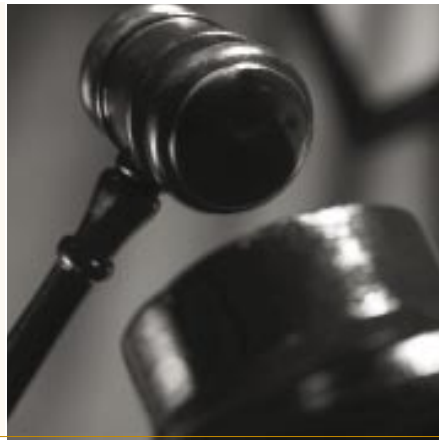
A question of profit



COMMISSIONER OF TAXATION V CONDELL [2006] FCA 1047

INTRODUCTION

On 15 August 2006 the Federal Court handed down its decision in *Commissioner of Taxation v Condell* [1] ("**Condell**") and overturned a decision of the Administrative Appeals Tribunal, which had determined that a dividend paid by the Hewlett Packard Company ("**Company**") by way of an in-specie distribution of shares in a subsidiary company was not assessable income because:

- a significant component of the distribution of the shares in the subsidiary was in the nature of a capital receipt on general principles, rather than wholly from profits.
- Section 44(1)(a) of the *Income Tax Assessment Act 1936* (Cth) ("**ITAA36**") only made dividends taxable if they were wholly derived from profits of the Company.

MATERIAL FACTS

In March 1999, the Company was restructured to separate its computing business from other businesses that it conducted. These other businesses included testing and measurement, semiconductor products, chemical analysis and healthcare solutions. The other businesses were sold to a wholly owned subsidiary, Agilent Technologies Inc. ("**Agilent**") on 1 November 1999 in exchange for shares in Agilent. On 18 November 1999, Agilent made an initial public offering of 15.9 percent of its stock to investors and raised US $2.1 billion after which time the Company held approximately 84.1 percent of Agilent's stock.

In April 2000, the Company's Board declared an in specie dividend of the majority of its shares in Agilent; in June 2000, the Company distributed these shares to its shareholders based on the number of shares they held in the Company on 2 May 2000 as a "tax-free spin off".

The respondent taxpayer ("**Taxpayer**") was a shareholder in the Company, and on 2 May 2000 he received 1,327 shares in Agilent with a market value of $168,961.68. The Taxpayer argued that in his hands the Agilent shares were a receipt on capital account because the distribution of Agilent shares resulted in a dilution of the value of the Taxpayer's shares in the Company. The Taxpayer also relied upon the fact that in other identical cases there were private rulings that were favourable to the Taxpayer. The Taxpayer in particular quoted from one private ruling which contained an affirmative answer to the question: "Were the Agilent shares acquired by way of a tax-free spin off?". However, private rulings only apply to the person who is seeking a ruling.[2]

While the facts are not entirely clear from reading the AAT decision, the decision of the Federal Court makes it clear that the Company accounted for the distribution of shares by debiting retained earnings by US $4.2 billion and crediting each of the asset accounts that relate to the discontinued businesses.

The Commissioner of Taxation issued an amended assessment to the Taxpayer for the year ending 30 June 2000 that included the $168,961.68 worth of Agilent shares in the Taxpayer's assessable income.

RELEVANT LEGISLATION

The Condell case turned on the provisions in the s 44(1)(a) of the ITAA36 relating to assessable income at the relevant time. Section 44(1)(a) provided that:

(1) The assessable income of a shareholder in a company (whether the company is a resident or a non-resident) shall, subject to this section and to s 128D:

(a) If he is resident – include dividends paid to him by the company out of profits derived by it from any source.[3]

The Federal Court also considered s 6 of the ITAA36. This provision defined "dividend" to include:

(a) distributions made by a company to any of its shareholders, whether in money or other property; and

(b) any amount credited by a company to any of its shareholders as shareholders.

ISSUES FOR THE COURT

Decision of the Tribunal

The main issue considered by the Tribunal was whether the requirements of s 44(1)(a) were met only when a distribution is made wholly out of profits. The reply of the Commissioner states "the appellant's contention that the requirements of s 44(1) are met only when a distribution is made wholly out of profits is rejected by the respondent".[4]

The Commissioner relied upon the decision of the High Court of Australia in *Federal Commissioner of Taxation v Slater Holdings Ltd*[5] ("**Slater Holdings**"). The Commissioner submitted that the distribution to the

shareholders in Slater Holdings "was a distribution of a mass of assets including an amount paid in reduction of capital and an amount of profits" and that *Slater Holdings* is authority for the proposition that the term "profits" will "include capital and revenue profits".[7]

The Slater Holdings case concerned whether a distribution to the taxpayer was assessable. There were three components to the distribution. One-third of the distribution was from the capital profits reserve. One-third of the distribution was clearly made out of profits. The contentious issue was that the remaining one-third of the distribution was from a gift that was made to the company by another member. The distribution was assessable on the basis that it represented an increase in assets and therefore represented a profit.

In *Slater Holdings* Gibbs CJ remarked that "what appears to be implicit in the judgment of Taylor J in *Federal Commissioner of Taxation v Uther*[8] is the suggestion that to come within s 44(1)(a) the distribution must have been made wholly out of profits; it is not enough that there is a distribution of a mass of assets which contains profits". Mason, Brennan, Deane and Dawson JJ agreed with the judgment of the Chief Justice. Mason and Brennan JJ also stated that they agreed with the "reasons" of the Chief Justice.

In the present case, neither the Taxpayer nor the Commissioner referred to these remarks of Gibbs CJ. Consequently there was no argument before the Tribunal as to whether those remarks should be adopted in this case. However, the Tribunal found that they represented the law and that they should be followed. The Tribunal also noted that there appear to be no criticisms of those remarks and that soon after the Slater Holdings decision was handed down Professor Parsons thought that it was open for an unlimited liability company to make a distribution expressed to be partly from share profits and partly from revenue profits.[9]

The Tribunal found that the distribution of Agilent shares was not wholly derived from profits or retained earnings of the Hewlett-Packard Company. Consequently, the Tribunal followed Slater Holdings and held that the distribution of Agilent shares by the Company to the Taxpayer was not taxable because s 44(1)(a) only captured dividends made wholly out of profits. The Tribunal also held that it is not possible to apportion a dividend between that part that is derived from profit and other sources so as to tax part of the dividend.

Issues before the Federal Court

On appeal from the Tribunal, there was no dispute regarding the Tribunal's finding that the distribution of shares was a dividend. Nor was there any dispute about the requirement that, for s 44(1)(a) to apply, the dividend must be wholly out of profits and apportionment is not possible.

The primary issue before the Federal Court was whether the distribution of Agilent shares to shareholders of the Company were paid out of the profits derived from the Company itself. The Court considered "profit" as a business term which referred to the amount of gain made during a certain period.[10] Section 44(1) refers not just to "profits" but to "profits derived". The Court considered that, in light of the earlier case of *Commissioner of Taxation v Sun Alliance Investments Pty Ltd*,[11] "profits derived" needs to be considered together and that the compound nature of "profits derived" suggests that the amount must be revealed by an accounting process.

The Commissioner again submitted to the Court that the retained earnings of the Company were surplus assets, being "the excess of the Company's assets over its liabilities and paid up capital and therefore profits"[12] however, the Taxpayer submitted that in his hands, the shares that he received were of a capital nature.

DECISION

The Federal Court held that because the distribution of shares had been accounted for by a charge to the retained earnings of the Company, the dividend was paid out of profits. In reaching this conclusion the Court carefully considered what would constitute the "profits" of the Company and reasoned that s 44(1) should be approached from the perspective of the Company making the distribution,[13] not from that of the Taxpayer.

Firstly, the Court noted that there have been many attempts to define the term "profit" and in its simplest form it is essentially a business term, "denoting the amount of gain made during a certain period".[14] However, this should only be regarded as a starting point or guide and not of universal application. In this regard, the Court referred to the case of *Evans v Deputy Federal Commissioner of Taxation for South Australia*,[15] which considered the interpretation of profit in considerable detail. In that case, Guinea Gold NL had sold mining leases to New Guinea Goldfields Ltd and received, as part of the consideration for the leases, shares in New Guinea Goldfields Ltd, which it then distributed to its shareholders. In considering the application of the statutory predecessor to s 44(1) to the distributed shares, Rich, Dixon and Evatt JJ said that the fact that the shares contained no profit on the sales of the leases did not mean that they represent capital and not profit of the company. The shares represented surplus assets, that is, assets not required to make good issued share capital. Profit is profit whatever its nature therefore, these surplus assets could still be considered as profit in a non-monetary form.[16]

Secondly, the Court held that the AAT's consideration of the market value of the Agilent shares was not relevant in the consideration of s 44(1),[17] as it said "nothing about whether the distribution was paid out of the profits derived by the [C]ompany making the distribution". Therefore, although the shares may have the indicia of capital in the hands of the Taxpayer, the Court held that this was not relevant because the question must be considered from the position of the Company making the distribution.[18]

Thirdly, the Court held that s 44(1)(a) would treat the dividend as income in the hands of the shareholders "where money or property such as shares is distributed…from 'profits derived' by the distributing company from any source"[19] and there is no limitation upon the source of these profits. Furthermore, the profits may be unconnected with the initial events that gave rise to the distribution of that property or money.

In the Condell case, the Court reasoned that the nature of the receipt could not be assessed by reference to the nature of the assets transferred by the Company to Agilent in the "spin offs". Consequently, the fact that a distribution is of a capital nature does not mean that it did not have its source in profits.[20] Section 44(1) is concerned with how the Company funded the distribution to the Taxpayer.

As a result the Court held that the shares were distributed from the profit, of the company and therefore the Taxpayer should have included the amount of these shares in their assessable income.

COMMENT

This case brings to mind an interesting question: will circumstances exist that will allow a company to make a tax free distribution to shareholders by following the Archer Brothers principle and being careful to debit the amount of the dividend to a capital account? In the 1953 case of *Archer Brothers Pty Ltd v Federal Commissioner of Taxation*[21] the High Court held that:

> "By a proper system of book-keeping the liquidator, in the same way as the accountant of a private company which is a going concern, could so keep his accounts that ... distributions could be made wholly and exclusively out of... particular profits or income ..."[22]

Simply, the principle is that if a liquidator appropriates or sources a particular fund of profit or income in making a distribution (or part of a distribution), that appropriation ordinarily determines the character of the distributed amount for the purposes of s 47 and other provisions of the Income Tax Assessment Acts.

CONCLUSION

The case of *Commissioner of Taxation v Condell* questioned whether the distribution by a company of shares in its subsidiary would be assessable income, and therefore should be included in the recipient shareholder's income tax return. In finding that the distributed shares were in fact assessable income the Federal Court carefully examined the meaning of "profits derived" and analysed the best approach to take when assessing the nature of the distribution. The Court held that the nature of the distribution must be determined from the company's perspective and that it would be determined by a process of proper accounting. The findings of the Court in the Condell case raise important questions for companies in their assessment of the nature of funding for share distributions. They also highlight that shareholders should obtain adequate information about distributions they receive so that they can make the required disclosures to the ATO.

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Reference notes

1 *[2006] FCA 1047.*
2 *Taxation Administration Act 1953 (Cth), s 14ZAF, s 142ZAG.*
3 *The facts of this case occurred in 2000. Section 44(1) was amended in 2001.*
4 *The Taxpayer and Commissioner of Taxation [2005] AATA 538 at [45].*
5 *Federal Commissioner of Taxation v Slater Holdings Ltd (1984) 156 CLR 447; (1984) 56 ALR 306.*
6 *Respondent's Submissions, para. 16*
7 *Respondent's Submissions, para. 18 (d)*
8 *(1965) 112 CLR 630.*
9 *See R W Parsons, Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting (1985) at [2.263].*
10 *See McFarlane v Commissioner of Taxation (1986) 13 FCR 356 at 361.*
11 *[2005] HCA 70.*
12 *Above n 1, at [19].*
13 *Ibid, at [29].*
14 *Above n 10, at 361.*
15 *(1936) 55 CLR 80.*
16 *Ibid, at 101.*
17 *Above n 1, at [24].*
18 *In accordance with the approach taken in Federal Commissioner of Taxation v Uther (1965) 112 CLR 630.*
19 *Above n 1, at [32].*
20 *Above n 1, at [29].*
21 *(1953) 90 CLR 140.*
22 *Ibid, at [13].*