[HIGH COURT OF AUSTRALIA.]

FEDERAL COMMISSIONER OF TAXATION . . . APPELLANT;

AND

L. J. NEWTON . . . . RESPONDENT.

FEDERAL COMMISSIONER OF TAXATION . . . APPELLANT;

AND

L. NEWTON . . . . RESPONDENT.

FEDERAL COMMISSIONER OF TAXATION . . . APPELLANT;

AND

H. J. LANE . . . . RESPONDENT.

FEDERAL COMMISSIONER OF TAXATION . . . APPELLANT;

AND

FENTON . . . . RESPONDENT.

FEDERAL COMMISSIONER OF TAXATION . . . APPELLANT;

AND

S. M. A. LANE . . . . RESPONDENT.

FEDERAL COMMISSIONER OF TAXATION . . . APPELLANT;

AND

CHRISTIAN . . . . RESPONDENT.

FEDERAL COMMISSIONER OF TAXATION . . . APPELLANT;

AND

NEWTON AND OTHERS (EXECUTORS OF THE ESTATE OF R. NATHAN, DECEASED) . . . RESPONDENTS.

H. C. OF A. 1956-1957.

1956, MELBOURNE, *May* 29, 30, 31; *June* 1, 5, 6, 7, 8, 11, 12, 13;

SYDNEY, *Aug.* 8.

Kitto J.

MELBOURNE, *Oct.* 11, 12, 15, 16, 17, 18, 19;

1957, *May* 31.

Dixon C.J., McTiernan, Williams, Fullagar and Taylor JJ.

Income Tax (Cth.)—Assessable income—Arrangements etc. to avoid tax—Companies liable to Div. 7 tax unless sufficient distribution—Conversion of existing shares into two classes—Attachment of special dividend rights to one class for limited period—Sale by shareholders of that class to share trading company—Receipt by latter company of dividends—Purchase by share trading company of new issue in private company and sale by it of shares comprising at purchase price to shareholders who had sold to it shares having special rights—Simultaneous presentation of all cheques involved in transactions at same branch of bank—Whether money and shares coming as result of transactions into hands of original shareholders assessable income—Income Tax and Social Services Contribution Assessment Act 1936-1950 (*No.* 27 *of* 1936—*No.* 48 *of* 1950) *s.* 260.

At the beginning of December 1949 the respondents were the holders of the 237,321 ordinary shares of £1 each which had been issued by a company L. T. was the holder of the 5,000 five per cent cumulative preference shares which constituted the remaining issued capital of the company. At that time the company had available for distribution profits in excess of £400,000 consisting as to part of profits derived during the year ended 30th June 1949, as to part of profits made during the then current income year and as to £8,569 of profits on which additional tax under Div. 7 had been paid. Early in December the existing 237,321 shares were converted into two classes. One third of each shareholder's holding, 79,107 shares in all, became A ordinary shares and two thirds became B ordinary shares. The unissued shares, 445,000 in number became B preference shares. Thereafter, subject to the rights of the holder of the existing 5,000 preference shares, special dividend rights were attached to the A ordinary shares. Pursuant to an amendment of the articles of association made on 14th December 1949 the holders of these shares became entitled to receive the whole of the dividends declared by the company on or after that date until such dividends should reach a total of not less than £5 15s. 10d. in respect of each share and to a fixed cumulative preferential dividend of five per cent per annum as from 1st January 1950. On 15th December 1949 the respondents gave to P., a company engaged in share-trading, options to purchase their A ordinary shares at £5 16s. 0d. per share and on 19th December 1949 P. exercised these options and delivered to the respondents in payments cheques totalling £458,820. Transfers of the A ordinary shares to P. were registered on the same day. Meanwhile, on 16th December 1949, L. resolved to make available for issue at par 402,679 B preference shares of £1 each and specified that such shares should be offered to the person or persons entitled to the dividends upon the A ordinary shares on or after 19th December 1949. On this date P. applied to L. for the issue to it of the 402,679 B preference shares and lodged with L. its cheque for £402,679. On 20th December 1949 L. resolved to pay dividends on the A ordinary shares amounting to £446,295 (i.e. £5 12s. 10d. per share) and thereafter to issue to P. the 402,679 B preference shares. On the same day L.'s cheque for £446,295 was handed to P. and the B preference shares were issued to it. On the same day P. sold the B preference shares to the respondents for £1 per share and received their cheques for a total sum of £402,679. All of the cheques which had passed between the parties were deposited in the same branch of the E. S. & A. Bank on 21st Decembei 1949, where each of the parties concerned had a current account. On 22nd March 1950 L. resolved upon the payment of a further dividend of 3s. per share in respect of the A ordinary shares out of the profits of the then current year. This dividend was paid to P. on the same day and completed the payments necessary to satisfy the special dividend rights attached to the A ordinary shares. Subsequently P. sold the 79,107 A ordinary shares to another company for £1 per share. The Commissioner of Taxation conceded that the various dealings had full legal force and effect according to their tenor.

Held by *Dixon* C.J., *McTiernan*, *Williams* and *Fullagar* JJ., *Taylor* J. dissenting, that s. 260 of the *Income Tax and Social Services Contribution Assessment Act* applied so as to leave the respondents taxable in respect of the distribution made by L. including the cash and shares which, when all the transactions were completed, were left in the hands of P., but not including the sum on which additional tax had been paid under Div. 7.

Deputy Federal Commissioner of Taxation v. *Purcell* (1921) 29 C.L.R. 464; *Jaques* v. *Federal Commissioner of Taxation* (1924) 34 C.L.R. 328; *Clarke* v. *Federal Commissioner of Taxation* (1932) 48 C.L.R. 56; *Bell* v. *Federal Commissioner of Taxation* (1953) 87 C.L.R. 548 and *War Assets Pty. Ltd.* v. *Federal Commissioner of Taxation* (1954) 91 C.L.R. 53, discussed.

Decision of *Kitto* J., reversed.

Appeal from *Kitto* J.

Lauri Joseph Newton, Lionel Newton, Henry James Lane, Leonard Alfred Fenton, Stella Maud Adeline Lane, Francie Una Christian and the executors of the estate of Robert Nathan, deceased, namely Lauri Joseph Newton, Lionel Newton and Frederic Ernest Bunny each appealed to the High Court of Australia against two amended assessments to income tax, one for the year ended 30th June 1950 and the other for the year ended 30th June 1951.

The appeals were heard together before *Kitto* J. in whose judgment hereunder the material facts appear.

R. M. Eggleston Q.C., *B. P. Macfarlan* Q.C., *A. B. Kerrigan* Q.C. and *J. A. Nimmo*, for the appellant in each appeal.

J. B. Tait Q.C., *D. I. Menzies* Q.C. and *K. A. Aickin*, for the respondent in each appeal.

Cur. adv. vult.

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Federal Commissioner of Taxation v. Newton.

Aug. 8, 1956.

The following written judgment was delivered by :—

Kitto J. Fourteen appeals under s. 197 of the *Income Tax and Social Services Contribution Assessment Act* 1936-1950 (Cth.) against assessments amended in exercise of the power given to the commissioner by s. 170 (2) of that Act have been heard together. The appellants are Lauri Joseph Newton, Lionel Newton, Henry James Lane, Leonard Alfred Fenton, Stella Maud Adeline Lane, Francie Una Christian, and the trustees of the estate of Robert Nathan deceased. Each appellant (counting the trustees as one) appeals against two amended assessments, one being in respect of income derived in the year ended 30th June 1950 and the other in respect of income derived in the year ended 30th June 1951.

In each case the amendment increased the liability of the taxpayer by including in assessable income, as income derived from property, certain amounts which were described, in an alteration sheet accompanying the notice of amended assessment, as the taxpayer's proportion of distributions made by three companies, Lane's Motors Proprietary Limited, Neal's Motors Proprietary Limited and Melford Motors Proprietary Limited. (In this judgment these companies will be referred to as Lane's, Neal's and Melford respectively, and together they will be referred to as the motor companies.) In some cases income from estates which were treated as having participated in such distributions was also included. In each case the amendment also assessed the taxpayer to additional tax under s. 226 (2), on the footing that the taxpayer had omitted these amounts from his return. Objections upon a number of grounds were duly lodged, and, having been disallowed by the commissioner, they were forwarded at the taxpayers' request to this Court as appeals.

The grounds of objection in each case in effect denied that the amounts included in assessable income by the amendment to the assessment had been derived by the taxpayer in fact, and denied that on any other ground those amounts were to be treated as forming part of the taxpayer's assessable income. Other grounds also were taken, but they have not been pressed. The facts concerning the distributions referred to in the alteration sheets were not disclosed to the commissioner before he made the original assessments. If the commissioner is right in his view that the appellants derived, or must be considered to have derived, assessable income in respect of those distributions, it is clear that in each original assessment there was an avoidance of tax, and that accordingly the commissioner had power under s. 170 (2) to amend the assessment. It is also clear that on the same hypothesis the commissioner was justified by s. 226 (2) in assessing the taxpayer to additional tax. The arithmetical correctness of the amended assessment is not disputed. The only issue is whether the hypothesis is correct.

The distributions were made as dividends upon shares which were held, at the respective dates on which the dividends were declared, by a company called Pactolus Pty. Ltd. (which will be referred to as Pactolus), and it was to that company that the dividends were paid by the motor companies. The nature of the case may be indicated broadly by saying that the shares had been acquired by Pactolus from the appellants (or the shareholders whom they represent), and that according to the commissioner's view the facts surrounding the transfers of the shares to Pactolus entitle him by virtue of s. 260 to treat the appellants as having received the dividends.

The history of the matter is complicated and a detailed investigation of it has been necessary. It will make for clarity if, when referring to the persons whose shares Pactolus purchased, I speak generally of " the original shareholders " in relation to each of the three motor companies, though the members of those companies at relevant times were not identical. In *Lane's*, at the earliest material date, 30th June 1949, the largest shareholder was Robert Nathan. The next largest was the estate of Robert Lane deceased, of which the appellants Henry J. Lane and Stella M. A. Lane were the trustees. Then there were the respective estates of Joseph Nathan deceased and Catherine M. Nathan deceased, the trustees of both these estates being the appellants Lauri J. Newton, Lionel Newton and Francie U. Christian. In addition, shares were held in his or her own right by each of the appellants Lauri J. Newton, Lionel Newton, Francie U. Christian, Stella M. A. Lane and Henry J. Lane. All the shares held by these persons were ordinary shares and the only other issued capital consisted of 5,000 preference shares held by one W. B. Thomas who was the manager and secretary of the company. In *Neal's*, Robert Nathan held at that date a large number of ordinary shares and the rest were held by the trustees (already mentioned) of the respective estates of Robert T. Lane deceased, Joseph Nathan deceased and Catherine M. Nathan deceased, and the appellants Lauri J. Newton, Lionel Newton, Francie U. Christian and Henry J. Lane. There were 5,000 preference shares, held by one Cedric Broomhall, the manager of the company. In *Melford*, Henry J. Lane and Stella M. A. Lane held shares as trustees of the estate of Robert T. Lane deceased, the appellants Stella M. A. Lane and Leonard A. Fenton (the manager of the company) each held shares beneficially, and one Lionel B.

Wallace held the balance in trust for the respective estates of Robert Nathan and Joseph Nathan. There were no preference shares in Melford.

With the exception of the three managers, and of Mr. Wallace who had no beneficial interest of his own, the persons who had been named belonged to two family groups, for Lauri J. Newton, Lionel Newton and Francie Una Christian were children of Joseph and Catherine Nathan and nephews and niece respectively of Robert Nathan, while Henry J. Lane was a brother, and Stella M. A. Lane was the widow, of Robert T. Lane deceased. The businesses of Lane's and Melford had been started by Robert T. Lane, and the business of Neal's by Henry J. Lane. By the time with which we are concerned in this case, the oversight of the affairs of all three companies had devolved mainly upon Henry J. Lane. On the side of the Nathan family, Lauri Newton was the only one who was taking much active interest, and he was more closely concerned with a furniture business carried on by a firm known as Maples. Robert Nathan was taking little part in the motor businesses—he died in June 1950—and Lionel Newton was abroad.

The three motor companies carried on business in Melbourne as distributors and sellers of motor cars, and similar businesses were carried on there by subsidiaries; including British Service Pty. Ltd., which was a subsidiary of Lane's, Allcars Pty. Ltd. and Overland (Victoria) Pty. Ltd. which were subsidiaries of Neal's, and Devon Motors Pty. Ltd. which was a subsidiary of Overland. The motor car selling business had been severely affected by conditions existing in the community during and immediately after the war; but in the year ended 30th June 1949 the three principal companies were able to pay large dividends on their ordinary shares. Although some of the profits they distributed were tax-free by virtue of Div. 7 to which reference will be made later, a large proportion was taxable as income in the hands of the recipient shareholders. This placed the shareholders under a heavy tax liability, for they were all persons whose incomes attracted income tax at the highest rate, at that time 15s. 0d. in the pound, and under the provisional tax system in force, any increase in one year's income over the income of the preceding year meant that the amount of the increase attracted not only ordinary income tax in excess of that which was covered by the provisional tax paid in the previous year but also provisional tax assessed on the assumption that the income of the next year would be maintained at the same level. Consequently the distribution of fully taxable dividends amongst the shareholders in the year ended 30th June 1949 involved them in finding amounts equal to 30s. 0d. in the pound on their respective proportions. It would seem that this result had not been brought home to them by the tax advisers whom they were consulting when the dividends were declared, but the unwisdom of making the distributions was to be emphasised to them later by a new consultant.

Business in the motor trade was markedly improving as the year ended 30th June 1949 advanced. The number of cars delivered by Lane's, for example, was to reach 4,519 by the end of that year and 6,479 by the end of the year next following. The total in the preceding year had been only 2,714, and only 1,008 in the year before that. Taxation difficulties due to rising private incomes were being felt acutely. This may be seen in cables which passed in April 1949 between Mr. Lauri Newton and his brother Lionel, who, as I have said, was abroad. Mr. Lauri Newton referred to difficulty he was having in getting bank accommodation for them both to meet their taxes. He indicated that he was being asked for an undertaking to float public companies within the next few months, and he mentioned the possibility of having to realise assets on behalf of Lionel. The latter replied stating a preference for floating the motor companies, presumably because so long as they remained private companies, in the sense that they were not listed on the stock exchange, realisation of shares at anything like their value was not likely to be easy. But by no means was the desire for public flotations unanimously supported. Mr. Harry Lane, in particular, had sentimental objections, and no doubt practical objections also, to an abandonment of the family character of the companies. But he was weakening in his opposition to the idea, and it provided a reason, in addition to others that existed, for considering whether the capital structure of the companies, including their dependence upon accumulated profits and loans for adequate working capital, ought to be substantially reformed. In any such consideration problems concerning taxation must necessarily have loomed large. In this situation, in June of 1949 there came a move on the part of Lauri Newton and Harry Lane which culminated in the transactions upon an examination of which the fate of these appeals must depend.

By those transactions, profits of the three principal companies, were dealt with, and, in most though not all instances, the paid-up capital of the companies was increased. The first step towards understanding what was done must be to consider the financial situation of each company as at the close of the year ended 30th June 1949, and see what were the difficulties inherent in it.

Lane's. The volume of business being done by this company as the post-war boom in motor car sales got under way may be seen

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from its gross sales figure of £3,442,565, which gave it a net operating profit for the year of £376,121. For a company doing so large a business, Lane's had a small paid-up capital: only £242,321 divided into 237,321 ordinary shares of £1 each and the 5,000 preference £1 shares held by W. B. Thomas. But its shareholder's funds of other kinds were large: in addition to a tax-paid profit reserve of £250,000, there were undistributed profits amounting to £387,125 (including £302,799 being the profit of the year just ended after deducting income tax), and loans (including dividend moneys undrawn or redeposited by shareholders) amounting to £164,009. The total shareholders' funds in the company therefore amounted to nearly £800,000. Its assets included Commonwealth bonds and money in the bank, but if these be treated as set off against sundry creditors it will be found that the whole of the shareholders' funds were represented by assets which, though almost all tangible and conservatively valued, were in use in the company's business.

Neal's. This company also was in a large way of business. Its gross sales figure for the year amounted to £2,197,227, and its net profit to £195,241. Yet its paid-up share capital was only £114,332, including the £5,000 paid up on the preference shares held by Broomhall. The credit balance in its profit and loss appropriation account was £268,438 (including the net profit of the year); it had a tax-paid profits reserve of £26,103, and its loan account stood at £239,749. The total of its shareholders' funds was £648,622; and this amount was represented by assets consisting of cash in the bank which may be taken (after deducting sundry creditors) at £86,000, Commonwealth bonds £54,565, and other assets, mainly tangible and all conservatively valued, but in use in the company's business.

Melford. This company also had large sales, the gross figure for the year being £1,586,731. Its paid-up capital was only £16,506, represented by 16,506 ordinary shares of £1 each. Other shareholders' funds consisted of a taxed-profits reserve of £192,449, shareholders' undrawn dividends £51,800, and the credit balance in the profit and loss appropriation account £134,629. The external liabilities, which (including income tax reserve) amounted to £74,342, were greater than the total of the cash in the bank and on hand plus Commonwealth loans; and the rest of the assets, though almost all tangible and conservatively valued, were employed in the business.

It will be seen from this that each of the three companies, facing a period of evidently increasing activity in the motor trade, could hardly do with much less money in its business than it had as shareholders' funds of one sort and another. It certainly could not pay out to shareholders the whole of its distributable profits without serious embarrassment, unless it replaced the whole or a substantial part with other moneys. In more primitive times a sensible course would have been to capitalise a sufficient part of the profits by means of dividends satisfied by an issue of paid-up shares; but that would have involved the shareholders individually in liability for income tax on the amount capitalised: cf. *Nicholas* v. *Commissioner of Taxes, Victoria* (1), a liability similar in kind to that to which the distribution of untaxed profits in the year before had exposed them, but considerably greater in amount. What in fact was done is said by counsel for the commissioner to have produced exactly this result, except for the interposition of certain steps which should be treated as void by virtue of s. 260 of the *Income Tax and Social Services Contribution Assessment Act*. It is important, in view of this contention, to make clear what was the tax position which called for the attention of anyone considering, say in the second half of 1949, what course it was expedient for the companies and their shareholders to pursue.

By annual taxing Acts there had been imposed, and was likely to continue to be imposed, what may be called ordinary company tax at the rate of 5s. 0d. in the pound on the first £5,000 of taxable income derived during the preceding year and 6s. 0d. in the pound on the excess: see Act No. 2 of 1949, s. 4 (7) and cl. 1 of the seventh schedule, and Act No. 49 of 1950, s. 9 and cl. 1 of the sixth schedule. This was subject to a rebate, under s. 46 of the *Assessment Act* (the *Income Tax and Social Services Contribution Assessment Act* 1936-1949), of (roughly) the amount of tax assessed on so much of the taxable income as consisted of dividends from other companies. In addition, taxes were annually imposed which differed according as a company was or was not a "private company" as defined in s. 103 of the *Assessment Act*. A company not being a "private company" was subject to a super-tax and an undistributed profits tax. The super-tax was at the rate of 1s. 0d. in the pound on the excess of its taxable income over £5,000: Act No. 2 of 1949, s. 5; Act No. 49 of 1950, s. 10. The undistributed profits tax, provided for by Pt. IIIA of the *Assessment Act*, was at the rate of 2s. 0d. in the pound on that portion of the taxable income which had not been distributed as dividends, ascertained by making from taxable income the deductions provided for in s. 160C of the *Assessment Act*: see Act No. 2 of 1949, s. 4 (7) and cl. 4 of the sixth schedule, and Act

(1) (1940) A.C. 744.

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No. 49 of 1950, s. 9 and cl. 4 of the sixth schedule. On the other hand, a company which was a "private company" (and Lane's, Neal's and Melford were such), though not subject to either the super-tax or the undistributed profits tax imposed upon other companies, was subject to a tax which will be referred to as Div. 7 tax, being the tax provided for by Div. 7 of Pt. III of the *Assessment Act*. Section 104 in that Division, as it applied to the three motor companies, provided in effect that where a private company had not made a sufficient distribution of its income of the year of income by the ensuing 31st December, the commissioner might assess the aggregate additional amount of tax which would have been payable by its shareholders if the company had, on the last day of the year of income, paid the undistributed amount as a dividend to the shareholders who would have been entitled to receive it, and that the company should be liable to pay the tax so assessed. What was "a sufficient distribution of its income of the year of income" was defined in s. 103 (2) (*e*) as a payment in dividends, out of the taxable income of that year, of an amount not less than the aggregate of certain stated percentages of defined portions of the distributable income. This left an amount (a comparatively small amount in the case of the three motor companies) which could be left undistributed without attracting Div. 7 tax, and this amount will be referred to as the retention amount. As has been mentioned already, the shareholders of the motor companies all had incomes of such a level that the tax payable by them on any amounts distributed to them by those companies would be at the rate of 15s. in the pound. Consequently, when the operations of the year ended 30th June 1949 produced, as they did, a large distributable profit, the tax liability of each company consisted of a liability to pay ordinary company tax and, in addition, 15s. 0d. in the pound on so much of a sufficient distribution as it failed to distribute in dividends by 31st December. Dividends subsequently paid wholly and exclusively out of the amount so left undistributed were tax-paid, in the sense that the recipients were entitled in respect of them to a rebate of tax as provided in s. 107. It is accurate enough for present purposes to say that the rebate was of the amount by which the proceeds of the dividends increased the income tax of a person who derived them, either directly or through any interposed company, trustee or partnership, by virtue of shares in respect of which a distribution was supposed to have been made for the purposes of the assessment of the Div. 7 tax on the company.

It will be seen that the end of a profitable year of income presented a "private company" with a choice: broadly speaking, in so far as it refrained from distributing to its members, by the following 31st December, dividends absorbing its taxable income of the year of income (except the retention amount)—a course which would involve its members in liability to pay tax on the amounts received by them individually—it would be liable itself to pay Div. 7 tax equal in amount to the aggregate tax which the members would have paid if the distribution had been made. The present appeals relate to five transactions, each of which, according to the commissioner's contention, was an arrangement entered into in view of this taxation position and for the purpose of avoiding both Scylla and Charybdis, that is to say the purpose of enabling a company to avoid incurring Div. 7 tax (by making in time a sufficient distribution of its income of the year ended 30th June 1949 and also of the year ended 30th June 1950), and yet of enabling those who were the shareholders at the beginning of the arrangement to say that they received from the distribution no income involving them in liability to pay income tax. Three of the transactions, one with respect to each of the three motor companies, took place in December 1949. A second transaction concerning Melford took place in December 1950, and a second concerning Neal's in June 1951. All five transactions were proposed by Mr. J. V. Ratcliffe, a consulting accountant of wide experience in financial and taxation problems, who had been called into consultation by Mr. Harry Lane and Mr. Lauri Newton in circumstances to which I shall later refer. It will be convenient to describe at once the main steps comprised in these transactions and to indicate the results which they achieved, assuming them for the moment to be unaffected by s. 260.

Lane's Transaction.

On 14th December 1949, special resolutions were passed which increased the capital of Lane's from £250,000 divided into £1 shares to £750,000 similarly divided. They created four classes of shares. The 5,000 preference shares held by Thomas were made A preference shares; the 237,321 issued ordinary shares were made as to one-third (79,107) A ordinary shares and as to two-thirds (158,214) B ordinary shares; 62,679 unissued shares were made B ordinary shares; and 445,000 unissued shares were made B preference shares. (The sub-division of the issued ordinary shares into the A and B classes was effected rateably, so that Lauri Newton (for example), who had held in his own right 15,072 ordinary shares, now held 5,024 A ordinary shares and 10,048 B ordinary shares). The rights attached to Thomas' 5,000 preference shares remained unaffected when they became A preference shares. Subject to

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these rights, the A ordinary shares were made to entitle the holders to the whole of the dividends thereafter to be declared by the company until they should amount in the aggregate to £5 15s. 10d. per A ordinary share (i.e. £458,161 7s. 6d. in all), including 2s. 2d. per share tax-paid under Div. 7. Beyond this, the A ordinary shareholders were given no right to participation in the company's profits except to the extent of a fixed cumulative preferential dividend of five per cent. They were given the same voting rights as the B ordinary shares until the dividends aggregating £5 15s. 10d. (which I shall call the special dividends) should be paid, but thereafter only voting rights of the kind ordinarily found in the case of preference shares, viz. to vote when their five per cent dividends should be in arrear for six months or on any proposal for reduction of capital, winding up, or sanctioning a sale of the undertaking, or directly affecting their rights. The B preference shares were made to confer a right (subject to the rights of the A preference and the A ordinary shareholders) to receive a five per cent fixed cumulative preference dividend, and other rights typical of preference shares. Thus the B ordinary shares were left as the only ordinary shares in the usual sense of the term.

On the next day, 15th December 1949, each of the ordinary shareholders gave to a company called Pactolus Pty. Ltd. an option in writing to purchase his or her A ordinary shares in Lane's at the price of £5 16s. 0d. per share. Pactolus Pty. Ltd. was a company which had been formed by Mr. Ratcliffe in the preceding March. He was the only substantial shareholder in it. This company, it is important to note, appears to have been carrying on business as a dealer in shares, though until then in a small way only.

On 16th December 1949, the directors of Lane's resolved that 402,679 of the B preference shares be made available for issue at par and be offered to the person or persons entitled to the dividends from the A ordinary shares on or after 19th December 1949. By letter of the same date, Pactolus was informed that this had been done.

On 19th December 1949, Pactolus exercised the options to purchase the A ordinary shares, and handed cheques for the appropriate amounts of purchase money (totalling £458,820 12s. 0d.) to the authorised agent of the vendors, a Mr. Ross, in exchange for completed transfers and the relevant share certificates. The transfers were immediately registered, and new share certificates were issued to Pactolus. On the same day Pactolus applied to Lane's for the 402,679 B preference shares which had been made available to be taken up, and gave Lane's a cheque for the amount payable therefor (£402,679).

Next day, 20th December 1949, the directors of Lane's declared three dividends on the A ordinary shares : £8,569 18s. 6d. (or 2s. 2d. per share) out of profits tax-paid under Div. 7, £262,232 out of the profits of the year ended 30th June 1949, and £175,493 8s. 0d. out of profits of the year ended 30th June 1950. The total was £446,295 6s. 6d., which was at the rate of £5 12s. 10d. per A ordinary share. This was only 3s. 0d. per share short of the amount of the special dividend rights which had to be satisfied before the A ordinary shares would become, in effect, five per cent preference shares. A cheque in favour of Pactolus for the amount of the dividends thus declared was handed to Ross on behalf of Pactolus. Later on the same day, the directors of Lane's allotted to Pactolus the B preference shares for which it had applied, and Pactolus gave Lane's a cheque for the full amount of these shares, £402,679. On the same day, Pactolus sold the whole of the newly-issued B preference shares at £1 per share to the original shareholders (now the holders of the B ordinary shares) in the proportions in which they held B ordinary shares ; and transfers thereof were on that day exchanged for cheques drawn by the transferees, totalling £402,679.

On 21st December 1949, all the cheques that have been mentioned were banked simultaneously at the South Melbourne Branch of the English Scottish and Australian Bank Ltd. Lane's and the shareholders had all had accounts there for some time, and an account had been opened there for Pactolus a few days before, with a deposit of £19,000.

Three months later, on 22nd March 1950, the directors of Lane's declared out of the profit of the year ended 30th June 1950 a further dividend of £11,866 1s. 0d. on the A ordinary shares. This was 3s. 0d. per share. It brought the total dividends to £5 15s. 10d. per share or £458,161 7s. 6d. in all, and the special rights attached to the A ordinary shares thus became exhausted. The amount of the new dividend was paid to the credit of Pactolus's bank account at the South Melbourne branch of the E. S. & A. Bank Ltd.

On 12th May 1950, Pactolus sold the whole of the A ordinary shares in Lane's to a company called Pactolus Investments Pty. Ltd., which will be referred to as Pactolus Investments and in which Mr. Ratcliffe and members of his family were the only shareholders. This sale was at £1 per share, which was the full value of the A ordinary shares as they then stood, that is to say as virtually five per cent preference shares.

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These steps had the following results: (1) in Lane's accounts, £402,679 of profits went out and was replaced by paid-up capital of the same amount represented by B preference shares in the hands of the original shareholders; (2) the difference between that figure and the total of the special dividends paid (£458,161) viz. £55,482, was contained in the sum of £56,141 which, as will be mentioned in a moment, was kept by the original shareholders in cash (the remaining £659 of the latter sum being put in by Pactolus); (3) the original shareholders, although they receive nothing directly from the distribution of Lane's profits, received between them £458,820 as the price of their A ordinary shares, keeping £56,141 of that amount in cash and applying the balance in the purchase of B preference shares from Pactolus; and (4) although Pactolus had to put in £659 in cash, being the amount by which the special dividends fell short of the price paid for the A ordinary shares, it sold those shares for £79,107 and thus made an over-all profit of £78,448. To put Pactolus's result in another way, it lost on the resale of the A ordinary shares £379,713, but the dividends it received amounted to £458,161, so that on the whole it made a profit of £78,448. On the footing, which has been assumed to be correct for the purposes of the argument, that Pactolus was a trader in shares, its taxable income would include, in respect of the Lane's transaction, only the last-mentioned amount and not the full amount of the dividends which Pactolus derived from the A ordinary shares.

First Neal's Transaction.

This transaction followed the same pattern as the Lane's transaction and was carried through contemporaneously with it. Of the ordinary shares in Neal's, 36,444 became A ordinary shares carrying a right to all dividends declared until they should reach not less than £13 7s. 0d. per share (i.e. £486,527) of which not less than £1 was to be out of profits tax-paid under Div. 7. Thereafter they were to become in effect five per cent preference shares. On 15th December 1949, options were given to Pactolus to purchase all the A ordinary shares at £12 8s. 4d. per share (or £452,513 in all). On 16th December 1949, 403,314 B preference shares were made available for issue, to be offered to the person or persons entitled to the dividends from the A ordinary shares on or after 19th December 1949 and Pactolus was so informed. On the latter date, Pactolus exercised the options to purchase the A ordinary shares, and handed over cheques for the purchase money in exchange for transfers which were thereupon registered. On the same day Pactolus applied for the new issue of B preference shares and handed its cheque to Neal's for the amount thereof. On 20th December 1949 dividends were declared by Neal's: £36,444 (or £1 per share) tax-paid under Div. 7, £137,086 out of profits of the year ended 30th June 1949, £121,556 out of profits of the year ended 30th June 1950, and £154,997 8s. 0d. out of dividends declared by the subsidiary Overland (Victoria) Pty. Ltd. (which included dividends from the sub-subsidiary Devon Motors Pty. Ltd.). These four dividends totalled £450,083 8s. 0d., which is £12 7s. 0d. per share. Later on the same day, the 403,314 B preference shares were allotted to Pactolus at par, and Pactolus thereupon sold them to the original ordinary shareholders for £1 per share. On 21st December 1949, the cheques were all banked simultaneously at the South Melbourne Branch of the E. S. & A. Bank: Pactolus's cheques in favour of the original shareholders for the price of the A ordinary shares (totalling £452,513), Pactolus's cheque in favour of Neal's for the amount to be paid up on the B preference shares (£403,314), Neal's cheque in favour of Pactolus for the amount of the dividends declared on the A ordinary shares (£450,083 8s. 0d.), and the shareholders' cheques in favour of Pactolus for the price of the B preference shares (£403,314). Then, on 22nd March 1950, a further dividend of £1 per share (£36,444) was declared and paid on the A ordinary shares to Pactolus out of Neal's profits for the year ended 30th June 1950, the special dividend rights being thereby exhausted. On 12th May 1950, Pactolus sold the A ordinary shares to Pactolus Investments for £1 per share.

The results achieved by these steps were: (1) £403,314 of Neal's profits were replaced in its accounts by paid-up capital of the same amount represented by B preference shares in the hands of the original ordinary shareholders; (2) the difference between that figure and the total of the special dividends paid (£486,517) viz. £83,203, was represented by £49,199 kept by the original shareholders in cash and £34,004 kept by Pactolus in cash; (3) the original shareholders, although they received nothing directly from the distribution of Neal's profits, received between them £452,513 as the price of their A ordinary shares, keeping £49,199 of that amount in cash and applying the balance in the purchase of B preference shares from Pactolus; and (4) Pactolus kept for itself the difference between the amount of the special dividends (£486,517) and the price it had paid for the A ordinary shares (£452,513), viz. £34,004, as well as the price it got on reselling those shares (£36,444), a total profit of £70,448. To put Pactolus's result in another way, it lost on the resale of the A ordinary shares £416,069, but the

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dividends it received were £486,517, so that on the whole it made a profit of £70,448.

First Melford Transaction.

The first Melford transaction occurred, as I have said, simultaneously with the Lane's transaction and the first Neal's transaction, and it followed the same general pattern, though with differences in detail. The 16,506 issued ordinary shares were divided into A ordinary and B ordinary shares in equal proportions, and 200,000 preference shares (unissued) were created. (There were no preference shares in this company previously.) The amount of the special dividends to be declared on the 8,253 A ordinary shares was in this instance £26 11s. 0d. per share, of which not less than £3 was to be out of profits tax-paid under Div. 7. On 15th December 1949, Pactolus was given options to purchase all the A ordinary shares at £24 per share (or £198,072 in all). On 16th December 1949, 189,819 preference shares were made available for issue, and were offered to the person or persons entitled to the dividends from the A ordinary shares on or after 19th December 1949. On the latter date, Pactolus exercised the options to purchase the A ordinary shares, and handed over cheques for the purchase money in exchange for transfers which were thereupon registered. On the same day, Pactolus applied for the new issue of preference shares and gave Melford its cheque for the requisite amount. On 20th December 1949, dividends were declared by Melford : £3 per share (totalling £24,759) out of tax-paid profits, £97,200 out of profits of the year ended 30th June 1949, and £72,399 out of profits of the year ended 30th June 1950. These totalled £23 11s. 0d. per A ordinary share, or £194,358. Later on the same day, the 189,819 preference shares were allotted to Pactolus at par, and Pactolus thereupon sold them to the original ordinary shareholders for £1 per share. On 21st December 1949, the cheques were all banked simultaneously at the South Melbourne Branch of the E. S. & A. Bank : Pactolus's cheque in favour of the original shareholders for the price of the A ordinary shares (totalling £198,072), Pactolus's cheque in favour of Melford for the amount to be paid up on the preference shares (£189,819), Melford's cheque in favour of Pactolus for the amount of the dividends declared on the A ordinary shares (£194,358), and the shareholders' cheques in favour of Pactolus for the price of the preference shares (£189,819). Then, on 22nd March 1950, a further dividend of £3 per share (£24,759) was declared and paid on the A ordinary shares to Pactolus out of Melford's profits of the year ended 30th June 1950. This brought the total special dividends paid to £219,117, which exhausted the special dividend rights. On 12th May 1950, Pactolus sold the A ordinary shares to Pactolus Investments for £1 per share.

The results achieved by these steps were : (1) £189,819 of Melford's profits were replaced in its accounts by a corresponding amount of paid-up capital represented by preference shares in the hands of the original shareholders ; (2) the difference between that figure and the total of the special dividends (£219,117), viz. £29,298, was represented by £8,253 kept by the original shareholders in cash and £21,045 kept by Pactolus in cash ; (3) the original shareholders, although they received nothing directly from the distribution of Melford's profits, received between them £198,072 as the price of their A ordinary shares, keeping £8,253 of that amount in cash and applying the balance in the purchase of the preference shares from Pactolus ; and (4) Pactolus got for itself the difference between the amount of the special dividends (£219,117) and the price it had paid for the A ordinary shares (£198,072), viz. £21,045, as well as the price it got on reselling those shares (£8,253) : a total profit of £29,298.

Second Melford Transaction.

On 29th November 1950, after £80,000 of tax-paid profits had been distributed to the original shareholders as dividends on the B ordinary shares, the capital structure of Melford was altered again. The 8,253 issued B ordinary shares were made C ordinary shares ; and the 200,000 preference shares (of which 189,819 had been issued) became B ordinary shares, making (with the previously existing unissued B ordinary shares) a total of 383,494. The new C ordinary shares were given rights similar to those which in the preceding year had been given to the A ordinary shares, the amount of the special dividends being fixed on this occasion at £26 11s. 0d. per share, of which not less than £3 per share was to be out of income tax-paid under Div. 7. On 30th November 1950, the C shareholders gave Pactolus options to purchase the C ordinary shares at £24 per share, totalling £198,072. On 4th December 1950, dividends of £19 per share out of profits of the year ended 30th June 1950 and £3 per share out of tax-paid profits were declared by Melford on the C ordinary shares. These dividends totalled £181,566. On the same day the directors of Melford resolved to allot 189,819 of the unissued B ordinary shares at par to the holders of the B ordinary shares already issued, thus doubling their holdings of such shares ; and the shareholders' cheques for the amounts required to pay in full for the new issue were handed to

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Melford on that day. On 6th December 1950 the various cheques were banked simultaneously at the South Melbourne Branch of the E. S. & A. Bank Ltd.: Pactolus's cheques in favour of the shareholders for the price of the C ordinary shares (£198,072); the shareholders' cheques in favour of Melford for the amount to be paid up on the new issue of B ordinary shares (totalling £198,819); and Melford's cheque in favour of Pactolus for the dividends on the C ordinary shares (£181,566). On 30th January 1951, Melford declared and paid a further dividend of £37,551 (at £4 11s. 0d. per share) on the C ordinary shares, bringing the total dividends on those shares to £219,117 (or £26 11s. 0d. per share) and thereby exhausting the special dividend rights. Pactolus did not sell the C ordinary shares to Pactolus Investments.

The results achieved by these steps were as follows: (1) £189,819 of Melford's profits were replaced in its accounts by paid-up capital of the same amount represented by newly-issued B ordinary shares in the hands of the original shareholders; (2) the difference between that figure and the total special dividends (£219,117), viz. £29,298, was represented by £8,253 kept by the old shareholders in cash and £21,045 kept by Pactolus in cash; (3) the original shareholders, although they received nothing directly from the distribution of Melford's profits, received between them £198,072 as the price of their C ordinary shares, keeping £8,253 of that amount in cash and applying the remainder in taking up the new B ordinary shares; and (4) Pactolus got for itself the difference between what it paid for the C ordinary shares (£198,072) and the amount of the special dividends (£219,117) viz. £21,045, and it retained in addition the C ordinary shares then worth £8,253. It will be noticed that in this second Melford transaction the new shares were taken up by the old shareholders directly; they were not taken up by Pactolus and sold by it to the old shareholders. The significance of this point of difference will be referred to later.

Second Neal's Transaction.

On 12th June 1951 the capital structure of Neal's was altered for the second time, 29,156 of the issued B ordinary shares being made C ordinary shares. This left 43,732 issued B ordinary shares. The C ordinary shares were given rights similar to those which in 1949 had been attached to the A ordinary shares, the amount of the special dividends being fixed on this occasion at £13 1s. 6d. per share, of which not less than 12s. 11d. was to be out of income tax-paid under Div. 7. On 21st June the C shareholders gave Pactolus options to purchase the C ordinary shares at £12 8s. 0d.

per share. On 25th June 1950, Pactolus exercised the options, the C ordinary shares were transferred to it in exchange for cheques, and dividends of 14s. 6d. out of tax-paid profits and £12 7s. 0d. out of profits of the year ended 30th June 1951 were declared on those shares. These dividends (at £13 1s. 6d. per share) totalled £381,214. On 27th June 1951 the cheques were banked simultaneously: Pactolus's cheques in favour of the shareholders for the price of the C ordinary shares (£354,245 8s. 0d.), and Neal's cheque in favour of Pactolus for the amount of the dividends (£381,214). Pactolus sold the C ordinary shares to Pactolus Investments for £1 per share. It will be seen that this time there was no increase in the paid-up capital of Neal's. That company distributed £381,214 of its profits; but it was Pactolus which received them. If there be set off against that sum the loss which Pactolus made on the resale of the C ordinary shares, viz. £325,089, Pactolus will be seen to have made an over-all profit of £56,125. The original holders of the C ordinary shares received £354,245 in cash, and this amount came to them as a capital receipt and not as income.

Such were the five transactions which took place. It is plain that, apart from s. 260, the original shareholders cannot be said to have derived from the dividends which were declared and paid in the course of these transactions anything that can be treated as assessable income in the assessment of their respective taxes. Every step taken was genuinely intended to have full effect; there was nothing in the nature of a sham or pretence. The original shareholders really and effectually divested themselves of all legal and beneficial interest in the A ordinary shares and the C ordinary shares, in consideration of the respective prices for which they stipulated in the options granted to Pactolus. So much the commissioner concedes. His case depends entirely upon an application of s. 260, which is in the following terms:—" 260. Every contract, agreement, or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly—(*a*) altering the incidence of any income tax; (*b*) relieving any person from liability to pay any income tax or make any return; (*c*) defeating, evading, or avoiding any duty or liability imposed on any person by this Act; or (*d*) preventing the operation of this Act in any respect, be absolutely void, as against the Commissioner, or in regard to any proceeding under this Act, but without prejudice to such validity as it may have in any other respect or for any other purpose."

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For the commissioner it is contended that each of the five transactions was, within the meaning of the section, an arrangement which, to the extent of the change in ownership of the A and C ordinary shares, had both the purpose and the effect of altering the incidence of income tax on the special dividends, of relieving the original shareholders from liability to pay income tax thereon, or of avoiding a liability imposed by the *Assessment Act* on the original shareholders to pay tax on taxable incomes assessed by including in their assessable incomes the amounts of the special dividends. This being so (the contention proceeds), the transfers of the A and C ordinary shares to Pactolus must be treated as void for the purposes of these proceedings, and the amended assessments should be sustained on the footing that the special dividends were derived in their entirety by the original shareholders, a portion of each such dividend having been actually received by them, and the remainder having been paid to Pactolus at their instance and retained by Pactolus with their consent and for its own benefit as something in the nature of a remuneration or a reward for its co-operation in the transactions.

Section 260 is a difficult provision, inherited from earlier legislation, and long overdue for reform by someone who will take the trouble to analyse his ideas and define his intentions with precision before putting pen to paper. There have not been many cases in which the meaning of the section has been considered, but some points must now be taken as settled. One is that, although the word " arrangement " does not include a conveyance or transfer of property as such, it does include any kind of concerted action by which persons may arrange their affairs for the stated purpose or so as to produce the stated effect ; and that a conveyance or transfer may be void as against the commissioner as forming part of a course of action which constitutes an arrangement in this sense : *Bell* v. *Federal Commissioner of Taxation* (1). It is also settled that since " this Act " (i.e. the *Assessment Act* as distinguished from the Acts which impose taxation at rates which they prescribe) imposes by s. 17 a general liability to pay tax at the rates declared by the Parliament upon the taxable income derived during the year of income by any person (subject to an exception), an arrangement having the purpose or effect of avoiding that liability in the case of any particular person is within the operation of s. 260 (*c*) : (2). A third point which is settled is that the section is an annihilating provision only, so that it avails the commissioner where, and only where, the result of its rendering an arrangement void to the extent

(1) (1953) 87 C.L.R. 548, at p. 573. (2) (1953) 87 C.L.R., at p. 574.

which it mentions is to leave standing a state of affairs in which a challenged assessment is justified : (1).

On this third point there seemed in the course of the argument in the present case to be what I regard as a misunderstanding, for some of the submissions that were made appeared to assume that the operation of the section upon any particular arrangement is to eliminate from consideration, as if it had never occurred, either everything that was done, or some severable part of the things that were done, in the course of the arrangement. Perhaps this comes from attributing to the word " annihilate ", as used in the earlier cases, the sense of blotting out and deeming never to have existed. The word has been used, however, only to emphasise the fact that the section has merely a destructive, and never a constructive, operation ; that it renders a contract, agreement or arrangement void to the stated extent, but never supplies any element which is absent and is necessary for a valid assessment. It must not be overlooked that what is meant by " void " is simply devoid of legal effect or significance. (Hence the courts have been constrained to reject, as inapplicable in the construction of s. 260, the meaning which " arrangement " has in some contexts, namely a *consensus*, generally of a more or less unformulated character, lacking in legally operative effect.) The section leaves all the facts of a case exactly as it finds them, requiring neither that anything which was not done shall be deemed to have been done nor that anything which was done shall be deemed not to have been done. As applied to a transfer of shares, for example, it leaves standing the fact that the transfer was executed and was registered, and merely requires that the title to the shares be considered as remaining nevertheless unchanged.

Then, too, it must be observed that the section is drawn on the footing that where the stated purpose or effect exists, it may be only to a limited extent that the arrangement is to be described as having or purporting to have that purpose or effect. In one sense, of course, if an arrangement has that purpose or effect to any extent, it is true to say that the whole arrangement has that purpose or effect ; but the section looks at the matter differently. It recognizes that the arrangement considered as a whole may have other purposes and effects as well ; and it requires that out of the legal consequences of everything that constitutes the arrangement those legal consequences be selected and treated as void which have the purpose or effect of themselves producing any of the results described in pars. (*a*), (*b*), (*c*) and (*d*) of the section, that is to say those consequences

(1) (1953) 87 C.L.R., at pp. 572, 573.

which are intended to form or in fact form the decisive or operative factors in bringing about such a result. And even such legal consequences are to be treated as void to the extent only that they have that purpose or effect. So, if it is the operation of a conveyance that is void (under par. (*c*) for example), it is void only in relation to the particular liability which it has the purpose or effect of defeating, evading or avoiding: it is not void, for example, in relation to all the future income of the property, but is void in relation to that income only which, but for its efficacy, would be assessable income of the conveyor.

The expression " the purpose or effect " is not without its difficulty. Only the actual legal effect of a thing can be made void, not an effect which, though aimed at, is not achieved even if the section does not apply. The meaning seems to be that if you find that an arrangement has such a purpose as the section describes, you must treat it as void as against the commissioner and you need not stay to inquire into its general validity; but that if you find that it is effectual apart from the section, then you must treat it as void as against the commissioner whether it had such a purpose or not. The expression " has or purports to have " seems to carry out the same idea. In other words, the meaning which I should place upon the expression " so far as it has or purports to have the purpose or effect of altering " (etc.) may be expressed by some such paraphrase as: " so far as its validity would have the consequence of altering (etc.), whether that was the purpose of the parties in entering into it or is only its *de facto* result, and whether such a purpose or result is or is not to be found acknowledged in the course of the transaction ".

Now, it is clear that in each of the five transactions with which the present appeals are concerned a company made a distribution of its profits. It is also clear that none of the taxpayers concerned participated directly in any of the distributions, for every penny went directly to Pactolus. It is equally clear that each of the taxpayers received money or both money and fully-paid preference shares from Pactolus, and that neither the money they received nor that which had been used to pay for the preference shares can be treated as their assessable income unless it has that character for income tax purposes in consequence of the operation of s. 260. I must now examine the history of the transactions—not so much to find whether they had one or more of the purposes mentioned in s. 260, but in order to discover whether, if the sales and transfers of the A and C shares be treated as void in law, a consideration of all that remains should lead to the conclusion that the moneys and shares received by the original shareholders, either alone or together with the moneys retained by Pactolus for itself, were derived by those shareholders as income.

The first step was taken in June 1949, when Mr. Ratcliffe was consulted. It had become apparent to those in charge of the motor companies' affairs that business was increasing, and that, as soon as restrictions such as petrol rationing were lifted and goods were in better supply, there would be (as Mr. Lane put it in evidence) " a lot of difficulty for us with our capital ". The difficulties referred to included, of course, the need to keep sufficient working funds in the businesses, bearing in mind that, as Mr. Lane said : " in the motor business everything you touch is a thousand pounds and a million pounds goes nowhere ". In addition, there was the fact that bank accommodation, if it should be required at any time, would be harder to get with balance sheets which showed so much of the working capital in the form of withdrawable funds, and the further fact that it would be difficult, with those balance sheets, to float public companies, and thereby to move out of the area of liability to Div. 7 tax and at the same time to place shareholders who might need cash in a position to sell shares readily. That these considerations were seen as difficulties, however, was due to the fact that the companies' profits could neither be retained as profits nor converted into paid-up share capital without taxes being incurred which would absorb a large part of them (or amounts equal to a large part of them). It is easy, therefore, to understand that, when Mr. Harry Lane was asked in cross-examination whether he was not concerned at the time that something should be done so that the tax liability which loomed should never arrive, he replied : " That is one of the reasons that we consulted Mr. Ratcliffe in regard to the formation of a public company, so we could remove from the private company tax ". And he went on to say that that was made clear to Mr. Ratcliffe. Mr. Ratcliffe was well known to Mr. Lane and Mr. Newton, for at an earlier date he had given advice concerning the Melbourne furniture firm of Maples, in which the Newtons and Mr. Harry Lane were interested. He was also associated with Mr. Lauri Newton, Mr. Harry Lane and Mr. Fenton on the board of a Sydney furniture company, Bebarfalds Ltd. It was at the close of a meeting of that board that Mr. Newton asked Mr. Ratcliffe to discuss the motor companies with Mr. Harry Lane. This he did, and they talked in general terms of the difficulties likely to confront the motor companies in relation to their capital, and of the question of forming them into public companies. Mr. Ratcliffe asked to be supplied with the accounts. When he had

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received and examined them, he saw that each company was seriously under-capitalised, and in August 1949 he had a discussion, confined to Lane's and Neal's, with Mr. Harry Lane and Mr. Newton. Mr. Ratcliffe suggested that the capital of Lane's should be increased to £800,000, and the capital of Neal's to £750,000. Mr. Lane did not favour a higher figure than £600,000 for Lane's, and in any case he made evident his personal feeling against converting the companies into public companies. Mr. Ratcliffe then put forward a preliminary outline of another plan. This, as he described it in his evidence, was that " they could divide their shares into two classes, giving one class special dividend rights and thereby deferring the second class, that they could sell the class I first referred to and that they could use that money to take up a large number of shares at par, and that would raise their capital." Being asked where they could sell the shares, he said he had a company which would be prepared to make an offer.

The matter was carried a stage further at a meeting in Melbourne in September, at which Mr. Ratcliffe developed his proposal in the presence of Mr. Robert Nathan, Mr. Harry Lane, Mr. Lauri Newton, the accountant of Maples named Atcheson, a public accountant named Wallace (a trustee shareholder in Melford), and Mr. F. E. Bunny a solicitor who was acting for the motor companies and their shareholders. It is evident that at this discussion the problem of private company tax draining away undistributed profits was very much wrapped up with the question of the companies' capital situation, for Mr. Ratcliffe, realising that the idea of listing the companies on the stock exchange was too controversial to be worth pursuing, mentioned, as an alternative to that, the possible course of bringing in a few new shareholders and so arranging the voting power that the companies could be made to be no longer private companies within the meaning of the *Income Tax and Social Services Contribution Assessment Act.* This would mean that they would have to pay (in addition to ordinary company tax) super-tax and Pt. IIIA tax on undistributed profits, amounting together to about fourteen and one-half per cent, instead of Div. 7 tax amounting to seventy-five per cent. In this suggestion he found that they were " really not interested ", because it had nothing to do with their capital but " was directly on the question of tax saving only ". (It was too late to do this so as to take effect with respect to the profits of the year ended 1949, but even as to those profits there was a course which would be effective, namely to form holding companies and let each motor company distribute its profits before 31st December 1949 to its holding company, the latter being, or becoming before the ensuing 30th June, a non-private company.) The main elements in the problem as they saw it were the need of each company for an increased share capital, the desirability of getting the increase from the company's own resources and without bringing in new money, and the apparent impossibility of getting it out of profits because income tax would in effect absorb the greater part of each year's profits either in the companies' hands or in the hands of the shareholders. The possibility of writing up assets and issuing shares for the amount of the increase was discussed, and so was the possibility of satisfying the existing loans by an issue of shares; but these courses together would not have provided the capital which Mr. Ratcliffe thought necessary and they were rejected. Most of the discussion seems accordingly to have been devoted to the plan Mr. Ratcliffe had propounded for a sale of shares with special dividend rights; and two questions about it assumed importance: whether the price obtained on the sale would be taxable in the hands of the vendors, and how the amount of the price would be determined. Mr. Ratcliffe, and apparently Mr. Bunny and the accountants, having ascertained that none of the shareholders had acquired his shares for resale at a profit, expressed the opinion that the price paid to them would be a capital receipt and not taxable, and that (to use words of Mr. Lane's) "such taxation as applied was Pactolus's, the obligation of Pactolus as the recipient of the dividends." The method suggested for arriving at the price was based on the view that probably no buyer could be found except a public company, that such a company would have to pay (in addition to the ordinary company tax which was a liability of private and non-private companies alike) approximately fourteen and one-half per cent tax on the dividends it received (taking super-tax at 1s. in the pound and Pt. IIIa tax at 2s. in the pound on the balance), and that such a company would be likely (according to an experience Mr. Ratcliffe had had) to want to keep the price low enough to allow both for these taxes and for a considerable margin above it, perhaps as much again, by way of profit on the deal. Mr. Ratcliffe said in effect, as I understand his evidence, that his company (Pactolus), being a trader in shares and able to resell the shares purchased under the plan and set off a loss so incurred against dividends received, could afford to offer a price equal to the amount of the dividends less only the fourteen and one-half per cent for taxes and a profit margin of £5,000. One other matter was mentioned in the discussion, namely the necessity which existed at that time to get official consent under the *Capital Issues Regulations* to the issue of the new shares. Mr.

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Ratcliffe told the meeting, in effect, that in order to get the consent granted with expedition as a formal matter the application should make it clear that the new shares would be paid for, not by new money, but out of " current resources ". At this stage, however, it seems not to have been contemplated that Pactolus would take up the new shares, for Mr. Bunny's evidence satisfies me it was proposed that the purchase money for the shares with special dividend rights should be used by the vendors to take up the new shares.

Mr. Ratcliffe was asked to put his proposal in writing. He did not do exactly that, but he wrote to Mr. Wallace a letter dated 30th September 1949 for consideration by all concerned. It dealt with the three motor companies, and also with a fourth company in which the same people were interested, Ajax Insurance Co. Ltd., as to which the proposal was eventually dropped. It enclosed three memoranda. The first dealt with the alterations required in the articles of association of the several companies, particularly for the purpose of creating the special dividend rights for a segregated class of shares to be called A shares. The second memorandum dealt with the matters to be covered in a proposed contract for the sale of the A shares to Pactolus, and it included a provision (ultimately not the subject of any written agreement but nevertheless quite distinctly agreed between all parties) that Pactolus would take up new preference shares and that " immediately these shares are fully paid " (without stipulating how they should be fully paid) Pactolus would sell them to the original shareholders in proportion to their holdings.

The third memorandum set out Mr. Ratcliffe's method of calculating the prices to be paid by Pactolus for the A shares and of the number of new shares to be issued and taken up by Pactolus. This memorandum used figures which were the actual figures for the year ended 30th June 1949, but were necessarily only rough estimates for the year ended 30th June 1950. I shall take the portion dealing with Lane's, as sufficient to show the nature of the document. It showed Mr. Ratcliffe's workings and was not in narrative form ; but what it conveyed to those for whom it was intended may be described briefly as follows. First, there was a calculation of the amounts which the company would need to distribute out of the profits of each of the two years in order not to be liable for Div. 7 tax. These (together with amounts similarly calculated in relation to a subsidiary company) came to £410,000. It followed that if Pactolus were to purchase from the shareholders a proportion of their shares carrying special dividends amounting to that sum, and that sum were thereafter distributed to Pactolus, Lane's would save Div. 7 tax amounting (at 15s. in the pound) to £307,500. That amount of tax might have been saved in another way, namely by the company ceasing to be a "private company", either by becoming listed on a stock exchange or by so altering its membership and control as to get outside the definition of "private company"; but this could only have been done at the cost of becoming liable to pay super-tax and Pt. IIIA tax, which would have amounted in all to £72,524. The net saving to the company by the distribution to Pactolus might be taken as the difference between these two figures, namely £235,000. Suppose, then, that the A shares bought by Pactolus were one-third of the issued ordinary shares, viz. 79,107 (enough to protect Pactolus's interest from interference by a special resolution but not enough to affect the general control of the company). Suppose, too, that the special dividends to which these shares entitled Pactolus were made to include a small amount of tax-paid profits (taken for convenience at £2,684), and that they would be worth £1 per share when the special dividends had been paid in full and the only rights remaining attached to them were a right to a five per cent cumulative preferential dividend and protective voting rights. On these hypotheses the A shares would be worth to Pactolus a gross amount of £491,791, made up of taxable dividends (£410,000) tax-paid dividends (£2,684) and capital value (£79,107). That would enable Pactolus to pay £419,267, or £5 6s. 0d. per share, and get as its profit an amount equal to the £72,524 which, as mentioned above, Lane's would have had to pay in super-tax and Pt. IIIA tax if it had been a public company and had made no distribution. The figure of £419,267 was described as "net price", the £5,000 margin for which Mr. Ratcliffe was stipulating being omitted from this memorandum because (as he explained in evidence) he wanted to show only the approximate equivalence between the three possible methods, namely listing on the stock exchange, ceasing by other means to be a "private company", and adopting his Pactolus plan. The document went on to show that in order to pay the dividends, taxable and tax-paid, which would thus be required, amounting to £412,684, Lane's would need to find only £10,005 in cash, assuming that enough of the dividends were turned into capital paid up on the new shares to bring the total paid-up ordinary capital to £640,000, viz. £402,679. This cash amount of £10,005 would go to the shareholders, together with a cash amount of £6,583 to be supplied by Pactolus, making £16,588 in all, to make the difference between the amount of new

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share capital in the company (£402,679) and the price Pactolus would be paying for the A shares (£419,267).

As I have said, the figures used in this memorandum were hypothetical, but the course indicated was in substance that which was pursued in the three transactions of December 1949; and a study of the memorandum shows what the practical effect of those transactions was to be. It was to enable the motor companies, (a) while parting with comparatively little cash, to replace the greater part of their 1949 and 1950 profits by paid-up share capital, (b) to make the distributions required in order to exonerate themselves from Div. 7 tax, and (c) at the same time to avoid involving the original shareholders, though they became the holders of the new share capital, in an income tax liability on the footing that they had participated in a distribution of profits. What those in charge of the motor companies' affairs had to consider in September, with Mr. Ratcliffe's memorandum before them, was whether it was good enough business to achieve this desirable result at the cost of letting Pactolus reap a profit broadly equal to the sum of the amount which would have gone to the Taxation Department if the companies had been public companies and had retained their profits undistributed, plus £5,000 of which some part at least would have been expended in the process of converting the companies to public companies.

By the end of that month it had become apparent to Mr. Ratcliffe, from communications which had passed, that the proposition he had submitted would probably be agreed to. He therefore set about providing Pactolus with sufficient funds to purchase the shares carrying special dividend rights. Pactolus had, or could raise from its shareholders, little more than £20,000, and another £125,000 seemed likely to be needed to tide over the interval between the purchase of the A ordinary shares and the receipt of the full amount of the special dividends. To obtain this amount, Mr. Ratcliffe applied in writing to his bank, the Commercial Banking Company of Sydney Ltd., for an overdraft. The figure was arrived at on the assumption that the Ajax proposal as well as the others would proceed; and as regards the motor companies it was based on more recent figures than had been available when the letter of 12th September was written. In calculating the amount Mr. Ratcliffe worked on an anticipation that the special dividends on the A shares would probably be declared as follows: Lane's, £373,130 immediately after sale and £39,554 in March 1950; Neal's, £358,366 immediately after sale and £81,999 in March 1950; Melford, £177,854 immediately after sale and £41,265 in March 1950.

The purchase prices for the A shares were taken at £419,267 for Lane's, £412,425 for Neal's and £198,072 for Melford. Although the amount of cash accommodation required was worked out by setting off the immediate dividends from the price to be paid for the A shares, the document said that the special dividends would be used to take up the new shares, totalling: Lane's 402,679; Neal's 405,668; and Melford 189,819. All these new shares, it was shown, would be sold at par to the vendors of the A shares for cash as soon as taken up. The application was not proceeded with, for two reasons. One was that the Ajax proposal fell through. The other was that the motor companies' profits exceeded Mr. Ratcliffe's expectations to such an extent that it proved possible, simultaneously with the purchase of the A shares by Pactolus, to pay dividends sufficient in amount to enable Pactolus to take up and pay for all the new shares without having to find more cash than it had available from its own resources. The written application was admitted in evidence without objection. It does not purport to state anything as having been agreed. The expectations it reflects are not shown by it to have been the expectations of anyone but Mr. Ratcliffe; and the use of the dividends to the necessary extent, as and when declared, to take up the new shares, is shown as intended (by him) but not as obligatory.

On 12th and 13th October 1949, the motor companies sent to the Capital Issues Board applications (with covering letters) for consent to the issue of cumulative preference shares: 402,679 in Lane's; 405,668 in Neal's; and 200,000 in Melford. Each covering letter said that it was proposed that these shares should be "taken up by the shareholders and paid for by them out of funds obtained through the declaration by the Company of tax-free and taxable dividends", Lane's and Neal's letters adding "or in part by the use of dividends previously declared and still owing". The letters added: "The Company does not wish to directly capitalise any profits but prefers to declare dividends and allow the shareholders to make application for the shares and use the funds from the dividends to pay for them." The application form in each case contained a statement that the proposed issue was "for the Company's business as the present paid-up capital is inadequate"; and it added: "It is not intended to capitalise any account but is intended to distribute tax-paid and taxable dividends at least equal to the amount paid on the new shares". On 14th November in the case of Melford, and on 17th November in the cases of Lane's and Neal's, the consent applied for was given; and in each instance a note was added, stating that the approval had been given on the

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undertaking that all the conditions pertaining to the issue of capital as set out on the application would be observed.

Correspondence ensued between Mr. Ratcliffe and the companies' legal advisors, Messrs. Corr & Corr, solicitors, of Melbourne. The topics dealt with included the amendments to be made in the respective articles of association, the application of the *National Security (Capital Issues) Regulations*, and the establishment of branch share registers in the Australian Capital Territory—a refinement introduced into the proposal to avoid difficulties of valuation and consequential delays which were thought likely to occur if the stamp duty laws of the States were encountered. One outcome of this was that, instead of having a contract executed by all parties for the sale and purchase of the A shares as Mr. Ratcliffe's letter of 12th September had proposed, it was decided to have options given by the shareholders to Pactolus, to be exercised in Canberra by a notice to Mr. Ross, as agent for the shareholders, and that Mr. Ross should be authorised both to accept the purchase money for the A shares and to pay Pactolus the purchase money for the new shares taken up by it. Only one other point discussed in the letters need be mentioned. Mr. Bunny, of Corr & Corr, showed that he understood the transactions to be preliminary to the ultimate conversion of the companies into listed public companies, for he proposed to make it a term of the transactions that if that should not happen within a stipulated period the vendors of the A ordinary shares should repurchase them at £1 each. Mr. Ratcliffe strongly opposed anything in the nature of a string to the purchase, mainly on the ground that it would enable the Commissioner of Taxation to contend that the vendors were engaged in a profit-making scheme. In a letter to Mr. Harry Lane he said that the adoption of Mr. Bunny's suggestion might " result in the loss of the advantage sought to be obtained "; and he added : " If the sale includes a ' string ' to the shares, opinion both official and public would be against us and the Commissioner might seek an amendment of the law to tax the transaction. If there is no ' string ' there is then only a sale of an investment which would be very difficult to legislate for, either retrospectively or otherwise." Plainly enough, the " advantage " referred to was the immunity of the profits from a drain of 15s. in the pound in favour of the Commissioner of Taxation ; and, equally plainly, the transactions which were being evolved were regarded as ensuring that immunity by reason of their being sales of investments and nothing more. With his letter of 18th October 1949, Mr. Bunny submitted to Mr. Ratcliffe a draft option agreement for the sale of the A ordinary shares. This included a covenant by the purchaser to apply for a number of new shares, to pay for them in full (without saying with what moneys), and to sell them to the original shareholder at £1 per share. It also contained an authority to Ross as the original shareholder's agent (*inter alia*) to receive the purchase money for the A shares and to pay out of it any amount payable by the original shareholder on his purchase of the new shares. The option agreements ultimately executed did not contain the second part of this authorisation.

The details of the proposed transaction were dealt with in a number of letters, and in the meantime Mr. Ratcliffe was being given the monthly figures of the motor companies. He was asked in November to draft the dividend resolutions and the drafts he prepared were ultimately varied in the light of the latest figures and the conclusions drawn from those figures as to the amounts that could be distributed. Mr. Ross prepared what he called a check sheet, setting out in detail all that had to be done to carry through the transactions. This was not agreed between the parties in the sense of becoming any part of the bargain, though Mr. Ratcliffe did see it and make the comment that it seemed to cover everything. On 8th December 1949, Mr. Ratcliffe wrote to Mr. Ross, referring to the account he had arranged to open for Pactolus with the South Melbourne branch of the E. S. & A. Bank Ltd., and saying (*inter alia*): "I have calculated that Pactolus Pty. Limited will need something less than £19,000 to meet the cheques which it will give on this new account, and I am, therefore, paying this amount into the Sydney Office of the I.A.C. to-day and would be glad if you would arrange with your (i.e. I.A.C.'s) Melbourne Office to draw a cheque for the same amount and pay it into the Bank when you open the Account." The calculation which Mr. Ratcliffe had made he checked against a statement supplied by Mr. Ross, which set out in schedule form exactly how each shareholder in the three motor companies would fare in consequence of the transactions and for what amounts each of them would have to provide cheques to be used in the carrying out of the transactions. The receipt of this statement, embodying final figures as it did, made it clear to Mr. Ratcliffe that the shareholders had finally decided to go on with his proposal; but there was never anything more specific by way of assent to it. Everyone concerned proceeded to carry out the transactions which I have described at an earlier stage of this judgment, all the details being attended to as worked out in Mr. Ross's check sheet.

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Counsel for the commissioner sought to show at the hearing, particularly by cross-examination of Mr. Harry Lane, that it was a term of the bargain that the special dividends, when paid to Pactolus, should be applied by that company in paying the purchase price of the A shares. On the whole of the evidence I do not think that it was. No doubt it was obvious to everyone that the amount to be paid upon the B preference shares would be balanced by the sale price of those shares, and that Mr. Ratcliffe would not be so foolish as to get cash for Pactolus from other sources and use it to pay for the A shares, except in so far as the dividends received by it up to the time of making the payment might fall short of the purchase moneys required. But it was uncertain whether they would fall short permanently (as proved to be the case in the Lane's transaction) or only for a brief period (as occurred in the other two cases), and I do not find that any stipulation on the subject was made. What was in fact done about the simultaneous banking of cheques was simply adopted as the obvious businesslike method of dealing with cross payments. I should add also that none of the original shareholders concerned himself with Pactolus's tax position. They assumed that Pactolus would have to meet substantial taxation by reason of its participation in the transactions; but what its tax liability would be was never the subject of negotiation. Moreover, although Pactolus was left free to resell the A ordinary shares if it chose, it was never made a part of the bargain that Pactolus should sell them to Pactolus Investments.

The transactions thus effected in December 1949 raised the paid-up share capital of Lane's and Neal's to amounts which were considered by all concerned to be sufficient, but they raised the capital of Melford to no more than half the amount which Mr. Ratcliffe had suggested. In the case of Lane's, the next step, the public flotation of a holding company, was eventually taken. Lane's Holdings Limited was incorporated in November 1950 and the flotation was in May 1951. This step was not taken with respect to Neal's, for reasons connected with the franchises held by that company and by its subsidiary Devon Motors. It was not taken with respect to Melford either; but in 1950 there occurred the second Melford transaction, by which the share capital of that company was raised by the same amount as in 1949. The proposal for this transaction was set out by Mr. Ratcliffe in a memorandum attached to a letter of 13th October 1950, and it followed the same general lines as its predecessor, with one important variation. The Capital Issues consent was applied for and obtained on the basis of cash subscription for the new C shares, and, as I have already shown, those shares were taken up, not by Pactolus, but by the original shareholders themselves. This point of difference was accounted for by the fact that by that time consents under the *Capital Issues Regulations* were being given for the asking, and no advantage in that connexion was to be gained by having the new shares issued to Pactolus as the holder of the shares on which the special dividends were to be paid. The C shares were resold by Pactolus, not to Pactolus Investments Ltd., but to two daughters of Mr. Fenton.

Then, in April 1951, Mr. Ratcliffe put forward a proposal for the second Neal's transaction. There was no question on this occasion of increasing the paid-up share capital of the company. Mr. Ratcliffe knew, having done work recently for the estate of the late Robert Nathan, that that estate needed a large sum of ready money for death duties, and he understood, as the fact was, that others of the shareholders also needed money. The proposal was for a sale of a class, to be newly created, of C ordinary shares carrying special dividend rights. It was accepted, after the shareholders had been advised by Mr. Bunny that (in Mr. Lane's words) " it was a sound legal transaction which would not attract tax to us." The matter was carried to completion in June 1951, in the manner I have already described.

It is convenient to deal with this last-mentioned transaction first, because of the comparative simplicity of its facts. The commissioner contends that the transaction was an arrangement, in the sense attributed to that word in *Bell's Case* (1) and that a legal consequence of the sales and transfers of the C ordinary shares to Pactolus as part of the arrangement was that one or more of the results mentioned in s. 260 occurred. This, it is said, may be seen by observing what consequences in relation to the special dividend moneys would flow from treating the sales and transfers as void.

Two views favouring the commissioner are possible. One is that there would be left in the transaction a declaration of the dividend by Neal's, a debt thereby created in favour of the original shareholders as notionally being still the holders of the C shares, a payment of the amount of that debt by Neal's to Pactolus with the assent of the original shareholders, a passing on of portion of the amount by Pactolus to the original shareholders, and a retention of the remainder by Pactolus by way of reward or remuneration for its co-operation in the transaction. On this view, it may be said that there would be discovered a receipt by Pactolus amounting to a derivation of the dividend, and therefore a derivation of income,

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by the original shareholders ; and that, this being so, the arrangement under which Pactolus was enabled to receive the dividend for itself as beneficial owner of the shares may properly be described as having, so far as it did so, the purpose and effect, or at least the effect, of altering the incidence of income tax, of relieving the original shareholders from liability to pay income tax on the dividend, and of avoiding the liability of the original shareholders to pay such tax.

In my opinion, in this way of looking at the matter there is a fatal flaw at the point at which the payment by Neal's is treated as a payment to Pactolus, with the assent of the original shareholders, of an amount owing to them. The preceding step is logical enough : the declaration of the special dividend created a debt owing to the person or persons who in law were the holders of the C shares, and if the sales and transfers made by the original shareholders are to be considered void it must follow that the debt should be treated as having become payable to them and not to Pactolus. But what is the justification for the next step, that the payment of the dividend to Pactolus was made with the assent of the original shareholders, in a sense which justifies the conclusion that the receipt of the dividend by Pactolus was a derivation of it by the original shareholders ? The statement that the payment was made with their assent is true in the very different sense (and only in the sense) that they intended, when they executed the transfers, that as a consequence of acquiring the shares Pactolus should become entitled to receive and should receive the special dividend for its own benefit. But they knew that Pactolus's right to receive payment when the dividend should be declared would arise from the fact of its being the registered holder of the shares, and not from any continuing assent of theirs. Indeed it must have been obvious to them, if they had adverted to the question at all, that once the transfers were registered Pactolus's right to the payment could not be affected even by the most explicit dissent on their part. Nothing was further from their minds than the possibility that the special dividend might be regarded, for some purpose, as becoming payable to them notwithstanding their alienation of the shares ; and they certainly did not at any time agree, or intend, or even contemplate, that any debt becoming payable to themselves should be discharged by the making of a payment to Pactolus. The contention I am considering would therefore need to rely upon s. 260, not only to annihilate the legal effect of the sales and transfers of the C ordinary shares, but to add to the facts of the case a fictional agreement by the original shareholders to the effect that, in the event of the transaction being regarded for any purpose as void so far as it vested in Pactolus the right to receive the special dividend, then their own right to receive that dividend (a right to be deemed for that purpose to exist) should be satisfied by a payment of the amount by Neal's to Pactolus. The short answer is that s. 260 cannot perform this feat, for as I have earlier pointed out it concerns itself only with the legal efficacy of contracts, agreements and arrangements to which it applies, never creating notional acts or events, but leaving the facts of every case exactly as it finds them.

The other possible view favourable to the commissioner as to the consequences of treating the sales and transfers of the C ordinary shares as void, is that the money paid by Pactolus to the original shareholders must be considered not to have been a price paid for the shares, and therefore not to have been capital; that the receipt of it should accordingly be held a receipt of income; and that, this being so, the arrangement which brought in that money to them, but with the character of capital, may be described as having to that extent the purpose and effect, or at least the effect, mentioned in one or more of the paragraphs of s. 260. There is here, however, a patent *non sequitur*. It does not necessarily follow, from the fact that the amount referred to is not to be considered as the price received on the sale of a capital asset, that it is to be considered as income. A receipt cannot be held either capital or income unless circumstances are found to exist which justify its being described as the one or the other. To remove from a case an existing reason for holding a receipt to be of a capital nature is one thing; to find in what is left of the circumstances a sufficient reason for holding the receipt to be of an income nature is quite another. The first is within the competence of a statutory provision having a voiding operation only, but the second is not. In the present case, there is nothing whatever in the proved circumstances which can be relied upon to give the money paid by Pactolus to the original shareholders the character of income in their hands, even if its actual role of a price be ignored. It is here that the case differs fundamentally from *Bell's Case* (1), and it is important that the contrast between the two should be clearly brought out. The decision in *Bell's Case* (1) proceeded from two main findings. One was that a sum of money consisting of profits, having been withdrawn from a company's bank account, passed into the taxpayer's bank account, indirectly but by steps which were clearly traceable on the face of the bank's ledgers. This, if it stood alone, would obviously have been insufficient. It would only have shown that money which started as a payment out of the company's profits could be traced

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until it reached the taxpayer ; but the fact that a person receives a payment out of another's income gives no clue to the problem whether the receipt is income or capital of the payee. It is a truism that the nature of a receipt is not determined by the nature of the fund out of which the money received is taken. It was the other finding in the case which showed why, if the transfer of the shares were to be regarded as void, the taxpayer's receipt of the money was to be considered a derivation of income. The arrangement was found, in purpose and effect, to be nothing but a method of impressing a dividend with the character of capital in the process of passing it from the company to the taxpayer. The purpose and effect of the arrangement were important at this point of the case, not only because of the reference to them in s. 260, but because they were the elements in the arrangement which enabled it to be seen as an agreed means of dealing with the dividend as a specific fund, and of ensuring that, with its character changed but its identity preserved, it should reach the hands which would have received it if the arrangement had not been made. No more was needed to justify the conclusion that a voiding of the sales and transfers of the shares would remove the only obstacle to recognising the receipt as being of an income nature.

In the present case it is not possible on the evidence to make similar findings. Neal's cheque for the special dividend moneys was paid to the credit of a bank account of Pactolus in which there was already a credit balance, apparently considerable in amount. The payments made to the shareholders are therefore not shown to have been made wholly, or to any ascertained extent, out of the dividend moneys. It seems clear, however, that they were made out of those moneys to some extent. Let it be supposed that the extent is ascertained. Still there remains the important difference between this case and *Bell's Case* (1), that in using the dividend to meet the purchase price of the C ordinary shares Pactolus was simply adopting by its own choice the method which it found convenient for making a payment out of its own money. There was no term in the agreement for the sale and purchase of the C ordinary shares that the price should be paid out of the dividend. Of course it must have been well understood by all concerned that Pactolus contemplated relying upon the dividend to put its account sufficiently in funds to meet the cheques drawn upon it for the purchase moneys. It may be right to infer (though there is no direct evidence of it) that the vendor shareholders promised as part of the bargain that they would not present Pactolus's cheques

(1) (1953) 87 C.L.R. 548.

before the dividend cheque was paid into Pactolus's account. But if they did, the promise was for the benefit of Pactolus, and the vendors for their part did not exact from Pactolus any promise to pay over the dividend (or any part of it) to them. It therefore cannot be found on the evidence that, from their point of view, the arrangement was a means of getting some of the company's distributable profits transferred to themselves. They sold their shares for a price, and it was of no consequence in the transaction to what funds Pactolus might resort in order to pay the price. The agreement required nothing more, as to the money to be used as the price, than that it should be Pactolus's money: and the money which was in the event used was received by the vendors as Pactolus's money, and not as a fund with any particular nature, attributes or history.

These considerations lead me to hold that s. 260 does not assist the commissioner in relation to the second Neal's transaction. The argument to the contrary could not be sustained except by holding that s. 260 operates as a statutory reversal of the doctrine of the *Inland Revenue Commissioners* v. *Duke of Westminster* (1), operating to bring into a taxpayer's assessable income any amount received by him under an arrangement which is considered to produce broadly, or substantially, or practically, the same results as another transaction would have produced under which the taxpayer would have received assessable income. The section cannot be so interpreted. " Where circumstances are such that a choice is presented to a prospective taxpayer between two courses of which one will, and the other will not, expose him to liability to taxation, his deliberate choice of the second course cannot readily be made a ground of the application of the provision. In such a case it cannot be said that, but for the contract, agreement or arrangement impeached, a liability under the Act would exist. To invalidate the transaction into which the prospective taxpayer in fact entered is not enough to impose upon him a liability which could only arise out of another transaction into which he might have entered but in fact did not enter ": *Clarke* v. *Federal Commissioner of Taxation* (2).

The other four transactions in question in these appeals, though more complicated, appear to me to be governed by similar considerations. The only difference in the case of the second Melford transaction is that the original shareholders applied the greater part of the price they received from Pactolus for the C ordinary

(1) (1936) A.C. 1.

(2) (1932) 48 C.L.R. 56, at p. 77.

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shares in paying in full for the new B shares which they took up. This point of difference is immaterial to any question in the case.

The three transactions of December 1949 differed from the second Melford transaction chiefly in this, that it was Pactolus which took up the new B preference shares and that the original shareholders acquired them from Pactolus. The true analysis of these transactions so far as the payments were concerned is, I think, (i) that Pactolus paid for the new B preference shares out of the special dividend moneys, in accordance with the third memorandum enclosed with Mr. Ratcliffe's letter of 12th September 1949, with the undertaking on which capital issues consent to the new issue had been obtained, and with Mr. Ratcliffe's understanding of the matter as shown in his application to the Commercial Banking Co. of Sydney Ltd. for overdraft accommodation ; (ii) that the original shareholders paid Pactolus the purchase price for the B preference shares out of the price they got from Pactolus for the A ordinary shares ; and (iii) that the excess of the special dividends over the amount paid up on the B preference shares was used by Pactolus (with an addition from its own moneys in the case of Lane's but leaving a balance in its own hands in the cases of Neal's and Melford) to make up the difference between the price it had to pay for the A ordinary shares and the price it got for the B preference shares. This means that when Pactolus transferred the B preference shares to the original shareholders it transferred assets which, from its point of view, were simply an investment of a portion of the special dividends. But, clear though it is that the purpose of the original shareholders was to bring about a distribution of profits by the companies and an increase in the paid-up capital of the companies (to be represented by fully paid B preference shares in their own hands), and to achieve these ends without adopting a course which would bring down any income tax liability upon their own heads, it remains true in these cases, as it is in the other two, that the original shareholders did not stipulate that they should receive the special dividend moneys. The transaction was not a procedure adopted for the common purpose of getting the special dividends to the original shareholders. It was a transaction on a purely commercial basis, in the sense that Pactolus's purpose was only to get something for itself, and the purpose of the original shareholders was only to get something for themselves coupled with an advantage for their companies. What Pactolus wanted was the A ordinary shares, and, by virtue of owning them, the special dividends. What the shareholders wanted for themselves was the B preference shares and cash, together equivalent to the amount they thought it reasonable to accept for the entirety of the rights contained in the A ordinary shares; and what they wanted for the companies was freedom from liability for Div. 7 tax (to be achieved by making a distribution of profits within the statutory period) and an increase in the amount of the paid-up share capital. Pactolus was left free to decide for itself what funds it would use for the purposes of the transaction, the common intention being exactly that which was stated in the application for the capital issues consent, namely "not . . . to capitalise any amount but . . . to distribute tax-paid and taxable dividends at least equal to the amount paid on the new shares."

In these circumstances it would not be sufficient, for the commissioner's success, to hold that by virtue of s. 260 the money and B preference shares which the original shareholders received should not be regarded as the price of the A ordinary shares. He must still fail, because, even with the sales and transfers of the A ordinary shares made void, it would not be possible to find that the money and shares reached the original shareholders with any attribute which would justify their being classed as income. It is not to the point that business men might loosely describe what was done in each company as substantially equivalent to a different transaction, namely a capitalisation of profits effected by a procedure involving a liability upon the original shareholders to pay income tax on the amount of the profits capitalised. The fact is that it was not such a capitalisation, and s. 260 cannot operate to justify an assessment made on the basis that notionally it was.

Nor is it material, though it is true, that the original shareholders found the proposition doubly attractive because, on the one hand, it provided the companies with new share capital to take the place of the profits which they could not have retained much longer without incurring liability for Div. 7 tax, and, on the other hand, it neither involved the original shareholders in income tax on the distributions nor admitted new shareholders to participate in the general conduct of the companies' affairs. Nothing at all was received by the original shareholders as distributed profits. It is true that they chose the course they adopted in preference to other possible courses because Mr. Ratcliffe satisfied them that it was the most advantageous course for themselves and their companies, having regard to the way in which the income tax law would operate. But the choice they made, and what they actually did, was to take the price they were offered for a parcel of shares carrying special rights with respect to distributable profits, and not to take

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the distributable profits; and it would require more than a merely voiding provision to reverse the choice.

In the result I am of the opinion that the amended assessments cannot be sustained, and that the appeals must be allowed.

From this decision the Commissioner of Taxation appealed to the Full Court.

J. B. Tait Q.C. (with him *D. I. Menzies* Q.C. and *K. A. Aickin*), for the appellant in each appeal. In approaching s. 260 of the Act three questions arise. (1) Whether there is an arrangement within the meaning of the section. (2) If there is, what is it that is avoided against the commissioner. (3) Whether there is on the facts exposed after the avoidance a situation in which the taxpayer is liable to assessment. The arrangement was to do what was done and its effect was to enable profits to be distributed to the shareholders in such a way that neither the company nor the shareholders were liable to pay tax. In *Bell* v. *Federal Commissioner of Taxation* (1) no moneys passed out of the company's account to Bell directly, nor was the money received by Bell traceable to the account nor was there any term of agreement that White or Corlett should use the moneys from the company to pay Bell's purchase price. [He referred also to *Jaques* v. *Federal Commissioner of Taxation* (2); *Deputy Federal Commissioner of Taxation* v. *Purcell* (3); *Clarke* v. *Federal Commissioner of Taxation* (4); *War Assets Pty. Ltd.* v. *Federal Commissioner of Taxation* (5).] On the corresponding provision of the land-tax legislation, see *Osborne* v. *The Commonwealth* (6); *Patterson* v. *Farrell* (7); *Molloy* v. *Federal Commissioner of Land Tax* (8); *In re Lucks Ltd.* (*In Liquidation*) (9). Under s. 260 " arrangement " embraces all kinds of concerted action by which persons may arrange their affairs for a particular purpose so as to produce a particular effect. The words " avoid any duty or liability imposed on any person by this Act " refer to a liability such as that contained in s. 17 to pay tax on taxable income. It is only against the commissioner or in regard to any proceeding under the Act that the transaction is void to the extent that it does avoid tax. Only so much of the concerted action is made void as has or purports to have the purpose or effect of avoiding tax or one of the other matters in pars. (*a*) to (*d*). What is destroyed here, in the sense of s. 260, is the sale of the shares, the transfer of

(1) (1953) 87 C.L.R. 548.
(2) (1924) 34 C.L.R. 328.
(3) (1921) 29 C.L.R. 464.
(4) (1932) 48 C.L.R. 56, at pp. 76, 77.
(5) (1954) 91 C.L.R. 53, at p. 97.
(6) (1911) 12 C.L.R. 321.
(7) (1912) 14 C.L.R. 348.
(8) (1937) 58 C.L.R. 352.
(9) (1928) V.L.R. 180.

the shares and the registration of them in the name of Pactolus. If the concerted action has the purpose or effect described by s. 260 it is immaterial that it may have some other purpose or effect as well. In this case there was concerted action which had the effect of avoiding tax which the original shareholders would have paid if the distribution by the company had been made without the sale of the A and C shares to Pactolus. That concerted action was on the part of the original shareholders, the motor companies and Pactolus. The arrangement was the whole of the action set out on the documents. The part void was the sale of the A and C shares to Pactolus and the transfer and registration of those shares. It was not necessary that there should be a stipulation that the dividends should be used in providing the purchase price. It is sufficient that they were used. All that is needed to make what the shareholders received assessable income is to destroy the sale and transfer of the A and C shares. It is conceded that the shareholders could not have been assessed if the dividends had not reached them but had remained in the hands of Pactolus. This case is indistinguishable from *Bell's Case* (1).

R. M. Eggleston Q.C. (with him *B. P. Macfarlan* Q.C., *A. B. Kerrigan* Q.C. and *J. A. Nimmo*), for the respondent in each appeal. The trial judge correctly applied the law to the facts correctly found by him. Section 260 only applies to a transaction which either has the purpose specified or purports to have the effect specified. Here there was no fulfilment of the requisite purpose or effect. Having regard to the history of s. 260 when the section speaks of transactions which have or purport to have a purpose or effect it is not to be read as dealing with transactions which merely have the effect of producing the same result as a taxable transaction but of transactions which have the purpose or effect of changing the incidence of tax from one person to another in some way. In that sense the purpose of the transaction relates to a motive. And the effect relates to contracts which on their face deal with the matters referred to. Accordingly the question of effect can be ignored here because these transactions did not purport to have any effect in relation to taxation. As regards motive the question is whether the case is within s. 260 (*c*). The commissioner does not rely on (*d*). If in fact, the transaction is not one under which tax is payable in accordance with the taxing provisions apart from s. 260, and it is conceded here that this is not a taxable transaction apart from the section, it becomes impossible logically

(1) (1953) 87 C.L.R. 548.

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to say that the transaction is entered into for the purpose of defeating, evading or avoiding any such duty or liability. If it should be held otherwise, any sale of an income-producing asset would be within the provisions of s. 260. There was here a genuine sale. It was immaterial to the vendors where Pactolus would obtain the purchase money. There was never any intention on the part of the vendors that Pactolus should use the dividends as the purchase price. The case is to be distinguished from *Bell's Case* (1) because there the intention of the shareholders was that they should obtain the company's money. Even assuming that an effect of avoiding tax can invalidate some transactions, this was not such a transaction since it neither had the purpose nor the effect of doing things which the section specifies. Before an avoidance of taxation can be found it must be found that the purpose in entering into the transaction was to avoid a probable liability and that there was no other way of carrying out the transaction except a way which would attract tax. Section 260 does not apply to a transaction which has a real existence independently of the elements which have the purpose or the effect of avoiding tax. If the transaction is a real one, having other purposes and effects, it is not struck at by s. 260 unless, under the section, severance of the void portion can take place without affecting the balance of the transaction. [He referred to *Purcell's Case* (2); *Jaques's Case* (3); *Clarke's Case* (4); *Bell's Case* (5).] If s. 260 can be applied to these transactions, the effect, except in the second Neal transaction, except as to the smaller sums in cash, would be to leave the moneys in the hands of the companies. In all the cases the effect of the application of s. 260 would be to annihilate the declaration of the dividend, since that alone avoided what would otherwise have been a liability for taxation. Section 260 cannot be applied to a case under Div. 7 because that Division itself contemplates that action may be taken to take the taxpayer out of its scope in respect of income already earned and accordingly the words "defeat, evade or avoid" cannot be read as including action designed to remove the company from the effects of Div. 7. There must be a set of circumstances in which, if nothing was done, there would be liability for tax before s. 260 can be applied to the situation. *Bell's Case* (1), was wrong in that it decided that s. 260 could operate to produce a tax liability which would not have existed if the challenged transactions had not been

(1) (1953) 87 C.L.R. 548.
(2) (1921) 29 C.L.R. 464, at pp. 466, 467, 473, 476.
(3) (1924) 34 C.L.R. 328, at pp. 331, 338, 359, 360, 362.
(4) (1932) 48 C.L.R. 56, at pp. 76, 79, 80.
(5) (1953) 87 C.L.R. 548, at pp. 571, 573.

entered into. It is illogical to read s. 260 as meaning that a man who enters into a transaction which is not taxable shall be taxed as if he had entered into part of the transaction and not the rest of it. Under the section it is the contract etc. which is void. Nothing is said about what is done to carry out the contract. The commissioner cannot make a man the owner of shares with which he has parted merely by making void the contract.

D. I. Menzies Q.C., in reply.

Cur. adv. vult.

May 31, 1957.

The following written judgments were delivered :—

DIXON C.J. I have had the advantage of reading the reasons prepared by *Williams* J. and those prepared by *Fullagar* J. and I agree in all substantial respects with the view expressed by their Honours.

In my opinion the appeals should be allowed, the orders under appeal set aside and the appeal from the assessments of the commissioner dismissed.

McTIERNAN J. The question in each of these matters is whether the respondent is liable to tax on dividends declared and paid by one or more of the companies, which have been called Lane's, Neal's and Melford, out of its taxable income. The case of each respondent is that he had sold and transferred to Pactolus Pty. Ltd. the shares on which the dividends were declared and that company received the whole of the dividends. The commissioner does not dispute these facts. But he relies upon s. 260 of the *Income Tax Assessment Act* 1936-1949 so far as the amended assessments for the year ended 30th June 1950 are concerned. Strictly, in the cases of those for the next year it is s. 260 of the *Income Tax and Social Services Contribution Assessment Act* 1936-1950, but the provisions of the two sections are the same. The commissioner's case is that the sale and transfer in each case were part of an arrangement within the meaning of the section and that such transactions are " absolutely void as against the Commissioner ". He maintains that the result of the operation of the section is that each respondent must be deemed to have derived as income the dividends paid on the shares which he had in fact sold and transferred. All the dividends in question were distributions made by the companies to Pactolus Pty. Ltd. Each of these distributions came within the definition of " dividend ". This is found in s. 6 (1) of the Act. Section 44 provides that the assessable income of a

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shareholder shall, subject to this section, include dividends paid to him by the company out of profits derived by it. The amended assessment in each case excluded amounts subject to the rebate provided by s. 107. The proportions of the distributions included in the amended assessment of each respondent would clearly have been part of his taxable income if such distributions had been made directly to him by the company. Was there in these matters an " arrangement " within the meaning of s. 260 ? The connotation of the word is as *Isaacs* J. said in *Jaques* v. *Federal Commissioner of Taxation* (1), " elastic ". Its meaning includes settlement of details made in anticipation of some event; also, the action taken as fulfilment of a plan. In *Bell's Case* (2), the Full Court decided that such action would be an " arrangement " if its character and consequences are as defined in s. 260. An " arrangement " is struck at by this section " so far as it has or purports to have the purpose or effect of in any way, directly or indirectly " contriving any of the things enumerated in (*a*), (*b*), (*c*), or (*d*). I think that in this context " purpose " means the object aimed at and accomplished, and " effect " means the end attained irrespective of the motive. The object of the section is to limit for the common good a freedom on which Lord *Simon* L.C. commented in *Latilla* v. *Inland Revenue Commissioners* (3). He there said : " My Lords, of recent years much ingenuity has been expended in certain quarters in attempting to devise methods of disposition of income by which those who were prepared to adopt them might enjoy the benefits of residence in this country while receiving the equivalent of such income without sharing in the appropriate burden of British taxation. Judicial *dicta* may be cited which point out that, however elaborate and artificial such methods may be, those who adopt them are ' entitled ' to do so. There is, of course, no doubt that they are within their legal rights, but that is no reason why their efforts, or those of the professional gentlemen who assist them in the matter, should be regarded as a commendable exercise of ingenuity or as a discharge of the duties of good citizenship. On the contrary, one result of such methods, if they succeed, is, of course, to increase *pro tanto* the load of tax on the shoulders of the great body of good citizens who do not desire, or do not know how, to adopt these manoeuvres " (4).

The provisions which are now s. 260 were introduced into the taxation laws of this country long before Lord *Simon* uttered these

(1) (1924) 34 C.L.R. 328, at p. 359.
(2) (1953) 87 C.L.R. 548.
(3) (1943) A.C. 377.
(4) (1943) A.C., at p. 381.

words. *Knox* C.J. in *Deputy Commissioner of Taxation* v. *Purcell* (1) explained the scope of the section corresponding with s. 260. He said : "The section, if construed literally, would extend to every transaction whether voluntary or for value which had the effect of reducing the income of any taxpayer ; but, in my opinion, its provisions are intended to and do extend to cover cases in which the transaction in question, if recognized as valid, would enable the taxpayer to avoid payment of income tax on what is really and in truth *his* income. It does not extend to the case of a *bonâ fide* disposition by virtue of which the right to receive income arising from a source which theretofore belonged to the taxpayer is transferred to and vested in some other person. The section is intended to protect the revenue against any attempted evasions of the liability to income tax imposed by the Act—that liability is imposed on the taxpayer in respect only of his income (s. 10) (2) ; and the *bonâ fide* gift or sale by a taxpayer of assets producing income is therefore in no sense an attempt to evade his liability to income tax" (3). *Isaacs* J. made some observations in *Jaques Case* (4) which are, I think, to the same effect. These are : "The section does not include a conveyance or transfer of property, legal or equitable, as such. It presupposes that apart from the 'contract, agreement, or arrangement' a taxpayer would bear a certain liability either to make a return, or to pay tax in respect of certain income. Then, assuming that the income (if any) still remains that of the taxpayer (because s. 53 does not contemplate an instrument actually changing the real ownership), the section supposes some 'contract, agreement, or arrangement' which apart from the provisions of the section itself would legally operate or purport to operate in one or more of the ways set out in pars. (*a*), (*b*), (*c*) and (*d*). Then, says the section, such a 'contract, agreement, or arrangement' shall be 'absolutely void' for any such purpose, but is not otherwise affected. The effect is that the taxpayer's liability to make a return, or in respect of any other liability under the Act, remains just as if there were no such 'contract, agreement, or arrangement'" (5). A transfer of shares before payment of a dividend thereon results in the previous owner being free from tax on the dividend : that tax is payable by the new owner to whom the dividend is paid. Such a transfer may be a re-arrangement of the previous owner's affairs. But it is not within s. 260 because neither the dividend nor any part of it is income derived by him. But in the present matters there are schemes involving more than mere

(1) (1921) 29 C.L.R. 464.
(2) (1914) 17 C.L.R. 665, at p. 671.
(3) (1921) 29 C.L.R., at p. 466.
(4) (1924) 34 C.L.R. 328.
(5) (1924) 34 C.L.R., at p. 359.

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sales and transfers of the shares in question. The commissioner was entitled to rely upon s. 260, if the proportion of the dividend included in the taxable income of each respondent was " really and in truth *his* income ". If it was, s. 260 removes the curtain which the carrying out of Mr. Ratcliffe's schemes erected in order to cover up this fact. The curtain was provided by the forms of sale and transfer of the shares. These elements of the schemes clearly had the effect of relieving each respondent from liability to which he would have been exposed had he continued to be the shareholder when the companies paid the dividends in question. The schemes were undoubtedly designed to secure that purpose, and their execution attained that end if the sales and transfers can stand against the commissioner. The artificial routine used in carrying out the sales and transfers carries its tax-avoiding purposes and effect on its face. The series of steps taken to carry out each scheme, in my opinion, constituted an " arrangement " : *Bell's Case* (1). It is not necessary in order to arrive at this result to find in any of the schemes a binding stipulation that Pactolus Pty. Ltd. would use the dividends as the fund out of which to pay for the shares transferred to it. I think that the mutual admissions of facts establish that Pactolus Pty. Ltd., acting in concert with the respondents and their companies, really and substantially—" as a hard practical matter of fact "—used the dividends to pay for such shares, to provide the cash which it retained, and to complete the transactions between itself and each company, involving the other shares subscribed for, transferred back by Pactolus Pty. Ltd. to each respondent. It is important to observe how insignificant were the moneys to the credit of Pactolus Pty. Ltd. before the companies paid the dividends to it, in comparison with the enormous amounts for which Pactolus Pty. Ltd. drew cheques in favour of the respondents by way of payment for the shares ; and that all the cheques were paid.

I agree with the argument advanced for the commissioner that the circumstances are analogous to those in *Bell's Case* (1), as determined by the Full Court, and call for a similar application of s. 260. Proceeding on the basis of this authority, I think that the transfers of the shares must be deemed to be absolutely void as against the commissioner. When they are set aside for the purposes of taxation, none of the respondents has any support for his plea that what he received from Pactolus Pty. Ltd. was the price of his shares and as such capital. This way of applying the section leaves standing the facts that the companies made these distributions out of their profits. If the distributions were void as against the

(1) (1953) 87 C.L.R. 548.

commissioner, the companies might be exposed to liability to additional tax under s. 104. The Act, however, allows a "private company" to escape such taxation by making a sufficient distribution of its income. It follows that it would not be reasonable to suppose that any such distribution was void for purposes of taxation. Indeed, it is within the scope of s. 260 to prevent shareholders escaping liability to the tax that may result from a distribution made to avoid "additional tax"; that, in my view, is what these respondents attempted to accomplish.

Section 260 having operated, the next question is whether it is correct to assess each respondent on the basis that he received a full amount of the dividend, as if he had been a shareholder. In fact he did not, as Pactolus Pty. Ltd. was entitled, under the "arrangement", to a portion and pursuant to the "arrangement", in effect, intercepted it. This company was entitled to keep the shares acquired by sale and transfer. If the transfers are absolutely void for purposes of taxation, the result is that, in the contemplation of the Act, the taxpayers were always *sub modo* the shareholders and as such derived the whole of the dividends as income. It is entirely consistent with this hypothesis to tax each respondent on the full amount of his proportion of the distribution. But, as s. 260 only sets aside the transfers in favour of the commissioner so far as is necessary to preserve the liability of the respondents to tax and no further, the ownership of the shares by Pactolus Pty. Ltd. is not otherwise affected.

The hypothesis that each respondent really and truly participated in the distributions made by the companies in cash involves the conclusion, in the case of the respondents who received shares back from Pactolus, that the purchase of those shares was a step subsequent to their deriving the dividends. This conclusion does not affect the question of their liability to taxation because the acquisition of such shares must be regarded as nothing but the utilisation of the portion of the assessable income which they did not desire to retain in cash.

I would allow the appeals and restore all the assessments which were set aside by *Kitto* J.

Williams J. These are fourteen appeals by the Commissioner of Taxation of the Commonwealth of Australia from orders of *Kitto* J. allowing appeals to this Court from amended assessments of the appellants for income tax under the provisions of the *Income Tax and Social Services Contribution Assessment Act* 1936-1950 (hereinafter called the *Assessment Act*). The appeals were ordered

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to be heard together because they all depend upon substantially similar facts and circumstances, the appellants or some of them being, until a company, Pactolus Pty. Limited, became a shareholder, all the shareholders in three private companies—Lane's Motors Pty. Limited, Neal's Motors Pty. Limited and Melford Motors Pty. Limited. The facts are very voluminous, *Kitto* J. has taken a great deal of trouble to set them out and I do not propose to attempt to go over all this ground again. I shall confine myself to dealing as shortly as I can with what appear to me to be the crucial facts. The material years of income are those ended on 30th June 1949 and 30th June 1950. In 1949 all three companies were carrying on the business of selling motor vehicles and other activities incidental thereto and were making very large and increasing profits. They were all private companies within the meaning of Pt. III, Div. 7 of the *Assessment Act* and were therefore all companies which, unless they distributed the distributable parts of their taxable incomes of the year ended 30th June 1949 before 31st December 1949, would become liable to pay additional tax under this division. All the shareholders were persons who were liable to pay income tax and social services contribution at the highest rates on their taxable incomes and these total rates reached a maximum of 15s. in the pound. The directors of the companies were anxious to increase their working capital in order to have sufficient funds to finance businesses that were expanding and to use the profits the companies were making for this purpose, but they found themselves in this position that if they decided not to distribute the distributable amounts of their taxable incomes the companies would become liable to pay additional tax at the same rates and therefore of the same total amount as the shareholders would have to pay if these amounts were distributed to them. If this course was adopted only approximately 5s. in the pound would be available for capitalisation. This fund could, of course, be capitalised without the shareholders incurring tax but it would not go very far. Various plans were discussed. If additional tax was not to be incurred in respect of the distributable amounts of the taxable incomes of the year ended 30th June 1949, it was necessary for the companies to distribute this amount before 31st December 1949 and it was also necessary for the companies to be converted into non-private companies prior to 30th June 1950 if they did not wish to be taxed as private companies in respect of the income of that year. If the companies were converted into non-private companies additional tax on the distributable amounts of the taxable incomes of the year of income ended 30th June 1950 would not be incurred, but all the taxes payable by non-private companies would be incurred, further shareholders would have had to be admitted, and several of the directors and shareholders did not want strangers as shareholders in the companies or public companies to be formed. The plan finally agreed upon was intended to overcome all these disadvantages. It meant the admission of one new shareholder, Pactolus Pty. Limited (hereinafter called Pactolus) but that company was in effect Ratcliffe, and the plan was not going to cost the companies any more moneys out of pocket than they would have had to pay in tax as non-private companies because Pactolus was willing to play its part in the plan for a remuneration which was substantially equivalent to the amount of tax the companies would have had to pay as non-private companies. Pactolus was a dealer in shares so that any loss that company incurred by investing in shares in the companies would be an allowable deduction from its assessable income. A lot was said about the alternative courses that were open to the companies to pursue in lieu of the plan finally adopted. It was submitted that a study of these alternative courses was relevant on the question whether this plan could be said to have been adopted for the purpose of avoiding income tax. But such a study is, in my opinion, quite irrelevant to the solution of the real issue. Even if it could be relevant it does not appear to me to lend any aid to that solution. Accordingly I find it only necessary to examine the plan that was finally adopted.

As appears from the judgment of *Kitto* J. there were five distributions of profits by the companies which form the basis of the assessment—one by Lane, two by Neal and two by Melford. There was a simultaneous distribution by each of the companies in December 1949, a second distribution by Melford in December 1950 and a second distribution by Neal in June 1951. Until steps were taken to effect the initial distributions in December 1949 the three companies were all companies in which the whole of the issued capital, apart from a comparatively few preference shares in Lane and Neal, consisted of ordinary shares. In order to give effect to the plan radical alterations had to be made to the capital structure of the companies. This was done by special resolutions. The rights attached to the existing preference shares were retained, the shares being renamed A preference shares. But the authorised capitals of the companies were increased and new B preference shares were created. The existing ordinary shares were divided into A ordinary shares and B ordinary shares. The holders of the existing ordinary shares converted them into the new A ordinary

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shares and B ordinary shares respectively so that they each received the same rateable proportion of the new A or B ordinary shares. But the A ordinary shares were not in truth ordinary shares. They were shares which, subject to the payment of the dividend on the A preference shares, were entitled to receive the whole of the dividends declared by the companies up to certain specified amounts. From 1st January 1950 they were entitled to receive a preference dividend of five per cent. Subject therefore to the payment of special dividends, they were really a form of preference shares. Only the B ordinary shares could be said to remain ordinary shares. The amounts of the special dividends the A ordinary shares were to receive were carefully calculated. They included some tax-free profits, no doubt because Pactolus was interested in tax-free profits. But they included mainly the amounts of their taxable incomes in respect of the year ended 30th June 1949 which the companies had to distribute before 31st December 1949 to escape additional tax under Div. 7 and amounts payable out of the anticipated profits of the year ended 30th June 1950. The latter amounts were part of the profits which the course of business indicated the companies were sure to make in that period which would later have to be distributed before 31st December 1950 if the companies wished to avoid having to pay additional tax under Div. 7 on the distributable amounts of their taxable incomes of the year ended 30th June 1950. The holders of the A ordinary shares gave Pactolus options to purchase these shares for sums in the case of Lane's 2d. more than the amount of the special dividend, but in the case of Neal's and Melford for sums well below the amounts of the special dividends so that, when all the special dividends had been paid in full, the total amount Pactolus would receive would exceed the sums Pactolus would have to pay to purchase the A ordinary shares by £55,000. Pactolus exercised the options, gave the representative of the shareholders cheques for the purchase money and the shares were transferred to Pactolus. At the same time the companies made the B preference shares available for issue and Pactolus applied for these shares and gave the companies a cheque to pay for them in full. These shares were allotted to Pactolus and purchased from Pactolus by the shareholders who had sold the A ordinary shares to Pactolus rateably according to the number they had sold and Pactolus received cheques from the representative of the shareholders for the purchase money. The dividends declared by the companies in December 1949 comprised three separate dividends the one out of the tax-free profits and the others out of the profits already mentioned, the dividends out of the profits derived during the year ended 30th June 1949 being the full amount the companies had to distribute to avoid having to pay additional tax under Div. 7 and the dividends out of the anticipated profits of the year ended 30th June 1950 representing such profits as were then available for distribution. The stage was now reached when all the cheques could be banked and banked they were, all in the same bank—the South Melbourne branch of the English Scottish & Australian Bank—where Pactolus had opened a new account for this very purpose. To enable all the cheques to be cleared pending the declarations of the further sums required to satisfy the special dividends out of the anticipated profits of the company of the year ended 30th June 1950 Pactolus had temporarily to contribute the sum of £19,000 and this amount was deposited to the credit of its account. But Pactolus was not to be out of pocket for long. It was as commercially certain as anything could be that profits to meet the further dividends required to recoup Pactolus would very shortly be available and that they would be declared within three months. The payment of these dividends was assumed to be so certain that the preference dividends on the A ordinary shares commenced to accrue from 1st January 1950. In March 1950 the companies declared the necessary further dividends to satisfy the special rights attached to the A ordinary shares leaving those shares for the future entitled only to the preference dividend of five per cent. The second Melford transaction and the second Neal transaction were carried out on the same basis. To effect them a surgical operation similar to that performed on the original shares of the company was repeated. In the case of Melford the issued B ordinary shares were made into C ordinary shares to which special dividend rights were attached similar to those attached to the A ordinary shares in the initial transactions and the existing preference shares were converted into A ordinary shares. In the case of Neal's part of the issued B ordinary shares were converted into C ordinary shares and similar special dividend rights were attached to these shares. A similar procedure was then followed commencing with the shareholders giving Pactolus an option of purchase over the C ordinary shares at a price less than the amount of the special dividend rights, Pactolus exercising this option, and the shares being transferred to Pactolus before the dividends were declared. In the case of the second Melford transaction the shareholders applied directly for the new issue of shares instead of Pactolus applying for them and then selling them to the shareholders, and in the case of the second

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Neal transaction no new shares were applied for, so that the shareholders retained the whole of the cash they received from Pactolus for the purchase of the C ordinary shares. But this cash was received on its face, like the shares and the cash in the other transactions, as capital. The cheques drawn by the companies, by Pactolus and by the shareholders to give effect to these two later transactions were again all banked together in the South Melbourne branch of the E. S. & A. Bank so that they would operate as cross cheques. The total special dividends in the five transactions amounted to £1,764,700 of which Pactolus retained £102,000 in cash. It also acquired 161,000 A and C shares.

It will be convenient I think to state shortly the chronological sequence of events in the initial transactions. As I have said, in order that the three companies should avoid tax on the distributable amounts of their taxable incomes derived during the year ended 30th June 1949, it was necessary that these amounts should be distributed prior to 31st December 1949. There was no time to be lost so arrangements were made to transfer the A ordinary shares from the shareholders to Pactolus at Canberra. This would save any delay that might take place if the shares were transferred in Victoria or New South Wales because they might have to be valued in order to determine the amount of duty payable. So that the transfers could be executed in Canberra, where there would be no duty payable, and there would therefore be no delay, branch registers of the three companies were established there and the A ordinary shares were transferred to that register. The special resolutions reorganising the capital of the companies were passed on 14th December 1949. On 15th December 1949 the holders of the A ordinary shares gave Pactolus the options to purchase these shares. On 16th December 1949 the directors of the three companies resolved that the requisite number of B preference shares should be made available for issue at par and be offered to the person or persons entitled to the dividends from the A ordinary shares on or after 19th December 1949. By letter of the same date Pactolus was told that this was done. On 19th December 1949 Pactolus exercised the options and handed cheques for the purchase money to the representative of the vendors in exchange for completed transfers and the relevant share certificates. The transfers were registered in Canberra on the same day. On the same day Pactolus applied to the companies for the new B preference shares and gave the companies cheques to pay for them in full. The total amount of all these cheques drawn by Pactolus on 19th December 1949 to pay the purchase moneys on the A ordinary shares and to pay for the new B preference shares was approximately £2,104,000. At that time Pactolus only had £19,000 in its new bank account. On 20th December 1949 the directors of the companies declared the dividends on the A ordinary shares amounting to £1,164,000 and gave Pactolus cheques for the dividends. They also allotted the B preference shares for which Pactolus had applied. The same day Pactolus sold the B preference shares to the shareholders in the three companies and received their cheques for the purchase money. Pactolus now had the necessary cheques, except for £19,000, to set off against the cheques it had given the previous day. On 21st December 1949 all the cheques were banked simultaneously in the South Melbourne branch of the E. S. & A. Bank. The 19th, 20th and 21st December 1949 were therefore three very busy days. But they were also fruitful for the plan was now completely executed except for the further dividends to be paid in March to complete the special dividend rights on the A ordinary shares. The plan was cleverly conceived. All the steps necessary to carry it out were taken quite openly. There was nothing unlawful about them. They were all intended to have the legal effect they purported to have. But the only moneys used to effectuate the whole of the transactions, apart from the £19,000 temporarily provided by Pactolus, were the moneys of the companies which were to be distributed to satisfy the special dividend rights of the A ordinary shares. The original shareholders remained the only shareholders in the companies except for Pactolus which had become the holder of the A ordinary shares. For those shares Pactolus had in truth paid nothing out of its own pocket apart from the £659 in the case of Lane to provide the 2d. per share already mentioned because the purchase moneys it had paid for them were more than provided by the dividends declared or to be declared to satisfy the special rights attached to these shares. These special dividends were, of course, assessable income of Pactolus. But Pactolus was a dealer in shares and the A ordinary shares were bound to fall in value from the amounts Pactolus had paid for them to what could confidently be expected to be £1 and it could claim this loss as a deduction from its assessable income. The companies had the working capital they so urgently required. It had been provided by the capitalisation of the profits required to make the B preference shares fully paid. The shareholders had received large sums in cash and were the holders of these shares. The companies had avoided additional tax under Div. 7 because they had distributed the distributable amounts of their taxable incomes of the year

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ended 30th June 1949 by 31st December 1949 and the shareholders had avoided income tax because all the benefits they had received were of a capital nature.

But for s. 260 the plan must have succeeded. This is admitted by the commissioner. The commissioner invokes this section and this section alone to support the assessment. It is advisable to set it out in full: "Every contract, agreement, or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly—(*a*) altering the incidence of any income tax; (*b*) relieving any person from liability to pay any income tax or make any return; (*c*) defeating, evading, or avoiding any duty or liability imposed on any person by this Act; or (*d*) preventing the operation of this Act in any respect, be absolutely void, as against the Commissioner, or in regard to any proceeding under this Act, but without prejudice to such validity as it may have in any other respect or for any other purpose." The meaning of the section has been discussed in three cases in this Court: *Jaques* v. *Federal Commissioner of Taxation* (1); *Clarke* v. *Federal Commissioner of Taxation* (2), and *Bell* v. *Federal Commissioner of Taxation* (3). During the argument of the present appeals the meaning of the words "purpose or effect" received considerable discussion. These words are in the alternative but they do not appear to me to have any real difference in meaning. The purpose of a contract, agreement or arrangement must be what it is intended to effect and that intention must be ascertained from its terms. These terms may be oral or written or may have to be inferred from the circumstances but, when they have been ascertained, their purpose must be what they effect. Section 260 strikes at a contract, agreement or arrangement so far as it has the purpose or effect of altering the incidence of income tax etc. and to that extent the contract, agreement or arrangement is absolutely void as against the commissioner. "Contract" is a technical word and implies an agreement enforceable by law but the words "agreement" and "arrangement" and in particular the word "arrangement" are apt to describe bargains of a looser kind. In *Bell's Case* (3) it is said: "In *Jaques* v. *Federal Commissioner of Taxation* (4) *Isaacs* J. said of the word 'arrangement' that in this collocation it is the third in a descending series, and means an arrangement which is in the nature of a bargain but may not legally

(1) (1924) 34 C.L.R. 328.
(2) (1932) 48 C.L.R. 56.
(3) (1953) 87 C.L.R. 548.
(4) (1924) 34 C.L.R., at p. 359.

or formally amount to a contract or agreement. It must be remembered, however, that the section is concerned only with contracts, agreements and arrangements which have an effect in law and accordingly are capable of statutory avoidance. With this in mind, it may be said that the word ' arrangement ' is the third in a series which as regards comprehensiveness is an ascending series, and that the word extends beyond contracts and agreements so as to embrace all kinds of concerted action by which persons may arrange their affairs for a particular purpose or so as to produce a particular effect " (1). It was submitted for the commissioner in the present case that there was an arrangement within the meaning of s. 260 having the purpose or effect of producing one or more of the objects set out in pars. (*a*), (*b*) or (*c*) of s. 260. (As I understood the argument (*d*) was not relied upon.) Of the objects described by the first three paragraphs those in par. (*c*) would appear to be the most appropriate. It was an arrangement entered into between the three companies, their directors, shareholders, and Pactolus to dispose of income of the companies which income would have to pay additional tax under Div. 7 if not distributed or become assessable income of the shareholders if distributed in such a way that the major part of this income would be retained by the companies as working capital by the issue of new shares to the shareholders as fully paid, and the balance would be received by the shareholders as cash, but the companies would not become liable to pay additional tax because they would have distributed the distributable amounts of their taxable incomes and the shareholders would not become liable to pay income tax on either the shares or the cash as part of their taxable incomes. That such an arrangement was made I have no doubt and I also have no doubt that it was an arrangement the purpose of which was directly or indirectly to defeat, evade or avoid a liability imposed on the shareholders by the Act. The income in the shape of the special dividends was in fact distributed ; these distributions, except for the sums that went to Pactolus, reached the hands of the shareholders ; part of the distributions which reached them was applied to pay for the new B preference shares which became their property and the balance was retained by them as cash. The whole of the income comprised in the special dividends, except the tax-free funds, would have been assessable income of the shareholders but for the steps that were interposed by the concerted action of the companies, their directors, shareholders and Pactolus. The companies wanted and no doubt badly wanted to increase their working capital but they did this,

(1) (1953) 87 C.L.R., at p. 573.

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not by attracting fresh capital, but by capitalising income which they had already earned. Pactolus did not contribute any fresh capital. In form it applied and paid for the new preference shares but in fact it was never intended that they should be paid for otherwise than out of the moneys that were to be distributed as special dividends. The arrangement is one to be inferred from all the circumstances and from them the inference is irresistible that all the parties intended that the moneys required to finance the whole of the steps that were taken, commencing with the passing of the special resolutions and ending with the shareholders becoming possessed of the new B preference shares and large sums of cash, were to be provided out of the income of the companies intended to be distributed by the special dividends declared on the A ordinary shares. The steps taken to carry out the arrangement have already been detailed. The commissioner seeks primarily to avoid these steps at the stage where the A ordinary shares were transferred to Pactolus so as to leave the shareholders the holders of these shares and entitled to the special dividends that were declared upon them. He does not seek to avoid the previous steps because they have not the purpose or effect of defeating, evading or avoiding any liability imposed on the shareholders by the Act. This liability would not be defeated, evaded or avoided by the companies reorganising their capital or declaring dividends on the A ordinary shares. It was quite lawful for the companies to distribute the distributable amounts of their taxable incomes required to avoid additional tax under Div. 7. To do this it was necessary for the companies to declare dividends because this is the proper way for a company to distribute its profits. The arrangement only commenced to have the proscribed purpose or effect when the A ordinary shares were transferred to Pactolus before the dividends were declared, whereby Pactolus became the shareholder entitled to the dividends in lieu of the original shareholders, when all along it was intended that the purchase money Pactolus was to pay the shareholders for the purchase of the A ordinary shares was to be provided out of the dividends to be declared in favour of Pactolus. This is one way of putting the case for the commissioner but it could be put equally well, I think, and perhaps better, by impeaching the whole of the steps commencing with the passing of the special resolutions. In *Bell's Case* (1) it is said, following *Clarke's Case* (2): " The section is, of course, an annihilating provision only. It has no further or other operation than to eliminate from consideration for tax purposes such contracts, agreements and arrangements as fall within the

(1) (1953) 87 C.L.R. 548. (2) (1932) 48 C.L.R. 56.

descriptions it contains. It assists the commissioner, in a case like the present, only if, when all contracts, agreements and arrangements having such a purpose or effect as the section mentions are obliterated, the facts which remain justify the commissioner's assessment" (1). The section is there said to be an annihilating provision only. If all the steps under discussion are avoided the facts that remain are that the moneys of the companies identified as the moneys distributed as special dividends on the A ordinary shares except for Pactolus's share reached the hands of the shareholders and these moneys were partly retained by them as cash but mostly used to pay for the new B preference shares of which they became the holders. But, whichever course is adopted, the result appears to me to be the same. The liability to pay income tax on income of the companies which reached the shareholders in the shape of fully paid shares or cash and which should have been part of their assessable income was avoided. Pactolus was under no legal obligation to use the special dividends declared on the A ordinary shares to purchase these shares from the shareholders but this is what the arrangement clearly contemplated. All the parties to it knew perfectly well that, when Pactolus purchased the A ordinary shares and applied for the B preference shares and gave its cheques to the companies on 19th December 1949, these cheques would not be presented for payment until the companies had declared the dividends on the A ordinary shares and given Pactolus their cheques for these dividends and the shareholders had given Pactolus their cheques to pay for the purchase of the B preference shares. Pactolus's cheques could not have been met, except to the extent of £19,000, until it had been put in funds by the companies, and the shareholders were never intended to become liable to pay Pactolus for the purchase of the B preference shares until they had been paid for the purchase of the A ordinary shares by Pactolus and the cheques that were set off against each other were set off for one purpose and one purpose only and that was to split the income in question between the companies, the shareholders and Pactolus. Steps of a precise legal character were required to carry out the arrangement such as the passing of the necessary special resolutions, the transfers and allotments of the shares and the declarations of dividends. But the arrangement itself was not of a precise legal character. It consisted of quite clear commercial understandings between the parties as to the concerted action that was necessary to carry it out and everyone was completely confident that each would perform his or its part in doing so. Everything was done

(1) (1953) 87 C.L.R., at pp. 572, 573.

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and intended to be done on the footing that, as Mr. *Menzies* said, the only real money to be used would come from the companies and most of it would go back to the companies as share capital and, in the meantime, on the way round would be used as the purchase price for the A and C ordinary shares. The arrangement was followed, as he said, because everybody intended that it should be followed, and, it might be added, because it appeared to be to everybody's interest that it should be followed, (and nobody appears to have seen the shadow of s. 260 lurking round the corner). During the argument the decision in *Bell's Case* (1) was much canvassed. I regard that case like every other case as primarily a decision on its own particular facts but, so far as it bears on the present case, it appears to me strongly to support the commissioner. There Bell received as a result of an arrangement made between Bell and his co-shareholders and White and his six clients a sum of money which the steps taken to implement the arrangement had converted into capital, but which was held by the operation of s. 260 to be income because the money that was really disposed of was the distributable profits of the company. Bell's share of these profits which he received, apart from the arrangement appearing to convert them into capital, could only have been received as profits. It was held that the arrangement, to quote from the judgment, " both in purpose and in effect, represented nothing but a method of impressing upon the moneys which came to the hands of Bell and his colleagues the character of a capital receipt and of depriving it of the character of a distribution by a company out of profits " (2). This passage, *mutatis mutandis*, aptly applies to the present facts. Emphasis was sought to be laid on the statement that the arrangement there represented nothing but a method of impressing upon the moneys the character of a capital receipt as indicating that the doing of what is proscribed by s. 260 must be the sole purpose and effect of the arrangement, and that in *Bell's Case* (1) the company had come to an end of its business life and the distribution of its accumulated profits was all that was left for it to do whereas in the present case the companies are, of course, still very much alive. That statement made in relation to the particular facts cannot be relied upon as an authority for the proposition that the sole purpose and effect of an arrangement that comes within s. 260 must be to carry out one of the proscribed objects. The section only avoids an arrangement in so far as it has that purpose or effect. Accordingly it is sufficient if the arrangement has in part that purpose or

(1) (1953) 87 C.L.R. 548.

(2) (1953) 87 C.L.R., at p. 573.

effect although the arrangement may have other purposes or effects as well. In the present case I would be prepared if necessary to hold that the sole purpose and effect of the arrangement was to defeat, evade or avoid the liability imposed upon the shareholders by the Act. Pactolus could not have come into the arrangement for any other purpose. The companies wanted to convert into capital as much of the income that was distributed by the special dividends on the A ordinary shares as possible, but not a single step that was taken to carry out the arrangement would have been necessary if they had not at the same time wanted to avoid having to pay tax on those profits, either themselves or their shareholders. Pactolus's sole role was that of the great transformer of particular income into capital. As I have said, it contributed nothing to the assets of the companies. It deprived the companies and their shareholders of quite a large proportion of those assets. The passage is therefore quite apt to apply to the present case. Perhaps I might add that, to be completely accurate, for the words " having such a purpose or effect " (at the top of the page) there should be substituted the words " so far as they have such a purpose or effect " (1).

The commissioner has assessed the shareholders on the basis that their assessable income does not include the tax-free dividends that were declared as part of the special dividends on the A and C ordinary shares. That appears to me to have been correct because when s. 260 has done its work it is the moneys represented by the special dividends that the shareholders must be considered to have received. There is also the question of the cash and of the A and C ordinary shares in the companies which Pactolus received. The commissioner contends, rightly I think, that the shareholders must be held to have consented to Pactolus acquiring the cash and shares as part of its remuneration for carrying out the arrangement. After s. 260 has done its work the whole of the special dividends must be considered to be for the purposes of income tax the property of the shareholders. Accordingly any portion of these distributions Pactolus received must be considered to have been paid to it with their consent. In the course of the transactions the A and C ordinary shares became the property of Pactolus. But the loss of these shares, if it is a loss, would be a loss of capital and not of income.

In my opinion the appeals should be allowed with costs. The orders under appeal should be set aside and in lieu of each such order an order should be made that the appeal from the amended assessment to which it refers should be dismissed with costs.

(1) (1953) 87 C.L.R., at p. 573.

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Fullagar J. These are appeals by the Commissioner of Taxation of the Commonwealth from orders made by *Kitto* J. The respondents, whom I will call the taxpayers, are Lauri Joseph Newton, Lionel Newton, Henry James Lane, Leonard Alfred Fenton, Stella Maud Adeline Lane, Francie Una Christian, and the trustees of the estate of Robert Nathan deceased, who died in June 1950. Each of these seven taxpayers (counting Robert Nathan's trustees as one) appealed to this Court under s. 197 of the *Income Tax and Social Services Contribution Assessment Act* 1936-1950 (Cth.) against two amended assessments to income tax—one in respect of income derived in the year ended 30th June 1950, and the other in respect of income derived in the year ended 30th June 1951. There were thus fourteen appeals. All, however, raised precisely the same considerations, and they were heard together by *Kitto* J. His Honour allowed the taxpayers' appeals, and ordered, in effect, that the fourteen amended assessments be quashed. The fourteen appeals to this Court were also heard together. The total of the amounts involved is very large.

The effect of the amended assessments was in each case to include in the assessable income of the taxpayer what the commissioner described as the taxpayer's " proportion " of certain " distributions " made by three companies in which the taxpayers (and, up to the date of his death in June 1950, Robert Nathan) were shareholders. It will conduce to simplicity, and be in no way misleading, to follow the course adopted by *Kitto* J., and to speak of the taxpayers as the original shareholders, although in fact the shareholders were not the same in all the companies, and, by reason of the death of Robert Nathan, changes took place in the actual holdings of shares. Some of the shares were held in trust. The actual position is explained in the mutual admissions made by the parties. The taxpayers have not challenged the apportionment, or the arithmetical correctness of the commissioner's calculations. They have maintained that what they received was not income derived by them. The three companies concerned, all of which carry on the business of trading in motor vehicles, are Lane's Motors Pty. Ltd., Neal's Motors Pty. Ltd., and Melford Motors Pty. Ltd. It will be convenient to refer to them collectively as " the motor companies ", and individually as " Lanes ", " Neals ", and " Melford " respectively. Two other companies, Pactolus Pty. Ltd. and Pactolus Investments Pty. Ltd., were also concerned in the relevant transactions. It will be convenient to refer to these respectively as " Pactolus " and " Pactolus Investments ". They were, as will be seen, aptly named. The three motor companies were incorporated in Victoria. Pactolus and Pactolus Investments were incorporated in New South Wales. Actually three other companies enter into the picture—British Service Pty. Ltd., which was a subsidiary of Lanes, and Overland (Victoria) Pty. Ltd. and Devon Motors Pty. Ltd., which were subsidiaries of Neals. Apart, however, from the fact that they declared certain dividends, which went to swell at material times the available funds of Lanes and Neals, these companies played no part in the transactions in question, and need not be further considered. The facts relating to the transactions in question were not disclosed to the commissioner before he made his original assessments of income derived by the taxpayers in the two relevant years, and the commissioner, when he made his amended assessments, in addition to assessing tax in respect of the " distributions ", assessed substantial sums by way of " additional tax " under s. 226 (2) of the *Assessment Act.* If he is right in his contention that the taxpayers are taxable in respect of the " distributions ", no question arises either as to his power to make the amended assessments under s. 170 (2) or as to his power to assess " additional tax " under s. 226 (2).

The transactions in question—although the fundamental idea behind them may be thought to be quite simple—are of a very complicated character. They were five in number—one in relation to Lanes, two in relation to Neals, and two in relation to Melford. They took place between December 1949 and June 1951. In order that the nature of the question arising may be understood at the outset, it should be said that they culminated in the receipt by the taxpayers of large sums in cash and a large number of fully paid shares in each of the three motor companies. The commissioner concedes that, if full face value, so to speak, must be given to the various steps which led up to this culmination, these receipts were not income receipts but capital receipts. While, however, he does not deny the genuineness of those steps in the sense that they were legally effective as between the parties, he maintains that s. 260 of the *Assessment Act* applies to the case, and that the result of the application of that section is to give, for income tax purposes, the character of dividends to the cash and shares which came into the hands of the taxpayers. Section 260 is in the following terms :—" Every contract, agreement, or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly—(*a*) altering the incidence of any income tax ; (*b*) relieving any person from liability to pay any income tax or make any return ; (*c*) defeating, evading, or

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avoiding any duty or liability imposed on any person by this Act; or (*d*) preventing the operation of this Act in any respect, be absolutely void, as against the commissioner, or in regard to any proceeding under this Act, but without prejudice to such validity as it may have in any other respect or for any other purpose." The effect of this provision will have to be considered after the facts relating to the transactions in question have been investigated.

In investigating those facts we have the advantage, in the reasons given by *Kitto* J. for the orders under appeal, of a clear and detailed statement of the circumstances which led up to the transactions in question, of the discussions and negotiations which preceded the formulation of the plan of action finally adopted, and of the steps taken in the carrying out of that plan. It is not necessary to repeat here all that his Honour said. It will be sufficient merely to refer to that statement, to set out briefly the circumstances in which the motor companies and their shareholders found themselves in the latter part of 1949, and to state in detail only the steps taken in relation to one of the companies, Lanes. One comment, however, must be made at this stage. His Honour, as has been mentioned, considered fully, and apparently attached much importance to, certain discussions which preceded the final formulation of what may be called a plan of action. These took place between directors of the motor companies and their advisers and in particular Mr. J. V. Ratcliffe, a taxation expert and consultant. A great deal of evidence was given with regard to these discussions. His Honour said that he looked at this evidence not so much with the object of ascertaining whether the purpose of those concerned was one of the purposes mentioned in s. 260, but rather with the object of ascertaining whether the receipts in question were capital or income receipts. I am, with respect, unable to agree with this approach. The evidence in question could, of course, be relevant to the question of the purpose which those concerned had in view—was it one of the purposes mentioned in s. 260, or was it some other and different purpose? (As will be seen, I do not think that this question could be the subject of any reasonable doubt.) That evidence could also be relevant if a question were raised as to the reality of the steps taken—was it really and truly intended that the legal position of those concerned should be governed by, and dependent on, those steps? (Actually the reality of the transactions in this sense was never challenged.) But the evidence in question could throw no light on the question whether the receipts of cash and shares ought to be regarded for income tax purposes as income receipts or capital receipts. That was the ultimate question in the case, and it was a question of law depending on the construction and effect of s. 260.

The position with regard to the taxation of companies in the two relevant years is fully explained in the reasons for judgment of *Kitto* J. The really important element in the situation—the element which clearly, in my opinion, dictated the form which the transactions now in question took—is to be found in Div. 7 of Pt. III of the *Assessment Act*. Division 7 (as it may be shortly called) related to " private companies " as defined in the Act, and the three motor companies were private companies as so defined. Such a company, like all other companies, was liable, under the general provisions of the Act, to pay income tax at a flat rate on its taxable income. If it paid a dividend out of its taxable income, that dividend was assessable income in the hands of the shareholders who received it (s. 44). This would be so whether the distribution was made in cash or by way of " bonus " shares representing a capitalisation of profits (see definition of " dividend " in s. 6 (1)). Division 7 was designed to deal with the case where a private company made no distribution or only a partial distribution of its taxable income of any year. Its provisions were necessarily somewhat complicated, but, for present purposes, their substance may be stated shortly. It defined what should be deemed to be a " sufficient distribution " of a private company's taxable income, and it provided that, if the company had not made a " sufficient distribution " within a prescribed period after the close of its financial year, it should be liable to pay, on the amount by which any distribution fell short of a " sufficient distribution ", the income tax which would have been payable by its shareholders if that amount had been distributed to them by way of dividend. It is evident that the intention was to create a true dilemma. In cases to which Div. 7 applied, the Act said to a private company : " Either you distribute such and such a proportion of your taxable income, or you do not distribute it. If you do distribute it, your shareholders will pay £x by way of income tax. If you do not, you, the company, will pay £x by way of income tax." It need only be added that, if the company paid tax under Div. 7, and later paid a dividend to its shareholders out of an amount on which tax had been so paid, the shareholder was entitled to a rebate in his assessment of the amount by which his tax was increased by the inclusion of that dividend in his assessment. It is usual to refer to a dividend so paid as a " tax-free dividend ", and to a fund in the hands of a company available for the payment of such a dividend as a " tax-free fund " or a " tax-free reserve ".

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The business in which the motor companies were engaged had been adversely affected by conditions existing during the war and in the immediately following years. In 1948, however, a very marked improvement set in, and in the year ended 30th June 1949 very large profits indeed were made. Confining attention for the time being to Lanes, the position of that company, as disclosed by its balance sheet at that date, and so far as material, was briefly this. The company's nominal capital was £250,000, divided into 5,000 five per cent cumulative preference shares of £1, and 245,000 ordinary shares of £1. The paid-up capital consisted of 5,000 preference shares (held by Mr. W. B. Thomas, the company's manager) and 237,321 ordinary shares, which were held by the taxpayers and Robert Nathan. Standing to the credit of profit and loss appropriation account was the large sum of £387,125, of which £302,799 represented profits of the year ended 30th June 1949. A proportion, but only a very small proportion, of the accumulated profits of previous years had paid tax under Div. 7 and constituted therefore a " tax-free fund ". On the liabilities side of the balance sheet appeared also a sum of £164,009, which represented " loans " (presumably at call) by the taxpayers and two other persons to the company. The assets side, although it included Commonwealth bonds of the value of £31,508 and a bank credit of £109,172, showed, as *Kitto* J. observed, that the greater part of the " shareholders' funds " was " used in the business ".

While, from one point of view, this balance sheet might well have brought a glow of pride and pleasure to the cheeks of all concerned, the capital position which it disclosed was, from other points of view, highly unsatisfactory. Several considerations were involved, one of them being that the paid-up capital of £242,321 was out of all proportion to the size of the company's business. In what *Kitto* J. aptly called " more primitive times " no real difficulty would have arisen. A substantial dividend in cash would have been paid to shareholders, and the greater part of what was left of the accumulated profits would have been capitalised and shares representing the increased capital issued to the shareholders. The company, however, was not living in a taxpayer's golden age. Its shareholders, or most of them, desired to receive a substantial cash distribution, and would doubtless have been happy to receive a large allotment of " bonus " shares. But all of them were wealthy persons, and any distribution made by the company to them, whether it were of cash or of shares, would have involved each of them in liability to pay income tax on what he or she received at the then maximum rate of 15s. in the £. Nor was this all, for there was the liability to pay "provisional" tax under Div. 3 of Pt. VI of the *Assessment Act*. On the other hand, the period within which the company had to make a distribution, if it was to avoid paying the same amount of tax under Div. 7, would expire on 31st December 1949. The position was exactly the same in relation to the other two motor companies. Moreover, it had become apparent that the profits of all three motor companies for the year commencing on 1st July 1949 were likely also to be very large and to equal or exceed those of the year to 30th June 1949.

In and after June 1949 much discussion of the position took place orally and by correspondence between the directors and Mr. Ratcliffe and other advisers of the motor companies. The position was, of course, considered from a "long term" point of view. Among other things, the conversion of those companies into public companies was considered, and in fact Lanes was at a later date converted into a public company. But these discussions do not appear to me to be of importance. It is beyond question that the immediate purpose and object of all concerned was to find some way of escape from what to an unenterprising mind would have seemed to be the plain dilemma created by Div. 7. It was Mr. Ratcliffe's mind which evolved the plan which was ultimately adopted.

In this plan the two companies which have already been mentioned, Pactolus and Pactolus Investments, played an important part. Pactolus had been incorporated on 23rd March 1949. The part actually played later by that company may or may not have been in contemplation at the time of its incorporation. Mr. Ratcliffe was aware at the time that the motor companies had their problems. Its issued capital consisted of 5,000 ordinary shares of £1. Mr. Ratcliffe held 4,999 of these, the remaining share being held by his son. The objects stated in its memorandum of association included "to purchase . . . and sell . . . or otherwise deal in shares and other securities". Pactolus Investments was incorporated on 25th October 1949. Its issued capital consisted of 15,000 ordinary shares of £1, all of which were held by Mr. Ratcliffe and persons of the same name—presumably members of his family.

It was necessary to attend to two preliminary matters. In the first place, the motor companies' share registers were in Melbourne, and the carrying out of the plan would involve the bringing into existence of certain share transfers, which, it was thought, might be subject to stamp duty under the *Stamps Act* 1946 (Vict.). The submission of these to the Comptroller of Stamps under the Act would have involved a delay which might have been fatal. The

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comptroller would certainly have given much thought to them. The necessary steps were therefore taken to establish branch registers of shareholders in the Australian Capital Territory, in which there is no *Stamps Act*, and all the share transfers which in fact were made were transfers of shares on registers situate in Canberra. In the second place, the carrying out of the plan would involve the issue of large numbers of new shares by the motor companies, and it was at that time unlawful for a company to make any new issue of capital without the consent of the Treasurer of the Commonwealth under the *National Security* (*Capital Issues*) *Regulations*. Application was therefore made for the consent of the Treasurer to the proposed new issues. The applications were made on 13th October 1949, and the consent of the Delegate of the Treasurer was given on 17th November 1949. It is interesting to note that in letters accompanying the applications the following passages occur : " It is proposed that the shares shall be taken up by the shareholders and paid for by them out of funds obtained through the declaration by the company of tax-free and taxable dividends . . . . Your consent is desired to the issue of the . . . shares to be paid for with cash provided by tax-free and taxable dividends declared or to be declared by the company." These things were said because it was known that the consent of the Treasurer was not likely to be withheld if he were satisfied that no outside capital was to be invested in the business of any of the companies. The letters, however, invite two comments. The first is that they contain a very incomplete statement of what was intended. If what was intended had been fully stated, it may indeed be doubted whether the consent of the Treasurer would have been given. On the other hand, ironically enough, they come very near to stating precisely what the commissioner says is in substance left after the application of s. 260.

The plan, in the case of Lanes, was carried out by means of the following steps:—

1. 1*st November* 1949. The nominal capital of the company was increased from £250,000 to £750,000, divided into shares of £1. At the same time the articles of the company were amended so as to divide the shares (issued and unissued) into four classes instead of two. Mr. Thomas's 5,000 preference shares became A preference shares : their rights were not altered, and they need not be mentioned again. Next, a class of 445,000 five per cent B preference shares was created. These carried the same rights as, but ranked subject to, the A preference shares. These were all unissued shares, but, as will be seen, a large number of them were issued a

little later. The remainder of the shares (300,000) were divided into 79,107 A ordinary shares and 220,893 B ordinary shares. Of the 237,321 ordinary shares which had been issued, 79,107 (one-third) became A ordinary shares. These carried a right (subject to the rights of the A preference shares) to the whole of the dividends declared by the company on or after 14th December 1949 until the dividends should reach a total of £5 15s. 10d. in respect of each share, and thereafter no right to participate in profits other than a right (subject to the rights of the A and B preference shares) to a fixed cumulative preferential dividend of five per cent per annum as from 1st January 1950. The remaining two-thirds of the issued ordinary shares (158,214) became B ordinary shares, which were ordinary shares of the usual type. The balance of the B ordinary shares which had been created (62,769) remained unissued. The aggregate amount of the "special dividend" attached to the A ordinary shares was £458,161 7s. 6d. In the light of what followed, it would seem clear that the amount of £5 15s. 10d. per share was approximately the amount which it was thought desirable that the company should distribute in cash and shares in the immediate or near future.

2. 15*th December* 1949. Each of the shareholders holding A ordinary shares by instrument under seal granted to Pactolus an option, exerciseable by notice in writing on or before 31st December 1949, to purchase his or her A ordinary shares at the price of £5 16s. 0d. per share, i.e. 2d. per share more than the amount of the "special dividend" attached to those shares.

3. 16*th December* 1949. A meeting of directors resolved that 402,679 of the B preference shares be made available for issue at par, and that such shares be offered to the person or persons entitled to the dividends on the A ordinary shares on or after 19th December 1949. Pactolus was informed immediately of the passing of this resolution.

4. 19*th December* 1949. (a) Pactolus by notices in writing exercised all the options, and handed to one Donald Ross, on behalf of the A ordinary shareholders, in exchange for transfers which were forthwith registered, cheques for the amounts payable to those shareholders in respect of their respective holdings. The aggregate amount of the several cheques so given was £458,820 12s. 0d. The cheques were drawn on the South Melbourne Branch of the English Scottish and Australian Bank, in which Pactolus had very recently opened a current account, paying in shortly afterwards a sum of £19,000.

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(b) Pactolus lodged with Lanes an application for the 402,679 B preference shares, together with a cheque for £402,679 drawn in favour of Lanes on the South Melbourne Branch of the E. S. & A. Bank.

5. 20*th December* 1949. (a) The directors declared a dividend at the rate of £5 12s. 10d. per share on the A ordinary shares. The total amount involved was £446,295 6s. 6d. Of this total a sum of £8,569 18s. 6d. was appropriated out of tax-free profits, a sum of £262,232 0s. 0d. out of taxable profits of the year ended 30th June 1949, and the balance of £175,493 8s. 0d. out of taxable profits of the current year, i.e. the year ended 30th June 1950. A cheque for the total amount of £446,295 6s. 6d., drawn by Lanes in favour of Pactolus on the company's account in the South Melbourne Branch of the E. S. & A. Bank, was handed to Mr. Ross on behalf of Pactolus.

(b) The directors allotted the 402,679 B preference shares to Pactolus.

(c) Pactolus sold and transferred the 402,679 B preference shares, for the price of £1 per share, to the holders of the B ordinary shares (who were the original ordinary shareholders) in proportion to their holdings of B ordinary shares. The transferees handed to Mr. Ross, on behalf of Pactolus, cheques for the respective amounts payable by them drawn in favour of Pactolus on accounts in the South Melbourne Branch of the E. S. & A. Bank.

6. 21*st December* 1949. All the cheques mentioned in the foregoing paragraphs were deposited in the accounts of the respective payees at the South Melbourne Branch of the E. S. & A. Bank, and were debited to the accounts of the respective drawers.

7. 22*nd March* 1950. Up to this stage the amount of the "special dividend" declared and paid on the A ordinary shares (£5 12s. 10d. per share) fell short by 3s. per share of the special dividend to which those shares were entitled under the amended articles. On 22nd March 1950 the directors declared a further dividend of 3s. per share on the A ordinaries out of profits of the year ended 30th June 1950. The total amount involved was £11,866 1s. 0d., and this amount was paid to Pactolus forthwith. The special rights attached to the A ordinaries were now exhausted, and those shares, although apparently still to be called "A ordinary" shares, became henceforth in reality preference shares having the same rights as, but ranking subject to, the A and B preference shares. The B ordinaries, all of which were still held by the original shareholders, were now the only true "ordinary" shares.

8. *12th May* 1950. Pactolus sold and transferred the 79,107 A ordinary shares (now in reality a third class of preference shares) to Pactolus Investments for the price of £1 per share. This sale does not seem to have been essential to the scheme. (It is a step which was omitted in one of the other four transactions.) Its object, or one of its objects, was possibly to make the income tax position of Pactolus itself appear quite clear. It will help to clear the ground if that position (as it existed on paper at any rate) is explained before an attempt is made to examine the net result of the operations described above. Pactolus had received, by way of dividends on the A ordinary shares, a total sum of £458,161. That sum was, of course, assessable income in its hands. On the other hand it paid £458,820 for those shares, when they carried special dividend rights, and it had sold them, when they had really become five per cent preference shares, for £79,107. It had thus made a loss on the purchase and sale of £379,613. On the footing that it was a company having for one of its objects dealing in shares, it would be prima facie entitled, for income tax purposes, to deduct the loss on the sale from the dividends received. The part which it had played in the Lanes transactions, therefore, left it with a net profit of only £78,548. This net profit, of course, in the last analysis, really represented a remuneration or reward to Mr. Ratcliffe for his services in connexion with the Lanes transactions.

It has already been said that the commissioner concedes that all the steps in the series described above were real and legally effective as between the parties. This, however, does not carry the taxpayers very far. It means no more than that (so far as the evidence goes) all parties intended each such step to have the legal effect which it purported to have. It means only that there was, so far as appears, no secret understanding or trust, by virtue of which the obstensible effect of any of those steps was actually or potentially negatived or qualified. The mere fact that a transaction is real and effective will not, of itself, take a case outside s. 260. I shall return to this point later.

Before considering s. 260, it is to be observed that, although the transaction must be taken to have been genuine in the sense explained above, the entire series of steps was intended to take effect *as a whole.* There was a preconceived end in view, and, if, at any stage before the depositing of the cheques on 21st December, any good reason had appeared for not proceeding to the end, it cannot be doubted that it was understood that what had been done should be undone. The whole series of planned steps was, however, in fact carried out to the end, and it is necessary to look at the end result.

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The end result is to be regarded from two points of view. From the point of view of Lanes, a sum of £458,161 had gone out of the accumulated profits of that company, and a sum of £402,679 had been added to its issued capital, and was represented by 402,679 B preference shares, which were fully paid. From the point of view of the original shareholders, they had acquired 402,679 B preference shares, and they had also received a sum of £56,141 in cash. This sum was the difference between the amount of the "special dividend" (£458,161) and the amount paid for the preference shares (£402,679) plus a sum of £659, which represented the difference of 2d. per share between the amount paid by Pactolus for the A ordinary shares (£458,820) and the amount of the "special dividend" (£458,161). At the same time Pactolus was left with 79,107 A ordinary shares which had become transmuted into five per cent preference shares, and which may be taken to have been worth approximately par.

Section 260 has been regarded as a difficult section. It should be mentioned that before the Act of 1936 the section did not contain the words "as against the commissioner or in regard to any proceeding under the Act". The added words make it quite clear that there is avoidance only for the purposes of the Act. But there is difficulty with regard to the construction of the section, and there is difficulty with regard to its operation. In the first place, the "purposes" or "effects" which will attract its operation are stated very vaguely. If we interpret it very literally, it will seem to apply to cases which it is hardly conceivable that the legislature should have had in mind. On the other hand, any limitation which we may seek to imply may appear to deprive the section of all practical effect. In the second place, even when we have discovered one of the "purposes" or "effects" which bring a case within the section, the actual effect of the section on the vitiated transaction is not immediately obvious. Something is "avoided", though only against the commissioner—i.e. only so far as it affects ostensibly the incidence or *quantum* of income tax. But is anything left, and, if so, what, when effect has been given to the "avoidance"? Fortunately, however, these difficulties have not now to be faced for the first time.

We begin, of course, with one fact, which is as important as it is obvious. The plain object of s. 260 is to defeat "tax avoidance" —an expression which Mr. *G. S. A. Wheatcroft* in a recent article (1) has defined as meaning "the art of dodging tax without actually breaking the law". The section is not aimed at fraudulent conduct,

(1) (1955) 18 Mod. L.R. 209.

or at pretended, as distinct from real, transactions. Such cases need no special statutory provision. It is aimed at transactions which are, in themselves, real and lawful, but which the legislature desires to nullify so far, and only so far, as they may operate to avoid tax. For this purpose it was necessary to adopt a criterion. The primary criterion adopted—though the section adds *ex abundanti cautela* a reference to " purported effect "—is the purpose which the particular transaction in question was designed to effect. If it is found that the transaction has taken a particular form because the purpose in view was one of the purposes mentioned in the section, then the section strikes at it. It is interesting to note that Mr. *Wheatcroft* mentions in his article certain recent English legislation, having the same object as our s. 260, which takes intention or purpose as the criterion. For the rest, four decisions of this Court have, in my opinion, sufficiently and satisfactorily explained the true construction and operation of the section.

The first case is *Deputy Federal Commissioner of Taxation* v. *Purcell* (1). This case was concerned with s. 53 of the *Income Tax Assessment Act* 1915-1916, which did not differ materially from s. 260 of the Act of 1936-1950. It was a case in which a transaction of a familiar kind was held not to fall within the section. The owner of a pastoral property and live stock depastured thereon declared himself a trustee of the land and stock for himself and his wife and his daughter in equal shares, reserving to himself wide powers of management, control and investment. *Knox* C.J. was satisfied on the evidence that, although he was " influenced to some extent by a desire to lessen the burden of taxation " (2), the taxpayer really did not intend to benefit his wife and daughter, and he rejected the commissioner's contention that the settlement was avoided by s. 53. He said :—" The section, if construed literally, would extend to every transaction whether voluntary or for value which had the effect of reducing the income of any taxpayer ; but, in my opinion, its provisions are intended to and do extend to cover cases in which the transaction in question, if recognized as valid, would enable the taxpayer to avoid payment of income tax on what is really and in truth *his* income " (3). The decision of *Knox* C.J. was upheld on appeal. *Rich* J. said : " it would be unreasonable to construe it " (*scil.* s. 53) " so as to include a genuine gift which had the incidental effect of diminishing the donor's assets and income " (4). In *Purcell's Case* (1) there was no " contract, agreement or arrangement " lying behind the actual

(1) (1921) 29 C.L.R. 464.
(2) (1921) 29 C.L.R., at p. 467.
(3) (1921) 29 C.L.R., at p. 466.
(4) (1921) 29 C.L.R., at p. 476.

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disposition of property, and having one of the purposes mentioned in s. 260.

The next case is *Jaques* v. *Federal Commissioner of Taxation* (1). Section 18 (1) (*i*) of the *Income Tax Assessment Act* 1915-1918 allowed a deduction from assessable income of the total amount of calls paid by a taxpayer on shares in a mining company operating in Australia. The facts are accurately stated in the headnote, which reads as follows :—" A company which carried on the businesses of coal mining and of cement making, having decided to reconstruct, went into voluntary liquidation, and the liquidator entered into agreements with two new companies to one of which he agreed to transfer the colliery business and to the other the cement business, the consideration to the old company being paid-up shares in the new companies which were to be distributed among the shareholders of the old company. After the agreements had been executed and the transaction had been otherwise partly completed, for the avowed purpose of enabling the shareholders of the new companies to obtain under the *Income Tax Assessment Act* 1915-1918 deductions from their incomes in respect of calls paid, a new scheme was adopted and carried into effect, under which, in substance, the old company sold its assets to the new companies respectively for specified sums, contributing shares were issued by each of the new companies to the shareholders of the old company, and upon those contributing shares calls were made of a sufficient amount to satisfy the purchase-money, which calls were to be paid out of the shareholders' respective interests in the assets of the old company. The payment of the calls and of the purchase-money was effected by an exchange of cheques between the liquidator of the old company and the new companies." *Rich* J. held that a shareholder in one of the new companies was not entitled to a deduction of calls paid, and his decision was upheld on appeal. *Knox* C.J. was of opinion that the taxpayer had not established that the transaction involving the calls was a " genuine *bona fide* transaction " (2), but he thought that in any case s. 53 " prevented the appellant from availing himself of the devious methods employed " (2). *Rich* J. and the other two members of the Full Court (*Isaacs* J. and *Starke* J.) regarded the course taken as genuine in the sense that a real liability to pay calls would result from the acceptance of contributing shares, but they were of opinion that, for income tax purposes, s. 53 annihilated the " agreement or arrangement " which provided for the issue of contributing shares and the payment of calls, with the result that the commissioner

(1) (1924) 34 C.L.R. 328.

(2) (1924) 34 C.L.R., at p. 355.

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need have regard only to the pre-existing reconstruction plan, which did not involve the payment of calls. *Rich* J. said :—" Sec. 53 regards the 'contract, agreement, or arrangement' as possibly a very real one, but attaches consequences to the purpose or effect " (1). From one point of view it may be said that *Jaques's Case* (2) is a particularly clear case. For, when once the agreement or arrangement was avoided by reason of its purpose or purported effect, there were seen to be left pre-existing express contracts which contained nothing relating to the making of calls. Two things, however, are to be noted about *Jaques's Case* (2) which are made plainer by the two later cases. Firstly, although the " purpose " was not seriously denied by the taxpayer in that case, it is made clear that the " purpose " may be readily inferred from the very form itself which the transaction assumes. This, of course, must obviously be so. Secondly, the effect of s. 53 (s. 260) is to avoid, for the limited purpose in hand, not merely the " contract agreement or arrangement ", which lies behind the actual things done, but the actual things done themselves. This is perhaps not quite so obvious, but a moment's reflection is enough to satisfy one that it must be so. The section would indeed be vain and useless if it avoided an executory contract but left standing everything done in execution of the contract, or avoided an " arrangement " while leaving untouched the carrying out of everything that had been " arranged ". The word " arrangement " is in truth apt—and was doubtless intended—to cover both the *a priori* formulation of a plan and the carrying out of the plan in the arranged form. There is a passage in the judgment of *Isaacs* J., in the course of which his Honour says that s. 53 " does not include a conveyance or transfer of property . . . as such " and " does not contemplate an instrument actually changing the real ownership " (3). But, as is in effect pointed out in a later case, such statements cannot be taken to mean that the section cannot affect a conveyance or transfer which is an integral part of the machinery for carrying out a contract agreement or arrangement of the character described.

The next case is *Clarke* v. *Federal Commissioner of Taxation* (4). Section 16 (*d*) of the *Income Tax Assessment Act* 1922-1925 brought into the assessable income of a taxpayer " premiums demanded and given in connexion with leasehold estates ". The section which corresponded to the present s. 260 was s. 93. The case involved a somewhat protracted and intricate series of negotiations and transactions, on which several questions arose, but for present purposes

(1) (1924) 34 C.L.R., at p. 338.
(2) (1924) 34 C.L.R. 328.
(3) (1924) 34 C.L.R., at p. 359.
(4) (1932) 48 C.L.R. 56.

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the essential facts can be stated quite shortly. The appellant taxpayer was the owner in fee simple of certain licensed premises known as the Burwood Hotel. He agreed to grant to one McDonough a lease of the hotel for five years from 1st July 1924, at a weekly rent of £30, for which lease a premium of £20,000 was to be paid in two instalments. Some months previously the appellant had formed a company named The Burwood Hotel Ltd., in which he was the sole beneficial shareholder. The transaction with McDonough was not carried out according to his terms, but the taxpayer granted a lease to the company, which forthwith assigned the lease to McDonough in consideration of a premium of £20,000 payable in two instalments. The company very shortly afterwards went into voluntary liquidation. The first instalment only of the premium (£10,000) came in question. That instalment appears to have been in fact paid to the appellant, but in its accounts the company treated itself as entitled (as in fact it was) to receive the instalment, and debited the appellant with the amount thereof. It then distributed its surplus assets to the appellant. The Court, consisting of *Rich*, *Dixon* and *Evatt* JJ., delivered a single judgment, in which it held that the case was covered by s. 93, and that the instalment of the premium was assessable income of the taxpayer. Speaking generally of the section, their Honours said :—" Where circumstances are such that a choice is presented to a prospective taxpayer between two courses of which one will, and the other will not, expose him to liability to taxation, his deliberate choice of the second course cannot readily be made a ground of the application of the provision. In such a case it cannot be said that, but for the contract, agreement or arrangement impeached, a liability under the Act would exist. To invalidate the transaction into which the prospective taxpayer in fact entered is not enough to impose upon him a liability which could only arise out of another transaction into which he might have entered but in fact did not enter. Where, however, the annihilation of an agreement or arrangement, so far as it has the purpose or effect of avoiding liability to income tax *leaves exposed a set of actual facts* from which that liability does arise, the provision effectively operates to remove the obstacle from the path of the commissioner and to enable him to enforce the liability " (1). (The italics are mine.) It is, of course, a striking feature of this case that the instalment of the premium was in fact paid into the hands of the taxpayer himself, although on paper it would appear to have been payable to the company. One feels that there was some carelessness somewhere ! At the same time,

(1) (1932) 48 C.L.R., at p. 77.

I find it impossible to think that the position would have been held to be different if the payment had been made to the company. The "arrangement" would have disguised the receipt, making it appear to be not an income receipt but a capital receipt. But, when the arrangement had been, so to speak, stripped away under s. 93, it would have become manifest that a premium had really found its way (albeit a devious way) into the pocket of the taxpayer. The Court said :—" The grant of the lease to the company, his automaton, and its immediate assignment to the intending lessee, and the subsequent liquidation of the company, and the entries in the books of the company narrating the taxpayer's accountability to it for the money and the accountability of himself as the company's liquidator in a like sum, all amount to an arrangement adopted for the sole purpose of intercepting the liability to income tax which would otherwise flow from the payment to him of a consideration actually demanded and actually given in connection with a leasehold " (1).

The latest and most important case is *Bell* v. *Federal Commissioner of Taxation* (2). This case, like the present case, involved the carrying out of a very elaborate plan, which had been carefully worked out beforehand for the benefit of the taxpayers by persons expert in taxation matters. The facts are fully set out both in the judgment of *McTiernan* J. and in the single judgment of five justices delivered on an appeal from *McTiernan* J., which failed. The details are, of course, important, but they need not be repeated here. A brief statement will suffice. The appellant taxpayer, Bell, was a member of a partnership of seven persons, which had been formed in Sydney about October 1946, and which had acquired from the Commonwealth Disposals Commission a quantity of surplus war material lying on Torokina Island in the Territory of Papua. In January 1947 they caused to be formed two companies. One, Torokina Disposals Pty. Ltd., was incorporated in New South Wales, the partners being the shareholders. The other was incorporated in Papua. The seven signatories to the memorandum of the latter company were Mr. White, a solicitor of Port Moresby, and six other residents of Papua, whose co-operation was obtained by Mr. White. Each subscribed for one share of £1 ; no other shares were ever allotted. In March 1947 the signatories to the memorandum transferred their shares to the partners, each partner acquiring for £1 one fully paid share. The intention was that the partnership should sell the goods bought from the Commission to the Papuan company at cost, and that that company should then sell the goods

(1) (1932) 48 C.L.R., at pp. 79, 80. (2) (1953) 87 C.L.R. 548.

at a profit to the Australian company. The profit on sale would thus be derived by the Papuan company, which, being a resident of Papua and deriving its profit from Papua, would be exempt from income tax under s. 7 (1) of the *Assessment Act*. It was contemplated at the beginning that tax would be payable on any distribution of profits by the Papuan company to the partners, who were now its shareholders, but later a more ambitious use of the Papuan company was conceived. By February 1948 a stage had been reached, at which all the disposals goods had been sold, and the New South Wales company had in its hands a sum of £78,520, representing the net proceeds thereof. On 4th February Bell and four other partners proceeded from Sydney to Port Moresby armed with a bank draft for this amount and a "Memorandum of Routine", which had been prepared by their advisers. What happened at Port Moresby is set out in detail in the report (1). It may be summarised as follows. The draft of £78,520 was paid into the Papuan company's account in the Bank of New South Wales. The company lent Mr. White the sum of £77,000. Mr. White had again (as he had done on the formation of the company) provided six local collaborators, and to each of these he lent a sum of £11,000. Mr. White and the collaborators bought the shares of the seven partners, each partner selling his £1 share for £11,000. The loans provided the purchase money. The purchaser of Bell's share was a man named Corlett. The company declared a dividend of £77,000 (payable, of course, to Mr. White and the collaborators). The collaborators repaid to Mr. White their respective loans of £11,000, and Mr. White repaid to the company his loan of £77,000. These things were done by means of cheques drawn on the Bank of New South Wales. The "routine" contained careful provision for the order of events in general, and for the order of the appearance of the cheques in the bank ledgers. Each of the six collaborators appears to have received a reward of £20, a sum which proved to be exactly £20 more than his services were really worth.

Of this transaction the Court observed that there was nothing fraudulent or otherwise dishonest in it. "If", it said, "there had been no more in the case than that Bell, in preference to retaining his share and deriving the dividends which it seemed certain to yield, chose to sell the share for a capital sum equal to the assured dividends, the commissioner would not have been entitled to treat the capital sum as assessable income on the ground of an actual or supposed economic or business equivalence between the two courses. But there was, of course, much more in the case than that. The

(1) (1953) 87 C.L.R., at pp. 569-571.

sale of the share was a part of a complex transaction carefully planned and carried through by Bell and a number of other persons acting in concert, for one predominant purpose, which was to ensure that Bell and his six colleagues should each receive £11,000 tax-free instead of £11,000 subject to tax " (1). Referring to the word " arrangement ", the Court said :—" The case of *Jaques* v. *Federal Commissioner of Taxation* (2) itself, and the later case of *Clarke* v. *Federal Commissioner of Taxation* (3), illustrate the application of the word. It is true that, as *Isaacs* J. observed in the former of these cases (4), the word does not include a conveyance or transfer of property as such ; but, as the cases cited show, under the section a conveyance or transfer of property may be void as against the commissioner as being part of a wider course of action which constitutes an arrangement in the relevant sense of the word " (5). It was, of course, clear that such an arrangement had been made, and the Court said :—" This arrangement, both in purpose and in effect, represented nothing but a method of impressing upon the moneys which came to the hands of Bell and his colleagues the character of a capital receipt and of depriving it of the character of a distribution by a company out of profits. It was therefore a means for avoiding the income tax which would have become payable had the £77,000 been distributed by the company in the normal way. Section 260 (*c*) postulates a duty or a liability imposed on a person by the Act, but this refers, not to a liability to pay a particular amount of tax (which would be a liability imposed by a taxing Act), but to liability such as s. 17 of the Act imposed on Bell, to pay tax in respect of his taxable income ascertained by including in his assessable income his proportion of the Papuan company's profits if and when he should participate in a distribution of them " (6). Finally the Court said : " Then, if this arrangement be treated as void, what remains ? Simply this, that on 3rd February 1948, £77,000, consisting entirely of profits, was withdrawn from the company's bank account, and £11,000 of it passed, indirectly but by steps which are clearly traceable on the face of the bank's ledgers, into Bell's bank account ; and Bell is to be considered as remaining at that time a shareholder in the company, his transfer to Corlett being *ex hypothesi* void as against the commissioner as an integral part of the arrangement. This means that the application of s. 260 in this case is to eliminate those features of the case upon which the exclusion of the £11,000 from assessable income depends, and

(1) (1953) 87 C.L.R., at p. 571.
(2) (1924) 34 C.L.R. 328.
(3) (1932) 48 C.L.R. 56.
(4) (1924) 34 C.L.R., at p. 359.
(5) (1953) 87 C.L.R., at p. 573.
(6) (1953) 87 C.L.R., at pp. 573, 574.

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by that means to establish the correctness of the assessment appealed against " (1).

I have spent a considerable time in an examination of the four cases cited, because they provide, in my opinion, a complete and sound exposition of the true construction and effect of s. 260. They are not the only relevant cases, but they are the most important, and there is, so far as I can find, nothing in any other case to cast the slightest doubt upon them. *Bell's Case* (2) in particular was a very carefully considered case, in which a unanimous judgment of the Full Court upheld a judgment of *McTiernan* J. *Bell's Case* (2) does not, I think, go any further than *Jaques's Case* (3) or *Clarke's Case* (4) but it contains the most complete analysis. It is in the light of the four cases, and especially of *Bell's Case* (2), that the present case must be examined. There are, as I have indicated, two questions. The first is whether the operations which the commissioner challenges were actuated by one or more of the purposes mentioned in s. 260. Was there a contract agreement or arrangement which had in view the attainment of one or more of those purposes ? If that question, which is ultimately a question of fact, is answered in the affirmative, the second question arises, which is—what is the effect of the application of s. 260 to the case ? It is essential that these two questions should be kept distinct, and dealt with in their logical order.

With regard to the first question, there are one or two passages in the judgment of *Kitto* J. which might lead one to think that he was not satisfied of the existence of a relevant purpose. I think, however, that his Honour was prepared to find that such a purpose existed. He says explicitly that the intended effect of the transactions was to be " to enable the motor companies ; (a) while parting with comparatively little cash, to replace the greater part of their 1949 and 1950 profits by paid-up share capital : (b) to make the distributions required in order to exonerate themselves from Div. 7 tax ; and (c) at the same time to avoid involving the original shareholders, though they became the holders of the new share capital, in an income tax liability on the footing that they had participated in a distribution of profits." The answer to the first question appears to me indeed to be beyond serious argument. What other inference is possible than that the very remarkable series of operations outlined above was undertaken and carried out in pursuance of an arrangement, which had for its purpose the avoiding of a liability to income tax imposed by the Act on persons

(1) (1953) 87 C.L.R., at p. 574.
(2) (1953) 87 C.L.R. 548.
(3) (1924) 34 C.L.R. 328.
(4) (1932) 48 C.L.R. 56.

in the position of Lanes and its shareholders? It is, of course, nothing to the point to say that what was being undertaken was a capital reconstruction of Lanes as part of a long term plan. That is merely a general description of what was being done. The position immediately to be faced was that Lanes had in its hands a very large sum of accumulated profits. If these were not distributed in cash or shares before 31st December, the company would have to pay a large amount in income tax thereon. Actually both Lanes and its shareholders desired a distribution. They desired that a comparatively small portion of those profits should go into the hands of shareholders in cash, and that a large portion of them should be capitalised by means of an issue of shares. The achievement of everything that everybody desired presented *of itself* no problem at all. It was the simplest thing in the world: it might almost be described as an everyday company operation: the forms are all in *Palmer's Company Precedents*. No god from a machine in the shape of Pactolus was needed. There was a real and pressing problem because, and only because, any distribution in cash or shares would involve the shareholders in a liability to pay income tax at 15s. in the £ on a very large sum of money, while to make no distribution would involve the company in a similar liability. It was this problem—the problem of escaping from the dilemma which Div. 7 had been designed to create—that the series of steps undertaken was intended to solve. That series of steps was worked out in the utmost detail with expert advice beforehand. It was obviously carried out in pursuance of an agreement or arrangement to which Lanes and its shareholders and Pactolus were parties. And I do not understand how anyone could suppose for a moment that that agreement or arrangement did not have for its purpose the avoiding of the liability imposed by s. 44 and Div. 7 of the *Assessment Act*.

Again, it is nothing to the point in considering the purpose of the agreement or arrangement, to assert that the agreement or arrangement was "genuine" or "intended to have real effect". Of course it was "genuine" and "intended to have real effect". Otherwise it could not on any view have achieved anything. As *Isaacs* J. said in *Jaques's Case* (1), "a sham transaction . . . needs no enactment to nullify it" (2). It is, as I have said, at genuine transactions, intended to have full legal effect as between the parties, that s. 260 strikes. It is said that, if a transaction is "genuine", there can be no distinction between form and substance—the form determines the substance. But it is not a mere question of form

(1) (1924) 34 C.L.R. 328. (2) (1924) 34 C.L.R., at p. 358.

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and substance. This whole approach is, in my opinion, quite wrong. The fallacy arises from a failure to keep distinct the two questions which I have propounded above—(1) Was there such an agreement or arrangement as will attract s. 260 ? and (2) If so, what is the result of the avoidance of it by s. 260 ? When the matter is thus approached, it is seen at once that the " genuineness " or " reality " of a transaction is not really a relevant matter at all. Either there was, or there was not, such an agreement or arrangement. If there was not, that is the end of the matter. If there was, all the " reality " in the world will not save the transaction from s. 260.

Section 260 being applicable to the case, it remains now to consider the effect of its application. The answer to this question again, when it is considered in the light of the authorities, appears to me to be clear enough. This case cannot, in my opinion, be distinguished in any material respect from *Bell's Case* (1). I have already stated what appears plainly to have been the end result of the series of operations undertaken. A sum of £458,161 has been distributed by Lanes out of its accumulated profits, and a sum of £402,679 has been added to its issued capital in the shape of 402,679 B preference shares, which are fully paid. The original shareholders have acquired 402,679 fully paid B preference shares, and have also received £56,141 in cash. The cash which the shareholders received, and the money which paid up the B preference shares, came out of the coffers of Lanes : Lanes' money was (literally or to all intents and purposes) the only real money which figured in the transactions which culminated in the Bank's busy day at South Melbourne. It seems to me nothing to the point to say that Pactolus may have had £19 or £19,000 to the credit of its account before the cheques were paid in, and that (presumably by the application of the rule in *Clayton's Case* (2) that amount should be regarded as used to pay in part the price of £458,820 payable for the A ordinary shares—to say nothing of the price of the shares in Neals and Melford, which have yet to be mentioned, and which involved also very large sums. The intention from the outset was obviously that the dividends should provide the real money to pay for the shares.

Section 260 alters nothing that was done as between the parties. But, for purposes of income tax, it entitles the commissioner to look at the end result and to ignore all the steps which were taken in pursuance of the avoided arrangement. When he does that, what he finds is simply that profits of the company have come, in

(1) (1953) 87 C.L.R. 548. (2) (1816) 1 Mer. 572 [35 E.R. 781].

the shape of cash and new fully paid shares, into the hands of the shareholders in the company. And, when that is all that is looked at, it means that those shareholders have received income—dividends within the meaning of s. 6 of the *Assessment Act*. The position may readily be stated *mutatis mutandis* in the very words used by this Court at the end of its judgment in *Bell's Case* (1). This passage has been quoted above.

The apparent difficulty of this case is, I think, entirely created by the complexity of the operations involved. There are so many trees that the view of the forest is obscured. I have said that the fundamental idea behind it all may be thought to be simple. That fundamental idea is perhaps best revealed by taking an exaggerated concrete example. A is a shareholder in a company which wishes to distribute accumulated profits of £500,000 of which A's proportion will be £400,000. A does not scorn the idea of receiving £400,000, but views with distaste the prospect of having to pay to the commissioner £300,000 out of this sum. He therefore sells his shares to a public hospital at a calculated price of £(x + 400,000). A public hospital is exempt from income tax under s. 23 (*ea*) of the *Assessment Act*. The company declares and pays a dividend, and the hospital receives £400,000. A then buys back the shares for £x. If there were no s. 260, it is difficult to see how A could be made liable to pay tax on the £400,000, by which he has been enriched. He has, in effect, sold shares *cum div.*, and bought them back *ex div.*, and his receipt is a capital receipt. The whole thing is perfectly "real". But s. 260 would step in and nullify, for the purposes only of the *Assessment Act*, the arrangement between A and the public hospital and the transfer and re-transfer made in pursuance thereof. The result would be to reveal nothing but a distribution by the company of profits amounting to £400,000 and a receipt by A of that sum, and that means that A has received a dividend of £400,000. The case would not be different if either the sale price or the purchase price were so calculated as to give to the hospital a suitable reward for its kind assistance. Nor would the case be different if the "reward" were provided for by allowing the hospital to retain a few of the shares sold. I would not suggest that the great complexity of what was done in the present case was designed with no other object than to give artistic verisimilitude to what might otherwise have seemed bald and unconvincing—although I think that some of the details, e.g. the difference of 2d. per share between the amount paid by Pactolus for the shares and the dividend declared and paid, and the existence on 21st December of a relatively

(1) (1953) 87 C.L.R., at p. 574.

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trifling initial credit balance in the bank account of Pactolus at South Melbourne, were possibly designed to cloud the real issues. Such details are of no importance. When once s. 260 has been allowed to do its work, there can be no doubt about where the money came from, and no doubt about where it went. There is no fundamental difference between my exaggerated example and the present case. Here there is no repurchase of any of the shares sold, but the equivalent of a repurchase of a large part of them is obtained. The whole are in fact retained by the purchaser as its reward, but only after they have become shares carrying rights very inferior to those which they carried when they were sold.

Kitto J. was of opinion that *Bell's Case* (1) was distinguishable from the present case. His Honour's view may, I think, fairly be taken to be summed up in a passage in his judgment in which he says that the decision in *Bell's Case* (1) proceeded from two main findings. The first was that a sum of money, consisting of profits, having been withdrawn from a company's bank account, passed into the hands of the taxpayer—indirectly but by steps which were clearly traceable. This, if it had stood alone, would, his Honour says, have been insufficient, because it would have given no clue as to whether the receipt was an income receipt or a capital receipt. The second finding—which stamped the receipt as an income receipt—was that the arrangement was found, in purpose and effect, to be " nothing but a method of impressing a dividend with the character of capital in the process of passing it from the company to the taxpayer ". I would, with respect, make two comments. In the first place, at the stage which his Honour has reached, we are not considering whether there was an agreement or arrangement which is struck by s. 260. We are considering the second question—the question of the operation of the section. The section being found to be applicable, I would say without hesitation that the first element or " finding " mentioned by his Honour was quite sufficient to dispose of the case in favour of the commissioner. For that very finding means that a shareholder has received from the company a share of the profits of the company. If it means anything else, it is not even a relevant finding. And such a receipt could not—or at any rate clearly prima facie would not—be anything but an income receipt. In the second place, what his Honour has called the second finding, is a finding which is relevant only to the prior question whether there has been such an agreement or arrangement as is struck by s. 260. It is not relevant to the logically subsequent question of what s. 260 does when it is applied. I have

(1) (1953) 87 C.L.R. 548.

already said that I regard it as clear that there was in this case such an agreement or arrangement. It may be going too far to say that there was "nothing but" such an agreement or arrangement, but it is quite sufficient to find that there was in fact such an agreement or arrangement.

So far specific reference has been made only to the Lanes transaction. There were, as has been said, five such transactions in all. Of the other four, two were in relation to Neals, and two in relation to Melford. The first Neals transaction and the first Melford transaction were identical with the Lanes transaction. In the case of Melford there were originally no preference shares, so that it was necessary only to divide the shares into three classes, but this is an immaterial difference. These two transactions were carried out by precisely the same steps, taken on the same respective dates and culminating in the banking of the several relevant cheques at South Melbourne on 21st December 1949. Nor did the second Melford transaction or the second Neals transaction differ in any material respect, though the last did not involve any new issue of shares. It seems necessary only to state certain figures relating to the receipts of the original shareholders in shares and cash and the rewards reaped by Pactolus. It has been noted that, in the case of Lanes, the amount ostensibly paid by Pactolus for what may be called the privileged shares *exceeded* by £659 (2d. per share) the amount of the special dividend paid by the company on those shares. The profit made by Pactolus was the value of those shares, which had become five per cent preference shares, *less* the sum of £659. In each of the other four cases it will be seen that the amount paid by Pactolus for the privileged shares was *less* than the amount of the special dividend, so that the profit made by Pactolus consisted of the value of the shares which remained in its hands *plus* a sum of money representing the difference between price paid and special dividend. The position in relation to each of the other four transactions (taking them, of course, at face value) was as follows.

1. *First Neals' transaction.* Pactolus paid for the privileged shares £452,513. The amount of the special dividend was £486,517. The shareholders received £49,199 in cash and 403,314 new fully paid shares. Pactolus was left with 36,444 shares and £34,004 in cash. Pactolus's total "profit" (taking the shares at par) was thus £70,448.

2. *First Melford transaction.* Pactolus paid for the privileged shares £198,072. The amount of the special dividend was £219,117. The shareholders received £8,253 in cash and 189,819 new fully paid shares. Pactolus was left with 8,253 shares and £21,045 in cash.

Pactolus's total "profit" (taking the shares at par) was thus £29,298.

3. *Second Melford transaction.* This transaction, which was completed by the banking of the relevant cheques at South Melbourne on 6th December 1950, was, arithmetically speaking, practically a repetition of the first Melford transaction. Pactolus paid for the privileged shares £198,072. The amount of the special dividend was £219,117. The shareholders received £8,253 in cash, and 189,819 new fully paid shares. Pactolus was left with 8,253 shares, and £21,045 in cash. Pactolus's total "profit" (taking the shares at par) was thus £29,298.

4. *Second Neals' transaction.* This transaction was completed by the banking of the relevant cheques at South Melbourne on 27th June 1951. Pactolus paid for the privileged shares £354,245. The amount of the special dividend was £381,214. On this occasion there was no new issue of shares in Neals. The shareholders simply received the sum of £354,245 in cash. Pactolus was left with 29,156 shares and £26,969 in cash. Pactolus's total profit (taking the shares at par) was thus £56,125.

Taking the five transactions together, the figures are these. The shareholders received £476,091 in cash, and 1,185,631 fully paid five per cent preference shares of £1 in the three motor companies. Pactolus received £102,404 in cash, and 161,213 fully paid five per cent preference shares of £1 in the three motor companies. The sands of the Lydian river were indeed golden, but there was no gold which did not come from the profits of the motor companies.

It follows from what I have said that the appeals of the commissioner should, in my opinion, be allowed. With regard to the order to be made, however, there is one point to which specific reference has not so far been made. The commissioner has excluded from his amended assessment of each taxpayer a due proportion of so much of the profits distributed by the company as came from a tax-free fund in the hands of the company. This is, of course, correct. He has, however, based his assessments in the aggregate (making a proper apportionment among the individual taxpayers) on the whole of the rest of what the shareholders received, without making any allowance for the cash and shares which, when all the transactions were completed, were left in the hands of Pactolus. It was suggested that he ought to have deducted from that aggregate the amount of the cash, and the value of the shares, which Pactolus in fact got. The shares at the relevant times were five per cent third preference shares (though still called A ordinaries), and their value was, as has been said, probably about par—the price at which

Pactolus later sold most of them to Pactolus Investments. The argument, as I understand it, is that the receipt and retention by Pactolus of its cash and shares is just as much part of what I have called the " end result " as the receipt by the taxpayers of their cash and shares, and that, although the taxpayers are richer by what they ultimately got, they are poorer by what Pactolus ultimately got.

The argument appears to me to be untenable. It is true that the gain of Pactolus is part of the end result, but it is a part which has no bearing on the taxability of the taxpayers. The whole basis of the argument disappears as soon as it is understood that what was received and finally retained by Pactolus was by way of remuneration or reward to Pactolus—which is the same thing as saying to Mr. Ratcliffe—for services rendered in conceiving, and assisting in carrying out, a plan which, it was hoped, would avoid the necessity of paying many thousands of pounds in income tax. It cannot be doubted that this was so. No other inference seems possible. No other explanation has been suggested. The commissioner has assessed the taxpayers only on what actually came into their hands. He has assessed them on nothing that they did not actually receive. The whole of what they received was, if my view of the effect of s. 260 is correct, assessable income within the meaning of the *Assessment Act*. If that be so, no allowance can be made for what Pactolus got, unless it can be claimed as a deduction under s. 51 of the Act. And it seems to me plainly impossible to say that what Pactolus got represented an outgoing of the taxpayers incurred in gaining or producing their assessable income. It need only be added that the notices of objection did not claim a deduction on this account, and s. 190 of the Act provides that a taxpayer shall be limited on an appeal to the grounds stated in his notice of objection.

The case of *War Assets Pty. Ltd.* v. *Federal Commissioner of Taxation* (1) should perhaps be mentioned. My view in that case was that the bank account known as the " P.F. Cody No. 2 Account " was in truth and in fact a trust account for War Assets Pty. Ltd. and certain other persons. On that view, of course, the commissioner had no need to rely on s. 260. When that view was rejected on appeal, there was obviously no room for the application of s. 260, for the simple reason that no money had ever come into the hands of War Assets Pty. Ltd.

In each of the fourteen cases the commissioner's appeal should be allowed with costs. The order of *Kitto* J. in each case should be discharged. In lieu thereof it should be ordered in each case that the taxpayer's appeal to this Court be dismissed with costs.

(1) (1954) 91 C.L.R. 53.

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Taylor J. The respondents in these appeals have been assessed to income tax in respect of dividends paid by three private companies out of their distributable profits. The dividends were not paid to the respondents by the companies concerned, but they were paid in respect of shares which, immediately prior to the declaration of the dividends and payment thereof, had been sold by the respondents to a company known as Pactolus Pty. Ltd. At the time when the dividends were declared and paid Pactolus Pty. Ltd. was registered as the owner of the shares in the books of each company and the dividends were paid to it. The evidence shows that, Pactolus Pty. Ltd. received by way of dividends an aggregate sum of £1,764,136 and that it paid £1,661,722 for the shares acquired. Furthermore it appears that practically the whole of the amount paid for these shares was paid by Pactolus Pty. Ltd. out of the dividends received by it.

In assessing the respondents to income tax, the commissioner relies upon the provisions of s. 260 of the *Income Tax and Social Services Contribution Assessment Act* 1936-1950. The facts under review are of a complicated nature, but the principal difficulty in the case arises from the circumstance that the section referred to is couched in language which does little to reveal the intention of the legislature with any real degree of precision. The section has, however, had a long history and from time to time attempts have been made in particular and, as a rule, very special, circumstances to invoke its operation for the purpose of determining questions of liability to income tax. Sometimes these attempts have succeeded and although the cases give some assistance in construing the section it was not until the comparatively recent case of *Bell* v. *Federal Commissioner of Taxation* (1) that the Court attempted to state in a more general fashion the nature of the circumstances which will call the section into operation and the effect which its application will produce.

The section is in the following terms: " 260. Every contract, agreement, or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly—(*a*) altering the incidence of any income tax; (*b*) relieving any person from liability to pay any income tax or make any return; (*c*) defeating, evading, or avoiding any duty or liability imposed on any person by this Act; or (*d*) preventing the operation of this Act in any respect, be absolutely void, as against the Commissioner, or in regard to any proceeding under this

(1) (1953) 87 C.L.R. 548.

Act, but without prejudice to such validity as it may have in any other respect or for any other purpose."

It is the contention of the appellant that the respondents were parties to arrangements in relation to the profits of each company which had the purpose or effect of defeating, evading or avoiding a "duty or liability imposed" by the Act. These arrangements, it is said, were constituted by or carried into effect by means of the transactions established by the evidence with the result that income tax which, otherwise, would have been attracted was avoided by them. Neither upon the hearing of the appeals before *Kitto* J. nor before us was there any suggestion that these transactions were illusory; on the contrary, it was explicitly stated by counsel for the commissioner that no grounds existed for denying that the transactions were genuine or that as between the parties they had full legal force and effect. The only claim made was that, so far as the arrangements had or purported to have the purpose or effect of in any way directly or indirectly "avoiding any duty or liability" imposed by the Act, they were void as against the commissioner. This, according to the submissions made on behalf of the appellant, involved the consequence that the dispositions between the various parties to the arrangements must, to the same extent, be regarded as void for the purposes of determining the liability of the respondents to income tax.

In earlier legislation the effect of prototypes of the section upon an offending "contract or agreement or arrangement" was to render the transaction wholly or partly void for all purposes and it was not until 1936 that the qualification "as against the Commissioner" was introduced. Prior to 1936 provisions similar to cll. (*a*) and (*b*) of the section had given rise to problems such as those which arose in *Harris* v. *Sydney Glass & Tile Co.* (1) and *De Romero* v. *Read* (2), but after the introduction of the qualification referred to those clauses lost a great deal, if not all, of their practical significance and in considering the section for the purpose of the present case it is sufficient to focus attention on cl. (*c*). When this is done and one asks what is meant by the expression "avoiding any duty or liability imposed upon any person by this Act" a difficulty arises immediately.

Section 17 of the Act provides: Subject to this Act, "income tax . . . at the rates declared by the Parliament, shall be levied and paid for the financial year commencing on the first day of July, One thousand nine hundred and fifty and for each financial year thereafter, upon the taxable income derived during the year of

(1) (1904) 2 C.L.R. 227. (2) (1932) 48 C.L.R. 649.

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income by any person . . .". The assessable income of a resident shareholder in a company includes, with certain immaterial exceptions, dividends paid to him by the company out of profits derived by it from any source (s. 44) and the expression dividend includes any distribution made by a company to its shareholders, whether in money or other property, and any amount credited to them as shareholders, and includes the paid-up value of shares distributed by a company to its shareholders to the extent to which the paid-up value represents a capitalisation of profits. Dividends are paid when they are credited or distributed (s. 6). Provision is made by s. 161 for requiring returns of income derived by taxpayers during any income year to be furnished to the commissioner and, from such returns and other information in his possession, the commissioner is required to make an assessment of the amount of the taxable income of any taxpayer and of the tax payable thereon (s. 166). Income tax so assessed becomes due and payable by the person liable to pay the tax on the date specified in the notice of assessment (s. 204) and when due and payable the tax constitutes a debt due to the Crown on behalf of the Commonwealth (s. 208). Upon consideration of these provisions it will be seen that if, as the cases have consistently assumed, the expression "liability" in s. 260 includes the liability to pay income tax, a difficulty arises at once. That liability, except in a very general sense, does not arise until income has been *derived* by a taxpayer and, even after it has been derived, no strict liability to pay any specific amount of income tax arises until it is seen whether the taxpayer has a taxable, as distinct from an assessable, income and until the tax has been assessed. But once income has been derived by a taxpayer no transaction thereafter entered into by him—whether it be accomplished by means of a "contract, agreement or arrangement", or otherwise—can destroy that fact as a circumstance which, at the appropriate time, must be taken into account in the assessment of his income tax. Therefore in cases where the commissioner proceeds to assess income tax on income which has actually been derived by a taxpayer no assistance is required from the provisions of s. 260 in determining either the extent of that taxpayer's assessable income or the amount of tax payable by him. In such cases the commissioner is concerned with assessing tax on an amount which represents the taxpayer's actual income and not with an amount which, by reasons of the operation of the provisions of s. 260, the commissioner is entitled to treat notionally as his income. Equally, the provisions of the section are not required to enable the commissioner to disregard sham transactions designed to facilitate the evasion of a liability to pay income tax, for such transactions, being shams, cannot have the effect of avoiding such a liability. Nevertheless the section, in terms, operates to avoid contracts, agreements and arrangements, so far as they have or *purport* to have any such purpose or effect, and it would seem that it was the intention of the legislature, for good measure, to provide for the statutory avoidance of such transactions. But the section goes further and provides for the avoidance of any contract, agreement, or arrangement so far as it has the purpose or effect of avoiding liability to income tax. And, since it is clear that the real work of the section is intended to be done in cases where the disputed item of income has not in fact or law been derived by a taxpayer, the section must be taken to contemplate that, even before income has been derived, a taxpayer may, by a legally effective contract, agreement or arrangement, avoid a liability to income tax on future income. But, as already appears, it is a condition precedent to the liability of a taxpayer that he shall derive income and it is difficult to understand how, except in a loose sense, a person can be said to avoid liability to tax by putting himself in a position where he will, neither in fact nor in law, derive future income. Nevertheless, in an attempt to give some intelligible meaning to the section the view has been taken that there may be, on the part of a taxpayer, an avoidance of liability to tax, within the meaning of the section,.in respect of income before that income has been derived. In *Bell's Case* (1) it was said : " Section 260 (*c*) postulates a duty or a liability imposed on a person by the Act, but this refers, not to a liability to pay a particular amount of tax (which would be a liability imposed by a taxing Act), but to a liability such as s. 17 of the Act imposed on Bell, to pay tax in respect of his taxable income ascertained by including in his assessable income his proportion of the Papuan company's profits if and when he should participate in a distribution of them " (2).

The assignment or transfer of income-producing property, of itself, has, however, the effect of avoiding tax in this general sense but such a transaction has never been regarded as offending against the section. In *Deputy Federal Commissioner of Taxation* v. *Purcell* (3) *Knox* C.J. said : " The section, if construed literally, would extend to every transaction whether voluntary or for value which had the effect of reducing the income of any taxpayer ; but, in my opinion, its provisions are intended to and do extend to cover cases in which the transaction in question, if recognized as valid, would enable the taxpayer to avoid payment of income tax on what

(1) (1953) 87 C.L.R. 548.
(2) (1953) 87 C.L.R., at pp. 573, 574.
(3) (1921) 29 C.L.R. 464.

is really and in truth *his* income. It does not extend to the case of a *bona fide* disposition by virtue of which the right to receive income arising from a source which theretofore belonged to the taxpayer is transferred to and vested in some other person " (1). Upon appeal *Gavan Duffy* and *Starke* JJ. observed : " The section, as the Chief Justice says, does not prohibit the disposition of property. Its office is to avoid contracts, etc., which place the incidence of the tax or the burden of tax upon some person or body other than the person or body contemplated by the Act. If a person actually disposed of income-producing property to another so as to reduce the burden of taxation, the Act contemplated that the new owner should pay the tax. The incidence of the tax and the burden of the tax fall precisely as the Act intends, namely, upon the new owner. But any agreement which directly or indirectly throws the burden of the tax upon a person who is not liable to pay it, is within the ambit of sec. 53 " (2). Indeed, in *Jaques* v. *Federal Commissioner of Taxation* (3) *Isaacs* J. expressed the view that the corresponding section in the legislation as it then stood did not contemplate instruments " actually changing the real ownership " of income-producing property and thought that the section supposed " some contract, agreement or arrangement which apart from the provisions of the section itself would legally operate in one or more of the ways set out in pars. (*a*), (*b*), (*c*), and (*d*) " (4). But in *Clarke* v. *Federal Commissioner of Taxation* (5) and in *Bell's Case* (6) it was held that the section operated to avoid, as against the commissioner, instruments of conveyance and transfer where they formed part of or constituted an arrangement within the meaning of the section. In the latter case, speaking of the word arrangement, it was said : " The case of *Jaques* v. *Federal Commissioner of Taxation* (7) itself, and the later case of *Clarke* v. *Federal Commissioner of Taxation* (5), illustrate the application of the word. It is true that, as *Isaccs* J. observed in the former of these cases (4), the word does not include a conveyance or transfer of property as such ; but, as the cases cited show, under the section a conveyance or transfer of property may be void as against the commissioner as being part of a wider course of action which constitutes an arrangement in the relevant sense of the word " (8).

It must now be taken as established that the section has no application in any case where there has been a genuine disposition of income-producing property even though the disposition may have

(1) (1921) 29 C.L.R., at p. 466.
(2) (1921) 29 C.L.R., at p. 473.
(3) (1924) 34 C.L.R. 328, at p. 359.
(4) (1924) 34 C.L.R., at p. 359.
(5) (1932) 48 C.L.R. 56.
(6) (1953) 87 C.L.R. 548.
(7) (1924) 34 C.L.R. 328.
(8) (1953) 87 C.L.R., at p. 573.

been influenced, or, even induced, by considerations of the incidence of income tax and, even though in the general sense in which that expression has been used, it results in the avoidance of income tax. But the decision in *Bell's Case* (1) requires that this statement should be understood subject to the qualification—stated at this stage in broad terms—that if any such disposition is found as part of an arrangement made for the purpose of avoiding income tax the section may be called in aid by the commissioner.

But can an arrangement, although induced by consideration of the incidence of income tax, be said to have such a purpose when its constituent parts are devised to do no more than effect the transfer from one person to another of income-earning assets ? In such a case, as in the case of a simple instrument of transfer or conveyance, the effect of the arrangement will be to transfer property from the taxpayer to another person in whose hands the future income will be taxable in accordance with the provisions of the Act. In this respect there is no difference between the effect of a transfer of income-producing property which is part of an arrangement and one which is not. Nor, unless some special character is to be found in the arrangement, can it be said that there is any difference in purpose in either case. But *Clarke's Case* (2), in which the effect of instruments disposing of property were held to be avoided as against the commissioner, shows that an arrangement may present features of a very special character and, indeed, that consideration of the dealings made pursuant to or constituting the arrangement may reveal that the various dealings have no practical economic or commercial significance beyond the avoidance of a liability to pay income tax. In such cases the arrangement, though not a sham in the strict sense, is removed from that category only by the presence of dealings which, although they are effective in law as such, serve no practical purpose other than the avoidance of income tax.

In *Clarke's Case* (2) the facts showed that the appellant was the owner of licensed premises which he proposed to lease to a tenant. Part of the contemplated consideration for the granting of a lease was the payment by the tenant of a substantial premium which, if it had been paid to the appellant pursuant to an agreement between them, would have constituted assessable income in the appellant's hands. But instead of granting a lease directly to the tenant he agreed that he would grant a lease in the proposed terms to a company of which he was the governing director and sole beneficial shareholder, and that, in consideration, *inter alia*, of the payment to the company of the specified premium, the company

(1) (1953) 87 C.L.R. 548. (2) (1932) 48 C.L.R. 56.

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would transfer the whole of its interest in the lease to the tenant. Thereafter the lease was granted to the company, the specified premium was paid and the company thereupon assigned the lease to the tenant. In fact the premium was received from the tenant by the appellant and was paid by him into his personal banking account but this is of little consequence for, in law, the tenant thereby discharged his liability to the company and the payment was treated by the company in its books as a payment to it. The only reason for mentioning this particular circumstance is to explain why when, shortly after, the appellant decided that the company should go into liquidation and that its assets should be distributed this amount was not paid by the company to him. It was however the subject of an adjustment and reconciliation in the course of the liquidation.

It was not suggested in *Clarke's Case* (1) that the dealings between the appellant and his company were mere shams. Indeed in the stated case it was expressly stated that none of them were " shams or fictitious transactions " and that " they were intended by the company to be operative and effective ". " But they were ", it was said, " entered into by the company solely because their operation and effect would or might prove advantageous to the appellant, both generally, and from the point of view of State and federal income tax legislation." It is, however, obvious from what has been said that, although a lease was granted to the company, the interest which it so acquired was not of the slightest use or benefit to it. Nor, indeed, was the premium which it received from the tenant and it may well be said that, although the various dealings were legally effective according to their tenor, they had no significance whatever other than the avoidance of income tax. As was said in the course of the Court's reasons : " The grant of the lease to the Company, his " (the appellant's) " automaton, and its immediate assignment to the intending lessee, and the subsequent liquidation of the Company, and the entries in the books of the Company narrating the taxpayer's accountability to it for the money and the accountability of himself as the Company's liquidator in a like sum, all amount to an arrangement adopted for the *sole* purpose of intercepting the liability to income tax which would otherwise flow from the payment to him of a consideration actually demanded and actually given in connection with a leasehold " (2). The italics are mine and emphasise that the dealings were dispositions of property in favour of the company in name only and that the sole purpose and significance of the arrangement of which they formed part was as a facade to defeat the provisions of the Act.

(1) (1932) 48 C.L.R. 56.

(2) (1932) 48 C.L.R., at pp. 79, 80.

It was possible to characterise the arrangement disclosed by the evidence in *Bell's Case* (1) in precisely the same way. In that case a company had been formed for the purpose of selling surplus military equipment which had been acquired by the appellant and the other six beneficial owners of the seven £1 shares which represented the issued capital of the company. The circumstances in which the appellant and the other beneficial owners secured transfers of these shares and, thereafter, resold them for £11,000 each are fully set out in the reasons delivered in that case and it is unnecessary to reiterate them. It is sufficient to say that the profits which, at the relevant time, became available for distribution to the ultimate shareholders amounted to approximately, £78,500, that the payment by the company to those shareholders of dividends of £11,000 per share almost entirely stripped it of its resources and that it was established that there was not the slightest intention on the part of anyone that the company should continue to function after the arrangement had been carried out. It was said that at the material time " The Papuan company had been paid £78,520 for the goods it had sold to Torokina Disposals Pty. Ltd., and this sum consisted almost entirely of distributable profits since the Papuan company had no external liabilities and its paid-up capital was only £7. It had disposed of £77,000 of these profits, and the old shareholders between them had received £77,000. The old shareholders had parted with their shares. The new shareholders held all the issued shares in a company whose assets consisted of a little over £1,100, being the surplus which remained after providing for directors' travelling expenses and other small outgoings. It may be added, in order to complete the history of the company, that Mr. White " (the solicitor engaged by the appellant and his colleagues) " on 6th February 1948 was paid his costs and obtained £1,000 from the company's funds as a loan. He later bought in for £20 each the shares which his six clients had purchased. The company had then only about £30 left in its bank account and no one seems to have troubled about it since " (2). The only difference between *Clarke's Case* (3) and *Bell's Case* (1) is that the company which was interposed between the appellant in the former case and the tenant to whom the lease was assigned received no benefit whatever from the carrying out of the arrangement, whilst, in the latter case, it appears that each of the six persons who had acted virtually as ciphers in the matter received a small reward for their co-operation and that the solicitor for the parties succeeded to practically the whole of the residual profits of the company, no

(1) (1953) 87 C.L.R. 548.
(2) (1953) 87 C.L.R., at p. 571.
(3) (1932) 48 C.L.R. 56.

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doubt, as remuneration for his services. In these circumstances it was said that: "This arrangement, both in purpose and in effect, represented nothing but a method of impressing upon the moneys which came to the hands of Bell and his colleagues the character of a capital receipt and of depriving it of the character of a distribution by a company out of profits. It was therefore a means for avoiding the income tax which would have become payable had the £77,000 been distributed by the company in the normal way" (1). I take these observations to mean that the Court saw nothing in the fact that the company retained a comparatively insignificant portion of its profits to defeat the otherwise inevitable conclusion that *the sole purpose and effect* of the arrangement was to avoid a liability to income tax and, accordingly, *Clarke's Case* (2) was directly in point. It was no doubt necessary to make provision for the remuneration of those who had co-operated in the carrying out of the scheme and, since it was not intended that the company should engage in any future business, it was convenient to arrange for their remuneration in the manner indicated.

The broad conclusion to which the above observations lead is that, although the operation of s. 260 is not invoked by every "arrangement" which has the effect of avoiding income tax in the general sense already indicated it will be invoked where the arrangement has no significance or purpose but the avoidance of tax in that sense. Indeed, as will appear the section would seem to be of little use except in such cases.

In the present case there can be no doubt whatever that consideration of the incidence of income tax determined the selection of the transactions which the parties subsequently carried out. Unless a sufficient distribution of the profits made by the several companies during the year ended 30th June 1949 was made before 31st December of that year additional tax under Div. 7 of the Act would have become payable. On the other hand the making of such a distribution to the existing shareholders would have resulted in the dividends paid becoming part of their assessable income and subject to income tax at a high rate. And the latter result would, of course, have ensued, if instead of declaring and paying dividends to the shareholders in cash, the company had issued bonus shares to them. But as appears from the evidence it was essential for the companies concerned to maintain their working capital intact, or substantially intact, and this could not be done if a large proportion of its profits was to be used in the payment of additional tax under Div. 7 or in the payment of dividends to the shareholders and subjected to taxation in their hands. One solution of the problem

(1) (1953) 87 C.L.R., at p. 573. (2) (1932) 48 C.L.R. 56.

was, of course, to convert the companies into public companies and seek additional capital from the public. But although a great deal of tax would have been saved by this method it did not find favour ; none of the interested parties were prepared to enlist public support to the extent of the capital required. Accordingly this method was rejected and the course ultimately pursued was decided upon. That is to say the parties determined that the companies should remain private companies and that, instead of proceeding to capitalise their profits, steps should be taken to secure the necessary capital in such a way that, whilst the companies would continue to remain under the control of the existing shareholders, no tax liability would arise.

In all, *Kitto* J. was required to consider five separate sets of transactions or " arrangements ". Three of these arrangements were made in December 1949 and the remaining two in November 1950 and June 1951 respectively. The earlier arrangements presented identical features whilst in the remaining two there were slight variations which it is unnecessary to notice. The manner in which it was sought to achieve the desired object may therefore be illustrated by stating as briefly as possible what occurred in December 1949 in relation to the shares and profits of Lane's Motors Pty. Ltd. (hereinafter referred to as Lane's), one of the three companies concerned. In the earlier part of that month the respondents (or persons whom they represented) were the holders of the 237,321 ordinary shares of £1 each which at that time had been issued by the company. One, Thomas, was the holder of the 5,000 five per cent cumulative preference shares which constituted the remaining issued capital of the company. At that time the company had available for distribution profits in excess of £400,000 and a substantial part of these profits had been derived during the year ended 30th June 1949. A further substantial part consisted of profits actually made during the then current income year whilst the residual sum, £8,569, represented profits upon which additional tax under Div. 7 of the Act had been paid. It is apparent, therefore, that the value of the ordinary shares was well in excess of their nominal value. It is equally apparent that had the shareholders, or any of them, been minded to sell their holdings the purchase price would have been received by them as capital and the purchaser would have become accountable for income tax purposes in respect of dividends subsequently declared and, thereafter, received by him. But the amount which any purchaser would have been prepared to pay to obtain any of these shares would have been greatly affected by two factors. Firstly, failure on the part of

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Lane's to make a sufficient distribution before 31st December 1949 of the profits earned during the year which had ended on 30th June previously would have resulted in the absorption of a considerable part of those profits in additional tax under Div. 7, with a resultant depreciation in the value of the shares and, secondly, the extent of the purchaser's liability to tax in respect of dividends received by him was a material factor. Assuming the certainty of a distribution before the critical date it is, of course, apparent that a public company might well have been prepared to pay a larger sum for the shares than an individual taxpayer and, in turn, that a charitable institution, the income of which was exempt from tax by virtue of the provisions of s. 23, could profitably have paid more for them than a public company. If the shareholders in Lane's had merely sold their shares to a purchaser answering either of these descriptions there could be no doubt that the subsequent receipt of dividends by the purchaser could not have involved the original shareholders in any liability to income tax. And this conclusion would follow whether the sale was induced by contemplation of a prospective liability to income tax and whether or not the dividends subsequently paid would, in the hands of the purchaser, attract a liability to income tax at the same or a lower rate or not at all. But the respondents had no wish to part with substantial control of their company and they had no intention of parting entirely with their existing holdings. Accordingly, the first step in the arrangement was to convert the existing 237,321 ordinary shares into shares of two classes. One-third of each shareholder's holding —79,107 shares in all—became A ordinary shares and two-thirds became B ordinary shares. The unissued shares, 445,000 in number, became B preference shares. Thereafter, subject to the rights of the holder of the existing 5,000 preference shares, special dividend rights were attached to the A ordinary shares. Pursuant to an amendment to the articles of association made on 14th December 1949 the holders of these shares became entitled to receive the whole of the dividends declared by the company on or after that date until the dividends should reach a total of not less than £5 15s. 10d. in respect of each share and to a fixed cumulative preferential dividend of five per cent per annum as from 1st January 1950. Save as provided in the articles as amended, the holders of these shares had, thereafter, no other right to participate in the profits of the company. On the following day, 15th December 1949, the shareholders in Lane's gave to Pactolus Pty. Ltd. options to purchase their A ordinary shares at £5 16s. 0d. per share and, on 19th December 1949, Pactolus Pty. Ltd. exercised these options and delivered to the respondents in payment cheques totalling £458,820. Transfers of the A ordinary shares to Pactolus Pty. Ltd. were registered on the same day. Meanwhile, on 16th December 1949, Lane's resolved to make available for issue at par 402,679 B preference shares of £1 each and by the same resolution it was specified that such shares should be offered to the person or persons entitled to the dividends upon the A ordinary shares on or after 19th December 1949. On the last-mentioned date Pactolus Pty. Ltd., as the holder of the A ordinary shares, applied to Lane's for the issue to it of the 402,679 B preference shares and lodged with Lane's its cheque for £402,679. On the following day Lane's resolved to pay dividends on the A ordinary shares amounting to £446,295 (i.e. £5 12s. 10d. per share) and, thereafter, to issue to Pactolus Pty. Ltd. the 409,679 B preference shares. On the same day Lane's cheque for £446,295 in respect of the dividends then payable was handed to Pactolus Pty. Ltd. and the B preference shares were issued to the latter company. Again, on the same day, Pactolus Pty. Ltd. sold the B preference shares to the respondents for £1 per share and received their cheques for a total sum of £402,679. All of the cheques which had passed between the parties were deposited in the same branch of the English Scottish and Australian Bank on 21st December 1949 where each of the parties concerned had a current account.

At a later stage, on 22nd March 1950, Lane's resolved upon the payment of a further dividend in respect of the A ordinary shares out of the profits of the then current year. The dividend so declared was 3s. per share and the amount involved, £11,866, was paid to Pactolus Pty. Ltd. on the same day. This payment completed the payments necessary to satisfy the special dividend rights attached to the A ordinary shares. Thereafter Pactolus Pty. Ltd., which has been formed for the purpose of trading in shares, sold the A ordinary shares to another company, Pactolus Investments Ltd., for £79,107 (i.e. £1 per share).

The effect of these transactions is compendiously stated by *Kitto* J. in the following passage : " These steps had the following results : (1) in Lane's accounts, £402,679 of profits went out and was replaced by paid-up capital of the same amount represented by B preference shares in the hands of the original shareholders ; (2) the difference between that figure and the total of the special dividends paid (£458,161) viz. £55,482, was contained in the sum of £56,141 which, as will be mentioned in a moment, was kept by the original shareholders in cash, (the remaining £659 of the latter sum being put in by Pactolus) ; (3) the original shareholders,

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although they received nothing directly from the distribution of Lane's profits, received between them £458,820 as the price of their A ordinary shares, keeping £56,141 of that amount in cash and applying the balance in the purchase of B preference shares from Pactolus; and (4) although Pactolus had to put in £659 in cash, being the amount by which the special dividends fell short of the price paid for the A ordinary shares, it sold those shares for £79,107 and thus made an over-all profit of £78,448. To put Pactolus's result in another way, it lost on the resale of the A ordinary shares £379,713, but the dividends it received amounted to £458,161, so that on the whole it made a profit of £78,448. On the footing, which has been assumed to be correct for the purposes of the argument, that Pactolus was a trader in shares, its taxable income would include, in respect of the Lane's transaction, only the last-mentioned amount and not the full amount of the dividends which Pactolus derived from the A ordinary shares."

In the transactions which concern the other companies Pactolus Pty. Ltd. received more than sufficient by way of dividends to enable it to purchase the holdings of the respondents and, although it is unnecessary to state the details of those transactions, it is of importance to notice that the respondents did in each case part with substantial numbers of shares and that, on the whole, those shares were sold for less than the special dividends available. That Pactolus Pty. Ltd. was able to pay so much for the shares resulted from the fact that the special dividend rights were of a temporary character and that it was a company engaged in share trading. Hereunder is appended a table showing the amounts paid by that company for the shares which it acquired in each company, the number of shares acquired, the amounts received by way of dividend and the difference between the two sets of amounts referred to :—

	Amount paid for purchase of shares	Number of shares purchased	Amounts received by way of dividends	Difference between amounts in columns 1 & 3
Lane's Motors Pty. Ltd. . .	£458,820	79,107	£458,161	£ Minus 659
Neal's Motors Pty. Ltd. (1st Transaction) . .	452,513	36,444	486,527	34,014
Melford Motors Pty. Ltd. (1st Transaction) . .	198,072	8,253	219,117	21,045
Melford Motors Pty. Ltd. (2nd Transaction) . .	198,072	8,253	219,117	21,045
Neal's Motors Pty. Ltd. . . (2nd Transaction) . .	354,245	29,156	381,214	26,969
TOTAL	£1,661,722	161,213	£1,764,136	£102,414

In the course of the same transactions the respondents acquired 1,185,621 new shares in the same three companies. These shares were made up as follows: 402,679 shares in Lane's; 403,314 shares in Neal's Motors Pty. Ltd.; and 379,638 shares in Melford Motors Pty. Ltd. For these shares the respondents paid in all the sum of £1,185,621.

It will be seen that Pactolus Pty. Ltd. paid for the shares which it purchased sums which, in the aggregate, fell short of the dividends which it received by £102,414 and that, for the amounts paid to the respondents, they parted with shares totalling in number 161,213. For these shares Pactolus Pty. Ltd. had paid £1,661,722 but when the special dividend rights had been fully satisfied they resold the shares for £161,213 making, it was contended, an over-all loss on the various sales of £1,500,509.

It should again be stated that the various dealings were not attacked as shams. Nor was it suggested that they did not have full legal force and effect according to their tenor. In these circumstances it is not open to doubt that the appellants sold their shares—161,213 in number—for £1,661,722 and that Pactolus Investments Limited is now the owner of these income-producing assets. Nor can it be asserted that the parties did not intend to produce this result. That the form of the transactions was induced by consideration of the incidence of income tax is, however, unquestionable and the submissions made on behalf of the commissioner focus attention on a number of features. The creation of special dividend rights, the use by Pactolus Pty. Ltd. of moneys received by way of dividend to finance its purchase of the respondents' shares and the reinvestment of the bulk of the purchase money in each of the three companies concerned were, it is said, all steps in an arrangement designed to defeat a liability to tax on the part of the respondents. But if a liability to tax was avoided by these transactions it was, in the loose sense already referred to, avoided because, when the dividends in question became payable, Pactolus Pty. Ltd., and not the respondents, were the owners of the shares and because that company was a company which traded in shares and its operations left room for the contention that comparatively little or no tax could be collected from it in respect of its income receipts for the relevant year.

To my mind the case is vastly different from *Clarke's Case* (1) and *Bell's Case* (2). As already appears the arrangements disclosed by the evidence in those cases had no purpose other than the avoidance of a liability to tax and had no significance beyond the achievement of this result. It is true that the dealings which were

(1) (1932) 48 C.L.R. 56. (2) (1953) 87 C.L.R. 548.

held to be avoided as against the commissioner by the operation of s. 260 were legally effective dispositions of property but it was inevitable that they should be regarded as having no commercial significance and as serving no other purpose than, prospectively, to transmute income into capital. On this basis s. 260 applied and its effect on the relevant dealings was such as to enable the commissioner to deny any such transmutation and to assert that the particular receipts were receipts of income. But in the present case no such simple solution is possible. It may be urged that when the arrangements are considered in their entirety it is clear that it was intended that the bulk of the money paid as dividends by the companies concerned should find its way into the hands of the respondents as capital and that, in the circumstances, the amounts received by them should be regarded as income. But this brief statement presents a picture which is quite inadequate for the arrangements reached much further. The fact is that each respondent sold and intended to sell shares which were and still remain of considerable value and, as consideration, for the various transfers the purchaser intended to pay and each respondent intended to receive the purchase price. Indeed the respondents parted with and intended to part with shares which constituted practically one-third of the issued capital of the companies concerned and which, notwithstanding the new issue which was subsequently made, remained a substantial holding in those companies. That it was profitable for Pactolus Pty. Ltd. to pay so much for the shares resulted from the circumstances that it was a company, that its operations were of a particular character and that it was intended that the special dividend rights attached to the shares would be discharged within a short space of time. But although these circumstances may have produced features which appear to be artificial their presence is by no means fatal to the respondents' contentions. As was conceded on behalf of the commissioner the dealings were within the capacity of the companies concerned and were genuine and effective and, in these circumstances, it cannot be said that the arrangements had no purpose or significance other than the avoidance of income tax. Whilst the various dealings were designed to ensure that no tax liability should arise as far as the respondents were concerned their purpose and object was to divest the respondents of a substantial part of their existing holdings and to ensure that at no time in the future would they derive income from them. They were at liberty to sell their shares and when they sold them they did so by dealings which were genuine and effective sales. Pactolus Pty. Ltd., having purchased them, became entitled to valuable income-earning assets and nothing emerges upon a consideration of the arrangements in their entirety to strip any of the relevant dealings of its commercial significance. It was, of course, otherwise in *Clarke's Case* (1) and *Bell's Case* (2). In these circumstances it is impossible to say that the sole purpose of the arrangements was, in the language of s. 260, to avoid any duty or liability imposed by the Act and, accordingly, the condition precedent to the operation of s. 260 has not been established.

But even if I thought otherwise I would agree with *Kitto* J. that s. 260 would not entitle the commissioner to treat the amounts actually received by the respondents as income. In *Clarke's Case* (1) and *Bell's Case* (2) the problem was comparatively simple. The only practical effect produced by the transactions which the commissioner was entitled to treat as void was to transmute prospective income into capital for the facts showed that, in neither case, did the taxpayer, in a commercial sense, really part with anything. In those circumstances the annihilation of the arrangements left each taxpayer in *statu quo*. But in the present case the respondents parted with assets of considerable value and it is impossible simply by ignoring one part of the relevant transaction, i.e. the transfer of the shares, to characterise the actual receipt of the price of the shares as the receipt of assessable income. The appellant approaches the problem by asserting that the transfers of the shares are to be regarded as void. That is to say, the respondents must be regarded as the shareholders at all material times. Then, the argument proceeds, what happened was, merely, that Pactolus Pty. Ltd. received dividends to which it was not entitled and passed them, or some part of them, on to the respondents as the shareholders. This final conclusion, however, does not depend merely upon the notional avoidance, as against the commissioner, of the several transfers ; it can be reached only by taking a further notional step for the purpose of giving a new colour or character to the payments, that is, by attributing to Pactolus Pty. Ltd. an intention to account to the respondents for the dividends received by it. But it is abundantly clear that nothing was further from the minds of the parties. The amounts paid by Pactolus Pty. Ltd. were paid in respect of a price legally payable and, although the notional annihilation of the transfers may, again notionally, leave those amounts without a character it cannot operate to invest them with a new character. Again it should be stressed that the problem in *Clarke's Case* (1) and *Bell's Case* (2) was quite different. In each of those cases the dealings between the respective parties were, as already appears, set up as a facade and upon its removal a state of affairs which involved the taxpayer in a tax liability was

(1) (1932) 48 C.L.R. 56. (2) (1953) 87 C.L.R. 548.

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left exposed. But, even if the section may be invoked where dealings which have no real commercial significance have taken place, the same observation is not open in those circumstances. In a case such as the present the section may, notionally annihilate the transfer of the shares in question and it may operate to divest the purchase price of its true character but this is far from saying that it can operate to invest the payments with a completely new character and one which is completely foreign to the circumstances in which they were made.

The challenged assessments include as the assessable income of each respondent, not only the amounts actually received by them, but, in the aggregate, the whole of the moneys paid as dividends by the three companies concerned and received by Pactolus Pty. Ltd. Nevertheless the more restricted view was put on behalf of the appellant as an alternative and since, as it seems to me, that view involves consideration of matters which are relevant in determining whether s. 260 may be invoked at all, it has been convenient to consider the alternative view first. But in reaching the conclusion that this view should be rejected enough has been said to indicate why it is impossible to maintain that the payments to Pactolus Pty. Ltd. when made by the companies concerned could, in any way, be regarded as income derived by the respondents. They were paid to and received by Pactolus Pty. Ltd. as moneys to which that company was entitled and the notional annihilation even of every one of the steps in the arrangements under consideration cannot enable the commissioner to treat those payments as having been received on account of or for the benefit of the respondents.

The extent to which the annihilation of an offending arrangement will assist the commissioner is well illustrated by the decision in *War Assets Pty. Ltd.* v. *Federal Commissioner of Taxation* (1) and it is not out of place to quote again the two passages from *Clarke's Case* (2) which were cited in that case. Speaking of s. 260 it was said (3): " In its application perhaps it can do no more than destroy a contract, agreement, or arrangement in the absence of which a duty or liability would subsist. Where circumstances are such that a choice is presented to a prospective taxpayer between two courses of which one will, and the other will not, expose him to liability to taxation, his deliberate choice of the second course cannot readily be made a ground of the application of the provision. In such a case it cannot be said that, but for the contract, agreement or arrangement impeached, a liability under the Act would exist. To invalidate the transaction into which the prospec-

(1) (1954) 91 C.L.R. 53.
(2) (1932) 48 C.L.R. 56.
(3) (1954) 91 C.L.R., at pp. 96, 97.

tive taxpayer in fact entered is not enough to impose upon him a liability which could only arise out of another transaction into which he might have entered but in fact did not enter. Where, however, the annihilation of an agreement or arrangement so far as it has the purpose or effect of avoiding liability to income tax leaves exposed a set of actual facts from which that liability does arise, the provision effectively operates to remove the obstacle from the path of the commissioner and to enable him to enforce the liability " (1); and that (2): " The section is, of course, an annihilating provision only. It has no further or other operation than to eliminate from consideration for tax purposes such contracts, agreements and arrangements as fall within the descriptions it contains. It assists the commissioner, in a case like the present, only if, when all contracts, agreements and arrangements having such a purpose or effect as the section mentions are obliterated, the facts which remain justify the commissioner's assessment " (3).

For the reasons given I am of the opinion that s. 260 has no application to these appeals and that, even if it has, it does not assist the appellant in upholding the assessments either wholly or in part.

In conclusion I desire to reiterate that the decision in this case depends essentially upon the meaning to be attributed to the wide and uncertain words of s. 260 and to add that, in attempting to give some reasonably precise and practical meaning to the section for the purpose of reaching a decision, I have failed to derive any assistance from current aphorisms which tend to obscure rather than reveal the solution. Nor have I found helpful observations such as those made by Viscount *Simon* in *Latilla* v. *Inland Revenue Commissioners* (4) concerning which I find myself in full agreement with the remarks of *Jordan* C.J. *In the Estate of William Vicars (dec'd.)* (5).

Appeals allowed with costs. Orders under appeal set aside. In lieu of each such order, order that the appeal from the amended assessment to which it refers be dismissed with costs. Liberty to apply.

Solicitor for the appellant in each appeal, *H. E. Renfree*, Crown Solicitor for the Commonwealth of Australia.

Solicitors for the respondent in each appeal, *Corr & Corr*.

R. D. B.

(1) (1932) 48 C.L.R., at p. 77.
(2) (1954) 91 C.L.R., at p. 97.
(3) (1953) 87 C.L.R., at pp. 572, 573.
(4) (1943) A.C. 377, at p. 381.
(5) (1944) 45 S.R. (N.S.W.) 85, at p. 93; 62 W.N. 28.