ASPECTS OF SECTION 26(a) OF THE INCOME TAX ASSESSMENT ACT

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In this article Messrs Walter and Myers examine aspects of the origins and operation of section 26(a) of the Income Tax Assessment Act and the procedures for assessment, objection and appeal in relation to that section. They also look at the application of the section to some common land and share transactions.

Section 26 of the Income Tax Assessment Act 1936-1971 (Cth) provides that '[t]he assessable income of a taxpayer shall include—(a) profit arising from the sale by the taxpayer of any property acquired by him for the purpose of profit-making by sale, or from the carrying on or carrying out of any profit-making undertaking or scheme'.

I THE CONTEXT OF THE SECTION[1]

The concept of income is central to the Income Tax Assessment Act. The very title of the Act reveals that it concerns primarily a tax upon income. Yet nowhere in the Act is 'income' defined.[2] Nor is its antithesis 'capital'. Both concepts have been found too complex to be capable of sufficiently precise statutory definition. Therefore whether a receipt is of an income nature is to be determined according to the principles of business and commerce[3] unless specific provision has been made in the Act. The definition of 'income from personal exertion' in the Act, though not well drafted, has been of some guidance to the courts in determining whether a receipt is of an income nature.[4]

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[1] On the section generally see Commerce Clearing House, *Australian Federal Tax Reporter* (loose leaf) i. paras 12-500 to 12-820; Bock and Mannix, *Australian Income Tax Law and Practice* (1969 ed.) i. 418-64; Hayek, *Manual of the Law of Income Tax in Australia* (2nd ed. revised 1969) 76-9.

[2] *Cf.* the position in England where liability to tax generally depends not simply upon whether a receipt falls with the ordinary concept of income but also whether it falls within one of the categories set forth in the Schedules to the Income Tax Act 1952 (as amended): see *e.g. Re Middleton* (1876) 1 T.C. 109. For this reason English authorities on the question of whether a receipt is of an income nature should be treated with great care: see *Federal Commissioner of Taxation* [hereinafter abbreviated *'F.C.T.'*] *v. Dixon* (1952) 86 C.L.R. 540, 555.

[3] See *Commissioner of Taxes v. Executor Trustee and Agency Co. of South Australia Ltd* (*Carden's* case) (1938) 63 C.L.R. 108, 151-60 *per* Dixon J. The admonition of Lord McNaghten should be heeded: '[i]ncome tax, if I may be pardoned for saying so, is a tax on income. It is not meant to be a tax on anything else. It is one tax, not a collection of taxes essentially distinct': *London County Council v. Attorney General* [1901] A.C. 26, 35.

[4] S. 6(1). See *F.C.T. v. Dixon* (1952) 86 C.L.R. 540.

But tax is also levied upon receipts which do not fall within the concept of income as commonly understood. 'Assessable income' is the basis upon which the amount of 'taxable income' and tax payable are ultimately assessed. 'Assessable income' for the purposes of the Act means the gross income of the taxpayer which is not exempt.[5] It includes not only income within the common meaning of that term not specifically excluded by the Act[6] but also receipts declared by the Act to be income or assessable income.[7] Such inclusions occur principally in section 26. Section 26(a) in particular has the effect of ensuring that certain profits which may or may not be income in the ordinary sense[8] are included in the assessable income upon which the Act proceeds towards the final assessment.

'Taxable income' means the amount remaining after deducting from 'assessable income' all allowable deductions[9] and upon which the final amount of tax is assessed subject to rebates.[10] Allowable deductions[11] may range from ordinary business expenses to concessional deductions to individuals where the outgoing is of a private or domestic nature.

Section 26(a) does not fall within the general scheme of the Act in that it brings in as assessable income *profit* arising from transactions falling within either limb of the section;[12] that is, a net sum is brought into account and not a gross sum as is generally the case.[13]

[5] S. 25. As to 'exempt income' see s. 23.

[6] Not only does the Act expressly exclude from the concept of income receipts which would otherwise fall within that concept (see ss 23, 44(2)-(6), 44A) but it also does this indirectly as in s. 26(d) which operates to exclude 95 *per cent.* of any compensation for loss of office payable under a service agreement which would otherwise be income according to ordinary principles: see *Dale v. De Soissons* [1950] 1 All E.R. 912.

[7] See also ss 36 and 47.

[8] *Infra* pp. 278-82.

[9] S. 6(1).

[10] See ss 46, 160-160AD.

[11] See especially ss 48-82K. Allowable deductions are primarily of two sorts. First general deductions which (with certain exceptions, *e.g.*, gifts to charities: s. 78) relate to expenses incurred in earning assessable income: see ss 51-82AAR. Second concessional deductions which are allowed as a matter of social policy and are unrelated to the earning of assessable income: *e.g.* dependants (s. 82B), medical expenses (s. 82F), life insurance (s. 82H) and education expenses (s. 82J). See also *infra* pp. 288-9.

[12] As s. 26(a) brings into account profit derived from the sale of property acquired for the purpose of profit-making by sale or arising from the carrying on or carrying out of a profit-making undertaking or scheme it is only fair that a deduction should be allowed in respect of losses arising out of such activities. This is done by s. 52. It should be noted that s. 52 confers a wide discretion on the Commissioner: see *Southern Estates Pty Limited v. Commissioner of Taxation (Cth)* (1967) 41 A.L.J.R. 122; *Investment and Merchant Finance Corporation Ltd v. Commissioner of Taxation (Cth)* (1970) 44 A.L.J.R. 73; *Mercantile Credits Ltd v. Commissioner of Taxation (Cth)* (1971) 45 A.L.J.R. 105.

[13] For another exception see s. 26(d). See also *Blockey v. F.C.T.* (1923) 31 C.L.R. 503; *cf. Ruhamah Property Co. Ltd v. F.C.T.* (1928) 41 C.L.R. 148. See also *Colonial Mutual Life Assurance Society Ltd v. F.C.T.* (1946) 73 C.L.R. 604; *Australasian Catholic Assurance Co. Ltd v. F.C.T.* (1959) 100 C.L.R. 502.

II THE ORIGINS OF THE SECTION

In 1930 the definition of 'income' in the Income Tax Assessment Act 1922-1928 (Cth) was amended by the insertion of the words which since 1936 have been section 26(a) of the present Act.[14] It appears[15] that the object of the amendment was to preserve the effect of *Blockey's* case[16] and to prevent the High Court following the decision of the House of Lords in *Jones v. Leeming*.[17] The taxpayer in *Blockey's* case[18] had in March 1918 agreed with two other persons that they would buy on a joint account wheat scrip to the value of about £5,000; that they would endeavour to resell at a profit any wheat scrip purchased and would divide any profits or losses upon resale in the proportions provided in the agreement. In a period of about two months wheat scrip was bought on various occasions and over a subsequent period of about one month resold in several lots at a substantial profit. Tax was assessed on Blockey's share of the profit. He objected and ultimately the matter came ot the High Court for its determination. The whole Court appears to have regarded the activities of Blockey and the other parties to the agreement as the carrying on of a business. However Isaacs J. went on to say:

> The appellant resisted on the ground that the adventure was not a "business". . . . I have expressed the opinion that it was. But nothing I have said must be taken as indicating that, if the adventure had not been a "business" and the Commissioner had assessed the profits as income from property, he would have failed. Whatever is "income" is income from property, unless it falls within the statutory definition of "income from personal exertion". A mere realization of property though producing profit does not, as I have said, produce income. It is a mere enlargement of capital. But if a man, even in a single instance, risks capital in a commercial venture—say, in the purchase of a cargo of sugar or a flock of sheep—for the purpose of profit making by resale and makes a profit accordingly, I do not for a moment mean to say he has not received "income" which is taxable. I intimated during the argument that this was possible; and leave it open.[19]

Higgins J. expressed the view that the important fact in the case was that the purchase of wheat scrip was made 'with a view to profit on

[14] See the Income Tax Assessment Act 1930 (Cth), s. 2(c). In the 1922 Act the definition of 'income' played a different role to that which it has in the present Act. Of course, the words which form s. 26(a) still appear in the definition of 'income': s. 6(1).

[15] See Commonwealth of Australia, *Parliamentary Debates,* House of Representatives, 15 July 1930, 3723-4, 29 July 1930, 4854-6; Commonwealth of Australia, *Parliamentary Debates,* Senate, 6 August 1930, 5316-7, 5328-30. See also *White v. Commissioner of Taxation (Cth)* (1968) 42 A.L.J.R. 139, 146 *per* Windeyer J.; (1965) 16 T.B.R.D. 313, 330-2 *Case* R68; Cullinan, 'Taxation of Profits from the Sale of Property' (1958) 32 *Australian Law Journal* 230.

[16] (1923) 31 C.L.R. 503.

[17] [1930] A.C. 415.

[18] (1923) 31 C.L.R. 503.

[19] *Ibid.* 508-9.

resale'[20] and the fact of one sale as opposed to a course of dealing was immaterial. Following *Blockey's* case,[21] the Commissioner made assessments on the basis that profit derived on the sale of property acquired with a view of resale at a profit was income.[22]

In 1930 *Jones v. Leeming*[23] was decided by the House of Lords. Leeming with three other persons acquired options to purchase two rubber estates in the Malay Peninsula for the purpose of resale at a profit to a company for public flotation. The sole object in acquiring the property was to resell it at a profit. It was an isolated transaction. It did not form part of a trade or business. The House of Lords was clear that the profit made on sale of the options was not income. Indeed Viscount Dunedin was moved to comment 'this case is a striking example of the class of appeal in income tax cases, which on a recent occasion I felt bound to deprecate. There is no new question of law involved in it, merely the application of old principles to the particular facts'.[24] The profit was not income. 'The fact that the parties intended from the first to make a profit . . . does not affect the question we have to determine.'[25]

Following the judgment by the House of Lords objection was made by several taxpayers[26] to assessments which had been made in reliance upon the *dicta* in *Blockey's* case[27] in the hope that the High Court would follow the House of Lords in preference to its own *dicta*.[28] The words which now form section 26(a) were inserted in the Act to deal with these objections and to secure the position of the revenue for the future.[29] For the former purpose the section had retrospective effect to 1922.

[20] *Ibid.* 509.

[21] (1923) 31 C.L.R. 503.

[22] Commonwealth of Australia, *Parliamentary Debates,* Senate, 6 August 1930, 5329.

[23] [1930] A.C. 415.

[24] *Ibid.* 421.

[25] *Ibid.* 425 *per* Lord Warrington of Clyffe. In giving judgment some reliance was placed by some members of the court upon the phrase 'annual profits and gains' appearing in the relevant schedule to the English Act. Nonetheless it is quite clear that all members of the court were satisfied of the quite independent matter that the profits arising from the taxpayer's activities in question did not fall within the ordinary concept of income.

[26] Commonwealth of Australia, *Parliamentary Debates,* House of Representatives, 29 July 1930, 4855. It is likely that the taxpayer in *Premier Automatic Ticket Issuers Ltd v. F.C.T.* (1933) 50 C.L.R. 268 was one of the taxpayers referred to by Mr Scullin.

[27] (1923) 31 C.L.R. 503.

[28] Mr Scullin lamented that the High Court sometimes followed English decisions rather than its own previous decisions: see Commonwealth of Australia, *Parliamentary Debates,* House of Representatives, 29 July 1930, 4855. See now Maher, 'The Common Law—Tears in the Fabric' (1969) 7 *M.U.L.R.* 97 and Cross, 'Recent Developments in the Practice of Precedent—The Triumph of Common Sense' (1969) 43 *Australian Law Journal* 3.

[29] *Supra* n. 15.

The retrospective effect of the section was criticized in Parliament[30] but virtually no attention was paid to the meaning of its imprecise terms.[31] The words of the section appear to have been gathered from the various (and inconsistent) judgments in *Blockey's* case[32] and several cases[33] decided both before and after it. The section appears to have been drafted in considerable haste.[34] It was felt that the section did no more than declare the law as formulated in *Blockey's* case.[35] In short, the grave dangers inherent in lifting judicial statements and phrases and reproducing such statements and phrases as a legislative enactment

[30] See especially the then Mr Latham's comments: Commonwealth of Australia, *Parliamentary Debates,* House of Representatives, 29 July 1930, 4854. Mr McTiernan (as he then was) also participated in the debate. Senator Pearce of Western Australia suggested that the section might 'offend against section 55 of the Constitution'; a point which does not appear to have been taken since: see Commonwealth of Australia, *Parliamentary Debates,* Senate, 6 August 1930, 5317.

[31] However, Senator McLachlan of South Australia did express doubt as to the meaning of the words comprising the second limb of the section and expressed the view that they might go beyond the then existing law: see Commonwealth of Australia, *Parliamentary Debates,* Senate, 6 August 1930, 5330. One may ask why the second limb of the section was necessary if the purpose of the section was merely to prevent the High Court following *Jones v. Leeming* [1930] A.C. 415.

[32] (1923) 31 C.L.R. 503. Knox C.J. appears to have been of the view that the taxpayer was carrying on a business but mentions the taxpayer's intention to resell at a profit: *ibid.* 506-7. For the view of Higgins and Isaacs JJ. see *supra* pp. 278-9; Rich J. said that the taxpayer's activities were limited to a 'particular adventure' but amounted to the 'carrying out [of] a profit making scheme': *ibid.* 509. Starke J. took the view that the taxpayer's activities amounted to 'a scheme for profit making by buying and selling wheat scrip' and were therefore a 'business': *ibid.* 510-1.

[33] See especially *Californian Copper Syndicate (Limited and Reduced) v. Harris* (1904) 5 T.C. 159, 166, where Clerk L.J. said 'it is . . . well established that enhanced values obtained from realisation or conversion of securities may be . . . 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; . . . [the] question to be determined being—Is the sum of gain that has been made a mere enhancement of value by realising a security, or is it a gain made in an operation of business in carrying out a scheme for profit-making?' See also *Re The Income Tax Acts. The Quat Quatta Company's Case* [1907] V.L.R. 54; *Commissioner of Taxes v. The Melbourne Trust Limited* [1914] A.C. 1001 (P.C.); *Ducker v. Rees Roturbo Development Syndicate Ltd* [1928] A.C. 132 ('a gain made in an operation of business in carrying out a scheme for profit making' *ibid.* 140 *per* Lord Buckmaster citing *Californian Copper Syndicate (Limited and Reduced) v. Harris (supra)*); *Ruhamah Property Co. Ltd v. F.C.T.* (1928) 41 C.L.R. 148 ('carrying on or carrying out any scheme of profit-making', 'an operation of business in carrying out a scheme of profit-making': *ibid.* 151, 152). See also a decision of the House of Lords referred to in several tax cases concerning moneylending in which the meaning of the term 'carrying on business' was considered: *Kirkwood* v. *Gadd* [1910] A.C. 422. See also *Commissioner of Taxation (N.S.W.) v. Mooney* (1907) 4 C.L.R. 1439 (P.C.); *McLachlan v. Commissioner of Taxes* [1912] S.A.L.R. 138.

[34] *Jones v. Leeming* [1930] A.C. 415 was decided on 18 March 1930. Objection was made by the taxpayer in the *Premier Automatic Ticket* case (1933) 50 C.L.R. 268 on 14 May 1930. The reading of the Bill took place on 3 July 1930: Commonwealth of Australia, *Parliamentary Debates,* House of Representatives, 3 July 1930, 3650.

[35] See the debates referred to *supra* n. 15 *passim; Premier Automatic Ticket* case (1933) 50 C.L.R. 268, 285-6, 289-90, 297-8, 302. See also *Official Receiver v. F.C.T. (Fox's* case) (1956) 96 C.L.R. 370, 387-8; *White v. Commissioner of Taxation (Cth) (White's* case) (1968) 42 A.L.J.R. 139, 146; *McClelland v. F.C.T.* (1967) 118 C.L.R. 353, 359.

were not heeded to the confusion of the law. These dangers were adverted to by Dixon J. in the *Premier Automatic Ticket* case:[36]

> The criterion, which the Legislature has now adopted and established, was formulated by the Courts in the absence of any statutory direction upon the way in which capital profits may be distinguished from income profits. So far as it lacks precision or is uncertain in its application, the cause is to be found in the powerlessness of the Courts to do more than state a wide general proposition and to apply it as each case arose. The statement of the proposition was not a definition, but rather an explanation of principle. No doubt, as the language of a statute it must receive a more literal interpretation. It is not easy to say whether the expression "profit-making by sale" refers to a sole purpose, or to a dominant or main purpose, or includes any one of a number of purposes. The alternative "carrying on or carrying out" appears to cover, on the one hand, the habitual pursuit of a course of conduct, and, on the other, the carrying into execution of a plan or venture which does not involve repetition or system.

III THE OPERATION OF THE SECTION

(a) *The Approach to the Problem*

Whatever might have been the view of those responsible for the enactment of section 26(a) it has long been recognized that the section goes beyond merely declaring the common law.[37] The proper approach, therefore, to the question of assessability or otherwise of profits is first to consider whether the profits in question are income of the taxpayer within ordinary principles and, if not, to proceed to the question whether the profits are caught by section 26(a). A profit falls within the ordinary concept of income if it arises from the carrying on of a business.[38] The most common example of profit arising from the sale of property in the course of carrying on a business is the sale of trading stock in the course of business by the proprietor of a shop. Precisely the same principle is applicable to the less obvious cases of a sale of land or shares by a trader in land or shares and the profit is none the less 'income' after the enactment of section 26(a).[39] The principle is often extremely

[36] (1933) 50 C.L.R. 268, 298.

[37] See *Premier Automatic Ticket* case (1933) 50 C.L.R. 268, 297-8 *per* Dixon J. The relation between the ordinary concept of income and s. 26(a) has not been clearly worked out in the cases. This is so particularly in regard to the second limb of the section following the decision of the Privy Council in *McClelland's* case (1970) 44 A.L.J.R. 422. See also *infra* pp. 300-4.

[38] Following the *dicta* in *Blockey's* case (1923) 31 C.L.R. 503 it appears that profit arising from an isolated transaction not in the course of carrying on a business might well be 'income' if the property sold was purchased with a view to resale at a profit. This view was probably inconsistent with existing authority in 1923. In addition, prior to the enactment of s. 26(a), it had long been established that profits derived from an operation of business in carrying on or carrying out any scheme of profit-making are 'income': see *supra* p. 280, n. 33.

[39] In respect of the sale or realization of assets the test for distinguishing between income and capital most often referred to is that formulated by Dixon J. in *Sun Newspapers Ltd v. F.C.T.* (1938) 61 C.L.R. 337, especially 359-60. His Honour put the question '[i]s the realization or expenditure of, or on, or part of "the profit (continued)

difficult to apply in particular fact situations.[40] In determining whether profits are the fruits of carrying on a business it is always essential to look at the activities of the taxpayer as a whole. If the profits in issue are within the ordinary concept of income there is no need to turn to section 26(a).[41]

(b) *The Structure of the Section*

The paragraph has two limbs. The first relates to property acquired for profit-making by sale; the second to profit-making undertakings or schemes. The first limb is by far the more frequently invoked. There is a comparative dearth of authority concerning the second limb. In *Bernard Elsey Pty Ltd v. Commissioner of Taxation (Cth)*[42] Windeyer J. remarked:

> The two branches of s. 26(a) reflect different economic concepts. They are expressed as alternatives. Sometimes they may overlap, and one be involved in the other. Sometimes they may be equally descriptive of a profit arising in a particular state of facts. . . . [But it] does not follow that a profit falling within the description of the second branch of s. 26(a), when that is applicable and the first branch is not, is to be calculated as if the first branch were applicable.

(c) *There must be a Profit*

It is only a 'realized' profit that is included in the assessable income of the taxpayer by the operation of either limb of the section. In the case of the first limb there is the additional requirement discussed below[43] that the profit must arise from a sale. A realized profit may be contrasted with a mere 'paper profit'. By the latter is meant, for example, an increase in the market value of shares or land held by the taxpayer. In the ordinary case a profit would arise only upon a sale of the shares or land. Until sale there is a mere expectation of profit.

However, it may not always be easy to determine whether a profit has been realized. This issue is largely determined according to business and accounting conventions. Kitto J. in *Becker v. F.C.T.*[44] said

> Section 26(a) . . . uses the language of everyday affairs without artificial restriction or enlargement. Whether a given amount is to be characterized as a profit within the meaning of the provision is a question of the application of a business conception to the facts of the case.

yielding subject"?'. If the answer is 'yes' then the test suggests that the realization (or expenditure) is of a capital nature. Many qualifications (*e.g.* in respect of repairs) may of course need to be made and the issue remains in all cases a question of degree. See Commerce Clearing House, *op. cit.* i. 11-760 ff.; Bock and Mannix, *op. cit.* 348 ff.; Hayek, *op. cit.* ch. 5.

Of course, 'income' may be derived otherwise than by carrying on a business: *e.g.* wages and salaries, dividends and interest payments are perhaps the most common examples of 'income'.

[40] See *Jolly v. F.C.T.* (1934) 50 C.L.R. 131, 138-9 *per* Dixon J.

[41] See *infra* p. 289.

[42] (1969) 43 A.L.J.R. 423, 427.

[43] *Infra* pp. 289-90.

[44] (1952) 87 C.L.R. 456, 467. See also *McRae v. Commissioner of Taxation (Cth)* (1969) 43 A.L.J.R. 229, 230.

Normally it would also be important to examine carefully the manner in which the property has been treated in the books of account of the taxpayer.[45] Certainly in the case of the second limb the realization need not be by way of sale, though in most cases involving that limb of the section the realization has in fact taken place by way of sale. It is submitted that at the least a profit could not be said to have been realized unless the benefit obtained by the taxpayer is capable of being valued in terms of money.[46] For example realization may occur upon conversion of government securities[47] or upon an exchange of shares.[48]

The recent case of *Kratzmann v. Commissioner of Taxation (Cth)*[49] is interesting in relation to the issue of realization of a profit. The taxpayer bought land in Surfers Paradise to carry out a profit-making scheme involving the borrowing of money to erect a building on the land and the realization of units in the building to cover repayment of the loans and the cost of the project, retaining the balance of the units in the building for himself as an investment. The profit-making scheme was not effectuated owing to the financial embarrassment of the taxpayer and the land was ultimately resold at a profit. However, Menzies J. observed that had the scheme been carried to fruition the benefit obtained by Kratzmann by way of units retained would have been a profit.[50]

It is, of course, important to determine not only whether a profit has been realized but also when the profit was realized. Upon the latter issue might depend the year of income in which the profit is to be brought into account in determining the taxpayer's assessable income. An important factor in determining the time of realization of the profit would doubtless be the nature of the scheme involved. Taking *Kratzmann's* case[51] as an example, it might be supposed that if the scheme had involved the selling of all units a profit could not be said to have arisen in respect of unsold units.

Often payment for land is made by instalments over a period of years and the question arises as to when the profit made by the taxpayer

[45] See *Commissioner of Taxation (Vic.) v. The Melbourne Trust Ltd* (1914) 18 C.L.R. 413.

[46] See *Tennant v. Smith* (1892) 3 T.C. 158. See also *Becker v. F.C.T.* (1951) 87 C.L.R. 456, 460 *per* Fullagar J. 'A profit can only be ascertained by comparing one sum of money with another.' 'Profit' is not to be regarded in its widest sense of any benefit or advantage as in '[h]is mind profited from a study of the great classical authors' but rather a gain capable of pecuniary assessment.

[47] *Westminster Bank Ltd v. Osler* [1932] All E.R. 917. See also s. 21.

[48] *Royal Insurance Co. Ltd v. Stephen* (1928) 14 T.C. 22; (1967) 18 T.B.R.D. 166 *Case* T 39. See also *Californian Copper Syndicate (Limited and Reduced) v. Harris* (1904) 5 T.C. 159, 167-8. Note that it would be necessary to look at the real value of the shares or debentures received by the taxpayer not merely their par value.

[49] (1970) 44 A.L.J.R. 293.

[50] *Ibid.* 294.

[51] (1970) 44 A.L.J.R. 293.

is assessable. After *Thorogood's* case[52] it appears that where the price is received over more than one year of income generally the portion of profit which is assessable in any year is the amount which bears the same proportion to the total profit as the amount received during the year of income bears to the total sale price. It is not proper for the Commissioner to assess the taxpayer on the whole of the profit in respect of a sale made during the year of income notwithstanding that the whole of the price has not been received. Nor can the taxpayer postpone assessment until the whole of the price is received.

A similar problem arises where property is purchased as a whole for resale at a profit or is brought into a profit-making undertaking or scheme as a whole by the taxpayer and only part of that property is resold or realized in carrying on or carrying out the profit-making scheme or undertaking in any one year of income. Under the Act taxable income is to be ascertained annually and it is recognized by section 170(9) of the Act that in making his assessment the Commissioner may include as assessable income an estimated profit on the basis that if events as they later transpire falsify the estimate the assessment will be appropriately amended.[53]

The calculation of a profit arising under either limb of the section may give rise to some difficulty. Generally the amount of a profit will be determined according to the principles of business and accounting and is to be found by deducting from the 'ultimate sum received the amount or value of all that in fact it has cost the recipient to obtain that ultimate sum'.[54] The transaction as a whole must be examined.[55]

For instance in *Petrie v. F.C.T.*,[56] a case involving the sale of land acquired for resale at a profit, Windeyer J. referred the case back to the Commissioner for re-assessment because he was not satisfied that the sum of £7,000 which the taxpayer had paid to settle a dispute with a person who claimed the taxpayer had agreed to sell the land to him,

[52] *F.C.T. v. Thorogood* (1927) 40 C.L.R. 454. See Commerce Clearing House, *op. cit.* i. para. 12-800. See also *J. Rowe and Son Pty Ltd v. Commissioner of Taxation (Cth)* (1971) 45 A.L.J.R. 21 which indicates that perhaps *Thorogood's* case (*supra*) is not as widely applicable as has been thought. It also indicates that the facts of the particular case must always be carefully scrutinized. *Rowe's* case (*supra*) did not concern s. 26(a).

[53] This matter was discussed by Kitto J. in *McClelland's* case (1969) 118 C.L.R. 365, 378-9. Conceivably the value of the property realized in the year of income could be incapable of ascertainment. Then it is submitted no profit could be included in the assessable income of the taxpayer for that year at least: see *Fox's* case (1956) 96 C.L.R. 370, 386-7; *McClelland's* case (1969) 118 C.L.R. 365, 377-8. See also Note, (1970) 44 *Australian Law Journal* 135, 136.

[54] *Becker v. F.C.T.* (*Becker's* case) (1952) 87 C.L.R. 456, 460 *per* Kitto J. See also 18 T.B.R.D. 398 *Case* R68.

[55] See *Investment and Merchant Finance Corporation Ltd v. Commissioner of Taxation (Cth)* (1970) 44 A.L.J.R. 73; *Mercantile Credits Ltd v. Commissioner of Taxation (Cth)* (1971) 45 A.L.J.R. 105.

[56] (1966) A.T.D. 234.

had been taken into account, as it should have been, in calculating the taxpayer's profit. In respect of the carrying out of a profit-making scheme relating to the sub-division and sale of land Windeyer J. in *Elsey's* case[57] said that the outgoings of the taxpayer to be offset against his receipts would include 'the cost to the taxpayer of levelling the land, of surveys and obtaining approval of the subdivision, agents' charges in respect of sales, and I think interest on moneys borrowed to enable the scheme to be carried out'.[58]

It sometimes happens the taxpayer carries on a business on property which is also part of a profit-making scheme or undertaking or which has been purchased for resale at a profit. In such a case it would be necessary, though perhaps difficult, to distinguish between outgoings in the course of the business and outgoings relating to the scheme or undertaking or to enable the property ultimately to be resold at a profit. The latter outgoings would be in the nature of capital holding costs.[59] It is also a nice issue whether and, if so, to what extent, taxation advantages accruing to the taxpayer from a transaction within section 26(a) can be taken into account in computing the profit of the taxpayer from that transaction.[60]

It is sometimes difficult to value property brought into an undertaking or scheme where the taxpayer acquires property and later commences a profit-making scheme or undertaking in relation to part only of that property. A similar problem may arise where a taxpayer acquires property with the intention of reselling part of that property at a profit. Problems of this nature may also arise where the Commissioner makes an estimate of profit in relation to a particular year of income because a transaction within the section has only been partially completed by the taxpayer in that year of income.[61] Unless the value of the property in issue can be ascertained the profit cannot be computed. In *Elsey's* case,[62] in considering the first of the two appeals determined in that case, Windeyer J. adverted to this problem. The taxpayer, a property owner and vigorous entrepreneur on the Gold Coast and in other Queensland

[57] *Elsey v. Commissioner of Taxation (Cth)* (1969) 43 A.L.J.R. 415.

[58] *Ibid.* 421. See also *Bernard Elsey Pty Ltd v. Commissioner of Taxation (Cth)* (1969) 43 A.L.J.R. 423, 429. If rates and taxes are paid in the course of carrying on or carrying out a profit-making scheme or undertaking or in holding property purchased for resale at a profit then those rates and taxes would be deductible in the year of income in which they were actually paid. Would they also be deductible in computing the taxpayer's ultimate profit under s. 26(a)? If so, would an allowance have to be made for the taxation advantage which accrued to the taxpayer when they were originally deducted? How would this taxation advantage be computed?

[59] See *Scharkie v. F.C.T.* (1968) 10 A.I.T.R. 678, especially 681 where similar issues were raised but not decided.

[60] See *e.g. Mercantile Credits Ltd v. Commissioner of Taxation (Cth)* (1971) 45 A.L.J.R. 105.

[61] *Supra* pp. 283-4.

[62] (1969) 43 A.L.J.R. 415.

holiday resort areas, purchased a parcel of land for £47,500. The land consisted of several lots numbered 1 to 7. Elsey intended to erect on the land what he called a 'boatel-motel' with service station facilities attached. The scheme as envisaged fell through. Lots 1, 2 and 4 were sold to an oil company for the erection of a service station. A motel known as 'Tiki Village' was built by the taxpayer but was of different design to that originally envisaged leaving lot 7 vacant. Lot 7 was sold in a later year of income. The Commissioner assessed Elsey on profits arising from the resale of lots 1, 2, 4 and 7. Windeyer J. held that the sales did not fall within either limb of section 26(a) and went on to observe that in any event he had doubts as to the method of calculation used by the Commissioner to ascertain the profits arising from the sales by Elsey. His Honour said[63]

> The Commissioner seems to have assumed that the price which the taxpayer paid for lots 1 to 7 inclusive represented an average of so many dollars per perch and that he could attribute this to the two areas sold and then subtract the result in each case from the price realized. That seems to me artificial. The case is quite unlike a sale of agricultural land of a more or less uniform kind—which can been seen as a sale at an average price per acre. It is also quite unlike a sale of vacant land having a frontage to a street and a uniform depth—which can be seen as a sale at a price of so much per linear foot. Here part of the total area had a river frontage, parts a frontage to a main road, parts to a side road, parts, lots 5, 6 and 7, were accessible through a cul-de-sac. To regard each perch of the whole as equal in value to every other perch and as bought for the same price seems to me an altogether untenable proposition.

Windeyer J. re-iterated these remarks in the associated case of *Bernard Elsey Pty Ltd v. Commissioner of Taxation (Cth)*.[64]

The problems of computation mentioned by Windeyer J. in the two *Elsey* cases[65] and *McClelland's* case[66] make the task of the Commissioner much more difficult. If the attitude of Windeyer J. is generally reflected in the cases the taxpayer will often have a strong basis for negotiation

[63] *Ibid.* 419.

[64] (1969) 43 A.L.J.R. 423, 425. See also *Chapman's* case (1968) 117 C.L.R. 167, 171-2.

[65] (1969) 43 A.L.J.R. 415; (1969) 43 A.L.J.R. 423.

[66] In *McClelland's* case (1967) 118 C.L.R. 353, 361-4 Windeyer J. took the view that even if the transaction had fallen within either limb of s. 26(a) the Commissioner's method of assessment was erroneous as the market value of the share of a tenant in common in vacant land is, generally speaking, considerably less than an amount calculated merely by reference to his fractional interest in the freehold value of the entirety. The Full Court upheld the Commissioner's computation ((1969) 118 C.L.R. 365, 379-80) and the Privy Council did not advert to the matter so the status of the remarks of Windeyer J. is somewhat in doubt. See *infra* pp. 301-3. Windeyer J. also commented unfavourably on the secretive attitude of the Commissioner as to his method of computation of profit: (1967) 118 C.L.R. 353, 361-3. See also the comments of Kitto J.: (1969) 118 C.L.R. 363, 377; Note, (1968) 42 *Australian Law Journal* 27; *The National Times*, 12 July 1971, 50; *infra* p. 306, n. 84.

with the Commissioner. In other cases it may be impossible to compute a profit and therefore to assess the taxpayer.

The emphasis of the first limb of section 26(a) is upon profit arising from the sale *by the taxpayer* of property acquired *by him* for the purpose of profit-making by sale. It is also important in the computation of profit that the second limb applies only to profit arising *to the taxpayer* from the carrying on or carrying out of a profit-making undertaking or scheme *by him*. If the taxpayer obtains property and sometime afterwards commences a profit-making scheme or undertaking in relation to that property it is necessary to ascertain whether the property has increased in value during the time elapsing before it was brought into the scheme. It is the value of the property at the time it was brought into the scheme which is to be deducted from the ultimate proceeds in ascertaining the profit arising to the taxpayer from the scheme.[67]

Further, if a profit-making undertaking or scheme is commenced by A and carried to completion by B (for example, A's executor[68] or trustee in bankruptcy[69]), in assessing the profit of B it is necessary to deduct from the amount ultimately realized the value of the property at the time it came to B. It is the profit arising to B in the sense that it is the net profit since B began the undertaking or scheme that is to be included in B's assessable income. This is well illustrated by *Fox's* case.[70] Fox had carried on a profit-making undertaking in the Gold Coast involving the reclamation and subdivision of land. He had partially completed the scheme when he died insolvent. His estate was administered by the Official Receiver who completed the undertaking and sold the subdivided land at a profit. The Official Receiver was assessed as trustee on the profit. The Full High Court in a joint judgment decided that though the Official Receiver had carried out a profit-making undertaking or scheme the basis of the Commissioners computation of his profit therefrom had been erroneous.

> The difficulty in supporting the assessments which have in fact been made in respect of the supposed income of the official receiver is that they do not recognize that the official receiver is not in the same situation as the deceased debtor Rankin [as Fox was more commonly known][71] but that on the contrary as trustee he begins *ab initio* with the assets that come to his hands and is pursuing a course for their realization to the best advantage.[72] If he has made a gain or profit in his capacity as trustee of

[67] See *Becker's* case (1952) 87 C.L.R. 456; *Fox's* case (1956) 96 C.L.R. 370, 385-6; *Bernard Elsey Pty Ltd v. Commissioner of Taxation (Cth)* (1969) 43 A.L.J.R. 423, 429.

[68] See *Spence v. Commissioner of Taxation (Cth)* (1968) 42 A.L.J.R. 3; Note, (1969) 43 *Australian Law Journal* 81.

[69] See *Fox's* case (1956) 96 C.L.R. 370.

[70] (1956) 96 C.L.R. 370.

[71] *Ibid.* 378.

[72] These comments of the Full Court must be regarded carefully in the light of later cases: see especially *McClelland's* case (1969) 118 C.L.R. 365, 371 *per* Barwick C.J.

> Rankin's estate by the realization of the assets that came to his hands, i must be because on a comparison, on the one hand, of the value of the assets in the condition in which they came to his hands when the order for administration of Rankin's estate in bankruptcy was made with, or the other hand, the net proceeds of sale after the deduction of all expenditure, it appears that owing to his activities there has been a rea gain or profit.[73]

The Full Court therefore held that the assessment of the Commissioner o the profit of the Official Receiver had been made on an erroneous basis Further, it is to be noted that the case contains no suggestion that the Official Receiver could have been assessed upon a notional profit deemed to have been derived by Fox up to the date of his death. It is likely that the Official Receiver could not be assessed on such notional profits since the section deals only with actual or realized profits. Similar issues arose in *Spence's* case[74] in relation to an executor.

Under section 26(a) net proceeds are brought into account in determining the assessable income of the taxpayer.[75] In some circumstances it will be to the advantage of the taxpayer to bring a transaction within the section rather than have gross proceeds from which allowable deductions may be made brought in as assessable income. It may be that gross income from a transaction less allowable deductions is a greater amount than net profit determined under section 26(a).[76] In *White's* case[77] Windeyer J. took the view that one was only entitled[78]

[73] (1956) 96 C.L.R. 370, 384.

[74] *Spence v. Commissioner of Taxation (Cth)* (1968) 42 A.L.J.R. 3. The problems of assessing an executor are outside the scope of this article but matters arising out of *Spence's* case are fully discussed in Note, (1969) 43 *Australian Law Journal* 81. See also ss 97, 99 and 101A of the Act.

[75] See *supra* p. 277.

[76] See *e.g.* (1956) 7 T.B.R.D. 121 *Case* G21. In this case a firm of sand contractors purchased a sand-bearing property. The taxpayer was a member of the firm. It was given in evidence that at the time of purchase of the property the taxpayer and his partners intended to resell the property at a profit as well as the sand. Over a period sand was sold by the firm. It appears that the taxpayer argued that purchase of the land and the sale of the land and sand was a scheme or undertaking within the second limb of s. 26(a) and that the partners were therefore assessable on the net profit of the venture. This argument was rejected by the Board on the grounds that the firm was carrying on a business the gross proceeds of which were assessable under s. 25(1) and that there could be no deduction of the cost of purchase of the land, that being a capital asset. See also *White's* case (1968) 42 A.L.J.R. 139, 147 *per* Windeyer J.

[77] (1968) 42 A.L.J.R. 139. The taxpayer in *White's* case was a timber merchant. The Commissioner included in his assessable income the sum of $5,000, an amount received by the taxpayer in the year ended June 1966 under an instalment contract entered into in 1956 for the sale to a company controlled by the taxpayer of hardwood piles and posts on land owned by him, together with a right to enter the land and cut the timber. On appeal from the assessment Windeyer J. held that the abovementioned amount was liable to tax as income under normal principles. The selling of timber from the land constituted 'a regular business': *ibid.* 146; His Honour held that the sum was also within the second limb of s. 26(a): *ibid.* 147. But not only did the taxpayer argue that the amount was not assessable income, he also put the objection that 'if the amount in question is held to be proceeds arising from a business of the selling of timber or rights to remove timber, then I am entitled to a deduction from such amount of the value of the growing timber disposed of which until its severance from the land formed part (continued)

to bring into assessable income net proceeds where the sole source of liability to tax was section 26(a). The view of His Honour makes it unnecessary for the purpose of computing the amount to be brought in as assessable income of the taxpayer to decide whether section 25 and section 26(a) are mutually exclusive, a matter upon there has been differences of opinion among members of the High Court and the Boards of Review.[79] It is submitted, with respect, that if section 25 and section 26(a) are not mutually exclusive the view of Windeyer J. on this matter is correct.

(d) *The First Limb*

(i) PROFIT MUST ARISE FROM A SALE BY THE TAXPAYER

Clearly devolution by will or upon intestacy is not a sale.[80] Nonetheless the notion of sale has been given an extended meaning in section 26(a). It may embrace transactions in which the element of mutuality of assent in the transfer of proprietorship commonly associated with the notion of 'sale' is absent.

A compulsory acquisition may be a 'sale'. In *Coburg Investment Co. Pty Ltd v. F.C.T.*[81] land owned by the taxpayer was compulsorily acquired under the Lands Compensation Act 1928. The acquisition procedures under the Act involved a notice to treat and a price determined by negotiation thereafter. The taxpayer submitted that though in form a sale, the transaction was not a sale since it was made under compulsion. Mutual assent, it was argued, was necessary for a sale. Windeyer J. rejected the taxpayer's argument saying:

> In *Nalukuya* v. *Director of Lands*[82] the Privy Council said "it is perhaps worth noticing that several of the speeches in *Kirkness* v. *John Hudson & Co. Ltd.* recognize that in the field of compulsory acquisition of land such

of my grazing property and, therefore, part of my non-circulating capital and that the value of the said growing timber at the date of its severance was not less than the aforesaid amounts paid to me': *ibid.* His Honour rejected this argument holding that the taxpayer was not entitled to the deduction claimed. His Honour did observe, however, that if 's. 26(a) were relied upon as the *sole* source of the liability to tax, then it may be that the taxpayer's claim to a deduction could be sustained': *ibid.* The decision of Windeyer J. was affirmed by the Full Court (1968) 43 A.L.J.R. 26 without comment upon this issue.

[78] Of course, there may be situations where according to the ordinary conception of income net proceeds rather than gross proceeds are brought in as assessable income: see *supra* n. 13.

[79] For the view that the sections are exclusive see *McClelland's* case (1969) 118 C.L.R. 365, 371 *per* Barwick C.J. and the ambiguous remarks of the Chief Justice on the matter in *White's* case (1968) 43 A.L.J.R. 26, 27 (Full Court). See also (1950) 1 T.B.R.D. 358 *Case* 89; (1956) 7 T.B.R.D. 121 *Case* G21 (*supra* n. 76). For the contrary view see (1965) 16 T.B.R.D. 313 *Case* R68; *Colonial Mutual Life Assurance Society Ltd v. F.C.T.* (1946) 73 C.L.R. 604. On this matter see generally Commerce Clearing House, *op. cit.* i. para. 12-615.

[80] See (1968) 18 T.B.R.D. 386 *Case* T77 (concerning s. 26(a)) and (1969) 69 A.T.C. 328 *Case* A57 (concerning s. 52) in which it was held a profit or loss upon cancellation of a contract could not fall within the first limb of s. 26(a) or s. 52 respectively as no sale of property acquired was involved.

[81] (1960) 104 C.L.R. 650.

[82] [1957] A.C. 325, 332.

> words as 'sale' and 'purchase' are frequently used in connection with transactions by which the transfer of ownership in land takes place in the absence of the element of mutual assent". In my view, s. 26 . . can be taken as an example of such extended use.[83]

His Honour then went on to make remarks of even more general application.

> Section 26 reflects and should be read in the reflected light of a general principle: that is that if property be acquired for the purpose of profit-making by dealing in it by sale, as distinct from for the purpose of retaining it as an income producing capital asset, then a surplus received when it is realized is, in an economic sense, received on income account and not on capital account. It matters not, for the application of the general principle, whether the actual realization occurred when it did and as it did as a result of compulsion or pressure or purely voluntarily: this is emphatically so when the actual amount obtained on realization is arrived at by mutual assent after negotiation.[84]

Clearly it is not possible to confine the remarks of Windeyer J. to transactions of compulsory acquisition in which the amount of compensation is determined after some process of negotiation.[85] Nonetheless, with respect, some of His Honour's remarks appear to give too little weight to the use of the words 'sale' in the first limb. Perhaps at the least a sale could be distinguished from a realization of property which is a barter or exchange albeit economically advantageous to the taxpayer.[86] The consideration is not a money consideration. Of course, such a transaction may fall within the second limb.

(ii) WHAT IS PROPERTY?

Without venturing upon the issue of the proper jurisprudential analysis of the concept of property in the law, it can be said that that concept has a very wide embrace. In *Jones v. Skinner*[87] Langdale M.R. said '[p]roperty is the most comprenhensive of all terms which can be used inasmuch as it is indicative and descriptive of every possible interest which a party can have'.

(iii) ACQUIRED BY THE TAXPAYER

It has been said that in section 26(a) 'acquire' is used in its primary sense and means the obtaining of something by an act of one's own volition.[88] Thus interests in property received under a will are not

[83] (1960) 104 C.L.R. 650, 663.
[84] *Ibid.*
[85] *Cf.* a case decided under a New Zealand provision similar to s. 26(a): *Public Trustee v. Commissioner of Inland Revenue (N.Z.)* (1961) 12 A.T.D. 385.
[86] See Sutton, *The Law of Sale of Goods in Australia and New Zealand* (1967) 17-8. See also *Royal Insurance Co. Ltd v. Stephen* (1928) 14 T.C. 22; *Westminster Bank Ltd v. Osler* (1933) 17 T.C. 381; (1969) 18 T.B.R.D. 166 *Case* T39.
[87] (1835) 5 L.J. Ch. 87, 90. See also (1969) 69 A.T.C. 124 *Case* A21. See *infra* pp. 395-7.
[88] See the remarks of the Chairman, Mr Gibson, in 14 C.T.B.R. 243, 249 *Case* 25. See also Voumard, 'Some Further Thoughts on Section 26(a)' (1970) 44 *Law Institute Journal* 77.

'acquired' for the purposes of section 26(a).[89] The first limb does not catch situations where the taxpayer becomes the owner of property involuntarily by operation of law, for example, as the executor of a deceased's estate[90] or as the trustee in bankruptcy of a bankrupt's estate.[91] It has also been held that a taxpayer could not be said to have acquired shares distributed to him following resolutions which he was not able to control notwithstanding that he was both a shareholder and one of the three directors of the company.[92]

The question whether a mere passive receipt of property by way of gift is within the first limb has been considered recently. In a case before the Board of Review the taxpayer had obtained by way of gift an interest in land owned by a syndicate. Some of the land was sold. The Board of Review confirmed the assessment of the Commissioner but on the basis of the second, not the first, limb of the section.

The Chairman said that the mere passive receipt by the taxpayer of an interest by way of gift was not an acquisition for the purposes of the first limb of the section. However he did observe:[93]

> I do not think that . . . where a person takes property by way of gift, he can never be said to have acquired that property for any particular purpose. Without undue stretching of the imagination, it is not difficult to conceive of situations where a gift is made by arrangement between the donor and the donee, and the latter has, at the time of acquisition, already a clearly formed purpose as to the use to which the gifted property will be put. However, on the evidence in this case, it appears that the taxpayer was not only a passive recipient of the gift of an interest in the syndicate, but was also, in all probability, an unwitting recipient.

Another recent Board of Review case is interesting in this regard.[94] The taxpayer acquired a block of flats in April 1956 for £21,000. He stated that his intention was to provide his then infant daughter with an income. In May 1956 the taxpayer, by a deed poll, declared that he held the property acquired by him in April in trust for his daughter absolutely. About a year later, being dissatisfied with the return from the flats by way of rents, the taxpayer subdivided the property and commenced selling the flats. The taxpayer was assessed on the profit derived from the sale of flats as trustee under section 102 of the Act whilst his daughter was a minor. Upon her majority the Commissioner began to assess the daughter on the profits. The whole Board[95] was of the view that the taxpayer had originally acquired the property for the

[89] *McClelland's* case (1967) 118 C.L.R. 353 (Windeyer J.); (1969) 118 C.L.R. 365 (Full Court); (1970) 44 A.L.J.R. 422 especially, 424-5, 428 (Privy Council); see *infra* pp. 300-3; *Spence's* case (1967) 41 A.L.J.R. 3.
[90] *Ibid.*
[91] *Fox's* case (1956) 96 C.L.R. 370.
[92] 14 C.T.B.R. *Case* 25.
[93] (1969) 69 A.T.C. 195, 196 *Case* A33.
[94] (1969) 69 A.T.C. 160 *Case* A26.
[95] Mr Donovan (Chairman), Messrs Davies and Thompson (members).

purpose of resale at a profit. However, although there is considerable ambiguity about their remarks, it appears that the Chairman and Mr Davies held that the taxpayer was not assessable on the profits on two separate grounds.[96] First that upon the declaration of trust the taxpayer as trustee did not *acquire* property within the meaning of section 26(a). Second, that upon acceptance of the property as trustee, whatever his earlier purpose in relation to that property, the taxpayer had no intention of reselling the property at a profit. Mr Thompson confined himself to the latter ground.

The meaning of 'acquire' envisaged by section 26(a) is in considerable doubt and the matter awaits determination by the High Court. In the meantime it would be imprudent to use a gift or declaration of trust as a means of avoiding the operation of the first limb. No doubt so long as the property disposed of was not stock in trade[97] of the donor, the only tax payable by the donor would be a comparatively small amount of gift duty. However, if the transaction of the donee falls within the first limb, his profit would presumably be computed without taking into account the cost of the property to the donor. In any event, it is possible that such an arrangement between donor and donee could fall within the second limb of the section, which, it should be noted, does not require that property be 'acquired'.[98]

(iv) FOR THE PURPOSE OF PROFIT-MAKING BY SALE

It is the requirement that the taxpayer must have acquired the property for the purpose of profit-making by sale that makes the operation of the first limb of the section unpredictable. If the taxpayer disputes an assessment made upon the basis of the first limb the burden is upon him to show that the property was not acquired with the requisite purpose.[99] Most cases involving the first limb merely concern the taxpayer's purpose. In determining the taxpayer's purpose it is 'necessary to make both a wide survey and an exact scrutiny'[1] of his activities. The relevant time for determining the purpose of the taxpayer is the time of acquisition.[2] The length of time the property has been held by the taxpayer is merely one factor, albeit an important one, to be taken into account

[96] See (1969) 69 A.T.C. 160, 164.

[97] See s. 36.

[98] See *Fox's* case (1956) 96 C.L.R. 370; Note, (1970) 44 *Australian Law Journal* 215.

[99] *Infra* pp. 307-8.

[1] *Petrie v. F.C.T.* (1966) 10 A.I.T.R. 126, 130 quoting from *Western Gold Mines N.L. v. Commissioner of Taxation (W.A.)* (1958) 59 C.L.R. 729, 740. Note that it is the purpose of the taxpayer that is important not the purpose of a company in which he holds shares: see *Hobart Bridge Co. Ltd v. F.C.T.* (1951) 82 C.L.R. 372.

[2] It seems that in the case of the purchase of land, the critical time for determining the taxpayer's purpose is the date of the contract not the date of completion or transfer of legal title: see (1964) 15 T.B.R.D. 112 *Case* Q21; (1965) 16 T.B.R.D. 304 *Case* R66.

in determining the taxpayer's purpose.[3] Very often a case will turn upon an assessment of the credit of the taxpayer.[4] It should be noted that the section refers not merely to a purpose of resale but resale at a profit. It will be observed that the section uses the word 'purpose' and not 'intention'.[5] A person may have mixed or multiple purposes or no purpose in mind at all when acquiring property[6] and as Dixon J. said in the *Premier Automatic Ticket* case:[7] '[i]t is not easy to say whether the expression "profit-making by sale" refers to a sole purpose, or a dominant or main purpose, or includes any one of a number of purposes'. It is now well established that the section refers not merely to a vague intention, or one among a number of purposes but to a sole or dominant purpose.[8] In *Pascoe v. F.C.T.*[9] Fullagar J. said

> When a man invests money in the purchase of any kind of property, it will generally be either with a view to holding it and deriving income from it, or with a view to realising sooner or later an enhanced capital value. And, while logically these "purposes" are not mutually exclusive, it will generally be possible to say that the one or the other is predominant at the time when the purchase is made. The question posed by s. 26(a) of the present Act is not, I think, different in nature from the question which is posed by the third proviso to s. 16(b)(i) of the Income Tax Assessment Act 1922-1930. Referring to that proviso in a joint judgment in *Evans* v. *Commissioner of Taxation,* [*sic*] *Rich, Dixon* and *Evatt,* JJ. said: "It is concerned with the well known difference between the enlargement of capital by sale of capital assets and obtaining detachable profit by buying and selling assets. The purpose of which it speaks is the dominant purpose actuating the acquisition of the assets—the use to which they are to be put".

In *Chapman's* case[10] the taxpayers purchased a single parcel of land

[3] (1961) 12 T.B.R.D. 218 *Case* M42.

[4] See *e.g. Petrie v. F.C.T.* (1966) 10 A.I.T.R. 126; *Wall v. F.C.T.* (1965) 13 A.T.D. 530, 531. See *infra* p. 308. *Cf. Smithfield Pastoral Co. Pty Ltd v. F.C.T.* (1966) 14 A.T.D. 170.

[5] In considering the meaning of a similar New Zealand provision (s. 79(c) of the Land and Income Tax Act 1923 (N.Z.)) in *Plimmer v. Commissioner of Inland Revenue* (*N.Z.*) (1957) 11 A.T.D. 480, 483 Barraclough C. J. said: '[a] man's purpose is usually, and more naturally, understood as the object which he has in view or in mind. One can scarcely have a purpose of selling without an intention of selling, but, in ordinary language, "purpose" connotes something added to "intention", and the two words could not be regarded as synonymous. Though "purpose" may sometimes mean "intention", the Court should hesitate to adopt that restricted meaning unless the statute clearly evidences such an intention.

[6] Mr Bernard Elsey, the taxpayer in *Elsey's* case (1969) 43 A.L.J.R. 415 and the controlling member and director of the taxpayer company in *Bernard Elsey Pty Ltd v. Commissioner of Taxation* (*Cth*) (1969) 43 A.L.J.R. 423 appears to have been successful in avoiding the operation of the first limb of the section by falling into the last category.

[7] (1933) 50 C.L.R. 268, 298.

[8] See *Evans v. Deputy F.C.T.* (*S.A.*) (1936) 55 C.L.R. 80, especially 99, 105; *F.C.T. v. Henderson* (1943) 68 C.L.R. 29, especially 35. Therefore if a person buys property with the dominant purpose of profit-making by sale it is immaterial that in the meantime he intends to take the rents and profits from the property: see *Buckland v. F.C.T.* (1960) 12 A.T.D. 166, especially 169.

[9] (1956) 11 A.T.D. 108, 112.

[10] *Chapman v. F.C.T.* (1968) 117 C.L.R. 167. See *supra* pp. 285-6 as to computation of profit.

with the intention of retaining part for a home and small farm and reselling the remainder at a profit. Menzies J. held that the taxpayers in purchasing the land had two purposes of which it could not be said that one was dominant and the other servient in relation to the land as a whole. His Honour took the view that it was possible to treat the acquisition as having been made with one purpose as to part and another as to the remainder. The profit obtained upon resale of the part in relation to which the dominant purpose of acquisition was resale at a profit was therefore properly part of the taxpayers' assessable income. It is perhaps important in *Chapman's* case[11] that the parts of the parcel of land purchased to which different purposes of the taxpayers related could be clearly physically differentiated. A purchaser in the position of the Chapmans may have the purpose of reselling part of a parcel of land acquired but may not have the purpose of reselling it at a profit. A different question arises if it is the taxpayer's purpose to sell part of the land acquired at a price in excess of the purchase price attributable to that part but at the time of acquisition has no clear purpose as to which part of the land is to be sold. The position probably is that the first limb of the section is inapplicable since the purpose of reselling at a profit must relate to an item of property and in this situation the purpose of the taxpayer is not sufficiently referable to a particular part of the land.[12]

In the case of a company it appears that its purpose is that of those who direct its affairs.[13] It may be that in the absence of meetings of the board of directors it will be the intentions of individual directors or employees that are to be scrutinized to ascertain the purpose of the company.[14] It must be emphasized that it is not the intention or purpose that these persons may have with respect to their personal affairs but is rather their intentions and purposes when they can be said to be acting on behalf of the company.[15] In the case of a 'one-man company' it is easy enough to attribute the purposes and intentions of its principal share-

[11] (1968) 117 C.L.R. 167. The Chapmans purchased their property jointly. Where persons purchase property jointly the purpose of each need not be the same: see (1954) 6 T.B.R.D. 1 *Case* F1. *Cf.* (1965) 16 T.B.R.D. 73 *Case* R17. See generally Commerce Clearing House, *op cit.* i. para. 12-680. (It is respectfully submitted that the views of the editors expressed therein are correct.)

[12] Support for this proposition can be derived from *Elsey's* case (1969) 43 A.L.J.R. 415 and *Bernard Elsey Pty Ltd v. Commissioner of Taxation (Cth)* (1969) 43 A.L.J.R. 423 where the inexactitude of the taxpayer's purpose at the time of purchasing the properties in question took the taxpayer outside the operation of the first limb of s. 26(a).

[13] See *Bernard Elsey Pty Ltd v. Commissioner of Taxation (Cth)* (1969) 43 A.L.J.R. 423; *H. L. Bolton (Engineering) Co. Ltd v. T. J. Graham & Sons Ltd* [1957] 1 Q.B. 159, 170-2.

[14] *Ibid.*

[15] *E.g.* an individual sells land to a company controlled by him at an inflated price and thus realizes a 'profit'. The company then sells the land at a loss. For the purpose of section 52 of the Act the profit-making purpose of the company cannot be the intent of the taxpayer at the time he sold the land to the company: it must be the purpose the taxpayer has for the company.

holder and director to the company,[16] but Windeyer J. in the recent case of *Investment and Merchant Finance Corporation Ltd v. Commissioner of Taxation (Cth)*[17] said of a public company that the purpose of one of two managing directors of the company was the purpose of the company.

(v) THE PROPERTY ACQUIRED MUST BE THE PROPERTY SOLD

The words of the section indicate that profits are brought into the assessable income of a taxpayer only if those profits arise from the sale of *the property acquired* with the requisite purpose. Profits arising from the sale in several lots of one parcel of land purchased by the taxpayer for profit-making by sale are assessable income. However, there exists some doubt as to the meaning of this requirement following *McClelland's* case.[18] In that case the taxpayer received under her uncle's will an interest as tenant in common with her brother in a parcel of land. She bought her brother's interest and sold the entirety. Windeyer J. held that the taxpayer's transaction did not come within the first limb. He said[19]

> The first part of s. 26(a) . . . applies to a transaction whereby a taxpayer sells any property he acquired for the purpose of sale. It applies whether he sells that property as a whole or in parts, and whether he sells to one buyer or to several buyers as joint tenants or tenants in common. But, as I read it, it does not apply when what is sold is essentially different in kind from the thing acquired. It would apply in the case of a taxpayer A who, by purchasing from two tenants in common, B and C, the share of each, acquired Blackacre for the purpose of thereafter selling it at a profit. There the thing acquired for the profit-making purpose was Blackacre. That is not this case. I cannot accept the proposition . . . that when Mrs. McClelland sold portion 5 she sold two separate shares in it, hers and her brother's. She did not. She was not selling separate shares. The shares had disappeared into a unity. She sold an entirety.

In the Full Court the Chief Justice agreed with the conclusion and reasons of Windeyer J., though his reasons in relation to the first limb are not entirely unambiguous.[20] The majority in the Full Court did not consider the first limb. Similarly, the reasons of both the majority and the minority in the Privy Council cast no light on this issue.[21] It would seem, therefore, that this issue, not having been clearly resolved in *McClelland's* case,[22] is likely to be relitigated.

[16] See *Bernard Elsey Pty Ltd v. Commissioner of Taxation (Cth)* (1969) 43 A.L.J.R. 423.

[17] (1970) 44 A.L.J.R. 73.

[18] (1967) 118 C.L.R. 353 (Windeyer J.); (1969) 118 C.L.R. 365 (Full Court); (1970) 44 A.L.J.R. 422 (P.C.); see *infra* pp. 300-3.

[19] (1967) 118 C.L.R. 353, 359. See also *Spence's* case (1968) 42 A.L.J.R. 3. Certainly no such requirement exists in respect of the second limb.

[20] (1969) 118 C.L.R. 365, 370-1.

[21] (1970) 44 A.L.J.R. 422, 425-6 (majority), 428 (minority). Both judgments seem to be concerned with the problem of acquisition.

[22] *Supra* p. 295, n. 18. Of course, appeals cannot now go to the Privy Council on tax matters: Privy Council (Limitation of Appeals) Act 1968 (Cth), ss 3, 4. *McClelland's* case was the last tax appeal.

Windeyer J. appears to have put forward the view that a taxpayer aggregating interests in land, some of which are 'acquired' within the meaning of section 26(a) and some of which are not, and who sells the interest resulting from his aggregation of interests in that land does fall within the operation of the first limb. The taxpayer has not then sold the precise 'property' acquired. Conversely it would seem that a taxpayer would not be caught by the first limb if he fragmented the interest acquired in the land so as to sell a lesser proprietory interest in that land.

The view of Windeyer J. is compelling. To a lawyer, 'property' is not a particular object or thing, be it tangible or intangible, but the rights enjoyed by various persons in relation to that object.[23] These rights, or certain of them, are what has been termed 'property'. Thus a joint tenant in a piece of land has an item of property, his interest as a joint tenant in that land, and if in due course that person becomes the fee simple owner of the entirety of the land he has a different interest or item of property in the land; the rights appropriate to such an interest holder. The test of Windeyer J. is capable of straight-forward application along lines well known to the courts. Moreover any other test which could be adopted seems difficult of application. For instance, suppose, for the purposes of section 26(a), property is taken to mean not the rights enjoyed in respect of an object but rather the object itself.[24] The question must then be whether the object was acquired with the relevant intent. If there was an aggregation of various interests in the object by the taxpayer the question must be whether overall the object was 'acquired' and, if acquired, whether with the appropriate intent.[25] Moreover, when the time comes to sell and the sale takes place by means of a fragmentation of the interests of the owner in the object the question must be one as to whether on balance the object has been sold. For instance, consider the lease of land for periods of 10, 25, 99 and 999 years respectively.

It may be, however, that the adoption of a strict legalistic interpretation of 'property' is out of character with the general canons of interpretation applied in relation to section 26(a) by the courts. The wide meaning given to 'sale' is an example of a flexible interpretation of section 26(a).[26] It is suggested that this does not bespeak inconsistency in interpretation of

[23] See *e.g.* the comments of Windeyer J. in *Pacific Film Laboratories Pty Ltd v. Commissioner of Taxation (Cth)* (1970) 44 A.L.J.R. 376, 380-1.

[24] In *McClelland's* case (1969) 118 C.L.R. 365, 366 before the Full Court counsel for the Commissioner sought to counter the approach of Windeyer J. by arguing by analogy from *Chapman's* case (1968) 117 C.L.R. 167 and *Buckland v. F.C.T.* (1960) 12 A.T.D. 108; both of which cases are not concerned with the fragmentation or unification of proprietory interests but rather the sale of the same proprietory interest in respect of part of the object in which those rights were held: *e.g.* part of land acquired.

[25] The result of *McClelland's* case (*supra* p. 295, n. 18) even applying this test would be uncertain. The members of the majority in the Privy Council, *supra* p. 295, n. 18 appears to be concerning themselves with this question, without having clearly stated agreement or disagreement with Windeyer J.

[26] *Supra* pp. 289-90.

the section as 'sale' is something capable of wide interpretation without distorting well known legal concepts, whereas 'property' has a well developed meaning and to apply it otherwise than Windeyer J. has suggested would call upon the courts to develop new confusing concepts of the nature of property.

(e) *The Second Limb*

(i) BEFORE *McClelland's* CASE

The second limb of section 26(a) includes in the assessable income of the taxpayer profit arising from the carrying on or carrying out of any profit-making undertaking or scheme. The chief characteristic of the second limb is an almost total absence of legal criteria by which to determine its operation. The relatively few decisions in which the second limb has been considered reflect the judicial and professional uncertainty as to its operation. These decisions consist generally of a statement of the taxpayer's activities and an expression of opinion, without reasons, as to whether those activities fall within the second limb.[27] To a large extent each case turns upon its own facts. Unfortunately the recent decision of the Privy Council has not clarified the matter. The situation is therefore unsatisfactory to the taxpayer and Commissioner alike.

It is commonly said that the second limb is to be interpreted with 'reasonable strictness' and that it only catches transactions which barely escape the first limb. Clearly the profit must arise from the carrying on or carrying out of the profit-making scheme or undertaking and not merely be incidental or adventitious to it. It must also arise from the carrying on or carrying out of the scheme or undertaking by the taxpayer.[28] However, property realized in the course of the profit-making scheme or undertaking need not be the precise property acquired[29] by the taxpayer or even 'acquired' in the primary sense of that word.[30]

The terms 'profit-making', 'scheme', 'undertaking' and 'carrying on or carrying out' have not been considered separately in the cases. The uncertainty surrounding the second limb is perhaps characterized by the studiously vague statement of Dixon J. shortly after the enactment of the section:

> The alternative "carrying on or carrying out" appears to cover, on the one hand, the habitual pursuit of a course of conduct, and, on the other, the carrying into execution of a plan or venture which does not involve repetition or system.[31]

[27] *E.g. Bjelke-Petersen v. F.C.T.* (1962) 12 A.T.D. 487.

[28] See *Fox's* case (1956) 96 C.L.R. 370; *Spence's* case (1968) 42 A.L.J.R. 3; *supra* pp. 287-8. See also *Clowes v. F.C.T.* (1954) 91 C.L.R. 209, especially 217-8 *per* Dixon C.J.

[29] See *McClelland's* case *infra* pp. 300-3. *Cf.* the position under the first limb *supra* pp. 295-7.

[30] *E.g. Fox's* case (1956) 96 C.L.R. 370; *supra* pp. 290-2 for the position under the first limb.

[31] *Premier Automatic Ticket Issuers Ltd v. F.C.T.* (1938) 50 C.L.R. 268, 298.

In relation to the second limb of section 26(a) the contrast is sometimes made between a mere realization of a capital asset not acquired with the view of profit-making by sale and the carrying on of a business of which the property realized forms part of the stock in trade. Some middle ground between those two activities appears to be occupied by section 26(a).

Two extreme views as to the operation of the second limb are perhaps illustrated by *Fox's* case[32] and the *Scottish Australian Mining* case.[33] In *Fox's* case[34] the court said that the taxpayer's activities amounted simply to the realization of assets in a way which appeared most advantageous, yet were within the second limb. The court emphasized the number of steps taken by the taxpayer in realizing the property. They said[35]

> there can be little doubt that in embarking, in pursuance of the resolution of creditors, upon the course of strengthening the title to the land, persuading the Southport Town Council to continue the agreement and allow him to fulfil it, causing the work to be completed under contract and causing the sub-divisional sales to be made through commission agents, the official receiver was adopting a set plan with a view of securing from the ultimate sale of the land a much greater net return than otherwise could be expected. These activities were planned, organized and coherent. . . . [G]iven the basal facts that land of a definite value was thus made to yield net proceeds considerably in excess of what otherwise could be obtained, it seems too difficult to deny that the official receiver adopted and pursued an undertaking or scheme that from his point of view satisfied the description "profit-making" and that he carried it out. . . . [A]lthough s. 26(a) is founded on language which was used in judicial decisions . . . it provides a statutory criterion which must be applied directly and cannot be treated as going no further and producing no different result than would a criterion expressed as "exercising trade" or "carrying on a business". English cases applying those tests cannot govern the application of s. 26(a), although no doubt they may give some assistance.

What is perhaps the other view of the second limb was clearly put by Williams J. in the *Scottish Australian Mining* case.[36] The taxpayer company was formed primarily for the purpose of carrying on the business of coal mining. However, certain land, purchased by the company in 1863 for the purpose of carrying on coal mining operations was, after mining thereon had ceased in 1924, sold from time to time. The sales of parcels of this land were at a considerable profit. Before land was sold it was subdivided for residential purposes and roads and a railway station were constructed, sites were made available for schools and churches and areas were set aside for parks.

[32] (1956) 96 C.L.R. 370.
[33] *Scottish Australian Mining Co. Ltd v. F.C.T.* (1950) 81 C.L.R. 188.
[34] (1956) 96 C.L.R. 370, 386; *supra* pp. 287-8.
[35] (1956) 96 C.L.R. 370, 387.
[36] (1950) 81 C.L.R. 288.

His Honour held that the land was purchased with the dominant purpose of mining thereon. His Honour said that the question of whether the activities outlined above fell within the second limb was 'really the same thing'[37] as whether they constituted the carrying on of a business and was to be contrasted with the 'process of realizing a capital asset'.[38] Relying heavily on English cases, Williams J. held that the activities outlined fell into the latter category and the profits therefore did not form part of the taxpayer's assessable income.

More recently in *White's* case[39] Barwick C.J. has taken a view very much akin to that of Williams J. The Chief Justice said:[40]

> With every respect to some of the reasons given in . . . [*Fox's* case] it is not enough, in my opinion, to make the proceeds of realization taxable income, that the taxpayer in realizing his capital asset has taken steps to increase the amount it will realize, even if those steps are clearly commercial steps, and even if they are of an organized or repetitive nature. It seems to me that it is not the circumstance that the taxpayer has endeavoured to improve the realizable value of his capital asset which provides the criterion but the circumstance that he has in reality put his capital asset to work as the whole or part of the capital of a business upon which he has ventured. Merely to realize a capital asset may involve money making as distinct from profit making but a business in the relevant sense of necessity involves the earning of or the intention to earn profits.

In *White's* case[41] Taylor and Owen JJ. in a joint judgment appear to have taken a different view of the second limb.[42] They observe that the concept embodied in the second limb and the concept of the proceeds of a business may overlap but quote the words from *Fox's* case[43] which indicate that the second limb cannot be regarded as going no further than the concept of carrying on a business. On the other hand they warn that

> it is not to be thought that the mere realization of a capital asset not acquired for the purpose of profit making by sale would constitute a scheme for the purposes of s. 6 and s. 26(a) even though the realization is effected in the most advantageous manner.[44]

In *Clowe's* case[45] the majority emphasized that the activities of the taxpayer merely constituted a 'casual' or 'isolated' investment.[46] A

[37] *Ibid.* 195.
[38] *Ibid.*
[39] (1968) 43 A.L.J.R. 26; *supra* p. 288, n. 77.
[40] (1968) 43 A.L.J.R. 26.
[41] *Ibid.*
[42] *Ibid.* 28.
[43] (1956) 96 C.L.R. 370, 387; quoted *supra* p. 298.
[44] (1968) 43 A.L.J.R. 26, 28.
[45] (1954) 91 C.L.R. 209.
[46] *Ibid.* 218, 223 *per* Dixon C.J. and Kitto J. respectively.

scheme, it was said, requires a 'programme, or plan of action'[47] and there was no suggestion that something akin to a business was necessary. The minority adopted a similar view of the second limb and held that the activities of the taxpayer fell within the section.[48] In a Board of Review case[49] after a lengthy examination of the history of section 26(a) Mr O'Neill said that the section had an operation differing in important respects from the concept of carrying on a business. In particular he said that the second limb may apply to isolated transactions.[50]

Therefore before *McClelland's* case,[51] the operation of the second limb was quite uncertain. It had been applied to an isolated transaction[52] but only an isolated transaction which was relatively complex and in which the taxpayer was clearly intending to make money by the disposition of property. On the other hand there was also a strong strand of authority in favour of the view that the second limb added very little, if anything, to the concept of proceeds derived from the carrying on of a business.

(ii) AFTER *McClelland's* CASE

On 27 September 1958 Henry John Spaven died. The rich uncle by his will gave the residue of his estate to his trustees upon trust to convert it and hold the capital and income thereon for his nephew, Reginald Spaven, and his neice, the taxpayer, Mrs Dolores McClelland, as tenants in common in equal shares. After payment of duties it appeared that the residue would consist primarily of a block of land some 3,600 acres in extent at Rockingham near Perth. The taxpayer wished to retain the land against a rise in market value and with an eye to future subdivision. Her brother wished to sell. He would not agree to partition. At a meeting concerning the land the taxpayer's brother said he had a purchaser for his interest for £40,000. The taxpayer was not willing to sell her interest and did not desire a stranger as tenant in common. The taxpayer did not have £40,000 to purchase her brother's interest but cast around for methods to raise the money. On 26 July 1962 she obtained an option to purchase her brother's interest for £40,000. Thereupon she had a

[47] *Ibid.* 225 *per* Kitto J. *Cf.* similar remarks of Windeyer J. in *Investment and Merchant Finance Corporation Ltd v. Commissioner of Taxation (Cth)* (1970) 44 A.L.J.R. 73, 77. His Honour said a 'scheme presupposes some programme of action, a series of steps all directed to an end result. Similarly an undertaking is an enterprise directed to an end result. Each word connotes activities that are co-ordinated by plan and purpose—that whatever is done under the scheme or pursuant to the undertaking is done as a means to an end. There may, in one sense, be several transactions, but they are related because all is directed to the attainment of the one end, profit.'

[48] (1954) 91 C.L.R. 231-2 *per* Taylor J.

[49] (1965) 16 T.B.R.D. 313 *Case* R68.

[50] Concerning an isolated transaction see *Becker v. F.C.T.* (1952) 87 C.L.R. 456, 460 *per* Fullagar J.

[51] *Infra* pp. 300-3.

[52] See *e.g. Fox's* case (1956) 96 C.L.R. 370; *Bjelke-Petersen v. F.C.T.* (1962) 12 A.T.D. 487.

plan of subdivision prepared whereby the land was divided into three portions. The taxpayer decided to keep portions 4 and 6 together being 525 acres in extent and nearest to the beach. This was the more valuable land. Portion 5 of 3,073 acres she determined to sell. The taxpayer was advised that to get a good price for the land she proposed to sell she would have to include in that part some of the more valuable land. On 10 September 1962 the option was exercised. By a contract dated 5 October 1962 the taxpayer agreed to sell portion 5 for £50 *per* acre, a deposit of £50,000 being payable. Out of the deposit the taxpayer paid her brother and lodged £10,000 with the trustees as required to meet certain specific bequests in her uncle's will. The balance of the purchase moneys were paid to the taxpayer later in the same year of income. The Commissioner assessed the taxpayer under section 26(a) and computed her profit at £56,951. The taxpayer asked the Commissioner how the 'profit' was computed. The Commissioner declined to reveal this. The taxpayer objected and the objection having been refused the matter came before Windeyer J.

His Honour held that the profit did not fall within either limb of the section.[53] He also disagreed with the Commissioner's method of computing the profit.[54] Windeyer J. observed that the taxpayer 'undoubtedly had a programme or plan of action' and had done very well out of the sale of portion 5.[55] However he pointed out that not every advantageous realization of property falls within section 26(a). His Honour said that sometimes cases may depend on matters of fact and degree. Apparently the taxpayer had not gone too far. In any event, her purpose was not profit-making. 'The taxpayer bought her brother's interest so that she might realize her plan of retaining her interest under her uncle's will as far as possible in the form of land.'[56] It appears therefore that the taxpayer was not within the second limb because her programme or plan of action was not sufficiently elaborate and because her dominant purpose was not profit-making.

The Commissioner appealed to the Full Court.[57] Barwick C.J. agreed with Windeyer J. The Chief Justice said that the land did not become the capital of a business as did the land in *White's* case.[58] Nor he said was it within section 26(a) for 'the realization of an inheritance even though carried out systematically and in a business-like way to obtain the greatest sum of money it will produce does not . . . make the pro-

[53] *Supra* pp. 295-7 for a discussion of His Honour's remarks concerning the first limb.
[54] See *supra* p. 286.
[55] (1967) 118 C.L.R. 353, 359-60.
[56] *Ibid.* 360. See *supra* p. 300, n. 47.
[57] (1969) 118 C.L.R. 365.
[58] (1968) 42 A.L.J.R. 139 (Windeyer J.); (1968) 43 A.L.J.R. 26; *supra* p. 288, n. 77.

ceeds either profit or income for the purposes of the Act'.[59] The Chief Justice went on to say that '[a]t best it was . . . no more than a scheme or plan to realize the enlarged interest in the land to the best advantage. It was a money-making scheme or plan'.[60] The view of the Chief Justice appeared to be that the second limb adds little, if anything, to the notion of carrying on a business.

The majority disagreed with Windeyer J. Kitto J. delivered the leading judgment in which Menzies and Owen JJ. concurred. The majority considered that not only were the profits of the taxpayer caught by the second limb of section 26(a) but would be income according to ordinary concepts as the net proceeds of an adventure in the nature of trade.[61] Kitto J. emphasized the elaborate nature of the taxpayer's plan and found that her dominant intention was not so much to retain as much as possible of her inheritance as land but to make a profit from the sale of her inheritance, part at once and part later by selling portions 4 and 6. Kitto J. did not adopt a fundamentally different approach from that of Windeyer J. Rather they differed as to the characterization of the taxpayer's activities. Kitto J. emphasized the complexity of the taxpayer's plan whereas Windeyer J. saw it as more analogous to simple transactions of realization of capital assets. They saw the taxpayer's dominant purpose differently. The approach of the Chief Justice on the other hand appears to be fundamentally different and gives little scope for the operation of the second limb.

The epic did not end in the Full Court. The taxpayer appealed to the Privy Council.[62] The appeal was upheld by a majority. Concerning the second limb of section 26(a) the majority said[63]

> Do these facts disclose a "profit-making undertaking or scheme" within the meaning of s. 26(a)? It is clear in the first place that not all such undertakings or schemes are caught by the section. Otherwise every successful wager would be within it. So also would the purchase of investments bought by a private investor as a hedge against inflation and sold—perhaps long afterwards—at more than the purchase price. The participator in a lottery would also be liable if he drew the winning ticket. The undertaking or scheme, if it is to fall within s. 26(a) must be a scheme producing assessable income, not a capital gain. What criterion is to be applied to determine whether a single transaction produces assessable income rather than a capital accretion? It seems to their Lordships that an "undertaking or scheme" to produce this result must—at any rate where the transaction is one of acquisition and re-sale—exhibit features which

[59] (1969) 118 C.L.R. 365, 371.
[60] *Ibid.* 372-3.
[61] *Ibid.* 377; see *supra* pp. 278-81.
[62] (1970) 44 A.L.J.R. 422.
[63] (1970) 44 A.L.J.R. 422, 426. The majority were Lord Donovan, Viscount Dilhorne and Lord Wilberforce; the dissientients Lords MacDermott and Pearson. Therefore, in the whole course of the litigation, 5 judges were for the taxpayer, 5 for the Commissioner.

> give it that character of a business deal. It is true that the word "business" does not appear in the section; but given the premise that the profit produced has to be income in its character their Lordships think the notion of business is implicit in the words "undertaking or scheme".

Their Lordships went on to consider whether the taxpayer's profit was income according to ordinary concepts. This they said was an independent issue but

> The whole of the facts have still to be considered; the same criteria have to be applied; the question to be asked and answered is still whether the facts reveal a mere realization of capital, albeit in an enterprising way, or whether they justify a finding that the appellant went beyond this and engaged in a trade of dealing in land albeit on one occasion only.[64]

The minority were of the opinion that the taxpayer's activities fell within the second limb. Lord Pearson referred to the taxpayer's 'elaborate scheme' and said that the transaction 'went beyond mere realisation and so is not excluded from the operation of s. 26(a)'.[65] It appears, with respect, that to regard a 'mere realization of a capital asset' as something in the nature of an exclusion or exception to the operation of the second limb is erroneous.

The reasoning of the majority appears, with respect, to be equally unsatisfactory. The majority reasoning seems in part at least to rely upon interpretations of an English statutory provision.[66] Further, as they confess, they introduced a requirement not found in the statute that the taxpayer's activities must be in the nature of a 'business deal'. The second limb according to this interpretation adds little, if anything, to the ordinary concept of income. The clock has been turned back by the Privy Council so that the words of the section add nothing to the ordinary concept of income developed in the judgments from which the words were derived.[67] It is submitted that the Privy Council have neglected the admonition of Dixon J. in the *Premier Automatic Ticket* case[68] that though section 26(a) is founded on language used in judicial decisions it, as a legislative enactment, cannot be treated as going no further and producing no different result than those judicial decisions. In any event the Privy Council have not clarified the meaning of section 26(a). The issues will certainly be relitigated. For the time the law is quite uncertain.[69] The principal contending views, it appears, being on the one hand that the second limb is merely declaratory of the common law and on the other that it involves issues of characterization depending chiefly on the complexity of the activities of the taxpayer

[64] *Ibid.* 426.
[65] *Ibid.* 429.
[66] *Ibid.* 424.
[67] *Supra* pp. 278-81.
[68] (1933) 50 C.L.R. 268, 298.
[69] See the extremely cautious judgment of Windeyer J. in *Mercantile Credits Ltd v. Commissioner of Taxation (Cth)* (1971) 45 A.L.J.R. 105. See also *infra* pp. 317-8.

in issue and the purpose of the taxpayer in engaging in those activities. The second view it is submitted is preferable.

IV PROCEDURAL ASPECTS

(a) *Assessment*

The Commissioner issues an assessment against a taxpayer to inform the taxpayer of the Commissioner's determination of his taxable income and his liability to tax.[70] In making his assessment the Commissioner draws upon information supplied by the taxpayer and from such other sources of information as the Commissioner may have available to him.[71] In some circumstances the Commissioner may amend an assessment already made.[72] This power is limited. If the taxpayer has made a 'full and true disclosure of all material facts necessary for his assessment',[73] the Commissioner may only amend the assessment to affect the taxpayer's liability within three years of liability arising under that assessment.[74] In such a case the amendment may only be made to correct a miscalculation or error of fact.[75] In the event of the taxpayer not making a 'full and true disclosure of all material' facts the Commissioner is given certain additional powers to amend assessments. Where there has been an avoidance of tax due to such non-disclosure the Commissioner may amend the assessment not only to correct miscalculations or errors of fact but also to assess the taxpayer to the appropriate amount of tax

[70] 'Assessment' as used in the Act has two meanings. It refers to the piece of paper issued by the Commissioner setting out the taxpayer's taxable income and tax payable. It is also defined by s. 6(1) to mean, subject to a contrary intention, the 'ascertainment of the amount of taxable income and the tax payable thereon'; that is, the establishment of the liability of the taxpayer to tax. This can ultimately only be established after the taxpayer has either foregone or exercised his rights of appeal under the Act. See *Bagatol v. F.C.T.* (1963) 109 C.L.R. 243, 251-3 *per* Kitto J. and also s. 166.

[71] Ss 166 and 169. S. 169 is cumulative to s. 166. S. 166 is concerned with the calculation of tax on the basis of the taxable income of the taxpayer. S. 169 allows the Commissioner to issue an assessment where the taxpayer is being assessed on some basis other than taxable income *e.g.,* Division 7 tax on private companies not making an adequate distribution of profits to shareholders. The Commissioner is also empowered to make default assessments where there has been a failure to supply an income tax return or where the Commissioner is dissatisfied with a return or has reason to believe that a return ought to have been furnished: s. 167.

[72] S. 170.

[73] S. 170(3). This expression has been interpreted on several occasions: see Commerce Clearing House, *op. cit.* ii. paras 80-010 to 80-126 and *Scottish Australian Mining* case (1950) 81 C.L.R. 188, 198 where Williams J. says of the phrase that it means 'every fact which he [the taxpayer] knows, or is capable of knowing, material to a correct assessment'.

[74] S. 170(3). The time when tax becomes due and payable under an assessment is to be not earlier than 30 days after service of the assessment but if a later date is specified may be that later date (s. 204) on the meaning of 'service' in this context see *Resch v. F.C.T.* (1942) 66 C.L.R. 198, 227-8 *per* Dixon J.; and now Acts Interpretation Act 1901-1966 (Cth), s. 29.

[75] S. 170(3). The expression 'miscalculation' requires no explanation. The expression 'error of fact' is more difficult of definition. If there has been a disclosure of all material facts then 'the error of fact' would have to be confined to wrong suppositions of fact by the Commissioner, contrary to the facts disclosed; see Commerce Clearing House, *op. cit.* ii. paras 80-140 to 80-150.

in the area of his non-disclosure.[76] It appears that the right of the Commissioner to re-assess in the case of non-disclosure relates to the whole head of liability in respect of which there has been non-disclosure and is not limited to the additional tax arising out of the matters not disclosed.[77] In the event of the Commissioner being of the opinion that the avoidance of tax arising out of the non-disclosure is due to 'fraud or evasion' the assessment may be amended at any time. In any other case the Commissioner may only amend the assessment within six years of liability arising under the assessment which it is sought to amend.

The result is that the taxpayer who is involved in a transaction which could conceivably fall within the operation of section 26(a) is in an unhappy position. If he discloses the full facts surrounding the transaction in the year of income in which he realizes the profit he will know the Commissioner's view of the transaction as soon as the assessment is issued for that year. Once the assessment is issued after a full and true disclosure the Commissioner only has the very limited powers of amendment referred to above.[78] On the other hand, if the taxpayer does not disclose the full facts relating to the transaction to the Commissioner he will avoid any conflict with the Commissioner until such time, if ever, as the Commissioner determines the matter to fall within the operation of section 26(a). Certain realizations of profit fall outside the operation of either limb of section 26(a). However, in view of the power of the Commissioner to amend assessments long after issue,[79] the taxpayer should disclose to the Commissioner the full facts of any transaction which might fall within the operation of section 26(a) in the year of income in which the profit from the transaction is realized.

(b) *Objection and Appeal*

There are two ways in which an assessment of the Commissioner may be challenged. That is, either by reference to a Board of Review or by reference to a court.[80]

The first step a taxpayer must take if he wishes to contest an assessment of the Commissioner is within 60 days of service of the assessment to

[76] S. 170(2).

[77] See *Denver Chemical Manufacturing Co. v. Commissioner of Taxation (N.S.W.)* (1949) 79 C.L.R. 296. Whether this decision supports the wide proposition in the text in relation to the Commonwealth legislation is doubtful: see Commerce Clearing House, *op. cit.* ii. para. 79-995. With this should be contrasted (1954) 4 C.T.B.R. (N.S.) 399 *Case* 75 in which the Board took the view that the Commissioner's amendment could deal with matters other than those precisely related to the matters not disclosed to the Commissioner by the taxpayer.

[78] *Supra* p. 304.

[79] Moreover it seems the Commissioner can apply the law as it has been developed by the courts and Boards of Review up to the time of amending the assessment.

[80] S. 187. In some circumstances the taxpayer may make application to the Commissioner to amend his assessment outside the normal objection procedures: s. 170 (b). However, the exercise of this power of the Commissioner to amend cannot be reviewed.

post or lodge with the Commissioner a written objection to the assessment.[81] In the case of an amended assessment the taxpayer may only object to the amendments. The objection need not be in any particular form[82] but must state 'fully and in detail'[83] the grounds on which the taxpayer contests the Commissioner's assessment. The grounds of objection limit the area within which the taxpayer may subsequently dispute the Commissioner's assessment.[84] Upon receipt of the taxpayer's objection the Commissioner is directed to consider the objection.[85] When he arrives at his decision he is to notify the taxpayer in writing of his decision.[86] The taxpayer must then, if he still wishes to proceed, within 60 days of being notified decide whether to use the appeal procedure of the Act. He may either request the Commissioner to refer the matter to a Board of Review or alternatively to refer the matter to a court for hearing.[87]

If the dispute is referred to a Board of Review then a new body, able to exercise all the powers of the Commissioner including his discretions, reconsiders the objection.[88] The Board publishes the reasons for its decisions setting out its findings of fact and reasons in law.[89]

On the other hand, if the objection is referred to a court—which may be constituted by a single justice of the High Court or of a State Supreme Court—the position is different. The court cannot re-exercise the discretions of the Commissioner as the Board of Review may do. The court must confine itself to justiciable questions: whether the assessment made by the Commissioner is correct both in the legal bases and the factual bases upon which it is made.[90]

[81] S. 185.

[82] However, the Income Tax Regulations, reg. 34, form 8 set out a form which may be adopted.

[83] S. 185. Commerce Clearing House, *op. cit.* ii. para. 81-885.

[84] S. 190(a). In some cases because of the lack of information in the adjustment sheet sent by the Commissioner when assessing the taxpayer in respect of an item which the taxpayer believed to be non-taxable, the taxpayer is at a disadvantage when framing the terms of his objection: see *McClelland's* case (1967) 118 C.L.R. 353, 361-2, where Windeyer J. suggested that where the taxpayer is prejudiced by this difficulty the court has power to refer the matter back to the Commissioner for reconsideration pursuant to s. 199 and is not bound to dismiss the appeal: *ibid.* 364-5. Windeyer J. subsequently applied this suggested power in *Elsey's* case (1969) 43 A.L.J.R. 415, 422. It seems that the decision of the Commissioner after such a reconsideration would be an assessment and would be subject to objection in the usual way.

[85] S. 186.

[86] S. 186.

[87] S. 187. If the Commissioner is dilatory in referring the matter to the tribunal requested there is a procedure whereby the taxpayer may force him to refer the matter: s. 189.

[88] Ss 192, 193(1); *cf.* s. 193(2).

[89] S. 195(2).

[90] S. 197. The choice of court is up to the taxpayer. It is usual in income tax disputes, to go to a single justice of the High Court but occasionally the matter will be referred to a single justice of a State Supreme Court: see *Darvall Estates Ltd v. F.C.T.* (1934) 3 A.T.D. 1.

There is no right to appeal from a decision of Board of Review to a court unless the decision of the Board involved a question of law.[91] Because the 'appeal' is an original exercise of federal judicial power the whole dispute is heard afresh once the pre-condition of a question of law being involved is fulfilled.[92] The court hearing the 'appeal' is to be a single justice of the High Court whose decision is to be final unless a case is stated for the Full Court of the High Court.[93] If the matter is first referred, at the request to the taxpayer, to a court without going to the Board of Review then appeals lie from that court in the normal way.[94]

Throughout all the proceedings relating to objections by the taxpayer to the Commissioner's assessment the burden of establishing that the assessment is excessive is placed upon the taxpayer.[95] The *quantum* of proof is that the taxpayer must satisfy the tribunal as 'a matter of belief'.[96]

If his objection has been disallowed by the Commissioner the taxpayer must first decide whether to go to the Board of Review or whether to go at once to a court. The Board of Review procedure of appeal is cheap but not quick. If a major question of considerable importance is being raised by the taxpayer the Board will tend to find for the Commissioner on the facts. If the matter involves a large sum of money and complex matters of law it is best to resort to the courts first as the dispute will ultimately be resolved there in any case.

Whichever method of proceeding is adopted, the taxpayer's next problem is what evidence can he adduce to support his contention that the transaction which has given rise to the Commissioner's assessment falls outside the operation of section 26(a). In some cases there will be no dispute as to the facts[97] but in most section 26(a) cases involving the first limb the taxpayer has based his objection on his not having purchased the property concerned for the dominant purpose of resale at a profit in that the property was purchased as an investment or home or to carry out a hobby.[98] Further, in most section 26(a) cases relating

[91] S. 196(1). Both the taxpayer and the Commissioner have the right to appeal.
[92] *Cf. British Imperial Oil Co. Ltd v. F.C.T.* (1925) 35 C.L.R. 422 with *F.C.T. v. Munro; British Imperial Oil Co. Ltd v. F.C.T.* (1926) 38 C.L.R. 153 and on appeal to the Privy Council as *Shell Co. of Australia Ltd v. F.C.T.* (1930) 44 C.L.R. 530.
[93] Judiciary Act 1903-1968 (Cth), s. 18 and Income Tax Assessment Act 1936-1971 (Cth), s. 198(1). See also *Fox's* case (1956) 96 C.L.R. 370, 378. For authority that the determination of the single justice of the High Court is final see *Watson v. F.C.T.* (1953) 87 C.L.R. 353 and *Point v. Commissioner of Taxation (Cth)* (1970) 45 A.L.J.R. 104.
[94] S. 200.
[95] S. 190(b).
[96] See, *e.g., Trautwein v. F.C.T.* (1936) 56 C.L.R. 63, 111.
[97] *E.g., McClelland's* case (1967) 118 C.L.R. 353; *Fox's* case (1956) 96 C.L.R. 370.
[98] *E.g., Wall v. F.C.T.* [1966] A.L.R. 949; *Petrie v. F.C.T.* (1966) 10 A.I.T.R. 129; *Scharkie v. F.C.T.* (1968) 10 A.I.T.R. 678; *Dudman v. F.C.T.* [1963] A.L.R. 31.

to the second limb the taxpayer has sought to establish that there are insufficient facts to support the conclusion that there has been a profit-making undertaking or scheme and has contended that there has been a mere realization of profit without any of the *indicia* of a profit-making undertaking or scheme.[99]

In previous cases evidence given at the hearing by the taxpayer as to his purpose at the time of purchasing the property has been critical to the decision of first limb cases.[1] The credibility of the taxpayer's evidence is a matter of great importance and in many cases under both limbs of section 26(a) the taxpayer has failed because his evidence was not believed.[2] In some cases the taxpayer, to support his evidence as to his purpose has sought to call witnesses to give evidence of his statements as to purpose both at the time of acquisition of the property and subsequently. In *Petrie's* case, Windeyer J. said:[3]

> I do not think that self serving statements by a party as to his intentions, motives or purposes, present or past, made out of court are admissible in his favour, unless they be somehow made admissible in the course of the trial, as for example by a suggestion that what he says in the witness box is a recent invention. Contemporaneous statements of intention or other states of mind made when entering into a particular transaction may however be admissible, if evidence of the transaction is admissible, as forming part of the transaction and explaining it.

To be contrasted with this is the view of Walsh J. in *Eisner v. Commissioner of Taxation (Cth)*[4] where the opinion is expressed, once again in relation to the first limb of section 26(a), that the above statement of Windeyer J. is not of general application. Statements by the taxpayer of his intention at the time of acquiring property may be admissible evidence. These statements will generally be proved by the persons to whom the statements were made giving evidence of the contents of the

[99] *E.g., Dudman v. F.C.T.* [1963] A.L.R. 31; *Elsey's* case (1969) 43 A.L.J.R. 415; *Bernard Elsey Pty Ltd v. Commissioner of Taxation (Cth)* (1969) 43 A.L.J.R. 423; *Kratzmann's* case (1970) 44 A.L.J.R. 293; *supra* pp. 297-304.

[1] See *Smithfield Pastoral Co. Pty Ltd v. F.C.T.* (1966) 10 A.I.T.R. 9, 10 *per* Owen J.: '[i]ts [the taxpayer's] case, therefore, depends in large measure upon the evidence of [Sir Ellerton] Becker . . . . I formed a favourable view of Becker as a witness and, notwithstanding criticisms that were made of some parts of his evidence, I am satisfied that he was telling the truth'. See also *Wall's* case [1966] A.L.R. 949, 951 *per* Menzies J.: '[f]rom what I have already said, it is obvious that the appellant's credibility must have a material bearing upon the result of his appeals. Of that I formed no high estimate. Apart from his general demeanour which, though confident, failed to inspire confidence, there were particular matters upon which it became apparent he was ready to mislead when he thought it was in his interests to do so'. In the former case the taxpayer succeeded; in the latter the taxpayer lost.

[2] *E.g., Wall v. F.C.T.* [1966] A.L.R. 949; *Petrie v. F.C.T.* (1966) 10 A.I.T.R. 129; *Scharkie v F.C.T.* (1968) 10 A.I.T.R. 678; *Elsey's* case (1969) 43 A.L.J.R. 415; *Pascoe v. Commissioner of Taxation* (1956) 30 A.L.J. 402; *Dudman v. F.C.T.* [1963] A.L.R. 31; *Buckland v. Commissioner of Taxation (Cth)* (1960) 34 A.L.J.R. 60.

[3] *Petrie v. F.C.T.* (1966) 10 A.I.T.R. 124, 134.

[4] (1971) 45 A.L.J.R. 110, 112.

statements.[5] Moreover, expressions by the taxpayer with regard to his intentions in respect of the property in the future are admissible in evidence in so far as they throw light on the intention of the taxpayer at the time he entered upon the transaction. These statements by Walsh J. are made in relation to the first limb of section 26(a) where purpose of the taxpayer at the time of acquisition is a matter in issue. Whether evidence as to the taxpayer's intention is admissible in disputes involving the second limb of section 26(a) is doubtful. One of the factors to be taken into account in ascertaining whether a transaction falls within the second limb of section 26(a) is the profit-making purpose of the taxpayer in relation to the scheme or undertaking. This, however, is not the matter directly in issue. It seems, therefore, that evidence as to statements of intention or purpose made by the taxpayer at the time of entering upon, or engaging upon, the transaction will only be admissible in evidence in relation to the first limb of section 26(a) and not in relation to the second limb of section 26(a) unless the preconditions for admissibility set out by Windeyer J. in *Petrie's* case[6] are fulfilled.

Evidence of the taxpayer's associates is also significant. His bank manager, solicitor, estate agent, colleagues and employees will all be important sources of primary and corroborative evidence as to the taxpayer's purpose and as to the nature of the transaction in issue. Some witnesses will be more readily believed than others; a bank manager is more usually disinterested than an employee of the taxpayer.[7]

An appeal may be taken from the decision of the body to which a matter has been referred.[8] An 'appeal' from a decision of a Board of Review to a single justice of the High Court is only open where the

[5] Conceivably, the taxpayer could give evidence of his previous statements though this would have little probative value.

[6] (1966) 10 A.I.T.R. 129; *supra* p. 308.

[7] See *Eisner v. F.C.T.* (1971) 71 A.T.C. 4022 (this report has a much fuller discussion of the evidence than (1971) 45 A.L.J.R. 110) where Walsh J. discusses the evidence of the estate agent, the accountant, an officer of a life insurance company and a business associate of the taxpayer. The evidence of these witnesses, which supported the evidence of the taxpayer, led to the success of the taxpayer's appeal. Without this alternative source of evidence the taxpayer would have failed. 'If the . . . [taxpayer's] case had to depend solely on his own testimony to establish to my satisfaction the essential facts as to the state of his mind when he entered into the contracts . . . the appeal would fail. He carries the onus of proof. [His Honour then recounts evidence given by the taxpayer.] I thought that his version of what occurred ought to be regarded as highly suspect': (1971) 71 A.T.C. 4022, 4025 *per* Walsh J. Occasionally it is desired, either by the Commissioner or the taxpayer, to lead documentary evidence recorded in the past relevant to the taxpayer's purpose and the course of the transaction in issue. In this context the Evidence Act 1958 (as amended), ss 90-8 (banker's books) and ss 54-8 (documentary evidence) should be considered as Commonwealth courts sitting in Victoria apply Victorian law in the absence of Commonwealth law to the contrary: Judiciary Act 1903-1968 (Cth), s. 79. These aspects of the Evidence Act have been considered in relation to equivalent legislation in other States: see *Elsey's* case (1969) 43 A.L.J.R. 415, 417 (Qld) and *Eisner v. F.C.T.* (1971) 71 A.T.C. 4022, 4028, 4031 (N.S.W.).

[8] *Supra* p. 307.

decision of the Board of Review involved a question of law.[9] In most section 26(a) cases before a Board of Review a decision on a matter of law is necessarily made either in relation to the interpretation of section 26(a) or in relation to its application to the particular facts.[10]

V DEALINGS IN LAND AND SHARES

Transactions in land and shares—the major forms of private wealth in our community—have given rise to most section 26(a) cases. It is proposed to examine some common dealings in land and shares which give rise to problems under section 26(a). While the reported cases will be the source of most examples, instances deriving from legal strategems which have not hitherto given rise to litigation will be examined.

(a) *Land Transactions*

1. Land may be purchased in an area where an appreciation in value is likely, typically on the outskirts of an expanding urban area. The land appreciates in value and in due course is sold at a profit. The Commissioner alleges that the transaction falls within the first limb of section 26(a). There is little doubt that all the requirements of the first limb of section 26(a) are met with one exception; that is, whether the land was purchased with the dominant purpose of resale at a profit. The taxpayer will allege that the land was purchased as an investment for the rental return, as a home, as a place to carry on leisure activities or as a place of business, depending on the particular facts. In one case the taxpayer seriously suggested that the land was purchased with the purpose of erecting a sign advertising the taxpayer's real estate agency.[11] The Commissioner will assert that the dominant purpose of the taxpayer in acquiring the property was to resell it at a profit. The onus is on the taxpayer to establish that the Commissioner's assessment is excessive.[12] He must establish that his intent when acquiring the property was to acquire with other than the dominant purpose of resale at a profit. It is often the case that the taxpayer does not have one dominant purpose. He purchases property not only to obtain a return on his assets but also to take advantage of the prospect of long term appreciation in value. Yet, the court is faced with the necessity of distilling one dominant purpose. In a situation such as that postulated the taxpayer generally would not be able to discharge the onus of proving that the land concerned was not purchased with the dominant purpose of resale at a profit. However, there are certain factors which can make all the difference between the evidence of the taxpayer being accepted and it being rejected, albeit

[9] *Supra* p. 307.
[10] *Buckland v. Commissioner of Taxation* (1960) 34 A.L.J.R. 60, 61 *per* Windeyer J.
[11] *Wall v. F.C.T.* [1966] A.L.R. 949, 954.
[12] *Supra* p. 307.

that the evidence is very much a straw in the wind. The taxpayer will encounter great difficulty having his evidence accepted if the property is left unused, or if any use to which the land is put or could be put returns an income far below normally prevailing returns on such investments, or if short term borrowed money has been used to finance acquisition and the land is sold shortly after acquisition. If, however, the land has been held for a long period of time, is unencumbered by debt and is giving a reasonable return on funds invested then the evidence given by the taxpayer as to his purpose at the time of purchase is quite likely to be accepted.

From the taxpayer's viewpoint the lesson is that a transaction along the lines of the one suggested above is likely to be assessed under the first limb. The second limb is probably inapplicable to a simple purchase and sale.

The question arises as to whether the taxpayer can plan against the operation of section 26(a) in the situation outlined above. There are two points at which planning can take place: at the time of acquisition of the land and at the time the land is sold.

Most planning at the time of acquisition depends upon the use of companies or trusts.[13] It is well established that the company is a separate legal person from its shareholders, even a controlling or sole shareholder. The shareholder may have a different dominant purpose from the company.

In some situations a taxpayer, by the use of a company structure, can avoid section 26(a). For instance an existing company in which the taxpayer is sole shareholder can acquire land; the land being its only asset. The taxpayer can advance money to the company or not, as the need arises, to enable the purchase of the land. Subsequently after the value of the land has appreciated, there is a sale of shares to a person who in effect wishes to purchase the land held by the company. When a loan has been made to the company this would be taken into account when pricing the shares. The taxpayer is clearly not taxable under the first limb of section 26(a) as his shares, the only item of property sold at a profit, were not originally acquired for the purpose of resale at a profit.

Since the shares must not be acquired for the purpose of resale at a profit, it is desirable, if possible, to use an existing company. It should be noticed that if the company later decides to resell the land any profit it derives upon resale will form form part of its assessable income. In some circumstances, this could result in the taxpayer obtaining an appropriately discounted price for his shares.

[13] See *e.g. Hobart Bridge Co. Ltd v. F.C.T.* (1951) 82 C.L.R. 372; (1969) 69 A.T.C. 160 *Case* A26.

[14] *Hobart Bridge Co. Ltd v. F.C.T.* (1951) 82 C.L.R. 372. See also *Becker's* case (1952) 87 C.L.R. 456.

The writers are led to understand that it is the practice of many public companies when acquiring real property to form a new subsidiary to acquire that property. In many cases it is intended that the property be developed or turned to account in some way. In order to avoid section 26(a) problems, so it is thought, the shares in the company are sold instead of the land itself. The sale of the shares gives rise to a substantial profit over allotment cost. This transaction would appear to fall within the first limb of section 26(a) if all along there has been an intention to resell the shares at a profit. However, the Commissioner has as yet made no attempt to assess the public company in such a situation probably because the land-holding subsidiary, by means of minutes being kept and the long term advice of professional advisers, is able to create the impression of having been created for other purposes than as a vehicle for avoiding section 26(a).

Another possible means of avoiding section 26(a) is by the land being acquired by the taxpayer and a company as joint tenants. The company is then put into liquidation and under the operation of section 28 of the Property Law Act 1958 (as amended) the interest in the entirety passes to the taxpayer. In due course the taxpayer sells the property at a substantial profit. This transaction may avoid the first limb because the property sold is not the property acquired. The taxpayer acquired an interest as a joint tenant in respect of a moiety of the land and sold the entirety. This is not to say that care should not be taken in such a transaction in relation to the second limb and section 260.

As has been said planning in relation to section 26(a) may also take place at the time of the sale of the property acquired for the purpose of resale at a profit. One method of planning which may be adopted is for the taxpayer to fragment his proprietary interest so that he does not sell that which he acquired. One means by which this could be done is by the taxpayer granting a lease for 999 years. Under the Transfer of Land Act 1958 (as amended), a certificate of title could issue to the lessee,[15] and there seems to be no reason why the lessee might not subdivide his leasehold entitlement if this is desired. This would appear on the basis of *McClelland's* case[16] to avoid the operation of the first limb of section 26(a).

One question which has not been explored so far is whether any of the suggested tax planning devices might give rise to liability under the second limb as being profits arising from a profit-making undertaking or scheme carried out by the taxpayer. It is submitted that if the 'company—sale of shares transaction'[17] is used there is little danger of there being a profit-making undertaking or scheme under section 26(a)

[15] S. 9.
[16] (1967) 118 C.L.R. 353; *supra* pp. 295-7.
[17] *Supra* p. 311.

as the mere realization of an asset has never been held to fall within the ambit of section 26(a). However, if an existing company in which the taxpayer holds shares is not used, the activities of the taxpayer in forming a company and the allotment of shares may bring the transaction within the second limb. However, the methods of fragmenting[18] or aggregating proprietary interests[19] so that the interest sold by the taxpayer is different from the interest acquired are in most cases quite complex transactions and therefore may be caught by the second limb. There are two reasons for thinking they are not. First *if* the approach of the majority of the Privy Council[20] and Barwick C.J. in *McClelland's* case[21] is correct and the taxpayer must carry on something in the nature of a business for the operation of the second limb then unless the sales of interests in land recurred then the taxpayer would not be assessable. Second, all second limb cases have been concerned with whether operations carried on by the taxpayer to maximize his profit in relation to the property concerned constitute a profit-making undertaking or scheme; here the taxpayer is not going through the steps for the purpose of maximizing profit, but rather to avoid the operation of section 26(a). It is a tax avoidance scheme not a profit-making scheme.[22]

2. Land may be acquired by the taxpayer with one purpose in mind and then that purpose is changed and the land realized or dealt with in a way totally different from that originally contemplated by the taxpayer.

The first limb of section 26(a) provides that any profit deriving from the sale of property acquired for the purpose of resale at a profit is assessable income. It is to be noted that there is no requirement that the profit on the resale derive from the particular profit-making purpose which the taxpayer had at the time of acquisition. Indeed cases have arisen under the first limb of section 26(a) where land purchased for one method of profit-making by sale is in fact later sold at a profit but in an entirely different way from that originally contemplated. For example land may be purchased for the purpose of sale as subdivisional allotments. It subsequently happens that the land is compulsorily acquired by a statutory authority, the compensation payable being more than the cost price of the land. It was held in the *Coburg Investment* case[23] that the profit deriving from the 'sale' was assessable under the first limb.

Under the second limb the profit must arise from the profit-making undertaking or scheme. Thus, if a taxpayer engaged upon a particular

[18] *Supra* pp. 295-7.
[19] *Ibid.*
[20] (1970) 44 A.L.J.R. 422.
[21] (1969) 118 C.L.R. 365, 371.
[22] See *Becker's* case (1952) 87 C.L.R. 456. S. 260 may be applicable to these transactions though this would seem to involve the breaking of new ground.
[23] (1960) 104 C.L.R. 650; *supra* pp. 289-90.

profit-making undertaking or scheme which he subsequently abandons, sells the land he purchased for the undertaking or scheme at a profit, the profit is not assessable under the second limb. For example, in *Kratzmanns* case[24] the taxpayer formed a company for the purpose of acquiring land on which was to be erected a block of flats and offices in respect of which there was to be the equivalent of a stratum plan of subdivision under which the ownership of certain shares in the company would entitle the holder to possession of a specified flat or office. The taxpayer intended to sell sufficient of the shares to enable him to repay the costs of erection of the flat and office block and still retain a capital asset worth more than the cost of the scheme. It was said that this was a profit-making scheme. However, the taxpayer for financial reasons was unable to consummate the scheme. He sold the land at a profit. It was held that the profit was not assessable as the profit did not derive from the profit-making undertaking or scheme and the land involved had not been purchased for the purpose of profit-making by sale.

What lessons are there in this for the taxpayer? Only that there are certain advantages for a taxpayer if he is in a situation which might be characterized as a profit-making undertaking or scheme and for some reason or other the situation is not within the first limb of section 26(a). There may be substantial tax savings to the taxpayer in abandoning the scheme and simply selling the land. It does, however, depend on the clarity with which the original profit-making scheme is formulated; if there is merely some general idea of turning the land to account this could conceivably be a profit-making undertaking or scheme but variations of quite an extensive nature within that general scheme might be feasible and yet the profit would still be derived from the profit-making undertaking or scheme.

3. It often occurs that a taxpayer owns land which he has not acquired for the purposes of the first limb. In order to realize the land for the best price obtainable it is necessary for the taxpayer to do some acts in relation to the land. This usually takes the form of subdivision of the land and the sale of the subdivided lots.

The operation of the second limb is now quite uncertain[25] but it does seem that there must be something more than an enterprising realization of assets. However, in these circumstances it may be better for the taxpayer to sell the land at valuation to a company controlled by the taxpayer (or simply to a land developer) which would carry out the steps necessary to realize the best price obtainable. This would certainly mean that the profits of the company would be assessable under section 26(a). If the taxpayer retains the land and develops it, it may not be

[24] (1970) 44 A.L.J.R. 293.
[25] *Supra* pp. 297-304.

clear when he commenced the profit-making scheme in relation to the land. If, however, the land is sold to a company the point at which the profit-making scheme of developing the land commenced is quite clear. This is, of course, important in the computation of the profit derived from the profit-making scheme.[26]

(b) *Share Transactions*

1. The first problem to be considered relates to shares in public companies listed on the stock exchange. In most cases shareholders are concerned both with the obtaining of dividends from their shares and the benefits of rights issues and realizing profits from the sale of shares. This situation gives rise to problems which were considered in relation to the dominant purpose of the taxpayer in acquiring land.[27] There are, however, some differences. For instance, it appears that merely buying a share which has a low dividend return compared with price will not of itself indicate that the purchase was made with the purpose of resale at a profit as shares may be purchased because of the prospect of bonus issues, rights issues and a growth of the dividend return. The problem of ascertaining dominant purpose is probably more difficult in the context of share dealings as share portfolios are maintained by investors to be turned over as circumstances demand and any share is bought with an eye toward ultimate resale at a profit.[28]

2. The company is a structure used in many tax situations.[28A] Probably the most significant of relevant situations are loss companies and dividend stripping operations.

(i) LOSS COMPANIES

A taxpayer may purchase a loss company[29] to utilize it as a structure within which he may generate income which will not be taxable in view of the previous losses of the company. As the purchaser of the shares in the loss company will almost certainly be unable to establish that he is carrying on continuing business[30] he will have to allow 40 *per cent.* of the ownership of the shares to remain vested in the previous shareholders of the company.[31] This could cause difficulties such as the continuing shareholders being entitled to 40 *per cent.* of the profits generated. To avoid this difficulty the purchaser of the 60 *per cent.*

[26] *Supra* p. 287.
[27] *Supra* pp. 310-1.
[28] See (1971) A.T.C. 100 *Case* C22; (1949) 69 A.T.C. 65 *Case* A13.
[28A] The application of section 26(a) to *'Gorton* case schemes' has not been discussed in this article. It seems to the writers that potentially section 26(a) could apply to aspects of such a scheme and this is often overlooked by estate planners: see *Gorton v. F.C.T.* (1965) 113 C.L.R. 604.
[29] Ss 80-80F: see also Voumard, 'Loss Companies and s. 26(a)' (1970) 44 *Law Institute Journal* 347.
[30] S. 80E.
[31] S. 80A.

interest in the company will often take an assignment of the debts owed by the company from the creditors of the company. This is often done in conjunction with a scheme of arrangement under section 181 of the Companies Act 1961 (as amended) whereby the assignee of the debts and purchaser of the shares can be assured that he is getting a clear title to the debts and is not subject to be defeated by some, at that stage unknown, creditor of the company. The assignment of the debts enables the holder of 60 *per cent.* of the shares to ensure that all the income of the company goes into repaying the sums of money due by the company to which the purchaser of the company's shares is entitled as assignee of the debts. A sum of money will be paid by the taxpayer for the debts owed by the company.[32] This sum will, however, be far below their face value as the debts are useless without the injection of funds into the company to enable their repayment. Thus the holder of the debts will recover a sum of money in respect of the debts far above the price he paid for them. Is the assignee assessable to tax in respect of this 'profit' as being profit derived from a profit-making undertaking or scheme?

The majority of a Board of Review considered the profit to be assessable income.[33] Obviously the first limb would be inapplicable on the basis, *inter alia,* that there was no sale. However, it was said that the second limb was applicable and

> having regard to the nature of the asset purchased, the price paid therefor, the probability that a profit would result on the purchase and the fact that a profit did in fact emerge within two days of purchase I have reached the conclusion that the said profit thrown up on the emerging basis was assessable income under the second limb of sec. 26(a).[34]

With respect, it is submitted that this view is not supported by the cases. One should examine the profit-making activities of the particular taxpayer.[35] Without looking at the totality of the scheme the taxpayer would not have been assessed, as all that would have appeared was that debts were purchased at a low price and there was a likelihood that these debts would subsequently be repaid. The majority of the Board did not consider the problem that if part of the circumstances of the transaction were taken into account then all the circumstances should be considered. Overall the taxpayer or taxpayers, as there will often be a maze of interlinked companies, have not earned any more profit: the aim of the scheme has been to use the corporate structure of the loss company as a base within which the existing profit-making structure may generate income. It cannot, therefore, be said that a profit has arisen from

[32] It is a nice question as to whether 'cost of the loss company' to the purchaser should be attributed to the shares or debts purchased.
[33] (1970) 70 A.T.C. 162 *Case* B35.
[34] *Ibid.* 164.
[35] *Supra* pp. 287-8.

the undertaking or scheme. This appears to have been the view of the dissenting member of the Board, and it seems the preferable view.

A further difficulty arises in relation to the second limb in that it is difficult to see how in any loss company situation the purchaser of the debts (and/or the 60 *per cent.* shareholder) can avoid entering into some agreement or understanding, albeit well concealed, with the 40 *per cent.* shareholder concerning dealings by the 40 *per cent.* shareholder with his shares. Such an understanding or agreement could well bring the activities of the particular taxpayer within the second limb.

(ii) DIVIDEND STRIPPING

Dividend stripping at its least subtle consists of the following transactions. There is a private company with large liquid assets. The company wishes to cease operations or must make a distribution of dividends to avoid the imposition of Division 7 tax. A public company comes into the picture. It purchases all the shares in the private company at a price which is somewhat less than the value of the assets of the private company. The former private company[36] then declares a dividend equal in value to the whole of its liquid assets to its public company shareholder. After the distribution of the dividends the former private company will, in most cases, be a mere husk. However, the husk may be sold as an excess distribution company,[37] at a price well below that originally paid for the shares in the former private company.

This transaction has certain advantages both to the shareholders of the private company and to the public company. The shareholders in the private company when they sell their shares are engaging in a capital transaction and will not be assessed to tax on the proceeds of the sale.[38] The public company can claim a rebate[39] of tax for the tax payable in respect of the dividend paid to it which makes the dividend virtually tax-free in its hands. Moreover, the public company will be able to claim a deduction in respect of the loss on the shares provided it is a share trader.[40]

It was suggested by Windeyer J. in the *Investment and Merchant Finance* case[41] that a dividend stripping operation was a profit-making undertaking or scheme in that there was a 'two phase' transaction:[42] the declaration and taking of the dividend and the selling of the shares. When calculating the profit or loss which results from the

[36] Ss 6(1), 103A.
[37] S. 106.
[38] The shareholders in the private company may have s. 260 applied to their sale of shares: see Commerce Clearing House, *op. cit.* iii. para. 87-850.
[39] S. 46(2)(b). *Investment and Merchant Finance* case (1970) 44 A.L.J.R. 73 and *Mercantile Credits* case (1971) 45 A.L.J.R. 105.
[40] *Rowdell Pty Ltd v. F.C.T.* (1963) 111 C.L.R. 106. Similar problems arise with respect to 'bond-washing'.
[41] (1970) 44 A.L.J.R. 73.
[42] *Ibid.* 76.

transaction it is necessary to compare the cost of the shares with the total of the dividends and the price obtained for the shares upon resale. This is to adopt a view of the second limb which is rather different from the approach of the Privy Council in *McClelland's* case.[43] It seems to follow from the Privy Council decision that the taxpayer would have to be carrying on the business of dividend stripping before the dividend stripping operation would fall within the operation of the second limb of section 26(a).[44]

In the *Mercantile Credits* case[45] in relation to another dividend stripping operation where the public company was not a share trader it appears to have been the basis of the judgment of Windeyer J. that the transaction was not within either the first or second limb of section 26(a) because the public company taxpayer was not a share trader. Windeyer J. appears to have changed his approach to the application of section 26(a) to a dividend stripping operation. It seems now to be required that the business which the taxpayer carries on be one of which dividend stripping is a part. This is to adopt the view of the majority of the Privy Council in *McClelland's* case.[46]

The position is quite unclear. It may be that the appeal in the *Investment and Merchant Finance* case[47] presently pending to the Full Court of the High Court will resolve the difficulties of the application of section 26(a) to dividend stripping operations. In the meantime a taxpayer engaging in a dividend stripping operation is entering upon a transaction the tax consequences of which are quite unpredictable. Nonetheless if a dividend stripping operation is caught by section 26(a) it merely means that, since the public company will obtain a rebate under section 46, the taxpayer public company does not obtain a tax-saving bonus.

VI CONCLUSIONS

Section 26(a) was introduced in haste in 1930 to counter the concept of income of the House of Lords in *Jones v. Leeming*.[48] It was based upon words used in *Blockey's* case[49] and other cases.[50] These cases were inconsistent among themselves and internally. From that humble beginning section 26(a) has had a pervasive effect, especially over the last 10 years, being used by the Commissioner as the other prong to section 260 in his offensive against tax avoidance. In some circumstances it has proved more successful than section 260.[51]

[43] (1970) 44 A.L.J.R. 422.
[44] *Supra* pp. 300-3.
[45] (1971) 45 A.L.J.R. 105.
[46] (1970) 44 A.L.J.R. 422.
[47] (1970) 44 A.L.J.R. 73.
[48] [1930] A.C. 415.
[49] (1923) 31 C.L.R. 503.
[50] *Supra* p. 280, n. 33.
[51] *E.g.* in the loss company and dividend stripping operations: see *supra* pp. 315-8.

Since 1930 judicial decisions have clarified the meaning of the first limb. Yet uncertainty still surrounds the requirement that the taxpayer must 'acquire' the property subsequently resold at a profit. Further it is not settled whether the interest in property acquired by the taxpayer must be the precise interest sold to realize the profit. In many cases it is well nigh impossible to establish the taxpayer's dominant purpose; rather there are a number of significant purposes. Therefore, the burden on the taxpayer to establish that his dominant purpose was not profit-making by resale may operate harshly.[52]

The operation of the second limb is not settled. All that can be said with certainty is that it does not catch purely fortuitous windfall capital gains realized by the taxpayer such as a profit on the sale of a house used for 20 years as the taxpayer's home. On its widest possible interpretation the second limb could catch almost anything else.

The computation of profit arising under either limb can be very difficult. Section 26(a) has given rise to much needless litigation because of the uncertainty of its operation; uncertainty which flows not only from the imprecise words of the section but also its use of criteria which do not reflect business reality. Royalties or the profits of a business have well developed meanings in commerce and accounting, whereas a profit-making undertaking or scheme has no such meaning. In many situations section 26(a) makes legitimate tax planning difficult, if not impossible.

Section 26(a) has operated to catch capital gains despite what appear to be the expectations of its framers. If capital transactions are to be taxed then a capital gains tax would appear to be a more sensible solution than section 26(a). One of the harsh aspects of the operation of section 26(a) is that the whole of a realized profit is brought into assessable income in the year the profit is realized. A capital gains tax would be at a lower rate than a tax upon income or an allowance would be made for the period during which the asset realized has been held by the taxpayer.[53]

[52] *Supra* p. 307-9, 310-1.

[53] It is suggested that the capital gains tax only operates when the profit reaches a certain minimum level, say $20,000. This would exclude, for example, the profit realized by the taxpayer selling a longtime family home.