Privy Council Appeal No. 106 of 1913.

The Commissioner of Taxes - - - *Appellant,*

v.

The Melbourne Trust, Limited - - - *Respondents.*

FROM

THE HIGH COURT OF AUSTRALIA.

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 24TH JULY 1914.

Present at the Hearing:

EARL LOREBURN.
LORD DUNEDIN.
LORD ATKINSON.
LORD SUMNER.
SIR JOSHUA WILLIAMS.
SIR ARTHUR CHANNELL.

[*Delivered by* LORD DUNEDIN.]

The Commissioner of Taxes for the State of Victoria assessed the Respondent Company for income tax in respect of the year 1910 upon the sum of 113,998*l.*, being the sum which in his judgment upon the figures appearing in the balance sheet and report of directors of the said company, dated 9th April 1910, fell to be assessed under the income tax Acts. The Respondent Company objected to the assessment in so far as it was levied upon the sums of 104,782*l.* 1*s.* 4*d.* and 509*l.* 1*s.* 0*d.*, which sums were admittedly included in the above-mentioned sum of 113,998*l.* What these sums were in respect of which objection was taken will be presently explained. The Commissioner of Taxes, at the request of the Respondent Company, stated a special case for the opinion of the Supreme Court of Victoria.

[71.] J. 360. 80.—7/1914. E. & S.

The questions for the opinion of the Supreme Court as put were :—

" (1) Whether the surplus of 104,782*l.* 1*s* 4*d* mentioned " in paragraphs 19 and 22 of this case is profits earned in or " derived in or from Victoria by the new Company during " the year 1909 or previous years within the meaning " of section 9 of Act No. 1819 so as to subject the new [*i.e.*, " the Respondent] Company to Income Tax in respect " thereof ?

" (2) Whether the difference of 509*l.* 1*s.* between the " prices of debenture stock and par mentioned in paragraphs " 19 and 22 of this case is profits of the kind mentioned in " Question (1) ?

The Supreme Court, by a majority of two to one, decided in favour of the Commissioner of Taxes, answering the questions put as follows :—

" 1. The surplus of 104,782*l.* 1*s.* 4*d.* mentioned in " paragraphs 19 and 22 of the said case is profits earned in " or derived in or from Victoria by a Company during the " year 1909 or previous years within the meaning of " section 9 of Act No. 1819 so as to subject the Company to " Income Tax in respect thereof.

" 2. The difference of 509*l.* 1*s.* between the prices of " debenture stock and par mentioned in paragraphs 19 and " 22 of the said case is also profits of the kind above- " mentioned so as to subject the Company to Income Tax " in respect thereof."

Appeal was taken to the High Court of Australia, and that Court by a majority of two to one reversed the judgment of the Supreme Court of Victoria, and in lieu of the order pronounced by that Court declared " that neither of the sums mentioned in the said questions is taxable."

From this judgment appeal is taken to their Lordships' Board.

It appears from what has been above stated that judicial opinion on the question has been strongly divided—three learned judges in all having been of one opinion and three of another. In such a state of matters it is not to be expected that the question should be one of easy solution, or that cogent arguments should not be found on both sides. Their Lordships recognise that fact, and have given careful and repeated consideration

to the arguments addressed to them, and to the reasons put forward for their judgment by the learned Judges of the Courts below. They will now state the result at which they have arrived.

To make the question intelligible it is necessary here to give as briefly as may be a history of the occurrences which led to the point arising.

Three Australian Banks, viz., the English and Australian Mortgage Bank, Limited, the Federal Bank of Australia, Limited, and the City of Melbourne Bank, Limited, were unable to satisfy their creditors, and went into liquidation. The shareholders had virtually no interest in the liquidations, as the assets were avowedly insufficient to pay the creditors. Eventually in 1897 schemes of arrangement were sanctioned by the High Court in England and the Supreme Court in Victoria and in the case of the second Bank also by the Courts of New South Wales and South Australia. In the case of each Bank the scheme as affecting it sanctioned in England was identical with that sanctioned in Australia. In pursuance of the schemes of arrangement three Companies were formed bearing the names of the English and Australian Assets Company, Limited, the Federal Assets Company, Limited, and the Melbourne Assets Company, Limited, respectively. In these Companies the creditors of the respective Banks were to receive in respect of their debts so much debenture stock and so many fully paid-up shares. The whole assets of each of the insolvent Banks were transferred to the respective Companies, and the liquidation of the Banks was brought to an end.

The respective Assets Companies then proceeded gradually to realise the assets, and with the proceeds to pay off the debenture stock, it being by the terms of its creation a redeemable stock. During the whole of the life of these

Companies the shares and debenture stock were transferable, and some of the stock and shares were in fact—but to an extent not accurately known—transferred.

By the year 1903 the whole of the debenture stocks had been redeemed.

In 1903 the Respondent Company was formed. The object of the Company was to acquire the undertakings of the three separate Companies in terms of agreements which had been made by the promoters of the Respondent Company with the three Companies. In terms of these agreements the whole of the assets of the three respective Companies were to be handed over to the new Company; the three Companies were to be wound up, and the shareholders of the respective Companies were in exchange for their shares to receive in the case of the Melbourne Assets Company and the English and Australian Assets Company, cash, debenture stock, and shares; in the case of the Federal Assets Company, debenture stock and shares, all calculated at the rates set out in the said agreements. This was done. The Respondent Company then proceeded with the gradual realisation of the massed assets, and applied various sums of the monies so received in paying off its debenture stock. This was effected partly by buying their own stock in the market, and partly by redeeming the same, it being by the terms of its issue a redeemable stock. By 15th October 1909 the whole of its debenture stock was paid off.

Their Lordships must now refer to the report and balance sheet of 9th April 1910, upon the terms of which the questions as put arise.

The balance sheet is preceded by a profit and loss account. This account is framed on the ordinary lines of the profit and loss account of a going concern, and deals solely with the yearly revenue, deducting outgoings and expenses of

the properties held by the Company. It brings out a profit balance of 25,183*l.* 18*s.* 2*d.* to be carried to the balance sheet. But it takes no account whatever of sums received from assets realised.

Coming to the balance sheet we find on the liabilities side shareholders' capital and creditors and sundry other liabilities stated in ordinary form. We then come to the following item, which is the matter for special attention.

"Realisation Reserve Account.—Net surplus "on realisation to date (*see* paragraph 5 of "Directors' Report), 144,765*l.* 9*s.* 8*d.*

"Discount on purchases and cancellation of "debenture stock, 3,943*l.* 5*s.* 6*d.*"

Then these two figures are summed and brought out at 148,708*l.* 15*s.* 2*d.*

Turning now to the report there are to be found the following passages :—

"5. As the result of the year's operations the Realization "Reserve Account (consisting largely of purchasers' "balances) has been increased by the sum of "47,442*l.* 15*s.* 5*d.*, making, with the amount brought "forward from the previous year, a net surplus of "148,708*l.* 15*s.* 2*d.*, on realizations and profit arising on "purchase of debenture stock for cancellation."

* * * * *

"7. In the Profit and Loss Account no credit has been "taken for accrued interest, rents, or dividends of an "estimated amount of 4,150*l.* After providing 1,855*l.* 8*s.* 3*d.*, "for interest paid on the Debenture Stock, the net profit "including the Balance brought forward from £ *s.* *d.*
"the previous year, 2,149*l.* 15*s.* 5*d.* is - 27,333 13 7
"The Directors recommend that from this "sum there be applied in payment of a "dividend of fourpence per share (equiva- "lent to slightly over 8 per cent.) free of "income tax - - - 22,777 15 4

"Leaving to be carried forward (subject to "payment of income tax) - - 4,555 18 3

"The whole of the Debenture Stock having been paid off "and the Share Capital of the Company, without taking

"into consideration the Realization Reserve Account, "being fully represented by assets, the Directors also "recommend to the shareholders that a distribution by "way of bonus of sixpence per share should be paid in "cash out of that account.

	£	s.	d.
"The sum at credit of the Realization Re- "serve Account is - - -	148,708	15	2
"The bonus now recommended amounts to	34,166	13	0
"Leaving at the credit of the Realization "Reserve Account - - -	114,542	2	2"

It is set forth in the special case that the assets of the three respective Companies as taken over were entered at a valuation in the Company's books which reproduced a valuation made by the Companies themselves four years before the transfer to the new Company. As any individual asset came to be realised the difference between the actual price realised and the figure at which that asset stood was if it were a gain carried to a realisation Reserve Account. It is also set forth that of the sum of 148,708*l.* 15*s.* 2*d.* mentioned in paragraph 7 of the report as above set forth, the sum of 104,782*l.* 1*s.* 4*d.* represents surplus on realisation of assets in Victoria, and 509*l.* 1*s.* represents the difference between prices paid and par for their own debenture stock in Victoria.

It is not necessary to set forth the particular provisions of the Income Tax Acts in force in Victoria. It is common ground that a company, if a trading company and making profit, is assessable to income tax for that profit. The argument for the Respondent Company can be stated in a single sentence. They say they were not a trading company but a realisation company; that the realisation was truly for the benefit of the original creditors of the three Banks; that all shareholders in the Company are either such original creditors or the assignees of such original creditors. If that is the true view

of the situation their Lordships do not doubt that the argument must prevail. If the liquidator of one of the Banks had made an estimate of the various assets held by him for realisation, and then on realisation had obtained more than that estimate, such surplus would not have been profit assessable to income tax.

Their Lordships cannot, however, come to the conclusion that that is the true view of the situation. It is not necessary to decide the question as it might have arisen in the case of the original three assets companies. At least at the inception of the present company it seems to their Lordships that all concerned were satisfied to discharge their old claims by accepting shares in a new venture, and that that new venture must then be looked at to see if profits assessable to income tax have been earned. The position may be tested in more ways than one. Were it a case of liquidation then the directors of the company would hold for the creditors of the old insolvent Banks. They do not do so. They hold for the shareholders of the company; and the shareholders of the company comprise persons who never were creditors of the Banks, but who acquired their shares in open market. Again, if it was liquidation, the right of each participant creditor, or creditor's assignee, would be strictly limited to the assets of the Bank of which he was a creditor or represented a creditor. If, for example, the Melbourne Bank assets on realisation turned out well, and the Federal Bank assets badly, the creditors of the one would benefit, and those of the other suffer. But as it is it is not so. Each shareholder has in respect of each share an equal interest in the proceeds of the massed assets which were originally assets of the three Banks but now are assets of the Company. Holding, then, that the shareholders of this company are share-

holders in an ordinary venture the only question that remains is whether the surpluses realised represent profits. Their Lordships think that the principle is correctly stated in the Scottish case quoted, *California Copper Syndicate* v. *Harris*, 6 F. 894, and 5 Tax Cases 159.

> "It is quite a well settled principle in dealing with "questions of income tax that where the owner of an "ordinary investment chooses to realize it, and obtains a "greater price for it than he originally acquired it at, the "enhanced price is not profit in the sense of Schedule D of "the Income Tax Act of 1842 assessable to income tax. "But it is equally well established that enhanced values "obtained from realisation or conversion of securities may "be so assessable where what is done is not merely a "realisation or change of investment, but an act done in "what is truly the carrying on, or carrying out, of a "business."

In the present case the whole object of the Company was to hold and nurse the securities it held, and to sell them at a profit when convenient occasion presented itself.

Their Lordships therefore come to the conclusion that there is ample evidence here that the Company is a trading Company and that the surplus realised by it by selling the assets at enhanced prices is a surplus which is taxable as profit.

There remains, however, a difficulty as to proof of the exact figure. It does not seem to their Lordships that the mere fact that an investment standing in the books at x pounds realises on sale $x + y$ pounds settles that a profit of y pounds has been made. It is not that their Lordships doubt that the initial figure in the books may be taken. These figures represent in their Lordships' view real values, for so the parties have treated them. It was argued that they were mere valuations. In one sense that is true, for, not being put to the test of the market at the moment, the only way to affix a

value was by valuation. But that they represent real value seems certain because, unless they did, it would have been impossible to regulate justly the share which each member of the three assets Companies was to get in the new mixed mass of assets—or in other words what shares and debentures he should get in the new Company. But it is possible that other investments on realisation may show loss instead of profit; and it is obvious that it is in the totality of the transactions that the question of profit comes to be fixed.

Their Lordships are, however, of opinion that the Company may well be held bound by its own actions. In distributing a bonus of 6*d*. per share it affirmed that to that extent at least there was profit realised. In the same way in making a distribution of debenture stock on and after 10th August 1910 they may be held to have distributed profit.

Section 9 (1) of the Income Tax Act of 1903 is as follows:—

"9. (1) So far as regards any company liable to pay tax "the income thereof chargeable with tax shall (except as "provided in paragraph (*g*) of Sub-section (1) of Section 7 "of the Principal Act or as hereinafter provided) be the "profits earned in or derived in or from Victoria by such "company during the year immediately preceding the year "of assessment."

This question of time does not seem to have bulked in the discussion in the Courts below —indeed the form of the question "during the "year 1909 or preceding year" rather precludes it—but has been very earnestly pressed upon their Lordships' attention.

As regards the question of when a profit is earned their Lordships' view is that a profit can be said to be earned when it is dealt with as a profit. In ordinary cases this synchronises with the realisation of the sums which swell the assets of

the person or company, and which entering the account (whether on the creditor or debtor side will depend on the particular account in view) go to bring out the balance which is deemed profit. But for the reasons already given their Lordships think that in a case like this the Company are entitled to hold at least a part of their realisations in suspense—as indeed they have done in their accounts—and that it is only when finally the same is given to the shareholders that the final impress of profit is, so to speak, stamped upon it, and that therefore, for the purposes of the Act, that is the time at which it is earned.

Holding this view their Lordships will humbly advise His Majesty to allow the appeal and set aside the judgment appealed against, and also the judgment originally passed by the Supreme Court, and remit the case to the Supreme Court with the following declarations:

1. Declare that the Respondent Company is so constituted and has so carried on its affairs that any surplus ascertained and realised of the proceeds of the assets of the Assets Companies over the consideration paid by way of purchase money for them, after making all just deductions, would be profits taxable as income in the following year; this being over and above any annual surplus of incomings over outgoings of the concern.

2. Declare that as regards the bonus of 6*d*. per share referred to in paragraph 7 of the Directors' Report of 9th April 1910 there is evidence sufficient to show that this is taxable as profit so far as it was earned in or derived from Victoria; and that *pari ratione* the distribution of debenture stock to shareholders calculated as justified by the state of the Realisation Reserve Account should be properly

held to be taxable as profit according to the pecuniary value thereof.

3. Declare that the case does not state facts sufficient to determine any other questions either as to the amount of the profits, or the years in which they are assessable.

4. Declare that the Commissioners be at liberty to apply to the Supreme Court for any enquiries and accounts that may be necessary.

5. Declare that neither party shall be entitled to costs.

There will be no costs to either party before this Board.

In the Privy Council.

THE COMMISSIONER OF TAXES

v.

THE MELBOURNE TRUST, LIMITED.

[DELIVERED BY LORD DUNEDIN.]

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