ARE BONUS SHARES INCOME?

One might expect that an Act levying income tax would define the word "income". The current Income Tax and Social Services Contribution Act No. 27 (Commonwealth) 1936 as amended (which will be referred to as "the Act") does not do this; presumably it was thought unnecessary, since the Act levies tax not on "income" but on "assessable income",[1] a term which it does define. However, in many places in the Act the word "income" is used in isolation, and it is sometimes vitally important to know exactly what the word means when so used. This was demonstrated by the *Fuller Case*,[2] in which a majority of the High Court of Australia held that the Act, by implication, gave the word a meaning wider than its ordinary meaning, and that because of this, the deductions which a company could make from its assessable income were much less than they otherwise might have been.

I. *The Facts, Issue and Holding*

The taxpayer, W. E. Fuller Pty. Ltd., a resident of Australia within the meaning of the Act, held 2,500 fully paid shares of £1 each in another company, Dewcrisp Products Ltd. During the year of income ended 30th June, 1952, the latter distributed 25,000 bonus shares of £1 each among its members in the proportion of one share for each share held by them, paid up by £25,000 standing to the credit of an assets revaluation account. The taxpayer accordingly received 2,500 bonus shares. It was common ground that these shares, or the amount applied to make them "paid-up", constituted a dividend within the meaning of the Act, which in s.6(1) defines "dividend" to include:

> . . . any distribution made by a company to its shareholders whether in money or in other property, and any amount credited to them as shareholders, and includes the paid-up value of shares distributed by a company to its shareholders to the extent to which the paid-up value represents a capitalisation of profits . . .

Dividends, irrespective of the source of the profits from which they are paid, are made part of the assessable income of a resident shareholder by s.44(1) of the Act, but s.44(2) states:

> The assessable income of a shareholder shall not include dividends . . . paid wholly and exclusively . . . out of . . . profits arising from the revaluation of assets not acquired for resale at a profit . . . if the dividend is satisfied by the issue of shares of the company declaring the dividend.

It was common ground that the dividend in this case was such a dividend and so was not liable to taxation.

Section 80(1) provides that a loss shall be deemed to be incurred in any year when the allowable deductions from the assessable income (other than "concessional deductions" and deductions under s.80 itself) exceed the sum of that income and the exempt income of that year, and that the amount of the

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[1] More accurately, tax is levied on assessable income less allowable deductions.
[2] *Commr. of Taxation* v. *W. F. Fuller Pty. Ltd.* (1959); 33 A.L.J.R. 190.

loss shall be deemed to be the amount of such excess; and s.80(2) provides that such losses incurred by a taxpayer in the seven years preceding the year of income as have not previously been allowed as a deduction, are allowable as a deduction. In its income tax return, the taxpayer, not taking into account the face value of the bonus shares, stated that it had incurred a loss of £3,374 in the year of the distribution of the bonus shares and that this amount was deductible from its assessable income of the year ended 30th June, 1953. However, the Commissioner for Taxation considered that the face value of the bonus shares was "exempt income" within s.80(1), and that the loss was therefore only £874.

In this action, the taxpayer claimed that the face value of the shares was not income within the meaning of the Act at all, and so could not be exempt income, which in the words of s.6(1) "means income which is exempt from income tax and includes income which is not assessable income".

The issue was therefore whether the face value of the shares constituted "income" as the word is used in the Act. It was dealt with by the High Court under two main headings:

1. Were the shares or the amount applied to pay them up "income" in the ordinary meaning of the word?

2. If not, were the shares or the amount applied to pay them up "income" in some extended meaning given to the word by the Act? Dixon, C.J. answered both questions in the negative and found for the taxpayer. Fullagar, J. answered both in the affirmative and found for the Commissioner; Menzies, J. answered the second in the affirmative and also found for the Commissioner. The decision was thus by a majority in favour of the Commissioner.

II. *Bonus Shares and "Income" in the Ordinary Sense*

The first question was not decided either way by a majority of the Court, since one judge answered it in the affirmative, another in the negative, and the third did not give a definite answer.

1. Dixon, C.J.

The Chief Justice said that the shares themselves were not income in the ordinary sense of the word since they "could not reach the shareholder as anything but capital",[3] and that the amount applied to pay them up was not income in that sense because the shareholder obtained no title to receive it. He supported these statements by referring to *I.R.C.* v. *Blott*.[4]

Blott's Case, decided by the House of Lords, dealt with the Finance Act, 1909-1910 (Eng.) (10 Ed.7 c.8) which imposed a tax on a taxpayer's "income from all sources". The word "income" in that phrase was treated by their Lordships to mean income in the ordinary sense of the word. A company passed a resolution declaring that out of its undivided profits a bonus should be paid to the shareholders and authorising, in satisfaction of that bonus, the distribution among the shareholders of certain of its unissued shares as fully paid up. It was held that neither the bonus nor the shares was income in the ordinary sense of the word, and so neither was caught by the Act. Viscount Haldane stated:

> . . . it is within the power of a company . . . to determine . . . whether it will withhold profits it has accumulated from distribution to its shareholders as income, and as an alternative not to distribute them at all, but apply them in paying up the capital sums which shareholders electing to take up unissued shares would otherwise have to contribute. If this is done, the money so applied is capital . . .[5]

And Viscount Cave said:

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[3] *Id.* at 192. [4] (1921) 2 A.C. 171. [5] *Id.* at 184.

> The resolution did not give the shareholder any right to sue for the dividend in cash, his only right being to have an allotment of fully paid shares in the capital of the company. The profits remained in the hands of the company as capital, and the shareholder received a paper certificate as evidence of his interest in the additional capital so set aside. The transaction took nothing out of the company's coffers, and put nothing into the shareholder's pockets. . . .[6]

The effect of the decision was summarized by the Judicial Committee in *Nicholas* v. *Commissioner of Taxes (Vic.)*[7] as follows:[8]

> Although in form a dividend was declared, it was inevitably at once applied to payment of the capital sums which the shareholders would otherwise have had to contribute. The share of profits so applied was never in the hands of the shareholder, nor had he ever a right to sue for it. Therefore in no sense could the shareholder be said to have received payment or to have had the right to demand payment, of a share of the profits, which in such event, would have formed part of his income for the purposes of British super-tax.

Thus a person must receive payment of an amount, or the right to demand payment, if that amount is to be part of his income in the ordinary sense of the word; and this is not the case with a dividend applied to pay up bonus shares.

Dixon, C.J. pointed out that the shareholder in *Blott's Case* would have been taxed in Australia, because the Income Tax Assessment Act 1915-1918 (Commonwealth) taxed "profits . . . credited to any . . . shareholder . . . of a company" and the appropriation of profits to pay up shares necessarily involved such a crediting, as was decided in *Nicholas's Case;* but that this did not affect the question of whether the profits so appropriated were income in the ordinary sense of the word.

It is believed that unless *Blott's Case* can be distinguished, or some equally strong authority to the contrary can be found, the Chief Justice's argument is unanswerable on this point.

2. Fullagar, J.

Fullagar, J. described the usual manner of effecting a bonus issue as—

> . . . by a capitalization of profits, followed by a declaration of a dividend with a provision that the dividend shall be satisfied by the issue of shares. Then in the books of the company the shareholder is credited with the amount of his dividend and treated as having applied it in paying up his new shares.[9]

He said that this was substantially the course followed in *Swan Brewery Co.* v. *The King,*[10] in which the Privy Council held that there had been a "crediting of a dividend" within the meaning of the Dividend Duties Act 1902 (W. Aust.); and also in *James* v. *Federal Commissioner of Taxation,*[11] in which the High Court held that the transaction was caught by the Income Tax Assessment Act 1915-18 (Commonwealth) which taxed "profits credited . . . to any shareholder". *Nicholas* v. *Commissioner of Taxes (Vic.)*[12] was concerned with an attempt to avoid the effect of these cases by not declaring a dividend or crediting the shareholder in the books of the company; it was held that the bonus share issue still necessarily involved a "dividend profit or bonus" being "credited or paid", and so was taxable.

His Honour said that in his opinion this last case established that: "where an issue of bonus shares involves a shareholder in liability to income tax, it

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[6] *Id.* at 200.
[7] (1940) 63 C.L.R. 191.
[8] *Id.* at 197.
[9] (1959) 33 A.L.J.R. 190, 195.
[10] (1914) A.C. 231.
[11] (1924) 34 C.L.R. 404.
[12] (1940) 63 C.L.R. 191.

must be not because the receipt by him of the new shares is a receipt of income, but because in the course of the transaction a dividend or share of profits has been allocated to him and applied on his behalf in paying for the new shares." He went on to say that he thought this concluded the case against the taxpayer:

> For it means that, even if we concede that the word "income" in the definition of "exempt income" and in s.80 denotes only what is income in the ordinary meaning of that term, what the taxpayer received in connection with the transaction of 1951 was income within that ordinary meaning. What is relevant for consideration is not the parcel of new shares in Dewcrisp Products, but the sum of £2,500 which represented its share of that company's capitalized profits and which was applied on its behalf in payment for those shares. I think that that sum was clearly income in the ordinary or commercial sense of the term.[13]

The present writer cannot agree with this argument. In the first place, it seems questionable whether *Nicholas's Case* did establish what his Honour said it did, as distinct from merely establishing that on the terms of the particular statute in question, it was the allocation of profits which involved the shareholder in income tax liability. It certainly does not preclude a different statute from defining "income" in such a way as to include the bonus shares themselves, and taxing these shares as income.

In the second place, even if we allow that the relevant thing for consideration was the sum of £2,500 applied on the taxpayer's behalf, it is difficult to see the grounds on which Fullagar, J. stated that it was "clearly" income in the ordinary sense of the word. All the cases which he quoted in which such sums were taxed dealt with statutes which taxed "profits credited to a shareholder" or the like; none involved a finding that the sums were income in the ordinary sense of the word. But *Blott's Case*, which decides that such sums are not income in that sense, was dismissed by Fullagar, J.; he said that it was "concerned with a different statute" (from that dealt with by the *Swan Brewery Case)*, and said nothing further to distinguish it. Certainly it was concerned with a different statute. It dealt with a statute which taxed income in the ordinary sense of the word, and so it would surely seem to be a more relevant case than those on which his Honour relied, which dealt with statutes taxing "profits credited", and the like.

The only authority quoted by Fullagar, J. which could support his conclusion was a statement in the *Swan Brewery Case*, made by Parker, C.J. in the Supreme Court of Western Australia, and quoted with approval in the judgment of the Privy Council in that case. With reference to the bonus share issue in that case, Parker, C.J. said: "Had the company distributed the £101,450 among the shareholders and had the shareholders repaid such sums to the company as the price of the 81,160 new shares, the duty on the £101,450 would clearly have been payable. Is not this virtually the effect of what was actually done? I think it is."[14]

This statement must be put in its context. In the *Swan Brewery Case*, the argument was advanced that the bonus share issue involved no dividend (and so no "crediting of a dividend") because nothing was distributed; the transaction had merely increased the number of shares held by members without increasing their total value and transferred money from the reserve account of the company to the share capital account. This argument was answered by saying that although in a sense there was only one transaction, in the contemplation of the law there were two — firstly, the crediting of the dividend, and secondly, its application to pay up the shares; and it is believed that the passage quoted merely made the point that there was just as much a dividend in this

[13] (1959) 33 A.L.J.R. 190, 195.
[14] (1914) A.C. 231, 236.

case as in the case where money was actually distributed and then received back, with the same end result. Thus interpreted, the statement gives no support to the argument of Fullagar, J. And if it is interpreted so as to support his Honour's argument, the statement is merely *obiter*, and so of far less persuasive force than the *ratio decidendi* of the House of Lords in *Blott's Case;* and also it is contradicted by the Privy Council itself in *Nicholas's Case* in its statement, quoted earlier of the effect of *Blott's Case*.[15]

It is believed, therefore, that Dixon, C.J.'s position is preferable to that of Fullagar, J.

3. Menzies, J.

Menzies, J. agreed with Dixon, C.J. that the shares were not income in the ordinary sense of the word. He said:

> According to the concepts of company law, although in such a case there must always be a fund of profits available for distribution as dividends, there is no distribution of these profits, but the character of the fund is changed from profits to capital which belongs to shareholders who would have been entitled to participate in the distribution of the fund and who receive it in its changed condition as fully paid shares, the fund being used for the purpose of paying up the shares.[16]

Although this conclusion is believed correct, the wording of the argument can be accepted only with reservations, because of the fundamental principle of company law that a company cannot issue shares unless it is paid for them; shares can only be treated as paid up to the extent of consideration actually received by the company for them.[17] For that reason, it is misleading to speak of profits being converted into shares which are distributed, because this would seem to indicate that the company is not receiving value for the shares, but is distributing them in the same way as it might distribute cash dividends, the only difference being that the nature of the thing being distributed is capital and not income. His Honour's statement must, with respect, be regarded as merely a fairly loose description of the practical effect of the transaction.

Menzies, J., although he did not rest his decision on this ground, inclined to the view that in the instant case the declaration and crediting of a dividend as a step in the bonus share issue was income in the ordinary sense of the word: "The language of s.44(2)(b)(iii) does indicate that the issue of shares is in satisfaction of a dividend paid from profits and in this context there is no reason why the word 'paid' should not include 'credited'. This, it is said, distinguishes *Blott's Case*."[18]

Blott's Case can scarcely be thus distinguished. The fact that "paid" is defined by the Act in s.6(1) to include "credited" and therefore does include it in s.44(2)(b)(iii), only means that s.44(2)(b)(iii) applies where the dividend is credited and not actually paid, a fact which was never in doubt. *Blott's Case* might have been distinguishable if the Act had said, for example, that whenever a dividend is credited, it shall be deemed to have been paid over, but s.6(1) merely provides that "paid" where used in the Act with the word "dividend" shall include "credited".[19]

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[15] (1940) 63 C.L.R. 191, 197.

[16] (1959) 33 A.L.J.R. 190, 195.

[17] *Ooregum Gold Mining Co. of India* v. *Roper* (1892) A.C. 125. An exception to this rule is established by the Companies Act, s.150 of which provides for issue of shares at a discount with the sanction of the Court.

[18] (1959) 33 A.L.J.R. 190, 198.

[19] It might be argued that *Blott's Case* can be distinguished because of s.19 of the Act, which provides: "Income shall be deemed to have been derived by a taxpayer although it is not actually paid over to him but is reinvested or otherwise dealt with on his behalf or as he directs." However, this section only applies to "income", so it cannot make something "income" which would otherwise not be income. "Income" in its ordinary sense includes amounts the payment of which a person has the right to demand, and s.19 merely

Thus it is submitted that on this first question, *Blott's Case* is indistinguishable, and the conclusion of Dixon, C.J. is correct.

III. *Bonus Shares and "Income" in Some Extended Statutory Sense*

Fullagar and Menzies, JJ. decided that even if the amount in question was not income in the ordinary sense of the word, the Act gives the word an extended meaning which does include such an amount. Dixon, C.J. decided that the Act gives no special meaning to the word.

1. Dixon, C.J.

The Chief Justice supported his conclusion with the following two statements:

(i) The word "dividend" is defined by the Act to include things which are neither dividends, nor income, at general law; but the meaning of the word "dividend" in the Act does not affect the meaning of the word "income" in the Act. It is not expressed to do so in the Act, nor does anything in the Act imply that it does.

(ii) The Act treats "income" as a known legal and commercial term, which it uses as a basis on which it builds the artificial, statutory notion of "assessable income"; and "the one thing which to my mind you cannot do is to work backward from what goes by express provision into 'assessable income' and use it to control the basal conception of 'income'. That appears to me to run counter to the plan on which the Act is constructed."[20]

We shall consider the first statement when we consider the contrary contention of Fullagar and Menzies, JJ. It is submitted that the second statement is proved incorrect by the following argument (suggested by words in the judgment of Menzies, J.). Section 23 exempts from income tax "the income" of enumerated people and organizations. Now according to Dixon, C.J. there is some assessable income which is not income within the meaning of the Act; and since s.23 applies only to "income", it would not apply to such assessable income. Thus, if an organization whose "income" is exempted by s.23 received income in the ordinary sense of the word and also assessable income which is not income in that sense, the former would be exempt from income tax, but tax would be payable on the latter because s.23 would not apply to it. A charitable institution with shares in a company would not have to pay tax on cash dividends; but it would have to pay tax on bonus shares paid up from normal trading profits (if we accept, as Dixon, C.J. does, that *Blott's Case* establishes that these are not income in the ordinary sense of the word). This would be anomalous and could not be intended by the Act, and since it follows necessarily from the view of Dixon, C.J., we would suggest with respect that his view is untenable. To put the argument another way, we should say that the Act, by exempting only "the income" of certain people and organizations, has given a clear indication that "income" as used by the Act includes assessable income, thereby displacing the presumption that where an Act uses a word which it does not define, it uses it in its ordinary sense.

This is supported by the fact that it is more reasonable to regard "assessable income" as meaning "income which is assessable" than as being a single indivisible term, since the former view is in accord with the principle of reading words in a statute in their ordinary and grammatical sense, and is confirmed by s.80(1) of the Act, which refers to "assessable income" as "that income",

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ensures that such amounts are regarded as "derived", and so are assessable income within the terms of s.25.

[20] (1959) 33 A.L.J.R. 190, 191.

thus implying that assessable income is a species of income. This explains how the word "income" comes to include assessable income; when the Act makes something assessable income, it makes it firstly "income" within the meaning of the Act, and secondly "assessable".

The Act would therefore seem to extend the meaning of "income" to include all amounts which it makes assessable income. But the amount in question in the *Fuller Case* was not assessable income (s.44(2)), so it is not caught by this extension of the word's meaning. A further extension must therefore be established if this second question is to be answered in the affirmative.

2. Fullagar, J.

Fullagar, J. gave the following reasons for his decision:

(i) To limit "exempt income" to income in the ordinary sense is "to stick too much to the letter and to miss the substantive intention".[21]

This, of course, is significant only if some clear indication of substantive intention can be found in the Act.

(ii) He quoted from the judgment of Dixon, J., as he then was, in *Dickson* v. *Federal Commissioner of Taxation,*[22] a passage stating that under the Act bonus shares were included in the assessable income of a shareholder unless subject to exemptions based on the peculiarity of the profit capitalized, and he stressed the naturalness of the use of the word "exemption".

The fact that it is natural to say that bonus shares are included in assessable income unless exempted seems to the present writer quite irrelevant to the question whether these exempted bonus shares are income and so can be exempt income.

(iii) "On the taxpayer's reading of that definition" (of exempt income in s.6(1), quoted above) "the second part of it would add nothing and would be altogether otiose". The second part was added to catch "in addition to receipts which the Act in terms 'exempts' from income tax, receipts which the Act treats as income but excludes from assessable income".[23]

It seems an artificial interpretation of the first part of the definition ("income which is exempt from income tax") which limits it to income which the Act in terms exempts. The phrase would ordinarily mean income on which income tax is not payable: if we accept this meaning the second part of the definition is otiose however we interpret "income".

Moreover if we accept his Honour's interpretation, the second part would not be otiose even if "income" is given its ordinary meaning. Consider the case of cash dividends paid to a non-resident out of profits derived from sources outside Australia. These are income in the ordinary sense of the word, but are not made assessable income by the Act (s.44(1)(b)). However, it is not at all clear that they are exempted in terms by the Act; s.23(r)[24] is the only section which might do this, and certainly until the case of *Parke Davis and Co.* v. *Federal Commissioner of Taxation*[25] was decided in 1959, it was doubtful whether it did so. It is possibly still doubtful, since the High Court in that case spoke of s.23(r) as "expressing the policy of the Act" which in this case is carried out by s.44(1)(b),[26] implying that it is only s.44(1)(b) which applies and not s.23(r). Here is an example of income in the ordinary sense of the word which might not be regarded as being exempted by the Act, and so might not come within the first part of the definition, but which does come within the

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[21] *Id.* at 196.
[22] (1940) 63 C.L.R. 687.
[23] (1959) 33 A.L.J.R. 190, 191.
[24] S.23 (r) exempts "income derived by a non-resident from sources wholly out of Australia".
[25] (1959) 33 A.L.J.R. 83.
[26] *Id.* at 86.

second part, which therefore serves the purpose of removing a doubt.

(iv) Section 44(1) read with the definitions of "dividend", of "income from personal exertion" and "income from property" clearly treats the amount in question as income.

This is much the same argument as that of Menzies, J., and it will be considered with the latter.

3. Menzies, J.

Dixon, C.J. said that the meaning of the word "dividend" in the Act does not affect the meaning of the word "income" in the Act; it is not expressed to do so, nor does the Act imply that it does. Fullagar and Menzies, JJ., however, thought that the Act does imply that "income" as used in the Act includes "dividends" as defined by the Act, and therefore includes the face value of the bonus shares.

Menzies, J. said that the Act expressly included "bonus shares within the definition of dividends (which are by their nature income)", the result, *prima facie*, being to give them the character of dividends, that is, income. This *prima facie* result, he said, was borne out by the scheme of the Act:

(i) The express exclusion of "dividends" in the definition in s.6(1) of "income from personal exertion" implies that dividends are income, but income from property.

(ii) Section 23 exempts "the income" of certain institutions from income tax. This undoubtedly operates to exempt dividends.

(iii) Section 44(1) assumes dividends are income, and lays down how far they are assessable income according to their source. Section 44(2), in taking certain types of dividend out of the class of assessable income, does not deny them the character of income.[27]

As regards s.23, we have seen that a reasonable result is achieved so long as "income" there includes "assessable income"; it need not include all dividends.

As for the rest of the argument, if it is regarded sympathetically it seems to carry some force. But it can all be categorically denied without producing any unreasonable results. Even if all dividends at general law were income at general law (and *Blott's Case* would seem to indicate that some are not), why does it follow that dividends as defined by the Act should all be income within the meaning of the Act? Why does the express exclusion of dividends from one class of income imply its complete inclusion in the full statutory sense in the other? On what grounds can it be said that s.44(1) "assumes" dividends are income and does not merely make certain dividends assessable income irrespective of whether or not all dividends are income? There are no convincing answers to these questions, and so one is inclined to the view that the argument of Fullagar and Menzies, JJ. does not establish that "income" as used by the Act includes "dividends" as defined by the Act; that is, it does not establish a further extension of the meaning of the word which would include the amount in question in this case.

IV. *Conclusion*

On the whole the *Fuller Case* seems unfortunate in that it confuses the picture as to the ordinary meaning of the word "income". *Blott's Case* decides specifically that the face value of bonus shares is not income within the ordinary meaning of the word, yet in this case one judge of the majority said that it is just that, and the other judge of the majority seemed inclined to agree with him; and neither of them gave any good reason for not following *Blott's Case*. It is

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[27] (1959) 33 A.L.J.R. 197-198.

believed that Dixon, C.J. must be followed on this point.

As to the second question dealt with by the Court, three possible meanings of the word "income" in the Act have been dealt with in this Note: (i) only income in the ordinary sense of the word; (ii) income in the ordinary sense of the word, plus assessable income which is not income in that sense; and (iii) income in the ordinary sense of the word, plus assessable income which is not income in that sense, plus dividends which are neither income in the ordinary sense of the word nor assessable income. The majority accepted the third meaning, and this case is now authority for that meaning. The present writer thinks the majority were right in rejecting the first meaning (that taken by Dixon, C.J.), and does not think that the third meaning is unreasonable. But with respect it is suggested that the second meaning is the most reasonable of the three, being most in accord with the principle of reading words in a statute in their ordinary sense as far as is possible, since while there are very good reasons for saying "income" as used in the Act includes assessable income, there are no really good reasons for saying that the word also includes all dividends.

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