Justice Hill and the Autopoiesis of Income Tax Law

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Justice Hill and the Autopoiesis of Income Tax Law

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1. Introduction

The theory that law may best be understood as an autopoietic system has gained considerable ground since Luhmann advanced it in 1981.[2] Nevertheless, there have been few endeavours to apply the theory in any practical way or to employ it to analyze particular areas of law. In a recent paper,[3] Geraldine Hikaka and the present author proposed the thesis that Luhmann's theories usefully illuminate the field of income tax law. The present paper illustrates this thesis by analyzing a leading case from each of the Privy Council and the High Court of Australia, namely *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue*[4] and *Federal Commissioner of Taxation v South Australian Battery Makers Pty Ltd.*[5] The paper will argue that the autopoietic nature of income tax law presents challenges to the judicial process that, as these cases illustrate, lead to income tax law becoming detached from the business profits that are an important part of its subject matter.[6]

The paper will then turn to *Macquarie Finance Ltd v Federal Commissioner of Taxation*,[7] one of the last tax judgments of the late Justice Graham Hill. It will be argued that in *Macquarie Finance Ltd* Justice Hill demonstrated a rare, almost unique, ability among judges: to reconcile the formalistic, autopoietic nature of tax law with the business substance that was the subject matter of the case. The paper turns first, however, to the question of what is meant by the autopoietic theory of law.

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[2] Niklas Luhmann "Evolution des Rechts" in N Luhmann *Ausdifferenzierung des Rechtsystems. Beitrage zur Rechtssoziologie und Rechstheorie* (1981 Frankfurt am Main: Suhrcamp); "Autopoiesis, Handlung und Kommunikative Verstandigung" (1982) 11 Zeitschrift fur Soziologie 366. For a collection that develops and analyses Luhmann's theories, see Gunther Teubner *Autopoietic Law: A New Approach to Law and Society* (de Gruyter, Berlin and New York, 1987). This volume has extensive bibliographies, including listings of Luhmann's work in English.

[3] Hikaka, Geraldine and John Prebble "Legal Autopoiesis and General Anti Avoidance Rules" (Society of Legal Scholars Tax and Jurisprudence Sections Conference, Keele University, England, 4-7 September 2006).

[4] [1976] 1 NZLR 546 (PC). This 1976 case is known as the Second *Europa* Case, to distinguish it from the First *Europa* Case, which involved the same taxpayer and very similar facts and was decided by the Privy Council in 1970: *Commissioner of Inland Revenue v Europa Oil (NZ) Ltd* [1971] NZLR 641, *sub nom Inland Revenue Commissioner v Europa Oil (NZ) Ltd* [1971] AC 760 (PC).

[5] (1978) 140 CLR 645, 8 ATR 879 (HCt FC).

[6] See further, John Prebble "Ectopia, Formalism, and Anti-avoidance Rules in Income Tax Law" (1994) in W. Krawietz N. MacCormick & G.H. von Wright (eds) *Prescriptive Formality and Normative Rationality in Modern Legal Systems* (Festschrift for Robert S. Summers, Duncker and Humblot, Berlin, 1994) 367; "Philosophical and Design Problems that Arise From the Ectopic Nature of Income Tax Law and their Impact on the Taxation of International Trade and Investment" (1995) 13 Chinese Yearbook of International Law and Affairs 111 reprinted as "Ectopia, Tax Law, and International Taxation" [1997] British Tax Review 383; "Can Income Tax Law be Simplified?" (1996) 2 NZ Journal of Taxation Law and Policy 187; "Should Tax Legislation be Written from a Principles and Purpose Point of View or a Precise and Detailed Point of View?" [1998] British Tax Review 112; "Income Taxation, a Structure Built on Sand" (2002) 24 Sydney Law Review 301, reprinted as "El Impuesto Sombre La Renta: Una Estructura Construida Sobre La Arena" (2006) 121 Cronica Tributaria 113; see also "Why is Tax Law Incomprehensible?" [1994] British Tax Review 380.

[7] (2004) 210 ALR 508, 2004 ATC 1433, [2004] FCA 1170, aff'd *Macquarie Finance Ltd v Federal Commissioner of Taxation* 2005 ATC 4829, [2005] FCAFC 205 French, Hely & Gyles JJ.

2. A conspectus of autopoiesis

Luhmann developed his theory of law as an autopoietic system from the theories of the Chilean biologists Humberto Maturana and Francisco Varela, who (to over-simplify) proposed the idea that living organisms could usefully be considered as a collection of closed systems, communicating within themselves but, to a very considerable degree, closed to outside influences.[8] Luhmann applied these ideas first to social systems in general and then to law in particular.[9] Other scholars, led by Gunther Teubner,[10] have developed this latter field. Hugh Baxter offers probably the most accessible and useful explanation for scholars from the Anglo-American tradition, at the same time as adding insightful criticism.[11] This paper attempts only a cursory summary.

As Luhmann explains, the fundamental point of the theory of autopoiesis (literally, "self-creation" or "self-reproduction") is that, "Law is … valid by virtue of [legal] decisions which make it valid. The legal system itself is obliged to believe in this ground of its validity".[12] In other words, it is immanent within the law that it relies for its validity on itself and not on exogenous factors.

When it comes to applying the analytical framework of autopoiesis to legal problems it is the corollaries that one derives from this essential feature of autopoietic theory that are most immediately important. This paper will examine a partial list, namely the concepts of *coding*, of *recursive reasoning*, and of *operative closure*.

3. Coding, recursive reasoning, and operative closure[13]

Luhmann asserts[14] that the basic units of a legal system are not legal norms but that law is a system of communications and that legal acts are communicative events that change legal structures. The relationship between legal acts and legal norms is both circular and self-creating,[15] hence autopoietic. The operation of the doctrine of precedent is a good example. The reasons that judges give for their decisions are communications. These communications rely on reasons in past judgments for their authenticity and they themselves will form reasons for future judgments. This is a recursive process, whereby the legal system reproduces itself in a network of system-specific communications.[16]

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[8] For a recent conspectus of their work see, Humberto R and Francisco J. Varela *The Tree of Knowledge: The Biological Roots of Human Understanding* (Shambhala Publications, Boston, 1998) ISBN: 0877736421.

[9] See footnote 2.

[10] Idem.

[11] Baxter, Hugh "Autopoiesis and the 'Relative Autonomy' of Law" (1998) 19 Cardozo L Rev 1987, 1992.

[12] Niklas Luhmann, unpublished conference paper, quoted in Jean-Pierre Dupuy "On the Supposed Closure of Normative Systems" in Gunther Teubner *Autopoietic Law: A New Approach to Law and Society* (de Gruyter, Berlin and New York, 1987) 51, 68.

[13] This section draws heavily on Hikaka, Geraldine and John Prebble "Legal Autopoiesis and General Anti Avoidance Rules" (Society of Legal Scholars Tax and Jurisprudence Sections Conference, Keele University, England, 4-7 September 2006) 6 – 7.

[14] Teubner, Gunther "Introduction to Autopoietic Law" in Teubner, Gunther *Autopoietic Law: A New Approach to Law and Society* (de Gruyter, Berlin and New York, 1987) 1, 3.

[15] Ibid, 4.

[16] Baxter, Hugh "Autopoiesis and the 'Relative Autonomy' of Law" (1998) 19 Cardozo L Rev 1987, 2006.

Luhmann contends[17] that system boundaries are established internally through the system's own operations and that, therefore, information is system-specific, having meaning only in the terms of the system whose operations produced it. That is, it bears the "codes" of that system. Within this context "coding" takes on the role of characterizing a distinction that is specific to law.[18] By "code" Luhmann means[19] that law uses a binary scheme (legal/illegal) in order to structure its own operations and to distinguish them from other facts. A positive value (legal) is applied if a fact conforms to the norms of the system; a negative value (illegal) is applied if a fact violates a norm of the system.[20] Luhmann uses "fact" idiosyncratically, stating:[21]

> A "fact" here is a construction of the system. The system does not acknowledge any external instance that could dictate to it what a fact is, even if the term "fact" can apply to both internal and external phenomena.

While idiosyncratic, this definition is informative. A good example of such a fact is independent corporate personality, something that is entirely a creation of the law but that is nevertheless from the perspective of tax law a fact that has very definite consequences, as this paper will explore.

The system distinguishes itself from its environment by its own system code, which closes the system off from the other systems in its environment by serving as a "rejection value" for the codes of other systems.[22] Codes only become autopoietically effective as distinctions with the help of a further distinction, that is, a distinction between coding and programming.[23] According to Luhmann, programming complements coding and fills it with content. He says:[24]

> Since the values "legal" and "illegal" are not in themselves criteria for the decision between legal and illegal, there must be further points of view that indicate whether or not and how the values of the code are to be allocated rightly or wrongly. We shall call these additional semantic elements (in law and in other coded systems) programmes.

"Legal programmes" include constitutions, statutes, regulations, court decisions and contracts.[25] Programmes must be suitable to direct the allocation of the values "legal" and "illegal". By "illegal" Luhmann does not appear to mean "criminal", nor even "to be condemned". Rather, to put the matter not as Luhmann did but in terms familiar to tax lawyers, he contrasts "having the legal effect for tax purposes that the taxpayer hopes or expects" (legal) with "not having that effect" (illegal).

A corollary to coding is said to be that legal reasoning is recursive and self-referential, justifying itself by its own norms (that is, by its own codes) rather than by external standards.[26] This recursivity or circularity of reasoning is fundamental. As we have seen, it appears in Luhmann's statement of the basic quality of

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[17] Ibid, 2005-2006.
[18] Luhmann, N *Law As A Social System*, translated by Ziegert, K (Oxford University Press, Oxford, 2004) 173.
[19] Ibid, 182.
[20] Ibid, 183.
[21] Idem.
[22] Baxter, Hugh "Autopoiesis and the 'Relative Autonomy' of Law" (1998) 19 Cardozo L Rev 1987, 2007.
[23] Luhmann, N *Law As A Social System*, translated by Ziegert, K (Oxford University Press, Oxford, 2004) 193.
[24] Ibid, 192.
[25] Baxter, Hugh "Autopoiesis and the 'Relative Autonomy' of Law" (1998) 19 Cardozo L Rev 1987, 2014.
[26] See, eg, ibid 1993 & 2011 and Luhmann, supra note 23, 182 & 195.

autopoiesis, quoted earlier: "Law is … valid by virtue of [legal] decisions which make it valid"[27] and explains what is meant when we say that law is self-creating.

That it is immanent in a legal system to operate according to its own codes and by means of recursive reasoning leads to another quality: that of "operative closure".[28] This term is calculated to capture the concept that the law is closed against other social systems in that it justifies itself and operates within its own terms. The present author is not persuaded that this is a good description of the law in general, but it does seem accurately to describe the quality of tax law.[29]

4. Income tax law

Income tax law is replete with cases that illustrate the coding, recursive reasoning, and operative closure of autopoiesis, but judgments that deal with companies often afford particularly good examples. Like law in general, tax law ordinarily treats companies as independent persons and does not attempt to penetrate the corporate veil. In general law, this policy makes sense. The purpose of company law is to enable investment and management to be separate; so it promotes, rather than erodes, company law policy when the general law recognizes limited liability, perpetual corporate succession, the division of powers and responsibilities between directors and shareholders, and other familiar incidents of corporate personality.

In tax law, the recognition of separate corporate personality is quite another matter. In the end, only individuals, not companies, can bear taxes. Yet tax law treats a company as a separate taxpayer. In Luhmann's terms, this separate taxpayer is a fact that the law creates. The case of companies that are associated often throws up examples of recursive reasoning that yield results that conflict with the economic reality of whoever in fact bears the incidence of the tax in question. Two examples will suffice, both relating to deductibility of outgoings: *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue*[30] and *Federal Commissioner of Taxation v South Australian Battery Makers Pty Ltd.*[31]

5. The *Europa* case: the facts

Europa Oil (NZ) Ltd was a member of the Todd group, a New Zealand corporate group involved in the transport industry and in petroleum products. Europa bought much of its trading stock, which it usually called "feedstocks", from foreign suppliers. It negotiated to buy petroleum products from Gulf Oil, the major international oil company. As a member of a price-fixing cartel, Gulf was bound by contract to charge what the cartel called "posted prices" for its products. As it happened, Gulf had a surplus of "light end products"[32] in the eastern hemisphere, and light end products were what Europa Oil wanted. That is, there was a basis for

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[27] Niklas Luhmann, unpublished conference paper, quoted in Jean-Pierre Dupuy "On the Supposed Closure of Normative Systems" in Gunther Teubner *Autopoietic Law: A New Approach to Law and Society* (de Gruyter, Berlin and New York, 1987) 51, 68. See text accompanying footnote 12.

[28] Baxter, Hugh "Autopoiesis and the 'Relative Autonomy' of Law" (1998) 19 Cardozo L Rev 1987, 1994.

[29] See generally, Hikaka, Geraldine and John Prebble "Legal Autopoiesis and General Anti Avoidance Rules" (Society of Legal Scholars Tax and Jurisprudence Sections Conference, Keele University, England, 4-7 September 2006).

[30] [1976] 1 NZLR 546 (PC).

[31] (1978) 140 CLR 645, 8 ATR 879 (HCt FC).

[32] "Light end products" are things like motor and aviation fuel, which are early distillates of the process of refining crude oil. Bitumen and other tars are examples of heavy end products.

Europa Oil to argue for a price reduction and an incentive for Gulf to grant it, but as a cartel member Gulf could not be seen to accept less than posted prices.

The upshot was a matrix of contracts between certain members of the Gulf group on one hand and Europa Oil and other members of the Todd group on the other hand. Omitting some elements, the essential features of these agreements included the following. By one contract, Europa Refining Ltd, another member of the Todd group, agreed to buy petroleum products from a Gulf subsidiary at posted prices. As it needed feedstocks, Europa Oil bought petroleum products from Europa Refining. There was no overarching purchasing contract between Europa Oil and Europa Refining, but the price reflected the posted prices that Europa Refining had to pay. Other contracts provided for what amounted to a price reduction, or, perhaps more precisely, a refund, for every gallon that Europa Oil acquired.

Gulf delivered the refund in the following manner. First, Europa Oil and Gulf took equal shares in Pan Eastern Refining Co Ltd, a brass plate company incorporated in the Bahamas. The parties' shares were held via subsidiaries, in Europa Oil's case by a company called Associated Motorists Petroleum Ltd. Secondly, whenever Europa Oil ordered petroleum products, Gulf would sell an equivalent gallonage of crude oil to Pan Eastern. Pan Eastern would have the oil refined and sell it back to Gulf. Pan Eastern, being a brass plate, had no refining capacity. It therefore sub-contracted the refining to another Gulf company. The returns were calculated so that Pan Eastern made a profit of five cents on every gallon. The five cents became a dividend of 2.5 cents per gallon to each of the Gulf interests and the Europa/Todd interests. The Europa/Todd dividends came back to Europa Oil, via Associated Motorists Petroleum.

6. The *Europa* case: the decision

At the time, New Zealand operated the classical system of company taxation. That is, companies paid tax on their profits and shareholders paid a second slice of tax on their companies' dividends. Potentially, this meant that there could be multiple tranches of tax as a dividend made its way up a corporate chain. New Zealand legislated to keep tax on company profits to only two exactions, when the company earned its profits and when the dividend eventually reached a human shareholder. The legislation achieved this result by exempting inter-corporate dividends from tax in the hands of the receiving company. For Europa Oil, this meant that its dividends from Associated Motorist Petroleum were exempt from tax.

Supposing that the price that Europa Oil paid for feedstocks was 20 cents per gallon, the upshot was that in economic terms there was a refund of 2.5 cents for each gallon. In effect, Europa Oil paid 20 cents per gallon but suffered an economic cost of only 17.5 cents. The other 2.5 cents was refunded as a non-taxed dividend. As Lord Diplock put it in delivering the judgment of the majority:[33]

> What the contracts did was to provide the means by which a share of the refiner's profit on finished products sold by the Gulf group to the Todd group would be obtained by the Todd group in the form of dividends on the shares in Pan Eastern held by AMP.

Nevertheless, in calculating its taxable income, Europa Oil deducted the full 20 cents. The Commissioner disallowed 2.5 cents of the cost on the basis that Europa

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[33] *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue* [1976] 1 NZLR 546, 550 lines 33 – 37 (PC).

Oil had paid only 17.5 cents for feedstocks and had spent the 2.5 cents per gallon to earn exempt income.

Citing *Commissioners of Inland Revenue v Duke of Westminster,*[34] their Lordships rejected the Commissioner's argument. As the passage from Lord Diplock just quoted makes clear, their Lordships recognized "what the contracts did", but this economic fact did not decide the matter, for the legislation did not tax by end result or by economic equivalence.[35] By paying the price for cargoes of petroleum products, Europa Oil obtained only one legal right: to the delivery of feedstocks.[36] The fact that other Todd companies could enforce the contracts that ensured that Europa Oil would receive a non-taxable dividend of 2.5 cents per gallon was neither here nor there.[37] Nor did it matter that Europa Oil's purchasing contracts:[38]

> … did not stand alone. They formed part of a complex of interrelated contracts entered into by various companies that were members of the Todd group or the Gulf group in connection with the same goods.

At least, the interrelationship of the contracts and of the companies did not matter if, from the point of view of the taxpayer, Europa Oil, the derivation of the dividend was only an "economic consequence" and not a legally enforceable right.[39]

7. *South Australian Battery Makers*: the facts

Federal Commissioner of Taxation v South Australian Battery Makers Pty Ltd[40] also involved an issue of deductibility. The taxpayer was a member of the Chloride group, a multi-national group based in the United Kingdom with subsidiaries in many countries. The main Australian holding company appears to have been Associated Battery Makers of Australia Pty Ltd, which can be known as "ABM". ABM negotiated with the South Australian Housing Trust to establish a factory near Adelaide. The Trust was a not-for-profit entity that enjoyed exemption from tax. One of its objectives was to promote industrial development.

The trust agreed with ABM that it would build a factory on a suitable ten-acre plot of land, which the trust would lease to ABM. A separate contract would accompany the lease, namely, an option to purchase the premises. Slightly over-simplifying, rent would be at either six per cent or ten per cent of the value of the land and factory. If ABM chose six per cent the option to purchase would be at valuation as at the date of exercise. If ABM chose ten per cent the price would start at cost and decrease from year to year of the lease as the additional four per cent amortized the cost of the premises. The perceived advantage to ABM of the second option was that ABM would be able in effect to deduct most of the capital cost of the factory in the form of the annual rent proposed to be paid. From a tax point of view the difference between the alternatives was immaterial to the Housing Trust because, as a non-taxpayer, it would not suffer tax either on rent or on receipts for the price of the premises.

ABM chose the ten per cent option and signed the lease. It then assigned the lease to the taxpayer, South Australian Battery Makers Pty Ltd, known as SABM.

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[34] [1936] AC 1 (HL).
[35] *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue* [1976] 1 NZLR 546, 553 line 13 (PC).
[36] Ibid, 555 lines 28 – 33.
[37] Ibid, 553 lines 35 – 55.
[38] Ibid, lines 32 – 34.
[39] Ibid, lines 35 – 37.
[40] (1978) 140 CLR 645, 8 ATR 879 (HCt FC).

ABM assigned the option to Property Options Pty Ltd. This was another subsidiary of the Chloride Group, but a subsidiary very remote within the group from ABM and SABM. Although Property Options Pty Ltd was remote from SABM in terms of the legal structure of the group, it was formed with the sole purpose of serving as a land-holding company for SABM.[41]

8. Issue and decision in *South Australian Battery Makers*

The issue in the case was whether SABM could deduct the whole of the rent in calculating its assessable income, notwithstanding that, as Gibbs ACJ put it for the majority:[42]

> [T]he payments were made not only with the knowledge, but also with the purpose, that part might be treated as part of the price of a capital asset which Property Options would probably acquire.

The majority's answer was, yes, SABM could deduct the whole of the expense and did not have to apportion the rent between its two purposes. In reaching this conclusion the majority followed Lord Diplock in *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue*, quoted above.[43] Gibbs ACJ adopted two reasons from the *Europa* case. First, the court should take account only of benefits to which the taxpayer became legally entitled as a result of the expenditure.[44] Here, SABM was legally entitled only to the right to occupy. SABM could not enforce the option to purchase. Secondly, if this rule was expressed too widely, then:[45]

> [I]t is the advantage which the expenditure was intended to gain, directly or indirectly, for *the taxpayer* that is relevant in determining the character of the expenditure, and … when an expenditure is genuinely made in the purchase in the payment of the price of trading stock, or in the payment of rent, it is not permissible, for the purpose of deciding whether the expenditure was in part of a capital nature, to consider an advantage gained by another person as a result of the payment, when the taxpayer neither shares in that advantage, nor can secure its enforcement.
>
> The outgoings in the present case were genuinely made in payment of rent.

9. Autopoietic reasoning in *Europa* and *South Australian Battery Makers*

The two cases, *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue* and *South Australian Battery Makers Pty Ltd v Federal Commissioner of Taxation*, are particularly good examples of autopoiesis. Both taxpayer companies were subsidiaries of large corporate groups where economic ownership and practical direction were concentrated at, or delegated from, the top level. Each company made payments that partly benefited another subsidiary in its respective group. The court in each case recognized that the payments were intended to have this effect. But because within their respective groups the beneficiary subsidiaries were siblings or distant cousins of the taxpayers the courts treated them as wholly independent. Had the taxpayers enjoyed contractual rights to enforce the rights of

[41] 140 CLR 645, 670 Jacobs J dissenting, referring to evidence that his Honour quoted at 666.
[42] Ibid, 656.
[43] *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue* [1976] 1 NZLR 546, 550 lines 33 – 37 (PC), text accompanying footnote 33.
[44] 140 CLR 645, 659. Stephen and Aikin JJ agreed, ibid, 661.
[45] Ibid, 660 (emphasis added).

the beneficiary companies[46] or, possibly, had the beneficiary companies been daughter subsidiaries of the taxpayers,[47] the results would have been different.

Practically speaking, the differences in legal structure just mentioned were of no consequence for the business operations of the taxpayers nor for their respective corporate groups. To the extent that any company in a group incurred expenditure or enjoyed legal rights, the human owners of the group incurred the expenditure economically and the human directors of the group could choose to enforce or to waive legal rights that any company in the group possessed. That is, the decisions in the two cases turned on legal simulacra[48] that were far from the true business facts, or, in terms of autopoietic theory, the decisions turned on legal frameworks that had created themselves with little reference to the economic reality that lay beneath. These frameworks were circular. In the *Europa* case the recursivity was so pronounced that there were circles within circles. For instance, the transactions that funded the exempt dividend that the taxpayer derived entailed the jointly-owned company, Pan Eastern, buying crude oil from one Gulf company, sending it to a second Gulf company for refining, receiving it again from the refining company, and then selling it back to Gulf at a pre-ordained profit. That profit then set out from Pan Eastern along the trail of a larger circle, to go to the taxpayer and eventually to reach the Todd group holding company. All these transactions were, of course, on paper. Pan Eastern, physically being no more than a brass plate, could not literally receive or deliver oil, either crude or refined.

The two cases furnish good examples of Luhmann's idea of coding. For their respective courts, the issue that was decisive as to deductibility was what *legal* benefit the taxpayers acquired by the monies that they expended. For Europa Oil, the benefit was trading stock. For SABM, the benefit was the right to occupy its factory. Since they were coded "legal", their Honours took these benefits into consideration. Since the taxpayers could not enforce them legally, their Honours gave no weight to the additional, purely economic, benefits that the taxpayers' expenditure obtained: dividends that were exempt from tax and an option to purchase that resided in a sibling company. In terms of autopoietic terminology, the courts' reasoning was operatively closed to social systems other than the legal system, and in particular it was closed to the systems of business and of economics.

10. Attacks on autopoietic reasoning

The kinds of decision that *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue*[49] and *Federal Commissioner of Taxation v South Australian Battery Makers Pty Ltd*[50] illustrate attract criticism from judges who prefer to found their decisions in factual reality. For instance, *Littlewoods Mail Order Stores Ltd v Inland Revenue Commissioners*[51] involved facts similar in relevant respects to *South Australian Battery Makers*. That is, the object of the taxpayer in paying certain rent was to obtain the freehold reversion for a subsidiary and the recipient

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[46] Ibid, 658 per Gibbs ACJ, citing *Inland Revenue Commissioner v Europa Oil (NZ) Ltd* [1971] AC 760, 775.

[47] Ibid, 655 cf *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue* [1976] 1 NZLR 546, 550 lines 1 - 3 (PC).

[48] See John Prebble "Income Taxation, a Structure Built on Sand" (2002) 24 Sydney Law Review 301.

[49] [1976] 1 NZLR 546 (PC).

[50] (1978) 140 CLR 645, 8 ATR 879 (HCt FC).

[51] [1969] 1 WLR 1241, [1969] 3 All ER 855 (CA).

of the rent was a tax-exempt charity. Lord Denning MR pierced the corporate veil in order to discern that the expense was capital, and thus to disallow it, saying:[52]

> I think that we should look at the [subsidiary] and see it as it really is–the wholly-owned subsidiary of Littlewoods. It is the creature, the puppet, of Littlewoods in point of *fact*: and it should be so regarded in point of *law*.

On similar lines, Murphy J, dissenting in *South Australian Battery Makers* itself, said:[53]

> The lease was a transparent device which is not consistent with the real transaction …. The companies were not at arm's length; they were all associates in what is described as "the Chloride group". ….
>
> It would make a mockery of the legislative intent if the taxpayer is able to pay to another (who finds it convenient because it is non-taxable or otherwise) excess amounts for goods or services on the basis that the excess will be passed on as a benefit for an associate of the taxpayer.
>
> As the Supreme Court of the United States said in *Gregory v Helvering*:[54] "To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose".

Such judicial efforts to align tax law with economic reality generally have little success. In *Federal Commissioner of Taxation v South Australian Battery Makers Pty Ltd*[55] Jacobs J joined Murphy J in the minority with a judgment that carefully analyzed the facts and interpreted their significance,[56] but neither judge's decision had much effect either in the case itself or subsequently. Lord Denning MR's judgment in *Littlewoods Mail Order Stores Ltd v Inland Revenue Commissioners*[57] suffered a similar fate. The learned judges who sat with his Lordship in *Littlewoods* agreed with him in the result, but took pains to distance themselves from the idea of piercing the corporate veil. Karminski LJ said,[58] "It is necessary … to ask … who really benefited from getting hold of the freehold". Sachs LJ took a similar approach.[59] That is, to both Lords Justices the question appears to have been what Littlewoods had spent the money on in reality, which did not necessarily entail piercing the veil, though unlike the taxpayers in *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue*[60] and *Federal Commissioner of Taxation v South Australian Battery Makers Pty Ltd,*[61] Littlewoods was itself the relevant parent company and therefore in a position to ensure that the benefit of the expenditure went to whomever it wanted. That is, in the *Littlewoods* case the question of whether the taxpayer had a legal entitlement to the benefit to which the expenditure went was less of a live issue than in the *Europa* and *Battery Makers* cases; at least, it was not an issue that the court addressed.

In conversation, tax lawyers dismiss such judgments as Lord Denning's and Murphy J's as the product of maverick reasoning by judges who are unfamiliar with tax law or simply by saying that the judge "got it wrong".[62] Reported judgments put it more politely, but the effect is much the same. Lord Denning's

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[52] [1969] 1 WLR 1241, 1254 C–D (emphasis in original).
[53] (1978) 140 CLR 645, 671 – 672.
[54] (1935) 293 US 465, 470; 79 Law Ed 596, 599.
[55] (1978) 140 CLR 645, 8 ATR 879 (HCt FC).
[56] (1978) 140 CLR 645, 662 – 670.
[57] [1969] 1 WLR 1241, [1969] 3 All ER 855 (CA).
[58] [1969] 1 WLR 1241, 1256.
[59] Ibid, 1255 – 1256.
[60] [1976] 1 NZLR 546 (PC).
[61] (1978) 140 CLR 645, 8 ATR 879 (HCt FC).
[62] Author's knowledge.

essay into economic reality has had no more success in later cases than it did in 1969.[63]

11. The contribution of Justice Graham Hill

One judge who from time to time put a subtle spoke into the wheel of the circular, autopoietic reasoning that is so familiar in tax judgments was the late Justice Hill. By virtue of his deep knowledge of tax law and by virtue of the esteem in which he was held as a scholar by both bench and bar, Hill J was better placed than anyone since Sir Owen Dixon to influence judicial reasoning in tax cases, though time will tell whether his endeavours in this particular regard will last. A good many of Hill J's judgments could illustrate what is probably, to the reader, a still somewhat obscure point, but the present author has chosen one of his Honour's last cases: *Macquarie Finance Ltd v Federal Commissioner of Taxation.*[64] A Full Court of the Federal Court upheld Hill J by a majority.[65]

There are several reasons to choose the *Macquarie Finance* case. First, like the *Europa* and *Battery Makers* cases, *Macquarie Finance* involved the issue of deductibility of outgoings in the context of a contrived business structure that passed economic benefits between sibling companies in a single corporate group. Secondly, *Macquarie Finance* dealt with the capital/revenue distinction, the field where one sees the most abundant flowering of autopoietic reasoning in tax cases. Thirdly, the case addressed interest, or, at least, interest-like outgoings, which is one of the more obscure corners of this field.

Fourthly, *Macquarie Finance* contains instructive examples of the three approaches to tax law reasoning that may be found in this kind of case. First, Hely J,[66] dissenting on appeal, hewed to the kind of formalism that the *Europa* and *Battery Makers* cases illustrate so well. Secondly, French[67] and Gyles JJ,[68] the majority in the Full Court, took a substance-based approach reminiscent of Murphy J in his Honour's minority judgment in the *Battery Makers* case.[69] Thirdly, and most significantly for the purposes of the present analysis, Hill J's[70] arguments did not so much fall between these extremes as construct a brilliant blend of both of them. That is, as will be argued in the remainder of this paper, his Honour located himself squarely within the autopoietic tradition of tax law at the same time as achieving a result that attuned with the economic substance of the case.[71]

Finally, the dates and circumstances of the case take on a particular poignancy when they are juxtaposed with the date of Justice Hill's death. His Honour delivered judgment as the primary judge on 14 September 2004. A Full Court of his colleagues on the Federal Court heard the taxpayer's appeal on 21 and 22

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[63] See, eg, *Federal Commissioner of Taxation v South Australian Battery Makers Pty Ltd* (1978) 140 CLR 645, 656, where Gibbs ACJ disapproved of Lord Denning's approach, citing *Inland Revenue Commissioner v Europa Oil (NZ) Ltd* [1971] AC 760, 771 (PC).

[64] (2004) 210 ALR 508, 2004 ATC 1433, [2004] FCA 1170.

[65] *Macquarie Finance Ltd v Federal Commissioner of Taxation* 2005 ATC 4829, [2005] FCAFC 205 French and Gyles JJ, Hely J dissenting.

[66] [2005] FCAFC 205, [114] – [246].

[67] Ibid, [1] – [113].

[68] Ibid, [247] – [261].

[69] See quotation at footnote 53, above.

[70] (2004) 210 ALR 508, 2004 ATC 1433, [2004] FCA 1170.

[71] Among the few reported examples of similar reasoning are Lord Templeman's judgments in *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513, 556 – 566 (PC) and *Ensign Tankers (Leasing) Ltd v Stokes (Inspector of Taxes)* [1992] 1 AC 655 (HL).

February 2005, but did not deliver judgment until 16 September 2005,[72] just over three weeks after Graham Hill's death on 25 August.

There is no suggestion that there was any relationship between the two events other than that of time, but his Honour was keenly aware[73] that his reasoning in the case had dismayed the tax profession. In his perception, many people condemned it and some even felt betrayed by it. The reasons are explained later in this paper.[74] Justice Hill died without having the satisfaction of knowing that the Full Court upheld his decision, albeit in judgments that were, with respect, less nuanced than his Honour's.[75,76]

12. The principal facts of the *Macquarie Finance* case

Macquarie Finance Ltd, known as "MFL" was a largely inactive subsidiary of Macquarie Bank Ltd, or "MBL". MBL was primarily a large and very active investment bank, but it was also licensed as a trading bank. In the latter capacity it was subject to the Australian Prudential Regulation Authority, which administered banking capital adequacy regulations promulgated by the Basle Committee on Banking Supervision of the Bank of International Settlements. The burden of these regulations was that banks were obliged to ensure that at least eight per cent of their assets were covered by their own capital (as opposed, for instance, to being covered by deposits from clients). At least half of the eight per cent had to represent shareholders' equity or securities approved by the Regulation Authority as equivalent, known as "tier 1 capital".

In 1999, MBL wished to raise $200 million in additional capital from the investing public. As a growing investment bank MBL no doubt had continuing demands for capital, but in 1999 there was a special need: MFL proposed to buy the financier Bankers Trust from its owner, Deutsche Bank AG, at a cost that had been estimated to be approximately $100 million,[77] that is, about half of the sum proposed to be raised. The invitation to invest proceeded on terms to be described in the following paragraphs. As things turned out, the invitation was over-subscribed and a second tranche of another $200 million was raised, making $400 million altogether. Let us use the figure of $400 million for purposes of the discussion that follows.

MBL was anxious that the $400 million should qualify as tier 1 capital. However, MBL did not wish to issue ordinary shares because its shareholders expected dividend returns of 25 per cent per annum, whereas bondholders were content with about 7 per cent interest. In addition, the cost of bonds would be even

[72] [2005] FCAFC 205, French and Gyles JJ, Hely J dissenting.
[73] Conversation between Hill J and the author, January 2005.
[74] See section 22 of this paper, "Conclusion".
[75] Idem.
[76] The order of events gives us cause to consider another question. When a court that is structured in the manner of the Australian Federal Court has among its members a judge who is an acknowledged leader of a specialist field of law, from the perspective of the development of that field of law is it better in any particular case that this judge should sit as the primary judge, or better that he or she should in due course be a member of the appellate panel? This question is hypothetical, because, no doubt, case assignments do not take such factors into consideration, but that does not prevent the question from being interesting to scholars. There is probably no general answer to the question, but the present author submits that in the *Macquarie Finance* case it was fortunate that Hill J was assigned to be the primary judge because his careful and highly refined analysis put the case into the right legal framework from its first hearing.
[77] [2004] FCA 1170, [10] Hill J.

cheaper if the interest were deductible for tax purposes. Bearing these matters in mind, MBL contrived a somewhat complex form of investment called “Macquarie Interest Securities”, or MIS. The Regulatory Authority approved MIS as tier 1 capital, but from the perspective of investors in the market MIS were tantamount to subordinated debt in the form of interest-bearing debentures, referred to as “notes” in the judgments. The crux of the case was the question of whether MIS also counted as interest-bearing debt for tax purposes.

13. Terms of the Macquarie Interest Securities

The Macquarie Interest Securities comprised two elements, four million preference shares issued by MBL and the same number of interest-bearing notes issued by MFL.[78] Each share and each note had a face value of $100. The two securities were stapled together in the sense that if a holder of a MIS disposed of one security without the other the MIS became void. The total value of each security was $400 million, making $800 million in aggregate, since both preference shares and notes were issued fully paid. Deutsche Bank underwrote the preference shares by subscribing $400 million for them directly to MBL and underwrote the notes by purchasing them from a trustee for debenture holders, who received the notes from MFL and passed Deutsche Bank’s purchase price of $400 million to MFL. That is, to all appearances, and according to the transactions described so far, the aggregate of the joint MBL/MFL invitation to invest and the actual sum invested involved $800 million, not the $400 million that was in fact raised.

By way of resolving this discrepancy, the documentation included a “procurement agreement”. This agreement was a contract between Deutsche Bank and MBL that tied various aspects of the capital-raising together and that, importantly, required MBL to pay Deutsche Bank $400 million when the MIS were issued. In effect, this $400 million off set the aggregate of $800 million from Deutsche Bank to MBL ($400 million directly and $400 million via the trustee), leaving a net transfer from Deutsche to MBL of $400 million.

The consideration for the $400 million paid by MBL to Deutsche was a kind of option granted by Deutsche to MBL. In essence, the option conferred a right on MBL to convert the MIS from interest-bearing loans to equity in MBL. This right to convert the MIS to equity was no doubt crucial in persuading the Regulatory Authority to classify the MIS as tier 1 capital. Section 15 of this paper explains in more detail how the process was to work, should conversion ever become necessary.

When Deutsche Bank on-sold the shares and the notes (combined as MIS) to the public the price was $400 million, not $800 million. That is, according to the documents Deutsche Bank paid $800 million for the securities and sold them for $400 million, but, as explained, Deutsche recovered the other $400 million directly from MBL.

As to the nature of the MIS, MBL had certain rights to redeem, but from the perspective of the investors the shares were irredeemable and the loans evidenced by the notes were not repayable but perpetual. If investors wished to recover their money they could do so only by selling their MIS on the market. However, if MBL were wound up there was an entitlement to $100 per preference share in preference to ordinary shares but no right to participate in surplus assets. There were similar

[78] The description of the MIS that follows is taken primarily from the judgment of French J, [2005] FCAFC 205, [15] – [31].

rights on any redemption, buy-back, or reduction of capital that occurred pursuant to MBL's rights.

Two features of the MIS were particularly relevant to the question of whether MFL was entitled to deduct the interest on the notes in calculating its taxable income and thus, in effect, in calculating the taxable income of the Macquarie group. First, different entities issued the shares and the notes, MBL and MFL respectively. If MBL had issued the notes as well as the shares it would have been "an affront to reality"[79] for MBL to argue that for tax purposes the interest on the notes was deductible as something to be considered separately from the equity-like nature of the shares. It was no doubt for this reason that MBL resurrected MFL from near-dormancy to take part as issuer of the notes. Earlier discussion within MBL had proceeded on the basis that MBL would be the only issuer.

Secondly, MFL lent the whole of the $400 million that it raised to a sibling subsidiary, Macquarie Leasing Pty Ltd, to fund Macquarie Leasing's business. The interest rate was enough above the rate that MFL paid on the notes to yield a modest profit. This employment of the new capital triggers two questions in the mind of the reader of the judgments. First, "How did Macquarie Leasing fund its business before the arrival of this no doubt welcome capital?" Secondly, "If MFL lent its new money to Macquarie Leasing, how did the Macquarie group fund the acquisition of Bankers Trust?" (It will be recalled that this acquisition was a principal purpose of the capital raising.[80])

Their Honours did not address either of these questions, but the explanation for both is no doubt the same: that is, money is fungible. It follows that within a single wholly owned group it is sensible, other things being equal, to arrange the commitments of group companies in the pattern that achieves the best overall tax effect. If this objective could have been achieved, or may perhaps have been achieved, by arranging for the money borrowed on MFL's issue of loan notes to be on-lent in a single, readily-identifiable transaction that was clearly part of MFL's business, then it made sense to re-finance Macquarie Leasing's intra-group borrowings, thus releasing funds elsewhere in the group for the purchase of Bankers Trust or for other purposes.

14. Links between the elements of the Macquarie Interest Securities

As well as the stapling that has been mentioned, a number of links between the shares and the notes knitted the two elements of the MIS together as a single economic entity. First, MBL guaranteed the interest on the notes; so from the perspective of the reliability of the return the notes might as well have been issued by MBL itself.

Secondly, as to the rate of return on the MIS: the rate of interest on the notes was 1.7 per cent above the rate payable on at-call deposits. The dividend rate for the shares was at a premium to the Australian Bill Swap Reference Rate.[81] However, (no doubt recognizing that investors contributed $400 million, not $800 million) investors were to receive either interest on the notes or dividends on the shares, but not both.

The fluctuating rate of return may be thought to be a weak indication of an equity-like flavour that characterized the MIS. More significantly in this respect,

[79] [2005] FCAFC 205, [253] Gyles J.
[80] See text accompanying footnote 77.
[81] [2005] FCAFC 205, [26] French J.

the obligation to pay a return on the notes was enlivened only if MBL had profits sufficient to fund the stipulated interest. Further, if dividends became an issue, the preference shares similarly yielded dividends only if MBL had profits to pay them. Further, they were non-cumulative.

15. The procurement agreement.

The "procurement agreement" was a contract between MBL and Deutsche Bank that tied together the various details just described. In effect, the agreement enabled MBL to trigger the transmogrification of loan notes into preference shares should that ever become necessary for MBL. This effect would come about by virtue of a "payment direction", which was an order by Deutsche Bank to the trustee for the note holders and to MFL to pay money due on the notes (that is, essentially, interest) to MBL instead of to the note holders. Deutsche Bank was to issue a payment direction if, essentially, MBL asked for this to happen or if either MBL or MFL became insolvent. These circumstances were "payment direction events". For completeness, on a payment direction MBL would pay any money due under its guarantee of the notes not to the investors but to itself.

A payment direction was irrevocable. Since the notes were perpetual there was never any obligation to repay principal and after a payment direction investors would have no right to interest, either. That is, the notes would cease to exist as notes for practical business purposes, and also for legal purposes, as will appear. On the other hand, although a payment direction would sterilize the notes it would enliven MBL's liability to pay dividends in respect of the preference shares: MIS holders would move from being note holders to holders of preference shares. As mentioned, these changes would occur as a matter of business reality; but they would also occur as a matter of law because the effect of a payment direction was (a) to nullify forever the legal incidents of the MIS that caused them to function as interest-bearing securities and (b) to enliven the incidents of the MIS that caused them to function as preference shares. A payment direction would not change the label of the MIS but it would change their legal character.

The procurement agreement had a second function, of at least equal importance, which was to specify the consideration that MBL had to pay to Deutsche Bank for the right to require Deutsche Bank to issue a payment direction in respect of money due on the notes. This consideration was called the "payment direction amount" and was $100 per note, which MBL paid to Deutsche Bank at the time of issuance of the MIS. That is, on issuance of the MIS, Deutsche Bank paid the Macquarie group $800 million, being $400 million to each of MBL and MFL, and the group paid Deutsche Bank $400 million in the form of the payment direction amount paid by MBL to the bank. The procurement agreement thus explains how a capital-raising that had an apparent face value of $800 million in fact raised $400 million.

The interaction between the procurement agreement and the rights of preference shareholders on winding up sheds further light on the nature of the MIS. Since winding up was a payment direction event it followed that on winding up investors' rights as preference shareholders would be enlivened. As mentioned, these rights included an entitlement to $100 per share on winding up in preference to ordinary shareholders. That is, in respect of the incidents of the MIS that were operative at one time or another, a holder of a perpetual loan note of $100 would become the holder of a preferential share enjoying priority on winding up of $100 over ordinary shareholders.

16. The issues and the legislation

The broad question in the case was whether Macquarie Finance Ltd could deduct the interest that it paid to investors in Macquarie Interest Securities in calculating its assessable income. At the relevant time Australia was part-way through rewriting its income tax legislation. Some rules had been revised and reenacted in the Income Tax Assessment Act 1997. Others remained in the eponymous statute of 1936. Neither Act contained a provision that related specifically to the deduction of interest. Rather, interest deductibility turned on the general deductions rule, which had been revised as section 8-1(1) and (2) of the 1997 Act. There were two issues under section 8-1: (A) whether the amount of interest that MFL incurred was an allowable deduction and (B), if so, whether the interest was nevertheless disallowed as a capital expense.

Apart from these questions, there were two issues under the 1936 Act, namely, (C) whether the MIS should be categorized as convertible notes under Division 3A of Part III of that Act, in which case special interest deductibility rules might apply, and, (D), whether (over-simplifying) the MIS amounted to a scheme to obtain a tax benefit vulnerable to Part IVA of that Act, the Australian general anti-avoidance rule. Hill J held that issue C did not arise, in that the MIS did not fall under relevant definitions in Division 3A.[82] Issue D arose only if the taxpayer succeeded under section 8-1 of the 1997 Act. Hill J held that if this were so, then Part IVA of the 1936 Act applied to deny the deduction.[83] This present paper, however, focuses on issues A and B. Section 8-1 read as follows:

> (1) You can deduct from your assessable income any loss or outgoing to the extent that:
>
> (a) it is incurred in gaining or producing your assessable income; or
>
> (b) it is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income.
>
> (2) However, you cannot deduct a loss or outgoing under this section to the extent that:
>
> (a) it is a loss or outgoing of capital, or of a capital nature ….

There are two general points in respect of section 8-1(1) as it applied on the facts of the *Macquarie Finance Ltd* case. First, there was no doubt that the taxpayer was both (a) engaged in producing assessable income and (b) carrying on business for the purpose of doing so. That is, for the purposes of the *Macquarie Finance Ltd* case there was no need to distinguish between limb (a) and limb (b) of section 8-1(1).[84] Rather, the issue was whether the expenditure was "incidental and relevant" to the process of gaining or producing income.[85] Secondly, although the MIS described the sums paid to investors as "interest", for the purposes of section 8-1 these sums had to be only "outgoings" incurred in producing assessable income. Strictly speaking, whether they were "interest" was not decisive. For this reason, and no doubt because the MIS themselves labeled the outgoings as interest, Hill J used quotation marks when referring to these sums as "interest".[86]

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[82] *Macquarie Finance Ltd v Commissioner of Taxation* [2004] FCA 1170, [72] Hill J.
[83] Ibid, [120].
[84] Ibid, [48].
[85] Ibid, [47] point (6), citing *Ronpibon Tin NL and Tongkah Compound NL v Federal Commissioner of Taxation* (1949) 78 CLR 47 (HC).
[86] Eg, ibid, [47] point (5).

17. Deductibility pursuant to section 8-1(1) (a) or (b)

In respect of the question of deductibility pursuant to section 8-1(1) (a) or (b), the Commissioner submitted that MFL did not subject itself to paying interest for its own business purposes but did so at the behest of and for the purposes of its parent company, MBL.[87] Indeed, MBL revived MFL from dormancy for the purposes of the transaction.[88] Hill J gave short shrift to these submissions, holding himself obliged to consider the position from the point of view of MFL alone. He said:

> So far as MFL is concerned it can be said that it entered the transaction intending the use of the "borrowed" funds in its business of lending at interest to companies of the MFL group. That intention is demonstrated by the use which MFL made of the funds. [That is, MFL lent the money to Macquarie Leasing Pty Ltd.][89] The fact that as well the interests of MBL were served does not require a conclusion that the "interest" was not an allowable deduction.

Here, Hill J's arguments demonstrate the classic reasoning of a tax judge. In particular, readers will observe that in disregarding the benefit that accrued to another company in the Macquarie group his Honour's reasons align perfectly with the two cases discussed earlier in this paper, namely *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue*[90] and *Federal Commissioner of Taxation v South Australian Battery Makers Pty Ltd.*[91] These reasons are entirely autopoietic. That is, they disregard the business considerations behind the form of the MIS and focus exclusively on their legal structure. Moreover, they disregard that there was no particular reason to fund the activities of Macquarie Leasing Pty Ltd via MFL other than to justify the deductibility of money that MFL paid to investors in the MIS. This structure ensured that MFL was seen to employ the invested funds in a business of its own, albeit a business that was created for MFL in order to demonstrate that MFL had employed the money in this manner: circular, self-referential reasoning indeed.

On appeal to the Full Federal Court, French J's reasoning on this point furnishes a sharp contrast. His Honour conducted a survey of cases on the deductibility of outgoings in general, and of interest in particular, before summarizing certain propositions, of which proposition 10 is particularly relevant. It reads:[92]

> When a corporation is part of a group and effectively under the control of a parent company or other members of the group, their purposes may be attributed to it when it acts at their bidding.

Unfortunately, his Honour did not specify precisely which of the authorities that he cited supports this proposition nor how they do so. The proposition is clearly contrary to cases like *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue,*[93] to *Federal Commissioner of Taxation v South Australian Battery Makers Pty Ltd,*[94] and to other cases too numerous to mention[95] that uphold the inviolability of the corporate veil in tax cases, apart from cases where an anti-avoidance rule applies.

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[87] Ibid, [49].
[88] Ibid, [50].
[89] See text between footnotes 79 and 80.
[90] [1976] 1 NZLR 546 (PC), discussed in text following footnote 30.
[91] (1978) 140 CLR 645, 8 ATR 879 (HCt FC), discussed in text following footnote 40.
[92] [2005] FCAFC 205, [100].
[93] [1976] 1 NZLR 546 (PC).
[94] (1978) 140 CLR 645, 8 ATR 879 (HCt FC).
[95] Examples include *Thiel v Federal Commissioner of Taxation* (1990) 171 CLR 338 (HCFC) and other cases on the separate residence of subsidiaries, *Cecil Bros Pty Ltd v Federal Commisisoner of Taxation* (1964) 111 CLR 430 (HCFC) and *Isherwood & Dreyfuss Pty Ltd v Federal Commissioner*

It is reasonable to argue that tax jurisprudence is unduly in thrall to form in general and to the independent status of the corporation in particular, but *Macquarie Finance Ltd v Federal Commissioner of Taxation* was probably not the most promising platform for French J to launch his attack. It is true that the structure of the MIS was fairly obviously contrived in order to justify the deductibility of interest, but the contrivance was convincing. MFL paid interest on the investors' money, but derived a larger sum of interest by virtue of on-lending the borrowed money.[96] That is, the taxpayer in MFL was in a stronger position than, for instance, the taxpayers in *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue*[97] or *Federal Commissioner of Taxation v South Australian Battery Makers Pty Ltd.*[98]

Looking at the latter two cases in economic terms, in the *Europa* case the taxpayer paid a premium for its trading stock, a premium that funded an exempt dividend. In *Battery Makers* the taxpayer paid a premium for its lease, a premium that funded the purchase of the demised premises by a sibling company. But in *Macquarie Finance* there was no premium at all. The consideration paid to the investors was the lowest that the market would accept and the whole of the investment was deployed in earning income for the taxpayer. There was, admittedly, an indirect economic benefit. That is, the investment improved the tier 1 capital of the Macquarie group, which no doubt allowed the group to earn a better overall return on capital than the return that Macquarie Finance Ltd earned on the MIS. The independent economic interest of MFL was sacrificed for the good of the group: a formal sacrifice, of course, since for business purposes it was immaterial to the group which company made its profits. But in focusing in effect on this economic sacrifice French J followed the chain of causation further and more logically than reasoning in tax cases ordinarily permits. In contrast, Hill J recognized and gave fiscal force to the legal reality of the borrowing and the on-lending at a profit.

It is true that in its focus on substance over form French J's proposition that the purpose of a parent company may be attributed to its subsidiary exhibits a large measure of common sense and, as indicated, logic. But in the respectful opinion of the present author it is unlikely that common sense that is spread on with such a large trowel will have a lasting effect on the development of tax jurisprudence. The more subtle approach of Hill J that is discussed under the next heading is likely to have a longer-term effect.

18. The capital limitation

Hill J reserved his most refined analysis in *Macquarie Finance Ltd v Federal Commissioner of Taxation* for the question of whether the interest that MFL paid should be disallowed as being of a capital nature, a question to which he answered

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of Taxation (1978) 8 ATR 753 (SCNSW, Meares J) and other cases on reinvoicing. The latter two cases are in a sense *a fortiori* examples in that the same individuals who procured the destination of the indirect benefit that emerged from the taxpayer company's expenditure controlled the pairs of companies involved in each case.

[96] Using the term "borrowed money" begs the question as to whether it was correct to describe the funds as a loan, but in the context of this paragraph that may be assumed for the sake of argument.

[97] [1976] 1 NZLR 546 (PC).

[98] (1978) 140 CLR 645, 8 ATR 879 (HCt FC).

"yes".[99] The fundamental reason was the connection between the two elements of the MIS, but his Honour's explanation was carefully reasoned.

He noted that, economically speaking, the interest-bearing notes from MFL and the preference shares from MBL were a single entity. That is, in economic effect, the MIS were shares rather than loan notes. The reason in short was that lenders could not demand repayment; at the option of MBL, lenders were subject to be converted into shareholders. As Gyles J later put it on appeal:

> From the point of view of both the investor and MBL (and its subsidiaries including MFL), the essential characteristics of the rights and liabilities did not alter whether governed by the note or by the preference shares after a Payment Direction Event. The transaction can be viewed as an affair of capital from start to finish.[100]

For this reason, the correct accounting treatment on consolidation left the shares as capital but eliminated the notes.[101] Hill J explained the reasons,[102] but Hely J's explanation on appeal is perhaps clearer:[103]

> [The accounting firm] KPMG advised MBL that under applicable accounting standards … the proper accounting treatment for monies raised in consequence of the issue of the MIS would be as follows:
> - the preference shares issued by MBL would be treated as equity in MBL's own accounts and in the consolidated group accounts;
> - the notes issued by MFL would be considered as debt in MFL's accounts and the related interest expense charged through the profit and loss account;
> - in consequence of the Payment Direction, MBL acquired (contingent) rights against MFL which would be considered as an asset in MBL's own accounts, but which would be eliminated on consolidation against MFL's liability on the notes; and
> - the interest expense on the notes would be reclassified as dividends in line with the overall structure of the remaining instrument, being the preference shares.
>
> In the result, as [Hill J] recorded, the consolidated accounts showed the preference shares as equity (the receivable and the notes having been eliminated) and an asset (cash, securities, loans) depending on what purpose the subsidiary of MFL used the money for within the MBL group.

In effect, KPMG pointed out that the MIS, which from a legal perspective consisted of two elements, in reality comprised only one element. This accounting treatment could not determine the issue of deductibility,[104] but the author suggests that it is a sobering reminder of the true business reality of what the MIS represented (equity shares) and even more so of what the MIS did not represent (interest bearing notes).

19. Commercial equivalence or juristic analysis

Nevertheless, following jurisprudential orthodoxy,[105] Hill J rejected any possibility of deciding the case on the basis of commercial reality or commercial equivalence.[106] Instead, his Honour approached the question by following "the direction of Dixon J to look at what the interest is paid for from a practical and business like point of view".[107] (Hill J inserted the word "like", which Dixon J did not use.) To those untutored in the arcana of judicial reasoning in tax cases, "a

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[99] [2004] FCA 1170, [63].
[100] [2005] FCAFC 205, [251].
[101] *Macquarie Finance Ltd v Commissioner of Taxation* [2004] FCA 1170, [57] Hill J.
[102] Ibid, [36].
[103] *Macquarie Finance Ltd v Commissioner of Taxation* [2005] FCAFC 205, [138] – [139].
[104] [2004] FCA 1170, [57] Hill J and [2005] FCAFC 205, [139] Giles J.
[105] Represented in this case by *Mullens Investments Ltd v Federal Commissioner of Taxation* (1976) 135 CLR 290, 301.
[106] [2004] FCA 1170, [65] point (3).
[107] Ibid, [61].

practical and business point of view" appears very much to intend to reflect "commercial reality". Indeed, that is probably what Dixon J meant when he said in *Hallstroms Pty Ltd v Federal Commissioner of Taxation*:[108]

> What is an outgoing of capital and what is an outgoing of revenue depends on what the expenditure is calculated to effect from a practical and business point of view, rather that upon the juristic classification of the legal rights, if any, secured, employed, or exhausted in the process.

However, after the *Hallstroms* case the Australian case of *Cecil Bros Pty Ltd v Federal Commissioner of Taxation*[109] held that deductibility turned on the legally enforceable rights acquired by the expenditure incurred. The Privy Council followed *Cecil Bros* in *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue.*[110] These cases furnish good examples of what the analytical framework of autopoiesis means by "coding". For justification, law looks to itself; so whether an outgoing is deductible turns on the nature of the legally enforceable rights that the outgoing secures for the taxpayer. The law ignores economic benefits or benefits to other persons because they are relevant to a different social system, being in the present context the economic system and its different codes.[111]

In *Federal Commissioner of Taxation v South Australian Battery Makers Pty Ltd,*[112] apparently overlooking that *Europa* had followed the Australian High Court in *Cecil Bros*, Gibbs ACJ pointed out that the *Europa* case appeared to be inconsistent with Dixon J's dictum and that, furthermore, the rule in Australia was that in testing deductibility one must take into account only advantages that accrue to the taxpayer who incurs the expenditure in question, not advantages that may inure to sibling companies.[113] In effect, later cases[114] so distorted Dixon J's words that judges tend to interpret them as demanding an inquiry into:

> what the expenditure is calculated to effect from a practical and business point of view, *[as tested by]* the juristic classification of the legal rights, if any, secured, employed, or exhausted in the process.[115]

The upshot is that the courts uniformly reject "commercial equivalence" as the appropriate test, but there has developed a distinction between judges who look at transactions in relative isolation, such as Lord Diplock speaking for the majority in *Europa*, and judges who make a careful analysis of all relevant legal relationships in order to determine precisely what advantages are acquired by the expenditure in question.

20. Justice Hill's refined analysis

Hill J fell into the second category. In *Macquarie Finance*, he used the expression, "from a juristic point of view", only two sentences after citing Dixon J's "practical

[108] (1946) 72 CLR 386, 397 (HCFC) Dixon J.
[109] (1954) 111 CLR 430 (HCFC).
[110] [1976] 1 NZLR 546 (PC).
[111] But see *Fletcher & Ors v Federal Commissioner of Taxation* (1991) 173 CLR 1, 91 ATC 4950 (HCA).
[112] (1978) 140 CLR 645, 659; 8 ATR 879 (HCt FC).
[113] Ibid, 660.
[114] There are many examples in a number of common law jurisdictions, particularly Australia, New Zealand, and the United Kingdom. Leading cases that are often cited include *Strick v Regent Oil Co Ltd* [1966] AC 295 (HL), *BP Australia Ltd v Commissioner of Taxation* [1966] AC 224 (PC), and *Tucker v Granada Motorway Services Ltd* [1979] 1 WLR 683 (HL). The more recent case of *Commissioners of Inland Revenue v John Lewis Properties plc* [2003] Ch 513, [2002] EWCA Civ 1869 usefully collects and categorizes a range of authorities.
[115] Author's rephrasing of Dixon J's words quoted at footnote 108, above.

and business like (sic) point of view", without seeming to suggest that there might be any difference between the two.[116] Both the juristic and the practical informed his Honour that he should not ignore "the composite nature of the security".[117] To do so would be to "disregard the substance of the transaction".[118] But by "substance" his Honour meant legal substance, not economic or commercial substance. Relevant factors that shed light on this legal substance included that the principal was not redeemable at the option of either the note holders or of their trustee; that the holders had no rights as creditors and the trustee only limited rights as a creditor; that the MIS related to MBL's capital adequacy requirements; and that payment of interest by MFL depended on MBL having distributable profits.[119]

In the immediately preceding paragraph of his judgment his Honour had noted the legal links between the shares and the notes that together made up the MIS[120] and that were described in sections 14 and 15 of this paper. He emphasized the role of the procurement agreement in contractually knitting the preference shares and the notes together as one security. Perhaps most importantly, the procurement agreement contrived the refund of half the sum that Deutsche Bank paid so that the MIS represented an investment of $400 million, not the $800 million that was the nominal sum.[121] It was the procurement agreement that empowered MBL to give a payment direction that would replace one set of legally operative provisions in the MIS (the notes provisions) with another set (the shares provisions). In the end, the note holders could look for repayment only as shareholders; at least, that was the position at the option of MBL.[122] It followed that:[123]

> The so-called interest which MFL is obliged to pay is not, in a practical business sense, the consideration paid by MFL for the noteholder (Deutsche Bank or its successors) being kept out of the funds advanced by Deutsche Bank and used to subscribe for the notes. The noteholders here might never obtain the repayment of the funds advanced by Deutsche Bank, they may, depending on what happens, be left to look to their rights as shareholders in MBL.

To paraphrase what Hill J was saying: looking at the congeries of contracts that made up the MIS from the perspective of both practical and legal reality, (A) the sums that the MIS labeled as "interest" payments to note holders were in fact and in law paid to note holders in their twinned role as shareholders, and (B) because MBL could at will replace the incidents of investors' status as lenders with the incidents of their status as shareholders, investors in the MIS were essentially shareholders in fact and in law.

This analysis was enough to decide the case, but his Honour concluded this part of his judgment by approaching the issue from another perspective, namely by comparing MFL's expenditure on the MIS with the ordinary case of outgoings of interest on borrowed capital. He quoted[124] from Bowen CJ and Burchett J in *Australian National Hotels Ltd v Federal Commissioner of Taxation:*[125]

> [T]here is a special feature of loan capital, which flows from the ephemeral nature of a loan. The cost of securing and retaining the use of the capital sum for the business,

[116] [2004] FCA 1170, [61].
[117] Idem.
[118] Idem.
[119] Idem.
[120] Ibid, [60].
[121] Idem.
[122] Idem.
[123] Idem. Spelling of "noteholder" as in original.
[124] Ibid, [62].
[125] (1988) 19 FCR 234, 240; 19 ATR 1575, 1581 – 1582.

> that is to say, the interest payable in respect of the loan, will be a revenue item. It creates no enduring advantage, but on the contrary is a periodic outgoing related to the continuance of the use by the business of the borrowed capital during the term of the loan.

Hill J noted[126] their Honours' emphasis on "the ephemeral nature" of loan capital. It is for this reason that periodic outgoings incurred as the cost of borrowed capital during the term of a loan are deductible. Such outgoings are usually and correctly called "interest", but it does not follow that, just because outgoings are labeled "interest", and even (*semble*) if that label follows correct legal usage, the outgoings are necessarily deductible.[127] If the taxpayer incurs the outgoings in respect of "ephemeral" loan capital then the expense is ordinarily deductible.[128] But if the expense relates to a permanent injection of capital, including equity capital in the form of preference shares, then the outgoings are not deductible. The same applies to securities that appear to have a dual loan and equity character, but that are at bottom equity, as in the case at bar.[129] Employing this sort of capital by lending it at interest to another company no more makes outgoings that are the cost of that particular capital deductible[130] than if the capital were ordinary equity and if the outgoings were ordinary dividends.

21. Evaluation of Justice Hill's judgment

Europa Oil (NZ) Ltd v Commissioner of Inland Revenue[131] and *Federal Commissioner of Taxation v South Australian Battery Makers Pty Ltd*[132] are good examples of the traditional, form-based reasoning that people have come to expect in tax cases. On appeal in *Macquarie Finance Ltd v Federal Commissioner of Taxation* Hely J (dissenting) hewed to orthodoxy. He focused on the payment as disbursed by MFL, and did not consider the context.

In contrast, French J[133] and Gyles J[134] held that the "interest" should be disallowed as not incurred in gaining or producing income. As French J explained it, the crucial reason was that MBL could at any time cause dividends to be substituted for the interest.[135] Also, both French J[136] and Gyles J[137] agreed with Hill J that the "interest" was capital in nature.

In the present context, both questions are of considerable interest, that is (A) whether the payments were deductible as incurred in gaining income by virtue of section 8–1(1), the general deductions provision of the 1997 Act, and (B), whether, if so, they were nevertheless disallowed as capital by virtue of section 8-(1)(2). We may describe Hely J's answer as wholly autopoietic. That is, his Honour analyzed the transaction in wholly legalistic terms, referring solely to the taxpayer. In contrast, French and Gyles JJ took what can only be described as an economically

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[126] [2004] FCA 1170, [62].
[127] But see *Chancery Lane Safe Deposit & Offices Co Ltd v Inland Revenue Commissioners* [1966] AC 85, 128 (HL) and *Wharf Properties Ltd v Commissioner of Inland Revenue (Hong Kong)* [1997] AC 505, [1997] STC 351 (PC).
[128] [2004] FCA 1170, [63].
[129] Idem.
[130] Idem.
[131] [1976] 1 NZLR 546 (PC).
[132] (1978) 140 CLR 645, 8 ATR 879 (HCt FC).
[133] [2005] FCAFC 205, [103].
[134] Ibid, [255].
[135] Ibid, [103].
[136] Ibid, [111].
[137] Ibid, [255].

substantive approach. They attached little significance to the loan from MFL to Macquarie Leasing Pty Ltd nor to the income that this loan generated for MFL.

Hill J took an intermediate line whereby he stayed within traditional tax orthodoxy while at the same time breaking away from a mechanical, blinkered approach. He held that section 8–(1)(1) authorized MFL to deduct the outgoings. This holding respected the fact that MFL had invested the principal in an income-earning loan. It also respected that in the year in question the loan produced assessable income. That is, Hill J looked at what actually happened according to law, not at changes that might have occurred (but that did not) or that might occur in the future.

On the other hand, his Honour's holding in respect of section 8–(1)(2), that the expenditure was of a capital nature, did not disregard any facts. Indeed, it took into account both the relevant facts and, more importantly, the manner in which the procurement agreement legally tied those facts to the circumstances of the expenditure.[138] Thus, his Honour's reasoning was notably subtle. It recognized the legal consequences of the autopoietic bundle of rights and duties that MBL's advisers had concocted. At the same time, it analyzed that bundle in its own autopoietic terms, asking, in effect, first, "What was the true legal (not economic) substance of the Macquarie Interest Securities?" and having discovered that substance, secondly, "What was the nature of that legal substance, capital or revenue?"

22. Conclusion

In this manner, Hill J both respected and developed orthodox tax law reasoning. Time will tell, but it is submitted that future courts will find themselves more comfortable with Hill J's approach than with either Hely J's strict formalism or with the iconoclasm of French and Gyles JJ. From the point of view of sound tax law development Hill J's approach is to be welcomed. Hely J's formalism maintains the gap between tax law and its economic subject matter that is so familiar. At first sight, French and Gyles JJ's approach is refreshing, but it can serve ill as a precedent. The problem is that rules formulated according to their Honours' approach too often turn out not to be rules at all. For instance, on analysis, the apparent rules,[139] "[I]ntra group transactions are not the same for all taxation purposes as arm's length transactions … [and] the immediate destination of moneys received or outlaid does not necessarily equate to the object of the receipt or payment" lead nowhere.

In contrast, Hill J's analysis of the MIS from the perspective of the congeries of legal rights that were involved is a form of argument that develops naturally from the courts' traditional formalism, but that will allow the courts to use the law to align fiscal results more closely to economic facts. It was this careful analysis that led Justice Hill to suspect that tax practitioners saw his judgment as a kind of betrayal. Practitioners could dismiss the substance-over-form reasoning of French and Gyles JJ as being no more likely to enter the canon than was the similar iconoclasm of Denning MR[140] and Murphy J[141] of earlier years. But Hill J's reasoning in *Macquarie Finance Ltd v Federal Commissioner of Taxation* played the game of tax law by its own autopoietic conventions. His Honour's reasoning

[138] See text following footnote 99.
[139] [2005] FCAFC 205, [254] Gyles J.
[140] See section 10 of this paper, "Attacks on autopoietic reasoning".
[141] Idem.

hewed to the recursive and the legalistic, but it minutely examined the precise legal relationships that the MIS and the procurement agreement embodied. Hill J did not break out of the operative closure of traditional tax law argument, but the judgment showed that the expenditure was on capital account according to its own terms, that is, according to the terms of the MIS and of the procurement agreement. In the words of Sir Owen Dixon, Hill J judged the expenditure according to its legal "complexion". Dixon J had said: [142]

> [W]hen it is said that the gaining or producing of assessable income must be the purpose of the expenditure if its deduction is to be allowed, no more can be meant than that the circumstances of the transaction must give it the *complexion* of money laid out in furtherance of a purpose of gaining income.

Hill J showed in the Macquarie Finance case that although the money was laid out in gaining income it was not only of a capital nature in economic substance (which did not decide the case for his Honour) but the complexion (or legal form) of the outlay, and therefore its quality for tax purposes, was capital.

[142] *Robert G. Nall Ltd v Federal Commissioner of Taxation* (1936 – 1937) 57 CLR 514, 712 (emphasis added).