14, 1958

No. 7 of 1958.

In the Privy Council.

ON APPEAL FROM THE HIGH COURT OF AUSTRALIA.

UNIVERSITY OF LONDON
W.C. 1
28 JAN 1959
INSTITUTE OF ADVANCED
LEGAL STUDIES

BETWEEN :

LAURI JOSEPH NEWTON, LIONEL NEWTON, FRANCIE UNA CHRISTIAN, HENRY JAMES LANE, LAURI JOSEPH NEWTON, LIONEL NEWTON AND FREDERIC ERNEST BUNNY, EXECUTORS OF THE ESTATE OF ROBERT NATHAN DECEASED, STELLA MAUD ADELINE LANE AND LEONARD ALFRED FENTON (*Respondents*) - *Appellants.*

52117

AND

THE COMMISSIONER OF TAXATION OF THE COMMONWEALTH OF AUSTRALIA (*Appellant*) *Respondent.*

(CONSOLIDATED APPEALS)

Case for the Respondent.

RECORD.

INTRODUCTION.

1. The principal question in this Appeal is whether the Full Court of the High Court of Australia was correct in deciding that the sum of £1,764,136, the aggregate of amounts declared as dividends by three companies, namely, Lanes Motors Pty. Ltd. (hereinafter referred to as " Lanes ") Neals Motors Pty. Ltd. (hereinafter referred to as " Neals ") and Melford Motors Pty. Ltd. (hereinafter referred to as " Melford "), formed part of the assessable income of the Appellants under the Commonwealth Income Tax and Social Services Contribution Assessment Act
10 1936–1951 (hereinafter referred to as " the Act ") in the income years ended 30th June 1950 and 30th June 1951. These three companies are hereinafter together referred to as the " Motor Companies ".

2. The facts giving rise to this question are both complex and detailed and, although it will be necessary to examine certain of the transactions in some detail, it will be convenient to summarise their basic features by way of general introduction. At all times material up to the 19th December 1949 the Appellants held between them all the issued ordinary shares in the Motor Companies. Each of the companies was at all times material a private company for the purposes of taxation and as such was liable to pay undistributed profits tax on substantially all of the profits that it earned in a year ended 30th June and did not distribute by the 31st December. The amount of such undistributed 10 profits tax was what would have been payable by its shareholders as personal tax if it had on the 30th June paid the undistributed amount as a dividend to the shareholders entitled to receive it. At all times material each of the Motor Companies was making large profits and moreover the Appellants were paying personal tax at the rate of 15s. in the £. If therefore the companies did not distribute their profits year by year they would each be faced with heavy assessments of undistributed profits tax, whereas if they were to make a sufficient distribution each of the Appellants would incur heavy liabilities for personal tax on the dividends paid to them. Furthermore each of the Motor Companies was in need 20 of further share capital. In this situation an arrangement was adopted and carried out in respect of each of the Motor Companies in and after December 1949 and repeated in the case of Melford in and after December 1950 and in the case of Neals in June 1951, the essence of which was that the Motor Companies should make a sufficient distribution but that their shareholding should be so arranged that the moneys paid as dividends should reach the Appellants in the guise of capital so that it would not attract personal tax and that out of the moneys so received the Appellants should invest a substantial part in further shares in the companies. This was impossible so long as the Appellants held the shares upon 30 which dividends would be paid, but it would, it was thought, be possible if the shares were sold to a company which would not have to pay tax upon the dividends received, but could and would use the dividends, when received, to pay the Appellants the purchase price of the shares.

3. The tax adviser of the Appellants, one Ratcliffe, controlled such a company which he had incorporated a short time before and had hopefully named Pactolus Pty. Ltd. (hereinafter referred to as " Pactolus "). This was an investment company and as a trader in shares was entitled to income tax deductions for losses suffered in dealing in shares. The

arrangement was therefore that each of the Motor Companies would by the amendment of its Articles of Association attach special dividend rights to the same proportion of the shares held by each Appellant so that the payment of dividends in accordance with those rights would exceed a sufficient distribution for each company. The shares with special rights would then be sold by the Appellants to Pactolus at a price around or somewhat lower than the amount of the special dividends payable thereon ; the companies would then declare the special dividends and pay them to Pactolus which would pay the Appellants the purchase
10 price of the shares ; the Appellants would then invest a substantial part of the purchase price in new shares in the companies and so increase their share capital ; after payment of the special dividend the shares purchased by Pactolus would become 5 per cent. preference shares worth approximately £1. The effect of this would be that Pactolus would suffer a loss of the difference between what it paid for the shares and £1, their value after payment of the dividend. To meet the situation which arose because the amount received in dividends would exceed losses incurred by Pactolus, there was this refinement, that some of the special dividends to be paid by the Motor Companies would be paid out of tax free reserves
20 so as to be rebatable in the hands of the persons to whom they passed. In this way the dividends would be received by Pactolus and the greater part of the moneys so received would be paid to the Appellants as purchase money for the shares and Pactolus would have the difference between the dividends received and that purchase price with the addition of the 5 per cent. preference shares into which the shares purchased would have been converted.

4. The aforesaid arrangement was carried out five times and in the years 1949, 1950 and 1951 the Motor Companies paid by way of special dividends the sum of £1,764,136 from which Pactolus paid
30 £1,661,722 to the Appellants and retained £102,414. From the sum of £1,661,722 received by the Appellants the sum of £1,185,631 was invested in new shares in the Motor Companies.

5. In the absence of special provision no part of the dividends distributed as aforesaid by the Motor Companies would have been subject to tax in the hands of the Appellants but the High Court (Dixon C.J., McTiernan, Williams and Fullagar JJ. with Taylor J. dissenting) reversed a decision of Kitto J. and decided that by reason of a special provision in the Act the dividends were so far as the Respondent was

concerned the income of the Appellants. This special provision is section 260 of the Act and is as follows :—

"260. Every contract, agreement, or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly—

(*a*) altering the incidence of any income tax ;

(*b*) relieving any person from liability to pay any income tax or make any return ;

(*c*) defeating, evading, or avoiding any duty or liability imposed on any person by this Act ; or 10

(*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 application of this section to the facts of these cases in the respectful submission of the Respondent is in short that the Appellants received or were entitled to receive moneys which came out of the profits of the Motor Companies and were distributed as dividends on shares of which the Appellants prior to the transfers to Pactolus were the owners. 20 Those transfers were part of an arrangement which had the purpose and effect of avoiding a liability imposed upon the Appellants by the Act to include in their returns and pay tax on distributions by each company among its shareholders otherwise than in the course of a liquidation or upon a reduction of capital, by giving the receipts the character of capital received from Pactolus in the place of profits received from the Motor Companies. The arrangement and the transfers were therefore void as against the Respondent by virtue of section 260 and the moneys received had the character of receipts by shareholders of part of the profits of the Motor Companies. So much of the moneys as were retained by Pactolus 30 were moneys to which the Appellants as the shareholders, so far as the Respondent was concerned, were entitled.

STATUTORY PROVISIONS.

6. In addition to section 260 there are a number of other provisions of the Act which are material to the present case.

So far as the tax position of the Appellants is concerned, the material provisions are—

(*a*) the definition of " dividend " in section 6(1) which is as follows :—

" 'Dividend' includes any distribution made by a company to its shareholders, whether in money or other property, and any amount credited to them as shareholders, and includes the paid-up value of shares distributed by a company to its shareholders to the extent to which the paid-up value represents a
10 capitalization of profits ; but does not include a return of paid-up capital or a reversionary bonus on a policy of life-assurance ".

(*b*) the definition of " assessable income " in section 6(1) which is as follows :—

" 'assessable income' means all the amounts which under the provisions of this Act are included in the assessable income ".

(*c*) the definition of " taxable income " in section 6(1) which is as follows :—

" 'taxable income' means the amount remaining after deducting from the assessable income all allowable deductions ".

20 (*d*) section 17 which is as follows :—

" 17. Subject to this Act, income tax and social services contribution at the rates declared by the Parliament shall be levied and paid for the financial year which commenced on the first day of July, One thousand nine hundred and fifty, and for each financial year thereafter, upon the taxable income derived during the year of income by any person, whether a resident or a non-resident ".

(*e*) section 44(1) which is as follows :—

" 44. (1) The assessable income of a shareholder in a
30 company (whether the company is a resident or a non-resident) shall, subject to this section—

(*a*) if he is a resident—include dividends paid to him by the company out of profits derived by it from any source ; and

(*b*) if he is non-resident—include dividends paid to him by the company to the extent to which they are paid out of profits derived by it from sources in Australia ".

(*f*) section 46(1) which is as follows :—

" 46. (1) Subject to this section, a shareholder, being a company which is a resident, shall be entitled to a rebate in its assessment of the amount obtained by applying to that part of the dividends included in its taxable income the average rate of tax payable by the company."

(*g*) section 47(1) which is as follows :—

" 47. (1) Distributions to shareholders of a company by a liquidator in the course of winding up the company, to the extent to which they represent income derived by the company (whether before or during liquidation) other than income which has been properly applied to replace a loss of paid up capital, shall, for the purposes of this Act, be deemed to be dividends paid to the shareholders by the company out of profits derived by it ".

7. The position of each of the Motor Companies in regard to undistributed profits tax was governed by the provisions of Division 7 of Part III of the Act. That division dealt with " private companies " as defined and each of the motor companies was a private company within Division 7 at all material times. The effect of Division 7 may be summarised by stating that unless a private company made a " sufficient distribution " of its profits within a period of six months after the end of the financial year, it became liable to pay additional tax known as " undistributed profits tax " or " Division 7 tax ". That additional tax was at the relevant time calculated by reference to the income tax which the shareholders would have paid if dividends amounting to a " sufficient distribution " had in fact on the last day of the year of income been declared and paid to them. The position of the Appellants at all material times was such that if they had received dividends from the Motor Companies they would have had to pay income tax thereon at the rate of 15s. in the £. Hence if any of the Motor Companies failed to make a " sufficient distribution " by the 31st December 1949 out of the profits of the year ended 30th June 1949 it would have become liable to tax under Division 7 at the rate of 15s. in the £. The substantial effect of Division 7 was to provide that in the case of a private company tax was to be paid upon its taxable income (less certain deductions provided for in section 103) at the rate which its shareholders would pay if dividends were declared and that that amount of tax was to be paid either by the

company if it failed to make the distribution by 31st December or by the shareholders if the distribution was in fact made to them. In a case in which Division 7 tax was paid there was thereby created a " tax-free " or " tax-paid " reserve, the amount of which was ascertained by deducting from the amount of the " sufficient distribution " any dividends paid and the Division 7 tax paid. Any dividends subsequently paid out of the " tax-free " or " tax-paid " reserve were in effect substantially exempt from tax in the hands of an individual to whom they were paid, notwithstanding that they might have passed through the hands of
10 interposed companies before being so paid. Such dividends were usually called " tax-free " or " tax-paid " dividends.

8. All companies (both those which were " private companies " as defined in Division 7 and those which were not) were liable under annual Taxing Acts to pay what was usually called " Ordinary Company Tax ". For the year ended 30th June 1950 this tax (for both private and non-private companies) was at the rate of 5s. in the £ on the first £5,000 of taxable income and 6s. in the £ on the amount of taxable income exceeding £5,000. For the year ended 30th June 1951 the rates were in the case of a private company 5s. in the £ on the first £5,000 of taxable income and
20 7s. in the £ on the taxable income in excess of £5,000. In the case of a company which was not a private company the rate was 7s. in the £ on the whole of the taxable income. For the purposes of ascertaining Ordinary Company Tax, section 46 operated to grant a rebate on so much of the taxable income as consisted of dividends from other companies.

9. Private companies were also liable to " Division 7 tax " in accordance with the provisions already referred to. Companies which were not private companies were subjected to " Super Tax " and an undistributed profits tax. Super tax was at the rate of 1s. in the £ on the excess of taxable income over £5,000 and undistributed profits tax
30 was at the rate of 2s. in the £ upon so much of the taxable income as was not distributed as dividends, after making certain specified deductions.

POSITION OF THE MOTOR COMPANIES.

10. On 30th June 1949 the position of each of the three Motor Companies in relation to the income year which ended on that date was as follows :—

(a) *Lanes*—taxable income £372,610 on which would be payable Ordinary Company Tax £110,287, leaving a nett profit after tax of

£262,323. Under Division 7 Lanes would be allowed a " retention allowance " of £27,232. The balance of £235,091 would, if not distributed in dividends by 31st December, 1949, bear Division 7 tax.

(b) *Neals*—taxable income £195,241 on which would be payable Ordinary Company Tax £57,705, leaving a nett profit after tax of £137,536. Under Division 7 Neals would be allowed a " retention allowance " of £14,753. The balance of £122,783 would, if not distributed in dividends by 31st December 1949, bear Division 7 tax.

(c) *Melford*—taxable income £138,229 on which would be payable Ordinary Company Tax £41,000, leaving a nett profit after tax of £97,200. Under Division 7 Melford would be allowed a " retention allowance " of £10,720. The balance of £86,480 would, if it were not distributed in dividends by 31st December 1949, bear Division 7 tax. 10

THE TRANSACTIONS IN QUESTION.

11. At 30th June 1949 and up till December 1949 Lanes had an issued capital of 242,321 shares comprising 237,321 ordinary shares and 5,000 preference shares. The 237,321 ordinary shares were held by certain of the Appellants as set out in paragraph 1 of the mutual admissions. The Directors were four of the Appellants and the Manager of Lanes who held the 5,000 preference shares but no ordinary shares. The capital of Neals consisted of £114,332 divided into 109,332 ordinary shares and 5,000 preference shares. The 109,332 ordinary shares were held by certain of the Appellants as set out in paragraph 2 of the mutual admissions. The Directors of Neals were three of the Appellants and the Manager who held the 5,000 preference shares but none of the ordinary shares. The issued capital of Melford consisted of 16,506 ordinary shares of £1 each which were held by certain of the Appellants as set out in paragraph 3 of the mutual admissions. The Directors of Melford were two of the Appellants and one L. B. Wallace who was not beneficially entitled to any shares in Melford but who held certain shares upon trust for some of the Appellants. 20 30

Vol. II, pp. 1, 2.
Vol. II, pp. 2–4.
Vol. II, pp. 4–5.

12. There were five transactions or, more properly, five series of transactions, concerned in the Amended Assessments now in issue. Three took place simultaneously in December 1949 and March 1950, one in relation to each of the three Motor Companies. In the following year a second transaction took place with regard to Melford in November

Vol. I, pp. 11, 31, 49, 63, 75, 87, 99, 101, 113, 125, 129 141, 153, 165, 175 and 185.

and December 1950 and the second transaction with regard to Neals took place in June 1951. The first three transactions were identical in form and differed only in the monetary figures involved. Some differences were introduced in the second Melford transaction and further differences again in the second Neals transaction. The genesis of all five transactions was certain discussions and negotiations which took place between Ratcliffe and two of the Appellants. Between July 1949 and November 1949 lengthy discussions and negotiations took place between the Appellants and Ratcliffe as a result of which agreement was ultimately
10 reached upon the steps to be taken.

LANES TRANSACTION.

13. As a result of that agreement, the following steps were taken in relation to Lanes :—

(*a*) On 14th December 1949 special resolutions were passed which increased the nominal capital of Lanes from £250,000 to £750,000 and which divided the capital into four classes of shares—the 5,000 preference shares already issued were now called " A " preference shares. The 237,321 issued ordinary shares were converted as to one-third (79,107) into " A " ordinary shares and as to two-thirds
20 (158,214) into " B " ordinary shares. 62,679 unissued shares were made " B " ordinary shares and 445,000 unissued shares were made " B " preference shares. The issued ordinary shares were sub-divided one-third and two-thirds in such a manner that each of the holders of ordinary shares in the Company had one-third of his ordinary shares converted into " A " ordinary shares and two-thirds into " B " ordinary shares. By these special resolutions the following rights were attached to the various classes of shares— The original 5,000 preference shares (now " A " preference) remained the same. Subject to the rights of the " A " preference shares the
30 " A " ordinary shares entitled the holders to the whole of the dividends thereafter to be declared by the company until they amounted to a total of £5 15s. 10d. for each £1 " A " ordinary share (i.e. £458,161 7s. 6d. in all) including therein 2s. 2d. per share tax paid under Division 7. Upon the satisfaction of those special dividend rights the " A " ordinary shareholders were entitled only to a fixed cumulative preferential dividend of 5 per cent. They were given the same voting rights as the " B " ordinary shares until the special dividends were paid, and thereafter only voting rights of the kind ordinarily attached to preference shares, i.e. when their

dividends were in arrears or upon proposals affecting their rights. The " B " preference shares were given a right subject to the rights of the " A " preference and " A " ordinary shareholders to receive a 5 per cent. fixed cumulative preference dividend and other rights customarily attached to preference shares.

(*b*) On 15th December 1949 each of the ordinary shareholders gave to Pactolus an option in writing to purchase his "A" ordinary shares in Lanes at £5 16s. 0d. per share.

(*c*) On 16th December 1949 the Directors of Lanes resolved that 402,679 " B " preference shares should be made available for issue at par and be offered to the persons entitled to the dividend from the " A " ordinary shares on or after 19th December 1949. By a letter of the same date Pactolus was informed that this had been done. 10

(*d*) On 19th December 1949 Pactolus exercised the options to purchase the " A " ordinary shares and handed cheques for the appropriate amounts of purchase money (totalling £458,820 12s. 0d.) to the authorized agent of the vendors (the ordinary shareholders) one Ross, in Canberra, in exchange for completed transfers and the relevant share certificates. The transfers were thereupon immediately registered in a Branch Register which had been established in Canberra in December 1949 and new share certificates were thereupon issued to Pactolus. On the 19th December 1949, Pactolus applied to Lanes for 402,679 " B " preference shares and gave to Lanes a cheque for the amount payable upon application therefor, i.e. £402,679. 20

(*e*) On 20th December 1949 the Directors of Lanes declared three dividends on the " A " ordinary shares, i.e. a dividend of £8,569 18s. 6d. (2s. 2d. per share) out of profits, tax paid under Division 7; £262,232 out of profits of the year ended 30th June 1949, and £175,493 8s. 0d. out of profits of the year ending 30th June 1950. The total was £446,295 6s. 6d., i.e. £5 12s. 10d. per " A " ordinary share. This was 3s. per share short of the full amount of the special dividend rights. A cheque in favour of Pactolus for the amount of the dividend thus declared was handed to Ross on behalf of Pactolus. Later on the same day the Directors of Lanes allotted to Pactolus the 402,679 " B " preference shares for which it had applied and for which it had already given Lanes the cheque for £402,679. 30

(*f*) On 20th December 1949 Pactolus sold the 402,679 " B " preference shares to the persons holding the " B " ordinary shares proportionately to the number of " B " ordinary shares held, at a price of £1 per share. Transfers of the " B " preference shares were executed by Pactolus and handed to Ross who handed to Pactolus in exchange for the transfers, cheques drawn by the holders of the " B " ordinary shares.

(*g*) On 21st December 1949 all the cheques above referred to were on the instructions of Ross banked simultaneously at the South Melbourne Branch of the E. S. & A. Bank Limited. Lanes and each of the ordinary shareholders had had accounts at that Branch for some time and an account had been opened there for Pactolus a few days earlier with a deposit of £19,000.

(*h*) On 22nd March 1950 the Directors of Lanes declared out of the profits of the year ended 30th June 1950 a further dividend of £11,866 1s. 0d. on the " A " ordinary shares, i.e. at the rate of 3s. per share. This brought the dividends declared on the " A " ordinary shares to £5 15s. 10d.—the full amount of the special rights. This cheque was paid to the credit of Pactolus' Bank Account at the South Melbourne Branch of the E. S. & A. Bank Limited.

(*i*) On 12th May 1950 Pactolus sold the whole of the " A " ordinary shares in Lanes (79,107) to a company called Pactolus Investments Pty. Ltd. in which Ratcliffe and members of his family were the only shareholders. This sale was at £1 per share which was the full value of the " A " ordinary shares as they then stood, the special dividend rights having been exhausted.

14. The steps above set out produced the following results :—

(1) In Lanes accounts £402,679 disappeared from profits and was replaced by paid up capital of the same amount represented by " B " preference shares in the hands of the original shareholders.

(2) The difference between that figure of £402,679 and the total of the special dividends paid (£458,161) namely £55,482 was contained in the sum of £56,141 which was kept by the original shareholders in cash (the remaining £659 of the latter sum having been put in by Pactolus).

(3) The original shareholders, although they had received nothing directly from the distribution of Lanes profits, received between them £458,820 as the price of their " A " ordinary shares; they kept £56,141 in cash and applied £402,679 in the purchase of 402,679 " B " preference shares from Pactolus.

(4) Pactolus had put in £659 in cash (the difference between the special dividends received and the price paid for the " A " ordinary shares). It had sold the " A " ordinary shares for £79,107 and had thus made an overall profit of £78,448.

NEALS AND MELFORD TRANSACTIONS. 10

15. The first Neals and the first Melford transactions followed exactly the same course (except as to the figures) as was done with regard to Lanes, and each of the steps was taken upon the same day. A summary of the financial results of the first Neals and first Melford transactions is included in the Table set out in paragraph 19 below.

16. The second Melford transaction which took place in November and December 1950 followed the same course as the Lanes transaction except as to the figures and save that Pactolus did not apply for the equivalent of the " B " preference shares and then sell them to the original shareholders. The equivalent of the " B " preference shares 20 was applied for by the original shareholders and paid for out of the proceeds of sale received from Pactolus. The financial results of the second Melford transaction are also set out in the table in paragraph 19 below.

17. The second Neals transaction followed further negotiation between the Appellants and Ratcliffe in the early months of 1951. As a result of those negotiations the following steps were taken:—

(*a*) On 12th June 1951 special resolutions were passed making further changes in the capital structure. 29,156 of the issued " B " ordinary shares were made " C " ordinary shares, leaving 43,732 issued " B " ordinary shares. The " C " ordinary shares were 30 given rights similar to those which in December 1949 had been attached to the " A " ordinary shares, the amount of the special dividends being fixed at £13 1s. 6d. of which not less than 12s. 11d. was to be out of tax paid profits under Division 7.

(*b*) On 21st June 1951 the holders of the " C " ordinary shares gave to Pactolus options in writing to purchase the " C " ordinary shares at £12 3s. 0d. per share.

(*c*) On 25th June 1951 Pactolus exercised the options and the " C " ordinary shares were transferred to it in exchange for cheques for the full amount of the purchase price, a total of £354,245 8s. 0d.

(*d*) On the same day (25th June 1951) the Directors of Neals declared two dividends on the " C " ordinary shares, namely a dividend of 14s. 6d. per share payable out of tax paid profits under
10 Division 7, and a dividend of £12 7s. 0d. per share payable out of the profits of the year ending 30th June 1951. These dividends exhausted the special dividend rights of the " C " ordinary shares and totalled £381,214 14s. 0d.

(*e*) On 27th June 1951 the cheques were banked simultaneously at the South Melbourne Branch of the E. S. & A. Bank.

(*f*) On 26th June 1951 Pactolus sold the 29,156 " C " ordinary shares to Pactolus Investments for the amount of £1 per share.

18. In the second Neals transaction there was thus no increase in the issued capital of Neals. Neals distributed £381,214 out of its
20 profits and paid that amount to Pactolus. The original shareholders received and retained £354,245 in cash from Pactolus. If Pactolus set off the loss which it incurred on the resale of the " C " ordinary shares against the dividends it received from the company it made a profit of £56,125.

19. The following Table summarises the financial results of each of these five transactions.

	"A" Ord. shares bought by Pactolus			Special Dividends received by Pactolus		"B" Prefs. acquired and sold at par	Ordinary shareholders left holding (in addition to "B" Ordinary Shares)		Pactolus left holding		
	No.	Price per share	(1) Amount	Per share	(2) Amount	(3) Amount	Cash (1)–(3)	"B" Prefs. (3)	Cash (2)–(1)	A. Ords.	Profit
		£ s. d.	£	£ s. d.	£	£	£	£	£		£
Lane	79,107	5 16 0	458,820	5 15 10	458,161	402,679	56,142	402,679	659	79,107	78,448
Neal	36,444	12 8 4	452,513	13 7 0	486,527	403,314	49,199	403,314	34,014	36,444	70,458
Melford ...	8,253	24 0 0	198,072	26 11 0	219,117	189,819	8,253	189,819	21,045	8,253	29,298
Melford 2nd ...	8,253	24 0 0	198,072	26 11 0	219,117	*	8,253	189,819*	21,045	8,253	29,298
Neal 2nd ...	29,156	12 8 0	354,245	13 1 6	381,214	†	354,245	†	26,969	29,156	56,125
	161,213	—	£1,661,722	—	£1,764,136	—	£476,092	£1,185,631	£102,414	161,213	£263,627

Sale price or value of "A's" after receipt of special dividends	£161,213	
Loss on shares	£1,500,509	£1,500,509
Profit to Pactolus		£263,627

* Subscribed for in cash direct by original shareholders.

† Cash only received by original shareholders, there being no increase in Neal's paid-up capital in this transaction.

SECTION 260.

20. In the submission of the Respondent the operation of section 260 of the Act involves two separate processes. The first is to determine whether or not there has been a "contract, agreement or arrangement" which "has or purports to have the purpose or effect of in any way directly or indirectly" producing any of the four results described in paragraphs (*a*), (*b*), (*c*) and (*d*) of section 260. Insofar as there is any such arrangement, the Act declares it to be "absolutely void as against the Commissioner". The avoidance of the arrangement
10 insofar as it has that purpose or effect does not, however, of itself affect the tax position of any person or bring any amount into charge for the purposes of tax. This leads to the second process which is involved, namely the application of the other provisions of the Act to the situation remaining after the appropriate "contract, agreement or arrangement" or parts thereof have been treated as void. It is thus to the "end result" or to the "set of actual facts remaining or revealed" that the other provisions of the Act must be applied in order to determine what is the true tax position of the persons concerned. The first task, therefore, is to ascertain whether there was in this case a "contract, agreement
20 or arrangement" which had the purpose or effect of achieving any of the four stipulated results. It is submitted on behalf of the Respondent that the purpose and effect of the arrangement made between the Appellants, the Motor Companies, Ratcliffe and Pactolus was to relieve the Appellants from their liability to pay income tax and to avoid the liability imposed on them by section 17 to pay tax on their "taxable income" under the Act. It is submitted on behalf of the Respondent that the arrangement made between the Appellants, the Motor Companies, Ratcliffe and Pactolus (as applied to the first three transactions) involved the following :—

30

(1) Increase of capital and alteration of Articles of Companies.

(2) Sale of shares by granting options and the exercise thereof.

(3) Transfers of shares to Pactolus.

(4) Cheques by Pactolus handed to the Appellants for the shares.

(5) Cheques by Pactolus for "B" preference shares handed to Motor Companies.

(6) Declaration of Dividend by the Motor Companies.

(7) Cheques for payment of such dividends handed to Pactolus.

(8) Issue of "B" preference shares to Pactolus.

(9) Purchase of " B " preference shares by the Appellants.

(10) Transfer of " B " preference shares from Pactolus to Appellants and cheques by Appellants handed to Pactolus for such shares.

(11) All cheques cleared in same bank on same day.

(12) Retention by the Appellants of certain amounts in cash.

(13) Retention by Pactolus of the " A " ordinary shares and certain amounts in cash.

The Respondent submits that the purpose and effect of steps (2) and (3), namely, the sale and transfer of the shares was to avoid the tax 10 payable by the Appellants upon the dividends declared by the companies and reaching their hands indirectly through Pactolus. Viewing the " end result " in this way, the Appellants were found in receipt of substantial sums of money and when one looks at the facts to determine the origin of that money it appears that it is money which came indirectly (i.e. via Pactolus) from the Motor Companies out of their distributable profits. The Appellants were shareholders in the companies and upon the hypothesis that the transfers were void as against the Respondent had never parted with any of their shares, but they had received money which was in truth the moneys of the companies paid out of their profits. 20 That money was a " dividend " within the meaning of the Act and as such must form part of the assessable income of the Appellants by virtue of section 44. The Respondent contends that the money the Appellants received is in truth and in substance the money of the companies paid out of their profits because, when the transactions are examined, it is apparent that the only real money which was used in any stage of the various payments and cross payments was the money of the companies.

21. Alternatively, the matter may be looked at in a manner suggested by Mr. Justice Williams, by taking the end result as being 30 the Appellants in possession of fully paid shares and cash. But for the interposition of the arrangement, those shares and that money (which were paid up out of or came out of the profits of the companies) would have constituted dividends received by the Appellants and would have been taxable as such in their hands. Here again, the fact that the only real money involved in any of the steps came out of the profits of the

companies is of importance in ascertaining the character of that which was found in the hands of the Appellants.

22. Section 260 requires an arrangement to be treated as void only insofar as it has the purpose or effect of " avoiding tax " and it does not matter that the arrangement may also have other purposes and other effects. Insofar as it has the purpose or effect of avoiding tax then it is void against the Respondent, but its other purposes and its other effects remain operative, even as against the Respondent. It is not necessary to the operation of section 260 that it should appear that the sole purpose
10 or the sole effect of the arrangement was to avoid tax.

23. Section 260 is concerned with contracts, agreements or arrangements which, but for the operation of the section, would be completely valid and effective for all purposes. It is not concerned with sham transactions which would of course be void in any event—a sham transaction does not need an Act of Parliament to declare it to be void.

24. It is not necessary for the purpose of the Respondent's primary argument on this Appeal to contend that the arrangements made between the Appellants, the Motor Companies, Ratcliffe and Pactolus had no purpose other than the avoidance of tax, but if it were necessary to do
20 so the Respondent would so submit. An examination of the transactions themselves and of the evidence given with regard to their origin shows that the arrangements had no purpose other than the avoidance of tax. All parties were persuaded of the necessity of the Motor Companies declaring dividends of an amount sufficient to take them outside the operation of Division 7. The steps which were taken were concerned solely with the problem of avoiding tax upon the dividend distributions which all concerned regarded as necessary. The steps which were in fact taken had no purpose other than the attempt to give to those moneys when they reached the hands of the Appellants the character of capital
30 rather than income.

25. A subsidiary issue is whether the Respondent should have taxed the Appellants only upon the value of the purchase price received by them from Pactolus (less 2d. in the case of Lanes) rather than upon the amount of the dividends declared and paid by the Motor Companies. The Respondent submitted and the majority of the Full Court accepted the argument that the whole of the dividends formed part of the income of the Appellants. It is submitted by the Respondent that this view

is correct for the following reasons :—If the transfers of the shares are treated as void, the position is that the Motor Companies declared dividends to which the Appellants, as the holders of the shares upon which the dividends were declared, were entitled. The dividend cheques were handed to Pactolus. Part of the money derived from the first and second Neals and the first and second Melford and the whole of the money from Lanes was passed on by Pactolus to the Appellants. The dividends must be regarded as having been derived by the Appellants—see section 19.

26. The special considerations which apply to the moneys which were in fact retained by Pactolus do not apply to the moneys which were paid over by Pactolus to the Appellants. The Respondent's alternative contention which was made to the High Court and which is now repeated is that even if he is wrong as to the amounts retained by Pactolus, the assessments were correct as to the moneys (being part of the dividends) in fact paid over by Pactolus to the Appellants and to that extent the assessments should be upheld, i.e. the assessments should be upheld save as to the amount of £102,414 of assessable income. 10

THE AUTHORITIES.

27. The use which the above argument seeks to make of section 260 is in the Respondent's submission supported by all the cases in which section 260 has been discussed by the High Court. The principal authorities dealing with section 260 are four decisions of the Full Court, i.e.—*Commissioner of Taxation* v. *Purcell* 29, C.L.R. 464; *Jaques* v. *Commissioner of Taxation* 34, C.L.R. 328; *Clarke* v. *Commissioner of Taxation* 48, C.L.R. 56, and *Bell* v. *Commissioner of Taxation* 87, C.L.R. 548. These cases show in the Respondent's submission a consistent adoption of the construction and operation of section 260 which is relied upon in the above submissions, and the present case is in the Respondent's submission entirely covered by the authority of those decisions, and is indistinguishable on its facts from the latest of those decisions, namely *Bell's* case. 20 30

28. In *Purcell's* case the owner of a pastoral property and live stock thereon declared himself to be a trustee of the land and the stock for himself, his wife and his daughter in equal shares. The trust deed reserved to him as trustee wide powers of the management and control and investment. Knox C.J. who tried the taxpayer's appeal from an Assessment issued by the Commissioner on the basis that the then

equivalent of section 260 applied, was satisfied on the evidence that, although the taxpayer was " influenced to some extent by a desire to lessen the burden of taxation ", he really did intend to confer benefits on his wife and daughter, and he held that the settlement could not be treated as void under the section, of which he said—

> " In my opinion its provisions are intended to and do extend to cover cases in which the transaction in question, if recognised as valid, will enable the taxpayer to avoid payment of income tax on what is really and in truth his income ".

10 The decision of Knox C.J. was upheld by the Full Court on Appeal. The judgments do not contain any elaborate analysis of the section but Rich J. does say that—

> " Whatever its meaning it would be unreasonable to construe it so as to include a genuine gift which had the incidental effect of diminishing the donor's assets and income ".

The taxpayer in that case never became beneficially entitled to any of the income sought to be taxed in his hands.

The next case is *Jaques* case. Under the Income Tax Assessment Act then in force calls paid by a taxpayer on shares in Mining Companies 20 operating in Australia were allowable deductions from assessable income. The following statement of the facts is taken from the headnote of the report—

> " A company which carried on the business of Coal Mining and of Cement Making having decided to reconstruct went into voluntary liquidation and the Liquidator entered into agreements with two new companies to one of which he agreed to transfer the colliery business and to the other the cement business, the consideration to the old company being paid up shares in the new companies which were to be distributed among the shareholders of the old company. 30 After the agreements had been executed and the transaction had been otherwise partly completed, for the avowed purpose of enabling the shareholders of the new companies to obtain under the Income Tax Assessment Act 1915–1918 deductions from their incomes in respect of calls paid, a new scheme was adopted and carried into effect under which in substance the old company sold its assets to the new companies respectively for specified sums, contributing shares were issued by each of the new companies to the shareholders of the old company and upon those contributing shares calls were

made of a sufficient amount to satisfy the purchase money, which calls were to be paid out of the shareholders respective interests in the assets of the old company. The payment of the calls and of the purchase money was effected by an exchange of cheques between the liquidator of the old company and the new companies ".

It was held by Rich J. that a shareholder in one of the new companies was not entitled to a deduction of the calls paid on the ground that although the transaction was a real one the taxpayer's contract or agreement with the new companies to take the shares plus the arrangement to make the call amounted in the circumstances to a contract, agreement or arrangement for one or more of the purposes or effects mentioned in section 53 (section 260). This decision was upheld by the Full Court. Knox C.J. was of opinion that the taxpayer had not established that the transaction was a " genuine *bona fide* transaction intended to create real rights and obligations ", and that it fell within the then equivalent of section 260. The other two members of the Full Court, Isaacs J. and Starke J. agreed with Rich J. in regarding the transactions as genuine, but regarded the then equivalent of section 260 as applicable, so that as Isaacs J. said—

" The effect is that the taxpayer's liability to make a return or in respect of any other liability under the Act remains just as if there were no such contract, agreement or arrangement ".

29. The next case is *Clarke's* case. By section 16(*d*) of the Income Tax Assessment Act 1922 it was provided that the assessable income of a taxpayer included " premiums demanded and given in connection with leasehold estates ". The then equivalent of section 260 was section 93. The Appellant taxpayer was the owner of certain licensed premises called the Burwood Hotel. He agreed to grant to one McDonough a lease of the hotel for five years from 1st July 1924 at a weekly rent of £30 for which lease a premium of £20,000 was to be paid in two instalments. Some months previously the Appellant had formed a company named Burwood Hotel Limited in which he was the sole beneficial shareholder. The transaction with McDonough was not carried out according to the terms agreed upon but the Appellant granted a lease to the company which forthwith assigned the lease to McDonough in consideration of the premium of £20,000 payable in two instalments. The company very shortly afterwards went into voluntary liquidation. The first instalment only of the premium was in question and that instalment was paid to the Appellant, and in its accounts the company treated itself as entitled,

as in fact it was, to receive the instalment and debited the Appellant with the amount thereof. It then distributed its surplus assets to the Appellant, there being in the Income Tax Assessment Act 1922 no provision corresponding to section 47 of the present Act which makes distributions by liquidators income in the hands of shareholders to the extent to which they represent income derived by the company. The matter came by way of Case Stated before a Full Court consisting of Rich, Dixon and Evatt JJ. In its joint judgment the Court said of the section—

10 " In its application perhaps it can do no more than destroy a contract agreement or arrangement in the absence of which a duty or liability would subsist. Where circumstances are such that a choice is presented to a prospective taxpayer between two courses of which one will and the other will not expose him to liability to taxation, his deliberate choice of the second course cannot readily be made a ground of the application of the provision. In such a case it cannot be said that but for the contract agreement or arrangement impeached a liability under the Act would exist. To invalidate the transaction into which the prospective taxpayer in fact entered 20 is not enough to impose upon him a liability which could only arise out of another transaction into which he might have entered but in fact did not enter. Where, however, the annihilation of an agreement or arrangement so far as it has the purpose or effect of avoiding liability to income tax leaves exposed a set of actual facts from which that liability does arise, the provision effectively operates to remove the obstacle from the path of the Commissioner and to enable him to enforce the liability ".

30. The latest of these four cases is *Bell's* case. The following 30 summary of the somewhat complicated facts of that case is taken from the judgment of Fullagar J. in the present Appeal—

" This case, like the present case, involved the carrying out of a very elaborate plan, which had been carefully worked out beforehand for the benefit of the taxpayers by persons expert in taxation matters. The facts are fully set out both in the judgment of McTiernan, J. and in the single judgment of five justices deliverd on an appeal from McTiernan, J., which failed. The details are, of course, important but they need not be repeated here. A brief statement will suffice. The appellant taxpayer, Bell, was a member of a partnership of seven persons which had been formed in Sydney

Vol. III, p. 92, l. 36. p. 94, l. 11.

about October, 1946, and which had acquired from the Commonwealth Disposals Commission a quantity of surplus war material lying on Torokina Island in the Territory of Papua. In January 1947 they caused to be formed two companies. One, Torokina Disposals Pty. Ltd., was incorporated in New South Wales, the partners being the shareholders. The other was incorporated in Papua. The seven signatories to the memorandum of the latter company were Mr. White, a solicitor of Port Moresby, and six other residents of Papua, whose co-operation was obtained by Mr. White. Each subscribed for one share of £1 : no other shares were ever 10 allotted. In March 1947 the signatories to the memorandum transferred their shares to the partners, each partner acquiring for £1 one fully paid share. The intention was that the partnership should sell the goods bought from the Commissioner to the Papuan company at cost, and that that company should then sell the goods at a profit to the Australian company. The profit on sale would thus be derived by the Papuan company, which, being a resident of Papua and deriving its profit from Papua, would be exempt from income tax under s. 7(1) of the Assessment Act. It was contemplated at the beginning that tax would be payable on any 20 distribution of profits by the Papuan company to the partners, who were now its shareholders, but later a more ambitious use of the Papuan company was conceived. By February 1948 a stage had been reached at which all the disposal goods had been sold, and the New South Wales company had in its hands a sum of £78,520, representing the net proceeds thereof. On 4th February Bell and four other partners proceeded from Sydney to Port Moresby armed with a bank draft for this amount and a " Memorandum of Routine " which had been prepared by their advisers. What happened at Port Moresby is set out in detail in the report (at pp. 569–71). It may be 30 summarised as follows. The draft of £78,520 was paid into the Papuan company's account in the Bank of New South Wales. The company lent Mr. White the sum of £77,000. Mr. White had again (as he had done on the formation of the company) provided six local collaborators, and to each of these he lent a sum of £11,000. Mr. White and the collaborators bought the shares of the seven partners, each partner selling his £1 share for £11,000. The loans provided the purchase money. The purchaser of Bell's share was a man named Corlett. The company declared a dividend of £77,000 (payable, of course, to Mr. White and the collaborators). The collaborators

repaid to Mr. White their respective loans of £11,000, and Mr. White repaid to the company his loan of £77,000. These things were done by means of cheques drawn on the Bank of New South Wales. The "Routine" contained careful provision for the order of events in general, and for the order of the appearance of the cheques in the bank ledgers. Each of the six collaborators appears to have received a reward of £20, a sum which proved to be exactly £20 more than his services were really worth."

The case was heard by McTiernan J. who held that the transactions
10 were not genuine transactions and without reference to section 260 he held that the sum of £11,000 was income which the taxpayer obtained by reason of the distribution by the company of its profits. On appeal to the Full Court consisting of Dixon, C.J., Williams, Webb, Fullagar and Kitto JJ. it was held that the transactions were perfectly genuine and that each step was intended to and did have the legal effect which it purported to have, but that section 260 applied. The Court said at pp. 572–3 :—

"The section is of course an annihilating provision only. It has no further or other operation than to eliminate from consideration
20 for tax purposes such contracts agreements and arrangements as fall within the description it contains. It assists the Commissioner in a case like the present only if when all contracts agreements and arrangements having such a purpose or effect as the section mentions are obliterated. The facts which remain justify the Commissioner's assessment".

Speaking of the word "arrangement" and its relation to transfers of property, the Court said at p. 573 :—

"It is true that as Isaacs J. observed in the former of these
30 cases (*Jaques'* case) the word does not include a conveyance or transfer of property as such, but as the cases cited show, under the section a conveyance or transfer of property may be void as against the Commissioner as being part of a wider course of action which constitutes an arrangement in the relevant sense of the word".

Speaking of what was done by the taxpayer *Bell* and his colleagues the Court said at p. 573—

"This arrangement both in purpose and in effect represented nothing but a method of impressing upon the moneys which came to the hands of Bell and his colleagues the character of a capital receipt and of depriving it of the character of a distribution by a

company out of profits. It was therefore a means for avoiding the income tax which would have been payable had the £77,000 been distributed by the company in the normal way. Section 260 (*c*) postulates a duty or a liability imposed on a person by the Act, but this refers not to a liability to pay a particular amount of tax (which would be a liability imposed by a taxing Act) but to a liability such as section 17 of the Act imposed on Bell to pay tax in respect of his taxable income ascertained by including in his assessable income his proportion of the Papuan Company's profits if and when he should participate in a distribution of them. It must therefore be held that the transactions of 2nd, 3rd and 4th February, 1948 constituted an arrangement made by Bell and the others who took part, having the purpose and (apart from the operation of 260) the effect of defeating and avoiding a liability imposed on Bell by the Act. Then if this arrangement be treated as void what remains ? Simply this, that on 3rd February, 1948 £77,000 consisting entirely of profits was withdrawn from the Company's Bank Account and £11,000 of it passed indirectly but by steps which are clearly traceable on the face of the Banks ledgers into Bell's Bank Account ; and Bell is to be considered as remaining at that time a shareholder in the Company, his transfer to Corlett being *ex hypothesi* void as against the Commissioner as an integral part of the arrangement. This means that the application of section 260 in this case is to eliminate those features of the case upon which the exclusion of the £11,000 from the assessable income depends, and by that means to establish the correctness of the assessment appealed against ".

31. The Respondent submits that those four cases were rightly decided and that the majority of the Full Court in the present case correctly applied the principles there laid down and that the present case is not distinguishable from *Bell's* case.

Vol. III, pp. 1–42.

JUDGMENT OF KITTO J.

32. In the present case the primary Judge, Kitto J., decided in favour of the Appellants. His reasoning and the Respondent's comments thereon are as follows :—

(1) His Honour held that apart from section 260 the original shareholders could not be said to have derived any assessable income, and that every step taken was genuinely intended to have full effect.

(2) His Honour said that it is to be regarded as settled that although the word arrangement in section 260 does not include a conveyance or transfer of property as such, it does include any kind of concerted action by which persons may arrange their affairs for the stated purpose or so as to produce the stated effect and that a conveyance or transfer may be void as against the Commissioner as forming part of the course of action which constitutes an arrangement in this sense. His Honour regarded it as also settled that an arrangement having the purpose or effect of avoiding the general
10 liability imposed by section 17 would be within section 260 (*c*). A third point which His Honour regarded as settled was that the section is an annihilating provision only, so that it avails the Commissioner where and only where the result of its rendering an arrangement void to the extent which it mentions is to leave standing a state of affairs in which a challenged assessment is justified.

(3) His Honour held, however, that the word "annihilate" as used in the cases does not mean that something which is to be treated as void is regarded as never having happened. He observes—

Vol. III, p. 21, l. 27 to l. 35.

"The section leaves all the facts of a case exactly as it
20 finds them, requiring neither that anything which was not done shall be deemed to have been done nor that anything which was done shall be deemed not to have been done. As applied to a transfer of shares for example, it leaves standing the fact that the transfer was executed and was registered and merely requires that the title to the shares be considered as remaining nevertheless unchanged".

(4) His Honour said that the section recognized that the arrangement considered as a whole may have other purposes and effects as well as those defined in the section, and that it requires
30 that out of the legal consequences of everything that constitutes the arrangement those legal consequences be selected and treated as void which have the purpose or effect of themselves producing any of the results described in paragraphs (*a*), (*b*), (*c*) and (*d*) and that even those legal consequences are to be treated as void to the extent only that they have that purpose or effect.

(5) His Honour then proceeded to examine the origin of the transactions as disclosed by the evidence as he put it—

Vol. III, p. 23, l. 10 to l. 19.

"Not so much to find whether they had one or more of the

purposes mentioned in s. 260 but in order to discover whether, if the sales and transfers of the " A " and " C " shares be treated as void in law, a consideration of all that remains should lead to the conclusion that the moneys and shares received by the original shareholders, either alone or together with the moneys retained by Pactolus for itself, were derived by those shareholders as income ".

(6) His Honour held on the facts that it was not a term of the bargain that the special dividends when paid to Pactolus should be applied by that Company in paying the purchase price of the " A " shares and that what was done in relation to the simultaneous banking of cheques was simply adopted as the obvious businesslike method of dealing with cross payments. 10

(7) His Honour then examined the second Neals transaction and the Commissioner's contention that when the transfer of the shares is treated as void there remains a payment of dividend by Neals to Pactolus with the assent of the original shareholders, a passing on of portion of the amount to the original shareholders and the retention of the remainder by Pactolus by way of reward or remuneration for its co-operation in the transaction. His Honour then said that there was no justification for treating the payment of the dividend to Pactolus as being made with the assent of the original shareholders in a sense which justified the conclusion that the receipt of the dividend by Pactolus was a derivation of it by the original shareholders. His Honour said that that contention involved not only annihilating the legal effect of the sales and transfers of the " C " ordinary shares, but adding to the facts a— 20

Vol. III, p. 36, l. 48 to p. 37, l. 7.

> " fictional agreement by the original shareholders to the effect that in the event of the transaction being regarded for any purposes void, so far as it vested in Pactolus the right to receive the special dividend, then their own right to receive that dividend (a right to be deemed for that purpose to exist) should be satisfied by a payment of the amount by Neals to Pactolus " 30

and His Honour said that section 260 cannot achieve that result and can never create " notional acts or events ". The Respondent submits that this is to misconceive the argument and to misunder-

stand the nature of the "set of actual facts left exposed" by the avoidance under section 260 of the transfers. It is not necessary to create any "fictional agreement" dealing with the contingency envisaged by His Honour.

(8) His Honour then considered the argument that upon treating the sales and transfers of the "C" ordinary shares as void the money paid by Pactolus to the original shareholders should be considered not as the price paid for the shares but as being income. His Honour held that it was not sufficient to destroy the nature of 10 the payment as a capital payment on a transfer of shares and that there was nothing in the circumstances to give the money paid by Pactolus to the original shareholders the character of income. His Honour then distinguished the case from *Bell's* case which he said proceeded upon two main findings, one that a sum of money consisting of profits having been drawn from the Company's Bank Account passed into the taxpayer's Bank Account, indirectly, but marked by steps which were clearly traceable on the face of the Bank's ledgers. The other finding was that the arrangement in purpose and effect was nothing but a method of impressing a dividend 20 with a character of capital in a process of passing it from the company to the taxpayer. He said that in *Bell's* case the arrangement was an agreed means of dealing with the dividend to create a specific fund and of ensuring that with its character changed but its identity preserved it should reach the hands which it would have reached if the arrangement had not been made.

(9) His Honour said that it was not possible in the present case to make similar findings, and he said that the payments made to the shareholders were not shown to have been made wholly or to any ascertained extent out of the dividend moneys, and that in 30 using some part of the dividend to meet the purchase price of the "C" ordinary shares Pactolus was simply adopting by its own choice the method which it found convenient for making a payment out of its own money. There is no term in the agreement for the sale and purchase of the "C" ordinary shares that the price should be paid out of the dividend. His Honour, therefore, said that it could not be found on the evidence that from the point of view of the original shareholders the arrangement was a means of getting some of the company's distributable profits transferred to themselves.

(10) Of the other four transactions His Honour said that they were not transactions constituting a procedure adopted for the common purpose of getting the special dividend to the original shareholders, and that they were transactions of a purely commercial character.

It is respectfully submitted that Kitto J. was wrong in deciding as he did for the reasons given by the majority of the Full Court in reversing his judgment. These reasons may be summarised as follows :—

(*a*) That if Kitto J. did not find that there was an arrangement that had the purpose and effect of relieving the Appellants of liability to pay tax or of avoiding a liability imposed upon them by the Act he was in error in not doing so. 10

(*b*) That there being an arrangement of the character referred to which resulted in the sales and transfers being void as against the Respondent (which was the basis upon which Kitto J. was prepared to proceed) then no more was necessary to sustain the amended assessments than to find, as was the fact, that the Appellants received from Pactolus £1,661,722 of the dividends paid on these shares so that in respect of that amount at least a distribution of profits by the Motor Companies had been received by their shareholders, i.e., the Appellants. Accordingly it was not necessary to enquire further as did Kitto J. (1) whether the Appellants should be deemed to have assented to Pactolus receiving the dividends or (2) whether in addition to requiring the Appellants to be treated as the holders of the shares section 260 had some further positive application in converting what they received as purchase money into dividends. On the footing established by section 260 the moneys received by the Appellants were dividends according to the principles of company law and the definition of " dividend " in section 6 of the Act without the need for attributing any further operation to section 260. 20 30

(*c*) That although Kitto J. was right regarding *Bell's* case as rightly decided he was in error in thinking it distinguishable.

(*d*) That what was decisive was not that Pactolus had agreed to pay to the Appellants the major part of what it received as dividends from the Motor Companies but that it did so and further, if it be necessary to go further, that it was intended by all concerned that it should do so.

JUDGMENTS IN THE FULL COURT.

Vol. III, pp. 55–126.

33. In the Full Court Dixon C.J. said that he agreed in all substantial respects with the views expressed by Williams J, and Fullagar J. and did not give separate reasons of his own.

Vol. III, p. 55, l. 8 to l. 14.
Vol. III, pp. 60–74.
Vol. III, pp. 74–104.

34. McTiernan J. ruled that the series of steps taken constituted an arrangement and that it was not necessary to find a binding stipulation that Pactolus should use the dividend as the fund out of which to pay for the shares transferred to it, and that " as a hard practical matter of fact " Pactolus used the dividend to pay for the shares. His Honour then said that if the transfers are treated as void the " taxpayers were always *submodo* the shareholders and as such derived the whole of the dividends as income. It is entirely consistent with this hypothesis to tax each Respondent on the full amount of his proportion of the distribution ".

Vol. III, p. 58.
Vol. III, p. 60, l. 9 to l. 13.

35. The reasoning of Williams J. was as follows :—

Vol. III, pp. 60–74.

(1) His Honour said that all the steps necessary to carry out the plan were taken quite openly and that there was nothing unlawful about them and that they were all intended to have the legal effect that they purported to have.

Vol. III, p. 67, l. 12 to l. 16.

(2) His Honour said, however, that the only moneys used to effectuate the whole of the transactions apart from the £19,000 temporarily provided by Pactolus were the moneys of the companies which were to be distributed to satisfy the special dividend rights on the " A " ordinary shares and that Pactolus had in truth paid nothing out of its own pocket on any of the shares apart from £659 in the case of Lanes to provide the 2d. per share by which the special dividend rights fell short of the purchase price.

Vol. III, p. 67, l. 16 to l. 27.

(3) His Honour in referring to the words " purpose or effect " in section 260 said that although the words are in the alternative they did not appear to him to have any real difference in meaning. The purpose of a contract agreement or arrangement must be what it is intended to effect and does effect.

Vol. III, p. 68, l. 24 to l. 34.

(4) His Honour regarded Paragraph (*c*) of section 260 as the most appropriate and said that what was done was " an arrangement entered into between the three companies, their directors, shareholders and Pactolus to dispose of income of the companies which

Vol. III, p. 69, l. 21 to l. 41.

income would have to pay additional tax under Division 7 if not distributed, or become assessable income of the shareholders if distributed, in such a way that the major part of this income would be retained by the companies as working capital by the issue of new shares to the shareholders as fully paid, and the balance would be received by the shareholders in cash, but the companies would not become liable to pay additional tax because they would have distributed the distributable amounts of their taxable incomes and the shareholders would not become liable to pay income tax on either the shares or the cash as part of their taxable incomes. That 10 such an arrangement was made, I have no doubt. I also have no doubt that it was an arrangement the purpose of which was directly or indirectly to defeat, evade or avoid a liability imposed on the shareholders by the Act ".

and then His Honour said—

Vol. III, p. 69, l. 49 to p. 70, l. 4.

" The whole of the income comprised in the special dividends, except the tax-free funds, would have been assessable income of the shareholders, but for the steps that were interposed by the concerted action of the companies, their directors, shareholders and Pactolus ".

(5) His Honour then said that from all the circumstances— 20

Vol. III, p. 70, l. 15 to l. 23.

" the inference is irresistible that all the parties intended that the moneys required to finance the whole of the steps that were taken commencing with the passing of the special resolutions and ending with the shareholders becoming possessed of the new " B " preference shares and large sums of cash were to be provided out of the income of the companies intended to be distributed by the special dividends declared on the ' A ' ordinary shares ".

(6) After referring to the Commissioner's contention that it was the transfers of the " A " ordinary shares which provided the purpose or effect within the meaning of section 260, His Honour 30 said that the case for the Commissioner could be put equally well—

Vol. III, p. 71, l. 5 to l. 7.

" by impeaching the whole of the steps commencing with the passing of the special resolutions ", and then after referring to the statement in *Bell's* case that section 260 is only an " annihilating provision " His Honour said—

Vol. III, p. 71, l. 20 to l. 33.

" If all the steps under discussion are avoided the facts that remain are that the moneys of the companies identified as the moneys distributed as special dividends on the " A '

ordinary shares except for Pactolus' share reached the hands of the shareholders and these moneys were partly retained by them as cash but mostly used to pay for the new " B " preference shares of which they became the holders, but whichever course is adopted the result appears to me to be the same. The liability to pay income tax on income of the companies which reached the shareholders in the shape of fully paid shares or cash and which should have been part of their assessable income was avoided ".

10 (7) His Honour held that what happened and what was intended to happen was that—

" The only real money to be used would come from the companies and most of it would go back to the companies as share capital, and in the meantime on the way round would be used as the purchase price for the ' A ' and ' C ' ordinary shares ". Vol. III, p. 72, l. 20 to l. 24.

(8) After referring to *Bell's* case, His Honour said that that case cannot be relied upon as an authority for the proposition that the sole purpose and effect of an arrangement, must, to come within 20 section 260, be to achieve one of the prescribed objects there set out. His Honour said that it was sufficient if the arrangement had in part one of those purposes or effects, although it may have had other purposes or effects as well. His Honour went on to say that in the present case he would if necessary be prepared to hold that the whole purpose and effect of the arrangement was to defeat evade or avoid the liability imposed upon the shareholders by the Act. Vol. III, p. 73. Vol. III, p. 73, l. 25 to l. 29.

(9) With regard to the amount of money which was retained by Pactolus, His Honour said that the shareholders must be held to have consented to Pactolus acquiring the cash and shares as part of 30 its remuneration for carrying out the arrangement and that after section 260 had done its work the whole of the special dividends must be considered to be for the purposes of income tax the property of the shareholders, and that accordingly any portion of those distributions Pactolus received must be considered to have been paid to it with their consent.

36. A summary of the reasoning of Mr. Justice Fullagar is as follows :— Vol. III, pp. 74–104.

(1) His Honour regarded the evidence of the origin of the transactions as throwing no light on the question whether the receipts Vol. III, p. 78, l. 13 to l. 17.

of cash and shares ought to be regarded for income tax purposes as income receipts or capital receipts.

Vol. III, p. 79, l. 7 to l. 15.

(2) The intention of Division 7 of the Act was to create a true dilemma for private companies—either their profits should be distributed as dividends to their shareholders, in which case the shareholders pay £X by way of income tax, or they are not distributed to the shareholders in which case the company would pay £X by way of income tax.

Vol. III, p. 81, l. 7 to l. 12.

(3) His Honour regarded as beyond question that the immediate purpose and object of all concerned was to find some way of escape from the dilemma created by Division 7. 10

Vol. III, p. 86, l. 28 to l. 45.

(4) His Honour stated that the end result of the Lanes transaction was, from the point of view of Lanes, a sum of £458,161 had gone out from the accumulated profits of the company and the sum of £402,679 had been added to its issued capital and was represented by 402,679 " B " preference shares fully paid, and from the point of view of the original shareholders, they had acquired 402,679 " B " preference shares and received in cash £56,141. At the same time Pactolus was left with 79,107 " A " ordinary shares, having paid out £659. 20

Vol. III, p. 87, l. 42 to p. 88, l. 1.

(5) His Honour stated that the primary criterion adopted by the section was the purpose which the particular transaction was designed to effect. If it is found that the transaction has taken a particular form because the purpose in view was one of the purposes mentioned in the section, then the section strikes at it. His Honour then analysed the decisions in *Purcell's* case, *Jaques'* case, *Clarke's* case and *Bell's* case, and stated that those cases established that there are two questions—first whether the operations challenged were actuated by one or more of the purposes referred to in section 260 and if that question which is a question of fact is answered in the affirmative the second question arises—what is the effect of the application of section 260 ? 30

Vol. III, p. 88 to p. 95.

Vol. III, p. 96, l. 1 to l. 10.

Vol. III, p. 96, l. 30 to l. 31.

(6) His Honour felt that there was no doubt (it was " beyond serious argument ") that the transactions had for their purpose—

Vol. III, p. 96, l. 35 to l. 37.

> " the avoidance of a liability to income tax imposed by the Act on persons in the position of Lanes and its share holders ".

(7) His Honour pointed out that the genuineness or reality of the transactions was not a relevant question, since if the transactions were not real and genuine no question could arise. On the other hand if the transactions were real and genuine the question was whether they had one of the purposes specified in section 260, and if they did then their "reality or genuineness" could not save them from the operation of section 260.

Vol. III, p. 97, l. 29 to p. 98, l. 8.

(8) Having concluded that section 260 was applicable to the case, His Honour then considered the effect of its application and held that the case could not be distinguished in any material respect from *Bell's* case. He held that the cash which the shareholders received and the money which paid up the "B" preference shares came out of the company—

Vol. III, p. 98, l.9.

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"Lane's money was (literally, or to all intents and purposes) the only real money which figured in the transactions"

Vol. III, p. 98, l. 27 to l. 29.

and that—

"the intention from the outset was obviously that the dividend should provide the real money to pay for the shares".

Vol. III, p. 98, l. 40 to l. 42.

(9) Section 260 enables the Commissioner to look at the "end result" and to ignore all the steps which were taken in pursuance of the avoided arrangement. When he does that what he finds is simply that the profits of the company have come in the shape of cash and new fully paid shares into the hands of the shareholders in the company, and when that is all that is looked at it means that those shareholders have received income—dividends within the meaning of section 6 of the Act.

Vol. III, p. 98, l. 45 to p. 99, l. 6.

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(10) As to the argument that the cash which was received and retained by Pactolus should not be included in the assessable income of the Appellants upon the basis that it was part of the "end result", His Honour says that what was received and finally retained by Pactolus was by way of remuneration or reward to Pactolus for services rendered.

Vol. III, p. 103, l. 42 to p. 104, l. 6.

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37. The reasoning of Taylor J. (who dissented), and the Respondent's comments thereon, are as follows :—

Vol. III, pp. 105 to 126.

(1) His Honour first discusses the question of the meaning of the expression "any duty or liability" in Paragraph (*c*) of section 260

Vol. III, p. 106, l. 25.

and the expression " liability to pay any income tax " in Paragraph (*b*) and observes that the cases showed that there may be on the part of a taxpayer an avoidance of liability to tax within the meaning of the section in respect of income before it has been derived. He then observes that the section has no application in a case where there has been a genuine disposition of income producing property, even though the disposition may have been influenced or even induced by considerations of the incidence of income tax, and even though in a general or loose sense it results in the " avoidance of income tax ". He then points out that the decision in *Bell's* case requires that statement to be understood subject to the qualification— 10

Vol. III, p. 111, l. 12 to l. 19.

> " That if any such disposition is found as part of an arrangement made for the purpose of avoiding income tax the section may be called in aid by the Commissioner ".

Vol. III, p. 111, l. 23 to l. 26.

(2) His Honour then said that *Clarke's* case showed that an arrangement may present features of a very special character which reveal that none of the dealings comprising the arrangement has any practical economic or commercial significance beyond the avoidance of a liability to pay income tax. In such cases the arrangement, though not a sham in the strict sense, is removed from that category 20 only by the presence of dealings which, although they are effective in law as such, serve no practical purpose other than the avoidance of income tax.

Vol. III, p. 111, l. 43 to p. 112, l. 10.

(3) Referring to *Clarke's* case, His Honour points out that the stated case being dealt with by the Court says expressly that the transactions were not sham or fictitious transactions but that they were entered into by the companies solely because their operation and effect would or might prove advantageous to the Appellant both generally and from the point of view of State and Federal Income Tax Legislation. His Honour then points out that in the 30 Court's reasons in *Clarke's* case it was stated that the arrangement was adopted for the " sole purpose of intercepting the liability to income tax which would otherwise flow from the payment ".

Vol. III, p. 112, l. 42 to p. 113, l. 5.

Vol. III, p. 113, l. 24 to l. 26.

(4) His Honour then observes that it was possible to characterise the arrangement disclosed by the evidence in *Bell's* case in precisely the same way, and said after quoting from the judgment of the Court that he took the Court to mean that—

Vol. III, p. 113, l. 35 to l. 37.

> " The Court saw nothing in the fact that the company

Vol. III, p. 115, l. 10 to l. 17.

retained a comparatively insignificant portion of its profits to defeat the otherwise inevitable conclusion that the sole purpose and effect of the arrangement was to avoid a liability to income tax, and accordingly *Clarke's* case was directly in point ".

(5) His Honour then concluded that, although the operation of section 260 is not invoked by every arrangement which has the effect of avoiding income tax in a loose and general sense, it will be invoked where the arrangement has no significance or purpose but the avoidance of tax in that sense.

Vol. III, p. 115, l. 24 to l. 30.

10 (6) His Honour points out that in the present case there can be no doubt that consideration of the incidence of income tax determined the selection of the transactions which the parties subsequently carried out.

Vol. III, p. 115, l. 33 to l. 36.

(7) His Honour, after referring to the details of the transactions, observed that it had not been suggested that they were shams nor that they did not have full legal force and effect according to their tenor. He then states that if a liability to tax was avoided by the transactions it was—

Vol. III, p. 121, l. 20 to l. 23.

" in the loose sense, already referred to, avoided because 20 when the dividends in question became payable Pactolus and not the Respondents were the owners of the shares, and because that company was a company which traded in shares and its operations left room for the contention that comparatively little or no tax could be collected from it in respect of its income receipts for the relevant year ".

Vol. III, p. 121, l. 43 to p. 122, l. 2.

(8) His Honour regarded the case as " vastly different " from *Clarke's* case and *Bell's* case. The arrangements disclosed by the evidence in those cases had no purpose other than the avoidance of the liabilities of tax, and had no significance beyond the achievement 30 of that result. They served no purpose other than " prospectively to transmute income into capital ". On that basis section 260 applied in those cases and its effect on the relevant dealings was such as to enable the Commissioner to deny the transmutation from income into capital. His Honour thought, however, that in the present case " no such simple solution is possible ".

Vol. III, p. 122, l. 3 to l. 20.

(9) His Honour said that in the present case the taxpayers sold and intended to sell shares which were and still remain of

Vol. III, p. 122, l. 30.

considerable value, and remained a substantial holding in the companies. It was profitable for Pactolus to pay the price for the shares because it was a company and its operations were of a particular character and because it was intended that the special dividend rights would be discharged within a short period—

Vol. III, p. 123, l. 7 to l. 16.

> " Whilst the various dealings were designed to ensure that no tax liability should arise so far as the Respondents were concerned, their purpose and object was to divest the Respondents of a substantial part of their existing holdings and to ensure that at no time in the future would they derive income from them. They were at liberty to sell their shares and when they sold them they did so by dealings which were genuine and effective sales ". 10

Vol. III, p. 123, l. 22 to l. 26.

His Honour held that in the circumstances it was impossible to say that the sole purpose of the arrangement was " to avoid any duty or liability imposed by the Act ".

Vol. III, p. 123, l. 29 to l. 43.

(10) His Honour also said that, even if he regarded the condition precedent to the operation of section 260 as having been established, he would agree with Kitto J. that the section would not entitle the Commissioner to treat the amounts actually received as income. He said that in *Clarke's* case and *Bell's* case the only practical effect produced by the transactions treated as void was to transmute prospective income into capital and in those circumstances the annihilation of the arrangements left each taxpayer in *statu quo*. In the present case, however, the taxpayers parted with valuable assets and— 20

Vol. III, p. 123, l. 43 to l. 47.

> " it is impossible simply by ignoring one part of the original transaction, i.e., the transfer of the shares, to characterise the actual receipt of the price of the shares as the receipt of assessable income ". 30

Vol. III, p. 124, l. 7 to l. 12.

(11) His Honour in dealing with the argument that the avoidance of the transfers leaves a situation in which Pactolus received dividends to which it was not entitled and passed them on to the taxpayers who were the shareholders, said that the conclusion that the amounts so received were dividends in the hands of the shareholders depended not merely upon the notional avoidance of the transfers but could only be reached by taking a further " notional step for the purpose of giving a new color or character to the payments ". His Honour

said that if section 260 can notionally annihilate the transfer of shares and operate to divest the purchase price of its true character it cannot operate to invest the payments with a completely new character and one which is foreign to the circumstances in which they were made.

Vol. III, p. 124, l. 32 to l. 39.

It is respectfully submitted that this judgment is in error as follows :—

(*a*) In deciding that section 260 applies to dispositions of property only when the arrangement of which they form part has no purpose or significance beyond avoiding any duty or liability imposed by the Act.

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(*b*) In deciding that *Clarke's* case and *Bell's* case were cases where the arrangement found to exist had no purpose or significance beyond avoiding any duty or liability imposed by the Act.

(*c*) In distinguishing *Bell's* case.

(*d*) In deciding that only by attributing to Pactolus an intention to account to the Appellants for what it received from the Motor Companies as dividends that the moneys in fact paid by Pactolus to the Appellants from such dividends could be regarded as dividends in the hands of the Appellants.

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(*e*) The decisive circumstance to which Taylor J. did not give proper significance was that the Appellants being shareholders for the purposes of the Act received a distribution of the profits of the Motor Companies of which they were shareholders. To adapt the words of *Bell's* case 87 C.L.R. 548 at p. 574, £1,764,136 consisting entirely of profits was withdrawn from the Motor Companies Bank Accounts and £1,661,722 of it passed by steps which were clearly traceable into the bank account of the Appellants who are to be considered as remaining as shareholders of the Motor Companies. This means that the application of section 260 in this case is to eliminate those features of the case upon which the exclusion of the £1,661,722 from assessable income depends, and by that means to establish the correctness of the assessments appealed from as to £1,661,722 at least.

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(*f*) In failing to treat the sum of £102,414 retained by Pactolus as part of the dividends to which so far as the Respondent was concerned the Appellants were entitled.

RESPONDENT'S SUBMISSIONS.

38. The Respondent therefore submits that the decision of the Full Court of the High Court was correct and should be affirmed for the following reasons :—

(1) The reasons of the majority of the Full Court were right and the reasons of Kitto and Taylor JJ. were wrong.

(2) Section 260 of the Act applies to the transactions entered into by the Appellants.

(3) There was a " contract, agreement or arrangement " within the meaning of section 260. 10

(4) That arrangement was void as against the Respondent insofar as it had the purpose or effect of relieving any person from liability to pay any income tax or of defeating evading or avoiding any duty or liability imposed on any person by the Act.

(5) The transactions entered into by the Appellants were part of an " agreement or arrangement " entered into by the Appellants and having the purpose or effect of relieving them from liability to pay income tax or of defeating evading or avoiding a duty or liability imposed by the Act.

(6) That arrangement was void as against the Respondent 20 insofar as it purported to relieve the Appellants from liability to pay income tax or to defeat evade or avoid a duty or liability imposed by the Act.

(7) The operation of section 260 was to avoid as against the Respondent the transfer of shares from the Appellants to Pactolus, leaving the Appellants as the holders of the shares upon which the special dividends were paid.

(8) Alternatively to (7), the operation of section 260 was to avoid as against the Respondent the whole of what was done other than the declaration of dividends and the issue of preference shares. 30

(9) That arrangement being treated as void as against the Respondent the Appellants were taxable upon the dividends declared by the Companies upon the basis that the whole of such dividends formed part of their assessable income, or alternatively upon so much of such dividends as came into their hands.

(10) The decision of the majority of the Full Court is in accordance with the earlier decisions of the High Court and in particular with *Jaques'* case, *Clarke's* case and *Bell's* case and those cases were rightly decided.

(11) The present case is not distinguishable from *Bell's* case.

(12) The only money effectively involved in any of the transactions was the companies' money declared as dividends and that money found its way into the hands of the Appellants.

(13) Section 260 is not confined to arrangements or transactions
10 which have no commercial reality.

(14) Section 260 is not confined to cases where the sole purpose of the arrangement was the avoidance of a duty or liability imposed by the Act.

(15) In any event in the present case the sole purpose of the arrangement entered into by the Appellants was the avoidance of tax.

J. B. TAIT.

DOUGLAS I. MENZIES.

K. A. AICKIN.

No. 7 of 1958.

In the Privy Council.

ON APPEAL FROM THE HIGH COURT OF AUSTRALIA.

BETWEEN

LAURI JOSEPH NEWTON and OTHERS

AND

THE COMMISSIONER of TAXATION of the COMMONWEALTH OF AUSTRALIA.

Case for the Respondent.

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