CASE LAW

LEGAL AVOIDANCE OF TAXATION: *BELL* v. *FEDERAL COMMISSIONER OF TAXATION*

The recent decision of the High Court in the case of *Bell* v. *Federal Commissioner of Taxation*[1] caused a considerable stir among those in the business and financial worlds and has raised once more a problem which has worried lawyers and business men for many years, namely, the effect of s. 260 of the Income Tax Assessment Act 1936-1948 (Cwlth.).[2]

The section reads as follows:

> 260. Every contract, agreement, or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall so far as it has or purports to have the purpose or effect of in any way directly or indirectly . . . (c) defeating, evading, or avoiding any duty or liability imposed on any person by this Act . . . be absolutely void, as against the Commissioner, or in regard to any proceeding under this Act, but without prejudice to such validity as it may have in any other respect or for any other purpose.

The facts in *Bell's Case* concerned an elaborate scheme carried out by Bell and six other partners with the advice of solicitors and accountants and involving the formation of companies for the disposal of a large amount of surplus war material. A large profit exceeding £77,000 was made, but, instead of this amount being distributed as dividends or as on a winding up to Bell and his partners, each sold his £1 share to another person for the proportion of the profits to which he was entitled, i.e. approximately £11,000, the purchasers subsequently receiving a dividend of that amount on each share which was not taxable, they being residents of the Territory. When the Federal Commissioner of Taxation included the sum so received in his assessment of Bell's taxable income, Bell objected on the ground that the amount was received by him from the sale of his share in the company which had been held by him as an investment and was not liable to be brought to tax under any provision of the Income Tax Assessment Act, i.e. that it was a capital receipt not liable to inclusion in assessable income. Bell appealed unsuccessfully to McTiernan, J. He now appealed to the High Court. The Court (Dixon, C.J., Williams, Webb, Fullagar and Kitto, JJ.) in the course of its joint judgment emphasised that the partners had acted throughout in good faith and had done nothing dishonest. They were animated by no other purpose than that of producing an immunity from tax in a manner which they believed was in strict conformity with the law. Moreover, there was no pretence or suppression about it. Of no step that was taken could it be said that it was not intended to be real or was intended as a cloak for anything else. "Since," the Court said, "all parties acted openly and there is no ground for denying that every step in their procedure was effectual as between themselves to do what it purported to do, the commissioner's assessment against Bell cannot be supported unless by reference to s. 260 . . . ." They went on to decide that s. 260 applied to the case and dismissed the appeal.

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[1] (1953) 27 *A.L.J.* 123, 10 Australian Tax Decisions 164.
[2] No. 27, 1936 — No. 44, 1948.

Many businessmen were agitated by this decision[3] and, protesting that s. 260 had hitherto been regarded as "dead wood", pointed out that before a prudent trader embarked on any enterprise it was usually essential for him to know what liability to taxation the venture would have to bear, and sometimes this might be the deciding factor. The operation of s. 260 would make this precision difficult if not impossible in some cases. The language used in Bell's case was very wide and apart from its application to the facts of that case seemed to give no indication of any limits on the operation of the section.

It is important, then, at this stage, to consider the law as to the citizen's right of "legal avoidance" of taxation and to attempt to draw, from such authorities as exist, some criterion for ascertaining with some degree of precision what are the arrangements struck at by the section. The early view of the English Courts as to "avoidance" was put by the Lord President when he said:

> No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores. The Inland Revenue is not slow—and quite rightly—to take every advantage which is open to it under the taxing statutes for the purpose of depleting the taxpayer's pocket. And the taxpayer is, in like manner, entitled to be astute to prevent, so far as he honestly can, the depletion of his means by the Inland Revenue.[4]

In other words the taxpayer could avoid taxation even if he could not evade it.

However, after World War 1, as fast as a loophole was discovered in taxing legislation it was stopped up by the Legislature, and in 1942 a change in the judicial attitude towards the social evils of legal avoidance became apparent.[5] In 1943 Lord Simon, L.C., said:

> . . . of recent years much ingenuity has been expended in certain quarters in attempting to devise methods of disposition of income by which those who were prepared to adopt them might enjoy the benefits of residence in this country while receiving the equivalent of such income without sharing the appropriate burden of British taxation. Judicial dicta may be cited which point out that, however elaborate and artificial such methods may be, those who adopt them are "entitled" to do so. There is, of course, no doubt that they are within their legal rights, but that is no reason why their efforts, or those of the professional gentlemen who assist them in the matters, should be regarded as a commendable exercise of ingenuity or as a discharge of the duties of good citizenship. On the contrary, one result of such methods, if they succeed, is, of course, to increase *pro tanto* the load of tax on the shoulders of the great body of good citizens who do not desire, or do not know how, to adopt these manoeuvres.[6]

However, whereas the English solution to the problem was to provide particular statutory provision to stop up particular loopholes in the taxing legislation, the Commonwealth Parliament enacted also a "blanket" provision, s. 260 in the present Act and its predecessors s. 93 in the Act of 1922[7] and s. 53 in the

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[3] *The Financial Review* (18/6/53) contained a full report of the judgment and commented on it under the headlines "High Court Decision Upsets Tax Avoidance Plans". The *Sunday Telegraph* heading (28/6/53) read "A New Tax Grab".

[4] *Ayrshire Pullman Motor Service and D. M. Ritchie* v. *Commissioners of Inland Revenue* (1929) 14 Tax Cas. 754, 763-64. In *Dewar* v. *Commissioners of Inland Revenue* (1935) 2 K.B. 351, 19 Tax Cas. 561, Romer, L.J., in the Court of Appeal (at 571), said: "But for the purposes of Income Tax, one does not take an account of an impossible income on the footing of wilful default." See also *per* Lord Hanworth M.R. at 571.

See *The Commissioners of Inland Revenue* v. *His Grace The Duke of Westminster* (1936) A.C. 1, 19 Tax Cas. 490; *S. W. Hawker* v. *J. Compton (H.M. Inspector of Taxes)* (1922) 8 Tax Cas. 306; *Levene* v. *Commissioners of Inland Revenue* (1928) A.C. 217; 13 Tax Cas. 486.

[5] See *Lord Howard de Walden* v. *Inland Revenue Commissioners* (1942) 1 K.B. 389.

[6] *Latilla* v. *Inland Revenue Commissioners* (1943) A.C. 377, 381. A similar change in attitude by the Courts took place in the United States of America.

[7] No. 37, 1922.

Act of 1915.[8] It now remains to consider what effect this provision has had on the general liberty of the subject legally to avoid taxation as recognized by the tribunals in England.

That this liberty still existed was stated in the case of *The Deputy Federal Commissioner of Taxation* v. *Purcell*[9], which was an appeal to the Full High Court from a decision of Knox, C.J. A taxpayer had settled property on his wife, his daughter and himself equally, reserving to himself wide powers of management. Gavan Duffy and Starke, JJ., said[10], "The right of every man to dispose of his property, if he can, in a way which will relieve him of taxation, and for that purpose, has been recognized by the highest authority." However, they considered Knox, C.J., justified in deciding that the settlor intended to make his wife and daughter owners of two-thirds of the property concerned and that the transaction was genuine. Upon the Commissioner's contention that even if the transaction were genuine it was struck by s. 53 of the Income Tax Assessment Act 1915, they replied:

> Its (s. 53's) office is to avoid contracts, etc., which place the incidence of the tax or the burden upon some person or body other than the person or body contemplated by the Act. If a person actually disposed of income-producing property to another so as to reduce the burden of taxation, the Act contemplates that the new owner should pay the tax. The incidence of the tax and the burden of the tax fall precisely as the Act intends, namely, upon the new owner. But any agreement which directly or indirectly throws the burden of the tax upon a person who is not liable to pay it, is within the ambit of s. 53.[11]

So, s. 53 did not apply to real genuine and valid dispositions of property even if made with the purpose of "legally avoiding" taxation. Knox, C.J., had summarised his view of the law as follows: (1) Under s. 53 the onus is on the Commissioner of taxation to establish facts from which the Court may, and should, conclude that the transaction is within the class struck at by that section. (2) That section is intended, and does extend, only to cover cases in which the transaction, if recognized as valid, would enable the taxpayer to avoid payment of income on what is in reality his income. (3) That section does not extend to the case of a bona fide disposition by virtue of which the right to receive income arising from a source theretofore belonging to the taxpayer is transferred to and vested in some other person.[12]

Knox, C.J., in reaching his decision had said: "I have no doubt that he was influenced to some extent by a desire to lessen the burden of taxation, but the existence of this motive, assuming the existence concurrently of the intention to part with the beneficial ownership of the property transferred, in no way vitiates the transaction."[13]

So this case seems to lay down that the "annihilating" effect of s. 260 is not attracted merely by an intention in a transaction to avoid taxation; nor is it attracted when the transaction, independently of intention, serves to transfer the right to receive income to some other person. What is struck at is the arrangement whereby the right to receive income after the transaction remains with the person to whom it belonged before the transaction. This appears to be a fairly clear test and, by the rejection of any criterion based solely on "intention", does not depart from the principle laid down by the Courts in England. Unfortunately, subsequent cases culminating in *Bell's Case* have not been so precise in the formulation of the reasons why s. 260 applied or did not apply to the transaction in question, and it is now proposed to consider the language used in these cases

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[8] No. 34, 1915.
[9] (1921) 29 C.L.R. 464.
[10] *Id.* at 472.
[11] *Id.* at 473.
[12] *Id.* at 466.
[13] *Id.* at 467.

and to demonstrate that they are at the least consistent with, and probably necessarily based on, a test of the nature of that indicated.

Jacques v. *The Federal Commissioner of Taxation*[14] was an important High Court decision on the topic. The facts were as follows. Section 18 (1) (i) of the Income Tax Assessment Act 1915 permitted deduction from income in respect of calls paid to certain mining companies. A company decided to reconstruct and transfer its assets to two new companies. Instead of carrying out the original intention, as laid down in an earlier agreement, of accepting shares in the new companies as consideration for the assets so transferred, and distributing these shares to the members of the old company, an arrangement was made whereby the shareholders subscribed for contributing shares in the new companies, calls being made for their face value. The calls were paid out of the proceeds of sale of the old company's assets by the old company to the new companies under the shareholders' authority, the transaction being consummated by the exchange of cheques. It was held that the shareholders were not entitled to a deduction in respect of the calls paid. Knox, C.J., said[15] that the appellant had failed to establish that the dealings "were genuine, bona fide transactions intended to create real rights and obligations", and they "were devised and carried out in order to conceal the true nature of the real agreement", which was an issue to the members of the old company of fully paid up shares in the new companies, and to enable members of the old company to escape wholly or in part from their liability to pay income tax on *their true taxable income* by obtaining a deduction under s. 18 (1) (i) to which they were not entitled, and that the transactions on which the claim to a deduction was rested constituted an arrangement having the purpose of relieving the shareholders of the old company from liability to pay income tax which on the true facts they were liable to pay and were to that extent avoided by s. 53 of the Act (the equivalent of s. 260 in the present Act). He seems to couple the effect of the agreement with the intention to avoid taxation in this criterion. He went on to say "If the (original) agreement . . . had been carried into effect in the ordinary course, the appellant would have had fully paid-up shares in the new companies, and would not have been entitled to any deduction under s. 18 (1) (i) of the Act. That agreement has in truth been carried into effect. . . . "[16]

The ground for the separate judgments of Isaacs and Starke, JJ., was that although the transactions under the new scheme were genuine, they fell within s. 53[17] and were void (semble, they used the word "genuine" in a more literal sense than did Knox, C.J.). Isaacs, J., said: "That the transaction is a reality is no reason for the non-application of the section. On the contrary, if the transaction were not real and effective apart from the section, that section would be unnecessary. A sham transaction is inherently worthless and needs no enactment to nullify it."[18] He continued:

> . . . the section does not include a conveyance or transfer of property, legal or equitable, as such. It presupposes that apart from the "contract, agreement, or arrangement" a taxpayer would bear a certain liability either to make a return, or to pay tax in respect of certain income. *Then, assuming that the income (if any) still remains that of the taxpayer (because s. 53 does not contemplate an instrument actually changing the real ownership)* the section supposes some "contract, agreement, or arrangement" which apart from the provisions of the section itself would legally operate or purport to operate in one or more of the ways set out in paras. (a), (b), (c) and (d).[19]

The transaction "in no way altered the income of the taxpayer or changed its

[14] (1924) 34 C.L.R. 328.
[15] *Id.* at 355.
[16] *Ibid.*
[17] Income Tax Assessment Act 1915 (Cwlth.).
[18] (1924) 34 C.L.R. at 358.
[19] *Id.* at 359.

ownership."[20]

Starke, J., said: "There is nothing wrong in companies and shareholders entering, if they can, into transactions for the purpose of avoiding, or relieving them of, taxation. . . . *But the transactions did not, in any business sense, alter the position of the shareholders; their income was not diminished, nor their property increased.*"[21]

Although the principles set out in *Purcell's Case* were not, in *Jacques' Case*, specifically adverted to as the test of the applicability of s. 260, it is obvious that the ground of the decision is the same.

In 1932, the High Court gave judgment in the case of *Clarke* v. *The Federal Commissioner of Taxation.*[22] Clarke had formed a company of which he was the sole beneficial shareholder. He granted a lease of a hotel to the company which immediately assigned it for a premium which was paid to Clarke. In its books the company debited Clarke with the premium received by him and expunged the debt by crediting him with a similar sum as the sole beneficial shareholder entitled to its surplus assets on winding up. The Court held that Clarke was assessable in respect of the premium as a result of the application of s. 93 (c) of the Act[23] (now s. 260 (c) of the present Act). The Court (Rich, Dixon, and Evatt, JJ.) during the course of its judgment said: " . . . all amount to an arrangement adopted for the sole purpose of intercepting the liability to income tax which would otherwise flow from the payment to him of a consideration actually demanded and actually given in connection with a leasehold."[24] The ground for this conclusion was set out earlier:

> 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 transaction into which he might have entered but in fact did not enter. Where, however, the annihilation of an agreement or arrangement so far as it has the purpose or effect of avoiding liability to income tax leaves exposed a set of *actual facts* from which that liability does arise, the provision effectively operates to remove the obstacle from the path of the Commissioner and to enable him to enforce the liability.[25]

This last paragraph, if read in its widest connotation, would possibly seem to bring the declaration of trust in *Purcell's Case* under the section although this was there held not to be the case. It is submitted that it must be read in a narrower sense and it will then be consistent with the principles expressed in *Purcell's Case* and *Jacques' Case*. *'Clarke's Case* itself presented certain special features: the "sole purpose" of the arrangement in *Clarke's Case* was to avoid income tax (p. 80); third parties were not affected by eliminating the agreement; the income receivable by the taxpayer, from the actual facts exposed, eliminating the arrangement, was the same as the amount receivable by him if the arrangement were not avoided.'[26]

The test of "sole purpose" as a sole test is inconsistent with the line of English decisions and was rejected in *Purcell's Case*; the notion of effect on third parties is hardly a valid ground for determining the applicability of the

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[20] *Id.* at 360. Itals. supplied.
[21] *Id.* at 362.
[22] (1932) 48 C.L.R. 56.
[23] Income Tax Assessment Act 1922 (Cwlth.)
[24] (1932) 48 C.L.R. at 80. [25] *Id.* at 77.
[26] J. V. Ratcliffe, J. Y. McGrath and J. R. W. Hughes, *The Law of Income Tax* (*The Commonwealth*) (1938) 158.

section; the idea of the taxpayer's income being the same is, it is submitted, the only practicable criterion yet raised and is identical with the principles laid down in *Purcell's Case*. Now to consider the effect of what was said by the Court in *Bell's Case*.

> Since his original acquisition of the share was not for the purpose of sale at a profit, this meant that the steps taken in accordance with the routine, if treated as valid, made all the difference between his deriving £11,000 as assessable income and deriving £11,000 as a capital receipt not liable to inclusion in assessable income.
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> If there had been no more in the case than that Bell, in preference to retaining his share and deriving the dividends which it seemed certain to yield, chose to sell the share for a capital sum equal to the assumed dividends, the Commissioner would not have been entitled to treat the capital sum as assessable income on the ground of an actual or supposed economic or business equivalence between the two courses. But there was, of course, much more in the case than that. The sale of the share was a part of a complex transaction carefully planned and carried through by Bell and a number of other persons acting in concert, for one predominant purpose, which was to ensure that Bell and his six colleagues should each receive £11,000 tax free instead of £11,000 subject to tax.[27]

This extract from the judgment seems to accept the test as laid down in *Purcell's Case* but seems also to make one, or possibly two, further requirements before s. 260 can apply, i.e. that there should be a "complex transaction" (s. 260 only purports to apply where there is a contract, agreement or arrangement), the "predominant purpose" of which is to avoid taxation. The test of intention as sole test has been rejected, but the High Court in *Bell's Case* seems to require such a purpose as complementary to the criterion of the taxpayer being left, in reality, with the same amount after the transaction as he would otherwise have had, and, it is submitted, the judgment in *Jacques* v. *The Federal Commissioner of Taxation*[28] makes the same requirement.

Bell's Case, therefore, when read in relation to the previously existing law, seems to carry the interpretation of s. 260 a stage further in definiteness by requiring the presence of three factors before the section can apply: (1) a contract, agreement or arrangement, which (2) has no effect in substance on the taxpayer's income before taxation (3) the predominant purpose of which is to avoid taxation. The effect of the case is summarised neatly by the Court[29]: "This arrangement, *both in purpose and effect*, represented nothing but a method of impressing upon the moneys which came to the hands of Bell and his colleagues the character of a capital receipt and of depriving it of the character of a distribution by a company out of profits."

As regards the point of view of the practising lawyer and business man then, the following remarks may be made as to the effect of *Bell's Case*. Section 260 was not an innovation and has existed in one form or another for many years. But the Commissioner of Taxation will invoke it only in a special case. Further, when invoked the section is not as sweeping as it may seem and constitutes merely a qualification to the rule that the citizen is entitled legally to avoid taxation. Even then its effect is limited to the extent outlined above; beyond these limits the right of the taxpayer so to arrange his affairs that he pays the minimum of taxation remains unimpaired.

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[27] (1953) 27 *A.L.J.* 123, at 123-25.
[28] (1924) 34 C.L.R. 328.
[29] (1953) 27 *A.L.J.* 123, at 125.