TD 2002/D16 - Income tax: Is a taxpayer entitled to an income tax deduction for purported partnership losses claimed to have been incurred as a result of entering a prepaid service warrant arrangement as described in Taxpayer Alert 2002/5?

This document has been finalised by TD 2003/9.

Draft Taxation Determination

Income tax: Is a taxpayer entitled to an income tax deduction for purported partnership losses claimed to have been incurred as a result of entering a prepaid service warrant arrangement as described in Taxpayer Alert 2002/5?

Preamble

Draft Taxation Determinations (DTDs) present the preliminary, though considered, views of the Australian Taxation Office. DTDs should not be relied on; only final Taxation Determinations represent authoritative statements by the Australian Taxation Office.

1. No.

2. Taxpayer Alert 2002/5 ('the Alert') was issued on 8 April 2002. It described an arrangement where a taxpayer claims large income tax deductions for partnership losses purportedly incurred in carrying on a business of buying and selling warrants for the provision of wealth creation seminars. The Alert indicated that the Australian Taxation Office (Tax Office) is examining the scheme.

3. The arrangement appears to be as follows:

   a) A taxpayer purports to enter into a partnership which claims to be in the business of acquiring and disposing of prepaid service warrants. The taxpayer does not know some or all of the other purported partners;

   b) The partnership claims to buy a series of warrants that are redeemable for services from an offshore seminar provider ('service provider'). The warrants expire at the end of one year after issue;

   c) The service provider requires part payment for the warrants, with the balance due when the warrant is redeemed for services to be provided. For example, warrants with a face value of $50,000 are acquired by paying $6,250 (12.5% of the face value) with the balance owing to the service provider;

   d) The arrangements tend to be entered into at the end of the financial year;

   e) The partnership's claimed objective is to endorse the warrants to a client for a fee so the client can redeem them for financial and wealth creation seminars from the service provider. There is a question as to whether any warrants are actually made available to the partnership;

f) All warrants that have not been endorsed to clients by the end of a 12 month period are said to be re-purchased by the service provider at a discount to their face value. Generally this discount is equal to the part payment made at the time the warrants were purchased. In the example at paragraph 3.c) above, a discount of 12.5% is applied to the face value of the warrant, resulting in the warrant being repurchased for an amount equal to the balance owing. This amount is credited against the outstanding loan balance, leaving no amount outstanding;

g) The partnership claims that the purchase of the warrants by the partnership will give rise to a partnership loss equal to the face value of the warrants in the year they are acquired;

h) The partnership also claims that on endorsing the warrants to the client or on the re-purchasing of the warrants by the service provider the partnership would derive assessable income in the subsequent year;

i) The partners claim a share of the partnership loss in their tax returns; and

j) Partners generally have a lack of knowledge of, and participation in, the operations of the purported business. They keep limited or no records or financial statements regarding its economic performance.

4. Our view on these arrangements is as follows:

Subsection 8-1 (General deductions)

5. It is a question of fact as to whether there is a partnership and if a business is being carried on in partnership. The question of a potential partner's intent and conduct when entering into a purported partnership arrangement is one that is looked at on a case by case basis (see Taxation Ruling TR 94/8).

6. It is also a question of fact as to whether any business is being carried on. In this arrangement, the taxpayer is not carrying on a business (whether in partnership or not) for the purpose of gaining or producing assessable income. There is no evidence of a purpose of profit making, of any business activity, of a business-like organisation, nor that any warrants were employed in the purported business.

7. Accordingly, the purported expenditure on the acquisition of warrants is not necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income and is not deductible under paragraph (b) of sub-section 8-1(1) of the *Income Tax Assessment Act 1997* ('ITAA 1997').

8. Nor is the expenditure deductible under paragraph (a) of sub-section 8-1(1). If no income is in fact produced, the relevant characterisation of the outgoing is to be found in the relationship between the outgoing and the assessable income that the outgoing 'would be expected to produce': *Ronpibon Tin v. FC of T* (1949) 78 CLR 47 at 58.

9. The question of whether the investment would be expected to produce income is crucial and integral in the present case to the application of the 'real and genuine commercial test' adopted in *Lau v. FC of T* 84 ATC 4618; (1984) 15 ATR 932 and *Brand v. FC of T* 95 ATC 4262; (1995) 30 ATR 426, and accepted as the relevant test

by Conti J in *Howland-Rose v. Commissioner of Taxation* 2002 ATC 4200 at 4262; 49 ATR 206 at 276.

10. When the arrangement is entered into, the partnership has no business plan or method of selling the warrants, nor is there any evidence of activity by the partnership to sell or promote these seminars, or of any warrants actually being transferred to the partnership. There is no evidence of any sales of seminars. In reality, there could be no expectation that the investment would produce assessable income, let alone assessable income in excess of the outgoing in the sense described in *Fletcher v. FC of T* 91 ATC 4950; (1991) 22 ATR 613.

11. Moreover, the fact that there appears to have been a general failure on the part of investors to conduct any inquiries, and that they seem to disregard easily ascertainable risks that the project would yield little or no return, also supports the conclusion that the outgoing was not genuinely incurred in gaining or producing assessable income (see *Vincent v. FC of T* 2002 ATC 4490 at 4513; (2002) 50 ATR 20 at 46 – paragraph 96 of the judgment).

12. Even if the expenditure is deductible under either paragraph (a) or (b) of subsection 8-1(1), the full cost has not been incurred at the time of entering the agreement. In the arrangement described above, the partnership incurs the cost of the deposit on the warrant at the time the warrant is issued. The balance of the money owing will become due and payable and be incurred at one of two points, either when the warrant is presented for redemption for services, or when the warrant expires at the end of the year of issue and is repurchased by the service provider.

13. As a result, the amount that is incurred in the first year of operation of the partnership could only be the amount of the deposits paid on the issue of the warrants to the partnership. It can be said of any remainder that it is no more than impending, threatened or expected and therefore not incurred in the sense described *in FC of T v. James Flood* (1953) 88 CLR 492; 10 ATD 240.

14. It is also noted that if, contrary to the position put above, the cost of the warrants has been incurred in carrying on a business, no partnership loss at the end of the year can be calculated without first bringing to account the value of warrants on hand at year end as trading stock pursuant to Division 70 of the ITAA 1997.

Part IVA applies (Schemes to reduce income tax)

15. In our view, no deduction for a partnership loss is allowable to investors in the pre paid service warrant arrangements described in paragraph 3. Therefore the arrangement will not give rise to a tax benefit within the meaning of section 177C of the *Income Tax Assessment Act 1936* ('ITAA 1936').

16. However, if the partnership loss was an allowable deduction, consideration would be given to the application of Part IVA. The Part must be applied on a case-by-case basis, and in each case the Tax Office must give proper consideration to the individual circumstances of taxpayers before making a decision on its application.

17. Nevertheless, based on the evidence set out above, it is likely that it would be concluded that, having regard to the statutory factors in section 177D of the ITAA 1936,

the sole or dominant purpose for the taxpayer (and the promoters) entering into or carrying out a scheme consisting of the whole, or some part of, the prepaid service warrant arrangement would be to enable an investor to obtain a deduction for the partnership loss. In this regard, see the finding by Conti J in *Howland-Rose v. Commissioner of Taxation* (above) at paragraph 142 of the judgment:

> 'The impact of the material in the various parts of the Prospectus which I have identified immediately above leads inevitably in my opinion to the conclusion that… the applicants acquired their respective syndicate participations objectively for the dominant purpose of obtaining the benefit of the taxation deductibility opportunities so prominently featured in the Prospectus. The circumstance that each applicant testified as to an incentive of deriving substantial revenue in due course, as a consequence hopefully of future successful research and product development, cannot in my opinion avoid the result that he or she adopted a mechanism for so doing by way of participation in the process of research and development at no, or virtually no, ultimate cash shortfall, by reason of the excess or likely excess of the monetary benefits flowing in principle from the incidents of taxation deductibility over the cost of participation outlaid in cash.'

18. Investors who have entered into or are contemplating entering into an arrangement similar to that described in this Taxation Determination, and who believe that the arrangement implemented in their case or proposed to be implemented is distinguishable from that described here, may wish to apply to the Commissioner for a Private Ruling.

Your comments

19. We invite you to comment on this draft Taxation Determination. We are allowing 4 weeks for comments before we finalise the Determination. If you want your comments considered, please provide them to us within this period.

Comments by date	**15 January 2003**
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Commissioner of Taxation
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Previous draft:
Not previously issued in draft form

Related Rulings/Determinations:
TR 92/1; TR 92/20; TR 94/8; TR 97/16

Subject references:
- schemes & shams
- tax havens
- carrying on a business
- internet
- part IVA

Legislative references:

- ITAA 1997 8-1
- ITAA 1997 8-1(1)
- ITAA 1997 8-1(1)(a)
- ITAA 1997 8-1(1)(b)
- ITAA 1997 Division 70
- ITAA 1936 Part IVA
- ITAA 1936 177C
- ITAA 1936 177D

Case references:

- Brand v. FC of T 95 ATC 4262; (1995) 30 ATR 426
- FC of T v James Flood (1953) 88 CLR 492: 10 ATD 240
- Fletcher & Ors v. FC of T 91 ATC 4950; (1991) 22 ATR 613
- Howland-Rose v. Commissioner of Taxation [2002] FCA 246; 2002 ATC 4200; (2002) 49 ATR 206
- Lau v. FC of T 84 ATC 4618; (1984) 15 ATR 932
- Ronpibon Tin NL and Paper Ltd v. FC of T (1949) 78 CLR 47; 8 ATD 431
- Vincent v. FC of T 2002 ATC 4490; (2002) 50 ATR 20

ATO References
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