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RICH J. I agree.

Appeal allowed. Order appealed from discharged. Rule nisi for prohibition discharged with costs. Respondent to pay costs of appeal.

Solicitor for the appellant, *F. W. Richards*, Crown Solicitor for South Australia.

Solicitors for the respondent, *Stock & Bennett.*

B. L.

[HIGH COURT OF AUSTRALIA.]

COLCLOUGH . . . . . APPELLANT;

AND

THE FEDERAL COMMISSIONER OF TAXATION . . . . . RESPONDENT.

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MELBOURNE, *March* 14.

Griffith C.J., Gavan Duffy, Powers and Rich JJ.

Income Tax—Assessment—Income from personal exertion—Employee of company—Shares issued to employee—Dividends—Remuneration for services—Income Tax Assessment Act 1915-1916 (*No.* 34 *of* 1915—*No.* 39 *of* 1916), *sec.* 3.

Pursuant to the articles of association of a company an employee received for his services, in addition to a fixed salary, the amount of the dividends upon a certain number of shares which were for that purpose allotted to him as fully paid up, but which he could only retain so long, substantially, as he remained in the service of the company.

Held, that the amount of such dividends was income from personal exertion within the meaning of sec. 3 of the *Income Tax Assessment Act* 1915-1916.

Decision of *Barton* J. reversed.

APPEAL from *Barton* J.

On an appeal by Richard Ernest Colclough from an assessment of him by the Acting Federal Commissioner of Taxation for income tax for the year 1916-1917, the following facts were admitted :—

For some years prior to 28th February 1913 Harry Huntington Peck and Richard Oren Peck carried on in partnership the business of stock, station and general agents, auctioneers and valuators under the style or firm of J. M. Peck & Sons, and the appellant was for many years prior to the above date engaged in the service of the firm as auctioneer, and was paid for such services partly by way of salary and partly by way of bonus calculated firstly at the rate of 2½ per centum, but afterwards increased to about 8 per centum, upon the net profits of the business from year to year. On 28th February 1913 a limited proprietary company was formed and duly registered to acquire and carry on the business. The shareholders in such company were H. H. Peck and R. O. Peck and certain other persons employed in the business. The company was formed in pursuance of a preliminary agreement dated 28th February 1913. The capital of the company consisted of £65,000, divided into 40,000 preference shares of £1 each, 9,063 employees' shares of £1 each, and 15,937 ordinary shares of £1 each.

By the memorandum of association it was provided that "Save as otherwise provided in the articles of association the holders of employees' shares shall have the same rights and privileges as the holders of the ordinary shares."

Among the articles of association of the company were the following :—

"8. The directors may allot the employees' shares remaining unallotted or any of them from time to time to such employees of the company as they think fit in consideration of services rendered and without payment in cash and such shares shall be issued as fully paid up.

"9. Each of the employees' shares shall whilst it is held by an employee of the company rank for dividend as if it were an ordinary share of £1 fully paid up and subject to the restrictions hereinafter contained shall confer all other rights and privileges as if it were such ordinary share and whilst held by any widow or mother of a

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deceased director under the provisions hereinafter contained it shall rank for dividend but shall not confer any other rights or privileges and whilst not held by an employee of the company or a widow or another as aforesaid it shall not carry the right to any dividend nor confer any other rights or privileges.

"10. An employee's share shall not be transferable except as provided by this article and articles 11 and 12. Any director of the company may by his will bequeath one-half of any employee's shares held by him at the time of his death to his wife during her life and widowhood or to his mother during her life and upon the death of the testator whilst acting as such director the said shares shall be transferred in accordance with the provisions of the said will and shall confer the limited rights as provided in clause 9 hereof. Upon the death or remarriage of the said wife or the death of the said mother as the case may be the executors or administrators of the deceased director shall transfer the said shares in accordance with the provisions of article 11.

"11. Whenever employees' shares are allotted or pursuant to these articles are transferred to any employee of the company such employee shall be entitled to retain and hold the same so long as he remains an employee of the company and if by death resignation withdrawal dismissal or otherwise he cease to be an employee of the company he or subject to article 10 his executors or administrators shall be bound upon the request in writing of the directors to transfer such shares without any payment therefor to such person as the directors may nominate and if such person is not an employee of the company such person shall at any time on the request of the directors transfer such shares to any employee of the company. Provided that in the case of any employee who at the time he ceases to be an employee of the company as aforesaid shall hold preference shares in the company he or his executors or administrators shall be entitled to hold and retain such number of employees' shares as shall from time to time be equal to one-sixth of the preference shares held by him or his executors or administrators.

"12. If any person who ought in conformity with the last preceding clause to transfer any shares makes default in transferring the same or no such person exists or can be found the directors may

by writing under the common seal appoint any person to make the transfer on behalf of the person in default and a transfer by such appointee shall be as effective as if it were duly executed by the person so in default. A certificate under the common seal that such power of appointment has arisen shall be conclusive for all purposes.

"13. In the preceding articles 'employee of the company' means and includes any salesman, manager, departmental manager, secretary, accountant, foreman, traveller, representative, clerk or workman, and all directors except Harry Huntington Peck and Richard Oren Peck."

By article 43 the appellant was appointed one of the directors of the company.

1,726 employees' shares in the company were allotted to the appellant in accordance with the memorandum and articles of association, and were issued to him as fully paid up. Since the date of the registration of the company the appellant has continued in the business, and has performed similar work and duties to the work and duties performed by him for the firm prior to the registration of the company. During the year beginning on 1st July 1915 and ending on 30th June 1916 the appellant received from the company a certain amount of income from the company including a certain sum for salary and a certain sum for dividends on the employees' shares. On 31st August 1916 the appellant, pursuant to the *Income Tax Assessment Act* 1915, furnished to the Federal Commissioner of Taxes a return showing the total amount of his income received from the company as income from personal exertion, and the Commissioner caused an assessment to be made whereby he assessed the appellant in respect of the sum received by him for dividends on the employees' shares as income derived from property. The appellant thereupon appealed to the High Court from such assessment.

In addition to the admissions evidence was given that prior to, and in contemplation of, the formation of the company an agreement was made that employees' shares should be allotted to each employee, including the applicant, the number of which should be such that each employee should receive in dividends from them a sum as nearly as possible equal to the bonus he had theretofore received;

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and that the dividends which had been paid were about 8 per centum of the net profits.

The appeal was heard by *Barton* J., who dismissed it with costs. From that decision the appellant now appealed to the Full Court of the High Court.

Starke, for the appellant. The substance of the matter should be looked at, and not the form. The substance is that the appellant received the dividends as remuneration for personal services rendered by him to the company, and the money paid is therefore income from personal exertion.

[GRIFFITH C.J. referred to *Syme* v. *Commissioner of Taxes* (1).]

Mann, for the respondent. In an ordinary case dividends received would be income from property. If an employer, instead of paying salary or wages to an employee, chooses to reward him for past services, and perhaps for future services, by bestowing on him property, as that term is ordinarily understood, then, although it is true that the employee receives the shares as remuneration for his services, the dividends from the shares lose the character of income from personal exertion within the meaning of the *Income Tax Assessment Act*. By virtue of the change in the nature of the right which the employee has and which was brought about by the formation of the company, the character of the reward changed into a fixed right of property to which is attached certain other fixed rights which he can enforce so long as he remains an employee. He has the right to vote and to exercise a control over the affairs of the company, and has a chattel interest in the property of the company. The motive for allotting shares to him is irrelevant to the question of what is the nature of the dividends upon them. As an indication of the nature of the rights the appellant has, he, being a director of the company, has a limited right to dispose of the shares. So far as the shares are concerned, he has changed his position from that of an employee to that of a member of the company. He has a valuable right of property which, by virtue of the *Companies Act* of Victoria, carries with it the right to share in the profits of the

(1) (1914) A.C., 1013.

company—a right not dependent upon his employment by the company.

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GRIFFITH C.J. It would be a misfortune if such a transaction as that in question were forbidden by law or made ineffectual by taxation. The question is whether the taxpayer is entitled to the benefit of the lower rate of taxation imposed on income from personal exertion, or whether the so-called dividends which he received in respect of the shares standing in his name must be regarded as income derived from property. There is no doubt that the money was, in fact, received by the taxpayer as agreed remuneration in respect of personal services rendered by him to the company. But it is said that the money cannot be so regarded, because it was in form paid by way of dividends from shares in the company. I think that the question must be determined by having regard to the substance of the transaction. Was the money received in substance and in fact personal earnings? The substance of the bargain between the taxpayer and the company is not in dispute. He is an employee of the company, and it is provided by the articles of association that employees may receive for their services, in addition to a fixed salary, a further sum to be calculated upon the basis of, and equal to, the amount of the dividends nominally payable on shares, which for that purpose are allotted to them as fully paid up, but which they can retain only so long, substantially, as they remain in the service of the company. As a matter of common sense, and apart from legal technicalities, that further sum is part of the remuneration for their services. The contention on behalf of the Commissioner is that the incorporation of the company renders such a transaction legally impossible. I do not think that the technical rules governing the mutual relations of companies and their members *inter se* have anything to do with the construction of the *Income Tax Assessment Act*, nor do I think that incorporation has the effect of preventing an honest transaction of that sort being carried out in that form. Such arrangements for the remuneration of employees by an interest in the profits of the adventure are at the present day regarded as worthy of encouragement. There is, on principle, no reason why the rate of an employee's remuneration

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Griffith C.J.

should not be fixed on any basis or payable in any form to which the parties agree. It is still remuneration for services, and if it is received in the form of money it is liable to income tax. My brother *Barton* held that this money was not income from personal exertion. We have not been favoured with his reasons, but I feel sure that, if he had heard the discussion that has taken place to-day, he would have agreed with the conclusion at which I have arrived.

I am of opinion that the appeal should be allowed.

GAVAN DUFFY J. I agree.

POWERS J. I agree.

RICH J. I agree.

Appeal allowed with costs. Appeal from Commissioner allowed with costs, and amount of assessed income to be reduced accordingly.

Solicitors for the appellant, *P. D. Phillips, Fox & Overend.*

Solicitor for the respondent, *Gordon H. Castle*, Crown Solicitor for the Commonwealth.

B. L.