“AUSTRALIA’S LARGEST TAX CASE” REVISITED: A NAIL IN THE COFFIN FOR THE OBJECTIVE APPROACH TO DETERMINING THE DEDUCTIBILITY OF EXPENSES?

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Prior to the introduction of the tax consolidation regime, tax considerations often acted as a disincentive for a company to receive dividends from its subsidiary where the company had borrowed money at interest in order to finance the acquisition of its shares in the subsidiary in question. Corporate groups would commonly carry out restructures in order to eliminate the existence of this disincentive, which was known as a “dividend trap”.

The effectiveness for taxation purposes of one such corporate restructure was considered by the Full Court of the Federal Court in Spassked Pty Ltd v FC of T*, a case said by the Australian Taxation Office to be “Australia’s largest tax case”. At issue was the deductibility of interest expenses incurred on loans taken out by an in-house finance company, and the Court held that the expenses in question could not be used to reduce non-dividend income that was not effectively exempt from taxation. With the High Court denying the taxpayer special leave to appeal, the decision in* Spassked *represents yet another successful attack in recent times on the financing practices of corporate groups which for long had gone unchallenged.*

Commentators to date have largely been unquestioning of the outcome of the case, but this article critically analyses the decision and argues that the judgments are fundamentally flawed because the Court misapplied

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certain long standing principles of income tax law. This is unfortunate because, even though the particular result sought to be achieved by the restructure in Spassked *is now attainable as a consequence of government policy that is embodied in the tax consolidation regime, under the positivist doctrine of stare decisis the reasoning adopted by the Full Court of the Federal Court in* Spassked *continues to be of potential relevance in relation to the broad and proper application of the general deduction provision.*

1. INTRODUCTION

On 8 December 2003, the Full Court of the Federal Court handed down its judgment in *Spassked Pty Ltd v FC of T*,[1] an appeal from the decision of Lindgren J at first instance.[2] That same day, the Australian Taxation Office issued a press release hailing the news that it had survived the appeal.[3] Based on the size of the deductions at issue,[4] *Spassked* was possibly the biggest tax case in Australian history.[5] The case concerned the effectiveness for taxation purposes of a corporate restructure carried out to eliminate "dividend traps" within the Industrial Equity Ltd ("IEL") group. The aim of the restructure was to determine whether interest expense deductions could be used to reduce non-dividend income that was not effectively exempt from taxation.[6] According to one commentator, restructures

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[1] (2003) 136 FCR 441 ("*Spassked*").
[2] *Spassked Pty Ltd v FC of T (No 5)* (2003) 197 ALR 553 ("*Spassked No 5*").
[3] Australian Taxation Office, *Tax Office Wins Australia's Largest Tax Case in Full Federal Court*, Press Release, Nat 03/118 (8 December 2003) 1 ("ATO Press Release").
[4] Namely, over $6.5 billion in capitalised interest expenses. See *Spassked* (2003) 136 FCR 441, 444 (per Hill and Lander JJ).
[5] ATO Press Release, above n 3, 1.
[6] In 1984, group loss transfer provisions were inserted into the *Income Tax Assessment Act 1936* (Cth) ("ITAA36") in the form of s 80G. This created the incentive for companies who had borrowed at interest to finance the acquisition of shares in subsidiaries to not receive dividends from these subsidiaries. The resulting interest losses of these companies would then be transferred down to the subsidiaries to reduce the taxable income of these subsidiaries.

of this kind were common at the time that the IEL group undertook the exercise.[7]

Although dividend traps are now less of a problem following the introduction of the tax consolidation regime,[8] *Spassked* remains relevant in relation to the guidance that it provides on the application of the general deduction provision in s 8-1 of the *Income Tax Assessment Act 1997* (Cth) ("ITAA97").[9] *Spassked* essentially considered the question of whether interest expenses incurred on loans taken out by an in-house finance company (in this case, the appellant, Spassked Pty Ltd ("Spassked")) are deductible under s 51(1) of the *Income Tax Assessment Act 1936* (Cth) ("ITAA36"), the forerunner to s 8-1.[10]

At first instance, Lindgren J found that Spassked was not entitled to a deduction for its interest expenses,[11] and the Full Court of the Federal Court upheld this finding.[12] Commentators to date have

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[7] J Reilly, "*Spassked*'s Case: What Lessons Can Be Learned?" (2004) 15(1) *Journal of Banking and Finance Law and Practice* 65, 65.

[8] Contained in *Income Tax Assessment Act 1997* (Cth) ("ITAA97"), Pt 3-90.

[9] C Colley, "Building a Better Dividend Trap" (2003) 37(10) *Taxation in Australia* 514, 514 and 518 ("Colley, Dividend Trap 1"); C Colley, "Dividend Trap Catches Taxpayer" (2004) 38(7) *Taxation in Australia* 351, 351 and 356 ("Colley, Dividend Trap 2"); and Reilly, above n 7, 65 and 67.

[10] According to the *Explanatory Memorandum* to the Income Tax Assessment Bill 1996 (Cth), 42, s 8-1 of the ITAA97 is intended to carry the same meaning as s 51(1) of the ITAA36. On the use of extrinsic material for the purposes of interpreting the ITAA97 see, eg, *Acts Interpretation Act 1901* (Cth), s 15AB; and *FC of T v McNeil* (2005) 60 ATR 275, 288 (per French J)

[11] *Spassked No 5* (2003) 197 ALR 553, 624.

[12] *Spassked* (2003) 136 FCR 441, 476 (per Hill and Lander JJ) and 479-480 (per Gyles J). This article does not speculate on whether the Spassked arrangement would have been caught by Pt IVA of the ITAA36, as the trial judge and Full Court of the Federal Court did not find it necessary to consider this issue. See *Spassked No 5* (2003) 197 ALR 553, 624 (per Lindgren J); and *Spassked* (2003) 136 FCR 441, 445 (per Hill and Lander JJ). In any event, Pt IVA could only have been properly applied if the interest expenses *were* deductible. See especially *Vincent v FC of T* (2002) 124 FCR 350, but compare *FC of T v Consolidated Press Holdings Ltd* (2001) 207 CLR 235.

largely been uncritical of the decisions,[13] but this article argues that the judgments are fundamentally flawed because the Court misapplied certain basic principles of income tax law.[14] It is therefore unfortunate that the High Court ended up denying Spassked special leave to appeal[15] but, as Menzies J recognised in *McHale v Watson*,[16] "hard cases make bad law".[17]

2. THE FACTS OF *SPASSKED*

Before it was disastrously taken over by the Adelaide Steamship ("Adsteam") group in late 1989, the IEL group had demonstrated the capacity to invest and grow at exceptional rates under the chairmanship of Sir Ronald Brierley.[18] The IEL group's main business was the acquisition of companies with a view to realising or retaining their assets.[19] IEL would acquire the shares of a target company through a subsidiary of IEL purchasing an interest in those shares.[20] To fund the purchase, the subsidiary would typically borrow money at commercial rates from Industrial Equity Finance Ltd ("IEF"), the IEL group's internal finance company.[21] The

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[13] See, eg, R O'Connor, "Tax Deductibility of Interest: A Synopsis of the Principles" (2004) 31(2) *Brief* 19, 21; Colley, "Dividend Trap 2", above n 9, 355-356; Colley, "Dividend Trap 1", above n 9, 517-518; and Reilly, above n 7, 67.
[14] On litigation involving other companies in the IEL group that has arisen as a result of *Spassked* (2003) 136 FCR 441 see, eg, *Queensland Trading & Holding Co Ltd v FC of T* (2004) 56 ATR 575.
[15] Transcript of Proceedings, *Spassked Pty Ltd v FC of T* (High Court of Australia, McHugh and Kirby JJ, 10 December 2004) 16 (per McHugh J). The Court repeated its usual mantra that "the Full Court of the Federal Court is ordinarily the tribunal for finally resolving issues concerning income tax questions … unless the case raises some important issue of general principle that calls for the [High] Court's intervention". It saw the proceedings as raising only "factual issues".
[16] (1966) 115 CLR 199.
[17] Ibid 225.
[18] *Spassked* (2003) 136 FCR 441, 445 and 472 (per Hill and Lander JJ).
[19] Ibid 445.
[20] Ibid.
[21] Ibid.

borrowing subsidiaries incurred large amounts of interest expense to IEF, which turned the subsidiaries into dividend traps.[22]

2.1 The Dividend Trap Problem

A "dividend trap" can be said to exist where a company does not have the incentive to receive dividends from a subsidiary because of tax considerations.[23] This is usually the case where the company has financed its acquisition of shares in the subsidiary with borrowed money, on which it incurs interest expenditure. The interest payable on the sum borrowed would ordinarily be deductible from the company's assessable income.[24] Dividend income received by the company from its subsidiary would form part of this assessable income,[25] but the company would then also be entitled to an inter-corporate dividend rebate.[26] The amount of the rebate would be equal to the amount of the tax payable on the company's "net" dividend income (ie dividend income less the amount of expenses incurred in gaining that income, eg interest payable on the money borrowed to finance the acquisition of the shares carrying the right to the dividend).[27]

Because, typically, large sums would be borrowed by the company to finance its acquisition of shares in the subsidiary (leading to large amounts of interest being payable by the company),

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[22] Ibid 446.
[23] Cf Colley, "Dividend Trap 2", above n 9, 351; and Colley, "Dividend Trap 1", above n 9, 514. Compare the notion of a dividend trap as discussed in Reilly, above n 7, 65.
[24] As acknowledged in *Taxation Ruling* IT 2606, para 9. Cf *Esquire Nominees Ltd v FC of T* (1973) 129 CLR 177, 221 (per Menzies J) and 229 (per Stephen J).
[25] ITAA36, s 44(1).
[26] Under ITAA36, s 46. For a discussion of s 46 see, eg, R Gelski, T Magney and R Vann, "Intercorporate Dividends" in R Vann (ed), *Company Tax Reform* (1988) 131. The rebate ceased to apply to the franked part of a dividend paid after 30 June 2002, and to the unfranked part of a dividend paid after 30 June 2003. See ITAA36, ss 46AA and 46AB.
[27] See, eg, ITAA36, ss 46(2), 46(3) and 46(7).

the result of the subsidiary paying the company dividends would effectively be to waste the inter-corporate dividend rebate available to the company. Accordingly, for taxation purposes the company had the incentive to not have its subsidiary pay it a significant amount of dividends while it was still servicing the loan, but to instead transfer the tax losses arising from its large interest expenditure to its subsidiary under s 80G of the ITAA36.

As the company's dividend income was essentially tax free because of the inter-corporate dividend rebate, "wastage" of the company's interest expense deductions was therefore prevented by transferring them from the company to the subsidiary generating the dividend income. This had the same tax effect as a transfer of the debt from the company to the subsidiary. The payment of anything more than nominal dividends to the company would usually be deferred until enough profit had accumulated in the subsidiary to enable it to pay to the company a dividend of an amount large enough to repay the company's loan, the classic way in which the dividend trap problem was resolved.

2.2 The Group Restructure

Because of the prevalence of dividend traps within the IEL group and the desire of IEL's shareholders to receive dividends,[28] the view was taken that the group should carry out a restructure in order to eliminate the dividend trap problem within the group. The restructure resulted in the incorporation of Spassked. Spassked then borrowed funds at commercial rates from IEF and used the money to subscribe for "A" class shares in an IEL subsidiary called Group Investment

[28] Because of the introduction of dividend franking, which created a new appetite among the shareholders of Australian listed companies for franked dividends. This forced the Adsteam group to resolve the IEL group's dividend trap problem, which was assisted by the introduction of the group loss transfer provisions in s 80G of the ITAA36. For a discussion of the introduction of the imputation system see, eg, T Magney, "The Operation of the Imputation System" in Vann, above n 26, 15; and R Gelski, "Planning For Imputation" in Vann, above n 26, 180

Holdings Pty Ltd ("GIH"). GIH used the money it had raised from Spassked to subscribe for shares in the existing IEL subsidiaries which had borrowed money from IEF at interest. The subsidiaries in question then used the funds that they had obtained from the issue of shares to GIH to repay their loans to IEF.[29]

In addition to the "A" class shares issued to Spassked, GIH would also issue "B" class shares to IEL. These "B" class shares only carried an entitlement to franked dividends. In contrast, the rights attaching to the "A" class shares allowed Spassked to receive either franked or unfranked dividends. When GIH received dividends from a subsidiary, GIH would make a tax profit largely because of the absence of any interest expenses. The subsidiary could also flow through any franking credits attaching to its dividend income from an acquired target company, and obtain the benefit of the inter-corporate dividend rebate to offset tax payable on this income.[30] The restructure had the same effect for tax purposes as a transfer of Spassked's debt to the acquired target companies.

Between 1988 and 1990, Spassked ended up borrowing approximately $3.5 billion in total from IEF.[31] During this period, Spassked only received about $43 million of unfranked dividend income from all of its "A" class shares in GIH.[32] GIH had received more than $43 million in dividend income from the IEL subsidiaries in which GIH had subscribed for shares as part of the group restructure, and therefore could have paid more than $43 million in dividends to Spassked, but it did not do so.

[29] Compare the facts of the restructure as described in Reilly, above n 7, 66.
[30] Under ITAA36, s 46.
[31] *Spassked* (2003) 136 FCR 441, 451-452 (per Hill and Lander JJ), quoting *Spassked No 5* (2003) 197 ALR 553, 578-579 (per Lindgren J).
[32] *Spassked* (2003) 136 FCR 441, 474 (per Hill and Lander JJ). For the year of income that was the subject of the appeal (1992), Spassked claimed $888 million in interest deductions and received $14.6 million in dividend income. See *Spassked* (2003) 136 FCR 441, 453 (per Hill and Lander JJ), quoting *Spassked No 5* (2003) 197 ALR 553, 581 (per Lindgren J).

2.3 The Result

The outcome of the restructure therefore was that the IEL group replaced the myriad of dividend traps which had emerged in its structure with one big dividend trap: Spassked. All tax losses previously spread among different subsidiaries in the group were now concentrated in Spassked, which would then transfer its tax losses to other companies in the group to reduce the assessable income of these companies.[33] It was these losses (about $6.5 billion in total, and which largely came about as the result of an excess of interest expense over dividend income) that the Federal Commissioner of Taxation ("Commissioner") contended were non-deductible.[34] At trial, Lindgren J found for the Commissioner on the basis that s 51(1) was not satisfied because Spassked had not incurred the interest expenses in gaining or producing assessable income.[35]

3. THE JUDGMENT

The leading judgment of the Full Court of the Federal Court was delivered by Hill and Lander JJ in a long joint judgment, with Glyes J effectively concurring with Hill and Lander JJ in a short judgment.

Under s 51(1) of the ITAA36, the amount of a loss or outgoing may be deducted from assessable income if the loss or outgoing is incurred in gaining or producing assessable income. In line with *Ronpibon Tin NL v FC of T*,[36] Hill and Lander JJ accepted that in order for a loss or outgoing to be deductible under the section it is not necessary for assessable income to materialise in the same financial year as that in which the loss or outgoing is incurred.[37] So long as the occasion of the loss or outgoing is *expected* to produce

[33] Under ITAA36, s 80G.
[34] See *Spassked* (2003) 136 FCR 441, 444 (per Hill and Lander JJ).
[35] *Spassked No 5* (2003) 197 ALR 553, 624.
[36] (1949) 78 CLR 47 ("*Ronpibon Tin*").
[37] *Spassked* (2003) 136 FCR 441, 462-463.

assessable income, the amount of the loss or outgoing will be deductible in the year that the loss or outgoing is incurred even if the income arises in a previous or later year.[38]

According to the cases, whether or not there is an expectation of producing assessable income from incurring the relevant expenditure is a matter that is to be determined objectively.[39] However, Hill and Lander JJ held that Spassked's actual purpose in incurring its interest expenditure could be used as evidence of whether it could objectively be expected that the interest expenses would produce assessable income for Spassked.[40] Their Honours adopted this approach because of the great disproportion between Spassked's interest expense (around $3.7 billion) and its dividend income (about $43 million) over the relevant period.[41]

In assessing Spassked's subjective purpose, Hill and Lander JJ held that it was relevant to consider the objectives which the common directors of Spassked and GIH had in mind from Spassked's borrowing from IEF (and thereby incurring the interest expenses).[42] Their Honours concluded from the evidence that GIH

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[38] *Ronpibon Tin* (1949) 78 CLR 47, 57 (per Latham CJ, Rich, Dixon, McTiernan and Webb JJ).

[39] See, eg, *Cecil Bros Pty Ltd v FC of T* (1964) 111 CLR 430 ("*Cecil Bros*"); *FC of T v Isherwood & Dreyfus Pty Ltd* (1979) 9 ATR 473 ("*Isherwood & Dreyfus*"); *Inland Revenue Commissioners (NZ) v Europa Oil (NZ) Ltd* [1971] AC 760 ("*Europa Oil*"); *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue (NZ) (No 2)* [1976] 1 NZLR 546 ("*Europa Oil (No 2)*"); *FC of T v South Australian Battery Makers* (1978) 140 CLR 645 ("*South Australian Battery Makers*"); *FC of T v Metal Manufactures Ltd* (2001) 108 FCR 150 ("*Metal Manufactures*"); and *Eastern Nitrogen Ltd v FC of T* (2001) 108 FCR 27 ("*Eastern Nitrogen*"). See generally S Barkoczy, "Section 51(1): Characterising Deductible Outgoings" (1995) 3 *Taxation in Australia* 206; and G Richardson, "Section 51(1): Unlegislated Tests of Deductibility" (1995) 24 *Australian Tax Review* 153.

[40] *Spassked* (2003) 136 FCR 441, 468-469.

[41] Ibid 453 and 468-469.

[42] Ibid 468-469, because these people are the directing mind and will of the relevant companies. See, eg, *Tesco Supermarkets Ltd v Nattrass* [1972] AC 153, 170-171 (per Lord Reid); *Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd* [1915] AC 705; *Hamilton v Whitehead* (1988) 166 CLR 121; and *S & Y Investments (No 2) Pty*

did not intend to pay dividends on the "A" class shares that it had issued to Spassked for an "indefinite" period of time.[43] Justices Hill and Lander were given documentation prepared by the IEL group's legal advisers which showed that it would theoretically be possible for Spassked to make a profit. However, their Honours held that this documentation was not indicative of the group's intention at the time of the restructure.[44] The documentation merely demonstrated the possibility that Spassked may, at some time, be able to repay its borrowings from IEF.

4. CRITIQUE

As noted above, the IEL group's restructure replaced the myriad of dividend traps within the group with one big dividend trap: Spassked. The Full Court of the Federal Court did not appear to appreciate the objective reality that dividend traps are typically and naturally ended by one massive dividend being released to the dividend trap company at a propitious time. The idea is for subsidiaries to wait until they have accumulated enough profit and then pay out a dividend (perhaps accompanied by a return of capital) of an amount large enough to enable the parent (dividend trap) to repay the debt and interest that the parent has incurred to finance its acquisition of the subsidiary.[45] The inter-corporate dividend rebate[46] would mean that the parent could receive this large dividend without tax. The effective loss of interest deductions for the corporate group may be avoided if the dividend is paid at the start of the year, before any interest for that year has accrued.

Ltd (in liq) v Commercial Union Assurance Co of Australia Ltd (1986) 44 NTR 14. See generally H Ford, R Austin and I Ramsay, *Ford's Principles of Corporations Law* (11th ed, 2003) 743-744; and R Grantham, "Attributing Responsibility To Corporate Entities: A Doctrinal Approach" (2001) 19 *Company and Securities Law Journal* 168.

[43] *Spassked* (2003) 136 FCR 441, 468.

[44] Ibid 472.

[45] Cf Colley, "Dividend Trap 2", above n 9, 356; and Colley, "Dividend Trap 1", above n 9, 518.

[46] Under ITAA36, s 46.

The problem with this strategy is that it usually takes a number of years to accumulate this amount of profit, and a dividend drought for a long period might imperil the deductibility of the acquirer's interest costs: precisely the problem highlighted in *Spassked*. As noted above,[47] an outgoing such as interest is only deductible if it is incurred in gaining or producing assessable income, or is incurred in a business carried on for the purpose of gaining or producing assessable income.[48] As *Spassked* shows, there are obvious risks if the asset funded by the debt does not produce any assessable income for a prolonged period.

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[47] In the text accompanying notes 36-39.

[48] The deductibility of interest has been considered in cases such as *Australian National Hotels Ltd v FC of T* (1988) 19 FCR 234 ("*Australian National Hotels*"); *Steele v DFC of T* (1999) 197 CLR 459 ("*Steele*"); *Travelodge Papua New Guinea Ltd v Chief Collector of Taxes* (1985) 16 ATR 867 ("*Travelodge*"); *Temelli v FC of T* (1997) 36 ATR 417 ("*Temelli*"); *Wharf Properties Ltd v Commissioner of Inland Revenue* [1997] AC 505 ("*Wharf Properties*"); *Hayden v FC of T* (1996) 68 FCR 19 ("*Hayden*"); *Begg v DC of T (SA)* [1937] SASR 97 ("*Begg*"); and *FC of T v Roberts* (1992) 37 FCR 246 ("*Roberts*"). For academic discussion of the deductibility of interest see, eg, K Burford, "Going Out On a Second Limb: An Analysis of the Deductibility of Interest By Recognising the Distinction Between the Positive Limbs of Section 51(1)" (1995) 5 *Revenue Law Journal* 100; G Cooper, "Interest Deductibility: Are the Courts Heading in a New Direction?" (1994) 28 *Taxation in Australia* 511; J Dabner, "Interest Deductibility: Australia and Canada Compared" (1999) 2 *Journal of Australian Taxation* 172; K Devos, "Healthy Interest" (1998) 33 *Taxation in Australia* 198; C Evans and W Scholtz, "The Limits of Interest Deductibility" (1994) 2 *Taxation in Australia* 222; M Knight, "Interest Deductibility: Unsettled Issues" (1994) 2 *Taxation in Australia* 230; A Myers, "Deductibility of Interest: In Search of Symmetry" (1990) 25 *Taxation in Australia* 196; G Richardson and H Anderson, "The Deductibility of Interest: An Asia-Pacific Regional Comparison" (1997) 23(3) *International Tax Journal* 6; G Richardson and K Devos, "The Deductibility of Interest Expense in Anglo-American Countries: A Comparison and Review of Policy" (1999) 9 *Revenue Law Journal* 33; P Stone, "Deductibility of Interest: The Commissioner Speaks" (1998) 72 *Australian Law Journal* 97; and I Wallschutzky and G Richardson, "The Deductibility of Interest" (1995) 24 *Australian Tax Review* 5.

Even so, the view generally held by practitioners before *Spassked* was that these risks were manageable.[49] In the ordinary scheme of things, a company may not pay dividends on its shares for a number of years.[50] For example, start-up companies often take some years to pay their first dividend.[51] Also, the typical exit from a dividend trap is by way of one massive dividend that makes up for the period when dividends were suspended.[52] As noted by Hill and Lander JJ, s 51(1) does not require a deductible expense to generate assessable income in the same year as it is incurred.[53] It is enough if the expense has the necessary connection with earning assessable income in general without that income being divided into years, so that assessable income expected to be produced in the future will do, as will assessable income produced in the past.[54]

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[49] Cf Colley, "Dividend Trap 1", above n 9, 517; and Colley, "Dividend Trap 2", above n 9, 355.

[50] Cf *Taxation Ruling* IT 2606, para 21, where the Commissioner acknowledges that:

> Despite the deferral of the receipt of income a deduction would still be allowable under the first limb of subsection 51(1) provided there was always an expectation and intention as well as the *potential* for dividends to be paid to the borrower company, albeit in the *long term*. (Emphasis added)

On the nature of public rulings such as *Taxation Ruling* IT 2606, see *Bellinz Pty Ltd v FC of T* (1998) 84 FCR 154, but compare *MLC Investments Ltd v FC of T* (2003) 137 FCR 288.

[51] Cf J Kyrwood, "Disclosure of Forecasts in Prospectuses" (1998) 16 *Company and Securities Law Journal* 350.

[52] Cf Colley, "Dividend Trap 2", above n 9, 356; and Colley, "Dividend Trap 1", above n 9, 518.

[53] *Spassked* (2003) 136 FCR 441, 463, citing *AGC (Advances) Ltd v FC of T* (1975) 132 CLR 175, 189 (per Barwick CJ) and 195-197 (per Mason J) ("*AGC*").

[54] On when assessable income must be produced see, eg, *FC of T v Finn* (1961) 106 CLR 60 ("*Finn*"); *Queensland Meat Export Co Ltd v DFC of T (Qld)* [1939] St R Qd 240; *Associated Minerals Consolidated Ltd v FC of T* (1994) 53 FCR 115; and *Placer Pacific Management Pty Ltd v FC of T* (1995) 31 ATR 253. Compare *Amalgamated Zinc (De Bavay's) Ltd v FC of T* (1935) 54 CLR 295, decided under s 23(1)(a) of the *Income Tax Assessment Act 1922* (Cth). On the question of timing, see generally G Lewis, "Section 51(1) and 'Continuing Business'" (1995) 7(4) *CCH Journal of Australian Taxation* 44; A Maples, "The Tax Treatment of Post-

Furthermore, it is not crucial that assessable (dividend) income ever be earned, so long as it is reasonable to expect that the application of the borrowed money will (eventually) produce assessable income of the same amount as the cumulative interest expense or more.[55] Consistent with this, Hill and Lander JJ cited the famous "occasion of" test set down by the High Court in *Ronpibon Tin*.[56] The High Court in that case held that for a loss or outgoing to be deductible "it is both sufficient and necessary that the occasion of the loss or outgoing should be found in whatever is productive of the assessable income, or, *if none be produced would be expected to produce assessable income*".[57]

Justices Hill and Lander then went on to confirm that the issue of what assessable income is expected is tested "objectively".[58] Thus, the inquiry is not primarily into what dividends the common directors of Spassked and GIH actually expected when Spassked borrowed the money and commenced incurring the interest expenses. Rather, the focus is on the "essential character" of these interest expenses in the circumstances and thus whether the "occasion of" incurring these interest expenses (namely, buying the "A" class shares in GIH with the money borrowed) could reasonably be expected to produce assessable income in the future of broadly the same amount as the interest costs incurred by then.[59]

Cessation Expenses and Losses in Australia" (2002) 31 *Australian Tax Review* 139; and P McCullough and R Thomson, "Companies in Crisis: Part 3 – Deductions Where Business Has Ceased" (1993) 27 *Taxation in Australia* 398.

[55] See especially *FC of T v Smith* (1981) 147 CLR 578, 585-586 (per Gibbs CJ, Stephen, Mason, Murphy and Wilson JJ).

[56] *Spassked* (2003) 136 FCR 441, 462-463.

[57] *Ronpibon Tin* (1949) 78 CLR 47, 57 (per Latham CJ, Rich, Dixon, McTiernan and Webb JJ) (emphasis added).

[58] *Spassked* (2003) 136 FCR 441, 463.

[59] On this objective approach, see generally *Cecil Bros* (1964) 111 CLR 430; *Isherwood & Dreyfus* (1979) 9 ATR 473; *Europa Oil* [1971] AC 760; *Europa Oil (No 2)* [1976] 1 NZLR 546; *South Australian Battery Makers* (1978) 140 CLR 645; *Metal Manufactures* (2001) 108 FCR 150; *Eastern Nitrogen* (2001) 108 FCR 27; and R Woellner et al, *Australian Taxation Law* (15th ed, 2004) 666-672 and 679.

For these reasons, before *Spassked*, practitioners appeared to generally hold the view that a lapse in time in receiving dividends (even a deliberate one) would not be fatal to the shareholder’s interest deductions, so long as:

- the delay was not for an unreasonable period (eg 50 years);
- the money borrowed was used to purchase shares at arm’s length amounts; and
- the investee company or its subsidiaries engaged in genuine profit making businesses, with no apparent reason for company profits (and thus dividends) to always be less than the shareholder’s interest expenses.[60]

4.1 What Dividends Could Spassked Objectively Expect?

Spassked borrowed the $3.5 billion from IEF progressively in the period from 1988 to 1990, and over that period it did not appear (either from the judgment of Hill and Lander JJ, or that of Gyles J) that there was any reason to suppose that the company in which Spassked had acquired “A” class shares (GIH) would be incapable of producing profits that would be more than the interest Spassked was accruing on its borrowings from IEL to fund the share acquisition. About two-thirds of the money was borrowed before IEL was taken over by the Adsteam group, and the balance was borrowed before the one year period after which it had become clear that Adsteam had paid too much for the IEL group (accordingly endangering the whole Adsteam group).[61]

The initial scenario that GIH would have enough accumulated profits in a reasonable period to allow Spassked to repay to IEF the debt principal and interest that Spassked owed seems to be borne out even with Spassked and GIH becoming embroiled unexpectedly in

[60] Cf *Ure v FC of T* (1981) 50 FLR 219 (“*Ure*”); *FC of T v Ilbery* (1981) 58 FLR 191 (“*Ilbery*”); and *Fletcher v FC of T* (1991) 173 CLR 1 (“*Fletcher*”).
[61] *Spassked* (2003) 136 FCR 441, 445 (per Hill and Lander JJ).

the insolvency of the greater Adsteam group. Justice Lindgren found that the subsidiaries that GIH had acquired had over $1.2 billion in unfranked dividends alone (leaving aside other potential profits), which could have been flowed up to GIH and ultimately to Spassked.[62] Further, by 1 July 1994 Spassked had repaid all of the money that it had borrowed from IEF.[63] This appears to have involved Spassked paying the $5.3 billion which it agreed was owing to IEF as at 20 December 1991, in addition to interest at (presumably) the much increased rate agreed to between Spassked and IEF from that date (the bill rate plus nine percent).[64] Before that, the interest rate had been the equivalent of the bill rate plus only a modest margin.[65]

It may even have been that the money that Spassked used to repay its debt to IEF could have been flowed up to Spassked as dividends, which would prove the point that Spassked did finally get the assessable dividends that would have justified allowing deductions for its interest costs. This is not entirely clear from the judgment of Hill and Lander JJ or that of Gyles J, but what is clear is that it became unsafe (from a legal liability point of view) for the GIH subsidiaries to pay up dividends as they might not have had enough assets left to pay their creditors after the Commissioner came forward as an unexpected creditor (with disputed assessments totalling over $2 billion).[66] These assessments were, presumably, the forerunner of the proceedings challenging the transfer of losses from Spassked.[67] It would have been unfortunate if raising the assessments against the subsidiaries had a self-fulfilling effect by blocking off the dividends which would have proved the deductibility of Spassked's interest expenses.

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[62] *Spassked No 5* (2003) 197 ALR 553, 607-608, cited in *Spassked* (2003) 136 FCR 441, 455 (per Hill and Lander JJ).
[63] *Spassked* (2003) 136 FCR 441, 454 (per Hill and Lander JJ).
[64] Ibid 453-454.
[65] Ibid 448.
[66] Colley, "Dividend Trap 2", above n 9, 353.
[67] Under ITAA36, s 80G. See now Subdiv 170-A of the ITAA97.

4.2 Was Subjective Purpose Relevant?

Justices Hill and Lander appear to have focused on Lindgren J’s finding that the scheme to suspend paying any substantial dividends to Spassked and to pay franked dividends around Spassked (to IEL direct) was “indefinite”.[68] Justice Lindgren reached this conclusion because of his Honour’s finding of fact that the parties had not given any serious thought as to when Spassked might be allowed to receive dividends again, not at least at the time of implementing the Spassked structure or during the 1988-1994 years in question.[69]

Even if this was so, Hill and Lander JJ did not seem to appreciate the objective reality that dividend traps are typically and naturally ended by the build up of profits in the subsidiary being released as one massive dividend at a propitious time, as discussed above.[70] Their Honours were given adequate evidence of this general practice by the testimony of the IEL group’s finance controller (Daniels) and a tax manager (Cottam), which their Honours dealt with at pages 473 to 476 of the report. However, Hill and Lander JJ did not believe that anyone had actually formulated these plans at the time of implementing the restructure or at the time of administering the Spassked dividend trap.[71] But taking into consideration what was actually in the minds of the relevant people would not have been necessary if there was sufficient evidence of what could reasonably be expected at the time of borrowing.[72]

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[68] *Spassked* (2003) 136 FCR 441, 468, 471-472 and 474-475.
[69] *Spassked No 5* (2003) 197 ALR 553, 623-624.
[70] In the text accompanying notes 45 and 52.
[71] *Spassked* (2003) 136 FCR 441, 475.
[72] An approach recognised and applied in many High Court decisions. See, eg, *FC of T v Snowden & Willson Pty Ltd* (1958) 99 CLR 431, 436 (per Dixon CJ); *John Fairfax & Sons Pty Ltd v FC of T* (1959) 101 CLR 30, 35 (per Dixon CJ, with whom Kitto J relevantly agreed) and 46 (per Menzies J); *Finn* (1961) 106 CLR 60, 68 (per Dixon CJ); *AGC* (1975) 132 CLR 175, 185 (per Barwick CJ, with whom Mason J relevantly agreed); *Ash v FC of T* (1938) 61 CLR 263, 271 (per Latham CJ); and *Moffatt v Webb* (1913) 16 CLR 120.

As Gleeson CJ, Gaudron and Gummow JJ observed in *Steele v DFC of T*:[73]

> [A] point to be made about s 51(1) is that the reference in it to "*the* assessable income" is not to be read as confined to assessable income actually derived in the particular tax year. It is to be construed as an abstract phrase which refers not only to assessable income derived in that or in some other tax year but also to assessable income which the relevant outgoing "would be expected to produce"
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> …
>
> It has also been said that the test of deductibility under the first limb of s 51(1) is that "it is both sufficient and necessary that the occasion of the loss or outgoing should be found in whatever is productive of the assessable income or, if none be produced, would be expected to produce assessable income".
>
> …
>
> As was explained in *Australian National Hotels Ltd v Commissioner of Taxation*, interest is ordinarily a recurrent or periodic payment which secures, not an enduring advantage, but, rather, the use of borrowed money during the term of the loan. According to the criteria noted by Dixon J in *Sun Newspapers Ltd v Federal Commissioner of Taxation* it is therefore ordinarily a revenue item. This is not to deny the possibility that there may be particular circumstances where it is proper to regard the purpose of interest payments as something other than the raising or maintenance of the borrowing and thus, potentially, of a capital nature. However, in the usual case, of which the present is an example, where interest is a recurrent payment to secure the use for a limited term of loan funds, then it is proper to regard the interest as a revenue item, and its character is not altered by reason of the fact that the borrowed funds are used to purchase a capital asset. The fact that the asset has not yet become, and may never become, income-producing may be relevant to a decision as to whether the case falls within the first limb of s 51(1). However, once it is determined, or accepted by hypothesis,

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[73] (1999) 197 CLR 459.

> that the interest is, during the relevant year, an outgoing incurred in gaining or producing the taxpayer's assessable income, (even though no assessable income is derived during that year, and no such income may ever be derived), the circumstance that the capital asset has produced no income is not a reason to conclude that the interest is an outgoing of a capital nature.[74]

Even though *Spassked* was an appeal, the Full Court of the Federal Court could take fresh evidence, make inferences of fact and generally had a duty to reach its own conclusions on the facts, as the appeal was by way of "rehearing".[75] Counsel for Spassked therefore invited the Court to make fresh findings of fact based on the objectively determined purpose of the borrowings, namely that it was for the purpose of deriving assessable dividend income even if the dividend would be deferred until it was large enough to stop Spassked being a dividend trap. The Court refused to do so however, notwithstanding the evidence about the expected profitability of the group and the typical way in which dividend traps are resolved (with one massive dividend). Justices Hill and Lander concluded that the issue of what the relevant directors were actually thinking at the time was paramount. On that matter, their Honours preferred to stay with the conclusions of Lindgren J at trial, who had the benefit of seeing the witnesses and the other evidence unfold, first hand.[76]

Justice Lindgren held that Spassked failed the s 51(1) criteria under the usual "objective" tests of the purpose of borrowing, and his Honour's inquiry into the subjective purposes of the common directors of Spassked and GIH was to see if the purposes saved the deductions.[77] The Full Court of the Federal Court said that Lindgren J had not erred at law by his Honour's inquiry into

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[74] Ibid 467 and 470-471.
[75] Under ss 27 and 28 of the *Federal Court of Australia Act 1976* (Cth). See, eg, *Suvaal v Cessnock City Council* (2003) 200 ALR 1; and *Fox v Percy* (2003) 197 ALR 201. See generally Colley, "Dividend Trap 2", above n 9, 356. This was acknowledged in *Spassked* (2003) 136 FCR 441, 473 (per Hill and Lander JJ).
[76] *Spassked* (2003) 136 FCR 441, 473 and 476-477 (per Hill and Lander JJ).
[77] *Spassked No 5* (2003) 197 ALR 553, 624.

subjective purpose,[78] and their Honours correctly identified that such an inquiry can be relevant in two circumstances.

4.2.1 Voluntary Outgoings

The first type of case where an inquiry into the subjective purpose of the taxpayer is relevant is where there are voluntary outgoings that are not incurred under a contract. Where such voluntary outgoings are incurred, an inquiry into subjective purpose assists in characterising what advantage the taxpayer seeks by incurring the outgoings.[79] According to *Magna Alloys & Research Pty Ltd v FC of T*,[80] where there is a business, the person carrying on the business should (within reasonable limits) determine whether an expense is incurred as part of that business.[81] Therefore, if the expense can objectively be said to be "incidental and relevant" to the business, then all that remains is whether the taxpayer subjectively regarded the amount as incurred as part of the business.[82] Justices Hill and Lander observed that this logic has also been held to apply to the first limb of s 51(1).[83]

With respect, it is submitted that this approach was not correctly applied in *Spassked*. Spassked's interest expenses were incurred under Spassked's contracts of loan with IEF.[84] These interest

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[78] *Spassked* (2003) 136 FCR 441, 469 (per Hill and Lander JJ) and 480 (per Gyles J).
[79] Cf AH Slater, "The Character of the Advantage Sought" (1997) 26 *Australian Tax Review* 131. For the view that by its nature a loss is not voluntarily incurred see, eg, *Allen v Farquarson Brothers & Co* [1932] 1 KB 59, 64 (per Finlay J); and R Upfold, "A Section 8-1 Loss" (2004) 33 *Australian Tax Review* 8, 8.
[80] (1980) 49 FLR 183.
[81] Ibid 210 (per Deane and Fisher JJ).
[82] Ibid.
[83] *Spassked* (2003) 136 FCR 441, 466, citing *Service v FC of T* (2000) 97 FCR 265, 278.
[84] A point overlooked by Reilly, above n 7, 67; misunderstood by Colley, "Dividend Trap 2", above n 9, 354; and not appreciated by Gyles J in *Spassked* (2003) 136 FCR 441, 479-480:

> Some business decisions are good, some are bad. Indeed, with the benefit of hindsight some may be seen as negligent or even profligate. The point may be made by

payments secured the use by Spassked of the money which it had borrowed.[85] The test of deductibility is whether the occasion of incurring the interest expense (namely, the borrowing and the use of the money to subscribe for "A" class shares in GIH) would objectively be expected to produce assessable income.[86] The dividend trap realities leading to a suspension of dividends for a period was one of those matters that could objectively be considered (even without subjective evidence), as was the building of a stock of profits and the need to resolve Spassked's accumulating losses.[87] The obvious way to address both of these matters was by payment of one massive dividend to Spassked, which would enable Spassked to repay all of its debt. Justices Hill and Lander still thought it necessary to ask Spassked's directors whether, subjectively, they thought the interest paid to IEF was incurred in gaining or producing

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> considering the arm's length external borrowing by the IEL group to make the corporate acquisitions in question. Some of those acquisitions might have been successful and some might have failed. In hindsight, some may have been doomed to failure. However there would be little doubt as to the deductibility of interest on all of those borrowings.
>
> The same principle does not apply to purely intra-group arrangements with no external aspect. All of the relevant arrangements were between companies with the same beneficial ownership. Many of the companies involved, including Spassked, had no external role at all. The arrangements involving those companies were inherently variable at the will of the ultimate board of directors. They do not reflect the exercise of business judgment in the relevant sense. Thus, the requisite connection or relationship between the outgoing and the earning of assessable income is not to be inferred but must be positively established.

[85] Cf *FC of T v Munro* (1926) 38 CLR 153.
[86] See, eg, ibid; *Australian National Hotels* (1988) 19 FCR 234; *Steele* (1999) 197 CLR 459; *Travelodge* (1985) 16 ATR 867; *Temelli* (1997) 36 ATR 417; *Wharf Properties* [1997] AC 505; *Hayden* (1996) 68 FCR 19; *Begg* [1937] SASR 97; and *Roberts* (1992) 37 FCR 246.
[87] See, eg, JD Heydon, *Cross on Evidence* (6th Aust ed, 2000) 121-131; and A Ligertwood, *Australian Evidence* (4th ed, 2004) 444-454.

Spassked's assessable income.[88] As discussed above,[89] this approach does not appear to be correct.[90]

4.2.2 Great Disproportion Between Expense and Income?

The other time when subjective purpose is relevant is when there is such a large disproportion between outgoings and expected income that the circumstances objectively suggest that the outgoings are incurred not just to derive that relatively small amount of assessable income.[91] The High Court confirmed in *Fletcher v FC of T*[92] that, in this situation, the issue of whether the outgoing is incurred wholly in gaining or producing assessable income is determined by "a weighing of the various aspects of the whole set of circumstances, including direct and indirect objects and advantages which the taxpayer sought in making the outgoing".[93] The court may then disallow some (or indeed, all) of the deduction if the assessable income is only there to add "colour" and does not genuinely explain the incurring of the outgoing.[94]

Justices Lindgren, Hill and Lander believed that there was such a disproportion in *Spassked*, noting that there were over $3 billion in interest costs and only a relatively paltry $43 million of unfranked dividends received during the period (and those dividends may well have been paid just to add "colour").[95] But Lindgren, Hill and Lander JJ may have cast their gaze too short. Their Honours chose to ignore the evidence before them that there was always the prospect of profits accumulating to the point where a massive catch-up

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[88] *Spassked* (2003) 136 FCR 441, 468-469.
[89] In the text accompanying notes 79-87.
[90] See, eg, Woellner et al, above n 59, 679.
[91] Such as in *Ure* (1981) 50 FLR 219; and *Ilbery* (1981) 58 FLR 191.
[92] (1991) 173 CLR 1.
[93] Ibid 18 (per Mason CJ, Brennan, Deane, Dawson, Toohey, Gaudron and McHugh JJ), citing *Robert G Nall Ltd v FC of T* (1937) 57 CLR 695, 699-700, 706, 708-709 and 712-713.
[94] *Fletcher* (1991) 173 CLR 1, 17-19 (per Mason CJ, Brennan, Deane, Dawson, Toohey, Gaudron and McHugh JJ).
[95] *Spassked* (2003) 136 FCR 441, 468-469 and 475-476.

dividend could be paid,[96] which would have destroyed the "disproportion" necessary to start this inquiry into the subjective. It would not matter that the view could be taken that an attempt had been made to improve the position by paying nominal dividends to Spassked, as the interest may still have been deductible if none had been paid at all. However, since dividends were in fact paid, on a correct application of *Ure v FC of T*,[97] the Full Court of the Federal Court should have allowed Spassked a deduction for its interest expenses of an amount at least equal to the amount of dividends paid to Spassked.[98]

5. CONCLUSION

Once it is appreciated that there was an objective expectation of adequate dividends being received by Spassked in the long run, it makes no difference that the common directors of Spassked and GIH had no "agreed plan, mechanism or time frame according to which Spassked would begin to receive dividends",[99] just as it is not to the point that a start-up company might not have a clear picture of when it will become profitable and have enough money to pay a dividend.[100] An investor in such a start-up company can expect interest deductions without the company necessarily having a firm plan of when dividends will start to be paid, as there is no objective reason at the time of investing in the company for doubting that the interest outgoings will produce at least proportionate assessable

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[96] Ibid 472-476.

[97] (1981) 50 FLR 219.

[98] Colley, "Dividend Trap 2", above n 9, 356 notes that Spassked did not make submissions to this effect, but the terms of s 51(1) of the ITAA36 ("All losses and outgoings to the extent to which") do not appear to require this. Compare O'Connor, above n 13, 21.

[99] *Spassked* (2003) 136 FCR 441, 475. The lack of relevant documentation was presumably due in part to the IEL group's focus on eliminating "unnecessary paper work". See, eg, Colley, "Dividend Trap 2", above n 9, 352; and Colley, "Dividend Trap 1", above n 9, 515-516.

[100] Cf Kyrwood, above n 51.

income from dividends at some time in the future.[101] It is submitted that it was open to the Full Court of the Federal Court to find the same in respect of Spassked's interest expenses. Unfortunately, the Court failed to grasp this basic point, preferring instead to see the case as an opportunity for a justifiable trip into the "subjective" field, where the Court could rest on the trial judge's findings.

[101] Cf *Ure* (1981) 50 FLR 219.