

HIGH COURT OF AUSTRALIA

GLEESON CJ,
GUMMOW, KIRBY, CALLINAN AND HEYDON JJ

COMMISSIONER OF TAXATION OF THE
COMMONWEALTH OF AUSTRALIA

APPELLANT

AND

SUN ALLIANCE INVESTMENTS PTY LIMITED
(IN LIQUIDATION)

RESPONDENT

*Commissioner of Taxation (Cth) v Sun Alliance Investments Pty Limited (in
liquidation) [2005] HCA 70
17 November 2005
S126/2005*

ORDER

- 1. Appeal allowed with costs.*
- 2. Set aside the orders of the Full Court of the Federal Court dated 9 March 2004 and, in their place, order that the appeal to that Court be dismissed with costs.*
- 3. Cross-appeal dismissed with costs.*

On appeal from the Federal Court of Australia

Representation:

G J Davies QC with R L Hamilton and S H Steward for the appellant (instructed by Australian Government Solicitor)

B J Shaw QC with M M Gordon SC and M T Flynn for the respondent (instructed by Maddocks)

Notice: This copy of the Court's Reasons for Judgment is subject to formal revision prior to publication in the Commonwealth Law Reports.

CATCHWORDS

Commissioner of Taxation (Cth) v Sun Alliance Investments Pty Limited (in liquidation)

Income tax – Capital gains and losses – Reduced amount of any consideration in respect of the acquisition of an asset – Royal and Sun Alliance Insurance Australia Holdings Limited ("RSA") formed by merger of the Royal Group and the Sun Alliance Group – RSA deemed by operation of s 160ZZS of the *Income Tax Assessment Act 1936* (Cth) ("the 1936 Act") to have acquired shares in two wholly owned subsidiaries on date of merger for a consideration equal to the market value of those shares on that date – Reconstructed accounts of subsidiaries showed unrealised accretions to the value of their assets at the merger date – Subsidiaries subsequently declared and paid dividends to RSA which attracted a rebate of tax payable on the dividends – RSA disposed of its shares in the subsidiaries and claimed capital losses on the disposals – Losses sought, in part, to be transferred to taxpayer – Whether, pursuant to s 160ZK of the 1936 Act, the consideration in respect of RSA's deemed acquisition of shares in the subsidiaries was required to be reduced by a rebatable dividend adjustment – Whether dividends distributed by the subsidiaries were attributable to profits derived by them before RSA's deemed acquisition of shares in those subsidiaries – Whether unrealised accretions to the value of assets must have permanent character in order to be profits – Whether unrealised profits can be said to be derived.

Words and phrases – "attributable to profits that were derived".

Income Tax Assessment Act 1936 (Cth), s 160ZK(5)(b).

1 GLEESON CJ, GUMMOW, KIRBY, CALLINAN AND HEYDON JJ. The respondent ("Sun Alliance") appealed to the Federal Court¹ from the disallowance by the appellant ("the Commissioner") of its objection to an amended income tax assessment in respect of Sun Alliance's year of income ending 31 December 1997. The amendment reduced by more than \$17 million certain capital losses claimed by Sun Alliance and consequently increased its taxable income. The losses in question had been incurred by Royal and Sun Alliance Insurance Australia Holdings Limited ("RSA") and, as permitted by the legislation, had been transferred to Sun Alliance. Sun Alliance was a wholly owned subsidiary of RSA. The losses were incurred in circumstances to which it will be necessary to refer in some detail.

2 The primary judge (Stone J) upheld the disallowance of the objection by Sun Alliance². An appeal by Sun Alliance to the Full Court (Lee, Sundberg and Conti JJ) was largely successful³ and the matter was remitted to the Commissioner for redetermination. The Full Court delivered a joint judgment. There is an appeal to this Court by the Commissioner and a cross-appeal by Sun Alliance.

3 Before turning further to consider the facts, something should be said of the provisions respecting capital losses upon which the litigation turns.

4 Part IIIA of the *Income Tax Assessment Act* 1936 (Cth) ("the 1936 Act") is headed "CAPITAL GAINS AND CAPITAL LOSSES" and comprises ss 160AX-160ZZU. The stated object of Pt IIIA is to provide for the inclusion in assessable income of net capital gains (ss 160AX, 160ZO(1)). Net capital losses are taken into account in accordance with s 160ZC but are not otherwise allowable as deductions (s 160ZO(2)). It is significant for this litigation that the application of Pt IIIA is confined to disposals of assets acquired on or after 20 September 1985 (s 160L(1)).

5 The present appeal and cross-appeal concern the treatment for income tax purposes of capital losses. The determination of the existence and amount of a capital loss requires a comparison between the reduced cost base of the asset (the

1 Under s 14ZZ of the *Taxation Administration Act* 1953 (Cth).

2 [2003] ATC 4171; (2003) 52 ATR 27.

3 (2004) 134 FCR 102.

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disposal of which by the taxpayer has given rise to the claimed loss) and the consideration received in respect of that disposal (s 160Z). The advantage to the taxpayer in establishing such a loss lies, not only in reduction to the taxpayer's net capital gain for the relevant year of income, but also in its availability, provided for in s 160ZC, for the loss to be carried forward to the immediately following year of income, to be absorbed by capital gains or to increase the net capital loss for that year.

6 Sections 160Z and 160ZC have been rewritten in ss 104-10 and 102-5 of the *Income Tax Assessment Act 1997* (Cth) ("the 1997 Act") respectively. This development is of no significance for the instant proceedings. The reason for this is to be found in s 1-3(2) of the 1997 Act, which provides that, where the 1997 Act appears to express in a simpler and clearer style the ideas in the 1936 Act, those ideas are not, for that reason alone, to be taken to be different.

7 The notion of "reduced cost base" is critical to the determination of a capital loss. As defined in s 160ZH(3) of the 1936 Act⁴, the reduced cost base of an asset is the sum of:

- "(a) the *reduced amount* of any consideration in respect of the acquisition of the asset;
- (b) the *reduced amount* of the incidental costs to the taxpayer of the acquisition of the asset;
- (c) the *reduced amount* of any expenditure of a capital nature incurred by the taxpayer to the extent to which it was incurred for the purpose of enhancing the value of the asset and is reflected in the state or nature of the asset at the time of disposal of the asset;
- (d) the *reduced amount* of any expenditure of a capital nature incurred by the taxpayer to the extent to which it was incurred in establishing, preserving or defending the taxpayer's title to, or a right over, the asset; and
- (e) the *reduced amount* of the incidental costs to the taxpayer of the disposal of the asset". (emphasis added)

4 The rewritten and reformulated rules for determining the reduced cost base of an asset which attracts capital gains tax may be found in subdiv 110-B of the 1997 Act.

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Each reference in this definition to a "reduced amount" was explained in s 160ZK(1), as enacted, as being a reference to the sum of:

- "(a) the amount of the consideration, the amount of the costs or the amount of the expenditure, as the case may be, reduced by any part of the consideration, of the costs or of the expenditure that has been allowed or is allowable, or would but for section 61 be allowable, as a deduction to the taxpayer in respect of any year of income; and
- (b) any amount that, as a result of the disposal of the asset by the taxpayer, is included in the assessable income of the taxpayer of any year of income by virtue of a provision of this Act other than this Part and is attributable to the part of the consideration, the part of the costs or the part of the expenditure, as the case may be, that was allowed or is allowable as a deduction".

Section 160ZK(5)

8 At issue in these proceedings is the proper construction of amendments made to s 160ZK by s 68 of the *Taxation Laws Amendment Act (No 2) 1994* (Cth) ("the Amending Act")⁵. The objective of those amendments was described as follows in the Explanatory Memorandum on the Bill for the Amending Act:

"4.2 The amendment will prevent a controller of a company or an associate of a controller from being able to generate a capital loss on the disposal of shares in the company in circumstances *where the controller or associate does not suffer an economic loss to the extent of that capital loss*.

4.3 Under the current law, a capital loss could be generated in relation to the disposal of shares in a company where there is no equivalent economic loss. This could arise where the shares are sold after the pre-acquisition profits of the company have been distributed in the form of rebatable dividends⁶. Pre-acquisition profits, in relation to a

5 These changes came into force on 23 June 1994, before the formulation of the 1936 Act appearing in Reprint No 9.

6 Sections 46 and 46A of the 1936 Act set out the circumstances in which a company, being a resident within the meaning of the 1936 Act and the recipient of a dividend from another resident company, may be entitled to a full or partial rebate of tax payable on that dividend. As was noted in the Explanatory (Footnote continues on next page)

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shareholding in a company, are profits retained in the company at the time the shareholding was acquired." (emphasis added)

- 9 The references to "*economic loss*" are significant. The objective so stated was pursued through the introduction into the 1936 Act of a new s 160ZK(1B). That sub-section, to which s 160ZK(1) is now expressed to be subject, provides:

"If the asset is a share, the amount worked out under subsection (1) is to be reduced by any rebatable dividend adjustment that arises in relation to the share (see subsection (5))."

Sub-section (5)⁷, in turn, provides that a rebatable dividend adjustment arises in relation to a share ("the RDA share") if four criteria specified in pars (a)-(d) are satisfied. It is the construction of par (b) which is critical for the present litigation. The paragraphs state:

- "(a) under an arrangement, a company makes a distribution to the holder of the RDA share; and
- (b) an amount (the '**attributable amount**'), being the whole or a part of the distribution, *could reasonably be taken to be attributable to profits that were derived by the company before the holder acquired the RDA share*; and
- (c) the holder of the RDA share is entitled to a rebate of tax (the '**dividend rebate**') in the holder's assessment for a year of income under section 46 or 46A in respect of an amount (the '**dividend amount**') being so much of the distribution as is a dividend; and
- (d) the holder of the RDA share is, at any time during the period in which the arrangement is made or carried out, a controller^[8] of the

Memorandum (par 4.10), "[a] full rebate has the effect of freeing the dividend from tax while a partial rebate reduces the tax payable on that dividend".

7 A rewritten form of this provision appears as s 110-55(7) of the 1997 Act.

8 The term "controller" is defined in s 160ZZRN(1) of the 1936 Act. There is no dispute in these proceedings as to the application of that definition.

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company or an associate⁹] of a controller of the company".
(emphasis added)

Sub-section (6) then sets out diagrammatically the formula by which the amount of the rebatable dividend adjustment is calculated:

"Attributable amount \times $\frac{\text{Amount of the dividend rebate}}{\text{Dividend amount}} \times \frac{\text{General company}}{\text{tax rate}}$ ".

10 In the judgments both of the primary judge and of the Full Court reference was made, for the purpose of assisting in the construction of s 160ZK(5), to an example provided in the Explanatory Memorandum of a situation in which that sub-section was to be engaged. That example is worth setting out at length:

"Company X acquired all the shares of company Y for their market value of \$10,000. At the time of acquisition of the shares, the balance sheet of company Y was as follows:

Share capital	\$ 2,000
Retained profits	<u>\$ 8,000</u>
	\$10,000
Assets	\$10,000

Company Y continued business operations over the next four years. During this period, it distributed all of its current earnings as well as the retained profits. Company X then disposed of the shares in company Y for \$2,000.

4.5 The dividends paid by company Y to company X qualified for the dividend rebate under section 46 of [the 1936 Act]. Consequently, no company tax was paid on those dividends. Moreover, company X has recovered the full amount of its investment of \$10,000 in company Y in the form of dividends (\$8,000) and disposal consideration (\$2,000). *Nevertheless, under the current law, company X may claim a capital loss*

9 The persons who may be described as "associates" for the purposes of s 160ZK(5) are identified in s 318.

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of \$8,000. This is the difference between the cost of the shares (\$10,000) and the disposal consideration (\$2,000).

4.6 The anti-avoidance provisions of Part IVA of [the 1936 Act] could apply where there is a scheme by way of or in the nature of dividend stripping or a scheme having substantially the effect of a scheme by way of or in the nature of dividend stripping. *However, it should be the general rule that a capital loss should not be able to be claimed where the result of the course of action is that there is no economic loss to the taxpayer.*

4.7 The amendments to the law will have the effect that a capital loss cannot be claimed by company X in the circumstances shown in the example." (emphasis added)

11 The contrast between the above example and the facts which have given rise to the present litigation discloses the main points of contention between the parties. The most salient of these is a dispute concerning the meaning of the phrase in par (b) of s 160ZK(5), "profits that were derived by the company". That dispute revolves around the question whether a profit can be said to have been derived at a time before the acquisition of the relevant shares by the taxpayer if, at the date of acquisition, a gain to the company (specifically an accretion in the value of some part, or all, of its asset portfolio) remained unrealised, albeit ascertained. The submissions by the Commissioner that the question should be answered "yes" should be accepted. To explain why that should be the outcome of the dispute it is convenient first to return to the facts.

The merger

12 Royal Insurance plc ("RIPLC") was a company incorporated in England and the beneficial owner of all the issued shares in Royal Australia Holdings Limited ("RAHL"). In an agreement ("the Merger Agreement") dated 8 October 1992 ("the merger date"), RIPLC agreed to sell its entire shareholding in RAHL to RSA (then styled "Sun Alliance Australia Limited"). As consideration, RSA agreed both to pay RIPLC a sum of \$A125 million and to issue to it an allotment of fully paid ordinary shares in RSA. This would, after issue, represent 40 per cent of the issued ordinary share capital in that company. Prior to the Merger Agreement, the beneficial owner of all of the issued shares in RSA had been Sun Alliance Holdings Limited ("SAHL").

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13 The Royal and Sun Alliance Group ("the RSA Group"), which represented a merger between the Royal Group and the Sun Alliance Group, was thus formed, with RSA as its Australian holding company.

14 As at the merger date, Phoenix Securities Pty Limited ("Phoenix") and Sun Alliance Insurance Ltd ("SAIL") were wholly owned subsidiaries of RSA. The shareholding of RSA in these companies pre-dated 20 September 1985. However, the 40 per cent change in ownership of RSA that was contemplated in the Merger Agreement, coupled with various other developments that had occurred between 1985 and the merger date, resulted in a change in the majority underlying interests in RSA. As a result of this, the shares held by RSA in both Phoenix and SAIL were, by operation of s 160ZZS of the 1936 Act¹⁰, deemed to have been acquired by RSA after 19 September 1985 (specifically, on 8 October 1992) for a consideration equal to their market value on that date. The market value of the shares in Phoenix on 8 October 1992 was \$28,477,898, and that of the shares in SAIL \$98,728,974.

15 The present appeal by the Commissioner and cross-appeal by the taxpayer relate to capital losses claimed by RSA upon its disposal of shares in both Phoenix and SAIL. As already noted, these losses were subsequently, in part, transferred to the taxpayer, which was itself a wholly owned subsidiary of RSA¹¹. It is important to note, for purposes of what follows, that RSA's years of income ended on 31 December.

10 Section 160ZZS(1) of the 1936 Act provides:

"For the purposes of the application of this Part in relation to a taxpayer, an asset acquired by the taxpayer on or before 19 September 1985 shall be deemed to have been acquired by the taxpayer after that date unless the Commissioner is satisfied, or considers it reasonable to assume, that, at all times after that date when the asset was held by the taxpayer, majority underlying interests in the asset were held by natural persons who, immediately before 20 September 1985, held majority underlying interests in the asset."

11 Section s 160ZP(7) contemplates the possibility of loss transfer agreements entered into by member companies of the one corporate group.

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Phoenix

16 Until its dissolution in 1997, Phoenix conducted a business of equity investments. This was consistent with the practice of insurance groups holding equities in separate vehicles to attract a tax rebate under s 46 of the 1936 Act. Phoenix held shares in companies listed on the Australian Stock Exchange. Prior to 1992, no formal accounts were prepared at the entity level for companies then in the Sun Alliance Group, of which Phoenix was one.

17 However, after the merger, shifts in the value of the shares held by Phoenix were reflected in its accounts, in accordance with Australian Accounting Standards Review Board requirement AASB 1010, as increments and decrements in its asset revaluation reserve. The affidavit evidence of Mr Harold Bentley, the Chief Financial Officer of RSA, suggests that it was the practice of the RSA Group to value those shares on a monthly basis and that these valuations disclosed significant monthly fluctuations in the value of Phoenix's portfolio of investments.

18 In this Court, the Commissioner contended that, as at the merger date, the shares held by Phoenix were valued at cost at \$8,928,016. They were then revalued at the time of the merger to a market value of \$20,728,138, reflecting what was said to be an unrealised gain in Phoenix's asset revaluation reserve of \$11,800,122.

19 However, to accept this particular description of the method by which the accretions in the value of Phoenix's share portfolio were recorded is to misunderstand the accounting systems that had been adopted by the Sun Alliance Group before the merger date. Prior to the financial year ended 31 December 1986, investments were stated in the accounts of the Sun Alliance Group at their historical cost. Thereafter, in the period between 31 December 1986 and 31 December 1992, assets were revalued and increases or decreases in value were taken to an asset revaluation reserve on an annual basis. In other words, at the merger date (8 October 1992) and reflected in its management accounts, Phoenix's investments had last been revalued at 31 December 1991.

20 The figures upon which the Commissioner relies were taken from an analysis of Phoenix's investments that had been undertaken subsequently by Arthur Andersen upon instructions from the Australian Government Solicitor. However, it is also true that a reconstructed balance sheet for Phoenix as at the merger date had been prepared in response to an information request from the Commissioner.

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21 In any event, Phoenix's investments were progressively realised during the period from 1994 to 1996 inclusive for an aggregate sum of \$30,159,729. This yielded a realised profit of \$21,231,714.

22 On 30 October 1992, less than a month after the merger date, Phoenix declared and paid a dividend of \$12 million to RSA, sourced only from its retained profits and gains on investments realised prior to the declaration of the dividend. Subsequent to this, as at 31 December 1992, the retained profits of Phoenix were \$438,842, and the balance in its investment realisation reserve was \$2,621,991.

23 Phoenix's after-tax operating profit for the financial year ended 31 December 1993 came to \$1,103,542. Given that there was no distribution made to RSA in 1993, it began the financial year ended 31 December 1994 with retained profits amounting to \$1,542,384. This, when added to its after-tax operating profit for that financial year of \$4,313,187 and allowing for the transfer from this sum of \$3,235,228 to its investment realisation reserve, left sufficient from which to declare and pay to RSA a dividend of \$650,000 on 25 May 1994. The retained profits of Phoenix at the end of the financial year ended 31 December 1994 thus amounted to \$1,970,343.

24 For the financial year ended 31 December 1995, Phoenix's after-tax operating profit was \$2,774,904, with \$1,604,683 transferred to its investment realisation reserve. Taking into account its retained profits from the previous financial year, the total sum available to Phoenix for appropriation was \$3,140,564, of which \$3,100,000 was paid on 28 December 1995 as a dividend to RSA and \$40,564 kept as retained profits.

25 In the following financial year, that ended 31 December 1996, Phoenix reported an after-tax operating profit of \$18,897,352 and transferred from its investment realisation reserve a sum of \$7,461,902. It was thus able early in September 1996 to pay to RSA a dividend of \$20,891,449.

26 There is no dispute that the dividends paid by Phoenix attracted the rebate provided for in s 46 of the 1936 Act. However, in the present appeal, Sun Alliance submitted that the facts outlined above were sufficient to establish that the dividends paid to RSA after 30 October 1992 were attributable to profits derived by Phoenix *after* the merger date; it followed that par (b) of s 160ZK(5) was not satisfied.

27 Phoenix was liquidated on 30 December 1997. RSA received \$5,835,661 in respect of its Phoenix shareholding. In estimating the capital loss incurred as a

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result of this, RSA reduced the cost base of its shares in Phoenix by attributing only the dividend of \$12 million paid on 30 October 1992 to profits derived before the merger date. The capital loss claimed by RSA thus came to \$10,642,237. It will be necessary later to return to this in detailing the substance of the Commissioner's response to RSA's self-assessment.

SAIL

28 SAIL carried on the business of general insurance. Prior to the introduction of AASB 1023¹², which took effect for the RSA Group during the financial year ended 31 December 1992, SAIL's accounts were prepared in accordance with the above-described practice and policy of the Sun Alliance Group. Put simply, there was not at the merger date a formal balance sheet available in respect of SAIL. However, in the period subsequent to the merger, it was the practice of the RSA Group, in accordance with AASB 1023, to recognise changes in the value of its investments as revenue or expenses in the profit and loss account; unrealised gains were transferred to an asset revaluation reserve known as the unrealised profits reserve.

29 At the time of the merger which resulted in the formation of the RSA Group, SAIL's assets included land and buildings located in Bridge Street, Sydney ("the Bridge Street properties"). The evidence of Mr Bentley suggests that RIPLC (heading the Royal Group) had a policy of not owning land and buildings, and that it considered the real estate investments contributed by RSA and its subsidiaries to the assets of the RSA Group to be an over-weighted risk within the RSA Group's asset portfolio. Therefore, in order to protect RIPLC from any risks and costs associated with holding the Bridge Street properties, all the potential gains and risks attendant upon that continued holding were acquired or assumed by a new company, Bridge Street Buildings Pty Ltd ("BSBPL"). This was wholly owned by SAHL.

30 The potential gains and risks thus identified were passed to BSBPL through, among other things, the Merger Agreement. The combined effect of cl 14 and Sched 10 of that instrument was that, if before 1 October 1999 the Bridge Street properties were sold for a price less than the valuation pertaining at the merger date, then BSBPL would make up the shortfall. Conversely, were the

12 This accounting standard requires an insurer to value investments integral to its insurance business on a "mark to market value basis" and to reflect those valuations in its profit and loss statements.

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sale price to exceed the valuation pertaining at the merger date, then the excess would be paid to BSBPL. It should also be noted that, on 2 November 1992, SAIL, RIPLC, BSBPL and SAHL entered into an agreement under the terms of which SAIL granted a sale option over the Bridge Street properties to BSBPL.

31 As at the merger date, the Bridge Street properties were valued at \$57,050,000. The historical cost of the properties was \$29,550,000. So it was that, after providing for deduction of certain unrealised losses, a balance of \$21,345,000 was recorded in the unrealised profits reserve in the Special Purpose Financial Report for SAIL for the financial year ended 31 December 1992.

32 On 31 August 1995, the Bridge Street properties were sold to a third party for a sum of \$38,623,500. The difference between this amount and the \$57,050,000 valuation pertaining on the merger date was thus met, pursuant to cl 14 and Sched 10 of the Merger Agreement, by BSBPL. As a result, there was realised the sum of \$21,345,000, already identified as the unrealised gain at the time of the merger on the Bridge Street properties.

33 On 30 October 1992, SAIL declared and paid to RSA a dividend of \$50 million.

34 The realised profits retained by SAIL at the merger date amounted to \$9,562,000. Much of this was used to meet an operating loss of \$7,732,000 incurred in the financial year ending 31 December 1993. Subsequently, in the years ending 31 December 1994 and 31 December 1995, SAIL earned after-tax operating profits of \$11,896,000 and \$1,266,000 respectively. These sums, combined with the balance of the profits retained at the merger date and the above-mentioned sum of \$21,345,000, amounted to \$36,337,176. In September 1996, the whole of that amount was distributed by SAIL to RSA as a rebatable dividend.

35 Thereafter, by an agreement dated 11 December 1996 and for a sum of \$11,108,952, SAIL bought back from RSA all but two of the issued shares in SAIL held by RSA. In calculating the amount of the capital loss thus incurred by it, RSA applied s 160ZK(1B) and (5) and deducted from the reduced cost base of those shares a sum comprising the whole of the \$50 million dividend paid on 30 October 1992 and \$9,562,000 of the \$36,337,176 dividend paid in September 1996. The capital loss claimed by RSA came to \$28,058,022.

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Transfer of losses

36 In its tax return for the year ended 31 December 1996, RSA claimed \$28,216,603 in net capital losses, of which a sum in the amount of \$10,416,262 was the subject of capital loss transfer agreements. In particular, an amount of \$2,958,296 was transferred to the taxpayer.

37 For the year ended 31 December 1997, RSA claimed a net capital loss of \$34,558,733. Of this, an amount of \$25,179,289 was transferred to the taxpayer, Sun Alliance, pursuant to s 160ZP(7), as explained earlier in these reasons.

38 Proceedings were instituted to liquidate Sun Alliance during the course of that year. It lodged two returns of income covering 1 January to 31 July 1997 and the liquidation period 1 August to 31 December 1997. In the first of these returns, it claimed a capital loss of \$693,788 transferred from RSA and, in the second, it claimed the balance of the capital losses transferred, namely a sum in the amount of \$24,485,501. Sun Alliance since has been reinstated under a court order and with the approval of the Australian Securities and Investments Commission.

The amended assessment

39 On 24 December 1998, a notice of amended assessment in respect of the taxpayer was issued. In relation to the capital loss returned by RSA following the liquidation of Phoenix, the Commissioner attributed an additional \$14,522,391 of the rebatable dividends paid to RSA after 30 October 1992 to profits derived before the deemed acquisition by RSA of its shares in Phoenix. This had the result of eliminating entirely the capital loss claimed by RSA. As for the capital loss incurred as a result of RSA's disposal of shares in SAIL, the Commissioner treated as attributable to profits derived before the deemed acquisition by RSA of those shares a further amount of \$8,128,000 of the dividend paid in September 1996. The net effect of these adjustments was a \$17,080,524 reduction in the net capital loss that had been available for transfer by RSA to the taxpayer.

40 On 22 December 1999, the taxpayer lodged a notice of objection to the amended income tax assessment. This objection was disallowed, with written reasons, by the Commissioner on 23 February 2000.

The proceedings

41 As already noted, the Commissioner was successful before Stone J. In its decision allowing the taxpayer's appeal, the Full Court held that the accretions in the value of Phoenix's share portfolio as at the merger date did not have a sufficiently "permanent character" to be accorded the status of "profit"¹³. The Full Court also held that no error was made by the Commissioner in attributing to profits derived by SAIL before the merger date the amount of \$17,688,000 of the total dividend of \$36,337,000 paid to RSA¹⁴. It is against this part of the decision of the Full Court that the taxpayer now cross-appeals.

"Profits that were derived"

42 The process of construing s 160ZK(5) of the 1936 Act begins with the recognition that the meaning of the word "derived", as it appears in that provision, cannot be ascertained without at least some reference to the thing being said to be derived, namely the profits of a company. The need for this first step is explained by the circumstance that the concept of profits is all too easily conflated in this field of discourse with that of income.

43 Such conflation should be avoided. A distinction is drawn in income tax law between the case where a taxpayer in relation to an item is treated as on a cash basis of tax accounting and that where the taxpayer is on an accruals basis. But "[f]or the most part, the law expresses an ordinary usage notion of derivation of a receipt"¹⁵. Thus the notion of income directs one's attention to "receipts"¹⁶ by a taxpayer – or, as Lord Macnaghten put it, "what goes into his pocket"¹⁷. This quality may not so readily be attributed to "profits", as that concept is generally understood. This much is apparent from a reading of what was said in an oft-cited passage from the judgment of Fletcher Moulton LJ in *In re Spanish Prospecting Co Ltd*¹⁸. That case concerned the construction of a provision in a

13 (2004) 134 FCR 102 at 133.

14 (2004) 134 FCR 102 at 133-134.

15 Parsons, *Income Taxation in Australia*, (1985), §2.10.

16 *Scott v Commissioner of Taxation* (1935) 35 SR (NSW) 215 at 219.

17 *Tennant v Smith* [1892] AC 150 at 164.

18 [1911] 1 Ch 92.

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service agreement that a salary was to be drawn "only out of profits (if any) arising from the business of the company which may from time to time be available for such purpose". His Lordship said¹⁹:

"Profits' implies a comparison between the state of a business at two specific dates usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at the two dates.

For practical purposes these assets in calculating profits must be valued and not merely enumerated. An enumeration might be of little value. *Even if the assets were identical at the two periods it would by no means follow that there had been neither gain nor loss, because the market value – the value in exchange – of these assets might have altered greatly in the meanwhile.*" (emphasis added)

These words have since been described by Gibbs CJ as setting down a "guide" rather than a "dictum ... of universal application"²⁰. Nonetheless, the notion that a profit may be revealed or disclosed by a revaluation even where the composition of the assets held by a business does not change²¹ appears at odds with the focus, naturally attendant upon discussions of the "ordinary usage" concept of income, on receipts coming into a taxpayer's hands.

44 It is for this reason that little assistance is to be found, for present purposes, in statements in cases such as *Federal Commissioner of Taxation v Thorogood*²² and *Carden's Case*²³. There, the question was whether the return of income on a cash basis or an earnings basis better discovered the gains which during the period of account have "come home to the taxpayer in a realized or

19 [1911] 1 Ch 92 at 98-99.

20 *Federal Commissioner of Taxation v Slater Holdings Ltd* (1984) 156 CLR 447 at 460.

21 See also the judgment of Latham CJ in *Dickson v Federal Commissioner of Taxation* (1940) 62 CLR 687 at 705, 712.

22 (1927) 40 CLR 454 at 458.

23 *Commissioner of Taxes (SA) v Executor Trustee and Agency Co of South Australia Ltd* (1938) 63 CLR 108 at 155.

immediately realizable form"²⁴. This well-known statement by Dixon J in *Carden's Case* should not be taken, as it was in this case by the Full Court²⁵, as providing a test for determining the applicability in a given case of s 160ZK(5)²⁶.

45 The taxpayer rightly submitted in this appeal that the word "derived" in that sub-section takes its meaning from its context. There is, as a consequence, some danger in seeking to rely upon those past authorities which have considered the content of the words "profits" and "derived" in isolation from each other.

46 One example of this may be found in the reliance by both the Full Court and the taxpayer in submissions on this appeal upon the decision of Lockhart J in *QBE Insurance Group Ltd v Australian Securities Commission*²⁷. His Honour held that a particular accounting standard did not convert into profits that which was incapable of the conversion and was not inconsistent with the prohibition in company law upon payment of dividends except out of profits. The standard was designed to require companies carrying on the business of general insurance to bring into account unrealised gains or losses on investments. However, *QBE* was taken by the Full Court²⁸ as authority for the general proposition that an unrealised accretion to the value of an asset may constitute a profit only where it is "of a permanent character"²⁹. It will be necessary to return to the matter of the correctness and width of this proposition later in these reasons. Presently, something should be said about the decisions of this Court in *Evans v Deputy*

24 *Carden's Case* (1938) 63 CLR 108 at 155; cf *Henderson v Federal Commissioner of Taxation* (1970) 119 CLR 612 at 646-647.

25 (2004) 134 FCR 102 at 133.

26 Other examples in which the term "derived" was considered in relation to the return of income include *Federal Commissioner of Taxation v Clarke* (1927) 40 CLR 246 at 261; *Tindal v Federal Commissioner of Taxation* (1946) 72 CLR 608 at 624; *Brent v Federal Commissioner of Taxation* (1971) 125 CLR 418 at 427-428.

27 (1992) 38 FCR 270.

28 (2004) 134 FCR 102 at 133.

29 (1992) 38 FCR 270 at 287.

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*Federal Commissioner of Taxation (SA)*³⁰ and *Read v The Commonwealth*³¹. Both involved some consideration of the compound concept "profits derived".

Evans and Read

47 It is convenient to deal first with what was said in *Read*. That case concerned the construction of s 18 of the *Social Security Act* 1947 (Cth) ("the Social Security Act"). This defined the term "income" as follows:

"'income', in relation to a person, means any personal earnings, moneys, valuable consideration or profits earned, derived or received by that person for his own use or benefit by any means from any source whatsoever".

The question was whether the issue of additional units in a unit trust to the appellant unit holder constituted "income" for the purpose of determining her pension entitlements under the Social Security Act. Noting that the gain represented by the additional units was an unrealised gain in the hands of the appellant, Mason CJ, Deane and Gaudron JJ said³²:

"In our opinion a mere increase in the value of an asset does not amount to a capital profit. A profit connotes an actual gain and not mere potential to achieve a gain. Until a gain is realized it is not 'earned, derived or received'. A capital gain is realized when an item of capital which has increased in value is ventured, either in whole or in part, in a transaction which returns that increase in value."

48 Counsel for the taxpayer in this appeal sought, during the course of oral argument, to call this statement in aid, submitting that, though *Read* was a decision ultimately concerned with social security and therefore coloured by the considerations arising in that particular context, the authorities cited therein related, in the words of the Full Court³³, "to relevant concepts of income". However, to the extent that the decision in *Read* did refer to concepts of income,

30 (1936) 55 CLR 80.

31 (1988) 167 CLR 57.

32 (1988) 167 CLR 57 at 67.

33 (2004) 134 FCR 102 at 121.

this manifested itself only in an assumption, apparent in the reasoning of Mason CJ, Deane and Gaudron JJ, that, in applying s 18 of the Social Security Act, the notion of capital profits is to be equated with that of capital gains, in the sense of realised capital gains³⁴.

49 This assumption may be contrasted with the proposition, established in a series of cases dealing with the prohibition against the payment of dividends by companies except out of profits³⁵, that the concept of profits in the context of company law is sufficiently broad to embrace unrealised capital profits. The meaning here of "profits" was said by Higgins J in 1910 not to be "rigid and absolute" and to be dependent upon the context in which it is being deployed³⁶. There is nothing in the text of s 160ZK(5) to suggest that an equation similar to that drawn in *Read* should be adopted in construing that sub-section. The present utility of the statements made in the course of deciding *Read* may therefore be doubted. Whether similar doubt attends what was earlier said in *Evans* is the subject of what follows.

50 At issue in *Evans* were the construction and application of s 16(b)(i)(1) of the *Income Tax Assessment Act* 1922 (Cth) ("the 1922 Act"). Subject to a presently immaterial proviso, that provision included within the assessable income of any resident shareholder in a company those dividends, bonuses or profits paid or distributed by the company to the shareholder out of profits derived by the company from any source. The relevant dividend in this case was a distribution made among its shareholders by Guinea Gold NL ("Guinea Gold") which consisted, in part, of shares in another company, New Guinea Goldfields Ltd ("NGGL"). Those shares had been acquired by Guinea Gold as part of the consideration for which it sold to NGGL certain gold mining leases it owned in respect of land in New Guinea. The total value of that consideration was exceeded by the amount which had been expended by Guinea Gold in connection with the leases.

34 (1988) 167 CLR 57 at 66-67.

35 *Dimbula Valley (Ceylon) Tea Co Ltd v Laurie* [1961] Ch 353 at 371; *Marra Developments Ltd v B W Rofe Pty Ltd* [1977] 2 NSWLR 616 at 629; *Hancock Family Memorial Foundation Ltd v Porteous* (2000) 156 FLR 249 at 277.

36 *Webb v Australian Deposit and Mortgage Bank Ltd* (1910) 11 CLR 223 at 241.

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51 The taxpayer was an Australian resident and a shareholder in Guinea Gold. On appeal to this Court, he submitted that, as the shares in NGGL did not contain any profits, their market value should not have been included in his assessable income. This submission was rejected by Rich, Dixon and Evatt JJ. In a statement upon which the Commissioner relied, their Honours said³⁷:

"In the first place, the fact that the shares contain no profit on the sale of the leases does not mean that they represent capital and not profit of the company. Actually they represented surplus assets, that is, assets not required to make good issued share capital. This appears from the last preceding balance-sheet. In the second place, s 16(b)(i)(1) brings into charge all dividends and distributions out of profit, whatever be the nature of the profit. The word 'derived' does not connote that the profit must be a realized profit. *It is enough at least if it is an ascertained profit, ascertained by a proper account.* Under the articles [of Guinea Gold], the 5s 6d contained in the share could not lawfully be distributed, except as a dividend satisfied by specific assets, and the dividend must be out of profits. The meaning of profits in s 16(b)(i)(1) is no narrower, and the state of the company's affairs, as disclosed by its balance-sheet, permitted such a dividend. It follows that the whole amount of the 5s 6d per share should be included in the appellant's assessable income." (emphasis added)

52 Two points may be made about this passage. First, contrary to the submission advanced by the Commissioner, their Honours' reference to the "surplus assets" of a company was not intended as a definition of the term "profits". It was directed instead towards demonstrating the error in the taxpayer's contention that the shares distributed by Guinea Gold were somehow representative of a sum on its capital account. However, as will later appear, the reference in the emphasised sentence to ascertainment by a proper account does assist the Commissioner.

53 Secondly, the provision in the 1922 Act which was construed and applied in *Evans* was the precursor to s 44 of the 1936 Act. That section provides in broadly similar terms to s 16(b)(i)(1) of the 1922 Act. This leads one to ask: if, for the purpose of defining a component of assessable income, the 1936 Act contemplates the possibility of dividends being paid out of unrealised profits, then why, for the purpose of prescribing the rules by which a capital loss is to be

37 (1936) 55 CLR 80 at 101.

calculated, should the application of the statute be confined to distributions reasonably attributable to, as distinct from distributions paid out of, profits that have been realised? In other words, what is there in the 1936 Act to limit the scope in s 160ZK(5) of the compound concept "profits derived" so that it is narrower there than in s 44?

54 This question is all the more significant for the fact that, in the Explanatory Memorandum on the Bill for the Amending Act, it was made very clear that the mischief towards which s 160ZK(5) was directed was a situation in which the controlling shareholder in a company could claim a capital loss on disposing of its shares in that company, despite not having incurred an equivalent economic loss. It suffices presently to say that, *prima facie*, the concept of economic loss does not respect the distinction between realised and unrealised gains and losses.

Section 160ZLA

55 In its submissions before this Court, the taxpayer argued that the answer to the question posed above lies in s 160ZLA(4) of the 1936 Act, which was enacted at the same time as s 160ZK(5)³⁸.

56 The essence of the taxpayer's submission is that, in referring expressly to a situation where rebatable dividends are paid out of revaluation reserves, s 160ZLA(4) operated to exclude from the ambit of the general terms in s 160ZK(5) the payment of such dividends.

57 It is unnecessary to set out the text of s 160ZLA(4). It was made clear in sub-s (1) of s 160ZLA that the rebatable dividend adjustments provided for in that section were intended only to bear upon the application of ss 160ZA and 160ZL of the 1936 Act. The first of these sections addresses the capital gains tax consequences where a capital gain has accrued to a taxpayer because of the disposal of an asset, but where, as a result of that disposal, an amount ("the included amount") will also be included in the taxpayer's assessable income under a provision of the 1936 Act other than Pt IIIA. For the purposes of that section, the amount of a rebatable dividend adjustment in relation to a share was

38 By s 70 of the Amending Act. Section 160ZLA was repealed by the *Taxation Laws Amendment Act (No 3) 1995* (Cth), Sched 1, Item 32; that Act introduced s 46H as one of a number of provisions dealing with disallowance of the rebate for certain dividends.

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taken not to be able to constitute an included amount (s 160ZA(4A)(b)). In contrast, as to s 160ZL, a rebatable dividend adjustment in relation to a share is taken, for the purposes of determining the capital gains tax consequences of a return of capital by a company to its shareholders, to be a non-dividend payment by the company to the taxpayer.

58 Neither provision touched then upon the calculation, for the purposes of Pt IIIA, of the reduced cost base of an asset. It cannot be said then that s 160ZLA(4), as enacted, was intended in any way to affect the construction of s 160ZK(5). These two sub-sections had, as the Commissioner rightly contended before the Full Court, "distinct and separate fields of operation"³⁹. Accordingly, the submissions advanced by the taxpayer, both on this point and in relation to the wider proposition that s 160ZK(5) is engaged only where a company's profits are realised, must be rejected.

The Merger Agreement

59 It should also be observed that the unrealised gains in the value, both of the shares held by Phoenix and the Bridge Street properties, were, in a sense, turned to account on the date of the merger between the Royal and Sun Alliance Groups. Contributions to the capital of the merged RSA Group were made by the Royal Group as to 40 per cent, and by the Sun Alliance Group as to 60 per cent, based on valuations of their respective assets as at the merger date. These valuations were required, pursuant to the terms of the Merger Agreement, to be reflected in a consolidated balance sheet for each of the Royal Group and the Sun Alliance Group as at 30 September 1992 ("the Completion Accounts"), where, following a series of adjustments, they would supply the basis for determining the monetary amounts of the contributions to be made. It was in this sense that value was given for the assets, both of Phoenix and of SAIL.

60 To say this, however, is not to dispose fully of the taxpayer's contentions.

Unrealised accretions in value "of a permanent character"

61 As was noted by Fletcher Moulton LJ in *Spanish Prospecting*, the word "profits", as it is generally understood, implies a gain made by a business and disclosed by a comparison between the state of that business at one point in time and its state at another. In a passage in *Evans* which has been set out earlier in

39 (2004) 134 FCR 102 at 130.

these reasons, Rich, Dixon and Evatt JJ indicated that it was sufficient to establish the derivation of a profit that it be ascertained by a proper account⁴⁰. It might be said then that at the very least, in contexts other than s 160ZK(5) of the 1936 Act, the compound concept of "profits derived" suggests an amount revealed by some process of computation or accounting.

62 However, the taxpayer submitted that more is required in order to establish "profits" than the process of comparison and computation described above: it is necessary also that one be able to ascribe a quality of permanence to the gain represented by the amount so calculated. This was accepted by the Full Court and provided the basis for its holding that the "[i]ncrements in value emerging from the valuations for the time being of the Phoenix share portfolio cannot realistically be characterised as having been derived pending ultimate realisation"⁴¹.

63 The "permanent character" requirement thus adopted was said to have originated from a dictum of Lockhart J in *QBE*⁴². His Honour gave extended consideration in that case to the concept of profits⁴³. However, as already noted, this was in the context of a discussion of s 201(1) of the Corporations Law, which provided that "[n]o dividend shall be payable to a shareholder of a company except out of profits or under section 191". The basis for the prohibition against the payment of dividends except out of profits was explained by Mason J in *Industrial Equity Ltd v Blackburn* in the following terms⁴⁴:

"The principle, which was certainly designed to protect creditors and, I think, shareholders, more particularly where there is more than one class of shareholder in a company, inhibits the payment by way of dividends out of a company's capital. It is founded on the proposition recognized in

40 (1936) 55 CLR 80 at 101. See also the remarks of Lord Herschell in *Russell v Town and County Bank* (1888) 13 App Cas 418 at 424.

41 (2004) 134 FCR 102 at 133.

42 (1992) 38 FCR 270 at 287. See also *Dimbula Valley (Ceylon) Tea Co Ltd v Laurie* [1961] 1 Ch 353 at 372.

43 (1992) 38 FCR 270 at 284-289.

44 (1977) 137 CLR 567 at 576.

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*Trevor v Whitworth*⁴⁵ that a reduction of capital can only be effected in accordance with the statutory procedure and that there can be no return of capital except in accordance with that procedure – *In re Exchange Banking Co (Flitcroft's Case)*⁴⁶. The rule is frequently expressed, as here, in the form of a prohibition against dividends being payable except out of profits."

64 It should also be noted, given the use of the word "payable", as distinct from "paid", in s 201(1), that the prohibition therein set down was directed to the declaration of a dividend, and not merely its payment⁴⁷. This may account, in large measure, for Lockhart J's adoption in *QBE* of a requirement, where an unrealised accretion to the value of a company's assets is sought to be treated as a profit against which dividends may be declared, that that accretion in value be "of a permanent character". For, to repeat what was said by Mason J in *Industrial Equity*, just as it "would be productive of confusion and uncertainty if companies were to declare dividends against the possibility that profits not in existence at the time of declaration would or might be earned or received by the time the dividend was paid"⁴⁸, so would it be productive of confusion and uncertainty if companies were to declare dividends against profits that are subject to constant fluctuations.

65 But this is not to say that like considerations should be taken as providing a guide for the purpose of construing s 160ZK(5) of the 1936 Act. After all, that sub-section speaks of distributions which "could reasonably be taken to be attributable to profits", rather than "dividend[s] ... payable ... out of profits", suggesting that the confusion and uncertainty contemplated above do not here constitute so pressing a concern as they do in the area of company law.

66 In *MacFarlane v Commissioner of Taxation*⁴⁹, in construing the phrase "dividends paid to him by the company out of profits derived by it from any source" in s 44(1)(a) of the 1936 Act, Beaumont J said there was "no reason, of logic or of experience, to import the technical requirements of the company law".

45 (1887) 12 App Cas 409.

46 (1882) 21 Ch D 519 at 533.

47 See *Industrial Equity Ltd v Blackburn* (1977) 137 CLR 567 at 578.

48 (1977) 137 CLR 567 at 579.

49 (1986) 13 FCR 356 at 376.

67 Moreover, as has already been demonstrated, there is nothing in the 1936 Act, not even in s 160ZLA(4), to render presently inapposite the notion, articulated in *Evans*, that the derivation of a profit may be established where such profit is ascertained. It might therefore be said that the application of par (b) of s 160ZK(5) in any given case requires the fulfilment of two key tasks: first, the ascertainment, by a process of computation and comparison, of a gain made by a company; and, secondly, the making of a determination as to whether a distribution by that company may reasonably be attributed to the ascertained gain. During the course of oral argument, counsel for the Commissioner submitted that ascription to an unrealised gain of the quality of permanence is more appropriately seen as going to the second of these tasks. It is not inherent in the nature of a profit, as that concept is employed in s 160ZK(5), that it should be of a permanent character.

68 In other words, fluctuations in the value of an unrealised gain would affect only the extent to which a subsequent distribution may reasonably be attributed to that gain. The Commissioner submitted that if, following the merger date, the unrealised gains as at that date in the value of the shares owned by Phoenix fluctuated, in the sense that they were constantly being eroded and restored, before being realised and distributed to RSA, then the amount of that distribution which would reasonably be attributable to profits derived before the merger would be the lowest point in the value of the gains between the merger date and the date of realisation. This proposition should be accepted as correct.

69 Nonetheless, the taxpayer contended that, even if this were so, an ascertained profit had not accrued to Phoenix at the time of the merger. To this contention we now turn.

Ascertainment of profits

70 In its submissions, the taxpayer gave significant emphasis to the circumstance first that there were no formal separate accounts for either Phoenix or SAIL at the merger date and, secondly, that Phoenix's investments had last been revalued at 31 December 1991 in its management accounts. It was conceded that those investments had been recorded at their market value as at the merger date in the consolidated Completion Accounts of the Sun Alliance Group, but this was said to be of little, if any, import. The reason given by the taxpayer was that the concept of profits directs attention to the circumstances of each individual company, specifically the manner in which that company, as distinct from any corporate group of which it is a member, keeps its accounts.

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71 Cited as providing authoritative support for this last proposition was a statement by Higgins J in *Webb v Australian Deposit and Mortgage Bank Ltd*⁵⁰, to which reference already has been made. His Honour said⁵¹:

"The truth is, that the meaning of 'profits' is not rigid and absolute; it is flexible and relative – relative to each company; and in ascertaining the meaning of the word in any context, we must consider the whole context."

When these words are themselves read in context, it is apparent that Higgins J was saying no more than that there is no universal legal meaning of the term "profits" applicable in every circumstance for every purpose. Nothing in this statement is to be taken as linking the concept of profits to the individual accounts of a given company. Perhaps realising this, the taxpayer relied also upon the observation by Mason J in *Industrial Equity* that⁵²:

"in all the cases it has been assumed the principle [concerning the payment of dividends out of profits] refers exclusively to the profits of the company declaring and paying the dividend".

However, Mason J was concerned with the prohibition on the payment of dividends except out of profits. It must be recalled that Rich, Dixon and Evatt JJ in *Evans* referred to the ascertainment of profits "by a proper account". There is nothing to suggest that accounts are any less proper for being consolidated.

72 In light of this, the circumstance that as at the merger date the unrealised increases in value of both Phoenix's share portfolio and the Bridge Street properties were recorded, not in separate accounts for Phoenix and SAIL respectively, but in the consolidated Completion Accounts of the Sun Alliance Group did not mean that those gains were not ascertained profits. (It will be necessary to return to the matter of whether those gains, insofar as they concerned the Bridge Street properties, were profits at all.) In any event, as the Commissioner contended, the fact that the reconstructed balance sheet for Phoenix was not produced until after the merger date is of minimal relevance: both the cost of acquisition and the market value of Phoenix's shares as at that date were known, giving an ascertained unrealised profit.

50 (1910) 11 CLR 223.

51 (1910) 11 CLR 223 at 241.

52 (1977) 137 CLR 567 at 577.

73 The same might be said, on the assumption that the unrealised accretion to the value of the Bridge Street properties had the character of a profit before the merger date, in respect of SAIL's ownership of those properties. Whether this assumption can be made good is a matter we now consider.

The Bridge Street properties

74 The primary submissions advanced by the taxpayer on the cross-appeal may be reduced to the following three propositions. First, in order to be treated as profit for the purposes of s 160ZK(5) of the 1936 Act, an unrealised increase in the value of an asset must be of a permanent character. Secondly, s 160ZK(5) speaks of profits that were derived before, as distinct from contemporaneously with, the acquisition by a taxpayer of the relevant shares. And thirdly, because the unrealised increase in the value of the Bridge Street properties did not assume a quality of permanence until the entry by members of both the Royal and the Sun Alliance Groups into the Merger Agreement, it cannot be said that SAIL derived any profit until the merger date at the earliest – that is, on the date on which RSA was deemed to have acquired its shares in SAIL. As a result, the taxpayer contended, s 160ZK(5) had no application in respect of the distribution made by SAIL to RSA in September 1996.

75 There is, however, an immediate answer to these submissions. As has already been explained in these reasons, the first of the propositions outlined above does not hold true. Nonetheless, it is upon the basis of this first proposition that the third proposition rests. It necessarily follows that that third proposition must similarly be rejected. In other words, to say that there was no profit accruing from the increased value of the Bridge Street properties until the merger date is to fall into error.

76 A profit had accrued to SAIL, and for the reasons already given, it was an ascertained profit. All that cl 14 and Sched 10 of the Merger Agreement did was to ensure that subsequent fluctuations in the value of the Bridge Street properties would not affect the process of reasonably attributing to that profit any distributions made by SAIL to RSA after the merger date.

"Could reasonably be taken to be attributable to"

77 It remains then to engage in that process of attribution required by par (b) of s 160ZK(5) in respect of the distributions made by Phoenix and SAIL. In doing so, several points should be noted. The first is that par (b) presents a question of characterisation of an amount which is the whole or a part of the

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distribution made by a company to the holder of the RDA share, as identified in par (a). Secondly, par (b) presents an inquiry as to the existence of a sufficient link between that whole or part of the distribution and profits derived by the company before a specified event (acquisition of the RDA share). Thirdly, that link may be described in terms of necessary causation but, as with all questions of causality, the starting point is the identification of the purpose (here the legislative purpose) to which the question is directed⁵³. Fourthly, here, the legislative purpose of s 160ZK(5) is to ensure that a capital loss not be claimed where the result of the course of action described in the sub-section is that there has been no economic loss to the taxpayer. Finally, the criterion of linkage in par (b), an attribution that is reasonable, is to be read and applied accordingly.

78 The evidence of Mr Robert Hardy, the Taxation Manager of RSA, indicates that it was the policy and practice of companies within the RSA Group to declare dividends from retained profits and realised gains on the sale of investments. As was previously adverted to in these reasons, the dividends paid by Phoenix and SAIL to RSA after 30 October 1992 were sourced in the retained and operating profits of both companies. As a consequence, the taxpayer submitted, those dividends could not reasonably be attributed to the unrealised gains which have been the focus of this litigation.

79 However, unlike s 44 of the 1936 Act, s 160ZK(5) speaks, not of "dividends paid ... out of profits derived" by a company, but of a distribution that "could reasonably be taken to be attributable to profits that were derived by the company" before the taxpayer's acquisition of shares in it. The inquiry contemplated by that provision is therefore not directed exclusively towards the identification of the source of funds from which a dividend is paid.

80 It is the concept of causation, rather than source, with which s 160ZK(5) is concerned. In determining whether the plaintiff's loss of employment was "attributable to" the provisions of the *Local Government Act 1972* (UK), Donaldson J in *Walsh v Rother District Council* said⁵⁴:

53 *Allianz Australia Insurance Ltd v GSF Australia Pty Ltd* (2005) 79 ALJR 1079 at 1089 [54]-[55], 1095-1096 [95]-[103], 1100 [126]; 215 ALR 385 at 398, 406-408, 413.

54 [1978] ICR 1216 at 1220; [1978] 1 All ER 510 at 514.

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"[T]hese are plain English words involving some causal connection between the loss of employment and that to which the loss is said to be attributable. However, this connection need not be that of a sole, dominant, direct or proximate cause and effect. A contributory causal connection is quite sufficient."

Nothing, either in the text of s 160ZK(5) or in its objects as expressed in the Explanatory Memorandum on the Bill for the Amending Act, indicates that a narrower meaning should be presently ascribed to that phrase.

81 As explained above, the phrase "could reasonably be taken to be" indicates that in order for s 160ZK(5) to be enlivened the relevant pre-acquisition profits need not actually be a contributory cause to a subsequent distribution: it would suffice that those profits may reasonably be capable of being seen as such.

82 The taxpayer submitted, rightly, that s 160ZK(5) requires an answer to the question whether a distribution is attributable to pre-acquisition profits, not whether profits realised subsequently to the acquisition of the relevant shares are attributable to pre-acquisition unrealised gains. Nevertheless, given the breadth of the nexus contemplated by the words "attributable to", where a pre-acquisition unrealised gain is a contributory cause to a post-acquisition realised profit, then that unrealised gain would, failing some break in the proverbial chain of causation, reasonably be capable of being taken to be a contributory cause to any distribution sourced in the subsequent realised profit.

83 The accretions in value of the shares held by Phoenix that occurred prior and up to the merger date, accretions which may be understood as profits derived by Phoenix before that date, were, in part, a cause of the dividends paid to RSA after 30 October 1992. The dividend paid by SAIL to RSA in September 1996 may similarly, and reasonably, be seen as being, in part, attributable to what was at the merger date the unrealised increase in the value of the Bridge Street properties.

Orders

84 The appeal by the Commissioner should be allowed with costs. The orders of the Full Court of the Federal Court dated 9 March 2004 should be set aside and in place thereof the appeal to that Court should be dismissed with costs.

85 The cross-appeal by the taxpayer should be dismissed with costs.