TAXATION OF GIFTS OF CAPITAL AND GIFTS OF INCOME*

I

The increases in all rates of taxation, particularly income tax, in the last generation have resulted in the devising of many new and ingenious schemes to lessen the total burden of revenue exactions. Once upon a time many of these schemes would have been broadly characterised as intended to defeat the revenue authorities, but nice distinctions have been relied upon to explain that they entail the avoidance and not the evasion of tax, and in more recent times we have come to describe them, somewhat euphemistically perhaps, as "tax planning".

It was obvious to the legislature that as soon as income tax rates rose sharply it would be necessary to limit a taxpayer's freedom to divest himself of income earning assets for the purpose of avoiding the impact of the sharply increasing rates of our progressive income tax scale. Thus it was that gift duty was imposed in 1941 by the Gift Duty Assessment Act of that year, but it is clear that, compared with income tax, the burden of gift duty is not a serious deterrent to tax planning schemes which entail the disposition of income earning assets without full consideration. In illustration, the gift duty on a disposition without consideration of $10,000 worth of stock and shares, yielding say 5 per cent, would be only $300, but if the dividends were included in the donor's taxable income the tax attributable to them would be (i) $187 on a total taxable income of $5000 (total tax $1140), (ii) $264 on a total taxable income of $10,000 (total tax $3487), or (iii) $308 on a total taxable income of $20,000 (total tax $9465). In other words provided the donor lives more than three years, he can in most cases save the amount of gift duty paid in a comparatively short period by means of the reduced levy of income tax, and presumably a minimum amount of income tax would be payable by the donee on the income from the assets given away; donees are always selected with this qualification clearly in view. If the donor should die within three years other questions arise because of the impact of death and estate duties, but for present purposes these can be disregarded.

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Whilst the device of transferring income producing assets to a relative in this fashion or creating some trust of those assets in a way which would avoid aggregation of the income therefrom with some other person's income seems to be both simple and effective, it is subject to some major problems; the chief of these are, first, that a donor who thinks of saving income tax is seldom philosophically disposed to paying gift duty and hence will be anxious to seek a way of avoiding liability to that impost as well; and, second, that many donors are not happy at the prospect of surrendering dominion over their assets absolutely and wish to reserve some control over them by such means as the reservation of a power to dispose of the capital or the restriction of the gift to the income only or perhaps to the income for some period of years only.

These problems are illustrated by several leading cases which can be conveniently collected into two groups for the purpose of discussion. The first group[1] concerns schemes or transactions which were adopted to secure the transfer of assets without incurring liability for gift duty and two aspects of such schemes will be mentioned; the second group[2] relates to dispositions of some right to future income without a transfer of the capital assets from which the income is derived.

II

The definition of "gift" in s.4 of the Gift Duty Assessment Act 1941-1963 has been cast in wide terms designed to include every means by which property can be divested inter vivos from a person without full consideration. That definition adopts "disposition of property" as the critical element of a gift, and the first five statutory examples set out in the definition embrace every conceivable 'type of transaction by which property is transferred from one person to another'.[3] The definition goes further and in paragraph (f) includes transactions which do not involve a disposition of property at all; such transactions are those 'entered into by any person with intent thereby to diminish directly or indirectly the value of his own property and increase the value of the

1 Fadden v. Federal Commissioner of Taxation, (1945) 70 C.L.R. 555; Grimwade v. Federal Commissioner of Taxation, (1949) 78 C.L.R. 119; Birks v. Federal Commissioner of Taxation, (1953) 10 A.T.D. 266; Gorton v. Federal Commissioner of Taxation, (1965) 113 C.L.R. 604; McGain v. Federal Commissioner of Taxation, (1965) 13 A.T.D. 556, (1966) 14 A.T.D. 190.

2 Norman v. Federal Commissioner of Taxation, (1963) 109 C.L.R. 9; Shepherd v. Federal Commissioner of Taxation, (1965) 113 C.L.R. 385.

3 Per Barwick C.J. and Taylor J. in Gorton v. Federal Commissioner of Taxation, (1965) 113 C.L.R. 604, 622.

property of any other person'. In *Grimwade's* case[4] a scheme whereby the rights attached to shares in a company were altered without the assent of a shareholder so as to diminish the value of those shares and increase the value of other shares in the company, was held not to be a transaction falling within the scope of this definition; but in *Birk's* case[5] the renunciation of rights to the issue of new shares to shareholders in an existing company with the consequence that those shares were allotted to other shareholders was held to constitute a transaction liable to gift duty. In *Gorton's* case[6] a scheme for the disposition of assets to a newly formed company in return for ordinary shares and the conversion of those shares at a general meeting into cumulative preference shares was held not to constitute a transaction which would be a disposition of property by the ordinary shareholder under the Gift Duty Assessment Act, notwithstanding that the practical effect of the various events and steps was to reduce the value of the ordinary shares by a considerable sum and to increase the value of shares later issued to other shareholders by a similar amount.

The intervention of some company structure as a means of rearranging the ownership of assets or varying the values of shares of different classes would appear, in the light of *Grimwade's* case and *Gorton's* case, to offer great potentialities. It is open to doubt, however, whether these potentialities may not be a little speculative. *Grimwade's* case has been criticised on occasions, and observations of two of the Judges in that case were disapproved in *Gorton's* case which itself presents some unsatisfactory aspects. In the first place, it was virtually a decision in which the members of the Court were equally divided, because McTiernan J., hearing the appeal as a single Judge, held that there was a dutiable gift, but on appeal the Full Court reversed this conclusion by a majority, Barwick C.J. and Taylor J., Windeyer J. dissenting. The basis upon which the majority held that there was no transaction is well known to most tax planners: the company in which the relevant shares were held was to be regarded as an agent neither of the so-called donor nor of the so-called donee, and the diminution in the value of the former's shares did not coincide with an increase in the value of the shares of other shareholders. This conclusion was criticised in trenchant terms in the dissenting judgment of Windeyer J. who referred to the 'unreality and formalism' of the

4 (1949) 78 C.L.R. 119.
5 (1953) 10 A.T.D. 266.
6 (1965) 113 C.L.R. 604.

scheme. His Honour took a practical view of the series of events and said:

> If as a result of a transaction one person is worse off and another person better off than they would have been if the transaction had not occurred, and if the transaction was entered into with intent to produce this result, then I consider the statutory description is satisfied . . . . The Act does not require that the diminution of the one and the increase of the other must necessarily correspond in amount.[7]

I would personally be disposed to adopt the views of McTiernan J. and Windeyer J. as more appropriately giving effect to the legislative intention of the Gift Duty Assessment Act, but perhaps it is not of much consequence, whilst the High Court's decision stands, to speculate upon this question. Two comments, however, are of relevance to the tax planner, who proceeds on the basis that the decision of the majority correctly expounds the law. The first of these is that a decision which is so finely balanced may not prove a very reliable foundation for a tax planning scheme dealing with property of substantial value; even if an identity of circumstance and event could be reproduced and the same result were reached by the High Court, one could never be sure that an appeal to the Privy Council would not produce a different result, and tax planning which depends upon speculation of what might happen in the event of an appeal from a decision on which the Judges are equally divided is a little more like wagering than tax planning. Secondly, the conclusion reached by the majority of the High Court does not eliminate all questions of gift duty because it is still open to debate whether, if there was no gift by the so-called donor whose shares were devalued, there was not a gift by the company to the shareholders who, in return for the payment of nominal subscription money, suddenly found themselves possessed of shares of considerable value.[8] There seems to be no reason why the issue of shares by a company at less than full value in such circumstances should not come within the definition of "gift" in the Gift Duty Assessment Act, since it is expressly included in paragraph (a) of the definition "disposition of property". Companies are bound by that Act equally with individuals and, except where some commercial advantage ensues contemporaneously with an allotment of shares, it is difficult to see why share issues for less than full value should not be liable to gift duty.

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7 Id. at 626; see also his comments in Peate v. Federal Commissioner of Taxation, (1964) 111 C.L.R. 443, 478-480.

8 This matter was mentioned by Windeyer J. in Gorton's case, (1965) 113 C.L.R. 604, 627.

III

The second aspect of schemes which have been adopted to avoid gift duty concerns questions of value, for once a "disposition of property" has been effected, the definition of "gift" requires that attention be paid to the character of any consideration passing at the time of the disposition. In *Fadden's* case[9] a transfer of shares in return for a promise to pay the full value of those shares was held not to constitute a gift even though the promise, which was regarded as immediately enforceable, had not in fact been enforced for some three years. The assumption has often been made in consequence of this decision that a transfer of shares or of other income producing assets will not constitute a gift if the transferee promises to pay the full value of the shares, regardless of what postponement of payment is agreed upon; and on occasions this has been taken to the lengths of providing that the value of the assets should be paid to the transferor out of future dividends or other income to be derived from the property transferred.

The recent decision of the High Court in *McGain's* case[10] shows that these assumptions are unfounded and that, in order to determine whether a disposition of this character constitutes a "gift", it is essential to consider the precise terms of any promise to pay the full value of the property which is the subject of the disposition. In *McGain's* case, for example, gifts were held to have been made where land, buildings and other assets were transferred by several transactions for amounts representing their actual value but on terms that payment in each case was to be made by a small deposit and equal annual instalments extending over a period of fifty years without interest. Of such promises Taylor J. said:

> To my mind it is obvious that the value of a contractual right to the payment at some remote future time of a specified sum is not the specified sum itself; it is a lesser sum which can be and commonly is ascertained by the application of an appropriate discount rate.[11]

The Full Court said:

> The inadequacy here arises from the very terms of the promise itself—that is that the present value of the property, less the cash payments, should be paid over fifty years without interest.[12]

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9 (1945) 70 C.L.R. 555.
10 (1965) 13 A.T.D. 556, (1966) 14 A.T.D. 190.
11 (1965) 13 A.T.D. 556, 561.
12 (1966) 14 A.T.D. 190, 193.

The existence of inflationary trends may furnish a sound reason for divesting income producing assets from one person in return for a fixed sum of money whether payable presently or in the future, but *McGain's* case illustrates one of the main hazards which the Gift Duty Assessment Act presents to such schemes. That hazard can be overcome either by specifying a rate of interest which is realistic or by increasing the capital sum which is agreed to be paid to compensate for deferred payment, though over a period of fifty years the increase in the capital sum would have to be quite substantial.[13] It is open to question to what extent assets can be transferred in return for a promise to pay their value on demand, particularly as the failure to make a demand for a period of six years could result in the debt becoming statute-barred, and this would itself be a gift under paragraph (d) of the definition of "disposition of property" and s.4(2) of the Act.

IV

I pass now to consider those cases in which a taxpayer has attempted to divest himself of income either for some limited period of time or without disposing also of the capital assets from which the income is derived, and in doing so any question of gift duty will be disregarded.

The practice of alienating income for short periods without a transfer of the assets producing that income was the subject of a specific recommendation by the Ligertwood Committee in 1961,[14] and subsequently ss.102A-102C were inserted in the Income Tax Assessment Act to deal with such practices, though in a fashion different from that recommended by the Committee. Briefly, the effect of these sections is to treat transfers of income for less than seven years as ineffective to pass the right to the income which is to be aggregated with the transferor's assessable income but, subject to their tenour, transfers for more than seven years will be effective to vest the income in the transferee.

Whilst these amendments clarify the position in many respects they are limited to assignments of income derived from property, and it will still be necessary to consider what other forms of income are capable of assignment. It was accepted by the Ligertwood Committee that 'income from salary or wages cannot be alienated for taxation

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13 See the calculation made by the Commissioner in the adjustment sheet set out in (1965) 13 A.T.D. 559.

14 See the Report of the Committee, para. 721.

purposes',[15] but there may nevertheless be categories of future income or remuneration payable under a contract or even under statute which can be validly assigned unless assignment is prohibited.[16] A wealth of light is thrown on these by the decisions in *Norman's* case[17] and *Shepherd's* case.[18]

The former of these decisions is notable for the erudite exposition of the equitable and legal principles of assignability contained in Windeyer J.'s judgment which received general approval from Dixon C.J. and subsequently, in a later decision, from Kitto J.[19] The case itself, however, related to the assignability for a period of one income tax year only of (a) the interest to accrue on a loan made by the assignor which was repayable on demand, and (b) the dividends to be declared upon shares which were registered in the assignor's name during the relevant year. Although the High Court held that the assignments were ineffective to divest the assignor of the interest and dividends for that year so that they remained assessable income in his hands, the substantial reason advanced for this conclusion was that future interest on the loan and future undeclared dividends on the shares were both in the nature of mere expectancies or possibilities which could not be assigned without consideration. This omission, however, could have been rectified by the importation of some consideration which, provided it is not illusory, need not have been adequate to the value of the anticipated future income.

This decision is to be contrasted with *Shepherd's* case, which related to the assignability by way of gift of a proportion of the royalties to be derived during a term of three years by the assignor from a licence to manufacture certain articles for which he held letters patent. The High Court rejected the contention that the subject matter of the assignment was a mere expectancy or possibility and, distinguishing *Norman's* case, held that the stated proportion of the royalties was validly transferred to the assignees so as to be excluded from the assignor's assessable income.

Both *Norman's* case and *Shepherd's* case fell to be decided in accordance with law as it existed prior to the addition of sections

15 Id., para. 715.

16 Compare the position of payments under the Wool Realization Scheme: Maslen v. Perpetual Executors Trustees and Agency Co. Ltd., (1950) 82 C.L.R. 101, 110 and 121.

17 (1963) 109 C.L.R. 9.

18 (1965) 113 C.L.R. 385.

19 In Shepherd's case, (1965) 113 C.L.R. 385, 393-397.

102A-102C to the Act in 1964. Apart from the fact already adverted to that there may be categories of income arising under contract or statute which would not come within those provisions because it is not 'income that will or may be derived from property', there are other limitations to their operation. For example, section 102B(2) excludes transfers of income where (a) the transferor was not the owner of the property from which the income was derived, or (b) the property itself has been transferred to someone else. It would seem, therefore, that a life tenant under a will or settlement may still be able to assign the future income for a term less than seven years without section 102B becoming applicable and that a divesting of income producing property in favour of a third person, even with the reservation of some power of appointment, may likewise enable a subsequent transfer of future income for less than seven years to be validly effected.

The adoption of such devices and many more refinements which can be conceived may, however, end in disaster because of the annihilating provisions of section 260 of the Income Tax Assessment Act.[20] This is no place to consider the scope of that section, which has been the subject of many recent decisions in both the High Court and the Privy Council, but it is significant that Menzies J. in *Norman's* case thought it proper to reserve expressly any consideration of the effect of section 260 upon the assignments which were challenged in that case.[21] It is clear, of course, that if section 260 operated to annihilate a transfer of future income that income would, by the operation of section 19 of the Act, be regarded as part of the assessable income of the transferor; the judgments in *Peate v. The Federal Commissioner of Taxation*[22] leave little doubt that this would be the case.

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20 The section reads as follows:

Every contract, agreement or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall so far as it has or purports to have the purpose or affect of in any way, directly or indirectly—

(a) altering the incidence of any income tax;

(b) relieving any person from liability to pay any income tax or make any return;

(c) defeating, evading or avoiding any duty or liability imposed on any person by this Act; or

(d) preventing the operation of this Act in any respect,

be absolutely void, as against the Commissioner, or in regard to any proceeding under this Act, but without prejudice to such validity as it may have in any other respect or for any other purpose.

21 (1963) 109 C.L.R. 9, 23.

22 (1964) 111 C.L.R. 443.

V

By way of conclusion it is pertinent to remind you that the situations I have chosen to discuss arise in the main from the impact of income tax, and that "income splitting" is seen as offering the simplest means whereby the burden of income tax can be reduced because the scale of income tax rates is progressive. It may be that the notion of progressive income tax rates is too deeply ingrained in our economic system and our political philosophies to be lightly discarded, but I have often thought that a flat rate of tax or a minimum number of grades of tax might make many tax planning schemes quite unnecessary and result in greater simplicity in the administration of the income tax legislation. In illustration, it is worth pondering how complex and different the structure of our large industrial and commercial enterprises could become if company tax increased progressively at the same rates as are levied on the incomes of individuals. And it is well known that the flat rates of company tax and the myriad arrangements which can be effected in the dividend rights and share structure of a company are inducing more and more individuals to vest their assets, businesses, homes and even their professional enterprises and skills in proprietary companies. As Windeyer J. said in *Peate's* case:

> A proprietary company, controlled by one man, has today taken the place of John Roe, William Roe and others, who at an earlier time came out of inkwells in attorney's offices to do acts in the law of which law-abiding citizens might have the benefit while avoiding disadvantageous consequences. By incantations by typewriter, the obtaining of two signatures, payment of fees and compliance with formalities for registration, a company emerges. It is a new legal entity, a person in the eye of the law. Perhaps it were better in some cases to say a legal *persona,* for the Latin word in one of its senses mean a mask: *Eripitur persona, manet res.*[23]

The functions which these new legal personae may be made to perform are legion, and the potentialities for tax planning which they afford are almost without limit.

For practical purposes it must be conceded that, with the guidance of the many decisions of the courts which have declared the law authoritatively, the paths which a successful tax scheme must follow in order to be successful are fairly well defined, and whilst I am no political prophet it seems reasonable to assume that, short of another comprehensive enquiry such as was conducted by the Ligertwood

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[23] Id. at 478.

Committee, it is unlikely that there will be any fundamental revision of the basis of income taxation for many years to come. The operation of section 260 of the Income Tax Assessment Act and the possibility that American decisions may be invoked to lift the veil of corporate personality may therefore prove to be the only clouds on the wide horizon of the tax planner.

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