

[HIGH COURT OF AUSTRALIA.]

ROBERT COLDSTREAM PARTNERSHIP . APPELLANT ;

AND

FEDERAL COMMISSIONER OF TAXATION . RESPONDENT.

*Income Tax (Oth.)—Assessment—Partnership—Share of net income of one partner under “real and effective control and disposal” of another partner—Liability of partnership to taxation—Income Tax Assessment Act 1936-1941 (No. 27 of 1936—No. 69 of 1941), s. 94.*

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By the terms of a deed of partnership between C., his wife and two daughters it was provided, *inter alia*, that C. should have the sole management and control of the business ; that each partner should be entitled to an equal share of profits ; that the wife and daughters should allow seventy per cent of their shares of the net income of the partnership to be credited to their capital accounts and the remaining thirty per cent to their drawing accounts ; that the wife and daughters should not be entitled to make withdrawals from their drawing accounts except with the consent of C. ; and that C. should be entitled at any time to sell or dispose of the partnership business upon such terms and conditions as he thought proper and should stand possessed of the purchase moneys arising therefrom upon certain trusts.

*Held* that although the wife and daughters had “not the real and effective control and disposal” of their shares of the net income of the partnership, within the meaning of s. 94 (1) of the *Income Tax Assessment Act 1936-1941*, C. had not “the real and effective control” of their shares within the meaning of clause *a* of that sub-section : therefore the partnership was not taxable under s. 94.

#### APPEAL.

This was an appeal by a partnership to the High Court from a decision of a Board of Review upholding an assessment of the partnership to Federal income tax. The appeal came on for hearing



H. C. OF A. before *Latham* C.J. The facts sufficiently appear in the judgment  
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*Fullagar* K.C. and *P. D. Phillips*, for the appellant.

*Coppel*, for the respondent.

LATHAM C.J. delivered the following judgment :—

This is an appeal from a decision of the Board of Review under the *Income Tax Assessment Act* 1936-1941, dismissing the appeal from an assessment to income tax of a partnership entitled the Robert Coldstream Partnership.

The Commissioner assessed the partnership to income tax under s. 94 of the Act. The Board confirmed the assessment on the ground that three of the members of the partnership, in their opinion, did not have the real and effective control and disposal of their shares of the net income of the partnership and that Robert Coldstream, the managing partner of the firm, did have real and effective control of their shares.

Section 94 provides :—

“(1) Where a partnership is so constituted or controlled, or its operations are so conducted, that any partner has not the real and effective control and disposal of his share of the net income of the partnership, the Commissioner may assess the additional amount of tax that would be payable if the share of that partner, or of all such partners if more than one—

(a) had been received by the partner who has the real and effective control of that share ; or

(b) had been divided between such other partners as have the real and effective control of that share in proportion to the extent to which, in the opinion of the Commissioner, they respectively have the real and effective control of that share,

(as the case may be) and had been added to and included in his or their assessable income, and the partnership shall be liable to pay the tax so assessed.”

The section refers in the first place to three circumstances or conditions. First, the constitution of the partnership, which must be determined upon a consideration of the terms of the partnership agreement ; second, the control of the partnership, which must be



determined by reference to the facts of management and the conduct of the business of the partnership, and, thirdly, the conduct of the operations of the partnership, which I have some difficulty in distinguishing from the second head.

The section provides that where any one of these three conditions is satisfied, then if two other conditions are satisfied—namely, a partner not having the real and effective control and disposal of his share of the net income of the partnership, and another partner having the real and effective control of that share—then the section is applicable.

The section is difficult to construe and apply and many cases may be suggested in which there would be difficulties in the application of the section.

I have to deal only with the case which is before me and I propose as far as possible to limit what I say to this case.

In this case argument has been based entirely upon the constitution of the partnership. No argument is based upon the control of the partnership otherwise than in accordance with the provisions of the partnership deed. Neither is any argument based upon the conduct of the operations of the partnership except so far as these operations are carried out, as in fact they were, in pursuance of the deed.

I have said that two conditions must be satisfied before the section can apply, in addition to the fulfilment of one of the conditions mentioned in the introductory part of the section with which I have already dealt. These two conditions are, first, a negative condition that a partner has not real and effective control and disposal of his share of net income and, secondly, a positive condition that another partner has real and effective control of that share. It is not sufficient that the first condition be fulfilled if the second condition is not also satisfied. If both of these conditions are satisfied and the other condition mentioned in the initial words is satisfied, then the partnership is liable to pay tax assessed under the section.

Generally speaking a partnership is not liable to pay tax—see s. 91 of the Act. The tax payable under s. 94 is the full amount of tax which would be payable if the share of the net income of the partner who has not the real and effective control and disposal thereof had been received by the partner who has the real and effective control of that share. The result of applying the section is that where a

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partner who has real and effective control of the share of the income of another partner has also other income, the partnership will pay tax at the rate applicable to the taxable income of the former partner. The result may be that, as in the present case, the amount of tax payable may be very greatly increased owing to the graduated scheme of taxation embodied in our income tax legislation. I observe that the legislation makes no provision for the allocation of this increased liability between the members of the firm.

A partner would be a partner who did not have the real and effective control and disposal of his share if he did not have the control and disposal of the *whole* of his share. Similarly, another partner could not be said to have the real and effective control of the share unless he had such control of the whole of that share. Further, I am of opinion that the section also deals with the whole control in both its positive and negative conditions—the whole control as distinct from the whole share. When it is inquired whether a partner has not the real and effective control and disposal, if the answer is that he has some control and disposal but not all, it could not be held, in my opinion, that he had real and effective control and disposal. In the same way, referring to the provision in par. *a* of the section, it could not be held that another partner had real and effective control of the share until he had the whole control of that share. The phrase is “*the* real and effective control” and not “a real and effective control” or “some real and effective control.” Further, in my opinion the section relates to the control and disposal or control of a share only in the net income of the partnership and therefore relates to a partnership as a going concern. I do not think that the section has any reference to powers of control or disposal of partnership assets upon a dissolution of the partnership.

Argument has been addressed to the Court upon a possible distinction between “control” and “disposal.” In the first part of the section both words are used; in par. *a* the word “control” only is used. These words cannot, in my opinion, be regarded as mutually exclusive. A power of disposal certainly appears to me to involve a right of control, and control over a share of income would ordinarily be exercised by disposal. But in the view which I take of this case it is not necessary for me to decide whether there can be control with no power of disposal.

I observe that a share of income may be so disposed of in accordance with the partnership agreement or by action of a partner that



it is no longer to be regarded as a share of income. It may change its character.

After this analysis of a section which is not very clear and as to the construction of which it is difficult to feel confident I come to apply the section to the present case.

It is first necessary to consider the terms of the deed of partnership. The partners are Robert Coldstream, his wife and two daughters. The partnership deed provides in clause 2 that the partnership shall be deemed to have commenced on the first day of July, 1940, and shall continue for a term of seven years at the least and thereafter until determined by any partner giving to the other partners six months' notice in writing of desire to dissolve the partnership. Thus any partner may bring about a dissolution of the partnership by six months' notice. The business which became the business of the partnership had been carried on by Robert Coldstream. The deed provides in clause 5 for the capital to be contributed by the partners. Clause 10 provides that the sole management and control of the business of the partnership shall be vested in Robert Coldstream as managing partner until he retires or is removed or dies or otherwise ceases to be capable of acting as managing partner, and that so long as he is managing partner he shall be entitled to determine the policy of the business and to place such conditions or restrictions upon the powers of the other partners or any or either of them with reference to the conduct of the business of the partnership as he may from time to time think fit. This clause places the sole management and control of the business in the hands of Robert Coldstream as managing partner. It does not, in my opinion, enable the managing partner to alter the rights of the other partners under the deed in respect of a share of net income or anything else. This clause enables the managing partner to determine how the moneys available for expenditure in the business are to be spent. He can conduct the business of the partnership in relation to all persons with whom the partnership deals without interference by other partners. The power to place restrictions or conditions upon the powers of the other partners relates only to the conduct of the business and does not allow the managing partner to restrict or alter their rights under the deed. In my opinion clause 10 does not allow the managing partner the control of net income of any other partner. If under the deed the partners are either entitled or

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required to deal with profits in a particular manner, clause 10 does not affect such provisions of the deed in any respect.

Clause 21 provides that the partners shall be entitled to the net profits and shall bear the losses of the said business in equal shares. Prima facie, therefore, according to this clause, each partner is entitled to draw an equal share of profits each year. But clause 22 contains other provisions which affect the right which would otherwise exist under clause 21.

Clause 22 is :—

“ 22. (a) As soon as each account has been taken pursuant to the provisions of clause 20 hereof, the net profit (if any) shown by such account to have been earned after all proper deductions allowances and payments during the period of such account shall be credited in the following manner :—

(i) in respect of the proportions due to the partners other than the managing partner, seventy per centum of the share thereof payable to each such partner shall be credited to her capital account and shall not be withdrawn from the business and the remaining thirty per centum shall be credited to the drawing account of such partner ;

(ii) in respect of the proportion thereof due to the managing partner the same may at his absolute discretion be credited either to his capital account or to his drawing account or partly to each.

(b) Before each such account is taken, interest at the rate of six per centum per annum shall be charged against the profits of the business and credited to the respective capital and drawing accounts of each partner in respect of the amount standing to the credit of such partner in each such account.

(c) The managing partner may at any time and from time to time at his own absolute discretion, withdraw from the business the whole or any part of the sum then standing to the credit of his drawing account, but no other partner shall be entitled to call for or receive payment of the whole or any part of the sum to the credit of her drawing account except such as may from time to time be approved by the managing partner.

(d) No part of the capital of the said business shall be payable to any partner except with the consent of all of the partners.”



The effect of clause 22 then is that the net profits of the partnership are subject to a certain degree of control by reason of the provisions relating to the constitution of the partnership. The constitution of the partnership may bring about the result that some partners have not real and effective control of their shares. Control depending upon the terms of the deed is to be distinguished from control depending upon the will of a partner. The former is referred to in the first words in s. 94 and the latter in par. *a*. Under clause 22 the three female partners must allow seventy per cent of their share of profits, that is, of their share of net income of the partnership, to be credited to capital account and, further, the remaining thirty per cent is to be credited to the drawing account of the particular partner. The managing partner, on the other hand, may have his share of profits credited either to capital account or drawing account. The managing partner is able, at his own discretion, to draw at any time any sum standing to the credit of his drawing account, but the three female partners are not entitled to draw upon their drawing accounts without the approval of the managing partner. Accordingly, in relation to the drawing account, the three female partners require the approval of the managing partner in order to draw anything. Finally, as far as the capital account is concerned, the position is that no part of the capital of the business can be withdrawn by any partner except with the consent of all of the partners.

The arguments upon this appeal have been based very largely upon the provisions of clauses 10 and 22.

Clause 23 provides for the expulsion of a partner pursuant to clause 4 and, upon the death of any one of the female partners, provides for the possible purchase of the share of the departing partner by the other partners and the basis upon which that purchase is to be made. Clause 24 provides that the managing partner may at any time sell or dispose of the whole of the partnership business and assets upon such terms as he thinks proper, and that he shall stand possessed of the purchase moneys arising therefrom upon certain trusts. Clause 26 provides that upon the determination of the partnership otherwise than pursuant to clause 23 or 24 the assets shall be realized and sold, the debts got in and the proceeds applied in the manner set out in the clause.

The Board of Review has held that the section was applicable ; that the female partners did not have the real and effective control

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of their shares by reason of the provisions, particularly, contained in clause 22 and that clause 24 combined with clause 22 showed that the managing partner did have the real and effective control of their shares.

I propose to deal with clause 24 first. Where a partnership is dissolved under clause 2 by giving six months' notice, clause 26 applies to determine what is to be done upon the dissolution. If there is a dissolution pursuant to clause 23 upon expulsion or death of a partner, the provisions in clause 23 apply. If there is a dissolution pursuant to action of the managing partner under clause 24, then the provisions of clause 24 apply.

In my opinion the provisions of the deed relating to the dissolution of the partnership are not relevant for the purpose of determining whether s. 94 of the Act applies. These provisions, including clause 24, deal not with a share in the income of the partnership but with the assets of the partnership. In particular, clause 24 controls income and corpus of a trust fund and not the share of any partner of the income of the partnership. Accordingly, I am of opinion that clause 24 is of no assistance for the purpose of determining this case.

I therefore take the partnership as a going concern and I ask what was the position with respect to the net income of the female partners? Under clause 22 they are bound to allow seventy per cent of their net share of income to be credited to capital account. In my opinion, this provision is part of the constitution of the partnership which prevents the female partners having real and effective control and disposal of their share. They are bound by reason of these provisions to allow their shares to be dealt with in this particular way and are not in a position at their own will to deal with them in any other way. Accordingly, in my opinion, what I have called the negative condition of the section is satisfied.

The partnership has been assessed upon the basis that the managing partner has the real and effective control of the whole—one hundred per cent—of the share of net income of the female partners. As to the thirty per cent which is credited under the deed to the drawing account of the female partners, they are able to draw from that account only such amounts as may from time to time be approved by the managing partner. The managing partner under this provision has a degree of control over this thirty per cent of the share but, in my opinion, he has not the real and effective control in the



sense in which I have explained that I understand these words. He only has power of veto, a power to prevent other partners applying the money to their own purposes. I am not prepared to decide that the section only applies where the other partner, who has real and effective control, is able to appropriate it for his own purposes. This is an important and difficult question not necessary to be decided. But it appears to me that the phrase "the real and effective control of that share" refers to exclusive and complete and not to divided control.

In the present case, before the Commissioner can justify his assessment it must be shown that the managing partner alone has real and effective control of the share, not the managing partner with other persons; otherwise it would be very difficult to apply the section. Take a case where each partner has the same degree of control by way of veto in relation to the share of each other partner. There the application of the section would produce very marked differences according to whether taxation was imposed upon the basis that A had real and effective control of the share of B, or that B had real and effective control of the share of A. It would appear to me to be impossible in such a case to apply the section with any fairness and a construction which would lead to that result ought, in my opinion, to be rejected. Here, under clause 22, in my opinion, all the partners have the same degree of control so far as it can be said to be control in relation to the seventy per cent of the share of each female partner. Accordingly, in my opinion, clause 22 does not confer upon the managing director the real and effective control of the whole of the share of income which it must be shown to do in order to support the assessment.

The Commissioner, however, further relies on clause 10 of the deed. Clause 10 gives the managing partner a general and very wide and exclusive power to manage the partnership business and apply the funds of the partnership as he thinks proper. He is therefore entitled to use for the purposes of the partnership as he thinks proper the moneys credited to the capital account. Accordingly it is argued that he has the control of the seventy per cent of the net share of income of each of the female partners. In my opinion, however, power to manage the partnership business cannot be said to be power to control shares of income. The deed controls the share of income by requiring that the income shall be appropriated and used in a particular way. The requirement of the deed is that

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seventy per cent of the income of the female partners shall be credited to capital account. When it is so credited it becomes part of the capital which each partner owns in the partnership and its quality as income accordingly, by virtue of the deed, has disappeared. Accordingly, the power to manage the business and to handle and control all the funds of the business conferred upon the managing partner by clause 10 does not satisfy the requirements of s. 94 so as to place him in real and effective control of the shares of income of the female partners.

For these reasons I allow the appeal with costs and direct the assessment to be set aside.

Solicitor for the appellant, *C. L. Barbour*.  
Solicitor for the respondent, *H. F. E. Whitlam*, Crown Solicitor for the Commonwealth.

E. F. H.