BONUS SHARES, INCOME TAX AND THE FEDERAL COURT: *FEDERAL COMMISSIONER OF TAXATION* v. *JOHN*[1]

(1987) 87 A.T.C. 4713

Introduction

A taxpayer who converts items previously held privately or as a capital asset into a revenue asset[2] of his or her business is entitled either to a tax deduction, if that item becomes trading stock,[3] or to a subtraction when computing any loss or profit on realisation, if that item becomes a revenue asset but not trading stock.[4] In their search for the perfect tax avoidance scheme, taxpayers and their financial advisers have been known to evolve arrangements which are remarkable for their imagination and ingenuity, which are certainly not in accordance with the spirit of the *Income Tax Assessment Act* 1936 (Cth.) (the Act), and yet which manage to remain on just the right side of the legislation so that they cannot properly be declared unlawful. An amendment to the Act outlawing the scheme in question is often an indication of its success.

John concerned the validity of one such scheme and was litigated against a backdrop comprising the decision in *Curran* v. *Federal Commissioner of Taxation*[5] and the *Income Tax Assessment Act* 1936-1977 (Cth.).[6] The tax avoidance arrangement, known as a *Curran* scheme, ran along the following lines: Where a taxpayer deals in shares, they will constitute trading stock and the cost of their acquisition will be taken

---

* The author wishes to thank Mr. Graham Cooper, Lecturer in Law at the University of Sydney, for reading through the drafts, making invaluable suggestions and correcting glaring errors.

[1] (1987) 87 A.T.C. 4713. Hereafter *John*.

[2] Defined by Professor Ross Parsons as an asset the realisation of which is inherent in, or incidental to, the carrying on of a business: R. W. Parsons, *Income Taxation in Australia*, 1985, The Law Book Company Limited, Sydney, p. 155, para. 2.478.

[3] Section 6(1) of the *Income Tax Assessment Act* 1936 (Cth.) includes in its definition of 'trading stock' anything produced, manufactured, acquired or purchased for purposes of manufacture, sale or exchange.

[4] Parsons, *op. cit.*, p. 435, para. 7.24.

[5] (1974) 131 C.L.R. 409. Hereafter *Curran*.

[6] As the activities the subject of litigation in *John* took place in 1977, only the Act as amended to that date is relevant.

into account when ascertaining his or her assessable income. If bonus shares are issued to the taxpayer, they will be deemed to have been purchased, and be perceived as an amount of money credited to the taxpayer by the company, even though that amount may be exempt from income tax. As bonus shares may be *regarded* as having cost, the practical effect of this was to generate a large tax deduction without any actual financial outlay.

The facts of the case

On 14 April 1977 Margaret Ruth John (the taxpayer) and nineteen strangers formed the Malindi Trading Company, a partnership to engage in the business of 'traders in shares, share rights and share options'. Its capital was equally subscribed to by the partners; its losses and profits would be equally divided. A subcommittee was appointed to oversee, with the assistance of an experienced share trading manager, the partnership's share trading activities. The subcommittee met on average twice a week and purchased and sold shares, trades and options on a substantial scale through two stockbrokers. All in all, as Bowen, C.J. observed, 'the enterprise was conducted in a regular, systematic and businesslike manner', the main reason for which was of course to be cloaked in sufficient professionalism to be classed as a *bona fide* share dealer and thereby be eligible to take advantage of the decision in *Curran.*

Malindi Trading then embarked on a series of transactions in accordance with arrangements made before its inception. On 27 April 1977 it acquired for $2,894,150.96 half the shareholdings of six companies (the Compinge group). On the very next day each of the six companies declared dividends out of profits arising from the realisation or sale of assets not acquired for purposes of resale at a profit.[7] The dividend payments were satisfied by issues of bonus shares. On 29 April both the original and the bonus shares in the Compinge group were sold for $2,895,650.65. Under the *Curran* principle the partnership suffered a loss of $2,577,286, the taxpayer's share of which was $128,864, give or take thirty cents. The Federal Commissioner of Taxation (the Commissioner) contended that the partnership had in fact made a small profit.

In her return for the financial year ending 30 June 1977 the taxpayer claimed a deduction for her share of the losses. The Commissioner rejected her claim and instead included in her assessable income an additional $23,436, being dividend income received by the partnership from the issue of bonus shares. The taxpayer appealed.

---

[7] And not part of the taxpayer's assessable income: s. 44(2), which was repealed in 1987. In the interests of accuracy, it should be noted that some of the profits of one of the companies did not fall within this category.

Judgment at first instance: Supreme Court of N.S.W., Administrative Law Division

The issues before Yeldham, J. at first instance[8] were essentially the taxpayer's claim to have suffered a loss or outgoing coming within s. 51 of the Act:[9] dividends not falling within the taxpayer's assessable income under s. 44(2) were declared and satisfied with the issue of bonus shares, the cost of which, applying *Curran*, will be credited to the taxpayer, though they were acquired at no cost to her.

The Commissioner argued that the partnership was not, at the relevant time, trading in shares and therefore did not attract the benefits of s. 51; alternately, the arrangement was struck down by s. 260, which avoids contracts designed to evade tax.

Yeldham, J. found that Malindi Trading was in fact carrying on a share trading business, and that while s. 44(2) applied to the transactions in question, s. 260 did not.

The Commissioner appealed on six grounds, the main ones being:

a. That his Honour erred in finding that Malindi Trading was carrying on a share trading business.
b. Alternately, if his Honour had not erred in paragraph (a) above, he did in finding that the disposal of the Compinge shares formed part of that business.
c. His Honour was mistaken in finding that s. 260 did not apply to the transactions.

Appeal to the Federal Court

In his judgment Bowen, C.J. had to decide whether the Compinge transactions were truly in the course of the business of share trading. His Honour noted that the purchase, bonus issue and resale of the Compinge shares had been arranged before the formation of the partnership and that elaborate steps were taken to ensure that a share trading business was in fact carried on. He then mentioned four cases. *F.A. & A.B. Ltd.* v. *Lutton*[10] and *Thomson* v. *Gurneville Securities Ltd.*[11] both concerned taxpayer companies well established as dealers in shares who entered into tax avoidance arrangements. The House of Lords found in both cases that the transactions in question were not in the course of their business. As Lord Morris of Borth-y-Gest said:

---

[8] 86 A.T.C. 4647.

[9] Section 51 basically provides that all losses or outgoings incurred in gaining or producing assessable income are deductible unless they are of capital or of a capital, private or domestic nature or are incurred in the gaining or production of exempt income.

[10] (1972) A.C. 634.

[11] (1972) A.C. 661.

> It does not follow that because a person is carrying on a trade as a dealer in shares every transaction into which he enters will be a dealing in shares in the course of his trade.[12]

However, Gibbs, C.J. in *Patcorp Investments Ltd.* v. *Federal Commissioner of Taxation*[13] held that the reasoning in the English cases could not be followed in Australia due to differences in the legislation; relevant here was s. 260 in the Act, whose presence did not allow the drawing of inferences to overcome any of its shortcomings. Thus if a taxpayer engages in a device to secure a fiscal advantage which is not expressly dealt with by the Act, the whole case will be determined with strict reference to s. 260.

In *Patcorp* and *Investment & Merchant Finance Corporation Ltd.*[14] taxpayer companies dealing in shares engaged in such tax avoidance devices and were allowed by the High Court to claim deductions for their losses.

Bowen, C.J., looking at the whole of the circumstances of the case before him, found the major flaw in the scheme to be the fact that the partnership was not an established share trading business. Malindi Trading was formed by strangers expressly to take advantage of the decision in *Curran, a fortiori* the fact that the Compinge transactions were arranged before the partnership had been formed. The indecent haste with which the transactions had been entered into—thirteen days after the inception of Malindi Trading—was of some significance to his Honour.

Fox, J. came to the same conclusion, following a line of reasoning akin to Bowen, C.J.'s. He noted that similar transactions were not entered into—'it was a unique activity distinctly outside the mainstream of the alleged business', made possible with the collaboration of the companies concerned.

The taxpayer's submission that trading was the main goal was not accepted because Fox, J. did not feel that this was an instance of a minor item properly taking its character from a larger aspect of which it is a part as there was a 'separate and distinct dealing of major importance.'

In a detailed judgment Beaumont, J. deduced that the Curran scheme was the *raison d'être* of the partnership. It was thus imperative to determine whether Malindi Trading was at the relevant time engaged in the business of share trading.

His Honour quoted passages from the judgments in *Curran* which showed the reasoning of the judges. He gave the *minutiae* of the background of *John*, referring to an affidavit filed by a solicitor who was one of the instigators of the scheme. He summarised the transactions each

---

[12] *Supra* fn. 10, p. 643.

[13] (1976) 76 A.T.C. 4225; 140 C.L.R. 247. Hereafter *Patcorp.*

[14] (1971) 71 A.T.C. 4140; 125 C.L.R. 249. Hereafter 'the *I.M.F.* case'.

individual company in the Compinge group entered into pursuant to the Curran scheme. He included in his judgment the share trading schedule and profit and loss account of the Malindi Trading Company for the period ending 13 June 1977.

After explaining why nothing turned on the fact that the taxpayer entered into the transactions as a member of a partnership rather than as an individual, his Honour stated that many of the Commissioner's complaints were valid, given that:

a. The forward planning reflected the reality of the situation: for the relatively small sum of $5,000, which went to make up the capital of the partnership, each member would obtain a considerable tax deduction.
b. The Compinge transactions were quite apart from those of the share trading business as, *inter alia*, the share trading manager was not involved in, and received no commission in respect of, the Compinge transactions, though he was entitled to a share of all profits earned by the partnership, and because the resale of the Compinge shares was negotiated at the time of their acquisition.

In rejecting the taxpayer's submission that the bonus shares satisfied the statutory definition of 'trading stock' in s. 6(1) of the Act, his Honour distinguished the *I.M.F.* case, *Patcorp, Curran* and *Federal Commissioner of Taxation* v. *Westraders*[15] in that they all involved acknowledged and established share traders. The taxpayer in *John* had not shown that 'the Compinge transactions were embarked upon as an adventure in the nature of trade. It would be more accurate . . . to describe the events of April 1977 as an adventure in the nature of tax minimisation.'[16] He further held that the key to the success of any *Curran* scheme is that the bonus shares be properly classified as trading stock, which was not the case here. The taxpayer's loss was therefore not deductible.

None of the judges found it necessary to deal with the implications of s. 260 as all held that the Compinge transactions were not within the course of the business of share trading.

Conclusion

The main issue in *John* is really one of tax accounting. The Federal Court in general failed to follow accounting principles dictated by logic and common sense; in particular it did not acknowledge, let alone resolve, a problem that has its roots in *Curran*.

In *Curran* the taxpayer, a stockbroker, paid $186,046.48 for two hundred shares (the original shares) in a private company. He was

---

[15] (1979-1980) 80 A.T.C. 4375.
[16] *Supra* fn. 1, p. 4732.

subsequently entitled to a dividend which, to come within the exemption offered by s. 44(2)[17] of the Act, was paid in the form of 191,000 fully paid up shares (the bonus shares) valued at $1 each. On the same day he sold the original shares for $197.52 and the bonus shares for $188,631.60. In his return the taxpayer claimed a deduction of $191,000, being the amount applied to paying up the bonus shares, and $186,046.48, paid out for the original shares, as their disposal resulted in a loss of $188,217.36.[18] The Commissioner argued that the cost to the taxpayer of acquiring the bonus shares was nil; consequently the sale of the shares netted him a profit of $2,782.64.

A majority of the High Court found that the taxpayer had incurred a deductible loss. Barwick, C.J. and Menzies, J. held that, by accepting the bonus shares rather than insisting on, e.g. a cash dividend, the taxpayer could be treated as if he had parted with cash for them, in spite of the fact that the shares were tax-exempt under s. 44(2). Gibbs, J. found that the bonus shares had become trading stock. In order to arrive at a true estimate of the taxpayer's income, the shares had to be assigned an approximate value—in this case their par value. In his dissenting judgment Stephen, J. declared that there was a transfer of value from the original shares to the bonus shares, in respect of which the taxpayer could not be said to have made any payment or incurred any expenditure.

The majority judgment in *Curran* is unusual, to say the least. Barwick, C.J. and Menzies, J. are in effect saying that the paid-up bonus share issue amounted to a declaration of a dividend which, in turn, was applied to pay up in full those selfsame bonus shares.

Gibbs, J. recoursed to 'common understanding and commercial principles' in his judgment. His Honour held that to ascertain the shareholder's true income, the bonus shares must be deemed to be trading stock acquired by the shareholders for business purposes, which is why they must be assigned an approximate value. His Honour's reasoning is wrong, implying as it does that the shareholder expended money in order to obtain income. The bonus shares were not acquired and immediately applied to derive income; rather they arose from a *process* of deriving income. Their sale would result in a gain which, to be calculated, requires the subtraction of some part of the cost of the original shares which gave rise to the bonus shares. His Honour was correct, however, in stating that an acquisition cost of nil must be assigned to the bonus shares.[19]

---

[17] Section 44(2) basically provided that dividends arising from their sale or from revaluation of assets not acquired for resale at a profit are not included in a taxpayer's assessable income.

[18] The loss was the difference between the total purchase price of *all* the shares ($186,046.48 + $191,000) and their sale price ($197.52 + $188,631.60). Of course the taxpayer only paid for the original shares.

[19] This has been made mandatory by statute. Section 6BA, inserted in 1978, retroactive from 16 August 1977, applies where:

In a brave dissent, Stephen, J. pointed out that the issue of bonus shares in such a manner will not, by virtue of s. 44 as interpreted in *Gibb* v. *Federal Commissioner of Taxation*,[20] produce income for the taxpayer. Rather, as in *McRae* v. *Federal Commissioner of Taxation*[21] the effect of such a transaction would be to transfer part of the value of the original shares to the bonus shares. Therefore the shareholder could not be said to have paid for, or incurred any cost or outgoing, in respect of those shares.

In *Curran* Barwick, C.J. in effect rejects his own interpretation of s. 44, for in a joint judgment in *Gibb* his Honour stated:

> We cannot agree that the definition of 'dividend' operates to invest the allotment of bonus shares . . . with the character of income for the purposes of the Act; it does no more than define the meaning to be assigned the word 'dividend' as used in the Act.[22]

The Federal Court in *John* did not seem to have picked up the shortcomings in the *Curran* decision; although *John* concerned a blatant *Curran* scheme, the Federal Court confined itself to debating whether Malindi Trading was engaged in the business of share trading. Given that the partnership had experienced advisers, kept proper records, bought and sold shares through two stockbrokers and generally conducted its business in a manner becoming to a share trading business, it cannot be denied that it *was* a share trading business. Indeed, because to be classified as a share trading business was a vital goal, it stands to reason that Malindi Trading would have done all that it could to be properly classed as such. The partnership could have been relied on to conduct itself with professional share trading business propriety, probably even more consciously so than genuine share traders would have done. Its motives in wishing to be so categorised may not have been of the purest; however, Bowen, C.J. and Fox, J. cannot be right in denying Malindi Trading the status of share trader.

Refreshingly, the judgment of Beaumont, J. did not concentrate on the nature of the business. Instead he focused mainly on the Compinge transactions and the role they played in the partnership's share trading business. He found against the taxpayer, as she had not been able to establish that the Compinge transactions were made in the ordinary course

---

[19] *continued*

(a) A taxpayer is entitled to a dividend in respect of his original shares;
(b) bonus shares are issued; and
(c) the company applies the dividend money as payment or part-payment for the bonus shares by the taxpayer, or otherwise regards the dividend as having been satisfied by the issue of the bonus shares.

Any part of a dividend is discharged in the manner described in paragraph (c) above is not to be regarded as a cost incurred by the taxpayer in acquiring the bonus shares.

[20] (1966) 118 C.L.R. 628. Hereafter *Gibb*.

[21] (1969) 121 C.L.R. 266.

[22] *Supra* fn. 20, p. 635.

of business. However, his line of reasoning leads one no closer to a practical accounting approach.

The Federal Court decision is correct in that it does deny bonus shares the cost of their acquisition. The reasoning, however, must be questioned. None of the judges, even with the benefit of hindsight in the shape of s. 6BA and post-*Curran* furore, attempted to, or made a pretence of attempting to, implement common sense accounting principles and hold that bonus shares must be awarded a value of nil as they have no actual or deemed cost. Instead they seemed to either have missed the boat entirely by enumerating the criteria a share trading business must meet—which criteria seem to include purity of motive—or else were intent on achieving the desired result by a roundabout, and by no means clear, method for reasons of their own.

The following material deals with the consequences a *Curran* scheme will encounter today, the result of which will be quite different, due to changes in the Act since 1974.

Firstly, the situation would be susceptible to the application of s. 6BA, which was inserted in 1978, retroactive from 16 August 1977. The effect is thus: some of the cost of the original shares will be apportioned, at the discretion of the Commissioner of Taxation, to the bonus shares, and any paid or partly paid up amount on the issue of the original shares will be held not to amount to a cost to the taxpayer *except* where the amount paid up has been or will be included in the taxpayer's assessable income: s. 6BA(2), (3) and (4).

Where dividends are paid, a shareholder can no longer claim the exemption from assessable income once offered by s. 44(2), which was repealed in 1987. As outlined in the paragraph above, s. 6BA(2) will not allow the taxpayer a cost for bonus shares if the acquisition is without consideration. Sub-section (4) adds that taxpayers of certain classes *will* be allowed a cost for bonus shares where that cost is or will be included in their assessable income.

Secondly, tax consequences of bonus shares sold will depend on the manner in which they have been utilised. If they are trading stock, s. 160L(3) of the Act applies, and capital gains tax will not be levied on any profits on disposal. For capital gains tax purposes, Part IIIA, Division 8 applies: s. 160ZYF.

Division 8[23] of Part IIIA holds that where the bonus shares are issued in respect of original shares acquired before 20 September 1985, s. 160ZYG deems the acquisition date to be that when the purchaser is first liable to pay; otherwise the bonus shares are deemed to have been acquired simultaneously with the original shares. Section 160ZYH

[23] Part IIIA, Division 8 is relevant only to bonus shares issued with a paid-up value in lieu of a dividend where those shares were issued between 10 December 1986 and 30 June 1987; bonus shares issued after the latter date are covered by Division 8A.

provides that, in relation to shares acquired on or after 19 September 1985, the cost of both the original and the bonus shares will be determined under s. 6BA. Under s. 160ZYH(3) the s. 6BA(3) cost attributed to the bonus shares is deemed to have been paid along with the original shares. Any other amounts attributable to the cost of the bonus shares, i.e. the dividends, are deemed to be paid at the time of payment: s. 160ZYH(4). Where the payment of the dividend is included in the taxpayer's assessable income, and s. 6BA does not exclude the amount of the dividend as the cost of a bonus share, s. 160ZYH(2) deems the taxpayer to have paid that amount at the time the bonus shares are issued to the taxpayer.

Division 8A of Part IIIA applies where the paid-up value of bonus shares issued after 30 June 1987 is a dividend and indicates how the cost base, indexed cost base and reduced cost base to the shareholder shall be determined, i.e. by assuming that any amount paid for the acquisition of the shares is increased by so much of the paid-up value as is a dividend: ss. 160ZYHB and 160ZYHC.

Where the bonus shares are revenue assets, the tax consequences of their disposal will be affected by Division 8A; s. 25, which holds that assessable income is to include gross income; and s. 160ZA(4), which provides for the reduction, within limitations, of the amount of capital gain by the difference between what is or will be included in assessable income due to, and the actual price paid for, the sale of the asset.

It should be noted, however, that some aspects of the accounting evident in *Curran* schemes have been preserved in the Act. For instance, s. 160ZH(9) provides that where a taxpayer acquires from another an asset without consideration; where the consideration given cannot be valued; or where the consideration is greater or less than the market value of the asset at the time of its acquisition and the parties were not dealing at arm's length, the taxpayer shall be deemed to have paid a consideration equal to the market value of the asset. This should not be taken to indicate that *Curran* schemes are sanctioned by legislation; there are occasions such as that described above—which is for the assessment of capital gains and losses for the purposes of capital gains tax—where items obtained in such a manner must be given an acquisition cost, so that the principle that gifts should not be taxed is preserved.

John is currently the subject of an appeal to the High Court. It is hoped that the High Court will take this opportunity to adopt a direct, common sense approach to *John* and hold that as the bonus shares were acquired at nil cost, the taxpayer is not entitled to any deductions, thereby finally laying to rest the ghost of *Curran*.

CHARLES WONG
Fourth Year Student