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COMMISSIONER OF TAXATION v SPOTLESS SERVICES LTD and Another*

General Division: Northrop, Beaumont and Cooper JJ

Victoria District Registry B

17 March, 27 November 1995

Income Tax — Interest — On money lent in Cook Islands — Indicia determining source of interest — Contract constituted by offer received in Australia and accepted by conduct in Cook Islands — Securities banker's letter of credit and certificate of deposit — Letter of credit received in Australia and certificate of deposit received in Cook Islands — Rights C *under letter of credit dependent on issue of certificate of deposit — Whether income sourced from Cook Islands — Whether exempt income under Income Tax Assessment Act 1936 (Cth), s 23(q).*

Income Tax — Tax avoidance — Income Tax Assessment Act 1936 (Cth), Pt IVA scheme — Scheme to be identified with factual specificity — Lending off shore — Dominant purpose to maximise income — Whether tax benefit obtained — Whether scheme to which Pt IVA, ss 177A applied D *— Income Tax Assessment Act 1936 (Cth), Pt IVA, ss 177A, 177C, 177D, 177F.*

Words and Phrases — Scheme — Tax benefit — Amount — Income Tax Assessment Act 1936 (Cth), Pt IVA, ss 177A, 177C, 177D.

In Australia there was promoted a scheme for depositing money with a company (BCL) a wholly-owned subsidiary of another (BC) both incorporated in the Cook E Islands and the payment of interest subject to Cook Island's modest withholding tax. Between Australia and the Cook Islands no tax treaty existed. The securities were to be a certificate of deposit issued by BCL and a letter of credit issued by Midland Bank plc (Midland). The scheme was expressly contrived to produce exempt income within s 23(q) to be sourced from the Cook Islands. Its promoters described it as investment in the certificate of deposit.

The respondents were Australian residents. Terms for deposits by the respondents with BCL were negotiated in the Cook Islands. By telex from the F Cook Islands to the respondents in Melbourne, an offer was made to them which was available for acceptance by them by delivery of a cheque drawn in favour of BCL at the offices of BC in the Cook Islands.

Afterwards, in Melbourne, one of the respondents (the respondent), for it and the other respondent, gave to or for Midland a cheque for the deposit (the money). The respondent received Midland's irrevocable banker's letter of credit. It was a precondition of the entitlement of the respondent to call on the letter of credit that there issue a certificate of deposit. Midland was authorised to apply the money to an account of the respondent in the Cook Islands. The respondent's attorney, G especially appointed to implement the scheme, was authorised to open an account with BC in the Cook Islands.

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*[EDITOR'S NOTE: An application for special leave to appeal to the High Court was granted on 16 April 1996.]

A Afterwards, in the Cook Islands, the respondent by its attorney drew a cheque on BC in favour of BCL or order (the cheque) which was handed to BCL. BCL gave to the respondent's attorney a certificate of deposit.

The respondent did not have an account with BC in the Cook Islands. On the evidence, the money was credited to BC's account with Midland's Singapore branch to be disbursed as directed by BC, and no money was credited to any account of the respondent with BCL.

The money was repaid with interest less withholding tax from the Cook Islands.

B A. At the relevant times, s 23(q) of the *Income Tax Assessment Act* 1936 (Cth) (the Act) provided, relevantly, that income derived by a resident from sources out of Australia was exempt income where it was not exempt from income tax in the country where the income was derived provided that there was a liability for tax in the country where that income was derived and the Commissioner was satisfied that the tax had been paid.

The Commissioner contended that the interest was sourced from within Australia and that s 23(q) did not apply. In holding that the interest was exempt income within s 23(q), the judge held the contract was constituted by the telexed C offer which was accepted by the conduct in the Cook Islands.

Held: (1) By Cooper J, Northrop J agreeing. As between the respondent and BCL, the cheque operated as the equivalent of cash. The effect of the receipt of the cheque was to credit the respondent with the money on deposit in accordance with the certificate of deposit. The cheque operated as payment of money and the risk of non-payment on presentation of the cheque drawn on BC was borne by BCL. (275D)

National Australia Bank Ltd v KDS Construction Services Pty Ltd (1987) 163 D CLR 668 at 676-677; *Barclays Bank Ltd v Astley Industrial Trust Ltd* [1970] 2 QB 527 at 539, applied.

(2) By the Court. The interest was sourced from the Cook Islands and was exempt income within s 23(q). (262F, 276D)

Per Beaumont J. So *held* from a practical business standpoint. (262F)

Per Cooper J, Northrop J agreeing. So *held* after considering the facts as matters of practical substance. (276C)

B. Under Pt IVA of the Act, where (i) there was a scheme (s 177A), (ii) in E connection with that scheme a taxpayer obtained a tax benefit, namely, an amount was not included in the assessable income of the taxpayer which might reasonably be expected to have been included in the taxpayer's assessable income if the scheme had not been undertaken (s 177C), and (iii) having regard to the matters specified in s 177D(b) it would be concluded that a person who carried out all or part of the scheme did so for the dominant purpose of enabling the taxpayer to obtain a tax benefit, then (iv) the Commissioner could under s 177F make a determination to include the tax benefit amount in the assessable income of the F taxpayer.

The Commissioner alternatively determined under s 177F(1)(a) if the interest was exempt income within s 23(q) that it was a tax benefit within s 177C.

Held, by Cooper J, Northrop J agreeing: (1) The definition of scheme in s 177A requires that the parties to the scheme, in so far as they are known, must be identified and the terms or content of any agreement, arrangement, understanding, promise or undertaking and the steps or stages of any course of action or proposal, in so far as they are relevant, be identified. It is not sufficient to identify a scheme by reference to a hoped-for fiscal outcome. Section 177A requires that the scheme G has an existence based in fact and reality and is not something based on the Commissioner's view of the facts or their legal effect. (279F-G)

(2) What are or are not objectively usual commercial considerations fall to be determined under s 177D(b) and not under s 177A or in a vacuum divorced from facts as found. (280B)

(3) There was a scheme within s 177A, it being the proposal to invest the money

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 proposal. (280E, 284E)

(4) In order to satisfy the test under s 177C what has to be ignored is not the tax consequence of s 23(q) on the derivation of interest which would otherwise be assessable as income under s 25 of the Act, but the scheme as identified. If that means that the interest would not have been earned then it is necessary to identify reasonable expectations as to what would in fact have occurred and not mere possibilities. What would have been derived must be assessable income. (282F)

Commissioner of Taxation (Cth) v Peabody (1994) 181 CLR 359 at 385, applied.

(5) The respondents received a tax benefit within s 177C in an amount equal to the interest less Cook Islands withholding tax which they received from the Cook Islands investments. (285B)

(6) The matters to which regard is directed under s 177D(b) are to be determined objectively having regard to the particular circumstances of the taxpayers, as is the ascertainment of the purpose of the person or one of the persons who entered into the scheme. (286B)

(7) The dominant purpose of the respondents was to obtain the maximum return on the money invested after the payment of all applicable costs, including tax and was not to obtain a tax benefit within s 177D. Accordingly, the scheme was not one to which Pt IVA of the Act applied. (288E)

Appeal against the decision of Lockhart J reported at (1993) 25 ATR 344, dismissed.

CASES CITED

The following cases are cited in the judgments:

Barclays Bank Ltd v Astley Industrial Trust Ltd [1970] 2 QB 527.

Esquire Nominees as Trustee of Manolas Trust v Commissioner of Taxation (Cth) (1972) 129 CLR 177.

Inland Revenue, Commissioner of (NZ) v NV Philips Gloeilampenfabrieken (1954) 10 ATD 435.

Nathan v Commissioner of Taxation (Cth) (1918) 25 CLR 183.

National Australia Bank Ltd v KDS Construction Services Pty Ltd (1987) 163 CLR 668.

Peabody v Commissioner of Taxation (1993) 40 FCR 531.

Spotless Services Ltd v Commissioner of Taxation (Cth) (1993) 25 ATR 344.

Tariff Reinsurances Ltd v Commissioner of Taxes (Vic) (1938) 59 CLR 194.

Taxation, Commissioner of v Jackson (1990) 27 FCR 1.

Taxation, Commissioner of (Cth) v Peabody (1994) 181 CLR 359.

Taxation, Commissioner of (Cth) v United Aircraft Corporation (1943) 68 CLR 525.

Thorpe Nominees Pty Ltd v Commissioner of Taxation (Cth) (1988) 19 ATR 1,834.

APPEAL

B J Shaw QC and *G T Pagone*, for the appellant.

J McL Emmerson QC and *J W de Wijn*, for the respondents.

Cur adv vult

27 November 1995

NORTHROP J. I would dismiss each appeal with costs. I concur with the reasons expressed by Cooper J.

A BEAUMONT J.

Introduction

These are appeals from orders made by a judge of the Court (Lockhart J) allowing appeals by two related taxpayers, Spotless Services Limited (Spotless Services) and Spotless Finance Pty Ltd (Spotless Finance), the present respondents, from decisions of the Commissioner of Taxation disallowing objections by the respondents against assessments of income tax in the 1987 year of income. (His Honour's decision is now reported: see *Spotless Services Ltd v Commissioner of Taxation (Cth)* (1993) 25 ATR 344.)

The return of income of each respondent disclosed the receipt of interest, in the amounts of $2,670,663 and $295,688 respectively, derived from the deposit of funds ($36 million and $4 million respectively) in the Cook Islands with European Pacific Banking Company Limited (EPBCL), a Cook Islands corporation. However, the respondents claimed that the interest was exempt from income tax by virtue of s 23(q) of the *Income Tax Assessment Act* 1936 (Cth) (the Act) which was then in force. (By s 23(q), as it then stood, it was provided, relevantly, that income derived by a resident from sources out of Australia was exempt income where it was not exempt from income tax in the country where the income was derived provided that there was a liability for tax in the country where that income was derived and the Commissioner was satisfied that the tax had been, or would be, paid.) The respondents said that the interest had been derived from a source outside Australia, namely, in the Cook Islands; that in the case of Spotless Services, interest in the sum of $2,670,663 had been paid by EPBCL, but withholding tax of $103,230 had been paid on that interest in the Cook Islands; and that in the case of Spotless Finance, it had received $295,688 by way of interest from EPBCL in the Cook Islands, but withholding tax of $11,409 had been paid on that amount there. On the other hand, in his assessments, the Commissioner asserted that the interest had been derived from a source within Australia, so that s 23(q) could not apply.

Alternatively, the Commissioner assessed the respondents upon the basis that if, contrary to his contention, the source of the interest was located in the Cook Islands, the provisions of Pt IVA of the Act, dealing with schemes to reduce income tax, applied. The Commissioner made a determination pursuant to s 177F(1)(a) of the Act, asserting that the respondents had obtained a tax benefit in connection with a Pt IVA scheme, namely that the amount in question was an amount which would have been included or might reasonably be expected to have been included in the respondents' assessable income if the scheme had not been carried out. Lockhart J rejected each basis of assessment.

The primary facts and background

There is no dispute about the primary facts or the background to the litigation, which were as follows:

Consideration by the respondents of possible avenues of investment of $40m

In September 1986, Spotless Services received a substantial injection of funds in response to a public float of its shares. As a result, the Spotless Group then had about $40 million of funds available to it which were surplus to its requirements for the year ended 30 June 1987. A number of possible avenues of investment of the funds were considered at the time, including the EPBCL proposal that was adopted. Other alternatives then considered included a similar

kind of investment to be made in Hong Kong; this proposal, suggested by a merchant banking firm, involved a tax clearance being granted by the Commissioner. After discussions with the respondent's legal advisers, it was decided not to proceed. Another Cook Islands proposal, introduced by an overseas bank and involving another financial institution in the Cook Islands, was considered but rejected.

Discussion with Bankers Trust and the provision of EPBCL's "Information Memorandum"

The subject transactions arose out of discussions in Sydney in late 1986 between the executives of the respondents and representatives of the merchant banking firm Bankers Trust. In the course of those discussions, the respondents were provided with a pamphlet, published by EPBCL's parent, European Pacific Banking Corporation (EPBC), entitled "Information Memorandum relating to the Issue of Certificates of Deposit". The pamphlet stated, under the heading "Issue Details", the following:

"ISSUE DETAILS

DEPOSIT TAKER:	European Pacific Banking Company Limited a 100 per cent owned subsidiary of European Pacific Banking Corporation, incorporated in the Cook Islands.
SECURITY:	Certificates of Deposit supported by Letters of Credit issued by Midland Bank PLC, Singapore Branch.
MINIMUM DEPOSITS:	AUD 10 Million.
TERMS:	90, 180, or 360 days, however longer terms are negotiable.
INTEREST RATE:	The rate will be quoted reflecting market conditions *at a margin under the Bank Bill Rate for the term of the investment. All interest will be subject to 5.0 per cent Cook Islands withholding tax on the interest amount.*
INTEREST PROFILE:	All interest will be paid on a discounted basis on issue date.
PURPOSE OF ISSUE:	To expand the bank's deposit base. In all circumstances funds raised by the issue of these Certificates of Deposit will be applied to the bank's activities outside Australia." [Emphasis added.]

Under the heading "Nature of Investment", the following was stated:

"NATURE OF INVESTMENT

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 Section 23(q) of the Income Tax Assessment Act.

Attached as Appendix A, is a legal opinion from Stephen Jaques Stone James confirming that investment in the Certificates of Deposit by Australian residents produces exempt income. However, the advice in this opinion has been provided for the benefit of European Pacific Banking

Corporation only and intending investors should seek independent legal advice upon their own particular circumstances."

The legal opinion of Stephen Jaques Stone James (Stephens) annexed was in the form of a letter from that firm's Sydney office dated 2 September 1986 addressed to EPBC and entitled "Deposit of Funds in the Cook Islands". In the letter, it was stated that EPBC had requested Stephens "to advise [it] on the taxation consequences of a proposed transaction involving the Cook Islands". Stephens said that they understood that it was "intended that an Australian resident corporation should arrange for funds to be placed on deposit with [EPBCL] in the Cook Islands ... ".

The letter went on to state the following by way of "Background":

"BACKGROUND

We understand that the following series of transactions will take place.

1. An Australian resident investor will be approached by EPBCL from the Cook Islands to suggest the placement of a deposit with EPBCL.
2. The investor will open an account with Midland Bank plc in Singapore and another account with EPBC in the Cook Islands.
3. The investor will appoint an attorney in the Cook Islands with power to draw funds or cheques upon the investor's account with EPBC in the Cook Islands.
4. The investor will place his account with Midland Bank plc in Singapore in funds.
5. The investor will then instruct that a transfer of funds from the Singapore account to the Cook Islands account take place.
6. EPBC will instruct Midland Bank plc to issue to the investor a letter of credit both with respect to the account with EPBC and any subsequent deposit with EPBCL.
7. The attorney in the Cook Islands will draw a cheque on the EPBC account in favour of EPBCL.
8. EPBCL will issue a certificate of deposit to the attorney and will in turn draw a cheque on its account with EPBC representing interest upon the deposit and hand the cheque for interest to the attorney. EPBC will deduct the appropriate amount of Cook Islands withholding tax from this interest. The attorney will hold the certificate of deposit in the Cook Islands.
9. The attorney will advise the investor of receipt of the certificate of deposit and receipt of the cheque for interest. The cheque for interest will be deposited with the investors account with EPBC with instructions that a transfer be made to the investor's account in Singapore with Midlands Bank plc.
10. EPBC as parent of the subsidiary will undertake to ensure the payment of withholding tax to the Cook Islands Government is included in the monthly return of EPBCL and receipt for the payment of the tax is forwarded to the investor in due course.
11. On maturity the Cook Islands attorney will surrender the certificate of deposit and receive back its face value. Proceeds will be banked in the EPBC account of the investor, with instructions to transfer to investor's Singapore account with Midland Bank plc."

Stephens then said that they had been asked to address the question "whether Australian resident investors will be subject to Australian tax on any

interest income they derive from the deposit''. In considering the question of the source of the income for the purposes of s 23(q), Stephens said:

> ''... in international transactions it is rarely, if ever, possible to say that any particular income unequivocally has its source in a particular place. Generally, it is a matter of ensuring that there are sufficient indicators of the source of a particular type of income as being in a particular place to lead one to conclude, with a high degree of probability, that such a place is the proper source of the income.''

After referring to some of the decided cases on the question of source, Stephens said:

> ''It can be seen from the foregoing that most of the above factors indicate that the source of the interest income in question is in the Cook Islands. Thus —
>
> (i) The agreement for the deposit is concluded in the Cook Islands when the deposit with EPBC is actually made by the Attorney on behalf of the Australian resident. It should of course be ensured that no agreement is concluded prior to this time in Australia;
>
> (ii) The moneys are deposited with EPBCL by the Australian resident's Cook Islands attorney in the Cook Islands. We strongly recommend that, if any agreement is concluded between the Australian resident (by his attorney) and EPBCL, before the deposit is made, it state that the deposit must be made in the Cook Islands;
>
> (iii) The moneys are drawn by the Australian resident's Cook Island attorney from a bank account with EPBC in the Cook Islands for the purpose of making the deposit;
>
> (iv) We are instructed that both EPBC and EPBCL are resident in the Cook Islands and are not resident in Australia. It would be preferable for the certificate of deposit to be retained in the Cook Islands;
>
> (v) The interest is payable by EPBCL in the Cook Islands. We would strongly recommend that any agreement entered into between EPBCL and the Australian Resident specifically state where the interest is payable.''

Stephens went on to say:

> ''In a broader context, it can be seen that large corporate entities, having direct terminal access to funds in numerous accounts with financial institutions throughout the world, in a very real sense derive their interest income as a result of carrying on a business of manipulating those accounts and, the manipulation of these accounts can be said to take place in Australia. Accordingly, in such circumstances there can be said to be a business in Australia to which interest income could be said to be related and, as a result, such interest income may have a source in Australia, notwithstanding that other factors indicate an overseas source.
>
> It is obvious that in the present instance a less sophisticated form of transactional procedure is envisaged. Accordingly, we believe that the decision making process which gives rise to the making of the investment should not in itself have a predominant effect in determining the source of the interest income. However, this can vary with the facts of a particular case and further supports our earlier suggestion that it be ensured that a

contract not be concluded (even in a practical sense) in Australia prior to the deposit being effected in the Cook Islands.

While it can be seen from the above that such questions are rarely unarguable, we believe that the proposed facts indicate that the source of the proposed interest income will be in the Cook Islands."

In considering the possible application of the anti-tax avoidance provisions in Pt IVA, Stephens stated:

"Although the circumstances of each investor must be examined individually, 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 by no longer deriving assessable income upon its current investments, but to seek a greater return upon investment by deriving income which, by virtue of the provisions of the Act, is exempt income.*" [Emphasis added.]

Also included in the Information Memorandum was a "Profile" of EPBC as follows:

"EUROPEAN PACIFIC BANKING CORPORATION — BANK PROFILE

European Pacific Banking Corporation ('EPBC') is the parent company of the deposit taker, European Pacific Banking Company Limited.

EPBC is a bank formed in the Cook Islands early in 1986 and is jointly owned by Brierley Investments Limited and Capital Markets Limited, both publicly listed companies in New Zealand.

Brierley Investments Limited is the largest company in New Zealand and is the parent company of Industrial Equity Limited and Industrial Equity (Pacific) Limited and holds major investments in many New Zealand public companies.

Capital Markets Limited is the listed arm of New Zealand based merchant bank, Fay, Richwhite & Company Limited and is ranked as twelfth largest in New Zealand by market capitalisation.

EPBC is the first bank to be issued with a Class A banking licence in the Cook Islands and conducts a full range of banking services.

EPBC has an authorised capital of US$100 million of which US$10 million has been paid up. The bank concentrates principally on wholesale banking transactions and has enjoyed substantial growth since commencing business.

Board of Directors

David M Richwhite (Chairman), Principal of Fay, Richwhite & Co Limited, joint Chief Executive and Director of Capital Markets Limited.

David W Lloyd (Deputy Chairman and Chief Executive), Chairman of Cook Islands Trust Corporation Limited.

Paul D Collins, Chief Executive and Director of Brierley Investments Limited.

Trevor C Clarke, Solicitor and Director of Cook Islands Trust Corporation Limited."

Also annexed to the Information Memorandum were a sample copy of a certificate of deposit, a form of letter of credit and a description of "settlement procedures" in these terms:

"Settlement procedures for this transaction are as follows:

1. Investor opens bank account with Midland Bank PLC, Singapore

branch and European Pacific Banking Corporation ('EPBC') in the Cook Islands.

2. Investor places his Midland Bank PLC, Singapore branch account in funds one business day prior to settlement to facilitate prompt funds flow on settlement day.
3. Investor appoints an attorney with power to draw funds upon Investor's account with EPBC.
4. On settlement day in the Cook Islands:
   (i) Attorney draws a cheque on Investors bank account maintained with EPBC made in favour of European Pacific Banking Company Limited ('EPBCL') for the face value of the Certificate of Deposit ('CD').
   (ii) EPBCL issues the CD to the attorney and draws a cheque on its account with EPBC in favour of Investor for an amount of the interest, net of Cook Island withholding tax.
   (iii) Attorney deposits the interest cheque with Investor's bank account maintained with EPBC, together with instructions to transfer funds for same day value to the Investor's bank account maintained with Midland Bank PLC, Singapore branch.
   (iv) Attorney will communicate completion of settlement to Investor in Sydney.
   (v) Attorney will hold the CD in safe custody in the Cook Islands until maturity date.
5. On settlement day in Sydney:
   (i) Midland Australia shall present Investor with the Letter of Credit in support of the CD issued in the Cook Islands.
   (ii) Investor shall give irrevocable instructions to Midland Australia to transfer funds from Investor's account maintained with Midland Bank PLC, Singapore branch to Investor's account maintained with EPBC in the Cook Islands.
   (iii) Midland Australia shall confirm transfer of the interest amount to Investor's account maintained with Midland Bank PLC, Singapore branch.
6. On maturity day in the Cook Islands, the Attorney shall surrender the CD to EPBCL, and receive payment for the face value of the CD from EPBCL. The Attorney will then deposit funds in Investor's account maintained with EPBC together with instructions to transfer funds to Investor's account maintained with Midland Bank PLC, Singapore Branch."

The EPBCL telex to Spotless Services dated 10 September 1986

Although Bankers Trust had arranged for EPBC to forward the "Information Memorandum" to the respondents in September 1986, there was no contact between the respondents and the EPBC Group until EPBCL (by its director, Mr Clarke) sent Spotless Services (via its director, Mr Williams) a telex dated 10 September in these terms:

"RE: ISSUE OF CERTIFICATES OF DEPOSIT

We are pleased to present terms and conditions of the certificates of deposit now on offer by European Pacific Banking Company Limited, a wholly owned subsidiary of European Pacific Banking Corporation:

MINIMUM DEPOSITS:	AUD 10 Million
INTEREST RATE:	*4½ per cent per annum under the Australian Bank Bill buying rate* quoted on Reuters page BBSW for the equivalent term of the deposit at 10.30 am Sydney time, two business days prior to the date of settlement. Interest is subject to Cook Islands withholding tax at a rate of 5% of the interest amount.
TERM:	90, 180 or 360 days as negotiated.
INTEREST PAYMENT:	Interest on the deposit will be calculated in accordance with the bank bill formula. Interest will be paid by cheque deliverable to your attorney at the offices of European Pacific Banking Corporation in the Cook Islands on settlement day.
SECURITY:	Redemption of the certificate of deposit will be supported by letter of credit issued by Midland Bank PLC.

Further deposit details are included in the memorandum currently being forwarded to you.

We look forward to your participation." [Emphasis added.]

(It should be noted that his Honour stated (at 348) that the telex mentioned an interest rate of "1.2%" pa below the Australian bank bill buying rate. However, though the copy of the telex in evidence is not easy to read, it appears, notwithstanding that the respondents made no concession before us on the point, that the figure mentioned was *4½ per cent*, rather than *1.2 per cent*.)

Discussions between the respondents and their legal advisers and Bankers Trust in late November and early December 1986

In this period, the respondents discussed EPBCL's proposal with their legal advisers and with Bankers Trust.

Discussion between the respondents and EPBCL on 5 December 1986 and the EPBCL's telex of that date

In the course of a discussion between Mr Williams and Mr Clarke on 5 December, Mr Clarke indicated that EPBCL was "prepared to increase the return, in effect". It was agreed that the respondents would proceed provided, as EPBCL accepted, it received "a rate of 13.3 per cent after tax to [it] . . . ." (It appears that the rate of 13.3 per cent was approximately 4 per cent below the Australian bank bill buying rate.)

This agreement was recorded in a telex from EPBCL to Spotless Services dated 5 December 1986 in these terms:

"RE: ISSUE OF CERTIFICATE OF DEPOSIT — OFFER 156.

We detail terms and conditions of the certificate of deposit now on offer for settlement on 9 December 1986, before close of business Cook Islands time (ie 1.00 pm 10 December 1986 Sydney time).

AMOUNT:	AUD 40,000,000.00
INTEREST RATE:	13.3 per cent per annum (AUD2,842,192) (payable in arrears) for the deposit period of 195 days and being net of Cook Islands withholding tax.

INTEREST PAYMENT: Interest will be paid in arrears together with repayment of the principal on the maturity date (22 June 1987 (Cook Islands time).

SECURITY: Redemption of the certificate of deposit will be supported by letter of credit issued by Midland Bank PLC.

This offer may be accepted by delivery of a cheque for AUD 40,000,000.00 to European Pacific Banking Company Limited at the offices of European Pacific Banking Corporation in the Cook Islands.

We thank you for your interest in depositing with us."

Communications between EPBCL and Midland International Australia Limited on 5 and 7 December 1986

By telexes sent on these dates, EPBCL informed Midland International Australia Limited (MIAL) that letters of credit were required for settlement of the transaction on Wednesday, 10 December, Sydney time.

Execution of the Spotless joint venture agreement on 8 December 1986 and preparation for settlement

By an agreement bearing this date, Spotless Services and Spotless Finance entered into an agreement which provided, inter alia, as follows:

"1. ASSOCIATION

The parties shall associate themselves as Joint Venturers and for the sake of convenience investments made shall be in the name of Spotless Services Limited.

2. OBJECT

The business or object of the Joint Venture shall be to invest funds in the Cook Islands.

3. DURATION

The Joint Venture shall continue until the redemption of the investment and any interest accruing thereon and the Joint Venture shall be a venture restricted to the carrying out of the said investment in the Cook Islands and nothing in this agreement or otherwise shall be construed as constituting any party hereto a partner, agent or representative of any other party or to create any Trust or commercial partnership.

4. BANK

A bank account of the Joint Venture shall be established with European Pacific Banking Company Limited in the Cook Islands such account to be in the name of Spotless Services Limited.

5. FINANCE

Moneys required and capital for operating costs for the purposes of the Joint Venture shall be as determined from time to time by the parties."

(As has been noted, the two companies contributed to the venture the sum of $40 million — as to $36 million (90 per cent) by Spotless Services; and as to $4 million (10 per cent) by Spotless Finance.)

On 8 December 1986, Mr Williams gave instructions to Mr Levy, a corporate solicitor with the Spotless Group, to draw up the documentation for settlement and to prepare to depart for the Cook Islands for this purpose. In this

connection, on 8 December, Spotless Services executed a power of attorney in favour of Mr Levy to perform the following acts in the Cook Islands:

"(i) To draw a cheque on the bank account of the Grantor maintained with European Pacific Banking Corporation in the Cook Islands ('the Account') in the sum of A$(40,000,000) in favour of European Pacific Banking Company Limited ('EPBCL').

(ii) To deposit the cheque referred to in item (i) above with EPBCL in the Cook Islands for the credit of the Grantor.

(iii) To receive a Certificate of Deposit issued by EPBCL, the face value of which will be the amount referred to in item (i) above ('the CD').

(iv) To hold the CD in safe custody for the Grantor in the Cook Islands and to send a copy of same by facsimile transmission to the Grantor.

(v) To surrender the CD to EPBCL at the offices of EPBCL in Rarotonga, Cook Islands and to receive upon surrender of the CD a cheque drawn by EPBCL upon the account it maintains with European Pacific Banking Corporation in the sum of A$40,000,000 plus interest in favour on the Grantor.

(vi) To deposit the cheque referred to in item (v) in the Account and at the same time to deliver instructions to European Pacific Banking Corporation to transfer funds equal to the same day value of the amount of the cheque from the Account to Spotless Services Limited for the credit of the Grantor or as the Grantor may direct."

On 8 December, Spotless Services also executed a mandate authorising EPBCL to open a bank account in its name with EPBCL at Rarotonga, Cook Islands.

On 8 December, Mr Levy travelled from Australia to the Cook Islands, arriving there on 9 December.

By memorandum dated 8 December (in which the "client" was stated to be EPBCL), MIAL requested Midland Bank plc, London to establish a letter of credit to be issued by that bank as a drawing under MIAL's approved facility. The beneficiary was stated to be Spotless Services, the amount AUD$40 million and interest AUD$2,966,351; settlement date was to be 10 December 1986; maturity date of the loan was to be 23 June 1987; and expiry date of the letter of credit was to be 7 July 1987. The memorandum requested the issue of an unconfirmed letter of credit by telex to the "Advising Bank", being Westpac Banking Corporation International Trade Department, Melbourne. (Westpac was the main banker to the Spotless Group.)

On 9 December, Westpac (Melbourne) received a telexed unconfirmed letter of credit for AUD$40 million issued by Midland Bank plc, London, dated 8 December. The beneficiary was Spotless Services and the irrevocable documentary credit was otherwise in the terms arranged. On the same date, arrangements were made between the parties, including Fay Richwhite & Midland, to amend the letter of credit and to change the settlement date to 11 December.

On 11 December, Midland Bank plc, London, issued an amendment advice to its original letter of credit. Following this advice, the letter of credit was stated to be effective from 11 December, the maturity date of the loan was changed to 24 June 1987 and the expiry date of the letter of credit was extended until 8 July 1987, and it was issued in connection with the EPBC certificate of deposit of AUD$40 million, plus interest of AUD$2,966,351, "less any withholding tax legally payable in the Cook Islands". Amongst the

conditions upon which drafts were to be drawn under the irrevocable documentary credit, were the following: A

"(D) EITHER:

(I) That European Pacific Banking Company Limited has failed to deliver to the beneficiary a cheque payable to the beneficiary and drawn on European Pacific Banking Corporation *for the face value of the certificate of deposit plus interest* of Australian dollars 2,966,351 (Australian dollars two million nine hundred and sixty six thousand three hundred and fifty one) less any withholding tax legally payable in the Cook Islands, in accordance with the terms thereof after having been requested to do so by the beneficiary or if that cheque has been delivered as requested by the beneficiary, the European Pacific Banking Corporation has failed to pay that cheque; or B

(II) That the beneficiary having deposited a cheque for the face value of the certificate of deposit plus interest of Australian dollars 2,966,351 (Australian dollars two million, nine hundred and sixty six thousand, three hundred and fifty one) less any withholding tax legally payable in the Cook Islands with European Pacific Banking Corporation Limited, European Pacific Banking Corporation had failed: C

(A) to transfer the amount of that cheque to the beneficiary's account with a bank to be nominated by the beneficiary; D

(B) to provide a bank cheque from a major Australian trading bank; or

(C) to deal with the funds in accordance with the beneficiary's instructions. After being requested to do so by the beneficiary." [Emphasis added.]

On 9 December, EPBC sent a telex to Midland Bank plc, Singapore giving "irrevocable instructions" as follows: E

"Upon receipt of AUD40,000,000 on Wednesday 10 December (Singapore time) in the account of [EPBC] with your bank ...

— Please immediately:

I. arrange for payment of A$39,680,481 to Bankers Trust Company, Hong Kong by preparation and delivery of a bank warrant to the credit of [BT's Sydney bank account].

II. credit the bank account of Midland International Australia Limited for an amount of AUD$118,549.54 at its [Sydney] account ... [This appears to be the remuneration or fee provided to Midland for the issue of the letter of credit, the fee being paid by the 'client', EPB Group.] F

III. place the balance of funds on a separate 7 day rollover deposit ..."

On 10 December (Australian time), Westpac paid out AUD$40 million on account of Midland Bank plc, Singapore to Bankers Trust. G

On 10 December (Australian time) Mr Levy arranged a time for settlement with EPBC at Rarotonga, but because there was a problem with the telegraphic transfer of funds from Australia, settlement was postponed until 11 December (Australian time).

Settlement on 11 December (Australian time)

On 11 December, Mr Williams collected from Westpac Melbourne a bank cheque for AUD$40 million payable to Midland, went to the offices of Bankers Trust in Melbourne, inspected Midland's letter of credit and handed over the bank cheque, together with a letter of authorisation from Spotless Services to Midland Bank plc, Singapore to credit the AUD$40 million to the account of Spotless Services with EPBCL in the Cook Islands.

On 11 December (Australian time) (10 December Cook Islands time), Mr Levy attended EPBCL's office in Rarotonga. Mr Levy signed a cheque dated 10 December for AUD$40 million drawn on the account of Spotless Services with EPBC payable to EPBCL. In return he received a certificate of deposit as follows:

"EUROPEAN PACIFIC BANKING COMPANY LIMITED
(Incorporated in the Cook Islands)
Parekura Place, Avarua,
Rarotonga,
Cook Islands
Non-Negotiable
Certificate of Deposit

Certificate No 156 Principal Amount:

AUD40,000,000.00
Deposit Date: 10 December 1986
(CI Time)
Maturity Date: 23 June 1987
(CI Time)

This is to certify that there has been deposited with European Pacific Banking Company Limited, (the 'Issuer') at its Head Office the Principal Amount of Australian dollars FORTY MILLION, (AUD40,000,000.00) repayable to SPOTLESS SERVICES LIMITED only on or after Maturity Date upon surrender of this Certificate to the Issuer at the said Head Office.

The Interest Amount on the deposit of the Principal Amount in respect of each Interest Payment Date shall be Australian Dollars Two Million Eight hundred and forty two thousand, one hundred and ninety two exactly (AUD2,842,192) being net of Withholding Tax due to the Government of the Cook Islands and without deduction of any other duties or levies and shall be payable upon presentation of this Certificate to the Issuer on or after the maturity date as listed.

In order to be entitled to repayment of the Principal amount this Certificate must be presented to the Issuer as aforesaid on a business day being no earlier than one business day prior to the Maturity Date. Payment will be made by draft or telegraphic transfer in Australian Dollars.

The rights and obligations of SPOTLESS SERVICES LIMITED and the Issuer shall be solely as provided in this Certificate and shall be governed by the laws of the Cook Islands.

EUROPEAN PACIFIC BANKING COMPANY LIMITED
(SGD)
Authorised Signatory"

Mr Levy also received an undertaking in these terms:

"EUROPEAN PACIFIC BANKING COMPANY LIMITED

To: Spotless Services Limited
225 Barkly Street
Brunswick
Victoria 3056

In consequence of you investing in a Certificate Deposit issued by European Pacific Banking Company Limited, European Pacific Banking Company Limited undertakes to pay promptly when due all withholding taxes payable in the Cook Islands in respect of all interest paid or payable on the said Certificate of Deposit and to promptly provide to you evidence of such payment.

(SGD)
Authorised Signatory"

(It was common ground that, on 20 June 1987, EPBC paid withholding tax of NZ$141,463.70 in respect of interest payable on this transaction in the amount of AUD$2,966,351.)

On 11 December (Australian time) Midland paid the AUD$40 million received from Spotless Services into Midland's account with Westpac, in discharge of the temporary overdraft granted to enable the payment to be made to Bankers Trust on 10 December. At the same time, EPBC notified Midland that the AUD$40 million had been disbursed to Bankers Trust in Hong Kong and was the subject of the charge previously given by Midland.

Maturity of the investment

On 5 June 1987, Midland's Sydney office asked Fay Richwhite's Sydney office to obtain instructions from Spotless Services as to the disposal of the funds at maturity. On 19 June, Midland's Sydney office requested EPBC to instruct Bankers Trust in Hong Kong to remit the proceeds of the deposit to Midland's account with Westpac, Sydney. On 22 June, Spotless Services requested EPBCL to pay the principal and the interest to Spotless Services' account with Westpac, Brisbane. EPBC then instructed Midland Bank plc, Singapore, upon receipt of $42,966,350.97 from Bankers Trust in Hong Kong to pay (i) $42,842,192 to the account of Spotless Services with Westpac, Brisbane and (ii) $124,158.97 to the account of EPBC which it held. It was common ground that payments were made accordingly. By letter to EPBCL dated 23 June, Spotless Services acknowledged repayment of the deposit of the principal of AUD$40 million, together with interest of AUD$2,842,192. The certificate of deposit was then returned.

The first issue on the appeal: the "source" of the interest and the operation of s 23(q)

In considering this issue, it will first be necessary to refer to the reasoning of the learned primary judge before going to the contentions advanced by the Commissioner on the appeal.

The reasoning at first instance

After citing the well-known statement of Isaacs J in *Nathan v Commissioner of Taxation (Cth)* (1918) 25 CLR 183 at 189-190, Lockhart J said (at 358) that the test to be applied in determining the source of income for the purposes of the Act "is to search for the 'real source' and to judge the question in a practical way". His Honour said (at 359) that, although not necessarily

A determinative of the question of the source of interest payable under a contract of loan, the place or places where the contract was made and the money lent were "of considerable importance". Lockhart J held (at 360) that although Midland's letter of credit was an important document, it could not "play a determinative role in ascertaining the source of the income". His Honour went on to say (at 360), that although what was done in Melbourne on 11 December was "preparatory" to the making of the contract, the event which concluded the contract was the delivery of the cheque in the Cook Islands on behalf of
B Spotless to EPBCL and the receipt of the certificate of deposit. That certificate was the "critical document" as it "gave rise to rights vested in the taxpayers against EPBCL ...". In concluding that the source of the interest was in the Cook Islands, Lockhart J referred (at 360) to the further circumstances that the borrower was incorporated in the Cook Islands and carried on business there and did not carry on business in Australia; moreover, the deposit was repaid, together with interest, from the Cook Islands.

C *The Commissioner's contentions on the appeals on this issue*

On behalf of the Commissioner, two main submissions are now made. First, it is said that the contract was made in Australia for the following reasons:

- Mr Levy's mandate was to open an account with EPBCL, not EPBC. Spotless Services never opened an account with EPBC. Midland's authority was to remit funds to EPBCL to the account of Spotless Services. Thus the cheque was drawn on an account which had not been
D opened; which Mr Levy had no mandate to open; into which nobody had authority to pay funds; and nobody did so.
- Further, before this, an act was done in performance of the contract (not merely preparatory), that is, the provision of security in the form of the letter of credit, as required by the contract. Spotless Services received the letter of credit in exchange for the bank cheque and this constituted the settlement of the transaction. Midland delivered the letter of credit on
E behalf of EPBCL in fulfilment of the contract with the respondents. Midland also received the bank cheque for $40 million on behalf of EPBCL. That this was so was confirmed by the manner in which the funds were disbursed. The bank cheque was paid into an account of Midland Bank plc, Singapore with Westpac, Sydney and then disbursed, almost entirely, to Bankers Trust in Hong Kong. None of this could have occurred unless the bank cheque was received by Midland on behalf of EPBCL. All of this conduct assumed that a contract existed and it is proper to infer that
F there was then a contract on foot.

Secondly, the Commissioner argues, even if the contract was made in the Cook Islands, the source of the interest was, in truth, in Australia when the following considerations are taken into account:

- Almost all of the negotiations took place in Australia and the formal location of the contract offshore was "designed to screen the reality".
- The scheme was a promotion of BT Australia.
G • The funds were Australian, remained here and were, by virtue of the security arrangements, subject to control in this country.
- The certificate of deposit was brought to Australia; and notwithstanding its terms, it was repaid, together with interest, in Australia.
- The letter of credit was of prime importance to the respondents. So far as EPBCL and Midland were concerned, the respondents were really

investing in the letter of credit, and, in determining source, practical substance should be looked for; mere "screens and strategies" should be disregarded.

Conclusions on the appeal on the issue of the "source" of the interest

As has been noted, Lockhart J stated, correctly in my view, that the test to be applied in determining the source of income is to "search for the 'real source' and to judge the question in a practical way". As his Honour went on to say (at 358-359), it is a matter of "judgment" and "relative weight" in each case to determine the various factors to be taken into account in reaching this conclusion. I also, with respect, agree with his Honour's statement (at 360) as to the relative importance, for present purposes, of the place or places where the contract was made and the money lent. I also concur in his Honour's assessment (at 360) of the significance of the letter of credit. But, given the apparent complexity of the present transactions, it is hardly surprising that the researches of counsel have failed to reveal any decided case directly in point, or truly analogous, since each case must depend upon its own facts. Moreover, both the form and the substance of the transaction should be taken into account. In *Tariff Reinsurances Ltd v Commissioner of Taxes (Vic)* (1938) 59 CLR 194 at 208, Rich J said:

> "We are frequently told, on the authority of judgments of this court, that such a question is 'a hard, practical matter of fact'. This means, I suppose, that every case must be decided on its own circumstances, and that screens, pretexts, devices and other unrealities, however fair may be the legal appearance which on first sight they bear, are not to stand in the way of the court charged with the duty of deciding these questions. But it does not mean that the question is one for a jury or that it is one for economists set free to disregard every legal relation and penetrate into the recesses of the causation of financial results, nor does it mean that the court is to treat contracts, agreements and other acts, matters and things existing in the law as having no significance."

In *Commissioner of Taxation (Cth) v United Aircraft Corporation* (1943) 68 CLR 525 at 538 Rich J said:

> "As the question to be determined in this case is a question of fact a decision on one set of facts is not binding and is often of little help on another set of facts. In *Premier Automatic Ticket Issuers Ltd v Commissioner of Taxation (Cth)* (1933) 50 CLR 268 and *Tariff Reinsurances Ltd v Commissioner of Taxes (Vic)* — cases which may, perhaps, be regarded as borderline cases — the Court considered that, on the facts in each case, the contract should be regarded as the sole source of income and that therefore the locus of the contract was the locus of the source. But 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 . . ."

(See also Gibbs J in *Esquire Nominees as Trustee of Manolas Trust v Commissioner of Taxation (Cth)* (1972) 129 CLR 177 at 191-193.)

On behalf of the Commissioner it is submitted, as has been noted, that if the contract was made in the Cook Islands, this was "merely a formal step designed to screen the reality"; and that "mere screens and stratagems" should be disregarded. But I have difficulty in accepting that such an approach is justified here. At all times, as Stephens' letter emphasised, it was the intention of the parties to locate the source of the income off-shore in a low tax area in

order to obtain the exemption from Australian tax offered by the operation of s 23(q). Not only was there no attempt to disguise this objective, it was explicitly mentioned as the central element in the tax-avoidance scheme promoted by BT. No attempt was made to conceal this. It was, in any event, a well-known fact that such a route was open. The context of the proposal to repeal s 23(q) and the ultimate introduction of Pt IVA was the circumstance that Australian taxpayers were believed to be, as one commentator put it, "increasingly utilising international transactions to avoid or minimise Australian tax" (see J Azzi, "Historical Development of Australia's International Taxation Rules" (1994) 19 MULR 793 at 804). Azzi went on to say (at 811):

> "In the course of tracing the historical development of Australia's international taxation rules up until the most recent changes to the international tax regime, it became evident that most of the changes were introduced to counter tax avoidance and tax minimisation opportunities. The deregulation of the Australian dollar in December 1983, and the consequent freeing-up of capital movements into and out of Australia made the prevailing s 23(q) exemption unsatisfactory from a policy perspective. It was encouraging Australians to invest overseas and derive foreign source income in low-tax jurisdictions. *Offshore investments were becoming tax rather than profit driven.*" [Emphasis added.]

In short, there was no need to disguise what was happening, or to "screen the reality", since the "reality" was that if the source of the income could be located in the Cook Islands, it was generally believed that s 23(q) would provide exemption from Australian tax. This was openly stated to be the objective of the BT proposal.

Although the Commissioner does not contend that there was a "sham" involved here, he seems to place reliance upon the reasoning of Lockhart J in another "source" case, *Thorpe Nominees Pty Ltd v Commissioner of Taxation (Cth)* (1988) 19 ATR 1,834. 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. It was held that the real source of the income was in Australia rather than Switzerland. Lockhart J, after referring (at 1,842) to a "plan or scheme ... devised in Australia for the purpose of avoiding income tax ...", said (at 1,843):

> "... 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." [Emphasis added.]

However, there 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 Cook Island rate was substantially less than the Australian bank bill buying rate (in the order of 4 per cent below). There

was nothing accidental about this. It reflected the realities of the situation in two entirely different markets.

Lockhart J referred (at 358), with approval, to the following observation of Burchett J in *Thorpe* at 1,846:

> "... 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."

Applying that test, or as Burchett J put it in *Thorpe* at 1,846, that "attitude of mind in which the Court should approach the task of judgment", I agree with Lockhart J that the source of interest was located in the Cook Islands.

It is true that not all factors point in this direction, and that the case is, as a consequence, on the borderline. Certainly, the origin of the dealings between the parties was to be found in activities undertaken in Australia. Likewise, the provision of the Midland Bank's letter of credit (with its origins elsewhere than the Cook Islands), to back up the transaction was essential from the taxpayers' standpoint. But, in my view, Lockhart J was correct to identify the certificate of deposit as the "critical" document for present purposes (at 360). As his Honour observed, it was this certificate which gave rise to rights vested in the taxpayers against EPBCL; and it was only in default of that certificate being honoured that Spotless Services was entitled to call on the letter of credit. (See also *Commissioner of Inland Revenue (NZ) v NV Philips Gloeilampenfabrieken* (1954) 10 ATD 435 at 443, per North J.)

Where, as in the present case, the transaction is complex in terms of its background, its nature and its execution, and where, as here, important aspects of the transaction have their origin in locations in several different countries, it will usually be difficult to identify the real source of income so generated. To attribute "source" is a matter of judgment, and of assessment, of the relative weight of all of the relevant surrounding circumstances. Although he recognised the importance of other aspects, for example, the security provided by Midland, his Honour fastened upon the certificate of deposit as the most significant for present purposes. I would agree.

This is so notwithstanding the Commissioner's contention that even if the certificate of deposit had not been issued, the taxpayers may have been able to show that, at an anterior stage, an implied contract had come into existence. In the events which happened, a formal contractual instrument, the certificate of deposit, was brought into existence. This was in accordance with the intentions of the parties. It was always intended to govern their relationship, not only as a matter of form, but as a matter of substance. It seems to me then to be of no practical significance, and thus for present purposes impermissible, to attempt to speculate about an outcome at law, or in equity, in the event that EPBCL failed to issue the certificate.

From a practical business standpoint, the better view is that the source of the entitlement to interest was located at the place, the Cook Islands, where the certificate issued and where it was enforceable.

The second issue on the appeal: did Pt IVA apply?

It will be necessary first to describe the legislative scheme and then to refer to the Commissioner's determination made under Pt IVA.

The legislative scheme

Unlike s 260, Pt IVA does not operate of its own force. Its operation is dependent upon the exercise of the Commissioner's discretion to make a determination cancelling a "tax benefit" obtained by a taxpayer in connection with a "scheme" to which Pt IVA applies. "Scheme" is defined, broadly, in s 177A(1) and it includes a reference to a unilateral scheme (s 177A(3)). A "tax benefit" is described, relevantly, as a reference to an amount not being included in the assessable income of the taxpayer of a year of income where that amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out (s 177C(1)(a)).

Part IVA applies to a scheme where first, a taxpayer (the relevant taxpayer) has obtained, or would but for s 177F obtain, a tax benefit in that connection (s 177D(a)); and where, secondly, having regard to, inter alia, the manner in which the scheme was entered into, its form and substance and the result in relation to the operation of the Act that, but for Pt IVA, would be achieved by the scheme:

> "... it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose [being the 'dominant' purpose — s 177A(3)] of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme ..." [s 177D(b)].

Where a tax benefit has been obtained, or would but for s 177F be obtained, by a taxpayer in connection with a scheme to which Pt IVA applies, in the case of a tax benefit that is referable to an amount not being included in the taxpayer's assessable income, the Commissioner may determine that the whole or part of that amount shall be included in that assessable income (s 177F(1)(a)).

The Commissioner's determination under s 177F(1)

The scheme was initially referred to by the Commissioner as:

> "... the actions proposed, and carried out, by Spotless Services [the taxpayer] in the making, on or about 10 December 1986, of a lending agreement with ... [EPBC] which was productive of $2,670,663 income for the taxpayer in the year of income ended 30 June 1987."

The determination went on to state the following:

> "8. For the purposes of Part IVA, then, it is possible in the present case, by reference to the documents listed in paragraph 9 below, to isolate a scheme which consisted of the carrying out of a plan under which it was proposed that a lending agreement, which, ostensibly, was otherwise to be entered into on a commercial basis, should be made, not in the location in which it would be made on the basis of usual commercial considerations, but that it be made in a remote location, with that alternative location being chosen on the basis of considerations other than commercial considerations.
>
> 9. The documents referred to in the previous paragraph are:
>
> (a) an undated 'Information Memorandum Relating to the Issue of Certificates of Deposit' published by EPBC;
>
> (b) memorandum of 26 November, 1986, to the Chairman and Directors of Spotless Services Ltd;
>
> (c) telex of 5 December, 1986 from EPBC to Spotless Services Ltd;

(d) grant of power of attorney by Spotless Services Ltd to Peter John Levy, dated 8 December, 1986; A
(e) a joint venture agreement of 8 December, 1986, between the taxpayer and Spotless Finance Pty Ltd;
(f) minutes of meeting of the directors of Spotless Services Ltd, held on 9 December, 1986;
(g) EPBC Certificate of Deposit, No 156, of 10 December, 1986 issued to Spotless Services Ltd.

B

10. In the consideration of the application of Part IVA to the matters referred to above, it is necessary also to have regard to the matters referred to in section 177D(b) of the Act. Thus, regard will now be had to the matters referred to in section 177D(b) in connection with the question as to whether the taxpayer entered into or carried out the scheme, identified above, for the purpose of enabling the taxpayer to obtain a tax benefit, with each of the sub-paragraphs of section 177D(b) being considered in turn:

C

(i) the scheme was contrived, in that there was no commercial reason for the taxpayer to perform the acts which constituted, on its part, its entry into the relevant agreement with EPBC;
(ii) while the taxpayer may have been entering into an agreement with a profit-making commercial purpose, nevertheless the relevant scheme did not constitute part of any commerciality of the agreement as such, and the substance of the scheme, as distinct from substance of the lending agreement, was specifically non-commercial;

D

(iii) the person given the power of attorney was acting under very specific instructions, and travelled outside of Australia for a single transaction only, and as such could not be said to be carrying on the business of the taxpayer outside of Australia during his brief period of absence from Australia;
(iv) if section 23(q) is available to the taxpayer, then the result in relation to the operation of the Act that would be achieved by the scheme, but for the operation of Part IVA, would be that the amount of $2,670,663 would not form part of the assessable income of the taxpayer;

E

...

11. It is thus possible to conclude that the taxpayer carried out the scheme for the purpose of enabling the taxpayer to obtain a tax benefit in relation to the scheme, namely the acquisition of a purported source outside of Australia for the amount of $2,670,663 of income, thus enabling that amount of income to become, by virtue of section 23(q), exempt income;

F

..."

The Commissioner's particulars of disallowance of the taxpayers' objections

In this connection, the Commissioner provided particulars of the scheme relied upon which included a reference to:

G

"... the carefully considered and executed plan of action by the taxpayer under which it armed an officer of the company with authority to enter into a relevant loan agreement, and the sending of that officer to the Cook Islands in order to enter into that agreement ..."

The reasoning at first instance

Lockhart J said (at 362-363) that the Full Federal Court decisions in *Commissioner of Taxation v Jackson* (1990) 27 FCR 1 and in *Peabody v Commissioner of Taxation* (1993) 40 FCR 531, were authority for the following, inter alia, propositions:

> "• in proceedings under Pt V of the Act, where a determination under s 177F has purportedly been made and relied upon by the Commissioner, it will be open to a taxpayer to challenge the existence of the conditions precedent to the making of the determination: for example, the existence of a scheme, whether there was a tax benefit, and whether the necessary conclusion as to purpose is to be arrived at, whether an invalid determination was made;
>
> • where, as a matter of fact, a scheme consists of a series of steps or a course of action, the Commissioner may not isolate out of that course of action one step and classify that as a scheme. Reference in Pt IVA to 'part of a scheme' suggests that where a series of steps constitutes a scheme, that whole series of steps is to be considered;
>
> • on a reference of an objection to a decision to the Court under Pt V of the Act, it is the scheme identified by the Commissioner which is to be considered by the Court. In *Peabody* the scheme identified by the Commissioner included ten steps. It was held that it was that scheme involving those steps that was to be considered by the Court and that the learned trial judge erred in holding that the scheme to be considered by the Court was merely one part of that scheme;
>
> • in determining whether the requisite tax benefit was obtained by the taxpayer in connection with the scheme it is necessary to determine what the expected outcome would be if the scheme adopted had not in fact been entered into or carried out;
>
> • Part IVA would seldom, if ever, operate to permit the Commissioner to make a determination where the overall transaction is in every way commercial, although containing some element which has been selected to reduce the tax payable."

In holding that Pt IVA could not apply, Lockhart J said (at 366):

> "A critical part of the steps taken by the taxpayers to achieve their investment was the sending of Mr Levy to the Cook Islands and the entry by him there into the transactions on their behalf. This constituted the acceptance of the offer. But the offer cannot itself be ignored as part of the scheme and it is to be found in the telex of 5 December. The offer and the acceptance together with the intervening acts and probably the steps commencing with the receipt by the taxpayers of the information memorandum and other documents earlier than 5 December all constitute the relevant commercial transaction and the scheme. The Commissioner selected out of the relevant series of steps only some of them and classified that isolated segment as the scheme for the purposes of Pt IVA. This he cannot do."

His Honour held, following the Full Federal Court decision in *Peabody*, that the Commissioner "made a determination of the elements of the scheme too narrowly, and incorrectly . . ." (at 367).

But, as has been noted, judgment in the appeal to the High Court in *Peabody*

(see *Commissioner of Taxation (Cth) v Peabody* (1994) 181 CLR 359) was delivered after the present decision. The High Court there 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 aspect.

The Full Federal Court decision in Peabody

In *Peabody*, it was held in the Full Federal Court that, on the scheme propounded by the Commissioner and relied on in his determination, there was no tax benefit to the taxpayer; nor could the conclusion as to purpose required by s 177D be reached. On the latter aspect, Hill J (Ryan and Cooper JJ concurring) said (at 548-549):

> "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. Once the scheme is analysed as encompassing the acquisition of shares, the financing of those shares and the ultimate flotation of a public company, it is hard to see, in a case such as the present, how the relevant conclusion as to purpose could have been drawn. Part IVA would seldom, if ever, operate to permit the Commissioner to make a determination, carrying with it as it does an automatic penalty upon a taxpayer assessed, where the overall transaction is in every way commercial, although containing some element which has been selected to reduce the tax payable. Part IVA is no more applicable to such a case than was its predecessor, s 260."

Earlier, in discussing the meaning of "scheme" in Pt IVA, Hill J said (at 540):

> "The expression 'scheme' is defined in s 177A. It encompasses, inter alia, non-enforceable arrangements or understandings as well as courses of action or courses of conduct. In a particular case a unilateral action may constitute a 'scheme' for the purposes of the definition. In other cases, as identified by the Commissioner in the present circumstances, the scheme may consist of a series of steps or a course of action. This is not to say that where, as a matter of fact, a scheme consists of a course of action comprising several steps, the Commissioner may isolate out of that course of action one step and classify that as a scheme. Reference in Pt IVA to 'part of a scheme' (cf s 177A(5)) suggests rather that, in a case where a series of steps constitutes a scheme, that whole series of steps is to be considered, the individual steps being seen as parts of the scheme rather than each step being capable of being seen as a scheme in itself: cf *Inland Revenue Commissioners v Brebner* [1967] 2 AC 18 at 26, 27."

The language of s 177D

Although the gist of this provision, which is central to the present question, has been previously stated, it is desirable next to set out its terms. So far as is relevant, s 177D provides that Pt IVA shall apply to a scheme where:

> "(a) a taxpayer (in this section referred to as the 'relevant taxpayer') has

obtained, or would but for section 177F obtain, a tax benefit in connection with the scheme; and

(b) having regard to —

(i) the manner in which the scheme was entered into or carried out;

(ii) the form and substance of the scheme;

(iii) the time at which 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;

(vi) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme;

(vii) any other consequence for the relevant taxpayer, or for any person referred to in sub-paragraph (vi), of the scheme having been entered into or carried out; and

(viii) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in sub-paragraph (vi),

it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so *for the purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme* or of enabling the relevant taxpayer and another taxpayer or other taxpayers each to obtain a tax benefit in connection with the scheme (whether or not that person who entered into or carried out the scheme or any part of the scheme is the relevant taxpayer or is the other taxpayer or one of the other taxpayers).'' [Emphasis added.]

The reasoning of the High Court in Peabody

The Full High Court said (at 382):

''The existence of the discretion [under s 177F(1)] is not made to depend upon the Commissioner's opinion or satisfaction that there is a tax benefit or that, if there is a tax benefit, it was obtained in connexion with a Pt IVA scheme. Those are posited as objective facts ... The erroneous identification by the Commissioner of a scheme as being one to which Pt IVA applies or a misconception on his part as to the connexion of a tax benefit with such a scheme will result in the wrongful exercise of the discretion conferred by s 177F(1) only if in the event the tax benefit which the Commissioner purports to cancel is not a tax benefit within the meaning of Pt IVA. That is unlikely to be the case if the error goes to the mere detail of a scheme relied upon by the Commissioner. An error of a more fundamental kind, however, may have that result — where, for example, it leads to the identification of the wrong taxpayer as the recipient of the tax benefit.''

Their Honours went on to say (at 382-383):

"Of course, the Commissioner may be required to supply particulars of the scheme relied on ... and in this case has supplied them in the form of the ten steps identified by the Commissioner. But the Commissioner is entitled to put his case in alternative ways. If, within a wider scheme which has been identified, the Commissioner seeks also to rely upon a narrower scheme as meeting the requirements of Pt IVA, then in our view there is no reason why the Commissioner should not be permitted to do so ... provided it causes no undue embarrassment or surprise to the other side. If it does, the situation may be cured by amendment, provided the interests of justice allow such a course."

The High Court held that the Commissioner was entitled to rely on the narrower scheme which had been identified by the primary judge. The Court said (at 383-384):

"... Pt IVA does not provide that a scheme includes part of a scheme and it is possible, despite the very wide definition of a scheme, to conceive of a set of circumstances which constitutes only part of a scheme and not a scheme in itself. That will occur where the circumstances are incapable of standing on their own without being 'robbed of all practical meaning' ... In that event, it is not possible in our view to say that those circumstances constitute a scheme rather than part of a scheme merely because of the provision made by ss 177D and 177A. The fact that the relevant purpose under s 177D may be the purpose or dominant purpose under s 177A(5) of a person who carries out only part of the scheme is insufficient to enable part of a scheme to be regarded as a scheme on its own. That, of course, does not mean that if part of a scheme may be identified as a scheme in itself the Commissioner is precluded from relying upon it as well as the wider scheme."

But the Court went on to hold that the taxpayer did not obtain a "tax benefit". It will be recalled that the statutory definition of this concept included a reference to what "might reasonably be expected". In this connection, the Court said (at 385):

"A reasonable expectation requires more than a possibility. It involves a prediction as to events which would have taken place if the relevant scheme had not been entered into or carried out and the prediction must be sufficiently reliable for it to be regarded as reasonable."

The Court concluded (at 386):

"... the method adopted ... was found below to be entirely explicable upon a commercial basis and it could not be said of any of the examples advanced [by the Commissioner in argument] that, even if commercially possible, they would have been adopted in the absence of the devaluation as a matter of reasonable expectation."

Conclusions on the appeal on the question whether Pt IVA applied

It will be convenient to consider the requisite ingredients in turn.

(a) The "scheme" alleged

On behalf of the Commissioner, two alternative versions of the "scheme" are advanced.

The first, and wider, version, has these elements:

- The dominant objective to be achieved by Spotless in its investment was to obtain income which would not be taxed in Australia. Reliance is placed

upon the statement by Stephens that generally the dominant purpose of the investor is "to seek a greater return upon investment by deriving income which, by virtue of the provisions of the Act, is exempt income".

- The elaborate steps that were undertaken were all designed to ensure that the investment would produce income that would benefit from the operation of s 23(q).
- To speak of a taxpayer, as the respondents now do, seeking to do no more than obtain a commercial return upon an investment obscures the real question: any immunity from tax necessarily produces a "commercial return", in the sense that a greater return is achieved, net of tax, than if tax is payable.

Alternatively, the Commissioner relies on the scheme identified in par 8 of his determination, that is:

> "... the carrying out of a plan under which it was proposed that a lending agreement, which, ostensibly, was otherwise to be entered into on a commercial basis, should be made, not in the location in which it would be made on the basis of usual commercial considerations, but that it be made in a remote location, with that alternative location being chosen on the basis of considerations other than commercial considerations."

(b) Did the Commissioner err in making his determination?

With respect to those who hold a different view, and although I accept that the question can, in some contexts, be a difficult one (see, eg J Passant, "Tax Avoidance in Australia: Results and Prospects" (1994) 22 FL Rev 493 at 517-519), I am not persuaded that the Commissioner did err in his determination. This is so, I think, whether the broader or narrower view of the "scheme" is adopted.

As has been noted, "scheme" is liberally defined in s 177A(1). It means:

> "(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 my opinion, it cannot seriously be disputed that the proposal outlined in general terms in the EPBC Information Memorandum was the basis for the subsequent negotiations between the parties which led to the making of their formal contract in the form of the issue of the certificate of deposit. All these dealings, that is, from the handing over of the Information Memorandum to the issue of the certificate of deposit and its subsequent redemption, constituted a plan of action which could fairly be described as a "scheme" within s 177A(1)(a) or (b).

Moreover, in my view, that course of action was, in terms of its dominant purpose, fiscally or tax driven; this was so from the standpoint of all the parties to the arrangement, but especially from Spotless' point of view.

As the Information Memorandum noted, the interest rate payable would be "at a margin under the [Australian] bank bill rate ...". It was then stated that the interest would be subject to Cook Islands withholding tax at the rate of 5 per cent. On its face, this appears to be a dealing otherwise than in the ordinary course of business. There is no commercial reason, in the absence of the receipt of a collateral, compensating advantage, why a potential depositor would submit to such disadvantageous, non-commercial terms. The answer, of

course, is that the proposal to pay interest less than the bank bill rate and to subtract 5 per cent withholding tax did not stand alone. It was proposed to be compensated for by a collateral tax advantage which provided the key to the whole transaction. The structure of the Information Memorandum is significant, in this respect. As has been noted, the document opens, in substantial terms, with a single page entitled "Issue Details", including the statements as to "security" and "interest rate". On the next page, as we have seen, under the sub-title "Nature of Investment", all that appears is about tax. There first appears another reference to the Cook Islands withholding tax and the balance is devoted, significantly in my view, to a discussion of the Australian tax position, that is, relevantly:

> "NATURE OF INVESTMENT
>
> ... 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 Section 23(q) ..."

Reference is then made to Stephens' opinion that the investment "produces exempt income" for tax purposes. All of this is eloquent testimony to the effect that the proposal was, in essence, dictated by taxation considerations. Moreover, there is no reason to suppose that Spotless viewed it differently.

In my opinion, it follows from the "form" and the "substance" of this scheme (see s 177D(b)(ii)) that it would be concluded that Spotless entered into the scheme for the purpose of enabling it to obtain a "tax benefit" in connection with the scheme. The form and substance of the proposal, as the Information Memorandum and Stephens' letter made clear, was to take steps to ensure that the source of the interest be located in the Cook Islands in order that s 23(q) might be relied upon. This was done both ostensibly and, as I have said, as a matter of reality. The dominant purpose of doing this was to achieve a particular fiscal result in terms of Australian tax; that is to say, a tax benefit in the form of the exemption from Australian tax of the amount of the interest remaining after the Cook Islands withholding tax was deducted.

Given the declaration of intention of Spotless to invest the fund of $40 million short-term, for the purposes of s 177C(1)(a), in my view, it might reasonably be expected that interest of at least that actually earned would have been earned in Australia and would have been included in its taxable income.

It is true that the evidence indicates that Spotless considered, but rejected, some other off-shore propositions with possible (at least as perceived) fiscal advantages. There is no reason to suppose that Spotless would, in fact, have embarked upon any of these proposals. In any event, there would remain the question whether tax benefits under such propositions might themselves have been cancelled by the Commissioner.

On behalf of the respondents, it is submitted that this is not a case where the taxpayer has diverted an existing income stream in such a way that it will not attract tax. I agree, but it is plain that Pt IVA can operate in other circumstances.

Then it is said on behalf of the respondents 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". There is an echo here of the "choice" principle developed in the earlier jurisprudence of s 260. In my opinion, such a principle has no place in Pt IVA. For one thing, as a matter of form and substance, the two provisions are quite different. Indeed one of the mischiefs sought to be remedied by the enactment of Pt IVA was the

A ineffectiveness of s 260 in important respects. Moreover, it is specifically provided by s 177B(1) that:

> "... nothing in the provisions of this Act other than this Part ... shall be taken to limit the operation of this Part."

Furthermore, in my view, it is not a fair description of these transactions to suggest that the taxation aspects were merely incidental or consequential. The fiscal aspects were highlighted in the contemporary documentation. They were clearly at the forefront of the parties' consideration. Without taxation benefits, B the proposal made no sense.

This is not to say that it is impossible to have a commercial reason, even a dominant one, for an investment offshore which will attract s 23(q), yet not be caught by Pt IVA. The dominant purpose of this particular investment is a question of fact — was it for tax reasons (as the Commissioner contends) or was it for commercial reasons (as in *Peabody*, as the respondents argue)? If the investment were, in terms of its dominant purpose, commercially actuated, one C would expect readily to find a commercial justification for its adoption. But none appears. 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. Why did the respondents choose to adopt such an D "uncommercial" course with so many disadvantages? The reason could only be that given by the Information Memorandum. The "nature of the investment", that is, its essential feature, 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 s 23(q). In short, the scheme was tax driven. It had no commercial basis. It follows, in my view, that Pt IVA applied to it.

E **Orders proposed**

I would propose that the appeals be allowed and that the orders made at first instance be set aside; and that, in lieu thereof, it be ordered that the applications made at first instance be dismissed. Since each side has succeeded on one issue, I would make no order for costs at first instance or on the appeals.

COOPER J. These appeals raise two questions for determination. The first F question is whether interest earned by the taxpayers was exempt income in consequence of the operation of s 23(q) of the *Income Tax Assessment Act* 1936 (Cth) (ITAA) by reason of its having a source in the Cook Islands. If the first question is answered "yes", the second question is whether Pt IVA of the ITAA permitted the Commissioner of Taxation (the Commissioner) to determine that the exempt income was a "tax benefit" within the meaning of s 177C of the ITAA and to treat the interest as assessable income and assess it to tax accordingly.

G **The source of the interest**

The relevant facts as to what occurred were summarised by Lockhart J at first instance as follows (*Spotless Services Ltd v Commissioner of Taxation (Cth)* (1993) 25 ATR 344 at 357):

> "... In late 1986 Spotless Services and Spotless Finance had available $40

million as a result of a successful company public flotation. They did not need to apply their funds for their current business needs during the year of income, so they sought a suitable short term investment in which to place the funds. They had been approached by Bankers Trust about the investment of funds in the Cook Islands and the tax benefits to be gained therefrom. A letter of offer had been received by the Spotless group from EPBCL which was considered by Spotless Services and Spotless Finance. They decided to place the $40 million on deposit with EPBCL in the Cook Islands. Mr Levy of Spotless Services was authorized to travel to the Cook Islands and attend to the investment. Mr Levy travelled to the Cook Islands and he attended at the appointed place for settlement on 10 December 1986 (AES time, being 9 December CI time). The transaction could not proceed that day because the investment was to be made by depositing funds against the certificate of deposit to be issued by EPBCL. That deposit was to be secured, in the interests of the Spotless companies, by a letter of credit from Midland.

On 10 December (AES time) the letter of credit was not in a form satisfactory to the Spotless companies so settlement did not proceed that day. Midland agreed to make suitable amendments to the letter of credit and on 11 December the transaction proceeded. The two Spotless companies provided funds which were placed to the credit of Spotless Services under the joint venture agreement with EPBC. Midland provided a letter of credit which would be invoked in the event that there was default by EPBCL on its certificate of deposit. Mr Levy drew a cheque for $40 million against the funds held on behalf of Spotless Services and Spotless Finance and that was applied by making a deposit against the certificate of deposit issued by EPBCL. After the funds had been deposited the transaction was completed on 11 December (AES time). On maturity in 1987 Spotless Services and Spotless Finance received back the principal together with interest less Cook Islands' withholding tax.''

On the hearing of the applications, and on the appeals, the Commissioner contended that the relevant investment contract was made in Australia when the taxpayers handed over to a representative of the Midland Bank plc (Midland) a bank cheque in the sum of $40,000,000 ($40 million) in exchange for an irrevocable banker's letter of credit issued by Midland obliging it to pay to the taxpayers the principal together with interest in the event of a default by European Pacific Banking Company Limited (EPBCL). It was contended that the presence of Mr Levy of Spotless Services Limited at the office of EPBCL in the Cook Islands and his executing a cheque drawn on European Pacific Banking Corporation (EPBC) in favour of EPBCL for $40 million which he handed to Mr Kuegler on behalf of EPBCL in exchange for a certificate of deposit, was all post-contract activity designed to give to the transaction a Cook Islands connection in order to attempt to attract the operation of s 23(q) of the ITAA.

Lockhart J dealt with the Commissioner's contention in this way (at 360-361):

''The telex of 5 December 1986 from Mr Kuegler was received by Mr Williams on the morning of 8 December 1986 and that telex confirmed the terms and conditions of the deposit that had been negotiated with Mr Clarke in the Cook Islands. It is clear on the face of that document that it is an offer made to the taxpayers which was available for acceptance by

A them by delivery of a cheque for $40 million to EPBCL at the offices of EPBC in the Cook Islands. It is true that EPBCL extended its offer for one further day beyond the time specified in the telex of 5 December; but that was because of the problem that arose with respect to the letter of credit requiring the extension of time. On 10 December (CI time) the cheque for $40 million was delivered to the place of business of the offerer, namely EPBCL, specified in the telex. It was delivered by Mr Levy on behalf of the taxpayers, who received in return the certificate of deposit. The B contract was made in the Cook Islands.

The taxpayers took very seriously the terms on which the letter of credit was to be issued by Midland. That was to provide their security after the deposit had been made in the Cook Islands; and it represented a very large sum of money, being the greater part of the capital recently raised in the public flotation. The letter of credit is itself an important document, but one which cannot play a determinative role in ascertaining the source of C 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. Until the cheque was handed over by Spotless Services in the Cook Islands the taxpayers were not bound by any contract. Similarly, the taxpayers were not protected by the letter of credit until they themselves became bound to make the loan. The letter of credit itself was made on the application of EPBCL and is directed to the Secretary of Spotless Services. Two events are stated as D preconditions entitling Spotless Services to call on the letter of credit and they are set out in par 1(d) of the letter and require as a precondition that the certificate of deposit must have issued. Spotless Services did not acquire any rights under the letter of credit until it received the certificate of deposit. The letter of credit was provided as collateral security to the taxpayers.

The event which concluded the contract and bound the parties was the E delivery of the cheque in the Cook Islands on behalf of the Spotless companies to EPBCL and the receipt of the certificate of deposit by them through their agent, Mr Levy. The certificate of deposit is the critical document for the purposes of the contract between the parties. It is that document which gave rise to rights vested in the taxpayers against EPBCL and it was only in default of that certificate being honoured that Spotless Services was entitled to call on the letter of credit which it had received.

F The contract of loan is between the two Spotless companies on the one hand and EPBCL on the other. It was not an agreement which the taxpayers had with Midland. The contract was in fact one constituted by the telexed offer of 5 December and was accepted by conduct in the Cook Islands.

The taxpayers were not contractually bound to EPBCL on 11 December when Mr Williams picked up the bank cheque for $40 million payable to Midland and went to the offices of Bankers Trust in Collins Street, G Melbourne and did the various other things to which reference has already been made, including in particular, the handing over of the cheque for $40 million with the letter of authorization. What was done in Melbourne on 11 December was certainly preparatory to the making of the contract. The taxpayers had available the bank cheque for $40 million payable to Midland which was handed by their representative to Midland with

instructions as to what should be done with it. Midland was acting as a conduit for the transmission of funds to the Cook Islands where they would be held on account of the taxpayers. What happened in Melbourne simply put the taxpayers in a position to conclude an agreement in the Cook Islands. The events in Melbourne on 11 December indicated that the taxpayers fully intended to go ahead with the making of the loan; but there was no contract that bound them to EPBCL until a cheque was drawn against the funds lodged in Melbourne and a cheque given by Mr Levy on their behalf to EPBCL in the Cook Islands and for which they received in return a certificate of deposit. Until those events occurred there was no binding contract of loan between the taxpayers and EPBCL. The contract was entered into in the Cook Islands not in Melbourne. The contract is between each of the taxpayers on the one hand and EPBCL on the other. It was concluded at the meeting in the Cook Islands on 10 December (CI time) when Mr Levy handed the cheque for $40 million to Mr Kuegler and Mr Kuegler handed Mr Levy in return the certificate of deposit.''

Each of the findings of fact made by his Honour 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. It was put to Mr Kuegler, an officer of both EPBC and EPBCL at the relevant time, that all that occurred in the Cook Islands was that he and Mr Levy ''swapped papers'', a suggestion rejected by Mr Kuegler. In his findings Lockhart J has inferentially rejected the suggestion of a sham and in so doing cannot be said to be clearly erroneous. The basis upon which the appellant contends that the conduct of Mr Levy and Mr Kuegler was of no practical or legal consequence is to be found in an apparent inconsistency in the documentation and the movement of funds.

The authority given to Midland when it received the bank cheque for $40 million was ''to apply $A40,000,000 (forty million Australian dollars) to the account of Spotless Services Limited in Rarotonga, Cook Islands''. The mandate which Mr Levy carried to the Cook Islands was to ''open an Australian (currency) bank account with European Pacific Banking Company Limited Rarotonga under the name Spotless Services Limited''. The power of attorney given to Mr Levy by Spotless Services Limited authorised him:

''(i) To draw a cheque on the bank account of the Grantor maintained with European Pacific Banking Corporation in the Cook Islands ('the Account') in the sum of A$(40,000,000) in favour of European Pacific Banking Company Limited ('EPBCL').

(ii) To deposit the cheque referred to in item (i) above with EPBCL in the Cook Islands for the credit of the Grantor.

(iii) To receive a Certificate of Deposit issued by EPBCL, the face value of which will be the amount referred to in item (i) above ('the CD').

(iv) To hold the CD in safe custody for the Grantor in the Cook Islands and to send a copy of same by facsimile transmission to the Grantor.

(v) To surrender the CD to EPBCL at the offices of EPBCL in Rarotonga, Cook Islands and to receive upon surrender of the CD a

A cheque drawn by EPBCL upon the account it maintains with European Pacific Banking Corporation in the sum of A$40,000,000 plus interest in favour on [sic] the Grantor.

(vi) To deposit the cheque referred to in item (v) in the Account and at the same time to deliver instructions to European Pacific Banking Corporation to transfer funds equal to the same day value of the amount of the cheque from the Account to Spotless Services Limited for the credit of the Grantor or as the Grantor may direct.''

B

In fact the evidence only goes so far as establishing that the $40 million was placed in an account of EPBC with Midland Singapore on 10 December 1986 thereafter to be disbursed in accordance with the directions of EPBC. There is no evidence that the funds were thereafter transferred or credited to any account of Spotless Services Limited with EPBCL.

In the Cook Islands Mr Levy executed a cheque drawn on EPBC in favour of
C EPBCL or order. The evidence of Mr Kuegler as to whether or not an account was opened with EPBC and whether or not there was a second cheque is less than satisfactory. However, at the time Mr Levy signed the cheque he was authorised to do so by the power of attorney and EPBC had received and retained for its benefit the $40 million from Midland Singapore. Therefore at the time the cheque was drawn there were funds of the taxpayers with EPBC to support the cheque. If EPBC acted in accordance with the direction contained in the cheque and paid to EPBCL or to its order $40 million, the cheque
D delivered by Mr Levy on behalf of Spotless Services Limited in fact would operate to pass $40 million into the control of EPBCL. However, the cheque as between Spotless Services Limited and EPBCL operated as the equivalent of cash. The result of the receipt of the cheque on that basis was to credit Spotless Services Limited with $40 million on deposit in accordance with the terms set out in the certificate of deposit. The cheque operated as a payment of money and the risk of non-payment on presentation of the cheque drawn on EPBC was
E borne by EPBCL (*National Australia Bank Ltd v KDS Construction Services Pty Ltd* (1987) 163 CLR 668 at 676-677; *Barclays Bank Ltd v Astley Industrial Trust Ltd* [1970] 2 QB 527 at 539).

The conclusion that the cheque was treated as cash is to be drawn from three circumstances. The first is that EPBC was the parent of EPBCL and Mr Kuegler was an officer of both companies. The second is that Mr Kuegler would not proceed with the transaction on 9 December 1986 (Cook Islands time) because the cheque was not then supported by funds to the extent of $40
F million within the control of EPBC. And the third is that the rights of Spotless Services Limited under the irrevocable banker's letter of credit issued by Midland arose immediately upon receipt of the certificate of deposit and were not dependent upon collection of the proceeds of the cheque by EPBCL.

The appellant did not submit that his Honour made any error in formulating the test to be applied to determine the source of any income for the purpose of s 23(q) of the ITAA. Nor did the appellant contend for any new or different
G test. Rather, the appellant submitted that upon the application of that test the source of the interest earned on the loan was Australia and not the Cook Islands.

In weighing the factors to be taken into account when reaching a conclusion as to the source of the income, his Honour gave considerable weight to the place where the contract was made and where the money was lent. These

events, his Honour found, occurred in the Cook Islands. His Honour continued (at 361): A

> "There are other facts and circumstances that in my view point strongly in the direction of the conclusions that the interest was derived by the taxpayers in the Cook Islands. The borrower, EPBCL, was incorporated in the Cook Islands and carried on business there. It did not carry on business in Australia. The deposit was repaid, together with interest, less withholding tax, from the Cook Islands. It is impossible to ignore the legal B effect of the arrangements entered into by the parties with respect to the lending of the money. Until the cheque for $40 million was handed over on 11 December in the Cook Islands (10 December CI time) and the certificate of deposit received in return there was no contract between the lender (the taxpayers) and the borrower (EPBCL). If EPBCL failed to honour the certificate of deposit on the due date the taxpayers could have sued on the certificate and there would have been no answer in law to their right to judgment." C

Once the contention that the contract was in reality made in Australia and that what occurred in the Cook Islands was a mere "formal step designed to screen the reality" is rejected and the banker's letter of credit issued by Midland is seen for what it was, a security to secure performance by EPBCL of repayment of the loan with interest, and not as an investment in itself, the matters contended for by the Commissioner as matters of practical substance sourcing the interest in Australia are either not factually correct or not sufficient D to outweigh the Cook Islands elements.

On the findings of fact made by his Honour the source of the income derived was the Cook Islands.

It was agreed by the parties that if the interest was sourced in the Cook Islands, s 23(q) of the ITAA applied and the interest was exempt income.

The appellant fails on the first question on the appeals.

Application of Pt IVA of the ITAA E

Counsel for the Commissioner submitted that the relevant operation of Pt IVA of the ITAA, if any, fell to be determined by answering a series of questions in sequence. Those questions were:

(a) Was there in existence a "scheme" as defined by s 177A of the ITAA?
(b) Was there a "tax benefit" as defined by s 177C?
(c) If there was a scheme, was it a scheme to which the Part applied as determined by s 177D? F
(d) Was the Commissioner entitled to determine that the interest earned be included in the assessable income of the taxpayers under s 177F?

In my view, the approach contended for is the correct one. To succeed on the appeal the Commissioner must obtain an affirmative answer to each of these questions. The respondents submitted that each question should be answered in the negative.

The term "scheme" is defined in s 177A as: G

> "'scheme' means —
>
> (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

A (b) any scheme, plan, proposal, action, course of action or course of conduct.''

The identification of the relevant scheme is important because Pt IVA is not concerned with all or any schemes. It is concerned only with those schemes which the entry into or carrying out of produce a tax benefit as defined (s 177D). And, it is concerned only with schemes where ''... it would be concluded that the person or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling the B relevant taxpayer to obtain a tax benefit in connection with the scheme ...'' (s 177D(b)). Similarly, the Commissioner's power to act under the Part is conditioned upon there being a tax benefit obtained ''... in connection with a scheme to which this Part applies ...'' (s 177F(1)).

In *Commissioner of Taxation (Cth) v Peabody* (1994) 181 CLR 359 at 382-383 the High Court in a joint judgment said:

''Under s 177F(1), the Commissioner's discretion to cancel a tax benefit C extends only to a tax benefit obtained in connexion with a scheme to which Pt IVA applies. The existence of the discretion is not made to depend upon the Commissioner's opinion or satisfaction that there is a tax benefit or that, if there is a tax benefit, it was obtained in connexion with a Pt IVA scheme. Those are posited as objective facts (see *McAndrew v Commissioner of Taxation (Cth)* (1956), 98 CLR 263 at 276-277, per Kitto J; cf *Avon Downs Pty Ltd v Commissioner of Taxation (Cth)* (1949) D 78 CLR 353 at 360, per Dixon J). The erroneous identification by the Commissioner of a scheme as being one to which Pt IVA applies or a misconception on his part as to the connexion of a tax benefit with such a scheme will result in the wrongful exercise of the discretion conferred by s 177F(1) only if in the event the tax benefit which the Commissioner purports to cancel is not a tax benefit within the meaning of Pt IVA. That is unlikely to be the case if the error goes to the mere detail of a scheme relied upon by the Commissioner. An error of a more fundamental kind, E however, may have that result — where, for example, it leads to the identification of the wrong taxpayer as the recipient of the tax benefit. But the question in every case must be whether a tax benefit which the Commissioner has purported to cancel is in fact a tax benefit obtained in connexion with a Pt IVA scheme and so susceptible to cancellation at the discretion of the Commissioner.

Of course, the Commissioner may be required to supply particulars of the scheme relied on (see *Bailey v Commissioner of Taxation (Cth)* (1977) F 136 CLR 214) and in this case has supplied them in the form of the ten steps identified by the Commissioner. But the Commissioner is entitled to put his case in alternative ways. If, within a wider scheme which has been identified, the Commissioner seeks also to rely upon a narrower scheme as meeting the requirements of Pt IVA, then in our view there is no reason why the Commissioner should not be permitted to do so (see *XCO Pty Ltd v Commissioner of Taxation (Cth)* (1971) 124 CLR 343 at 349, per G Gibbs J), provided it causes no undue embarrassment or surprise to the other side. If it does, the situation may be cured by amendment, provided the interests of justice allow such a course (*Bailey v Commissioner of Taxation (Cth)* at 219).''

Their Honours continued (at 383-384):

''... Pt IVA does not provide that a scheme includes part of a scheme and

it is possible, despite the very wide definition of a scheme, to conceive of a set of circumstances which constitutes only part of a scheme and not a scheme in itself. That will occur where the circumstances are incapable of standing on their own without being 'robbed of all practical meaning' (see *Inland Revenue Commissioners v Brebner* [1967] 2 AC 18 at 27). In that event, it is not possible in our view to say that those circumstances constitute a scheme rather than part of a scheme merely because of the provision made by ss 177D and 177A. The fact that the relevant purpose under s 177D may be the purpose or dominant purpose under s 177A(5) of a person who carries out only part of the scheme is insufficient to enable part of a scheme to be regarded as a scheme on its own. That, of course, does not mean that if part of a scheme may be identified as a scheme in itself the Commissioner is precluded from relying upon it as well as the wider scheme."

In the proceedings at first instance the scheme determined by the Commissioner under s 177F(1) was stated as follows:

"8. For the purposes of Part IVA, then, it is possible in the present case, by reference to the documents listed in paragraph 9 below, to isolate a scheme which consisted of the carrying out of a plan under which it was proposed that a lending agreement, which, ostensibly, was otherwise to be entered into on a commercial basis, should be made, not in the location in which it would be made on the basis of usual commercial considerations, but that it be made in a remote location, with that alternative location being chosen on the basis of considerations other than commercial considerations.

9. The documents referred to in the previous paragraph are:

(a) an undated 'Information Memorandum Relating to the Issue Of Certificates of Deposit' published by EPBC;

(b) memorandum of 26 November, 1986, to the Chairman and Directors of Spotless Services Ltd;

(c) telex of 5 December, 1986 from EPBC to Spotless Services Ltd;

(d) grant of power of attorney by Spotless Services Ltd to Peter John Levy, dated 8 December, 1986;

(e) a joint venture agreement of 8 December, 1986, between the taxpayer and Spotless Finance Pty Ltd;

(f) minutes of meeting of the directors of Spotless Services Ltd, held on 9 December, 1986;

(g) EPBC Certificate of Deposit, No 156, of 10 December, 1986 issued to Spotless Services Ltd."

In the particulars of disallowance of the taxpayer's objections the Commissioner had stated:

"(b) a 'scheme' for the purposes of Part IVA, namely the carefully considered and executed plan of action by the taxpayer under which it armed an officer of the company with authority to enter into a relevant loan agreement, and the sending of that officer to the Cook Islands in order to enter into that agreement, was properly identified."

His Honour in respect of the scheme so identified said (at 366):

"A critical part of the steps taken by the taxpayers to achieve their investment was the sending of Mr Levy to the Cook Islands and the entry by him there into the transactions on their behalf. This constituted the

A acceptance of the offer. But the offer cannot itself be ignored as part of the scheme and it is to be found in the telex of 5 December. The offer and the acceptance together with the intervening acts and probably the steps commencing with the receipt by the taxpayers of the information memorandum and other documents earlier than 5 December all constitute the relevant commercial transaction and the scheme. The Commissioner selected out of the relevant series of steps only some of them and classified that isolated segment as the scheme for the purposes of Pt IVA. This he cannot do. In fairness to the Commissioner he did not have the benefit of the Full Court's judgment in *Peabody* when making his amended assessments in 1991. If he had, then he may have defined the scheme in different and wider terms.''

The appellant submitted that having regard to the later decision of the High Court in *Peabody*, his Honour erred in the conclusion which he took.

On the appeal the appellant submitted that the effect of the High Court C decision in *Peabody* is that the Commissioner is not bound by the original identification of the scheme and may now rely on alternative formulations of the scheme. Accordingly, in its outline of argument, the appellant identifies a broad scheme:

> ''15. Thus the Court may regard the scheme as the deliberate and calculated adoption of a means of investment to render the income immune from tax by reason of s 23(q). In this case the taxpayer adopted a means of investment to avoid the imposition of tax that would otherwise D arise. That is a significant difference from the facts in *Peabody* where the taxation consequence of the commercial arrangement was incidental. Accordingly, the Court may regard the scheme as the agreement of the parties to include within an otherwise complete and commercial investment transaction provisions for the settlement of the transaction calculated and intended to locate abroad the source of the income to be derived from the transaction and which, but for the inclusion of those E provisions, would have been located within Australia, thereby attracting the tax benefit afforded by s 23(q) of the Act.''

and a narrower scheme:

> ''18. Here the Commissioner defined the scheme as:
>
> > 'A scheme which consisted of the carrying out of a plan under which it was proposed that a lending agreement, which, ostensibly, was otherwise to be entered into on a commercial basis, should be made, not in the location in which it would be made on the basis of usual F commercial considerations, but that it be made in a remote location, with that alternative location being chosen on the basis of considerations other than commercial considerations.' ''

In my view, the definition in s 177A requires that the parties to the scheme, in so far as they are known, must be identified and the terms or content of any agreement, arrangement, understanding, promise or undertaking and the steps or stages of any course of action or proposal, in so far as they are relevant, be G identified. It is not sufficient to identify a scheme by reference to a hoped for fiscal outcome. Section 177A requires that the scheme has an existence based in fact and reality and is not something based on the Commissioner's view of the facts or their legal effect. Thus in the instant case, it is wrong to identify a scheme which involves as an element an investment by deposit of funds with EPBC or EPBCL agreed in Australia which would in the ordinary course have

been performed in Australia but which as part of the scheme was agreed to be settled in the Cook Islands in order to attract the operation of s 23(q) of the ITAA. On his Honour's findings there was no agreement made between EPBCL and the taxpayers in Australia. The commercial arrangement between those parties was made and performed in the Cook Islands. The formulation in par 15 of the appellant's outline does not relevantly identify a scheme for the purposes of Pt IVA. A

The alternative formulation in par 18 likewise does not identify a scheme. If the word "ostensibly" is intended to carry with it the implication that the lending agreement was a sham, then the Commissioner failed in that regard. Further, in my view, questions of what are or are not objectively usual commercial considerations fall to be determined under s 177D(b) and not under s 177A or in a vacuum divorced from the facts as found. On those facts there was not available to the taxpayers a choice to make the lending agreement in Australia or in the Cook Islands, as the taxpayers chose. For the reasons found by his Honour, if the taxpayers were to invest with EPBCL, that required that the contract be made in the Cook Islands where EPBCL carried on business and where the offer contained in the telex of 5 December 1986 was in terms to be accepted by conduct which required that a cheque be deposited with EPBCL at its place of business in the Cook Islands. B C

The scheme particularised and relied upon at first instance is not capable of standing on its own and having practical meaning (as required by the High Court in *Peabody*) if it is severed from the antecedent conduct, including the offer, or from the subsequent conduct in concluding the loan agreement in the Cook Islands. D

In my view it is possible to identify a scheme within the meaning of s 177A in two alternative ways. The first is to do as his Honour did (at 366) and identify the scheme as:

> "[t]he offer and the acceptance together with the intervening acts and probably the steps commencing with the receipt by the taxpayers of the information memorandum and other documents earlier than 5 December." E

The second way to identify a relevant scheme is to say that the scheme was the proposal of the taxpayer 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 proposal.

The first question posed on the Pt IVA issue should be answered in the affirmative but not for the reasons or on the basis of the schemes identified by the appellant.

The second question on the Pt IVA issue requires the existence of a "tax benefit" within the meaning of s 177C(1). At the relevant time that section provided: F

> "(1) Subject to this section, a reference in this Part to the obtaining by a taxpayer of a tax benefit in connection with a scheme shall be read as a reference to —
>
> (a) an amount not being included in the assessable income of the taxpayer of a year of income where that amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out; or G
>
> (b) a deduction being allowable to the taxpayer in relation to a year

A of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out;

and, for the purposes of this Part, the amount of the tax benefit shall be taken to be —

(c) in a case to which paragraph (a) applies — the amount referred to in that paragraph; and

B

(d) in a case to which paragraph (b) applies — the amount of the whole of the deduction or of the part of the deduction, as the case may be, referred to in that paragraph.''

The appellant submitted that ''amount'' in the section means the quantitative statement of the income in dollar figures. On this construction ''that amount'' merely refers to any other money earned in the same quantitative amount. Thus the appellant submitted all that need be shown is that the taxpayers would or C might reasonably be expected to have included in the taxpayer's assessable income for the year in issue an amount equal to the interest less withholding tax earned had the scheme not been entered into or carried into effect.

The High Court in *Peabody* at 385 said as to ''reasonable expectation'':

''... A reasonable expectation requires more than a possibility. It involves a prediction as to events which would have taken place if the relevant scheme had not been entered into or carried out and the prediction must be sufficiently reliable for it to be regarded as reasonable (see *Dunn v Shapowloff* [1978] 2 NSWLR 235 at 249, per Mahoney JA).''

D

The taxpayers submitted that ''amount'' and ''that amount'' when used in s 177C means the income in fact derived, in this case the interest actually earned from EPBCL. On this construction it is necessary to show that if the scheme (as identified) had not been entered into or carried into effect nonetheless the interest actually earned from EPBCL, either in fact or as a reasonable expectation, would have been included in the assessable income of E the taxpayers. That test cannot be satisfied, it was submitted, where the right to interest comes from the loan agreement with EPBCL which is part of the scheme itself. Without the scheme there is nothing to sustain the existence of the interest. If the loan agreement had not been entered into as part of the scheme, the interest from EPBCL would not have been earned and would not therefore have been part of the taxpayers' assessable income for the relevant year.

The submission of the appellant on this issue was:

F

''MR SHAW: Now [sic] first question is, and I do this without precisely identifying the scheme, whether one can say a tax benefit was obtained in connection with the scheme. That is to say whether it is a reasonable prediction to say if the scheme had not been carried out there would have been an amount included in the assessable income. Now it will be — two things are to be recalled. One is that there were a number of competing propositions which were put forward to Spotless which were not accepted, G but which were at least in one case, almost equally attractive, and each of them was designed in the same way to use the provisions of section 23(q).

And it seems to be said by the taxpayer, if we hadn't invested the money with EPBCL on the BT scheme, we would have invested in [sic] with Harcourt, I think its name was, on some other section 23(q) scheme, and in our submission it can hardly be an answer to say, well if I hadn't

carried out one scheme, I would have carried out another. The other question is, well, assume one had not carried out a scheme designed to obtain a tax benefit at all of any kind, is it likely that there would have been assessable income; that is to say, is it a reasonable prediction that there would have been assessable income. In our submission the answer must inevitably be yes, because Spotless had $40 million; it had no immediate use for it; it wanted it in six months or so, it had the money on short term deposit.

If it had not done anything else with it, it could have just left it in the short term deposit, and would have derived assessable income, or if it could have invested it on some longer term deposit with some local institution and, in our submission, it is a reasonable prediction to say that there would have been assessable income if there had not been an attempt to use section 23(q), and then it said, well suppose that to be so, how do you know that the amount of the tax benefit is going to be the — or would have been — the amount of income that was actually derived, exempt so it said, under the provisions of section 23(q).

Our answer to that is, we do not have to be able to say if they had not done this, they would have invested it with, say, Westpac at such and such a percentage, and that would have produced say, a larger amount than was actually produced. It is sufficient to say, well the income that was actually derived would have been taxable, that is to say, part of the assessable income.

BEAUMONT J: Were it not for 23(q)?

MR SHAW: Yes.

BEAUMONT J: Yes, but you cannot say 23(q) is part of the scheme, can you?

MR SHAW: No, no, no.

BEAUMONT J: Are you not really saying that?

MR SHAW: No. No, what we are saying is that what one looks at in these circumstances, there may be different circumstances. This is no doubt a special circumstance, because this is a special provision of the act that makes the income exempt, you say, well, they did get so much income, whatever it is, and then you say, well, would the income they got had it not been for the scheme, have been assessable income.''

In order to satisfy the test under s 177C, what has to be ignored is not the tax consequence of s 23(q) on the derivation of the interest which would otherwise be assessable as income under s 25 of the ITAA, but the scheme as identified. If that means that the interest would not have been earned then, even on the construction contended for by the appellant, it is necessary to identify reasonable expectations as to what would in fact have occurred and not mere possibilities. Further, what would have been derived must be assessable income. Any capital gain or exempt income derived by the taxpayers would not satisfy the test.

The appellant submitted that it is self-evident that the taxpayers would not have left the $40 million idle and pointed to the fact that when the transaction was delayed for a day, the $40 million was placed on the overnight money market. With that submission I agree. However the difficulty is that it is necessary to show as a matter of reasonable expectation and not just as a possibility that the $40 million would have been used to produce assessable

A income in an amount of not less than the income earned in the Cook Islands as interest.

The question of what would have been done with the money was not directly explored in cross-examination of Mr Williams, the senior financial officer of Spotless Services Ltd. It was touched on indirectly as part of an examination of the circumstances leading to the investment with EPBCL. The extent of the relevant evidence given by Mr Williams is as follows:

B "MR SHAW: Now, in — you mentioned that when you had this meeting at the offices of Bankers Trust in December of 1986, there was an officer or a representative of Bankers Trust present; what had Bankers Trust got to do with this? — Bankers Trust were like a number of other banks that we spoke to at the time in terms of inviting investment proposals. Bankers Trust just happened to have been the organisation that advised us of the availability of this particular overseas deposit.

And when had that occurred? — That had occurred prior to the telex that C was exhibited a moment ago dated 10 September.

And had it — had you approached them or had they approached you? — Well, essentially before the float of Spotless Services, the corporate treasurer and I, knowing that we were going to receive a reasonably significant amount of money and knowing also that we didn't have any short-term, medium-term operational use of those moneys, invited proposals from a great number of financial institutions, and Bankers Trust were — was one of those organisations.

D It was they who had suggested to you this deposit with the European Pacific Banking Company Limited, is that right? — That is correct.

...

MR SHAW: And then I take it from your evidence that in early December some decision was made as to which were the most promising of the alternative investments that were available; is that right? — That is correct.

E And one of the ones which was a possible goer was the certificate of deposit with the European Pacific Banking Company? — Right.

And I think you said there were others. What were the alternatives? — There were two other alternatives. Initially we received a proposal in respect of a similar investment in Hong Kong that was brought to our intention [sic] by Rothchild. That particular proposal was assessed. That particular proposal carried with it a section 14C tax clearance from the commissioner, but after discussions with our legal advisers we decided F that we would not proceed with that on the basis of security.

Yes? — The other proposal was an almost identical proposal from another financial institution in the Cook Islands which went under the name of Harcourt Acceptance Corporation, and that was first introduced to us by the Bank of New Zealand.

Yes? — At about this time we were going through a similar appraisal of that particular one.

G And when you said that the Hong Kong proposal was rejected on the basis of security, I take it that you meant that the security — either that no security was being offered or that security was not adequate as you thought? — Correct.

Which of the two? — Well it was inadequate, as our legal advisers thought.

And why was it that you preferred the proposal of the European Pacific Banking Company to the Harcourt — I think you said Harcourt something? — Harcourt Acceptance Corporation.

Harcourt Acceptance proposal? — There was no real preference until the yield — the after tax return question.

So I take it from that that the Harcourt Acceptance proposal also offered some form of security you were satisfied with? — That is correct.

Now when you spoke to — I think you said it was Mr Clarke on 4 or 5 December — I cannot remember which day? — 5 December.

5 December. When you spoke to him, he, as I understood you, told you that he was prepared to increase the return, in effect? — That is correct.

And he presumably said that he confirmed that to you by telex; is that right? — Correct.

And did you say to him that if he did you would prefer his proposal to the other proposal, or you go ahead, or what did you say to him? — I indicated that given a rate of 13.3 percent after tax to us that we would proceed with that particular one.

...

MR SHAW: Well, it is true, is it not, that the after tax rate of return which you wanted could only be obtained in this investment if you got the advantage of section — the operation of section 23(q)? — Correct.

And there was no purpose in your mind in carrying out this transaction in the Cook Islands, except that it would give you that advantage. That is right, is it not? — As you have stated, we were looking to maximise our after tax return."

How this evidence is to be used depends ultimately upon the proper meaning of "amount" in s 177C and the scheme identified by the operation of s 177A.

The characterisation of the "amount" for the purpose of s 177C as the particular sum of money received from EPBCL as interest, as contended for by the taxpayers, is too narrow. No doubt there are circumstances where, for example, a pre-existing income stream is diverted, the amount as a particular amount of income remains the same and comes from the same source. However, an amount of income may be identified more generally as the income produced from a particular source or activity. This is such a case. The particular source or activity is the investment of the capital sum of $40 million and its use to generate a return to the taxpayers.

For present purposes the second formulation of the scheme set out above is to be applied.

The question to be answered is whether, if that scheme had not been entered into or carried out, an amount of income from the use of the $40 million equal to the amount of income in fact earned in the nature of interest would have been or could reasonably be expected to have been included in the assessable income of the taxpayers in the relevant year. In my view that question has to be answered "yes". This is because the scheme as identified requires that any possible investment with Harcourt Acceptance as a Cook Islands investment be ignored. For the reason that the Hong Kong investment was originally rejected as not having adequate security, it is not reasonable to expect that the taxpayer would have invested there if not in the Cook Islands. As his Honour found, the issue of security of the funds invested and the income to be earned was one of great importance to the taxpayers. This leaves no other particular non-Australian sourced proposal. That the funds were invested on the overnight

money market to earn interest and that the Cook Islands investments under consideration were funds on deposit to earn interest and having regard to the investment period of up to nine months, the reasonable expectation is that the taxpayers would have invested the funds to earn interest and absent any other proposal would have invested the funds in Australia. The income earned on the investment of the $40 million in Australia would have been assessable income for the purpose of s 25 of the ITAA. As the interest rate earned on the investment in the Cook Islands was, on the evidence, some 4 per cent below the applicable bank rates available in Australia at that time the amount of money which it is reasonable to expect that the taxpayer would have received would not have been less than the interest in fact received.

It follows in my view that the taxpayers received a tax benefit within the meaning of s 177C in an amount equal to the interest less Cook Islands withholding tax which they received from the Cook Islands investment.

I now turn to the question of whether the scheme as identified is one to which the Part applies. That is to be determined in accordance with s 177D of the ITAA which provides:

> "This Part applies to any scheme that has been or is entered into after 27 May 1981, and to any scheme that has been or is carried out or commenced to be carried out after that date (other than a scheme that was entered into on or before that date), whether the scheme has been or is entered into or carried out in Australia or outside Australia or partly in Australia and partly outside Australia, where —
>
> (a) a taxpayer (in this section referred to as the 'relevant taxpayer') has obtained, or would but for section 177F obtain, a tax benefit in connection with the scheme; and
>
> (b) having regard to —
>
> (i) the manner in which the scheme was entered into or carried out;
>
> (ii) the form and substance of the scheme;
>
> (iii) the time at which 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;
>
> (vi) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme;
>
> (vii) any other consequence for the relevant taxpayer, or for any person referred to in sub-paragraph (vi), of the scheme having been entered into or carried out; and
>
> (viii) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in sub-paragraph (vi),
>
> it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling the relevant taxpayer to obtain a tax

benefit in connection with the scheme or of enabling the relevant taxpayer and another taxpayer or other taxpayers each to obtain a tax benefit in connection with the scheme (whether or not that person who entered into or carried out the scheme or any part of the scheme is the relevant taxpayer or is the other taxpayer or one of the other taxpayers)."

The matters to which regard is directed under par (b) of the section are to be determined objectively having regard to the particular circumstances of the taxpayers, as is the ascertainment of the purpose of the person or one of the persons who entered into the scheme. Where the scheme or part of a scheme is entered into or carried out for two or more purposes, the relevant purpose in so far as Pt IVA is concerned is the dominant purpose of the person or persons who entered into or carried out the scheme (s 177A(5)).

It is necessary to consider each of the matters in s 177b(i) to (viii), to which I now turn.

As appears from the evidence of Mr Williams which is set out above, the taxpayers, because of the successful public float, had $40 million available for investment and sought investment proposals from various banks and financial institutions. One of those was Bankers Trust which introduced the taxpayers to the EPBCL proposal. The manner in which the scheme was entered into and carried out was the subject of a number of findings by his Honour. Mr Williams negotiated up the interest rate on offer from EPBCL, the taxpayers took legal advice as to the form of the security offered and had the form of the irrevocable banker's letter of credit which was offered varied to provide greater security, the investment chosen was one of a number of alternative proposals, the funds used were real funds and an officer of the taxpayers attended in the Cook Islands to make the contract and obtain the certificate of deposit. The taxpayers took independent legal advice, took security which was satisfactory to them, and involved themselves directly through their staff in the making of the contract in the Cook Islands and in obtaining the certificate of deposit. The taxpayers had promotional material supplied by the bank which emphasised the operation of s 23(q) of the ITAA to render the interest earned in the Cook Islands exempt from Australian tax if it were held to be sourced in the Cook Islands and tax paid. The material also included a legal opinion given to the bank as to the likely operation of s 23(q) and the non-operation of Pt IVA. The taxpayers did not blindly follow the steps outlined in information material supplied to them as to the operation of the investment.

The deposit of $40 million with EPBCL was real and not a sham and it had the form and substance which it took. The investment was entered into after the funds from the float became available and the period of the investment related to the period of time the officers of the taxpayers believed the money was available for investment before it was needed for some other purpose of the taxpayers.

Because the income was derived in the Cook Islands and Cook Islands tax was paid on it, s 23(q) of the ITAA operated to characterise the income as exempt income which would not be included as assessable income in the year in which it was earned (s 25, ITAA) and unless Pt IVA operated to allow the Commissioner to determine that the amount of interest be included in the assessable income, the income would not be taxed beyond that which was paid in the Cook Islands.

The investment in the Cook Islands and the payment of Cook Islands tax, if s 23(q) of the ITAA operated in respect of the interest earned, enabled 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. The higher financial return from the investment arises because, although the gross interest received was lower in the Cook Islands because of the lower interest rates on offer, the Cook Islands taxation rate was substantially lower than the then applicable taxation rate in Australia. As a result the application of the Cook Islands taxation rate to the income derived in the Cook Islands left a money sum greater than would have been available if the money was invested, interest was earned and tax paid on the interest in Australia at local rates.

For the purposes of subpars (b)(vi), (vii) and (viii) it has not been suggested that there was any person who was not a party to the scheme who benefited from it. Of those who were parties to the scheme, there is no material to suggest that they received any other financial benefit directly attributable to the scheme other than ordinary fees and charges, for example to Midland for providing the irrevocable banker's letter of credit and for transferring the funds to Singapore and thence to Hong Kong.

From these circumstances the following conclusions can be drawn:

(a) subject to the security of the money invested, the investment in the Cook Islands would not have been made if the funds could have been invested elsewhere and would have returned to the taxpayers a higher after tax return, irrespective of the operation of s 23(q) on the income earned;

(b) if a higher after tax return could have been achieved in Australia even paying a higher rate (and therefore money sum) of tax, the taxpayers would have invested in Australia;

(c) the taxpayers would not have invested in the Cook Islands if the interest earned was to be included in their assessable income for the relevant year and taxed in Australia;

(d) that s 23(q) operated in respect of the income earned so as to characterise it as exempt income was the factor which determined as between Australia and the Cook Islands where the funds were invested. Consequently any business decision as to whether to invest in either of the two countries would have as an element a consideration of the operation of ss 25 and 23(q) of the ITAA.

On its proper construction, s 177D requires that no person who entered into or carried out the scheme objectively did so for the purpose, or dominant purpose as defined in s 177A(5) where there is more than one purpose, of enabling the taxpayer to obtain a tax benefit in relation to the scheme. It is for this reason that I earlier stated that it was important to identify the parties to the scheme. The appellant in the present appeal did not seek to argue that Bankers Trust, Midland, EPBC or EPBCL had other than a commercial purpose to earn fees or to attract funds on deposit in doing anything in respect of the scheme as identified. The only parties in respect of which the appellant addressed any argument as to dominant purpose were the taxpayers.

Having regard to the above considerations can it objectively be said that the dominant purpose of the taxpayers in making the investment was to obtain a tax benefit? In my view it cannot be said that such was their intention. In coming to this conclusion I accept that but for the operation of s 23(q) the investment would not have been made because of the operation of s 25 and other provisions of the ITAA leading to a liability to pay Australian tax on the interest earned. However a decision not to invest in the Cook Islands would be

made, not for the reason that Australian tax would be payable but rather because the interest rate offered on the investment in the Cook Islands would be insufficient to admit of a rational commercial decision to invest in the Cook Islands in preference to Australia. If the interest rates offered in the Cook Islands were sufficiently high that after paying both Cook Islands and Australian tax, the net after tax return was higher than investing in Australia at lower interest rates and paying Australian income tax, the rational commercial decision would be to invest in the Cook Islands notwithstanding the incidence of double taxation.

Where the activity under consideration is a bona fide investment of capital funds the tax payable on the interest earned is, for the purpose of deciding whether or not to undertake any particular investment, a relevant consideration. Where the available alternative investments are all taxed at the same rate, the relevant and predominant considerations are the interest rate offered, the term of the investment and the risk of each of the available investments. Where all other things are equal the investment offering the highest rate of interest will be chosen. Where 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. For example, the treatment of income from gold mining operations as exempt income (s 23(o) of the ITAA) may be a factor which influences an investment in a gold mine returning income at a lower rate as a percentage of capital invested than an investment of the funds on deposit at a higher gross rate of return but subject to the payment of full income tax. Therefore, when investing outside Australia, the incidence of tax and the operation of any relevant double taxation treaties between Australia and the countries in which investment is being considered will be relevant to a decision to invest overseas or not. Where by the operation of the foreign taxation laws and the existing Australian taxation laws the net return after the payment of all applicable tax and other costs of the investment is higher investing offshore than within Australia, it cannot be said that, objectively, the dominant purpose of the investor investing offshore is 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. In 1986, Australian tax was not payable on income derived in the circumstances specified in s 23(q) of the ITAA because it was exempt income. That situation has changed since the repeal of s 23(q).

As the dominant purpose of the taxpayers was not to obtain a tax benefit, the scheme identified was not one to which Pt IVA of the ITAA applied. In consequence the Commissioner was not entitled to exercise the power under s 177F to determine that the interest earned be included in the taxpayers' assessable income for the relevant year.

Conclusion

The appellant has failed on each of the principal questions on the appeal. The orders made by Lockhart J at first instance in each application were correct and no basis to disturb them or any of them has been made out by the appellant.

Each appeal should be dismissed with costs.

Orders accordingly

Solicitor for the appellant: Australian Government Solicitor.

Solicitors for the respondents: *Minter Ellison Morris Fletcher.*

RODEN PRITCHARD