REPORTS OF CASES

DETERMINED IN THE

HIGH COURT OF AUSTRALIA

[PRIVY COUNCIL.]

L. J. NEWTON . . . . . APPELLANT;

AND

FEDERAL COMMISSIONER OF TAXATION . RESPONDENT.

L. NEWTON . . . . . APPELLANT;

AND

FEDERAL COMMISSIONER OF TAXATION . RESPONDENT.

H. J. LANE . . . . . APPELLANT;

AND

FEDERAL COMMISSIONER OF TAXATION . RESPONDENT.

FENTON . . . . . APPELLANT;

AND

FEDERAL COMMISSIONER OF TAXATION . RESPONDENT.

S.M.A. LANE . . . . . APPELLANT;

AND

FEDERAL COMMISSIONER OF TAXATION . RESPONDENT.

CHRISTIAN . . . . . APPELLANT;

AND

FEDERAL COMMISSIONER OF TAXATION . RESPONDENT.

NEWTON AND OTHERS (EXECUTORS OF THE ESTATE OF R. NATHAN DECEASED) APPELLANT;

AND

FEDERAL COMMISSIONER OF TAXATION . RESPONDENT.

ON APPEAL FROM THE HIGH COURT OF AUSTRALIA.

PRIVY COUNCIL
1958.
May 5, 6, 7, 8, 12;
July 7.

Viscount Simonds, Lord Tucker, Lord Keith of Avonholm, Lord Somervell of Harrow and Lord Denning.

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—Meaning of words—"Arrangement"—"Purpose"—"Effect"—"Avoid"—"Absolutely void"—Penalty—Whether income "omitted" from return—Income made such by avoidance of arrangement—Income Tax and Social Services Contribution Assessment Act 1936-1950 (*No.* 27 *of* 1936—*No.* 48 *of* 1950) *ss.* 226 (2), 260.

Section 260 of the *Income Tax and Social Services Contribution Assessment Act* 1936-1950 provides:—"Every contract, agreement, or arrangement . . . entered into, orally or in writing, . . . shall so far as it has or purports to have the purpose or effect of . . . (*c*) . . . avoiding any . . . liability imposed on any person by this Act . . . be absolutely void as against the Commissioner . . .".

Held, that a taxpayer " avoids a liability imposed " when he takes steps to get out of the reach of a liability which is about to fall on him.

Held, further, that the word " arrangement " is apt to describe an understanding between two or more persons which may not be enforceable by law and comprehends not only the initial plan but also all the transactions by which it is carried into effect.

Held, further, that the word " purpose " means, not motive, but the effect which it is sought to achieve and the word " effect " means the end accomplished or achieved.

In order to bring the arrangement within the section one must be able to predicate of it, by looking at the overt acts by which it was implemented, that it was implemented in that particular way so as to avoid tax. If one has to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, the arrangement does not come within the section.

Held, further, that the section can still work if one of the purposes or effects was to avoid liability for tax.

Held, further, that s. 260 alters nothing that was done between the parties, but, for the 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.

Bell v. *Federal Commissioner of Taxation* (1953) 87 C.L.R. 548; *W. P. Keighery Pty. Ltd.* v. *Federal Commissioner of Taxation* (1958) 32 A.L.J.R. 118; 11 A.T.D. 359; *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 and *Clarke* v. *Federal Commissioner of Taxation* (1932) 48 C.L.R. 56, approved.

Decision of the High Court of Australia: *Federal Commissioner of Taxation* v. *Newton* (1957) 96 C.L.R. 577, affirmed.

APPEALS from the High Court of Australia.

These were appeals by special leave from the decision of the High Court in *Federal Commissioner of Taxation* v. *Newton* (1).

Sir *Garfield Barwick* Q.C., *R. M. Eggleston* Q.C., *J. A. Nimmo* Q.C., and *R. Gatehouse*, for the appellants.

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

Their Lordships took time to consider the advice they would tender to Her Majesty.

(1) (1957) 96 C.L.R. 577.

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LORD DENNING delivered the judgment of their Lordships as follows :—

The question in this case is what was the assessable income of the appellants for the years which ended on 30th June 1950, and 30th June 1951 ? In particular, did it include certain sums declared by three companies as special dividends amounting in all to £1,764,136 ? The matter has given rise to considerable difference of opinion in the High Court of Australia. *Kitto* J., who heard the case at first instance, decided that those sums did not form part of the assessable income of the appellants. But the Full Court, by a majority, consisting of *Dixon* C.J., *McTiernan*, *Williams* and *Fullagar* JJ. (with *Taylor* J., dissenting) held that it did form part of the assessable income of the appellants and that they must pay tax on it and also a penalty (1). Very large sums of money are involved.

In these days, when rates of tax are high, it is natural enough for a man to seek so to order his affairs that the tax attaching under the appropriate Acts is less than it otherwise would be. In England there is no general provision against it, but special provisions have been enacted so as to counter particular devices and to deal with particular situations. In Australia there is a general provision which is said to cover " tax avoidance " and it comes now before their Lordships for the first time. But before setting out the section, their Lordships think it better to summarise the facts which give rise to the question.

In the autumn of 1949 the position was this : Three private companies (which dealt in motor cars) had made large profits and were still making them. Under Australian law these profits would ordinarily be liable to a heavy tax. If they were distributed to the shareholders as dividends in cash or as bonus shares, the shareholders—being wealthy persons—would be liable to pay tax at the rate of 15s. 0d. in the pound. If the profits were not distributed to the shareholders by 31st December 1949, but kept in the coffers of the company, the company would be liable—under Div. 7 of the Act—to pay the tax which the shareholders would have paid, that is, at 15s. 0d. in the pound.

In December 1949—before the last day—several transactions took place. For simplicity their Lordships will consider what happened in the case of one of the private motor companies only : but all three carried out similar transactions. The company amended its articles of association so as to give special dividend rights to 80,000 ordinary £1 shares, which entitled the holders of the shares to a

(1) (1957) 96 C.L.R. 577.

dividend of £5 15s. 10d. on every £1 share. That comes to a total of nearly £460,000 as special dividend. After the payment of that dividend, those shares were to carry only a five per cent fixed dividend. The original shareholders then sold these shares to a company called Pactolus Limited (which was a private company controlled by a consulting accountant) at a price of nearly £460,000 —roughly equal to the anticipated dividend. The Pactolus company paid to the original shareholders the price by cheque, and at about the same time received from the motor company a cheque for the special dividend. The two cheques were for about the same amount—£460,000. The Pactolus company was only able to pay for the shares because of the special dividend it received on them.

The Pactolus company also applied to the motor company for 400,000 five per cent preference £1 shares (freshly issued) and paid for them by a cheque in favour of the motor company for £400,000. On the next day the Pactolus company sold these 400,000 shares to the original shareholders (from whom they had bought the 80,000 ordinary shares) at a price of £400,000. The original shareholders paid this sum, by cheque in favour of the Pactolus company, out of the £460,000 they had received for the 80,000 ordinary shares.

All the cheques in the above transaction were banked simultaneously, with the result that by the end of December 1949 the motor company had distributed £460,000 as special dividend. This had found its way back to the original shareholders who had received £460,000, of which they had reinvested £400,000 as capital in the company and kept £60,000 in cash. The Pactolus company had received 80,000 shares on which it was thenceforward only entitled to a fixed dividend of five per cent. These were now worth £80,000, and the Pactolus company sold them to a subsidiary company for that sum in cash.

The Pactolus company was, of course, liable to pay tax on the special dividends it received: but it was a company dealing in stocks and shares and as such it was entitled to deduct losses on its deals from the dividends it received. On the purchase and resale of the shares it had made a loss. It had bought the shares for £460,000 and sold them for £80,000—a loss of £380,000. That loss could be set against the special dividend which it had received of £460,000, leaving it with a net profit of only £80,000 on which it had to pay tax.

So much for the one company. Taking the transactions of all three companies together the result at the end of it all was that the motor companies distributed £1,764,136 as special dividends. Most

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of this found its way back to the original shareholders, who received £1,661,772 in cash, of which they had reinvested £1,185,631 as capital in the companies and kept £476,091 in cash. The Pactolus company had received 161,213 shares on which it was thenceforward entitled to a fixed dividend of five per cent. The Pactolus company had also retained £102,404 in cash.

It has not been disputed that all the transactions were genuine and not shams. They were all intended to have the effect they purported to have. If the commissioner is bound to accept them at their face value, then the shareholders have disposed of their shares for a capital payment of £1,661,772. They have derived no income and are not liable to tax thereon. If the transactions are to be questioned, it can only be by virtue of s. 260 of the *Income Tax and Social Services Contribution Assessment Act* 1936-1950 (Cth.). It is in these 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 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 Commissioner of Taxation says that the section covers this case because there was, he says, an " arrangement " which had or purported to have " the purpose or effect " of " avoiding " a " liability imposed " on any person by the Act.

Sir *Garfield Barwick*, for the taxpayers, submitted to their Lordships that the section had no application to this case. He put in the forefront of his argument two submissions which were not made to the High Court of Australia. First, Sir *Garfield Barwick* submitted that the section was of no effect at all. He referred to the history of the section and pointed out that before 1936 the words " as against the Commissioner " were not there. He said that in those days the section had only a social effect—an effect as between two or more subjects—not allowing one of them to put on to another the duty to make a return of tax or to bear it, and so forth. It had, he said, no fiscal effect—no effect, that is, as against the commissioner. Then in 1936, by inserting the words " as against the

Commissioner " the section was deprived of any effect as between subjects: and, as it already had no effect as against the commissioner, it had thenceforward no effect at all. The insertion of those words, he said, stultified the section. Their Lordships cannot accept this argument. They are quite clearly of opinion that long before 1936 the section had a fiscal effect. Its principal effect was to avoid transactions as against the commissioner—as in cases such as *Clarke* v. *Federal Commissioner of Taxation* (1). But it had—as originally drafted—an unexpected effect in that in *De Romero* v. *Read* (2) it was held to avoid a transaction between subjects. It seems to their Lordships that the reason for the insertion of the words " as against the Commissioner " was to do away with the decision in *De Romero* v. *Read* (2).

Next, Sir *Garfield Barwick* submitted that in s. 260 (*c*) the words " liability imposed on any person " meant a liability which had already accrued: and that " avoid " meant displace. He said that in order that an arrangement should be avoided, it must be an arrangement which sought to displace a liability which had already come home to a taxpayer—in respect of income which had already been derived by him. Their Lordships cannot accept this submission. They are clearly of opinion that the word " avoid " is used in its ordinary sense—in the sense in which a person is said to avoid something which is about to happen to him. He takes steps to get out of the way of it. It is this meaning of " avoid " which gives the clue to the meaning of " liability imposed ". To " avoid a liability imposed " on you means to take steps to get out of the reach of a liability which is about to fall on you. If the submission of Sir *Garfield Barwick* were accepted, it would deprive the words of any effect: for no one can displace a liability to tax which has already accrued due, or in respect of income which has already been derived. Their Lordships notice that, although this point was not raised in the High Court, *Taylor* J. did consider it and they find themselves in agreement with what he said upon it.

So much for Sir *Garfield Barwick's* new arguments. Their Lordships turn to consider the other points raised in the case. Their Lordships are of opinion that the word " arrangement " is apt to describe something less than a binding contract or agreement, something in the nature of an understanding between two or more persons—a plan arranged between them which may not be enforceable at law. But it must in this section comprehend, not only the initial plan, but also all the transactions by which it is carried into

(1) (1932) 48 C.L.R. 56. (2) (1932) 48 C.L.R. 649.

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effect—all the transactions, that is, which have the effect of avoiding taxation, be they conveyances, transfers or anything else. It would be useless for the commissioner to avoid the arrangement and leave the transactions still standing. The word " purpose " means, not motive, but the effect which it is sought to achieve—the end in view. The word " effect " means the end accomplished or achieved. The whole set of words denotes concerted action to an end—the end of avoiding tax.

But, said Sir *Garfield*, if such a wide interpretation is given to the words, where is the section to stop ? Does it enable the commissioner to avoid all transactions by which a man seeks to escape a liability to tax which is about to fall on him ? He gave numerous illustrations to show that the Parliament of Australia cannot have intended so sweeping a result. Take the case of a man who sells shares *cum* dividend—because he does not wish to pay the tax on the dividend when received : or of a private company which is turned into a non-private company in order to escape Div. 7 tax : and so forth. Can the commissioner go behind those transactions ?

The answer to the problem seems to their Lordships to lie in the opening words of the section. They show that the section is not concerned with the motives of individuals. It is not concerned with their desire to avoid tax, but only with the means which they employ to do it. It affects every " contract, agreement or arrangement " (which their Lordships will henceforward refer to compendiously as " arrangement ") which has the purpose or effect of avoiding tax. In applying the section you must, by the very words of it, look at the arrangement *itself* and see which is *its* effect—which *it* does—irrespective of the motives of the persons who made it. *Williams* J. put it well when he said " 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 " (1). In order to bring the arrangement within the section you must be able to predicate—by looking at the overt acts by which it was implemented—that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section. Thus, no one, by looking

(1) (1957) 96 C.L.R., at p. 630.

at a transfer of shares *cum* dividend, can predicate that the transfer was made to avoid tax. Nor can anyone, by seeing a private company turned into a non-private company, predicate that it was done to avoid Div. 7 tax, see *W. P. Keighery Pty. Ltd.* v. *Commissioner of Taxation* (1). Nor could anyone, on seeing a declaration of trust made by a father in favour of his wife and daughter, predicate that it was done to avoid tax, see *Deputy Federal Commissioner of Taxation* v. *Purcell* (2). But when one looks at the way the transactions were effected in *Jaques* v. *Federal Commissioner of Taxation* (3); *Clarke* v. *Federal Commissioner of Taxation* (4), and *Bell* v. *Federal Commissioner of Taxation* (5)—the way cheques were exchanged for like amounts and so forth—there can be no doubt at all that the purpose and effect of that way of doing things was to avoid tax.

Applying these principles to the present case, the first question is—Was there an arrangement? The answer is "Yes". The whole complicated series of transactions must have been the result of a concerted plan; and the nature of the plan is to be ascertained by the overt acts done in pursuance of it.

Next, what was the purpose of the arrangement? It can clearly be seen to be three-fold: (i) To increase the capital of the motor companies—and to do it by ploughing back over £1,000,000 of the profits into the businesses—and to do it in a way which would attract as little tax is possible. (ii) To enable the original shareholders to receive a large sum—nearly £500,000 in cash—without paying tax on it. (iii) To enable the Pactolus company to make a handsome profit in return for its part in the affair.

(It is to be noticed that—in so far as it was the purpose of the transaction to let the motor companies escape from the additional tax under Div. 7—this could have been effected by turning the motor companies into non-private companies.)

Finally, what was the effect of the arrangement? It was this: (i) The motor companies received new capital of £1,185,631—of which they were much in need for the conduct of their businesses. (ii) The original shareholders received a capital payment of £1,661,772 in return for the sale of shares, but had received no dividend on which they could be taxed. (iii) The motor companies distributed a dividend of £1,764,136 which was a sufficient distribution to enable them to avoid being liable for tax on undistributed profits under Div. 7. (iv) The Pactolus company made a profit on

(1) (1958) 32 A.L.J.R. 118; 11 A.T.D. 359.
(2) (1921) 29 C.L.R. 464.
(3) (1924) 34 C.L.R. 328.
(4) (1932) 48 C.L.R. 56.
(5) (1953) 87 C.L.R. 548.

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its share dealings. It had received 161,213 £1 shares: and it had also £102,404 in cash on which it was liable to pay tax.

It is clear from this analysis the avoidance of tax was not the *sole* purpose or effect of the arrangement. The raising of new capital was an associated purpose. But nevertheless the section can still work if one of the purposes or effects was to avoid liability for tax. The section distinctly says "*so far* as it has" the purpose or effect. This seems to their Lordships to import that it need not be the sole purpose.

Looking at the whole of this arrangement, their Lordships have no doubt that it was an arrangement which is caught by s. 260. The whole of the transactions show that there was concerted action to an end—and that one of the ends sought to be achieved was the avoidance of liability for tax.

This question then arises: What is the effect of s. 260 on that arrangement? It is quite clear that nothing is avoided as between the parties but only as against the commissioner. As against him the arrangement is "absolutely void" so far as it has the purpose or effect of avoiding tax. This is not a very precise use of the words "absolutely void". Ordinarily if a transaction is absolutely void, it is void as against all the world. In this case what is meant is that the commissioner is entitled completely to disregard the arrangement and the ensuing transactions—so far as they have the purpose or effect of avoiding tax. In the words of the Courts of Australia, it is an "annihilating" provision the commissioner can use the section so as to ignore the transactions which are caught by it. But the ignoring of the transactions or the annihilation of them—does not itself create a liability to tax. In order to make the taxpayers liable, the commissioner must show that ~~some~~ moneys have come into the hands of the taxpayers which the commissioner is entitled to treat as income derived by them. Their Lordships agree with the way in which *Fullagar* J. put it in his judgment: "Section 260 alters nothing that was done 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" (1).

In this case the commissioner must accept the arrangement in so far as it had the effect of creating special dividend rights in the original shareholders—for that did nothing to avoid tax: but he can ignore the arrangement in so far as the original shareholders transferred those dividend rights (with the shares) to Pactolus for

(1) (1957) 96 C.L.R., at p. 656.

money—for it was that transaction which gave the character of capital to the money received by the shareholders. When that transaction is ignored, it becomes apparent that special dividends were declared on shares which are to be deemed for this purpose to be still held by the original shareholders. Those dividends amount to £1,764,136 paid out by the company. If and so far as the commissioner can show that those special dividends reached the hands of the original shareholders, he is entitled to treat it as income derived by them from the shares. Now the commissioner can trace the sum of £1,661,772 in cash actually into the hands of the original shareholders. He is entitled, therefore, to treat it as income derived by them. He cannot trace the balance of £102,404 actually into their hands. It remained in the pocket of Pactolus Pty. Limited. It was ostensibly the profit of Pactolus on buying the shares. But when the transfer is ignored, that profit is seen to be nothing more nor less than remuneration which the original shareholders allowed Pactolus to retain for services rendered. The position is the same as if the shareholders had received it as part of the special dividend and then returned it to Pactolus as remuneration. The commissioner can therefore treat this £102,404 also as income derived by the shareholders.

The commissioner cannot avoid or ignore the taking up of 400,000 £1 preference shares: for that did nothing to avoid tax. Nor can he avoid or ignore the fact that Pactolus now holds 161,213 shares shorn of special dividend rights because that does nothing to avoid tax. He can only avoid or ignore the transfer is so far as it transferred the special dividend rights.

In the course of the argument Sir *Garfield Barwick* submitted that *Bell's Case* (1) was wrongly decided. In the opinion of their Lordships it was rightly decided and the exposition of the law there given by the High Court of Australia is a valuable guide to the true understanding of the section.

Sir *Garfield Barwick* sought to raise before their Lordships a further point which was not raised below. The commissioner assessed the shareholders in the tax due on the moneys received by them and in addition included a sum as a penalty under s. 226 (2) of the Act. This penalty amounts to over £600,000. Sir *Garfield* sought to say that s. 226 (2) did not apply because the taxpayer could not properly be said to have " omitted " the income from his return—seeing that it was not income when he received it or when he made his return—but only has become so *ex post facto* when the

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

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commissioner decided to treat it so. Their Lordships were not disposed to allow Sir *Garfield* to raise this point as it had not been raised before and does not appear in the case of the appellants—but in any case they think it is a bad point. In the events that have happened, the money has been determined to be assessable income. As such it ought to have been included—and has not. The taxpayer is therefore liable to the penalty.

Their Lordships will therefore, humbly advise Her Majesty that this appeal should be dismissed. The appellants must pay the costs.

Solicitors for the appellants, *A. F. & R. W. Tweedie.*

Solicitors for the respondent, *Coward, Chance & Co.*

R. D. B.