[HIGH COURT OF AUSTRALIA.]

THE FEDERAL COMMISSIONER OF TAXATION APPELLANT;

AND

THE MIDLAND RAILWAY COMPANY OF WESTERN AUSTRALIA LIMITED . . . RESPONDENT.

H. C. OF A.
1951-1952.
1951.
PERTH,
Sept. 5.
1952.
MELBOURNE,
March 6.
Dixon,
Webb
and
Fullagar JJ.

Income Tax (Cth.)—Assessment—Deductions—"Losses and out-goings to the extent to which they are . . . necessarily incurred in carrying on a business for the purpose of gaining or producing" assessable income—Method of paying interest to holders of cumulative income debenture stock altered by issue of reversionary certificates—Certificates redeemable out of profits—Whether redemption payments allowable deductions—Income Tax Assessment Act 1936-1944 (*No.* 27 *of* 1936 —*No.* 3 *of* 1944), *s.* 51 (1).

The tax-payer company was incorporated in England and was carrying on business in Western Australia. In 1902 the company issued certain cumulative income debenture stock which stock entitled the holders thereof to interest at the rate of six per cent per annum from 30th June 1898, payable only out of the surplus revenue of the company. The company, in fact, did not have any surplus revenue at any time during the twelve years ending 30th June 1910, and interest for that period amounted to £701,080. In the year 1910 the company reduced its share capital and re-organized its share and loan capital, and the arrears of interest up to 30th June 1910 were covered by issuing to the holders, *inter alia*, reversionary certificates to the total value of £701,080. These certificates were issued on conditions which provided that one-third (later reduced to one-sixth) of the net profits of the company which from time to time the directors should determine to divide should be applied in their redemption. In the year ending 30th June 1943 the company set aside a certain sum out of profits for that year as a provision for redemption of reversionary certificates and the money was, in fact, spent for that purpose in the ensuing year. The company claimed a deduction of the amount expended in the redemption of the certificates under s. 51 (1) of the *Income Tax Assessment Act* 1936-1944 and the claim was disallowed by the commissioner.

On appeal to the High Court, *held* (*Fullagar* J. dissenting), that the reversionary certificates were issued in respect of the £701,080 unpaid interest

H. C. of A. 1951-1952.

Federal Commissioner of Taxation v. The Midland Railway Co. of Western Australia Ltd.

on the six per cent cumulative income debenture stock but did not operate as a payment or satisfaction of such unpaid interest and the amounts paid in redemption of the reversionary certificates, being in the nature of payments of interest on moneys borrowed by the company for the purpose of its business, were allowable deductions in the year in which the certificates were redeemed.

Decision of *Kitto* J.: *Midland Railway Co. of Western Australia Ltd.* v. *Federal Commissioner of Taxation*, (1950) 81 C.L.R. 384, affirmed.

Appeal from *Kitto* J.

The Midland Railway Company of Western Australia Limited appealed to the High Court against an assessment to Federal income tax based upon income derived by the company during the year ending 30th June 1944.

The appeal was heard by *Kitto* J. who allowed it (*Midland Railway Co. of Western Australia Ltd.* v. *Federal Commissioner of Taxation* (1)).

From that decision the commissioner appealed to the Full Court of the High Court of Australia.

The facts and relevant statutory provisions are set forth in the judgments hereunder.

F. W. Leake K.C. (with him *A. L. Gleedman*), for the appellant. The holders of the cumulative income debenture stock ceased to be creditors of the company when the reversionary certificates were issued to them in 1910. *British Sugar Manufacturers, Ltd.* v. *Harris* (2) is not in point as in that case a creditor was to be paid before the fund available for distribution was ascertained. In this case no such creditor exists. The holders of the reversionary certificates are in the same position *vis à vis* the company as ordinary shareholders. No debt for accrued interest on the cumulative income debenture stock existed in 1910. As at that date a contingent claim for interest was satisfied by the issue of the reversionary certificates. The obligation of the company thereafter was of a capital nature: *Armco (Australia) Pty. Ltd.* v. *Federal Commissioner of Taxation* (3). The reversionary certificates were realizable securities and this feature strengthens the contention that the debt was, by their issue, converted into a debt of a capital nature: see *Raja Raghunandan Prasad Singh* v. *Commissioner of Income Tax, Bihar and Orissa* (4).

R. I. Ainslie (with him *R. E. Blanckensee*), for the respondent. The holders of the reversionary certificates were entitled to have

(1) (1950) 81 C.L.R. 384.
(2) (1938) 2 K.B. 220.
(3) (1948) 76 C.L.R. 584.
(4) (1933) L.R. 60 I.A. 133.

H. C. OF A. 1951-1952.

FEDERAL COMMISSIONER OF TAXATION *v.* THE MIDLAND RAILWAY CO. OF WESTERN AUSTRALIA LTD.

set aside one-third of the "net profits" of the company which the directors should from time to time determine to divide but this fund did not correspond with the "taxable income" of the company on which income tax is payable under s. 17. It was not a profit-sharing agreement. The dictum of Lord *Macmillan* in *Pondicherry Railway Co. Ltd.* v. *Commissioner of Income Tax, Madras* (1) that "a payment out of profits and conditional on profits being earned cannot accurately be described as a payment made to earn profits" was explained in *Adamson* v. *Union Cold Storage Ltd.* (2); in *Indian Radio & Cable Communications Co. Ltd.* v. *Income Tax Commissioner Bombay Presidency, and Aden* (3) and in *British Sugar Manufacturers Ltd.* v. *Harris* (4). [He also referred to *Commissioner of Taxation (W.A.)* v. *Boulder Perseverance Ltd.* (5); and *Davies Coop and Co. Pty. Ltd.* v. *The Commonwealth* (6).] If the scheme of 1910 had not been entered into then once the company had made profits there would have been an obligation to pay interest to the 6 per cent cumulative income debenture holders and even if no interest had been paid it would have been a debt and an allowable deduction under s. 51. [He referred to *Emu Bay Railway Co. Ltd.* v. *Federal Commissioner of Taxation* (7)].

Apart from the scheme of 1910 the 6 per cent cumulative income debenture stock holders would have been entitled to all the "net profits" when and as profits were made. By the scheme of 1910 they accepted something less than they were then entitled to. The scheme of 1910 and the reversionary certificates did not confer any additional rights: they simply deprived the 6 per cent cumulative income debenture stockholders of rights they already had. The Court should look at the substance and not the form of the scheme of 1910: *Permanent Trustee Co. of N.S.W. Ltd.* v. *Commissioner of Taxation* (8); *Henley* v. *Murray* (9); and see *Inland Revenue Commissioners* v. *Duke of Westminster* (10). The issue of the reversionary certificates did not operate as a payment or satisfaction of the interest which was then unpaid. Indeed the scheme of 1910, merely altered the method by which the interest was to be paid: see *Commissioner of Income Tax, Bihar and Orissa* v. *Maharajadhiraja of Darbharga* (11); and *Cross* v. *London & Provincial Trust* (12). To give security for a debt is not to pay a debt nor is payment

(1) (1931) L.R. 58 I.A. 239, at p. 251.
(2) (1931) 16 Tax. Cas. 293, at p. 331.
(3) (1937) 3 All E.R. 709, at pp. 713, 714.
(4) (1938) 2 K.B. 220, at pp. 237, 240.
(5) (1937) 58 C.L.R. 223.
(6) (1935) 54 C.L.R. 154, at p. 172.
(7) (1944) 71 C.L.R. 596.
(8) (1940) 2 A.I.T.R. 109, at p. 111.
(9) (1950) 1 All E.R. 908, at p. 910.
(10) (1936) A.C. 1, at p. 25.
(11) (1933) L.R. 60 I.A. 146, at p. 161.
(12) (1938) 1 K.B. 792.

H. C. OF A. 1951-1952.

FEDERAL COMMISSIONER OF TAXATION v. THE MIDLAND RAILWAY CO. OF WESTERN AUSTRALIA LTD.

made when a further or better security for a debt is given. [He referred to *Raja Raghunandan Prasad Singh* v. *Commissioner of Income Tax, Bihar and Orissa* (1).] Here the 6 per cent cumulative income debenture stockholders received a different but not a further or better security for the payment of the interest. The 6 per cent cumulative income debenture stockholders did not receive anything realizable or the equivalent in cash. [He referred to *Cross* v. *London & Provincial Trust* (2); *Permanent Trustee Co. of N.S.W. Ltd.* v. *Commissioner of Taxation* (3); and *Inland Revenue Commissioners* v. *Oswald* (4).]

Cur. adv. vult.

March 6.

DIXON J. The question for decision upon this appeal is whether the respondent company is entitled to a deduction from its assessable income of an amount expended in redeeming certain reversionary certificates which it claims to have issued in respect of arrears of interest on debenture stock.

Kitto J., from whose decision the Commissioner of Taxation brings this appeal, held that the amount expended was a proper deduction, subject to its being shown how much of it was paid in redemption of certificates which actually did represent such arrears of interest.

The year of income with which the appeal is concerned is that ending 30th June 1944 and the amount paid by the company during the year in redeeming reversionary certificates was £2,966. To explain the nature of the payment a short account of a portion of the financial history of the company is necessary.

The company, which is incorporated in England, carries on its business in Western Australia. In the year 1902 the affairs of the company were re-organized and as part of a plan of arrangement it created £1,000,000 of 6 per cent cumulative income debenture stock of which it issued an amount of £973,723. This was a conversion of a then existing issue of 6 per cent debentures which ranked as a third charge. The new cumulative income debenture stock ranked for interest as from 30th June 1898 but the interest was payable only out of the company's surplus revenue after providing for interest on certain 5 per cent stock and for prior revenue charges. Apparently there was no such surplus revenue in the next decade, for by 30th June 1910, the unpaid interest upon the 6 per cent cumulative income debenture stock amounted to £701,080. Another plan of arrangement was submitted to the holders of debenture

(1) (1933) L.R. 60 I.A. 133.
(2) (1938) 1 K.B. 792.
(3) (1940) 2 A.I.T.R. 109.
(4) (1945) A.C. 360.

H. C. of A. 1951-1952.

Federal Commissioner of Taxation v. The Midland Railway Co. of Western Australia Ltd.

Dixon J.

stock and of shares. As part of this plan the holders of the £973,723 cumulative income debenture stock were to take (1) a second mortgage debenture stock to the amount of £600,000 being 61.62 per cent of the amount of their then capital holding ; (2) £373,723 of unified ordinary shares or stock, being the remaining 38.38 per cent of the amount of their capital holding ; (3) £146,058 of the unified ordinary shares or stock as a premium of 15 per cent of the amount of their then capital holding ; (4) a new reversionary certificate for the amount of £701,080 representing all arrears of interest to 30th June 1910.

The plan included a re-organization of share capital involving a reduction of existing share capital and, as an incident of that part of the plan, reversionary certificates amounting to £107,920 were to be issued to shareholders. Thus, in all, new reversionary certificates amounting to £809,000 were to be issued. These were to be payable only out of one-third part of the divisible revenue of the company. The certificates to be redeemed out of the one-third part of the divisible revenue might be drawn by lot and paid off at par or the company might purchase the stock below par. The shareholders adopted special resolutions to give effect to the scheme of arrangement and so did the various classes of debenture stock holders and so much of it as involved a reduction of capital was confirmed in the Chancery Division on 21st February 1911.

A trust deed was executed for the purpose of carrying out the scheme and of expressing among other things the rights of the holders of reversionary certificates. The scheme was embodied in a schedule. The clause material to the issue of the certificates amounting to £701,080 to the holders of the old 6 per cent cumulative income debenture stock consisted of a provision that the £973,723 six per cent cumulative income debenture stock be satisfied by the issue to the holders thereof, to be divided amongst them in proportion to their holdings, of the said £600,000 second mortgage cumulative income debenture stock and of 519,781 new ordinary shares of £1 each to be issued fully paid and of reversionary certificates to the total amount of £701,080 and that the same be accepted in full satisfaction of all claims to principal moneys, premium and interest in respect of the said 6 per cent cumulative income debenture stock.

The provisions of the deed relating to the creation of the reversionary certificates fixed the total nominal amount at £809,000 (i.e. so as to cover the amount of £107,920 of such certificates distributed among shareholders as well as the £701,080). The deed provided that all such certificates should rank *pari passu*

H. C. of A. 1951-1952.

Federal Commissioner of Taxation v. The Midland Railway Co. of Western Australia Ltd.

Dixon J.

and should entitle the holders to participate *pari passu* according to the nominal amount thereof in the distribution of the share of net profits of the company to be from time to time distributed in manner thereinafter appearing. It was then provided that the company should in each year, beginning in the year 1911, set aside for distribution among the certificate holders one third of the net profits of the company which the directors of the company should from time to time determine to divide. When the directors determine to divide any profits the auditors are to certify the amount and then after providing, out of the moneys available for distribution among certificate holders for income tax payable to the British and Westralian Governments in respect of the profits so distributable, the company is required to apply the balance in the redemption of the certificates, in the option of the company either (a) by drawings at par, (b) by the purchase of the certificates by tender under par, or (c) by purchase in the market under par. A clause provides how a drawing of the certificates to be redeemed must be conducted if the redemption is to be by drawings at par.

Another clause of the deed provides that the holders of the reversionary certificates should not be entitled to rank against the assets in a winding up except in case of a winding up for purposes of reconstruction and then only against any surplus over share capital paid up. The deed provides a form of reversionary certificate and requires the company to keep a register of such certificates. The form certifies that the person named is the registered holder of reversionary certificates for such an amount entitling him to share in the distribution of one-third share of the profits of the company which the directors should from time to time determine to divide, subject to income tax, pursuant to the trust deed. It is also provided that every holder is to be entitled to transfer his certificate or a part thereof by an instrument in writing which is to be registered. In 1925 a further scheme of arrangement was made by which the rights *inter se* of the second mortgage cumulative income debenture stockholders, the unified ordinary stockholders and the reversionary stockholders were readjusted. The scheme was embodied in a supplemental trust deed. Under the readjustment the proportion of surplus profits to be set aside for redemption of the reversionary certificates was reduced from one-third to one-sixth but the holders of such certificates obtained a right, in the event of liquidation for any purpose or on a sale of the company's undertaking, to receive one-tenth of the company's surplus assets.

Out of profits of the year ending 30th June 1943, which the directors determined to divide, £2,966 was appropriated for the

H. C. of A. 1951-1952.

Federal Commissioner of Taxation v. The Midland Railway Co. of Western Australia Ltd.

Dixon J.

purpose of redemption of reversionary certificates. In the year ending 30th June 1944, the year of income with which the appeal is concerned, that sum was applied in the purchase of such certificates below par. The question to be decided is whether the sum so applied or any part of it is allowable as a deduction in the assessment of the company's taxable income derived during that year. It was not suggested that, if the deduction was allowable, the sum of £2,966 should be attributed to the previous year when the profit was earned. Such a contention would be erroneous because what is material is the expenditure during the year it occurred. But in any event it would not matter because the company paid in the ensuing year a somewhat larger sum for the purchase of reversionary certificates in consequence of determining to divide profits earned in the year ending 30th June 1944. The commissioner's contention is that expenditure by the company in redeeming its reversionary certificates does not form an allowable deduction at all. He maintains that it is not a deduction which is authorized by s. 51 (1) of the *Income Tax Assessment Act* 1936-1944. He disputes the conclusion that the expenditure was in truth an outgoing on account of arrears of interest which had accrued on money borrowed for the purpose of carrying on the undertaking and so was an expenditure incurred in carrying on a business for the purpose of gaining or producing assessable income. He says that it was not an outgoing incurred in gaining the assessable income, that its true character was a distribution of net profits or income and not an expenditure to be taken into account in ascertaining net profits or income and that the liability it discharged, namely, that arising upon or expressed by the reversionary certificate, is of a capital nature.

The case is a difficult one because of its peculiar features. In reaching a solution of the difficulties it presents it appears to me that there are three considerations which it is important to keep steadily in mind. The first is that from beginning to end the issue is whether the payment or any part of it was an outgoing incurred in gaining or producing the assessable income or necessarily incurred in carrying on a business for the purpose of gaining or producing such income: s. 51 (1) of the *Income Tax Assessment Act* 1936-1944. The issue is not whether the payment when made possessed the character of interest on borrowed money, borrowed for the purpose of the business. It is not whether the obligation in pursuance of which it was paid had taken this or that form. It does not depend upon the identity of the actual payee. The question is not what was his title to payment or what was the character of the money in his hands. Further it is not decisive of the issue under s. 51 (1) that it was paid or payable out of profits, that is so long as it was not payable out of the precise fund called by the Act taxable income.

The second consideration is that what governs the issue is the business purposes for which the outgoing was incurred from the point of view of the taxpayer company. The controlling factors are those which arise from the character of the business or undertaking and the relation which the expenditure or the liability to make it bore to the carrying on of the business or the gaining of assessable income.

The third consideration is that if a liability of a revenue nature is incurred, subsequent changes in the legal form of the liability, in the identity of the creditor or in the circumstances or contingencies in which it is to become immediately due or in the specification of the sources of payment do not matter, so long as the liability is not capitalized, that is to say converted in some way into a contribution to the capital structure of the business or undertaking.

In approaching a consideration of the case the feeling is natural that there can be little connection between the assessable income of the year under assessment and a payment made on account of a financial obligation originating in a transaction so long ago. But the claim to the deduction does not depend upon a causal connection between the gaining of the assessable income of the given year and the actual expenditure. Such a causal connection may be found wanting and yet the claim may succeed. It depends upon the continuity of the business or undertaking of the taxpayer and the fact that items of revenue expenditure must be met in a continuing business if they are the necessary result of conducting it. For the words of s. 51 (1) upon the application of which this case depends are " necessarily incurred in carrying on a business for the purpose of gaining or producing such income ", words which express a criterion formerly resting upon judicial decision. It is not an answer in the case of a continuing business that the revenue charge claimed as a deduction today is the outcome of a transaction entered into in carrying on the business at an earlier time or that the gains of the company have long since ceased to reflect any advantage the transaction may have brought to the undertaking as " a profit yielding subject " (the phrase of Lord *Blackburn* in *United Collieries Ltd.* v. *Inland Revenue Commissioners* (1) cf. *Sun Newspapers* v. *Federal Commissioner of Taxation* (2)).

(1) (1930) S.C. 215, at p. 220 ; (1929) 12 T.C. 1248, at p. 1254.

(2) (1938) 61 C.L.R. 337, at pp. 359, 360.

H. C. of A. 1951-1952.

Federal Commissioner of Taxation v. The Midland Railway Co. of Western Australia Ltd.

Dixon J.

For example a trader who opened an additional shop for which he obtained a long lease and, because it proved unprofitable, closed the branch was allowed a deduction on account of so much of the rent as he could not recover by subletting, though the residue of the term was twenty-eight years: *Hyett* v. *Lennard* (1). It was so decided by *Macnaghten* J. who said (2), " I do not see on what ground it can be held that, if the lease has only three years to run, the rent continues to be a deductible expense, but if it has twenty-eight years to run it cannot be deducted at all. If it was an expense of the trade during the first year or two after the business was no longer carried on at the premises, how could it cease to be an expense of the trade during the later years ? "

It is clear enough that if the 6 per cent cumulative debenture stock created under the plan of arrangement of 1902 had remained on foot interest accuring upon the stock would, if and when paid, have formed an allowable deduction : cf. *Farmer* v. *Scottish North American Trust Ltd.* per Lord *Atkinson* (3). So much is not denied.

It is true that the debenture was created as a conversion of a previous issue of 6 per cent debentures. But they secured a loan for the purposes of the company's undertaking. It is true also that the interest upon the debenture stock created in 1902 was payable only out of the company's surplus revenue after providing for interest on other debentures with a superior ranking and after providing for prior charges. But that is nothing but a restriction on the sources whence payment may be exacted ; it amounted only to making the liability contingent upon the existence of such a surplus. There was not then a Federal Income Tax Assessment Act and, therefore, it cannot be said that the accrued amount of interest, £701,080, formed a deduction from the assessable income of the year in which it might be paid. But it is correct to say that it was a floating contingent liability on revenue account the payment of which would have been allowable as a deduction had the liability continued into the period of Federal income tax.

Now I think that it is undeniable that, of the £809,000 reversionary certificates under the later plan of arrangement or rearrangement, £701,080 represented this sum of accrued interest contingently payable by the company out of any future surplus. The accrued interest was represented by £701,080 of the reversionary certificates because the existing contingent liability of the company in that sum was converted into a new contingent liability evidenced by reversionary certificates in the like amount.

(1) (1940) 2 K.B. 180.
(2) (1940) 2 K.B., at p. 186.
(3) (1912) A.C. 118, at p. 127.

H. C. of A. 1951-1952.

Federal Commissioner of Taxation v. The Midland Railway Co. of Western Australia Ltd.

Dixon J.

The commissioner however says that reversionary certificates were accepted in satisfaction of the old liability; that the holders of the £973,723 six per cent cumulative income debenture stock on which the interest had accrued accepted in satisfaction of all their rights as stockholders (1) the second mortgage debenture stock, (2) the unified ordinary shares in stock, and (3) the new reversionary certificates. He says that the £701,080 then lost its legal character as a contingent debt for interest and took on a new character, namely a liability upon the special terms governing the so-called reversionary certificates under the plan of arrangement.

All that I readily accept. But it does not seem to me to matter. It would of course matter if the special terms governing the new liability were incompatible with the fulfilment of the conditions upon which the allowability of a deduction depends, as for instance if the contingent debts were transformed in some way into a liability of a capital nature. But that is not because the contingent debt has been satisfied by the acceptance of a new obligation, not because it has ceased, as between the obligor and the obligee, to wear the legal complexion of a debt for interest, contingently payable. It would be wholly because of the particular character of the new contingent liability. It will be necessary to consider whether the terms governing the company's liability in respect of reversionary certificates are inconsistent with the conditions of deductibility. But apart from that possibility why should the substitution of a new liability matter? From the point of view of the company it had incurred a responsibility for a money sum payable (contingently) on revenue account as part of a transaction necessarily entered upon in carrying on its business. From the point of view of the company it remained responsible on revenue account in the same sum of money. Nothing had happened that had changed the business character of the responsibility. The fact that the certificates were transferable could not be material. The transferability and transmissibility of the right to recover the payment can have no bearing on the question whether, from the company's point of view, the payment formed an out-going necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income.

To my mind the allowability of the payment as a deduction under s. 51 (1) comes down to the question whether the terms governing the redemption of the reversionary certificates take the payment out of the category of an outgoing necessarily incurred in carrying on a business for the purpose of gaining assessable income.

H. C. of A. 1951-1952.

Federal Commissioner of Taxation v. The Midland Railway Co. of Western Australia Ltd.

Dixon J.

Now so far from the purpose of these terms being to convert what originally was a contingent liability for interest into a liability belonging to the capital structure of the undertaking its tendency was in the opposite direction. Its purpose was to take the liability still further from the ordinary description of indebtedness which is answerable out of any or all of the assets of the undertaking and place it so to speak last in priority upon the line of successive burdens upon the revenue of the undertaking which must be met before the shareholders may actually enjoy the residue that is liberated to them. The point upon which the appeal appears to me to turn is the correctness of the commissioner's contention that in doing this the company has gone so far as to substitute, for an obligation to meet, in a contingency, what was or would have been an outgoing incurred in carrying on a business for the purposes of gaining assessable income, a mere contract to distribute a share of the taxable fund, the taxable income.

When capital is raised by a company by the issue of shares the shareholder contributes to the capital structure of the "profit yielding subject" and obtains a title to share proportionately in the distribution of the profits yielded. This is so even when they are preference shares bearing a fixed rate of dividend. The profits available for distribution represent pretty nearly what is the taxable fund under the Income Tax Acts of the United Kingdom and roughly so for the purposes of the Federal Income Tax Assessment Acts. But capital may be contributed upon contractual terms entitling the contributor to a share of the profits of "the profit yielding subject", although he does not become a shareholder. When such an investment of capital is made in order to obtain a share of ultimate profits, a distribution of the share of profits has not been considered to be an outgoing incurred for the purpose of earning profits and so to be antecedently deductible as a trade expense before the ascertainment of the taxable fund: *A. W. Walker & Co.* v. *Inland Revenue Commissioners* (1).

Again if a company remunerates an employee for services in its trade or business the outlay is prima facie deductible as a trade expense, even although the amount may be calculated as a percentage of profits. But if there is a joint adventure the profits of which are to be shared between the parties to it the fact that one of them contributes nothing but his services to the enterprise will not put his share of profit into the category of a deductible trade expense of the business. Difficulties have been experienced in drawing the line between the case of deductible remuneration

(1) (1920) 3 K.B. 648; (1920) 12 Tax. Cas. 297.

H. C. of A. 1951-1952.

Federal Commissioner of Taxation v. The Midland Railway Co. of Western Australia Ltd.

Dixon J.

comprising a percentage of profits and the division of profits between parties jointly earning or gaining them. It is discussed in *British Sugar Manufacturers, Ltd.* v. *Harris* (1) where *Greene* M.R. said, " I can see no reason at all in principle why a contract providing for remuneration by commission and nothing else should not produce the result that the sum payable under it to the employee is a proper deduction ". As Mr. *Farnsworth* said in his *Income Tax Case Law* (1947), at p. 25, " it is the quality of the payment that matters and not its admeasurement ".

But it is not in the cases concerning remuneration by a share in profits that the commissioner finds the analogy to the present case but rather in those cases where for an advance of capital or for an advantage enuring to capital in some other form, a right to a share of divisible profits is obtained.

To my mind the analogy is mistaken. What is there acquired by the lender, or the person contributing the advantage of a capital nature, is the recurrent right to participate in the profits of the profit-yielding subject to the capital structure of which he is contributing. In principle it is the same as the purchase of a share of profits in a business. " If a person purchases a share of profits, of course, the profits paid to that person cannot be deducted " : per *Greene* M.R., *British Sugar Manufacturers, Ltd.* v. *Harris* (2).

Thus in *A. W. Walker & Co.* v. *Inland Revenue Commissioners* (3) of the facts of which there is a summary in *Commissioner of Taxation* (*W.A.*) v. *Boulder Perseverance Ltd.* (4) which I shall not repeat, *Rowlatt* J. said : " The contract simply gives the lenders a share of the profits, without any rights or liabilities of partners ; it simply takes three-twentieths of the profits and gives it to the lenders and the borrowers take the other seventeen-twentieths themselves ".

By contrast to this it is to be noticed that the holder of a reversionary certificate obtains no right to a proportionate share in profits. He is not entitled to any recurring interest in profits. His certificate entitles him to be paid once for all when and if there is a divisible profit and his certificate is drawn. The provision for the redemption of such certificate by the application of part of the amount of profits the directors are prepared to distribute was not an advantage for which he stipulated. It was a restriction of the contingent right to payment of accrued interest subsisting under the first scheme of arrangement which the holders of the

(1) (1938) 2 K.B. 220, at p. 233.
(2) (1938) 2 K.B. 220, at p. 234.
(3) (1920) 3 K.B. 648; (1920) 12 Tax. Cas. 297.
(4) (1937) 58 C.L.R. 223, at p. 233.

H. C. of A. 1951-1952.

Federal Commissioner of Taxation v. The Midland Railway Co. of Western Australia Ltd.

Dixon J.

6 per cent cumulative income debenture stock surrendered when they took the reversionary certificates. The evident purpose was to make it possible for the company to declare dividends notwithstanding that the company could not first discharge the very heavy liability for arrears of interest which would otherwise make a prior claim on surplus revenue or " profits " and at the same time to reduce that liability ratably with the distribution of dividend. Suppose this case. A company incurs an ordinary trading debt or liability in a large amount which it finds itself unable to discharge. It tells the creditor, who has his own reasons for desiring that the business of the company should continue, that if it has to pay him it will make default in paying its preference dividend and that liquidation will follow. It asks him to postpone his debt to the company's liability for the payment of preference dividends and to agree that payment of the debt owing to him shall not commence until in some subsequent year profits available for dividend shall exceed the preference dividend and then only by the application from time to time of the amount by which such profits exceed the amount of the preference dividend will his debt be paid off. I take this example because the right to payment is thrust, so to speak, along the order of priority in claims upon revenue a step beyond the point at which company law, at all events, treats net profit as finally ascertained.

Yet why should this make the liability any the less a trading debt, any the less an outgoing incurred in gaining the assessable income or necessarily incurred in carrying on the business for the purpose of gaining such income ? The postponement of the debt in the order of claims upon revenue, the nature of the contingency by which the creditor's right to payment is qualified, the fact that the only source to which he may look for payment is profit after all expenditure has been deducted including preference dividends so that only dividends on ordinary shares remain, these elements do not appear to me in any way to detract from the character of the disbursement as an outgoing incurred for the purpose of carrying on the business and gaining assessable income. It all amounts only to an attenuation and restriction of the creditor's rights leaving the business origin and purposive character of the debt unchanged.

The complications of the transaction in the present case tend to obscure its essential character. But essentially it appears to me not to be a disposal of a share in profits to a purchaser or party acquiring a right to share in profits as a *quid pro quo* for some benefit given to the proprietor of the business. It is the replacement of a liability, a contingent liability, to pay a sum of money incurred for the purpose of gaining income with a liability which although a new obligation in point of law is a liability for the same sum of money. The obligees take no percentage or proportion of profits whatever they may amount to. They are entitled to no more than the fixed amount of the old debt and the existence of profit provides only the occasion and means of payment.

The contingencies introduced are all in derogation of the obligees' former rights which are reduced and postponed. But the business foundation of the liability is the same ; nothing that is done seems to me to be relevant to or to affect the reason why the undertaking saddled itself with the liability in the sum and remains saddled therewith and that is the criterion which s. 51 (1) adopts. The obligees accepted the disadvantages of the further attenuation of their rights to the £701,080 arrears of interest, no doubt, partly because of the better prospects of rehabilitating their capital investment and of other advantages the scheme of rearrangement held out, and partly because the £701,080 was to be represented by a marketable security, the reversionary certificates.

The right given to the holders of reversionary certificates by the supplemental trust deed of 1925 to payment in the event of a liquidation for any purpose or on a sale of the company's undertaking does not, I think, affect the allowability of the outgoing as a deduction. The clause is drawn with an unfortunate economy of expression, but two things seem clear. One is that the right only arises in a liquidation and the other is that the one-tenth of the surplus assets are to be received for distribution among certificate holders in accordance with the trust deed ; that is the deed embodying the re-arrangement of 1911. This draws in cll. 6 to 10 and no doubt if need be the following clauses of the deed. The result, I think, would be that no reversionary certificate holder would be entitled to more than the full amount of his certificate and no payment would be made in respect of certificates already redeemed. If the one-tenth of the surplus exceeded the amount of the outstanding certificates, no doubt a question as to its disposal would arise ; but I do not think it was the intention of the deed that the certificate holders should get it. If it were otherwise, however, it is difficult to see how it would disqualify the outgoing from deductibility.

I therefore think that moneys paid by the company in discharging the liability evidenced by the reversionary certificates representing any part of the £701,080 form an allowable deduction from the assessable income of the year in which the payment is made. This

H. C. of A. 1951-1952.

Federal Commissioner of Taxation v. The Midland Railway Co. of Western Australia Ltd.

view applies equally to moneys applied in redeeming or taking up such certificates. The sum of £2,966 in question was applied in taking up certificates in this manner, some of which at all events represented part of the £701,080. The notice of appeal does not complain of so much of the decision of *Kitto* J. as deals with the difficulty arising from the taxpayer company's failure to prove fully how much of the £2,966 was expended in redeeming certificates representing the £701,080 as distinguished from the certificates representing the further amount of £107,920.

But in any event I agree in the view his Honour took of the difficulty and the course he adopted.

In my opinion the appeal should be dismissed with costs.

Webb J. The facts, so far as they appear to me to be material, are, briefly, that before 1899 the taxpayer company had issued 6 per cent debentures to obtain capital to carry on its business. Had these debentures continued in existence the interest payable on them would have been an allowable deduction under s. 51 of the *Income Tax Assessment Act* 1936-1944. That is not contested. But in 1899 the company planned the re-organisation of its *loan capital*, and, in 1902, issued 6 per cent cumulative income debenture stock to the amount of £973,723 by way of conversion of the 6 per cent debentures. This new stock entitled the holders to interest from 30th June 1898, payable only out of "surplus revenue". But there was no surplus revenue up to 30th June 1910, and at that date the interest had accumulated to the extent of £701,080. Had there been surplus revenue, and had the interest been paid out of it, then such payments would also have been allowable deductions under s. 51. That again is not contested. However, in 1910 the company prepared another scheme; this time for the reduction of its share capital and the re-organisation of its *share capital and loan capital*. In a circular issued by the directors, when submitting the scheme to the shareholders and debenture-holders for their approval, it was stated that there would be issued to the debenture holders stock of a specified amount; and also reversionary certificates mounting to £701,080 "representing all arrears of interest to 30th June 1910". The scheme was approved, and to carry it into effect an indenture dated 15th April 1911, was executed. This indenture recited the debenture and share capital, including the £973,723 six per cent cumulative income debenture stock "with arrears of interest amounting to £701,080", and that the company was desirous of creating reversionary certificates. Clause 2 of the indenture provided that the company should create reversionary certificates to the amount of £809,000 entitling the holders to participate in the distribution of one-third of the " net profits ", and also to a specified extent in a winding up for the purposes of reconstruction. Reversionary certificates were thereafter issued as follows :—

1.	To the holders of the 6 per cent cumulative income debentures	£701,080
2.	To shareholders	107,920
		£809,000

By a further indenture dated 8th June 1925, the " surplus profits " to be set aside for the redemption of the reversionary certificates were reduced from one-third to one-sixth, and in the event of a winding up for any purpose the holders of unredeemed reversionary certificates were given specified rights of participation.

I think it is proper to conclude from these facts that the £701,080 reversionary certificates issued to the 6 per cent debenture holders were issued in respect of the arrears of interest. But I do not think it is proper to conclude that the arrears of interest were capitalised, and that the reversionary certificates created a capital liability, as if they were shares in the company, except to the specified extent in a winding up. Actually no interest was due, and none would have become due, if it so happened that there was no surplus revenue. In any event, even as regards the shareholders who received certificates, no capital liability was created, except as aforesaid, although one was displaced by the issue of the reversionary certificates to shareholders.

In my opinion the issue of the debenture holders' reversionary certificates had the same effect as the issue of transferable coupons for interest would have had. The certificates represented in their case interest payable out of " surplus revenue " or " net profits ", or " surplus profits ". I am inclined to think that all three expressions are inter-changeable, as they are used in these transactions between the company and its shareholders and debenture holders ; but in any event none of the three expressions is identical with " taxable income ". If they were identical, then money paid for the redemption of a certificate, even for a certificate originally issued to a debenture holder, could not be an allowable deduction under s. 51. In that event the debenture holders, in accepting the certificates, would, in effect, have ceased to be lenders of money to the company and have become joint adventurers in the business with the shareholders.

H. C. of A. 1951-1952.

Federal Commissioner of Taxation v. The Midland Railway Co. of Western Australia Ltd.

Webb J.

But in my opinion the provision for payment out of surplus revenue or profits still left it open to hold, and it is proper to hold, that money paid to redeem debenture holders' certificates was a deduction under s. 51, because the issue of the reversionary certificates did not change the relationship of the debenture holders to the company, but merely altered the nature of the security for the payment of interest on money lent. The debenture holders continued to be such, i.e., lenders of moneys to the company to carry on its business.

Because payments to redeem certificates issued to shareholders could not be allowed as deductions under s. 51 it does not follow that payments in redemption of certificates issued to debenture holders could not be allowable deductions. It is true that every certificate, no matter to whom issued, was part of the same issue and in the same terms. But if, say, only one hundred certificates had been issued to shareholders that would not have altered the relationship between the holders of the 973,723 debentures and the company from that of lenders of money to joint adventurers with the shareholders in the business. And the position is not, I think, different because 107,920 certificates were issued to shareholders. To those who received them as shareholders the money they represented was not interest on money borrowed for the business of the company, and so was not an allowable deduction under s. 51. But those issued to debenture holders were really interest coupons designated reversionary certificates. To the debenture holders a certificate represents a right to receive money owing to him for interest on money lent to the company; to the shareholders it also represents the right to receive money, but not for interest. The reversionary certificates gave identical rights but were in discharge of different obligations. To both debenture holder and share holder a certificate represents a right to receive money. So too would a cheque. But s. 51 is not concerned with the form of payment, but with the nature of the obligation discharged by payment, in whatever form.

I would dismiss the appeal.

Fullagar J. This is an appeal from a judgment of *Kitto* J. given on an appeal by the taxpayer company against its assessment to income tax on income derived by it during the year ended 30th June 1944. The question at issue is whether the company was entitled, for the purpose of arriving at its taxable income of that year, to bring into account as a deduction a sum of £2,966 (or some part thereof) paid by it during the year in the redemption of certain " reversionary certificates " issued by it many years ago on terms and in circumstances which require close examination. His Honour held that the company was entitled to make the deduction claimed. I regret that I am not able to agree with his Honour or with my brothers on this appeal.

The company is a company incorporated in England and carrying on business in Western Australia. At the beginning of the century the company seems to have been in serious difficulties with secured and unsecured creditors, and in 1902 it carried into effect a scheme of arrangement which involved a re-organisation of its loan capital. It is unnecessary to consider the details of this scheme. It is sufficient to say that it involved the creation of £250,000 of what was called 5 per cent cumulative income debenture stock and £1,000,000 of what was called 6 per cent cumulative income debenture stock. The former stock is not directly relevant in this case. The 6 per cent cumulative income debenture stock was issued to a total amount of £973,723. Of this amount £749,400 was issued to the holders of 749,400 third debentures of the company, who also received between them a further £184,656 of the 6 per cent stock " in satisfaction of interest to 30th June 1898 ". The balance of £40,067 appears to have been issued to certain unsecured creditors of the company. The scheme contained an elaborate set of conditions relating to the rights of the holders of the 5 per cent cumulative income debenture stock, but the record discloses with regard to the 6 per cent stock, merely that it was provided that it should " rank for interest from the 30th day of June 1898 but payable only out of surplus revenue after providing for the interest on the 5 per cent cumulative income debenture stock and prior revenue charges ". Presumably the conditions attached to it were the same *mutatis mutandis* as those attaching to the 5 per cent stock. It seems clear enough that interest, though payable only out of surplus revenue, was to be cumulative. The company did not in fact have any such surplus revenue in any year up to 30th June 1910. Consequently no interest on the 6 per cent cumulative income debenture stock became payable or was paid during that period. The amount of accumulated interest for that period was £701,080.

In 1910 the company adopted a scheme which involved a reduction of its share capital and a re-organisation of both its share capital and its loan capital. The scheme was adopted by special resolution and approved by the various classes of persons interested. So far as the reduction of capital was concerned, this was confirmed by the High Court of Justice in England in accordance with the *Companies Act* 1908. At this stage the company had issued

H. C. of A. 1951-1952.

Federal Commissioner of Taxation v. The Midland Railway Co. of Western Australia Ltd.

Fullagar J.

(a) £300,000 4 per cent debentures guaranteed by the Government of Western Australia on which interest was in arrear, (b) £77,404 " prior lien debenture stock ", on which interest was in arrear, (c) £123,923 five per cent cumulative income debenture stock with arrears of interest cumulative but payable only out of " surplus revenue ", (d) the £973,723 six per cent cumulative income debenture stock with arrears of interest cumulative but payable only out of " surplus revenue ", (e) 200,000 ordinary shares of £6 paid to £1, and (f) 40,000 founder's shares of £1 fully paid. The total issued share capital is thus seen to have been £1,240,000.

The scheme provided for the redemption of the 4 per cent debentures, the prior lien debenture stock, and the 5 per cent cumulative income debenture stock, by means of an issue of " 4 per cent first mortgage debenture stock ". The details of the method by which this result was to be accomplished do not matter for present purposes. The capital of the company was then to be increased by the creation of 520,000 " new " shares of £1 ranking as ordinary shares. The *existing* share capital of £1,240,000 was then to be reduced to £80,000 divided into 200,000 ordinary shares of 4s. 6d. each to be treated as fully paid and 40,000 founder's shares of 17s. 6d. each to be treated as fully paid. The " new " ordinary shares of £1, the 200,000 ordinary shares of 4s. 6d. and the 40,000 founder's shares of 17s. 6d. were to become henceforth ordinary shares ranking *pari passu* for all purposes and to be converted into " one unified ordinary stock ". The holders of the £973,723 6 per cent cumulative income debenture stock are not covered by the scheme as so far outlined. They were provided for in this way. They were to accept " in full satisfaction of all claims to principal moneys, premiums and interest " (a) £600,000 four per cent second mortgage debenture stock to be created, (b) 519,781 of the " new " shares of £1, and (c) £701,080 " reversionary certificates " to be constituted. These securities were to be issued to the holders of the 6 per cent cumulative income debenture stock and " divided amongst them in proportion to their holdings ". Finally the scheme provided that to the holders of the 200,000 ordinary shares of 4s. 6d. there should be issued " reversionary certificates " to the total amount of £60,705, and to the holders of the 40,000 founder's shares of 17s. 6d. " reversionary certificates " to the total amount of £47,215. The total amount of reversionary certificates to be issued was thus £809,000, of which £107,920 was to go to existing shareholders and £701,080 to holders of cumulative income debenture stock.

It is with respect to these " reversionary certificates ", or, rather, with respect to such of them as were issued to the holders of the

6 per cent cumulative income debenture stock, that the question in this case arises. The expression " reversionary certificate " is, of course, a mere arbitrary description, which does not explain itself. The rights of the holders of the certificates were defined and secured by a trust deed dated 15th April 1911. The recitals to this deed included a reference to the " six per cent cumulative income debenture stock to the total amount of £973,723 with arrears of interest amounting to £701,080 ". They also refer to the scheme of re-organisation, which is set out in the first schedule to the deed. The second schedule contains the form of certificate to be issued to the holder. This certifies that he " is the registered holder of reversionary certificates for £ entitling him to share in the distribution of one-third share of the profits of the company which the directors shall from time to time determine to divide *subject to income tax* pursuant to the trust deed " of 15th April 1911. The actual rights conferred upon the holder against the company are set out in detail in the body of the deed, and are repeated in the third schedule. It is not worth while to attempt to summarise the main provisions. They are, taken from the body of the deed, as follows :—

" 2. The company shall forthwith create a series of Certificates to the total nominal amount of Eight Hundred and Nine Thousand Pounds each to be for the sum of One Pound or any multiple of One Pound and all such Certificates shall rank pari passu and shall entitle the holders of the Certificates *to participate pari passu* according to the nominal amount thereof *in the distribution of the share of net profits* of the Company to be from time to time distributed in manner hereinafter appearing ".

" 6. As and whenever any of the Certificates ought to be redeemed or paid off in whole or in part in accordance with the provisions hereof the Company will pay to the Certificate holder the amount so to be redeemed or paid off as hereinafter appears and such payment shall operate in satisfaction in full or in part as the case may be of the Certificates in respect of which the same shall be made ".

" 7. The Company shall in each year beginning in the year One Thousand nine hundred and eleven set aside for distribution among the Certificate holders *one-third of the net profits* of the Company *which the directors shall from time to time determine to divide* ".

" 8. The certificate in writing of the Company's auditor or auditors as to the amount of the profits of the Company which the directors on any occasion determine to divide or as to there being no profits so to be divided shall be conclusive ".

H. C. of A. 1951-1952.

Federal Commissioner of Taxation v. The Midland Railway Co. of Western Australia Ltd.

Fullagar J.

" 9. As and when the Directors shall upon any occasion determine to divide any profits the auditor or auditors of the Company shall certify the amount so to be divided without deduction of income tax and such auditors' certificate shall be forthwith communicated to the Trustees and the Company shall forthwith thereafter apply the amount so certified by the auditors or auditor as aforesaid in the redemption or purchase of the Certificates in manner hereinafter appearing ".

" 10. The company shall out of the moneys so available for distribution among the Certificate holders deduct and retain and pay over to the British & West Australian Governments a sum equal to the amount of *income tax* for the time being payable in England and Australia *in respect of the profits so distributable* and shall apply the balance of the said sum in the redemption of the Certificates in the option of the Company either (a) by drawings at par, (b) by the purchase of the Certificates by tender under par, or (c) by purchase in the market under par, *the par value of the Certificates* in each case *being reckoned as the nominal amount thereof less the amount of income tax at the rate for the time being payable on the profits of the Company* ".

" 16. The certificate holders shall not be entitled in respect of the Certificates to rank against the assets in any winding up of the Company other than a winding up for the purpose of reconstruction in which case they shall be entitled to rank to the extent of the amount of the Certificates held by them respectively then remaining unredeemed against the surplus assets of the Company remaining after repayment of the amount paid or credited as paid on the ordinary shares for the time being of the Company and shall be entitled to be paid the full amount in respect of which they shall so rank as aforesaid before any further distribution shall be made among the holders of the said ordinary shares ".

The deed contains provisions for the mode of drawing by lot in cases where the company elects to redeem " by drawings at par ", and for the calculation of par value. It also provides for the giving of notice as to the certificates which are to be redeemed and the fixing of a time and place of payment. At that time and place the certificates are to be produced, and on payment are to be delivered up to the company to be cancelled. The company is then to cancel the certificates and hand them over to the trustees. So soon as the total amount of the profits distributable as aforesaid among the certificate holders equals the amount of £809,000 or the certificates shall all have been redeemed or purchased, the company is to cease to be bound to distribute any further part of its net profits pursuant to the provisions of the deed.

The rights attached under the scheme of 1911 to the 4 per cent second mortgage debenture stock, the unified ordinary stock and the reversionary certificates, were modified by a further scheme of arrangement in 1925, the modifications being embodied in a deed dated 8th June 1925. So far as the reversionary certificates were concerned, the " proportion of surplus profits to be set aside for redemption of the certificates " was reduced from one-third to one-sixth, and, " as a consideration therefor ", the holders were given, in lieu of their existing rights in a winding up for the purpose of reconstruction, a right, in the event of a liquidation for any purpose or on a sale of the company's undertaking, to receive one-tenth of the surplus assets after payment of all the company's debts. A question might arise whether certificates which have been " redeemed " out of profits and " cancelled " were intended to carry the right thus given in a winding up or were to be regarded as simply extinguished. The latter view could lead to a curious result, because a liquidation might take place after all but a very few certificates had been redeemed out of profits, and in that event the holders of the very few outstanding certificates would receive by virtue of that holding a tenth of the whole of the surplus assets of the company. It is unnecessary, however, to pursue this question.

It should be mentioned that in September 1910, the directors of the company, in submitting the proposed scheme to the persons interested, forwarded with details of the scheme a circular containing the following passage :—

" In the absence of the Plan no material amount of interest on (D) the £973,723 Six Per Cent Cumulative Income Debenture Stock could be paid during the next few years, and the arrears thereon could not fail to be materially increased meanwhile. Under the Plan there will be issued to the holders of the £973,723 Six per cent Cumulative Income Debenture Stock the following stocks :—

1.	Second Mortgage Debenture Stock .. .. .. This is equivalent to 61.62 per cent on their present capital holding.		£600,000
2.	New Unified Ordinary Stock .. .. This represents the remaining 38.38 per cent of their present capital holding.	£373,723	
	New Unified Ordinary Stock .. .. This represents the Fifteen per cent premium to which the holders are entitled if now redeemed.	£146,058	
			£519,781
			£1,119,781

H. C. OF A. 1951-1952.

FEDERAL COMMISSIONER OF TAXATION v. THE MIDLAND RAILWAY CO. OF WESTERN AUSTRALIA LTD.

Fullagar J.

3.	Reversionary Certificates	£701,080
	This represents all arrears of interest to 30th June, 1910.	

The advantages of the Plan to the Six per cent Cumulative Income Debenture Stockholders are that they will at once have an interest-bearing security in respect of 61.62 per cent of their capital, while for the remaining 38.38 per cent and the premium of 15 per cent payable on redemption they will have 86.66 per cent of the entire Unified Capital Stock and thereby the control of the Company. Such holdings, in conjunction with their Reversionary Certificates, will permanently secure to them a like percentage of whatever there is to accrue either in capital or revenue from the Company's Railway and Lands ".

I doubt, and I think that *Kitto* J. doubted, whether this circular was admissible in evidence. I would not, however, attach any importance to it in any case, and it is clear that *Kitto* J. would have reached the conclusion which he did reach even if the circular had been excluded from consideration.

The revenue account of the company for the year ended 30th June 1943, showed a net profit of £E16,668. This amount was carried down to what is, though it does not seem to be so called, a profit and loss appropriation account, which includes a credit balance brought forward as at 30th June 1942, of £E58,204. In that account an appropriation is made in the following terms :—

" To proposed dividend of 4% less income tax at 10/- in the £ on unified ordinary stock	£E11,863
To provision for amount to be applied for redemption of reversionary certificates, being the sum applicable to that purpose in terms of the trust deed ..	£E2,373 "

It is this sum of £E2,373 (=£A2,966) which is in question in this case. An entry of the same amount on the credit side of the appropriation account might lead one to think that this sum was applied in the redemption of certificates during the year ended 30th June 1943, but this appears not to have been done. In fact the sum was so applied during the following financial year. The deduction is accordingly claimed in respect of that year, i.e., the year ended 30th June 1944. The revenue account of the company for that year showed a net profit of £15,616, which was carried down to the appropriation account. The amount then standing to the credit of that account was then appropriated as follows :—

To proposed dividend of 4% less income tax at 9/7d. in the £ on the unified ordinary stock	£E12,358
To provision for amount to be applied for redemption of reversionary certificates	£E2,471

The sum of £E2,471 (=£A3,089) was applied in redemption of certificates during the year ended 30th June 1945, so that a similar question arises as to that sum (though it is not the subject of this appeal) in relation to the company's income derived in that year. In their report for the year ended 30th June 1944, the directors of the company stated that the credit balance in the revenue account for the year (i.e. the company's net profit) amounted to £15,616, and that the addition of this sum to the credit balance brought forward at 30th June 1943, produced a balance of £62,016. (The figures in the report are in sterling). The report then proceeded :— " The directors recommend that the balance be dealt with as follows :—

(a)	In payment of a dividend of 4% on the unified ordinary stock for the year, requiring, after deduction of income tax at 9/7d. in the £.. ..	£12,358
(b)	For redemption of reversionary certificates, being the proportion applicable to that purpose in terms of the trust deed, requiring, after deduction of income tax at 9/7d. in the £	2,471
	Leaving to be carried forward	47,187
		£62,016 "

One final matter of fact must be noted. It has been seen that of the £809,000 of reversionary certificates issued only £701,080 went to the holders of the cumulative income debenture stock, the balance of £107,920 going to original shareholders. While the company is able to identify many of the certificates redeemed in the year ended 30th June 1944, as having been originally issued to the holders of 6 per cent cumulative income debenture stock, there is a large proportion which it is now unable so to identify. The company has not contended that it is entitled to deduct any part of the sum of £2,966 which was applied to the redemption of reversionary certificates issued to original shareholders.

Kitto J. held that, for the purpose of arriving at its taxable income of the year ended 30th June 1944, the company is entitled to deduct so much of the sum of £2,966 as represents money applied to the redemption of reversionary certificates issued in 1911 to holders of 6 per cent cumulative income debenture stock. It was suggested to him by counsel for the company that, since the ratio of certificates issued in respect of debenture stock to certificates issued to shareholders was approximately as seven is to one, his Honour should reduce the assessment by a sum equal to seven-eighths of £2,966. His Honour declined to do this, but, allowing the appeal, remitted the assessment to the commissioner in order that the actual

H. C. of A. 1951-1952.

Federal Commissioner of Taxation v. The Midland Railway Co. of Western Australia Ltd.

Fullagar J.

deduction might be quantified by agreement or otherwise. It seems clear enough that the company can, on any view, only deduct so much of the sum of £2,966 as it can prove to have been applied in redemption of reversionary certificates originally issued to holders of cumulative income debenture stock.

If the scheme evolved in 1910 had not been carried into effect, interest on the 6 per cent cumulative income debenture stock would have become payable as and when the company had surplus revenue, and, upon any such interest becoming payable and being paid, the amount paid would have been an allowable deduction as being interest upon moneys borrowed for the purpose of carrying on the company's income-producing activities. Commencing with this proposition (which is not, one would think, controvertible) *Kitto* J. took the view that the reversionary certificates issued to the holders of the cumulative income debenture stock were referable specifically to their unpaid interest. All that was done was to alter the method by which that interest was to be paid. Whatever became payable by way of redemption of the certificates partook, therefore, of the character of a payment of interest on moneys borrowed by the company for the purposes of its business. His Honour was of opinion that this position was not affected by the fact that the certificates were redeemable only out of divisible net profits : he thought the case belonged to the class exemplified by *British Sugar Manufacturers Ltd.* v. *Harris* (1) and not to that exemplified by *A. W. Walker & Co.* v. *Inland Revenue Commissioners* (2), and *Commissioner of Taxation (W.A.)* v. *Boulder Perseverance Ltd.* (3).

I have not regarded this case as by any means simple or easy, but, after full consideration, and with the greatest respect, I have found myself unable to accept the above view. It does not seem to me to accord with the realities of the case. The 6 per cent cumulative income debenture stock conferred upon holders (or at least one would infer that it did) both a right (at least in certain events) to a repayment of capital and a right (in certain events) to payment of interest. I have no doubt that in 1911 the amount of second mortgage debenture stock and of unified ordinary stock or shares which they were to receive was determined by reference to their existing actual or potential capital rights, or that the amount of reversionary certificates which they were to receive was determined by reference to their existing potential interest rights. But it by no means follows that sums paid to holders of the certificates in accordance with their terms constitute an outgoing incurred in

(1) (1938) 2 K.B. 220.
(2) (1920) 3 K.B. 648.
(3) (1937) 58 C.L.R. 223.

gaining or producing the company's assessable income or necessarily incurred in carrying on its business for the purpose of gaining or producing such income. The question whether such sums constitute such an outgoing depends, in my opinion, not upon any position existing before the schemes of 1911 but upon the position created by that scheme.

I do not myself think that there is any justification for regarding the issue of the certificates as constituting a separate consideration for the discharge of the company's obligations in respect of interest. It seems to me that it would be correct to say that there was a single consideration for the discharge of the company's pre-existing obligations in respect of the 6 per cent cumulative income debenture stock. I do not, however, attach critical importance to this. It is true that this view, if correct, is probably decisive of the whole case. But my opinion would be the same if that view were not correct.

In considering the nature of what was done in 1911 it is necessary not to be influenced by the view that the company might have achieved the same result in a different way. Actually, as will be seen, no different way would really have achieved what the company wanted to do.

It is not without importance to observe at the outset that in 1911 no interest was owing to the holders of 6 per cent cumulative income debenture stock. It is natural enough to speak of " arrears " of interest in such a case, just as it is common to speak of " arrears " of preference dividend. But no interest was owing. There was only a possibility of interest becoming payable in the future. What the holders of the 6 per cent stock were being asked to give up was not an accrued right to interest but a contingent future right to interest. This, again, is not of decisive importance. But it meant in 1911 that there could be no real question of " funding " interest, and I think it was one of the factors which conditioned the character of the scheme actually adopted in that year.

It was of the very essence and substance of that scheme that all pre-existing obligations of the company to holders of 6 per cent cumulative income debenture stock were absolutely discharged. They were wiped out. There was no postponement of payment : there was nothing to postpone. There was no discharge by payment : nothing was payable or paid. The holders of the debenture stock were not creditors of the company and the scheme did not make them creditors. The conditional promise to pay interest was discharged. It was expressly provided that the holders of the debenture stock in question were to accept the new debentures,

H. C. of A. 1951-1952.

Federal Commissioner of Taxation v. The Midland Railway Co. of Western Australia Ltd.

Fullagar J.

the new stock, and the certificates " in full satisfaction of all claims to *principal moneys, premiums and interest* ". If there had been a new promise to pay interest in the future in a new way or from a different source, the company's claim in the present case might nevertheless, of course, be sustained. But there was nothing of the kind. There was instead a right to share, up to a point, in the *net distributable* profits of the company.

For it was indeed also of the essence and substance of the scheme that those who had held cumulative income debenture stock should henceforth become shareholders. The old shareholders remained, though their shares became of reduced denomination. The holders of the 6 per cent cumulative income debenture stock received practically all the " new " shares, which gave them a large majority shareholding. The reversionary certificates were issued to the old shareholders and the new shareholders. None were issued except to shareholders. So long as they remained in the hands of the shareholders who received them in 1911, they served no useful purpose, because the shareholders were entitled to all the distributable profit of the company anyhow. Indeed, it might well be thought that their existence was a positive disadvantage—except in the eyes of a holder who liked a mild gaming element—the possibility of a larger dividend in one year accompanied by the certainty of a smaller dividend in a later year. But in truth and in substance, if the certificates had been non-transferable, there would have been no point in issuing them, and any setting aside of one-third or one-sixth of a distributable profit to pay them off would have been an empty formality. It was only their transferability that gave them any practical or useful significance. Even when transferred, they carried no preferential right. It was only a right to " participate *pari passu* " with shareholders in a distributable profit ascertained without reference to the rights which they carried. It was the same *kind* of right as an ordinary shareholder has, though more limited in content. The rights carried are, in their nature, essentially shareholder rights, dividend rights. They include a limited right in a winding up.

I am not myself able to see any ground for distinguishing between the reversionary certificates issued to the old shareholders and the reversionary certificates issued to the new shareholders. Every certificate carried exactly the same rights. Even if it be said that the occasion of the issue of the former lay in the fact that there were " arrears " of dividend, while the occasion of the issue of the latter lay in the fact that there were " arrears " of interest, I cannot see that this makes any difference. The position, as I see it, is simply that, from 1911 onwards, the dividend rights of the old shareholders and the dividend rights of the new shareholders were affected in precisely the same way by the existence of certificates, the holders of which were entitled to a share of the dividend fund. There was no reason for the company to distinguish in its books between two classes of certificates, and it is not surprising that it did not do so. I have already called attention to the way in which the revenue accounts of the company were kept, and in particular to what is really a profit and loss appropriation account. The way in which this account was made up seems to me to be correct, and to represent the realities of the position and the real effect of the scheme of 1911.

The contention of the company is that sums paid in " redemption " of certificates are outgoings incurred in gaining or producing assessable income, or outgoings necessarily incurred in carrying on a business for the purpose of gaining such income. Having regard to what I have said, it seems to me impossible to maintain that the sum in question falls within either category. What is the assessable income of a company ? Strictly speaking, I suppose, it is its gross revenue, though I think we often treat a gross profit as if it were assessable income, probably because the controversial items commonly arise between the ascertainment of a gross profit and the ascertainment of a net profit. For all the purposes of the present case we state a sound proposition if we say that a company's net profit is its *taxable* income, i.e., assessable income less allowable deductions. The soundness of this proposition is not affected by the fact that the company's profit and loss account for commercial purposes will differ from its profit and loss account for income tax purposes. This is only because the prudent (or imprudent) man of business will be actuated only by commercial reasons in estimating such matters as depreciation and bad debts, &c., whereas the revenue will insist on rules being followed in such matters. But, in the present case, if assessable income is gross revenue, amounts paid to certificate-holders cannot *ex hypothesi* play a part in the ascertainment of gross revenue. Strictly speaking, the conception of " gross profit " may not be appropriate to such a concern as that of the Midland Railway Co. But, if it were, and if assessable income were gross profit, those amounts could not play a part in the ascertainment of gross profit. Then, when it becomes a matter of ascertaining the deductions to be made from gross profit in order to arrive at net profit, how can it be said that a sum is to be deducted which is payable only out of, and by reference to, net profit ? It seems to me impossible to say that such a sum is an outgoing incurred in gaining or producing gross profit. It has nothing to do with gross profit. We do not know

H. C. of A. 1951-1952.

Federal Commissioner of Taxation v. The Midland Railway Co. of Western Australia Ltd.

Fullagar J.

whether anything will be payable at all until we have ascertained (without reference to any such sum) not only what is the gross profit but what is the net profit—and until a further step is taken —a determination by the directors to distribute all or some of the net profit. It seems to me to be equally impossible to say that such a sum is an outgoing necessarily incurred in carrying on a business for the purpose of gaining or producing gross profit. The gaining or producing of gross profit is not in the least degree or in any way affected by the possibility that there may be a net profit and that out of that net profit the directors of the company may or may not determine to make a distribution to persons entitled to share in a distribution of net profit. What the taxpayer really seeks in this case seems to me to be not a deduction from assessable income but a deduction from taxable income.

The position is in no way affected by certain well known cases in which it has been held that a taxpayer is entitled to deduct a salary or similar expense payable " out of profits " or " net profits " or by reference to a percentage of " profits " or " net profits ". A number of such cases are cited in *Commissioner of Taxation (W.A.)* v. *Boulder Perseverance Ltd.* (1). One of the earliest cases of this type is *Last* v. *London Assurance Corporation* (2). The decision of *Finlay* J. in *British Sugar Manufacturers Ltd.* v. *Harris* (3) was reversed by the Court of Appeal after this Court had delivered judgment in the *Boulder Perseverance Case* (4). The principle applied in these cases is fully explained in the joint judgment of *Latham* C.J. and *Dixon* and *McTiernan* JJ. in the *Boulder Perseverance Case* (5). There the sum in question was payable out of " net profits ". Their Honours said :—" The solution of the difficulty must in every case be found in determining the point as at which the ascertainment of net profits is required, and this depends on the purpose for which they are to be computed." The question, when it arises, thus turns on the construction or effect of the contract under which the sum in question is paid. In cases in which the sum in question is held deductible, it is, in effect, held that what is contemplated is that " profit " or " net profit " must be computed in two different ways for two different purposes. It must be computed at one point for the purpose of ascertaining the amount payable, and at another and later point for the purpose of ascertaining an ultimately divisible fund. In such cases there is a *creditor*, who must be satisfied before there can be any *divisible* fund. Here the holder of a reversionary certifi-

(1) (1937) 58 C.L.R. 223, at p. 233.
(2) (1885) 10 App. Cas. 438.
(3) (1938) 2 K.B. 220.
(4) (1937) 58 C.L.R. 223.
(5) (1937) 58 C.L.R. 223, at p. 230.

cate is not a creditor, and never becomes a creditor, except perhaps in the sense in which a shareholder may be said to be a creditor in respect of a *declared* dividend. The relevant computation must be made at one and the same time for both purposes, because it is one and the same distributable fund which is to be shared by stockholders as such and certificate holders. Such cases as the *British Sugar Manufacturers' Case* (1) have, to my mind, no bearing on the present case.

One final point is to be noted. The scheme provides that the auditor's certificate, on which the distribution is to be based, shall certify the amount to be divided without deduction of income tax. But from the payments to be made to certificate-holders there is to be deducted a sum equal to the amount of income tax payable in England and Australia *in respect of the profits so distributable* (i.e. to the certificate-holders)—the par value of each certificate " being reckoned as the nominal amount thereof less the amount of income tax at the rate for the time being payable on the profits of the company ". This is provided by cl. 10 of the deed, which is set out in full above. The extract from the directors' report for the year ended 30th June 1944, which is also set out above, shows that the sum actually to be " distributed " among certificate-holders was arrived at after deducting income tax at the rate of 9s. 7d. in the £. The amount of " dividend " strictly so called is arrived at after a deduction for income tax at the same rate. The company could hardly claim to deduct income tax and then not pay income tax, and it seems to me that the company must now maintain, if it is to succeed in this case, that it was wrong in deducting income tax. It is, one supposes, quite at liberty to advance such a contention, but it cannot be regarded as without significance that the deed was framed on the assumption that the profit fund available for stockholders and certificate-holders was a single profit fund subject to income tax, and that the directors so regarded the position when they came to make a distribution. The intention was that the payments in respect of the certificates should be made out of a taxable fund.

In my opinion, this appeal should be allowed with costs, and the taxpayer's appeal against its assessment dismissed with costs.

Appeal dismissed.

Solicitor for the appellant, *D. D. Bell*, Crown Solicitor for the Commonwealth.

Solicitors for the respondent, *Stone, James & Co.*

F. T. P. B.

(1) (1938) 2 K.B. 220.