a ratcheting down exercise"*.

Instead, the Court held that a penalty of $180,000 for each Taxpayer was **just and appropriate** in the circumstances. In coming to this decision, the Court distinguished the contravening conduct giving rise to the civil penalty from other conduct engaged in by the Taxpayers during and after the relevant period. The Court also gave considerable weight to the Taxpayers' personal and financial circumstances which would have reduced the effectiveness of any deterrence intended by a harsher penalty. In particular, the Court noted that the penalty to be imposed could usually be expected to exceed the benefit received in respect of the scheme, however such a penalty would be insurmountable by the Taxpayers in this instance.

The key factors considered by the Court are examined in greater detail below.

The contravening conduct

The Court consistently pointed out that the '*vice'* (contravening conduct) to be penalised was the belief held by the Taxpayers that the signatories could be substituted after 30 June 2007 for investors. It was this belief which gave rise to seven separate breaches of the promoter penalty provisions. The Court also noted that but for this **erroneous belief**, there would have been no contravention in promoting the scheme.

"The Court consistently pointed out that the *'vice'* to be penalised was the belief held by the Taxpayers that the signatories could be substituted after 30 June 2007 for investors"

Personal circumstances

The Court placed great emphasis on the personal and financial circumstances of the Taxpayers, including: both have been made bankrupt, neither retained the benefit of the schemes, both experienced damage to their personal health, and irreparable harm to previously friendly relations.

Deterrence

It is with regards to deterrence that the Court adopted an approach that moved substantially away from the suggestions of the Commissioner who submitted that a penalty should be aimed at specific deterrence.

The Court commented in obiter that the Commissioner's submissions with regards to the conduct of the Taxpayers in the context of deterrence *"cannot be accepted without qualification and without substantial caution"*. Further, the Court stressed that there needed to be a "*link between the penalty imposed, the specific conduct to be deterred and the specific compliance to be promoted*".

It followed that, whilst acknowledging that the penalty should be aimed at general and specific deterrence, the Court reduced focus on conduct by the Taxpayers that was raised by the Commissioner but was outside of the scope of the proceeding. In particular:

- misrepresentation and dishonesty were separate offences not prosecuted by the Commissioner, and should not have been included in support of that contention;
- the act of contesting the Commissioner in *Ludekens* should be allocated minimal weight, particularly given the Taxpayers won at first instance; and
- the fact that one of the Taxpayers continued to offer financial products as late as July 2015 was not shown to be wrongful or requiring direct or indirect sanction.

"… the contravention was the making of applications with the names of people who had no intention of entering the partnership or carrying on the business"

Instead, the Court found that specific deterrence did not warrant an unduly heavy penalty – particularly given that the conduct in question had already resulted in financial and personal loss and hardship for each Taxpayer.

Nature and extent of the contravention

The Commissioner contended that the contraventions involved the promotion of a tax avoidance scheme which:

- Involved substantial amounts of money;
- Depended on falsely-premised scheme benefits;
- Was inherently risky to participants; and
- Involved significant elements of misrepresentation and dishonesty.

In dismissing the Commissioner's submission, the Court instead held that the nature of the contravention was the making of applications with the names of people who had no intention of entering the partnership or carrying on the business.

Importantly, the course of determining the nature of the contravention is distinguished from an evaluation of the commercial viability of the scheme, and also distinguished from any hypothetical consideration of how the scheme could have been implemented. Rather, it focuses on the actual conduct and actions taken. Therefore, the nature of the contravention which needed to be reflected in the penalty was the use of the 'signatories' to claim participation in the project when they did not intend to do so beyond their initial role as applicants.

Also, whilst the extent of the contravention was relatively confined, as there was no public marketing, the Court acknowledged that it needed to be reflected in the penalty.

Cooperation

The Commissioner submitted that the Taxpayers were not cooperative, contending that:

- Both held the belief that they could substitute the signatories with investors at a later date;
- Both contested the Commissioner in the Federal Court; and
- Neither were cooperative during the investigation.

Again, the Court dismissed the Commissioner's submissions and distinguished the Taxpayer's erroneous belief as the contravention at the heart of the offence, and not an indicator of noncooperation. The Court also dismissed the fact that the Taxpayers contested the Commissioner at trial (and won at first instance whilst being mostly unrepresented) could be taken to be noncooperation, noting the Commissioner's handling of the matter was also the subject to similar criticism.

Instead, the Court found the Taxpayers' conduct during the investigation to be the key and noted blatant inconsistencies during the ATO audit, including:

- Communicating to the ATO that the signatories were committed to the partnership;
- Continued belief, as communicated to the ATO, that there existed an entitlement to GST refunds despite a realisation this was not the case;
- Encouraging and requesting signatories and investors sign but not date any documents; and
- Subsequently backdating those documents.

"… the Taxpayers could not have been under a reasonable mistake of law"

The Court held any cooperation was significantly compromised by the dishonest conduct and wilful communication of incorrect information to the Commissioner.

Honest and reasonable mistake of law?

The Commissioner submitted that the contraventions were deliberate and the Taxpayers could not have been under a reasonable mistake of law. In doing so, the Commissioner again raised factors which the Court cautioned

as more appropriately captured by alternative penalty provisions and not within the scope of the promoter penalty regime.

In contrast, the Taxpayers sought to rely on this element as a major mitigating factor for any proposed penalty citing the reliance on legal and accounting advisers as well as previous experience in similar schemes and resulting interaction with the ATO.

The Court confirmed that here, at the penalty stage of the proceeding, what the Taxpayers thought they were doing, and why they were doing it, was relevant. However, the evidence given during the penalty stage must take into account the findings made against them in the contravention stage of the proceeding (where subjective evidence was not relevant). In saying that, only those facts that were fundamental to the decision arrived at before the Full Court were said to be binding.

The Court accepted that the Taxpayers actually thought that the Commissioner would accept the substitution of investors post 30 June 2007. However, it was held that such erroneous belief did not make it either correct or justifiable for the Taxpayers to act as they did. Further, the contravening conduct was deliberate and the mistake was neither reasonable nor one of law.

Also of note – the issue of subjective evidence raises some question as to process adopted by the Court at the contravention stage of the proceeding. In this regard, Pagone J commented that whether the approach adopted to remove subjective reasons or intentions of the Taxpayers until the penalty proceeding was an appropriate course was not challenged or tested. It will be interesting to see if this is revisited in a future proceeding before the Federal Court.

Contacts

James Fabijancic
National Leader
Legal Practitioner Director
Deloitte Lawyers Pty Ltd
Tel: + 61 3 9671 7370
Email: jfabijancic@deloitte.com.au

Colin Little
Legal Practitioner Director
Deloitte Lawyers Pty Ltd
Tel: + 61 2 9322 5854
Email: colittle@deloitte.com.au

Eric Cheung
Associate
Deloitte Lawyers Pty Ltd
Tel: + 61 2 9322 5568
Email: ercheung@deloitte.com.au

Adam Hounsell
Associate
Deloitte Lawyers Pty Ltd
Tel: + 61 3 9671 6106
Email: ahounsell@deloitte.com.au

Jasmine Chan
Lawyer
Deloitte Lawyers Pty Ltd
Tel: + 61 2 9322 3776
Email: jasmchan@deloitte.com.au