

Corporate groups: the intersection between corporate and tax law

Commissioner of Taxation v BHP Billiton Finance Ltd

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Abstract

The use of corporate groups to conduct commercial activities is a common occurrence in large and small business undertakings. It is common for each entity to perform a specialist function, including asset management and finance. Within corporate groups, a central parent or holding company often takes management responsibility for the strategic direction of the group, and will appoint directors and managers of its subsidiaries. The group subsidiaries will often depend upon the parent for finance and accounting services, human resources and procurement, with all key decisions made by the parent. The use of an enterprise group of entities to conduct a business leads to tensions with traditional corporate law notions of each company being a separate legal entity. The blurring of lines of independence can pose challenges for regulators assessing the status of transactions conducted within the group. The High Court of Australia will consider the use of corporate treasury companies in an upcoming appeal on the meaning of limited recourse debt for the purposes of income tax legislation.¹ This note will discuss the context of the decision and argue that the use of a member of a corporate group to provide in-house finance should not, ordinarily, defeat the presumption of a company's independent and separate existence; nor, based on the facts of the BHP Billiton case, should the use of intra-group transactions render otherwise commercial loans between corporate group members limited recourse.

I Introduction

Phillip Blumberg, the leading author on corporate groups, has observed that corporate groups of enormous size with complex multi-tiered corporate structures

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¹ Transcript of Proceedings, *Commissioner of Taxation v BHP Billiton Finance Ltd* [2010] HCA Trans 229 (3 September 2010) (appeal against *Commissioner of Taxation v BHP Billiton Finance Ltd* (2010) 182 FCR 526).

dominate the national and world economy.² Typically, the business is conducted by a group of affiliated companies under the control of a parent company that operates with a unity of purpose and a common design.³ As noted by the author, when legal issues involving any of the affiliated companies arise, the courts are often called upon to determine whether to attribute the rights, or to impose the duties of, one affiliated company on another affiliate of the group in order to achieve the objectives of the law in the area in dispute.⁴ Within this context, unsurprisingly, the issue of intra-group transactions arose recently in a dispute involving various companies in the BHP Billiton group and the Commissioner of Taxation. The dispute concerns the tax consequences resulting from the failure to repay intra-group loans made by companies within the BHP Billiton group in respect of two failed projects that cost over \$2 billion. On 3 September 2010, the High Court of Australia granted special leave to the Federal Commissioner of Taxation in respect of a decision of the Full Federal Court over the tax status of various deductions claimed by BHP Billiton.⁵

Surprisingly, with reference to the undisputed facts of this case, the commissioner led arguments contrary to well established legal principles suggesting that one of the group companies was a ‘mere conduit’ of its parent company.⁶ As part of this argument, the commissioner attempted to apply div 243 of the *Income Tax Assessment Act 1997* (Cth) (designed to recapture ‘excess’ tax deductions for depreciating assets financed by limited recourse debt) in a manner characterised by the Full Federal Court as controversial.⁷ The BHP Billiton dispute is significant as it is the first case to consider the scope of div 243.⁸

This note will consider the context of the *BHP Billiton* decision and comment on the arguments raised by the commissioner in respect of the intra-group transactions which are, arguably, flawed for reasons advanced below with reference to corporate law principles and policy considerations underpinning the operation of div 243 of the tax law. It will be submitted that the High Court should refuse the commissioner’s appeal from the decision of the Full Federal Court on the application of div 243 to the facts of this particular case.

The discussion in the next part of this article on the use and regulation of corporate groups, is instructive for one of the legal issues which the commissioner raised in the *BHP Billiton* case concerning the separate existence of a corporate

² Phillip Blumberg, ‘The Transformation of Modern Corporation Law: The law of corporate groups’ (2005) 37 *Connecticut Law Review* 605, 608.

³ Ibid 606.

⁴ Ibid.

⁵ Transcript of Proceedings, *Commissioner of Taxation v BHP Billiton Finance Ltd* [2010] HCA Trans 229 (3 September 2010) (appeal against *Commissioner of Taxation v BHP Billiton Finance Ltd* (2010) 182 FCR 526).

⁶ *Salomon v A Salomon & Co Ltd* [1897] AC 22; *Hobart Bridge Co Ltd v Federal Commissioner of Taxation* (1951) 82 CLR 372; *Walker v Wimborne* (1976) 137 CLR 1; *Industrial Equity Ltd v Blackburn* (1977) 137 CLR 567; *Dennis Willcox Pty Ltd v Federal Commissioner of Taxation* (1988) 79 ALR 267; *Briggs v James Hardie & Co Pty Ltd* (1989) 16 NSWLR 549.

⁷ *Commissioner of Taxation v BHP Billiton Finance Ltd* (2010) 182 FCR 526, 279 [92].

⁸ The authors searched both the Australian Tax Reports, the Australian Tax Cases and LexisNexis Unreported Judgments for decisions discussing ‘limited recourse debt’ which resulted in only the BHP Billiton cases. Search conducted 22 October 2010.

entity and the relationship between the parent and its subsidiaries. It pays to review the legal treatment of corporate groups before proceeding to discuss the case.

II The use and regulation of corporate groups

The relatively modern concept of utilising corporate group structures to operate businesses and assist with partitioning assets is widespread and entrenched in modern society. The utility of such arrangements depend on legal recognition and endorsement of the separate legal entity concept as applied to each member of the corporate group, including wholly- and partially-owned subsidiaries. The High Court of Australia has characterised corporate groups as involving ‘a number of companies which are associated by common or interlocking shareholdings, allied to unified control or capacity to control’.⁹

Research undertaken by Ramsay and Stapledon on the prevalence and use of group structures in Australia’s Top 500 listed companies during 1997 showed that 89 per cent of the listed companies surveyed controlled other entities.¹⁰ This research demonstrates that larger and more valuable companies tended to have more controlled entities.¹¹ This is unsurprising, given the numerous economic benefits that can flow from the use of integrated corporate groups to conduct business activities. The range of economic and commercial benefits available from operating corporate group structures include:¹²

- reducing commercial risk, or maximising potential financial return, by diversifying an enterprise’s activities into various types of businesses, each operated by a separate group company;
- taking advantage of commercial opportunities by forming subsidiaries for use in joint venture projects, without involving the rest of the enterprise;
- helping to reduce transaction costs by streamlining systems and building economies of scale;
- taking advantage of tax benefits by operating local group companies in various countries with favourable tax treatment;
- attracting capital without losing overall corporate control by creating a separate subsidiary to conduct the business and allowing minority shareholders to invest in it;
- lowering the risk of legal liability by confining high liability risks, including environmental and consumer liability, to particular group companies, with a view to isolating the remaining group assets from this potential liability; and
- providing better security for debt or project financing—for example, a separate group company may be formed to undertake a particular project and obtain additional finance by means of substantial charges over its own assets and undertaking.

⁹ *Walker v Wimborne* (1976) 137 CLR 1, 6 (Mason J).

¹⁰ Ian Ramsay and Geof Stapledon, ‘Corporate Groups in Australia’ (2001) 29 *Australian Business Law Review* 7.

¹¹ *Ibid* 27 (Table 5).

¹² See Companies and Securities Advisory Committee, ‘Corporate Groups Final Report’ (Report, May 2000); Ramsay and Stapledon, above n 10, 13; Melvin Eisenberg, ‘Corporate Groups’ in Michael Gillooly (ed), *The Law Relating to Corporate Groups* (Federation Press, 1993) 1.

There are few legal restrictions on a company's ability to structure as a corporate group, with regulation of corporate groups generally based on the recognition of each group member remaining a separate legal entity.¹³ The benefits of separate legal status also include limited liability for shareholders, even where the company is a wholly-owned subsidiary in a corporate group.¹⁴ Many commercial structures and arrangements are shaped by the legal fiction afforded by this basic legal doctrine. The concept of limited liability, as noted by one commentator,¹⁵ is entrenched in legal theory and is a fixed reality of the political economy. The use of corporate groups allows for a dual level of limited liability available to both parent and subsidiary companies, which while attractive for business investors wishing to shield themselves from individual liability through share ownership in the ultimate parent company, is not without its critics.¹⁶ A generally strict application of the separate entity approach in Australia by the High Court has facilitated the widespread use of group structures.¹⁷

One means of regulating abuse of individual entities operating within corporate groups is to look behind the separate corporate personality of those companies and hold the ultimate group controllers liable for the actions or debts of the group companies.¹⁸ At common law, there is 'no common, unifying principle, which underlies the occasional decision of courts to pierce the corporate veil'.¹⁹ This outcome is not surprising as veil lifting cases are inherently fact-specific and subject to individual interpretation, often resulting in the absence of clarity.²⁰ Notwithstanding these difficulties, the courts have long recognised that the corporate form can be abused and the tendency of many business people to perform a kind of 'dance of the corporate veils' and to 'duck and dive behind the corporate veil'.²¹

¹³ See above n 6.

¹⁴ *Corporations Act 2001* (Cth) s 516.

¹⁵ For a review of the debate on the justification for limited liability, see Robert Rhee, 'Bonding Limited Liability' (2010) 51 *William and Mary Law Review* 1417.

¹⁶ The leading critic is Phillip Blumberg: see Phillip Blumberg, 'Limited Liability and Corporate Groups' (1986) 11 *Journal of Corporation Law* 573 and more generally Phillip Blumberg, *The Multinational Challenge to Corporation Law* (Oxford University Press, 1993). Blumberg's comprehensive critique of corporate group regulation is compiled and maintained in the looseleaf service by Blumberg et al: Aspen Publishers, *Blumberg on Corporate Groups* (2nd ed).

¹⁷ *Walker v Wimborne* (1976) 137 CLR 1; *Industrial Equity Ltd v Blackburn* (1977) 137 CLR 567. For a similar approach in the US, see *BASF Corp v POSM II Properties Partnership LP* (Court of Chancery of the State of Delaware, CA No 3608-VCS, 3 March 2009) reported in (2010) 35 *Delaware Journal of Corporate Law* 342.

¹⁸ See *Corporations Act 2001* (Cth) s 588V which lifts the corporate veil by making the holding company liable for the debts of its subsidiary when there are reasonable grounds for suspecting that the subsidiary was insolvent at the time of incurring the debt. See further, Ian Ramsay, 'Holding Company Liability for the Debts of an Insolvent Subsidiary: A law and economics perspective' (1994) 17 *University of New South Wales Law Journal* 520.

¹⁹ *Idoport Pty Ltd v National Australia Bank Ltd* [2004] NSWSC 695 (13 August 2004) [144] (Einstein J).

²⁰ Some US commentators have advocated the abolishment of veil piercing due to the dysfunctional nature of the doctrine. See, for example, Stephen Bainbridge, 'Abolishing Veil Piercing' (2001) 26 *Journal of Corporation Law* 479, 506–14. For a strong counter-view, see Robert Thompson, 'Piercing the Veil: Is the common law the problem?' (2005) 37 *Connecticut Law Review* 619.

²¹ *Caesar's Empire Karaoke (a firm) v Lam Chuen Ip* (Unreported, High Court of Hong Kong Special Administrative Region, Muttrie J, 24 March 2004, 4594/2003) [27]. For discussion on veil piercing,

One mechanism frequently argued as a basis for piercing the corporate veil within a corporate group is to allege that the parent and subsidiary company are involved in an agency relationship.²² At common law, the principal is liable for the contractual actions of its agent acting with the scope of its authority.²³ Commonly it is argued that where a parent company totally controls its subsidiary, so that the subsidiary can be said to not have a separate existence, the parent company is the principal and should therefore be liable for the authorised conduct of its subsidiary.²⁴ However, an assessment of modern Australian decisions on this point reveals that control—even overwhelming control—of a company is not sufficient to create an implied agency between the company and the controller.²⁵ The judicial attitude to the treatment of companies within corporate groups is captured in the following remarks by Dodds-Streeton J in *Varangian Pty Ltd v OFM Capital Ltd*:

The underlying unity of economic purpose, common personnel, common membership and control have not been held to justify lifting the corporate veil. As recognised by Rogers J in *Briggs v James Hardie & Co Pty Ltd*, even the complete domination or control exercised by a parent over the subsidiary is not a sufficient basis for lifting the corporate veil. This is an area in which ‘the law pays scant regard to the commercial reality’.²⁶

The above discussion demonstrates that Australian corporate law is reasonably settled on the point that parent and subsidiary company relationships commonly involve extensive (even overwhelming) control being exercised by the parent, however this is not sufficient to pierce the corporate veil to ignore the separate and distinct existence of the subsidiary entity. It is somewhat surprising then that the Commissioner of Taxation has been locked in a prolonged battle with mining giant BHP Billiton concerning the tax treatment given to financial arrangements between various wholly-owned subsidiaries. The commissioner’s argument, as we shall see below, is based on a complete disregard of the separate legal status of the subsidiaries.

see Anil Hargovan, ‘Piercing the Corporate Veil on Sham Transactions and Companies’ (2006) 24 *Company and Securities Law Journal* 436; Anil Hargovan, ‘Breach of Directors’ Duties and the Piercing of the Corporate Veil’ (2006) 34 *Australian Business Law Review* 304; Anil Hargovan and Jason Harris, ‘Piercing the Corporate Veil in Canada: A comparative analysis’ (2007) 28 *The Company Lawyer* (UK) 58.

²² Ian Ramsay and David Noakes, ‘Piercing the Corporate Veil in Australia’ (2001) 19 *Company and Securities Law Journal* 250.

²³ Francis Reynolds, *Bowstead and Reynolds on Agency* (Sweet and Maxwell, 17th ed, 2001) art 73.

²⁴ See the frequently cited, although rarely applied, decision of Atkinson J in *Smith Stone & Knight Ltd v Birmingham Corp* [1939] 4 All ER 116. For a critique see Jason Harris, ‘Lifting the Corporate Veil on the Basis of an Implied Agency’ (2005) 23 *Company and Securities Law Journal* 7.

²⁵ *ACN 007 528 207 Pty Ltd (in liq) v Bird Cameron* (2005) 91 SASR 570; *McConnell Dowell Constructors (Aust) Pty Ltd v Gas Transmission Services WA (Operations) Pty Ltd* [2007] VSC 301; *Premier Building and Consulting Pty Ltd v Spotless Group Ltd* (2007) 64 ACSR 114. See further Anil Hargovan and Jason Harris, ‘The Relevance of Control in Establishing an Implied Agency Relationship Between a Company and its Owners’ (2005) 23 *Company and Securities Law Journal* 459.

²⁶ [2003] VSC 444 (12 November 2003) 28–9 [142]. See similar comments in *Ace Property Holdings Pty Ltd v Australian Postal Corp* [2010] QCA 55 (19 March 2010) 24–5 [88] and in *Adams v Cape Industries plc* [1990] Ch 433, 536.

III The BHP Billiton litigation

A *The facts of the dispute*

The facts of the dispute include tax deductions associated with the costs of two major industrial developments that involve several billion dollars. A large number of companies were involved and the nature of the transactions was complex. The following is a concise explanation of the main facts.

BHP Billiton Ltd is one of the largest mining and resources companies in the world with a market capitalisation value in excess of US\$165 billion,²⁷ and has operations that span the globe.²⁸ To speak of the company as a single entity (BHP Billiton) is in fact a misstatement as the ‘company’ is made up of dozens of subsidiary companies and other controlled entities that operate in six continents.²⁹ The scale of operations undertaken by the corporate group required a continuous stream of significant debt finance. BHP Billiton was of the view that it would be a complicated and inefficient process for each of the controlled entities in the group to arrange their own finance, which led the group to establish a finance subsidiary in 1975 to act as a treasurer for the entire group (BHP Billiton Finance Ltd—‘Finance Ltd’).

Finance Ltd borrowed funds for operational purposes from a range of external creditors (who were not members of the BHP Billiton group) using a mix of short-, medium- and long-term funding arrangements. The sources of finance included single and syndicated bank loans, commercial paper and medium-term notes with creditors based largely in the United States, Europe and Japan. Finance Ltd was a wholly-owned subsidiary within the BHP Billiton group and had no individual employees. Its workforce was provided by other entities in the BHP Billiton group which were paid from Finance Ltd’s funds for the supply of labour and other financial and accounting services. As a wholly-owned subsidiary it is unremarkable to note that the Board of Finance Ltd was made up of appointees from the parent company. All funds borrowed by Finance Ltd were guaranteed by the parent company BHP Billiton.

During the relevant period in the late 1990s, Finance Ltd provided all of the debt finance for the members of the BHP Billiton group which amounted to tens of billions of dollars. Finance Ltd lent money to the members of the group on standard terms and conditions that were the same for all transactions. Finance Ltd’s lending and borrowing activities each year were determined by treasury guidelines set by BHP Billiton finance and accounting staff and approved by senior finance, tax and accounting executives in the group and ultimately by the parent company’s board. Decisions about the capital funding structure of particular projects were made by

²⁷ BHP Billiton is a dual listed company as a result of the merger between BHP and Billiton in 2001. Its securities are listed on various securities exchanges around the world (with primary listings on the ASX and London Stock Exchange).

²⁸ BHP Billiton, *Annual Report 2010*, 5.

²⁹ *Ibid* notes to the financial statements 25, 26.

the parent company and then implemented by Finance Ltd to the extent the projects required debt funding.

Borrowers within the BHP Billiton group were required to maintain loan accounts with Finance Ltd's external bank facilities that involved a daily cash sweep. At the end of each day the accounts were cleared out and recorded as either being in debit or credit. Finance Ltd earned significant interest income (in excess of \$1 billion) each year from the repayment of the various loans it made to group members, which it paid tax on.

The dispute at the centre of the case concerned the tax deductibility of two failed projects undertaken by the BHP Billiton corporate group during the 1990s.

B *The first project*

The first project involved BHP Direct Reduced Iron Pty Ltd ('DRI') which was established to build and manage an industrial plant that would produce a saleable product made from the waste generated from the group's substantial iron ore mining activities. At the time of the project's commencement in 1995, it was considered that the waste produced from the iron ore activities was a drag on the profitability of the group, not only because of the nil value of the waste but also because of the cost of storing the waste. The project was forecast to realise significant internal rates of return (in excess of 17 per cent) although this would require the expenditure of several billion dollars in construction and maintenance costs. Approval was granted to undertake the project and funding was provided by a mix of debt from Finance Ltd and equity from other companies in the BHP Billiton group. The group's Treasury Guidelines stated that projects should not be funded from 100 per cent debt unless necessary.

The DRI project experienced significant technical problems that resulted in diminished capacity and quality of output. More frequent maintenance was required than was originally anticipated and this contributed to delays and increased the costs of the project. The global market for its product also dropped in value. These developments led to significant writedowns in the value of the project by more than \$1 billion. Finance Ltd provided a letter of comfort to the directors of DRI stating that it did not intend to seek repayment within 12 months of its loans to DRI. The amount owed by DRI to Finance Ltd at this time was more than \$2 billion.

A strategic review undertaken by Ernst & Young in 2000 indicated that the value of the DRI project was only \$346 million, and would be nil if the project was shut down. The board of directors of Finance Ltd resolved to record the majority of the loans owed by DRI as bad debts (amounting to over \$1.8 billion) with a provision set aside for the remaining \$346 million. The directors of Finance Ltd also resolved at this time that 'it would not be economically prudent to expend additional monies in taking proceedings to recover any or all of the [loan funds] once they have been written off'. Finance Ltd also gave written assurance to the directors of DRI that it would not seek to recover its debts for the next 12 months, although it reserved the right to do so.

However, within the next 6 months further capital expenditure was made which seemed to resolve the technical issues and BHP subsequently took action under the *Income Tax Assessment Act 1997* (Cth) div 245 to cancel a substantial

portion of the losses that Finance Ltd had previously claimed as bad debt deductions.

C *The second project*

The second project concerned a mineral sands operation in Western Australia (WA) known as BHP Titanium Minerals Pty Ltd ('TM'). TM was a wholly-owned subsidiary in the BHP Billiton group. The group's plan was to develop the mining facility in conjunction with the acquisition of a mineral processing facility in Norway, with the product of the project being shipped from WA to Norway. The facility, which cost over \$300 million to construct and maintain, was funded by Finance Ltd after approval from the BHP Billiton board. The project, however, was plagued by technical problems from the start that resulted in several large writedowns. After an attempt to sell the business failed, the directors decided to close it down and Finance Ltd wrote off its debt.

The parent company provided several letters of comfort to the TM directors to assist with their assessment of the company's solvency. The comfort letters stated that Finance Ltd did not intend to call on the repayment of the loan for the duration of the letter (usually 12 months). The comfort letters were then replaced by a formal deed of support which covered the TM directors from future liabilities relating to their obligations to the WA Government under the terms of the mining agreement. Once this support deed was executed, the comfort letter was revoked and Finance Ltd called in the repayment of the debt. When the debt could not be repaid (which Finance Ltd knew at the time of calling for the repayment of the debt) it took the remaining balance held in its account for TM in partial repayment (approximately \$11 million) and wrote off the remaining loan as a bad debt.

IV BHP Billiton's tax claims

As noted above, Finance Ltd wrote off large portions of its debts owed by DRI and TM as being bad. It claimed these as deductions under the *Income Tax Assessment Act 1997* (Cth) s 25.35, which requires that the debt be lent during the course of a business lending money. Importantly, for the purpose of the appeal to the High Court, the tax treatment of the debt-funded development costs were not subjected to the limited recourse loan provisions in the *Income Tax Assessment Act 1997* (Cth) div 243.³⁰ These provisions require tax deductions for capital allowances to be reduced where some or all of the loan funds that allowed the acquisition of the asset (whose value was then written-down) was limited recourse debt.³¹ Limited recourse

³⁰ A substantial portion of the debts were however subject to consolidation after BHP Billiton became a consolidated tax group following the introduction of group consolidation rules after the relevant events occurred. For a discussion of the tax consolidation regime see Kristen Grover, 'Impact of the Consolidation Regime on Project Finance in Australia' (2004) 23 *Australian Resources and Energy Law Journal* 246.

³¹ A capital allowance deduction involves recognition for the depreciating value of a capital asset, in this case the value of the plant and equipment funded by the loans from Finance Ltd. Capital allowance deductions are permitted under a number of divisions of the 1997 Act: see for example, *Income Tax Assessment Act 1997* (Cth) divs 40 and 43.

debt is determined by consideration of whether the creditor's enforcement rights are limited in some way, including a limitation of recourse only to the property acquired by the loan funds.³² An alternative mechanism for establishing the existence of limited recourse debt is to examine the relationship between the debtor and creditor and make an assessment whether it is:

(2) ... reasonable to conclude that the rights of the creditor as against the debtor in the event of default in payment of the debt or of interest are capable of being limited ... hav[ing] regard to:

the assets of the debtor ... ;

any arrangement to which the debtor is a party;

whether all of the assets of the debtor would be available for the purpose of the discharge of the debt ... ;

whether the debtor and creditor are dealing at arm's length in relation to the debt.³³

The limited recourse debt provisions were introduced as part of the tax law reforms in 1997 and have no previous place in Australia's tax laws.³⁴ They serve the purpose of ensuring that capital allowances do not over-compensate for losses recorded by the borrower when they were never fully at risk of having to repay the debt in full. The BHP Billiton dispute is significant as it is the first case to consider the scope of div 243.

The Commissioner of Taxation issued a notice disallowing the deductions on the basis that Finance Ltd was not operating a business of lending money but rather as a mere conduit for BHP Billiton's investment activities. Furthermore, the commissioner challenged the quantum of deductions claimed under both the general anti-avoidance rules and div 243. The assessment was challenged by Finance Ltd in the Federal Court.

A Case history

The following matters fell for determination before the Federal Court:

1. whether Finance Ltd was entitled to a deduction in respect of each amount written-off as bad;
2. in relation to the TM loan, whether the loan was in fact bad and whether the commissioner made a valid determination under general anti-avoidance rules in *Income Tax Assessment Act 1936* (Cth) pt IVA to cancel that bad debt deduction; and

³² *Income Tax Assessment Act 1997* (Cth) s 243.20(1).

³³ *Ibid* s 243.20(2).

³⁴ Thomsonreuters, *Australian Income Tax 1997 Commentary* (Thomson Tax and Accounting Online database and loose-leaf service), [243.1010], (viewed 20 October 2010).

3. in relation to the DRI project, whether div 243 applied to disallow capital allowance deductions claimed by BHP Billiton as head entity of a tax consolidated group in respect of the decline in value of DRI's assets.

B Was Finance Ltd in the business of lending money?

The main issue for determination here was whether Finance Ltd was in the business of lending money and, if so, whether each loan was made by the company in the ordinary course of business. The main submissions of the commissioner centred on a theme which disputed that Finance Ltd was a separate legal entity and alleged that it was acting at the behest of the corporate group.

The primary judge concluded that the fact that the directors of the corporate boards overlapped and that Finance Ltd relied upon the staff and processes of the corporate group (for which it paid a fee), did not detract from the inevitable finding that Finance Ltd was not a sham, nor a mere conduit.³⁵ Justice Gordon held that the commissioner's submissions to the contrary were not only against the facts, but also, contrary to long established legal authority.³⁶ The fact that Finance Ltd might have been, or in fact was, acting in the corporate group's interests was held not to be unusual.³⁷

The Full Court, in a unanimous judgment,³⁸ emphatically dismissed the appeal by holding that the facts did not support the commissioner's argument that Finance Ltd was in a business that was merely an appendage to the business of the corporate group as a whole.³⁹ Justice Edmonds, on behalf of the Full Court (Sundberg and Stone JJ agreeing), held that this was not a case where Finance Ltd's activities of borrowing and lending money were ancillary, subservient or subordinate to some other business carried on by Finance Ltd. On the contrary, his Honour held that the evidence established that:

Finance's activities involved the borrowing of money and the lending of that money to companies in the Group; that these activities were carried on over a substantial number of years on a regular and systematic basis; that the amounts ... involved very substantial sums of money; that the amounts lent were invariably lent at a rate of interest higher than the rate at which it borrowed those funds; that in consequence, over a period from 1986 to 2002 it derived interest income in excess of \$34 billion, accounting profits after tax in excess

³⁵ *BHP Billiton Finance Ltd v Commissioner of Taxation* (2009) 72 ATR 746 (Gordon J).

³⁶ See authorities cited in n 6 above.

³⁷ For a similar conclusion, see *NEAT Domestic Trading Pty Ltd v AWB Ltd* (2003) 216 CLR 277 which was relied on.

³⁸ *Commissioner of Taxation v BHP Billiton Finance Ltd* (2010) 182 FCR 526.

³⁹ The court relied on the following precedents for the trite proposition that, where a subsidiary, even if wholly owned by a parent company, carries on a business, the business is that of the subsidiary not the parent irrespective of how closely it may monitor the business activities of the subsidiary: *Commissioner of Taxation v Bivona Pty Ltd* (1980) 21 FCR 562; *Commissioner of Taxation v Tasman Group Services Pty Ltd* (2009) 180 FCR 128.

of \$2.8 billion and aggregate taxable incomes in excess of \$4.4 billion; more telling, in only two of those 17 years did it suffer a taxable loss ...⁴⁰

The commissioner's submissions, under such circumstances, were held to be 'perverse'.⁴¹ In light of the undisputed evidence which showed that Finance Ltd was a separate legal entity which exercised an independent corporate mind, the Full Federal Court affirmed that the write-off of the BDI debt and the TM debt as bad were losses incurred by Finance Ltd and, indeed, were allowable deductions under s 8.1(1) of the *Income Tax Assessment Act 1997* (Cth).⁴²

C Was Part IVA applicable to the deduction for the write-off of the TM debt as bad?

Part IVA of the *Income Tax Assessment Act 1936* (Cth) relates to schemes designed to obtain a tax benefit.⁴³ The Full Federal Court, in agreement with the primary judge, held that the existence of comfort letters did not preclude Finance Ltd from writing the debt off as bad on the basis that all the evidence pointed to the TM debt being 'conjecturally bad'⁴⁴ before the revocation of the comfort letter. In light of this conclusion, it followed that Finance Ltd could not have obtained a tax benefit in connection with the scheme (that is, the replacement of the comfort letter with a narrower deed of support and the subsequent removal of the comfort letter) identified and relied upon by the commissioner. Justice Edmonds noted in passing, with reference to the commissioner's concession on this issue, that the writing-off of the TM debt by Finance Ltd was the most obvious and simple commercial solution and that this course of action was not surprising having regard to the facts of the case.

1 Division 243

The Full Federal Court affirmed the primary judge's conclusion that the loans from Finance Ltd to DRI were not 'limited recourse debt' for purposes of div 243, described earlier. As a matter of statutory interpretation, the commissioner contended that in determining whether the rights of the creditor (Finance Ltd) against the debtor (DRI), in the event of default by the debtor, are limited wholly or predominantly to rights in relation to the debt property—the word 'rights' in s 243.20(1)(a) should be given a wide meaning extending beyond contractual rights to also include legal rights. Furthermore, the commissioner submitted that the word 'limited' did not ask whether the rights on a relevant event of default were contractually confined in some way, but rather how far, in practice, were those

⁴⁰ *Commissioner of Taxation v BHP Billiton Finance Ltd* (2010) 182 FCR 526, 537 [23].

⁴¹ *Ibid* 537–8 [24]. The court relied upon the test in *Fairway Estates Pty Ltd v Federal Commissioner of Taxation* (1970) 123 CLR 153 to determine whether the lending by Finance Ltd was made in the ordinary course of its business of lending money.

⁴² For a similar result in a case also involving loans made to other subsidiaries of the Foster's group involving written-off bad debts, see *Ashwick (Qld) No 127 Pty Ltd v Commissioner of Taxation* [2009] FCA 1388.

⁴³ For definition of 'tax benefit', see s 177C(1) of the *Income Tax Assessment Act 1936* (Cth); for definition of 'scheme', see s 177A(2) of the Act. A similar attempt by the commissioner to use pt IVA to disallow deductions claimed by corporate group members of the Foster's group was unsuccessful in *Ashwick (Qld) No 127 Pty Ltd v Commissioner of Taxation* [2009] FCA 1388.

⁴⁴ *Commissioner of Taxation v BHP Billiton Finance Ltd* (2010) 182 FCR 526, 551 [68].

legal rights projected to extend. According to the commissioner, this approach looked to the financial position of the borrower at the time the advance was made rather than any contractual confinement of the lender's recourse to determine whether the lender's rights on a relevant event of default were 'limited' in the sense used in the section.

After reviewing the legislative policy underlying div 243, namely to reverse capital allowance deductions that have been obtained for expenditure funded by debt when the debtor is not fully at risk in relation to the expenditure and the debt is not fully repaid, Edmonds J (Sundberg and Stone JJ agreeing) rejected the commissioner's contentions for the following reasons:

the proper construction of ss 243.20(1) and (2) ... are to be construed so that their application is confined to situations where, at the time of borrowing, the debtor is not fully at risk in relation to the expenditure because of contractual limitations on the lender's rights of recourse on a relevant event of default or, where, at the time of borrowing, the debtor or someone else has the capacity to subsequently bring about that state of affairs.⁴⁵

The Full Court agreed with the primary judge's approach that it is to be inferred that where, as here, all of the assets of the debtor (DRI) are available for the purpose of the discharge of the debt, that would be a factor supporting the conclusion that the rights of the creditor (Finance Ltd) against the debtor (DRI) in the event of default are not capable of being limited in the manner specified.⁴⁶ A contrary finding could result in all loans to start up businesses being classified as limited recourse.

V Issues before the High Court

The commissioner sought special leave from the Full Federal Court's decision in respect of both projects. In relation to the TM project, the commissioner sought to challenge the lower court's refusal to apply the powers in pt IVA of the *Income Tax Assessment Act 1936* (Cth). The High Court refused special leave on this matter, which left only the DRI project losses.

The court granted special leave to appeal the lower court's refusal to characterise the DRI loans as limited recourse or non-recourse under div 243 of the *Income Tax Assessment Act 1997* (Cth). The central point in this argument is whether the capital allowance deductions (in writing-off most of the value of the DRI project) obtained by BHP Billiton should have been reduced because in making the loans Finance Ltd was never fully at risk.

The commissioner's argument for special leave concerns the proper interpretation of s 243.20 of the *Income Tax Assessment Act 1997* (Cth). Subsection (1) of that provision provides a definition of limited recourse debt by reference to limitations in the creditor's legal rights in enforcing the repayment of the loan.

⁴⁵ Ibid 581 [104].

⁴⁶ Ibid 581-2 [106].

Subsection (2) of that provision goes on to say that debt is *also* limited recourse if it is reasonable to conclude that it is having regard to a range of factors. The main point of difference between the parties in the High Court appeal is to determine how these two provisions work together. The relevant portions of the section are as follows:

243.20 What is limited recourse debt?

(1) A limited recourse debt is an obligation imposed by law on an entity (the debtor) to pay an amount to another entity (the creditor) where the rights of the creditor as against the debtor in the event of default in payment of the debt or of interest are limited wholly or predominantly to any or all of the following:

- (a) rights (including the right to money payable) in relation to any or all of the following:
 - (i) the debt property or the use of the debt property;
 - (ii) goods produced, supplied, carried, transmitted or delivered, or services provided, by means of the debt property;
 - (iii) the loss or disposal of the whole or a part of the debt property or of the debtor's interest in the debt property;
- (b) rights in respect of a mortgage or other security over the debt property or other property;
- (c) rights that arise out of any arrangement relating to the financial obligations of an end-user of the financed property towards the debtor, and are financial obligations in relation to the financed property.

(2) An obligation imposed by law on an entity (the debtor) to pay an amount to another entity (the creditor) is also a limited recourse debt if it is reasonable to conclude that the rights of the creditor as against the debtor in the event of default in payment of the debt or of interest are capable of being limited in the way mentioned in subsection (1). In reaching this conclusion, have regard to:

- (a) the assets of the debtor (other than assets that are indemnities or guarantees provided in relation to the debt);
- (b) any arrangement to which the debtor is a party;
- (c) whether all of the assets of the debtor would be available for the purpose of the discharge of the debt (other than assets that are security for other debts of the debtor or any other entity);
- (d) whether the debtor and creditor are dealing at arm's length in relation to the debt.

As can be seen, the definition of limited recourse debt contains two parts and here lies the difficulty with the construction issue. One way to interpret the provisions is to treat them separately so that sub-s (1) deals with legal limitations to recovery, while sub-s (2) deals with practical limitations to recovery. Another way to construe sub-s (2) is to hold that it builds on the scope of sub-s (1) so that a practical ability to limit the creditor's rights to recover (in a way mentioned in sub-s (1)) would constitute limited recourse debt.

The commissioner argued during the special leave hearing that the lower courts failed properly to address the scope of sub-s (2). However, with respect, it is difficult to see how loans from Finance Ltd for the DRI project could be characterised as limited recourse. The mere fact that the loans were made in an intra-group financing arrangement does not necessitate the result that the loans are practically or legally limited. Counsel for the commissioner noted in the special leave hearing that the debtor and creditor were not necessarily dealing with each other on an arm's length basis (which is a relevant consideration under s 243.20(2)(d)). However, the terms of the intra-group loans were stricter than the terms under which Finance Ltd dealt with its external lenders. Simply put, Finance Ltd expected to (and in fact did) earn profits from the loans it made. Loans were made under commercial terms with group borrowers, not as part of a scheme to generate tax deductions but to make the funding arrangements as simple as possible for external lenders. Finance Ltd expected to be paid and demanded commercial decisions to be taken by its debtors in response to deteriorating economic fundamentals associated with the project.

Furthermore, the mere fact that the loans involved intra-group transactions does not mean that recourse was necessarily limited to the assets acquired through use of the loan funds in building the project (see s 243.20(2)(a)). The commissioner's assumption is that Finance Ltd would not seek to pursue another group company beyond the value of its capital assets. Finance Ltd made a commercial decision that to pursue DRI for the remaining balance would not be beneficial. It should be noted that Finance Ltd had already undertaken an extensive review of the project with external advisors.

It is difficult to argue that the intention of the parties at the time of making the loan was that Finance Ltd's rights would be limited to the capital developed in the project. The argument of economic equivalence was, in our view, rightly rejected by the lower courts. The operation of div 243, as a matter of statutory interpretation, does not extend to situations where companies borrow money to establish their business. In such situations, the creditor's rights of recovery are limited to the assets acquired with the loan funds because those are the only assets held by the company. In the case of the loans to DRI, Finance Ltd seized funds held with it on deposit and made provision for the estimated value of the capital assets while writing off the remaining loan funds as bad. To apply div 243 to such circumstances would be to render most start-up loans as limited recourse—a conclusion that defies common sense and would surely trigger the application of s 243.20(6):

(6) Also, an obligation that is covered by subsection (1), (2) or (3) is not a limited recourse debt if, having regard to all relevant circumstances, it would be unreasonable for the obligation to be treated as limited recourse debt.

Indeed, as observed by the Full Court, the construction contended by the commissioner would place business in this country, particularly for those involved in resources and infrastructure projects, in a ‘tortuous straight jacket’.⁴⁷

The ATO has clearly, and repeatedly, signalled its concern in public on the tax treatment of claims arising from intra-group money lending transactions.⁴⁸ Readily it is accepted that some in-house finance companies may seek to abuse tax provisions, seek to gain excessive tax deductions in an illegitimate manner and that the commissioner has a legitimate purpose to test the law and seek clarification on its operation in an appropriate case. It is unclear however, from the facts of the *present* case, what is the mischief that is being sought to be addressed by the commissioner in the context of commercial financial arrangements undertaken in legitimate intra-group transactions by sophisticated parties, with the lender (Finance Ltd) registered as a financial institution and money market operator. It is submitted that acceptance of the commissioner’s submission on the construction of div 243, with reference to the facts of the present case, will arguably result in a strained interpretation of div 243 and signify an attempt to drive a square peg into a round hole.

VI Conclusion

The use of corporate groups is an entrenched feature of the modern commercial world. The principle most famously recognised by the House of Lords in *Salomon v A Salomon & Co Ltd*—that a company is a separate legal entity regardless of the identity of its true owners—continues to have force more than 110 years later. It is worth repeating the basal proposition advanced by Tamberlin J in *Richard Walter Pty Ltd v Federal Commissioner of Taxation*:

I think it is artificial in the circumstances of the present case [corporate group context] to draw a distinction between the loans made to members of the group and loans to other persons or bodies.⁴⁹

It is easy to understand why wholly-owned corporate groups operating under a similar brand name such as BHP Billiton can result in misconceptions being made that the entities in the group are mere conduits or agents for the group and not independent in their own right. While a wholly-owned subsidiary usually takes its management and strategic direction from its parent or holding company, that in no way diminishes the separate and independent status that each company has. This simple proposition has profound legal consequences that pervade every aspect of the law.

⁴⁷ Ibid 582 [107].

⁴⁸ See the recent speech given by the Assistant Commissioner (Jim Killaly), ‘Assisting Compliance and Managing Tax Risks in the Large Market: Understanding ATO approaches and perspectives’ (Speech delivered at the Fifth Annual Corporate Tax Forum, Sydney, 18 May 2009).

⁴⁹ (1995) 95 ATC 4440, 4458.

The pending decision of the High Court of Australia in the *BHP Billiton* case involves financial transactions within corporate groups that are increasingly common and in widespread use in Australia for both small and large organisations. It is to be hoped that the Court will apply the rules in div 243 in a manner that reflects the explicit statutory direction in s 243.20(2) and (6)—that the characterisation of a loan arrangement as limited recourse debt must be reasonable in the circumstances.