HIGH COURT OF AUSTRALIA

FRENCH CJ,
HAYNE, KIEFEL, BELL AND GAGELER JJ

ANDREW VINCENT MILLS APPELLANT

AND

COMMISSIONER OF TAXATION RESPONDENT

Mills v Commissioner of Taxation
[2012] HCA 51
14 November 2012
S225/2012

ORDER

1. *Appeal allowed with costs.*

2. *Set aside the orders of the Full Court of the Federal Court of Australia made on 8 December 2011 and, in their place, order that:*

   (a) *the appeal be allowed with costs; and*

   (b) *the orders of Emmett J made on 11 March 2011 be set aside and, in their place, order that:*

      (i) *the appeal be allowed with costs;*

      (ii) *the objection decision dated 12 January 2010 be set aside; and*

      (iii) *the objection dated 29 December 2009 against the determination of 14 December 2009 under s 177EA(5)(b) of the* Income Tax Assessment Act *1936 (Cth) be allowed and the determination be set aside.*

On appeal from the Federal Court of Australia

Representation

A H Slater QC with D F C Thomas and G S Antipas for the appellant (instructed by Herbert Smith Freehills)

N J Williams SC with J O Hmelnitsky for the respondent (instructed by Australian Government Solicitor)

CATCHWORDS

Mills v Commissioner of Taxation

Taxation – Income tax – Equity interests – Imputation system – Schemes to reduce income tax – Power of Commissioner under *Income Tax Assessment Act* 1936 (Cth), s 177EA to make determination that no imputation benefit to arise – Whether "having regard to the relevant circumstances" scheme entered into or carried out for purpose of enabling taxpayer to obtain imputation benefit – Whether purpose an "incidental purpose" – Relevance of distribution being traceable to source not taxed in Australia – Relevance of scheme resulting in reduced cost of capital to whether scheme results in "change" in financial position.

Words and phrases – "change in financial position", "frankable distribution", "incidental purpose", "purpose", "relevant circumstances", "untaxed or unrealised profits".

Income Tax Assessment Act 1936 (Cth), ss 177D, 177EA.
Income Tax Assessment Act 1997 (Cth), Pt 3-6, Div 974.

1 FRENCH CJ. I agree with the orders proposed by Gageler J for the reasons given by his Honour.

2 HAYNE J. I agree with Gageler J.

3 KIEFEL J. I agree with Gageler J.

4 BELL J. I agree with Gageler J.

GAGELER J.

Issue

5 "PERLS V" is an acronym for "Perpetual Exchangeable Resaleable Listed Securities V" issued by the Commonwealth Bank of Australia ("the Bank") on 14 October 2009 and traded on the Australian Securities Exchange. Each security comprises a preference share and a subordinated unsecured note. PERLS V are "stapled securities" in the sense that their conditions of issue generally prevent the shares and the notes being traded separately.

6 This appeal from a decision of the Full Court of the Federal Court arises out of proceedings commenced in the Federal Court under Pt IVC of the *Taxation Administration Act* 1953 (Cth) ("the TAA") by a taxpayer, who is a holder of PERLS V, as a test case to determine whether the circumstances of the issue of PERLS V were such that the Commissioner of Taxation ("the Commissioner") can make a determination under s 177EA(5)(b) of the *Income Tax Assessment Act* 1936 (Cth) ("the ITAA 1936") to the effect that no franking credit is to arise in respect of payment of interest on the notes forming part of those securities.

7 The issue in the appeal is whether, "having regard to the relevant circumstances" of the arrangements for the issue of PERLS V, it would be concluded from the perspective of a reasonable person that the Bank entered into and carried out those arrangements "for a purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling [a taxpayer who is a holder of PERLS V] to obtain [a franking credit]" within the meaning of s 177EA(3)(e) of the ITAA 1936.

8 The Full Court, by majority (Dowsett and Jessup JJ; Edmonds J dissenting)[1], upheld the decision of the primary judge (Emmett J)[2] that the issue should be resolved in the affirmative. I would resolve the issue in the negative and would therefore allow the appeal.

Legislation

9 To put the issue in its appropriate legislative context, mention must be made at the outset of two aspects of the design of the *Income Tax Assessment Act* 1997 (Cth) ("the ITAA 1997"). One is the distinction, for which Div 974 of the ITAA 1997 makes provision, between "debt interests" and "equity interests". The other is the "imputation system" in Pt 3-6 of the ITAA 1997.

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1 *Mills v Federal Commissioner of Taxation* (2011) 198 FCR 89.

2 *Mills v Federal Commissioner of Taxation* 2011 ATC ¶20-247.

10 The significance of the distinction between debt interests and equity interests is succinctly captured in the statement in the "Guide" to Div 974 of the ITAA 1997 that "returns on debt interests are not frankable but may be deductible while returns on equity interests are not deductible but may be frankable"[3]. The Division sets out a multi-part test which focuses less on the legal form than on the economic substance of an interest in terms of its impact on the position of the issuer[4]. That multi-part test involves a "debt test"[5] and an "equity test"[6] together with a "tie breaker" to the effect that an interest which satisfies both the debt test and the equity test is to be treated as a debt interest[7]. It is sufficient for the purposes of the appeal to note that an equity interest can include not only an interest in a company as a member but also an interest that carries a right to a variable or fixed return from the company where the right itself or the amount of the return is either in substance or in effect contingent on the economic performance of the company or at the discretion of the company[8].

11 Within the meaning of the ITAA 1997: a company is a "corporate tax entity"[9]; its payment of a dividend (or something taken to be a dividend) is a "distribution"[10]; the holder of an equity interest in the company is an "equity holder"[11]; an equity interest in a company that is not solely a share is a "non-share equity interest"[12]; and the company in distributing money to the holder of such an interest makes a "non-share distribution"[13] which may also be a "non-share dividend"[14]. A company cannot deduct a non-share distribution[15].

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3 Section 974-1 of the ITAA 1997.

4 Sections 974-5(1) and 974-10(2) of the ITAA 1997.

5 Subdivision 974-B of the ITAA 1997, particularly s 974-20.

6 Subdivision 974-C of the ITAA 1997, particularly s 974-75.

7 Section 974-5(4) of the ITAA 1997.

8 Sections 974-70 and 974-75 of the ITAA 1997.

9 Section 960-115 of the ITAA 1997.

10 Section 960-120 of the ITAA 1997.

11 Section 995-1(1) of the ITAA 1997.

12 Section 995-1(1) of the ITAA 1997.

13 Section 974-115 of the ITAA 1997.

14 Section 974-120 of the ITAA 1997.

12 The imputation system in Pt 3-6 of the ITAA 1997 partially integrates the income tax liabilities of Australian corporate tax entities and their Australian members[16]. The main object of the Part is expressed to be "to allow certain *corporate tax entities to pass to their *members the benefit of having paid income tax on the profits underlying certain *distributions"[17]. Other objects of the Part are expressed to be to ensure that the imputation system it establishes is not used "to give the benefit of income tax paid by a *corporate tax entity to *members who do not have a sufficient economic interest in the entity" or "to prefer some members over others when passing on the benefits of having paid income tax" as well as to ensure that "the *membership of a corporate tax entity is not manipulated to create either of [those] outcomes"[18]. An asterisk is used in the 1997 Act to indicate that the relevant term is defined elsewhere.

13 By operation of Pt 3-6 of the ITAA 1997, every corporate tax entity has a "franking account"[19], which is "used to keep track of income tax paid by the entity, so that the entity can pass to its members the benefit of having paid that tax when a distribution is made"[20]. A corporate tax entity, if not a mutual insurance company and if not acting in a capacity of trustee, is a "franking entity"[21]. The franking account of a franking entity that satisfies an Australian residency requirement for an income year[22] typically receives a "franking credit" when the entity pays income tax or receives a franked distribution in respect of the year[23], and typically receives a "franking debit" when the entity receives a refund of tax or franks a "frankable distribution"[24]. Distributions and non-share dividends are frankable distributions unless they fall within one of a number of

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15 Section 26-26 of the ITAA 1997.

16 Section 200-5 of the ITAA 1997.

17 Section 201-1(1) of the ITAA 1997.

18 Section 201-1(2) of the ITAA 1997.

19 Section 205-10 of the ITAA 1997.

20 Section 200-15(1) of the ITAA 1997.

21 Section 202-15 of the ITAA 1997.

22 Sections 202-20 and 205-25 of the ITAA 1997.

23 Sections 200-15(3) and 205-15 of the ITAA 1997.

24 Sections 200-15(4) and 205-30 of the ITAA 1997.

specified categories of "unfrankable distributions"[25], the object of which is "to ensure that only distributions equivalent to realised taxed profits can be franked"[26]. Part 3-6 of the ITAA 1997 applies to a non-share equity interest in the same way as it applies to a membership interest, and it applies to an equity holder in an entity who is not a member of the entity in the same way as it applies to a member of the entity[27]. A franking entity franks a distribution by allocating a franking credit to it[28] in which case the amount of the franking credit is to appear on a statement that accompanies the distribution[29]. As a general rule, an amount equal to the franking credit on the distribution is included in the member's or the equity holder's assessable income and the member or equity holder is entitled to a tax offset equal to the same amount[30]. In some cases, the member or equity holder needs to satisfy an Australian residency requirement for the general rule to apply[31].

14 The ability of a franking entity to frank a frankable distribution under Pt 3-6 of the ITAA 1997 is subject to two principal restrictions. One is that the entity cannot frank a distribution with a franking credit "that exceeds the maximum amount of income tax that could have been paid by the entity on the profits distributed"[32]. The maximum franking credit for a distribution is the amount of the distribution multiplied by the corporate tax rate and divided by a factor of (one hundred per cent minus the corporate tax rate)[33]. The other is that the entity cannot, without incurring "over-franking tax" (for over-franking) or forfeiting franking credits (for under-franking), depart from "the benchmark rule", which is that the entity must frank all frankable distributions made within a particular "franking period" (ordinarily corresponding to an income year) by the same franking percentage[34]. The franking percentage, which cannot exceed one

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25 Sections 202-25 to 202-45 of the ITAA 1997.

26 Section 202-35 of the ITAA 1997.

27 Section 215-1 of the ITAA 1997.

28 Section 200-20(1) of the ITAA 1997.

29 Section 200-20(2) of the ITAA 1997.

30 Section 207-5(1) of the ITAA 1997. See also ss 207-10 to 207-20 and 207-70 of the ITAA 1997.

31 Sections 207-5(2) and 207-60 to 207-65 and 207-75 of the ITAA 1997.

32 Sections 200-25 and 202-65 and Div 202 of the ITAA 1997.

33 Section 202-60(2) of the ITAA 1997.

hundred per cent, is the franking credit allocated to a frankable distribution expressed as a percentage of the maximum franking credit for the distribution[35].

15 It is also relevant to note two categories of unfrankable distributions. One is that specified in s 202-45(e) as "a distribution that is sourced, directly or indirectly, from a company's *share capital account". A "share capital account" is an account that the company keeps of its share capital, or one that was created on or after 1 July 1998 and to which the first amount credited was of share capital[36]. The other is that specified in s 215-10, relevantly in the following terms:

> "(1) A *non-share dividend paid by an ADI (an authorised deposit-taking institution) for the purposes of the *Banking Act 1959* is ***unfrankable*** if:
>
> (a) the ADI is an Australian resident; and
>
> (b) the non-share dividend is paid in respect of a *non-share equity interest that:
>
> …
>
> forms part of the ADI's Tier 1 capital … (within the meaning of the *prudential standards); and
>
> (c) the non-share equity interest is issued at or through a *permanent establishment of the ADI in a *listed country; and
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> (d) the funds from the issue of the non-share equity interest are raised and applied solely for one or more purposes permitted under subsection (2) in relation to the non-share equity interest.
>
> (2) The permitted purposes in relation to the *non-share equity interest (the ***relevant interest***) are the following:
>
> (a) the purpose of the business of the ADI carried on at or through the permanent establishment …"

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34 Section 200-30 and Div 203 of the ITAA 1997.

35 Section 203-35 of the ITAA 1997.

36 Section 975-300 of the ITAA 1997.

The "prudential standards" are those determined by the Australian Prudential Regulation Authority ("APRA") and in force under s 11AF of the *Banking Act* 1959 (Cth)[37], a "permanent establishment" is a place at or through which a person carries on a business[38] and "listed country" includes New Zealand[39].

16 Before turning to s 177EA of the ITAA 1936, mention is also usefully made at this point of the general rule, for which s 23AH of the ITAA 1936 makes provision, that income derived by an Australian resident company at or through a permanent establishment in another country is excluded from assessable income.

17 Section 177EA is within Pt IVA of the ITAA 1936. The heading to Pt IVA, which forms part of the ITAA 1936[40], is "Schemes to reduce income tax". Section 177B(1) provides that nothing elsewhere in the ITAA 1936, or in the ITAA 1997[41], limits the operation of the Part.

18 Section 177A(1) defines "scheme" in Pt IVA of the ITAA 1936 to mean "any agreement, arrangement, understanding, promise or undertaking …" and "any scheme, plan, proposal, action, course of action or course of conduct". Section 177A(5) provides that reference in the Part to a scheme being entered into or carried out by a person for a particular purpose is to be read as including a reference to the scheme "being entered into or carried out by the person for 2 or more purposes of which that particular purpose is the dominant purpose". Section 177EA(12) provides that the section applies to a "non-share equity interest" in the same way as it applies to a "membership interest", applies to an "equity holder" in the same way as it applies to a "member", and applies to a "non-share dividend" in the same way as it applies to a "distribution". Those expressions in the ITAA 1936 have the same meaning as in the ITAA 1997[42].

19 The focus of s 177EA of the ITAA 1936 is on a taxpayer obtaining an "imputation benefit". A tax offset to which a member of a corporate tax entity

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37 Section 995-1(1) of the ITAA 1997.

38 Section 995-1(1) of the ITAA 1997 and s 6(1) of the ITAA 1936.

39 Section 995-1(1) of the ITAA 1997; s 320(1) of the ITAA 1936; reg 152C and Sched 10 of the Income Tax Regulations 1936 (Cth).

40 Section 13 of the *Acts Interpretation Act* 1901 (Cth).

41 Section 6(1) of the ITAA 1936, defining "this Act".

42 Sections 6(1) and 177EA(2) of the ITAA 1936.

becomes entitled as the result of the allocation of a franking credit to a frankable distribution under Pt 3-6 of the ITAA 1997 answers that description[43].

20 Section 177EA(3) sets out the circumstances in which s 177EA of the ITAA 1936 applies. It provides:

> "(3) This section applies if:
>
> (a) there is a scheme for a disposition of membership interests, or an interest in membership interests, in a corporate tax entity; and
>
> (b) either:
>
> (i) a frankable distribution has been paid, or is payable or expected to be payable, to a person in respect of the membership interests; or
>
> (ii) a frankable distribution has flowed indirectly, or flows indirectly or is expected to flow indirectly, to a person in respect of the interest in membership interests, as the case may be; and
>
> (c) the distribution was, or is expected to be, a franked distribution or a distribution franked with an exempting credit; and
>
> (d) except for this section, the person (the ***relevant taxpayer***) would receive, or could reasonably be expected to receive, imputation benefits as a result of the distribution; and
>
> (e) having regard to the relevant circumstances of the scheme, it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for a purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling the relevant taxpayer to obtain an imputation benefit."

21 The expression "relevant circumstances" has a meaning affected by s 177EA(17), which provides:

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43 Section 177EA(2) of the ITAA 1936; ss 204-30(6) and 995-1(1) of the ITAA 1997.

"The ***relevant circumstances*** of a scheme include the following:

(a) the extent and duration of the risks of loss, and the opportunities for profit or gain, from holding membership interests, or having interests in membership interests, in the corporate tax entity that are respectively borne by or accrue to the parties to the scheme, and whether there has been any change in those risks and opportunities for the relevant taxpayer or any other party to the scheme (for example, a change resulting from the making of any contract, the granting of any option or the entering into of any arrangement with respect to any membership interests, or interests in membership interests, in the corporate tax entity);

(b) whether the relevant taxpayer would, in the year of income in which the distribution is made, or if the distribution flows indirectly to the relevant taxpayer, in the year in which the distribution flows indirectly to the relevant taxpayer, derive a greater benefit from franking credits than other entities who hold membership interests, or have interests in membership interests, in the corporate tax entity;

(c) whether, apart from the scheme, the corporate tax entity would have retained the franking credits or exempting credits or would have used the franking credits or exempting credits to pay a franked distribution to another entity referred to in paragraph (b);

(d) whether, apart from the scheme, a franked distribution would have flowed indirectly to another entity referred to in paragraph (b);

(e) if the scheme involves the issue of a non-share equity interest to which section 215-10 of the *Income Tax Assessment Act 1997* applies – whether the corporate tax entity has issued, or is likely to issue, equity interests in the corporate tax entity:

(i) that are similar, from a commercial point of view, to the non-share equity interest; and

(ii) distributions in respect of which are frankable;

(f) whether any consideration paid or given by or on behalf of, or received by or on behalf of, the relevant taxpayer in connection with the scheme (for example, the amount of any interest on a loan) was calculated by reference to the imputation benefits to be received by the relevant taxpayer;

(g) whether a deduction is allowable or a capital loss is incurred in connection with a distribution that is made or that flows indirectly under the scheme;

(ga) whether a distribution that is made or that flows indirectly under the scheme to the relevant taxpayer is sourced, directly or indirectly, from unrealised or untaxed profits;

(h) whether a distribution that is made or that flows indirectly under the scheme to the relevant taxpayer is equivalent to the receipt by the relevant taxpayer of interest or of an amount in the nature of, or similar to, interest;

(i) the period for which the relevant taxpayer held membership interests, or had an interest in membership interests, in the corporate tax entity;

(j) any of the matters referred to in subparagraphs 177D(b)(i) to (viii)."

22 Section 177EA(17)(b) must be read with later provisions of s 177EA which operate to set out a non-exhaustive list of the cases in which "a taxpayer to whom a distribution flows indirectly" receives a "greater benefit from franking credits" than another entity referred to in s 177EA(17)(b), one of which is if the taxpayer is, but the entity is not, an Australian resident in the year of income in which the distribution giving rise to the benefit is made[44]. The expression "greater benefit from franking credits" in s 177EA(17)(b) also has a meaning affected by provisions of the ITAA 1997 which operate to set out a non-exhaustive list of the cases in which a member of an entity derives such a benefit in comparison with another member of the entity, one of which is if one member, but not the other, is a foreign resident in the income year in which the distribution giving rise to the benefit is made[45].

23 The matters referred to in s 177D(b)(i) to (viii), as incorporated by reference in s 177EA(17)(j), are as follows:

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

(ii) the form and substance of the scheme;

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44 Sections 177EA(18) and 177EA(19)(a) of the ITAA 1936.

45 Sections 204-30(7) and 204-30(8)(a) of the ITAA 1997, read with s 177EA(2) of the ITAA 1936 and s 995-1(1) of the ITAA 1997.

(iii) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;

(iv) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;

(v) any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;

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

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

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

The reference to "this Act" in s 177D(b)(iv) includes the ITAA 1997 as well as the ITAA 1936[46].

24 Section 177EA(4) provides:

"It is not to be concluded for the purposes of paragraph (3)(e) that a person entered into or carried out a scheme for a purpose mentioned in that paragraph merely because the person acquired membership interests, or an interest in membership interests, in the entity."

25 Section 177EA(5) provides in part:

"The Commissioner may make, in writing, either of the following determinations:

(a) …

(b) a determination that no imputation benefit is to arise in respect of a distribution or a specified part of a distribution that is made, or that flows indirectly, to the relevant taxpayer."

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46 Section 6(1) of the ITAA 1936.

Section 177EA(5) adds that a determination does not form part of an assessment. However, s 177EA(9) allows a taxpayer to whom a determination relates and who is dissatisfied with it to object against the determination in the manner set out in Pt IVC of the TAA.

26 Section 177EA was inserted into the ITAA 1936 in an earlier form in 1998[47], was amended by the addition of the equivalent of s 177EA(17)(e) in 2001[48], was repealed and substituted in 2003[49], and was amended by the addition of s 177EA(17)(ga) in 2007[50]. In the form in which it was originally inserted in 1998, s 177EA(3) corresponded with the current s 177EA(3) with immaterial textual differences and s 177EA(19) corresponded with the current s 177EA(17) with immaterial textual differences save that s 177EA(19) had no equivalent of s 177EA(17)(e) or s 177EA(17)(ga).

27 The Explanatory Memorandum for s 177EA as originally inserted into the ITAA 1936 in 1998 explained the section as "a general anti-avoidance rule … to curb the unintended usage of franking credits through dividend streaming and franking credit trading schemes"[51]. It went on to explain "dividend streaming" as "the distribution of franking credits to select shareholders"[52] and "franking credit trading schemes" as schemes that "allow franking credits to be inappropriately transferred by, for example, allowing the full value of franking credits to be accessed without bearing the economic risk of holding the shares"[53]. A Supplementary Explanatory Memorandum described the section as a "catch-all" provision, the object of which was to protect Pt 3-6 of the ITAA 1997 from "abuse of the imputation system through schemes which circumvent the basic rules for the franking of dividends … not otherwise prevented by those basic

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47 *Taxation Laws Amendment Act (No 3)* 1998 (Cth) (No 47 of 1998).

48 *New Business Tax System (Debt and Equity) Act* 2001 (Cth) (No 163 of 2001).

49 *New Business Tax System (Consolidation and Other Measures) Act* 2003 (Cth) (No 16 of 2003).

50 *Tax Laws Amendment (2007 Measures No 3) Act* 2007 (Cth) (No 79 of 2007).

51 Australia, House of Representatives, Taxation Laws Amendment Bill (No 7) 1997, Explanatory Memorandum at [8.2].

52 Australia, House of Representatives, Taxation Laws Amendment Bill (No 7) 1997, Explanatory Memorandum at [8.7].

53 Australia, House of Representatives, Taxation Laws Amendment Bill (No 7) 1997, Explanatory Memorandum at [8.6].

rules"[54]. Further statements in the Explanatory Memorandum and the Supplementary Explanatory Memorandum are significant because they bear directly on the construction of the parenthesised words in s 177EA(3)(e)[55]. The Explanatory Memorandum stated: "[a] purpose is an incidental purpose when it occurs fortuitously or in subordinate conjunction with another purpose, or merely follows another purpose as its natural incident."[56] The Supplementary Explanatory Memorandum went on to explain that the parenthesised words were "inserted for more abundant caution" in that a reference to a "purpose" of a scheme "is usually understood to include any main or substantial purpose" of the scheme and the parenthesised words "clarify that this is the intended meaning here"[57]. It added: "[a] purpose will be an incidental purpose when it occurs fortuitously or in subordinate conjunction with one of the main or substantial purposes of the scheme, or merely follows that purpose as its natural incident."[58] Relevantly to the construction of s 177EA(3)(e), the Explanatory Memorandum also stated: "[c]ircumstances … relevant in determining whether any person has the requisite purpose … are not limited to … the factors listed in [s 177EA(19)]."[59]

28 The Explanatory Memorandum for the addition of s 177EA(17)(ga) in 2007 explained that paragraph, and s 202-45(e) of the ITAA 1997, which was inserted at the same time, as consequential on the repeal of "dividend tainting rules" in the ITAA 1936[60] which had until then operated to ensure that some distributions were not frankable[61]. One of those "dividend tainting rules" had

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54 Australia, Senate, Taxation Laws Amendment Bill (No 3) 1998, Supplementary Explanatory Memorandum at [2.3].

55 Section 15AB of the *Acts Interpretation Act* 1901 (Cth).

56 Australia, House of Representatives, Taxation Laws Amendment Bill (No 7) 1997, Explanatory Memorandum at [8.76].

57 Australia, Senate, Taxation Laws Amendment Bill (No 3) 1998, Supplementary Explanatory Memorandum at [2.6].

58 Australia, Senate, Taxation Laws Amendment Bill (No 3) 1998, Supplementary Explanatory Memorandum at [2.7].

59 Australia, House of Representatives, Taxation Laws Amendment Bill (No 7) 1997, Explanatory Memorandum at [8.79]. See also at [8.91].

60 Sections 46G to 46M of the ITAA 1936, repealed by *Tax Laws Amendment (2007 Measures No 3) Act* 2007 (Cth).

61 Australia, House of Representatives, Tax Laws Amendment (2007 Measures No 3) Bill 2007, Explanatory Memorandum at [6.1]-[6.15].

been that a dividend credited against one of a number of "disqualifying accounts", which included a share capital account and a reserve to the extent that the reserve consisted of profits from the revaluation of assets, was not frankable[62].

Facts

29 The Bank is incorporated in Australia and carries on a business of banking and providing financial services predominantly in Australia. It also has branches in other countries, which include New Zealand.

30 The Bank is an authorised deposit-taking institution ("ADI") for the purposes of the *Banking Act* 1959 (Cth) and, as an ADI, it is required to comply with prudential standards determined by APRA under s 11AF of that Act. Those prudential standards include standards designed to ensure that an ADI maintains adequate capital to act as a buffer against risk. The prudential standards require an ADI to maintain a minimum ratio of total capital to risk-weighted assets[63]. They further require that a specified proportion of the capital required to maintain that ratio meet the standard of "Tier 1 capital" as distinct from "Tier 2 capital", that a specified proportion of that Tier 1 capital fall within the category of "Fundamental Tier 1 capital" and that a further specified proportion fall within the categories of either "Fundamental Tier 1 capital" or "Non-innovative Residual Tier 1 capital" as distinct from "Innovative Residual Tier 1 capital"[64]. The essential characteristics of Tier 1 capital are that it must provide a permanent and unrestricted commitment of funds, be freely available to absorb losses, not impose any unavoidable servicing charge against earnings and rank behind the claims of depositors and other creditors in the event of winding up[65]. Fundamental Tier 1 capital comprises paid up ordinary shares, general reserves, retained earnings, current year earnings, foreign currency translation reserve, capital profits reserve and minority interests arising from consolidation of Tier 1 capital of subsidiaries[66]. Non-innovative Residual Tier 1 capital comprises perpetual non-cumulative preference shares meeting specified conditions[67],

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62 Sections 46H(1) and 46M (repealed).

63 Australian Prudential Regulation Authority, Prudential Standard APS 110.

64 Australian Prudential Regulation Authority, Prudential Standard APS 111, par 57.

65 Australian Prudential Regulation Authority, Prudential Standard APS 111, par 17.

66 Australian Prudential Regulation Authority, Prudential Standard APS 111, par 18(a).

67 Australian Prudential Regulation Authority, Prudential Standard APS 111, par 18(b)(i), Attachment A, par 4.

including perpetual non-cumulative preference shares issued directly by an ADI and stapled to securities issued directly by an overseas branch of the ADI and which meet specified conditions[68].

31 As at 30 June 2008, the Bank's Fundamental Tier 1 capital consisted mainly of ordinary shares, reserves and retained earnings. It had a consistent practice of paying and fully franking dividends on its ordinary shares. Its Non-innovative Residual Tier 1 capital consisted mainly of preference shares stapled to subordinated notes issued by its New York branch, known as "PERLS IV".

32 In September 2008, management projected that the Bank would face a substantial capital requirement over the ensuing year due to business growth, potential acquisitions and foreign exchange movements. The nature of the Bank's other capital raisings and the imminent expiration of certain transitional rules in relation to the proportion of Innovative Residual Tier 1 capital the Bank could include within its Tier 1 capital meant that the Bank needed to raise further Tier 1 capital that was either Fundamental Tier 1 capital or Non-innovative Residual Tier 1 capital to be able to comply with the applicable prudential standards into the future. Management's recommendation to the Board of Directors ("the Board") was that the Bank offer to new investors "an alternative non-innovative Tier 1 security – PERLS V". The Board decided not to proceed with the issue at that time because the prospectus would have required disclosure of commercially sensitive information about a particular potential acquisition. The recommendation was renewed in February 2009. The reasons given for the renewal were that the "economic environment continue[d] to place pressure on the Tier 1 ratio targets" and that PERLS V provided "a diversified, cost effective way to increase Tier 1 [capital]". The recommendation was that the terms for PERLS V "be similar to PERLS IV – a convertible non-innovative hybrid Tier 1 security with a conversion term of approximately 5 years … structured as a stapled security, PERLS V substituting NZ Branch as the Notes issuer for NY Branch". The decision of the Board in response to that renewal recommendation was to approve "pursuing a non-innovative residual Tier 1 capital issue offering – PERLS V for $500m with a potential to increase the issue up to $1.5b, to be launched when there is sufficient market capacity".

33 The Board was updated with a management paper in July 2009. The paper contained a capital ratio forecast suggesting that about $700 million of additional Tier 1 capital would be required by June 2010. The paper also informed the Board that, in response to market feedback concerning "the volume of demand for a 'vanilla' hybrid structure similar to PERLS IV", management was also pursuing an alternative structure which "include[d] an equity option".

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68 Australian Prudential Regulation Authority, Prudential Standard APS 111, Attachment A, par 4(d).

The paper continued to inform that "[f]or either structure, the issue would be structured as a note issued from the NZ branch stapled to a preference share issued from Australia" and that "[i]n addition to providing non-innovative Tier 1 capital to the group, this structure [would deliver] funding to the Group's New Zealand operations at a price comparable to senior debt (after allowing for franking credits)." The paper went on to note a tax issue that impacted on "both the vanilla and option hybrid structures". Discussions with the Commissioner had revealed that, while the Bank would be required to frank distributions on the securities, as they were equity for tax purposes, and while the Commissioner had previously ruled that s 177EA of the ITAA 1936 did not apply to the arrangements for the issue of PERLS IV, in light of the recent addition of s 177EA(17)(ga) the Commissioner had formed the preliminary view that s 177EA would apply to the arrangements for the issue of PERLS V on the basis that PERLS V distributions would be "sourced from unrealised or untaxed profits" being those from the Bank's New Zealand business. Another section of the paper estimated the economic cost of the securities to the Bank, after tax and including the cost of franking credits, to be 5.58 per cent for the "vanilla hybrid" (rising to 8.28 per cent if there were an adverse tax outcome) and 6.47 per cent for the "option hybrid" (rising to 9.02 per cent if there were an adverse tax outcome) compared with 14.20 per cent for ordinary equity. In response to the update, the Board did not do more than to note that management expected to "launch a non-innovative hybrid Tier 1 transaction" following the announcement of results in August 2009 and noted the tax issues associated with the transaction.

34 The Board was updated with further management papers in August 2009. One paper explained that work had been progressing towards the "'vanilla' hybrid structure" discussed in the management paper of July 2009, as indications were that that lower cost structure should achieve a viable transaction size of between $600 million and $1 billion. It also explained that a tax ruling on the transaction had been sought from the Commissioner and that, although that ruling was expected to be adverse, the Commissioner was likely to agree to an arrangement under which the application of s 177EA of the ITAA 1936 would be tested in a court and under which the Bank would make a cash payment to the Commissioner to settle the tax obligations of holders if the view of the Commissioner were to prevail. The papers contained revised estimates of the economic cost of PERLS V to the Bank, after tax and including the cost of franking credits, at 5.86 per cent (rising to either 7.48 or 7.87 per cent if there were an adverse tax outcome) compared with 6.02 per cent for Tier 2 capital and 14.20 per cent for ordinary equity. The Board noted that PERLS V was "still well priced" even if the view of the Commissioner were to prevail and the Bank had to make the additional payment to the Commissioner. The Board went on to approve an offer of PERLS V of approximately $600 million, with the ability to issue more or less up to $1.2 billion, subject to all necessary internal and regulatory approvals being obtained.

35 A prospectus for PERLS V was lodged on 28 August 2009. Less than two weeks later, however, management informed the Board of strong feedback from brokers indicating a likely final demand of close to $3 billion. Management also reported that capital forecasts showed that there was Tier 1 hybrid capacity over the ensuing year for an offer size of up to $1.9 billion and that, if the amount of PERLS V were $2 billion, there would be an estimated excess of $332 million reclassified as Tier 2 at December 2009, decreasing to $95 million by June 2010. The Board agreed to increase the maximum size of the issue of PERLS V to $2.25 billion and to limit the offer to Australian residents who were existing shareholders or holders of prior issues of similar securities. A draft replacement prospectus for PERLS V was lodged accordingly on 7 September 2009.

36 The replacement prospectus limited the offer of PERLS V to Australian residents who held ordinary shares in the Bank or who were holders of PERLS IV or were or had been holders of specified similar securities that had been issued by the Bank before PERLS IV. Australian residents in fact then comprised over ninety-eight per cent of the holders of ordinary shares in the Bank. The prospectus also provided that PERLS V were to be issued to Macquarie Group Holdings New Zealand Ltd which was then to transfer them to successful applicants under the offer made by the replacement prospectus.

37 The key features of PERLS V, highlighted in the replacement prospectus and the subject of detailed provision in the terms of issue, were as follows. PERLS V were stapled securities each comprising an unsecured subordinated note issued out of the Bank's New Zealand branch and a preference share issued by the Bank which could not generally be traded separately. They entitled holders to quarterly distributions which were expected to be fully franked. Distributions on them were expected to comprise interest on the notes at a distribution rate to be calculated each quarter as the bank bill swap rate plus a margin of 3.4 per cent together multiplied by a factor of (one minus the Australian corporate tax rate applicable at the relevant distribution payment date). Distributions on them were also to be non-cumulative (giving rise to no claim or entitlement to payment in the future if not paid on a distribution date) and at the discretion of the Bank (but if not paid a "dividend stopper" restricting the Bank from paying dividends, interest or distributions or returning capital on ordinary shares and certain other securities would arise). They were to be exchanged on 31 October 2014 by resale at face value, conversion into ordinary shares or repurchase by the Bank. They gave holders no rights to redemption. However, the Bank could, with the approval of APRA, exchange them by resale, conversion or repurchase on the happening of certain events (including the Bank being advised of a material risk that franking credits might not be available on any distribution) and could elect for some or all of the notes to be de-stapled from the preference shares and assigned to the Bank on the happening of certain other events (including cessation or suspension of its business, a winding up proceeding being commenced against it or regulatory steps being taken by APRA against it) in which case dividends would become payable on the corresponding

preference shares in an amount equal to the interest previously payable on the notes. The terms of issue of the notes also provided a mechanism by which, if interest payments on the notes were not fully franked, those payments were to be increased by a cash amount to compensate holders for the amount of the franking credit forgone as a tax offset.

38 The effect of those features was to make the return to holders of PERLS V equal to the sum of the interest paid on the notes and the value of the attached franking credit. If the full value of the franking credit was taken into account, the yield would be the fixed margin of 3.4 per cent over the variable bank bill swap rate.

39 Ten million PERLS V were issued on 14 October 2009 for an aggregate issue price of $2 billion. Following their transfer to successful applicants, there were over 30,000 registered holders almost all of whom were recorded in the Bank's register as having an Australian address.

40 Most of the funds raised by the issue were lent through the New Zealand branch of the Bank to ASB Bank Ltd ("ASB"), a New Zealand resident subsidiary of the Bank. The remaining proceeds, consisting of $NZ500 million, were obtained by the New Zealand branch of the Bank to fund the business undertaken by that branch. The expectation of the Bank at the time of issue was that interest on the notes would be paid by the New Zealand branch of the Bank and that funds used by the New Zealand branch to pay interest on the notes would be earned from the various business activities of the New Zealand branch, including the loan to ASB.

41 Income derived by the Bank in carrying on a business at or through its New Zealand branch, although excluded from the Bank's assessable income by s 23AH of the ITAA 1936, is subject to income tax in New Zealand. On 23 December 2009, the Bank through its New Zealand branch applied to the New Zealand Inland Revenue Department for a private ruling under s 91E of the *Tax Administration Act* 1994 (NZ) that distributions on the notes forming part of PERLS V would be expenses deductible against the assessable income of the New Zealand branch of the Bank for New Zealand income tax purposes on the basis that interest paid on the notes would be incurred by the New Zealand branch in order to derive New Zealand assessable income or in the course of carrying on a business for the purpose of deriving New Zealand assessable income. A private ruling to that effect was ultimately provided on 16 June 2010.

42 The arrangement between the Bank and the Commissioner foreshadowed at the time of the Board's approval of an offer of PERLS V in August 2009, under which the application of s 177EA of the ITAA 1936 to the arrangements for issue of PERLS V would be tested in a court and the Bank, if unsuccessful, would make a cash payment to the Commissioner to settle the tax obligations of holders, was formalised in a deed the existence and effect of which was recorded

in the replacement prospectus. In accordance with the procedure contemplated in that deed, the Commissioner on 14 December 2009 made a determination under s 177EA(5)(b) of the ITAA 1936 in relation to a nominated taxpayer who was a holder of PERLS V and an Australian resident that no imputation benefit was to arise in respect of the first franked distribution that the Bank was to make on PERLS V on or about 1 February 2010. It was as an appeal by that taxpayer from the Commissioner's subsequent disallowance of his objection to the determination that the proceedings giving rise to this appeal came before the Federal Court under Pt IVC of the TAA.

Federal Court

43 The parties proceeded in the Federal Court on an acceptance that PERLS V were non-share equity interests in accordance with Div 974 of the ITAA 1997, with the consequence that interest payments on the notes were non-share dividends and frankable distributions under Pt 3-6 of the ITAA 1997. The parties accepted that distributions on the notes were not made unfrankable by s 215-10. That was explained in this Court to be on the basis that a PERLS V stapled security as a whole was a non-share equity interest. As only the note was issued out of the New Zealand branch of the Bank, the criterion in s 215-10(1)(c) was not met for PERLS V. Nor could it be met for any stapled security able to be issued by the Bank that qualified as Non-innovative Residual Tier 1 capital.

44 It was uncontroversial in the Federal Court that: the arrangements for the issue of PERLS V amounted to a scheme for the disposition of non-share equity interests within s 177EA(3)(a) of the ITAA 1936; a frankable distribution in the form of interest on the notes was expected to be payable in respect of those non-share equity interests within s 177EA(3)(b)(i); the distribution was expected to be franked within s 177EA(3)(c); and, except for s 177EA, the taxpayer could reasonably be expected to receive imputation benefits as a result of that distribution within s 177EA(3)(d). In relation to s 177EA(3)(e) of the ITAA 1936, it was also uncontroversial that: s 177EA(4) operated to make any purpose of the taxpayer irrelevant; the Bank was the person who entered into and carried out the scheme; no meaningful distinction was to be drawn between the Bank entering into the scheme and the Bank carrying out the scheme; and the words "would be concluded" required the undertaking of an objective assessment from the perspective of a reasonable person in the same way as do the identical words in s 177D(b) of the ITAA 1936[69].

45 The issue was – as the issue remains in this appeal – wholly as to whether, within the meaning of s 177EA(3)(e) of the ITAA 1936, having regard to the

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69 *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 186 CLR 404 at 422; [1996] HCA 34.

"relevant circumstances" of the arrangements for the issue of PERLS V, it would be concluded from the perspective of a reasonable person that the Bank entered into and carried out those arrangements "for a purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling [a taxpayer who is a holder of PERLS V] to obtain an imputation benefit" by reason of the allocation of a franking credit to the payment of interest on a note.

46 For the purposes of addressing that issue, the primary judge separately analysed each of the "relevant circumstances" in s 177EA(17) of the ITAA 1936. He took the view that: the circumstances referred to in ss 177EA(17)(a), 177EA(17)(c) and 177EA(17)(d) were each neutral in that they pointed neither towards nor away from the Bank having a purpose of enabling a holder to obtain an imputation benefit; the circumstances referred to in ss 177EA(17)(b), 177EA(17)(f), 177EA(17)(ga) and 177EA(17)(h) each pointed towards the Bank having a purpose of enabling a holder to obtain an imputation benefit which was not merely incidental; and the circumstances in ss 177EA(17)(g) and 177EA(17)(i) each pointed away from the Bank having such a purpose. He noted that the circumstance referred to in s 177EA(17)(e) had no application. Of the circumstances referred to in ss 177D(b)(i) to 177D(b)(viii), as incorporated by s 177EA(17)(j), he took the view that many had no application beyond the circumstances he had already taken into account but that those referred to in ss 177D(b)(ii) and 177D(b)(iv) pointed towards the purpose. In relation to s 177EA(17)(ga), he accepted the submission of the Commissioner that the fact that interest on the notes was to be paid out of the New Zealand branch of the Bank from a source of funds that bore no Australian income tax was sufficient for the distribution to be characterised as being sourced from "untaxed profits". He also regarded the fact that the interest payments were frankable in Australia yet deductible against assessable income in New Zealand as part of the "form and substance" of the scheme within s 177D(b)(ii) and as bearing on the result that would be achieved by the scheme by operation of the ITAA 1997 within s 177D(b)(iv)[70]. Having earlier described the franking credit attaching to the payment of interest on a note as "integral to the return on the [n]ote" and as "the very thing that makes an investment in [PERLS V] commercially acceptable"[71], the primary judge expressed his conclusion as follows[72]:

> "Having regard to all the relevant matters and circumstances, some of which do not point towards the relevant purpose, I consider, on balance, that overall they point towards the purpose of enabling holders of [PERLS V], such as the [t]axpayer, to obtain an imputation benefit. That

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70 2011 ATC ¶20-247 at 12,151 [133].

71 2011 ATC ¶20-247 at 12,149 [118].

72 2011 ATC ¶20-247 at 12,151 [134].

> is a basic and fundamentally important aspect of the terms of the [n]otes. The characteristics of [PERLS V] are much more like those of debt than of equity. By issuing [PERLS V] in New Zealand, the Bank was able to achieve the result that it obtained a deduction in New Zealand in respect of the [d]istributions on the [PERLS V], but had the advantage, in terms of cost, of offering Australian residents the imputation benefit."

47 In the Full Court, both the majority and the minority emphasised that the circumstances referred to in s 177EA(17) are not exhaustive of "relevant circumstances" within the meaning of s 177EA(3)(e) and that the weight to be accorded in a particular case to any of the circumstances referred to in s 177EA(17) must vary according to the extent to which that circumstance is in that case probative of a purpose of the kind referred to in s 177EA(3)(e). There was no dispute before the Full Court that s 177EA(17)(e) had no application. There was no challenge to the view of the primary judge that the circumstances referred to in ss 177EA(17)(g) and 177EA(17)(i) each pointed away from the proscribed purpose. None of the members of the Full Court had difficulty agreeing with the view of the primary judge that the circumstances referred to in s 177EA(17)(a) were neutral[73]. As to ss 177EA(17)(c) and 177EA(17)(d), the majority considered that absent the scheme the Bank would not have received the franking credits, which pointed away from the proscribed purpose[74], while the minority agreed with the primary judge that the factors were neutral[75].

48 The members of the Full Court unanimously disagreed with the view of the primary judge that the circumstances referred to in ss 177EA(17)(b) and 177EA(17)(h) pointed towards the Bank having a purpose of the kind referred to in s 177EA(3)(e). As to s 177EA(17)(b), the fact that the offer of PERLS V was restricted to Australian residents (able to benefit from franking credits) was of little significance given that the overwhelming majority of the Bank's ordinary shareholders were also Australian residents and was explicable on either commercial or regulatory grounds[76]. As to s 177EA(17)(h), merely to characterise distributions on the notes as "in the nature of, or similar to, interest" did not advance the analysis[77].

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73 (2011) 198 FCR 89 at 110 [50]-[51], 142 [185]-[186].

74 (2011) 198 FCR 89 at 145 [193]-[194].

75 (2011) 198 FCR 89 at 113-114 [68]-[76].

76 (2011) 198 FCR 89 at 111-113 [52]-[67], 143-144 [189]-[191].

77 (2011) 198 FCR 89 at 119-120 [102]-[104], 149-150 [210]-[212].

49 The members of the Full Court also unanimously disagreed with the primary judge in relation to the circumstance referred to in s 177EA(17)(ga). That circumstance, they held, was not present on the proper construction of that paragraph: its reference to a distribution "sourced, directly or indirectly, from unrealised or untaxed profits" is to payments sourced from profits not revenue; a distribution expensed from revenue not taxed in Australia does not answer the statutory description[78]. As to whether the primary judge was correct in treating as relevant the deductibility for New Zealand income tax purposes of the interest payments on the notes, members of the Full Court took different views. To Jessup J, the deductibility in New Zealand of distributions frankable in Australia was "an exemplar of what the legislature had in mind when it posited a distinction between 'form' and 'substance' in [s 177D(b)(ii)]"[79]. To Edmonds J, it was wholly irrelevant[80].

50 The critical difference between the majority and the minority in the Full Court was in their assessment of the import and interrelationship of two circumstances. One circumstance was that distributions on the notes were to be calculated by reference to the franking credits that were to be received by holders. Both the majority and the minority accepted that to be a relevant circumstance within s 177EA(17)(f)[81]. The majority also accepted the receipt of those franking credits to be a result within s 177D(b)(iv)[82]. The other circumstance, which neither the majority nor the minority sought to locate squarely in any provision of s 177EA(17), was captured crisply by Jessup J in terms of "the Bank's need to raise Tier 1 capital and the practical inevitability that any distributions made in consequence of the raising of such capital would be franked"[83]. It was explained by Edmonds J in three steps as follows. First[84]:

> "It [was] not in contest that the dominant purpose of the Bank in issuing the PERLS V securities was to raise Tier 1 capital. To make an issue of Tier 1 capital the Bank had the option of fundamental Tier 1 capital, viz, ordinary capital (which was rejected because of the amount of

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78 (2011) 198 FCR 89 at 117-118 [95]-[99], 148 [206]-[207].

79 (2011) 198 FCR 89 at 150 [214].

80 (2011) 198 FCR 89 at 120-121 [109].

81 (2011) 198 FCR 89 at 114-115 [79]-[85], 145-146 [196]-[197].

82 (2011) 198 FCR 89 at 151 [216].

83 (2011) 198 FCR 89 at 151 [219].

84 (2011) 198 FCR 89 at 121 [111].

such capital already issued and its cost) or non-innovative Tier 1 capital. The Bank chose the latter being less costly."

51 Second, flowing from the test in Div 974 of the ITAA 1997[85]:

> "Whatever form of Tier 1 capital was issued, it would necessarily be treated as equity and not as debt; necessarily, … for tax purposes it was in substance, whatever its form, equity and all distributions would be either dividends or non-share dividends."

52 Third, flowing from the "benchmark rule" in Pt 3-6 of the ITAA 1997[86]:

> "Any distribution on the PERLS V securities was effectively required to be franked at the same rate as other distributions by the Bank – which, as the Bank had fully franked other dividends, meant that the distributions on the PERLS V securities were effectively required to be fully franked."

53 To Edmonds J, the Bank's overriding purpose of raising Tier 1 capital, inevitably through the issue of what would amount for taxation purposes to equity interests giving rise to frankable distributions, led (in the absence of any features of the scheme suggestive of trading in or streaming of imputation benefits) to an objective conclusion that the issue of PERLS V "was simply an issue of Tier 1 capital on terms that it would be franked to the same extent as all other capital of the Bank"[87] and that "the provision of franking credits to the recipients of the distributions (including the [taxpayer]) was at most no more than an incidental purpose of the issue and the subsequent payment of distributions"[88].

54 To Jessup J, that approach suffered two difficulties. One was that it tended "to disconnect the various elements of the scheme by taking it as a given that the Bank had a dominant purpose – the raising of Tier 1 capital – to which all other purposes associated with the scheme were subordinate"[89]. The other

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85 (2011) 198 FCR 89 at 121 [112].

86 (2011) 198 FCR 89 at 121 [113].

87 (2011) 198 FCR 89 at 121 [117].

88 (2011) 198 FCR 89 at 121 [118].

89 (2011) 198 FCR 89 at 145 [197].

was that it tended to "shift the focus of inquiry to questions of how else the Bank might have raised Tier 1 capital"[90]. As to that, he said[91]:

> "whatever might be the case elsewhere in Pt IVA, s 177EA(3)(e) is not concerned with alternative courses or counterfactuals. Rather, to the extent that the paragraph requires one to contemplate different scenarios, it is more in the nature of a 'before and after' analysis. The presumptive starting point is that the taxpayer in question is not able to obtain imputation benefits. The question which must be asked about the scheme is whether it was someone's purpose to 'enable' the taxpayer to obtain such benefits. How that person might have proceeded otherwise is not, at least directly, to the point."

He continued[92]:

> "It does not … satisfactorily come to grips with the question which arises under para (e) to propose that the Bank could not have raised Tier 1 capital save in a way that carried the consequence that distributions would have to be franked. The existence of such a state of affairs is not inconsistent with the Bank having the non-incidental purpose, in relation to the scheme which was in fact entered into and carried out, of enabling security-holders to receive the benefits which conventionally flow from franking."

He concluded[93]:

> "Under the scheme in the present case, the delivery of imputation benefits to the [taxpayer] was not simply something that happened as the natural incident of the capital raising undertaken by the Bank. It was intended by the Bank. The architecture of PERLS V – specifically the rewards made available to the [taxpayer] in return for his investment – included the fact of franking as a specific component. … Any conclusion that the purpose of enabling the [taxpayer] to obtain imputation benefits was, on the part of the Bank, only incidental would … be quite at odds with the important features of PERLS V".

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90 (2011) 198 FCR 89 at 146 [198].

91 (2011) 198 FCR 89 at 146 [198].

92 (2011) 198 FCR 89 at 146 [199].

93 (2011) 198 FCR 89 at 152 [220].

Appeal

55 The taxpayer argued in the appeal to this Court that the majority in the Full Court implicitly adopted an incorrect understanding of "incidental purpose" in s 177EA(3)(e) of the ITAA 1936. He argued that a purpose answers that description if it is in furtherance of, or consequential upon, another purpose. The Bank had the overriding purpose of raising Tier 1 capital. Pursuit of that overriding purpose inevitably required that the Bank issue equity interests on which it would pay frankable distributions. The Bank had a purpose of franking distributions on the particular equity interests it chose to issue but that purpose was in furtherance of, or consequential upon, pursuit of its overriding purpose of raising Tier 1 capital. As an alternative and logically anterior argument, the taxpayer argued that the same overriding purpose prevented the purpose of franking distributions being one of "enabling" the taxpayer to obtain an imputation credit. The taxpayer also argued that the majority was wrong to the extent that, in considering s 177D(b)(ii), it attributed significance to the consequences for the Bank of the deductibility of interest paid on the notes under New Zealand income tax law.

56 The Commissioner joined issue with each of those arguments. The Commissioner also relied on the circumstance that the frankable distributions on the notes were deductible against the Bank's assessable income under New Zealand income tax law to advance as a positive case a variant of the argument that had found favour with the primary judge. The critical point was that the Tier 1 capital raised by the Bank from the issue of PERLS V was to be used by the Bank for the generation of income that was assessable in New Zealand rather than for the generation of Australian taxed profits. The Bank got the benefit of "releasing" franking credits to reduce its after tax cost of capital "without any corresponding generation of franking credits". The Bank "could have proceeded by way of a straight issue of non-redeemable preference shares in Australia" in which case "it would have generated Australian-sourced income, which would in turn have generated franking credits". The Bank instead structured the transaction "in such a way that all of the income that is generated is untaxed New Zealand income which generates no franking credits". The Commissioner argued that this was a circumstance covered by s 177D(b)(ii) and by s 177D(b)(iv). He also argued, on a notice of contention, that the circumstance was covered by s 177EA(17)(ga) and by s 177D(b)(vi). In relation to s 177EA(17)(ga), he argued that the construction adopted by the primary judge should be preferred to that adopted by the Full Court. In relation to s 177D(b)(vi), he argued that there was a "change" in the financial position of the Bank resulting from the arrangements for the issue of PERLS V constituted by the raising of capital by the Bank at a "cheaper cost" or on "terms that were favourable". The Commissioner, by notice of contention, in addition challenged the weight given in the Full Court to s 177EA(17)(h), arguing that it was significant to the conclusion to be drawn under s 177EA(3)(e) that, from the point of view of a

holder, the return on PERLS V "is like a payment of interest" rather than "like a distribution of Australian taxed profits".

57 The parties divided on the extent to which, if at all, s 177EA(3)(e) of the ITAA 1936 imported, or admitted, any form of counterfactual analysis: consideration of alternatives that may have existed to the scheme actually entered into and carried out. The taxpayer relied on the inability of the Bank to raise Tier 1 capital without frankable distributions. The Commissioner supported the approach of Jessup J, arguing that the fact that an alternative capital raising would have given rise to frankable distributions was not directly to the point[94]. Yet, as is apparent from the recitation of the positive case he argued, the Commissioner himself relied on a comparison of the incidents of alternative capital raisings.

Analysis

58 Part IVA of the ITAA 1936 "is as much a part of the statute[s] under which liability to income tax is assessed as any other provision thereof" and "is to be construed and applied according to its terms"[95]. In the construction of those terms, the text of Pt IVA is to be read in the context of the ITAA 1936 and the ITAA 1997 as a whole, and an available construction of that text that advances the objects of the Part is to be preferred to one that does not. The heading to Pt IVA indicates that an object of Pt IVA as a whole is to address schemes to reduce income tax. The more specific object of s 177EA, to adopt the explanation given at the time of its introduction, is to prevent abuse of the imputation system in Pt 3-6 of the ITAA 1997.

59 A purposive construction of the text of s 177EA(3)(e) is particularly important given the place of s 177EA(3)(e) within the structure of s 177EA(3). Read with s 177EA(12), and in the light of applicable definitions, s 177EA(3) is an exhaustive statement of the jurisdictional facts that are necessary and sufficient for s 177EA to apply so as to found an exercise of power by the Commissioner to deny a franking credit under s 177EA(5)(b). The facts posited in s 177EA(3)(a)-(d) will exist in most capital raisings. That is because the franking of distributions to be made to equity holders on the equity interests created will be the common expectation of both the issuer and investors. That common expectation reflects no more than the normal operation of Pt 3-6 of the ITAA 1997. If s 177EA is to be targeted to its purpose of preventing abuse of that system, then it is through the operation of s 177EA(3)(e).

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94 (2011) 198 FCR 89 at 146 [198].

95 *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 186 CLR 404 at 414.

60 The conclusion a reasonable person would draw in answer to the question statutorily posed by s 177EA(3)(e) will therefore, for most capital raisings, be the jurisdictional fact on which the application of s 177EA will turn. The conclusion to be drawn under s 177EA(3)(e) "having regard to the relevant circumstances" of the scheme of capital raising is a conclusion as to a purpose of one or more persons who entered into or carried out that scheme. Those persons necessarily include the issuer and, by operation of s 177EA(4), necessarily exclude investors who do no more than become holders of the equity interests created by the issuer. If the conclusion drawn is that the issuer or some other person entered into or carried out the scheme, or some part of it, "for a purpose … of enabling" a holder to obtain a franking credit then the jurisdictional fact to which s 177EA(3)(e) refers will exist and s 177EA will apply unless the conclusion to be drawn is that the issuer's purpose of enabling a holder to obtain a franking credit is "an incidental purpose".

61 Two uncontroversial features of "the relevant circumstances" to which s 177EA(3)(e) refers can usefully be noted. The first is that the relevance of the relevant circumstances lies in the extent to which they are probative of the ultimate question as to purpose. The second is that the circumstances referred to in s 177EA(17) are not exhaustive of the circumstances that might be probative of that ultimate question. They are nevertheless mandatory relevant considerations. Where they exist, they must be taken into account and their degree of relevance will vary according to the extent to which they are probative of the ultimate question. Those features place in perspective the contest between the parties as to the existence of circumstances of the kinds referred to in ss 177EA(17)(ga) and 177D(b)(vi). The contest must be determined; but the contest is not determinative. Its determination can be deferred until two, more significant, questions of construction are addressed.

62 The questions of the construction of s 177EA(3)(e), pivotal to the application of s 177EA, are twofold: what amounts to "a purpose … of enabling"; and when is such a purpose "an incidental purpose"?

63 The reference to "purpose" in each of those phrases is to that of a person who may, but need not, be the issuer. A purpose is a consequence intended by a person to result from some action. Here it is a consequence intended by the person in entering into or carrying out a scheme for the disposition of relevant interests. A person will often intend that a single action have multiple consequences. It is to the relationship between multiple intended consequences that the parenthesised words of s 177EA(3)(e) are directed.

64 There is, in the Explanatory Memorandum for s 177EA as originally inserted into the ITAA 1936 in 1998, already quoted, a very clear statement that "[a] purpose is an incidental purpose when it occurs fortuitously or in subordinate conjunction with another purpose, or merely follows another purpose as its natural incident." The statement, repeated in the Supplementary Explanatory

Memorandum, employed the word "or" disjunctively because a purpose may be in subordinate conjunction with another purpose or may do no more than follow another purpose as the natural incident of that other purpose without necessarily being fortuitous. The statement accords with standard definitions of the word "incidental" to be found in mainstream dictionaries and with a natural reading of the statutory text, "an incidental purpose", in the context of s 177EA(3)(e). The adoption of the meaning conveyed by the statement as the proper construction of the statutory text produces the result that a purpose of a person, in entering into or carrying out the scheme for the disposition of equity interests, of enabling a holder to obtain a franking credit is "an incidental purpose" outside the scope of s 177EA(3)(e) if that purpose does no more than further some other purpose or follow from some other purpose. That result confines the application of s 177EA in a manner that is consistent with its object. The meaning ought, for those reasons, to be adopted.

65 Adopting that meaning of "an incidental purpose", there is no textual or contextual warrant for further confining the application of s 177EA by adopting a strained meaning of the word "enabling" in s 177EA(3)(e). The word "enabling" is there directed to the end of obtaining an imputation benefit. It is best read in the sense suggested by Jessup J: that of "supplying with the requisite means or opportunities to [that] end"[96]. It follows that the disposition of an equity interest to an equity holder enables that holder to obtain whatever franking credit subsequently accrues to the holder when there is a distribution on that equity interest.

66 Where I disagree with Jessup J in relation to the construction of s 177EA(3)(e) is in two respects. First, a purpose can be incidental even where it is central to the design of a scheme if that design is directed to the achievement of another purpose. Indeed, the centrality of a purpose to the design of a scheme directed to the achievement of another purpose may be the very thing that gives it a quality of subsidiarity and therefore incidentality. That is not impermissibly to confine the scope of s 177EA(3)(e) to a dominant purpose: the categories of "dominant" and "incidental" are not exhaustive. The parenthesised words in s 177EA(3)(e) make clear that a dominant purpose of enabling a holder to obtain a franking credit is sufficient but not necessary for the requisite jurisdictional fact to exist, but it does not follow that a purpose which does no more than further or follow from some dominant purpose is incidental. Second, counterfactual analysis is not antithetical to the statutory inquiry mandated by s 177EA(3)(e). Purpose is a matter for inference and incidentality is a matter of degree. Consideration of possible alternatives may well assist the drawing of a conclusion in a particular case that a purpose of enabling a holder to obtain a

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96 (2011) 198 FCR 89 at 139 [176].

franking credit does or does not exist and, if such a purpose exists, that the purpose is or is not incidental to some other purpose.

67 On that construction of s 177EA(3)(e), there is in the case of a capital raising where the issuer intends to frank distributions on the equity interests disposed of a "purpose … of enabling" the holders of those equity interests to obtain franking credits. Any such capital raising is therefore potentially within the scope of s 177EA(3)(e). If, however, the intended franking of distributions serves no purpose other than to facilitate the capital raising then the purpose is an incidental purpose: s 177EA(3)(e) is not engaged and s 177EA does not apply. That is to be contrasted with franking credit trading and franking credit streaming where it is the issue of equity interests that is incidental to the provision of the franking credits. No doubt, there are other scenarios within the "catch-all" operation of s 177EA where the circumstances are more nuanced. The present case does not involve one of them.

68 Before turning to the application of s 177EA(3)(e) in the present case, it is necessary for the identification of "the relevant circumstances" to deal with questions as to the construction of ss 177EA(17)(ga) and 177D(b)(vi).

69 The construction of s 177EA(17)(ga) is complicated by the obscurity of its language as well as by the lack of any precise object emerging from the legislative history of its addition to s 177EA in 2007. Although the provision was enacted as a consequence of the repeal of the former "dividend tainting rules" (the focus of which was on payments credited against certain forms of disqualifying company accounts) and at the same time s 202-45(e) was inserted into the ITAA 1997 (making a distribution "sourced … from a company's *share capital account" an unfrankable distribution), its language of distributions being "sourced, directly or indirectly, from unrealised or untaxed profits" was new. The expression "unrealised or untaxed profits" is not further defined. It is difficult not to read that language in light of, and as complementary to, the more general list of categories of unfrankable distributions into which s 202-45(e) of the ITAA 1997 was inserted. Those categories are not confined to payments credited to particular kinds of accounts. Their listing has as its stated object "to ensure that only distributions equivalent to realised taxed profits can be franked"[97]. The word "profits" has no rigid meaning in income tax law[98]. It is consistent with the object of s 177EA as a whole to treat s 177EA(17)(ga) as designed to capture distributions outside the listed categories of unfrankable

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97 Section 202-35 of the ITAA 1997.

98 *Federal Commissioner of Taxation v Sun Alliance Investments Pty Ltd* (2005) 225 CLR 488 at 512 [71]; [2005] HCA 70.

distributions which were traceable to a source which had not borne income tax[99]. The circumstance that distributions on the notes were to be paid by the New Zealand branch of the Bank without payment of Australian income tax by the Bank on the source of funding is therefore a relevant consideration within s 177EA(17)(ga).

70 The construction of s 177D(b)(vi) is more straightforward. Section 177D(b)(vi) (referring to "any change in the financial position of any person who has … any connection … with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme"), like s 177D(b)(v) (referring to "any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme"), is directed to an effect of the scheme. It is concerned with a difference in financial position that has resulted from the scheme. The comparison it requires can be described as "before" and "after"[100] but with more precision as "with" and "without". Adopting the reasonable inference that without PERLS V the Bank would have raised Tier 1 capital by other means at a higher cost, I therefore accept the argument of the Commissioner as to the existence of a "change" in the financial position of the Bank resulting from the arrangements for the issue of PERLS V constituted by the raising of capital by the Bank at a "cheaper cost".

71 Quite independently of ss 177EA(17)(ga) and 177D(b)(vi), the critical point on which the Commissioner seeks to rely – that the Tier 1 capital raised by the Bank from the issue of PERLS V was to be used by the Bank for the generation of income that was assessable in New Zealand rather than for the generation of Australian taxed profits – fits within s 177D(b)(ii). It was an aspect of the "substance of the scheme". That reference "invites attention to what in fact [the relevant person] may achieve by carrying it out" including to matters "not to be found within the four corners of an agreement or an arrangement"[101]. The degree, if any, to which the point has a bearing on the conclusion to be drawn under s 177EA(3)(e) is quite another matter.

72 The fact that the Bank needed to raise Tier 1 capital in circumstances where all the means available to the Bank to raise Tier 1 capital would have involved the Bank franking distributions to the same extent similarly fits within s 177D(b)(ii). It is a "relevant circumstance" in any event because it is logically probative of the conclusion to be drawn under s 177EA(3)(e).

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99 Section 202-45 of the ITAA 1997.

100 *Federal Commissioner of Taxation v Hart* (2004) 217 CLR 216 at 260 [88]; [2004] HCA 26.

101 *Federal Commissioner of Taxation v Hart* (2004) 217 CLR 216 at 260 [88].

73 It has been observed in the context of the more familiar operation of s 177D within Pt IVA that having regard to the eight matters listed in s 177D(b) does not require that they each be analysed individually; provided they are taken into account, a "global assessment of purpose" is permissible[102] and often it is appropriate. The same is true of the eighteen circumstances listed in s 177EA(17) read with s 177D(b)(i)-(viii). The upshot of the painstaking analysis conducted by the primary judge and by the members of the Full Court is to demonstrate that very few of those circumstances have a material bearing on the conclusion ultimately to be drawn under s 177EA(3)(e). There is little point in subjecting to further fine analysis the particular question raised by the Commissioner on his notice of contention as to the extent to which a distribution on the notes can be characterised for the purposes of s 177EA(17)(h) as being in the nature of interest. The answer could not bear materially on the result.

74 For the purposes of the present case, the question posed by s 177EA(3)(e), and to be answered from the perspective of a reasonable person, can be broken down into two sub-questions. In issuing PERLS V, did the Bank have a purpose of enabling holders to obtain franking credits? If so, was that purpose subordinate to or in subsidiary conjunction with some other purpose?

75 The answer to both those sub-questions is "yes". The Bank obviously issued PERLS V with the intention of holders obtaining franking credits: the proposed franking of distributions was not only disclosed in the prospectus, it was integral to the calculation of the distribution on the notes (s 177EA(17)(f)), integral to the calculation of yield to investors (ss 177D(b)(ii) and 177D(b)(iv)) and integral to the calculation by the Bank of its after tax cost of capital (ss 177D(b)(ii), 177D(b)(iv) and 177D(b)(vi)). The Bank equally obviously issued PERLS V because the Bank needed to raise Tier 1 capital in circumstances where all the means available to the Bank to raise Tier 1 capital would have involved the Bank franking distributions to the same extent and where PERLS V represented the most commercially attractive of those available means (s 177D(b)(ii)).

76 The circumstances that Tier 1 capital raised by the Bank from the issue of PERLS V was to be used by the Bank to generate income in New Zealand not taxable in Australia, and that distributions on the notes were deductible against assessable income in New Zealand, are required to be taken into account as relevant circumstances (ss 177EA(17)(ga), 177D(b)(ii) and 177D(b)(vi)). However, their probative value for the purpose of answering the question ultimately posed by s 177EA(3)(e) is elusive. They do not make it more or less

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102 *Federal Commissioner of Taxation v Consolidated Press Holdings Ltd* (2001) 207 CLR 235 at 263 [94]; [2001] HCA 32. See also *Federal Commissioner of Taxation v Hart* (2004) 217 CLR 216 at 241 [58].

likely that the Bank had a purpose of enabling the holders of PERLS V to obtain franking credits and they do nothing to alter the relationship between that purpose and its purpose of raising Tier 1 capital.

Conclusion and orders

77 It would be concluded from the perspective of a reasonable person that the Bank entered into and carried out the arrangements for the issue of PERLS V for a purpose of enabling taxpayers who became holders of PERLS V to obtain franking credits. It would also be concluded that the purpose was incidental to the Bank's purpose of raising Tier 1 capital. The jurisdictional fact in s 177EA(3)(e) does not exist and s 177EA therefore does not apply.

78 The following orders should be made:

1. Appeal allowed with costs.

2. Set aside the orders of the Full Court of the Federal Court of Australia made on 8 December 2011 and, in their place, order that:

    (a) the appeal be allowed with costs; and

    (b) the orders of Emmett J made on 11 March 2011 be set aside and, in their place, order that:

        (i) the appeal be allowed with costs;

        (ii) the objection decision dated 12 January 2010 be set aside; and

        (iii) the objection dated 29 December 2009 against the determination of 14 December 2009 under s 177EA(5)(b) of the *Income Tax Assessment Act* 1936 (Cth) be allowed and the determination be set aside.