CASE NOTES

ORD FORREST PTY LIMITED v. FEDERAL COMMISSIONER OF TAXATION[1]

Gift Duty—Allotment of shares in a company at par value and premium—Actual value in excess of amount paid—Gift Duty Assessment Act 1941-1967 (Cth) Section 4(1).

On 23 April 1969 there occurred a series of transactions which had the effect of decreasing Mrs Palfreyman's assets by $2,590,480 and increasing the total assets of certain members of her family by the same amount. The Commissioner treated these transactions as involving a gift made by Ord Forrest Pty Ltd, a family holding company, and therefore assessed the Company for $772,743 and 92 cents duty under the Gift Duty Assessment Act 1941-1967. This assessment was upheld by Stephen J.[2] On appeal to the Full High Court, Their Honours were equally divided[3] and as a result the original assessment stands. It will be submitted that this case gives rise to a number of serious analytical difficulties and that the reasoning of the dissenting judges is to be preferred.

The Company was incorporated on 17 March 1969 with nominal capital $30,000 divided into 30,000 ordinary shares. Two shares were issued and Mrs Palfreyman was the beneficial owner of both of them. She then lent the Company $2,500,000 at call. On 23 April 1969, she applied for and was allotted 24,800 more shares in the Company at a total cost of $2,480,000.[4] This transaction, of course, largely extinguished the debt of the Company, but left her as beneficial owner of its entire equity. Later in the same day, however, all her shares were converted to $1 non voting 4% preference shares which entitled their holders to participate in a winding up only to the extent of their nominal value.

As Mrs Palfreyman was at the time the sole shareholder, this last transaction left the Company in a rather odd state. First, no existing shareholder was entitled to vote at any general meeting. Secondly, the total entitlement of existing shareholders to the Company's assets in the event of winding up was only $24,820 while the assets themselves were worth about a hundred times this sum. Both the control and most of the equity of the Company were thus, in a sense, 'floating' and would vest in any persons who became holders of ordinary shares. In the event, eight ordinary shares were issued, four to Mrs Palfreyman's children and four to a trustee company as trustee for certain of her grandchildren. The holders of these eight shares paid $100 each, but had

[1] [1974] A.T.C. 4034. High Court of Australia; Barwick C.J., McTiernan, Gibbs and Mason JJ.
[2] (1973) 47 A.L.J.R. 193.
[3] Barwick C.J. and McTiernan J. were in favour of allowing the appeal and Gibbs and Mason JJ. of dismissing it.
[4] Each share cost $100, the cost being made up of $1 par value plus $99 premium.

the Company been wound up immediately after the issue of the shares could have expected to receive $323,910[5] each.

Do these facts give rise to a liability to pay Gift Duty under the Commonwealth Act? Clearly, Mrs Palfreyman intended to confer and did confer a benefit on certain members of her family, but it has been held[6] that a benefactor under these circumstances is not liable to pay Gift Duty. Was the Company then liable? The Gift Duty Assessment Act[7] defines a 'gift' as

> any disposition of property which is made otherwise than by will (whether with or without an instrument in writing), without consideration in money or money's worth passing from the disponee to the disponor, or with such consideration so passing if the consideration is not, or, in the opinion of the Commissioner, is not, fully adequate.

Two questions arose in this case. First, was there a 'disposition of property' by the Company? Secondly, if so, was the consideration 'fully adequate'? Now clearly there was at no stage a disposition of property in the usual sense from the Company to the shareholders. When the shares were issued the shareholders simply acquired a newly created chose in action against the Company. However, this does not conclude the matter since the Act defines 'disposition of property' rather widely as

> any conveyance, transfer, assignment, settlement, delivery, payment or other alienation of property and, without limiting the generality of the foregoing, includes—
>
> (a) the allotment of shares in a company; . . .
>
> (f) any transaction entered into by any person with intent thereby to diminish, directly or indirectly, the value of his own property and to increase the value of the property of any other person.

For the Commissioner, it could be argued that the definition explicitly includes 'the allotment of shares in a company' and that these words should be given their literal meaning irrespective of context. Moreover the presence of clause (f) makes it clear that the legislature intended to include transactions that were not, strictly speaking, alienations of property.[8] For the Company, it could be argued that clauses (a) to (f) are intended simply as *examples* of alienations of property and are to be read subject to the opening words of the definition.[9] This limitation is a severe one. When a company allots shares in itself, it does not alienate any of its property. Hence if this submission is correct there was no disposition of property by the company in this case[10] and the phrase 'allotment of shares in a company' should be confined to cases in which the allotment is procured at the instance of a third party who then becomes the disponor. For instance A may pay a company to allot shares to B. As between A and B, there would be a movement of property or at least a movement of *value*. Similarly, there is a movement of value in the

[5] This figure was agreed between the parties. The published information does not make it quite clear how it was made up.

[6] *Gorton v. F.C.T.* (1965) 113 C.L.R. 604.

[7] S. 4(1).

[8] See [1974] A.T.C. 4034, 4042 *per* Gibbs J., 4048 *per* Mason J.

[9] This view was adopted by Barwick C.J. His Honour thought that some of the clauses might have been unnecessary in that they described transactions that were comprehended within the opening words of the definition. It is not clear whether he considered that this same comment applied to clause (a). See [1974] A.T.C. 4034, 4038-9.

[10] [1974] A.T.C. 4034, 4038 *per* Barwick C.J.

transaction described under clause (f). On this view, clauses (a) and (f) show that the concept of alienation is to be treated as a wide one which can extend to movements of value as well as movements of property,[11] but there is no call to read clauses (a) to (f) as applying to cases in which there is no alienation of property at all. Proponents of this view point out that clauses (a) to (f) are stated to be *included* in the opening words and that the logical structure of the definition does not appear to give them a completely independent operation.

While each side could, and did, argue that its own interpretation was the more natural, it is submitted that the Company's interpretation is to be preferred. Although it is clear that the definition of 'disposition of property' is intended to be a wide one, it surely must be confined conceptually to cases in which the total value of the assets of the disponor are decreased and the total value of the assets of the disponee are increased.[12] To take it outside these limits is to strain the meaning of words and there is nothing in section 4(1) that compels the court to do this. In the present case the allotment of shares at $100 each *increased* the total assets of the Company, that is the 'gift', if any, was one that enriched the 'donor'. This fact takes the transaction right outside any analytically satisfactory concept of a gift. Nevertheless, the majority held that there was a gift and as a result of this there arose the curious anomalies discussed below.

Now, accepting for the moment that there is a disposition of property by the Company, the question arises whether the consideration is 'fully adequate'. In order to decide this question the majority judges compared the asset backing of each share with the subscription paid and came to the conclusion that it was grossly inadequate. The Company argued that this test was incorrect, that all that a company is obliged to ask when it issues shares is their par value and that consequently consideration can never be inadequate when par value or greater is paid. This argument was briskly and, with respect, correctly dismissed.[13] The par value of a share represents the minimum sum for which the company may contract to allot it but it does not in any sense represent its true value. The mere fact that two parties enter into a binding contract does not, after all, imply that consideration on both sides is adequate.

The Company's second argument was more weighty. If a company has floating equity then the proposed test would mean that the consideration could *never* be adequate. For suppose that the floating equity is worth X dollars and that Y dollars are subscribed for shares then the total shareholders funds will be increased to X + Y dollars, which will always exceed Y dollars subscribed *however large Y is*. For instance, suppose that a company has a floating equity of $2,000 and that shares are allotted for a subscription of $1,000. According to the reasoning of the majority justices, this subscription would be regarded as consideration for the shares. But the value of the shares on a winding up would be $3,000 ($2,000 floating equity plus $1,000 subscribed capital) and thus the consideration would not be adequate.

The attempts by the majority justices to deal with this point were not, with respect, particularly happy. Gibbs J.[14] suggested that the value of the shares

[11] *Ibid.* 4039 *per* Barwick C.J. It does not, however, extend to *all* movements of value. See, for example, *Gorton v. F.C.T.* (1965) 113 C.L.R. 604.
[12] The actual definition, of course, is not as wide as this.
[13] [1974] A.T.C. 4034, 4037 *per* Barwick C.J., 4044 *per* Gibbs J.
[14] *Ibid.* 4045.

should be computed *before* the subscription is added to the Company's assets. This suggestion may be open to several objections. In the first place, it is highly artificial. The subscription *does* go to swell the company's assets and so accrues to the benefit of shareholders. A 'comparison of the value of what was promised or paid with the value of what was given'[15] would surely include it. There seems little justification for introducing an artificial concept of value merely to save an artificial concept of gift. Secondly, the value of the shares in this case was *in fact* calculated as on a winding up[16] and in a winding up any subscribed capital would be (and for the purposes of calculation was) taken into account. Finally, such a method of valuation would make it an easy matter to circumvent the effect of the present decision. For if the floating equity is worth X dollars then according to this argument X dollars should be subscribed for the shares. The shareholders would then receive assets worth 2X dollars for an outlay of X dollars and a tax free benefaction would have been effected.

Mason J. raised two arguments. First, that the value of shares is not usually equivalent to their assets backing. Secondly, that when an established company issues new shares 'the accretion to the company's assets . . . will go to augment the value of the existing shares'.[17] These arguments lose much of their force when it is remembered that in the present case the value of the shares was determined solely by considering their asset backing[18] and that there were no existing ordinary shares whose value could be augmented. It seems that in the present case the majority would be in a stronger position if they conceded that on their view consideration can never be adequate but held this to be the intention of the legislature.

More serious analytical difficulties spring from the fact that, far from suffering a diminution of its assets through making the 'gift', the company is actually *enriched* by the transaction. It has already been argued that this leads to an exceedingly odd extension of the concept of 'disposition of property'. At first instance, Stephen J. attempted to meet this point by arguing that although the Company's assets were augmented by the allotment of the shares they could have been augmented still further if the price had been raised to the level that would be commercially feasible having regard to the floating equity. By failing to sell the shares for a full commercial price the Company had, he thought, suffered a detriment.[19] This argument seems to ignore the fact that, as we have seen, no consideration however large can represent the full commercial value of the shares. It follows, that, according to the reasoning of Stephen J., if a company with floating equity raises capital by the issue of shares *at however large a premium* it suffers a 'detriment'. Since its assets would be even smaller if it failed to issue shares at all, its situation would appear hopeless.

At this point it is convenient to consider some further analytical difficulties which were not discussed in the judgments. Suppose that a company has a floating equity of X dollars and that it issues one share for Y dollars. By the present decision, it would be deemed to have made a gift of X dollars. But the company retains control of its equity and it can in effect 'give' it away *again*. For suppose that it issues a second share, also at Y dollars. Then the value of

[15] *McGain v. F.C.T.* (1966) 116 C.L.R. 172, 176.
[16] (1973) 47 A.L.J.R. 193, 194.
[17] [1974] A.T.C. 4034, 4047.
[18] (1973) 47 A.L.J.R. 193, 194.
[19] *Ibid.* 195.

that share would be Y + ½X dollars[20] and the company would be deemed to have made a second 'gift', this time of ½X dollars. Similarly if it issued a third share it would make a 'gift' of ⅓ X dollars. By continuing to issue shares, it could 'give' away an indefinitely large sum.[21]

Of course, the sum total of the assets that it had to give away would be only X dollars. But since, according to the reasoning of the present case, it is possible to make a gift *while still retaining that which makes the gift valuable,* the value of these X dollars can be given away again and again. It is difficult to believe that the legislature intended this curious result.

These considerations also make it necessary to enquire whether the *value* of the gift would be calculated in a fair manner according to the reasoning in the present case. If a company with floating equity X dollars issues a share at Y dollars then the asset backing of that share is X + Y dollars. But this situation continues only until more shares are issued. If more shares are issued, then the value of the original share can be reduced. If N shares are issued, then each is worth only Y + X/N. For instance if a company has a floating equity of $1,000,000 and issues one share then that share has an asset backing of $1,000,001. But if 999,999 more shares are issued then the asset backing of each share is only $2.[22] It follows that the commercial value of the original share at the time of its issue depends on an assessment of whether the company is or is not going to issue more shares. Yet section 18(2)(c) provides that the value of the shares may be taken to be 'such sum as the holder thereof would receive in the event of the company being voluntarily wound up on the date when the gift was made'. That is, it seems to take no account of the possibility that the value of the shares may be reduced by further allotments.[23] It is thus possible that the allottee of the first share might find himself liable for a large sum in gift duty[24] yet be deprived by the 'donor' of that which makes the 'gift' valuable.[25]

A further problem with the present case arises because the incidence of gift duty operates directly to affect the value of the gift. Duty becomes payable as a joint and several debt by the company and the shareholder when the shares are allotted.[26] But if the company incurs a debt this would have to be taken into account in estimating the value of the shares as on a winding up of the company.[27] It is true that section 18(i)(c) provides that in computing the value of a gift no deduction shall be allowed in respect of any liability existing at the time of making the gift if the donee is entitled as against the donor to any right of indemnity or contribution. But in the first place it is not clear

[20] The total shareholders' funds would be X + 2Y dollars, being the X dollars floating equity and the 2Y dollars subscribed for shares. Each of the two shares would be worth half this sum, that is Y + ½X dollars.

[21] The series X + ½X + ⅓ X + ¼X + . . . is divergent.

[22] The total ordinary shareholders funds would be $2,000,000 made up of the $1,000,000 original floating equity and $1,000,000 subscribed funds. Spread amongst 1,000,000 shares, this amounts to 2 dollars *per* share.

[23] The determination of the value of shares when that value can be effected by a contingency is of course a very difficult matter. See, for instance, the remarks of McInerney J. in *Re Alex Russell* [1968] V.R. 285. Note that Mrs Palfreyman retained no voting rights in the Company.

[24] S. 25(2).

[25] No doubt this sorry state of affairs is unlikely to occur in practice, but the possibility does not increase confidence in the analytical soundness of the Act interpreted according to the present decision.

[26] S. 25(1) and (2).

[27] S. 18(2)(c). This section was used to calculate the value of the shares in the present case: (1973) 47 A.L.J.R. 193, 194.

that this liability exists 'at the time of making the gift'. It would seem to arise only when the gift is perfected. Secondly, any indemnity or contribution by the company goes directly to reduce the value of its assets and hence of the 'gift'. Hence it seems at least arguable that the total value of the 'gifts' in this case should have been calculated as floating equity *less* duty payable, not full floating equity.[28] This point is not, however, dealt with in the judgments.[29]

Their Honours did, however, consider other possible consequences of more wide spread application. It was argued by the Company that the present decision would render a company liable to pay gift duty whenever it allotted shares at less than full market price *e.g.* as bonus shares or employees' shares. Barwick C.J. (with whom McTiernan J. agreed) appeared to accept this argument at least in its application to employees' shares.[30] Gibbs J., however, argued that an issue of shares to existing shareholders would generally be a fulfillment of existing rights and that an issue of employees' shares would be protected by section 14(f) as a 'gift which is made in the course of carrying on a business for the purpose of obtaining [a] commercial benefit'.[31] Mason J. agreed with Gibbs J. about bonus shares but considered the question of employees' shares a difficult one on which he expressed no opinion.[32] The position of a company wishing to issue shares at less than market price is thus left in a state of considerable uncertainty.

To sum up: the present decision is to be regretted for several reasons. First and foremost, it seems to lead to several conceptual and analytical difficulties. It postulates a disposition of property in which neither property nor value passes and a 'gift' transaction which in fact increases the assets of the 'donor'. Moreover, the 'gift' transaction leaves the 'donor' in possession of that which makes the 'gift' valuable and free to 'give' it away again. The 'donor' can indeed, by repeated 'giving' reduce the value of the 'gift' essentially to zero while nevertheless becoming liable with its 'donees' to duty on a sum that greatly exceeds its total assets. The minority judgments make it clear that this paradoxical result was not forced on the Court by the clear words of a statute. Rather it depends on taking a clause out of context. Taken in context, the clause seems to have a much narrower meaning than was allowed by the majority and a meaning moreover that would make the entire enactment more satisfactory analytically. Secondly, it is at least arguable that even if there was a gift in the present case its value was calculated incorrectly. Finally, the decision leaves uncertain the position of companies that for entirely legitimate reasons wish to issue shares at less than the full market price. It is to be hoped that an opportunity will arise for the matter to be reviewed.

J. McL. EMMERSON

[28] This change in the basis of valuation would save the Company approximately $170,000 if the full duty had to be borne by the Company. It is possible that the effect of S. 25 might be to make the company and shareholders each liable for half of the duty. In this case the change in the basis of valuation would save the Company approximately $65,000.

[29] This situation may be contrasted with that of an ordinary gift. In the latter case, the duty is merely a *charge* on the gift (s. 25(3)) — that is, the gift is security for the primary debt owed by donor and donee.

[20] [1974] A.T.C. 4034, 4038.

[31] *Ibid.* 4043.

[32] *Ibid.* 4047.