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Are Tax Schemes Legitimate Commercial Transactions? *Commissioner of Taxation v Spotless Services Ltd* and *Commissioner of Taxation v Spotless Finance Pty Ltd*

Commentary on a judgment of the Full Court of the Federal Court of Australia 27 November 1995, (reported in (1995) 95 ATC 4775)

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Income tax - tax avoidance - relationship between commercial result of a transaction and the purpose of obtaining a tax benefit in producing that result - s 177D Income Tax Assessment Act 1936 (Cth)

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1. Elements of Part IVA

{1} This case concerned Part IVA of the Income Tax Assessment Act 1936 (Cth) ('ITAA'). For Part IVA to apply there must be: a "scheme" as defined in ss 177A(1) and (3); which provides the "relevant taxpayer"; with a "tax benefit" as defined in s 177C; and a person must enter into the scheme for the "sole or dominant purpose" of enabling the relevant taxpayer to obtain a tax benefit (s 177D).

{2} If these elements are satisfied the Commissioner may cancel any tax benefit stemming from the arrangement (s 177F).

{3} As will be seen below, it is only the last element that is the subject of appeal to the High Court. Under s 177D, Part IVA only applies where, having regard to the eight factors listed in s 177D(b), it would be concluded that a person entered into or carried out the scheme for the

sole or dominant purpose of enabling the taxpayer to obtain a tax benefit. The eight factors to which reference is to be made are:

1. the manner in which the scheme was entered into or carried out;
2. the form and substance of the scheme;
3. the time when the scheme was entered into and the length of the period during which the scheme was carried out;
4. the result achieved but for Part IVA;
5. any change in the financial position of the taxpayer as a result of the scheme;
6. any change in the financial position of any person who has a connection (whether family or business) with the taxpayer as a result of the scheme;
7. any other consequences for the relevant taxpayer or any other person referred to in sub-paragraph (vi); and
8. the nature of any connection (whether family, business or other) between the taxpayer and a person referred to in sub-paragraph (vi).

{4} In Peabody v FCT (1993) 93 ATC 4104 at 4113-4114, Hill J held that "the Commissioner must have regard to each and every one of the matters referred to in s 177D (b)" when ascertaining the dominant purpose underlying the scheme. Further, the dominant purpose is to be determined on an objective basis, having regard solely to the factors detailed in s 177D (b) (at 4113). Hence, strictly, no reference should be made to the subjective motives of the taxpayer.

2. The facts

{5} The successful public float of Spotless Services Ltd left the taxpayer companies, Spotless Services Ltd and Spotless Finance Pty Ltd, with a surplus of funds, namely $40m, to invest in a suitable short term investment vehicle. An investment adviser provided them with an Information Memorandum concerning investing with a bank in the Cook Islands, European Pacific Banking Co Ltd ('EPBCL'). This Memorandum detailed a series of steps that had to be undertaken if the taxpayers wished to invest with EPBCL:

- EPBCL would approach the taxpayers, suggesting they deposit funds with EPBCL;
- the taxpayers would open an account with the Midland Bank in Singapore and another account with EPBCL's parent company, European Pacific Banking Co ('EPBC'), in the Cook Islands;
- the taxpayers would appoint an attorney in the Cook Islands with power to draw funds or cheques upon their EPBC account;
- the taxpayers' funds would be deposited in the Midland Bank account;
- the Midland Bank would then be instructed to transfer such funds to the EPBC account;
- the deposit in the account with EPBC and any subsequent deposit with EPBCL would be secured by a letter of credit issued by the Midland Bank;
- the taxpayers' attorney in the Cook Islands would then draw a cheque on the EPBC account in favour of EPBCL;
- EPBCL would issue a certificate of deposit to the attorney;
- on the maturity of the investment, the attorney would surrender the certificate of deposit and receive back the principal and interest (at a rate 4.5% less than the Australian bank bill buying rate) less Cook Islands' withholding tax at the rate of 5%.

{6} A legal opinion supplied with the Information Memorandum stated that the interest would be exempt from Australian taxation under s 23(q) ITAA as the steps outlined above would ensure that the source of the interest was the Cook Islands and hence outside Australia.

{7} The taxpayers received a telexed offer from EPBCL for the investment of their funds in the manner outlined. The taxpayer companies negotiated a higher rate of interest than that offered by EPBCL (approximately 4% below the Australian bank bill buying rate) and invested the $40m. Arrangements were made for the deposit of the $40m for EPBC with Midland and for the issue of the letter of credit. They sent one of their officers, Mr Levy, to the Cook Islands as attorney with authority to draw a cheque for $40m from the EPBC account, deposit the cheque with EPBCL and receive the certificate of deposit. On maturity, and the surrender of the certificate of deposit, the principal ($40m) and interest ($2.96m), less withholding tax, were repaid in Australia.

{8} The taxpayer companies claimed in their taxation returns that the interest was exempt from Australian tax under s 23(q) ITAA. This provision exempted foreign source income that was taxed in the source country. This provision has since been repealed. The Commissioner issued assessments on the basis that (i) the interest was Australian sourced or (ii) Part IVA applied and rendered the interest assessable. The taxpayers objected and appealed to the Federal Court from the Commissioner's refusal to allow their objections.

3. History of the case

{9} At first instance the Court ((1993) 93 ATC 4397 (Lockhart J)) held in the taxpayers' favour. He found that the source of the interest was the Cook Islands, not Australia, and that Part IVA did not apply. In relation to the latter point, Lockhart J believed the Commissioner's formulation of the relevant scheme was too narrow as it excluded integral parts of the whole arrangement and thus did not satisfy s 177A. In light of this conclusion his judgment contains little discussion of the other elements of Part IVA, in particular, the taxpayers' dominant purpose in entering into the arrangement.

{10} On appeal, a majority of the Court ((1995) 95 ATC 4775 (Northrop and Cooper JJ, Beaumont J dissenting)) dismissed the Commissioner's appeal. The majority judgment is that of Cooper J, with whom Northrop J concurred. All members of the Court agreed with Lockhart J that the source of the interest was the Cook Islands. The division in the Court stemmed from the application of Part IVA. Both Cooper and Beaumont JJ believed there was a scheme as defined in s 177A and that the taxpayers had obtained a tax benefit, as defined in s 177C, as a consequence of the scheme through the non-inclusion of the interest in their assessable income. They disagreed, however, as to the dominant purpose underlying the arrangement. Beaumont J found that the dominant purpose of the taxpayers in entering into the arrangement was to obtain this tax benefit, thereby satisfying s 177D. By contrast, Cooper J held that the dominant purpose was to "obtain the maximum return on the money invested after the payment of all applicable costs, including tax." (at 4812). Even though he found that the investment would not have occurred but for the tax benefit, Cooper J nevertheless held that Part IVA did not apply.

4. The issue on appeal: can Part IVA apply to commercial transactions based on tax considerations?

{11} The Commissioner's appeal to the High Court is confined to this latter point of the Full Court's decision. Of the issues of law stated for consideration in the Notice of Appeal ('NA') and Summary of Argument in the Application for Special Leave ('SAASL'), the essential matter for consideration is "[w]hether Part IVA can ever apply as a matter of law to a transaction where:
(a) the transaction is commercial; but
(b) the commercial attraction of that transaction is to be explained wholly or largely by the tax benefit derived by the taxpayer" (para 2 SAASL).

{12} Thus the key issue for consideration is whether s 177D would be satisfied where "the scheme is commercially advantageous to the taxpayer because it gives a higher after-tax return than the alternatives available ... [and] the after-tax return from the scheme is higher in this way solely because of the tax benefit obtained by the taxpayer in connection with the scheme" (para 1 SAASL).

{13} To evaluate the Commissioner's appeal it is necessary to first understand the divergence of approach adopted by Beaumont and Cooper JJ. (For a fuller discussion of Beaumont and Cooper JJ's judgment see Cassidy, "Have the ghosts of s 260 come back to haunt the Commissioner of Taxation?" (1996) BIFD (forthcoming)).

(i) Beaumont J

{14} While it will be seen it is Cooper J whom the Commissioner 'accuses' of not considering all of the factors detailed in s 177D(b), it is Beaumont J who only refers to one factor, s 177D (b)(ii) (at 4797). This factor directs a consideration of the form and substance of the scheme. In this case Beaumont J believed the form and substance of the scheme was to obtain a tax benefit by ensuring the source of the interest was located in the Cook Islands in order that the taxpayer might rely upon s 23(q) (at 4797).

{15} Having regard to this factor, Beaumont J concluded that the scheme was "fiscally or tax driven" in the sense that it was based on exempting the income from Australian tax (at 4797). "[T]he taxation aspects were not merely incidental or consequential ... Without the taxation benefits, the proposal made no sense" (at 4797). This conclusion was supported, inter alia, by the emphasis placed on taxation benefits in the above mentioned Information Memorandum (at 4797-4798).

{16} Beaumont J could not identify any commercial justification for the scheme:

"The interest rate was unattractive, being substantially less than the domestic rate. Moreover, there appeared to be a security risk in dealing with an off-shore, Cook Islands Bank. Hence the need to introduce security from Midland (a step not necessary if a similar domestic investment had been made). Further, the Cook Island dealings were far more complicated, time-consuming (in executive travel time) and expensive in their execution than a similar domestic transaction" (at 4797).

{17} Thus he concluded that the transaction was "an 'uncommercial' course" that entailed many disadvantages (at 4797). In light of these disadvantages it could only be concluded that the attraction to the scheme "was not its commercial attraction, but its taxation benefits. Its dominant purpose was to offer a tax advantage by combining a nominal tax regime located offshore with the operation of a 23(q)" (at 4797). Consequently, Part IVA applied.

{18} Beaumont J rejected counsel for the taxpayers' submission that "[w]hat the taxpayers did was simply to invest surplus funds in a form of investment in respect of which the ... Act provided certain consequences" (at 4798). In essence, counsel for the taxpayer had sought to rely on the 'broad' choice principle, derived from the jurisprudence of Part IVA's predecessor, s 260. This 'exempted' from the scope of s 260 transactions that merely took advantage of "tax consequences for which the Act makes provision" (Cridland v FCT (1977) 140 CLR 330 at 338).

{19} Beaumont J asserted that "as a matter of form and substance, [Part IVA and s 260] are quite different" and that a principle developed with respect to s 260 should not, therefore, be introduced into Part IVA (at 4798). Moreover, s 177B, which directed that "... nothing in the provisions of this Act other than this Part ... shall be taken to limit the operation of this Part" prohibited the use of the choice principle to limit the scope of Part IVA (at 4798). Hence, he believed counsel for the taxpayers' submission was flawed and Part IVA applied to the arrangement.

(ii) Cooper J

{20} While, as noted above, the Commissioner suggests on appeal that Cooper J did not consider each and every factor in s 177D(b), Cooper J in fact systematically referred to each of these factors (at 4810). While Cooper J found that the tax benefits stemming from s 23(q) were determinative in so far as the investment would not have occurred but for this tax benefit, he nevertheless concluded that, in light of these eight factors, the arrangement was not a sham, but rather a legitimate commercial transaction (at 4810).

{21} The arrangement allowed "the taxpayers to achieve a higher net return on the money after the payment of all costs, including tax, than the taxpayers could have obtained in Australia investing the money on deposit at the current Australian interest rates on offer" (at 4810). Tax considerations could legitimately be taken into account when making a bona fide commercial decision (at 4811). More specifically, he asserted that "[w]here the taxation rates on particular investments are different, the incidence of tax as a cost becomes one of the important matters for consideration in coming to an investment decision" (at 4811). This was, he said, no different from taking advantage of other exemptions provided for under the Act, such as the treatment of income from gold mining as exempt income under s 23(o) (at 4811). He consequently concluded that "objectively, the dominant purpose of the investor investing off-shore is [not] to get a tax benefit; the purpose is to obtain the maximum return on the money invested after the payment of all applicable costs, including tax" (at 4812).

(iii) Counsel for the Commissioner

{22} In essence, counsel for the Commissioner is arguing on appeal in the High Court that Beaumont J's, rather than Cooper J's, conclusion with respect to the dominant purpose underlying the arrangement is correct. Even if all of Cooper J's findings of fact are accepted, counsel submits that Cooper J's conclusion must nevertheless be rejected (para 20 SAASL).

While it is accepted that the taxpayers' after-tax return from the Cook Islands investment was higher than for a like domestic investment, this was only because of the difference in the tax treatment of income sourced in the Cook Islands and Australia (para 20 SAASL). Hence, while counsel accepts that the scheme had a commercial advantage for the taxpayers, that advantage depended wholly on obtaining the tax benefit (para 20 SAASL). The tax benefit is "the reason for the commercial outcome" (para 23 NA). In the absence of the tax benefit, the scheme had no commercial advantage (para 20 SAASL). In such a case, counsel submits, the conclusion should be drawn that the dominant purpose for s 177D purposes was to obtain a tax benefit (para 20 SAASL).

{23} Counsel suggests that if Cooper J is suggesting that "Part IVA could not apply as a matter of law wherever a transaction produced a commercial return irrespective of the fact that the tax benefit obtained from the transaction entered into was what made the particular transaction attractive" this approach must be rejected (para 22 NA). Section 177D cannot be answered by the taxpayer simply saying "it is clear that I did this for commercial reasons, that is to say because, if I do this I will end up richer" (para 20 SAASL). Where a taxpayer pays less tax than he or she would have otherwise, the taxpayer "will always be the richer" (para 20 SAASL). Part IVA can apply to commercial transactions that have "been entered into in such circumstance that the conclusion required by s 177D can be drawn" (para 21 SAASL). Where it is the tax benefit that makes the transaction commercially attractive, and hence is the operative factor, Part IVA should be applicable notwithstanding the commercial result (para 24 NA). Part IVA will be substantially weakened if it cannot apply to "a transaction producing a commercial return or giving effect to a commercial agreement" even though it is chosen in preference to another because the tax benefit makes it more attractive (para 24 NA).

{24} Counsel's submissions are also based on how s 177D should be approached. As noted above, counsel suggests that Cooper J erroneously only had regard to one of the factors in s 177D (b) (para 20 SAASL). Counsel also submits that both Cooper and Beaumont JJ referred to the taxpayers' subjective motive, rather than utilising an objective test (para 22 SAASL). To this end counsel contends that s 177D does not call for a conclusion of fact, but rather a conclusion of law (paras 20 and 22 SAASL). It requires "an artificial construct derived from analysis of the matters referred to in s 177D(b) and those matters only, ignoring not only [subjective] motivations but also all other matters" (para 20).

(iv) Counsel for the Taxpayers

{25} In essence, counsel for the taxpayers simply refutes the Commissioner's submissions. It is asserted that Cooper J considered all eight factors detailed in s 177D (b) and that he correctly adopted an objective test (paras 12 and 18 Summary of Respondents' Application for Special Leave (SRASL)). It is contended that the divergence in conclusions between that of Cooper and Beaumont JJ does not stem from a difference in approach but simply rests in a difference of opinion as to the factual conclusion to be drawn from the eight factors to be considered under s 177D(b) (para 13 SRASL).

{26} Counsel suggests that it is the Commissioner that erroneously fails to have regard to each and every factor in s 177D (b) (para 16 SRASL). The test as formulated by the Commissioner, it is contended, fails to do this by solely concentrating on the tax benefits as against the commercial benefits (para 16 SRASL).

{27} Counsel submitted that s 177D required the determination of a question of fact, not law, to be determined on the facts of each case (para 15 SRASL). The relevant test, it is contended, is expressed by Hill J in Peabody v FCT (1993) 93 ATC 4104 at 4118:

> "The fact that an element of that scheme had a tax advantage does not detract from the dominant purpose of Mr Peabody in relation to the scheme as a whole. The matters to which regard may be had under s 177D clearly direct attention on the one hand to the commercial elements of the scheme and on the other hand to the tax elements. They require a balancing of the two. But the factors which predominate in the present scheme considered as a whole are purely commercial."

{28} Counsel also contended that the Commissioner had misrepresented the facts. It was asserted that the "after tax return on an investment depends on the difference between interest earned and all applicable tax and other costs ... it does not depend solely on the relevant taxation regime" and hence the transaction was based on commercial concerns (para 16 SRASL).

5. Does Part IVA apply to commercial transactions?

{29} It will be readily apparent that the dispute in Spotless stems from the difficulty that tax benefits are in themselves commercial benefits in so far as they give rise to a monetary saving. It is submitted that Beaumont J's approach to this matter is to be preferred to that of Cooper J. Section 177D requires us to distinguish between tax and commercial concerns. A conclusion to the contrary would render Part IVA useless as it would never apply to commercial transactions; that is, any transaction that gave rise to a commercial return. As counsel for the Commissioner aptly asserts, "an interpretation of Part IVA that excludes its operation where the tax benefit is the operative factor in choosing one transaction over another effectively amounts to permitting taxpayers to chose whether to pay tax or not" (para 25 NA). A preferable approach will acknowledge that Part IVA may apply to commercial transactions where tax benefits are wholly or predominantly the reason for entry into that commercial transaction.

{30} As noted above, despite making rather damning findings of fact which suggest that obtaining the tax benefit provided by s 23(q) was the dominant factor underlying the taxpayers' decision to invest in the Cook Islands, Cooper J converts this illegitimate objective into a legitimate commercial concern. It is submitted that Cooper J wrongly allows the financial outcome of the scheme to dictate the conclusion required by s 177D. In accordance with counsel for the Commissioner's submissions, it is submitted that this is erroneous as it, inter alia, focuses on only one of the factors in s 177D(b), namely (viii), without reference to other relevant factors, such as (iv) and (v), that point to the tax benefits underlying the arrangement.

{31} It is submitted that this approach is not contrary to Hill J's statement in Peabody v FCT (1993) 93 ATC 4104 at 4118 that Part IVA would "seldom, if ever, ... [apply] where the overall transaction is in every way commercial, although containing some element which has been selected to reduce the tax payable." While counsel for the taxpayers suggest that the transaction did not depend solely on the tax benefits and that other costs were relevant to the decision to enter into the transaction, this does not accord with either Beaumont or Cooper JJ's findings. Tax benefits aside, there was no other costs savings. In fact it was more expensive to invest in the Cook Islands. See for example Beaumont J's conclusions at 4797. Even Cooper J's findings of fact suggest that the tax benefits were not just "some element" of

the transaction that was selected to reduce tax. He stressed that, but for the operation of s 23(q), the investment would not have occurred (at 4811). Hence the tax benefits were more than just secondary or incidental concerns. The whole arrangement was dominated by the reduction of tax.

{32} It is consequently submitted that given, inter alia, the emphasis placed in the Information Memorandum on the tax benefits stemming from the investment agreements being concluded in the Cook Islands, Beaumont J correctly held that the dominant purpose of entering into the scheme was to obtain a tax benefit. While Cooper J concluded that the overall arrangement was explicable by commercial concerns, namely investing in a manner to ensure the maximum return, as noted above, this conclusion does not sit comfortably with his damning finding that without the tax benefits provided by s 23(q) the taxpayers would not have entered into the scheme. It is consequently submitted that Beaumont J was correct in concluding that these tax considerations were not purely incidental.

{33} As to how s 177D should be approached, it is submitted that, contrary to counsel for the Commissioner's submission, the Court did not adopt a subjective test. While the pages to which counsel for the Commissioner refers contain references to "the taxpayers' intention" and "Spotless' point of view", the Court goes on to determine this intention / point of view by reference to objective considerations, such as the Information Memorandum, rather than the taxpayers' subjective evidence.

{34} Perhaps more importantly, it is submitted that refusing to consider evidence of subjective motivations is nonsensical. While the courts also held that the applicable test in Part IVA's predecessor (s 260) was purely objective (Newton v FCT (1958) 98 CLR 1 at 8; Tupicoff v FCT (1984) 84 ATC 4851) a survey of the cases nevertheless reveals a great reliance on evidence of the taxpayer's intentions. See, for example, Bayly v FCT (1977) 77 ATC 4045. It is submitted that it would be preferable to recognise the taxpayer's evidence as an obvious source of assistance, while also acknowledging that that evidence is not definitive and will be tested against objective facts.

6. Are tax considerations legitimate factors to be taken into account?

{35} It will be recalled that counsel for the taxpayers' argued before the Full Court of the Federal Court that it was legitimate for the taxpayers to take advantage of s 23(q)'s treatment of income sourced outside Australia. As noted above, this submission is akin to the 'broad' choice principle, developed in the s 260 jurisprudence, that allowed taxpayers to arrange their affairs to attract any tax concessions provided for in the Act (Cridland v FCT (1977) 140 CLR 330 at 338). This is to be contrasted with the 'narrow' choice principle which requires the Act to give the taxpayer a specific choice between two approaches before the arrangement will fall outside s 260's scope (Gibbs CJ and Wilson J in FCT v Gulland; Watson v FCT; Pincus v FCT (1985) 160 CLR 55).

{36} While Cooper J does not expressly refer to counsel's submission, it appears that he agrees with counsel's sentiments. Cooper J states that if the Act treats income differentially by, for example, exempting it under s 23(q) or some other provision of the Act, taxpayers can legitimately take that fact into account when choosing a course of action (at 4811). This

appears to echo the 'broad', rather than the 'narrow', choice principle as the sections to which he refers, ss 23(q) and 23(o), do not provide taxpayers with specific choices.

{37} It is submitted that Cooper J has wrongly reintroduced the 'broad' choice principle into Part IVA. As with s 260, this principle would render Part IVA largely ineffective. As long as the tax benefit derived from the arrangement stemmed from a provision of the Act, the taxpayer could plead that he / she was merely making use of a choice provided by the Act and hence Part IVA could not apply. Even if tax considerations provided the dominant reason for entering into the arrangement, Part IVA would be inapplicable. Such an interpretation would render Part IVA useless and was clearly not intended by Parliament. In fact, Part IVA was introduced with one of its express goals being to 'bury' the broad choice principle which had annihilated s 260. See further Case W58 (1989) 89 ATC 524 at 533; John v FCT (1989) 89 ATC 4101 at 4108; Davis v FCT (1989) 89 ATC 4377 at 4399; FCT v Peabody (1993) 93 ATC 4104 at 4110.

{38} Contrary to Beaumont J's suggestion, however, Part IVA does include a modified version of the 'narrow' choice principle (Cf Case W58 (1989) 89 ATC 524 at 536-7). Echoing the 'narrow' choice principle, s 177C (2) excludes from the notion of tax benefit the non-inclusion of income or the allowance of a deduction that is "attributable to the making of a declaration, election or selection, the giving of a notice or the exercise of an option expressly provided for by" the Act. However, as s 23(q) did not expressly extend to taxpayers a right to elect whether to have their income treated as Australian, or externally sourced, income, but rather merely specified the consequences if income was externally sourced, s 177C(2) would not be applicable on the facts in Spotless.

{39} Moreover, unlike the choice principle, s 177C(2) will not apply if the scheme was entered into or carried out to create a circumstance or state of affairs "which is necessary to enable the declaration, election, selection, notice or option to be made, given or exercised ...". Hence, unlike the choice principle where the taxpayer is protected even if the arrangement was entered into for the dominant purpose of obtaining the tax benefit, s 177C (2) will not exempt the arrangement when the scheme was entered into to enable the tax benefit to be attracted. As the taxpayers in Spotless appeared to purposely source the income in the Cook Islands to enable them to take advantage of the tax benefit s 23(q) extended, s 177C (2) would not exempt the transaction.

7. Conclusion

{40} It is submitted that the Commissioner's appeal should succeed. The dominant purpose underlying the arrangement was the attraction of the tax benefits afforded by s 23(q) within s 177D. Cooper J erroneously classified such tax benefits as legitimate commercial concerns in a manner akin to the broad choice principle - a principle which, it is submitted, finds no place in Part IVA.