[HIGH COURT OF AUSTRALIA.]

THE FEDERAL COMMISSIONER OF TAXATION . . . . . } APPELLANT;

AND

HYLAND . . . . . RESPONDENT.

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MELBOURNE, *Mar.* 26; *May* 10.

rk e J.

June 8, 9, 10, 16.

Knox C.J., Isaacs, Higgins, Gavan Duffy and Rich JJ.

Income Tax—Assessment—Income—Shares distributed by company—Capitalization of profits—"Current assessment"—Income Tax Assessment Act 1922 (*No.* 37 *of* 1922), *secs.* 16 (*b*), 20, 21.

Sec. 16 (*b*) (ii.) of the *Income Tax Assessment Act* 1922 provides that the assessable income of any person shall include, in the case of a member or shareholder of a company which derives income from a source in Australia, "the face value of shares distributed by a company to its members or shareholders in consequence of the capitalization of the whole or any part of the assessable income of the company which it is liable to include in its return for the purposes of its current assessment."

Held, by *Isaacs*, *Higgins*, *Gavan Duffy* and *Rich* JJ. (*Knox* C.J. dissenting), that the distribution of shares there referred to is a distribution made in the year next following the year in which the company has earned the income the whole or part of which it has capitalized.

Decision of *Starke* J. reversed.

APPEAL from *Starke* J.

Herbert Leslie Penfold Hyland, having been assessed for Federal income tax for the year 1922-1923 in respect of his income for the year 1921-1922, appealed from that assessment to the High Court.

The appeal was heard by *Starke* J., in whose judgment hereunder the material facts appear.

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Owen Dixon K.C. and *Russell Martin*, for the appellant.

Sir Edward Mitchell K.C. and *Herring*, for the respondent.

Cur. adv. vult.

May 10.

STARKE J. delivered the following written judgment:—

Penfold's Wines Ltd. took over an established business from a company of the same name, and during the first year of its trading, ending 30th June 1921, it made a profit of £68,591, which was carried to a Development Reserve Account. At an extraordinary general meeting of the company held on 6th December 1921, a resolution was carried that a dividend of one shilling and fourpence and four-fifths of a penny per share, amounting to the sum of £42,000, be declared from the profits earned during the year ended 30th June 1921, and that it be paid out of the moneys which were placed to the credit of development reserve, and that in lieu of payment of cash, shares to the full value of such dividend be issued to the shareholders entitled to the dividend in accordance with their respective rights thereto. The resolution was confirmed on 22nd December 1922. This resolution was acted upon, and proper entries made in the books of the company. The sum of £42,000 was carried to a Bonus Shares Distribution Account, and thence to Capital Account, and ultimately share certificates were issued to shareholders in accordance with the resolution and appropriate entries made in the Share Register. The genuineness of the transaction was not in any wise challenged, and I see no reason to suspect it, though it is uncertain when the entries in the various accounts were made, and some, at least, appear to have been made after the year 1922. Pursuant to the resolution of the company, 20,608 shares were issued or allotted to the appellant Hyland during the financial year 1921-1922, and the Commissioner has included the face value of those shares, namely, the sum of £20,678—it should be £20,608—in his assessable income for the financial year 1922-1923. It is from the inclusion of this sum in the assessment that an appeal has been brought to this Court.

The liability of the taxpayer depends upon a proper interpretation of the *Income Tax Assessment Act* 1922, sec. 16 (*b*) (i.) and (ii.).

James v. *Federal Commissioner of Taxation* (1) has not settled the question, for since that decision the law has been altered. By sec. 16 (*b*) (ii.) it is provided that the assessable income of a person shall include the face value of shares distributed by a company to its members or shareholders in consequence of the capitalization of the whole or any part of the assessable income of the company which it is liable to include in its return for the purposes of its current assessment. A phrase such as "capitalization of income," or of "profits," must be understood in the sense in which it is used in business. Thus *Palmer* (*Company Precedents*, Part I., 12th ed., pp. 1012-1013), writing upon the capitalization of profits, says:— "Cases very commonly occur in which it is desired to capitalize undivided profits. If the issued shares are only in part paid up, the capitalization can be effected by declaring a bonus out of the undivided profits and making a call payable at the same date. But more commonly what is desired is to issue paid-up bonus shares to the members and at the same time to carry from reserve to capital account a corresponding amount. . . . In order . . . . to compass what is desired, it is necessary to declare a bonus or dividend payable out of reserve . . . so that each member may have an individual right, and then this indebtedness of the company for the bonus or dividend can be satisfied by the issue of paid-up shares." (Cf. *Bouch* v. *Sproule* (2).) The latter method is that substantially adopted by the company and its shareholders in the present case: the transaction did not liberate and was not intended to liberate the accumulated profits of the company to the shareholders—it added to or increased the company's capital. That, in my opinion, is a capitalization of income within the meaning of the section.

But what is the "current assessment" of a company within the meaning of sec. 16 (*b*) (ii.) of the 1922 Act? In the present case the profits were actually made in the financial year 1920-1921; they were capitalized, and shares allotted to the shareholders of the company in the financial year 1921-1922, and the taxpayer is assessed for the financial year 1922-1923. These profits were part of the total assessable income of the company, which it was liable, under the income tax law then in force, to return, for the purpose of its

(1) (1924) 34 C.L.R. 404.

(2) (1887) 12 App. Cas. 385.

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assessment to income tax, for the financial year 1921-1922. The company was not liable to return these profits for the purpose of its assessment for the financial year 1922-1923: they were not income upon which the assessment of the company for that year could be based. The Commissioner contends that the "current assessment" referred to in the section is the assessment of a company current in the financial year in which the shares are distributed, namely, in this case, in the year 1921-1922. I am unable to assent to this view. Income tax is payable in respect of each financial year, based upon the income received during the twelve months preceding the year for which tax is payable (Act, sec. 13). Now, sec. 16 is ancillary to sec. 13. The income which can be included pursuant to sec. 16 must be income received for the twelve months preceding the financial year for which the tax is payable. Sec. 16 (*b*) (ii.) no doubt treats the distribution of shares by a company to its members as income received by those members. So far, then, it would seem that the taxpayer's income for 1922-1923 might include the full value of shares received in 1921-1922. But sec. 16 (*b*) (ii.) is more specific: the shares must represent assessable income which has been capitalized and which the company is liable to include in its return for the purposes of its current assessment. Those words suggest a period for the assessment identical with that for which the member of the company is also assessed. And that view is supported, I think, by the scheme of secs. 20 and 21. A company is allowed to deduct from its total assessable income for the financial year in respect of which it is being assessed, so much of that income as is distributed to its shareholders. The income must be derived by the company and distributed to its shareholders in the same period. And what the company deducts the shareholder adds to his assessable income. The provisions of secs. 20 (4) and 21 fall into line with this scheme. But it cannot be said, in the present case, that the profits capitalized and distributed in the form of shares formed part of the company's assessable income for 1922-1923, which is the period in respect of which the taxpayer is assessed. Consequently, the provisions of sec. 16 (*b*) (ii.) do not warrant the inclusion of the face value of the 20,608 shares in the taxpayer's assessment.

The Commissioner did not, as I understood the argument, rely upon sec. 16 (*b*) (i.) and the decision in *James's Case* (1), for in sec. 16 there is a proviso that "nothing in this section shall render liable to taxation the value of shares issued by a company to its members or shareholders in consequence of the capitalization of any other of its profits." It was rightly conceded, I think, that this proviso excluded from the assessable income of a taxpayer profits credited or paid to him as a shareholder as part of a capitalization scheme other than the profits covered by sec. 16 (*b*) (ii.).

Declare that the taxpayer was not assessable to income tax for the financial year 1922-1923 in respect of the sum of £20,678, as the face value of shares distributed to him by Penfold's Wines Ltd. Direct that the assessment be amended in accordance with this declaration and that the amount of tax paid by reason of the inclusion of the sum of £20,678 in the said assessment be refunded. Liberty to apply. Order the Commissioner to pay the costs of appeal.

From that decision the Federal Commissioner of Taxation now appealed to the Full Court.

Sir Edward Mitchell K.C. (with him *Herring*), for the appellant. In sec. 16 (*b*) (ii.) of the *Income Tax Assessment Act* 1922 the words "current assessment" mean the assessment of the company for the financial year in which the capitalization was made, and not the assessment of the company for the financial year in respect of which the shareholder was being assessed. Any other view would be impracticable, for there could not arise a case in which a company capitalized its profits in the same year in which those profits were earned. Alternatively, there being no article of association which authorized the company to capitalize its profits, what was done in this case by the company was *ultra vires* and could not bind dissenting shareholders. It must be taken, therefore, that each shareholder voluntarily took the dividend and applied it in taking up the new shares. Each shareholder, therefore, had an option as to whether he would or would not take up new shares. In sec. 16 (*b*) (ii.) capitalization means capitalization by the company, and does

(1) (1924) 34 C.L.R. 404.

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not apply to such a voluntary act on the part of shareholders (see *Inland Revenue Commissioners* v. *Coke* (1); *Inland Revenue Commissioners* v. *Fisher's Executors* (2); *Commercial Banking Co. of Sydney* v. *Federal Commissioner of Taxation* (3); *Federal Commissioner of Taxation* v. *Foster Brewing Co.* (4)). If that is so, the sum in question would be taxable under sec. 16 (*b*) (i.) (*James* v. *Federal Commissioner of Taxation* (5)).

Owen Dixon K.C. (with him *Russell Martin*), for the respondent. Sec. 16 (*b*) (ii.) renders taxable the distribution of such shares only as are paid up out of that income of a company which is not taxable in its hands. That income can only be income which is distributed by the company in the year in which it is earned. Sec. 20 (1) provides that, for the purpose of ascertaining the taxable income of a company, there shall be deducted from its total assessable income so much of the assessable income as is distributed to the shareholders. Sec. 20 (4) then provides that, where the distribution of income takes place in a year subsequent to that in which the income was derived, the shareholder shall receive a rebate on account of the tax already paid by the company thereon. The distribution in this case accomplished by the capitalization was made in the year following that in which the company derived the income. If the distribution by capitalization and allotment of shares had been made in the year in which the income so capitalized had been derived, such income might, on the one hand, have been deducted by the company from its assessable income under sec. 20 (1), and, on the other hand, the shares so distributed representing such income would have come within sec. 16 (*b*) (ii.), and would thus have formed part of the shareholder's assessable income. Sec. 16 gives directions to be obeyed in every year by those preparing the return for the taxpayer and the assessment by the Commissioner. Sec. 16 (*b*) (ii.) directs that in the case of a shareholder of a company his assessable income shall include the face value of shares distributed (that is, in the year upon which the assessment is based) by a company to its members in consequence of the capitalization (which must be

(1) (1926) 42 T.L.R. 329.
(2) (1926) 42 T.L.R. 340.
(3) (1917) 23 C.L.R. 102.
(4) (1917) 22 C.L.R. 545.
(5) (1924) 34 C.L.R. 404.

accomplished by such distribution and be therefore in the same year) of the whole or any part of the assessable income of the company (that is, again, for the year upon which the assessment is based) which it is liable to include in its return for the purposes of its current assessment (that is, the assessment in hand—then being made upon the company—current with that being made upon the member—contemporary with the assessment of the shareholder). In other words, sec. 16 (*b*) (ii.) taxes only the shares paid up out of the income of the company which otherwise would be the subject of assessment for the same financial year as that for which the shareholder is being assessed. There are cases in which a company might, in the same year in which it earns income, capitalize and distribute in the shape of shares the whole of that income, for example, where there is a winding up for the purpose of reconstruction when the business of the company is seasonal, where the company capitalizes in advance the income it expects to receive.

Sir Edward Mitchell K.C., in reply, referred to *Webb* v. *Federal Commissioner of Taxation* (1); *Brice on Ultra Vires*, 3rd ed., p. 47.

Cur. adv. vult.

June 16.

The following written judgments were delivered :—

KNOX C.J. The question for decision in this appeal is whether my brother *Starke* was right in holding that the respondent was not assessable to income tax for the financial year 1922-1923 in respect of the sum of £20,608, representing the face value of shares distributed to him by Penfold's Wines Ltd. The appellant relies on sec. 16 (*b*) (ii.) of the *Income Tax Assessment Act* 1922, which is in the words following :—"The assessable income of any person shall include the face value of shares distributed by a company to its members or shareholders in consequence of the capitalization of the whole or any part of the assessable income of the company which it is liable to include in its return for the purposes of its current assessment: Provided that nothing in this section shall render liable to taxation the value of shares issued by a company to its

(1) (1922) 30 C.L.R. 450.

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members or shareholders in consequence of the capitalization of any other of its profits." The respondent does not deny that the shares in question were distributed to him in consequence of the capitalization of part of the assessable income of the company, but he contends that in the circumstances the assessable income which was capitalized does not answer the description of " assessable income of the company which it is liable to include in its return for the purposes of its current assessment."

The relevant facts are (1) that the income capitalized was derived by the company in the financial year 1920-1921 (i.e., between 1st July 1920 and 30th June 1921); (2) that the capitalization and distribution took place in the financial year 1921-1922, and (3) that the assessment of the respondent now under consideration is that for the financial year 1922-1923 based upon income derived by him during the financial year 1921-1922. The question at issue really turns on the meaning to be attributed to the word " current " in the phrase " for the purposes of its current assessment."

Dealing first with the words used in sec. 16 (*b*) (ii.) apart from the other provisions of the Act, it will be observed that sec. 16 is to be applied for the purpose of determining what is to be included in the assessable income of the taxpayer. The assessable income of a taxpayer for a given financial year is the gross income not exempt from taxation derived by him during the preceding financial year. It follows that the occasion for the application of the section arises only in the financial year after that in which the taxpayer received the amount or benefit as to the inclusion of which in his assessable income the question arises. In the present case the shares were received by the respondent in the financial year 1921-1922, and there was therefore no occasion to apply sec. 16 (*b*) (ii.) until the return for the purposes of the assessment for the financial year 1922-1923 was being made up. The question which then required an answer in order to determine whether the section applied was—according to the literal meaning of the words of the section—" Is the company liable to include in its return for the purposes of its current assessment the income in consequence of the capitalization of which the shares were distributed to the shareholders ? " In this setting I think the expression " current

assessment" can only mean "assessment for the financial year now current," and if that be so the question suggested must be answered in the negative, for the liability of the company was to include the income in question in its return for the purposes of assessment for the financial year 1921-1922, the income having been derived in the financial year 1920-1921. It appears that the company had in fact included this income in its return for the purposes of assessment to income tax for the financial year 1921-1922 made under the Act then in force. Apart from other considerations, I think my brother *Starke* was justified by the very words of the enactment in concluding that "current assessment" should be read as meaning the assessment for the financial year for which the shareholder's income was being assessed. And I agree with him in thinking that this view is supported by a consideration of other provisions of the Act—particularly secs. 20 and 21.

The effect of sec. 20 (1) is that a company is not liable to pay income tax in respect of so much of its assessable income as is distributed to shareholders in the year in which such income is derived, but the amount so distributed is included in the assessable income of the shareholders who receive it. The result is that income tax is paid on the whole of the profits and there is no double taxation. If the company distributes no part of its profits during the financial year in which they were derived, the whole of such profits is included in the assessable income of the company. If such profits were distributed to shareholders in a subsequent year the amount received by each shareholder would be included in his assessable income for the next financial year, and, but for sub-sec. 4 of sec. 20, there would be double taxation. But that sub-section, read with sec. 16 (*b*) (i.), performs two functions: it prevents double taxation and at the same time ensures the collection of income tax on profits distributed to shareholders at the rate of tax appropriate in the case of each shareholder. It does this by allowing the shareholder a rebate calculated with reference to the tax paid in a previous year by the company on the amount distributed subsequently.

So long, therefore, as the amounts distributed by the company to shareholders could be regarded as distributions of income, the provisions of sec. 16 (*b*) (i.) and sec. 20 (fortified by sec. 21) effectively

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protected the revenue and prevented double taxation. But these provisions might be, and probably were, regarded as ineffectual to reach cases in which a company capitalized and distributed its profits in the financial year in which they were derived; for it might well be thought that in such a case, while the company could claim a deduction under sec. 20 (4) of the amount of profits so distributed, the shareholder receiving shares received them as capital and not as income and would not be liable to include the value of those shares in his return. In that event the amount of income of the company which was capitalized would escape income tax. It was, I think, in order to meet cases of that kind that sec. 16 (*b*) (ii.) was inserted in the Act; and that enactment, interpreted in accordance with the opinion expressed by my brother *Starke*, effectively provides for what is apparently the only case in which, in the absence of such a provision, part of the income of a company would escape liability to income tax.

On the other hand, the interpretation of the section suggested by the appellant inevitably results in double taxation in every case in which the capitalization and distribution—which must, it seems to me, be simultaneous—take place in any financial year other than that in which the income was derived; for, as I have pointed out above, in every case in which the order of events is that the income derived in one financial year is capitalized in a subsequent financial year the company is liable to assessment on the whole of the income derived and has no right to obtain a refund of any tax paid, or an alteration of its assessment, by reason of the subsequent capitalization and distribution of the whole or part of such income. The position may be summed up as follows:—Under the Act, apart from sec. 16 (*b*) (ii.), the only assessable income of a company which is excluded from liability to taxation is that which it distributes in the financial year during which it was derived by the company. The income so excluded is assessable in the hands of the shareholders to whom it was distributed, except perhaps in the case of capitalization of such income and distribution in the form of shares. It was necessary for the protection of the revenue to meet this excepted case in which income derived by a company would be excluded from liability to assessment, and sec. 16 (*b*) (ii.) effectively protects the revenue if

interpreted as applicable only where the capitalization and distribution take place in the financial year in which the income capitalized is derived by the company. If interpreted otherwise, the section involves double taxation in every case in which the capitalization and distribution take place in a financial year subsequent to that in which the income capitalized was derived by the company.

For these reasons I am of opinion the appeal should be dismissed.

ISAACS J. This is an appeal from a judgment of my brother *Starke* by which the respondent's assessment under the *Income Tax Assessment Act* 1922 was amended. The judgment declared that the respondent was not assessable to income tax for the financial year 1922-1923 in respect of the sum of £20,678 (really £20,608) as the face value of shares distributed to him by Penfold's Wines Ltd., with consequential directions. The amount of tax required of the respondent is considerable, but the legislation which applies to this case has practically lost general importance because it is superseded by provisions of a very different character.

The material facts giving rise to the controversy are these:— During the financial year 1920-1921, ending 30th June 1921, the company called Penfold's Wines Ltd. made £68,591 profit. In December 1921 the company capitalized £42,000 of those profits by resolving to create a dividend to be paid, not in cash, but in shares to the value of the dividend. The sum of £42,000 was carried to a Bonus Shares Distribution Account, and share certificates were, on 12th December 1921, issued to shareholders, including the respondent, in accordance with the resolution. On these facts the Commissioner contends and the respondent denies that the face value of the shares fell within par. (ii.) of sec. 16 (*b*) of the Act above mentioned as "assessable income" of the respondent. That paragraph, read with the governing and introductory words so far as they are material, is as follows: "The assessable income of any person shall include, in the case of a shareholder of a company which derives income from a source in Australia, (ii.) the face value of shares distributed by a company to its members or shareholders in consequence of the capitalization of the whole or any part of the assessable income of the company which it is liable to include in its return for the purposes

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of its current assessment." The contest is as to the true application of the words "current assessment." The Commissioner contends that "its current assessment" means the company's assessment in the year of capitalization, that year being the year immediately following the year in which the company received the income capitalized. The respondent contends that it means the company's assessment in the same year as the taxpayer's assessment—in a word, that "current" really means "concurrent."

The learned primary Justice agreed with the respondent's view. The matter has been very elaborately argued; but ultimately I am forced, on a consideration of the Act as a whole, to agree with the Commissioner's contention. I disavow any attempt to rest my conclusion on implications as to the policy of the Act or on the desirability of harmonizing all its provisions. That is all unnecessary and perhaps confusing. I simply, by the light of the statute as a whole, interpret the words of the relevant paragraph and apply them. But I must observe that the conclusion arrived at is not out of harmony with any relevant provision in the Act. For instance, the contention pressed for the respondent that the appellant's view results in an abnormal double taxation is met by the combined operation of sec. 16 (*b*) (i.) and sec. 20 (1), whereby every dividend or bonus distributed out of a company's profits of the previous year results in double taxation subject to certain subsequent adjustment. No point here arises as to subsequent adjustment. The only question argued or arguable—see sec. 51A (3) (sec. 12 of the *Income Tax Assessment Act* 1925)—was as to the value of the shares being "assessable income" of the "taxpayer" for the year of receipt.

The first words to consider are the opening words of the section. Here it is that I think the radical fallacy of the respondent's argument lurks. That argument is that those opening words, namely, "The assessable income of any person shall include" point to directions to be obeyed in preparing the return and the assessment. That is not the direct function of the words, though, as a consequence of the enactment, returns and assessments must conform. Their direct function is to declare what, besides ordinary income, shall be included in "assessable income," not for the consequential and

mechanical processes of returns and assessments, but for the purpose of *measuring liability*. Sec. 16 is under the heading Part III., "Liability to taxation." "Returns and assessments" are in Part IV., commencing with sec. 32. It is that section which gives the direction to a taxpayer as to what is to be included in a return. It is to be "the income derived by him from sources in Australia during the financial year ending on the preceding thirtieth day of June." To comply with this direction he must know what is the "income" for which he is liable, that is, what is the income to be assessed. For this he has to turn to Part III., where (*inter alia*) he finds sec. 16 which assumes that elsewhere in the Act the necessary directions as to returns will be found. The direct and immediate object of sec. 16 is perhaps more distinctly perceived when the definition of "assessable income" in sec. 4 is read, namely, "the gross income which is not exempt from taxation." That is the first step towards finding the ultimately "taxable income" so as to satisfy those words in the taxing Act. The latter Act places rates on "the taxable income" and incorporates the Assessment Act to which we must turn in order to ascertain individual liability. The process is :—(a) "Income" includes all mentioned in sec. 4, all that is comprised under the two heads "Income from personal exertion" and "Income from property." As a first step the "assessable income" is selected and made the basis, or primarily taxable income, and, finally, the taxable income is definitely obtained by permitted deductions from the "assessable income." For the purpose of declaring what shall be the "assessable income," sec. 16 is—among other sections—enacted. But the point is *it has reference to the year of income*; that is, it enacts that certain income received in that year shall go towards forming the fund which by sec. 23 is taken as the basis of *liability* subject only to permitted deductions, so as to arrive at "taxable income." That is all determined by what takes place during the year of income, though its official recognition and calculation take place next year. Sec. 16 is utterly unconcerned with the assessment of the taxpayer. This is the cardinal point of the matter. Mr. *Dixon* argued strenuously that the company's "current assessment" must have reference to the opening words of the section. If they have, then from what I have said it is apparent

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that they refer to the taxpayer's year of receipt of income and not to his subsequent year of assessment upon that income. Once we grasp that central fact, the matter works out almost automatically, always remembering that in the absence of special indications legislation, and particularly tax legislation, is presumed to meet ordinary affairs of life and not to be confined to out-of-the-way possibilities.

The " face value of shares distributed " is, then, an item statutorily declared to be part of the potentially taxable and, indeed, primarily taxable income of the receipt year. Subject to any permitted deductions it is taxable. But its potential or primary taxability is dependent on the origin of the shares. They must arise in consequence of " the capitalization of the whole or any part of the assessable income of the company." Again, we must observe that " the assessable income of the company " means potentially or primarily taxable income received in its income year. Further, the " assessable income of the company " which is capitalized must be such as it is liable to include in its return for the purposes of " its current assessment." When can it be said that the company " is liable " to include the converted profits in its return for the purposes of its current assessment ? " Current " is a relative term, and there is nothing to which, without violence to its context, it can be relative except the capitalization. As shown, there is not a word having reference to the taxpayer's assessment. That is a negative consideration. Then the provision refers to the " capitalization of the whole " of the assessable income of the company as well as of part. " Current," to fit the respondent's argument, must apply to the " capitalization of the whole " as well as to that of a part. But here I find an insuperable difficulty in his way. Speaking of ordinary and normal company operations, when can a company capitalize the whole of its year's profits ? Clearly only after the year of receipt has expired. The succeeding year is, therefore, the earliest normal year of capitalization of income as well as the legal year of the company's assessment. That is a positive consideration indicating that " current " relates to " capitalization." A tabulation of events will make the position clear :—Year 1 may be taken as the receipt year of company's income. Year 2 will be the company's assessment

year, its earliest normal capitalization year and probably its distribution year : if distribution, then also the taxpayer's receipt year of the income distributed. Year 3 is, in that case, the taxpayer's assessment year. If the respondent's view be correct, then, normally, the legislation under construction could not operate. It is possible to conceive of capitalization during Year 1 of part of the income of that year. Unless distribution also took place in that year the legislation again would, on the respondent's argument, normally fail to operate. If distribution took place in that year, then, on the respondent's view, the legislation would operate as to the portion of the income capitalized and as to no other part of that income. But the admitted possible operation as mentioned as to part would be improbable, assuming a genuine capitalization; much more improbable than an interim dividend or bonus without a permanent alteration of capital. It would mean permanent capitalization without knowing the result of the year's trading, and perhaps without being sure that subsequent operations during the year would not cut down the profits; and it would leave the normal operations of any capitalization in the next year and then distributing quite outside the statute. These are the considerations which lead me to the conclusion that the Commissioner's view ought to prevail, and that consequently this appeal should succeed.

My brothers *Gavan Duffy* and *Rich* authorize me to state that they have read and agree with this judgment.

HIGGINS J. The solution of this problem depends ultimately on the true meaning of sec. 16 (*b*) (ii.) of the *Income Tax Assessment Act* 1922; and when we ascertain the true meaning thereof it settles the problem, unless there be found something in the rest of the Act to negative or qualify that meaning. The construction must be upon the entire instrument. I address myself first to sec. 16 (*b*) (ii.) directly.

Sec. 16 states certain things which the assessable income of any person shall include; and (*b*), in the case of a shareholder of a company deriving income from Australia, it includes dividends paid or distributed to the shareholders by the company (sub-sec. (*b*) (i.)). But it is provided that where a company distributes to

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its shareholders accumulations of income—" any undistributed income accumulated prior to the first day of July one thousand nine hundred and fourteen "—the sum so received by him shall *not* be included as part of the shareholder's income. This effort to prevent dividends drawn from accumulations from being treated as shareholder's assessable income throws light on the following clause, sub-sec. (*b*) (ii.), where shares distributed, not dividends, are dealt with similarly.

Sec. 16 (*b*) (ii.) directs that shares distributed out of the assessable income of a company are to be included in the assessable income of the shareholder; but this is limited to such of the company's income as " it is liable to include in its return for the purposes of its *current* assessment." The full words are: " The face value of shares distributed by a company to its members or shareholders in consequence of the capitalization of the whole or any part of the assessable income of the company *which it is liable to include in its return for the purpose of its current assessment.*" The question is: What is the meaning of the company's current assessment—current when ?

Here we have to recall the fact that, under the scheme of the taxation, a company is assessed for the year July 1921 to July 1922 on its income earned in the year July 1920 to July 1921 (sec. 13 (1)), and that it pays tax for the year of assessment on the basis of its income earned in 1920-1921. If it pays a dividend to its shareholders out of these profits in 1921-1922, each shareholder is to include the dividends which he gets in his assessment for the financial year 1922-1923. But if, in place of dividends, the company distribute shares to the shareholders on capitalization of the profits, the face value of the shares distributed in 1921-1922 is to be included as dividends would be included, in the assessment of the shareholder for the year 1922-1923. The shareholder's assessment in such a case must be for the year *after* the year for the company's assessment. The intention is obviously to prevent (as is prevented in the case of dividends being distributed instead of shares) the inclusion in the shareholder's assessment of any shares issued out of accumulations of profits made in previous years, and to limit the inclusion of

the shares in the return to shares distributed out of profits of the company, made in the next preceding year and not before.

But why, it may be asked, is the limitation expressed as it is? Probably the reason was that profits *might* be capitalized and shares distributed in the very year that the company derived the profits; and therefore the limitation was not to the company's profits derived in the year preceding the shareholder's receipt of the shares, but to the "assessable income of the company"—the profits of the company—which the company would have (but for the distribution) to include in its return for assessment purposes during the year of distribution of the shares.

But whatever may be the reason for the phraseology adopted, it seems obvious that, under the circumstances of this case, where the company earned the profits in 1920-1921, and capitalized them, and distributed the shares in 1921-1922, the shareholder has to include the face value of the shares distributed to him in his return for 1922-1923; because the company is liable to include the assessable income (out of which the shares came) in its return for assessment for the year 1921-1922. The "current" assessment of the company refers to the assessment for the year of distribution to the shareholders. "Current" means current during the year of the operation referred to in the paragraph—that is to say, the operation of distribution. The distribution of shares out of income, like the distribution of dividends out of income, reduces the company's assessment and increases that of the shareholder.

Then the proviso to sub-sec. (*b*) (ii.) is seen to be merely a proviso for greater caution. It merely says that nothing in the section is to make shares liable to taxation (shares issued to a shareholder) if they are out of *other* profits of the company (such as old accumulations or income from former years).

So far, I should have thought that the Commissioner is obviously right in treating these shares which come to the shareholder in 1921-1922 as assessable income of the shareholder for 1922-1923. A distribution of shares is to be included in the assessment for 1922-1923 in the same way exactly as a distribution of dividends.

But reliance is placed by the taxpayer on sec. 20 (1): "For the purpose of ascertaining the taxable income of a *company* there shall

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be deducted from the total assessable income, in addition to any other deductions allowed by this Act, so much of the assessable income as is available for *distribution* and *is distributed* to the . . . shareholders of the company." This sub-section has nothing to do with the distinction between the year of deriving income and the year of assessing income ; and it has nothing to do with the assessable income of a shareholder. It deals with the assessment of the *company* ; and it merely provides that the company is not to include in its return income which, being available for distribution, is in fact distributed to the shareholders. The shareholder is taxed on the dividends that come to him ; and the company is not to be taxed on the amount of its income that goes in dividends.

If the company should happen to include in its return required for 1921-1922 all its income made in 1920-1921, and should afterwards in 1921-1922 decide to distribute some of that income in shares among the shareholders, there are provisions in Part IV. framed to enable the Commissioner to alter his assessment so as to meet the position (sec. 37, &c.) and double taxation of the same income is thus avoided. And when the company has actually paid income tax on undistributed income which is afterwards distributed, special provision is made by sec. 20, sub-sec. 4—" Where a company *has paid income tax on undistributed income* and that income is in any year subsequent to that in which it was derived by the company distributed to the . . . shareholders of the company, a . . . shareholder who is a taxpayer shall be entitled to a rebate " (described) " in his assessment."

This sub-section does not apply to this case. The company has not paid income tax on the part of its income distributed to its shareholders in 1921-1922. The idea obviously is that if the company has paid income tax on income distributed *after* the year in which the company derives its income, the shareholder is not to suffer, by taxation on the same income both through the company's assessment and through his own assessment. To speak more accurately, he is allowed a rebate.

As for sec. 21, it relates to the case of a company retaining its income and not making a reasonable distribution thereof. The

Commissioner is to determine what sum could reasonably have been distributed, to calculate the additional tax which would have been payable by the shareholders if it had been distributed; and the company has to pay the excess of that additional tax over the tax payable by the *company* on the sum determined.

Now, in what way can it be reasonably said that these secs. 20 and 21, on which counsel for the taxpayer relies, negative or qualify the natural meaning of the section ultimately in question—sec. 16 (*b*) (ii.)? Mr. *Dixon* has handed up a useful compendium of his argument, stating:—The taxpayer contends that this provision renders taxable the distribution of such shares only as are paid up out of that income of a company which is *not* taxable in its hands. The income is and can only be income which is distributed by the company in the year in which it is earned."

No doubt, any income of the company derived by it in the year 1920-1921, and distributed in that year, would not be liable to taxation in the hands of the company for the year 1921-1922; but where do we find any such limitation in sec. 16 (*b*) (ii.) to income distributed in 1920-1921? The sub-section (*b*) relates to the assessment of the shareholder; and there is to be included in his return and assessment the face value of shares distributed (to him) as the result of capitalization of (the whole or any part of) "the-assessable-income-of-the-company-which-it-is-liable-to-include-in-its-return-for-the-purpose-of-its-assessment." The words which I have hyphened represent the one complex thing out of which the shares must come if the shareholder is to be taxed in respect thereof. But for the distribution of these shares—if there were no distribution of these shares—the amount of their face value is assessable income of the company which it is liable to include in its return for 1921-1922 for the purpose of its assessment for that year; and that year is the current year, "current" in relation to the operation referred to in the sub-section, the distribution of the shares. In other words, that which would go into the company's return for 1921-1922, if it actually go to the shareholders in the form of shares in 1921-1922, is to be treated as assessable income of the shareholder, not assessable income of the company—that is to say, ultimately. For, as has to

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be borne in mind throughout, there are the widest powers to alter assessments—even after payment of tax (sec. 37, &c.); and if the company shall have actually paid the tax on all its income derived in 1920-1921, and the income is subsequently distributed, the shareholder is taxed accordingly, but gets a rebate (sec. 20 (4)).

For these reasons I am unable to take the view expressed by my brother *Starke* that, for the purpose of applying sec. 16 (*b*) (ii.) to the shareholder's assessment, "the income must be derived by the company and distributed to its shareholders in the same period." If such a condition had been intended, a condition so arbitrary, so foreign to the rest of Part III. of the Act, so objectless (as one would think *a priori*)—Parliament would have said so; and it has not. It is clear that if these profits of the company made in 1920-1921 were distributed in dividends in 1921-1922, the shareholder would have to bring the amount of his dividend into his return of 1922-1923, based on his receipts in 1921-1922 (secs. 13 (1), 16 (*b*) (i.), 32 (1)): why not, then, bring in the amount of his shares received in lieu of dividend? It is clear also that if there were no company concerned, all income of a taxpayer has to be treated as "derived" by him, if, in place of being actually paid over to him it be "reinvested, accumulated, capitalized," &c. (sec. 19); and if it be derived in 1921-1922, it would have to be included in his return for 1922-1923: why should we infer a different intention as to his share of profits of a company? This sec. 16 (*b*) (ii.) was first introduced into this complex of Assessment Acts in 1922, as a consequence, no doubt, of observations made in the case of *Webb* v. *Federal Commissioner of Taxation* (1). That case was decided on 19th June 1922, and the Act of 1922, introducing this clause in question, was passed on 18th October 1922. In *Webb's Case* sub-sec. (*b*) (i.) was in debate, as to "dividends, bonuses on profits . . . credited, paid or distributed to the . . . shareholder from any profit derived from any source by the company"; and doubts were expressed as to these words being satisfied by a direct distribution of shares instead of a crediting payment or distribution of dividends. It is a fair inference that sub-sec. (*b*) (ii.) was inserted in order to meet these doubts. In my opinion, the doubts (which were confirmed in the

(1) (1922) 30 C.L.R. 450.

case of *James* v. *Federal Commissioner of Taxation* (1)) have been met; and the appeal ought to be allowed.

Appeal allowed. Declare that the respondent was assessable in the financial year 1922-1923 *in respect of the sum of* £20,608 *as the face value of shares distributed to him by Penfold's Wines Pty. Ltd. in the preceding financial year. Respondent to pay costs of appeal from Commissioner of Taxation and of this appeal.*

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

Solicitors for the respondent, *Blake & Riggall.*

B. L.

(1) (1924) 34 C.L.R. 404.