

[HIGH COURT OF AUSTRALIA.]

REDBANK MEATWORKS PROPRIETARY }
LTD. }

APPELLANT ;

AND

THE COMMISSIONER OF TAXES (QUEENS- }
LAND) }

RESPONDENT.

ON APPEAL FROM THE SUPREME COURT OF
QUEENSLAND.

*Income Tax (Q.)—Assessment—Company—Capital—Reserve—Invested in business—
Debit in profit and loss account—Profits liable to tax or exempt from tax—The
Income Tax Assessment Act of 1936 (Q.) (1 Edw. VIII. No. 32), s. 34.**

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A company having sold its premises at a profit of £40,640 16s. 11d., credited that amount first to an assets realization account, subsequently to depreciation reserve account and ultimately to assets realization reserve account. The proceeds of sale were paid into the general fund of the company in its banking account, and amalgamated with other funds of the company. The moneys became part of the floating assets of the company and were used in the general course of the business including the purchase of trading stock. At the commencement of the year of income 1939-1940 there was a debit in the profit and loss account of accumulated trading losses exceeding £40,640 16s. 11d.

BRISBANE,
June 14.
—
SYDNEY,
July 28.

Held, by Latham C.J. and Rich J. (McTiernan J. doubting), that the amount of £40,640 16s. 11d. was a reserve invested in the business of the company

Latham C.J.,
Rich and
McTiernan JJ.

* Section 34 of *The Income Tax Assessment Act of 1936 (Q.)* provides as follows:—“(1) The percentage which the profits of the company bear to the capital of the company which was invested in assets which were used during the year of income in production of assessable income shall be the basis on which the rate of tax payable by the company shall be calculated. . . . (3) The capital of the company shall be ascertained by adding the amounts averaged over a full year of income of the capital and reserves of the company as set out hereunder, namely :— . . . (b) reserves and parts of reserves (including in such reserves amounts standing to the credit of profit and loss account) invested in the business, and which have been created out of profits liable to tax or exempt from tax under this Act or under any previous income tax law of the State. . . .”

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during the income year 1939-1940 within the meaning of s. 34 (3) (b) of *The Income Tax Assessment Act of 1936* (Q.), but, by the whole Court, that the reserve had been created out of profits which were neither liable to tax nor "exempt from tax" within the meaning of s. 34 (3) (b), and that therefore the amount should not be taken into account in ascertaining the capital of the company for the purposes of s. 34 (1) of the Act.

Decision of the Supreme Court of Queensland (Full Court): *Commissioner of Taxes v. Redbank Meatworks Pty. Ltd.*, (1943) Q.S.R. 85, affirmed on another ground.

APPEAL from the Supreme Court of Queensland.

Redbank Meatworks Pty. Ltd. appealed to a Court of Review against its assessment to income tax under *The Income Tax Assessment Act of 1936* (Q.) in respect of income received in the year ended 1st June 1940, on the ground that in ascertaining the capital of the company, for the purpose of determining the percentage of profits to capital (which is, under s. 34 of the Act, the basis on which the rate of tax payable by a company is calculated) the Commissioner of Taxes did not take into account certain amounts which the company claimed should have been included under s. 34 (3) (b) of the Act. The appeal was heard before *Mansfield J.*, sitting as a Court of Review, who allowed the appeal and set aside the assessment. At the request of the Commissioner *Mansfield J.*, pursuant to s. 48 (7) of the Act, stated for the opinion of the Full Court of the Supreme Court a case which was substantially as follows:—

The taxpayer, Redbank Meatworks Pty. Ltd., is a limited company, duly incorporated in the State of Queensland in the year 1924, and it has carried on business in the said State since then as wholesale and retail butchers and slaughtermen in all its branches.

Prior to 8th April 1932 the taxpayer owned as part of its assets certain premises and plant at Redbank in the said State, known as the Redbank Meatworks.

By an agreement for sale dated 8th April 1932 the taxpayer agreed to sell the premises of the Redbank Meatworks to Swift Australian Co. (Pty.) Ltd., for the sum of £50,000. This amount was received by the taxpayer in cash on or before 30th June 1934.

This transaction was entered in the books of the taxpayer as at 30th June 1932, and against the sale price was charged the book value of the premises and plant at Redbank to show a profit of £29,828 8s. 6d. This amount of profit was placed to the credit of an account in the books of the taxpayer called "Assets Realization Account." It remained to the credit of this account until 30th June 1936, when it was transferred to the credit of an account in

the books of the taxpayer called "Depreciation Reserve Account." No amount was at any time debited to this account for depreciation on assets, this item being provided for in the ordinary way from year to year by an amount sufficient to cover depreciation being debited to the profit and loss account.

By a journal entry made on 10th March 1940, the said sum of £29,828 8s. 6d. was transferred from "Depreciation Reserve Account" to credit of an account called "Assets Realization Reserve Account." The entry was made as at 1st July 1939.

Prior to 10th March 1940 it was discovered that the book value of the plant of the Redbank Meatworks, viz., £10,812 8s. 5d., had been incorrectly charged against the original sale price of £50,000. The plant was not in fact included in the sale. By reason of this the profit on the sale was increased by £10,812 8s. 5d., making the total amount of profit on the transaction £40,640 16s. 11d.

By journal entries made on 10th March 1940, this error was corrected and the sum of £10,812 8s. 5d. was credited to "Assets Realization Reserve Account." The entry was made as at 1st July 1939.

As the proceeds of the sale were received by the taxpayer, they were paid into the general funds of the taxpayer to the credit of the taxpayer's account at the English, Scottish and Australian Bank Ltd., Brisbane, and were amalgamated with other funds of the taxpayer and became part of the floating assets of the taxpayer and have been used in the general course of business by the taxpayer for, *inter alia*, the purchase of trading stock.

On 10th November 1939, the taxpayer received the sum of £2,884 6s. 7d. by way of adjustment paid by its insurers in respect of damage sustained by the taxpayer by loss by fire of portion of its assets. After debiting against this amount the depreciated book value of the destroyed asset and other proper charges, the profit on this transaction was £2,190 17s. 4d. On 10th November 1939, this profit was transferred to "Assets Realization Reserve Account" in the books of the taxpayer. These moneys when received by the taxpayer were paid into the general funds of the taxpayer at the said bank and became part of the floating assets of the taxpayer in the same manner as the proceeds of the sale of the premises of the Redbank Meatworks.

The profit on both the above-mentioned transactions was exempt from State income tax.

On 1st July 1939, the paid-up capital of the taxpayer was £75,000. On 12th April 1940, a further 12,000 one pound shares were duly issued and paid for in cash.

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The accounts of the taxpayer disclose that as at 1st July 1939 there was at debit of the profit and loss account an accumulated trading loss of £46,742 9s. 3d.

For the purposes of s. 34 of *The Income Tax Assessment Act of 1936* (Q.), the taxpayer claimed that its capital for the twelve months ended 30th June 1940 was £119,417 16s. 11d. made up as follows:—

| | |
|---|----------------|
| (a) Paid-up capital as at 1st July 1939 .. | £75,000 0 0 |
| (b) Paid-up capital of £12,000 added on 12th April 1940 proportion for year—79/366 of £12,000 | 2,590 0 0 |
| (c) Reserve invested in the business as per assets realization reserve account 1st July 1939 | 40,640 16 11 |
| (d) Reserve invested in the business, £2,190 17s. 4d. added to assets realization reserve account on 10th November 1939— Proportion for year | 1,187 0 0 |
| | <hr/> |
| | £119,417 16 11 |

The Commissioner of Taxes disallowed items (c) and (d) and on 17th March 1941 issued an assessment in accordance with his decision. Notice of objection against the assessment was duly lodged by the taxpayer on 16th April 1941.

By notification dated 30th July 1941 the Commissioner informed the taxpayer that he had not allowed the objection.

By letter of 10th September 1941 the solicitors for the taxpayer duly gave notice to the Commissioner requesting him to treat the objection as an appeal.

The appeal came on for hearing and determination before me. I decided that the amounts of £40,640 16s. 11d. and £1,187 were reserves invested in the business which had been created out of profits exempt from tax and were invested in assets which were used during the year ending 30th June 1940 in the production of assessable income of the taxpayer. I therefore allowed the appeal, directed that the assessment of the Commissioner be set aside and a fresh assessment be issued in accordance with my judgment, and directed the Commissioner to pay the costs of the taxpayer fixed at £68 5s. : *Redbank Meatworks Pty. Ltd. v. Commissioner of Taxes* (1).

The questions for the opinion of the Full Court of the Supreme Court were:—

1. Was I correct in deciding that the sums of £40,640 16s. 11d. and £1,187 or either of them were or was reserves invested in the business of the taxpayer which had been created out of profits exempt from income tax, and invested in assets which were used during the year ending 30th June 1940 in the production of assessable income of the taxpayer?
2. Was I correct in allowing the appeal, directing that the assessment of the Commissioner be set aside and a fresh assessment be issued in accordance with my decision, and in directing the Commissioner to pay the costs of the taxpayer fixed at £68 5s.?

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Upon the appeal to the Full Court it was agreed that the sum of £1,187, representing insurance payments in respect of the loss by fire, which was derived during the year of income, could not be included in reserves for the purpose of ascertaining the capital of the company.

The Full Court held, by a majority (*Webb C.J.* and *E. A. Douglas J.*, *Philp J.* dissenting), that the amount of £40,640 16s. 11d. was not a reserve invested in the business within the meaning of s. 34 (3) (b) of the Act. It also held that a further objection raised by the Commissioner that the profits placed to reserve were not exempt from taxation within the meaning of s. 34 (3) (b) was not maintainable. The appeal was allowed, and both questions were answered—No: *Commissioner of Taxes v. Redbank Meatworks Pty. Ltd.* (1).

From that decision Redbank Meatworks Pty. Ltd. appealed to the High Court.

Fahey, for the appellant. The profit made on the sale by being placed in a reserve was invested in the business of the company and must be taken into account in arriving at the capital of the company. The statute in no way authorizes the Commissioner of Taxes to deduct from the amount of the capital any sum shown as a debit in the profit and loss account. The reserve has been created out of profits and has been invested in the business. It remains in the business until it has been written off (*Hooper & Harrison Ltd. (in Liquidation) v. Federal Commissioner of Taxation* (2)).

[*RICH J.* referred to *In re Wragg; Wragg v. Palmer* (3).]

The reserve has been created out of profits and forms part of the capital of the company (*In re Hoare & Co. Ltd. and Reduced* (4)).

Real, for the respondent. Profits are of two kinds, those exempt from tax and those liable to tax. The words "exempt from tax"

(1) (1943) Q.S.R. 85.

(2) (1923) 33 C.L.R. 458.

(3) (1919) 2 Ch. 58, at pp. 64, 65.

(4) (1904) 2 Ch. 208.

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do not mean "not liable to tax": they mean liable to tax but released from tax by some special provision. A new field of taxation has been created and all profits are liable to tax unless exempted by s. 8 of *The Income Tax Act of 1924*. The money is not a reserve within the meaning of the statute. A reserve invested in the past and expended is not an existing reserve. It must be presently invested in the assets producing the income (*Hooper & Harrison Ltd. (in Liquidation) v. Federal Commissioner of Taxation* (1)). The reserve must be available for the purpose of producing income. The statute does not speak of money expended in the past.

Fahey, in reply. The statute is designed to give a company the benefit of all capital employed and which has been employed to make profits. The words "exempt from tax" have no technical meaning.

Cur. adv. vult.

July 28.

The following written judgments were delivered:—

LATHAM C.J. This is an appeal from a decision of the Full Court of the Supreme Court of Queensland upon a special case stated by a Court of Review (*Mansfield J.*) for the opinion of the Full Court under s. 48 (7) of *The Income Tax Assessment Act of 1936* (Q.).

The matter before the Court of Review was an appeal from an assessment of Redbank Meatworks Pty. Ltd. to income tax under *The Income Tax Assessment Act of 1936* (Q.) in respect of income received in the year ended 1st June 1940. The amount of tax payable by the company depended upon the ratio of profits of the company, ascertained in a particular manner, to the "capital of the company which was invested in assets which were used during the year of income in production of assessable income" (*The Income Tax Assessment Act of 1936*, s. 34 (1)). The greater the capital, the less would be the tax. In order to ascertain the capital of the company for the purpose of s. 34 it was necessary to determine (1) whether an amount of £40,640 (omitting shillings and pence) shown in the accounts of the company as standing to the credit of an "Assets Realization Reserve Account" was "a reserve invested in the business" of the company, and (2) whether that fund had been "created out of profits liable to tax or exempt from tax" under the Act or any previous income tax law of the State of Queensland (s. 34 (3) (b)). *Mansfield J.* answered both of these questions in the affirmative, and stated a case for the opinion of the Full Court. The Full Court (*Webb C.J.* and *E. A. Douglas J.*, *Philp J.* dissenting)

(1) (1923) 33 C.L.R. 458.

held that the amount in question was not a reserve fund which should be included in the capital of the company for the purpose of s. 34. The ground of the decision was that, as there was, in the relevant year, a debit to profit and loss account of £46,742, it could not be said that the reserve fund really existed. *Philp J.* held that it was sufficient that the amount in question, representing profits, had been placed to reserve account and had been used in the business, even if it had, owing to losses, disappeared. The majority also held (agreeing with *Mansfield J.* on this point) that the profits in question were profits which were exempt from taxation under *The Income Tax Act of 1924*, s. 10 (1), which was in force when the profits in question were made and received. *Philp J.* was of opinion that the question whether the profits were or were not exempt or liable to tax was not open upon the case stated. The appellant contends that the judgment of the Full Court was wrong on the first point, and right on the second point, also arguing that the second point is not open upon the case stated. The respondent submits opposite contentions on both points.

It is stated in the case that the taxpayer company carried on business as wholesale and retail butchers and slaughtermen. Prior to 8th April 1932 the company owned certain premises and plant known as the Redbank Meatworks. On 8th April 1932 the company agreed to sell the premises (but not the plant) for the sum of £50,000. The price was paid and, upon comparison with the book values of premises and plant, the transaction showed a profit of over £29,000. This profit was first credited to an assets realization account, subsequently to a depreciation reserve account, and ultimately to an assets realization reserve account. It was then discovered that the book value of the plant, over £10,000, had been incorrectly charged against the original sale price of £50,000. A correction was made and the profit on the sale was then more accurately recorded as £40,640 16s. 11d.

The proceeds of the sale were paid into the general funds of the company to the credit of the company's banking account, were amalgamated with other funds of the company, became part of the floating assets of the company, and have been used in the general course of the company's business for, *inter alia*, the purchase of trading stock.

On 1st July 1939 the paid-up capital of the company was £75,000. On 12th April 1940 a further 12,000 £1 shares were issued and paid for in cash. An amount of £2,590, being a proportion of £12,000 corresponding to the unexpired period of the year ending 30th June 1940, was taken by the Commissioner as added to the paid-up capital

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for the year. Thus the paid-up capital of the company at the relevant time was £77,590.

The sum of £40,640 had been placed in a reserve account, but as at 1st July 1939 there was a debit in the profit and loss account of an accumulated trading loss of £46,742 9s. 3d.

Before *Mansfield J.* a question was raised as to a sum of £1,187, representing insurance payments in respect of a loss by fire. Upon appeal to the Full Court it was realized that an error had been made by the parties in relation to this item and it is agreed that this amount cannot be regarded as part of the capital of the company for the purposes of the application of s. 34 of the Act.

The first question which arises is whether what appears in the accounts of the company as the reserve fund of £40,640 is a reserve fund which can properly be included in the capital of the company as ascertained under s. 34 (3) of the Act for the purpose of calculating the percentage of profits to the capital of the company invested in assets used in production of assessable income. That percentage of profits determines the rate of tax payable by the company: see *The Income Tax Act of 1936*, sixth schedule, under which the rate of tax increases with the percentage of the profits to the capital of the company so invested.

Section 34, so far as material, is in the following terms:—

“34. (1) The percentage which the profits of the company bear to the capital of the company which was invested in assets which were used during the year of income in production of assessable income shall be the basis on which the rate of tax payable by the company shall be calculated.

(2) The profits of the company shall be ascertained by deducting from the taxable income of the year of income any income tax payable in respect of the taxable income of the company derived during the year preceding the year of income under any Act of the Commonwealth or the State relating to income tax, and which is not an allowable deduction, and any casual profit and any amount included in the taxable income under the provisions of paragraph (g) of subsection one of section sixteen of this Act.

(3) The capital of the company shall be ascertained by adding the amounts averaged over a full year of income of the capital and reserves of the company as set out hereunder, namely:—

- (a) the capital paid up in cash or value on all shares actually issued by the company;
- (b) reserves and parts of reserves (including in such reserves amounts standing to the credit of profit and loss account) invested in the business, and which have been created out

of profits liable to tax or exempt from tax under this Act or under any previous income tax law of the State, except profits derived during the year of income or profits on which additional tax would be chargeable on distribution under subsection two of section thirty-five of this Act,

and deducting therefrom the amount of any item specified in subsection four of this section”.

(Provisos follow which are not material for the purpose of this case).

“(4) From the average amounts of capital and reserves of the company, ascertained in accordance with the provisions of subsection three of this section, the following items shall be deducted :—

- (a) any amount invested by the company in shares in other companies or in securities of the kind mentioned in subsection eleven of section thirteen of this Act ;
- (b) such an amount as, in the opinion of the Commissioner, should be deducted on account of the use of an asset in production of exempt income where such asset has been used during the year of income in production of both assessable and exempt income ;
- (c) so much of the amount of any goodwill, franchise issued under ‘ *The Tolls on Privately Constructed Road Traffic Facilities Act of 1931* ’, Order in Council, copyright, patent right or undertaking appearing as an asset in the company’s accounts as in the opinion of the Commissioner should reasonably be deducted.

(5) (a) The capital of the company which was invested in assets which were used during the year of income in production of the assessable income of the company shall be taken as that part of the capital of the company ascertained in accordance with the provisions of subsections three and four of this section which bears the same proportion to such capital as the average value of the assets of the company used in production of the assessable income bears to the average value of the total assets of the company.”

Sub-section 5 (b) prescribes a method for calculating the average value of the assets of the company. Sub-section 6 is as follows :—

“(6) The percentage referred to in subsection one of this section shall be that percentage which the amount ascertained in accordance with the provisions of subsection two of this section bears to the amount ascertained in accordance with the provisions of subsection five of this section.”

Section 34 is directed towards ascertaining a basis for the taxation of the income of a company, regard being had to the moneys which

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the shareholders have put into the company, and to the proportion of the actual assets of the company used in producing assessable income. The basis of the legislation is that taxation should be imposed, not merely in relation to the actual amount of profit made by a company in a particular year, but also in relation to the ratio of that profit to the money which has been invested by the shareholders in the company, either in actual contributions to capital or by allowing to be used in the business of the company moneys which represented profits which they might, if they had so elected, have distributed as dividends: Cf. *Burland v. Earle* (1).

Under sub-s. 1 it is provided that the basis upon which the rate of tax shall be calculated shall be the percentage which the profits of the company (as to which see sub-s. 2, which prescribes an artificial method of ascertaining such profits) bear to "the capital of the company which was invested in assets which were used during the year of income in production of assessable income." The majority decision of the Full Court is based upon the view that the capital of the company, as ascertained under sub-s. 3, at least so far as it consists of reserves, should really represent assets of the company used during the year of income in production of assessable income. In the present case, the debit in the profit and loss account exceeded the amount of the alleged reserve fund, and it was held that accordingly the reserve fund was not a real reserve fund, but a fictitious reserve fund, because it could not be said to represent assets of the company. Upon this view a reserve fund must be a real reserve fund in the sense that there are assets belonging to the company which, when realized, are sufficient to pay off all outside creditors, to repay the whole of the paid-up capital, and to leave a surplus equal to the amount of the reserve fund. I refer to the *Australian Manual of Accountancy and Commercial Law*, 11th ed. (Morley & Tait), p. 186, where it is said: "If the assets will do this . . . the reserve fund is a real one notwithstanding that there may not be any separate investments outside the business to represent it. But if the assets are stated at an excess value then the reserve fund is not a real one to the extent of the overvaluation, even if it is separately invested." It is pointed out by the authors that a reserve fund may be real without separate investment, and it may not be real, even with separate investment.

There has been much discussion by auditors and accountants as to the real nature of a reserve fund, and it has been urged that nothing should be called a reserve fund unless it is separately invested. The matter may be studied in *Nixon & Stagg, Accountancy*

and *Banking*, (1907), pp. 113, 114; *Spicer and Pegler, Bookkeeping and Accounts*, (1908), p. 41: *Dicksee on Auditing*, 13th ed., pp. 243, 278.

In the present case it is not necessary to consider whether a reserve can properly be "invested in the business" of a company.

Section 34 (3) (b) expressly refers to, and refers only to, reserves and parts of reserves "invested in the business." Accordingly there is no doubt that a reserve may exist for the purposes of the section though it is used in the business, and though no particular assets have been appropriated to it.

In my opinion it is not relevant for the purpose of construing and applying s. 34 to ask whether a reserve fund is actually represented by assets. The phrase which appears in s. 34 (1) is "the capital of the company which was invested in assets which were used during the year of income in production of the assessable income." But the section in my opinion does not require, or indeed allow, the Commissioner to inquire how much of the capital was in fact invested in assets which were in fact used during the year of income in production of assessable income. The phrase quoted is given a special meaning for the purposes of the section. It re-appears as the introductory words of sub-s. 5 (a), which provides that "the capital of the company which was invested in assets which were used during the year of income in production of the assessable income" (the same words as those which are found in sub-s. 1) "*shall be taken as*" a particular part of the capital of the company as ascertained in accordance with the provisions of sub-ss. 3 and 4; that is to say, this phrase is given a special artificial meaning for the purposes of the section, and for the purpose of applying it it is neither necessary nor proper to inquire whether and how far the capital of the company is actually represented by assets, though, as will immediately appear, it *is* necessary, under sub-s. 5, to ascertain the value of the assets of the company—which is a different thing from reaching any conclusion about the capital of the company.

In order to discover what is the capital of the company "invested in assets which were used" &c., it is necessary under sub-s. 5 first to ascertain the capital of the company in accordance with sub-ss. 3 and 4, then to ascertain the average value of the assets of the company used in the production of assessable income, and then to ascertain the average value of the total assets of the company, in accordance with sub-s. 5 (b). The amount of the capital "invested in assets which were used" &c., is then calculated by applying to the capital ascertained under sub-ss. 3 and 4 a fraction, the numerator of which is average value of assets of the company used in production of assessable

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income, and the denominator total assets of the company. It is in ascertaining this fraction that the value of the assets of the company must be taken into account, but such value is taken into account only for the purpose of ascertaining the fraction, which is then applied to the capital artificially ascertained under sub-ss. 3 and 4.

Reference to those sub-sections shows that the amount of the capital of the company so ascertained is independent of the value of the assets of the company. It does not depend upon the value of those assets. It is determined by the moneys which the shareholders have sunk in the company.

Sub-section 3 provides that the *capital* of the company (a proportion only of which is the capital of the company "invested in assets which were used," &c.—sub-s. 5) shall be ascertained by adding together two amounts averaged over a full year of income. Those amounts are, first, the capital paid up in cash or value on all shares actually issued by the company. It is plain that under this head the capital paid up in cash or value on issued shares is to be taken into account to its full amount, irrespective of whether or not there have been losses of such capital. The capital of a company in this sense may be £50,000, but its assets may be worth only £1,000. The second element in ascertaining the capital of the company under sub-s. 3 is "reserves and parts of reserves . . . invested in the business" created out of certain profits subject to certain deductions. Here again, in my opinion, the amount to be taken into account is the amount which has been placed in a reserve fund, whether or not it is represented by assets. It must be really placed in a reserve fund with, as was said in *Hooper & Harrison Ltd. (in Liquidation) v. Federal Commissioner of Taxation* (1), a certain intention permanently to use those profits for the purposes of the business (See the report (2)) or, as *Starke J.* said in *Sharp, Stevenson & Hare Pty. Ltd. v. Federal Commissioner of Taxation* (3), the profits are "invested in the business" if they are used in the business "in a manner indicating some fixedness in that use."

It is true that, if there is a debit to profit and loss account exceeding the amount of any reserve fund, the reserve fund may be fictitious; that is to say, upon a realization of the assets of the company there might be nothing to answer the figure representing the reserve fund in the balance-sheet of the company. But, on the other hand, the assets of the company, when realized, might exceed in value the amount of debts and paid-up capital, and the reserve fund might therefore be commercially real though the profits

(1) (1923) 33 C.L.R. 458.

(2) (1923) 33 C.L.R., at p. 469.

(3) (1927) 39 C.L.R. 158, at p. 172.

out of which it had been created had been lost in the course of trading. The "reality" of any reserve fund always depends upon the true value of the assets of the company. But the section which has to be construed in the present case looks to creation and investment of reserves. It says nothing about their continued existence in relation to assets. There is no such provision as that contained, for example, in the *Victorian Companies Act 1928*, s. 115 (4), that a reserve fund must be "actually existing." A reserve may be invested in the business and may be lost—just as capital paid up in cash and used in the business of the company may be lost. The loss of capital paid up in cash admittedly does not result in the exclusion of any part of such capital from the calculation required to be made by sub-s. 3. Similar considerations, in my opinion, apply to the reserves referred to in sub-s. 3 (b).

This view is, I think, supported by reference to the provision in sub-s. 4, which provides for the deduction from the amounts of capital and reserves ascertained in accordance with sub-s. 3 of, *inter alia*, "any amount invested by the company in shares in other companies . . .". In my opinion under this provision an amount representing what has been invested by the company in shares in other companies is to be deducted whether those shares have appreciated or depreciated in value. If the company invested £1,000 in shares in another company, then, in my opinion, the amount to be deducted under sub-s. 4 (a) would at all times be the amount invested, namely £1,000, and not the value of the shares as varying from time to time. The shares might depreciate in value so that they were worth only £200, but it would not be correct to say that the company had invested only £200 in shares. Similarly the shares might increase in value and become worth £5,000. But it would, I think, be equally incorrect to say that the company had invested £5,000 in shares.

Sub-section 4 specifies certain deductions which are to be made from the total of the amounts mentioned in sub-s. 3. It would have been a simple thing to provide that a debit in the profit and loss account should be deducted. This would have gone a long way towards securing that reserves should be "real" in the sense for which the respondent contends. But there is no such provision—though a precedent was available for such a provision in not dissimilar legislation in s. 17 of the *Commonwealth War-time Profits Tax Assessment Act 1917-1918*.

This view of the section does not mean that the true value of the assets of a company is completely immaterial. The section expressly

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provides (sub-s. 5) for a valuation of assets as an element in determining the proportion of the ascertained capital (sub-s. 3) which is to be taken as being the invested capital. But it is only for the purpose of ascertaining the proper proportion of the ascertained capital that the assets must be valued.

It is sometimes said, using the term "capital" in a commercial sense, that accumulated profits placed to reserve account and used in the business of a company become part of the capital of the company. Such funds may be added to the capital of the company in the legal sense by methods now well known which make it possible for a company to capitalize its profits: See *Bouch v. Sproule* (1) and *Inland Revenue Commissioners v. Blott* (2). It is plainly not necessary, however, in order that moneys standing to the credit of a reserve account should be included in the capital of a company under sub-s. 3, that the moneys should be capitalized in such a manner, because, upon that view, par. (b) of the sub-section would have no effect at all: capitalized reserves would be included in capital under par. (a) of the section.

Accordingly, in my opinion, in ascertaining the capital of the company under sub-s. 3 it is proper to take into account the amount of any reserve fund created out of profits, as in the present case, which exists as a reserve fund, in the sense that the profits have been credited to it with an intention, of some degree of permanence, though not necessarily an irrevocable intention, of using them in the business of the company. Upon this view neither losses of capital paid up in cash or value, nor losses of reserves so set aside, should be taken into account for the purposes of the section. Accordingly, in my opinion, the decisions of *Mansfield J.* and of *Philp J.* upon the first point in the case were right and it should be held that the amount of £40,640 was a reserve invested in the business of the taxpayer which had been created out of profits.

The next question is whether the profits out of which the reserve was created were "liable to tax or exempt from tax under this Act or under any previous income tax law of the State" (sub-s. 3 (b)).

Mansfield J. held that the profit on the sale of the meatworks was exempt from tax under a previous income tax law, namely *The Income Tax Act of 1924*. It did not fall within any of the heads of income declared to be exempt under s. 8 of the Act. But s. 10 (1) of the Act provided that assessable income should include as income from personal exertion all net gains or profits arising from the sale of any real property ascertained in the manner specified in the section, provided that, unless the taxpayer purchased or acquired

(1) (1887) 12 App. Cas. 385.

(2) (1921) 2 A.C. 171.

the property during the year in which the sale took place or the six years prior thereto profit made from the sale should not be liable to tax. It appears from the transcript of evidence annexed to the case and to be taken as part of the case that it was common ground that the meatworks had been acquired by the taxpayer more than seven years before the sale in 1932 and, accordingly, the profit upon the transaction was not liable to tax under the legislation in force at the time of the receipt of the purchase price. It was held by *Mansfield J.* that the profit was exempt from tax, but apparently this matter was not argued before him.

The first question which was submitted to the Full Court was as follows :—

“ Was I correct in deciding that the sums of £40,640 16s. 11d. and £1,187 or either of them were or was reserves invested in the business of the taxpayer which had been created out of profits exempt from income tax, and invested in assets which were used during the year ended 30th June 1940 in the production of assessable income of the taxpayer ? ”

It was contended before us that the question of whether the reserve fund had been created out of profits exempt from income tax was, upon the case, not open before the Full Court or this Court.

Under s. 48 (7) of the 1936 Act the Court of Review may state a special case on either the whole matter or on any question arising at the review for the opinion of the Full Court. When the special case is remitted to the Court of Review that Court shall “ make an order in respect of the matters referred to such Full Court in conformity with the judgment of such Full Court.” What matters were submitted to the Full Court with respect to the sum of £40,640 ? Consideration of the precise form of the first question shows that all the following questions were submitted :—Was the sum a reserve ? Was it invested in the business of the taxpayer ? Had it been created out of profits ? Were those profits exempt from income tax ? Were they invested in assets of a particular description ? Upon the form of the question I can see no justification for excluding any one of these questions from the possible scope of decision by the Full Court.

But it is true, as *Philp J.* says in his reasons for judgment, that the case categorically states: “ The profit . . . was exempt from State income tax.” It is admitted that the point was not contested before *Mansfield J.* There is no reference in the case itself to facts which, in the circumstances, would have to be considered before reaching a decision upon the question whether the

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“profit” was exempt or liable to tax. Similarly there are no facts stated which would make it possible to determine whether the sum of £40,640 was really a profit, although that question is also submitted. It represents the difference between book values and sale price. But there is nothing to show what the book value represented. Yet the form of question would, as already stated, leave it open to the Full Court to express an opinion on the point whether that sum was really a profit. I find it difficult to believe that the latter question was intended to be submitted. I have the same difficulty with respect to the former question.

The case does, however, include the transcript of evidence. In that evidence the only relevant passage is the following:—

Mr. *Fahey* (for the taxpayer):—“I take it my friend will admit this. That profit did not attract income tax because the property had been owned by the vendor for more than seven years?” The witness (not the opposing counsel) replied: “That is so”—and no more attention was given to the matter. The question was not argued and the learned judge simply stated in the case that the profit was exempt from income tax. Thus, until the case actually came before the Full Court, it was assumed that the profit was exempt from income tax because it was liable to tax, if at all, only under s. 10 (1) of the Act of 1924, and that section did not apply because the property had been owned by the vendor for more than seven years.

But I think that it must be held that the question actually submitted enabled the Full Court to determine this point, though probably it was never intended that this should be the case. It would be a dangerous and uncertain procedure to limit the scope of a question formally submitted by a conjecture, however reasonable, that the question had been unintentionally stated in terms which were too wide.

If the facts stated did not make it possible to answer the question, of course it would not be answered. If there were any ground for believing that, if the question had been contested before *Mansfield J.*, either party could have adduced further relevant evidence, the question should not, in those circumstances, be answered. But all the relevant facts are before the court in the admission of the parties made during the hearing before *Mansfield J.* as to the ownership of the meatworks for more than seven years before sale. No additional evidence could affect the decision on this point. The question is purely one of law arising upon admitted facts, the admission being contained in a document which is made part of the case. I agree

with what *Philp J.* says in his reasons for judgment as to the confusion which is likely to arise in most cases when evidence is incorporated in a special case. But in the present instance no difficulty arises because the relevant facts are plainly admitted and it cannot, I think, reasonably be suggested that, in order to allow the Court to consider these facts, there should have been a formal finding by the judge stating the case that the admission was true.

I therefore proceed to inquire whether the profit of £40,640 was rightly held to be "created out of profits liable to tax or exempt from tax under this" (1936) "Act or under any previous income tax law of the State." The Act of 1936 had no application to the profit made in 1932. The relevant provisions of the Act of 1924 have already been stated. The profit did not fall within any of the heads of exemption set out in s. 8. It was not "liable to tax" under s. 10 or any other provision of the Act. Thus the answer to the question must be against the company.

The only means of escaping this conclusion is that adopted by *E. A. Douglas J.*, who said:—"It was not disputed that the sale in question falls within the latter provision" (proviso to s. 10 of Act of 1924) "and is not within the ambit of the section. I think such profits might reasonably be described as exempt from taxation. The words 'exempt income' may be confined to the express exemptions contained in the Act, but I do not think that this conclusion should determine the meaning of exempt profits in s. 34." The result of this view is that the words "exempt from tax" are construed as having the same meaning as "not liable to tax." Thus the words "liable to tax or exempt from tax" in s. 34 would be read as if they were "liable to tax or not liable to tax." Such a description would apply to all profits. Thus the words "exempt" and "liable to tax" would be deprived of all significance. It was plainly not intended to include within the class of profits mentioned in the section all profits irrespective of their relation to income tax legislation. I therefore find myself unable to agree that the profit was exempt from tax, and it is not disputed that the profit was not liable to tax.

In my opinion the answer to the first question should, on this ground, be "No," and the appeal should be dismissed.

RICH J. The present appeal involves the construction of s. 34 of *The Income Tax Assessment Act of 1936 (Q.)*. The relevant facts have been fully stated in the judgment of the Chief Justice, and I shall therefore not repeat them. The purpose of s. 34 is to determine the basis on which the rate of tax payable by a company

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is to be calculated. Sub-section 1 provides that this basis is to be the percentage which the profits of the company bear to the capital of the company which was invested in assets which were used during the year of income in production of assessable income. Hence, it is necessary to ascertain (1) what assets of the company were used during the relevant year in production of assessable income, and (2) what capital of the company was invested in those assets. The answers to both of these questions depend upon matters of fact; and, to answer the latter, it is necessary to know in what sense the phrase "capital of the company" is used. Sub-section 3 provides that the capital of the company shall, for this purpose, be ascertained by adding the amounts, averaged over a full year of income, of (a) the capital paid up in cash or value on all issued shares, and (b) reserves and parts of reserves (including in such reserves amounts standing to the credit of profit and loss account) invested in the business and created out of profits liable to tax or exempt from tax. Sub-section 5 provides that the capital of the company which was invested in assets which were used during the year of income in production of the assessable income of the company shall be taken as that part of the capital of the company which bears the same proportion to such capital as the average value of the assets of the company used in the production of the assessable income bears to the average value of the total assets of the company. Hence, in order to work out the percentage, it is necessary, first, to take the amount of the company's paid-up share capital and the amount of its reserves, invested in the company's business, which were created out of profits of the kind stated, and, second, to ascertain how much of these amounts was, during the relevant year, invested in the assets of the company which were being used in production of assessable income. The result of this inquiry gives the capital sum on which the percentage of profits is to be arrived at.

At any given time, the actual assets of an incorporated company limited by shares (apart from its uncalled capital) consist of (a) so much as still remains, of the money or property acquired by it by disposing of its shares, or of any property subsequently acquired by means of such money or property, and (b) so much as still remains of any profits which it has made and has not distributed amongst its shareholders, or of anything acquired by it by means of such profits. These actual assets, or part of them, may or may not, for the time being, be used in the carrying on of the company's business. In a sense, the total share capital, as received by the company, is invested in the former group of assets, and the total profits which the company has ever made and has not distributed amongst its

shareholders are invested in the latter, in the same sense that if a man buys a house for £1,000, this sum is invested in the house whether its value has since risen to £1,500, or, through damage by fire, has fallen to £500. Is this the sense in which the phrase, "the capital of the company which was invested in assets" used during the year in the production of income, is employed in s. 34 (1)? I think that it is, and that this follows from the provisions of s. 34 (5). This sub-section provides that, to ascertain the amount of the capital of the company which was invested in assets which were used during the relevant year in the production of income, it is necessary to ascertain the average value of the assets so used and the average value of the total assets, and the proportion which the former bears to the latter. The same proportion of the total capital of the company, as defined by sub-s. 3, is the capital of the company for the purpose of working out the percentage as required by sub-s. 1. Hence, the value of an asset is not to be taken as the measure of the capital invested in it. If the total *de facto* assets of the company are used in the production of income, the total "capital of the company" must be treated as invested in those assets for the purposes of the section. It follows that, broadly speaking, capital here means money or other property once acquired, not money or other property still existing.

It is in the light of these considerations that it is necessary to approach the definition of capital in sub-s. 3. There is ordinarily no difficulty in ascertaining how much has been paid to a company, in cash or value, for its shares. This gives the first element of capital. The second involves the ascertainment of how much of all the profits that the company has earned up to, but not including, the relevant year has been both (a) devoted by it to the creation of reserves of profits (and these include amounts standing to the credit of the company's profit and loss account), and also (b) invested by it in its business. As regards any profits not distributed to shareholders, if these have in fact been invested in the company's business, they must, for the purposes of s. 34, be treated as capital of the company, irrespectively of whether they are still represented by actual assets, and the amounts of any such reserves standing to the credit of the company's profit and loss account (if they have been invested in the business) must be treated as capital of the company whether they now represent actual assets or not. In other words, in the simple case of a company which employs all its property in its business in the production of assessable income, it follows from the combined operation of sub-ss. 1, 3 and 5 of s. 34 that its capital, for the purposes of the section, is neither its actual property nor

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the value of its actual property, but is the total amount of its paid-up share capital together with the total amount of any profits of the kind specified which it has made since its inception and has not distributed amongst its shareholders but has retained and at some time invested in its business, irrespectively of whether they are still represented by any actual property.

I do not think that any assistance in arriving at the meaning of s. 34 is to be obtained from an examination of authorities on s. 17 of the *War-time Profits Tax Assessment Act 1917-1918* (Cth.), such as, for example, *Hooper & Harrison Ltd. (in Liquidation) v. Federal Commissioner of Taxation* (1). As is pointed out in that case, s. 17 "is directed to all businesses, whether owned by individuals, firms or companies. Nothing turns on what is known as the *de jure* capital, or share capital, of limited companies" (2). Section 34 of the Queensland Act, on the other hand, is addressed to joint stock companies limited by shares, it deals specifically with the share capital of such companies, it is different in language, and entirely different in scheme and purpose. Similarly, I do not think that anything is to be gained by examining the opinions, sometimes conflicting, of writers on accountancy, as to the proper meaning of the terms "reserves" and "reserve funds." The question is, what is meant by the phraseology of s. 34, using the section as its own dictionary?

It follows that, in my opinion, *Mansfield J.* and *Philp J.* were right in their view that the amount of £40,640, was a "reserve invested in the business of the company," for the purposes of s. 34, notwithstanding that it was no longer represented by any actual property: Cf. *Commissioners of Inland Revenue v. Terence Byron Ltd.* (3).

On the second question, however, I am of opinion that, although this profit was not "exempt from tax" within the meaning of that phrase as used in s. 34 (3) (b), it was not liable to tax, and that hence the reserve in question was not "created out of profits liable to tax or exempt from tax."

It follows that, although the amount of £40,640 was a reserve invested in the business, it was not a reserve created out of profits liable to tax or exempt from tax, and hence it is not an element to be taken into account in order to ascertain the capital of the company for the purpose of arriving at the percentage of the profits of the company as referred to in s. 34 (1).

I agree, therefore, that the appeal should be dismissed.

(1) (1923) 33 C.L.R. 458.

(2) (1923) 33 C.L.R., at p. 480.

(3) (1944) 60 T.L.R. 367, 368.

McTIERNAN J. Two questions are raised by this appeal: they affect the rate of tax which is payable by the appellant to the State of Queensland in respect of income derived during the year ended 30th June 1940. One question is: Does the sum of £40,640 16s. 11d. mentioned in the special case constitute "reserves or part of reserves" "invested in the business" within the meaning of s. 34 (3) of the State's *Income Tax Assessment Act of 1936*? And the other question is: Was the profit represented by that sum "liable to tax or exempt from tax" within the meaning of the above-mentioned sub-section?

The rate of tax payable by a company under the above-mentioned Act is by s. 34 made to depend upon the proportion in which profits are to capital: and this section contains provisions for working out the amounts of profits and capital which are to be used in determining this proportion. Section 34 (1) defines the capital which it is necessary to take into account in calculating the rate of tax as "the capital of the company which was invested in assets which were used during the year of income in production of assessable income." The amount of such capital which is to be used in the calculation, is defined in s. 34 (5) as "that part of the capital of the company ascertained in accordance with the provisions of subsections three and four of this section which bears the same proportion to such capital as the average value of the assets of the company used in production of the assessable income bears to the average value of the total assets of the company."

Section 34 (3) provides that the capital which in sub-s. 5 is referred to as the "capital of the company" shall be ascertained by adding the amounts averaged over a full year of income of the "capital" and "reserves" and deducting the amount of any item specified in sub-s. 4.

Clause (a) of sub-s. 3 describes the "capital" which is to be included in this sum of "capital" and "reserves" as "the capital paid up in cash or value on all shares actually issued by the company," and clause (b) provides that the "reserves" to be included in such sum are the "reserves and parts of reserves (including in such reserves amounts standing to the credit of profit and loss account) invested in the business, and which have been created out of profits liable to tax or exempt from tax under this Act or under any previous income tax law of the State." An exception, not now material, is made of certain profits which would otherwise come within these provisions.

The capital of the company which it is necessary to ascertain in order to determine the amount of the capital "which was invested

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in assets which were used during the year of income in production of assessable income" is, therefore, the amount of money paid up in cash or value by the shareholders in respect of the issued capital with the addition, if any, of reserves invested in the business and created out of specified profits.

The sum of £40,640 16s. 11d. mentioned in the special case was entered to the credit of the assets realization reserve account as at 1st July 1939; this date was the beginning of the year of income in respect of which the questions in this appeal arise. That sum is equal to an amount of profits which had in a previous year been set aside as a reserve and employed or used in the business. It was not separately invested. But a debit balance of £46,742 9s. 3d., representing accumulated trading losses, is shown in the profit and loss account at 1st July 1939. It is evident that a sum greater than that entered as a reserve had been lost in the business before 1st July. The entry in the assets realization reserve account therefore does not represent a real reserve existing at any time during the year of income.

It may be conceded that the sum of £40,640 16s. 11d. was an amount of profits that had been set aside as a reserve and employed in the business previously to 1st July in such a way that according to the true construction of s. 34 (3) it had been invested in the business. It is contended on behalf of the appellant that s. 34 (3) requires that any reserve which was invested in the business and was created out of the specified profits should be added to the amount of the issued capital, even if the amount of the reserve had been lost before the beginning of the year of income.

The effect of s. 34 (3) is, it seems to me, to require an inquiry to ascertain what during the year of income was the amount of the issued capital and the amount of the reserves invested in the business and created out of the specified profits. The determination of the amount of the issued capital is not affected in any way by the consideration that the moneys paid up by the shareholders on their shares have been lost previously to the beginning of the year of income. But on the other hand it would not be true to say that any amount was during the year of income a reserve invested in the business which had been previously invested in the business but had been lost before the beginning of such year.

If these considerations are right they should lead to the exclusion of the sum of £40,640 16s. 11d. in calculating the rate of tax payable by the appellant on its income for the year ended 30th June 1940. But if on the other hand the correct view is that the amount of all reserves at any time vested in the business, whether lost or not,

may be added to the amount of the issued capital in ascertaining "the capital of the company" under sub-s. 3, I think that the appeal should nevertheless be dismissed. For I agree with the opinion of the Chief Justice that the question whether the profits which were set aside to create the reserve were liable to tax or exempt from tax was open on the special case and that it should be decided in the respondent's favour. On this part of the case I have nothing to add.

In my opinion the appeal should be dismissed.

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Appeal dismissed with costs.

Solicitors for the appellant, *McCullough & Robertson*.

Solicitor for the respondent, *W. G. Hamilton*, Crown Solicitor for the State of Queensland.

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