A COMMENTARY ON SECTION 260 OF THE INCOME TAX AND SOCIAL SERVICES CONTRIBUTION ASSESSMENT ACT 1936—1965[1]

Mr Justice Holmes' view that payment of taxes should not be begrudged —as they are the price of civilisation—is of course not shared by the vast majority of tax-paying citizens. Judicial recognition of the general lack of this public-spirited attitude, and the reason for the enactment of the sweeping provisions of section 260 to counter tax avoidance, is found in the judgment of Menzies J. in the recent case of *Peate v. Commissioner of Taxation*—

> It is perhaps inevitable in an acquisitive society that taxation is regarded as a burden from which those who are subject to it will seek to escape by any lawful means that may be found. This is generally called tax avoidance and it is successful if by reason of what is done what is potentially taxable is put outside the effective operation of the revenue laws. Furthermore, in the absence of a special law a genuine transaction does not lose its legal effect because it was carried out to avoid, limit or postpone tax. It is the recognition of this that accounts for the legislature casting its net wide to frustrate the attempts of those confronted with tax liabilities to get round the law. As often as a particular loophole is closed through which it has been discovered that revenue is lost, another is likely to be found, so that as long as it confines itself to stopping gaps the legislature is always a step behind reluctant taxpayers and their ingenious advisers. It is not, therefore, surprising that Parliament has sometimes sought to anticipate tax avoidance by general laws rendering ineffectual against the Commissioner arrangements which are not shams but are entered into to avoid taxation obligations that would otherwise in due course be incurred. Such a law is s. 260 of the *Income Tax Assessment Act* (Cth) . . .[2]

A first reading of section 260 would appear to suggest that it covered all situations whereby the tax liability of any person was reduced.[3]

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[1] The text of s. 260 is as follows—

> 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—
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> (a) altering the incidence of any income tax;
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> (b) relieving any person from liability to pay any income tax or make any return;
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> (c) defeating, evading, or avoiding any duty or liability imposed on any person by this Act; or
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> (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.

[2] (1962) 36 A.L.J.R. 258, 259.

[3] See *per* Knox C.J. in *Deputy Federal Commissioner of Taxation v. Purcell* (1921) 29 C.L.R. 464, 466.

Widely though as the section is expressed the Courts have, however, always stopped short of giving it its literal operation which would render it an instrument of oppression.

The first occasion on which the High Court considered the section was in *Deputy Federal Commissioner of Taxation v. Purcell*[4] where the Court seemed to lay down two principles in relation to its application[5]—

(1) The section did not strike at *bona fide* dispositions or gifts of income producing property, even if coupled with an intention to avoid tax; and

(2) The section aimed at arrangements whereby the taxpayer attempted to avoid the duty to pay tax on what in reality remained his income.[6]

The next important decision of the High Court was *Clarke v. Federal Commissioner of Taxation*[7] where Rich, Dixon and Evatt JJ. first formulated the 'annihilation' principle to be applied in respect of section 260—a principle which has now been endorsed by the Privy Council —as follows—

> In its application perhaps [section 260] 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 is not enough to impose upon him a liability which could only arise out of another transation 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.[8]

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[4] (1921) 29 C.L.R. 464. And the Court in *Jaques v. Federal Commissioner of Taxation* (1924) 34 C.L.R. 328—the first case where the application of s. 260 was upheld by the High Court—also appeared to have similar principles in mind.

[5] But note however the explanation of Fullagar J. of this case in *Federal Commissioner of Taxation v. Newton* (1957) 96 C.L.R. 577, 647-648 which was referred to by the Board of Review in 10 C.T.B.R. (N.S.) Case 33 at 217. In *Newton's* case on appeal, the Privy Council further explained *Purcell's* case, in order to reconcile it with the principles they expounded.

[6] See also *Jaques'* case (1924) 34 C.L.R. 328 *per* Isaacs J. at 359-360, *per* Starke J. at 362. *Cf. Molloy v. Federal Commissioner of Taxation* [1925] R. & McG. 113 and *Tunley v. Federal Commissioner of Taxation* (1927) 39 C.L.R. 528.

[7] (1932) 48 C.L.R. 56.

[8] *Ibid.* 77.

In *Bell v. Federal Commissioner of Taxation*[9] it would seem to be implicit in the reasoning of the Court that to attract section 260 the scheme must be in the nature of a complex transaction. The Court also reiterated the 'annihilation' principle as formulated in *Clarke's* case.

From these early decisions then, we can only see the emergence of some very broad general principles in relation to the scope of section 260. It remained for the High Court in *Newton's* case to finally state, and enlarge, these principles. On appeal—*Newton v. Federal Commissioner of Taxation*[10]—the Privy Council substantially accepted the High Court's reasoning. Furthermore their Lordships approved the earlier High Court decisions reconciling them with the new test they enunciated.

Their Lordships laid down the following propositions in relation to the section[11]—

(1) It is not necessary that the arrangement should be legally enforceable, it is enough if it is something in the nature of an understanding between two or more persons—a plan arranged between them which may not be enforceable at law.[12] However, the transactions must be genuine—if they are mere shams, the Commissioner can ignore them without the aid of section 260.

(2) The motives of the parties to the arrangement are irrelevant—*its* purpose or effect[13] is the all important thing.[14]

However, notwithstanding this assertion it is submitted that the taxpayer's motives are still important—for whether the Court can 'objectively predicate' that the purpose of an arrangement is to avoid tax will undoubtedly be influenced by the number and relative importance of its other objects—and these may only become apparent by examining the taxpayers motives. And in fact, the High Court has on several subsequent occasions made reference to the parties' intended objects.[15]

(3) The purpose (or effect) referred to in proposition (2) depends on an evaluation of the means employed to carry out the arrangement—'In order to bring the arrangement within the section you must be able to predicate—by looking at the overt acts by which it was implemented—that it was implemented in that particular way so as to avoid tax. If you cannot so

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[9] (1953) 87 C.L.R. 548.

[10] [1958] A.C. 450; (1958) 98 C.L.R. 1.

[11] *Cf. per* Kitto J. in *Hancock v. Federal Commissioner of Taxation* (1961) 108 C.L.R. 258, 283-284.

[12] [1958] A.C. 450, 465.

[13] The Privy Council treated the words 'purpose' and 'effect' in s. 260 as being practically synonomous: *cf. per* Williams J. in the same case in the High Court: (1957) 96 C.L.R. 577, 630.

[14] [1958] A.C. 450, 465.

[15] See for example *per* Menzies J. in *Mayfield v. Commissioner of Taxation* (1961) 108 C.L.R. 303, 319 and *per* Kitto J. in *Peate's* case (1964) 38 A.L.J.R. 164, 165.

predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section.'[16]

On the strength of this test, the Privy Council supported, *inter alia*, the decision in *Keighery Pty Ltd v. Federal Commissioner of Taxation*[17] saying that one could not ' by seeing a private company turned into a non-private company, predicate that it was done to avoid Division 7 tax '.

However, it is submitted that just such an inference could be drawn from those circumstances—and that the transaction was not explicable as an ' ordinary business or family dealing '. It is submitted that the *Keighery* decision is properly explicable on the basis that section 260 does not derogate from a choice of action contemplated by the Act itself.[18]

(4) Tax avoidance need not be the sole or even the predominant purpose of the arrangement (this proposition being based on the words ' so far as it has . . . the purpose ' in section 260).

For example, in *Newton's* case the arrangement was also for the purpose of capitalising accumulated profits ; and in *Hancock's* case the arrangement also enabled acquisition of a controlling interest in the company.

(5) The section voids as against the Commissioner both the initial plan and all transactions which carry the plan into operation, that is, have the purpose or effect of avoiding tax.

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[16] [1958] A.C. 450, 466. Professor Ford, ' Legislation Against Tax Avoidance: The Australian Experience' [1961] *British Tax Review* 247, 252 has pointed out the excellent analogy of this test to that of proof of a criminal conspiracy. The difficulties inherent in the Privy Council's formulation have been ably demonstrated by Trebilcock, ' Section 260: A Critical Examination ' (1965) 38 *Australian Law Journal* 237, 241-242.

[17] (1957) 100 C.L.R. 66.

[18] Challoner, ' Arrangements to Avoid Income Tax: A Consideration of the Effect of Newton's Case ' (1958) 32 *Australian Law Journal* 109, 116-117; (1959) 3 *Sydney Law Review* 153, 161. See also the *Keighery* decision itself: (1957) 100 C.L.R. 66, 92-94 and *cf. Federal Commissioner of Taxation v. Sidney Williams (Holdings) Ltd* (1957) 100 C.L.R. 95. Challoner, *op cit.* however also suggests that the Privy Council's remarks may be taken either to support a restrictive approach as to the cases in which a court will be prepared to hold that a scheme was implemented to avoid tax, *or* that the section does not derogate from a choice of action contemplated by the Act itself: *cf.* (1959) 2 *Melbourne University Law Review* 110, 113. It is suggested that the latter view is correct: in addition to the *Keighery* and *Sidney Williams* decisions referred to above, the High Court has on several occasions recognised the somewhat wider principle that where there are alternative courses, of which one will, and the other will not, expose the taxpayer to a liability (even though the distinction may be one of form rather than substance), his deliberate choice of the latter course cannot readily be made a ground for ignoring the legal effect of the transaction: see *per* Kitto J. in *Hobart Bridge Co. Ltd v. Federal Commissioner of Taxation* (1951) 82 C.L.R. 372, 384-386, *Eisen v. Commissioner of Taxation (N.S.W.)* (1930) 1 A.T.D. 73, the statement of Rich, Dixon and Evatt JJ. in *Clarke's* case (1932) 48 C.L.R. 56, 77 which was followed in *War Assets Pty Ltd v. Federal Commissioner of Taxation* (1954) 91 C.L.R. 53.

However when the arrangement is thus annihilated, the Australian cases[19] have established that there must remain facts which leave the taxpayer exposed to a liability to tax ; and the Privy Council accepted this principle which was concisely expressed by Kitto J. as follows—'. . . the section has merely a destructive and never a constructive operation ; that [is] it renders a contract, agreement or arrangement void to the stated extent, but never supplies any element which is absent and is necessary for a valid assessment.'[20] This principle although easily stated has proved of the utmost difficulty in application; and to preserve an effective area of operation for section 260 the courts have not strictly adhered to its terms.[21]

In the light of these principles, it is now proposed to examine some of the recent decisions under the three most common methods of lessening the incidence of tax, namely—

(A) Causing receipts to be characterised as capital rather than income ;
(B) Causing outgoings to be characterised as revenue rather than expenses of a capital, private or domestic nature ; and
(C) Diverting or splitting income among several people so the rate of taxation applicable is lower.

Class A

The type of scheme that has concerned the courts here is what is commonly described as 'dividend stripping'. Here, basically, a private company desires to rid itself of large accumulated profits so as to avoid Division 7 tax, but in a manner so as not to expose its shareholders to a high rate of taxation. Attempts to overcome this dilemma have been made (basically) as follows—

(a) the accumulated profits of a group of private companies are channelled into an investment company within the group which is then ripe for dividend stripping ;
(b) the investment company sells its business assets to another company (or companies) within the group to ensure the retention of the business enterprise within the group ;
(c) the shares in the investment company are then sold to a 'transformer'[22] company, usually a company which trades in stocks and shares, *cum* dividend ;

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[19] *Bell v. Federal Commissioner of Taxation* (1953) 87 C.L.R. 548, 572-573; and see also *Clarke's* case (1932) 48 C.L.R. 56, 77. For a case where even if the scheme had been avoided, the exposed set of facts would not have rendered the taxpayer liable see *Dickenson v. Federal Commissioner of Taxation* (1958) 98 C.L.R. 460.

[20] (1957) 96 C.L.R. 577, 597. Professor Ford, *op. cit.* 256-257, has given some examples of difficulties that must attend a strict application of this principle. It has even been said that *Newton's* case is an example of a gloss on this principle—(1959) 3 *Sydney Law Review* 153, 162—and see also the comment on *Hancock's* case in (1964) 38 *Australian Law Journal* 31, 32.

[21] Trebilcock, *op. cit.* 244-246.

[22] The apt term used by Williams J. in *Newton's* case (1957) 96 C.L.R. 577, 635. Another possible solution to the dilemma is of course to float the company as a public company. This method has not commended itself to taxpayers because of the risk of their losing control, but by adopting a *Keighery* scheme of arrangement, this can be averted.

(d) the transformer company strips the investment company of its profits by way of dividend ;[23]

(e) the transformer company resells the shares in the investment company to the original owners *ex* dividend or, as is more commonly the case, liquidates the investment company.

However, this type of scheme with all its variations has been held to attract the operation of section 260.

In *Bell's* case, the scheme stopped short of revesting control in the original shareholders. Nevertheless it was still held to attract section 260. The Court said that the scheme—' both in purpose and in effect, represented nothing but a method of impressing upon the moneys . . . the character of a capital receipt and of depriving it of the character of a distribution by a company out of profits '.[24] Bell was accordingly still treated as a shareholder for the purposes of assessment: the transfer of his shares being rendered void by the operation of the section.

In *Newton's* case, the ' revesting ' of control was achieved by the transformer company taking up a large quantity of preference shares and re-selling these, thus retaining the originally acquired shares.[25]

The Privy Council held that the case fell within the test they had enunciated, and therefore the section rendered the scheme void *to the extent* it avoided taxation. Accordingly the Commissioner could avoid the sale to the transformer company so far as it transferred shares *cum* dividend (for this gave the money received by the taxpayer a capital character) ; which then left taxpayers in receipt of money from the company in which they were notionally shareholders.

Furthermore, the taxpayers were liable to assessment on the *full* amount of the dividend, notwithstanding that some of it had been retained by the transformer company; the Board taking the view that the position was ' the same as if the shareholders had received it as part of the special dividend and then returned it to [the transformer company] as remuneration '.[26]

In *Hancock's* case[27] the main object of the taxpayers in entering into the transaction was to acquire a controlling interest in a company in which they then only had a minority shareholding. This was achieved by third party (majority) shareholders also selling their shares to the

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[23] This is usually termed the ' milking ' operation.

[24] (1953) 87 C.L.R. 548, 573.

[25] By virtue of a special resolution, the original shares carried a special dividend right, but after this had been paid they reverted to ordinary preference shares.

[26] [1958] A.C. 450, 468. The Privy Council's decision on this point was applied in *Hancock's* case and *Mayfield v. Commissioner of Taxation* [No. 2] (1961) 108 C.L.R. 323. It has been cogently criticised: Trebilcock, *op. cit.* 245.

[27] (1959-1961) 108 C.L.R. 258: this decision has been applied by the Board of Review in 10 C.T.B.R. (N.S.) Cases 32 and 33.

transformer company,[28] which subsequently sold the shares acquired from both sources back to the taxpayer.

This case is an example of the application of the fifth proposition enunciated in *Newton's* case, that is, as it was clear that the transaction also had the purpose of avoiding tax, it was to that extent void as against the Commissioner.

The main difficulty in the case stemmed from the fact that finance for the transactions involved was supplied partly from the transformer company's own resources,[29] which raised the question whether the Commissioner had to trace what the taxpayer received back to the dividend fund of the distributing company (as a literal reading of a passage of the Privy Council in *Newton's* case would suggest).[30]

The Court (Menzies J. dissenting on this point) answered this question in the negative, the approach of the Court being best seen in the following passage of Dixon C.J.—

> When the purpose is to assess a taxpayer who has reached a situation which but for a scheme swept away by s. 260 would or might spell liability to tax, it does not appear to me to be necessary to trace the identity of moneys as if one were seeking to identify in an investment trust funds that had been misapplied. . . . The resource of ingenious minds to avoid revenue laws has always proved inexhaustible . . . [but it] does not seem to me to matter at all what interim financial expedients were resorted to or which moneys or whose credit was used in the course of carrying out the transaction. It is the result that exposes the taxpayer to liability : a result necessarily involving the employment by the taxpayer of a distribution of the profit fund.[31]

In thus rejecting the requirement of a process of tracing the decision represents an extension of the application and effect of the section beyond that enunciated in *Bell's* case and *Newton's* case.

Although not involved in the case, the question whether the transaction was void as between the Commissioner and the *transformer* company was discussed by Kitto and Windeyer JJ. who came to differing conclusions.

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[28] Note that the third party shareholders were subsequently held by a Board of Review *not* to be caught by s. 260, as there was no evidence of a scheme on *their* part to avoid tax: see 10 C.T.B.R. (N.S.) Case 31.

[29] Whereas in *Newton's* case the transformer company's finance came substantially from the ' expected ' dividends.

[30] [1958] A.C. 450, 468.

[31] (1961) 108 C.L.R. 258, 281-282. This passage was approved by Menzies J. in *Mayfield v. Commissioner of Taxation* [No. 2] (1961) 108 C.L.R. 323, 334; but in *Mayfield v. Commissioner of Taxation* (1961) 108 C.L.R. 303, 321 he noted that the reasoning of Dixon C.J. (with whom Windeyer concurred) in *Hancock's* case was not identical with that of Kitto J., and both differed from that of Fullagar J. whose judgment was affirmed.

This matter has now been resolved by *Rowdell Pty Ltd v. Federal Commissioner of Taxation*[32] where the taxpayer concerned was the very transformer company in *Hancock's* case. The issue that arose in *Rowdell's* case was whether the money received by Rowdell from the distributing Company was a ' dividend ' (and thereby entitled to certain rebates and deductions) or remuneration for services rendered, and this turned directly on the question whether the transaction was void as between the Commissioner and Rowdell. The High Court[33] unanimously held that the fact that section 260 operated to avoid the transfer as between Hancock and the Commissioner, did not thereby avoid the transfer as between the Commissioner and Rowdell, in the absence of evidence showing that the arrangement was a means of tax avoidance on the part of Rowdell itself. Here, this was obviously not the case, as but for Rowdell's participation in the transaction, no liability to tax would have arisen on its part.

In reaching this conclusion, Menzies J. relied on the phrase ' so far as '[34] in section 260 as limiting its operation to an ' arrangement's tax-avoiding purpose and effect '.[35]

Kitto J. pointed out that Lord Denning's statement in *Newton's* case that the moneys in that case were ' nothing more nor less than remuneration which the original shareholders allowed [the transformer company] to retain for services rendered '[36], was so characterised only as regards Newton and the Commissioner.

The last case under this head is *Mayfield v. Commissioner of Taxation.*[37] The facts in this case were extremely complex; but greatly simplified, the scheme consisted of the control by the Mayfield family of an operating company through a holding company; the sale of the operating company's shares *cum* dividend to a transformer company ; the ' milking ' by the latter company of the operating company's profit fund (by a declaration of dividends) ; the liquidation of the operating company, when returns were made and accounts settled so as to allow the transformer company a profit; and the receipt by the Mayfield family of the accumulated dividends, ostensibly in the form of a capital receipt. On these facts, Menzies J. concluded that although one purpose of the arrangement was to preserve the Mayfields' control over the operating

[32] (1963) 111 C.L.R. 106.

[33] Affirming a majority Board of Review decision—see (1961) 12 T.B.R.D. Case No. M29; 10 C.T.B.R. (N.S.) Case 64 especially at 390-391 and 398.

[34] Which thus has a double significance in the interpretation of s. 260: see also the Privy Council's fifth proposition in *Newton's* case.

[35] Notwithstanding such other phrases as ' absolutely void ' and ' in regard to any proceeding ' relied on by Challoner and Greenwood, *Income Tax Law and Practice (Commonwealth)* (1962, 2nd ed.) 1207 to support a contrary conclusion. See also Trebilcock, *op.* cit. 247.

[36] [1958] A.C. 450, 468.

[37] (1961) 108 C.L.R. 303.

company through the holding company, they would obtain the benefit of its distributions without incurring any tax liability. Accordingly, section 260 operated to avoid the scheme so far as it avoided tax consequent upon a distribution of dividends,[38] and as in *Hancock's* case the transfer of shares to the transformer company was rendered void. Hence the Mayfields were taxable as though they had remained shareholders in the company up to the time of its dissolution. Accordingly, applying *Newton's* case and *Hancock's* case, the dividend distribution and the liquidator's distribution to the extent it was paid out of the income derived by the operating company was assessable, notwithstanding that neither of these amounts had actually reached the Mayfields' hands. However, as neither the amount paid on liquidation by way of return of capital, nor that paid from the capital profit reserve fund (arising from the sale of the shares in the operating company) would normally have been taxable, section 260 did not operate so as to render them taxable.

Class B

On the basis of the decision in *Cecil Bros Pty Ltd v. Commissioner of Taxation*[39] it appears that section 260 will not be readily applicable to a scheme of this kind. The facts in *Cecil Bros'* case were comparatively simple : the taxpayer was a family company which bought goods from another family company (whose shareholders were close relatives of the shareholders in the taxpayer company) at a price higher than the ruling market price, thus allowing the latter company to make a profit. The problem thus raised was the converse of that which normally arises, for as Owen J. said—

> [I]n most, if not all, the cases in which s. 260 has been held to apply, the fact has been that moneys have come into the hands of the taxpayer which the section has enabled the Commissioner to treat as an income receipt. This is the converse case. Section 260 is being called in aid to reduce the amount of the taxpayer's outgoings and thus increase its taxable income . . .[40]

Owen J. held that the critical question was whether the transactions were capable of explanation by reference to ordinary business or family dealing (having rejected the Commissioner's submission that the transaction was a sham) and he answered this question in the negative. His decision, however, was reversed on appeal.[41]

Dixon C.J., Kitto, Taylor and Windeyer JJ., doubted whether there was in this case any contract, agreement or arrangement falling within

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[38] As nothing was avoided by the distribution itself: *cf. Newton's* case [1958] A.C. 450, 468.

[39] (1964) 37 A.L.J.R. 445.

[40] (1962) 36 A.L.J.R. 65, 67.

[41] However in the intervening period it had been followed by a decision of a Board of Review: see 10 C.T.B.R. (N.S.) Case 88.

section 260 (Menzies J. assumed there was but did not finally decide this point), or whether section 260 could ever operate to extinguish a deduction otherwise properly allowable under section 51. However, the Court put its decision on the ground that the partial disallowance of the contract price would amount to an unauthorised reconstruction of the facts when the section had purely an annihilatory operation. The case thus shows an extension of the annihilatory principle into the field of outgoings ; and, when it was applied here all that was shown was that the taxpayer could have bought its stock for less than it did.[42]

This being the case, the well-known principle in *Ronpibon Tin N.L. and Tongkah Compound N.L. v. Federal Commissioner of Taxation*[43] was applicable; namely, that—'[i]t is not for the Court or the commissioner to say how much a taxpayer ought to spend in obtaining his income, but only how much he has spent.'[44]

Accordingly, it seems that the section will rarely apply to schemes falling within Class B.

Class C

The first case to be considered under this head is *Millard v. Commissioner of Taxation*[45] where a bookmaker transferred his business to a family company, and thenceforth purported to carry on his bookmaking business as the company's agent: in fact he carried on precisely as before. Taylor J. said that irrespective of whether the scheme was illegal (as being in contravention of the Bookmakers Act 1953 (Vic.)) or a sham—'it is about as plain as it could be that the whole purpose and effect of the agreement was to split the appellant's income into a number of parts in order to minimize the amount of tax which would become payable.'[46] Accordingly, he held the Commissioner was entitled to disregard the dispersal of the income through the medium of the company which left the taxpayer receiving income on his own account.

The most recent case under this head is *Peate v. Commissioner of Taxation*[47] which essentially involved the incorporation of a professional practice. In this case, medical practitioners, immediately following the dissolution of a pre-existing medical partnership, each formed a family company (in the instant case hereafter referred to as Raleigh) which purchased his practice and equipment, and he agreed to serve it or its nominees for a salary. Furthermore, as under the memorandum and

[42] See *per* Menzies J. (1964) 37 A.L.J.R. 445, 446.

[43] (1949) 78 C.L.R. 47.

[44] *Ibid.* 60. *Cf.* the statement of Rich, Dixon and Evatt JJ. in *Clarke's* case (1932) 48 C.L.R. 56, 77.

[45] (1962) 108 C.L.R. 336.

[46] *Ibid.* 342.

[47] (1962) 36 A.L.J.R. 258; on appeal (1964) 38 A.L.J.R. 164; 13 A.T.D. 346. The Privy Council has granted special leave to appeal.

articles he, as governing director, had power to determine his own salary he could thus regulate the amounts payable to the members of his family by way of dividends. A group company was formed simultaneously (hereafter referred to as Westbank), its shareholders being the family company of each doctor. A tripartite agreement was then entered into by the doctors, their family companies and Westbank whereby each doctor bound himself to ensure that his patients would contract with Westbank (to which all fees were payable),[48] and that he would pay Westbank an amount equivalent to these fees as liquidated damages if he failed to carry out this obligation.[49] The moneys thus received by Westbank were applied at the direction of the doctors (as directors of Westbank), *inter alia*, to— (a) meeting Westbank's expenses in providing medical services; (b) making contributions to a superannuation fund for employees; and (c) paying a ' service fee ' to the family company of each doctor. In fact this ' fee ' was the equivalent of each doctor's share of the previous partnership profits.

Menzies J. held, applying *Newton's* case, that—

> [I]t was not an ordinary business transaction for a body of professional men who are entitled to sue for fees for medical services to transfer their practices, their libraries and their instruments to a company which could not sue for fees and to become that company's servants in the conduct of their profession, particularly in the circumstance that, to the extent to which patients paid fees to the company, their expenditure was not rebateable under s. 82F.[50] *What, outside a profession, might be regarded as an ordinary business transaction may, within a profession, have an altogether different appearance.*[51]

It may be argued, however, the assertion made in the sentence italicised above is open to the objection that the court has now given the section a construction which penalises the professional man; when similar conduct by his commercial counterpart would be characterised as ' ordinary business dealing '.[52]

Menzies J. rejected the submission that section 260 was limited to income already in existence[53] (relying on *Millard's* case and the decision

[48] Apparently, most of the patients did not know of this agreement, so applying normal contractual principles there would have been no binding contract between the patient and Westbank: see Gibson, ' Income Tax and Companies Formed by Medical Practitioners' (1958) 32 *Australian Law Journal* 144, 145.

[49] The Commissioner might even be able to argue that—irrespective of s. 260—this was income derived by the practitioner: see Gibson *op. cit.* 145-147.

[50] Gibson, *op. cit.* 144-145 also points out that the doctors would also be disentitled to certain other payments; and in the High Court it was noted that payments from institutions had been made to the doctors personally.

[51] (1962) 36 A.L.J.R. 258, 265. Italics added.

[52] See (1963) 4 *Melbourne University Law Review* 275, 278-279; Gibson *op. cit.* 144.

[53] Taylor J. expressly agreed with this on appeal. A literal reading of *Newton's* case might suggest a contrary conclusion as the Privy Council spoke of a liability ' about to fall ' on the taxpayer: see (1959) 2 *Melbourne University Law Review* 110, 113; Gibson, *op. cit.* 148 and Challoner, *op. cit.* 119.

of Owen J. in *Cecil Bros'* case[54]); nor did he think that the section was any the less applicable because prospective income was derived from personal exertion rather than from property. He thus held section 260 applied and stated that the annihilation of the agreements between the taxpayer, Raleigh and Westbank left the assessable income of the taxpayer as his proportion of the difference between the gross fees paid to the group company less the group expenses and the amount paid by it for the benefit of its employees and dependants (as these were normally properly allowable under section 66).

From this decision the taxpayer appealed to the Full High Court which unanimously dismissed the appeal.

Kitto J. (with whom McTiernan and Owen JJ. concurred) agreed with Menzies J. that the overt acts done in pursuance of the plan could be characterised as a means to avoid tax, irrespective of their other ends. He then rejected the submission that section 260 was confined to cases where it had been sought to convert income into capital, stating that it applied to any scheme which sought to avoid tax.

Having decided that the section applied, Kitto J. then considered the difficult question as to which part of the scheme was avoided by its operation, and whether the facts left exposed justified the Commissioner's assessment. On this aspect he agreed with Menzies J. that the section avoided the separate corporate existence of Westbank; that is, nullified the patients' and doctors' contracts with Westbank and the doctors' positions as directors of Westbank, so that—

> What remains is the income produced by an association of doctors, received by them jointly, and subject to division in agreed proportions so that, in the language of s. 19, each doctor's distributable share was dealt with as he directed. It follows that each doctor must be considered to have derived his proportion of the income. . . . Clearly s. 260 does not enable contracts that were made between patients and Westbank to be notionally replaced by contracts between patients and the individual doctors ; but no such process is required for the upholding of the assessments. If all the patients' contracts be simply treated as void, so that all fees paid are regarded as having been paid gratuitously, it makes no difference. The fees are none the less income, brought into existence by the associated activities of the doctors and those who worked at their direction, and channelled into the common fund which bore the name of Westbank, there to be dealt with in the agreed manner.[55]

Taylor J. also rejected the submission that the scheme might be viewed as an ordinary business or family dealing, saying that even if it was conceded that it had other ends as well—'avoidance of tax . . . was at the very heart of the arrangement which was about as far removed as possible from any concept of ordinary business or family dealing'[56].

[54] The decision of Owen J. was reversed on appeal, but not on this point.
[55] (1964) 38 A.L.J.R. 164, 166.
[56] *Ibid.* 168.

He considered (Windeyer J. expressly agreeing on this point) the scheme equivalent to the case where a taxpayer had assigned his future gross income upon the condition that the assignee, after paying the taxpayer's working expenses, would deal with the balance as directed. Like Menzies J. he rejected the submission that the section was limited to schemes involving the dispersion of a pre-existing fund, pointing out that in *Newton's* case the shareholders after having entered into the arrangement had no immediate right to participate in the dividend fund.

His Honour did not have to finally consider whether the appellant had to actually receive the income as he agreed with Menzies J. that the avoidance of the agreements made by the appellant with Raleigh and Westbank produced a situation in which—

> [W]hat is left exposed is a receipt of moneys by Westbank on account of the medical practitioners in question and that . . . the appellant can be said, within the meaning of s. 19 of the Act, to have derived income.[57]

Windeyer J. agreed generally with Kitto and Taylor JJ. but made some additional comments. He agreed that a taxpayer might fairly regard it as businesslike to arrange his affairs so as to attract the minimum of tax, but added—'. . . that does not mean that whatever method he adopts to that end can itself be said to be explicable as an ordinary business or family dealing putting it outside s. 260.'[58]

Windeyer J. then rejected the submissions that the scheme could be considered analagous to the case of a company carrying on the business of a partnership which it had taken over, or to the distribution by a private company of income arising from its management of capital assets, because of the extraordinary and inter-related activities of Westbank and Raleigh.

In the course of the appellant's argument, stress had been laid upon the separate legal identity of the companies concerned, but Windeyer J. was not prepared to give much weight to this—

> [N]ot much assistance for questions such as arise in this case is got by emphasizing that in law a company is an entity distinct from its members. *What is important is the function that the company in fact performs and which it was created to perform.* It is not necessary for the application of s. 260 to find that the case is one for 'lifting the veil'.[59]

And here, Windeyer J. preferred to regard Raleigh as a means to the taxpayer's ends rather than a 'facade or screen' which the court might go behind.

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[57] *Ibid* 169.

[58] *Ibid.*

[59] *Ibid.* 170. Italics added.

The High Court thus unanimously dismissed the appeal.

The conclusion to be drawn from these two cases seems to be that the courts will be particularly ready to apply section 260 to any scheme adapted to carry on professional practices as corporate entities. And, as already noted, this might seem somewhat harsh in view of the apparent freedom which will be available to the businessman as a result of the *Cecil Bros* decision.

To sum up generally, it seems that schemes falling within Classes A and C will be carefully scrutinised by the courts, and it almost seems that the mere fact that liability to tax is lessened will *prima facie* stamp an arrangement as bad. However, schemes falling within Class B would generally appear to escape the net cast by section 260.

P. K. WAIGHT