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Inspector-General of Taxation

Review of the Tax Office's management of complex issues — Case study on research and development syndicates

A report to the Minister for Revenue and Assistant Treasurer

May 2007

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3 May 2007

The Hon Peter Dutton MP
Minister for Revenue and Assistant Treasurer
Parliament House
CANBERRA ACT 2600

Dear Minister

I am pleased to present to you my report on findings and recommendations in respect of the review of the Tax Office's ability to identify and deal with issues concerning research and development syndicates. This review was announced as one of the three case studies which I would examine pursuant to my review into the Tax Office's ability to identify and deal with major, complex issues within reasonable timeframes. This report has been prepared under section 10 of the *Inspector-General of Taxation Act 2003*.

The Tax Office has accepted that it took too long to resolve this issue and that its communications with taxpayers could have been better. It has also fully accepted 7 of the 10 conclusions in the report. I am also pleased that the Tax Office has accepted my recommendation to reconsider the fairness of its settlements, albeit not on the basis set out in the recommendation. In the report I have also signalled many areas in need of further improvement.

It is to be expected that from time to time the Tax Office and I will not agree on all matters. I will be discussing these matters with the Tax Office as part of the process leading up to the finalisation of my final and overall report on the Tax Office's ability to deal with major complex issues within reasonable timeframes. It is expected that this process will lead to agreed tax administration improvements that will address the main issues identified in this and the other two case studies.

I offer my thanks for the support and contribution of the many government bodies, professional bodies, business groups and individuals to this review. The willingness of many to provide their time in preparing submissions and discussing issues with myself and my staff is greatly appreciated.

Yours sincerely

David Vos

David Vos AM
Inspector-General of Taxation

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CHAPTER 1 — CONDUCT OF REVIEW

1.1 This is a report on the case study of the Australian Taxation Office's (Tax Office) handling of research and development (R&D) syndication. It is a case study within a broader review conducted by the Inspector-General of Taxation (Inspector-General) on the Tax Office's handling of major, complex issues. Two other case studies form part of this review. They are the case study on service entity arrangements and the case study on living away from home allowances. Separate reports have been prepared for those case studies. A further report drawing together consistent themes from the three case studies (the fourth report) will be prepared in due course.

1.2 The review was conducted pursuant to subsection 8(1) of the *Inspector-General of Taxation Act 2003* (IGT Act 2003). It was initiated by the Inspector-General. The decision to undertake this review was prompted by concerns raised by industry and tax practitioners.

1.3 On 11 August 2005, the Inspector-General announced his forward work programme which included this review as a potential review. On 17 August 2005, he met with the Tax Office to discuss his forward work programme. Terms of reference for the review were announced on 31 October 2005. A copy of the terms of reference is reproduced in Appendix 1 of this report. The review team comprised Rick Matthews, Deputy Inspector-General of Taxation, and David Pengilley, Senior Adviser.

1.4 In relation to the R&D syndicates case study, the Inspector-General received 37 submissions from a range of investors and researchers in research and development syndicates, tax practitioners and representative organisations. A summary of the issues raised by these submissions was provided to and commented on by the Tax Office. Inspector-General staff visited the Tax Office's National, Sydney, Waymouth and Casselden Place offices to interview Tax Office staff and access documents. Staff also visited private sector offices, conducted reference groups in Melbourne and Sydney and visited the offices of AusIndustry and the Treasury. The Inspector-General did not look at all 245 syndicate cases. He viewed Tax Office files for a sample of cases to understand what had happened during the Tax Office's handling of the issue. Inspector-General staff also discussed issues relating to a case the Tax Office mediated with the mediator involved.

1.5 During the course of the review, the Inspector-General was made aware of several public documents. These are cited in Appendix 2.

1.6 In accordance with section 25 of the IGT Act 2003, the Commissioner of Taxation was provided with a reasonable opportunity to give submissions on any implied or actual criticisms contained in this report. A submission was received on 16 April 2007. This submission, incorporating the Inspector-General's comments, is reproduced in Appendix 3.

CHAPTER 2 — OVERVIEW

2.1 The R&D tax concession was a major part of the then Government's late 1980s package of measures to encourage innovation in Australian companies. The aim of the concession was to attract investment into early-stage, high-risk R&D — an area where no market previously existed. The concession provided special tax incentives designed to encourage investment in R&D where it was either too big or too risky for one company.

2.2 The main form of syndication was the guaranteed syndicate. In these syndicates a 100 per cent deduction was given for investments, and investors could guarantee themselves a rate of return regardless of the technical or commercial success of the R&D work.

2.3 A 1994 report of the Bureau of Industry Economics' review of R&D syndication commented that:

> Notwithstanding its complex guise, the program is an officially sanctioned mechanism for financing new R&D through the sale of tax losses. (BIE report, 1994, page 8.)

2.4 The R&D and finance scheme was scrutinised by the Industry Research & Development Board (IRDB). The IRDB was a Government-appointed body assisted by the Tax Concession Committee (TCC) and AusIndustry in the then Department of Industry, Tourism and Resources (and its predecessors). If all requirements were met, the syndicate was registered and eligible to claim the tax concession.

2.5 The Tax Office was at all times responsible for compliance with the relevant tax laws, including a specific anti-avoidance provision (subsection 73B(31) of the *Income Tax Assessment Act 1936*) introduced in 1991. It had observer status on the TCC and provided the TCC advice on tax matters.

2.6 A critical factor to the viability of syndicates was the price of the eligible 'core technology' at the heart of the research. The anti-avoidance provision was specifically focused on whether the core technology price was an 'arm's length' amount. This was the core compliance issue.

2.7 In the early 1990s, the R&D tax concession was reviewed by the Australian National Audit Office (ANAO) and by the BIE. The Tax Office commenced audits of some syndicates in 1992 and it took a compliance project approach to syndicates from 1994. In late 1995, the TCC announced that it would increase its scrutiny of proposed syndicates; in particular, it began pressing for arm's length valuations of core technology.

2.8 The concession was closed off to new syndicates by the then Government in 1996 because there were by then widespread concerns that it was being exploited, particularly by means of inflated core technology values. Applications for registration that were already in the pipeline were, however, allowed to proceed.

2.9 The Tax Office was legally able to review core technology deductions without time limits on those periods for review. However, all syndicates incurred core technology deductions and all investors utilised the resulting losses many years ago, in some cases up to 14 years ago.

2.10 Following an expensive but unsuccessful lead case litigation strategy aimed at applying the specific and general anti-avoidance provisions, the Tax Office mediated a case in 2003–04 in order to produce guidelines for reviewing its compliance cases. The mediation rejected the zero or negative value approach to core technology prices that the Tax Office had maintained in previous years.

2.11 Some 245 syndicates were registered during the period the concession was available. At one stage the Tax Office estimated that some $3.4 billion of revenue was involved. This estimate was based on the Tax Office view that core technology values were zero or negative. It also included full interest and penalties.

2.12 In 2004, the Tax Office decided to pursue only 40 or so of the largest investors. The remaining 'smaller' investors (less than $3 million invested) have never been contacted. In late 2006, following discussions with the Inspector-General, the Tax Office also decided that the additional scrutiny undertaken by the TCC from late 1995 would be a determinant factor in whether it would pursue particular cases or not.

2.13 At the time of this report the Tax Office has settled with most of the 40 investors for around $143 million with potential for a further $73 million to be collected from eight investors' investments still under examination, including penalties and interest. Tax Office activity could have cost the community more than what the Tax Office has collected as a result of its actions. Although no formal calculation of the cost to the community has been attempted, the Inspector-General has conservatively estimated that the overall cost to the community of the Tax Office's compliance activity over the 15 years that this issue has so far taken to resolve is between $35 million and $55 million.

The Inspector-General's conclusions

2.14 The review's foremost conclusion is that, had the Tax Office provided early, practical information to make clear its compliance expectations, this issue would never have ballooned into the protracted and expensive problem it became. The Tax Office was aware that core technology valuations were a potential compliance issue at least as early as 1991 when the specific anti-avoidance provisions were introduced. It commenced an audit project specifically on R&D syndication in 1994; but, practical guidelines on its expectations did not issue until 2004; and, as at 2007 it still has a number of cases to resolve (in spite of screening out the vast majority of 'smaller' cases).

2.15 Having noted that the Tax Office missed that opportunity to prevent things going wrong in the first place, the review has found a number of reasons for why the issue then took so long for the Tax Office to resolve. The Tax Office accepts that it took far too long.

2.16 Noting evidence that the Tax Office believed and continues to believe that R&D syndicate arrangements are tax abuse, the conclusion of the Inspector-General is that an unchecked cultural influence of 'hitting tax abuse hard' has been a major contributing factor to why the R&D syndication issue has taken well over a decade to near resolution.

2.17 The Inspector-General also has concerns about what the review has shown about the Tax Office's approach to major compliance issues. These concerns include the Tax Office:

- acting unfairly;
- lacking transparency;

- using litigation purely to strengthen its negotiating position in settlements rather than to test the issues objectively;
- failing to communicate directly with taxpayers on matters that affect them;
- exhibiting an inability to undertake an objective reconsideration of its position until some external 'searchlight' sheds light on it that the Tax Office cannot ignore; and
- not deciding major aspects of its compliance strategy until many years after the matter was identified as a major compliance issue.

2.18 While these behaviours undoubtedly contributed to the excessive timeframes, they have also undermined the Tax Office's relationships with major taxpayers and its own objectives of promoting voluntary compliance into the future. Questions also arise as to whether the Tax Office acted in line with its espoused values and the Taxpayers' Charter in this matter.

2.19 The Inspector-General has concluded that an underlying cause of these behaviours has been the Tax Office's conviction from the outset that R&D syndicates were 'rorts'. The Tax Office was right to be concerned about compliance in this area and exploitation has been identified by the Tax Office in a number of cases (but far from all of them). But compliance concerns should not, in the view of the Inspector-General, get in the way of being a fair and objective administrator.

2.20 Specific conclusions are listed below and expanded upon in Chapter 3. They reflect that this report focuses on issues with the most potential for future tax administration improvements rather than on every aspect of interest or concern in this complex issue. In this context, the review also notes a number of legislative and administrative improvements that would help better to manage issues of this magnitude and complexity.

Specific Inspector-General conclusions

1. Aspects of the concession's design and its administration created a high risk of inflated core technology values.
2. The Tax Office had good reason to be concerned.
3. The Tax Office took far too long to give practical guidance and this caused significant unnecessary compliance costs and extended the resolution's timeframes.
4. Investors could have done more to be able to demonstrate compliance, but this was unrealistic in the circumstances especially in the absence of practical guidance from the Tax Office.
5. The Tax Office took far too long to finalise its compliance action; it displayed no material sense of urgency for a major period of the timeframe.
6. Only when very senior Tax Office executives directly managed the issue did the Tax Office take positive action to speed up its resolution.
7. An unchecked cultural influence of 'hitting tax abuse hard' has been a major contributing factor to why the R&D syndication issue has taken well over a decade to near resolution.

8. The Tax Office used litigation purely to strengthen its settlement position rather than to test the issues objectively.

9. The Tax Office failed to communicate effectively.

10. In some specific cases the Tax Office acted unfairly.

Changes to tax administration

2.21 Since these issues arose, there have been a number of changes to tax administration. Amongst those changes the more significant are:

- recent changes to the tax laws to allow the Tax Office to provide private binding rulings on matters of fact, including valuations;
- recent changes to the tax laws placing time limits on the effective unlimited time periods for review of 'nil' assessments; and
- Tax Office use of 'Taxpayer Alerts' to advise taxpayers of potential Tax Office concerns with certain tax arrangements and the reasons for those concerns.

Recommendation

2.22 This review and report are part of a broader study of the Tax Office's management of large complex issues. The Inspector-General plans to issue a fourth report that will make specific recommendations for changes to tax administration that draw on the findings of this case study and on the case studies of living away from home allowances, and service entities. This report signals a number of areas for inclusion in discussions with the Tax Office on the fourth report:

- Providing early practical compliance guidance in matters of complexity and uncertainty. This includes the early publication of guidance and the early communication to relevant taxpayers that their claims may be reviewed in the future.
- Improving the mechanisms to trigger management at an appropriate senior level of those complex issues experiencing delays, without relying on bottom-up escalation processes.
- Providing sufficient reasoning on technical issues to enable an informed understanding of the strengths and weaknesses of each party's case. This could include developing and applying a set of guidelines as to the form, content and purpose of a position paper.
- Introducing circuit breakers to require independent and objective reassessment of the Tax Office's view and compliance approach where significant technical or compliance issues are not being resolved in a timely way.
- Introducing processes (checks and balances) to minimise any risk of potential cultural, or other extraneous, influences getting in the way of administrative objectivity (noting that all organisations, not only the Tax Office, are subject to unconscious influence by their culture).

- Using lead cases to reduce compliance costs of the majority of potential auditees in areas of uncertainty. These lead cases could be representative of the class of cases against which the outcome will be applied. They could be used to reduce uncertainty and provide practical guidance. These cases could be clearly identified as lead cases at the outset.

- Ensuring that there is no basis for allegations of bias in review processes either by implementing sufficient transparency and external assurance in those processes, or by engaging tax officers without a prior history in the matter.

- Ensuring that there is no basis for criticism of settlement offers by ensuring that the alternative action to settlement was not arbitrary or overstated. This could include obtaining appropriate external counsel opinion on the litigation risks (both in terms of the view of the law and an assessment of the evidentiary basis to sustain that view for that case) and likelihood of success. Greater clarity around the weight of factors for adjusting settlement terms could also be given.

2.23 This review has concluded that the Tax Office has acted unfairly towards some R&D taxpayers. The report therefore makes the following recommendation that is specific to the Tax Office's management of R & D syndicate cases.

RECOMMENDATION

The Inspector-General recommends that the Tax Office fully reconsider whether it has fairly struck settlements with:

(a) the 19 investors that the Tax Office did not formally advise that their investments made more than eight years previously would be subject to review; and

(b) those investors with whom the Tax Office negotiated settlements without telling them that at the same time it was mediating a case to develop guidelines for the resolution of R&D syndicate cases.

Tax Office response

2.24 The Tax Office provided the following response to the above recommendation.

> In relation to the 19 investors mentioned in paragraph (a), it should be noted that settlements have been made in respect of only six cases with another three cases yet to be finalised. In the remaining cases, adjustments have not been made to claimed deductions.
>
> The Tax Office accepts that it would have been better if direct contact was made with these investors earlier. However, it is our view that most, if not all, of those investors and their advisers would have been aware of the Tax Office's ongoing review of R&D syndication arrangements.
>
> In the small number of these cases where adjustments have been made, the settlements were entered into in good faith and were based on the fact that the deductions claimed by investors were not fully allowable under the law. To unwind these settlements for the reasons suggested in the report would raise questions of fairness to other taxpayers who have complied with their tax obligations under the law. It would also raise questions of fairness to other taxpayers who have settled or otherwise finalised assessments in circumstances where the Tax Office has reviewed old issues, for example, loss company cases.

It should also be noted that in reviewing these cases the Tax Office did take into account the length of time since the transactions took place in considering our position and the terms of settlement in each case.

In response to the cases settled during the course of the mediation mentioned in paragraph (b), each case was settled at a time when the Tax Office had not contemplated making a general settlement offer. This offer was considered towards the end of the mediation and was announced following the mediation. The cases were also settled before the Commissioner announced in April 2004 that the general anti-avoidance provisions in Part IVA of the Act would not be applied to deny deductions for core technology expenditure. The timing of the events relating to the two cases referred to in the report is set out in the attachment.

While not raised in the report, the overall complex and special circumstances of the R&D syndication issue may warrant that consideration should be given to reviewing any case settled on less favourable terms than the general settlement offer made towards the end of 2004. Although these cases would have been settled in good faith, there is an issue whether such investors have been unfairly disadvantaged compared to other investors simply because they chose to finalise their case in a more timely way. We will review this matter further taking into account all of the circumstances relating to these cases.

Inspector-General's comments on the Tax Office's response

2.25 I am pleased that in the last paragraph above the Tax Office has accepted my recommendation to reconsider the fairness of some of its settlements, albeit not on the basis set out in the recommendation.

2.26 In relation to the 19 investors mentioned in recommendation (a), the Tax Office accepts that it should have directly contacted these investors earlier. But, the Tax Office fails to acknowledge as unfair the fact that it did not. It also fails to acknowledge that apart from the lack of adequate communication there were also other aspects of unfair treatment of these taxpayers. Unlike other loss company cases, it was aware of all the relevant facts before arrangements were entered (including the details of the syndication arrangements and their tax effect), it was aware that this matter was, in its view, a significant compliance issue 12 to 14 years ago and it was aware that the losses were utilised by the investors at least eight years ago. It was aware of these matters many years before it sent them a settlement offer out of the blue (see paragraphs C10.3 to C10.3.5 in Chapter 3).

2.27 The Tax Office agrees that there was no fraud or evasion in these cases. In this context the Tax Office should have acted promptly within normal period-for-review time limits. After those periods it should have moved on, noting that in 2004 it pragmatically chose not to pursue over three-quarters of investors.

2.28 Further dialogue on these recommendations will be undertaken as part of the process leading up to the finalisation of my final and overall report on the Tax Office's ability to deal with major complex issues within reasonable timeframes.

Tax Office's submission to criticisms contained in this report

2.29 As afforded under section 25 of the *Inspector-General of Taxation Act 2003*, the Inspector-General gave the Commissioner of Taxation an opportunity to make submissions on criticisms in this report. The Tax Office gave a written submission.

2.30 In summary, the Tax Office clearly admits that the finalisation of its compliance action has taken too long and the communication with affected taxpayers could have been better. The Tax Office also fully accepts 7 of the 10 conclusions in the report.

2.31 However, the Tax Office did not fully accept three of the conclusions (conclusion 3, 7 and 10 — see 'specific Inspector-General conclusions' above) and some of the findings relevant to those conclusions.

2.32 Overall, the Tax Office submission does not address the substantive points raised by the conclusions. Its submission does nothing to dispel the conclusions. In some places it even appears that the submission asks the reader to accept propositions which are contrary to the Tax Office's role in a self assessing environment — for example, providing tax certainty in large complex matters.

2.33 The Tax Office submission on these disputed conclusions appears to focus on its later attempts of resolution with a blind eye to the prior 10 years. In an attempt to support its rejection of these disputed conclusions it seeks to dispute one or more references in the conclusions without addressing the range of other behaviours and areas of unfairness found in those conclusions. I assume that by not challenging these other references (neither in its final submission nor during previous discussions) the Tax Office fully accepts those findings.

2.34 The submission also asserts the report contains 'factual errors', 'omissions' and 'misleading inferences'. On closer inspection, however, these assertions are unfounded and clearly do not affect the conclusions on which they are based. I have responded to those assertions in the submission itself in some detail and further substantiated the report where relevant.

2.35 In an attempt to maintain brevity, the Tax Office's submission has truncated the facts to the point of misrepresentation in some places. The Tax Office submission also gives a mis-stated view of the facts in places. For example, the submission appears to take credit for initiating action to remedy identified unfairness. The simple fact is that without my office's strong urging to do so the Tax Office would not have taken the action it now takes credit for initiating. The Tax Office has conveniently omitted these facts from its submission.

2.36 I have reproduced the Tax Office's submission in Appendix 3. In order to reduce the length of this report and prevent duplications I have provided my detailed comments on the Tax Office's submission in the submission itself.

CHAPTER 3 — FINDINGS AND CONCLUSIONS

3.1 This chapter starts by setting out the background to the review. It then describes what R&D syndicate arrangements were and how they operated in simple terms. A brief history is given, outlining key events. The Inspector-General then sets out his conclusions and recommendation. The chapter concludes by signalling issues for review in the fourth report.

3.2 The Tax Office has taken a very long time to deal with this issue. There were many factors that contributed to the long timeframes. The Inspector-General's report does not aim to cover every contributing factor. It does not reproduce every issue that was raised with him, that was considered by him or that concerned him. Rather, the report focuses on key issues with the most potential for future tax administration improvements.

BACKGROUND

3.3 This case study is one part of a broader review. That broader review examines how the Tax Office handles major, complex issues. The reasons for the case studies arose from the Inspector-General's *Review into the Length of Time to Complete Tax Office Active Compliance Activities*. In that review the Inspector-General generally concluded that overall the Tax Office finalises audits within reasonable timeframes. However, the review also found that in some instances the Tax Office took far too long to finalise certain major, complex matters.

3.4 The aim is to identify systemic issues common to three case studies. These are the Tax Office's handling of living away from home allowances, service entities and R&D syndicate arrangements. A report will issue for each case study. A fourth report will bring together common issues and recommended action to address these common issues.

3.5 This case study identifies why the Tax Office took too long to come to grips with and satisfactorily resolve a major, complex issue — the Tax Office's compliance approach to syndicated R&D core technology claims. Many aspects of these audits have their roots in the early to mid-1990s. The Inspector-General acknowledges that we are applying today's standards with the benefit of hindsight. Although not obvious at the time, we can now assess the effect of certain approaches and decisions. This can be used to improve future tax administration approaches in major, complex issues.

What is the R&D tax concession and an R&D syndicate arrangement and how do they work?

R&D tax concession

3.6 The R&D tax concession was a major part of the then Government's late 1980s package of measures to encourage innovation in Australian companies. The aim of the concession was to attract investment into early-stage, high-risk R&D — an area where no market previously existed. Researchers were largely unsuccessful in accessing external funding for costly R&D projects. Financiers were discouraged by the significant technical and commercial risks. The tax concession offered a substantial tax benefit to investors to attract private funding of these projects.

3.7 From November 1987 to July 1996 syndicates could register to claim the R&D tax concession. Syndicates comprised two or more eligible companies jointly registered for the tax concession. They contracted out or undertook eligible R&D project(s). They claimed their proportion of R&D expenditures.

3.8 The concession was designed to encourage investment in R&D where it was either too big or too risky for one company. Initially, syndicates were required to expend a minimum of $1 million on the R&D project. This threshold was lowered to $500,000 in May 1994. Initially syndicates were required to involve financial institutions but this requirement was removed in mid-1991.

3.9 The tax concession provided a 150 per cent tax deduction for investments in 'fully at risk' syndicates. In these syndicates investors accepted the full balance sheet risks associated with the project. A 100 per cent deduction was given for investments in 'guaranteed syndicates'. In these syndicates investors could guarantee themselves a rate of return regardless of the technical or commercial success of the R&D work. This was done through the exercise of a 'put option'. Researchers would effectively 'buy the investor out' of the syndicate at a pre-agreed amount. A 1994 report of the Bureau of Industry Economics' (a predecessor to the Productivity Commission) review of R&D syndication commented that:

> Notwithstanding its complex guise, the program is an officially sanctioned mechanism for financing new R&D through the sale of tax losses. (BIE report, 1994, page 8.)

3.10 The main form of syndication was the guaranteed syndicate. The Government accepted that financial institutions would not participate without a guaranteed return.

R&D syndicates

3.11 There were three phases in the life of a syndicate.

3.12 The first phase was the establishment phase. It comprised formation of the syndicate. A researcher with an R&D proposal and investor with start-up capital were brought together. The R&D and finance scheme was scrutinised by the Industry Research & Development Board (IRDB). The IRDB was assisted by the Tax Concession Committee (TCC) and AusIndustry in the Department of Industry, Tourism and Resources (and its predecessors). If all requirements were met, the syndicate was registered and eligible to claim the tax concession.

3.13 The second phase was the research phase. During this phase, R&D work was carried out over a period of 2-3 years. If the work was a technical success, a marketing company could be formed by the syndicate that would oversee the marketing of the product. The marketing of the product was the final phase.

3.14 The investor was obliged to consider whether to continue the arrangement. Where the investor decided to discontinue the arrangement it exercised a 'put option'. This resulted in the researcher buying the syndicate from the investors at a pre-agreed price. This usually occurred within 2-7 years.

3.15 Syndicates operated by effectively 'trading' researchers' tax losses in exchange for investors financing early-stage R&D work. The following is an extract from a Government report. It sets out a simple example of how a guaranteed syndicate works. It excludes the complications of interest payments, profit margins and other accretions. The ratios used in actual syndicates varied. Although this is an overly simplistic example it does give the sense of how R&D syndicates operated.

> A research company wishes to conduct $2 million of R&D. A syndicate [comprising, in part, of a special purpose company] is formed with an investor (who effectively has a 100 per cent share in the syndicate). The investor injects $12 million of funds into the syndicate. $2 million is passed onto the researcher to undertake R&D, while a further $10 million is … paid to the researcher as a core technology licence fee. The terms of the agreement with the researcher stipulates that [if the investor exercises the put option] the researcher must … purchase the [special purpose company] at an agreed price at the end of a specific period. The agreed price, in this case, is the core technology value. The investor receives total deductions of $12 million x 0.33 (the tax rate [at the time]) = $3.96 million. Assuming that the investor [exercises the put option resulting in the researcher buying the special purpose company], then the investor receives back the $10 million originally injected, so that their overall return is $3.96 + $10 - $12 = $1.96 million.
>
> The researcher receives $2 million of R&D, and gives up tax losses. The researcher has tax losses of more than $10 million. The core technology fee is assessable as income — and accordingly the researcher gives up $10 million of these losses, which, if immediately realisable, are worth $10 x 0.33 (the tax rate) = $3.3 million. No actual taxes are paid. (BIE 1994, pp 34-35) …
>
> The 'price' of the core technology licence, and to a lesser extent, profit on the contracted R&D, are the major vehicles for enabling the [special purpose company] to transfer tax loss to the major financial investor [by virtue of section 80G of the ITAA 1936] and at the same time provide guaranteed returns on gross funds invested. The researcher … agreed to completely set aside the proceeds from the core technology licence and the R&D profit margin in a deposit account which accumulates interest and is ultimately used to provide security on funds invested by the [special purpose company] in the syndicate.
>
> The researcher draws down the R&D funds provided by the syndicate in accordance with a predetermined schedule. These funds then meet the costs associated with the new R&D. Any interim interest earned on this account is also generally allocated to the deposit account to help meet the POP (put option). (BIE 1994, pages 37-38.)

3.16 One of the key factors in 'trading' tax losses is the core technology value. The following simplistic example assumes that the put option is exercised:

> A 20 per cent increase in the core technology valuation, without a compensating increase in R&D funding, reduces the research firm's terms of trade and raises the rate of return to the investor. In order to buy the same amount of R&D, the researcher must give up more [tax] losses relative to the base case….
>
> The research company depletes its tax losses as the core technology valuations increase because the core technology licence fees are taxable. The core technology income is set aside as security on the start up project finance, and is not available to the research firm for its own use. In this sense the core technology licence fees and the concomitant depletion of accumulated tax losses can be visualised as a way of financing new R&D … Viewed in this light [and assuming the amount paid in relation to the core technology is taxable in the researcher's hands], it is clear that the researcher has an interest in keeping the core technology valuation as low as possible (for a given amount of

new R&D) so long as the investor is still willing to supply finance at the level of the core technology value that is chosen.

In contrast, the financial investor is able to [effectively] buy more tax deductions as a percentage of total capital outlay and augment the rate of return on funds invested if the value of core technology increases (for a given amount of new R&D). There is clearly a tension in valuation of core technology [assuming the core technology licence fees are taxable in the hands of the researcher] …

… in the case of tax exempt bodies the pressure to constrain core technology valuations vanishes as they are not relinquishing valuable tax losses when the core technology value rises. Such researchers may have an incentive to 'load' the core technology valuation to attract an investor. It is certainly true that core technology to R&D ratios are much higher for such tax exempt bodies. The concern that such exempt bodies could inflate core technologies to attract investors and crowd out private sector firms was, in part, the basis for which their eligibility for syndication was revoked. (BIE, 1994 pages 45 and 49.)

3.17 If a project was a technical success it could enter a marketing phase. A major proportion of proceeds would accrue to the researcher with a royalty paid to the syndicate. Investors would be paid royalties in proportion to their interests. These royalties reduced the price of the put option.

3.18 According to the Tax Office, all syndicates failed to be commercially successful. This was because no syndicate made returns which exceeded the total outlays on the core technology, associated interest and contracted R&D spend. There were some cases where the developed technology was commercially successful. But this was after investors had exercised the put option and the syndicate terminated.

3.19 Most syndicates were registered in the early to mid-1990s.

Registration process and scrutiny

3.20 Syndicates needed to be registered by the IRDB to claim the concession. There were three main stages.

3.21 Firstly, the IRDB decided whether the proposed activities were eligible. This included assessing whether the proposed activities would be 'R&D activities' under the law, whether the company claiming the concession was undertaking the proposed R&D activity on its own behalf and whether the proposed R&D activities contained an adequate level of Australian content. Syndicates could also request an optional determination of eligibility of the 'core technology'.

3.22 Secondly, the IRDB assessed whether the syndicate's proposed financial arrangements (the finance scheme) were 'not ineligible'. The IRDB accepted financial arrangements that included an attractive risk free-return to investors. This return flowed from the tax benefit and put option exercise. The put option exercise gave investors a minimum 'guaranteed' return. This was irrespective of the technical or commercial success of the project. Where the put option was not exercised, the concession required the results of the R&D activity to be exploited on normal commercial terms and in a manner that was to benefit the Australian economy.

3.23 Thirdly, syndicates submitted the final syndicate registration details so that the IRDB could register the syndicate. Parties could claim the tax concession after the IRDB accepted the proposed syndicate and officially registered it.

3.24 The IRDB relied on the TCC's advice regarding syndicates' eligibility. The TCC scrutinised applications. It required full disclosure of all relevant information. This included the financial arrangements and their tax effect.

3.25 The IRDB made it clear that the Tax Office had sole power to make determinations in relation to tax law matters. This included determining compliance with the specific anti-avoidance provision, subsection 73B(31) of the *Income Tax Assessment Act 1936* (ITAA 1936). However, core technology valuations were still considered in the context of registration. The IRDB sometimes rejected valuations.

3.26 All investors obtained advance opinions and private binding rulings from the Tax Office before entering syndicates. Many applications asked for binding advice on the core technology valuation and the anti-avoidance provisions. The Tax Office refused in almost all cases to give this advice. The Tax Office considers that the law prevented it from giving private binding rulings on matters of fact, such as valuations (please note: the law has since been amended to allow the Tax Office to provide private binding rulings on matters of fact). It also did not rule on the anti-avoidance provisions. The Tax Office claimed it depended on the future implementation of the arrangement.

3.27 The IRDB could de-register syndicates in certain cases. This included cases where the syndicate did not implement the arrangements as set out in the registration application.

3.28 Over the life of the concession 246 syndicates were registered. Their investors claimed a total of around $3.7 billion in tax deductions. This included around $2.1 billion of claimed core technology expenditure.

Core technology and valuations

3.29 'Core technology' was essentially novel and unique intellectual property. It was not sufficiently developed to be commercially valuable. There was no established market for that technology. Therefore valuations or prices paid could not be easily compared.

3.30 During the early 1990s, the Australian valuation profession was in its infancy in dealing with unique and novel intellectual property. Accountants and valuers were used to estimate values. However, valuations were a time consuming and costly process. In some cases, costs ranged from $60,000 to $100,000. Expertise was difficult to locate as knowledge was needed of the relevant markets. It also took time to give an opinion of the reasonable value, particularly from overseas experts. Due to the short lead times for R&D work, that time was not always available. In any event, expert opinion did not prove the price that should be paid. Often, highly qualified experts gave significantly different values for the same core technology.

3.31 Generally, promoters and researchers arranged the core technology valuations. The valuations considered the researcher's assumptions and forecasts. Generally, investors relied on those valuations. In a few rare cases, investors also obtained their own valuation of the core technology.

3.32 At the time there were many different valuation methodologies to use.

3.33 The discounted cash flow methodology estimated the future cash flows of a project. It then applied discount rates reflecting, among other things, the level of risk, inflation and time value of money. It was based on a series of assumptions that could not be precisely verified. This gave an estimated range of values. Many experts considered the discounted cash flow methodology as the most appropriate for valuing core technologies.

3.34 Essentially, the discounted cash flow method valued the inherent value of the core technology itself. It ignored any contractual features particular to the contract, for example, the value of special negotiation rights, advance royalties and taxes payable. It also ignored any idiosyncratic factors that influenced the parties' bargaining position or special value the particular vendor or purchaser placed on the technology. Depending on the discount rates applied, the discounted cash flow method could result in negative values.

3.35 The historic cost method used the previous expenditure incurred by the researcher as a starting point.

3.36 A comparables analysis method considered the value of other similar products or enterprises in the market. It had regard to their operations and stage of development.

3.37 Other methodologies were used also.

The specific anti-avoidance provision, subsection 73B(31)

3.38 Subsection 73B(31) of the ITAA 1936 aims, among other matters, to address the risk of core technology overvaluation. It provides the Commissioner with the power to adjust claimed core technology expenditure.

3.39 Before the power can be exercised, the Commissioner must be satisfied of two things. Firstly, the Commissioner must be satisfied that the parties to the core technology were not dealing at arm's length in relation to the core technology expenditure. Secondly, the Commissioner must be satisfied that the amount of core technology expenditure would have been less if the parties had dealt with each other at arm's length in relation to the incurring of that expenditure.

3.40 If the Commissioner is satisfied of these two issues, he can adjust the claim to a reasonable amount, having regard to:

- the connection between the parties;
- the amount of the expenditure that would, in the opinion of the Commissioner, have been incurred if the parties had dealt with each other at arm's length in relation to the incurring of that expenditure; and
- such other matters as the Commissioner considered relevant.

Tax laws providing unlimited periods for review

3.41 Syndicates involved the transfer of losses from the special purpose company to the investor group. The core technology deduction, amongst other things, was claimed by the special purpose company. It returned a 'nil' assessment. The resulting losses were transferred under section 80G of the ITAA 1936 to other investor group members (loss transferee companies).

3.42 Most loss companies transferred the core technology loss in the same year as incurring that expense. All transferred it within two years. No syndicate incurred a core technology expense after 1996.

3.43 Under tax law, 'nil' assessments were not assessments for the purpose of determining time limits for periods of Tax Office review. Effectively, the Tax Office had no time limit to amend these assessments. The Tax Office relied upon these laws to deny loss companies' core technology deductions. The Tax Office then adjusted the losses transferred to the loss transferee companies. Subsection 80G(15) also permits adjustments at any time.

3.44 Treasury considered the unlimited periods for review in its 2004 Review of Aspects of Self Assessment (ROSA). Among other things it recommended that time limits be imposed for 'nil' assessments. The *Tax Laws Amendment (Improvements to Self Assessment) Act 2005* gave effect, amongst others, to this recommendation.

Key events

3.45 In November 1987, law was enacted to permit syndicates to register and claim the R&D tax concession. This concession had a sunset clause and was due to expire in 1993. The first syndicate was registered in December 1989.

3.46 In May 1991, the Tax Office published a public ruling, IT 2635. It set out the Tax Office view on different R&D tax concession issues. The ruling accepted guaranteed returns where a syndicate was set up according to the structure set out in the ruling. In relation to core technology values, the ruling asked the reader to assume that there was no guaranteed return, that the price was not simply equated with an expert's valuation and that it reflected 'market realities'.

3.47 In December 1991, a specific anti-avoidance provision was inserted into the tax law — subsection 73B(31) of the ITAA 1936. Among other things, it effectively allowed the Commissioner to substitute a reasonable amount for claimed core technology expenditure. However, the Commissioner first needed to be satisfied that the parties were not dealing with each other at arm's length in relation to the core technology expenditure. He also needed to be satisfied that the expenditure would have been less if they had dealt with each other at arm's length.

3.48 In mid-July 1992, the Tax Office commenced its first audits of investments in syndicated R&D. These audits not only looked at potential core technology overvaluation but also included other syndication issues. By late 1992, the Tax Office's National Taxpayer Audit area considered syndicated R&D a substantial compliance issue. It recommended a national project.

3.49 In late 1992, the tax concession's sunset clause was removed. It could now operate indefinitely. Around this time, concerns with core technology overvaluation were raised by the TCC. The concession was changed to exclude public sector tax exempt researchers who had little commercial motivation to contain core technology values. In March 1993, the law introduced guidelines for determining finance schemes' eligibility. It gave the IRDB greater discretion.

3.50 From March 1993, the Government was:

> concerned to exclude those schemes whose arrangements [were] primarily intended to achieve a guaranteed return for investors as opposed to returns generated as a result of commercialisation of R&D results.

3.51 In 1993, the Australian National Audit Office (ANAO) reviewed the concession's administration. In late 1993, it recommended that a sample of R&D syndicates involving suspected inflated core technology valuations be examined. By September 1994, the Tax Office started a project to audit R&D syndicates.

3.52 Also in late 1993, the TCC sought to cap core technology values. It changed the finance scheme requirements to limit core technology expenditure to around two-thirds of the syndicate's total expenditure.

3.53 The Tax Office had an observer on the TCC. From March 1994, this was the Tax Office's R&D syndication project manager. Part of his role was to manage the Tax Office's audits of R&D syndicates.

3.54 During 1994, the Bureau of Industry Economics (BIE) (a predecessor to the Productivity Commission) evaluated the syndicated R&D programme. It published its report in October 1994 (the BIE report). The report said that notwithstanding the problems with syndication, the programme should continue. This was because it generated 'significant net social benefits'. The report recommended that private tax exempt researchers be barred from the programme. This was because of concerns with inflated core technology values.

3.55 The BIE report discussed many issues. It questioned whether core technology valuations were a reliable means to ensure an arm's length value. It observed that many syndicates considered their valuations 'artificial'. Some 'simply estimated the most defensible valuation … treating it as a genuine valuation exercise'. The report asked the Tax Office and others to reduce uncertainty. Its first recommendation was that the Tax Office and others should clarify the treatment of core technology and financial structures. The Tax Office has never publicly responded to this report.

3.56 By this time the Tax Office had obtained an Australian Valuation Office (AVO) critique of a particular syndicate's valuation. It indicated that the values were inflated. It indicated further lines of inquiry to determine what parties dealing at arm's length would have paid for the core technology.

3.57 In early 1995, a senior tax counsel officer gave a speech at an R&D industry conference. The notes indicate a general talk on core technology pricing and that the Tax Office was still considering its response to the BIE report.

3.58 In late 1995, a former Commissioner of Taxation was appointed Chairman of the TCC. Following public consultation, the TCC issued new guidelines on the registration requirements for syndicates. The Guidelines imposed more stringent conditions. It was intended to 'eliminate potential syndicates using artificial structures'. The TCC began to scrutinise core technology valuations more closely.

3.59 In March 1996, the TCC Chairman gave a public speech at an industry conference. He said that core technology valuations provided a raft of issues. He referred to a widespread perception that valuations were 'substantially on the too high side'. He indicated the TCC had received 'unsustainable' valuations. He outlined five criteria by which the TCC would assess core technology valuations. He also said that the TCC was prepared to commission its own valuations if necessary. A Tax Office senior tax counsel also gave a speech at this conference. He referred to 'early indications of questionable valuations of core technology'.

3.60 At this time also the Government had changed. The Department of Industry, Technology and Regional Development commissioned the author of the BIE report to review syndication again. A report of that review was published in July 1996. It commented that 'like a chameleon, the program has continually changed in ways which favour the easy extraction of large tax deductions'. It recommended that the programme be terminated. The Government acted on this recommendation by closing off the concession to new applicants. Those applicants that had already received advance approvals were still able to access the concession. No case pursued by the Tax Office involved core technology claims made after 1997.

3.61 In one key audit that started in 1995, the Tax Office told the investor in mid-1996 that it had finished its inquiries. It was waiting on an AVO valuation and would then finalise the audit. That investor did not hear from the Tax Office again on this matter until mid-1999.

3.62 In September 1996, a Tax Office senior tax counsel gave a speech at an R&D industry conference. He said that notwithstanding the Government's decision, the Tax Office was continuing its audits of syndicates. He commented that Tax Office-engaged valuers supported the earlier views of serious overvaluation of core technology in the cases under review. He said that the Tax Office was close to issuing position papers in those cases. They would likely flag amendments based on non-arm's length transactions and possibly Part IVA.

3.63 In late 1997, the TCC Chairman gave a speech at an industry conference. He outlined the TCC's forward compliance approach. He commented that he suspected that quite of number of registered syndicates would not get approval from the TCC if they applied for registration today. He said that the TCC was working in close collaboration with the Tax Office. He referred to the Tax Office's 'review responsibilities' in connection with core technology valuations and Part IVA. He also said that a possible outcome of TCC and Tax Office reviews would be to disallow deductions. However, in early 1998, the TCC Chair announced that the TCC would not revoke registrations merely because the estimated projections did not come to fruition. However, it would seek to revoke registration for those cases where investors impeded the commercialisation of the developed technology.

3.64 In April 1998, the Tax Office obtained an external legal opinion in a syndicate case under audit. In relation to the specific anti-avoidance provision it advised the following:

- There was no one test to determine an arm's length dealing. The closest thing to a test was a judicial suggestion that the outcome of the dealing must be 'a matter of real bargaining'.
- The position paper in the audit did not identify matters supporting the Tax Office's conclusion of no arm's length dealing but the Case Manager's earlier internal report did. The Case Manager's reasons were that:
  - there was documentation that suggested the investor was seeking to achieve deductions of an amount near that outlaid for the core technology licence before the researcher was even chosen;

- there was documentation to show that the core technology fee was pre-determined — the investor and packager had agreed on the core technology outlay and also applied for IRDB registration before the licensor had completed its valuation of the core technology;

- there was documentation to show that there was an absence of any real bargaining — the researcher had accepted an increase to the core technology licence by about a million dollars so as to incorporate the packager's fee;

- there was documentation to indicate that the researcher was

aware that [the investor's] primary concern was its high tax liability and not the commercialisation of research results. This could provide a basis for concluding that [the researcher] and [the investor] were not dealing at arm's length in relation to the core technology fee but were acting in collusion to achieve a reduction in [the investor's] tax liability. 'We are aware that the high profitability of the group of [the financial year in question] has given rise to a considerable taxable income and that this is the primary reason for the company considering entering research and development agreements with [the researcher].

- The 'matter of greatest significance' was the value of core technology opined in the AVO valuation:

The marked discrepancy between the two valuations seems to us to be at the centre of the issue as to whether the parties were dealing with each other at arm's length.

- It was surprising, in a commercial context, to find that a company outlaid millions of dollars for a licensing arrangement on reliance of a valuation provided by the licensor. However,

the preparedness of [the investors] to do so in the present circumstances is probably explained by the existence of the put option, which effectively eliminated any commercial risk on the part of [the investor] should the valuation prove inaccurate.

- Based on the assumption that the AVO valuation was correct, the Commissioner was entitled to be satisfied both that there was no arm's length dealing and that the value opined by the AVO was reasonable to be allowed as the amount incurred as core technology expenditure for the purposes of paragraph 73B(31)(d) of the ITAA 1936 on the basis of the matters referred to in the Case Manager's internal report above and the following conclusions:

  - The investor outlaid tens of millions to acquire core technology rights which had a value of less than half a percent of the claimed amount.

  - The investor never obtained a 'truly independent valuation'.

  - The investor was assured of recovering the outlay for the core technology through the put option mechanism, which insulated the investor against any adverse commercial consequence flowing from the inaccuracy of the licensor's valuation.

- The legal advice stressed that it was assumed that the AVO valuations were correct. It noted that the AVO had no expertise in that field of technology and that there was need for further input from independent expert valuers before concluding a view in relation to subsection 73B(31). This was because the Commissioner needed to have a 'high degree of confidence' in the valuations relied upon to amend the assessments.

3.65 In April 1999, the Tax Office issued its first position papers to investors in one syndicate. Those papers did not provide adequate reasons for decisions to enable auditees to understand the Tax Office's case against them. They were also based on AVO valuations.

3.66 In August 1999, the Part IVA Panel considered one investor's core technology claim. It advised that the claim should be reduced to zero. This was on the basis of the specific anti-avoidance provision (subsection 73B(31)). It concluded that the core technology was grossly overvalued when compared to the AVO valuation (zero) and that both parties were aware of that fact. However, the Panel concluded that the case would not be so strong if the investor was not aware of the overvaluation.

3.67 Around this time, the Tax Office had also engaged expert valuers. Those experts opined that investors' valuations contained errors which would substantially inflate core technology values. Examples of these errors included no independent assessment of sales forecasts and inappropriate use of maximum royalty rates. They also advised that the valuations incorrectly had regard to the contractual features of the syndicate which were idiosyncratic to the way in which the syndicate was structured. They opined that core technology valuations should ignore the contractual features and any special value the particular vendor or purchaser placed on the technology. They opined that the valuation should value the core technology itself. Other matters which were generally thought not have a material effect on the value of the core technology licences were the historical costs and background of investors. This approach to valuing core technology led the experts to conclude that zero or negative values were appropriate.

3.68 In early 2000, the R&D syndication issue was escalated to one of the most senior tax officials. A 'hands on' approach was taken. A litigation strategy for the R&D syndication issue was developed. During this time, mediation was also discussed with an investor. File notes of that discussion record that senior tax officials did not see the point of mediating a case that did not establish principles that could be applied to other cases.

3.69 The Part IVA Panel met again in June 2000 to consider another three R&D syndicates involving the same investor. These syndicates involved tax exempt researchers. The syndicates were established before legislation excluded tax exempt researchers from registering for the programme. The Panel decided that Part IVA applied. This was because the 'excessive valuation was the primary indicator of non-arm's length dealing' and the arrangements had been entered before the valuation was done. The Panel said it had seen enough 'representative R&D schemes'.

3.70 By July 2000, there was significant internal Tax Office discussion at senior levels on designing an overarching resolution to the R&D syndication issue. At this time position papers in only two audits had issued. Investors repeatedly requested reasons for the Tax Office's decision. It was not until mid-2001 that the Tax Office first released a position paper that provided reasoning for its decision.

3.71 In late 2000, the Tax Office sent a report to the TCC. It said that 'there were limited options available to the Tax Office to compel termination of syndicates'. The report also said that the Tax Office was considering the option of legislative amendment.

3.72 In March 2001, senior tax officials met to decide the Tax Office's forward strategy. They decided to run a lead case litigation strategy to 'maximise leverage' for settlement. Many audits would be put on hold. Two of the more advanced cases were to be progressed to litigation. Mediation was not to be pursued at that point. A record of the discussions at this meeting shows that the Tax Office wanted a favourable court decision. This was so the Tax Office could:

> be in a stronger position to achieve resolution on other cases on an acceptable basis to the Tax Office … A settlement basis acceptable to the Tax Office is unlikely to be able to be achieved until we strengthen our hand in this matter.

3.73 In March 2002, the Tax Office received external legal advice on a syndicate. It said that the Tax Office and the investors were 'misdirected' in their technical arguments. This was because the arguments were based on 'arm's length values' rather than the questions posed by the specific anti-avoidance provision, subsection 73B(31). It commented that the valuations the Tax Office had commissioned proceeded on a 'misconceived and erroneous basis'. This was because the valuations did not use an appropriate method to value experimental technology. Assessing the potential returns from the commercial exploitation of technology and applying reasonable risk-based discount rates would 'inevitably produce a present value of a negligible amount'. The adviser said that subsection 73B(31) required the Commissioner to have regard to 'what the actual syndicate members would, if dealing at arm's length, have paid'.

3.74 The advice also recommended valuation on a basis analogous to a comparables basis — an expert in venture capital investment would be in a better position to give an opinion 'rather than an accountant or a person with narrow expertise in intellectual property evaluation'.

3.75 It also opined that if the investors relied on expert advice, 'properly sought and reasonably assessed,' in determining the market value, then the Tax Office should not conclude that the price paid was excessive merely because the Tax Office had a valuation which differed in value to the investor's claim.

3.76 The Tax Office discounted this advice because large parts of it were contrary to the advice it had received to date that indicated close to zero or negative values. This included using a comparables method to value the contractual rights to the core technology (rather than a discounted cash flow method that valued the intrinsic value of the core technology itself) and focusing the arm's length dealing inquiry on the legal entity of the special purpose vehicle rather than the economic entity of the investor's group of companies. It also said that later that year the QC gave similar advice to another investor in another syndicate.

3.77 In August 2002, the Administrative Appeals Tribunal (the Tribunal) heard the case of *Zoffanies Pty Ltd and Commissioner of Taxation* [2002] AATA Tribunal 758 (4 September 2002) (Zoffanies). The taxpayer applied to the Tribunal. It sought a merits review of the Commissioner's decision to apply the specific and general anti-avoidance provisions to deny its core technology and associated claims.

3.78 The Tribunal decided in the taxpayer's favour in relation to both the specific and general anti-avoidance provisions. It rejected the Tax Office's 'zero' valuations which were supported by overseas experts. It concluded that the parties' dealing over the relevant expenditure was at arm's length; they had applied their separate minds and wills in forming a bargain. It also found that the investor's valuer acted independently in preparing his valuation.

3.79 The Tribunal rejected the Tax Office's submission that there was persuasion and cooperation amounting to collusion between the parties. It also rejected the Tax Office's submission that indifference to the price indicated a lack of bargaining. The Tribunal also concluded that obtaining a tax benefit in connection with the scheme was undoubtedly an important purpose of the scheme. However, it concluded that it was not the dominant purpose. The dominant purpose was investment.

3.80 Although the outcome of the case did not turn on it, the Tribunal considered the approach to take in determining the amount under subparagraph 73B(31)(b)(ii) — the amount that parties would have expended if they were dealing at arm's length. It considered that with the benefit of hindsight:

> it is easy to be critical after the event when what was then unknown is now known. In the context of what was no more than an estimate of value, care needs to be taken when substituting one valuer's opinion for another without good reason. [136] With regard to s 73B(31)(b)(ii), it should be noted that the relevant question is what would the expenditure have been if these parties had been dealing with each other at arm's length? Would a competent and independent valuer other than Dr Venning have made a different valuation which the parties would have relied on in concluding the terms of transaction so that the amount of the relevant expenditure would have been less?

3.81 The Tribunal concluded that another competent and independent valuer might have made a similar valuation. It was not satisfied that the valuation was flawed such that the Tribunal should substitute a different valuation. There was insufficient evidence that the relevant expenditure would have been any less had the valuation been made by a different valuer.

3.82 A little after this time the Tax Office settled the other lead case prior to it being heard in court.

3.83 The Tax Office appealed to the Full Federal Court against the Tribunal's decisions on the specific anti-avoidance provision and the general anti-avoidance provision. In July 2003, the Tax Office withdrew its appeal against the Tribunal's decision on the specific anti-avoidance provision. This happened four days before the Federal Court hearing. One day before the appeal hearing the Tax Office entered a mediation agreement with another investor. The purpose was to determine 'guidelines for reviewing R&D arrangements, thereby potentially removing the need for detailed syndicate audits and/or litigation'. The mediator was a former High Court Chief Justice and also a former Solicitor-General.

3.84 In September 2003, the Tax Office agreed to settle with another taxpayer. This was on the basis of 'economic neutrality'. Effectively, the taxpayer paid back to the Tax Office the tax benefit it received through the claims it made. No interest or penalties were applied.

3.85 In October 2003, the Full Federal Court (*Federal Commissioner of Taxation v Zoffanies Pty Ltd* 2003 ATC 4942) decided in the Tax Office's favour in respect of the approach to be taken in considering the general anti-avoidance provision. The Court found the Tribunal had erred in law. It ignored the additional tax benefits relied upon in the Commissioner's alternative case. It also applied the wrong test in stating its conclusions as to purpose. However, it did not overturn the Tribunal's findings on arm's length dealings or the independence of the valuer. This was because those findings were not before the Court for reconsideration as the Tax Office had withdrawn this ground of appeal. The Court also declined to apply Part IVA to the arrangement itself. The Court ordered that the Tribunal's decision should be set aside only insofar as it related to the Part IVA issue. It ordered that the Part IVA issue should be remitted to the Tribunal for re-determination. In May 2004, the Tax Office withdrew its case and the Tribunal issued consent orders in the taxpayer's favour. The Tax Office says that this case was 'wrongly decided' and is confined to the facts of this case.

3.86 In March 2004, the mediator gave his evaluation of the issues in the case under mediation (refer paragraph 3.83). Amongst other views, he rejected the Tax Office's submission that the core technology had a nil or negative value. He also rejected both the investor's and the Tax Office's approaches to determining whether dealings are at arm's length. The question to be answered was:

> whether the parties in relation to the particular matter — here the incurring of the expenditure on core technology — have dealt with each other as arms' length parties would be expected to do.

3.87 The Commissioner gave a speech in April 2004. He announced that he would not apply Part IVA to core technology values where the specific anti-avoidance provision did not apply. This was a change to the Tax Office's previous approach.

3.88 In July 2004, the mediator gave an addendum to his March evaluation. He gave draft guidelines which dealt with the application of private binding rulings and the question of arm's length dealing. He also set out his approach to determining an arm's length amount.

3.89 This approach was significantly different to the Tax Office's previous approach. It would significantly change the values arrived at by the Tax Office's experts, although it did not endorse the investor's approach or that of the Tribunal. The outcome of the mediation was to arrive at a range of values that was different to the range of values relied on by both the Tax Office and the investor. The range of values was significantly more than the Tax Office's previous negative or zero value. It was also significantly less than the investor's value.

3.90 In September 2004, the Tax Office published guidelines which would be used to determine whether core technology deductions were properly allowable. Those guidelines gave practical guidance on when the Tax Office would be bound by a private binding ruling. They also gave practical guidance on what factors should be considered in assessing whether there was an arm's length dealing. They gave general guidance on determining an amount where there was no arm's length dealing. This guidance was contained in Part C of those guidelines.

3.91 However, the published guidelines did not disclose the factors that the mediator considered relevant in determining the arm's length amount. In particular, they did not indicate the mediator's rejection of the Tax Office's previous approach of relying on a valuation methodology that led to close to zero or negative values. The following is distilled from the mediator's reasons and compares with the guidance published in Part C of the Tax Office's published guidelines:

- In determining subparagraph 73B(31)(b)(ii), it is open to the Commissioner to demonstrate that the arm's length value is less than the amount paid by showing the arm's length value is within a range of values, the highest of which is lower than the amount paid. [Covered by Tax Office guidelines in point 2 and 6(ii)]

- The Commissioner may have regard to expert valuations to provide guidance on the arm's length value, including opinions on the appropriate values for sales projections and royalty rates. [Covered by Tax Office guidelines in point 4(i) — the Tax Office guidelines also suggest that other material indicating overinflation may also be used]

- Subparagraph 73B(31)(b)(ii) does not permit the substitution of a value determined by an independent valuer for an arm's length amount. This is because factors external to the valuation may influence the investors to pay more than the amount of the value independently ascertained. However, an arm's length value can be ascertained by reference to expert valuations so long as: [NOT covered by Tax Office guidelines]

  - those valuations adopt the test in *Spencer v Commonwealth* (1907) 5 CLR 418 — what is the price that a willing purchaser would have had to pay a vendor not unwilling but not anxious to sell?; and

  - those valuations are adjusted to take account of any special characteristics of the parties to the particular transaction.

- In taking account of any special characteristics of the parties, relevant factors include: [NOT covered by Tax Office guidelines]

  - The availability of the tax benefits would have inclined investors to agree to the high end of a range of permissible values. In determining a 'permissible value', the discounted cash flow methodology of itself will not provide an arm's length amount. However, it does provide guidance in what parties would have expended had they been dealing with each other at arm's length.

  - It would be unrealistic to suggest that the researcher would dispose of core technologies for derisory amounts where significant sums had been spent in developing that technology. The amount that the researcher spent in developing the technology up to the point at which the syndicate was entered was relevant.

  - The timeframes for successful development of the technology.

  - The constraints on the researcher's ability to fund further development, including the researchers' access to alternative finance for developing the core technology and whether the research could have been undertaken without the funds.

  - The timing of the tax benefits and whether there was income against which the tax deductions could be immediately offset.

  - Any factors which would suggest that the technology was developed to a point where its value exceeded the amount expended by the researcher on it.

- However, taking account of the special characteristics of the parties does not require the Commissioner to engage in an elaborate exercise, seeking to reconstruct what the parties would have done had they been dealing with each other at arm's length, by reference to the investors' actual attributes, knowledge, expertise and risk profile, through administrative and contemporaneous observation and record. [NOT covered by Tax Office guidelines]

- Although not an exhaustive list and otherwise relevant to the degree of comfort investors derived, the following factors are to be ignored in determining an arm's length value: [NOT covered by Tax Office guidelines — although can be inferred from the Tax Office's previous approach]

- the value of the guaranteed return — for example, through the exercise of a put option or a non-recourse loan;
- the registration process; and
- the reputation of the researcher.

- Where the inherent risks in the project were drawn to the registering bodies' attention before registration, it is irrelevant to determining an arm's length value that the project was risky, ambitious or in too short a timeframe. The very purpose of the tax concession was to encourage investment in short-term R&D projects which were risky and ambitious. [NOT covered by Tax Office guidelines]
- Reconstruction of an arm's length value as at the relevant date must not be made with reference to what was not known or knowable by the parties at that time — for example, considering the market influence of a competitor where it is questionable whether that influence was apparent at that time. However, that does not mean that it is necessary for the Commissioner to identify a contemporaneous valuation ignored by the investors, or letters or file notes which establish an inflated price. [NOT covered by Tax Office guidelines]
- The arm's length value will not be nil or negative. This is because the taxation benefits which the investment attracted gave it a higher value than that. [Covered by Tax Office guidelines at point 6(i)]
- The Commissioner need not precisely quantify the arm's length value under subparagraph 73B(31)(b)(ii). But in determining a reasonable amount under paragraph 73B(31)(d) a precise amount must be quantified. [Inferred by Tax Office guidelines at point 5]
- An arm's length value under subparagraph 73B(31)(b)(ii) may be different to the amount the Commissioner determines as reasonable to allow as a deduction under paragraph 73B(31)(d). [Covered by Tax Office guidelines at point 6(iii) — the Tax Office goes further to say reasonable amount will not be less than arm's length amount]
- In determining a reasonable amount under paragraph 73B(31)(d), the Commissioner may, in addition to the approach and factors outlined above:
  - take other factors into account — such as the relationship between the parties; and
  - determine an amount to allow as a deduction in excess of the maximum permissible value, so long as he considers it reasonable. [Covered by Tax Office guidelines at point 6(iv)].

3.92 The mediator also provided the Tax Office with draft guidelines for reviewing R&D arrangements, thereby potentially removing the need for detailed syndicate audits and/or litigation.

3.93 The Tax Office then looked at different settlement options. It concluded that there was a maximum amount of around $3.4 billion of revenue involved. This was based on the Tax Office's approach before the mediation. It included 50 per cent penalty and full general interest charge (GIC) over a number of years.

3.94 The Tax Office decided to offer settlement terms of denying half of the core technology claims and half of six years of GIC. Under this offer, the Tax Office stood to recover a maximum amount of around $580 million.

3.95 The Tax Office also decided to target only the largest core technology deduction claims. The claims of the 40 investors with the largest claims were targeted. These investors had each claimed more than $3 million for core technology expenditure in syndicates that involved a total amount of core technology of $10 million or more. Their claims comprised a little over half of all the claimed core technology expenditure and associated interest. The remaining investors were excluded from compliance review. Under this approach, the Tax Office stood to recover a maximum amount of around $280 million. This figure excludes those investors that had already settled with the Tax Office.

3.96 In late 2004, the Tax Office offered a settlement to those 40 investors. The Tax Office offered two options. Investors could settle for half of their core technology claimed and half GIC over six years with no questions asked. Or, investors could choose to prove to the Tax Office's satisfaction their compliance with the recently issued guidelines.

3.97 For 19 of these investors it was the first time that the Tax Office advised them that they had to prove that they were compliant and had to evidence that compliance in order to retain their claims that were made 8 to 12 years ago.

3.98 Over three-quarters of investors were excluded from potential review. This was essentially because the Tax Office believed that, given the smaller amounts (under $3 million), there was less scope for large core technology overvaluation in these smaller claims than in the larger claims. However, the costs and time for assessing these claims would be the same as for the larger claims. These investors were not contacted. Most, if not all, were unaware of the Tax Office's potential concerns with their investments.

3.99 The Tax Office limited the period in which the settlement could be accepted to six months. However, this was extended after strong lobbying. As long as investors continued to work actively with the Tax Office towards resolution, the offer would remain open.

3.100 Most investors subjected themselves to the review to prove compliance with the guidelines. The Tax Office was surprised that so many investors sought this option and did not settle on the 'no questions asked' basis. The Tax Office kept investors informed of the progress of their review if investors initiated contact with the Tax Office.

3.101 In late 2004, Treasury reviewed aspects of the income tax self assessment system. Amongst other matters, it recommended: that the law be changed to allow private binding rulings to be made on matters of fact; that market valuation guidelines be developed with the industry; and, that limits be imposed on the effective unlimited periods for review arising from 'nil' assessments. It also flagged further review of other unlimited periods for review.

3.102 In late 2005, another Tribunal decision was handed down. Its conclusions and findings of fact were adverse to the Tax Office's position on subsection 73B(31). Although this case posed different legal questions, the facts considered were materially similar. In this case the Tax Office had amended a syndicate researcher's assessment to include the undeclared receipt of money for a core technology licence. The researcher argued the investor's valuations were a sham. It argued the valuation was not independent. The researcher had relied on a Tax Office-engaged valuation which the Tax Office had used against the investor in the syndicate to deny their core technology deduction. The researcher argued that the Tax Office-engaged valuer's evidence should be preferred and therefore the value of the core technology should be zero. The Deputy President rejected that evidence and found that the investor's valuation was independent and open to the contracting parties to accept.

Current administrative approach and situation

3.103 Of the 246 syndicates originally registered, the Tax Office has finalised compliance action in most cases. It has also decided that over three-quarters of investors, those with relatively smaller claims, will not be reviewed. One case was litigated, resulting in the deductions being allowed in full. During the recent Tax Office reviews of the top 40 investors, a little over one-third of claims were accepted by the Tax Office in full. Most of the remainder were settled.

3.104 There are nine cases (9 investors in 11 syndicates) still being reviewed. Three investors (four syndicates) have been told that their claims do not satisfy the guidelines. The Tax Office is seeking valuation advice in these cases. In the remaining cases the Tax Office is in the process of determining whether there was an arm's length dealing. Either the Tax Office has indicated a preliminary view and is awaiting the investor's response or investors are collating more material on the matter.

3.105 The total revenue recovered to date by Tax Office action is about $110 million and $33 million in notional tax (losses recouped). This figure includes GIC and penalties. A further $73 million of potential revenue relates to the nine cases still under review.

3.106 Based on information provided to the Inspector-General and on a conservative estimate, the overall compliance costs to the community are thought to be in the range of $35 to $55 million. Taxpayers' direct compliance costs (expenses paid to external advisers and in-house personnel in response to Tax Office compliance action on the issue) are estimated to be about $20 to $35 million. The Tax Office's direct costs and salary costs are estimated to be about $15 to $20 million.

Conclusions

3.107 The Tax Office has taken a very long time to deal with this issue. There were many factors that contributed to the long timeframes. The Inspector-General's conclusions do not aim to cover every contributing factor. They do not reproduce every issue that was raised with him, that was considered by him or that concerned him. Rather, the following conclusions focus on key issues with the most potential for future tax administration improvements.

1. Aspects of the concession's design and its administration created a high risk of inflated core technology values

C1.1. Both investors and researchers could benefit from overvaluing core technologies. Researchers obtained more R&D financing the higher the core technology value. Investors were assured a guaranteed return on exercise of a put option. This was irrespective of any technical or commercial success. The IRDB and the Tax Office both approved the use of put options. The concession effectively removed the usual commercial tension between purchasers and vendors in striking bargains.

C1.2. There were certain measures that 'capped' core technology values. The availability of tax losses pressured taxable researchers to limit values. In 1993, the IRDB imposed maximum ratios of these values as a proportion of total R&D expenditure. However, the concession effectively relied on the tax law's specific anti-avoidance provision to contain core technology overvaluation. That provision aimed to address the risk of non-arm's length core technology values. However, the technologies had no established market by which their price could be easily compared. The technologies were novel and unique. Different experts advised different values for the same technology. That expertise was costly and time consuming to obtain.

C1.3. The R&D tax concession was jointly administered by the IRDB and the Tax Office. The IRDB checked compliance on a range of matters before syndicates were registered. The IRDB made it clear that compliance with the tax anti-avoidance provisions was solely within the Tax Office's power to determine.

2. The Tax Office had good reason to be concerned

C2.1. The investors were major organisations knowledgeable and experienced in taxation matters. There were strong signals that many core technology values were inflated. The Tax Office had good reason to be concerned about the behaviours it observed. By the time the issue was publicly raised in late 1993, the Tax Office had to act.

C2.2. The Tax Office considered that many investors took advantage of the concession. It generally claims the following:

C2.2.1. Some investors derived unintended benefits. The financial arrangements extracted large tax deductions for investors and fees for the promoters on the basis of overvalued core technology. They were tax effective financing transactions with little concern for the commercialisation of the developed technology.

C2.2.2. Investors may have done what was required to get syndicates registered. But they did not do all that could have been done to comply with tax law anti-avoidance provisions. In many cases, extra steps were not taken to ensure that their dealings were consistent with those that they would normally adopt in an arm's length transaction.

C2.2.3. In 1989, the Government of the day intended to attract private equity investment in high-risk, early-stage R&D. But it did not permit the overvaluation of core technology. This is why the specific anti-avoidance provision was enacted. This is also why the Government of the day chose to 'shut syndication down' in 1996.

C2.2.4. Many core technology values were 'back solved' — generated by first determining the required return on investment rather than the potential future profits in the event of successful commercialisation of the R&D results. In some cases these values were subsequently confirmed by valuations that were not independent. They were provided by a select group of valuers who did not test vendors' assumptions, the optimistic market shares and the optimistic sales forecasts.

C2.2.5. Many investors did not carry out the prudential measures in testing the core technology values and bases for valuations. A financially sophisticated, well-advised, large corporate would be expected to carry out these measures when entering a large financial transaction.

C2.3. Investors dispute these claims. They generally claim the following:

C2.3.1. Two Administrative Appeals Tribunal cases rejected the Tax Office's approach.

C2.3.2. Carrying out costly and lengthy testing on valuations in the circumstances was not a commercially realistic option. This was because of the minimal commercial risk to the investment capital and the short lead times to enter the investments. If there was an administrative requirement to conduct these measures and that was communicated to investors at the time, they would have complied. However, no such requirements were communicated to investors at the time of investment.

C2.3.3. The Government induced private investment by offering attractive tax benefits. At the relevant time, published material made it clear that the Tax Office was responsible for addressing matters relating to the tax laws. All investors had to comply with an involved registration process. The IRDB specifically advised registrants of the need to comply with the tax anti-avoidance provisions. Investors sought, but did not obtain, Tax Office private binding rulings on the application of the anti-avoidance provisions to their particular investments. They provided detailed factual material to the Tax Office, including the valuations, financial arrangements and their tax effect. The tax laws prevented private rulings on matters of fact. But the Tax Office did not express any concerns. The Tax Office did not rule on the anti-avoidance provisions because it depended on the future implementation of the arrangements. But, the arrangements were required to be implemented as stated or else the IRDB would de-register the syndicate. There was a great deal of uncertainty surrounding core technology values. This was publicly known. The Tax Office and others were asked to reduce this uncertainty. They did not.

C2.4. The Tax Office should not have relied on the mere existence of the tax anti-avoidance provisions to prevent overvaluation. One purpose of an anti-avoidance provision is to act as a deterrent. In a self assessment environment it is up to the taxpayer to comply with the law. However, the Tax Office should not have expected taxpayers to act conservatively in these circumstances just because the anti-avoidance provisions were there. The existence of these provisions increased the Tax Office's obligation to provide certainty rather than replaced or reduced it.

C2.5. Given the uncertainty around the effect of the provision and the number of requests to clarify the Tax Office position, there was an obligation on the Tax Office to state what it would expect to see as compliant arrangements. The anti-avoidance provision had a diminished value as a deterrent without further certainty being provided.

3. The Tax Office took far too long to give practical guidance and this caused significant unnecessary compliance costs and extended the resolution's timeframes

C3.1. The Tax Office took far too long to give practical guidance on the specific anti-avoidance provision. The Tax Office knew the risks arising from the concession's design and the way syndicates were marketed. It was also involved in the concession's administration. In this environment the Tax Office should have provided practical guidance on its compliance expectations at the outset. It did not. If it had done so, many of the problems of this case study would have been averted.

C3.2. The Tax Office gave general guidance on core technology values in mid-1991. This was through a public ruling. That ruling drew attention to key considerations on 'arm's length market values' for core technology. It said core technology prices should not be merely equated to a valuation, should not ignore the guaranteed returns and should reflect market realities. The specific anti-avoidance provision was enacted in late 1991. It dealt with the risk of core technology overvaluation, amongst others. At the time the Tax Office was responsible for giving instructions on amendments to tax law provisions. Therefore, the Tax Office was well aware of the risk of inflated core technology values before this anti-avoidance provision was drafted, introduced into Parliament and enacted into law. However, the public ruling was not updated to consider that provision. The Tax Office did not give practical guidance on that provision until September 2004.

C3.3. The Tax Office received several signals to reduce the uncertainty in relation to core technology values. However, it was the TCC that took steps to reduce uncertainty. In early 1996, the TCC Chairman publicly announced the framework by which it would assess the reliability of core technology valuations. Prior signals that should have alerted the Tax Office to act sooner include the following:

C3.3.1. The Tax Office gave advance opinions and private binding rulings in relation to around 245 syndicates. Although it could not rule on matters of fact, it did not raise concerns with the industry or in the rulings themselves.

C3.3.2. The specific anti-avoidance provision was enacted in December 1991. The then Government removed the sunset clause for tax concessions for R & D syndicates in 1992, signalling an intention to allow the concession to operate indefinitely. However, public Tax Office guidance on the concession was not updated before the concession was closed to new entrants.

C3.3.3. The 1993 ANAO report recommended that the Tax Office should examine a sample of syndicate arrangements with suspected inflated core technology values.

C3.3.4. In December 1993, the IRDB introduced ratios to cap the amount of core technology claimed.

C3.3.5. By March 1994 concerns over potentially inflated core technology values were well known. The Tax Office R&D syndicate project manager joined the TCC as an observer. His role included the management of the Tax Office's audits of R&D syndicates.

C3.3.6. By November 1995, some core technology values were rejected by the TCC. They were subsequently accepted when values were reduced.

C3.3.7. The 1994 BIE report of its inquiry into syndicates specifically recommended that the Tax Office clarify issues for taxpayers on the treatment of core technology and financial structures. The Tax Office never responded to this recommendation or to the BIE report generally. This was despite the report observing taxpayer behaviour that appeared to be contrary to the Tax Office's 1991 Public Ruling IT 2635.

C3.3.8. In October 1994, the Tax Office had expert advice that suggested further lines of inquiry to better determine what parties dealing at arm's length would have paid for the core technology.

C3.3.9. In early 1996 the Tax Office first made its general concerns known publicly — in a speech by a senior officer to an industry conference.

C3.3.10. In late 1995 and early 1996, the TCC signalled it would be expecting to see 'arm's length market values' as part of its registration process. It also pointed to specific issues that a valuation should address. The Tax Office acknowledges that this approach led to improved compliance with the tax laws. It has accepted that the core technology expenditure deductions were validly claimed in all cases where the TCC scrutinised valuations after this date.

C3.4. In September 2004, the Tax Office issued practical guidelines on the application of the specific anti-avoidance provision (subsection 73B(31) of the ITAA 1936). These guidelines were developed during mediation with a key investor. They were developed for the purpose of:

> reviewing R&D arrangements, thereby potentially removing the need for detailed syndicate audits and/or litigation.

C3.5. The Tax Office could have provided practical guidance before arrangements were entered into. The Tax Office knew the details of the financial arrangements and their tax effect before arrangements were entered into. Investors sought advance opinions and private binding rulings from the Tax Office. But the then tax laws prevented private binding rulings on matters of fact, including valuations. The Tax Office also refused to rule on the anti-avoidance provisions, which was common practice at the time. The Tax Office had an observer on the TCC. However, the Tax Office was ill-equipped to check compliance at that time and Tax Office auditors were initially ill-supported to deal with the technical and strategic issues.

C3.6. But none of these constraints would have prevented the Tax Office from providing investors with practical guidance on what it would expect to see in a tax compliant syndicate before arrangements were entered into.

C3.7. Initially, the Tax Office relied on the TCC to identify inflated core technology values. The TCC comprised of subject experts. The valuations appeared credible on the surface. The TCC also questioned and rejected some valuations during the registration process from November 1995. Before November 1995, the TCC looked at matters associated with core technology values but did not assess those values. Before this time the Tax Office had a growing awareness that some values were inflated. The Tax Office had no expertise itself in valuing novel and unique intellectual property. Its expertise in engaging experts was in its infancy. Staff were not skilled in instructing valuers or testing their opinions. Staff were also unaware of the relative reliability of different experts. They did not know which experts had an in-depth knowledge of the relevant markets, including the competition, take up of the market and likelihood of technical success of the technology. That advice was costly and time consuming. It could not be applied to other cases because it valued novel and unique intellectual property. In any event, that advice was not conclusive proof of the value the relevant parties would have struck had they been dealing at arm's length.

C3.8. The Tax Office's reliance on the TCC changed following public comments, escalating claimed both core technology values and concerns about their reasonableness of core technology values. By the time the Tax Office commenced audits to check compliance many syndicates had already been registered. The Tax Office considers the TCC did not perform its role in relation to scrutinising core technology valuations.

C3.9. Many legislative and administrative changes were made by the IRDB during the life of the concession. Some of these aimed to address overvaluation concerns. However, the power to make determinations in relation to core technology expenditure remained solely with the Tax Office.

C3.10. Investors had an impression of acceptance of the arrangements. The Government accepted that without the concession, financial institutions would not invest in the core technologies. The tax benefits were more generous than those offered in other tax shelter arrangements. Investors saw a pattern of registrations that extracted very large tax benefits. Changes were made to the concession. Investors changed arrangements to comply with these changes. The Tax Office did not raise any specific concerns until after all syndicates were entered.

C3.11. Because of the above factors there was a significant need for the Tax Office to give early practical guidance. If the Tax Office had given practical guidance earlier, significant compliance costs, extended timeframes and the uncertain scope of this problem would have been significantly reduced, if not prevented. Had practical guidance been given before arrangements were entered, up to 12 years and $30 to 40 million of direct compliance costs could have been avoided. At the very least, investors would have been better equipped to demonstrate compliance. It may have also led to more conservative core technology values in some cases. This may have led to the Tax Office considering the issue a low priority for its compliance focus. The Tax Office also would not have placed itself in a position of denying deductions claimed by many investors 8 to 14 years ago.

4. Investors could have done more to be able to demonstrate compliance, but this was unrealistic in the circumstances especially in the absence of practical guidance from the Tax Office

C4.1. In the absence of practical guidance from the Tax Office, investors could not anticipate what evidence would satisfy it of compliance. Most investors could have done more to ensure that their claim was unassailable in any Tax Office audit, but this was disproportionate to the risks at the time.

C4.2. Before arrangements were entered into, investors tried to obtain Tax Office private rulings on the anti-avoidance provisions. The private rulings gave little comfort and the Tax Office did not provide practical guidance to assist investors with their compliance. Through the Tax Office's public ruling, *IT 2635*, investors were aware in general terms that an 'arm's length market value' was expected. However, this ruling was not updated when the specific anti-avoidance provision was enacted. Had the Tax Office given guidance on what its compliance expectations were, investors would almost certainly have followed that guidance.

C4.3. Investors were experienced, well resourced and 'tax savvy'. They could have done more ground work to ensure that their claims would be unassailable in any Tax Office audit. They could also have ensured that they could evidence that they had undertaken additional valuations, obtained marketing advice about key sales projections and considered at the Board level core technology qualities, price negotiations and transaction risks.

C4.4. However, taking steps to ensure that their claims were unassailable was disproportionate to the risks at the time.

C4.5. At the time there was no specific administrative need to take these steps to evidence compliance. The Tax Office did not publicly express any general concerns with core technology values until early 1996. It did not give practical guidance until September 2004.

C4.6. There was little commercial need to engage costly and lengthy expertise to address a perceived low risk. Lead times for syndicates were short and pressing. The technology was needed to be developed quickly to maintain any potential competitive advantage. Researchers indemnified the investors of any risk that the deductions would not be allowed by the Tax Office. Investors relied on the impressions of administrative acceptance of the risk free returns flowing from the tax benefits and put options exercise. The effect of relying on these impressions was that there was little commercial reason to be concerned about the price paid for core technologies.

C4.7. In any event, had such preparation equipped taxpayers to demonstrate their compliance when required, it would have done no more than to reduce the timeframes from that point forward and potentially provide them individually with a satisfactory resolution. It would have done nothing to reduce the protracted delays in the Tax Office finalising its compliance action.

5. The Tax Office took far too long to finalise its compliance action; it displayed no material sense of urgency for a major period of the timeframe

C5.1. The Tax Office took far too long to finalise its compliance action. The Tax Office started its audit project in September 1994. It was not until 2004 that the Tax Office took a strategic decision not to pursue most of the investors. The Tax Office issued practical guidance and offered a practical settlement from September 2004. By late 2006, the Tax Office had settled or excluded from compliance review almost all investors in the 246 syndicates.

C5.2. The tax laws allowed the Tax Office legally to amend deductions claimed by investors 8 to 14 years ago. But for these laws, the Tax Office would have been pressured to resolve its concerns within four years. This was the standard period of review (six years if the tax avoidance provisions were applied). Together with the sunset provisions (that were removed in 1992) these laws reduced any material sense of urgency within the Tax Office.

C5.3. The Tax Office initially considered R&D syndicates a relatively low compliance priority until 1994. The life of the concession was limited. It was extended and then from August 1992 allowed to operate indefinitely.

C5.4. Investor resistance in initial audits contributed some months to the extended timeframes. This included taking time to coordinate Tax Office visits through to refusal to meet and defending legal professional privilege claims on requested documents. In one case, a syndicate delayed the start of an audit by eight months. This was because it insisted all parties be present at the opening meeting. However, these timeframes were not long when compared to other factors that materially contributed to the timeframes of the issue.

C5.5. Eliminating investor and promoter delays would not have sped up the finalisation of any audit before late 1999. This is because before this time the Tax Office did not settle its initial technical view of the specific anti-avoidance provision to a point where it could be communicated to investors. Nor would it have sped up the resolution of any case after early 2000 unless it was treated as one of the few lead cases. Other cases were put on hold pending the outcome of these cases.

C5.6. The following factors materially contributed to the compliance action timeframes.

C5.6.1. Obtaining valuations and developing an initial Tax Office technical view added around four years to the timeframes. The Tax Office had started reviewing R&D syndicates as early as mid-1992. It started an audit project by September 1994. It was aware of the core technology valuation issue in October 1994. However, the Tax Office did not issue its first position paper until April 1999. Soon after in late 1999, the Tax Office first settled its position on the general anti-avoidance provision. This was four years after the audit was commenced. This position was, effectively, that where the Tax Office-engaged valuer gave a valuation of close to zero or a negative value, it was 'best evidence' on non-arm's length dealing. Adjustments to investors' claims would be made to reflect that Tax Office-obtained valuation. No amended assessments were issued until October 2000. In one case, the Tax Office advised an auditee it was awaiting a valuation to finalise the audit. The Tax Office next contacted the auditee over three years later.

C5.6.2. The TCC announced its forward compliance approach to syndicates in early 1998. It decided that it would not cancel registration on the basis of overvalued core technology. This approach was based on legal advice.

C5.6.3. The Tax Office took until 2000, to escalate the issue for it to be managed at a very senior level. Prior to this time, senior management was 'monitoring' the progress of this issue. The Inspector-General questions the adequacy of Tax Office bottom-up escalation processes as a mechanism for ensuring that complex issues that are subject to delays receive appropriate and timely management of senior tax officials. It should not take at least six years for a hotly contested complex matter involving significant costs and revenue to begin to be managed at an appropriately senior level.

C5.6.4. From 1999 until September 2004, the Tax Office maintained its reliance on expert valuation and legal advice as the basis for adjusting core technology claims where the Tax Office-obtained valuation opined the core technology's value was close to zero or negative. The Tax Office considered this was the best evidence of non-arm's length dealing. This view was held notwithstanding the Tax Office's views on valuations being an inexact means to value core technology and the eventual adverse Tribunal decision on critical findings of fact. Investors and promoters considered the Tax Office's approach unreliable.

C5.6.5. Tax Office resourcing also posed a problem. Auditors needed to examine and analyse a considerable amount of documentation. Auditors needed to travel extensively because documentation was typically held in different States. Also, high-level well-qualified auditors were in short supply because of their demand within the Tax Office.

C5.6.6. Each case needed to be dealt with on its merits. Many investors did not accept the Tax Office's approach to determining the issues. Without generally accepted practical guidance, the Tax Office effectively needed either that the relevant investors acquiesce to denial of their claims, or part thereof, in settlement, or, itself to undertake costly and resource-intensive audits that involved obtaining time consuming and costly valuation advice.

C5.6.7. The Tax Office's lead case litigation strategy contributed around two years to the timeframes. In March 2001, the Tax Office decided to litigate two of the most advanced cases. Having lost its key lead case in the Tribunal, the Tax Office settled one case and withdrew one critical ground of appeal in the other by July 2003. It then commenced a mediation to determine guidelines to resolve R&D syndicate cases.

C5.6.8. The Tax Office's mediation strategy contributed around one year to the timeframes. In mid-2003 parties formally agreed to mediate. In mid-2004 the mediator gave his final advice. The timeframes were mainly attributable to the complexity of the issues. A considerable period of time was taken to agree on a set of facts and guidelines.

C5.6.9. The Tax Office's post-September 2004 reviews have contributed more than two years to the timeframes. By early 2007, most investors had either settled with the Tax Office or satisfied the Tax Office that claims were validly made. Some investors took many months collating the requested material for the Tax Office. Much evidence relied on people's recollections of events, the continuing existence of documents and availability of key people. This took time to collate. The Tax Office took many months considering the information provided. It did not have the resources to deal quickly with the 'surprising' number of investors that sought to satisfy the Tax Office of their claims. There were disagreements between some investors and the Tax Office on the application of the guidelines to the facts of their case. A key issue was whether the valuations investors relied upon were 'independent'. Two cases are obtaining further information from the Tax Office after the Tax Office advised the investor's representative in November 2006 of a 'determinative' factor that would lead to satisfying the Tax Office of reliance on the valuation, namely TCC additional scrutiny of the valuation where the finance scheme was assessed after November 1995.

C5.7. From September 2004, the Tax Office offered a practical settlement to 40 of the largest investors. These investors were offered an alternative. They could accept 'base level' terms of settlement on a 'no questions asked' basis. Or, they could seek to satisfy the Tax Office that their claims complied with the guidelines (or convince the Tax Office of better terms of settlement) by subjecting their claims to lengthy and costly review. The remaining investors were excluded from review. By early 2007, most investors had either settled with the Tax Office or satisfied the Tax Office that their claims were validly made.

C5.8. The Tax Office accepts that it took far too long to finalise its compliance action.

C5.9. The extended timeframes led to accrued GIC. The terms of the settlement offers from September 2004 included a 50 per cent remission of six years of GIC. This was, in part, recognition of the Tax Office delays involved. However, in some cases this remission was not an accurate reflection of the delays involved. For example, in one case taking more than six years to complete, four years were spent awaiting a Tax Office-commissioned valuation and the Tax Office's position paper. Also, for those audits commenced in 2005, the Tax Office's offer of GIC remission does not reflect the Tax Office current GIC remission policy. However, this policy was released after the settlement was first offered to taxpayers.

C5.10. The Inspector-General finds this approach to GIC remission to be sloppy administration. It fails to differentiate compliance approaches sufficiently. It fuels public perceptions that the Tax Office takes 'one size fits all' approaches for administrative ease at the expense of proportionate and fair treatment.

6. Only when very senior Tax Office executives directly managed the issue did the Tax Office take positive action to speed up its resolution

C6.1. By 2000, the Tax Office recognised the difficulties of dealing with matters of complexity within a mainstream 'audit and litigate on a case by case' approach. From early 2000, very senior Tax officials directly managed the issue. From this time the Tax Office sped up its compliance action by a combination of positive factors.

C6.1.1. It removed the issue out of the Tax Office's mainstream 'audit and litigate on a case by case' process. By early 2001, a strategy was devised to use lead cases to resolve the issue and minimise costs.

C6.1.2. It engaged a key investor in mediation with the intention of developing practical guidance to resolve the uncertainty surrounding the application of the specific anti-avoidance provisions.

C6.1.3. It published that practical guidance, albeit with material exclusions on the approach the mediator took to determine the amount parties would have agreed to if they had dealt with each other at arm's length.

C6.1.4. It offered a practical settlement that allowed taxpayers either to pay and walk away or convince the Tax Office of better settlement terms based on stronger claims than those who could walk away.

7. An unchecked cultural influence of 'hitting tax abuse hard' has been a major contributing factor to why the R&D syndication issue has taken well over a decade to near resolution

C7.1. Despite considerable uncertainty which accommodated a variety of reasonable views, the Tax Office tenaciously believed that views contrary to its own were wrong. It took far too long to reassess its position objectively. Eventually it was forced to do so. In some cases it also ignored a major part of that reassessment and applied a flawed resolution approach as a result. This was because it believed the arrangements amounted to tax abuse.

C7.2. The Inspector-General believes that to be a fair administrator, the Tax Office has an obligation to maintain its objectivity in all circumstances. Processes are required to ensure that the cultural influences that are part of any organisation, including the Tax Office, do not get in the way of administrative objectivity. To achieve administrative objectivity also requires the Tax Office to rise above any prevailing community, political or media views about the issue in question.

C7.3. The Tax Office did not objectively reassess its view earlier because it tenaciously believed that views contrary to its own were wrong and that the arrangements were 'tax rorts'. The Inspector-General considers that the Tax Office belief that arrangements were tax rorts triggered a cultural response that the Tax Office's view was correct both in the desired outcome and the path to reach that outcome. This culture led the Tax Office to assess selectively and subjectively the weight of external signals and the perspectives of investors. Those signals that supported its view were correct. Those that did not were wrong.

C7.4. The Tax Office claims that this conclusion is fundamentally flawed because it misunderstands the Tax Office's approach. The Tax Office asks what more it could have done. It says that:

- it was responsive to industry suggestions to mediate the issue in April 2002;
- in July 2002, it agreed to mediate;

- the Zoffanies case was being litigated at the time so it had to await the result of that case before mediating; and
- a formal agreement to mediate was entered into in July 2003.

C7.5. The Inspector-General considers that this claim ignores the previous decade of continuing uncertainty both outside of and within the Tax Office on how these arrangements should be treated under the specific anti-avoidance provision. Because the Tax Office disputes this conclusion, the Inspector-General goes to some lengths to set out the background leading to it. Key points supporting this conclusion are organised under the following headings:

- The Tax Office believed that the arrangements were 'tax abuse'.
- The Tax Office stuck to an approach that led to zero or negative core technology values that would effectively wipe out syndicates.
- The Tax Office was aware of a range of other valid views.
- The Tax Office discounted views that were contrary to its position.
- The Tax Office was eventually forced to reassess its view objectively.
- The Tax Office's view was changed significantly by objective reassessment by an independent mediator.
- The Tax Office should have checks and balances over its culture of 'hitting tax abuse hard'.

The Tax Office believed that the arrangements were 'tax abuse'

C7.6. The Tax Office strongly believed that the behaviours it observed amounted to 'tax abuse'. It tenaciously believed and overtly stated that the behaviours it observed amounted to 'tax abuse'. This view continued to be expressed during the course of this review.

C7.7. For example, during the course of the review, the Inspector-General asked the Tax Office to comment on investors' observations of Tax Office behaviour. One of these observations was that in the press release announcing the Government's 1996 decision to close syndication off to new registrants, there were four examples of 'tax abuse'. However, investors observed that these were examples of syndicates rejected by the IRDB and refused registration and they therefore never came into existence. The Tax Office's written response to the Inspector-General was that:

> Examples given were to illustrate a point. This comment is old copy and reflects unwillingness by promoters etc at the time of closure, and apparently even now, to accept that syndication represented tax abuse.

C7.8. The Tax Office has also indicated a willingness to disregard a major part of the mediator's advice and the questions posed by the specific anti-avoidance provision where it holds this strong belief.

C7.8.1. For example, in one particular case in applying the guidelines to a key investor's claim, tax officers involved in the review ignored the advice of Sir Anthony Mason in determining section 73B(31)(b)(ii) and 73B(31)(d) issues and continued to recommend that the Tax Office apply the approach that merely substituted a zero value for the investor's claimed core technology expenditure.

> It is the ATO's contention that [the investor] … and [the researcher] were not dealing with each other at arm's length … It is the ATO's contention that [the researcher] merely acquiesced to the Core Technology Licence Fee of $ … millions which was determined by [the investor]. The ATO relies on [its commissioned] valuation report to refute [the syndicate's] valuation of the Core Technology Licence Fee in the range of $[just below the claimed Licence Fee] million to $[15 per cent above the claimed Licence Fee] million and to satisfy the Commissioner that the Core Technology Licence Fee would have been less than $[the claimed Licence Fee] million if [the investor] … and [the researcher] had dealt with each other at arm's length and that the Core Technology Licence Fee would have been nil had [the investor] … and [the researcher] dealt with each other at arm's length.

C7.8.2. This document evidences a particular culture within an area of the Tax Office. It is consistent with other comments made by officials that inferred the entity engaged in tax abuse.[1]

C7.8.3. The Tax Office says this recommendation was never adopted as the Tax Office position nor accepted by senior officers. This view of maintaining a 'nil' core technology value is adopted elsewhere in the internal report also. Further, the Tax Office has not produced contemporaneous evidence to support its assertion. Despite this willingness to adopt a 'nil' core technology value approach in this case (contrary to the mediator's advice), the tenor of settlement negotiations in this case did not require the Tax Office to pursue this particular approach with the taxpayer. As flagged in Chapter 3 at paragraph 114, The Inspector-General will further examine R&D syndicate settlements in the context of my future review of settlements generally.[2]

C7.8.4. The Tax Office also says it accepted the advice of the mediator in finalising its position in respect of this case. However, the Tax Office did not follow the mediator's advice in how to determine the core technology price that parties should have reached. This is because it merely used the non-arm's length 'indicative proposal price, which was assumed to equal the market value' (set before valuations were obtained) as a basis for the arm's length price. It did not consider the factors the mediator considered relevant to determine what the price would have been if those parties had dealt with

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1 This paragraph was inserted subsequent to receiving the Tax Office submission in Appendix 3 in order further to substantiate points raised in that submission.

2 *Ibid.*

each other at arm's length. This approach also appears inconsistent with the Tax Office's view on subparagraph 73B(31)(b)(i) — that the parties were not dealing with each other at arm's length in relation to the core technology price. It is incongruous that the Tax Office genuinely believed that the parties were not dealing with each other at arm's length and then used the indicative proposal pre-valuation price (the price the Tax Office rejected as evidence of an arm's length dealing) as the basis for an arm's length price. However, following the Zoffanies case, the Tax Office was hampered in merely asserting a 'nil' core technology value to the investor without expending considerable amounts of money and resources in prosecuting such a view. A pragmatic resolution was reached. The tenor of settlement negotiations in this case also did not require the Tax Office to pursue this particular view with the taxpayer and therefore it was never communicated to the taxpayer.[3]

C7.8.5. While applying the guidelines the Tax Office repeatedly stated and inferred during the review that this investor, and others, had engaged in tax abuse. Also, during discussions tax officials told Inspector-General staff that it was unrealistic to expect the Tax Office to follow the mediator's guidance on section 73B(31)(b)(ii) and (d) issues because it was 'not practical' to follow that advice, the cases amounted to 'tax abuse' and the legislative provision did not adequately enable the Tax Office to address that abuse.[4] General comments were also made that the arrangements amounted to tax abuse and that was why the Government 'wanted syndicates closed down'.

C7.9. The Tax Office says its belief was supported by expert valuers and legal advice. It was also supported by the views of others that the arrangements were 'tax rorts'.

C7.9.1. The TCC publicly commented that some arrangements were 'rorts' relying on 'unsustainable valuations'. The TCC however, decided in early 1998 that it could not rescind registration on the basis of overvaluation of core technology.

C7.9.2. The Department of Industry, Science and Resources (DIST) recommended in mid-1996 that the concession be terminated. It reported that:

> like a chameleon, the program has continually changed in ways which favour the easy extraction of large tax deductions.

C7.9.3. In July 1996, the Government closed off syndication to new registrations but allowed existing syndicates to continue to access the concession. This was because 'the [then] current arrangements with regard to syndication have become focussed on tax minimisation rather than the provision of genuine R&D'.

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3 *Ibid.*

4 This sentence was altered subsequent to receiving the Tax Office submission in Appendix 3 in order further to substantiate points raised in that submission.

C7.9.4. No syndicate was commercially successful. However, some technologies did go on to be successfully commercialised after the syndicate's put option was exercised.

C7.9.5. The Tax Office adjusted the core technology claims in many cases.

The Tax Office stuck to an approach that led to zero or negative core technology values that would effectively wipe out syndicates

C7.10. The Tax Office's expert advice led to zero or negative outcomes in valuations. These outcomes were a significant part of the way the Tax Office had considered the issue up to this point. From investors' perspective, the approach that led to zero or negative values amounted to 'zero tolerance' of syndication. It was seen as a means to 'wind syndicates up'. Effectively, it characterised the arrangements as 'tax rorts'. This entrenched investors' resistance to the Tax Office's approach to the issue.

The Tax Office was aware of a range of other valid views

C7.11. There was considerable uncertainty around the application of the anti-avoidance provisions. This gave enough scope for many contrary views to be validly held. The Tax Office itself received various, and sometimes conflicting, advice on how to apply the specific anti-avoidance provision and how to quantify the amount that should be allowed as a deduction. (The Tax Office also says that it received a number of oral advices before the mediation, including advice given in the Zoffanies matter, in addition to the legal advices referred to below. It has not provided a written summary of these advices.)

C7.11.1. In early 1998, the Tax Office obtained external legal advice in a case that advised:

- there was no one test to determine an arm's length dealing;
- the 'matter of greatest significance' as to whether the parties were dealing with each other at arm's length was the marked discrepancy between the value of core technology opined in the AVO valuation and the syndicate's valuations;
- it was assumed that the AVO valuations were correct, however, because the AVO had no expertise in that field of technology there was need for further input from independent expert valuers before concluding a view in relation to subsection 73B(31); and
- if the AVO valuations were correct, the value opined by the AVO was reasonable to be allowed as the amount incurred as core technology expenditure for the purposes of paragraph 73B(31)(d).

C7.11.2. In late 1999 and mid-2000, the Tax Office's Part IVA Panel, in relying on AVO valuations, gave an opinion that:

- the application of the specific and general anti-provisions depended on the syndicate's valuation of the core technology being excessive — it was 'the primary indicator of non-arm's length dealing';

- core technology expenditure claimed by the investor ought to be reduced to zero on the basis of subsection 73B(31) where the syndicate's valuation was excessive in comparison to the AVO's negative valuation — 'A valuation based on a discounted cash flow could yield a theoretically negative valuation, indicating that the investor would want to be paid to develop the core technology';
- the correct methodology for the core technology was likely to be a significant point — the Panel noted that the investor 'purported that the valuation methodology used by the AVO was flawed'; and
- the non-arm's length argument might not be so strong if the purchaser was in fact not aware of the overvaluation of the core technology.

C7.11.3. In a case in early 2002, the Tax Office obtained external legal advice that:

- both the Tax Office's and investor's arguments were 'misdirected' because they did not answer the questions posed by subsection 73B(31);
- the question of arm's length dealing should be directed towards the investor group's special purpose subsidiary company rather than the investor group (the advice concluded that there was no arm's length dealing in this case);
- the Tax Office's case was unlikely to succeed if it found that the valuations obtained were genuinely relied upon in the dealings relating to the core technology;
- the Commissioner cannot conclude that investors paid a price in excess of what they would have paid on an arm's length dealing merely because a different valuer now considers an arm's length value to have been greater;
- the allowable arm's length expenditure is to be assessed by what the actual parties, with their knowledge at the time (without the benefit of hindsight), would have paid if they were dealing with each other at arm's length;
- what the Commissioner is required to have regard to is what the actual syndicate members would, if dealing at arm's length, have paid, which requires the 'circumstances peculiar to the parties to be taken into account'; and
- all valuations, the Tax Office's and the investor's, proceeded on a 'misconceived and erroneous basis' because the appropriate method of valuation should have been one analogous to a comparables basis — an expert in venture capital investment would be in a better position to opine on core technology prices than an accountant or a person with narrow expertise in intellectual property evaluation.

C7.11.4. In 2002, the Administrative Appeals Tribunal, among other things, held that:

- persuasion is part of the normal process of negotiation and that cooperation does not, of itself, indicate that parties fail to exercise their separate minds and wills in reaching a bargain;
- in the context of what was no more than an estimate of value, care needs to be taken when substituting one valuer's opinion for another without good reason as it is easy to be critical with the benefit of hindsight when what was then unknown is now known; and
- with regard to subparagraph 73B(31)(b)(ii), it should be noted that the relevant question is what would the expenditure have been if these parties had been dealing with each other at arm's length — would a competent and independent valuer other than the one relied upon have made a different valuation which the parties would have relied on in concluding the terms of transaction so that the amount of the relevant expenditure would have been less?

C7.11.5. In 2004 in another case, the mediator evaluated the Tax Office's and an investor's position during the course of a mediation. The substance of his advice on the arm's length dealing issue is set out in the guidelines that the Tax Office published in September 2004. His evaluation also gave the following advice:

- Subparagraph 73B(31)(b)(ii) does not permit the substitution of a value determined by an independent valuer for an arm's length amount. This is because factors external to the valuation may influence the investors to pay more than the amount of the value independently ascertained. However, an arm's length value can be ascertained by reference to expert valuations so long as those valuations are adjusted to take account of any special characteristics of the parties to the particular transaction.
- The arm's length value will not be nil or negative. This is because the taxation benefits which the investment attracted gave it a higher value than that.
- It would be unrealistic to suggest that the researcher would dispose of core technologies for derisory amounts where significant sums had been spent in developing that technology. The amount that the researcher spent in developing the technology up to the point at which the syndicate was entered was relevant.
- Reconstruction of an arm's length value as at the relevant date must not be made with reference to what was not known or knowable by the parties at that time — for example, considering the market influence of a competitor where it is questionable whether that influence was apparent at that time.

- The availability of the tax benefits would have inclined investors to agree to the high end of a range of permissible values. In determining a 'permissible value', the discounted cash flow methodology of itself will not provide an arm's length amount. However, it does provide guidance in what parties would have expended had they been dealing with each other at arm's length.

C7.11.6. The Tax Office also relied on valuations about which it had doubts. In addition to the concerns expressed in the legal advices above, one very senior tax official thought that some of the values returned in valuations were 'not intuitive' and 'did not sound right'. The Tax Office also recognised that valuation was 'more of an art form than a science'. It gave the Inspector-General examples of 'blatant cases' showing 'obvious rorting'. However, it conceded that it was not obvious on the face of it or picked up during the registration process because of the complexities of valuations. What was needed was experience in dealing with valuers and valuations to identify the problems.

C7.11.7. From 1999, the Tax Office applied the general anti-avoidance provisions in an attempt to deny the core technology deductions. This was notwithstanding the existence of a specific anti-avoidance provision aimed, amongst other mischiefs, at core technology overvaluation. This was also despite the concession being designed to induce investment by offering a tax benefit to investors and the acceptance by the IRDB and the Tax Office of the operation of the put option to guarantee investor returns. In early 2004, the Tax Office retracted its view of Part IVA's application to core technology claims.

The Tax Office discounted views that were contrary to its position

C7.12. However, in spite of these independent views that were contrary to the Tax Office's view, the Tax Office tenaciously believed that its view of how to apply the law was correct and that its approach to valuations was also correct. For example:

C7.12.1. The Tax Office considers that the 1998 legal advice above supported its approach. The adviser concluded that the Tax Office was entitled to be satisfied that there was no arm's length dealing in that case. However, on a reading of this advice, it should have been clear to the Tax Office that there was significant uncertainty in which legal test to adopt and the evidentiary material needed to prosecute its case. The advice specifically alerted the Tax Office to the lack of experience underlying the AVO valuations and therefore their unreliability on which to base the exercise of the specific anti-avoidance provisions. However, the Tax Office went on to use AVO valuations in other cases to issue Part IVA determinations and amended assessments. It also engaged other expert valuers. However, the Tax Office considered it would have been a waste of money to get further valuations unless the AVO valuations were challenged by investors.

C7.12.2. The Tax Office discounted the 2002 legal advice. The Tax Office says that the 2002 advice 'ran against all the advice the Tax Office had received up to that time'. Also, it says that some time later the same QC advised investors in another case. However, key parts of this advice were later echoed in the evaluation given by the mediator.

C7.12.3. The Tax Office discounted the Tribunal's 2002 decision. The Tax Office took the view that it was 'wrong' and had no precedential value.

C7.13. The Tax Office also says that there is no evidence to show that it did not appropriately consider its view or did not consider it objectively. The Tax Office argues that oral advice also strongly supported its approach. However, it has not provided a written summary of this advice. The Tax Office says that it saw conduct which concerned it, and so did the Government, in 1996.

C7.14. However, one of the legal advices above commented that both the Tax Office's and investor's approaches were 'misdirected'. The other written legal advice expresses uncertainty about which test to apply and the reliability of the Tax Office-engaged valuations. These points at least should have triggered the Tax Office to reassess its position objectively and further test its views. The Tax Office did not.

C7.15. Further, the Inspector-General notes that these advices came relatively recently. A decade of difficulty preceded this and was, of itself, a clear signal that the issue needed to be objectively reassessed. The Tax Office did not objectively reassess its position before then because there was no Tax Office check or balance to trigger a requirement to do so.

C7.16. Because it did not objectively reassess its view earlier the Tax Office did not understand the strengths and weaknesses of each party's case. The Tax Office also hampered investors from understanding the strengths and weaknesses of each party's case. Until mid-2001, the Tax Office issued 10 position papers without giving sufficient reasons for its view. By mid-2001 the Tax Office was pursuing litigation to strengthen its settlement position. It only issued amended assessments in specific cases. This was either where the investor agreed to settle or the case was selected as a lead case. Before this time the Tax Office was unresponsive to requests to provide reasons. However, it did give detailed reasons to the Tribunal while litigating the Zoffanies matter.

The Tax Office was eventually forced to reassess its view objectively

C7.17. The Tax Office says that it was not forced but merely accepted a proposal from industry to mediate the issue. The Inspector-General concludes that this view is the Tax Office making a virtue of necessity. It was effectively forced to reassess its position objectively because of the considerable pressure brought to bear. Both of the two lead cases failed to achieve their aim of strengthening the Tax Office's position. One was settled on the steps of the Federal Court under confidential terms. The other damaged the Tax Office's position. The Tribunal's decision was publicly available. Key investors were well resourced and prepared to litigate more cases. These investors also tenaciously believed that their view was the correct view, relying on expert valuer and legal advice that supported their position. Litigation required costly and time consuming expert opinions that could not be applied to other cases. These opinions varied significantly and created significant litigation risks for the Tax Office.

C7.18. The Tax Office acknowledges that it could not ignore the effect that the outcome of the Zoffanies decision had on its resolution of its review of core technology claims. Views were polarised for 10 years and this decision forced the Tax Office to enter into a process that ultimately led to the objective reassessment of its position.

The Tax Office's view was changed significantly by objective reassessment by an independent mediator

C7.19. The Tax Office's and a key investor's views were objectively reassessed in 2003-04 by a well-respected lawyer. This was for the purpose of determining guidelines for reviewing R&D arrangements. The effectiveness of this reassessment primarily relied on two features. Firstly, it was critical that both parties had a high degree of confidence in the objectivity and skill of the lawyer. Among other roles, Sir Anthony Mason had performed the roles of Chief Justice of the High Court and Solicitor-General (the Government's principal legal adviser). In both roles he was well known to be 'concerned to diminish the possibility of abuse of power in what were once the opaque processes of government' (Brennan, G, 'A tribute to the Hon. Sir Anthony Mason, AC KBE', speech at The Mason Court & Beyond Conference, Melbourne, 8 September 1995). Secondly, the Tax Office intended to use the process to determine practical guidance that could be used to review other R&D syndicate cases.

C7.20. The published guidelines coming from the mediation gave clear practical guidance on the 'arm's length dealing' issue. This issue is effectively the threshold for the exercise of the Commissioner's power to adjust core technology expenditure claims. The guidelines also gave four general propositions that were relevant to how the Tax Office would determine the reasonable value of the core technology where it concluded that the parties were not dealing with each other at arm's length:

- the core technology licence fee is likely to have a positive value (as distinct from a negative or nil value);
- the arm's length amount may be within, and is likely to be within, a range of estimated amounts;
- subsection 73B(31) contemplates that the amount that the Commissioner considers reasonable will not necessarily coincide with the arm's length amount, but will not be less than the arm's length amount; and
- section 73B(31) enables the Commissioner to reach a conclusion in a given case that a part of the expenditure on the core technology licence fee is reasonable even though it does not correspond to the arm's length amount and may exceed that amount.

C7.21. However, the Tax Office did not publish the practical guidance the mediator gave on the factors to take into account in determining reasonable values for core technologies.

C7.22. It was not until the mediator objectively reassessed the Tax Office's approach leading to zero and negative core technology values that the Tax Office started to reconsider its approach and steps were taken on the path towards resolution.

C7.23. The mediator rejected the approach that led to zero or negative outcomes. He discounted the Tax Office's reliance on a discounted cash flow methodology that ignored the contractual features and the special value that the parties may have placed on the technology and the influence on price of the tax benefits themselves. He considered that the Tax Office must consider what price that particular investor and researcher would have struck if they had dealt with each other at arm's length. This was because the specific anti-avoidance provision required this to be considered. Values were not to be determined with the benefit of hindsight. Parties were likely to agree on a price in the upper range of values if they had dealt with each other at arm's length. This was because the concession created a demand, if not a market, for the core technology. This approach would have the effect of substantially increasing the core technology values from those the Tax Office-engaged valuers previously gave. However, it may not have increased the values to the extent claimed by investors. This was because the mediator also highlighted key deficiencies in the investor's position.

C7.24. The importance of objectively reassessing the Tax Office's longstanding prior approach that led to zero or negative values cannot be overemphasised. From investors' perspective, the approach that led to zero or negative values amounted to 'zero tolerance' of syndication. It was seen as a means to 'wind syndicates up'. Effectively, it characterised the arrangements as 'tax rorts'. This entrenched investors' resistance to the Tax Office's approach to the issue.

C7.25. The Tax Office should have been more transparent about how the mediation changed that approach. The Tax Office says it could not have put more into the guidelines because they were a product of the mediation and agreed by the parties, including the mediator. The Inspector-General rejects the proposition that the Tax Office could not have transparently provided full information on how the mediation had changed its position. A full disclosure of the relevant factors that it would now take into account, would have created a more open and constructive environment for final resolution of this issue. It would have enabled investors to understand fully the Tax Office's basis for compliance action. It would have demonstrated that the Tax Office had objectively reassessed and changed its position on what had been a critical point of difference. It would have reduced investors' resistance, especially where the Tax Office concluded that the core technology expenditure was not incurred in relation to an arm's length dealing.

C7.26. The Inspector-General notes that by not publishing this guidance the Tax Office avoided weakening its' settlement position. This does not mean that the Tax Office intended its inaction to achieve this result. It was merely the result of such inaction. The Tax Office says that it did not try to hide anything. The guidelines were settled by the mediator and the Tax Office 'did not want to tamper with' those guidelines. This was because it thought that it would weaken the credibility of the guidelines. In final discussions, the Tax Office further claimed that the material in the mediator's report had a different purpose to the guidelines. However, the specifics of the mediator's report provided a line of thought of general application to other R&D syndication cases. But notwithstanding who was responsible for settling the guidelines or the purpose of the advice the mediator gave, the Tax Office remained responsible for clearly articulating its forward compliance approach. This approach included how the Commissioner would exercise the power under paragraph 73B(31)(d) in determining an amount allowable as a deduction, to indicate (as it had in relation to the question of arm's length dealing in subparagraph 73B(31)(b)(i)) what factors were relevant and to indicate what weight those factors might be given. There was also nothing preventing the Tax Office from publishing this further guidance in addition to the guidelines settled by the mediator.

C7.27. It was wrong not to publish this guidance fully. The guidelines did note that core technology values were likely to be positive rather than nil or negative as they had previously been. However, without publishing that full guidance investors were left with the impression that the Tax Office would continue to value core technologies in accordance with its previous approach. In its final submission to this report (see appendix 3), the Tax Office says that it 'finds it difficult to understand how investors would have been left with the impression that the Tax Office would continue to value core technology in accordance with our previous approach.' As previously pointed out to the Tax Office, there is evidence that senior officials were well aware of this impression. The following is an extract from a 13 October 2004 email sent from one senior official to four others that documented a telephone conversation between the senior official and an investor's representative on the guidelines:

> [The investor's representative] also queried why the guidelines revealed that the core technology price is likely to have a positive value. He well understood the evidence of the Commissioner in Zoffanies that the status quo valuation and methodology would reveals a zero value or negative value for most syndicates if not all syndicates. It was explained that this point arose out of the mediation …
>
> As to the guidelines arrived at by Sir Anthony Mason [the investor's representative] was of the view that they 'were not clear …'
>
> [the Guidelines] should set more explicitly, what is required …
>
> [The investor's representative] observed 'we get nothing' if we go to Part C.

C7.28. Since the outcome of the mediation, there was a substantial change in the Tax Office's approach. This has substantially changed the quantum of revenue involved. The overall compliance outcome is now only a small proportion of the total originally thought to be involved — about 5 per cent or $143 million including GIC and penalties plus a potential further $73 million subject to review.

The Tax Office needs checks and balances over its culture of `hitting tax abuse hard´

C7.29. The points above support the Inspector-General's view that a Tax Office compliance culture of 'hitting tax abuse hard' exists within the organisation. This culture is expected and, in circumstances where tax abuse clearly exists, is justified.

C7.30. However, if there are insufficient checks and balances to prevent this culture from denying a fair process then Tax Office processes are likely to be flawed and the resolution highly problematic. Unchecked, this culture could impede the objective assessment of whether tax abuse actually exists. It could also impede the correct resolution of cases regardless of whether tax abuse, in fact, exists. Processes are needed to trigger the objective reassessment of Tax Office positions in order to prevent the adverse impact of this culture in matters of uncertainty and complexity.

C7.31. The Inspector-General concludes that this unchecked cultural influence has been a major contributing factor to why the R&D syndication issue has taken well over a decade to approach resolution. Further, notwithstanding recent changes to the tax system, the culture exhibiting these behaviours continues to be demonstrated.

C7.32. It could be argued that such conduct promotes future voluntary compliance by 'tax abusers'. However, based on discussions the Inspector-General has had with investors, the Tax Office's conduct in these matters has only served further to entrench future resistance to Tax Office views in areas of uncertainty. Further, such conduct is contrary to the Tax Office's Compliance Model and the Taxpayers' Charter. It also does not sit easily with the Commissioner's recent statement to large business taxpayers:

> Given the significance of large businesses to the efficient and effective operation of Australia's tax system, and the inherent uncertainty in the application of the tax law to complex arrangements, it is critical that we develop a close and constructive working relationship with the large business sector, including the efficient and proper resolution of disputes. [Commissioner's foreword, *Large business and tax compliance 2006*, 29 August 2006]

C7.33. The Tax Office is entitled to come to a view of the law that it believes is the correct view. It is entitled to believe that other views of the law are 'not the better view'. It is entitled to believe what the right outcome should be in any particular case. However, it must also ensure that the process by which it arrives at that outcome is fair and appropriate. It must also be open to objectively reassessing its view where it receives signals that its view may not be the correct one.

C7.34. The Tax Office did not objectively reassess its view earlier because it tenaciously believed that views contrary to its own were wrong and that the arrangements were 'tax rorts'. The Inspector-General considers that the Tax Office belief that arrangements were tax rorts triggered a cultural response that the Tax Office's view was correct both in the desired outcome and the path to reach that outcome. This culture led the Tax Office to assess selectively and subjectively the weight of external signals and the perspectives of investors. Those signals that supported its view were correct. Those that did not were wrong.

C7.35. The Tax Office's tenacity was fuelled, in part, by the suspected amount of revenue at risk. This amount kept increasing. Until investors exercised the put option, they continued to claim large interest deductions. One Tax Office report to the TCC forecast claims in the hundreds of millions for three syndicates 'unless they were closed down'. In the Tax Office's view at the time, R&D syndicates involved about $3.4 billion of revenue. The size of this figure contributed to the Tax Office's belief that the issue required firm treatment. It also engendered concern with others, including Government.

C7.36. If the Tax Office had objectively reassessed both its and investors' views earlier, long time periods and significant costs would have been avoided. Had these views been objectively re-assessed before the initial audits were concluded in 2000, up to three years and more than $11 million of direct compliance costs could have been saved. Additionally, significant erosion of investors' confidence in the Tax Office would have been avoided, particularly that relating to the Tax Office's ability to reassess its technical views objectively.

8. The Tax Office used litigation purely to strengthen its settlement position rather than to test the issues objectively

C8.1. The Tax Office used litigation purely to strengthen its settlement position rather than to test the issues objectively. It intended to use litigation to resolve other R&D cases 'on an acceptable basis to the Tax Office'. At the time the Tax Office saw mediation as an option but 'highly problematic' without a case successfully litigated. The Tax Office did not have extensive experience in using mediation to resolve highly complex matters, involving polarised views. The Tax Office saw litigating high-profile cases would lead to other investors viewing the Tax Office-obtained valuations more favourably. The aim was to obtain outcomes capable of applying across the syndicate population.

C8.2. However, applying the outcome to the other cases was problematic. This was because the issues in dispute were essentially factual and therefore easy to distinguish. Strictly speaking, all judicial decisions in common law jurisdictions are distinguishable on the facts of their case. Existence of an arm's length dealing is essentially a finding of fact. What amount should be substituted for the claimed deduction essentially relies on the facts of the case. However, parties can obtain great guidance from the reasoning given by a court or tribunal. Parties can see how the issues in dispute are resolved, including the questions that the law poses, the process through which those questions are answered, what facts are considered relevant and irrelevant, how much weight the differing facts are given, what is needed to evidence those facts and how they influence the outcome.

C8.3. The Tax Office's intended approach hindered it from properly assessing whether it might lose in litigation or what it would do if it did lose. When it did lose, the Tax Office sought to confine the adverse impact that the Tribunal's decision in Zoffanies had on its position. The Tax Office said that the Tribunal 'got it wrong' and was not precedential. This was contrary to the Tax Office's initial thinking on its reasons for litigating this case — that it obtain 'outcomes which are capable of application across the syndicate population'. (The issue is also further evidence of the issue discussed at page 167 of the Inspector-General's report on his review of the Tax Office's management of litigation.)

C8.4. The Tax Office could have used the Tribunal's reasoning as a guide in determining facts in other cases. The Tribunal is not a judicial body. It 'stands in the shoes' of the decision maker. It 'remakes' the decision as if it were the decision maker. Therefore, the reasoning adopted by a body reviewing the merits of the Commissioner's decisions is an important and significant indicator of the reasoning approach that should be applied by the Tax Office in assessing the merits of other like cases. However, the Tax Office disagrees that in these circumstances it could have done this. It says that it was in mediation at the time the Full Federal Court decision in the Zoffanies case was published. Although the Tax Office agrees that the Tribunal decision gave guidance on how to approach the application of the law to the facts, it says that the mediation process was a better process through which to achieve this, especially as it did not agree with the approach taken by the Tribunal.

C8.5. If the Tax Office disagreed with the decision it should have alerted investors to its view, how it intended to challenged the decision and how it would administer the provisions in the interim. It did not. Nor did it widely inform the community that it was taking an alternative course in mediating a case to clarify the issue.

C8.6. Had the Tax Office used the litigated case to give practical guidance in how the Commissioner would approach the anti-avoidance provisions, then up to a year and around $5 million in direct compliance costs could have been saved. However, the sole intention of using litigation to strengthen its settlement position drove the Tax Office into an alternative strategy, the mediation, instead of using the decision immediately to move forward to resolve the issue.

9. The Tax Office failed to communicate effectively

C9.1. The Tax Office failed to communicate effectively. This contributed to investors' resistance. It also undermined confidence in the Tax Office as a fair administrator. In spite of the syndicate investors being a small population and known to the Tax Office, at no time over the 15-year period did the Tax Office communicate directly with all of them to provide practical guidance or convey its concerns. If practical guidance were communicated directly and earlier it would have likely led to a different compliance outcome.

C9.2. The following are examples of ineffective communication.

C9.2.1. In the absence of clearly communicated concerns, investors considered they were reasonably entitled to assume that there was administrative acceptance of their investment once it was registered. People were reasonably aware of the overvaluation of core technology (especially by October 1994 when the BIE pointed out widespread perception of artificial core technology valuations — although the basis for this perception was not explored). Full disclosure of the financial arrangements and valuations, including their tax effect, was made during the registration process. However, the Tax Office did not indicate tax law concerns until after the TCC publicly specified its concerns with valuations in 1996.

C9.2.2. Investors considered that they met the letter of the law as understood at the time of their investments. The laws and administrative requirements were progressively changed to address compliance concerns. Investors relied on promoters' experience and material in obtaining registrations. The TCC scrutinised arrangements during the registration process. Investors were unable to change the arrangements once registered. The Tax Office had an observer in the TCC registration process. This observer had no voting power but did advise the TCC on tax matters. Investors' perceptions in this context are important and the significance of the observer's status is lost on them. Some applications were rejected but later approved when lower core technology values were tendered. From November 1995, the TCC considered the valuations more closely.

C9.2.3. The Tax Office did not tell investors before they entered arrangements that core technology overvaluation was a significant compliance risk. The Tax Office refused to give binding advice on core technology values or the anti-avoidance provisions. At the time, this was typical of the Tax Office's approach towards giving advice on the anti-avoidance provisions. The Tax Office started audits from 1992. Tax Office officers gave speeches at industry conferences from early 1996 saying that there 'were early indications of questionable valuation of core technology'. However, these are insufficient and unrealistic means to communicate compliance concerns to others. They did not give sufficient information to enable people to assess the merits of their own claims.

C9.2.4. The Tax Office took far too long to communicate that it had objectively reassessed its view. Investors saw the Tax Office discounting earlier signals that its view might not be the correct view. The Tax Office maintained that its view was correct because it relied on expert valuer advice and that it was reasonable to rely on this advice. Investors perceived a double standard. The Tax Office used the same argument that investors had used to defend their reliance on their valuations. However, investors comment that although the Tax Office used this argument to support its own case, it rejected the argument when it was used by investors.

C9.2.5. The Tax Office refused to acknowledge to investors that it contributed to the behaviours it was observing. It refused to accept it allowed uncertainty to continue. It refused to accept that its inaction towards the continuing uncertainty influenced the taxpayer behaviours. Investors considered the Tax Office was trying to 'rewrite history' by retrospectively applying a view that was not known at the time. Investors believe that if the Tax Office had given that guidance before arrangements were entered, they would have followed it.

C9.2.6. The Tax Office litigated the Zoffanies case. Once the Tax Office lost on the grounds of the specific anti-avoidance provision, it distinguished the case on its facts. Investors heard the Tax Office say that the Zoffanies case was the most expensive case it had ever litigated. Investors asked why the Tax Office would litigate a case for a relatively low amount of revenue if it had no precedential value.

C9.2.7. The Tax Office did not inform auditees that it was executing lead case strategies. Auditees perceived Tax Office inaction. Others that were not audited were surprised to receive later a choice of accepting an offer of settlement or subjecting their claim to review.

C9.2.8. The Tax Office excluded from review investors with investments of under $3 million. This was because the Tax Office considered the largest investments represent the greatest risk — there being greater scope for inflation in a larger amount than a small one. The Tax Office did not publicly provide its reasons for this decision. By not publicly providing its reasons for differentiating its compliance treatments the Tax Office left itself exposed to allegations that the decision was merely based on an arbitrary revenue figure and not on compliance behaviours or attitudes. This was especially where the smaller investments were thought to be less likely to have as strong claims as the larger investments in having conducted due diligence which evidenced an arm's length dealing.

C9.2.9. Some investors found the way in which the Tax Office offered its September 2004 settlements to be threatening. They had claimed the deductions 8 to 12 years earlier. For 19 of the 40 investors selected for Tax Office compliance review from September 2004, they heard nothing on the matter from the Tax Office until late 2004. They were forced into either 'admitting guilt' and paying half of the core technology claimed with half of six years back interest, or, submitting to an expensive review process to prove the innocence of their claims.

C9.2.10. Investors initially considered that the Tax Office was applying a 'double standard' in response times to its settlement offer. For some the Tax Office took over 10 years to notify them of the issue. It expected investors to provide a response to the settlement offer within 6 months. This issue was resolved by the Tax Office later writing to investors to offer extensions of time, without accruing GIC during those periods, where investors actively worked with the Tax Office to resolve the issue.

C9.3. The Tax Office did not effectively communicate its review and resolution strategies. It did not alert relevant taxpayers that their claims might be reviewed in the future (in many cases more than eight years later). This allowed GIC to accrue and investors to be ill prepared when the time came for review. The Tax Office did not tell taxpayers that it was focusing its resources on resolving lead cases to establish guidance for the resolution of other cases. In one case this allowed an investor to settle on substantially more detrimental terms than would have awaited the outcome of the mediation. It did not communicate the change to its long held approach to quantifying an arm's length amount following the mediation. This would have allayed investors' concerns that the Tax Office would merely continue to substitute investors' valuations with the Tax Office-commissioned 'close to zero' valuations. It would have promoted transparent administration and reduced investors' resistance. The Tax Office disputes the conclusion that it did not communicate the change to its long-held approach to quantifying an arm's length amount following the mediation. However, the Inspector-General maintains his view that the Tax Office did not provide as much information as it could have done on this point. What was communicated did not adequately convey the change in the Tax Office's approach or the factors that should be considered in quantifying these amounts.

C9.4. The Tax Office relied on indirect communication of the issue (speeches at industry conferences and other auditees telling the investors). It argues that all investors would reasonably be aware of the Tax Office's scrutiny of this issue by reason of its audits of key investors and general public statements. The Tax Office states that the vast majority of syndicates were managed by four merchant banks, which had ongoing roles in conjunction with the investors in relation to the R&D programme for each syndicate. They were the subject of intense Tax Office audit action. The Tax Office finds it difficult to conceive that the ongoing issue of core technology values, of which promoter banks were well aware, was not raised at these meetings.

C9.5. This view is unrealistic. The investors were in competition with each other. They would not discuss such sensitive information with anyone unless it was a threat to their syndicate and then only with other syndicate members. This information would cause market concern and depress the share price.

C9.6. Further general statements in a public forum are not enough to alert taxpayers to the Tax Office's concerns. Specific information about the concerns was needed. The first time the Tax Office provided specific information was in its position papers to some auditees from mid-2001.

C9.7. Further, the arrangements and their tax effects were examined before arrangements were entered. Investors complied with a Government registration process in which the Tax Office was involved.

C9.8. The Tax Office could have engaged industry much earlier. It did discuss mediation with a key investor three years earlier. However, the investor withdrew from these discussions when the Tax Office insisted that amended assessments should issue in parallel to the mediation and the Tax Office did not respond to the investor's requests to give reasons for its decision.

C9.9. The Tax Office could have arrived at an understanding of the strengths and weaknesses of each party's case much earlier. The Tax Office could have struck a compliance framework that showed it appropriately considered industry's views. Had it done so when the specific anti-avoidance provision was enacted, up to 12 years and $30 to $40 million of direct compliance costs would have been saved. Also, with more effective communication the Tax Office would have avoided the erosion of investors' confidence in its administration of the tax laws.

C9.10. The Tax Office accepts that with the benefit of hindsight it should have had greater communication with investors to advise them of emerging concerns and the Tax Office's audit programme.

10. In some specific cases the Tax Office acted unfairly

C10.1. There were also instances where the taxpayers were treated unfairly. This was not only through the excessive timeframes in resolving disputes. It was also in the Tax Office's handling of various aspects of the disputes. This included the following:

C10.1.1. It was not until mid-2001 that the Tax Office gave reasons for decision to auditees in its position papers, and then not in all cases. The Tax Office says that it relied on 'explicit' legal advice not to disclose its reasons. However, the legal advices provided to the Inspector-General do not indicate this. One advice merely comments that the position paper did not disclose reasons for the decision. Before this time auditees were unable to understand the case made against them. This impeded an adequate understanding of the strengths and weaknesses of each party's case. This in turn hindered an objective assessment of the issue early on.

C10.1.2. Investors thought it 'incredible' that core technologies would have close to zero or negative values. This was especially the case where the researcher had a history of successfully developing technologies and had spent significant time and money (in the millions of dollars) in developing the core technology before entering the syndicates. The approach leading to close to zero or negative values had been rejected by the Administrative Appeals Tribunal in the Zoffanies case (as well as by the mediator). Submissions also pointed to a 2005 Administrative Appeals Tribunal case (*The Taxpayer and The Commissioner of Taxation* [2005] AATA 1039, 20 October 2005, Sydney) which also rejected that approach. Investors had their own contemporaneous valuations that supported their position. Investors perceived that the Tax Office was applying a view retrospectively with the purpose of 'winding syndicates up'. This was despite a Government policy decision in July 1996 that allowed existing syndicates to continue to claim the concession.

C10.1.3. Part IVA Panel decisions relied on untested auditors' submissions. This is because investors were not afforded adequate opportunity to be heard in relation to these submissions.

C10.1.4. The Tax Office also effectively denied taxpayers the right to have its' view reviewed by an independent body. Non-lead and less advanced cases were to be put on hold. This meant that it was unlikely that other cases would progress to amended assessments. This would deny the taxpayer the right to exercise their right to challenge the Tax Office view under Part IVC prior to the lead cases being finalised. In only two cases did the Tax Office issue amended assessments without first settling the matter. All other investors were unable to exercise choice in pursuing any merits review through Part IVC of the *Taxation Administration Act 1953*. Access to review under Part IVC depends on the Tax Office issuing amended assessments. Taxpayers are able to seek merits review of assessments of tax liabilities through Part IVC. Unless an 'unlimited period of review' provision applies, as was the case here, the Tax Office is limited to a time period in which it may amend a taxpayer's assessment. The Tax Office argues that although it effectively may be a denial of a right, it is a right that the taxpayers did not want to exercise. It may be true that many investors did not want amended assessments before settling the matter because it would adversely affect their market value and financing. They did, however, want the matter to be independently reviewed. The Part IVC dispute resolution process did not enable independent review of the matter without exposure to adverse market responses.

C10.1.5. The Tax Office also denied four requests for internal review in one case. The Tax Office says that the requests did not satisfy its criteria for internal review. It saw these requests as a delaying tactic. This case was ultimately resolved in the taxpayer's favour four years later.

C10.1.6. One potential effect of the Tax Office's September 2004 settlement strategy was to impose greater costs on those more compliant taxpayers. Investors could settle on a 'no questions asked' basis without review. Taxpayers that had potentially made excessive claims could settle without review and without compliance costs. However, investors that believed they had made valid claims were required to incur greater compliance costs in undergoing a review to prove compliance. Some investors who have settled state that minimising ongoing compliance costs was seen as a better outcome than seeking to prove their belief of eligibility. Serious consideration was given to settlement even though they considered their claims validly made. They point to the prohibitive financial costs in disputing any Tax Office amendment or submitting to an audit on this issue. They also perceive considerable loss of productive time that senior executives would incur if involved in negotiations or disputes on the issue.

C10.1.7. In the absence of full disclosure by the Tax Office, investors assumed that the Tax Office would continue to apply its previous approach to determining quantum — that was thought to be to substitute the core technology deduction that the investors claimed for the negligible value in the Tax Office-commissioned valuation. This placed greater pressure on taxpayers to settle without review.

C10.1.8. In late 2004, the Tax Office unnecessarily selected a number of cases for review. Syndicates that were registered and had their valuations scrutinised by the TCC from November 1995 had the right to assume that they were compliant on this issue when they were registered. This was because the TCC made it clear in 1996 that it had been examining core technology valuations to determine if they evidenced arm's length market values as part of registration since November 1995. The Tax Office acknowledges this and found those cases compliant. However, the Tax Office did not exclude these cases from review. It required the investors to provide detailed submissions. This unnecessarily increased the compliance costs for those cases. The Tax Office considers that it is 'up to the investor' to prove that the TCC scrutinised their valuation. However, the Tax Office could access that information from the TCC directly as part of its case selection and should have done so.

C10.1.9. The Tax Office hindered quick and fair resolution of some cases reviewed after September 2004. The Tax Office perceived the cases amounted to 'tax abuse'. It considered 'it was up to the investor' to make a claim for a better basis for settlement. The Tax Office questions the need to discuss cases in detail. However, as the Tax Office disagrees with this conclusion, the Inspector-General considers it necessary to recount the following relevant matters in some detail.

C10.1.10. In late 2004, three investors in different syndicates were offered a choice to settle on a 50 per cent basis or subject themselves to review according to the published guidelines. Over the next two years there was correspondence between the Tax Office and the investors on whether there was an arm's length dealing in relation to the core technology price.

C10.1.11. In early November 2006, the Tax Office wrote to one investor advising that the Tax Office would take no further action. The taxpayer was not given any reasons in the letter. However, the Tax Office told the Inspector-General that it took this decision because the TCC registered the syndicate after it announced that it had been scrutinising core technology values as part of its registration process since November 1995. The Tax Office decided to take no further action after meeting with Inspector-General staff in October 2006. At this meeting the Inspector-General discussed the key issues identified in the course of the review and expressed the view that the Tax Office should have taken account of the strengthened TCC scrutiny in its risk assessment and compliance strategy. The Tax Office agreed and commented that it had seven cases falling into this category. It was only uncertain in relation to one. This was because although the syndicate was registered after November 1995, it was unclear whether the TCC had approved the finance scheme before that date. There was usually a time delay between assessing the finance scheme and the date of registration. In its final submission to this report (see appendix 3), the Tax Office now says that 'additional TCC scrutiny was one of the factors taken into account'. This latest response is contrary to advice the Tax Office gave the Inspector-General in October 2006 and confirmed in February 2007. It is also contrary to advice it gave to an investor's representative in February 2007, that the factor was 'determinative'.

C10.1.12. For the second investor the Tax Office advised in late November 2006 that, in its view, there was no arm's length dealing. It also gave an indication of the likely amount it would allow as a deduction by enclosing a copy of the Tax Office-commissioned valuer report. The Tax Office gave the second investor until mid-February 2007 to make submissions on the value of the core technology.

C10.1.13. The second and third investors were made aware of the issue of additional TCC scrutiny by their adviser. In late November 2006, the second investor asked for more time to collate relevant information going back more than 10 years to demonstrate additional TCC scrutiny. This was because the TCC had initially rejected the registration because of the financial arrangements. The Tax Office advised that it would not give this extra time and that it had already determined the issue of arm's length dealing (on the basis of material in the investor's submission given many months before the Tax Office decided that the factor was determinative). However, it said that it would consider anything the investor provided before mid-February.

C10.1.14. However, for the second investor the Tax Office had evidence that indicated the TCC may have scrutinised the initial valuation. This was because auditors had previously obtained an IRDB letter declining to register the syndicate on the ground that its financial arrangements did not comply with the finance scheme guidelines. The Tax Office could have provided this information to the investors. The Tax Office could have satisfied itself of the scrutiny and either excluded the investors from its compliance actions or informed the investor why it was not satisfied that the scrutiny given was enough. This would thereby have avoided the investor having to incur costs in preparing submissions. The Tax Office did not provide this information.

C10.1.15. It is also unfair administration to receive a submission, later decide a factor is determinative of the issue, not communicate that factor and then refuse investors reasonable time to reconsider their submission in light of that additional factor. The Tax Office must keep compliance activity moving. However, this should not be at the expense of appropriate procedural fairness.

C10.1.16. The third investor was involved in another syndicate which was registered six months after the TCC commenced additional scrutiny of core technology valuations. Its finance scheme was scrutinised during the period from which the TCC Chairman said that the TCC was scrutinising core technology values as part of its registration process. However, the Tax Office did not advise that third investor that additional TCC scrutiny was a significant factor in determining the issue. Also, the Tax Office assumed that the TCC did not scrutinise the syndicate's core technology value because that syndicate's finance scheme was examined by the TCC shortly before the issue of the new finance scheme guidelines. This was notwithstanding the fact that the syndicate's finance scheme was considered during the period in which the TCC was scrutinising core technology values. This was also notwithstanding the fact that even though the announcement of the new finance scheme guidelines was made in late November, the TCC Chairman stated that applications under the old finance scheme guidelines for advance approval of the finance scheme leading up to the announcement of the new guidelines were subject to the TCC's 'close administrative scrutiny'.

C10.1.17. The Tax Office then said in final discussions with the Inspector-General's office that if investors did not refer to additional TCC scrutiny of their valuation in their submission (given to the Tax Office some time before the Tax Office decided that additional TCC scrutiny was a 'determinative factor') it would not consider that the investor relied on that scrutiny. The Tax Office considers that there must be evidence of additional scrutiny as well as reliance on that additional scrutiny.

C10.1.18. The Inspector-General considers this an ill-considered approach. Whether or not investors *claimed* reliance on additional scrutiny became irrelevant once core technology valuations were scrutinised before the syndicates were registered. The specific reason for the TCC's additional scrutiny was to address the risk of inflated core technology values before syndicates were registered. Inflated core technology values were a significant concern for government bodies by late 1995. The Tax Office had observer status on the TCC and provided the TCC with advice on tax matters. In August 1995, the TCC's newly appointed Chairman (a former Commissioner of Taxation) immediately embarked on public consultation on new draft guidelines by which syndicates' financial arrangements would be assessed. During this period he gave speeches stating that he thought core technology valuations were on 'the too high side'. One speech clearly and unambiguously set out five factors of concern that the TCC would consider when looking at core technology valuations. The Chairman indicated that the TCC would not recommend registration of syndicates with valuations it considered excessive and, further, the TCC would be prepared to commission its own valuations 'if necessary'. However, most of the syndicates, that were the subject of this review, had been processed by the TCC prior to this time.

C10.1.19. The Tax Office did not tell investors that additional TCC scrutiny was a 'determinative' factor because it was likely that all investors would claim they relied on registration regardless of whether they in fact did. However, arguing that arm's length values depended on investors claiming reliance would likely lead to inequitable outcomes. In the absence of knowing that the additional scrutiny was a determinative factor the taxpayer may have relied on the additional scrutiny but simply not mentioned it in their submission. A better approach was to use an objective measure: whether the TCC assessed the financial arrangements after the date on which the TCC began to address the risk of inflated core technology prices.

C10.1.20. In spite of accepting that the TCC's additional scrutiny was a determinative factor, the Tax Office's strong belief that these cases amounted to 'tax abuse' continued to impede its ability to demonstrate a fair and quick review of these cases.

C10.1.21. In its final submission to this report (see Appendix 3), the Tax Office appears to have now accessed the TCC records. The Tax Office now says that the TCC did not scrutinise the valuation and the core technology valuation was not obtained at the time the TCC scrutinised the finance scheme. However, it also appears from the Tax Office's submission that it has now finalised this case without adjustment.

C10.1.22. In another matter, two investors settled with the Tax Office while the Tax Office was involved in the mediation. The mediation was conducted for the purpose of providing guidelines for the resolution of other R&D cases. The Tax Office did not inform the investors of the mediation or its purpose. The investors found out through a Commissioner's speech given in April 2004. For the investor who settled before the Commissioner's speech, the terms of settlement were far less concessional than those offered to the other investor who delayed settlement until after the Commissioner's speech. All facts were materially similar. The Tax Office considers the earlier settlement a 'commercial decision to settle'. At that time the investor would have been aware of the Zoffanies Full Federal Court decision and considered the risks. Further, the Tax Office says it could not tell investors it was involved in a mediation to provide guidance 'because of the terms of confidentiality'. This is not supported by the terms themselves. Further, these terms did not prevent the Commissioner from publicly announcing the Tax Office's involvement in the mediation three months before its completion.

C10.1.23. In its final submission to this report, the Tax Office argues that the earlier case was settled at a time when the Tax Office had not contemplated making a general settlement offer. Although the Tax Office may not have contemplated a general settlement at the time this does not mean that the mediation would not affect terms of settlement being negotiated in individual cases. It is clear that the output of the mediation was intended to have wide application to other R&D syndication cases and would therefore likely affect the terms of any settlements being negotiated on the issue, even though the extent that the mediation would affect those terms was uncertain until the end of the mediation. The Tax Office continued negotiations with the first taxpayer and entered into a settlement with them at the same time it was developing a global policy to deal with all matters of that kind, without notice to that taxpayer.[5]

C10.1.24. The Inspector-General considers this unfair and inconsistent administration. Such conduct erodes public confidence in the Tax Office's ability to administer the tax laws objectively. It gives the perception that the Tax Office took advantage of the prevailing uncertainty solely to obtain a better revenue outcome. The Tax Office was aware of the mediation. It was aware that the mediation was aimed at producing 'guidelines for reviewing R&D arrangements'. It should have been aware that this would

5 *Ibid.*

affect the position taken in relation to the taxpayer. It knew that the investor was not aware of this. It therefore settled on an unfair basis. This conduct is inconsistent with the Taxpayers' Charter. It is also inconsistent with community expectations that the Tax Office will be fair and transparent in its dealings.

C10.1.25. For 19 of the 40 investors targeted in late 2004, the settlement offer was the first time that the Tax Office told them that the claims they made 8 to 12 years ago would likely be reviewed. Other investors were already told many years earlier that their claims would be reviewed. At the time there was significant uncertainty and the Tax Office was aware of the detail of the arrangements and their tax effect before arrangements were entered.

C10.2. The Inspector-General considers it unconscionable for the Tax Office to have allowed one investor to hold off concluding a settlement because of the mediation but not the other investor it was in settlement negotiations with when all the time the Tax Office was aware that there was a process being undertaken to provide guidelines for reviewing R&D arrangements.

C10.3. In relation to the 19 investors that were not formally notified of the likely Tax Office review of their claim at all until late 2004, the Inspector-General concludes that the Tax Office acted unfairly, albeit legally. It retrospectively applied a compliance view to claims made 8 to 12 years previously without prior notice to those taxpayers that it might do so.

C10.3.1. The tax laws allow the Tax Office unlimited time to amend a 'nil' assessment.

C10.3.2. The Government recently placed limits (with prospective effect) on the amendment of 'nil' assessments. It considered the general issue during the ROSA review.

C10.3.3. However, the facts of this case are materially dissimilar to those of other 'nil' assessment cases. All investors sought Tax Office binding advice, the Tax Office was aware of the compliance issue yet did not provide practical guidance despite many adequate opportunities to do so over 13 years, it was aware of the facts and their tax effect before arrangements were entered, all losses were utilised more than eight years ago and the Tax Office did not alert those 19 investors that it might review their claims at any point in the future. It waited more than eight years to do so.

C10.3.4. The Tax Office argues that it must take action where it has formed a view that there is a significant compliance problem. However, it agrees that there was no fraud or evasion in these cases. It also, in 2004, pragmatically chose not to pursue over three-quarters of the investors.

C10.3.5. The Tax Office could have reviewed all claims many years earlier but it failed to do so. Despite familiarity with all the investors, the Tax Office inappropriately relied on indirect communication to alert taxpayers to the probability of reviews. It gave private binding rulings to investors in the 246 syndicates. Through AusIndustry it had access to the details of all investors.

THERE HAVE BEEN A NUMBER OF CHANGES TO TAX ADMINISTRATION

3.108 During the period from 1991 to 2007 there have been a number of changes to tax administration. These include the following.

3.109 Since 2002, the Tax Office has aimed to improve awareness of the effects that policy and law design will have on tax administration (the Integrated Tax Design). The aim is to address tax administration issues during the policy development and drafting of tax laws.

3.110 There have been recent law and administrative changes aimed at improving practical guidance.

- The law was recently changed to allow the Tax Office to provide private binding rulings on matters of fact, including valuations.
- The Tax Office has agreed to implement Treasury's recommendations flowing from its Review of Aspects of Self Assessment (ROSA) report. This includes indicating in private binding rulings whether the Tax Office considered the general anti-avoidance provisions. Treasury recommended that where Part IVA has been substantively addressed and there has been a full and true disclosure of all material facts, the Tax Office should be prevented from reopening an assessment.
- The Tax Office has also implemented Treasury's recommendations to develop Market Valuation Guidelines. These guidelines were published after discussions with business, accountants and valuers. Generally, the guidelines set out detailed criteria that the Tax Office will apply when assessing the quality of market valuations. They also provide a framework for the Tax Office to give binding advice on valuations.
- The Tax Office is beginning to extend its practice of entering pre-assessment agreements in complex matters — for example, advanced pricing agreements in transfer pricing cases.
- Since 2003, the Tax Office has sought to raise awareness at the corporate board level of tax risks.
- Since late 2005, the Tax Office has had the benefit of the joint advice of the Solicitor-General and Australian Government Solicitor (sought by the Tax Office in connection with the Inspector-General's review of the Tax Office's management of litigation) This advice gives practical guidance in how to administer the tax laws in circumstances where the Tax Office disagrees with case law. In particular, this advice provides guidance to the Tax Office on how it should inform taxpayers of how it will administer the law following adverse decisions.

3.111 There have also been law and administrative changes aimed at reducing the timeframes for periods of review and the adverse effects of extended review periods.

- The Tax Office amended its GIC remission policy (Practice Statement 2006/8) as a result of the Inspector-General's audit timeframes review to give GIC and SIC remission where delays are not caused by the auditee.
- Since 2004, the Tax Office has implemented improved case management of large case audits, including reporting of 'aged cases' directly to senior management on an

ongoing basis and having two of its most senior officials involved in the case management of the most difficult cases.

- As a result of the Inspector-General review of audit timeframes and Tax Office discussions with the Corporate Tax Association, the Tax Office currently aspires to complete large complex audits within five years.
- The law was recently changed to place time limits on the effective unlimited time periods for review of 'nil' assessments. This gave effect to Treasury's recommendations in its ROSA review. Treasury also flagged for more detailed review other unlimited periods for review in the tax laws.
- The tax laws were changed to reduce the rate of interest accruing before amended assessments are issued. However, they will not impact on the R&D syndicate core technology audits. The changes operate prospectively.

3.112 The Tax Office has also implemented mechanisms aimed at improving its communication with taxpayers.

- Since the early 1990s the Tax Office has further refined its internal processes to identify, prioritise and communicate to the public compliance risks. For example, the Tax Office publishes its compliance programme annually which sets out its compliance focus for the coming year. It has also refined its processes for the escalation of technical issues for resolution.
- The Tax Office has improved its public communication on compliance issues. Since 2000, the Tax Office has used 'Taxpayer Alerts' to advise taxpayers of potential Tax Office concerns with certain tax arrangements and the reasons for those concerns. It also uses media releases, industry meetings and professional forums to draw public attention to high compliance risks.
- As a result of the Inspector-General's review of the Tax Office's management of litigation, a number of changes were recommended that would go some way to improving the Tax Office's use of litigation — for example, introducing a standard communication product to communicate the application of finalised court and tribunal decisions.
- In 2005, the Tax Office changed its procedures to provide taxpayers with the opportunity to be heard at Part IVA Panel meetings. This is set out in Practice Statement 2005/24.

RECOMMENDATION

3.113 The Inspector-General makes the following recommendation.

RECOMMENDATION

The Inspector-General recommends that the Tax Office fully reconsider whether it has fairly struck settlements with:

(a) the 19 investors that the Tax Office did not formally advise that their investments made more than 8 years previously would be subject to review; and

(b) those investors with whom the Tax Office negotiated settlements without telling them that at the same time it was mediating a case to develop guidelines for the resolution of R&D syndicate cases.

3.114 In making this recommendation, the Inspector-General notes that he will be further examining R&D syndicate settlements in the context of his future review of settlements generally.

Tax Office response

3.115 The Tax Office provided the following response to the above recommendation.

> In relation to the 19 investors mentioned in paragraph (a), it should be noted that settlements have been made in respect of only 6 cases with another 3 cases yet to be finalised. In the remaining cases, adjustments have not been made to claimed deductions.
>
> The Tax Office accepts that it would have been better if direct contact was made with these investors earlier. However, it is our view that most, if not all, of those investors and their advisers would have been aware of the Tax Office's ongoing review of R&D syndication arrangements.
>
> In the small number of these cases where adjustments have been made, the settlements were entered into in good faith and were based on the fact that the deductions claimed by investors were not fully allowable under the law. To unwind these settlements for the reasons suggested in the report would raise questions of fairness to other taxpayers who have complied with their tax obligations under the law. It would also raise questions of fairness to other taxpayers who have settled or otherwise finalised assessments in circumstances where the Tax Office has reviewed old issues, for example loss company cases.
>
> It should also be noted that in reviewing these cases the Tax Office did take into account the length of time since the transactions took place in considering our position and the terms of settlement in each case.
>
> In response to the cases settled during the course of the mediation mentioned in paragraph (b), each case was settled at a time when the Tax Office had not contemplated making a general settlement offer. This offer was considered towards the end of the mediation and was announced following the mediation. The cases were also settled before the Commissioner announced in April 2004 that the general anti-avoidance provisions in Part IVA of the Act would not be applied to deny deductions for core technology expenditure. The timing of the events relating to the two cases referred to in the report is set out in the attachment.

While not raised in the report, the overall complex and special circumstances of the R&D syndication issue may warrant that consideration should be given to reviewing any case settled on less favourable terms than the general settlement offer made towards the end of 2004. Although these cases would have been settled in good faith, there is an issue whether such investors have been unfairly disadvantaged compared to other investors simply because they chose to finalise their case in a more timely way. We will review this matter further taking into account all of the circumstances relating to these cases.

Inspector-General's comments on Tax Office response

3.116 I am pleased that in the last paragraph above the Tax Office has accepted my recommendation to reconsider the fairness of some of its settlements, albeit not on the basis set out in the recommendation.

3.117 In relation to the 19 investors mentioned in recommendation (a), the Tax Office accepts that it should have directly contacted these investors earlier. But, the Tax Office fails to acknowledge as unfair the fact that it did not. It also fails to acknowledge that it was aware of all the relevant facts (including the details of the syndication arrangements and their tax effect) and the utilisation of the tax losses at least eight years before it sent them a settlement offer out of the blue (see paragraphs C10.3 to C10.3.5 in Chapter 3).

3.118 Further dialogue on these recommendations will be undertaken as part of the process leading up to the finalisation of my final and overall report on the Tax Office's ability to deal with major complex issues within reasonable timeframes.

ISSUES SIGNALLED FOR FOURTH REPORT

3.119 This report also signals issues arising from this review that may be the subject of recommendations to be made in the Inspector-General's fourth report or the subject of other reviews. These issues will be assessed and discussed with the Tax Office before drafting the fourth report. The focus of these issues is on matters of administrative objectivity, timely resolution and provision of certainty that have been identified in this review of R&D syndicates.

- Providing early practical compliance guidance in matters of complexity and uncertainty. This includes the early publication of guidance and the early communication to relevant taxpayers that their claims may be reviewed in the future.
- Improving the mechanisms to trigger management at an appropriate senior level of those complex issues experiencing delays, without relying on bottom-up escalation processes.
- Providing sufficient reasoning on technical issues to enable an informed understanding of the strengths and weaknesses of each party's case. This could include developing and applying a set of guidelines as to the form, content and purpose of a position paper.
- Introducing circuit-breakers to require independent and objective reassessment of the Tax Office's view and compliance approach where significant technical or compliance issues are not being resolved in a timely way.

- Introducing processes to minimise any risk of potential cultural, or other extraneous, influences getting in the way of administrative objectivity (noting that all organisations, not only the Tax Office, are subject to unconscious influence by their culture).

- Using lead cases to reduce compliance costs of the majority of potential auditees in areas of uncertainty. These lead cases could be representative of the class of cases against which the outcome will be applied. They could be used to reduce uncertainty and provide practical guidance. These cases could be clearly identified as lead cases at the outset.

- Ensuring that there is no basis for allegations of bias in review processes by either implementing sufficient transparency and external assurance in those processes, or engaging tax officers without a prior history in the matter.

- Ensuring that there is no basis for criticism of settlement offers by ensuring that the alternative action to settlement was not arbitrary or overstated. This could include obtaining appropriate external counsel opinion on the litigation risks (both in terms of the view of the law and an assessment of the evidentiary basis to sustain that view for that case) and likelihood of success. Greater clarity around the weight of factors for adjusting settlement terms could also be given.

CHAPTER 4 — CHRONOLOGY OF KEY FACTS ARISING FROM CASE STUDY

4.1 The following information has been extracted from Tax Office audit and technical files, AusIndustry information, Bureau of Industry Economics and Australian National Audit Office reports, Administrative Appeals Tribunal and Full Federal Court decisions.

1987

4.2 On 20 November 1987, legislation was enacted which effectively provided for syndicates' eligibility to the R&D tax concession. Generally, the IRDB could provide 'in principle' approval, and subsequent 'joint registration' for two or more participating companies (a syndicate) undertaking joint activities.

1988

4.3 In 1988, the *Taxation Laws Amendment Act (No.5) 1988* inserted subsection 73B(11) into the *Income Tax Assessment Act 1936* (ITAA 1936) allowing accelerated expenditure. Deductibility for core technology expenditure for R&D tax concessions was already provided for by subsection 73B(12) of the ITAA 1936.

4.4 On 1 July 1988, section 39P was inserted into the *Industry Research and Development Act 1986*. This provision, amongst other things, required at least one of the investors to be unable to use the results of the R&D in their business and to have expended not less than $1 million on the project or projects. This section also restricted syndicates to only those which included financial institutions. (See page 54 of the Explanatory Memorandum to the *Taxation Laws Amendment Act 1990*.)

1989

4.5 In May 1989, the sunset clause for the R&D tax concession was extended for a limited period.

4.6 On 1 July 1989, the company tax rate changed to 39 per cent.

4.7 On 7 December 1989, the Industry Research and Development Board (IRDB) registered the first syndicate.

1990

4.8 On 7 June 1990, the *Taxation Laws Amendment Act 1990* was enacted. Amongst other things it effectively removed the restriction in section 39P of the *Industry Research and Development Act 1986* that at least one of the investors in syndicates had to be a financial institution.

1991

4.9 On 9 May 1991, the Tax Office published Taxation Ruling IT 2635. The relevant paragraphs for R&D tax concession core technology issues are the preamble and paragraphs 29-32 and 35-37. Paragraphs 35-37 ask the reader to assume that there is no guaranteed return, that the price is not simply equated with an expert's valuation and that it reflects market realities. Also, paragraphs 3, 4 and 8-10 accept that a syndicate established according to the structure set out in paragraph 4 and the associated diagram is a means by which investors may participate in R&D activities within section 73B of the ITAA 1936 on a 'guaranteed return' basis.

4.10 By letter issued in 1991, the Tax Office provided a ruling on a taxpayer's question on a valuer's methodology used in preparing the valuation of core technology:

> [Taxpayer proposition set out in the ruling request]
>
> We seek Rulings on behalf of each of the Syndicate Members from the Commissioner of Taxation confirming the issues set out below. A discussion of each issue is contained in Appendix 1. …
>
> 9. That the methodology employed in preparing the valuation of core technology is acceptable. …
>
> APPENDIX 1 …
>
> 9. Valuation of Core Technology
>
> In preparing the valuation the valuers were directed to have regard to the statements of the Taxation Office set out in paragraphs 35 to 37 of IT2635.
>
> It is noted that not only does the independent valuation prepared by [the valuers] support the value placed on the core technology by the Syndicate Members, it also demonstrates the following:
>
> (a) the technical feasibility of the project being undertaken;
>
> (b) the close proximity to commercial exploitation;
>
> (c) the competence of [the researcher] based on current resources and a proven track record, to effectively carry out the research to a commercial exploitation phase.
>
> (refer page 21 of the valuation)
>
> In the Executive Summary to the valuation, [the valuers] state that they believe a valuation using historical cost and revenue/profit cash flows projected to the year 2000 of $11 million to $12 million is reasonable.
>
> Given the risks perceived by the Syndicate Members in relation to the project, and the fact that the parties are themselves dealing at 'arm's length', the licence fee for the core technology eventually agreed upon of $8.5 million cannot be said to be anything other than fair and reasonable and, therefore, acceptable to the Commissioner of Taxation.

Dealing specifically with the matters raised in paragraphs 35 to 37 of IT2635 the following comments are made:

(a) there is clearly a proper commercial reason for acquiring the right to use the core technology. The valuation itself clearly demonstrates that without the core technology a marketable product, being the aim of the R&D syndicate, could not be achieved;

(b) it is noted that the Commissioner of Taxation is concerned in situations where a valuation of core technology is based on future benefits or the service potential of successfully developed [intellectual property] and where the so-called 'arm's length' price attributes the profit on the core technology component of such sales to the vendor. In the present circumstances one method of valuation which has been adopted by [the valuers] is based upon revenue/profits and cash flow projections to the year 2000. Details of this are set out on the bottom of page 19 of the valuation. This valuation method, however, does not have as its starting point the previous expenditure incurred by [the researcher] on the core technology. As a result, given that the price eventually agreed upon by the parties was actually less than historic cost ($8.5 million v $12.147 million) there cannot, by definition, be in the amount paid any 'profit' element from the subsequent sale of the [intellectual property] attributable to the vendor;

(c) the valuation has not been done by reference to the existence of the Minimum Royalty Payment. It has been calculated by reference to projected sales to be made of the commercialised product;

(d) it is submitted that given the [valuers'] knowledge of the product and the market place, the likely commercial success of the product and [valuers'] independence, the choice of discount rate in the valuation based on projected future cash flows cannot be objectively challenged. In addition the valuation method adopted is clearly appropriate given the proximity to commercialisation;

(e) in conclusion, therefore, it is submitted that the attached valuation clearly:

  (i) reflects market realities in that an independent valuation has produced a valuation in excess of the price eventually agreed to between the parties, ie the Syndicate Members have discounted the price to reflect the perception of the commercial risk;

  (ii) the valuation does not depend upon the existence of an MRP.

Given these facts and the extent of the work done in order to produce the independent valuation it is strongly contended that the price paid for the core technology licence of $8.5 million can clearly and objectively be said to represent an 'arm's length' price.

[the Tax Office's response to the applicant:]

We advise that the Commissioner cannot be bound in cases of this nature by opinions given as to the manner in which the law will be applied to transactions. When the time comes to assess or review liability to tax the Commissioner must apply the law then in force to the facts as established at that time …

OPINIONS …

We note the Commissioner's comments in paragraphs 35-37 of IT2635 in respect of the valuation of core technology and confirm the proposition you advance here.

4.11 With effect from 19 December 1991, subsection 73B(31) of the ITAA 1936 was enacted. That provision provides:

> Where:
>
> (a) an eligible company has incurred an amount of research and development expenditure, an amount of core technology expenditure or an amount of expenditure in the acquisition or construction of plant, a building or an extension, alteration or improvement to a building for use by the company exclusively for the purpose of the carrying on by or on behalf of the company of research and development activities; and
>
> (b) the Commissioner is satisfied that:
>
> (i) having regard to any connection between the company and the person to whom the expenditure was incurred and to any other relevant circumstances, the company and that other person were not dealing with each other at arm's length in relation to the incurring of that expenditure; and
>
> (ii) the amount of that expenditure would have been less if the company and that other person had dealt with each other at arm's length in relation to the incurring of that expenditure;
>
> so much only of that expenditure as the Commissioner considers reasonable having regard to:
>
> (c) the connection between the company and that other person;
>
> (d) the amount of the expenditure that would, in the opinion of the Commissioner, have been incurred by the company if the company and that other person had dealt with each other at arm's length in relation to the incurring of that expenditure; and
>
> (e) such other matters as the Commissioner considers relevant;
>
> shall be taken into account for the purposes of this section.

1992

4.12 In March 1992, the Tax Office's Strategic Research & Analysis Group identified R&D syndication as a potential high compliance risk.

4.13 In May 1992, the TCC raised with the ANAO concerns with R&D syndicates exploiting the R&D tax concession.

4.14 In July 1992, the Tax Office commenced audits in two R&D syndicate cases as part of its large case audit programme.

4.15 In August 1992, the Treasurer announced that the R&D tax concession was extended to operate indefinitely.

4.16 Section 39EA of the *Industry and Development Act 1986* was enacted to enable the IRDB to develop Guidelines to assess whether a finance scheme used to finance R&D was ineligible.

4.17 The *Taxation Laws Amendment Act (No. 2.) 1992* was enacted and, amongst other things, excluded public sector tax exempt bodies from the R&D tax concession.

4.18 In November 1992, the Tax Office's National Office Taxpayer Audit area was concerned that syndicated R&D was a substantial compliance issue. It recommended a national project on R&D syndication.

1993

4.19 The Finance Scheme Guidelines were introduced by the *Taxation Laws Amendment Act (No. 5) 1992* with effect from 31 March 1993. They enabled the IRDB to exercise greater discretion to prevent exploitation:

> The Board will, as stated in the Guidelines, adopt a balanced approach to the determination of whether a finance scheme is eligible. This overall approach recognises that certain features of finance scheme proposals, such as the use of a tax exempt organisation or overseas company as the core technology provider, or the utilisation of unrelated third party tax losses in generating the guaranteed return, would not comply with the Finance Scheme Guidelines if they occur in isolation. In such circumstances, the Board would expect that the commercialisation arrangements for the R&D would be such as to offset any negative aspects of the syndicate finance scheme. In the absence of such evidence it would be unlikely that the finance scheme would satisfy the Board's Guidelines. [p 206] … Recognising the lack of specific details on acceptable structural features of syndicates may cause uncertainty amongst investors and promoters, the Board will liaise with promoters to ensure that syndicate structures are acceptable [p 207] ….
>
> It is recognised that syndication, as a mechanism for raising funding for R&D must compete in a market characterised by a limit on the overall availability of funds and that accordingly finance schemes to fund research and development must be competitive with other forms of structured or tax effective finance.
>
> However, the Government is concerned to exclude those schemes whose arrangements are primarily intended to achieve a guaranteed return for investors as opposed to returns generated as a result of the commercialisation of R&D results ….
>
> The manner in which the R&D results are to be commercialised is a critical element in the determination of whether a syndicate is established for the purpose of undertaking R&D with a realistic prospect of successful commercialisation or whether the scheme is merely an elaborate mechanism for generating a guaranteed return to investors …
>
> In considering the specific details of such schemes the Board will make reference to the following:
>
> - Valuation for core technology;
> - The ratio of core technology expenditure to total R&D expenditure; ….
> - The manner in which the company generates the tax losses that must exist in order for a syndicate to operate

4.20 On 19 November 1993, the ANAO published the report of its review of the R&D tax concession. Amongst others, it recommended:

The Tax Office and DITRD jointly select and examine a sample of syndication arrangements covering a geographic spread and a number of syndicate promoters involving:

- … Suspected inflated core technology valuations and sinking funds … [Recommendation 17]

4.21 Until the ANAO report, the Tax Office considered the R&D syndication compliance risk as a relatively low priority because the R&D legislation initially had a sunset clause due to expire in 1991.

4.22 In December 1993, the TCC issued a document, *Finance Scheme Guidelines – Interpretation*. It provided further information to proposed syndicates on the TCC's finance scheme requirements. It placed a limit on allowable core technology expenditure of around 65-70 per cent of total syndication expenditure.

1994

4.23 In 1994, the Department of Industry, Technology and Regional Development published a book called *150% Tax Concession: Guide to Benefits: It's Your Break – Revised Edition 1994* (the 1994 R&D book). The 1994 R&D book stated that the IRDB 'examines the eligibility of the proposed R&D project(s) … and all aspects of the financial and commercial arrangements associated with the syndicate'. The Tax Office 'is responsible for addressing matters relating to tax law' [page 199] and 'is responsible for determining whether expenditure claimed by companies and their financial structures are eligible under the various legislative provisions of the ITAA' [page 16].

4.24 The objective of the R&D tax concession was:

To make Australian companies more innovative and internationally competitive through:

- increasing investment in R&D
- encouraging better use of existing research infrastructure
- improving conditions for commercialising research, and
- developing a greater capacity for the adoption of foreign technology. (R&D Book, 1994, page 12) …

The syndicated provision of the concession intended to contribute to these goals by encouraging R&D projects that are (a) too big or (b) too risky for any one company, to be undertaken by a group of companies (page 194)

4.25 The 1994 R&D book stated:

It is generally accepted that financial institutions will not participate in syndication in the absence of a guaranteed return. [page 207]

4.26 The IRDB issued a guide to core technology determinations, *Valuing core technology*. It states:

It should be noted that section 39LA does not give the Board power to make determinations in relation to the value of any core technology purchase or licence. The power to make determinations relating to 'core technology expenditure' and 'research and development expenditure' remains solely the jurisdiction of the Tax Office. However, core technology valuation is an issue considered in the context of finance scheme guidelines …

Any valuation of core technology submitted to the Board should be conducted using appropriate expertise. The credibility of any valuation will be prejudiced by the extent of any disclaimers.

The core technology valuation should describe and use an appropriate valuation methodology, and the scope of the valuations should be limited to the core technology described (above). Where the core technology involves publicly available knowledge, the valuation should provide reasons why that technology has particular value in relation to the particular research and development activities.

4.27 From March 1994, the Tax Office observer on the TCC was also the Tax Office's R&D syndication project manager.

4.28 On 1 July 1994, the company tax rates changed to 33 per cent.

4.29 On 30 September 1994, a Tax Office project was approved to implement the ANAO's recommendation 17 with a view to completing 6 to 12 audits by 30 June 1996 with six staff. The project initiation brief referred to a 'proposal to have a Senior Tax Counsel appointed to concentrate on R&D issues on a national basis'. It made the following comments in relation to revenue risk:

REVENUE AT RISK

Since the introduction of the syndication provisions in November 1987 there have been 115 syndicates registered with the IRDB with the great majority of them commencing in the 1990 or a later income year. Estimated expenditure on R&D activities for these syndicates was $1.75 billion and the cost to revenue has been calculated by AusIndustry as being approximately $370 million.

In the 1993-94 income year 38 syndicates were registered with the IRDB with estimated R&D expenditure of $338 million and a cost to revenue of approximately $96 million. Once again these figures have been provided by AusIndustry.

These figures do not include the interest on borrowings by syndicates which is substantial and will greatly increase the cost to revenue.

AusIndustry has not made any forward projections in respect of syndicate registrations for the 1994-95 income year but it is generally accepted that the risk to revenue from syndicated structures is a significantly escalating risk.

4.30 In October 1994, the Bureau of Industry Economics (BIE) evaluated R&D syndication (*Report No. 60 – Syndication R&D – An evaluation of the Syndication Program*). The report noted that it was too early to assess the commercial benefits of the program. It also pointed to a number of problems with syndication but recommended that the programme nonetheless be retained because it generated significant net social benefits. It found that considerable uncertainty existed in relation to core technology valuations. It also considered that there were misperceptions that syndication was merely a tax shelter. It made the following recommendations:

> Recommendation 1:
>
> The BIE considers that there would be advantages in reduced uncertainty from clarification by the Tax Office and other parties of the treatment of core technology and admissible financial structures. It may be worth removing the requirement for a core technology valuation …
>
> Recommendation 3:
>
> The BIE considers that steps should be taken to correct widespread misperceptions about the nature and benefits of the programme.

4.31 The Tax Office has not publicly responded to the BIE report.

4.32 The BIE report also questioned whether the valuations were a means to ensure an arm's length transaction:

> The core technology licence value is subject to independent valuation. This is intended to ensure arm's length commercial transaction. Whether or not this value accurately reflects the market price of the core technology is open to question … (page 37)
>
> The core technology payment has a crucial role as the means by which tax loss benefits are transferred under syndication. Its status under the program is ambiguous because on the one hand it is merely a financing mechanism, while on the other it is perceived as a legitimate valuation exercise which must stand up to Tax Office scrutiny … Notionally, all firms either valued technology by aggregating the historical costs of producing core technology and/or estimating the present value of an after-tax royalty stream … Many firms argued that the point estimate of the core technology valuation was determined by:
>
> - The need to undertake a certain amount of R&D and to set up a core-technology value that was consistent with investors' required rate of return … These firms were called R&D led (RLED) firms.
> - The desire to convert lowly valued tax losses into highly valued R&D … In their case, the binding constraint on the possible value of the core technology was the level of their tax losses … These firms were called tax-led (TLED) …
>
> Some firms claimed that they … simply estimated the most defensible valuation of core technology, treating it as a genuine valuation exercise. These firms we called core technology led (CTLED). In their case, if the resulting core-technology valuation could not support the desired R&D or exceeded their tax losses, then they would not use syndication. In contrast, the RLED and TLED firms would engineer core-technology valuations consistent with their commercial aspirations, so long as the valuation still lay within the wide bounds of the original core-technology valuation exercise.

… [of the firms surveyed] 14 of the 25 firms who produced core technology valuations were RLED or TLED with 11 being CTLED. Many firms perceived syndication to be sanctioned tax benefit transfer, but concealed in a confusing parcel involving an artificial core technology valuation which obscured this function. They called for the explicit recognition of this aspect of the programme. [page 48]

4.33 The BIE report also commented on the motivation for excluding private and public tax exempt researchers from the tax concession:

… until their [public sector research infrastructure] elimination from the program, syndication allowed public sector tax sector tax exempt bodies to exploit syndication. There was evidence that the public sector tax exempt bodies tended to employ higher core-technology valuations, relative to the R&D conduct, so as to attract financial investors. There was insufficient data to evaluate whether the public tax exempt entities had conducted high quality research with strong commercial prospects. [page 120] …

Currently, tax public sector research firms are disqualified from participation in syndication. The motivation for their exclusion is the concern that:

- A tax exempt body has no incentive to contain the core technology valuation for any given amount of R&D, so that genuine tax loss firms are at a competitive disadvantage when seeking investors.
- As tax exempt bodies are not giving up valuable tax losses, they do not face the same incentives to undertake commercially orientated high returning research. This is a critical distinction relative to taxable entities. Taxable firms use their tax losses as a means of obtaining finance for R&D, whereas no tax loss transfers take place at all for tax exempts.

The net effect of this is that less worthwhile projects conducted by tax exempt bodies may crowd out those in taxable companies …

The critical issue when considering the role of private or public tax exempt bodies is whether worthwhile R&D with high social spill overs is being conducted, relative to the costs of revenue foregone. If it were possible:

(a) to eliminate cases where the tax exempt body is able to secure a competitive advantage vis a vis taxable entities (for example, where the core technology valuation was inflated artificially); and

(b) to discriminate between R&D projects with high social rates of return from those with lower returns,

then there would be *some* basis for allowing both private and public sector tax exempts to participate under special monitoring arrangements. However, even then, a case would have to be made that syndication was a **preferred** vehicle for subsidising such R&D relative to other tried mechanisms, such as grants …

… DIST could stipulate notional terms of trade for R&D for tax losses for a public tax exempt body … In this way, core technology valuations or other mechanisms could not be easily exploited to provide the public tax exempt body with any competitive advantage …

Finally, the insuperable difficulty regarding public and private tax exempt bodies is the high revenue costs. The analysis in Chapter 5 suggests an historical effective subsidy rate of about

140 per cent for tax exempt syndicates. Notwithstanding, high inducement rates, the revenue losses are so appreciable that large spill over rates are required to be certain that such syndicates produce net benefits. That certainty is not possible in the face of substantial uncertainty regarding the magnitude of spill over effects. Moreover, a traditional mechanism, such as a direct grant, may well produce a higher bang for buck than syndication for such tax exempt institutions.

Recommendation 5:

Because of the extreme rate of subsidy, the low and uncertain net social return and the general absence of market disciplines for tax exempt bodies, the BIE considers both public and private tax exempts should be barred from the programme. [pages 125-6]

4.34 The BIE report also recognised the R&D syndication tax concession as a sanctioned means to sell tax losses:

Notwithstanding its complex guise, the program is an officially sanctioned mechanism for financing new R&D through the sale of tax losses. (p 8) …

… syndicated R&D is fundamentally a mechanism for the transfer of tax losses from R&D researchers who cannot take full advantage of them to financial investors who can. (p 43)

4.35 In October 1994, the Australian Valuation Office provided the Tax Office with a critique of a syndicate's valuation.

4.36 On 11 October 1994, the Tax Office received independent legal advice on, amongst others, subsection 73B(31) issues. That advice concluded that:

The valuation report behind tab 25 in my brief (critique) does rather suggest that the amount settled between the parties was higher than parties dealing with each other at arm's length would have paid. The valuation also suggests further lines of enquiry which the Commissioner should undertake to ascertain what a willing but not over anxious buyer of the technology would have paid for it. The question is essentially one for a valuer to undertake and it may be that further enquiries would reveal that determining the reasonable expenditure will be quite complicated and difficult.

4.37 On 26 October 1994, an investor in syndicate A lodged a private binding ruling request with the Tax Office.

4.38 In late 1994, syndicate A was rejected by AusIndustry because it did not meet the finance scheme guidelines. Changes were made which satisfied AusIndustry. Registration was provided later in 1994 on the condition that:

… 2. that in all other respects, your proposal will be able to satisfy the requirements of section 73B …

4. that any Australian Taxation Office requirements are satisfied.

1995

4.39 A senior tax technical officer was made available to the R&D syndication audit team from early 1995.

4.40 An audit into syndicate B started around 1 February 1995.

4.41 On 16-17 February 1995, a Tax Office Senior Tax Counsel gave a speech at an industry conference on 'Syndicated R&D'. The notes for his speech referred to the following relevant points:

Part IVA

- general issues for syndicates: see IT 2635 paras 29-37

– Arm's length basis for dealing?

– Nature and commerciality of R&D project

– artificial structure attributes one party's R&D expenditure to another? …

- syndication issues

– guaranteed return ignores value of core and results

– return assured by return of funds to syndicate members

– core technology pricing ignores value and provides fixed tax benefit and return to fund further work

Current topics …

- BIE report …

– Suggest no economic grounds for concern overvaluation of core technology: this depends on analysis of syndication as loss transfer

– No formal Tax Office position on BIE report as yet

4.42 On 23 February 1995, the Tax Office issued a private binding ruling to the investors into syndicate C:

[Applicant's proposition]

That on the assumption that the R&D Program comes within the definition of 'Research and Development Activities' as defined in Section 73B(1) of the Income Tax Assessment Act: …

(iii) that the amount paid on 30 June 1994 by way of Licence Fee … under the [licensing and marketing development agreement] by the [investors] in respect of the licence of certain existing [core technology] … fall within the definition of 'core technology expenditure' in terms of subsection 73B(1) of the Income Tax Assessment Act;

(iv) That the core technology valuation process (supported by an independent report provided by independent consultants [the valuers]) is consistent with the process required to satisfy the terms of IT2635, para 35;

[Commissioner's ruling]

(iii) Confirmed, subject to the following: …

(a) Under section 39LA of the IR & D Act, the IRDB has responsibility for determining whether particular technology is 'core technology' in respect of particular R&D activities. The Commissioner would rely on the IRDB in determining whether expenditure constitutes 'core technology expenditure' for the purposes of the R&D provisions.

(b) It should be understood that the Commissioner makes no determination that the Core Technology Licence Fee is accepted as being an arm's length or commercial price for the licence in question. Such a determination can only be made after a factual investigation of the dealing surrounding the acquisition of the licence. We advise that such an investigation cannot be undertaken as part of a response to a private ruling request; this is as contemplated by subparagraph 14ZAN(j)(i) of the Administration Act.

(iv) Refer 1.(iii) above.

4.43 On 17 March 1995, the Tax Office issued the following ruling to an investor in syndicate A:

[Applicant's proposition]

That the … following expenditures will be deductible to the Investors under section 73B of the Act: Core Technology Licence fee paid to [abc company] under the … Deed … That the methodology employed in preparing the valuation of Core technology is acceptable to the Commissioner …

[Commissioner's ruling]

It should be understood that the Commissioner makes no determination that the Core Technology Licence Fee is accepted as being an arm's length or commercial price for the licence in question. Such a determination can only be made after a factual investigation of the dealing surrounding the acquisition of the licence. We advise that such an investigation cannot be undertaken as part of a response to a private ruling request.

[Applicant's proposition]

That the Transactions in the Transaction Documents do not invoke the operation of the provisions of Part IVA of the Act to any aspect of the R&D syndication structure … [and] That the provisions of … Part IVA of the Act have no application to any aspects of the R&D Syndication structure … or to any transactions entered into by any of the parties to the various operative agreements in connection with the R&D Syndication …

[Commissioner's ruling]

There would appear to be no specific features in the arrangement which would call for the consideration of Part IVA. However, the question of the application of Part IVA will ultimately have to be determined having regard to the facts of the legal rights of the parties, the factual outcomes of the Syndication and the manner in which the Transaction Documents are given effect by the parties. To the extent to which the confirmation of this Proposition requires the Commissioner to make assumptions relating to future events we decline … to make the Ruling sought.

4.44 In May 1995, the Government announced that it would act on a BIE recommendation to exclude private sector tax exempt bodies. The *Taxation Laws Amendment Act (No. 4) 1995* gave effect to this announcement.

4.45 Around August 1995, the TCC was partially reconstituted. A former Commissioner of Taxation was appointed as Chairman to the TCC. The TCC consulted the public on a draft set of new finance scheme guidelines in August 1995.

4.46 In November 1995, the *Finance Scheme Guidelines No. 2* were gazetted.

4.47 The *Finance Scheme Guidelines No. 2* increased the at risk component to a minimum of 10 per cent, required 50 per cent of the core technology either to be owned by researchers for at least two years, developed by them or the deduction limited to Australian income tax paid. The primary purpose was to fund and commercialise R&D and not provide profit through tax effective arrangements. The guidelines capped at $15 million each guaranteed investment.

4.48 In November 1995, the TCC Chairman gave a speech to an R&D industry conference saying that these finance guidelines were issued to eliminate potential syndicates using artificial tax structures. They would address concerns with:

> attempts to widen the scope of tax saving 'fuel' that has come to evidence the power source of 'guaranteed' R&D syndicates and the question of core technology valuations.

4.49 In November and December 1995, the TCC began pressing syndicates for arm's length valuations of core technology for new applicants:

> Last November/December the TCC began pressing for arm's length valuations of core technology, in a way that it had not until then been administrative practice always to do so.
>
> In early January, the background to and reasons for this approach were outlined to representatives of the principal packagers. In subsequent meetings, at both most senior and operative management levels, the Board's and the TCC's considered, determined, stand has been further explained to key people in the industry. (TCC Chairman speech paper to AIS industry conference 20-21 March 1996.)

4.50 By the end of 1995, all Tax Office information gathering in the syndicate B audit was finalised.

1996

4.51 In 1996, the Innovations segment of the Tax Office was tasked with responsibility for coordinating the technical views and compliance strategy for R&D syndication.

4.52 By letter dated late February 1996, the Tax Office asked the manager of syndicate D to answer a questionnaire on the syndicate. It responded eight months later.

4.53 The Government changed in March 1996.

4.54 On 20 March 1996, a Tax Office Senior Tax Counsel publicly stated during an R&D industry conference that the Tax Office was aware of 'early indications of questionable valuations of core technology'.

4.55 At an industry conference on 21 March 1996, the Chairman of the TCC announced the TCC's five particular concerns with core technology valuations and its intention to get its own valuations if need be:

> As a result of the scrutiny that has been applied the Committee is concerned to see:
>
> 1. that the valuation is of a high professional standard and meets the accepted criteria of being both independent and at arm's length …
>
> 2. that income projections do not appear to high or over-optimistic and that they are made with sufficient supporting evidence …
>
> 3. that royalty rates … are established on the basis of substantiated industry practice and verified by independent expert statements …
>
> 4. that the nature and underling rationale of risk and risk factors be clearly identified and factored into the valuation …
>
> 5. that the form of the disclaimer made by the valuer is not too broad and that there is adequate independent verification of key assumptions and facts …
>
> The five points I have just outlined, together with an understanding of the issues arising from the Australian Valuation Office critiques I referred to earlier, will assist the TCC to make some broad judgements in relation to core technology valuations, in the context of addressing all relevant matters relating to each application. Hopefully, that will be enough to make decisions, but we recognise that it may also be necessary for the TCC to itself commission full-scale valuations in some instance. We stand ready to do that.

4.56 The Chairman of the TCC also commented in relation to the issuing of the guidelines that core technology valuations provided a raft of issues:

> One of the things that struck me … was the widespread perception that valuations of core technology were substantially on the too high side.
>
> One gained the clear impression that, too often, the amount of a core technology valuation represented not much more than a set of numbers designed to bring about a desired set of outcomes for the participants.
>
> Last November/December [1995] the TCC began pressing for arm's length valuations of core technology, in a way that it had until then had been administrative practice always to do …
>
> Unfortunately, from our point of view, there has been practically no movement by proponents away from what the Board and the Committee consider may be unsustainable valuations. I say this in the general sense, of course, as each situation is entitled to be decided on its own facts and merits. But in the generality, valuations presented to us cannot, we believe, be sustained (we doubt that they would be accepted as sound by a bank that was asked to lend money on the strength of them) and it is necessary in particular cases to apply approaches which reflect the appropriate level of consistency across all cases.
>
> The TCC is conscious that all of this has disturbed the previous flow of decision-making through the Committee. We regret this but do not accept that the criticism is to be laid at our door.

> We have been proceeding actively on the basis of expert legal and technical valuation advice, particularly from the Australian Valuation Office. That Office has provided us with critiques of a number of the valuations that are contended by proponents to be valuations on an arm's length basis.
>
> These critiques have served to confirm the general unease that has developed about valuations, has helped to bring to light common deficiencies in valuations and provides a basis for the establishment of a framework to be used in assessing valuations that come to the TCC [the Chairman then set out 3 key deficiencies and 5 expectations in relation to valuations of core technology] …

4.57 At that conference, the Chairman of the TCC also outlined the TCC's concern with guaranteed returns:

> That guaranteed return may, in keeping with policy, be 'fuelled' by tax losses of the researcher but not through a core technology acquisition the licensor in which does not bear Australian tax on the receipt because the recipient is tax exempt or is a non-resident entity not subject to Australian tax or because the asset being disposed of is a pre-capital gains tax asset.

4.58 He also considered that the tax concession operated by trading researchers' tax losses in exchange for investors financing early-stage R&D work:

> … the then Minister Senator Cook, provided a formal answer to a question asked in Senate Estimates Committee D, in the course of which he set out what had become the policy of the syndication provisions:
>
> - … The basis of a syndicate is the trade off of tax losses in exchange for R&D finance with the result that the research company reduces the magnitude of carry forward tax losses and thus accelerates the time when the company becomes tax positive …
>
> Syndication was conceived of as a mechanism for providing companies in a tax loss position with access to critical capital. (Trevor Boucher speech to AIC Conference, 20 March 1996.)

4.59 During May 1996, promoters approached the ministers in the new Government to argue for the retention of the R&D syndication tax concession.

4.60 The audit into syndicate E started in early June 1996.

4.61 On 1 July 1996, the company tax rates changed to 36 per cent.

4.62 In July 1996, DITR seconded the author of the 1994 BIE evaluation of syndication to review syndication. The resulting report recommended that R&D syndication should be terminated:

> Syndication has a number of virtues — in particular its ability to stimulate new R&D. BIE (1994) also found it produced a number of other less tangible benefits — such as better management and planning of R&D projects in technology driven firms.
>
> But these desirable features of the program are offset by some large drawbacks whose impact has intensified since the BIE's first examination of the programme.
>
> - The quality of some of the R&D and the likelihood of its commercialisation is low because (a) good tax loss companies are more scarce in good times and (b) some of the new

structures have avoided taxes on payments made to research companies under syndication both increasing the cost to revenue and reducing the incentives of managers and investors to discriminate on the basis of the quality of R&D. We are sceptical that the new guidelines issued in November 1995 will deal with these problems over the longer term.

- Like a chameleon, the program has continually changed in ways which favour the easy extraction of large tax deductions. In August 1992 the then government barred *public* sector (tax exempt) organisations from using syndication — because the revenue costs were too high. In the aftermath of that change, *private* tax exempt syndicates developed. The BIE (1994) strongly recommended the removal of such private tax exempts from participation of the program because of the extreme rate of effective subsidy, the low and uncertain net social benefit and the absence of market disciplines for good R&D. This recommendation was acted on in the 1995 Budget. However, new structures quickly evolved which had an identical impact (such as so-called cost base syndicates). The incentives continued for financial innovation — to use syndication as a vehicle for obtaining large tax deductions — outpace the incentive for real technological innovation. We have little confidence that the program can be made immune to renewed efforts to extract such deductions without excessively complex and continually evolving tax legislation and R&D guidelines, and without substantial resources devoted to careful monitoring of the program …

We do **not** believe that all syndicates are bad — some involve companies with legitimately acquired losses doing worthwhile R&D which would not otherwise have been funded. There have been some outstanding success stories under the syndication program — some of which were reviewed in BIE (1994). (pages xi and xii.)

4.63 In late July 1996, the Tax Office wrote to an investor in syndicate B advising them of Tax Office delays:

I am writing to you to inform you of the current position of the income tax audit of the above named syndicate. You will recall that in previous telephone conversations I have had with you I indicated that our enquiries were completed and that we were awaiting the valuation of the syndicate's core technology by the Australian Valuation Office.

That remains the present position … When the completed AVO valuation is received we will be in a position to formally conclude the audit … Although the delay in obtaining the core technology valuation has been due to causes largely out of our control, I must nevertheless apologise for any inconvenience the syndicate members have suffered as a result. I assure you that every effort will be made to expeditiously bring things to conclusion once the AVO report is at hand.

4.64 On 23 July 1996, the Treasurer and Minister for Industry, Science and Tourism jointly announced the closure of the R&D syndication programme to new syndicates.

The Government has decided to close off new syndicates qualifying for the R&D tax concession as from 5:00 p.m. this afternoon …

The Government has made this decision because the current arrangements with regard to syndication have become focussed on tax minimisation rather than the provision of genuine R&D.

Tax benefits from R&D syndication commonly exceed the cost of R&D work still to be done. These unintended tax benefits have made it impossible for the Government to allow further syndication of R&D …

Investors under existing syndicates, and under planned syndicates which have already received advance approvals, will not be prevented from seeking the R&D tax concession.

4.65 On 24-25 September 1996, at the R&D Tax Conference, another Tax Office Senior Tax Counsel gave a paper on the Tax Office perspective of the 'new rules'. That paper relevant states:

(3) Syndication

Notwithstanding the 23 July 1996 announcement to end syndication, the Tax Office is continuing its audits of existing syndicates. I mentioned at an AIC R&D conference in March this year that we had concerns with early indications of questionable valuations of core technology. The work that the valuers we have engaged have done since is supporting the early views of serious over-valuation of the core technology in the cases under review. We are getting close to issuing position papers that are likely to flag amendments based, inter alia, on apparent non arm's length transactions (sebsec.73B(31)) or possible application of the general anti-avoidance provisions in Part IVA.

Another area of concern is syndicate termination arrangements. I mentioned in March the need for syndicates to ensure that any terminations are in accordance with arrangements originally, or subsequently, approved in A Tax Office private ruling.

We plan to continue to examine syndicates to ensure compliance with ruled upon arrangements …

4.66 The *Taxation Laws Amendment Act (No. 3) 1996* was enacted in December 1996 to give effect to the BIE's recommendation that syndication should be terminated by effectively barring further guaranteed syndicate R&D registrations.

1997

4.67 At an industry conference on 10 November 1997 the Chairman of the TCC considered the TCC's forward compliance approach to R&D syndicates:

Over the years a key question facing registration decision-makers has been whether each particular syndicate was dominated by a purpose of providing risk free returns out of particular tax advantages (to put it colloquially, a 'tax rort'), or whether the aim was genuinely to carry out the nominated R&D and carry it through to successful and beneficial commercialisation … it is not clear as to the extent to which earlier decisions (particularly those made under Finance Scheme Guidelines No 1) would, under review today, attract the same outcomes. Given the more rigorous approach adopted by the TCC on issues such as the manner in which tax losses were generated, projected commercialisation benefits and the validity of core technology valuations, I suspect that quite a number would not. (Pages 3-4.)

4.68 The Chairman of the TCC outlined at an industry conference on 10 November 1997, the role of the Tax Office:

… In many cases, the claims made about the expected multitude of sales, the projected share of global markets, the absence of competition, and the marketable life of the technology were, in the minds of the TCC, stretching credulity to say the least …

Similarly, many core technology valuations submitted to the TCC as part of the syndicate's proposed finance scheme raised questions as to the independence of the valuations, the appropriateness of the discount rates utilised, the validity of expected royalty rates and the credibility of forecast sales projections. Nevertheless, given the need for the TCC to come to a balanced decision having regard to all the criteria, favourable advance decisions from the TCC on the R&D, the core technology and the finance scheme were generally obtained, although over the last 12 months before syndication was abolished it became harder to get finance schemes approved. [Page 4] …

[The Chairman outlined the TCC's concerns with syndication arrangements ongoing technical progress reporting obligation and efforts to commercialise and the IRDB's review functions in disallowing where no commercialisation].

We are, in all of this, working in close collaboration with the Tax Office, which under its legislation has specific and additional review responsibilities notably in connection with core technology valuations and the anti-avoidance provisions of Part IVA of the ITAA 1936.

It may be that an outcome of the Board and the Tax Office reviews will be that the tax deductions sought to be obtained by syndication arrangements will have to be disallowed, with all the consequences attaching to disallowance. And associated with any disallowances, or Board certificates leading to them, would be the costs of ensuing litigation. [Pages 7-8.]

4.69 The audit into syndicate F started in December 1997.

1998

4.70 On 30 March 1998, the Tax Office's R&D syndication project manager made a speech at an AIC conference. However, a copy of this presentation was not provided to the Inspector-General.

4.71 On 31 March 1998, the TCC Chairman announced at an industry conference the TCC's forward compliance approach to previously registered syndicates. It would not seek to render syndicates ineligible so long as investors did not impede commercialisation:

In approving finance scheme at registration, the Board has generally taken the position that it will not subsequently take action against those schemes unless there has been material change to the finance scheme structure …

Excessive optimism by itself may or may not be viewed as culpable. However, if a high Core Technology Valuation had been based on the promise of a large 'pot of gold' upon successful completion of the R&D, but syndicate investors showed no interest in pursuing that 'pot of gold' through genuine support for commercialisation efforts at the end of a successful R&D project, then there are two possible conclusions which could be drawn — both with legal ramifications.

The first conclusion might be that the promised 'pot of gold' had been a work of fiction — that the Core Technology Valuation had not been a legitimate, arms-length commercial valuation. As Ray Veitch told you yesterday, this can lead to action under section 31(1) of the Tax Act.

The alternative conclusion would be that the investor had never been in the game for the 'pot of gold' after all — that the real primary intent had been to obtain the tax deductions. This would contradict the case made out to the Board at the time of the finance scheme approval. Legally, this might be viewed as a material change to the finance scheme, leading again to action under section 39MA of the IR&D Act. (Pages 5-6) …

In all of this, the Board is following some key principles:

... A second principle is that the TCC will not pursue syndicates just because the current TCC may have come to a different decision than did its predecessors about whether a syndication proposal should have been registered … Syndicates will not be targeted for action purely on the grounds that the Board wishes it could reverse the original decision. (Pages 8-9.)

… it needs to be said that this exercise [ensuring commercialisation not impeded by investors] is not about catching syndicates out and getting back the tax deductions, except as a last resort. (Page 12.)

4.72 On 3 April 1998, the Cash Economy Task Force provided its Second Report to the Commissioner of Taxation. It proposed a theoretical model to improving voluntary compliance:

Without an understanding of the structural influencers it is possible that Tax Office efforts to tackle the cash economy will prove ineffective. An approach which relies simply on detecting non-compliance and imposing sanctions on detected non-compliers will tend to be short term in effect and increasingly resource intensive for the Tax Office. It will also place an unreasonable compliance burden on good compliers. (Page 19) …

An extensive review of the compliance literature by the Tax Office has identified some commonly mentioned factors impacting on a taxpayer's compliance decisions. An appreciation of these factors, and their interrelationships, will help the Tax Office address the structural influencers on the cash economy identified by the Task Force in its first report.

The research to date has revealed that taxpayer compliance decisions can be affected by factors which can be broadly categorised as psychological, sociological, economic and industry. The business profile adopted by the taxpayer can also influence compliance. [BISEP factors] (Page 20) …

… the many competing factors impacting on the taxpayer cause the taxpayer to adopt a particular posture or stance. Underlying each stance are beliefs, values and attitudes which influence the behaviour of a taxpayer. These stances indicate the degree of acceptance or rejection a taxpayer has towards the Tax Office and can be summarised as follows:

1. managerial accommodation or initiation: the taxpayer includes the regulatory requirements in their management plans and actively complies, and may encourage others to do so;

2. capture or conformity: the taxpayer accepts the regulatory requirements, and has faith in the Tax Office;

3. resistance: there is confrontation between the taxpayer and the Tax Office;

4. disengagement: withdrawal of the taxpayer from the regulatory process.

Taxpayers in the first and second categories are generally compliant, while those in the third and fourth categories are non compliant. The way an industry approaches its taxation obligations may be determined by the make-up of the participants in that industry. An industry comprising a significant number of disengagers will require a different Tax Office approach to regulation than an industry made up of primarily initiators. (Page 23.)

4.73 In April 1998, the Tax Office obtained an external legal opinion in a syndicate case under audit. In relation to the specific anti-avoidance provision it advised the following:

- There was no one test to determine an arm's length dealing. The closest thing to a test was a judicial suggestion that the outcome of the dealing must be 'a matter of real bargaining'.
- The position paper in the audit did not identify matters supporting the Tax Office's conclusion of no arm's length dealing but the Case Manager's earlier internal report did. The Case Manager's reasons were that:
  - there was documentation that suggested the investor was seeking to achieve deductions of an amount near that outlaid for the core technology licence before the researcher was even chosen;
  - there was documentation to show that the core technology fee was pre-determined — the investor and packager had agreed on the core technology outlay and also applied for IRDB registration before the licensor had completed its valuation of the core technology;
  - there was documentation to show that there was an absence of any real bargaining — the researcher had accepted an increase to the core technology licence by about $1 million so as to incorporate the packager's fee;
  - there was documentation to indicate that the researcher was

aware that [the investor's] primary concern was its high tax liability and not the commercialisation of research results. This could provide a basis for concluding that [the researcher] and [the investor] were not dealing at arm's length in relation to the core technology fee but were acting in collusion to achieve a reduction in [the investor's] tax liability. We are aware that the high profitability of the group of [the financial year in question] has given rise to a considerable taxable income and that this is the primary reason for the company considering entering research and development agreements with [the researcher].

- The 'matter of greatest significance' was the value of core technology opined in the AVO valuation:

The marked discrepancy between the two valuations seems to us to be at the centre of the issue as to whether the parties were dealing with each other at arm's length.

- It was surprising, in a commercial context, to find that a company outlaid millions of dollars for a licensing arrangement on reliance of a valuation provided by the licensor. However, the preparedness of [the investors] to do so in the present circumstances is probably explained by the existence of the put option, which effectively eliminated any commercial risk on the part of [the investor] should the valuation prove inaccurate.

- Based on the assumption that the AVO valuation was correct, the Commissioner was entitled to be satisfied both that there was no arm's length dealing and that the value opined by the AVO was reasonable to be allowed as the amount incurred as core technology expenditure for the purposes of paragraph 73B(31)(d) on the basis of the matters referred to in the Case Manager's internal report above and the following conclusions:
  - The investor outlaid tens of millions of dollars to acquire core technology rights which had a value of less than half a per cent of the claimed amount.
  - The investor never obtained a 'truly independent valuation'.
  - The investor was assured of recovering the outlay for the core technology through the put option mechanism, which insulated the investor against any adverse commercial consequence flowing from the inaccuracy of the licensor's valuation.
- The legal advice stressed that it was assumed that the AVO valuations were correct. It noted that the AVO had no expertise in that field of technology and that there was need for further input from independent expert valuers before concluding a view in relation to subsection 73B(31). This was because the Commissioner needed to have a 'high degree of confidence' in the valuations relied upon to amend the assessments.

4.74 In August 1998, the Tax Office started audits of syndicate H, syndicate J and syndicate K.

4.75 Prior to September 1998, the Tax Office had commenced 15 audits of syndicates. Each syndicate may have involved more than one investor.

1999

4.76 In April 1999, the Tax Office issued a position paper to an investor in syndicate G. It recited the relevant facts, issues and findings of the audit and pointed to the relevant law. It then provided conclusions with no reasons that indicated which facts were relied upon for evidence of the conclusions, the weight placed on the evidence in reaching the conclusions or the reasoning process used to reach those conclusions. It then set out the proposed audit adjustments.

4.77 In May 1999, Tax Office auditors presented the investors in syndicate B with proposed adjustments.

4.78 In July 1999, the Tax Office started audits of syndicate A, syndicate L, syndicate M and syndicate N.

4.79 The Part IVA Panel meeting on 2 August 1999 considered the application of subsection 73B(31) and Part IVA to two schemes, both applying to one investor in a syndicate which was entered during the 1992 financial year.

> **Scheme 1:** The Panel was of the view that the deduction for the core technology expenditure claimed by [investor] ought to be reduced to zero (ATO valuation) on the basis of 73B(31). This is on the basis that the core technology was grossly overvalued, and that both parties were well aware of that fact (and hence not trading at arm's length). The Panel noted that the non-arm's

length argument might not be so strong if the purchaser was in fact not aware of the overvaluation of the core technology …

The Panel agreed that Part IVA would also apply, but that the application of Part IVA to this scheme would depend, like the application of 73B(31), on the valuation of the core technology being excessive …

Scheme 2: The Panel noted that this scheme represents a commonly-occurring structure in R&D, being a structure that involves either a loss entity or an exempt entity. As such it represents a significant issue for the Tax Office, that ought perhaps to be the subject of a nationally coordinated approach …

The Panel did not reach a conclusion as to whether Part IVA applies to Scheme 2.

4.80 The auditor's submission to the Part IVA Panel on these two schemes stated:

Scheme 1

The scheme is a deliberate and calculated use of an inflated CTL [core technology licence] Fee and the portion of the interest deduction that attaches to the borrowings used to fund the CTL Fee to incur losses can be transferred to income companies in the Group. These deductions plus the deductions for the R&D Contract Sum and the balance of the interest paid to [investor parent] would not have been sufficient to guarantee the required guaranteed return of [investor parent] if a commercial arms' length market value had been applied to the CTL Fee. These funds *paid* by [investor] to [researcher] have been set aside on a deposit with [deposit holder] for the purpose of guaranteeing [researcher's] obligation to [the investor parent]. Only $[xxx] million [approximately one-third of the total R&D expenditure] is permitted to be drawn down to fund the R&D programme. [The researchers] only have rights to access these funds to the extent of the after tax amount of any royalty income received by [investor] from exploitation of the Research Results. [Investor] has obtained a tax benefit within the ambit of paragraph 177C(1)(b). [Paragraph 45.] …

Scheme 2

The dominant purpose of the [investor group] for the whole syndicate arrangement was to guarantee [the investor parent] a preconceived tax free rate of return on its investment in [the investor] and incur losses which could be transferred to income companies in the Group irrespective of the true worth of the CTL and the success of the R&D project. [Paragraph 57.]

4.81 In October 1999, the Tax Office issued a position paper to an investor in syndicate P.

4.82 In December 1999, the Tax Office started an audit into syndicate Q.

2000

4.83 Around February 2000, the Tax Office instructed its auditors to discontinue audits of R&D syndicates pending further instructions.

4.84 On 28 March 2000, a decision was made to hold off obtaining independent valuations in some R&D cases. Previously the Tax Office had relied on AVO critiques of the investors' valuations. The decision recognised that unless the AVO critiques were challenged it would be an unnecessary waste of public monies to do so. It also recognised that to delay obtaining independent valuations for the cases and also to await the outcome of other cases would 'compound delays'. In one case the valuation would have potentially cost about $100,000. The core technology value disputed in that case amounted to tens of millions of dollars, not including the interest deductions flowing from that value.

4.85 By 29 March 2000, a senior tax official was involved in developing the litigation strategy for R&D syndication.

4.86 On 3 April 2000, the Tax Office provided to external legal counsel a copy of its proposed position paper to an investor in syndicate B.

4.87 An external legal service provider verbally advised the Tax Office in 2000 that further valuations were needed to bolster the Tax Office's evidence in litigation.

4.88 In April 2000, the Tax Office released its position paper to an investor in syndicate B. The Tax Office asked the investor to respond within a month. The Tax Office states that it is difficult to ascertain in the short term whether any amendments were made to the position paper because all its records of this case are archived. The position paper issued recited the relevant facts and then concluded, amongst others, that:

> [the researchers and investors] did not deal at arm's length in relation to the CTL (core technology licence) Fee payable by the Syndicate and the CTL of $[tens of millions] was not at arm's length for the purposes of subsection 73B(31) of the ITAA 1936.
>
> The amount claimed as a deduction under subsection 73B(12) for core technology expenditure does not represent arm's length consideration. The Commissioner considers that the arm's length amount in terms of subsection 73B(31) is zero dollars ($0).

4.89 The position paper then set out the amendments proposed. No reasons were provided for the Commissioner's conclusions.

4.90 In May 2000, a senior Tax Office officer discussed the possibility of mediation with a syndicate investor. However, this mediation was to run parallel to any assessment action. A Tax Office auditor's record of the meeting states:

> [Tax official] then suggested that both parties might like to consider whether mediation is warranted and appropriate, and what the process might be.
>
> [Investor representative] said that [the investor] had not thought about that in detail, and will again consider it.
>
> [Tax official] then repeated that the normal assessment process will continue concurrently with any mediation.
>
> [Tax official] then suggested that principles established in relation to this syndicate may be useful in relation to [other syndicates in which [the investor] is [an investor]. However, [the investor's representative] said that the facts are different in each case. [The investor's representative] then stated that limitation to this particular syndicate will reduce the potential of any mediation, and so reduce the usefulness of such an approach.
>
> [Tax official] asked what would be the purpose of mediating in relation to only one syndicate, and [the investor] responded that others may not be so different on their facts.

4.91 By early May 2000, position papers had only been released to investors in 2 out of 15 syndicates undergoing audit.

4.92 During May and June 2000 the investor in syndicate B asked the Tax Office to provide reasoning to support the position paper.

4.93 On considering the effect of the caveats in private binding rulings given to investors before they entered arrangements, the Tax Office's Part IVA Panel reported the following from its 7 June 2000 Part IVA meeting:

> The Panel noted that the PBR did not give a 'tick-off' to Part IVA or to section 73B(31) or the valuation. However, the PBR did basically approve the internal financial structures including the put options, which needed to be taken into account. However, because the PBR did not cover Part IVA, valuation or arm's length acquisition, in effect it did not give the taxpayer much comfort, and this could also be taken into account. Overall, the Panel was of the view that the PBR did not mean that Part IVA could not be applied.

4.94 The Part IVA Panel meeting on 7 June 2000 considered the application of subsection 73B(31) and Part IVA to three syndicates registered during the 1994 financial year.

> **Non-arm's length dealing**
>
> The Panel noted that the excessive valuation was the primary indicator of non-arm's length dealing … There was also a chronology point, that suggested that the commercial arrangements may have been entered into before the valuation had been done.
>
> **Valuation**
>
> The correct valuation methodology for the core technology was likely to be a significant point.

4.95 The auditor's submission to the Panel stated:

> [Syndicates 1 and 2]
>
> **Core technology expenditure**
>
> The Commissioner takes the view that, in the absence of any real bargaining between the parties and having regard to the valuation provided by the AVO:
>
> - The investors and [the valuer] were not dealing with each other at arm's length;
> - The arm's length value of the core technology for the purposes of subsection 73B(31) of the ITAA was between nil and $1 million; and
> - It is not considered reasonable to allow any deduction for the core technology expenditure.
>
> **Part IVA**
>
> Firstly the round robin of funds:
>
> [Parent investor] provided [investor] funds to finance their share of the equity to acquire the licence of the core technology, contract fee for R&D payment, management fee and arrangement fee. The cheques in relation to licence of the core technology and contract fee for R&D payment paid to [investor] were endorsed by [researcher], who endorsed the cheques to [subsidiary of

parent investor] which are held in the account of [the researcher]. The cheques were all endorsed [during 1994 financial year]. The funds that were initially loaned to [investor] are then loaned back to [investor parent] in the form of an interest free loan by [subsidiary of parent investor].

The consequence of the above transaction is [parent investor] receives a tax deduction by way of losses transferred from [investor] in terms of s80G of the ITAA without outlaying any funds.

Secondly the put option: …

(1) When the Put Option notice is given to the Researcher …

(a) the Researcher must subscribe for the additional shares and pay the subscription amount to the first investor …; and

(b) the First Investor must issue additional shares to the Researcher,

(2) At settlement on the Put Option Settlement Date:

(a) the researcher will pay the subscription amount to the First Investor by authorising and directing the Deposit Holder to pay an amount equal to the subscription amount from the Deposit by cheque to the First Investor who will endorse that cheque in favour of the Parent and deliver it to the parent in repayment of the monies outstanding,

(b) the Researcher will pay the Put Option price to the Parent by authorising and directing the Deposit Holder to pay balance (if any) of the Deposit to the Parent.

The consequence of this action would extinguish the debt of [investor] to the [parent investor].

4.96 No reason for the Commissioner's view was provided for syndicate 3.

4.97 The researcher in syndicate 3 was a public sector tax exempt organisation. It is not noted on the submissions or Panel report whether the researchers in syndicates 1 and 2 were tax exempt.

4.98 The report for the June 2000 meeting outlined the forward approach to applying Part IVA:

Future dealing with R&D schemes

The Panel considered that it had seen enough representative R&D schemes involving the following features:

- Excessive valuation of core technology by taxpayer
- Our valuation of core technology was zero or negative.

Future schemes involving these factors did not need to return to the Panel, but could be signed off for Part IVA by TCN. R&D schemes involving a change to this standard type (for example, Valuation not zero) would need to come back to the Panel.

4.99 After syndicate-caused delays, the Tax Office first met with syndicate Q in mid-June 2000 to start the audit.

4.100 By July 2000, there was significant internal Tax Office discussion on designing an overarching resolution to the R&D syndication issue.

4.101 One investor asked the Tax Office for an internal review in July 2000. The investor expressed concern at Tax Office suggestions that 'amendments may issue shortly' given that five years had elapsed in the audit. The investor stated:

> **Mediation**
>
> We have received [senior official's] letter of [late] June 2000 on the status of the mediation proposal and will respond. In the letter he agrees with our suggestion that there be an open exchange of views prior to mediation. We believe that provision of full details of the Tax Office reasoning would be consistent with such an open exchange of views and is necessary before a complete response can be provided on the Tax Office position paper.

4.102 In a follow-up letter the investor stated:

> … in the spirit of cooperation we have suggested that the matter be mediated. If this occurs, it should allow an open exchange of views without the need for expensive litigation. Our attempts to progress this mediation have been met with ambivalence from the Tax Office …
>
> We anticipate that the new valuation will be received shortly and we intend to discuss it with you once a mediation agreement has been signed. However, unless you agree to defer the issue of assessments until after the mediation we reserve our right to withhold the material, lodge an early objection, and require you to determine it at an early date. …
>
> In any event, we still believe that we are entitled under the Tax Office's own 'Audit Guidelines' to have a pre-assessment internal review conducted by senior Tax Office officers independent of those … who are part of the team which proposed to raise the assessments.

4.103 An internal review was again requested by the investor later in July 2000.

4.104 A Tax Office report to the TCC dated 24 August 2000 stated:

> … 6. Apart from the considerable time and cost of an audit where not prevented by legislative or other constraints, there are limited options available to the Tax Office to compel the termination of syndicates …
>
> [the report discussed three meetings with syndicates]
>
> 15. For technical and legislative reasons, the audit option is not available to the Tax Office in relation to any of these syndicates [presumably because the syndicate pre-dated the enactment of the specific anti-avoidance provisions in subsection 73B(31)]. By January 2003 the aggregate potential assessable income of these three syndicates will exceed [hundreds of millions of] dollars, and will double by 2007.
>
> 16. As a result of these discussions, the Tax Office is discussing the option of legislative amendment … . [The report then went onto discuss matters to consider in any legislative proposal.]

4.105 According to Administrative Appeal Tribunal reasons for decision, on 11 October 2000 the Tax Office issued amended assessments to Zoffanies Pty Ltd for the Substituted Accounting Period ending on 30 September 1992.

4.106 On 11 October 2000, the Tax Office started joint risk evaluations with AusIndustry.

4.107 In mid-October 2000, an investor wrote to the Tax Office outlining concerns with the audit and position taken:

Mediation

6. We have received fourteen Notices of Amended Assessment in relation to this matter. We are disappointed that that this has occurred without a mediation to allow [the investor] to put its position to the Commissioner. In particular:

   (a) the Tax Office refused to provide the reasoning underlying the conclusions in its position paper, but kept demanding that [the investor] provide it with further information; and

   (b) the apparent ambivalence and equivocation of the Tax Office toward mediation and consequently the time that has now passed since the idea was first raised. It is [the investor's] position that a mediation could have occurred prior to the issue of amended assessments had the Tax Office shown greater interest in it.

7. As assessments have now been issued, we suggest that mediation be reconsidered once both parties have lodged their evidence in chief with the Court. At this stage each party should have greater knowledge of the other's position. We note your suggestion that the next steps is to contact [the mediator] to discuss the framework of the mediation. We would welcome [the mediator's] view (and yours) on the specifics of the mediation proposal set out in our [late March 2000 email] to [the Tax Office].

4.108 By November 2000, a senior tax official was involved in 'case reviews' to ensure that progress was made on R&D syndicate audits and to assess whether the R&D syndication issue was still a compliance priority when compared to current issues.

4.109 According to Administrative Appeal Tribunal reasons for decision, Zoffanies Pty Ltd's objections were lodged on 14 November 2000.

4.110 In late November 2000, the Tax Office received a specialist valuation of the core technology in syndicate C, valuing it at $0.

4.111 On 8 December 2000, the Tax Office provides an investor in syndicate F with its position paper. It set out the relevant facts, findings and issues and pointed to the relevant law. It then recited the following relevant Tax Office conclusions, without providing further reasoning for the decisions:

5.1 Neither [abc company] and [xyx company] collectively as 'Investors', nor [third investor], dealt at arm's length with [mno company] as 'Researcher', in relation to the Licence Fee of $x million in the year ended 30 June 1994. As noted, the valuation of [Tax Office's valuer] dated 1 December 1999 determined that the arm's length value of the Core Technology was $Nil, and therefore the Syndicate should be allowed no deduction for the Licence Fee pursuant to s 73B(31) …

5.7 The Syndicate arrangement was a scheme as defined in s 177A of the ITAA 1936, which having to the eight matters set out in paragraph 177D(b), was entered into or carried out by [the investors] for the dominant purpose of enabling the 'relevant taxpayer' … to obtain a tax benefit in connection with the scheme as defined in s 177C of the ITAA 1936.

2001

4.112 An auditor's summary of an 8 March 2001 meeting between senior tax officials stated:

Strategy position

> As [a senior tax official] stated, the best action is to push through to court or settlement on those cases most currently advanced. If we get a break through with good outcomes the Tax Office will be in a stronger position to achieve resolution on other cases on an acceptable basis to the Tax Office. A settlement basis acceptable to the Tax Office is unlikely to be able to be achieved until we strengthen our hand in this matter …
>
> *Summary*
>
> Without such a break through it is difficult to progress the other cases and it may not be appropriate to do so. If taxpayers have obtained valuations and the Tax Office has not the Tax Office will not be able to successfully challenge the valuation.
>
> The taxpayer would only be attracted to settlement if they have viewed a valuation obtained by the Tax Office and as a result were led to believe that they have a material risk that the Tax Office will be successful in the court and also successful in recovery. If some high profile cases are successfully dealt with by the Tax Office other taxpayers are likely to more favourably view the external valuations obtained by the Tax Office.
>
> Further, if success is obtained in the lead cases the Tax Office could then explore preparing a generic document outlining acceptable settlement terms rather than the Tax Office embarking on the costly exercise of obtaining valuations and disputing on a case by case basis.

4.113 An internal memo dated 9 March 2001 provided recommendations to senior management for future strategies:

> The recommendations include:
>
> - Continue work on leading cases through to litigation with a view to obtaining outcomes which are capable of application across the syndicate population.
> - Review other audits with objective of identifying priority cases and adequately resourcing these through to litigation stage.
> - Mediation not to be pursued at this point.

4.114 The memo noted that:

> The strategy adopted to date has involved audits of a range of syndicates with particular emphasis on progressing 2 of the larger cases with a view to obtaining court decision(s) which will provide leverage in other cases …
>
> There has been some correspondence between the Tax Office and representatives of the 2 leading syndicates around the possibility of mediation. While this is certainly a possible means of bringing forward resolution in some cases, it is highly problematic as to whether mediation will be effective without litigation of at least one case.

4.115 The 9 March 2001 memo considered the broader compliance effect of the Tax Office's compliance treatments. In rejecting an option not to take action against syndicates that had not already been audited:

> … its adoption would mean that most syndicates would be 'home free'. This could lead to unfairness complaints by those syndicates audited and a far from desirable outcome in terms of the Tax Office influencing future promoters of tax planning arrangements.

4.116 In proposing the selection of additional audits, it commented that further audits:

> … would seem the best way of influencing future compliance and optimising recovery of taxes avoided through these arrangements.

4.117 Alternative settlement options were also considered in the 9 March 2001 memo. It is also recognised that due to the cost and time involved the 'ATO cannot achieve the "ideal" position of auditing all syndicates on a simple cost-benefit basis'. Significant litigation risk was also recognised and that valuation evidence 'will play a critical role':

> In order to maximise leverage and maintain costs a review of all cases in progress could be undertaken with a view to identifying the priority cases and directing available resources to them. The remaining cases could be put on hold until there are some outcomes from the initial cases.

4.118 The memo recommended that existing audits be completed, to 'use the results for approaches to all remaining syndicates for settlements along the lines of those achieved' and audit of 'a selection of additional syndicates'.

4.119 As at 9 March 2001, there were 27 audits in progress. Ten audits had position papers prepared or in the process of being prepared. Expert valuations were obtained in seven cases with AVO critiques being obtained for the rest. Amendments were issued in two cases with objections received in both.

4.120 In May 2001 senior technical staff, after reviewing the deliberations of the Part IVA Panel, gave an opinion to compliance staff to only apply 'Part IVA to core technology expenditure (and associated interest) where there is evidence that this has been incurred on a non-arm's length basis' and that 'it seems that the best evidence of non-arm's length dealing is a market value of the core technology as opposed to the value arrived at by the syndicate participants'.

4.121 By way of email dated 10 May 2001, a senior technical officer confirmed the Tax Office's approach to Part IVA in R&D syndication to other senior tax officials:

> It might be that [another senior technical officer] and I are being far too cautious in not looking at these arrangements and concluding, reasonably, but OBJECTIVELY that Part IVA applies to all R&D syndicates involving, for instance, a put option and tax exempt participant. However, if we are not caught by a ruling and it is clear that Part IVA applies by application of s177D, without regard to the value of the core technology, then it is unclear whether we can amend to the extent the syndicate's core technology amount varies from the arm's length or market valuation. Inevitably it is the core technology and its financing which is the source of the mischief in R&D syndicates.

4.122 By 10 May 2001, senior technical staff recognised the need for judicial consideration of the Tax Office's approach to the 'interrelationship between inflated core technology and the orthodox syndicate finance techniques' in relation to Part IVA.

4.123 Discussion on whether to re-engage external valuers continued from 28 March 2000 until 5 June 2001 when the Tax Office made a decision to re-engage them.

4.124 From May 2001 until May 2002, the Tax Office developed a position paper for investors in syndicate A.

4.125 In June 2001 the Tax Office issued a position paper to an investor in syndicate C. It provided the following relevant reasons for decision on the subsection 73B(31) issue:

> 3.2 In determining whether the parties were dealing at arm's length, the Commissioner is in essence considering whether 'the outcome of their dealing is a matter of real bargaining' *(Trustee for the Estate of Furse v FCT (1991) 91 ATC 4007)* or in fact the product of collusion to achieve a particular result *(Granby v FCT (1995) 129 ALR 503).*
>
> 3.3 The following matters indicate that the Investors and [the researcher] were not dealing with each other at arm's length in relation to the incurring of the [core technology licence fee]:
>
> (a) when the suite of transactions are viewed as a whole it was in all parties' interests to maximise the tax benefits to the Investors by maximising the [core technology licence fee];
>
> (b) the Tax Office has been unable to find any evidence of real bargaining on the part of the Investors;
>
> (c) the core technology valuer was engaged by representatives of the Licensor rather than by the Investors;
>
> (d) [abc company] holds an interest in [the researcher], which is the parent of [the contracted researcher], and [abc company] holds an interest in some of the Investors;
>
> (e) the licence of the core technology was part of a suite of transactions marketed to Investors as a package, the terms of which were set prior to the identification of any of the Investors.
>
> 3.4 Having regard to these matters the Commissioner is likely to be satisfied that, for the purposes of section 73B(31), the Investors and [the researcher] were not dealing at arm's length in relation to the incurring of core technology expenditure …
>
> 3.6 Having regard to the valuation obtained by the Tax Office of the core technology, it is likely that the Commissioner would be satisfied that had the parties been dealing at arm's length the core technology expenditure would have been less and in fact would have been nil.

4.126 According to the Administrative Appeal Tribunal's reasons for decision, the Commissioner disallowed Zoffanies Pty Ltd's objections on 26 July 2001.

4.127 Delays in obtaining critiques were initially due to AVO resourcing. By September 2001 these concerns were resolved to the Tax Office's satisfaction.

4.128 According to Administrative Appeal Tribunal reasons for decision, on 20 September 2001, an application was filed in the Tribunal to have Zoffanies Pty Ltd's application for review heard.

4.129 An internal Tax Office Minute dated 21 September 2001 noted amongst other things, that the audit guidelines for the relevant periods of the R&D syndicate audits required auditors to give taxpayers notice of an intention to audit in writing and allow a reasonable opportunity (usually four weeks) for a reply. It also referred to 'one case' in which the taxpayer's objection had been denied and was listed for directions hearings in the Federal Court.

2002

4.130 On 27 March 2002, the Tax Office received an external legal advice in relation to its audit of syndicate C. Amongst other things it opined:

- that much of the argument between the Tax Office and the taxpayers, and much of the valuation material, had been 'misdirected' in that it sought to address 'arm's length value', amongst other things, rather than addressing questions posed by subsection 73B(31) (page 36);
- that the syndicate investment vehicles (subsidiary companies set up by the investors specifically for the purpose of participating in the R&D syndicate) did not deal with each other at arm's length in relation to the core technology:

> [they] did no more than perform a role preordained by them, and that they subjugated their (notional) 'will' to that of the dominant participants in the arrangement: that is to the wills of the investors and the research group (and, in its role as packager). The price paid for the licence, and the fee paid for the research work, were not matters which appear to have been considered by the boards of the [investment vehicles] separately and independently by the investors (Page 42);

- determining an amount that would have been incurred if both parties were dealing with each other at arm's length required the 'circumstances peculiar to the parties … to be taken into account'. (p 44)
- in determining the price for the core technology, the investment vehicles would have been influenced by the tax advantages. However, those vehicles did not benefit it was their parent company which benefited and would have been influenced by the tax advantages:

> One factor which undoubted influenced the syndicate members was the tax advantage by way of deduction, to be obtained under sec 73B (page 45) … That is not to say that the 'independent' value of the technology and research work … is irrelevant. The arm's length price between the actual parties is increased by the value of the tax benefit, but it is not created solely by the tax benefit: there must be an underlying substance. …
>
> The effect of the 'guaranteed return' elements of the structure — the deposit of the fees and the put option over the shares in the syndicate [investment vehicles] — is to make it substantially irrelevant *to the investors* what the underlying value of the technology may be. … (Page 46)
>
> On an arm's length basis they are prepared to pay, in effect, whatever the researchers are prepared to receive. … However, theses elements of the structure do not seem to us to confer any benefit on the syndicate [investment vehicles]. …
>
> In the result, it seems to us that the 'arm's length' expenditure against which must be measured the actual outlay of the syndicate [investment vehicles] to form the opinion called for by sec

73B(31)(b)(ii) … is one to be assessed on the basis that the party making the expenditure is one who can claim, or make effective use of, the tax reduction arising from the sec 73B deduction.' (Pages 46-7)

- the arm's length expenditure was to be assessed by what the actual parties, with their knowledge at the time (without the benefit of hindsight), would have paid if they were dealing with each other at arm's length;
- the Tax Office's case was unlikely to succeed if it found that the valuations obtained were genuinely relied upon in the dealings in relation to the core technology:
  - It would be reasonable that to expect that a syndicate member, acting in good faith, would have turned its corporate mind to such matters as the premises and acceptability of the valuation advice. …
  - If it is found that a syndicate member obtained valuation advice which was not a sham, sought and given as a mere screen for a transaction which had regard only to the tax consequences and put option exit mechanism, and that it genuinely acted in reliance on that valuation advice in dealings over the technology and research, that syndicate [investment vehicle] will probably, in our view, be found to have acted at arm's length. (Page 48);
- all valuations, the Tax Office's and investors', proceeded on a misconceived and erroneous basis:
  - We say this notwithstanding that, as it seems to us, the valuations of all the valuers who have been consulted in this matter proceed on a misconceived or erroneous basis. All of the [Tax Office-engaged valuer's] valuations have proceeded on the basis of assessing a potential return from commercial exploitation of the technology on a variety of assumptions … assessing a level of risk of the potential return not being achieved, and using the assessed risk to fix a discount rate for the purpose of capitalising a discounted cash flow to arrive at a present value. While such a process is appropriate to many investments, we do not think it is appropriate to an investment in experimental technology, that is, technology with a medium to high level of technological risk. The application of a reasonable risk-based discount rate to a reasonable prediction of future return, bearing in mind the time at which the return is likely to emerge in any significant amount, will inevitably produce a present value of a negligible amount …
  - The appropriate method of valuation is, it seems to us, one analogous to a comparables basis. While it is unlikely that there will be a transaction involving directly comparable technology, it is not so unlikely that there will have been transactions involving loosely comparable technologies … This involves a wider and more detailed survey of research activity and transactions than has been undertaken by any of the valuers or by those instructing us. (pages 49-50) …
  - What the Commissioner is required to have regard to is what the actual syndicate members would, if dealing at arm's length, have paid; and if it is not apparent that the syndicate members took into account, in deciding what to pay, some extraneous consideration, but rather [if] it appears that they relied on expert advice, properly sought and reasonably assessed, as to the market value of the technology, we do not think that the Commissioner can conclude that they paid a price in excess of what they would have paid on an arm's length dealing merely because a different valuer now considers an arm's length value to have been greater. (Page 50.)

- in considering the strength of evidence supporting the Tax Office's case, the legal adviser concludes that:

> There are we think a number of matters which would support the formation by the Commissioner of an opinion adverse to the taxpayers. We do not, however, presently think that it can be predicted with any confidence that the taxpayers will be unable to establish that they acted in good faith on the basis of information and valuations supplied to them by putative experts, that they believed that there was a market for the technology if successfully deployed, and that they … were dealing on an arm's length (albeit mistaken) basis with the researchers in agreeing to the [core technology licence fee] and the research contract. (Page 52.)

- further information was needed to determine an arm's length amount for the core technology licence:

> … we consider it would be necessary to obtain further evidence as to:
>
> - What the particular companies involved in the … syndicate might reasonably be expected to have done in assessing or ascertaining the amount that each of those companies might have paid for the [core technology licence fee] had they been dealing with each other at arm's length with the researchers; and
>
> - What reasonable value could have been expected to have been attributed to the 'core technology' … by reference to transactions involving loosely comparable technologies.
>
> An expert in venture capital investment would, in our view, be in a better position to opine as to these matters than would an accountant or a person with narrow expertise in intellectual property evaluation … The category of investors most likely to be comparable to the syndicate members are members of a venture capital syndicate, and the place where we would expect the most likely source of useful expert evidence to be is the major market for venture capital, which we understand to be the United States.

4.131 In April 2002, the Australian Innovation Association (AIA) approached the Tax Office to discuss the possibility of alternative resolution of the R&D syndication issue. The AIA describes itself as a group of investors and researchers set up to represent the interests of R&D participants in Australia.

4.132 By May 2002, Tax Office staff recognised that an investor's tax adviser was unlikely to recommend settlement with the Tax Office where the investor had a valuation but the Tax Office did not.

4.133 In May 2002, a position paper for an investor in syndicate A was settled and issued. However, it was authorised to be released to the taxpayer with the express instruction to Tax Office staff that 'no assessments based on such position papers should issue' because 'the overall position in relation to Tax Office strategies on R&D syndicates is being further considered and reviewed'.

4.134 The position paper reached substantively the same relevant conclusions as the position paper in syndicate B. However, it provided two-and-a-half pages of reasons for its conclusions, including the Commissioner's views on which facts led to the conclusions and how they led the Commissioner to these conclusions in applying the law to those facts.

4.135 In July 2002, the AIA first met with the Tax Office. All parties agreed to resolve the issue by mediation.

4.136 In July 2002, the Tax Office issued a position paper to an investor in relation to investments made in syndicates. The position paper provided three pages of reasoning on why the Commissioner proposed to deny the core technology deductions. It set out the source in law of the relevant test to be applied, the particular details on why the Tax Office thought the valuation was incorrect and materially overstated, communications on changes in price, the effect of the financing arrangements, the assertion that the investor did not avail itself of its usual due diligence process, the absence of documents evidencing bargaining on price and the particular pieces of evidence indicating that the investor did not exercise its separate mind and will in fixing the price paid for core technology.

4.137 In July 2002, the Tax Office released its position paper to an investor in syndicate Q in relation to deductions claimed eight to nine years previously.

4.138 The Tax Office re-issued amended position papers to investors in syndicate Q over July and August 2002. The investors were asked to respond within a month. Extensions of time to respond were granted.

4.139 The amended position paper given to an investor in syndicate Q provided reasoning for its view:

> … There is no evidence whatsoever that [researcher company], as licensor, and [manager company], as Manager, or [investment vehicles for investors] as syndicate members, engaged in any negotiations at all in respect of determining the amount of Core Technology Licence Fee. On the contrary the evidence available indicates that the amount of the Core Technology Licence Fee was determined independently of [researcher company] and that [researcher company] simply accepted the amount of [$x million] determined by [manager company].
>
> [Manager company] had determined the value of core technology at [$x million] by [date] whereas [the initial valuer's] valuation of the core technology … was not completed until [one month later]. [Researcher company] did not obtain its own valuation of the core technology.
>
> [Tax Office valuer's] valuation of the Core Technology Licence Fee as nil is also significant in demonstrating the lack of arm's length dealing between the … Syndicate and [Research company] in arriving at the amount of the Core Technology Licence Fee. The fact that a company … was prepared to outlay an amount of [$x million] to acquire a licence to the rights to core technology which had a value of nil raises questions about the true purpose of the outlay … The [Investor A] Put Option and the [Investor B] Put Option effectively eliminated any commercial risk on the part of [Investor A] and [Investor B] in respect of their investments in [investment vehicle company] and meant that [Investor A] was assured of obtaining substantial financial benefits originating from income tax deductions being claimed by [investment vehicle company] for core technology expenditure, research and development expenditure and interest. [Investor A] was actually advantaged by [investment vehicle company] paying an inflated amount for the core technology.
>
> In summary, having regard to the fact that:
>
> (a) [investment vehicle company] outlaid an amount of [$y million] to acquire a licence to the rights to core technology which had a value of nil;
>
> (b) [Researcher company] did not obtain an independent valuation of the core technology, but merely accepted the Core Technology Licence Fee of [$x million] offered to it by [Manager company] on behalf of the … Syndicate;
>
> (c) the factual matters described in [section in position paper outlining the relevant facts];

> it is considered that the … Syndicate and [Researcher company] were not dealing with each other at arm's length when the Syndicate incurred the Core technology Licence Fee of [$x million] for a [number of years] licence to the … core technology.
>
> [The position paper then went on to provide reasons on other areas of the tax laws. It then gave similar conclusions to those stated in earlier position papers and provided details of proposed amendments.]

4.140 The Tribunal hearing of the Zoffanies matter started on 5 August 2002 and continued for three weeks.

4.141 The Tribunal handed down its decision on 4 September 2002 in favour of the taxpayer.

4.142 The Administrative Appeals Tribunal concluded that the syndicate's valuer, Dr Venning, acted independently in preparing his valuation:

> 131. The Tribunal finds that Dr Venning acted independently in preparing his valuation. As a matter of common sense, it was necessary for him to have ongoing communication with Dr Smeaton because he was the main source of information about Bresatec required by Dr Venning in the preparation of his report. Dr Smeaton gave evidence that he formed the view, after his meeting with Dr Venning on 17 March 1992, that Dr Venning would take an independent view in making his valuation. Mr Phillips said that in the valuation Dr Venning had prepared for MBL previously in relation to another matter, he had been impressed by, amongst other things, Dr Venning being protective of his independence. Mr Phillips said he would have rejected Dr Venning's report if he had thought it was not independent.
>
> 132. Dr Venning also impressed the Tribunal as a person who guarded his independence and sought to form his own independent view. The Tribunal accepts that the assistance he gave Dr Smeaton in looking over the draft IRDB letter and suggesting an additional paragraph from a previous IRDB application, was a separate matter and did not compromise his independence. Ultimately, Dr Venning's valuation was that the core technology was worth between $10 million and $19 million, and that a valuation of $15 million was reasonable. The fact that he amended this figure from $15 million to $15.35 million after discussion with Mr Phillips does not, in the Tribunal's view, compromise his valuation. He said $15.35 million was within his range of values and he considered this reasonable. The Tribunal notes, as the expert witnesses made clear, that valuation is often not a precise science especially where projections for the development and commercialisation of biotechnology are concerned.
>
> 133. The Tribunal rejects the Respondent's submission that there was persuasion and cooperation amounting to collusion between the parties. It notes, in passing, that persuasion is part of the normal process of negotiation and that cooperation does not, of itself, indicate that parties fail to exercise their separate minds and wills in reaching a bargain. The Tribunal also rejects the Respondent's submission of indifference on MBL's part. Mr Phillips' evidence and the process of negotiation between the parties indicates that this was not the case.

4.143 Although it was not an issue on which the Tribunal had to base its decision, it did offer its observations on the valuation evidence. In doing so the Tribunal cautioned care substituting one valuer's opinion for another without good reason:

> 135 … It is also worth noting that the five expert witnesses had the benefit of hindsight and that it is easy to be critical after the event when what was then unknown is now known. In the context of

what was no more than an estimate of value, care needs to be taken when substituting one valuer's opinion for another without good reason.

4.144 The Tribunal also commented that in relation to determining a reasonable amount:

136. With regard to s 73B(31)(b)(ii), it should be noted that the relevant question is what would the expenditure have been if these parties had been dealing with each other at arm's length? Would a competent and independent valuer other than Dr Venning have made a different valuation which the parties would have relied on in concluding the terms of transaction so that the amount of the relevant expenditure would have been less?

137. The Tribunal finds that Dr Venning acted bona fide in making an independent valuation. He is a Doctor of Philosophy in Microbiology as well as having a Bachelor of Economics degree. The Tribunal accepts that his scientific background facilitated his understanding of the transgenic technology developed by Bresatec and of the ESC technology developed by the University's research scientists, the intellectual property in which was vested in Luminis. The Respondent's expert witnesses were critical of Dr Venning's assumption of success for the project, of his optimistic projections of future revenue from commercialisation, and of his appreciation of what they considered to be an unrealistically low discount rate, thereby recognising a low level of risk. The Tribunal notes that Mr Lonergan [the Tax Office's valuer] proceeded on the basis that he was assessing the market value of the core technology licence. While he is undoubtedly an experienced valuer, the Tribunal's impression, in terms of his adjustments to the projected revenues and choice of discount rate, is that he was unduly pessimistic about the future of the project. Certainly he did not have the scientific understanding of the technology that Dr Venning had. Mr Lonergan also criticised Dr Venning's projection for penetration of the US market without, apparently, giving credence to Dr Venning having based his projection of 30 per cent penetration on Mr Mooney's figures (transcript, 16 August 2002, page 853) …

139. The conclusion reached by the Tribunal in the light of Dr Smeaton's view of the worth of the technology, and of the value attributable to Bresatec by virtue of Cyanamid's investment in its shares, is that a competent and independent valuer other than Dr Venning might have made a similar valuation. The Tribunal is not satisfied that his valuation, which was conducted using the most widely accepted methodology, was flawed such that the Tribunal should substitute a different valuation. The Tribunal finds, having regard to the matters set out in s 73B(31)(c), (d) and (e), that Dr Venning acted professionally, from an informed scientific and economic background, and that there is insufficient evidence to suggest that the relevant expenditure would have been any less had the valuation been made by a different competent and independent valuer undertaking the valuation in 1992.

4.145 Following the decision of the Tribunal, the Tax Office appealed to the Full Federal Court on the grounds that the Tribunal had erred in relation to Part IVA and subsection 73B(31).

4.146 In December 2002, an investor settled with the Tax Office prior to a Federal Court hearing.

2003

4.147 The investors in syndicate Q responded to the Tax Office's amended position paper in late February 2003.

4.148 In July 2003, the Tax Office sent adjustments sheets to the investors in syndicate Q and issued amended assessments reflecting these adjustments.

4.149 On 25 July 2003, four days before the Federal Court hearing of the Tax Office's appeal in the Zoffanies matter, the Tax Office withdrew the subsection 73B(31) appeal ground because it was of the view that it was a factual matter. There is no avenue of appeal to the Full Federal Court on factual matters.

4.150 On 28 July 2003, the Tax Office and a taxpayer entered an agreement to mediate the dispute and, amongst others:

> determine Guidelines for reviewing R&D arrangements, thereby potentially removing the need for detailed syndicate audits and/or litigation.

4.151 The Full Federal Court heard the Zoffanies matter on 29 and 30 July 2003.

4.152 In September 2003, an investor and the Tax Office agreed to settle on the basis of 'economic neutrality'. The effect was that the parties agreed to adjust the original core technology deduction by reducing it to 30 per cent of the original amount claimed.

4.153 Investors in syndicate Q lodged objections in September 2003.

4.154 Judgments were handed down in the Zoffanies case on 24 October 2003. The Full Federal Court commented on the outline of evidence in the Tribunal's reasons:

> It may be remarked that the Tribunal's reasons consist substantially of an outline of the evidence given by the various witnesses who gave evidence at the hearing which extended over a period of three weeks. It seems to be the case that the Tribunal accepted all evidence recorded in that outline [per Hill J at paragraph 15].

4.155 The Court held that the Tribunal had erred in its approach to the Part IVA issue and remitted the matter back to the Tribunal for reconsideration on that ground. However, when considering whether the Court should determine the application of Part IVA to the case, Hill J opined:

> It would be necessary for the Court on appeal to consider all of the evidence before the Tribunal, from a hearing which extended over some three weeks, before it could be in a position to decide whether only one outcome was possible. This I decline to do for it is clear from the Tribunal's reasons and particularly its factual findings (excluding matters of subjective purpose) that it would be possible to reach either a conclusion favourable to the Commissioner or one favourable to the taxpayer [at paragraph 66].

4.156 Further, Gyles J opined (at paragraph 92):

> There is a good deal to be said for the view that the Tribunal did not fully analyse, consider and take into account the tax implications of the scheme for what might be called the Macquarie Group as a whole … [However] An administrative tribunal is not bound to deal with all factual matters proposed by a party as relevant to a topic in the manner put forward to it. Put another way, the statute only requires consideration of the topic, not pieces of evidence relating to it.

4.157 On 30 October 2003, the Tax Office's priority technical issue proposal, PTI 170, notes amongst other things:

Brief outline of the risk mitigation strategy and how resolution of the technical issue relates to it (for example, No Tax Office view exists/education programme cannot proceed until application of law is clarified and published. Explain whether the problem exists because of a difficulty in applying, administering or interpreting the law):

Overvaluation of core technology generates a tax benefit to Investors in the scheme. Subsection 73B(31) requires an arm's length valuation of the core technology but there are practical difficulties in applying this section. The schemes also involve a round robin of funds ensuring a guaranteed return of the investors' funds. Part IVA is also an argument.

2004

4.158 The mediator gave his evaluation of the issues on 10 March 2004 and gave the following opinions:

- A court would not hold that the private binding ruling issued to the investors in this case would be binding on the Commissioner in relation to the issue of arm's length dealing. This was because to do otherwise would disregard the reservations stated in the Commissioner's ruling and the two conditions imposed by DITAC in requiring compliance with section 73B. There was also no basis for a claim of legitimate expectation (paragraphs 121-127).
- An absence of bargaining or indifference to price does not necessarily establish a non-arm's length dealing (paragraph 145).
- The question in each case was whether the parties had dealt with each other as arm's length parties would be expected to do (paragraph 146).
- Directly relevant factors to determining the arm's length issue were how the core technology came to be identified and how the core technology price came to be quantified (paragraphs 147-155).
- There were a number of possible explanations for a departure from what arm's length parties would be expected to do (paragraphs 156-159):
  - Lack of risk for investors because of the availability of the concession and the acceptance by the Government of guaranteed returns;
  - the 'assurance' that the registration process provided;
  - the limited time in which to complete the project;
  - the 'inducement' of the tax concession to 'cut corners' by relaxing the insistence that a prudent investor might have in specifying the technology and its valuation;
- The positive rather than zero or negative value the core technology seems to have as the Commissioner argues.

171. I have difficulty with the Commissioner's submission and the approach taken by the experts because they overlook what to me is a fundamental point, namely that government policy as manifested in the Tax Concession, along with the acceptance of guaranteed returns and registration constituted 'in principle' approval was instrumental in creating a demand, if not a

market, for core technology which might not otherwise have existed. There were investors who were prepared to invest in projects based on core technology because the tax benefits were a sufficient inducement, even if the projects based on that technology had slim prospects of a successful outcome. …

173. I do not accept that the amount of expenditure on core technology which would have been incurred, had these parties dealt at arm's length, would necessarily have reflected the prospects of technical and commercial success or failure. On the other hand, I do not accept that investors **dealing at arm's length** with an owner/researcher would have incurred expenditure on core technology without subjecting the proposals to risk assessment, independent valuation or independent expert scrutiny.

4.159 On 15 April 2004, Commissioner of Taxation publicly announced that he would not apply the general anti-avoidance provision, Part IVA, to R&D syndication deductions where the specific anti-avoidance provision did not apply. He also announced that a mediation was underway to help resolve the uncertainty:

In 1997 I stated that there would need to be unusual circumstances before Part IVA could be employed to strike down the benefits available under a specific legislative concession. By unusual circumstances I mean artificial arrangements designed to exploit the concessions. This remains the case. It would be incongruous for Part IVA to apply across the board to deny access to a specifically legislated concession.

This issue has become topical because of our review of Research and Development Syndication arrangements entered into in the 1990's. The reason we opened up enquiries here is quite simple — the Australian National Audit Office recommended we do that.

The reasons for our concern following a review of the arrangements is equally straightforward. The financial arrangements typically associated with the investment in the relevant core technology meant that in the event the venture failed, the investors were entitled to receive back their investment in that technology with interest.

While not fatal in themselves, the effect was that the arrangements created a situation where much of the normal bargaining tensions over price were absent.

Investors had little to lose from the core technology purchase price being overstated. Indeed on one view, they gained from such a result through inflated tax savings. That is not to say that was the result in particular syndicates. However it does explain our interest in verifying the outcome.

As it happens the law specifically provided for this potential abuse.

Under specific anti-avoidance provisions, an arm's length price can be substituted where it is found that the parties were not dealing with each other at arm's length in relation to the acquisition of the core technology.

Given our specific concern with some of the arrangements, the tax outcome for the cost of the core technology will be determined by the application of those specific provisions.

Where the parties are found to be dealing with each other at arm's length, Part IVA will have no application.

To assist in resolving our approach in this area we have been engaged in a lengthy mediation process in the considered hands of Sir Anthony Mason.

We have embarked on this course of action in recognition that this is a particularly difficult area of the law to apply.

For example, how do you determine an arm's length price for core technology that, in the absence of tax concessions, has proved to have no real market?

The mediation process is designed to establish principles to be applied in individual cases to determine whether there are arm's length dealings and, where there are not, the principles to be applied in determining the appropriate arm's length price.

Given the inherent difficulties in determining an arm's length price, we will be looking to pursue only those cases where there is a material gap between the price determined under these principles and the claimed purchase price.

Where the specific anti-avoidance provisions operate to reduce the claim we will also make a pro-rata reduction in any interest claimed on moneys borrowed to fund the purchase of the core technology.

In adopting this course we would be relying on the primary provisions of the law. However, as a back up, we will consider the possible application of Part IVA to support this particular adjustment.

My focus today has been on Part IVA, the income tax anti-avoidance provisions.

However, attempts to artificially generate tax benefits are not limited to income tax …

The significance I place on the use and operation of the general anti-avoidance provisions should be clear.

Because of this I have been concerned to ensure its use is carefully and judiciously guided through a panel comprising senior tax officers and appointments of tax experts from academia and the legal and accounting professions.

To enhance their consideration of particular cases, we will shortly be introducing arrangements to allow taxpayers the opportunity of personally presenting the facts and their position to the panel.

This will extend the present opportunity to have written material considered by the panel.

I want to stress that this is not about introducing quasi-judicial processes: it is not about quizzing the panel.

It is about enhancing our ability to ensure the position ultimately taken by the Tax Office is done with the fullest possible understanding of the circumstances of the particular case. [The Art of Tax Administration: Two Years On, 6th International Conference on Tax Administration, Commissioner of Taxation, 15 April 2004.]

4.160 On 5 May 2004, the Tribunal issued orders in Zoffanies Pty Ltd's favour.

4.161 By July 2004, audits were ongoing in 33 syndicates involving 37 main investors.

4.162 By July 2004, the Tax Office proposed to another investor to settle on the basis of 'economic neutrality'. Following these discussions the Tax Office advised the investor that negotiations were on hold pending the outcome of a mediation. Assurance was given that previously agreed figures would be honoured if the outcome was less favourable. In September 2004, the Tax Office offered a significantly more favourable settlement, generally in accordance with the global settlement offer. This settlement was later concluded.

4.163 On 16 July 2004, the mediator gave an addendum to his 10 March 2004 evaluation. He gave draft guidelines which dealt with the application of private binding rulings and the question of arm's length dealing. He also, amongst other things, gave the following opinions:

- Subparagraph 73B(31)(b)(ii) does not require the Commissioner to specify what the arm's length amount should be to reach a conclusion that the amount claimed should be amended:

  20. It is open to the Commissioner, without specifying a particular sum as the arm's length amount, to demonstrate that an arm's length amount is less than the amount paid by showing that the arm's length amount was within a range of figures, the highest of which was lower than the amount paid.

- In ascertaining the arm's length amount it is not permissible to have regard to hindsight. One can only look at what was known or was knowable by the parties when the amount was determined (paragraph 23).

- The discounted cash flow method does not of itself produce the arm's length amount (paragraph 76).

- The arm's length amount should be based on idiosyncratic factors that influenced the parties bargaining position rather than a mere valuation of the technology itself (see paragraphs 78-84, especially paragraph 83 where the valuation methodology which ignored the contractual features and special value that the parties placed on the technology was rejected). The following factors were considered:

78. … the parties acted on the footing that the project had potential for success, notwithstanding the inherent risks. Indeed, a strong criticism of the investors made by the Commissioner is that they, and for that matter [the researcher], underestimated the risks. While this justifiable criticism undermines the value they placed on the project and the core technology, it also has relevance for the amount they would have been prepared to pay for the core technology licence had they been acting at arm's length in that respect. The tax benefits would have inclined them to agree towards the high end of a range of permissible values. Further the investors drew comfort from the registration of the Syndicate by DITAC and appeared to have regarded registration as an indication that the project had significant potential, though any reliance on the registration as evidence of the value of core technology would not have been justified. The investors regarded [the parent of the researcher] as being a leading player in the field (which it was at that time) and possessing very considerable expertise (which it had) …

79. [The researcher], for its part, along with [its parent company], had expended not less than $[just over half of the value of core technology claimed] on the development of the core technology before the Syndicate was established. It would be unrealistic to suggest that [the researcher] was willing to dispose of the core technology for a derisory amount. The materials indicate that [the researcher] had an inflated estimate of the worth of the technology and its potential for development and success, a view which it communicated to the investors through [the packager]. On the other hand, it stands to reason that [the researcher] would have been prepared to accept significantly less than $[the amount expended in developing the core technology before entry into the syndication] had the parties been acting at arm's length and had attention been directed to

making an independent assessment of the value of the core technology and the matters relevant to the making of such as assessment. [The researcher] has no other available source of funding and the time frame for potential successful development of the technology was limited.

80. The Commissioner makes the point that the IRD Board was told that, without funds, the research would not have been undertaken. There was not apparent funding available to [the researcher's Australian parent company] as [the overseas parent company's] then policy was that all research was to be locally funded. Australian banks would not provide debt lines for R&D funding and [the overseas parent] could not access the local equity market. It was on this basis that IRD Board approval was sought in order to secure the benefit of the Tax Concession. It may well be that, without the benefit of the R&D funding through syndication, [the researcher] would have been unable to continue its development of the core technology. This possibility would, in all likelihood, have induced [the researcher] to accept an amount significantly less than $[the amount expended in developing the core technology before entry into the syndication] for the core technology.

81. Apart from the [accountant's] assessment, there was nothing to suggest that [the researcher] had developed the technology to a point where its value exceeded the amount expended on it. Nor was there anything else to indicate that the value of the technology was equal to the amount of that expenditure. On the assumption that [the researcher] considered that the Syndicate project had potential for technical and commercial success, it was the expenditure on R&D by the Syndicate that would bring that success about. It seems to follow that, had the investors engaged in a bargaining process with [the researcher], [the researcher] would have been willing to dispose of the core technology for a sum significantly less than the amount [the researcher] had expended in it, in return for the Syndicate's injection of funds for R&D. Likewise, had the investors engaged in arm's length approach to the expenditure to be made on core technology, they would have been unwilling to agree to pay an sum equal to the amount expended by [the researcher] on the core technology. …

… 83. My rejection of the view that the core technology had a negative or nil value involves my rejection of [the Commissioner's valuer] detached valuation methodology, although, as I have indicated, its focus on valuing the technology rather than on valuing the contractual rights is persuasive. At the same time, the [researcher's] sales forecasts are far too optimistic and need to be discounted though I would not discount them to the extent that [the Commissioner's valuer] discounts them.

84. … In what is a difficult, imprecise and hypothetical exercise, my conclusion is that a court or tribunal might well find that the technology had a positive value and that the arm's length amount stands somewhere in a range between $[one-fifth to almost half of the amount claimed].

- Subparagraph 73B(31)(b)(ii)'s 'reasonable amount' may be different to the arm's length amount. It may be within the range of estimated amounts. It may be more than the figures in that range (paragraphs 86-88).
- A 'reasonable amount' is not simply the value of the core technology:

89. Another possible interpretation which I have rejected is to interpret the arm's length amount simply as the value of the core technology to be objectively ascertained without having regard to the particular parties and to their attributes and then to reinstate the particular parties and their attributes in determining the amount of the expenditure that is reasonable. This interpretation does not give effect to the language in which [73B(31)](b)(ii) is expressed.

4.164 In July 2004, the Tax Office estimated the revenue at risk under different scenarios. These estimates were as at 16 July 2004, for 237 syndicates on a range of varying assumptions:

- for the total 237 syndicates, $3.978 billion total tax deductions claimed (comprising $2.21 billion claimed core technology deductions and $1.768 billion claimed interest deduction — assuming 80 per cent of core technology deduction) giving a tax cost (at a 36 per cent rate) of $1.43208 billion;

- for the 66 total post-December 1991 syndicates with $10 million core technology and over where individual investments by investors were more than $3 million (48 investors), $2.18232 billion total tax deductions claimed (comprising $1.2124 billion claimed core technology deductions and $0.96992 billion claimed interest deduction claimed — assuming 80 per cent of core technology deduction) giving a tax cost (at a 36 per cent rate) of $0.78564 billion;

- ratios (tax, penalty and interest: core technology), assuming an effective tax rate of 34 per cent, core technology of $10 million, core technology interest of $8 million, syndicate commenced in 1995, GIC calculations to 31 March 2004 applied to total > $10 million syndicate population where individual investments by investors were more than $3 million (that is, $1212.4 million core technology deductions) in four scenarios.

Tax and Penalty analysis

	Scenarios			
	Deny all core technology and interest deductions, apply a 50 per cent penalty and full GIC	**Deny half core technology and interest deductions, apply no penalty and full GIC**	**Deny half core technology and interest deductions, apply no penalty and four years maximum GIC**	**Deny half core technology deductions and no interest deductions, apply no penalty and four years maximum GIC**
Ratio (tax, penalty and interest: CT)	1.56	0.627	0.444	0.234
Ratio applied to total >$10m syndicate population where investments >$3m (that is, $1212.4m) in $m	1890.72	759.92	538.13	283.7
Ratio applied to total syndicate population (that is, $2.21b) in $m	3447.6	1385.67	981.24	517.1

(From Tax Office's 'Revenue at Risk – all syndicates' spreadsheet, dated 16 July 2004).

4.165 The Tax Office also estimated that if it denied half of the core technology deductions and no interest deductions, and applied no penalty and six years maximum GIC, then a tax, penalty and interest to core technology ratio of 0.263 would apply. This resulted in an estimated:

- $319.4 million revenue at risk for total over $10 million syndicate population where individual investments by investors were more than $3 million; and

- $582 million revenue at risk for the total syndicate population.

4.166 These amounts also included those investors who settled before the Tax Office announced its global settlement offer. Their core technology deductions initially claimed amounted to $153 million. If these cases are excluded from the last scenario above then the revenue at risk amounts to:

- $279.1 million for the total over $10 million syndicate population where their investment was more than $3 million; and
- $541.7 million revenue at risk for the total syndicate population.

4.167 In August 2004, during its Review of Aspects of the Income Tax Self Assessment system, Treasury reconsidered the issue of unlimited periods for review generally and those relating to the R&D provisions. The report of that review (the ROSA report) stated:

> The law sets out over 100 instances where the Tax Office has no time limit on its power to amend. Examples include … research and development expenses. The reasons for these unlimited periods vary. The most common reason is that the primary liability rules contain a condition that might only be satisfied (or cease to be satisfied) outside the normal amendment period. In some cases, the original reason is unclear or no longer relevant.
>
> The Review has concluded that it is undesirable that a taxpayer who is not fraudulent or seeking to evade tax be exposed indefinitely to the possibility that their assessment will be increased to implement a particular provision. [ROSA Report, paragraph 3.2.5]

4.168 Treasury recommended that it conduct a more detailed review of these provisions. At this stage, such a review has not been completed but Treasury has indicated that it will consider the usefulness of these provisions and, if such usefulness is outlived, whether the provisions ought to be repealed.

4.169 The ROSA report also recommended:

> Recommendation 2.11:
>
> The category of PBRs should be expanded to cover matters of administration, procedure, collection, and ultimate conclusions of fact involved in the application of a tax law. However, the Commissioner should not be obliged to rule where to do so would prejudice or unduly restrict the administration of the tax law.
>
> Recommendation 3.10:
>
> The Tax Office should extend its practice of entering into pre-assessment agreements to a wider range of transactions or circumstances, wherever it is cost-effective to do so.

4.170 In summary and as at 1 September 2004, five investors (company groups) had settled with the Tax Office (investments in 18 syndicates). One investor litigated and had orders awarded in the taxpayer's favour. The Tax Office had released position papers in relation to 14 out of 33 audits. The Tax Office had determined that Part IVA applied in 14 syndicates.

4.171 On 6 September 2004, the Tax Office announced that it would only pursue taxpayers who invested in syndicates where the core technology expenditure for the syndicate was $10 million or more and the taxpayer's share of that expenditure was $3 million or more. It offered terms of settlement to 40 investors. The Tax Office said that it would not pursue the remaining investors. They effectively retained their core technology and associated claims.

4.172 In September 2004, the Tax Office published guidelines which would be used to determine whether core technology deductions were properly allowable. Those guidelines gave practical guidance on when the Tax Office would be bound by a private binding ruling. It also gave practical guidance on what factors should be considered in assessing whether there was an arm's length dealing. It gave general guidance on determining an amount where there was no arm's length dealing. This guidance was contained in 'Part C' of those guidelines:

1. If the Commissioner considers that an Investor does not satisfy Part B in relation to core technology expenditure which it has incurred, he may be satisfied, that, in the circumstances, the Investor and the researcher were not dealing with each other at arm's length in relation to the incurring of the core technology licence fee.

2. If the Commissioner is so satisfied, then s 73B(31)(b)(ii) requires the Commissioner to be satisfied that the amount paid by the Investor would have been less, had the Investor been dealing at arm's length with the researcher. If not satisfied in this respect, the Commissioner does not meet the requirements of s 73B(31)(b)(ii), and cannot adjust the deduction claimed for the core technology licence fee.

3. In order to enable the Commissioner to be satisfied that the amount of the expenditure on the core technology would have been less if the Investor and the researcher had dealt with each other at arm's length in relation to the incurring of that expenditure, there needs to be material to support the Commissioner's conclusion.

4. Such material may take various forms. By way of illustration only, it may take the form of:

   i. a valuation by an independent expert which shows that the value of the core technology was at the time of the R&D transaction less than the amount paid;

   ii. material which establishes, either on its own or in conjunction with other material, that the parties inflated the price above the price which would have been paid had the parties been dealing at arm's length; or

   iii. other material which establishes, either on its own or in conjunction with other material, that the parties paid a price in excess of the price which would have been paid had the parties been dealing at arm's length.

5. If the Commissioner is satisfied under section 73B(31)(b)(ii), section 73B(31)(d) requires the Commissioner to arrive at an amount which he considers to be reasonable to allow as a deduction. Prior to his forming this view as to the amount, the Commissioner will consider any material put to him by the Investor.

6. In relation to paragraph 2 above, the following propositions are relevant:

   i. the core technology licence fee is likely to have a positive value (as distinct from a negative or nil value);

   ii. the arm's length amount may be within, and is likely to be within, a range of estimated amounts;

iii. section 73B(31) contemplates that the amount that the Commissioner considers reasonable will not necessarily coincide with the arm's length amount, but will not be less than the arm's length amount; and

iv. section 73B(31) enables the Commissioner to reach a conclusion in a given case that a part of the expenditure on the core technology licence fee is reasonable even though it does not correspond to the arm's length amount and may exceed that amount.

4.173 During September to December 2004 the Tax Office wrote to 40 investors (79 syndicates) offering a settlement and attaching the Mediation Guidelines:

> It is important that we remind you that in accordance with the attached statement, you are only required to consider the settlement offer if the syndicated R&D arrangements in which you participated or from which you benefited involved:
>
> (1) core technology incurred on or after 19 December 1991; and
>
> (2) core technology expenditure of $10 million or more and your share of core technology expenditure of $3 million or more.
>
> **Settlement offer**
>
> As your company or a company in your group has benefited (eg by way of a transfer of losses pursuant to former section 80G of the ITAA 1936) from syndicated R&D arrangements which meet the above criteria, the Tax Office will allow part of the benefit you received based on the following terms [terms of settlement were then set out, amongst other things, to allow 50 per cent of core technology deductions, 100 per cent of interest expenses, 0 per cent shortfall penalties and 50 per cent of GIC at the statutory rate capped at six years]
>
> **Options**
>
> You have a number of options:
>
> **Option 1:** Within six (6) months from the date of this letter, you can apply to accept the settlement offer by writing to the Tax Office in the manner described … below. The settlement offer expires six months from the date of this letter.
>
> **OR**
>
> **Option 2:** Within six (6) months from the date of this letter, you can inform the Tax Office that you intend to seek to demonstrate to the Tax Office that you satisfy the attached Guidelines because:
>
> (1) you were dealing with the researcher at arm's length in relation to the incurring of the core technology licence fee; OR
>
> (2) if not (1), either that the core technology licence fee represented an arm's length price or that some other amount greater than 50 per cent of the core technology licence fee was a reasonable amount.
>
> There is no expectation that the process of a taxpayer demonstrating to the Tax Office that it satisfies the Guidelines will be competed within six (6) calendar months from the date of this letter ...

> If you do not either accept the settlement offer within six months or demonstrate to the Tax Office that you satisfy the Guidelines, the Tax Office will take appropriate action to determine the amounts allowable for core technology and associate interest expenditure. Subject to individual circumstances, any future settlement of disputes would be significantly less concessional than the offer outlined in this letter.

4.174 During November and December 2004, the Commissioner reissued its settlement letters making it clear that extensions of time would be granted and that no GIC would accrue during these extensions so long as the investors continued to work with the Tax Office towards resolution.

2005

4.175 On 8 February 2005, the Tax Office conducted an information session on the September 2004 Guidelines at the invitation of a law firm.

4.176 On the 20 October 2005, the Tribunal handed down a decision in *The Taxpayer and The Commissioner of Taxation* [2005] AATA 1039, 20 October 2005, Sydney. The Deputy President, the Hon R N J Purvis, accepted Venning's valuation in that case. In that case the Commissioner assessed a $2.4 million core technology licence fee as assessable to the researcher. The syndicate was registered in the 1993-94 year. The researcher argued, amongst other lines of argument, that the 'payment to the Applicant of the $2.4 million for the grant of the licence was a sham [and alternatively] the real value of the licence fee was not $2.4 million but significantly less. The amount was paid to maximise claimable tax losses. The additional amount beyond the true value of the licence is not assessable income. It is a windfall.'

> **VALUATION OF THE LICENCE TO THE CORE TECHNOLOGY**
>
> 16. It is maintained on behalf of the Applicant that the licence granted by it to the licensee, Lafoten, of the core technology was worth considerably less than the $2.4 million. The difference, it is said, between the true value and $2.4 million was not paid to the Applicant as consideration for the licence but in order to maximise the claimable tax losses of Lafoten. This additional amount, it is further said, is not assessable in the hands of the Applicant. Indeed it is maintained that the licence agreement was a sham.
>
> 17. It is basic to the Applicant's argument that the value attributed to the licensing of the core technology was not a real value and that Dr Venning was influenced in arriving at his valuation by suggestions put to him by AusAsean [the promoter]. If this contention can be maintained, then a factor relevant to the sham argument has been established. It is said that Dr Venning had a relationship with AusAsean in which he provided reports. Whilst not submitting that Dr Venning was entirely 'a pawn' it is contended that he was not wholly independent and that he submitted 'a false valuation and the figures were adjusted to come up with $2.4 million'.
>
> 18. The criticism made of Dr Venning's report was based on a number of contentions, each of which it was said, cast doubt not only on its reliability but on it being genuine in the sense of a report and a valuation reached after an objective appraisal of all relevant factors. But even if the Applicant is able to satisfactorily establish that the valuation report was not correct in the sense of being based on a false premise or premises, there is other evidence before the Tribunal as to a proper valuation which may substantiate that of Dr Venning. Discussion is had elsewhere in these reasons as to the meaning that is to be ascribed to the word 'sham'. The valuations and opinion of valuers is relevant only if they are such as to cast sufficient doubt on the genuineness of

Dr Venning's report and the $2.4 million valuation. As I have said, it is not sufficient to show, that the valuation was wrong.

19. So in order to establish the falsity of the valuation and the lack of independence on the part of Dr Venning, the Applicant refers to aspects of the report which are said to be faulty and calls in aid the opinions expressed by other valuers and experts who commented upon the report or themselves valued the licence.

20. Material was contained in Dr Venning's report (Exhibit O/58) relating to the 'potential size of the market for the transformer equipment'. This information was provided by the managing director of the Applicant. It was maintained that the 'figures were entirely unrealistic' yet Dr Venning, whilst acknowledging that he could not corroborate what he been told, did say that there was no reason known to him to doubt the estimates made. Again when estimating potential revenue (Exhibit O/59) Dr Venning referred to discount rates reflecting the 'moderate risks' associated with developing the product and introducing it to overseas markets of 20 per cent to 30 per cent (13.4 per cent to 20.1 per cent after tax). Even be it evidence was tendered to the effect that the setting of a discount rate is a subjective exercise, criticism was made of Dr Venning in that the figures used by him were said to have been 'much too optimistic' in that one valuer (Mr Lonergan) had suggested a range of 35 to 50 per cent and another (Mr Banks) approximately 19 per cent. Professor Officer did not carry out a valuation but spoke of a discount figure of 30 per cent. Out of all this arose the contention that Dr Venning was so over optimistic as to the probability of the product's success that a Tribunal of fact could only conclude that the figures he used were influenced by the results he was asked to achieve. This Dr Venning strongly denied.

21. It seems to me that not only did Dr Venning use and rely upon the figures supplied to him by the Applicant but that the explanation given by him in his report for relying on them was open to him. Dr Venning placed a value on the core technology in the range of $2.6 million — $3.6 million stating that it was 'fair and reasonable for the syndicate to attach a figure of $2.6 million to the core technology' (Exhibit O/64). It attached a figure of $2.4 million.

22. Dr Venning in his oral evidence said that he received a letter of instructions (Exhibit P) on 30 May 1994 following which he prepared preliminary material based on information received by AusAsean from the Applicant, attended the Applicant's premises and had a discussion with the Applicant on 24 June 1994 seeking such information for the report on that day as was made available to him. His report was finalised a few days later. A basis for his report was that the transformer embodying the core technology was 'a product that had been and was accepted in the market place'. It was not to be breakthrough research. It was to be only a one year program and the chief researcher, the Applicant, 'knew where he hoped to be. It was design and production. For a one year program a major breakthrough in the area was not needed'. The task, Dr Venning said, was inter alia to 'assess whether the task could be completed in one year at a cost of approximately $1.3 million'. In looking at the commercial risks he noted acceptance in the market, past performance and the way in which the product was widely seen by reason of awards won. He did say that it was not easy 'to get a lot of information out of the Applicant'. Subject to assessing their reasonableness he accepted the figures that were given to him. From his own experience and what he was told, he expected 'the product project to be achieved'. A significant figure, 'a yard stick' in his valuation, was the expenditure incurred by the Applicant in generating the technology and the know how associated with the development of the multipurpose loading platform, the in-house knowledge which was given to him by the Applicant as 'at least $2.15 million'. The amounts spent to date were thus relevant to the valuation.

23. Dr Venning's overall impression of the Applicant and its managing director was that they 'were quite bullish, their expectations were high'. He was also fortified by the fact that the technology had a value by reason of the past success of the Applicant and its managing director.

24. The Tribunal accepts the evidence of Dr Venning. He supported his assertions with rational explanations. The more he was questioned the more persuasive were his answers.

25. It was the report by Mr Lonergan of Price Waterhouse Coopers, Chartered Accountants, of 1 December 1999 assessing the 'fair market value of the Core Technology as at 27 June 1994 to be zero' (Exhibit S) that laid the foundation for an initial submission of the Applicant. Mr Lonergan in his oral evidence before the Tribunal took issue with conclusions drawn by Dr Venning, tending to minimise past success of the Applicant and its managing director and saying that 'value is to be determined by future benefits to be generated'. He spoke of removing 'the optimism of the developer' and criticised various percentages used by Dr Venning. He was aware of reports by Mr John Banks and Professor Officer, which were critical of his own report and in cross examination (page 458 of the transcript) said:

'Mr Quinn: In the business of valuation there are always — there is always scope for alternate views; is there not? — Yes.

> And in fact the reports of Professor Officer and John Banks provide alternate views? — Yes
>
> And are you aware as to whether there was a committee formed to consider all reports, including your own, the Banks' report, and the Professor Officer report? — I don't know the answer to that question.
>
> One particular factor would be — in considering valuations would be whether the technology already had a presence in the marketplace? — Yes
>
> And the position of the inventor, say, working in the garden shed on an invention and the position of an inventor who was established in the marketplace, had a track record, had successfully commercialised inventions, they are considerations as well, are they not? — Yes
>
> And if it was — and I think you would agree that if there was a tax break which was available to IMB by reason of deductions, that is a factor which could affect valuations of core technology? — It could.
>
> I think the Banks' report considered that the valuation should fall within a range between a fair market value and a market value where the buyer had special interests? — Yes
>
> And that was a view taken by John Banks? — Yes'

26. Mr John Banks provided two reports (Exhibit 48) on the syndicate and the licence attributable to the core technology. He is a Chartered Account and a consultant with KPMG in Forensic Accounting. In his report of 30 March 2001 he stated:

'… It is my opinion that the value range of $(472,510) to $164,848 determined in the PwC Valuation for the Core Technology acquired by the [Applicant] R&D Syndicate is inappropriate and the conclusion that the Core Technology as at 27 June 1994 had a zero value is significantly flawed.

It is my view, based on the available data, that the valuations should fall within the following ranges for a 'fair market value' ('FM Value') and a fair market value where the market consists of buyers with special interests ('SFM Value') (see Section 5 for detailed explanation of SFM Value) after adopting the PwC market share and the 7 per cent royalty rate:

	FM Value		**SFM Value**	
	Tax deductions claimed immediately earned		**Tax deductions claimed as income available**	
	60 per cent	**80 per cent**	**60 per cent**	**80 per cent**
	Success rate	**Success rate**	**Success rate**	**Success rate**
	$000's	**$000's**	**$000's**	**$000's**
7 year life				
Low (20% discount rate)	500	974	1,166	1,599
High (16% discount rate)	877	1,438	1,373	1,877
12 year life				
Low (20% discount rate)	939	1,559	1,605	2,184
High (16% discount rate)	1,404	2,149	1,983	2,690

27. It is not necessary for me to do other than note the areas in which Mr Banks differed with Mr Lonergan. This I have done. It is relevant to note that uppermost in Mr Banks' valuation was that *'it is clear that [the Applicant] had the ability to research, develop and commercialise products similar to the subject product'*. He further expected *'that a valuer in June 1994 would have assessed the probability of success highly and likely to be greater than 80 per cent'* (Exhibit 48, Report 29 April 2002 page 3).

28. Mr Banks noted the commercial success achieved by the Applicant prior to June 1994 with patented products. This would impress him as a valuer he said, and encourage him to pay heed to what he would have been told by the Applicant. The project was to be short term and on the basis of such success and information supplied the probability of further success was enhanced. The product, he noted, put together component parts, which had been developed over a period of time and patented.

29. Professor Officer conducted a critique of the Lonergan Report, mainly restricted to the valuation methodology used, and a commentary on that of Mr Banks. After noting that Dr Venning *'relied heavily'* on the managing director of the Applicant for technical advice, Professor Officer noted the advantages accruing to an investor from investment in R&D projects and this undoubtedly being a relevant factor. He was critical of various basis used by Mr Lonergan and queried some of his findings. He concluded by saying that the criticism by Mr Banks of the Lonergan valuation was reasonable. He noted that Mr Banks was influenced by the Applicant's *'position in the market and its clear expertise in the product area for which the Research and Development is to be carried out'* (Exhibit 42). He would have sought as much corroboration as was possible. He discussed the use of tax losses (would have increased Dr Venning's valuation), commercialisation, risk factor, discount rates, royalty rates and the reliance that would be placed on the researcher (the Applicant) for the provision of information.

30. On the basis of the material tendered before the Tribunal and after considering the matters above discussed, I am satisfied that the licence of the core technology had a true value and I see no reason for finding that the valuation of Dr Venning was other than one open to him on the basis of the material provided and the conclusions that were properly drawn. The Applicant concurred in the provision of information and was an active participant in it being so provided.

31. The licence agreement was not a sham. Both parties intended for there to be a licensing of the core technology for its use in advancing the project and for a consideration of $2.4 million. A valuation of $2.4 million was a proper and true valuation. This is so even if other valuers would

arrive at a different figure either more or less. It was based on information provided to Dr Venning. The assumptions made and conclusions reached in aid of arriving at the valuation were properly available to a competent and objective valuer. There was not a *'windfall gain'* to the Applicant.

…

37. I do not accept a submission made on behalf of the Respondent that the managing director was engaged in acts of duplicity referable to disclosure in the project schedule or he 'falsely allowed' a suggestion as to the stage of development of the retractable platform to remain in the documentation. He may have been overly enthusiastic or optimistic as to the transformer. If there were errors at this time, I am satisfied that the representations were not made with any intent to deceive. Likewise market projections and expectations as to market share taken up by Dr Venning may well have been based on optimistic expectations, but honestly made.

…

84. It is contended on behalf of the Applicant that the real value of the licence was less than $2.4 million and the difference between the real value and the $2.4 million was paid in order to maximise the claimable tax losses of Lafoten and IMB Limited. The assessable income arising from payment of the licence fee was limited, it is said, to the real value of the licence. The additional amount was not income assessable to the Applicant.

…

87. This contention is basic to the argument referable to the reasonableness of the Venning valuation. Reliance is placed upon the commentary on the valuation made by Mr Banks (Exhibit 48, pages 2-3) and the cost of capital being adjusted so that any valuation made by Professor Officer would be less than that of Mr Banks (Exhibit 42).

88. It is of note to mention the evidence of the managing director of the Applicant in paragraph 8(b) of his statement of 4 February 2005 (Exhibit J) where he says that 'accordingly I did not consider the amount of $2.4 million extraordinary', this in the context of the Applicant group of companies at that time being involved in 'deals worth millions of dollars' and having sold a patent in 1989 for $3.25 million.

89. For the reasons earlier given when considering the valuation of the licence of the core technology, the Tribunal is satisfied that a valuation of $2.4 million for the technology licence was open to the parties to accept. The real value of the licence was not significantly less than a value of $2.4 million.

4.177 On 13 December 2005, the Commissioner issued PS LA 2005/24 which provided the policy and procedures to implement his 15 April 2004 announcement in relation to providing taxpayers with an opportunity to be heard at the Part IVA Panel. It outlines the procedures that govern the period of time that is given to taxpayers, the material they are provided and the limits of their involvement in the Part IVA Panel meeting.

4.178 On 15 December 2005, the Solicitor-General and Australian Government Solicitor's Chief General Counsel gave a joint opinion to the Tax Office on providing administrative guidance on following judicial decisions:

13. We consider that, in order to resist accusations that the Tax Office is disregarding judicial decisions contrary to the rule of law, it is important that, if the Tax Office considers that a decision is wrong, it should as soon as possible put those affected on notice of this view. It should only seek

> to challenge an earlier decision where it has legal advice to the effect that the decision is wrong. To avoid criticism it will also normally be appropriate, if the Tax Office launches a challenge to the earlier decision, to fund or organise suitable assistance to bring a test case. Pending the outcome of such a decision, other taxpayers affected should be informed of the proposed course of action. [Inspector-General of Taxation's Report on the Review of Tax Office Management of Part IVC litigation, page 249.]

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4.179 On 16 January 2006, the Solicitor-General and Australian Government Solicitor's Chief General Counsel gave a joint opinion to the Tax Office on providing administrative guidance on following judicial decisions:

> 2. … Clearly, it is not appropriate for the Tax Office to seek to challenge a particular interpretation of the tax laws adopted by a court or tribunal just because, as a matter of policy, it considers it wrong or undesirable. If that is the basis for concern then the appropriate approach is to change the tax law. However, if the basis of the Tax Office's attack on an earlier decision is that as a matter of law it is wrong, then our earlier advice indicated that it was proper for the Tax Office to seek an appropriate vehicle in which to test that issue. However, it should, among other things, before making a decision to do that have legal advice that supports the argument that the decision is legally wrong. …
>
> 5. It is important in this regard to distinguish between the policy decision to pursue a challenge to a legal decision and the provision of legal advice to support that decision. Normally, a policy decision will need to be made at an appropriately high level within the organisation reflecting the nature of the decision, the likely impact that the challenge to an earlier decision may have on other tax payers and broader tax policy. In making the policy decision, legal advice supporting a challenge is an important element but not the only element to be considered. The legal advice is concerned only with whether there are reasonable legal arguments for a particular interpretation which justify an attack on a previous decision that, for probably good reasons, was not appealed from at the time. The policy decision needs to consider broader issues. For this reason, it will usually be undesirable for the legal advice to be given by the person making the policy decision.
>
> 6. In many ways the decision to challenge an earlier decision is not that dissimilar to the decision that might have been taken when the original decision was handed down as to whether an appeal should be pursued. The Legal Services Directions require that an appeal not be pursued unless an agency believes that it has reasonable prospects for success or that the appeal is otherwise justified in the public interest. For that purpose legal advice is obtained. It may be that at the time of the original decision the factual or other circumstances did not make an appeal appropriate. It seems to me, however, that the same burden needs to be met where an earlier decision is to be challenged in another case. The legal advice obtained for this purpose needs to be sufficiently robust and credible to ensure the decision can be seen as consistent with the same principles as determine whether an appeal is justified. Beyond that it does not seem to me necessary or appropriate to try and be prescriptive as to the precise form that any legal advice to support an attack on an earlier decision should take. [Inspector-General of Taxation's Report on the Review of Tax Office Management of Part IVC litigation, pages 252-255.]

4.180 As at 4 April 2006, 15 investors (investments in 30 syndicates) had settled with the Tax Office or agreed on settlement terms. One investor also had other investments under review. Ten investors (investments in 14 syndicates) had satisfied the September 2004 guidelines. Four investors had other investments under review. One investor also had an investment which was settled. Twenty-two investors (investments in 32 syndicates) had investments subject to an unfinalised review.

4.181 As at May 2006, the Tax Office had only amended assessments in two syndicates without first concluding settlement negotiations.

4.182 In early November 2006, the Tax Office notified an investor representative that it would not pursue a claim. No reasons were given:

> Dear [investor's representative]
>
> I refer to the letter which issued from this office [of the kind reproduced to paragraph 4.173 above] and subsequent correspondence in connection with the investment by [the investor] in [the syndicate].
>
> I am writing to advise that the ATO will take no further action in connection with the participation by [the investor] in this arrangement.
>
> Yours faithfully

4.183 The Tax Office decided not to pursue this claim on the basis that the TCC had scrutinised the core technology valuation during registration.

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4.184 The following table provides the status of the Tax Office's review of R&D syndicate claims as at 5 February 2007. It focuses on those 40 investors who had invested in syndicates with $10 million of core technology and invested more than $3 million in any of those syndicates.

Status of Tax Office reviews as at 5 February 2007

Status of investors' investments	Number of investors	Number of investments
All settled	14	25
All satisfied guidelines or otherwise 'NFA'	11	14
All under review	6	7
Some settled, some satisfied guidelines	6	23
Some satisfied guidelines, some under review	3	10
TOTAL	**40**	**79**

4.185 The following table is from DITR and shows the number of syndicates registered and amounts claimed by financial year.

Total registered syndicates

Period	No. of syndicates	R&D ($m)	Core Technology ($m)	Total ($m)
1989–90	7	120	72	192
1990–91	11	101	110	211
1991–92	24	202	185	387
1992–93	37	287	250	537
1993–94	30	131	211	342
1994–95	49	285	553	838
1995–96	74	320	643	963
1996–97	12	101	164	265
1997–98	1	4	3	7
1998–99	1	2	2	4
Totals	246	1,553	2,193	3,746

APPENDIX 1 — TERMS OF REFERENCE

In accordance with subsection 8(1) of the *Inspector-General of Taxation Act 2003*, the Inspector-General conducts the following review on his own initiative.

1. Within each and across all the following three case studies the Inspector-General will identify issues which, when addressed, will improve the Tax Office's handling of major, complex issues into the future:

- research and development syndication arrangements
- Living Away From Home Allowances (LAFHAs)
- service entity arrangements.

2. Each case study will focus on:

   (a) the timeframes to identify and deal with the issue;

   (b) the nature and cause of those timeframes, and if they were reasonable in the circumstances;

   (c) the extent and cause of uncertainty to affected taxpayers, including any initial Tax Office guidance or representations;

   (d) the Tax Office's approaches to the issue, the reasons for them, and if they were reasonable in the circumstances, including:

      (i) its compliance, legal and resolution approaches; and

      (ii) its communications with members of the community; and

   (e) the adverse impacts and costs that the Tax Office's approaches and timeframes may have had on businesses and other areas of the community.

APPENDIX 2 — PUBLIC REFERENCES

Parliamentary and ministerial papers

Costello, P (Treasurer) and Moore, J (Minister for Industry, Science and Tourism) 1996, 'Government closes R&D syndication', media release, Parliament House, Canberra, 23 July 1996.

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Australian Taxation Office 1991, *Taxation Ruling IT 2635*, Australian Taxation Office, Canberra.

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Australian Taxation Office 2005, *Consolidation and market valuation*, Australian Taxation Office, Canberra.

Australian Taxation Office 2005, *Practice Statement PS LA 2005/24*, Australian Taxation Office, Canberra.

Australian Taxation Office 2006, *Practice Statement PS LA 2006/8*, Australian Taxation Office, Canberra.

Australian Taxation Office 2006, *Large business and tax compliance 2006*, Australian Taxation Office, Canberra.

Carmody, M 2004, *The art of tax administration: two years on*, address by the Commissioner of Taxation to the sixth international conference on tax administration, Sydney, April 2004.

Other Official Papers

Auditor-General 1993, *Audit Report No.12 1993-94: Administration of the taxation incentive for industry research and development*, Australian National Audit Office, Canberra.

Boucher, T 1996, 'Current issues in R&D syndication', address by the Chairman of the Tax Concession Committee to the Conference on R&D Innovation Statement & Finance Scheme Guidelines, Sydney, 21 March 1996.

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Bureau of Industry Economics 1994, *Research report 60, Syndicated R&D: an evaluation of the syndication program*, Bureau of Industry Economics, Canberra.

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Industry Research and Development Board 1995, *Industry Research and Development Board Guideline – finance schemes*, AusIndustry, Canberra.

Inspector-General of Taxation 2005, *Review into the length of time to complete Tax Office active compliance activities*, Inspector-General of Taxation, Sydney.

Inspector-General of Taxation 2006, *Review of Tax Office management of Part IVC litigation*, Inspector-General of Taxation, Sydney.

The Treasury 2004, *Report on aspects of income tax self assessment*, Commonwealth of Australia, Canberra.

Court cases

Zoffanies Pty Ltd and Commissioner of Taxation [2002] AATA 758.

Federal Commissioner of Taxation v Zoffanies Pty Ltd 2003 ATC 4942.

The Taxpayer and The Commissioner of Taxation [2005] AATA 1039.

APPENDIX 3 — TAX OFFICE SUBMISSION

Australian Government
Australian Taxation Office

Mr David Vos
Inspector-General of Taxation
GPO Box 551
Sydney N.S.W 2001

Dear David

<u>Research and Development (R&D) Case Study</u>

Thank you for the final draft report on the case study. Our response to the report is enclosed.

As mentioned in your letter to the Commissioner, the report refers to the mediation which was subject to a confidentiality agreement between the Tax Office and the other party. I understand from your officers that the other party has indicated agreement to the publication of the mediation material which was in an earlier draft of your report. Provided the other party agrees to the publication of the relevant material in your final report, the Tax Office will also agree to its publication.

Yours sincerely

Kevin Fitzpatrick
Chief Tax Counsel
13 April 2007

REPORT: RESEARCH AND DEVELOPMENT (R&D) CASE STUDY

I refer to the final draft report on this case study**.**

It is evident from the report that R&D syndication has been a very complex issue. It has raised some very difficult issues for the Tax Office including in particular questions about the valuation of core technology.

As you have concluded, the 'Tax Office was right to be concerned about compliance in this area and exploitation has been identified by the Tax Office in a number of cases'. This concern is reflected in the fact that over $140 million has been raised to date as a result of non-compliance by 19 taxpayers.

While it is clear that the Tax Office had to address non-compliance by some taxpayers who sought to exploit the concession provided in the law to encourage R&D, it is equally clear that the finalisation of the Tax Office compliance action has taken too long.

I also accept the conclusion in the report that the Tax Office's communication with affected taxpayers was not always effective and could have been better.

As noted in the report, there have been a number of changes to tax administration since the R&D syndication issue commenced. As a result of those changes, it is clear that many of the adverse findings in the report would not arise today. In other words, the improvements identified in the report have largely been implemented.

This particularly applies to the timeframes for finalising audit action, the ability to provide rulings and other guidance on valuation issues and improved communication with taxpayers. This is rightly recognised in the report.

While we accept some of the report's conclusions, there are others which we do not accept. In our view they are not soundly based and, at least to some extent, result from a misunderstanding of the facts. This is probably not surprising because the R&D syndication issue is very complex. Despite our best endeavours during the course of the review to clearly explain the facts and circumstances and respond to issues and assertions raised, the draft report contains some factual errors or omissions. A summary of key factual errors and omissions is set out in an attachment to this letter.

Inspector-General's comments on the Tax Office's submission

The Tax Office fully accepts that the finalisation of its compliance action has taken too long and the communication with affected taxpayers could have been better. It also fully accepts 7 of the 10 conclusions in the report.

However in relation to the conclusions with which it does not fully accept, the Tax Office submission appears to focus on the final stages of its resolution with somewhat of a blind eye to the prior 10 years. In some places it truncates the facts to the point of misrepresentation, perhaps a result of trying to achieve brevity. The Tax Office submission also gives a misstated view of the facts. In relation to the gratuitous implication that the facts have been misunderstood because the issue is complex, I have examined the key 'factual errors' attached to the submission. Most are not errors but re-statements of the Tax Office's perspectives. None are material to the conclusions. Critically, the submission does not address the substantive issues identified in the report. In my view, the submission does nothing to dispel the conclusions drawn in the report.

The Tax Office also appears to infer that the problems encountered in its handling of R&D syndication would never arise again because the improvements I have identified in the report have since been implemented. Although many improvements have been made to tax administration since 1991, I do not agree that my finding can be so stretched to conclude that the adverse findings in the report would not arise today. In fact, some of the adverse findings relate to recent and continuing conduct — for example, the Tax Office's continuing failure to communicate adequately with taxpayers on issues that are critical to their claims and its continuing unchecked culture. Further, in Chapter 3 at paragraph 3.119, I have signalled many areas in need of further improvement. In particular, there is still a major systemic gap with the mechanisms to trigger involvement of top management in complex issues experiencing delays, rather than relying on 'bottom-up' escalation processes. I intend to discuss the possible improvements in these identified areas further with the Tax Office in the process of finalising the fourth report on this review.

I have inserted comments in the text below on the specific matters raised in this submission to reduce duplication and the length of the report.

I now turn to those conclusions which we do not fully accept.

Conclusion 3: The Tax Office took far too long to give practical guidance.

As noted in the report, the Tax Office issued a public ruling, IT2635, in 1991 which drew attention to key considerations on arm's length values for core technology. That ruling provided guidance to potential investors in R&D syndicates on the application of the relevant provisions of the tax law. The discussion in the ruling on the arm's length price for core technology was also relevant to the enactment later in 1991 of the specific anti-avoidance provision dealing with arm's length dealings.

It should also be recognised that investors involved in R&D syndicates were sophisticated taxpayers with professional advisers. They would have been well aware of the hallmarks of a dealing entered into on an arm's length basis.

While reasonable views can differ on the sufficiency and appropriateness of guidance on issues, given the nature of these arrangements it is difficult to understand what further practical guidance should or could have been provided before arrangements were entered into by syndicate investors.

Inspector-General's comments on the Tax Office's submission

The Tax Office submission indicates that its public ruling IT2635 gave adequate practical guidance and that the Tax Office could do no more. It also implies that the Tax Office is absolved from the need to provide clear guidance where, in its view, taxpayers are sophisticated or the Tax Office assumes they are well aware of the implications. Both of these propositions are highly contestable.

In relation to what more the Tax Office could have done, the Tax Office ignores the fact that there was considerable uncertainty around this issue very early on. In fact, another Government body publicly recommended that the Tax Office remove this uncertainty in 1994. The Tax Office ignored this recommendation. The TCC (the other body administering the R&D tax concession) gave syndicate applicants practical guidance in late 1995 and publicly announced this guidance in early 1996. The Tax Office failed to provide practical guidance until late 2004. Further, the Tax Office provides practical guidance on many other areas of emerging compliance risk. If the Tax Office is suggesting that there is no need to provide practical guidance on how to comply in relation to complex matters until arrangements are entered into then this, of itself, would indicate a major systemic tax administration issue.

In relation to being absolved of the need to provide clear guidance where taxpayers are sophisticated, the Tax Office ignores the private binding rulings and advance opinions requested by most, if not all, syndicate participants. If the Tax Office is suggesting this proposition as a point of principle then it would run counter to its cooperative compliance approach to large business. One expects large taxpayers' requests for Tax Office certainty to be made in complex matters — failure to do so would risk protracted and unnecessary disputes where contrary views are taken by the tax administrator many years after the fact. In the case of R&D syndication, the consequence of the Tax Office not providing practical guidance earlier was to extend the resolution of this compliance issue for more than 15 years and impose tens of millions of dollars of compliance costs on the investors concerned and the community generally.

I have flagged this issue in Chapter 3, paragraph 3.119 of the report as an area that may be the subject of further recommendations in my fourth report on this review.

Conclusion 7: Unchecked cultural influences of 'hitting tax abuse hard'

The Tax Office does not accept this conclusion and some of the findings in this section of the report.

There are factual errors or omissions in the report which impact on the conclusion. There are also misleading inferences in the report.

For example, at paragraph C7.8 of the report, it is stated that the Tax Office has disregarded the mediator's advice and commented that the mediator's advice on the relevant tax law provisions was unrealistic. This is not correct. The evidence referred to in the report to support the assertion that we have disregarded the mediator's advice is a reference to an internal Tax Office report in respect of a particular case. The views expressed in the quoted extract from the report were not accepted by senior tax officers as the correct conclusion. Importantly, the views in this internal report were not conveyed to the taxpayer.

The circumstances and outcome of this particular case are much different to what is inferred in the report. The Tax Office accepted the advice of the mediator in finalising its position in respect of this case.

At no stage during the course of this review did the Tax Office state, or hold the view, that the mediator's advice was unrealistic. The evidence clearly points to a contrary conclusion. Following the mediation we have applied the guidelines, which were settled by the mediator, in finalising cases. In doing so, we have been guided by the advice provided to us by the mediator.

Inspector-General's comments on the Tax Office's submission

The Tax Office submission accepts that it took too long to resolve this matter, but it makes no attempts to address my conclusion on why it took so long. My conclusion here is that a Tax Office cultural view that investors in R&D syndicates were all tax abusers (while an appropriate stance where justified) continued unchecked in its handling of the matter for many years and was a major factor in delaying resolution. Stakeholders recounted much Tax Office conduct, prima facie, evidencing this attitude. The Tax Office itself demonstrated orally and in writing an attitude of hitting tax abuse hard, even where 'tax abuse' was not established. By 2004, the impact of this attitude had been felt strongly. Even now there is clear evidence that this attitude continues to exist. This has been made clear in written responses to this review.

Notwithstanding the Tax Office's choice to focus on later events in its submission, I have updated paragraphs C7.8.1 to C7.8.5 of the report to substantiate further our views on the points raised by the Tax Office in its submission on this conclusion.

The Tax Office also makes some unfounded assertions in its submission on this conclusion, assertions that I must correct. I have inserted my comments on these assertions in the text below and in the attachment to this submission.

While it is clear that the finalisation of the Tax Office compliance action has taken too long, the report's finding that we took far too long to objectively reassess our view and were eventually forced to do so indicates a misunderstanding of the facts.

The Tax Office views about syndication arrangements prior to the mediation were formed after audits of a range of cases and having regard to valuation advice from qualified valuers and legal advice from external counsel. It was clear to us that the application of the relevant anti-avoidance provisions in these cases depended on the particular facts including assessments by valuation experts. The legal advice we received supported this view.

Prior to the AAT decision in the *Zoffanies* case, we were approached by taxpayer representatives to enter into mediation as a means to help resolve cases rather than protracted case by case litigation. We agreed to the mediation. It was always our objective to test our views of the application of the law through the mediation. The agreed objectives of the mediation were 'to determine guidelines for reviewing research and development syndication arrangements'. The report is wrong in stating that 'the Tax Office was eventually forced to objectively reassess its view'.

Inspector-General's comments on the Tax Office's submission

The Tax Office submission on this point misrepresents the course of events and is contrary to the Tax Office's previous statements that it was its intention to test its views through litigation. The agreed facts are set out in Chapter 4 in some detail. In summary, the Tax Office agreed to mediate with an investor before the AAT decision in the Zoffanies case. However, this investor pulled out of negotiations because the Tax Office continued to pursue litigation and refused to provide adequate reasons for its decision in denying the deductions. From March 2001 through to July 2003, the Tax Office also expressly decided not to pursue mediation until it had conducted litigation so that the Tax Office would 'be in a stronger position to achieve resolution on other cases on an acceptable basis to the Tax Office' (see Chapter 4, paragraphs 4.90, 4.92, 4.101-4.103, 4.107 and 4.112-4.114). When litigation failed to achieve its purpose of strengthening its position, the Tax Office entered a mediation agreement in July 2003. This was well after the AAT case and only after the Tax Office abandoned its appeal on the AAT's findings on the specific anti-avoidance provision. The issue is discussed in Chapter 3 at paragraphs C7.17 and C7.18.

In finalising cases since 2004 the Tax Office has taken into account the outcomes of the mediation as well as the *Zoffanies* decision.

The report comments that the Tax Office should have published not only the guidelines which were settled by the mediator but also further information contained in the mediator's report to the parties involved in the mediation. We do not agree with this view. The mediator's report was in respect of the particular syndicate which was the subject of the mediation. In accordance with the mediation agreement, the mediator's report to the parties remained confidential between the parties and the relevant investors. The mediator's report had a different purpose to that of the guidelines.

Inspector-General's comments on the Tax Office's submission

The Tax Office infers that the confidentiality clauses did not allow it to provide further guidance. This assertion is already considered in Chapter 3 at paragraph C7.26. In relation to the alternative Tax Office argument of the purpose of the guidelines and the report, I have updated the report to reflect this additional Tax Office submission in paragraph C7.26. The specifics of the mediator's report provided a line of thought of general application to the application of other R&D syndication cases. Notwithstanding who was responsible for settling the guidelines or the purpose of the advice the mediator gave, the Tax Office remained responsible for clearly articulating its forward compliance approach. There was also nothing preventing the Tax Office from publishing this further guidance in addition to the guidelines coming out of the mediation.

As I noted earlier, reasonable views can differ on the sufficiency of guidance on issues. It was our view that the published guidelines provided clear guidance to investors on how the Tax Office would determine whether the relevant anti-avoidance provisions would be applied to reduce claimed deductions.

In the light of the published guidelines I find it difficult to understand how investors would have been left with the impression that the Tax Office would continue to value core technology in accordance with our previous approach. In no case was this approach adopted following publication of the guidelines.

Inspector-General's comments on the Tax Office's submission

This difficulty in understanding how investors would be left with the impressions mentioned above is contrary to evidence that senior officers were made well aware of these impressions in October 2004, around one month after the guidelines were published. I have updated the report to reflect this additional Tax Office position and contrary evidence in paragraph C7.27.

Conclusion 10: In some cases the Tax Office acted unfairly

We do not accept that we acted unfairly in some specific cases. Cases which have been settled were done so on the basis that deductions claimed were excessive in accordance with the law.

In relation to those seven syndicates referred to in the report which were subject to additional scrutiny by the Tax Concession Committee (TCC), the Tax Office has not made adjustments to the claimed deductions because we were not satisfied that the amount paid by each investor for core technology was greater than an arm's length amount. In coming to this conclusion, the additional TCC scrutiny was one of the factors taken into account.

The report discusses three cases in some detail. Unfortunately, the report contains some factual errors concerning these cases. These errors are corrected in the attachment.

In a further matter, the report makes some adverse findings and also a recommendation concerning two investors who 'settled with the Tax Office while the Tax Office was involved in the mediation' (see paragraph C10.1.21). The facts outlined in the report concerning these two cases are, in our view, misleading for the reasons detailed in the attachment.

I also point out for completeness that a further four cases were settled during the course of the mediation. I understand that the investor representatives in these cases were aware of the mediation but wished to finalise settlements on behalf of their clients.

Inspector-General's comments on the Tax Office's submission

The Tax Office submission disputes only a few of the areas of unfairness identified in this conclusion. However, conclusion 10 extensively considers other cases dealing with a range of behaviours in the handling of this protracted issue, ranging from the lack of adequate procedural fairness to inconsistent treatment. It is a much wider range than the Tax Office deals with in its submission on this conclusion.

The Tax Office refers to the seven cases registered after the TCC announced it would give additional scrutiny to core technology valuations. The TCC did this to address the risk of overvaluation. The issue is that taxpayers would have relied on the additional TCC scrutiny as giving them assurance that the Government considered the core technology prices were not overvalued. Whether that scrutiny actually occurred or what form it took is a subsidiary issue, given that more than 10 years have passed since the syndicates were scrutinised. The Tax Office appears also to submit that because no adjustments were made to these taxpayers' claim they were treated fairly — alls well that ends well. This does not address the unfairness identified in the report. Regardless of the outcome of the case, the fact that the Tax Office did not tell investors that TCC scrutiny was a determinative factor was, of itself, unfair.

The Tax Office submission of 'factual errors' 'omissions' and 'misleading inferences' (sic) is addressed in detail in the attachment.

Recommendation

The Inspector-General recommends that the Tax Office fully reconsider whether it has fairly struck settlements with:

(a) the 19 investors that it did not formally advise that their investments made more than eight years previously would be subject to review; and

(b) those investors with whom it negotiated settlements without telling them that at the same time it was mediating a case to develop guidelines for the resolution of R&D syndicate cases.

Response

In relation to the 19 investors mentioned in paragraph (a), it should be noted that settlements have been made in respect of only 6 cases with another 3 cases yet to be finalised. In the remaining cases, adjustments have not been made to claimed deductions.

The Tax Office accepts that it would have been better if direct contact was made with these investors earlier. However, it is our view that most, if not all, of those investors and their advisers would have been aware of the Tax Office's ongoing review of R&D syndication arrangements.

In the small number of these cases where adjustments have been made, the settlements were entered into in good faith and were based on the fact that the deductions claimed by investors were not fully allowable under the law. To unwind these settlements for the reasons suggested in the report would raise questions of fairness to other taxpayers who have complied with their tax obligations under the law. It would also raise questions of fairness to other taxpayers who have settled or otherwise finalised assessments in circumstances where the Tax Office has reviewed old issues, for example, loss company cases.

It should also be noted that in reviewing these cases the Tax Office did take into account the length of time since the transactions took place in considering our position and the terms of settlement in each case.

In response to the cases settled during the course of the mediation mentioned in paragraph (b), each case was settled at a time when the Tax Office had not contemplated making a general settlement offer. This offer was considered towards the end of the mediation and was announced following the mediation. The cases were also settled before the Commissioner announced in April 2004 that the general anti-avoidance provisions in Part IVA of the Act would not be applied to deny deductions for core technology expenditure. The timing of the events relating to the two cases referred to in the report is set out in the attachment.

While not raised in the report, the overall complex and special circumstances of the R&D syndication issue may warrant that consideration should be given to reviewing any case settled on less favourable terms than the general settlement offer made towards the end of 2004. Although these cases would have been settled in good faith, there is an issue whether such investors have been unfairly disadvantaged compared to other investors simply because they chose to finalise their case in a more timely way. We will review this matter further taking into account all of the circumstances relating to these cases.

Inspector-General's comments on the Tax Office's submission

I am pleased that in the last paragraph above the Tax Office has accepted my recommendation to reconsider the fairness of some of its settlements, albeit not on the basis set out in the recommendation.

In relation to the 19 investors mentioned in recommendation (a), the Tax Office accepts that it should have directly contacted these investors earlier. But, the Tax Office fails to acknowledge as unfair the fact that it did not. It also fails to acknowledge that apart from the lack of adequate communication there were also other aspects of unfair treatment of these taxpayers. Unlike other loss company cases, it was aware of all the relevant facts before arrangements were entered (including the details of the syndication arrangements and their tax effect), it was aware that this matter was, in its view, a significant compliance issue 12 to 14 years ago, and it was aware that the losses were utilised by the investors at least eight years ago. It was aware of these matters many years before it sent the investors a settlement offer out of the blue (see paragraphs C10.3 to C10.3.5 in Chapter 3).

The Tax Office agrees that there was no fraud or evasion in these cases. In this context the Tax Office should have acted promptly within normal period for review time limits. After those periods it should have moved on, noting that in 2004 it pragmatically chose not to pursue over three-quarters of investors.

Further dialogue on these recommendations will be undertaken as part of the process leading up to the finalisation of my final and overall report on the Tax Office's ability to deal with major complex issues within reasonable timeframes.

ATTACHMENT

Summary of key factual errors or omissions

Report	ATO response	IGT comment
Page 24, Para 3.91 'The published guidelines did not disclose the factors that the mediator considered relevant in determining the arm's length amount'	This is incorrect. The guidelines which were published following the mediation were settled by the mediator following submissions by both parties to the mediator. They therefore reflected the factors and issues which the mediator considered relevant to this issue.	The Tax Office response merely re-states the Tax Office's position already set out in the report. Paragraph 3.91 is factually correct. The Tax Office does not address the key issue that it had information in its possession to give further certainty to taxpayers but did not to provide that guidance. This issue and the Tax Office's position are discussed in detail in paragraph C7.25 of Chapter 3.
Page 25, Para 3.91 The report states that other 'special characteristics of the parties' which the mediator said should be accounted for include the following factors: - the cost of development of technology - timeframes for successful development - researcher funding constraints - timing of tax benefits etc	This statement is misleading. None of the items mentioned were referred to as 'special characteristics of the parties' by the mediator. The guidelines state that the Commissioner will consider any relevant material put to him by an investor. This includes any special characteristics of the parties.	The Tax Office infers that the report misquotes or misrepresents the mediator. This assertion is unfounded because the report clearly states the factors that are distilled from the mediator's advice. Also, the Tax Office agrees that the mediator considered these factors as relevant. The Tax Office does not address the underlying issue that these and other factors (including the Tax Office intention to consider the special characteristics if raised by the investor) were not communicated to investors. This issue is discussed in detail in paragraphs C7.20 to C7.27.
Page 40, Para C7.8.1 'In applying the guidelines to a key investor's claim the Tax Office ignored the advice of Sir Anthony Mason in determining section 73B(31)(b)(ii) and 73B(31)(d) issues and continued to apply the approach that merely substituted a zero value for the investor's claimed core technology expenditure.'	This is incorrect. The ATO did not ignore the advice of the mediator in applying the guidelines. The suggested zero value was not adopted as the ATO position, nor was it communicated to the taxpayer.	I have updated the paragraph to state that the position was never communicated to the taxpayer. I have also added further material demonstrating that the Tax Office did not follow the mediator's advice in this case.
Page 41 , Para C7.8.5 'While applying the guidelines the Tax Office repeatedly stated and inferred during the review that this investor and others had engaged in tax abuse. Also during discussions, comments were made that the mediator's advice on section 73B (31)(b)(ii) (d) were unrealistic.'	This statement is incorrect. In applying the guidelines it was not the Tax Office practice to repeatedly state and infer that investors had engaged in tax abuse. We were seeking to apply the law and make adjustments to claims where, in our view, there was non-compliance with the law. At no stage has the ATO asserted that the mediator's advice was unrealistic.	The Tax Office appears to be distancing itself from comments made by tax officials orally and in writing to Inspector-General staff during the review. This Tax Office response appears to consider such comments as immaterial where it is not 'Tax Office practice'. These comments fail to consider appropriately my conclusion that an **unchecked** cultural influence of 'hitting tax abuse hard' has been a major contributing factor to why the R&D syndication issue has taken well over a decade to near resolution. I have elucidated the wording used in the report to 'Tax officials told Inspector-General staff that it was unrealistic to expect the Tax Office to follow the mediator's guidance on determining an arm's length amount because it was "not practical" to follow that advice'. The elucidation does not change the fact that in the case in question the Tax Office did not follow the mediator's advice on determining section 73B(31)(b)(ii) and (d) issues — the factors to consider in quantifying the arm's length price.

Summary of key factual errors or omissions (continued)

Report	ATO response	IGT comment
Page 54, Para C9.3 'The Tax Office did not effectively communicate its review and resolution strategies … it did not communicate its change to its long held approach to quantifying an arm's length amount following the mediation. This would have allayed investors' concerns that the Tax Office would merely continue to substitute investors' valuations with the Tax Office commissioned 'close to zero' valuations'	As stated in the report, the Tax Office disputes this conclusion. The change was communicated in the guidelines at Part C Para 6(1) which states 'the core technology licence fee is likely to have a positive value (as distinct from a negative or nil value)'.	The Tax Office response merely re-states the Tax Office's position already set out in the report. Paragraph C9.3 is factually correct. I have updated that paragraph to include evidence that senior tax officials were made well aware of investors' impressions that if they go to Part C, they 'get nothing'.
Pages 57–58, Paras C10.1.9-16	There are several factual errors in this section of the report. The facts in relation to these three cases are:	
In summary, the report concludes that three clients of an advisor were unfairly treated, as their investments were perceived to amount to 'tax abuse'.	Case 1: In November 2006, the ATO accepted that the guidelines had been satisfied. A factor taken into account was the additional TCC scrutiny of the core technology valuation.	The Tax Office appears to downplay the weight it gave this factor. The Tax Office told the Inspector-General in October 2006 that this factor was **the** reason the Tax Office accepted that the guidelines had been satisfied in 6 of 7 of these cases. It was unsure of the date on which the seventh case had its finance scheme assessed by the TCC. This was again confirmed by the Tax Office in February 2007. The Tax Office also told an investor's representative in February 2007 that this factor was 'determinative'. Now in its final submission on the report, the Tax Office, for the first time, asserts that this factor was not the key factor
	Case 2: In November 2006, the ATO had formed a preliminary view that the guidelines were not satisfied. Copies of TCC documents held by the Tax Office show TCC close consideration of some aspects of the finance scheme but no scrutiny of the core technology valuation. The statement at para 10.1.14 that 'The Tax Office had evidence that indicated the TCC may have scrutinised the initial valuation' is therefore wrong.	These comments imply that the Tax Office formed its preliminary view after considering the TCC documents. However, the Tax Office has failed to point out that it only accessed the TCC documents after the Tax Office had formed its preliminary view and only after the matter had been raised by Inspector-General staff. Until that time the Tax Office did not appear to consider as relevant documents in its possession that showed the rejection of the syndicate's finance scheme. Inspector-General staff pointed out that it would be better public administration to uncover the basis for that rejection and whether that basis was the core technology price or some other reason. This issue is discussed in paragraphs C10.1.12 to C10.1.20 in detail. The Tax Office should have determined this issue before rejecting the investor's claim. It did not. It only accessed this information when urged to do so.

Summary of key factual errors or omissions (continued)

Report	ATO response	IGT comment
Pages 57–58, Paras C10.1.9-16 (continued)	Case 3. In November 2006, the ATO had formed a preliminary view that the guidelines were not satisfied. Copies of TCC documents held by the Tax Office do not indicate any scrutiny of the core technology valuation. The statement that 'The Tax Office assumed that the TCC did not scrutinise the syndicate's core technology value because that syndicate's finance scheme was examined by the TCC shortly before the issue of the new finance scheme guidelines', is therefore incorrect. The inaccuracy of the statement is further evidenced by the fact that the core technology valuation had not even been commissioned at the time the finance scheme guidelines were approved.	I am disappointed that these additional facts have come so late in the review. It appears that the Tax Office only discovered these facts after final discussions on the Inspector-General's report. Nevertheless, these 'factual errors' do not alter the fundamental unfairness identified at paragraph C10.1.19 — that the Tax Office did not tell taxpayers before they made submissions on the issue that reliance on the additional TCC scrutiny was a factor in resolving their case. Also it was a reasonable assumption that investors who had their applications considered after the TCC announced that it would apply additional scrutiny would rely on that additional scrutiny as having been applied.
	In both cases 2 and 3 the advisor sought additional time to make further submissions and the requests were granted.	The Tax Office has failed to point out that the adviser's initial requests for additional time were declined. The additional time was given only after Inspector-General staff told the Tax Office that not to do so in the circumstances would likely be the focus of specific adverse comment in the report.
Page 60, Paras C10.1.21-22 'Two investors settled with the Tax Office while the Tax Office was involved in the mediation ... The Tax Office did not inform the investors of the mediation or its purpose … It therefore settled on an unfair basis.'	This is misleading as it omits material facts. The following events occurred: 9/3/2001 — Tax Office decision to 'continue work on leading cases through to litigation with a view to obtaining outcomes which are capable of application across the syndicate population; and mediation not to be pursued at this point.' 4/9/2002 — the AAT hands down its decision in the Zoffanies case and the ATO soon after appeals to the Federal Court; 25/7/2003 — Amendment issued to first taxpayer adjusting syndicate claims;	The facts referred to by the Tax Office are in the report, and were previously fully considered and discussed with the Tax Office in considering those issues discussed in paragraphs C10.1.20 and C10.1.21. The Tax Office appears to imply that it could not have known at the time it settled with the first taxpayer that more favourable settlement terms would be issued at the end of the mediation. However, the Tax Office submission has failed to point out key facts adverse to its position. I have inserted these opposite and highlighted them in red.

Summary of key factual errors or omissions (continued)

Report	ATO response	IGT comment
Page 60, Paras C10.1.21-22 (continued)	25/7/2003 — the Tax Office withdrew its appeal to the Federal Court of the AAT's decision in Zoffanies on the specific anti-avoidance provisions grounds 29,30/7/2003 — Federal Court (appeal) hearing in Zoffanies; 30/07/2003 — Mediation agreement entered into with a purpose to 'determine guidelines for reviewing R&D arrangements, thereby potentially removing the need for detailed syndicate audits and/or litigation'; 8/9/2003 — settlement terms agreed with first taxpayer without telling the taxpayer of the mediation or its purpose; 24/10/2003 — Federal Court outcome in Zoffanies — referred back to AAT; 10/12/2003 — settlement deed with first taxpayer signed; From 24/10/2003 to 14/4/2004 — senior officers seek external advice on the applicability of Part IVA to core technology overvaluation and recommend to the Commissioner not to apply Part IVA to these deductions; 14/4/2004 — ATO announces decision not to apply Part IVA and announces for the first time the existence of mediation and the mediation's purpose; Between 14/4/2004 and 14/7/2004 — second taxpayer becomes aware of the ATO announcement and asks ATO to hold off settlement; 14/7/2004 — ATO advises second taxpayer that ATO prepared to hold off settlement discussions until outcome of mediation; 24/9/2004 — general settlement offer made to second taxpayer; 10/12/2004 — settlement deed with second taxpayer signed.	The Tax Office's purpose for entering the mediation was to determine guidelines for the resolution of other R&D syndication cases. The Tax Office did not tell the first taxpayer it entered mediation or the purpose of that mediation. The second taxpayer became aware of the mediation through the Commissioner's 14 April 2004 announcement and asked the Tax Office to hold off finalising the settlement pending the outcome of the mediation. The Tax Office agreed to this and advised the taxpayer on 14 July 2004. It is clear that the mediation, whose output was intended to have wide application, would likely affect settlement terms for all R&D syndication cases involving disputes over core technology deductions. However, taxpayers in settlement negotiations (and taxpayers generally) were never told of the mediation or its purpose until the Commissioner's April 2004 speech, more than eight months after the mediation started. The second taxpayer who held off settlement received better terms of settlement merely by settling their case later. These facts led me to find that the Tax Office continued negotiations with, and entered into a settlement with, the first taxpayer at the same time it was developing a global policy to deal with all matters of that kind, without notice to that taxpayer. This action was not in good faith, and was unfair.