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John Azzi

Solicitor of the Supreme Court, New South Wales

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Abstract

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Keywords

interest income, tax, law, tax law

Cover Page Footnote

This article has benefited from written comments by Dr Julie Cassidy, Associate Professor of Law, Deakin University

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John Azzi
Solicitor of the Supreme Court
New South Wales

This paper examines the High Court's landmark decision in *Spotless*, extrapolates principles from that decision, and applies them in searching for the real source of interest income derived from a tax avoidance scheme. It argues that the Full Court of the Federal Court was wrong in applying a form over substance approach in determining the source of interest income. The paper also focuses on the High Court's "foster and protect" doctrine, that tax laws should be applied and understood to recognise that the commercial environment is as important to a taxpayer as the economic reality of taxes. The doctrine will help to create a more flexible and effective tax system, and prevent a dangerous loss of faith in the system.

I INTRODUCTION

On 3 December 1996, the High Court of Australia (Brennan CJ, Dawson, Toohey, Gaudron, McHugh, Gummow and Kirby JJ), handed down their unanimous and succinct (14 page) decision in favour of the Commissioner of Taxation in the appeal from the decision of the majority of the Full Court of the Federal Court¹ in *Federal Commissioner of Taxation v Spotless Services*

* This article has benefited from written comments by Dr Julie Cassidy, Associate Professor of Law, Deakin University.

¹ *FCT v Spotless Services Ltd* (1995) 62 FCR 244. The Commissioner's appeal to the High Court of Australia, contended that the majority in the Federal Court (Cooper J with whom Northrop J agreed; Beaumont J dissenting), in the words of the High Court, "erred in construing or applying the provisions of Pt IVA when dismissing appeals by the Commissioner from decisions of the primary judge (Lockhart J)". The Commissioner had originally applied Pt IVA (which contains Australia's general anti-avoidance provisions), in bringing to tax an amount of interest income, A\$2,670,663, earned by Spotless Services (the taxpayer), which is an Australian resident as defined in s 6(1) of the Act. The litigation arose because, the taxpayer, in its tax return for the year ended 30 June 1987, claimed that the interest income was sourced in the Cook Islands (and subject to 5% Cook Islands withholding tax), and thus exempt from

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*Ltd*² (“*Spotless*”). The decision is a fundamental reappraisal of the approach adopted by tax practitioners and some academics in interpreting what constitutes “the obtaining of a tax benefit” for the purposes of Part IVA of the Income Tax Assessment Act 1936 (the “Act”),³ and in determining where income which is derived from a “tax driven” offshore investment scheme is sourced.⁴ The *Spotless* decision is also an excellent example of clarity in purpose, approach, and execution, in a well reasoned and balanced judgment. This is rarely achieved in tax cases.⁵ The general confusion about Australian

Australian tax under s 23(q) of the Act. Section 23(q) broadly operates to exempt income from Australian tax where that income (which is liable to foreign tax) was derived “by a resident from sources out of Australia”.

² (1997) 34 ATR 183.

³ The issue before the High Court was “whether, on the footing that the steps which were taken by *Spotless Services*, amounted to a ‘scheme’, there was present the necessary ‘dominant purpose’ to obtain a ‘tax benefit’, so as to satisfy the criteria necessary then to have made the relevant determinations under para (a) of s 177F(1) [of Pt IVA]” (*Spotless*, above n 2 at 188). The High Court described the operation of Pt IVA (which was introduced into the Act on 27 May 1981), as follows (ibid at 185-186):

Pt IVA operates where:

- (i) there is a “scheme” as defined in s 177A;
- (ii) there is a “tax benefit” which, in relation to income amounts, is identified in para (a) of s 177C(1) as an amount not included in the assessable income of the taxpayer where that amount would have been included or might reasonably be expected to have been included in that assessable income for the relevant year of income if the scheme had not been entered into or carried out;
- (iii) having regard to the eight matters identified in para (b) of s 177D, it would be concluded that there was the necessary dominant purpose of enabling the taxpayer to obtain the tax benefit; and
- (iv) the Commissioner makes a determination that the whole or part of the amount of the tax benefit is to be included in the assessable income of the taxpayer (s 177F(1)(a)). The Commissioner then “shall take such action as he considers necessary to give effect to that determination”(s 177F(1)).

⁴ (Footnote omitted).
The question of source of the interest income derived by the taxpayer in *Spotless* (which the Full Court of the Federal Court unanimously held was the Cook Islands), was not taken on appeal to the High Court: see *Spotless*, above n 2 at 186 particularly at n 3. However, there is some dicta expressed by the High Court particularly on the form and substance of the “Cook Islands scheme” in reaching its conclusion that the “dominant purpose” of *Spotless* in entering into the “scheme” was to avoid Australian tax (by taking advantage of an exemption from tax provided under s 23(q) of the Act), that could cast serious doubt on the correctness of the Full Court’s approach in ascertaining the “real source” of the income derived by *Spotless* from that “scheme”.

⁵ Compare the confusion caused by the Full Court of the Federal Court decision in *Peabody v Commissioner of Taxation* (1993) 40 FCR 531, and the subsequent High Court decision (on appeal), in *FCT v Peabody* (1994) 181 CLR 359 (*Peabody*), which lead the primary judge (Lockhart J) in *Spotless Services Pty Ltd v FCT* (1993) 25 ATR 344 at 366, erroneously to hold in favour of the taxpayer by concluding that the Commissioner had erred in

anti-avoidance provisions may have lead to the litigation in *Spotless*. It is not unique: the New Zealand tax law is currently in a state of confusion, partly created by the Government's recent reforms to the statutory framework for tax avoidance and tax evasion.⁶

This paper examines the High Court's decision concerning the tax avoidance aspect of the investment scheme that the taxpayer in *Spotless* entered into, and extrapolates principles which could be applied in searching for the "real source" of income "with an eye focused on practical business affairs, rather than on nice distinctions of the law".⁷ It re-visits two submissions on the source of income that were pleaded unsuccessfully by the Commissioner of Taxation before Lockhart J (at first instance) and the Full Court:

- a) that the contract of loan which the taxpayer entered into was made in Australia (the substance over form approach); and
- b) that other relevant facts and circumstances should support the conclusion that the true source of the income was Australia (referred to in this paper as the "analogy theory").⁸

This article builds on a series of articles⁹ on the broad subject of "the

applying Pt IVA to the scheme when he "selected out of the relevant series of steps only some of them and classified that segment as the scheme for the purposes of Pt IVA".

On appeal, Beaumont J in *Commissioner of Taxation v Spotless Services Ltd* (1995) 62 FCR 244 at 265 correctly put the matter to rest when he concluded that:

... judgment in the appeal to the High Court in [*Peabody*] ... held that the Commissioner was entitled to rely on the narrower scheme identified by the trial judge in *Peabody*, thus disapproving the reasoning of the Full Federal Court on this point.

The confusion surrounding the interpretation of the decisions in the *Peabody* cases lead the High Court in *Spotless* (above n 2), to decree that:

Lockhart J delivered judgment on 7 June 1993 after the decision of the Full Court in *Peabody v Commissioner of Taxation* (1993) 40 FCR 531, but before that decision was affirmed, on different grounds by this Court on 28 September 1994: [*Peabody*]. That decision of this Court preceded the decision of the Full Court in the present case. The result was that the Full Court approached the question of whether there was a scheme to which Pt IVA applied on a different basis to Lockhart J.

⁶ See Sawyer AJ, "Blurring the Distinction Between Avoidance and Evasion - The Abusive Tax Position" (1996) 5 BTR 483.

⁷ *Thorpe Nominees Pty Ltd v FCT* (1988) 19 ATR 1834 at 1846 per Burchett J; which was also quoted by Lockhart J in *Spotless Services Ltd v FCT* (1993) 25 ATR 344 at 358.

⁸ See *Spotless* (1995) 62 FCR 244 at 275.

⁹ See Azzi J, "Historical Development of Australia's International Taxation Rules" (1994) 19 MULR 793; "The Need For Further Reform of Australia's International Taxation Rules in View of the *Spotless Services* Cases" (1996) 4 *Bulletin for International Fiscal Documentation* 164; and "Policy

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practical realities of taxation of offshore investments". It aims to draw conclusions from the *Spotless* decision on the role of tax laws in commerce, which are "an economic reality in the businessman's world, much like the existence of a competitor".¹⁰ This reality may be a bitter pill for some tax practitioners and taxpayers to swallow (in an increasingly competitive market). Nevertheless, it is the law handed down by a unanimous High Court.

The *Spotless* decision also bears on the manner in which the Australian Tax Office ("ATO") administers tax laws. Citing Justice Oliver Wendell Holmes in the US Supreme Court,¹¹ that "taxes are what we pay for civilized society", their Honours went on to add that an important element of that society included the conduct of commerce, which is "*fostered and protected*" by tax laws as well as Part IV of the Trade Practices Act 1974 (Cth), "which regulates or proscribes certain restrictive trade practices".¹² The application of the High Court's "foster and protect" approach to tax administrators and taxpayers alike,¹³ dictates that in order to foster and protect commerce, tax laws should recognise that the environment in which commerce functions is as important as the economic reality of taxes to a taxpayer engaged in commerce. This could help create a more effective and thus efficient tax environment; otherwise, we may face a dangerous loss of faith in the system.¹⁴

The discussion begins with an analysis of the High Court's conclusion that the "dominant purpose" of the taxpayer in entering into the "Cook Islands scheme" was to obtain a "tax benefit" in the form of an exemption under

Considerations in the Taxation of Foreign Source Income" (1993) 11 *Bulletin for International Fiscal Documentation* 457.

¹⁰ *Spotless*, above n 2 at 187.

¹¹ *Compania de Tabacos v Collector of Internal Revenue* (1927) 275 US 87 at 100 per Holmes J, Brandeis J concurring.

¹² *Spotless*, above n 2 at 187-188 (emphasis added).

¹³ Equally, to those charged with ensuring that commerce is protected from "trade abuses" and those whose commercial interests are protected by Pt IV of the Trade Practices Act.

¹⁴ It appears that the Catholic Church is also having to find an equilibrium in applying traditional views of the Virgin which are held, amongst others, by Pope John Paul II (which "has caused concern within the Church"), and "theological clarity". In responding to such concerns, Cardinal Carlo Maria Martini ("sometimes mentioned as successor to John Paul") said:

I believe the time has come to take a new look at the state of Marian devotion, to find an equilibrium between theological clarity and the spiritual yearnings of the Christian people and of ourselves. Otherwise we may face a dangerous loss of warmth and feeling in our faith, our prayer, and our life ... We have arrived at a point where this cold, scientific attitude no longer responds to obvious emotional need for an attachment to Mary.

(Quoted from *Life Magazine*: "Two thousand years after the Nativity, the mother of Jesus is more beloved, powerful and controversial than ever, The Mystery of Mary" (December 1996) at 50.

s 23(q) of the Act.¹⁵ The article then analyses the true source of the interest income derived from the Cook Islands scheme in view of the High Court's findings on the form and substance of the scheme for the purposes of Part IVA. This article contends that the Full Court (Northrop, Beaumont and Cooper JJ), erred by adopting a form over substance approach¹⁶ to find that the source of the interest income was the place where the certificate of deposit was issued (ie, the Cook Islands), rather than where the agreement (ie, letters of credit) securing the whole scheme was devised and executed (ie, Australia).¹⁷ The discussion then briefly explores the wider implications of the *Spotless* decision in Australia.

II A LESSON FOR THE UNWARY IN APPLYING PART IVA

Early in their judgment, the members of the High Court in *Spotless* were clear that Cooper J (with whom Northrop J agreed), erred in accepting a "false dichotomy"¹⁸ that the presence of a "rational commercial decision" precludes a finding that the dominant purpose of the taxpayers in making the investment was to obtain a tax benefit for the purposes of Part IVA.¹⁹ Their Honours said: (footnote added)

A person may enter into or carry out a scheme,²⁰ within the meaning

¹⁵ Section 23(q), which was abolished in 1987 with the introduction of the Foreign Tax Credit System (the "FTCS"), exempted income from Australian tax where:

income (other than an amount of income attributable to a dividend, being a dividend paid on or after 19 October 1967), or profits or gains of a capital nature, derived by a resident from sources out of Australia and Papua New Guinea, where that income is not, or those profits or gains are not, exempt from tax in the country where the income is, derived ...

¹⁶ Azzi, above n 9 at 164 and 166-167 (particularly nn 21-24).

¹⁷ Compare *Thorpe Nominees Pty Ltd v FCT* 19 ATR 1834 at 1842-1843 per Lockhart J.

¹⁸ In elaborating on the "false dichotomy" accepted by Cooper J (in the Full Court), the High Court observed that it is to be expected that revenue considerations influence the "shape" or "form" of a "transaction" (to enable a taxpayer to pursue a particular objective or requirement). *Spotless*, above n 2 at 188:

The adoption of one particular form over another may be influenced by revenue considerations and this, as the Supreme Court of the United States pointed out, is only to be expected. A particular course of action may be, to use a phrase found in the Full Court judgments, both "tax driven" and bear the character of a rational commercial decision.

¹⁹ *Spotless*, ibid at 187. The fact that there was a scheme for the purposes of Pt IVA was not in dispute before the High Court.

²⁰ In *Spotless*, ibid at n 13, the High Court noted with approval that Cooper J accepted Lockhart J's formulation ((1993) 25 ATR 344 at 366) of the scheme which was:

the offer and the acceptance together with the intervening acts and probably the

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of Part IVA, for the dominant purpose of enabling the relevant taxpayer to obtain a tax benefit where that dominant purpose is consistent with the pursuit of commercial gain in the course of carrying on a business.²¹

In ascertaining the relevant motivating purpose underlying the Cook Islands “scheme”,²² their Honours recognised the purpose of the taxpayers in seeking a short-term investment which, “would yield the best return for their benefit and the benefit of their shareholders, ‘having regard’ ... ‘to the importance of having the investment adequately secured’”.²³ However, their Honours were also careful to counter-balance the reasons (ie, subjective) for the taxpayers investing their surplus funds in the Cook Islands with the objective view of the facts that “bear upon the manner in which the scheme was entered into and the form and substance of the scheme”.²⁴

The Cook Islands levied withholding tax at the rate of 5 per cent of the amount of interest. The interest rate payable to the depositors was approximately 4 per cent below the Australian bank bill buying rate. However, what might be seen as the commercially unattractive aspects of the deposit with EPBCL [the Cook Islands entity] would be more than offset if the interest were exempt from income tax in Australia. As will appear, it was this collateral tax advantage which provided the key to the whole transaction and gave it its particular commercial attraction.²⁵

The “manner”²⁶ in which the scheme was “entered into” (not in the restricted sense), and the “form and substance” of the scheme are two of the “eight

steps commencing with the receipt by the taxpayers of the information memorandum and documents earlier than 5 December [1986].

²¹ *Spotless*, ibid at 187.

²² A “scheme” (which may be unilateral) is defined in s 177A(1) very broadly to mean:

- a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and
- b) any scheme, plan, proposal, action, course of action or course of conduct.

In the present litigation, all members of the Full Court (and the High Court) were agreed that there was a scheme as defined in s 177A of the Act. Cooper J identified it as follows:

[T]he proposal of the taxpayer [was] to invest \$40 million on deposit in the Cook Islands and to pay Cook Islands withholding tax on the interest earned, and the taking of all necessary steps to implement the proposals. (Footnotes omitted).

²³ *Spotless*, above n 2 at 188.

²⁴ Ibid at 191.

²⁵ Ibid at 185.

²⁶ “‘Manner’ includes consideration of the way in which and method or procedure by which the particular scheme in question was established”: ibid at 191.

criteria”²⁷ that the Commissioner must look at in making a determination under s 177F of the Act that the taxpayer has obtained a “tax benefit” in relation to the scheme. The requirements, in the opinion of the court, “would be met if the dominant purpose was to achieve a result whereby there was not included in the assessable income an amount that might reasonably be expected to have been included if the scheme was not entered into or carried out”.²⁸ That is, the Commissioner would need to show that the necessary “dominant purpose” to obtain a “tax benefit” was present in order to justify the relevant determinations under paragraph (a) of s 177F(1).²⁹ This, the Commissioner had achieved. In holding that the Cook Islands scheme was “tax driven” (in the statutory sense), their Honours concluded that the taxpayer’s “most influential and prevailing or ruling purpose, and thus dominant purpose” in entering into and carrying out the particular scheme was “the obtaining of a tax benefit” in “the form of the exemption under s 23(q) of the Act”.³⁰

Considerations which the High Court held threw further light upon the form and substance of the scheme and the manner in which the scheme was carried out included:

²⁷ The eight matters identified in para (b) of s 177D (which are “posited as objective facts”: *FCT v Peabody* (1994) 181 CLR 359 at 382; and the High Court in *Spotless*, *ibid* at n 24), and to which the Commissioner shall have regard to in determining whether a person has entered into a scheme for the dominant or sole purpose (which is either of the person or one of the persons who entered into or carried out the scheme: *Spotless*, *ibid* at 188-189), of obtaining a tax benefit include, *inter alia*:

- (i) the manner in which the scheme was entered into or carried out;
- (ii) the form and substance of the scheme;
- (iii) the time the scheme was entered into and the length of the period during which the scheme was carried out;
- (iv) the result in relation to the operation of this Act that, but for this part, would be achieved by the scheme;
- (v) any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme; ...

Inasmuch as the High Court stipulated that the eight matters “should be set out in full” (*Spotless*, *ibid* at 188), they appear only to deal with the first four paras of s 177D(b) in reaching their conclusion (see *Spotless*, *ibid* at 191).

²⁸ *Spotless*, *ibid* at 188; see also s 177C(1)(a) as to the definition of “tax benefit”. The appeals before the High Court did not concern tax benefits arising from allowable deductions: see *Spotless*, *ibid* at n 7 and s 177C(1)(b) of the Act.

²⁹ *Ibid*.

³⁰ *Spotless*, above n 2 at 193. Apart from the s 23(q) exemption, other factors which the Court referred to in determining the true purpose of the particular scheme were:

- (i) the fact that the Cook Islands (which had no income tax) levied withholding tax at only 5 per cent on the amount of income; and
- (ii) the interest rate payable to the depositors was approximately 4 per cent below the Australian bank bill buying rate.

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- (i) the agreement evidencing the provision of letters of credit, which were offered in order to induce potential investors, and to provide security for the obligations of European Pacific Banking Corporation Limited ("EPBCL").
- (ii) the time at which the scheme was entered into, and the length of period during which it was carried out.³¹

In reaching their conclusion as to the substance and form of the Cook Islands scheme, their Honours in the High Court quoted from a passage in a pamphlet titled "Information Memorandum Relating to the Issue of Certificates of Deposit" (the "pamphlet"). It contained a description of the investment proposal offered by EPBC³² utilising its wholly-owned subsidiary, EPBCL, which was the holder of a Cook Islands banking licence, to officers of *Spotless Services*.³³ It stated:

The interest on this investment is subject to withholding tax at its source in the Cook Islands and as no international tax treaty exists between the Cook Islands and Australia, the interest derived from the deposit should be exempt income for tax purposes in accordance with s 23(q) of the Income Tax Assessment Act.³⁴

The High Court also referred to the legal opinion (attached to the pamphlet as Appendix A), of EPBC's Australian lawyers (a leading national firm), which advised that:

it will generally be correct to say that the dominant purpose of the investor when it enters into the proposed transaction is not to obtain a tax benefit ... but to seek a greater return upon investment by deriving income which, by virtue of the provisions of the Act, is exempt income.³⁵

Based on that legal opinion (which was prepared prior to the decision in *Thorpe Nominees*), counsel for the taxpayers successfully argued before the Full Court that the dominant purpose in the adoption of the particular scheme by Spotless Services was to maximise its after-tax return. In agreeing with that submission, the majority of the Full Court (Cooper J with whom Northrop J agreed) concluded that Part IVA did not apply to the scheme because the dominant purpose of the taxpayers was to obtain the maximum

³¹ Ibid at 191.

³² European Pacific Banking Corporation ("EPBC"), was owned by European Pacific Investments SA, a Luxembourg publicly-listed company.

³³ Because EPBCL was not authorised to conduct business outside the Cook Islands, the investment proposal was promoted in Australia by representatives of Bankers Trust Australia Ltd ("BT").

³⁴ *Spotless*, above n 2 at 190.

³⁵ Ibid.

return on the money invested after the payment of all applicable costs, including tax, and not to obtain a tax benefit.³⁶

In rejecting Cooper J's line of reasoning, the High Court simply observed that "the operation of Part IVA is not so confined"³⁷ and concluded that a "scheme" can have the characteristics of a "rational commercial decision" and also the dominant purpose of obtaining of a tax benefit. That is:

the scheme was the particular means adopted by the taxpayers to obtain the maximum return on the money invested after payment of all applicable costs, including tax. The dominant purpose in the adoption of the particular scheme was the obtaining of a tax benefit. In reaching a contrary conclusion, or, rather, placing the matter on a different footing, the majority of the Full Court fell into error.³⁸

The High Court had earlier noted that:

the form and substance of the EPBC proposal had been to take steps to ensure that the source of the interest was located in the Cook Islands. The "dominant purpose" of the taxpayers in doing this was to achieve a tax benefit in Australia in the form of the exemption under s 23(q) of the Act. Without that benefit the proposal would "have made no sense..."³⁹

Another submission which was pleaded unsuccessfully by the taxpayer turned upon the use of the expression "an amount not being included" in s 177C(1)(a) of the Act. Based on those words, the taxpayers submitted that Part IVA was not applicable because in the present case the taxpayers had not diverted "an existing income stream" so that it would not attract tax. The taxpayers submitted that the Full Court erred by holding that if the scheme had not been entered into or carried out, an amount of income from the use of the surplus funds would have been, or could reasonably be expected to have been, included in the assessable income of the taxpayer for the year of income. In the words of the High Court:

The submission is that the reference in this case is to the amount of interest actually received from EPBCL after imposition of withholding tax. It is said that without the scheme there would have been no investment with EPBCL, that amount would not have existed, and para (a) of s 177C(1) would have had no subject-matter upon which to operate.⁴⁰

³⁶ (1995) 62 FCR 244 at 288.

³⁷ *Spotless*, above n 2 at 190.

³⁸ *Ibid* at 193.

³⁹ *Ibid* at 192.

⁴⁰ *Ibid* at 193.

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In rejecting the taxpayer's submission, the High Court stated that the definition of "tax benefit" in s 177C(1)(a) should be applied more generally than as the taxpayer identified it. They held that Spotless Services and its related company, Spotless Finance Limited, had surplus funds which arose from a successful public flotation of shares in Spotless Services, and wished to invest those funds in a short-term investment, which was evidenced by a joint venture agreement (made on 8 December 1986), between the two Spotless companies. Therefore, it was reasonably expected that an amount would have been included in the assessable income of the taxpayers from the use of the surplus funds because "the reasonable expectation is that, in the absence of any other acceptable alternative 'off-shore' investment at interest, the taxpayers would have invested the funds, for the balance of the financial year, in Australia".⁴¹

The High Court noted earlier that:

paragraph [(a) of s 177C(1)] speaks of the amount produced from a particular source or activity. In the present case, this was the investment of \$40 million and its employment to generate a return to the taxpayers. It is sufficient that at least an amount in question might reasonably have been included in the assessable income had the scheme not been entered into or carried out.⁴²

McHugh J, who agreed with the rest of the Court, delivered a separate judgment endorsing the Court's already strong judgment. However, his Honour drew a cautionary note:

Part IVA does not authorise the Commissioner to make a determination under para (a) of s 177F(1) merely because a taxpayer has arranged its business or investments in a way that derives a tax benefit. More is required ... First, the scheme must be examined in the light of the eight matters set out in para (b) of s 177D. Second, that examination must give rise to the objective conclusion that the taxpayer or some other person entered into or carried out the scheme for the sole or dominant purpose of enabling the taxpayer or the taxpayer and some other person to obtain a tax benefit in connection with the scheme. That conclusion will seldom, if ever, be drawn if no more appears than that a change of business or investment has produced a tax benefit for the taxpayer.⁴³

Although McHugh J did not elaborate on the types of schemes that may fall foul of Part IVA, based on the above passage, it is arguable that Part IVA would not apply to switching from a long-term capital investment to a short-term deposit (or vice versa) even where the switch results in a tax benefit for

⁴¹ Ibid at 194.

⁴² Ibid at 193.

⁴³ Ibid at 194.

the taxpayer (or some other person).⁴⁴ For his Honour, Part IVA will not apply where the scheme is not predominantly tax driven. “More is required before the Commissioner of Taxation can lawfully make a determination [under s 177D(b)]”; the Commissioner would also have to show that, on an objective assessment of the facts, “the taxpayer or some other person entered into or carried out the scheme or a part of the scheme for the sole or dominant purpose of enabling the taxpayer or some other person to obtain a tax benefit in connection with the scheme”.⁴⁵

There is little practical merit or benefit in engaging in academic debate about whether McHugh J’s judgment limits the definition of “tax driven” under Part IVA adopted by the rest of the High Court. McHugh J agreed with the findings of fact set out in the joint judgment of Brennan CJ, Dawson, Toohey, Gaudron, Gummow and Kirby JJ. There is little to suggest that McHugh J’s statements in any way conflict with the approach adopted by the rest of the High Court in applying Part IVA.⁴⁶

In summary, some of the lessons that can be drawn from the High Court’s decision in *Spotless* are:

- a) taxes are what we pay for civilised society and commerce (ie, tax laws affect the shape of nearly every business transaction);
- b) Part IVA is not to be construed in the light of old doctrines concerning other anti-avoidance legislation;⁴⁷
- c) tax laws are only one part of the legal order within which commerce is fostered and protected, another being Part IV of the Trade Practices Act 1974 (Cth);
- d) a scheme can have as its outcome a commercially justifiable purpose and still be entered into for the dominant purpose of obtaining a tax benefit:

a particular course of action may be, to use a phrase found in the Full Court judgments, both ‘tax driven’ and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine the answer to the [former] question...;⁴⁸

and

⁴⁴ The tax benefit could, eg, either take the form of non-inclusion of an amount in assessable income because the timing in which an “income stream” is recognised is shifted due to the shift in the investment, or an increase in a deductible amount where an amount of expense arises which would otherwise not have arisen were it not for the shift in the investment.

⁴⁵ *Spotless*, above n 2 at 194.

⁴⁶ See above n 3 where the High Court’s interpretation of how Pt IVA applies is set out.

⁴⁷ See *Spotless*, above n 2 at 185 and *Spotless* 25 ATR 344 at 368, per Lockhart J.

⁴⁸ *Spotless*, above n 2 at 188.

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- e) whether an amount would have been included in assessable income of the taxpayer is to be judged by interpreting the scheme broadly to discover what would reasonably have been expected to occur were it not for the scheme.

III A LESSON IN IDENTIFYING MATTERS OF FORM AND SUBSTANCE IN DETERMINING THE SOURCE OF INCOME FROM A "TAX DRIVEN" SCHEME

As the High Court did not hear an appeal on the source issue, the Full Federal Court's decision (Beaumont, Cooper and Northrop JJ) on this point applies. It affirmed and followed Lockhart J's decision at first instance. The High Court in *Spotless* approached the question of the form and substance of the scheme which *Spotless* entered into, on an objective analysis of the "series of transactions" leading to the scheme. This differs from the analysis required under s 23(q) of the Act.⁴⁹

When determining source of income under s 23(q) of the Act, which exempts income from Australian tax where, inter alia, that income was "derived by a resident from sources out of Australia", the question is: did the resident derive income from sources out of Australia? The question the High Court considered was whether the dominant purpose of the taxpayer in entering into the Cook Islands scheme was to derive s 23 (q) exempt income.⁵⁰ The two questions are unrelated because, as the High Court observed, the criteria for Part IVA may be satisfied even where the taxpayer would not have entered into the scheme but for the opportunity to derive foreign source income.⁵¹

Determining source of income under s 23(q) requires a practical analysis of the facts surrounding the derivation of income by the taxpayer from a particular scheme.⁵² Lockhart J had the unenviable task of applying the "practical analysis" approach to the very involved circumstances in *Spotless*. He held that:

⁴⁹ Section 23(q) had no operation after 1 July 1987. Notwithstanding, the manipulation of source rules for highly mobile income still represents a serious concern for the Australian Government because it undermines the domestic tax base.

⁵⁰ For a discussion of Australia's source of interest income rules: see Azzi, above n 9 at 165-168. For a general discussion of the traditional bases upon which Australia asserts fiscal jurisdiction: see Azzi, above n 9, at 796-798.

⁵¹ See above n 39.

⁵² See *Nathan v FCT* (1918) 25 CLR 183 especially at 189-190 per Isaac J; *Thorpe Nominees Pty Ltd v FCT* (1988) 19 ATR 1834 at 1846, per Burchett J (with whom Lockhart J agreed); *Esquire Nominees v FCT* (1973) 129 CLR 177 at 192, per Gibbs J; and *Spotless* 25 ATR 344 at 358.

... where the source of interest payable under a contract of loan lies at the heart of the judicial inquiry the place or places where the contract was made and the money lent are of considerable importance; but it goes too far to say that the source ... is necessarily determined solely by reference to the place where the contract of loan was made.⁵³

His Honour nevertheless goes on to apply a formalistic analysis of the facts by noting that the event which concluded the contract was the issuance of the certificate of deposit “which is the critical document for the purposes of the contract”.⁵⁴ In contrast, and according to s 177D(b)(ii), the High Court examined both the form and substance of the scheme and, in the process, emphasised the importance of the circumstances surrounding the issue to the taxpayer of an “irrevocable non-transferable standby letter of credit” by the International Division in London of Midland Bank Plc (the “letter of credit”) on the application of EPBCL.⁵⁵ The letter of credit was provided by an agreement (made in Australia on 23 September 1986), between Midland International Australia Ltd (“MIA”), EPBC, and EPBCL in order to induce investors to make deposits with EPBCL.⁵⁶ It was after taking some time to consider the letter of credit that the board of *Spotless* authorised Mr Williams, the Executive Director of Finance, Spotless Services, to proceed with the EPBCL proposal. As the High Court noted: to the board, the letter of credit “was most important because it secured the position of the taxpayers”.⁵⁷

Would Lockhart J have found differently on the importance of the certificate of deposit to the contract for loan had he known of the High Court’s subsequent finding on the existence of a tax avoidance purpose, and the wishes of the taxpayer to have the transaction properly secured? It is not certain. It does appear that regardless of the underlying purpose of the scheme in *Spotless*, the number of steps devised and executed in Australia, and their relative importance to realising that scheme, Lockhart J firmly

⁵³ *Spotless* 25 ATR 344 at 359.

⁵⁴ *Ibid* at 360.

⁵⁵ After a few amendments, the Midland Letter of Credit was available at a branch of Westpac in Melbourne and drafts drawn under were to be accompanied by a statutory declaration specifying a default by EPBCL: *Spotless*, above n 2 at 190.

⁵⁶ These are matters which the High Court said “bear upon the form and substance of the scheme” for the purposes of paras (i) and (ii) of s 177D.

⁵⁷ *Spotless*, above n 2 at 191. The importance of the letter of credit was also emphasised by the primary judge and the Full Court. Beaumont J, for instance, described the letter of credit (“with its origins elsewhere than the Cook Islands”) as “essential” from the taxpayer’s standpoint: *Spotless* (1995) 62 FCR 244 at 262. The importance of the letter of credit to the taxpayer is evident from the taxpayer’s refusal to proceed to settlement on 10 December 1996 because, in the words of Lockhart J, it “was not in a form satisfactory to the Spotless companies” (*Spotless* 25 ATR 344 at 357; and 62 FCR 244 at 272 per Cooper J).

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believed that the only critical document was the certificate of deposit, without which no rights to earn interest income would have vested in the taxpayers.

1 Identifying the relevant contract evidencing the scheme: form over substance

This section argues that the taxpayer would not have entered into the contract of loan in the Cook Islands were it not for provision of adequate security in Australia. To hold that the source of income from the scheme was the place where the certificate of deposit was issued appears to ignore practical reality by giving undue weight to matters of form. It may be true that the “critical” document evidencing the deposit of the money is the certificate of deposit. However, it does not follow that, in every case where a contract is one of the sources, the contract should be regarded as the sole source.⁵⁸ A\$40 million is a vast sum of money to invest in a risky offshore investment simply on the undertaking that a certificate of deposit will be issued by a relatively unknown entity in the Cook Islands when it receives that sum in the form of a cheque.

The conclusions on fact reached by Lockhart J, and affirmed unanimously by the Full Court, as to the relative importance of the place where the certificate of deposit was issued, over the place where the “letter of credit” was issued, presupposes an outcome which is far from settled. It was not an issue in *Spotless*, particularly where his Honour said:

The letter of credit is itself important, but one which cannot play a determinative role in ascertaining the source of the income. It is true that the letter of credit was the security to the taxpayers for the loan, but it *only took effect upon the issue of the certificate of deposit* in the Cook Islands.⁵⁹

The significance of the certificate of deposit to Lockhart J was that the contract of loan (which was at the heart of the judicial inquiry), was concluded when the certificate of deposit was received by the taxpayer upon depositing the cheque in the Cook Islands.⁶⁰ To sustain such an analysis, Lockhart J noted that the taxpayers did not have any rights of action under the letter of credit until the certificate of deposit was issued. That conclusion cannot be reached until all matters of law and equity have been addressed.⁶¹

Without analysing the contractual or equitable remedies, there is,

⁵⁸ *FCT v United Aircraft Corporation* (1943) 68 CLR 525 at 538 per Rich J; and *Spotless* (1993) 25 ATR 344 at 359.

⁵⁹ *Spotless*, ibid at 360 (emphasis added).

⁶⁰ *Spotless*, ibid at 359.

⁶¹ Compare Beaumont J who did not attribute any practical significance to the speculation about an outcome at law, or in equity, in the event that EPBCL failed to issue a certificate of deposit: *Spotless* (1995) 62 FCR 244 at 262.

nevertheless, some scope for arguing that the letter of credit may have taken effect prior to the issue of the certificate of deposit, especially if the cheque which was delivered to the Cook Islands by Mr Levy (on behalf of the taxpayers), had been “misappropriated” before reaching the Cook Islands but after leaving Australia. Which Court would have jurisdiction to hear the legal suit that the taxpayers would invariably commence in order to recover the misappropriated funds? This question ultimately leads into the question of where the responsibility for the loss should rest. Nevertheless, it is not beyond doubt that the letter of credit could have taken effect prior to the delivery of the cheque in the Cook Islands.

The degree of importance that Lockhart J (and the Full Court) attached to matters of form (viz, the certificate of deposit), is untenable in view of the High Court’s subsequent ruling that the Board of Spotless would not have released the funds, and thus entered into the contract for loan in the first place, if it were not for the irrevocable non-transferable letter of credit. To justify this finding, the High Court noted that the rate of return in the Cook Islands was some 4.5 per cent below the domestic rate and there were extra risks and costs involved in undertaking the scheme that would not otherwise have had to be taken if the taxpayer had invested surplus funds in Australia.⁶² Further, it is contended that a practical businessperson, operating in a world of all-important shareholder returns, would not have risked funds of her/his company by depositing them in a risky (and low yielding) offshore venture simply on the basis that a certificate of deposit would be issued at some future time.⁶³

Therefore, by undervaluing the importance of the letter of credit to the

⁶² See *Spotless*, above n 2 at 188 where the High Court observed that: what the taxpayers sought was a short-term investment which ... would yield the best return for their benefit and the benefit of their shareholders, ‘having regard ...’ to the importance of having the investment adequately secured.

Compare *FCT v Efstathakis* 79 ATC 4256 at 4259 per Bowen CJ who observed that the rules for determining source of income, “is not to be found in the cases, but in the weighing of the relative importance of the various factors which the cases have shown to be relevant”.

⁶³ The High Court noted that it is to be reasonably expected that “in the absence of any other acceptable alternative proposal for ‘off-shore’ investment at interest, the taxpayers would have invested the funds, for the balance of the financial year in Australia”: *Spotless*, above n 2 at 194. See also Beaumont J’s description of the scheme (62 FCR 244 at 271; affirmed by the High Court in *Spotless*, above n 2 at 191 and n 28), where his Honour said (emphasis added):

The interest rate was unattractive, being substantially less than the domestic rate. Moreover, there appeared to be a security risk in dealing with an offshore, 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 Islands dealings were far more complicated, time-consuming (in executive travel time) and expensive in their execution than a similar domestic transaction... In short, the scheme was tax driven.

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taxpayer, Lockhart J (and the Full Court) fell into error by approaching the question of source of income with an eye focused on nice distinctions of the law rather than “practical business affairs”.⁶⁴ In substance, it could be argued that the “real origin” of the interest income can be traced back to the successful public flotation of shares in Spotless Services in about September 1986, and the wishes of the taxpayer to invest the surplus funds in a properly secured short-term investment. Applying a substance over form approach, the place where the contract evidencing that monies are held on account of the taxpayer, should be regarded as only one of a number of factors in determining the source of interest income derived by the taxpayer in *Spotless*.⁶⁵

2 The analogy theory

This section builds on the preceding analysis and also provides support for the contention that the Federal Court applied a formalistic approach in determining the question of where interest income is sourced. It is submitted that Lockhart J at first instance, (with whom the Full Court agreed), fell into error by holding that there was no “case directly in point to the present appeals” when considering the source of income derived by the taxpayer in *Spotless* for the purposes of s 23(q) of the Act.⁶⁶ This contention is premised on the facts and findings of the Full Court of the Federal Court (of which Lockhart J was a member) in *Thorpe Nominees* (discussed below). Support is also drawn from the High Court’s finding in *Spotless* that, the prevailing or most influential purpose for entering into the scheme was to avoid Australian tax on the interest income to be derived from the scheme. However, note that Lockhart J’s overall understanding of the Cook Islands scheme differed

⁶⁴ See *Thorpe Nominees* (1988) 19 ATR 1834 at 1846 per Burchett J where His Honour said (emphasis added):

What the cases [on source] require is that the truth of the matter be sought with an eye focused on practical business affairs, rather than on nice distinctions of the law. For the word ‘source’, in this context, has no precise or technical reference. It expresses only a general conception of origin, leading the mind broadly, *by analogy* The substance of the matter, metaphorically conveyed when we speak of the source of income, is a large view of the origin of the income - where it came from - as a businessman would perceive it.

⁶⁵ See above n 58.

⁶⁶ Cooper J (with whom Northrop J concurred) similarly said (at 62 FCR 244 at 274):

Each of the findings of fact made by his Honour [Lockhart J] and the inferences which his Honour drew from those facts were open on the evidence. His Honour’s reasoning and conclusion as to the parties to the contract, its terms and the time, place and mode of its creation, have not been shown to be erroneous. Unless the documentation and conduct in the Cook Islands is to be treated as a sham, the conclusion of his Honour follows necessarily from a consideration of the documents, in particular the telex offer of 5 December 1986 and the contractual terms recorded in the certificate of deposit.

substantially from the High Court's.⁶⁷ He did not think that *Spotless* (unlike the taxpayer in *Thorpe Nominees*) had entered into a tax avoidance scheme either for the purposes of the now repealed s 260 or Pt IVA.⁶⁸

Both Lockhart J and the Full Court searched for an analogous case with similar facts to those in *Spotless*, but with no apparent success. Consequently, Beaumont J (with whom the other members of the Full Court had agreed on this point) followed Lockhart J's analysis of the facts and application of the test of source to those facts. He concluded that the source of the income was the place where the "certificate of deposit"⁶⁹ which vested rights in the taxpayer against EPBCL was issued (ie, the Cook Islands).⁷⁰ In the process, his Honour distinguished the facts in *Thorpe Nominees* from the facts in *Spotless* by focusing on the "non-accidental" nature of locating the investment in the Cook Islands.⁷¹ The discussion in this part focuses mainly on Beaumont J's decision on source because, unlike the majority (Cooper and Northrop JJ), his Honour held that the taxpayer had the requisite purpose of avoiding tax when entering into the Cook Islands scheme.

By holding that there is no decided case which is "truly analogous" to the present case, Beaumont J, with respect, fell into error by accepting a "false dichotomy". He distinguished between the "accidental" and "non-accidental" choice of a foreign jurisdiction in determining source of income for the purposes of the s 23(q) exemption. His Honour appears to have put an unnecessary and arguably unprecedented restriction on the operation of s 23(q) by focusing on the taxpayer's choice of a foreign jurisdiction in determining source of income under s 23(q) of the Act. That section simply provides, inter alia, that income is exempt where income is "derived by a resident from sources out of Australia".⁷²

⁶⁷ See above n 5 and *Spotless*, above n 2 at 192 where it was stated that "the scheme was the particular means adopted by the taxpayers to obtain the maximum return on the money invested after payment of all applicable costs, including tax".

⁶⁸ *Spotless* 25 ATR 344 at 366-367.

⁶⁹ The certificate of deposit issued by EPBCL: (*Spotless*, above n 2 at 191) certified that there had been a deposit of \$40 million with EPBCL at its head office and that this was repayable to *Spotless Services* on or after maturity date of 23 June 1987, with interest of \$2,842,192, net of withholding tax due to the Government of the Cook Islands.

⁷⁰ Beaumont J was able to discount the importance of the letter of credit by noting that the issue of the letter of credit in Melbourne "simply put the taxpayers in a position to conclude an agreement in the Cook Islands" (1995) 62 FCR 244 at 262. Cooper J appears to agree with this finding (see 62 FCR 244 at 274).

⁷¹ *Spotless* (1995) 62 FCR 244 at 260.

⁷² Compare Lockhart J in *Thorpe Nominees* where his Honour observed that "Switzerland was selected as a place outside Australia ...": 19 ATR 1834 at 1842.

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Beaumont J said that in *Thorpe Nominees* the choice to use Switzerland was “accidental” whereas the choice of the Cook Islands in *Spotless* was a pre-arranged plan (ie, non-accidental).⁷³ Although, his Honour concedes further on in the judgment that this case is “borderline”. At this point in the discussion it is useful briefly to describe the tax avoidance scheme entered into by the taxpayer in the *Thorpe Nominees* case.⁷⁴ There, options to purchase land in Australia were granted to an Australian trustee company or its nominee; agreements for the sale to a related Australian company of nomination rights in relation to the options were executed in Switzerland; the options were exercised in Australia; and the consideration for the sale of the nomination rights was received in Australia.⁷⁵

In *Thorpe Nominees*, Lockhart J (with whom Sheppard and Burchett JJ agreed), concluded that, as a matter of substance rather than form, the source of the income derived by the taxpayer from option agreements signed in Switzerland was Australia and not Switzerland. His Honour noted that the activities conducted in Switzerland originated from a pre-arranged plan devised in Australia and that the pre-arranged plan required a place outside Australia to ensure that the Australian resident taxpayer was able to take

⁷³ *Spotless* 62 FCR 244 at 262 per Beaumont J:

[T]here was nothing “accidental” in the selection of a Cook Islands corporation as the borrower of the funds in question. For one thing, as BT’s promotion emphasised, the accrual of liability for the Cook Islands’ modest withholding tax had the intended consequence of exempting the lender from Australian tax. The second thing to be noticed, also of considerable monetary significance, is the difference in interest rates between Australia and the Cook Islands. It will be recalled that the Island rate was substantially less than the Australian bank bill buying rate (in order of 4% below). There was nothing accidental about this. It reflected the realities of the situation in two entirely different markets.

The Cook Islands proposal was a pre-arranged plan partly because (*Spotless*, above n 2 at 190):

other alternatives which had been under consideration by Spotless Services included a similar kind of investment to be made in Hong Kong. That proposal, which appears to have been made by Rothschild Australia Ltd, was rejected. It would have required the issue of a tax clearance certificate under s 14C of the *Taxation Administration Act 1953*(Cth).

⁷⁴ In *Thorpe Nominees*, Lockhart J spoke of a tax avoidance scheme but his Honour did not have to elaborate on whether that scheme was entered into for the dominant purpose of obtaining a tax benefit because the transaction was governed by s 260 (Pt IVA’s lame predecessor). In view of the fact that Lockhart J found that the source of the income was Australia, it was not necessary for his Honour then to go on to consider the applicability of s 260: (1988) 19 ATR 1834 at 184-1843. However, in view of the High Court’s decision in *Spotless*, there is little doubt that the scheme the taxpayers in *Thorpe Nominees* entered into would have breached Pt IVA if the transaction had been entered into after May 1981.

⁷⁵ For a more detailed analysis of the similarities between the steps taken by the taxpayer in *Spotless* and *Thorpe Nominees*: see D’Ascenzo M “Substance versus Form” (1997) 10 *Asia-Pacific Tax Bulletin* 330 at 336.

advantage of the exemption from Australian income tax in s 23(q).

In that sense Switzerland was but an accident in the selection of an international scene for an essential step in the plan. It would give undue weight to matters of form to regard Switzerland as the source of the income in question. Having regard to the practical realities of the situation and the substance of the matter, the real source of the income in question was Australia.⁷⁶

Despite the fact that the taxpayers' rights to exercise nomination rights were vested under agreements executed in Switzerland, a more important consideration to the taxpayers, in the opinion of Lockhart J in *Thorpe Nominees*, was to take advantage of the "beneficial tax rate afforded by s 23(q) of the Act".⁷⁷ This underlying purpose is identical to the purpose of the taxpayers in *Spotless*. The Cook Islands were selected by the taxpayers because it was the jurisdiction chosen by EPBCL. EPBCL selected the Cook Islands because: no international tax treaty exists between the Cook Islands and Australia; the interest derived from the deposit was subject to 5 per cent Cook Islands withholding tax; the interest was exempt from Australian tax under s 23(q); and the transfer of the funds to the Cook Islands did not require the issue of a tax clearance certificate. However, regardless of how and why the Cook Islands was chosen, it was a place outside Australia, which was necessary to obtain the s 23(q) exemption and the favourable tax rates.

Although the scheme in *Thorpe Nominees* consisted of a number of steps in Australia and Switzerland, Lockhart J nevertheless looked at the scheme as a whole.

[I]t is unreal to sever the relevant events into occurrences in Australia on the one hand and those in Switzerland on the other. *The relevant events must be looked at as a whole to determine the practical question of the source from which Thorpe Nominees derived the income in question in this case.*⁷⁸

⁷⁶ 19 ATR 1834 at 1842-43 (emphasis added). Compare the scheme in *Spotless* where:

- (i) almost all of the negotiations took place in Australia;
- (ii) the scheme was promoted by BT Australia;
- (iii) the funds were Australian, remained here and were, by virtue of the security arrangements, subject to control in Australia (Midlands being, in the words of the High Court, a "mere conduit");
- (iv) the certificate of deposit which (was issued in the Cook Islands) was brought back to Australia; and
- (v) notwithstanding its terms, it was repaid, together with interest in Australia: see *Spotless* (1995) 62 FCR 244 at 260 where Beaumont J sets out the Commissioner's arguments in relation to the matter of source of the income.

⁷⁷ *Thorpe Nominees* 19 ATR 1834 at 1843 per Lockhart J.

⁷⁸ (1988) 19 ATR at 1842 (emphasis added).

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Consequently, Lockhart J concluded that the source of income was Australia largely because “there was a plan or scheme ... devised in Australia for the purpose of avoiding income tax and to a lesser degree of saving New South Wales stamp duty”.⁷⁹ This is despite the fact that some steps were taken in Switzerland which included:

- (i) the registration by Vaucraft of a branch office in Switzerland (in the Canton of Glarus);
- (ii) the appointment of Vaucraft as trustee of the Duncan Trust in place of *Thorpe Nominees* and the appointment of Mr Thorpe to negotiate on behalf of Vaucraft in the sale to Nawor of the right to be nominated to exercise the options granted over the New South Wales land;
- (iii) the making of a written offer by Nawor’s Australian accountant to purchase the options; and
- (iv) the acceptance of that offer in Switzerland by a Swiss attorney (who was appointed by Mr Thorpe).⁸⁰

Application of a similar approach should have been adopted by the Full Court in *Spotless*, given the tax avoidance purpose of the scheme.

In summary, the Federal Courts’ approach in determining the source of income derived by the taxpayer in *Spotless* contradicts a long line of established authorities which caution against approaching such a question based on nice distinctions of law rather than on the practical reality of business affairs. Such reality, “like beauty, is often in the eye of the beholder”.⁸¹ In this instance, the reality was that the taxpayer would not have concluded the contract for loan if it were not for the representations and security provided in Australia. The Court applied form over substance.

⁷⁹ Ibid.

⁸⁰ Ibid at 1837-1838 and 1842 where Lockhart J concluded (emphasis added):

There was a plan or scheme ... devised in Australia for the purpose of avoiding income tax ... The Duncan Trust was established in Australia. All companies and natural persons relevantly connected with the plan were Australian residents, the companies being *Thorpe Nominees*, Collaroy Holdings, Vaucraft and Nawor; and the natural persons being Mr and Mrs Thorpe, the solicitor, the accountant ... and other directors of Vaucraft. The land subjected to all the fine tuning was situated in New South Wales and was ultimately sold to persons in New South Wales. Collaroy Holdings granted the options to *Thorpe Nominees* in Australia. Although [some] steps ... were taken in Switzerland ... they were taken on advice of Australian lawyers and were plainly taken pursuant to a plan pre-arranged in Australia.

⁸¹ As quoted in *Spotless* 25 ATR 344 at 358.

IV THE BROADER IMPLICATIONS OF *SPOTLESS*

The beneficial effects accruing to the ATO from the High Court's decision in *Spotless* are enormous. This case is a decisive victory for the ATO in its attack on tax driven investments that utilise international transactions to avoid or minimise Australian tax. The *Spotless* decision is also the most authoritative statement by the Court on the inapplicability in interpreting Part IVA of Lord Tomlin's statement⁸² that, every man has a right "to order his affairs so that the tax attaching under the appropriate Acts is otherwise less than it would be"⁸³ (the "choice principle"). Arguably, it was the "choice principle" that lead to the demise of Part IVA's predecessor, s 260.⁸⁴

The High Court in *Spotless* interpreted Part IVA broadly, so that schemes that are not commercially justifiable but for the tax benefit obtained from them will be struck down. This reinforces the efforts of various Australian Governments over the last decade to counter tax driven offshore schemes through controlled foreign company and foreign investment fund rules.⁸⁵ However, the psychological advantage that the ATO has arguably derived from the High Court's decision in *Spotless* should not be overstated nor employed in such a way as to hinder the pursuit of genuine commerce - in keeping with the High Court's "foster and protect" doctrine. Tax officials may now be able more effectively to utilise the information (as well as knowledge and expertise acquired in the area of transfer pricing), on related party international transactions (as required under Schedule 25A) to determine the existence or otherwise of a tax driven scheme under Part IVA. This would be the case whether or not the particular transaction breaches the transfer pricing provisions in the Act.

From an economic point of view, the High Court's decision could potentially improve Australia's balance of payments position by further reducing the attractiveness of shifting funds offshore in the pursuit of the "tax dollar"

⁸² The High Court, above n 2 at 185 rejected the statement applied by Lord Templeman in the Privy Council in *Commissioner of Inland Revenue v Challenge Corporation* [1987] AC 155 at 167.

⁸³ *Inland Revenue Commissioners v Duke of Westminster* [1936] AC 1 at 19.

⁸⁴ For a discussion of how the choice principle may have been applied by the Full Court of the Federal Court in *Spotless*, see Cooper T and Lee A, "Part IVA after *Spotless Services*: Is 'Choice' Alive and Well in Tax-effective Financing?" (Dec 1995/Jan 1996) *The CCH Journal of Australian Taxation* 2, and Cassidy J, "Have the Ghosts of s 260 Come Back to Haunt the Commissioner of Taxation" (1997) 1 *Bulletin for International Fiscal Documentation* 20.

⁸⁵ For a general discussion of the purpose served by these regimes see Azzi (1994) above n 9.

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which "is just as real as one derived from any other source".⁸⁶ The balance of payments records the balance from trade in goods, services, and income, including entries for unrequited transfers and financial flows. Australia's balance of payments for financial flows should improve in the short-term as it becomes more expensive to derive the "tax dollar" offshore from income that otherwise would have been subject to Australian tax. In the long-term, Australian demand for foreign funds should wane as more funds are invested in Australian rather than foreign banks. This should, other things being equal, lead to a general reduction in interest rates. The High Court in *Spotless* should be commended for its insightful and economically responsible decision (from the point of view of the nation as a whole).

However, the benefits from the High Court's decision in *Spotless*, must be counter-balanced against the uncertainty created by the Federal Courts' decision on source of interest income and the undue weight given to matters of form (the certificate of deposit) over substance. In fairness, Lockhart J in *Spotless* was of the view that the taxpayers had not breached Part IVA because the Commissioner of Taxation could not select "out of the relevant series of steps [that comprised the scheme] only some of them and classify that isolated segment as the scheme for the purposes of Part IVA".⁸⁷ Nevertheless, it is argued that the decision on source of income in *Spotless* contradicts the approach adopted by the Courts in recent times, particularly that of the Federal Court, which dictates that substance should prevail over form when determining source of income derived from a tax driven scheme.

The uncertainty created by the decision in *Spotless* may encourage offshore operators to sell their uncommercial/unproductive products in Australia using Australian promoters (who provide security for the scheme which is backed by weighty Australian legal opinion), without the fear of being exposed to Australian tax (or other) liability. The profits from the scheme would be exempt under s 23(r) of the Act - being foreign income of a non-resident. Such an unsatisfactory state of affairs would seriously detract from the High Court's "foster and protect" doctrine espoused in *Spotless*. Arguably, in *Spotless*, without the tax benefit, the Australian security provided, and the appropriate letter of comfort from the Australian lawyers, the offshore operator would not have had much commerce to conduct in Australia, especially if the rate of return offered on the scheme was comparatively much

⁸⁶ Per Harlan J in *Commissioner of Revenue v Brown* (1965) 280 US 563 at 579-580, as quoted by the High Court in *Spotless*, above n 2 at 187.

⁸⁷ *Spotless*, 25 ATR 344 at 366. As noted previously, the High Court in *Spotless*, and Beaumont J in the Full Court (see above n 5) noted that Lockhart J was bound to conclude that Pt IVA did not apply because of the Full Federal Court's decision in *FCT v Peabody* which was later rejected on appeal to the High Court. *Spotless*, above n 2 at 185 especially n 6.

lower, and the risk much greater, than an alternative Australian venture. Viewed in this light, the Federal Courts' decision in *Spotless* on source is economically irresponsible.

V CONCLUSION

The High Court's decision in *Spotless* is clear, concise, lucid, and insightful; something rarely achieved by any tax court. The Court's economically responsible approach is premised on the realisation that tax laws affect the shape of nearly every business transaction. The need to comply with complex tax laws explains the preponderance of tax advisers in commerce, that is, to assist businesspeople plan their affairs around tax laws. *Spotless* shows that application of the foster and protect doctrine should help create a tax environment which is more responsive to the needs of "commercial" or "profit driven" pursuits while ensuring that "tax driven" pursuits (in the statutory sense) are not tolerated. This is a very important objective underlying any tax law. Achieving it requires finding an equilibrium between protecting and fostering commerce, which in turn requires an understanding of how commerce is conducted. After all, "taxes are what we pay for civilized society, including the conduct of commerce".

The practical reality of the situation post-*Spotless* appears to increase the price of deriving the "tax dollar". Tax practitioners might find it necessary to increase their fees substantially to cover potential law suits that could arise from endorsing schemes which may have an element of tax avoidance. The commercial attractiveness of investment schemes that solely or predominantly rely on avoiding Australian tax to maximise after-tax returns has been seriously affected by the *Spotless* decision.

However, the decision and facts in *Spotless* demonstrate how easily the source of interest income can be shifted. All the taxpayers had to do, in view of the caution sounded by the legal advisers to the scheme, was to ensure that the contract of loan was concluded outside Australia. The decision of Lockhart J and the Full Court in *Spotless* represents a return to form over substance that had prevailed during the Barwick CJ era. This case also demonstrates a need to reform Australia's source rules, whose manipulation has undermined the integrity of Australia's efforts to bolster its anti-avoidance and international tax regime.⁸⁸

The source test used in *Spotless* should have focused on substance over form which the High Court considered was important, in ascertaining whether the scheme had achieved its dominant purpose of taking advantage of the s 23(q) exemption. That, and the approach of Lockhart J in *Thorpe Nominees*, should

⁸⁸ See Azzi (1996) above n 9 at 176.

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cast serious doubts on the decision of the Full Court in *Spotless*. It is suggested that the Full Court and Lockhart J (at first instance), in *Spotless*, failed to apply a “holistic” approach in searching for the real source (ie, origin) of the income.

In view of the similarities between the matters of form and substance in *Thorpe Nominees* and those in *Spotless*, their Honours in *Spotless* placed undue weight on the place where the certificate of deposit was issued (being the last step in a series of transactions that were commenced in Australia on 8 December 1986). Instead, given the tax avoidance purpose of the taxpayers in *Spotless*, the whole series of events leading up to the issue of the certificate of deposit (in view of the uncommercial rate of return), should have been scrutinised more intensely in deciding the real origin of the income, which is as much a “hard matter of fact” as it is a matter of practical business reality. Consequently, in view of the tax avoidance purpose of *Spotless* in entering into the investment scheme, the source of the interest income was Australia. Australia was the origin of the dealings between the parties and the place of the security for the transaction. That is, the scheme was a pre-arranged plan devised in Australia for the purpose of avoiding Australian income tax. Accordingly, the Full Court should have followed the Full Court’s decision in *Thorpe Nominees* and held that the source of the income in *Spotless* was Australia.