TAX PLANNING FOR THE FAMILY BUSINESS IN QUEENSLAND

I. Introduction

"In these days, when rates of tax are high, it is natural enough for a man to seek so to order his affairs that the tax attaching under the appropriate Acts is less than it otherwise would be".[1] The object of tax planning is to give effect to this natural desire by developing methods of carrying out transactions so that the total tax payable thereon is kept to a minimum. The evaluation of the efficacy of any method proposed must obviously be based on its effect in minimising the impact of taxes from all sources, State taxes as well as Commonwealth taxes, stamp, gift, and death duties as well as income taxation. Of course, certain devices have been developed so as to reduce the amount of particular taxes, and any tax planning scheme must take account of them. But a synoptic approach must be adopted. There is no great virtue in avoiding income tax, for example, only to attract a greater liability by way of death duties. There is no advantage in avoiding stamp or gift duties at the expense of a reduction in income tax which would exceed the amount of duties so avoided.

The basic concepts upon which all tax planning schemes are founded are quite simple. First, since the rates of income tax and social service contribution are highly progressive, the aggregate tax payable will decrease if a given total amount of income is divided among several recipients. One objective therefore will be to spread income as widely as possible. Secondly, since estate and succession duties are levied either on the estate of the deceased or on the beneficial interest passing upon the death of the predecessor to the successor, the amount of such duties may be reduced either by *inter vivos* dispositions[2] or by the adoption of methods designed to diminish the value of the property held by the deceased upon or prior to his death. Finally, since stamp duty is a charge upon instruments rather than upon transactions,[3] no liability to stamp duty will arise if a transaction is effected without an instrument having been prepared.

Whilst these three principles must be kept constantly in mind in tax planning, the development of a plan to meet the needs of a particular client will be affected by a multiplicity of considerations.

1. *Newton v. F.C.T.* [1958] A.C. 450, 463.
2. Subject however to the provisions of s. 8 (4) of the Estate Duty Assessment Act 1914-1957, ss. 9 and 10 of the Succession and Probate Duties Act of 1892, and s. 4 of the Succession and Probate Duties Act of 1904.
3. Stamp Acts 1894-1958, s. 4.

The client's capacity to understand and implement the plan, his family situation, his assets, the sources of his income, the size and prospects of growth of his business, his age and condition of health, must all be taken into account. Clearly a plan which might be perfectly suitable in the case of a happily married man would be quite unsuitable where proceedings for dissolution of marriage or for maintenance are being contemplated. Matters which might be pertinent in the case of a client operating a large manufacturing business might have little relevance in the case of a client who owns a small hardware store or a dairy farm.

The object of this article is to set out certain taxation considerations which are relevant in drafting a tax plan for a person who is contemplating starting a business or who wishes to reorganise a business of moderate size. It is assumed that he wishes to admit members of his family to a share of the income derived from his business, and to leave his property to them upon his death. It is further assumed that the founder of the business desires to retain control of it for so long as he wishes and to have the power to dispose of it when he thinks fit.

In these circumstances the application of the first principle stated above makes it clear that the choice is between organising or reorganising the business as a partnership or as a company in which the members of the family are admitted as partners or as shareholders, either directly or by the intervention of trustees. An examination must therefore be made of the taxation considerations which must be kept in mind in the formation of a partnership or company, and of the comparative advantages and disadvantages from the taxation viewpoint of these two methods of conducting a business.

II. Formation or Reorganisation of a Business

(a) *Formation of a Partnership.*—The Partnership Act of 1891 defines partnership as the relation which subsists between persons carrying on a business in common with a view to profit. S. 6 of The Income Tax and Social Services Contribution Assessment Act 1936-1959 (hereinafter referred to as the Income Tax Assessment Act) extends this definition to include an association of persons in receipt of income jointly. With that exception, the question whether a partnership exists or not will be determined by the ordinary principles of the law of partnership. In particular, the fact that a person receives a share of the net profits of the business is *prima facie* evidence that he is a partner. Since partnership is a relation resulting from a contract, the partnership agreement requires consideration in order to be binding. This consideration may be provided by a contribution of capital or labour, or both.

It follows from this that if a wife and/or children (whether adult or minor) work in the business a bona fide partnership agreement may be entered into by the members of the family so employed. The same position will obtain if they have capital of their own which they contribute to the partnership capital. If they are unable to contribute capital, it may be necessary for the father of the family to provide them with the necessary capital. This may take the form of a gift by the father, in which case gift duty may be attracted. Gift duty will be imposed if the disposition by the father is gratuitous or for an inadequate consideration, but he may make a disposition for full consideration though no money passes to him from the disponees. In *Fadden v. Federal Commissioner of Taxation*[4] the facts stated showed that F owned shares in a company and that he sold 1,975 shares to each of his four children at a price of £2/4/- per share. No money was in fact paid by the children, and three years later the Federal Commissioner caused an assessment to gift duty to be made in respect of the transactions. It was admitted that the transactions were made bona fide. The High Court set aside the assessment, on the basis that the promise to pay the admitted full value of the shares, being immediately enforceable, was good consideration for the transfer of shares.[5] Therefore if a father transfers property to members of his family to enable them to make a contribution of capital in the formation of a partnership and receives from them a promise to pay the full value of the property so transferred, no liability to gift duty will arise.[6]

Whether stamp duty will be attracted on the formation of a partnership depends upon whether an instrument in writing is required to transfer assets from one partner to the others or to purchase assets from a third party. An instrument in writing is required to transfer real property, but it is not necessary to transfer chattels. In some States of Australia it is therefore possible to reduce stamp duty by a written conveyance of the real property and an oral agreement to transfer chattels; but in Queensland a proviso to s. 49 of the Stamp Acts provides that a conveyance or transfer of any property shall for the purposes of the Act be deemed to comprise live stock and other movable chattels included in the

4. (1945) 70 C.L.R. 555.

5. But "if the appellant were at any time to release the debt so that the promise would no longer be enforceable, a quite different set of circumstances would arise, because the release of a debt is included in the definition of disposition of property and may therefore be a gift": *per* Latham C.J., at p. 558.

6. It should be remarked that the use of this method may result in an increase in the total tax payable. If the transferor dies three years after the promise to pay is made, and the promise has not been fulfilled, the chose in action constituted by the promise will form part of his estate for death duty purposes; whereas if a gift were made and gift duty paid, the property transferred would not after three years be included in the deceased's estate.

transaction, notwithstanding that the same are not included in the instrument of conveyance or transfer but pass upon or by delivery or by or pursuant to another writing or instrument, or in any other manner, and notwithstanding that the same are not at the date of the execution of the instrument upon such property.[7] It may be remarked that this proviso will not include in a conveyance an oral agreement by a sole proprietor of a business that debts due to him shall form part of the partnership property.

The formation of a partnership may also involve a certain liability to income tax. S. 36 of the Income Tax Assessment Act provides for the inclusion in the assessable income of a taxpayer of the value of trading stock, standing or growing crops, crop-stools, or trees which have been planted and tended for the purposes of sale when they constitute or constituted the whole or part of the assets of a business which is or was carried on by the taxpayer, and where they have been disposed of otherwise than in the ordinary course of carrying on that business. In *Rose v. F.C.T.*[8] the High Court held that s. 36 was not applicable to the transfer of an undivided fractional interest in the assets disposed of: it was "directed at the disposal of the entirety of ownership in the assets and not the conversion of single ownership into collective ownership".[9] The effect of this decision has, however, been removed by the enactment of s. 36A, so that upon the formation or dissolution of a partnership, or a variation in the constitution of a partnership or in the interests of the partners, s. 36 applies as if the person or persons who owned the property before the change had, on the day on which the change occurred, disposed of the whole of the property to the persons by whom the property is owned after the change. S. 59A also provides in the same circumstances for the excess or deficiency in the real value of an asset upon which depreciation has been allowed to be brought into account in the ascertainment of the taxable income of the transferor.

(b) *Formation of a Company.*—If the execution of a written instrument is necessary to transfer assets to a newly formed company, stamp duty will be charged as upon a conveyance on sale. It should be remarked that where the device is employed of incorporating both an operating or subsidiary company and a holding company,[10] a simple means of avoiding the operation of the first proviso to s. 49 of the Stamp Acts is available. If the real property is vested in the holding company, and the remainder of the assets

7. There is a departure in this proviso from the principle that stamp duty is a charge upon instruments; the charge is clearly imposed upon the transaction.
8. (1951) 84 C.L.R. 118.
9. 84 C.L.R. 124.
10. The taxation advantages of the use of such a device are discussed later in this article.

in the operating company, there are two quite distinct "transactions". Conveyance of the real property will not include any live stock and other movable chattels, and though stamp duty must be paid on such conveyance, it may be avoided so far as the transaction of vesting the movable property in the operating company is concerned if this is done by an oral agreement. The holding company may then orally lease the real property to the operating company.

Where the members of a partnership convert it into a company by transferring the partnership property to the company in consideration of the allotment of shares of the company in proportion to their respective interests, the transfer will be chargeable with *ad valorem* duty as a conveyance on sale, even though the partners who conveyed the property are the individuals who constituted the company.[11]

The transfer of the assets to the company must of course be for an adequate consideration, or there will be a gift to the company. The consideration will normally take the form of the allotment of shares in the company. The allotment of shares falls within the definition of a disposition of property under both the Commonwealth and State gift duty legislation. Hence an allotment of shares without fully adequate consideration in money or money's worth passing from the allottee to the disponor company will constitute a gift. If, therefore, a sole proprietor of a business wishes to reorganise it as a company and to admit members of his family as shareholders, gift duty will be attracted, either if he transfers the property to the company for an inadequate consideration or if the company allots shares to members of the family from whom it has received an inadequate consideration.[12]

There are several ways out of this difficulty. The simplest is for the sole proprietor to transfer the assets to the company for full value, the consideration received by him being left as a debt due to him from the company. Assume that the value of the assets so transferred is £20,000, and that the company requires £100 working capital, which it proposes to raise by the issue of one hundred one pound shares. The shares are purchased at their nominal value by the members of the family. The balance sheet of the company before it commences operations will stand as follows:

11. *John Foster & Sons Ltd. v. I.R.C.* [1894] 1 Q.B. 516.
12. *Grimwade v. F.C.T.* (1949) 78 C.L.R. 199 may be mentioned in this connection. This case is important as suggesting a method by which a person may diminish the value of his property in favour of other shareholders, and it will be considered later in this article in that context. In Grimwade's case a gift to the sons of the value of the shares allotted to them was in fact made in 1936; but the Commissioner could not reach this, since the Gift Duty Assessment Act was not enacted until 1941.

Balance Sheet of XYZ Co. Pty. Ltd.

Liabilities		Assets	
Paid up Capital ..	£100	Buildings, Plant, etc.	£20,000
Creditor (transferor) ..	20,000	Cash	100
	£20,100		£20,100

In these circumstances it is submitted that there will be no gift from the transferor to the company, since the transfer was for fully adequate consideration, nor from the company to the allottees, since the full value of the shares at the time of allotment is the difference between the value of the assets transferred and the debt due to the transferor, and this has been provided in cash by the allottees.[13]

The formation of a company may involve the transferor in income tax liability by virtue of ss. 36 and 59 of the Income Tax Assessment Act in respect of disposals of trading stock and adjustments in the depreciable value of plant.

(c) *Infant Partners and Shareholders.*—An infant may be a partner or a shareholder. But there are disadvantages in admitting infants either as partners or shareholders. An infant is not liable for partnership debts contracted during his infancy, and this will obviously affect the credit standing of the partnerships particularly of a trading partnership. Since an infant may avoid a transfer of shares, purchasers will be rather wary of dealing with them. An infant may also repudiate the partnership contract or an allotment of shares during infancy or on attaining majority. Added to these reasons are the general considerations which would lead one to vest property destined for the benefit of infants in trustees.

In drafting the terms of the trust, it is necessary to bear in mind the provisions of the Income Tax Assessment Act relating to assessments in respect of trust income. S. 102 of that Act is particularly important. It provides:

(1) Where a person has created a trust in respect of any income or property (including money) and . . . (b) income is, under that trust, in the year of income, payable to or accumulated for, or applicable for the benefit of a child or children of that person who is or are under the age of twenty-one years and unmarried, the Commissioner may assess the trustee to pay income tax, under this section, and the trustee shall be liable to pay the tax so assessed.

(2) The amount of the tax payable in pursuance of this section shall be the amount by which the tax actually payable on his own

13. The necessary cash may of course be provided by gifts from one member of the family to the others. The sums involved would not attract gift duty.

taxable income by the person who created the trust is less than the tax which would have been payable by him if he had received, in addition to any other income derived by him, so much of the net income of the trust estate as . . . is payable to or accumulated for, or applicable for the benefit of, a child or children of that person who is or are under the age of twenty-one years and unmarried.

It will be observed that this section applies to trusts in favour of unmarried minors only if two conditions are fulfilled. The first condition is that the settlor must be a parent of the child or children in question; the second is that the income must be, in the year of income, payable to or accumulated for or applicable for the benefit of the child or children. It is thus an easy matter to avoid the operation of this section by arranging for the trust to be created by someone other than the parents of the intended beneficiaries.[14] It is submitted that the initial trust fund may subsequently be increased by contributions from the parents without attracting the operation of s. 102, provided that the trustee (who may be a parent) is obliged to hold these contributions upon exactly the same trusts as apply to the initial fund.

Hobbs v. F.C.T.[15] illustrates how the second condition may be defeated. A settlor directed trustees to hold certain shares upon trust for her infant child subject to and upon his attaining the age of twenty-five years or marrying under that age. Power was given to the trustees in the meantime to pay or apply the whole or part of the income for the maintenance and advancement of the child as they in their absolute discretion should think fit, and the trustees were directed to accumulate all income derived from the corpus of the trust estate or so much thereof as was not applied for the purposes expressed. In the year of income, income was received by the trustees which was not applied for the infant's benefit but accumulated. The High Court held that s. 102 (1) (b) did not apply. To fulfil the condition

> "it must be possible to say of the income that under the trust it must in the year of income be payable to or accumulated for or applicable for the child or children and to deal with it otherwise is not within the trust. The fact that the child is only contingently entitled makes this impossible".[16]

Since parents contemplating the formation of a family partnership or company would probably be willing or even anxious to

14. It scarcely needs saying that the funds for the creation of the trust must not be supplied by a parent. See Case No. H 33 (1957) 8 T.B.R.D. 121.
15. [1957] A.L.R. 857.
16. *Per* Dixon C.J., at p. 860.

make the vesting of the child's interest contingent upon his attaining a certain age or marriage, and to give the trustees (who may be themselves) considerable discretion as to the application of the interim income, Hobbs' case shows how effect may be given to their wishes without entailing the high rate of tax imposed by the application of s. 102 (2).

III. THE CARRYING ON OF A BUSINESS. INCOME TAX CONSIDERATIONS

(a) *The Operation of a Partnership.*—The taxation considerations relevant to the formation of a business are, as we have seen, mainly concerned with the impact of gift and stamp duties. Once the business has been formed, however, the incidence of income taxation and death duties becomes of primary concern.

The principal advantage of the partnership form of enterprise from the viewpoint of income taxation is that the income tax legislation accepts the principle of the common law that a partnership is not a legal entity distinct from the persons who comprise the partnership, and consequently income tax is not levied upon the partnership as such. Instead, the individual interest of a partner in the net income of the partnership of the year of income is included in his assessable income, and his individual interest in a partnership loss incurred in the year of income is an allowable deduction.

To this principle there is one exception. S. 94 of the Income Tax Assessment Act provides (*inter alia*) that where a partnership is so constituted or controlled, or its operations are so conducted, that any partner has not the real and effective control and disposal of his share of the net income of the partnership, the Commissioner may assess the additional amount of tax that would be payable if the share of that partner, or of all such partners if more than one, had been received by the partner who has the real and effective control of that share, and had been added to and included in his assessable income, and the partnership shall be liable to the tax so assessed. The effect of an assessment under this section would be to destroy the income tax advantages arising from spreading the aggregate income from a business among a family group. Since it will often happen that the sole proprietor who has reorganised his business as a partnership, or who has provided the capital for its formation, will wish to have a degree of control over the partnership income, s. 94 might seem to provide a formidable obstacle to the realisation of his wishes. However, judicial interpretation of this section has removed its sting. In *Robert Coldstream Partnership v. F.C.T.*[17] a partnership agreement between C, his wife and

17. (1943) 68 C.L.R. 391.

two daughters provided that C should have the sole management and control of the business; that the partners should be entitled to the net profits and bear the losses of the business in equal shares; that the three female partners should allow seventy per cent of their share of profits to be credited to capital account, and that they should not be entitled to draw upon their drawing accounts without the approval of C; and that C should be entitled at any time to sell or dispose of the partnership business upon such terms and conditions as he thought proper. A Board of Review had upheld an assessment of the partnership under s. 94. An appeal was allowed by Latham C.J. He agreed that the wife and daughters had "not the real and effective control and disposal" of their shares of the net income of the partnership, but he found it impossible to say that C had "the real and effective control" of their shares. C had merely a power of veto, a power to prevent other partners applying the money to their own purposes; before s. 94 could be invoked, it must appear that C had exclusive and complete control of the shares of his wife and daughters. Power to manage the partnership business could not be said to include power to control shares of income. Finally, the section referred to the control of a share in the net income and therefore related to a partnership as a going concern; it had no reference to powers of control or disposal of partnership assets upon a dissolution of the partnership. It is clear, therefore, that a particular partner may reserve to himself the sole right to manage and sell the business, and a large measure of control over the disposition of the net profits, without subjecting the partnership itself to income tax liability.

Since a partner's interest in the net income or loss of the partnership is included in his individual assessment, the partnership form of enterprise presents a considerable advantage over the company form when a business incurs a net loss. Company losses may be carried forward in accordance with s. 80 of the Income Tax Assessment Act, but since a company is a distinct legal entity from its shareholders, company losses may not be set off against income derived by the shareholders. This consideration is particularly important in the case of a newly established business or one liable to considerable fluctuations of fortune. It is suggested that where a taxpayer has income from other sources, one should hesitate to advise him to form or reorganise his business as a company unless there is reasonable certainty that temporary trading losses will not be incurred.

A further point in favour of the partnership form of organisation is that it permits advantage to be taken of the averaging provisions contained in Division 16 of the Income Tax Assessment Act. These provisions apply only to the income derived by a

primary producer; but if a taxpayer carries on a business of primary production[18] together with other businesses, the averaging provisions will apply to the whole of his taxable income.[19]

As against this, the partnership form of organisation presents a considerable disadvantage in the case of a rapidly expanding business by reason of the application of the provisions of the Income Tax Assessment Act relating to Provisional Tax and Contribution.[20] Since the tax is collected in the case of a partnership in advance of the assessment, the partners may find that the development of their business is being retarded by the withdrawal therefrom of funds to meet the tax liability. In the case of a company, however, the primary tax is payable only at the date specified in the notice of assessment; and by virtue of s. 103 of the Income Tax Assessment Act, a private company attracts additional tax on the undistributed amount of its income only if it has failed to make a sufficient distribution within the prescribed period, which is a period of ten months after the end of the year of income. As we shall see, it is a simple matter to postpone this period still further by forming a chain of private companies, and to avoid the additional tax altogether by floating a non-private company.

(b) *The Operation of a Company.*—The basic feature of the income tax legislation relating to companies is the division of companies into two categories, private and non-private. S. 105A of the Income Tax Assessment Act defines a private company by reference to six positive descriptions, one or more of which it must answer, and three negative descriptions, none of which must be applicable to it. In a general way it may be said that a private company is one which is controlled by a small group of shareholders. It is therefore the category into which most family companies would fall.

The great advantage of incorporation as a private rather than as a non-private company lies in the fact that lower primary tax rates are applied to primary companies.[21] As against this, a private

18. "Primary Production" is defined in s. 6 of the Income Tax Assessment Act.
19. The application of the averaging provisions will not always operate to the taxpayer's advantage. A primary producer may therefore make an election under s. 158A of the Income Tax Assessment Act that Division 16 shall not apply to him. Such an election binds him as regards all subsequent years of income. Alternatively, where a taxpayer establishes that there has been a permanent reduction of his taxable income to an amount which is less than two-thirds of his average taxable income (a situation which might well come about as a result of the taxpayer bringing in members of his family as partners), the existing average calculation is abandoned, and the averaging provisions apply to his future income as if he had never been a taxpayer before that year.
20. Sections 221 YA—221 YH.
21. At the time of writing, the primary tax is five shillings in the pound on the first five thousand pounds of taxable income, and seven shillings in the pound on the remainder of the taxable income in the case of a private company; the corresponding figures for non-private companies are seven shillings and eight shillings in the pound.

company which fails to make a sufficient distribution in relation to the year of income is liable to pay additional tax upon the undistributed amount at the rate of ten shillings in the pound. Those who are concerned with the management of a prosperous and developing private company are therefore faced with this dilemma: If they plough the profits of the business back into it, and thereby fail to make a sufficient distribution, the company will be liable to the heavy additional tax; if they distribute the profits to themselves by way of dividends, they will be taxed personally on their receipts; and if they float the business as a non-private company, they will incur the danger of losing control of it, and in any case the corporate earnings will be taxed at a higher rate.

An attempt to solve this dilemma by a form of dividend stripping fared disastrously: *Newton v. F.C.T.*[22]. But in the same case the Privy Council expressly approved the decision of the High Court in *W. P. Keighery Pty. Ltd. v. F.C.T.*[23], and it is through the device employed in that case that a solution to the problem may be found. The essential fact upon which the draftsman of that company's constitution seized was that the various descriptions contained in the definition of a private company were referable to its situation on the last day of the year of income. If the position on that day was that the issued shares were held by more than twenty persons, each of whom had only one vote, and that no shareholder had the means to govern the voting of another, the company would not fall within the definition of a private company. How, then, were the members of the family (a husband and wife) to retain control? Something could be done by choosing the other shareholders carefully; but complete security was available by issuing to the shareholders other that the husband and wife redeemable preference shares, reserving to the husband and wife the power as directors of the company to redeem the preference shares on giving seven days' notice, except that no such redemption should be made between 24th June and 7th July in any year.

In these circumstances, the Commissioner assessed the company as a private company, on the basis that on the 30th June in the year in question it was "capable of being controlled by not more than seven persons". [S. 105 (1) (f)]. The assessment was affirmed by Williams J., but an appeal to the Full Court succeeded. In a joint judgment, Dixon C.J., Kitto and Taylor JJ. stated:

> "To describe a company as capable of being controlled by a person or group of persons is to attribute to that person or

22. [1958] A.C. 450. An excellent account of this involved case and the principles established by it will be found in Challoner: Arrangements to Avoid Income Tax: A Consideration of the Effects of Newton's Case (1958) 32 A.L.J. 109.
23. (1958) 100 C.L.R. 66.

group a presently existing power of control. 'Capable of being controlled' in this context cannot be interpreted so widely as to be satisfied whenever a possibility of obtaining control over the company exists by reason of something in its constitution or its special circumstances."[24]

The first matter established by *Keighery's* case is that it is possible for a small family group to retain firm control of a non-private company. But there is a further important matter settled by that case. The device of creating the non-private company was only part of the scheme. Mr. and Mrs. Keighery were interested in a private company called Aquila Steel Pty. Ltd., which had a substantial amount of profits available for distribution. To avoid payment of tax on the undistributed amount, they took steps to create the appellant company as a non-private company. The appellant company then purchased the shares held by the Keigherys in Aquila Steel Pty. Ltd., and the latter company declared dividends sufficient to relieve it of liability to the additional tax. The result was that Aquila Steel Pty. Ltd. paid primary tax at the rates applicable to a private company, but no undistributed profits tax, whilst W. P. Keighery Pty. Ltd., the non-private appellant company paid no tax, since the whole of the taxable income derived by it resulted from the dividends declared by Aquila Steel Pty. Ltd., and hence was subject to a complete rebate under s. 46 of the Income Tax Assessment Act. An attempt by the Commissioner to invoke s. 260 of the Income Tax Assessment Act (the section which annihilated the scheme propounded in Newton's case) was rejected. The Act itself presented taxpayers with the choice of incorporation as a private or non-private company, and s. 260 could not be invoked to deny them the benefits arising from the exercise of such a choice.

It is thus possible to have the best of both worlds by operating the business under the form of a private company, and by creating a holding company modelled on W. P. Keighery Pty. Ltd. to which distributable profits may be transferred.[25] Of course, the necessity for a holding company only arises where the operating company is troubled by the need to make a sufficient distribution. A very small company which makes enough merely to pay the salaries of its employees (including the family shareholder employees) will derive no benefit from the formation of a holding company, except the stamp duty benefit mentioned earlier in this article (which may not equal the cost of incorporating the holding company).

Where the business in question is relatively large, consideration

24. (1958) 100 C.L.R., at p. 86.
25. See Gunn: Private and Holding Companies (1960) 31 Chartered Accountant in Australia, p. 3.

should be given to the advisability of creating a group of private companies, the shares of which are held by a non-private holding company. A group of companies has two advantages over a single company. First, since the primary tax rate on the first five thousand pounds of the taxable income is less than that on the remainder, the total tax payable will be reduced according as the income from each unit of the group approximates five thousand pounds. Secondly, the retention allowance will increase as the number of units is multiplied. Its major disadvantage (apart from the extra cost and labour involved in forming and operating a group of companies rather than one company) is that, since the various units are distinct legal entities, losses made by one unit may not be set off against gains made by others.

We have seen that a sole proprietor who is contemplating converting his business into a partnership can retain a large measure of control without subjecting the partnership itself to income tax liability. A company will of course be taxed independently of any internal arrangements contained in its memorandum or articles of association about the matter of control. It is clear, however, that Queensland company legislation presents no obstacle to drafting suitable clauses so as to ensure that the former sole proprietor retains control over the company's activities and dividend policy.[26]

We have further seen that the principal advantage of the partnership form of organisation is that the partnership itself will not generally attract tax, whilst a company will be assessed on its taxable income. In the case of a relatively small business, however, it will often be possible for the entire net income to be disbursed in salary payments or other allowable deductions to the members of the family, with the result that the company itself will have no taxable income. Where this can be done, the income tax consequences of conducting the business as a partnership or as a company will be identical. The limits to this means of reducing the taxable income of a company are set by s. 109 of the Income Tax Assessment Act:

"So much of a sum paid or credited by a private company to a person who is or has been a shareholder or director of the company or a relative of a shareholder or director, being, or purporting to be—

(a) remuneration for services rendered by that person; or

(b) an allowance, gratuity or compensation in consequence of the retirement of that person from an office or employment held by him in that company, or upon the termination of any such office or employment,

26. See Greenwood and Others: Shades of Sir W. S. Gilbert: A few Special Points about Family Partnerships and Family Companies (1956) 26 The Chartered Accountant in Australia 243, 320.

as exceeds an amount which, in the opinion of the Commissioner, is reasonable, shall not be an allowable deduction and shall, for all purposes of this Act, be deemed to be a dividend paid by the company on the last day of the year of income of the company in which the sum is paid or credited".

The total income tax liability involved in the two forms of carrying on business may be illustrated as follows:—

Case 1:—Assume that the net profits (apart from salary payments) of a business are £4,000. If the business is run as a partnership in which a husband (H) and a wife (W) share profits equally, the total tax payable for the income tax year ending 30th June, 1960, will be £752. If it is conducted as a private company which reasonably pays £2,000 each by way of salary to H and W, the total tax payable will be the same.

Case 2:—Assume that the net profits (apart from salary payments) of a business are £5,600. The total tax payable by the partners will now be £1,342. If the private company reasonably pays £2,000 each by way of salary to H and W and makes a sufficient distribution the total tax payable will be £1,340.[27]

Case 3:—Assume that the net profits (apart from salary payments) of a business are £8,000. The total tax payable by the partners will be £2,392. On the assumptions set out above, the total tax payable if the private company form of enterprise is adopted will be £2,331.

Case 4:—Assume that the net profits (apart from salary payments) of a business are £16,000. The total tax payable by the partners will be £6,819. If two operating companies are formed, each of which has a net profit of £8,000, out of which it reasonably pays £2,000 by way of salary to H and W, and each of which makes a sufficient distribution, the total tax payable will be £6,053.

If the shares in the operating companies are held by a holding company, to which the sufficient distribution is made, and which itself declares no dividends to its shareholders H and W, the total tax payable will be only £3,652.

The tax payable by a sole proprietor in the four situations set out above would be £1,196; £2,031; £3,410, and £8,418 respectively.

(c) *The Misery of Sole Proprietorship.*—The lot of a sole proprietor is obviously not a happy one. In these days of highly progressive income taxation it is regarded by certain persons who have traditionally carried on their profession in that manner as intolerable. In recent years a large number of medical practitioners

27. Private company (Division 7) tax = £360. Tax payable by H. and W on personal income of £2,322 (£2,000 salary plus £322 dividend) = £490 each.

in particular have formed companies to carry on their practices, and have arranged for the shares to be allotted to members of their family either directly or by the interposition of a holding company. There are considerable difficulties involved in the operation of such a scheme.[28] In particular, if the medical practitioner fails to bring to the notice of the patient the fact that he is an employee of the medical company, the contract will be between the patient and the medical practitioner, and the fees paid will be deemed by virtue of s. 19 of the Income Tax Assessment Act to be derived by the latter though credited to the company's account.

A surer method which is apparently beginning to find favour with the medical profession, but which can readily be applied in other professions, consists in the formation of an auxiliary service company. The sole proprietor carries on his business or profession in the ordinary manner, but instead of employing nurses, typistes, secretaries etc. himself, the sole proprietor arranges for these services to be provided for him by a service company. The same company will often also own the property or practice at which the business or profession is carried on, the sole proprietor taking a lease from the company. The shares in the service company are held by the members of the sole proprietor's family. Since the payments made to the service company are incurred in gaining or producing the assessable income of the sole proprietor, they are allowable deductions under s. 51 of the Income Tax Assessment Act. It is irrelevant that this manner of carrying on business may be more expensive:

"It is not suggested that it is the function of Income Tax Acts, or of those who administer them, to dictate to taxpayers in what business they shall engage or how to run their business profitably or economically. The Act must operate on the results of a taxpayer's activities as it finds them".[29]

It is submitted that only to the extent[30] that it can be shown that the payments made bear no relation to the assessable income gained or produced will the Commissioner be free to disallow them.

IV. The Carrying on of a Business. Death Duty Considerations

There are, in general, two methods by which one may diminish the value of one's estate so as to attract less estate duty or succession duty. One may either dispose of property *inter vivos* or take steps to reduce its value. It is impossible in an article of this nature to

28. Gibson: Income Tax and Companies formed by Medical Practitioners (1958) 32 A.L.J. 144.
29. *Tweddle v. F.C.T.* (1942) 7 A.T.D. 186 at p. 190 (Williams J.).

discuss fully the death duty problems that arise to plague a person who is seriously devoted to the task of minimising his total tax liability. A few comments on these two methods must suffice.

(a) *Inter Vivos Dispositions of Property.*—The great secret for preserving the *splendor familiae* at the present day is a nice appreciation of one's expectation of life. S. 8 (4) (a) of the Estate Duty Assessment Act 1914-1950 includes in the notional estate of the deceased property which has passed from the deceased person by any gift *inter vivos* or by a settlement made within three years before his decease. S. 4 of the Succession and Probate Duties Act of 1904 provides that every disposition of property made by any person less than two years before his death and purporting to operate as an immediate gift of the property *inter vivos* whether by way of transfer, delivery, declaration of trust, or otherwise, shall upon the death of the donor be deemed to confer a succession on the donee.[31] Voluntary dispositions of property will therefore be effective to avoid estate or succession duties only if made three years or two years respectively before death.

A natural concern of anyone contemplating parting with his property in favour of other members of his family will be to ensure that his own financial security is not imperilled. It is apparently common in the case of a family company for arrangements to be made whereby a father is appointed governing director for his life at a certain salary, and in return the father transfers shares to the other members of the family. Such an arrangement is not advisable. In *Re Stewart*[32] a family agreement was made between S and his children by which the remuneration of S as governing director of a private company was increased from one thousand pounds per annum to three thousand five hundred pounds per annum for his life, and S settled shares in the company on trustees in trust for his children. Shand J. held that s. 9 of the Succession and Probate Duties Act applied upon the death of S:

> "In my opinion, then, the yearly amount or yearly value of the benefit was £2,500, and not £3,500, and the succession in respect of which succession duty is payable by the testator's children (as the persons whom the determination of the payment of £2,500 a year must be taken to have conferred an increase of beneficial interest in the settled shares) should be a sum of

30. S. 51 (i) of the Income Tax Assessment Act "adopts a principle that will allow of the dissection and even apportionment of losses and outgoings. It does this by providing for the deduction of losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income"; *Ronpibon Tin N.L. v. F.C.T.* (1949) 78 C.L.R. 47, at p. 55.
31. Both Acts provide relief from double duty. Estate Duty Assessment Act s. 8 (6); The Succession and Probate Duties Act of 1904, s. 4.
32. [1920] St. R. Qd. 207.

money of which the annual value would be equal to £2,500 a year in perpetuity."[33]

It seems clear also that s. 8 (4) (c) of the Estate Duty Assessment Act would apply so as to include the settled shares as part of the notional estate of the deceased.

A better arrangement would be that the father receive in exchange for a transfer of his shares a salary until he attain a specified age, and a lump sum upon his retirement.

If one is minded to make an *inter vivos* gift or settlement, consideration should be given to the question whether the property is likely to increase or decrease in value. The Estate Duty Assessment Act requires that the value of the property comprised in the estate be assessed as at the date of death. In a recent decision, *Gale v. C. of T.*[34] the High Court held that the property deemed to be part of the estate of the deceased was the actual property given and not property into which it had been transferred prior to his death. In so holding, it overruled three previous decisions of its own—*Trustees Executors and Agency Co. Ltd. v. F.C.T.* (Teare's case)[35]; *Vicars v. C.S.D.*[36] and *Moss v. F.C.T.*[37], and applied *Sneddon v. Lord Advocate.*[38] It is now clear that what must be valued as at the date of death is the asset disposed of by the deceased, even though it is no longer in the hands of the disponee. The property disposed of is to be treated just as if it had remained the property of the deceased until his death and had then passed as part of his estate.

Sneddon v. Lord Advocate illustrates how estate duty may be lessened in the light of the above principles. In that case it was held that what passed as a gift *inter vivos* by way of a declaration of trust of £5,000 to be invested by the trustees in shares which at the date of the death of the settlor were worth £9,250 was the £5,000 and not the trust fund. Accordingly, where the value of the shares in the family company is likely to rise, it is preferable that the disponor provide cash with which the disponees may purchase the shares rather than make a gift of the shares themselves.

Another device which may be employed is for the disponor to transfer shares to the disponees, and for the company subsequently

33. At p. 230. The terms of s. 9 expressly indicate that the assessment is to be based upon the annual value of the reserved benefit, without regard to the nature of the successor's interests in the property which is the subject of the disposition. The method by which the assessment is to be made once the annual value is determined is not prescribed by the Act. The solution adopted in *Re Stewart* was based on the fact that S was entitled under the company's articles of association to a fixed cumulative preferential dividend at the rate of 6 per cent. on the nominal value of the shares so long as he held them.

34. (1960) 33 A.L.J. 564.

35. (1941) 65 C.L.R. 134.

36. (1945) 71 C.L.R. 309.

37. (1947) 77 C.L.R. 184.

38. [1954] A.C. 257.

to issue bonus shares.[39] It has been held in England that property separated although derived from the gift such as subsequent income, or bonus shares, is excluded from the notional estate.[40] The result is that the property comprised in the estate will be the original shares given, but their value will be diminished by the issue of the bonus shares. Other applications of the principle established in *Sneddon's* case can readily be envisaged. According to Wheatcroft:—

> "This state of the law enables a donor to assist his donee to avoid (estate) duty by choosing as the medium of his gift a type of property which will quickly disappear, or diminish in value in such a way that the donee receives the equivalent of his loss in some non-dutiable form. This 'disappearing trick', as it is called, can be performed with a mortgage, or Treasury bill, soon to be repaid, and in many other ways".[41]

It is submitted that s. 4 of the Succession and Probate Duties Act of 1904 likewise requires the very asset disposed of by the donor to be brought into account upon the donor's death. S. 4 is closely modelled on s. 2 (1) (c) of the (English) Finance Act 1894, the legislation under consideration in Sneddon's case. S. 12 of the Succession and Probate Duties Act prescribes that the duties to be paid in respect of every succession are to be according to the value thereof at the time when the succession takes effect. In *re Goggs*[42] it was held that the value was to be taken at the time when the successors first became entitled to the actual enjoyment of the benefit conferred by the succession, since a succession takes effect when the successor comes into possession or enjoyment of it. In the case of an immediate gift, the successor-donee will be in possession or enjoyment of the property at the time when the succession is deemed to be conferred, namely upon the death of the donor, and the property will be valued for succession duty purposes at that time.

(b) *Reducing the Value of Property*.—One of the outstanding tax advantages of carrying on business in the closely controlled corporate form is the capacity it affords to a shareholder to diminish

39. If possible, out of profits arising from the revaluation of assets not acquired for the purpose of resale at a profit. See Income Tax Assessment Act, s. 44 (2) (b) (iii). Where bonus shares are issued to shareholders in proportion to their shareholdings the value of their interests will not be affected and no question of a gift will arise.
40. *A.-G. v. Oldham* [1940] 2 K.B. 485.
41. Taxation of Gifts and Settlements, at pp. 49-50. The passage has been transcribed in the present tense; the enactment of the Finance Act 1957 compelled Wheatcroft to write it in the past tense. Professor Ford doubts whether the "disappearing trick" will work successfully here. See his article "Federal Estate Duty—Valuation of Gifts inter vivos" (1960) 34 A.L.J. 139, at p. 141.
42. [1909] St. R. Qd. 27.

the value of his shares either prior to his death or upon his death without attracting gift duty or death duties.

The first case which requires consideration is *Grimwade v. F.C.T.*[43] G formed an investment company in 1936. Its issued capital was 10,002 A shares of £1 each of which G held 9,997; and 180,760 B shares of £1 each held by G's sons. G paid the company £190,762 for them; and the company used the money to purchase shares held by G in various other companies. The A shares alone conferred voting rights. By special resolutions the capital was reduced to £23,845, consisting of 10,002 A shares of 2/6 each, and 180,760 B shares of 2/6 each. Hence 17/6 per share was returned to the holders of the shares. To make the repayments the company sold the shares it had purchased from G. The Federal Commissioner assessed G to gift duty on the net benefit to the shareholders other than G, relying on paragraphs (d) and (f) of the definition of "disposition of property" contained in the Gift Duty Assessment Act 1941. Williams J. held that paragraph (d) was inapplicable. He pointed out that by voting for or failing to vote against the special resolutions G could not be said to have forfeited or abandoned any interest in property. He had no legal or equitable interest in the property of the company which he could forfeit or abandon. The moneys to which his sons became entitled were the property of the company and not property in or over which he had at any time a legal or equitable interest or power. But Williams J. was of opinion that paragraph (f) applied.[44] In this he was overruled by the full High Court. It agreed with Williams J. that G had the intent specified in that paragraph, but denied that any "transaction" had been "entered into". When a shareholder makes up his mind to vote in a particular way and casts his vote accordingly, he cannot be said to be entering into a transaction. A transaction by a person must be a transaction with some other person. Here there was no transaction with any person.[45]

The intentional diminution of the value of one's property with the consequential increase in the value of the property of others will therefore not amount to a gift unless it results from a transaction entered into between the donor and donee;[46] and unless a company acts as agent or trustee for a shareholder, its acts are not those of any shareholder, even of one who holds all the shares.[47] It is thus possible for a controlling shareholder to vote in favour of increasing

43. (1949) 78 C.L.R. 199.
44. Disposition of property includes: (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. Gift Duty Assessment Act, s. 4.
45. Per Latham C.J. and Webb J., at p. 220.
46. For an instance where paragraph (f) was properly applied, see *Berks v. F.C.T.* (1953) 10 A.T.D. 266 (Kitto J.).
47. *Macaura v. Northern Assurance Co. Ltd.* [1925] A.C. 619, at p. 633.

the rate of dividend upon the class of shares held by the other shareholders or of varying in other ways the rights of different classes of shareholders with the intent of reducing the value of his shares without attracting any gift duty.

An even more formidable weapon in the armoury of the tax planner is provided by the decision of the High Court in *Robertson v. F.C.T.*[48] The articles of association of MacRobertson Pty. Ltd. provided that upon the death of MacPherson Robertson, the governing director of the company, the whole of the issued shares of the company, which were previously undifferentiated, would be divided into No. 1 class shares and No. 2 class shares. Shares standing in the share register in the name of the deceased became No. 2 class shares, and all other shares became No. 1 class shares. Thenceforth the rights attached to No. 2 class shares, with respect both to dividend and to winding-up, were much less advantageous than those attached to No. 1 class shares. This article produced the result that the shares held by the deceased depreciated greatly in value upon his death. The inclusion of this article precluded the listing of the company's shares by the Stock Exchange of Melbourne during the deceased's lifetime, but not after his death. In valuing the shares which formed part of the estate of the deceased, the Commissioner made an assessment on the basis that he was entitled by virtue of s. 16A of the Estate Duty Assessment Act to strike out the articles which prevented listing on the Stock Exchange, or alternatively that s. 8 (4) (e) of the same Act was applicable.

The High Court allowed an appeal against the assessment. As to s. 8 (4) (e), Williams J. stated:—

> "The relevant beneficial interest in property which the deceased had at the time of his death was the beneficial interest in the shares he then owned in the company. Article 6 operated upon his death to make these shares less valuable and the shares owned by other shareholders more valuable. But this circumstance is not sufficient to satisfy the provisions of para. (e). To satisfy these provisions, the beneficial interest in the shares owned by the deceased must, by virtue of some settlement or agreement made by him, have passed or accrued or devolved on or after his decease to or upon some other person. The subject property in the present case is the shares which the deceased owned at his death. These shares formed part of his estate after his death. No part of the beneficial interest in these shares passed or accrued or devolved on or after his death to any other person. They simply became shares of less value than they were before. No one acquired any beneficial interest in

48. (1952) 86 C.L.R. 463.

them except as part of his estate. The No. 1 shares increased in value but they were not the shares of the deceased. They were not his property at the date of his death. He had no beneficial interest in them. Consequently no beneficial interest in these shares could pass or accrue or devolve on or after his death to or upon any other person. He was not in a position to make a settlement or agreement about them because they were not his to settle or agree about".[49]

S. 16A had no application, because the estate had to be valued upon the hypothesis that the deceased had died, and it was involved in that hypothesis that the article no longer precluded listing. The shares which formed part of the deceased's estate were shares in a company which then conformed to the Stock Exchange requirements, and consequently there was no necessity to apply S. 16A.[50]

The question of the liability to succession duty of those whose shares have increased in value as the result of the operation of the articles of association upon the death of a shareholder has recently been raised before the Supreme Court of Queensland. The decision has not yet been delivered.

Those who have conducted their business in the form of a partnership have in general much less scope for avoiding death duties by reducing the value of their interests. But *Thomas' case*[51] is now a source of considerable comfort to them. A partnership agreement provided that upon the death of any partner five of the surviving partners were to have the option of purchasing the share of the deceased in the assets; but that, in computing the purchase money payable on the exercise of those options, no sum should be taken into account for goodwill. Upon Thomas' death, the five surviving partners exercised their options. The question which arose was whether the share of the deceased in the goodwill, valued at £20,000, formed part of his dutiable estate under the Estate Duty Assessment Act. The Commissioner, relying on the decision of the majority of the High Court in Milne's case[52] added £20,000 to the value of the deceased's interest in the partnership. Upon appeal, the High Court refused to reconsider the correctness of the decision in Milne's case[53]. A further appeal to the Privy Council was successful.[54] Their Lordships held that the entire interest of the deceased partner in the assets of the partnerships including goodwill vested in the executors on his death. It was thus assessable to duty as being personal property of the deceased within s. 8 (3) (b) of the Act; and since sub-secs. (3) and (4) of s. 8

49. At p. 478.
50. Per Kitto J., at pp. 486-7.
51. *Perpetual Executors and Trustees Association Ltd. v. F.C.T.* [1956] A.L.R. 1.
52. *Trustees Executors and Agency Co. Ltd. v. F.C.T.* (1944) 69 C.L.R. 270.
53. (1949) 77 C.L.R. 493.
54. [1954] A.C. 114.

were mutually exclusive provisions, it could not be assessable under s. 8 (4) (e). The question of the value of the deceased's share in the partnership, including the goodwill, was referred back to the High Court. Upon the reference, the High Court held (McTiernan J. dissenting) that since it was certain that the options would be exercised, the value of the interest at the date of death could not exceed the purchase price obtainable from the surviving partners.

It will be observed that the basis of this decision is the conception that sub-secs. (3) and (4) of s. 8 are mutually exclusive. The authority for this view consisted primarily of a dictum of Lord Macnaghten in *Earl Cowley v. I.R.C.*[55] which was repeated by Lord Haldane in *Att. Gen. v. Milne*[56]. But in *Public Trustee v. I.R.C.*[57] this view was decisively rejected by the House of Lords.[58] It therefore becomes necessary to consider the applicability of s. 8 (4) (e).[59] However, the Privy Council did express "grave doubt" whether considering only the language of s. 8 (4) (e) the respondent could bring the facts of Thomas' Case within it.

It would seem from *Robertson and Others v. C.S.D.*[59] that the option given to the surviving partners to purchase the share of a partner upon his death at a reduced value is not regarded as conferring a succession upon them under s. 4 of the Succession and Probate Duties Act.

K. W. RYAN*

55. [1899] A.C. 198, at p. 212. 56. [1914] A.C. 765, at p. 769.
57. [1960] 2 W.L.R. 203.
58. "Observations so patently wrong (may I be forgiven for saying so) that they leave only a sense of wonderment . . . —flatly contradicted in 1924 by Lord Haldane who in 1914 had adopted them—the source of endless doubt and confusion to all who have been concerned in the examination or administration of this branch of the law—all these factors lead me to the conclusion that I can properly invite your Lordships to say that (the two sections) are not mutually exclusive": per Viscount Simonds, at p. 213.
59. S. 8 (4) (e) includes in the deceased's estate property . . . being a beneficial interest in property which the deceased person had at the time of his decease, which beneficial interest, by virtue of a settlement or agreement made by him, passed or accrued on or after his death to, or devolved on or after his decease upon, any other person.
60. [1958] Qd. R. 342.

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