

Defining Ordinary Income after *McNeil*

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Abstract

The High Court decision in *FCT v McNeil* (2007 HCA 5) decided that the market value of put options issued to shareholders over their shares in the company, as a mechanism for carrying out a share buy-back, was ordinary income at the time of issue in the hands of those shareholders who chose not to participate. The jurisprudential basis on which this decision was made is not manifestly clear, but the impact of the decision has the potential to set aside the traditional distinction which has been made between receipts which are on revenue account and those which are on capital account. This article seeks to establish that the approach which is manifest in *McNeil* is out of step with established principles and that the High Court provided no convincing reasons for setting aside the principles which have traditionally been accepted as determining which receipts are to be regarded as being on revenue account. This article seeks to show that the approach which is manifest in *McNeil* was also apparent in the earlier majority High Court decision in *FCT v Montgomery* (1998) 198 CLR 639, although *McNeil* does not appear to have relied on *Montgomery*. However, the authors seek to establish that the principles which can be derived from the majority decision in *Montgomery* are not sustainable. The problem which emanates from *Montgomery* is identified and a return to the position which existed prior to *Montgomery* is advocated as the solution to the problem which now exists. It is suggested that the legislative response of creating different tax treatment for call and put options is a disappointing response, with a preferable approach being the restoration of the previous tax treatment, which had been the undertaking given to industry and capital markets by the government.

1. INTRODUCTION

It might have been anticipated that by the beginning of the 21st century the principles used to determine what constitutes income according to ordinary concepts for the purposes of the *Income Tax Assessment Acts* 1936 and 1997 (Cwlth), would be clear and settled. Regrettably, that is not so.¹ The confusion which has arisen is largely attributable to recent law making by the High Court. *Federal Commissioner of Taxation* (“FCT”) v *Montgomery*,² decided in 1999, is an early manifestation of the High Court’s attempt to set aside established principles. *FCT v McNeil*³ is the latest. *McNeil* decided that the market value of put options issued to shareholders of St George Bank Ltd (“SGL”) over their shares in SGL, as a mechanism for carrying out a share buy-back, was assessable income on revenue account at the time of issue, in the hands of those shareholders who chose not to participate.

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¹ For an historical analysis of the development of the concept of income and the development of income tax principles in Australia see Slater A H, ‘The Nature of Income’, (2007) 36 *AT Rev* 138.

² (1999) 198 CLR 639.

³ 2007 HCA 5.

The impact of the High Court's decision was not properly appreciated until the Australian Taxation Office ("ATO") subsequently issued a draft class ruling to Hutchison Telecommunications⁴ advising that it would treat the value of a proposed issue to shareholders of renounceable rights in the issuing company as assessable income on revenue account in the hands of shareholders, from the date on which the rights were issued. This ruling meant that shareholders would be taxed on the value of the rights when they were issued, rather than on the net proceeds of sale when they were sold. In other words, the ATO was seeking to impose tax on unrealised, or paper profits on rights issues, relying on its success in relation to the SGL buy-back to extend the impact of *McNeil*'s case.

This led to calls for immediate action from the Federal government to reverse the controversial ruling, because of the harm it would do to capital markets in Australia.⁵

To address the uncertainty created in capital markets by the decision in *McNeil*, the Government has legislated specific tax treatment for call options and put options.⁶ In relation to call options, whereby a company or trustee issues rights to shareholders or unitholders to buy additional shares or units, the legislative provisions affirm existing law that no amount would be included in assessable income of the shareholder, or unitholder, on issue of the rights, with the market value of the rights being non-assessable non-exempt income. Rather, a capital gain or loss would be made when a CGT event happens to the rights. This provision, then, maintains the capital/income distinction with any gain being a capital amount and not assessable income.

However, for put options, whereby a company issues shareholders with rights to sell their shares back to the company, the provisions effectively enshrine in legislation the decision in *McNeil*. The provisions operate to include the market value of the put options in assessable income, and then act to prevent double taxation by including any assessable amount in the cost base of the rights or the shares disposed of as a result of exercising the right. The inclusion of any assessable amount in the cost base would prevent the amount being taxed twice, as income when the option is issued, and as capital when a CGT event happens to the rights or options.

However, it would appear that the concerns of industry and the markets following the decision in *McNeil* have not been addressed. Rather than restoring the law to the pre-*McNeil* position, the legislation has enshrined the *McNeil* decision, allowing for the taxation of an unrealised paper profit as assessable ordinary income at the time the rights are issued.

2. OBJECTIVE

This article suggests that the approach which is manifest in the majority decision of the High Court in *McNeil*,⁷ and which has now been adopted in legislation, is out of step with established principles and authority for determining what constitutes

⁴ CR 2007/42.

⁵ The Editor, *The Australian Financial Review*, 15 May 2007, p 62; Goode C, Chairman, Australia and New Zealand Banking Group Ltd, *The Australian Financial Review*, 1 June 2007, p11.

⁶ *Tax Laws Amendment (2008 Measures No 3) Act 2008* Schedule 1

⁷ Gummow ACJ, Hayne, Heydon and Crennan JJ; Callinan J dissenting.

ordinary income. Furthermore, it is argued that no convincing reasons were apparent for setting aside time-honoured principles, and that there is arguably an internal tension in the reasoning of the majority decision in characterising the nature of the put option.

While there has been commentary on the practicalities and potential impact of the decision in *McNeil*,⁸ this analysis seeks to identify and examine in greater detail the jurisprudential underpinnings of the judicial reasoning underlying the majority High Court decision, and demonstrate how this reasoning accords with, or diverges from, established principles and decided authority that existed prior to the *McNeil* decision.

This examination is carried out by reference to the principles which have underpinned the determination of ordinary income for many generations. These principles are examined in the context of property derived from shares – since *McNeil* dealt with property arising from shares – with a view to establishing when such receipts have been regarded as being on revenue account and when they have been regarded as being on capital account. Consideration is also given to the apparent unsatisfactory nature of the decision in *Montgomery*, which appears to be the watershed for the new approach to the characterisation of receipts.

While it may be difficult to discern the precise jurisprudential basis on which *McNeil* was decided, the analysis examines the reasoning in the decision, in the light of the existing authorities discussed, with a view to highlighting its potential shortcomings. From this examination it will emerge that the decision has potentially effectively prescribed that anything which comes into the hands of a taxpayer can be regarded as being ordinary income. This is a situation which would effectively set aside the distinction between receipts on revenue account and those which are on capital account.

Given the suggestion that the decision of the majority, and the ensuing legislation, have overturned existing principles as to the nature and identification of income, it is argued that attention needs to be given to re-establishing the principles that establish and maintain the revenue/capital dichotomy, since there are different taxing regimes in Australia for each category of receipt.

3. THE ESSENCE OF *MCNEIL*'S CASE

The *McNeil* case arose out of an on-market share buy-back undertaken by SGL, whereby it sought to buy back 5% of its share capital. The share buy-back was structured through a series of interconnected unilateral and bipartite documents which had the effect of creating rights in the hands of the shareholders, with the rights enforceable against the parties to the transaction.

To effectuate the buy-back SGL created put options (called sell-back rights in the documentation) over its share capital, whereby SGL undertook to buy back any shares which shareholders required SGL to acquire pursuant to exercising their rights as grantee under the put option. The number of sell-back rights to which each

⁸ See for example Ian Stanley, "As of right – *McNeil*'s Case", *Tax Specialist* 2007, 10(4).

shareholder was entitled was proportional to the member's shareholding. The sell-back rights were issued without consideration. The sell-back rights were not granted to the shareholders directly. Instead, they were granted in favour of a trustee company, which undertook to hold the number of rights to which shareholders were entitled on separate trusts for the absolute benefit of each shareholder.

If a shareholder wished to sell into the share buy-back, the shareholder was required to give notice to the trustee to vest the sell-back rights in the shareholder, so that the shareholder could then exercise the put option and require SGL to buy back the requisite number of SGL shares. SGL had assumed an obligation to do so under the interconnected documentation.

If a shareholder did not wish to sell shares, then the shareholder was not required to do anything. But in this situation the trustee company was obliged to take steps to require a merchant bank to sell those sell-back rights and account to the shareholder for the proceeds of sale (if any). The merchant bank was under a similar duty to account for the proceeds of sale, although this obligation could be satisfied by transferring the money to SGL, which would then account to the shareholder.

The taxpayer was one of those shareholders who took no steps to exercise the sell-back rights. As a result, the trustee required the merchant bank to sell her rights. The merchant bank did so. The trustee then accounted to the taxpayer for her proportional share of the net proceeds of sale arising from the sale of all of the rights of shareholders who did not participate in the buy-back. The amount received by the taxpayer from the sale proceeds was actually more than the price quoted on the Australian Stock Exchange ("ASX") on the date of the grant, but it was accepted that the difference between that price and the total amount received was as an assessable capital gain. The SGL share buy-back was funded ultimately from the share capital of SGL.

The decision of the High Court, which was a majority decision, was both cryptic and strained. The underlying reason for the Court's decision can be discerned only from the fact that the majority accepted the FCT's primary submission. That submission was to the effect that the grant of the sell-back right (put option) by SGL to the shareholder/taxpayer constituted the derivation of income according to ordinary concepts by the shareholder/taxpayer. In accepting this submission it followed that the grant of the put option was regarded as a revenue receipt in the hands of the shareholder, derived on the same date and having a value equal to the ASX volume weighted net selling price of sell-back rights on that date.

Callinan J dissented. His Honour did not consider that the grant of the put option constituted the receipt of money, or any entitlement to receive money by the taxpayer, let alone income. It was a capital item which arose out of the reduction of capital carried out by SGL and was taxable only if the capital gains tax regime applied, which, in his view, was not triggered in these circumstances. On the question of value, even if the rights had been taxable on revenue account, the judge did not consider that the price of the rights quoted on the ASX accurately reflected their value, since that price inherently reflected the quoted price of the shares, which was lower than the price SGL was offering. Nor, in his view, could the price be accurate, when it might

be based on perceptions which were later found to be incorrect, or dependent on tax consequences which were not then known.

The two limbs of the majority decision appear to be that:

- 1) a determination about whether a receipt has the character of the derivation of income depends upon its quality in the hands of the recipient, not the character of the expenditure by the other party.
- 2) a determination about whether the gain arising from shares has an income characterisation depends on whether the gain has been severed from the shares.⁹

While these two limbs will be considered separately, they inevitably converge.

4. IMPACT OF *MCNEIL*'S CASE

Rights issues have been a popular capital raising method in Australia. For the period 2002-06 it has been estimated that some \$26 billion had been raised in this way.¹⁰ The ruling was seen as jeopardising this market both at the institutional and individual level, because of adverse tax consequences. As a response to the criticism which erupted, the Minister for Revenue announced that the pre *McNeil* position for taxing rights issues would be restored, with effect from the 2001-02 income year – as a tax compliance initiative.¹¹ The long standing position of treating rights issues as being on capital account would be maintained and changes to the capital gains tax rules would be made.

Despite the assurances of the then Minister, the legislation enacted does not fully restore the pre-*McNeil* position of rights issues being treated as on capital account. As noted above, in relation to rights in the form of call options, the legislation provides that on satisfying a number of conditions, the market value of the call option will be treated as non-assessable non-exempt income.¹² The conditions effectively require that:

- rights are issued only to taxpayers owning original interests of shares or units at the time the rights are issued,
- rights are issued to the taxpayer because of the ownership of the original interests, and
- the original interests are on capital account and not revenue account.

However, in relation to rights in the form of a put option, the legislation effectively enshrines the *McNeil* decision, rather than restores the previous treatment of such rights being on capital account. The legislation accepts that the market value of the rights at the time of issue will be assessable income, and then operates to prevent double taxation by including this assessable amount in the cost base of the rights or the shares disposed of as a result of exercising the right.

⁹ *McNeil* at paras 20 and 21.

¹⁰ *The Australian Financial Review*, 27 June 2007, p4.

¹¹ *Taxation of Rights issues* – Press Release, Minister for Revenue and Assistant Treasurer, 26 June 2007.

¹² New s 59-40 ITAA 1997

The Second Reading Speech accompanying the Bill suggested that the new amendments "... will overcome the impact of the High Court of Australia's decision in *Commissioner of Taxation v McNeil*."¹³ This suggestion would appear to be in accord with the previous announcement that the legislation proposed would reverse the effect of the decision in *McNeil*, and restore the previously existing law.

The legislation, however, does not restore the previous law, but rather it operates to enshrine the *McNeil* decision in legislation, thus changing the long accepted position that the gains from rights or options would be a matter of capital, and not assessable as ordinary income at the time of issue. Further, the legislation now provides separate and distinct treatment for call options and put options, which can only operate to add complexity to an already complex area of law.

The Explanatory Memorandum accompanying the Bill provides no discussion or explanation as to why there should be divergent treatment of rights represented by call options and rights represented by put options. Also there is no examination or explanation as to why the *McNeil* decision should be adopted. It may have been expected that if the legislation were to codify the law from the *McNeil* case there would have been some degree of analysis of the principles and authority which the legislation was enacting. As a result of the legislation, there is now the added complexity of different taxation treatment for rights depending on the nature of the right, an outcome which, it is suggested, can hardly be seen as optimal.

Given the uncertainty created in markets by the decision in *McNeil*, the dearth of reasoning in the *McNeil* decision itself, and the fact that rather than restoring the previous position, the legislation enshrines the *McNeil* decision in legislation, the outcome from this Bill and enacting legislation can only be seen as a less than satisfactory outcome for industry and the operation of the capital markets.

In analysing the suggested shortcomings in the majority decision in *McNeil*, the paper examines the principles underlying the concept of ordinary income, and the authorities that have led to the establishment and endorsement of these principles. The analysis then considers the decision in *McNeil*, highlighting the suggestion that the majority have diverged from established principle without having clearly enunciated any new principle, and highlighting the apparent tension within the majority decision. Again this analysis draws upon long established authority as to the rights carried by a share, with consideration of the delineation between payments which represent a return on capital as distinct from a return of capital.

5. WHAT IS ORDINARY INCOME?

The determination of what constitutes income goes to the very heart of tax law. It is of fundamental importance and yet there is nothing determinative which characterises just what income is for tax purposes. Even the *Income Tax Assessment Act 1997* (Cwlth) ("ITAA 1997") provides little in the way of assistance.

Section 6-5(2) ITAA 1997 provides that, for Australian residents, assessable (or taxable) income includes income according to ordinary concepts from any source, so

¹³ *Second Reading Speech* to the Tax Laws Amendment (2008 Measures No 3) Bill 2008.

long as the income has been derived by the taxpayer. Then s6-5(4) goes on to provide an extension to the concept of derivation, in that a taxpayer is taken to have received income according to ordinary concepts as soon as it is applied or dealt with on the taxpayer's behalf, or as the taxpayer directs.

So first of all, the ITAA 1997 requires a receipt to be identified as income and then once identified, a determination needs to be made about whether it has been derived by the relevant taxpayer. There are two steps in this process, not one. Income cannot be derived until a receipt of an income nature has been identified. The ITAA 1997 does not define income, other than to provide that it includes income according to ordinary concepts. Nor does the ITAA 1997 define the concept of income according to ordinary concepts, or the concept of derivation.

The leading statement of principle regarding the nature of income is to be found in the judgment of Jordan CJ in *Scott v Commissioner of Taxation*¹⁴:

*The word income is not a term of art, and what forms of receipt are comprehended within it, and what principles are to be applied to ascertain how much of those receipts ought to be treated as income, must be determined in accordance with the ordinary concepts and usages of mankind....*¹⁵

In considering the meaning of income according to the “ordinary concepts and usages of mankind,” the courts have not adopted the economist's broad view that income is an accretion to economic or spending power. This was the view advocated by the leading American economist Henry Simons in the late 1930's in his text *Personal Income Taxation*¹⁶. It was also reflected in what Lord Kaldor said in his dissent to the United Kingdom Royal Commission's *Final Report on the Taxation of Profits and Income, 1955*.¹⁷

There have been more recent attempts to popularise economic concepts of income. In 1998 the *Review of Business Taxation* considered that economic income would provide a better base for taxing, as the same economic transaction should not be subject to different taxation treatment because of differences in form. But this view has not been embraced by the courts, although there have been some recent moves in this direction taken by Parliament.¹⁸

In considering what may be regarded as income according to the “ordinary concepts and usages of mankind,” Professor R Parsons, in his definitive text, *Income Taxation in Australia*¹⁹, identified some propositions which provide the hallmarks of income according to ordinary concepts.

Parsons considered that the concept of income denotes two component parts. First, there must be a gain by the taxpayer²⁰. Second, once a gain has been established, there

¹⁴ (1935) NSW 215.

¹⁵ Ibid p219.

¹⁶ H Simons, *Personal Income Taxation*, (1938) University of Chicago Press, Chicago.

¹⁷ 1955, Cmd. 9474.

¹⁸ Div 974 ITAA 1997.

¹⁹ Parsons R, *Income Taxation in Australia*, (1985) The Law Book Co.

²⁰ Ibid p26, proposition 4.

must be something which comes in²¹. This latter component relates to the concept of derivation. However, there cannot be a derivation until a gain with an income character has been identified.

In his text Parsons turns to make a number of assertions, or propositions, which can be used in a general way to identify receipts as income. It is proposed to benchmark the principles which emerge from *McNeil's* case against these propositions, but since *McNeil's* case concerned the characterisation of a property-based receipt, only those propositions which are relevant to the identification of receipts arising from property are noted. These are that:

1. a gain from property has the character of income²²;
2. the character of an income item as income must be judged in the circumstances of its derivation by the taxpayer and without regard to the character it would have if it had been derived by another person²³;
3. a gain which is one of a number derived periodically has the character of income²⁴.

As with all general propositions, they may be subject to exceptions or re-formulation, depending on particular circumstances.

5.1 WHEN ARE GAINS FROM PROPERTY INCOME?

5.1.1 INCOME FROM PROPERTY

This discussion relates to the first of Parson's propositions outlined above.

McNeil's case concerned a gain which arose from property. In determining whether a gain has arisen from property, the issue which arises is whether the gain is capital or income – however unscientific that distinction may be – and, however difficult it may be to make in particular instances.²⁵

There is no precise equation which can provide an answer to this dichotomy, but it requires a distinction to be made between a return which arises from the property, as distinct from the return of the property or part of the property itself. Because the distinction is so difficult to make, metaphors have been used to assist in clarifying the distinction. In this context reference is constantly made to the *Memorandum of Dissent to the United Kingdom Royal Commission's Final Report on Taxation of Profits and Income* where income was referred to as "*something which recurrently emerges and is separated off from its perpetual source, like the harvest from the soil...*"²⁶ But the most frequently quoted source of this metaphorical approach is to be found in the

²¹ *Ibid*, proposition 1.

²² *Ibid*, proposition 12.

²³ *Ibid*, proposition 3.

²⁴ *Ibid*, proposition 11.

²⁵ Dixon J, *Hallstroms Pty Ltd v FCT* (1946) 72 CLR 634, 646 indicated that the traditional approach was not to attempt definitions, but state "*what positive ...factors in each given case led to a decision assigning the expenditure to capital or to income as the case might be.*"

²⁶ 1955, Cmd. 9474, p 358.

decision of the Supreme Court of the United States of America in *Eisner v Macomber*.²⁷ There it was said that

The fundamental relation of 'capital' to 'income' has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop: the former being depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time....

*...Here we have the essential matter: not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value, proceeding from the property, severed from the capital however invested or employed, and coming in, being 'derived', that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal: – that is income derived from property.*²⁸

From this passage it can be seen that the essence of the nature of a gain arising from the use of property is that there must be a severance of the gain from the property, before it can be said that any income arises. This passage was accepted in Australia by the High Court in *Montgomery*²⁹ as containing the essence of the meaning of income derived from property and it has been resorted to on many occasions. It was utilised in *McNeil*.

5.1.2 IS A GAIN FROM A SHARE INCOME?

McNeil's case involved property relating to shares. In the context of shares the same metaphor has been adopted³⁰ and re-expressed in various ways.³¹ But in considering whether a gain emanating from shares constitutes ordinary income or not, a distinction is drawn between a receipt which is in satisfaction of rights which make up the property in the share, being in effect a return of some part of that property in the share; and a receipt which is derived from, or which flows from, or is a product of the share, but does not represent part of the property held in the share. The former concept relates to a return of capital. The latter relates to a profit which has been released or detached, essentially in the form of a dividend.³²

There is a conceptual difficulty inherent in this, because a share is a bundle of rights, and in one sense, whether the shareholder receives capital or profit, the receipt comes to the shareholder in satisfaction either in whole, or part, of the rights which make up the property in the share. But once share capital has been returned, that receipt is seen as representing the extinguishment or release of part of the right held by the shareholder to participate in a return of capital. In other words, the right to the share capital is no longer intact; it has either been diminished or extinguished.

²⁷ 252 US 189 (1919).

²⁸ Ibid pp 204-207.

²⁹ The position had been accepted by the High Court in *Charles v FCT* (1953) 90 CLR 598, a case which related to rights to shares.

³⁰ *FCT v Uther* (1965) 112 CLR 630, 634 (Kitto J).

³¹ *Webb v FCT* (1922) 30 CLR 450, 461; *C of T (NSW) v Stevenson* (1937) 59 CLR 80, 99; *FCT v Blakely* (1951) 82 CLR 388, 407; *FCT v Uther* (1965) 112 CLR, 630, 634.

³² For further elaboration of the same point see Parsons above n 19, p 90-92.

On the other hand, where a dividend is paid to a shareholder, the share, as Kitto J explained in *FCT v Uther*,³³ remains intact as a capital asset. There is no release of the right to receive further dividends, since the right to a recurrent payment remains intact.

The distinction has also been considered in cases dealing with bonus shares. From the authorities it is clear that bonus shares did not represent any severance from the original share, even when they were funded out of the share premium account: they were merely a reframing of the shareholder's interest in the capital of the company.³⁴

This leads to the question of whether rights to shares, or options issued to shareholders over shares in their company could be regarded as a detachment from the shares and thus be regarded as the produce arising from them. Parsons considered this issue and took the view that since a payment out of profit is an implicit element of the produce arising from a share, this could not be satisfied by options or rights.³⁵

5.2 CHARACTERISATION ON REVENUE ACCOUNT THROUGH CIRCUMSTANCES OF DERIVATION

This is the second of Parsons' propositions outlined above.

If there is a receipt which can be seen as a gain arising from shares, then it is necessary to be able to characterise that gain. The fact that a gain has been identified does not automatically give the gain an income character, notwithstanding that a cursory reading of the first of Parsons' general propositions above, relating to gains from property, may suggest a contrary conclusion.

The characterisation of a gain arising from shares went to the very heart of the matter in *McNeil*.

5.2.1 GENERAL PRINCIPLES – QUALITY OF RECEIPT IN HANDS OF RECIPIENT

It will be recalled that Parsons asserted that the determination about whether a receipt is the produce of shares, or comes in satisfaction of rights making up the shares requires, at least primarily, an examination from the point of view of the shareholder as recipient. That view was based on the test which had been established by Windeyer J in *Scott v FCT*³⁶, a case which was before the High Court in 1966. In that case Windeyer J said "*whether or not a particular receipt is income depends on its quality in the hands of the recipient.*"³⁷ That test is objective.³⁸ This principle has been accepted since that time as the appropriate test.

Without making any reference to *Scott*, the majority in *McNeil* adopted similar terminology in the first of the principles which the case appears to establish, but qualified the test by stating that the character of the expenditure in the hands of the

³³ *FCT v Uther* at 634.

³⁴ Parsons, above n 19, p 93: *IRC v Blott* [1921] AC 171; *Gibb v FCT* (1966) 118 CLR 628. This must be even more so under the *Corporations Act* 2001, which has abolished the concept of par value shares and authorised capital.

³⁵ Parsons, above n 19 p 93.

³⁶ *Scott v FCT* (1966) 117 CLR 514.

³⁷ *Ibid* pg 526.

³⁸ *Hayes v FCT* (1956) 6 AITR 248.

payer was not relevant. That statement does not accurately reflect the second of Parsons propositions referred to above. Nowhere in his text did Parsons state that the character of the amount in the hands of the payer was irrelevant. But it followed, in the view of the majority in *McNeil*, that the character of the sell-back right could be determined by isolating the receipt from the SGL buy-back process, which arose out of the capital restructuring of SGL.³⁹ This was despite determinations to the contrary in the Full Federal Court, when *McNeil* was before that court.

GP International Pipecoaters Pty Ltd v FCT,⁴⁰ a unanimous decision of the High Court in 1990, which adopted the test laid down in *Scott*, was referenced in support of this view. How *Pipecoaters* supported the view taken by the majority was not made clear. Ian Stanley, in his article *As of Right – McNeil's Case*, strongly declaims that it does not.⁴¹

However, the dissenting judgment of Callinan J in *McNeil*, provides some insight into this issue. There, in criticising the approach of the majority, the judge said “*In my view the character of a payment for the purposes of the statutory definition of income,cannot always be determined simply and solely by reference to its quality in the hands of a recipient. I do not take GP International Pipecoaters Pty Ltd v FCT to be denying reference to the full circumstances leading to the receipt in the hands of the taxpayer. It will usually only be by reference to a transaction as a whole that the quality of a receipt, otherwise perhaps even unintelligible, will begin to be able to be ascertained.*”⁴²

From this it appears that what was decisive for the majority was the focus of the inquiry. Characterisation could be determined by concentrating the inquiry just on part of the facts, rather than the facts as a whole. This suggests that the decision could turn on selectively isolated facts, rather than having regard to the factual context as a whole as required by the authorities. In this case, the relevant facts appear to be just those which were most proximate to the receipt of the payment by the taxpayer. Ian Stanley in his article is rightly critical of the majority judgment on this aspect, as it sets aside 50 years of consistent authority without appropriate justification, or indeed explanation.⁴³

So, it needs to be determined which of these two divergent views is properly supported by appropriate authority.

While it is accepted that characterisation of a receipt is determined primarily from the point of view of the recipient, that focus alone does not determine characterisation. The real issue then becomes how that income quality, or character, is ascertained. Until recently there was no doubt about the test which had to be applied. That question had been resolved years ago by what Kitto J said in *The Squatting Investment Co Ltd v FCT*,⁴⁴ a case which was before the High Court in 1953. In that case Kitto J

³⁹ *McNeil* at para 23.

⁴⁰ (1990) 170 CLR 124.

⁴¹ Stanley, above n 8, 220, 224.

⁴² *McNeil* at para 55

⁴³ Stanley, above n 8, p 224.

⁴⁴ (1953) 86 CLR 570.

established the test as being “whether a receipt comes in as income must always depend for its answer upon a consideration of the whole of the circumstances.”⁴⁵

That approach was endorsed in 1987 by *FCT v The Myer Emporium Ltd*,⁴⁶ a unanimous decision of the High Court. This case involved the characterisation of the receipt of a payment made for an assignment of interest payable under a loan. Myer Emporium had lent funds to its finance subsidiary and immediately assigned the income stream arising under the loan to an independent finance company for a lump sum. Myer Emporium argued that the payment made to it under the assignment was an extra-ordinary receipt for a retailer and property developer and as such was on capital account, thereby escaping the normal rule that a receipt by a business in the normal course of its business was on revenue account.

The Court disagreed and held that the receipt was on revenue account. The Court accepted that if the assignment could have been regarded as a separate transaction, it may have been possible to say that no gain of a revenue nature would have arisen, because the receipt of the value of the chose-in-action assigned could have been seen as the realisation of a capital asset. But when the facts were viewed as a whole, particularly the fact that the taxpayer had assigned its interest under the loan immediately after the loan was advanced, in order to obtain the immediate benefit of the future interest payments, the receipt was seen as a receipt on revenue account, because it represented no more – nor less – than the quantified present value of the future interest payable under the loan. As a consequence the receipt was not a capital item.

Pipecoaters, which was decided after Myer Emporium, was also a unanimous decision of the High Court. *Pipecoaters* concerned the characterisation of a receipt to assist in establishing new plant for coating industrial pipes. *Pipecoaters* accepted what had been laid down by the earlier authority and finessed in Myer Emporium, but gave more expansive expression to the manner in which characterisation was to be determined. The High Court in *Pipecoaters* expressed the situation in the following way.

Although the amount received as establishment costs was expended by, and was intended by (the payer of the amount) to be expended by, the taxpayer to meet the costs of constructing the plant so far as that amount would extend, and although the amount expended on the construction of the plant was a capital expenditure, it does not follow that the taxpayer's receipt of the establishment costs was a receipt of capital. To determine whether a receipt is of an income or of a capital nature, various factors may be relevant. Sometimes the character of receipts will be revealed most clearly by their periodicity, regularity or recurrence; sometimes, by the character of a right or thing disposed of in exchange for the receipt; sometimes, by the scope of the transaction, venture or business in or by reason of which money is received and by the recipient's purpose in engaging in the transaction, venture or business. The factors relevant to the ascertainment of the character of a receipt of money are not

⁴⁵ Ibid p 627.

⁴⁶ (1987) 163 CLR 199.

necessarily the same as the factors relevant to the ascertainment of the character of its payment.⁴⁷

The emphasis, which is apparent here, on the whole of the factual matrix, is underscored by the reference made later to the need to apply “a business conception to the facts, see *FCT v Becker* (1952) 87 CLR 456 at 467”⁴⁸ when characterising a receipt.

In making these observations on the characterisation of receipts, the High Court in *Pipecoaters* did not say that the nature of the payment in the hands of the payer was irrelevant: simply that its nature in the hands of the payer did not determine its character in the hands of the recipient. Nor did *Pipecoaters* say that the general context in which the payment was received was irrelevant, or that only part of the facts should be considered. On the contrary, it said that characterisation was determined by considering the whole of the factual matrix. These observations accord with Parsons’ view on this issue.

Myer Emporium is also important for two other things which it established in relation to the characterisation of receipts.

First, it accepted longstanding authority that a gain derived in the course of carrying on a business is income. Where the transaction which gives rise to the profit is part of the ordinary business of the taxpayer, the identification of the business itself may characterise the receipt. For instance, the profit on the sale of shares by a share-trader would be on revenue account. The same situation would arise where the sale is part and parcel of the business activity of the taxpayer, even if it is not the main business, because the profit-making purpose can be inferred from the association of the transaction with that business activity. So, if a taxpayer dealt in shares and switched investments regularly to maintain a growth profile, then that would be regarded as arising out of a normal operation in the course of the taxpayer’s business.

Secondly, it did not follow that a gain made in a transaction which was not in the ordinary course of the taxpayer’s business was not income. The Court said that if the facts disclosed that there was a gain, then it would be regarded as income, even if the transaction was extra-ordinary, so long as it was entered into for the purpose of making a profit. This was, of course, apparent from the decision itself. But the reasoning underscored that this purpose could only be determined from a consideration of the facts as a whole.⁴⁹

Then, there is the later unanimous decision of the Full Federal Court in *Westfield Ltd v FCT*,⁵⁰ which is important for the additional light which it sheds on the second of the *Myer Emporium* principles. *Westfield* involved the characterisation of the proceeds of the sale of land by a developer and manager of shopping centres. The profit arising on the sale of some surplus land, which was not required for a shopping centre that

⁴⁷ *Pipecoaters* at pp 137-138.

⁴⁸ *Ibid* p 141.

⁴⁹ For a comprehensive review of the *Myer Emporium* case and its impact and the historical context in which it is to be viewed see: Young N J, ‘The Historical Significance of the High Court’s decision in *FCT v The Myer Emporium Ltd*’, (2007) Vol 37 *Melb Univ L Rev* 266.

⁵⁰ (1991) 21 ATR1398.

Westfield would own and operate itself, was held not to be on revenue account. This was because the profit-making purpose did not “*exist in relation to the particular operation*.”⁵¹ In considering what profit-making means in this context Hill J said that a profit-making purpose must be discerned “*in the very means*”⁵² by which the gain was made. By this the judge meant that the mode of achieving that gain must have been contemplated by the taxpayer as at least one of the alternatives by which the gain could be realised. Where property has been acquired and later sold, the requisite purpose does not exist simply because at the time of acquisition there was merely the possibility of resale contemplated, because such a possibility exists in the acquisition of all property.

At the time *Myer Emporium* was decided it was regarded as something of a watershed case, but while the case accepted that payments received in the course of carrying on a business are income, it is not authority for the proposition that all receipts are income. If there were any doubt about that, then they were put to rest by the Full Federal Court in *FCT v Spedley Securities Ltd.*⁵³ There the Federal Court said that such a proposition would be “*contrary to authority, to the Act (ITAA) itself and to basic concepts concerning the distinction between capital and income*.”⁵⁴

Nor can the character be determined by the way a receipt is spent by the recipient. As was pointed out by the High Court in *Pipecoaters*, to do so would be unreliable, since a taxpayer may apply income in the acquisition of a capital asset, or apply a capital receipt to discharge a liability of a non-capital nature.⁵⁵

While the cases which have established these principles have related to business taxpayers, there has been no suggestion, either prior to these cases or subsequently, that the characterisation principles established by them are not of general application and relevant to the characterisation of receipts in the hands of non-business taxpayers, including investors. It has been accepted specifically in relation to investors, that the issue is covered by what was said by Clerk L J in the English case *Californian Copper Syndicate v Harris*.⁵⁶

*It is quite a well settled principle in dealing with questions of assessments of income tax, that where the owner of an ordinary investment chooses to realise it, and obtains a greater profit from it than he originally acquired it at, the enhanced price is not profit in the sense of Sch D of Income Tax Act 1842 assessable to income tax. But it is equally well established that enhanced values obtained from realisation or conversion of securities may be so assessable, where what is done is not merely a realisation or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business.*⁵⁷

In the following paragraph of the judgment it was said that the test is whether “*...the sum of gain that has been made (is) a mere enhancement of value by realising a*

⁵¹ Ibid, 1407

⁵² Ibid 1408.

⁵³ (1988) 19 ATR 938.

⁵⁴ Ibid p 942.

⁵⁵ *Pipecoaters* at p 136.

⁵⁶ (1904) 5 TC 159.

⁵⁷ Ibid p 165-166.

security, or is it a gain in an operation of business in carrying out a scheme for profit-making.”

In applying what was said there, it is necessary to undertake a “*wide survey and an exact scrutiny of the taxpayer’s activities.*”⁵⁸ So in this regard the approach accords with that developed in *Pipecoaters* and *Myer Emporium*. The approach is manifest in such cases as *Hayes v FCT*,⁵⁹ which involved the characterisation of the receipt of a gift.

This was how things stood until *Montgomery* reached the High Court in 1999. In this case the Court was required to characterise a payment received by a firm of lawyers as an inducement to take a lease of commercial premises. In the Full Federal Court it had been found that the inducement was an extra-ordinary payment, when gauged against the firm’s normal activities, and one which the firm had received not for the purpose of obtaining the inducement, but for the purpose of obtaining new premises from which to carry on business. As such, the receipt was on capital account. In reaching this conclusion the Full Federal Court applied accepted principles and its approach was entirely in line with *Myer Emporium*.

In the High Court, by a majority, that conclusion was reversed. The receipt was found to be income. To reach this conclusion on the basis of the principles laid down in *Myer Emporium*, it would have been necessary to establish that receiving incentive payments was part and parcel of the taxpayer’s normal business activities, or that the incentive payment was received for the purpose of making a profit. The evidence did not support the acceptance of either view; nor does the majority appear to have adopted either view. What the majority appears to have done is accept – contrary to the authority of *Pipecoaters* and *Myer Emporium* – that it could make a decision just by reference to the facts which immediately preceded the receipt of the payment.

The minority in *Montgomery* was critical of this approach and stated categorically that the payment was not received in the ordinary course of the taxpayer’s legal practice, nor was the lease entered into for the purpose of obtaining the inducement. Furthermore, the minority did not consider it to be appropriate to characterise a receipt “*disregarding the entire transaction and directing attention to only part of it.*”⁶⁰ In this, the approach of the minority was entirely consistent with *Myer Emporium*. Furthermore, the deficiencies of the majority’s amorphous decision have been subject to strident criticism, including a recent article by N J Young, *The Historical Significance of the High Court’s decision in FCT v The Myer Emporium Ltd.*⁶¹

Since the majority in *McNeil* appears to have taken the view that receipts could be characterised simply by reference to those facts which related directly to the receipt and not by reference to the facts as a whole, it might have been expected that *Montgomery* – which was the trail blazer for this new approach – would have been

⁵⁸ *London Australia Investment Co Ltd v FCT* (1977) 138 CLR 106 at 116 (Gibbs J), approving what was said in *Western Gold Mines NL v DCT (WA)* (1938) 59 CLR 729 at 740.

⁵⁹ 6 AITR 248.

⁶⁰ *Ibid* p 656.

⁶¹ Young, above n 49.

adopted as the precedent. It was not used in this context at all. The judgment gives the impression the majority was merely expounding an orthodoxy.

5.2.2 GENERAL PRINCIPLES – SEVERENCE OF GAIN FROM SHARES

The second general principle upon which the majority in *McNeil* relied was that a gain from property has the character of income, if it has been severed from the underlying property.

This was also an issue in *Montgomery*. The majority in that case concluded that the inducement payment was not a gain which was linked to the lease and therefore capital, but a gain severed from the lease. Reference was made to what was said in *Eisner* that there was “not a gain accruing to capital....but a gain...severed from the capital however invested or employed, and coming in, being derived, that is received or drawn by the recipient (the taxpayer) for his separate benefit and disposal.”⁶² In explaining the application of this principle to the facts, the majority said that the taxpayer had exploited its capital in securing the inducement and it was received, not as some growth or increment in value to its profit-yielding structure, but as a payment severed from that and available to the taxpayer for use as it saw fit.

The minority rejected the view that the payment could be seen as fruit arising from the firm’s capital. The principal reason was that at the time of the payment the lease itself was not property of the firm. Nor could it be regarded as being the fruit arising from the exploitation of the firm’s goodwill or reputation, since the payment was not severed from its reputation. The minority considered that there was an inexorable link between the incentive payment and the assumption of the obligations of the lease in the same way that such payments were regarded in England and New Zealand. For these reasons the incentive payment was not the fruit of the firm’s capital.⁶³

It is at this point that it can be seen that the two elements of the characterisation inquiry intersect: the necessity to determine that a gain must be severed from capital before it can be regarded as income, and, the factual matrix against which the gain, in the hands of the recipient, is considered. It is clear that the majority in *Montgomery* was able to regard the inducement payment as having been severed from the lease only because it chose to regard the payment as being divorced from the background facts which gave rise to it. As such it was devoid of any character. But having been received in the course of the taxpayer’s business, it could therefore be regarded as having an income character.

The problem which this creates is manifest. If the character of a receipt can be determined in this way, then the receipt will always be capable of being seen as a receipt coming in as part of the recipient’s income revenue. But as already indicated, the Full Federal Court in *Spedley* said, that to view the matter so broadly would be contrary not only to authority, but also to the provisions of ITAA and basic concepts relating to the distinction between income and capital. To like effect is the warning of

⁶² *Montgomery* at p 677.

⁶³ The criticism is supported by Young, above n 49.

Hill J in *Westfield*, that this would “eliminate the distinction between an income and a capital profit.”⁶⁴

The problem which this limited vision causes is manifest. The High Court in *McNeil* saw the position of the shareholders who chose not to participate as being an entitlement “to be paid the proceeds of trading activities in their rights which were conducted on their behalf by the (merchant bank).”⁶⁵ That entitlement was also seen as being entirely generated by the documentation creating the sell-back rights. But if the full facts had been considered, it would have been apparent that the money paid to these shareholders ultimately came from the share capital account of SGL.⁶⁶ Those funds did not have a revenue character.

The importance of judicial consideration of the entire factual matrix, rather than selectively isolated facts, was again highlighted in the High Court decision in *FCT v Hart*,⁶⁷ albeit in a context of considering the application of Part IVA, the general anti-avoidance provision.

Under Part IVA the FCT can attack transactions which constitute schemes, where the dominant purpose of someone connected with the scheme was to obtain a tax benefit. There has been much debate about the way in which schemes are identified. A scheme might be drawn narrowly, so that it is identified just by those facts which constitute the tax benefit, or a scheme might be drawn more broadly by reference to the transaction which the taxpayer entered into. If the scheme were drawn by reference just to the identified tax benefit, then inevitably the requisite dominant purpose will be present. This was the view supported by Gummow and Hayne JJ in *Hart*. But this view is contrary to unanimous High Court authority to the contrary.⁶⁸ It is also contrary to the approach propounded by Gleeson CJ and McHugh J in *Hart* that where a tax benefit relates to a deduction, the scheme cannot be defined without reference to all the facts which give the expense the character of deductibility for tax purposes. So in *Hart*, while the tax benefit had been identified as capitalised interest payable under a loan, those facts alone could not identify the scheme. The scheme could only be identified by reference to the borrowing transaction which the taxpayer had undertaken for the purpose of acquiring an investment property. As Gleeson CJ and McHugh J said “A description of the scheme that did not include the borrowing would make no sense.”⁶⁹

An analogy may arguably be drawn with the *McNeil* decision in that the majority decision, in characterising the amount, limited its consideration to the nature of the payment in the hands of the recipient, arguing that this had its genesis in the deeds poll, rather than seeing the complete factual matrix which identified the rights as a means to effect a share buy back. From the above it may be suggested that a characterisation that did not include a consideration of the whole buy-back scheme would make no sense. It is suggested that this limitation of the consideration to the

⁶⁴ *Westfield* at p 342.

⁶⁵ *McNeil* at para 13.

⁶⁶ *McNeil v FCT* 55 ATR 384,392; Conti J at first instance.

⁶⁷ *FCT v Hart* (2004) 217 CLR 216.

⁶⁸ *FCT v Spotless Services Ltd* (1996) 186 CLR 404.

⁶⁹ *Ibid* 225.

selectively isolated facts, rather than to the whole factual matrix, may have contributed to a misconception as to the character of the receipt.

5.3 PERIODIC DERIVATION INDICATES A RECEIPT ON INCOME ACCOUNT

This is the third of Parsons' propositions outlined above. Little needs to be said about this proposition. The sell-back right was a one off receipt. It was not part of a recurring series of receipts. While this fact does not determine the character of the sell-back right it is indicative of the fact that it is not inherently of a revenue character.

6. CRUX OF PROBLEM IN *MCNEIL*

The crux of the problem with the decision of the majority in *McNeil* lies in the two incompatible strands of the reasoning which were used to underpin it. The majority took the view that the rights which the taxpayer enjoyed had been severed from her shareholding. Yet, at the same time, the majority saw the rights as being distinct property, having no relationship to the shares themselves. The severance analogy is seen from the endorsement of *Eisner*.⁷⁰ The view that the sell-back rights were quite separate property is identified from the following passages. First, "...the sell-back rights which the taxpayer enjoyed and which were turned to account on her behalf did not represent any portion of her rights as a shareholder under the constitution of SGL. The sell-back rights were generated by the execution, and subsequent performance of covenants in the (documents which created the rights)... and later....the scheme took its life from (those documents)..."⁷¹

Having rejected the view that the sell-back rights represented any part of the rights attached to her shares, the justices went on to reject the argument that those rights represented the realisation of the shareholder's right to participate in a return of capital. This rejection is found in the following passage: "*Contrary to the taxpayer's submission, it is insufficient to say that SGL issued the sell-back rights to (the trustee) on behalf of shareholders in partial satisfaction of the shareholders' right to participate in reductions of capital, this being within the congeries of rights comprising the shares. It is the character of the grant of rights to the shareholders that is decisive. It is not the reduction of capital effected by SGL pursuant to the new statutory processes provided by the Corporations Law.*"⁷²

But, if the taxpayer's interest in the sell-back rights did not represent any portion of the taxpayer's rights as a shareholder under the *Corporations Act* 2001, or the constitution of SGL, and, they were divorced from SGL's reduction of capital and arose quite separately out of the documentation which created them, then it would seem difficult to maintain that the rights had been severed from the shares. The documentation which effectuated the rights had independently created the rights as discrete property. As such they were not shorn from the shares. As discrete property, it would follow that the sell-back rights were capital assets. In accepting the FCT's submission that the rights were income, the majority appears to have fallen into error,

⁷⁰ *McNeil* at paras 21-22.

⁷¹ *Ibid* paras 23 & 37.

⁷² *Ibid* para 36.

since by its own analysis, the rights had been shown to be separate capital assets created independently of the underlying shares.

This incompatibility between the two strands of reasoning creates a tension in the judgment which is difficult to reconcile.

If their Honours were suggesting that the rights were 'shorn from the shares' then this would suggest, using the Eisner analogy, that the rights represented a return on the shares rather than a return of some part of the rights attached to the shares, and such a return could then be seen as analogous to a dividend return, and take an income character.

The tension in the reasoning is highlighted by the second strand in the judgment which suggests that the rights were items of distinct property, being solely a creation of the deeds poll as "The scheme took its life from the deeds poll executed on the record date".⁷³ On this basis the rights had no relationship at all with the shares themselves, and could not be seen as representing a return on the shares, or a return of some part of Mrs McNeil's rights as a shareholder.

It is suggested that in this latter conception of the rights being property distinct from the shares, the High Court has failed to view the entire factual matrix, as a review of the complete facts would reveal the rights as a mechanism for a return of capital by means of a share buy-back. So much would appear to be suggested by Callinan J when noting that "The fact that the capital of the company suffered a reduction is far from irrelevant".⁷⁴

Given this apparent tension in the *McNeil* judgment, the discussion that follows analyses previous authorities which have examined the issue of the nature of the rights carried by shares. It is suggested that reference to previous authorities on this issue casts the *McNeil* decision as an example of a judgment which is difficult to support on the basis of the previously existing authorities.

7. CHARACTER OF *MCNEIL* SELL-BACK RIGHTS

The sell-back right was a put option. Since SGL wished to achieve a reduction in its share capital of a pre-determined percentage and it was anticipated that there would be a market in these rights, the put option mechanism was a vehicle for effectuating that commercial objective. It was anticipated that the market, which would thereby be created, would enable those who did not wish to sell their shares to have their rights taken off their hands and sold to others, who wished to increase their entitlement to participate in the return of capital. In this way no shareholder would be disadvantaged by the reduction in share capital, if they did not participate, as they were entitled to be paid the inherent value of the rights regardless.

As a prelude to a discussion regarding the character of the sell-back right, it is appropriate to consider the nature of a share, since once the jurisprudential basis of a share is ascertained, it is easier to ascertain whether a put option is part of the rights

⁷³ *Ibid* at para 37.

⁷⁴ *Ibid* Callinan J at para 56.

attached to the share, and, can then be seen as having been shorn from the share to which it relates.

Traditionally, a share has been described as a chose-in-action, but this is not particularly helpful as this description is notoriously vague. The authorities show that a share is a bundle of rights and those rights are the ingredients of the chose-in-action. The one right it does not confer is a right to a physical thing. The classic statement regarding the nature of a share is to be found in what Farwell J said in *Borland's Trustee v Steel Bros & Co Ltd*:

*A share is the interest of a shareholder measured by a sum of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders inter se in accordance with (the appropriate companies legislation). The contract contained in the articles of association is one of the original incidents of the share. A share...is an interest measured by a sum of money and made up of various rights contained in the contract, including the right to a sum of money of a more or less amount.*⁷⁵

The reference here to measuring the interest by a sum of money was a reference to the par value of a share. That is no longer quite as apposite, since the *Company Law Review Act 1998 (Cwlth)* abolished the concept of shares having a par value, as well as authorised share capital. So now share capital is represented just by the number of issued shares, each representing a fraction of the company's undertaking with each having a pro rata value calculated by reference to the whole of the company's undertaking.⁷⁶

In considering Farwell J's classic definition of a share, Gower's *Principles of Modern Company Law*,⁷⁷ took the view that the underlying jurisprudential basis was that the contract constituted by the Articles of Association, or constitution, defined the nature of the rights attached to shares. Of course, that contract is also subject to the provisions of the relevant corporations' law. But the respected author was equally clear that those rights are not purely personal rights. As well, they conferred some sort of proprietary interest in the company, although not in its property. The company is treated not merely as a person, the subject of rights and duties, but also as a res, the object of rights and duties. So a shareholder has rights in the company, as well as rights against it.

There are several Australian cases which have examined the nature of a share. Principal among these is *Archibald Howie Pty Ltd v Comr for Stamp Duties (NSW)*.⁷⁸ This case concerned the imposition of stamp duty on a transfer of assets in satisfaction of a resolution made to reduce capital. Here Dixon J, as he then was, averted to the fact that a share is an aliquot proportion of the company's share capital, with reference to which the shareholder has certain rights. Those rights were recognised as arising out of the company's constitution and the authority of the relevant corporations' legislation. One of those rights was to have share capital returned in accordance with

⁷⁵ [1901] 1 Ch 279, 288.

⁷⁶ Ford H A J, *Principles of Corporations Law*, (8th ed, 1997), p717.

⁷⁷ Davies P D (ed), *Gower's Principles of Modern Company Law*, (6th ed 1997) p 301.

⁷⁸ (1948) 77 CLR 143.

the provisions of the company's constitution. That right, together with all the rights which a shareholder has, was seen as arising out of the "*contract inter socios*."⁷⁹

The Australian case which has given one of the most exhaustive reviews of the jurisprudential nature of a share is a decision of the New South Wales Supreme Court in *FCT v Miranda*.⁸⁰ This discussion arose in the context of whether rights to new shares had been acquired with the same profit making purpose as the original shares, so as to make them assessable to tax as having been acquired for the same purpose of profit making by sale. Nevertheless, the observations made during the course of the judgment are of general application.

In this case, after reviewing the relevant authorities, including *Borland* and *Archibald Howie*, Rath J accepted the jurisprudential basis outlined in *Archibald Howie* and observed that on the allotment of a share the shareholder becomes, *inter alia*, contingently entitled to dividends and to participate in reductions of capital. The entitlement becomes a legal right of enforcement once the company has taken the steps necessary to confer such rights on the shareholders. These are rights which are included in the bundle of rights which constitute the share. Those rights may change from time to time, but the rights are always referable to the contract *inter socios* that came into force on the allotment of the shares. In the view of the judge "*(t)he share in substance remains what it always was, namely an aliquot proportion of the company's share capital with reference to which (the shareholder) has certain rights.*"⁸¹

On the issue of rights to new shares Rath J considered that a shareholder's entitlement to a rights issue also arises out of the contract which exists between the company and the shareholder and the relevant corporations' legislation. The judge expressed the position as being "...I do not think that the reality of the situation is that the right is to be regarded simply as a part of the original share. The reality of the situation appears to me to be that the right is independent of the share, and that it is not an incident of the share. It has come into existence as a result of the actions of the company, and is not merely an internal or inherent development of the share itself."⁸² In reaching this conclusion the judge regarded as significant the fact that the share and the right were capable of existing independently in the market place.

In *Miranda* the FCT had argued that the right did not create anything in the nature of an entitlement. It was simply an offer made by the company, which the shareholder had to accept, before any enforceable legal right arose. That argument was rejected as being inconsistent with the basic analysis of the nature of a share made by Dixon J in *Archibald Howie*. *Miranda* was considered by the High Court in *Macmine Pty Ltd v FCT*⁸³ without any criticism of the analysis made by Rath J. *Macmine* was applied by the Supreme Court of New South Wales in *Palmarc Investments Pty Ltd v FCT*.⁸⁴

What this establishes is that shares, while conferring proprietary rights on the holders, are, in fact, entitlements to benefits (and obligations) which are provided by the

⁷⁹ Ibid 152.

⁸⁰ 6 ATR 367.

⁸¹ Ibid pp 375-376.

⁸² Ibid p 378.

⁸³ (1979) 24 ALR 217.

⁸⁴ (1985) 16 ATR 671.

company's constitution and the relevant companies' legislation. A right or option to take up shares is not an inherent part of a share. It arises independently – out of the contractual arrangements which exist between the company and its shareholders – from the actions of the company.

Whether a shareholder has any entitlement depends on the actions of the company. This can be tested by reference to an example. A right to a new issue of shares need not necessarily be made to existing shareholders. If a right to a new issue of shares were granted to a company's financiers, who were not shareholders, it would be difficult to argue that the entitlement to take up the new issue arose out of the shares in the company already on issue. Once created, the entitlement is a separate item of property, but it is not an item of property which is shorn from the share itself. If options to take up new shares are property separate from the shares themselves, then a fortiori, options created over shares, in order to create a mechanism to sell them, would also be separate from the shares themselves.

8. IMPORTANCE OF CAPITAL REDUCTION TO SELL-BACK RIGHTS

Share buy-backs are reductions of capital. One of the main cases to examine the nature of a share specifically in relation to a reduction of capital was *Archibald Howie*. Here, Dixon J made the point that when a shareholder contributes the amount paid for the share to the capital of the company, this contribution measures his right to any return of capital which the company may make, either as a going concern, or on liquidation. Today this would probably be rephrased to indicate that his shareholding affords him a proportional right to share with other shareholders in a distribution of the capital of the company. But what the case makes clear is that this right is conferred by the contract of membership, which arises from the company's constitution.

As Dixon J said “*The reduction involving the payment off of part of the paid up share capital must therefore be considered an effectuation of a provision of the contract of membership.*”⁸⁵ Thus the right to a return of capital arises out of the contract which exists between the company and the shareholder. It must follow that the right to participate in a reduction of capital is not imbedded in the share itself: it arises from the contractual arrangement which exists between the company and the shareholder.

Archibald Howie and *Uther* both make it clear that a return of capital does not constitute a severance of a capital amount, or indeed anything else, from the share itself. It represents a receipt by the shareholder of a part of the underlying asset value of the share. Once it has been received, the underlying value of the share has been irretrievably diminished and so has the right to receive further returns of capital. Indeed, if the capital has all been repaid, then the right has been entirely satisfied. But, it is not accurate to describe that impact as the severance of a gain. What has happened is that the shareholder has given up part (or all) of the entitlement to the profit yielding structure. This is entirely consistent with the general principles which relate to the basic nature of a share and share capital already outlined.

⁸⁵ *Archibald Howie* at p 152.

In *McNeil* the majority did not refer to *Archibald Howie*, but did refer to *Uther*, and certain other liquidation cases.⁸⁶ However, these authorities were rejected on the basis that they afforded no sound analogy. *Miranda* and *Macmine* were also rejected, on the grounds that they were not cases concerned with the revenue nature of the rights considered in them. No reason was advanced why the general principles relating to the nature of shares and rights to them, and which are to be found in these cases, were not applicable. The fact that cases are not directly in point has never prevented courts from drawing on general principles established by analogous cases. It might also be pointed out that *Miranda* and *Macmine* were obviously not concerned with the revenue nature of rights or options to shares, because these rights are inherently of a capital nature.

In his dissenting judgment Callinan J considered that the taxpayer's receipt was not severed from her shares. While the taxpayer was left with her shares intact, that did not lead to the conclusion that what she had received had been shorn from her shares. What the taxpayer received was access to an early return of the capital of SGL and that flowed to her as part of the bundle of rights which constituted her capital assets. The taxpayer still had a contingent right to the capital of SGL, but that entitlement in a quantitative sense, had been reduced by the amount of capital which had been used to buy back part of the bank's capital. Part of the money used to do this was what the taxpayer had received. That view is entirely consistent with established principle.

9. CHARACTER OF OPTIONS OVER SHARES

The sell-back rights created under the deeds poll in *McNeil* were effectively seen as put options under which SGL would be required to purchase one share for each option at the buy-back price. The holder of a put option over shares generally has the right, but not the obligation, to sell a set number of shares at a specified price. In this case the taxpayer, as holder, did not exercise the option which she was granted, but in effect sold the option through intermediaries. Given that the Court accepted that the sell-back rights were put options, the issue arises as to the source of the right or option, as ultimately characterisation turns on the nature and source of the right.

As already indicated there has been significant judicial consideration concerning the nature of the rights carried by a share. In expanding on what Dixon J had said in *Archibald Howie*, Williams J said the rights which are part and parcel of a share:

*...include the right to participate in dividends whilst the company is a going concern and the right to participate in the distribution of assets available for the shareholders upon a winding up. They also include the right to receive capital in excess of the wants of the company.*⁸⁷

The judge continued:

[these rights] are legal rights which flow from the original issue of shares. They are ingredients in the chose in action which each original shareholder purchased from the

⁸⁶ *FCT v Stevenson* (1937) 59 CLR 80; *Thornett v FCT* (1938) 59 CLR 787; *FCT v Blakeley* (1951) 82 CLR 388; *FCT v Uther* (1965) 112 CLR 630; *FCT v Slater Holdings Ltd* (1984) 156 CLR 447.

⁸⁷ *Archibald Howie* at p 156.

*company. If an original shareholder sells and transfers his shares the transferee upon registration will become legally entitled to all the rights of the member.*⁸⁸

In *Ord Forest Pty Ltd v FCT*⁸⁹ the majority followed the approach manifest in *Archibald Howie* as to the nature of the rights constituted by a share in a company in relation to an issue of bonus shares. That case emphasises that in being provided with the right to participate in bonus issues or reductions or returns of capital the proportionality of shareholding entitlements must be preserved so that the value of the shareholders' rights remain unaffected. In this case Mason J also made some observations in relation to rights issues.

*Nor is any difficulty occasioned when a company makes an offer to shareholders of renounceable rights to take up new shares in proportion to their existing holdings. The shareholder is then at liberty to sell his rights to take up new shares. The difference between the value of the new shares when allotted and the amount payable to the company for it, reflects the value of the right to take up the share which is itself a satisfaction of the existing shareholders' rights under the memorandum and articles of association.*⁹⁰

However, despite this authority as to the rights carried by a shareholding, the High Court in *McNeil* was able to determine that the sell-back rights did not represent any portion of the taxpayer's rights as a shareholder. They were to be seen as being generated solely from the covenants in the deeds poll which created them.

There would appear to be a difficulty in reconciling this view with previous High Court authority regarding the basis of entitlements which flow from shares. The covenants in the deeds poll were only of consequence for existing shareholders, and, the authorities would suggest that the shareholders obtained the sell-back rights as part of the package of rights associated with the holding of shares in the company. On this view, the covenants would not be viewed as creating the rights, but merely providing a system and methodology for dealing with a right which arose from the existing package of rights enjoyed by a shareholder.

This latter view would appear to be in accord with the observations of Mason J in *Ord Forest* noted above. As in that case, it is arguable that in the *McNeil* case the company was simply making entitlements available to shareholders in respect of the capital of the company in a manner which ensured that the entitlements were made available proportionally to their shareholdings. The documentation did not create anything new, but was simply the means adopted to ensure proportionality in the issue for existing shareholders and so as not to disadvantage any shareholder. The fact that *Ord Forest* was concerned with an issue of bonus shares and *McNeil* was concerned with a return of capital would not seem to be a material distinction, because both are concerned with matters relating to the capital structure of a company.

In similar vein, Gibbs J in *Archibald Howie*, in suggesting that shareholders' rights measured the right to a return of capital either on a winding up or as a going concern,

⁸⁸ Ibid 158.

⁸⁹ (1973) 130 CLR 124.

⁹⁰ Ibid p 157.

found that this would be the case, even if the rights offered to existing shareholders contained an element of bonus to the shareholders. But even more importantly the judge suggested that a resolution to return capital created a legal right in the shareholders and that this legal right was a right which flowed from the original issue of shares and was passed on by the registration of shareholdings. It would follow that if the legal right arose from the shareholding, it could not have emanated solely from the resolution to return capital.

On this basis, it becomes difficult to reconcile the High Court's view that the sell-back rights did not represent part of the rights carried by a share, but were created solely by the covenant. It may appear that the High Court's view accepts part of the reasoning of Gibbs J in *Archibald Howie* that the resolution creates a legal right in the shareholder, but then fails to apply the remainder of the reasoning in identifying the true source of the legal rights created by the sell-back rights – the true source being the rights carried by the existing shares. Based on the analogous authorities, the sell-back rights could be seen as rights arising from the portion of rights held by a shareholder and the covenant as merely the form of resolution chosen to return capital and ensure that the proportionality of shareholding remained intact.

In addition to finding that the rights arose from the deeds poll, rather than the package of rights encompassed within the existing shares, the High Court took the view that the sell-back rights were separate and detached from the shares and became objects of "commerce." However, it would appear to be arguable from the authorities that trading in rights would not be sufficient to change their character. In *Ord Forest* there is no suggestion in the judgment of Mason J, or in any other of the judgments, that any sale by the shareholders of renounceable rights had, or could have, any bearing on characterisation issues.

10. EXISTING TAXATION PROVISIONS FOR OPTIONS OVER SHARES

Given that the sell-back rights had been identified as on revenue account, this obviated the need for the High Court to direct attention to the provisions of ITAA 1997 which provide that options are specifically included as capital gains tax (CGT) assets. This suggests that there is a legislative intention that the legislative regime explicitly recognises that options are treated as being on capital account. As with most CGT assets, the capital gain or loss provisions would be limited in their application if the asset were a revenue asset, such as trading stock.

In *McNeil's* case the put option was a right in the shareholder to require SBL to buy shares from the shareholder as part of the capital reduction arrangement. Such a put option would be a CGT asset, with nothing in the surrounding circumstances to suggest that the asset could be a revenue asset of the taxpayer.

Under the CGT regime which applies to options, the grant of an option would not generate a capital loss or gain. Any capital loss or gain would occur when the option ceases to exist, either due to exercise of the option, or some other reason.

While CGT event D2 happens when an option is granted, any capital gain or loss made by the grantor of the option will be disregarded if the option is exercised, with the determination of any capital gain or loss for the grantor being determined under

s134-1 ITAA 1997. On the granting of an option, the holder/grantee will have acquired a CGT asset and if the option is exercised, any capital gain or loss on exercise will be disregarded, as the exercise of the option is merged with the disposal transaction, with the capital gain or loss being determined on that transaction.

If an option is not exercised, the relevant CGT event would be event C2, which happens when ownership of an intangible CGT asset ends by being redeemed, cancelled, released, discharged, satisfied, expiring, abandoned, surrendered or forfeited. It is then provided that the capital loss made when an option ends in one of these ways will be the amount paid for the option, together with legal fees. In circumstances where no amount had been paid for the option and the option ends other than by exercise, presumably no capital loss would arise to the holder/ grantee.

This specific CGT regime for the taxation of options, whether or not exercised, suggests a legislative intent that options be taxed as capital assets with a determination of a capital gain or loss as provided under Part 3 ITAA 1997 – and not as income. The exception to the CGT regime – when an option would generate ordinary income – would arise when the options were revenue assets in the nature of trading stock, which they were certainly not in *McNeil*. The specific CGT regime seems to have been overlooked by the High Court.

11. ADDITIONAL PROBLEMS INHERENT IN *MCNEIL*

This final part of the discussion highlights three additional problems which may be seen as arising from the decision in *McNeil*.

11.1 ASSESSABILITY OF SELL-BACK VALUE

The principal issue which the majority in *McNeil* said that it had to consider was framed in the following manner. It was said: “*The Commissioner [] submits that the grant... of the ... sell-back rights in respect of the taxpayer’s shareholding and held by [the trustee] for her absolute benefit was the derivation of income by her in the amount of [\$x]... It is [this] submission that should be accepted.*”⁹¹

It has already been shown that this proposition inappropriately attributes an income characterisation to the grant of the sell-back right simply because it was received by, or on behalf of, the taxpayer. But there is an additional problem. The statement also inappropriately equates the creation of a right with its derivation for income tax purposes.

Under the provisions of the ITAA 1936 a company passes assessable income to its shareholders through the payment of a dividend. A dividend is a distribution made or credited by a company to its shareholders. The distribution can be made in money or property. If the distribution consists of property, then the value of the property is its market value.⁹² But the fact that a distribution answers the definition of a dividend does not, of itself, lead to the inclusion of the amount in the assessable income of a shareholder. To be assessable, a dividend must be paid out of profits. It was said in *Re*

⁹¹ *McNeil* at para 18.

⁹² Sec 21 ITAA 1936.

Spanish Prospecting Co Ltd that: “Profits implies a comparison between the state of a business at two specific dates usually separated by an interval of a year. The fundamental meaning is the amount of gain by the business during the year. This can only be ascertained by a comparison of the assets of the business at the two dates.”⁹³ This statement of principle was approved by the High Court in *FCT v Slater Holdings (No 2) Ltd*.⁹⁴

It is implicit in this statement that profits arise out of the business activities of the company. So profit, in its ordinary sense, means the excess of returns over the outlay of capital.⁹⁵ It follows that the issue by SGL of options over its own shares could only have been brought to account as part of its business profit, if SGL were engaged in trafficking in buying back its own shares. SGL was not so engaged. Indeed, for SGL to have done so would have been contrary to the maintenance of capital rule, which has underpinned company law since the first companies law Acts were introduced in England in the mid 19th Century. Under the provisions of the Corporations Act (Cwlth) a company is only entitled to buy back its shares to the limited extent provided under that Act, and, once shares are bought back, they must be cancelled. As such, at the end of the financial year there would be no accretion to the financial position of the company as a result of the buy-back in any event. In other words, no excess of returns over the outlay of capital could exist. Therefore, the grant of the sell-back right could not be regarded as a dividend which had been derived by the taxpayer, because it had not been paid out of profit and could not, therefore, be assessable in the shareholder’s hands.

11.2 OWNERSHIP OF SELL-BACK RIGHT

The second problem which arises out of framing the issue as the majority did, is that it contains an assumption that the sell-back rights were the property of the taxpayer, or at least she had a proprietary interest in them on creation. It will be recalled that on creation the sell-back rights were held on trust for the taxpayer. In the situation which eventuated it was necessary – before it could be said that the taxpayer had an interest in the sell-back rights on revenue account – that she had a present entitlement to them, on the date on which the rights were created. From a reading of the reports which trace the progress of the case,⁹⁶ there does not appear to have been any serious consideration of the nature of the entitlement of the taxpayer to the rights. Indeed, it appears from what Stanley has said,⁹⁷ that no argument was addressed to the courts on this issue in order to isolate the main issues more clearly. If that is so, then the omission would appear to have had the opposite effect.

The facts disclose that on the day on which the sell-back rights were created they were immediately transferred to a trustee which undertook, in respect of each of the shareholders who did not participate in the buy-back, to hold the rights which they had not taken up, upon trust for each absolutely. Later those rights were transferred to a merchant bank, which undertook to take reasonable steps to sell them. Then the total

⁹³ (1911) Ch 92, 98.

⁹⁴ (1984) 15 ATR 1299.

⁹⁵ Ibid (Gibbs CJ) p 1306.

⁹⁶ 55 ATR 384; 60 ATR 275.

⁹⁷ Stanley, above n 8 pp 221 and 228.

net proceeds of sale had to be determined and the entitlement to those proceeds, of each non-participating shareholder, calculated in accordance with a prescribed formula. Once that had been done, the trustee had to ensure that the net proceeds of sale (if any) were accounted for to the non-participating shareholders in the proportions to which they were entitled to share in those proceeds.

In the Federal Court at first instance and on appeal, the non-participating shareholders were accepted as having (and probably held to have) no more than a right to compel performance of these arrangements. This must mean that although the documents referred to the rights being held for the non-participating shareholders on trust absolutely, they had no proprietary rights in the sell-back rights which constituted the trust property. Even the High Court did not put the matter any higher. The High Court simply observed that the taxpayer's rights were a beneficial interest in the covenants supporting the obligations undertaken by SGL and that those rights were accrued not executory and were vested.⁹⁸ The High Court made no mention of the use of the terminology in the documentation that the rights were held for the taxpayer absolutely.

For the taxpayer to have been regarded as having any proprietary entitlement to the sell-back rights under a trust arrangement, it would have been necessary for her to have been the beneficiary under what is ordinarily referred to as a bare trust. G E Dal Pont and D R C Chalmers in their text *Equity and Trusts in Australia* describe a bare trust as one where a “person holds property in trust for the absolute benefit and at the absolute disposal of beneficiaries who are of full age and capacity in respect of that property, but has no interest in that property other than by reason of legal title as trustee, and has no further duty to perform in respect of the property except to convey it upon demand to the beneficiaries or as directed by them.”⁹⁹

If there were a bare trust, it might have been possible to maintain that the trustee held the rights as nominee, so that the rights in the hands of the trustee could be said to be those of the beneficiary. But Mrs McNeil's interest under the trust was not that of a beneficiary under a bare trust. For one thing, the trustee had active duties to perform – such as selling the trust assets, without reference to the beneficiaries and without their direction. Such obligations are inconsistent with the notion of a bare trust.¹⁰⁰ For another, Mrs McNeil's rights were accepted as being no more than a right to compel performance of certain obligations. Under a bare trust the trustee is only a repository of trust assets and a beneficiary has a right to call for a transfer of the trust property and have it conveyed.

The use of the word ‘absolute’ in the documentation to describe the taxpayer's interest was probably used to indicate that her interest was indefeasible. This would accord with the view taken by the High Court that the interest was vested and accrued – not executory. It may also have been used to emphasise that it was a trust obligation in favour of Mrs McNeil separate from the trust obligations undertaken by the trustee for each of the other shareholders/beneficiaries. But the use of the word “absolute” in its

⁹⁸ McNeil at para 27.

⁹⁹ Dal Pont G E & Chalmers D R C, *Equity and Trusts in Australia* (3rd ed, 2004) p 603: *Lysaght v Edwards* (1876) 2 Ch D 499, 516-517; *Re Cunningham and Frayling* [1891] 2 Ch 567, 571-572; *Motor Vehicle Dealers Inst Inc v UDC Finance* (1991) Ltd [1994] 1 NZLR 659, 664.

¹⁰⁰ *Herdegen v FCT* 88 ATC 4995, 5003-4.

context cannot be seen as providing the taxpayer with a proprietary, or ownership right to the sell-back right itself, at any point during the time the trust arrangement subsisted.

In so far as Mrs McNeil was concerned, all she was entitled to under the trust was her proportional share of the net proceeds of the sale, when they had been ascertained. Until that happened there was no certainty that she would receive anything, let alone any specific quantified amount. Until that time she had no more than an expectancy of receiving some sale proceeds. Likewise, until that time her beneficial interest was no more than a right to ensure due performance on the part of the trustee.

11.3 WRONG QUESTION POSED, THE DERIVATION ISSUE

The third issue which arises out of the way the question was framed by the High Court was that it led to the wrong question being posed for determination. The principal issue raised for determination was posed as being “*whether a particular receipt has the character of the derivation of income depends upon its quality in the hands of the recipient ...*”¹⁰¹ That was also a proposition which the FCT put forward as flowing inexorably from his primary submission. But s6-5 ITAA 1997 is not concerned with the character of derivation. As was said at the outset of this paper, it is concerned with whether the receipt can be classified as income, and, only after that has been done, is it concerned with whether it has been derived and therefore forms part of the taxpayer’s assessable income. Those are separate considerations, each of them dealing with different issues.

Therefore, the characterisation of a receipt as income cannot be made to depend on its derivation. By concatenating the issue which needed to be determined the majority would appear to have fallen into error. Indeed, if derivation determined the character of the receipt, then all receipts would be income and that would not only eliminate the distinction between income and capital; it would set aside fundamental principles on which income tax is founded. The effect of the High Court’s decision is to do just that. Parsons did not accept such a proposition and it is contrary to authority such as *Federal Coke Co Pty Ltd v FC*,¹⁰² which was not referred to by the High Court.

ITAA 1997 does not define what is meant by derivation. The word “derived” does not necessarily have the same meaning as “earned”. The Macquarie Dictionary defines the verb “to derive” as meaning “to receive or obtain from a source or origin”. It has been accepted that unless the ITAA makes some special provision to the contrary, the amount derived is determined by ordinary business and commercial principles and the method of accounting to be adopted – as Carden’s case established – is the method which “is calculated to give a substantially correct reflex of the taxpayer’s true income.”¹⁰³ Furthermore, as Dixon J, as he then was, said in that case “...in the assessment of income the object is to discover what gains have during the period of account come home to the taxpayer in a realized or realizable form.”¹⁰⁴ But Dixon J is

¹⁰¹ *McNeil* at para 20.

¹⁰² 77 ATC 4255.

¹⁰³ *Executor Trustee & Agency Co of South Australia Ltd v FCT* (Carden’s case) (1938) 63 CLR 108, 154; *Brent v FCT* (1971) 125 CLR 418.

¹⁰⁴ *Ibid* p 155.

not to be taken as having indicated that receipts which are realizable, but not received, are always derived. In situations which do not relate to trading income, the judge said that there must be something coming in, since “*for income tax purposes, receivability without receipt is nothing.*”¹⁰⁵

This is illustrated by *Brent v FCT*.¹⁰⁶ In this case the wife of a notorious train robber had sold her life story for a sum of money which was to be paid at certain specified times. The taxpayer accounted on a cash basis. She was assessed to tax on two of the payments which had fallen due, but not been paid. The non-payment arose because the payments had not been requested by the taxpayer. The High Court set aside the assessment, because those sums had not been received. It followed that they had not been derived.

Mrs McNeil accounted on a cash basis. The option was not paid out to her on the date of creation, nor was it payable in a quantified amount. It may have had a value on the date of creation, but holding something of value is not sufficient to constitute a receipt of income. If there was no receipt in *Brent*, then a fortiori, there could be no receipt in so far as Mrs McNeil was concerned. There would need to be something which was not only realised but received, before it could be said that the gain had been derived.

Under ITAA 1997 there can be a constructive receipt of income. Section 6-5(4) provides that a taxpayer is deemed to have derived income if it is applied or dealt with in any way on the taxpayer's behalf, or as directed by the taxpayer. It had been submitted by the FCT in *Brent*, that the taxpayer fell within the predecessor of s6-5(4) because, in failing to call for payment, the income had been “*dealt with*” on her behalf. The Court rejected this. Furthermore, the Court also indicated that, even if the taxpayer had requested the company to defer payment, that would not have fallen within the meaning of the phrase “*dealt with*”. The purpose of the provision was said to be “*to prevent a taxpayer escaping though his resources have actually increased by the accrual of the income and its transformation into some form of capital wealth or its utilisation for some purpose.*”¹⁰⁷

So it follows, as Parsons maintained, that constructive receipt requires some change in the relationship between the debtor and the creditor. Accordingly, it is well settled that the making of an entry in the books of the company does not establish the payment of a dividend to a shareholder, if it is not done with his consent.¹⁰⁸ It is, however, accepted that where a bank credits interest to the account of a cash basis taxpayer, this is treated as a constructive receipt on the basis of actual or constructive consent, arising from standard banking practice.¹⁰⁹ That custom could not exist in relation to the creation of put options, even by a bank. But what this establishes is that apart from specific situations which arise out of banking practice, or some other accepted custom, deemed receipt of income does not arise out of mere quiescence on the part of the taxpayer.

¹⁰⁵ Ibid.

¹⁰⁶ 125 CLR 418.

¹⁰⁷ Ibid, Gibbs J p430, quoting with approval observations of Rich J in *Permanent Trustee Company of New South Wales v FCT* (1940) 2 ATR 109.

¹⁰⁸ *Manzi v Smith* (1975) 132 CLR 671.

¹⁰⁹ Parsons, above n 19, p 650.

Since the ITAA 1997 does not alter the substance of provisions formerly contained in ITAA 1936, it can be assumed that the same considerations apply to s6-5.

So, for Mrs McNeil, there not only needed to be a gain that was realised, that gain also needed to be received, or applied to her credit, or dealt with on her behalf in some way, before it could be said that she had derived income. On the day on which the put option was created Mrs McNeil had merely been provided with a facility which enabled her shares in SGL to be sold. The ability to do so was not, in the circumstances which eventuated, a right which was even exercisable by her. In fact, she had no proprietary interest in the sell-back right at all. Nor had there been any change in her relationship with SGL, so as to put her into a position of being a creditor of SGL, or something akin to that. At the earliest, that occurred on the day the amount payable to her was quantified. Even if it could have been said that the taxpayer received a payment on the day on which the sell-back rights were created, what has been established is that the receipt of a payment by itself does not give the receipt an income character.

12. CONCLUSION

What emerges from this analysis is that the High Court's decision in *McNeil* is out of line with established and accepted authority regarding the nature of income. While it is accepted that characterisation of a receipt is determined primarily from the perspective of the recipient, that focus alone does not – as *McNeil* would have it – determine characterisation. The test established by two unanimous High Court decisions in *The Myer Emporium* and *Pipecoaters* is that the answer to determining whether what comes in is income, depends on a consideration of all of the circumstances in the entire factual matrix. Receipt of an amount by itself does not determine the character of the amount received. If it did, then the distinction between income and capital would evaporate.

Such authority as there is which supports the *McNeil* view that characterisation can be determined from a consideration of part of the facts, and in particular those facts which relate just to the receipt, is not widely accepted as being authoritative. This position was established by *Montgomery*. But the strong dissenting judgment in *Montgomery* reflects the weakness of the majority view in *Montgomery*. The majority in *McNeil* took the same approach that is apparent in the majority judgment in *Montgomery*. Both judgments diverge from existing established principles, such as those enunciated by Parsons, and from previous authority, without either judgment explaining why the prevailing orthodoxy was not correct, arguably making *Montgomery* and *McNeil* two nails in the coffin of the jurisprudence underlying the income/capital dichotomy.

The narrowness of the *McNeil* perspective led the Court to see the characterisation of the receipt in the hands of the taxpayer as having arisen from the sale of the sell-back rights, rather than from the buy-back of share capital undertaken by the corporate entity. Since what the taxpayer received arose from the sale of rights to shares undertaken by a merchant bank which traded in shares, this was seen as determining the character of that receipt in the hands of the recipient. If the authority of *The Myer Emporium* and *Pipecoaters* had been followed, the character of the receipt could not have been determined in this way. It would have been necessary to consider the whole

factual matrix to determine the nature of the receipt. That would have necessitated proper consideration of the circumstances which related to the issue of the sell-back rights. That in turn would have linked the receipt to the reduction in capital which is what the sell-back rights were effectuating.

The Federal Court saw the whole transaction as being on capital account from beginning to end and Callinan J in *McNeil* (dissenting) saw the situation in the same way. Furthermore the authorities – *Archibald Howie* included – establish that a return of capital cannot be regarded as a severance of the capital amount from the share itself. To regard a return of capital as a severance from the share, in the sense given to that concept in *Eisner*, would effectively obliterate the distinction which has traditionally been used to differentiate between receipts which are on revenue account and those which are not. Indeed, it would strike at the capital/revenue dichotomy which is maintained under the provisions of ITAA 1997. To return to the metaphor of the fruit and the trees, as Lord MacDermott did in *IRC v Reid's Trustees*, “The ripe tree loses weight when it sheds its fruit, but the fruit remains fruit and no more, unless in its fall it has taken part of the tree with it.”¹¹⁰ The majority in *McNeil* overlooked that a return of capital fells part of the tree.

The legislative response from the government has been disappointing in that, rather than restoring the previous tax position as had been announced, the legislation has enshrined the *McNeil* decision in relation to put options. However, the existing law has been retained in relation to call options, thus acting to create greater complexity with divergent tax treatment for rights which have previously been subject to the same taxation treatment, without explanation as to underlying principles as to why the treatment should now differ. The new legislation does little to allay the fears expressed earlier by capital markets, and worse, it enshrines in legislative form arguably unsustainable law relating to the characterisation of income. The problem identified in the *McNeil* decision remains. The promised legislation should have removed the difficulties as the Government undertook to do – not compounded them.

¹¹⁰ [1949] AC 361, 383.