IT 2473 - Income tax : amounts appropriated by shareholders from a company for their own use; whether deemed dividends assessable in their hands; whether paid out of profits.

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TAXATION RULING NO. IT 2473

INCOME TAX : AMOUNTS APPROPRIATED BY SHAREHOLDERS FROM A COMPANY FOR THEIR OWN USE; WHETHER DEEMED DIVIDENDS ASSESSABLE IN THEIR HANDS; WHETHER PAID OUT OF PROFITS.

F.O.I. EMBARGO: May be released

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I 1019855	DIVIDENDS	44(1)(a)
	DEEMED DIVIDENDS	108

PREAMBLE This ruling deals with that part of the decision of the Full Court of the Federal Court of Australia (Fisher, Beaumont and Burchett JJ) in MacFarlane v F.C. of T (86 ATC 4477; 17 ATR 808) concerning the treatment as deemed dividends of amounts appropriated by the taxpayer from a company. An application by the taxpayer for special leave to appeal was refused by the High Court of Australia on 4 December 1986. The question of beneficial entitlement to investment income, which was another important aspect of the MacFarlane case, is to be the subject of a separate Taxation Ruling.

2. The MacFarlane case was decided on the provisions of section 108 of the Income Tax Assessment Act as they stood before their amendment by section 15 of the Taxation Laws Amendment Act (No.3) 1987 (Act No.108 of 1987). By that amendment section 108 deems, in respect of distributions after 4 June 1987, an amount to which the section applies to be a dividend paid out of profits derived by the company.

FACTS 3. In about December 1967, the taxpayer and a Miss Masterman purchased a service station business conducted on premises leased from an oil company; each contributing $2000 towards the purchase price of the business. Although the assets of the business were held in the name of the taxpayer, it was agreed between the taxpayer and Miss Masterman that the business and the investments generated therefrom would be "between the two of us in the proportions 50/50".

4. In August 1976, the taxpayer and Miss Masterman acquired the share capital of a shelf company, changed its name to Matthew MacFarlane Pty. Limited (the company), and arranged for it to acquire from them their service station business. The company's issued share capital consisted of four shares of which three shares were held by the taxpayer and one share by Miss Masterman. The company traded profitably in the years in question i.e. the years ended 30 June 1977 to 1979. However, an investigation of the company's affairs carried out in 1979 revealed that the returns of income lodged by it in respect of

that period were false in a number of respects. In each of these income years the company significantly understated its income. It also made a number of spurious claims for deductions.

5. In respect of the year ended 30 June 1977, the company omitted from its return, income estimated at $10,000. This was the amount received by the company on certain undisclosed cash sales of petroleum less the estimated cost of acquiring that petroleum. The taxpayer ultimately accepted that this amount, which was derived from a number of cash transactions, had been appropriated by the taxpayer for his own use, albeit with the acquiescence of Miss Masterman. The company also claimed as a deduction a total amount of $17,592 which was said to have been paid to employees as wages. However, in the course of the inquiries, it emerged that the employees in question were fictitious. The "wages" had, in fact, been paid by the company's cheque into the taxpayer's bank account from time to time. This amount also was applied by the taxpayer to his own use, again with the acquiescence of Miss Masterman. The company further claimed to be allowed a deduction in the sum of $8,250 as a contribution said to have been made by it to a superannuation fund established by it for the benefit of its employees. Part of this amount was also attributable to fictitious employees. A similar position emerged in respect of the years ended 30 June 1978 and 1979.

6. The amount assessed to the taxpayer as deemed dividends, in essence, equated the net cash from undisclosed sales and a net amount for wages claimed in respect of fictitious employees appropriated by the taxpayer for his own use.

7. In the Supreme Court of New South Wales, Enderby J, 85 ATC 4015; 16 ATR 77, concluded that, on the facts of the case, it was open to the Commissioner to find that the amounts were paid in such a way that they met the requirements of section 108 in respect of deemed dividends. His Honour also held that there was nothing to show that the deemed dividends were paid otherwise than out of "profits" within the meaning of that word in paragraph 44(1)(a). In his opinion the word "profits" should be given the general meaning it has in the language of businessmen. It's meaning should not be restricted to that given to it by accountants who identify it with a "profit fund" available for dividends. The wages and net cash sales appropriated by the taxpayer were "income" of the company for the purposes of section 108. The amounts appropriated from the company, when the company was solvent and there was no intention to pay tax thereon, were held to be dividends paid out of profits under paragraph 44(1)(a).

8. The taxpayer appealed to the Federal Court from the decision of the Supreme Court of New South Wales. The Full Court of the Federal Court unanimously upheld the decision of the primary judge that the deemed dividends were paid out of the profits of the company. The Court therefore held that the provisions of paragraph 44(1)(a) were satisfied and the taxpayer was assessable under section 44 on the amounts paid by the

company and deemed by section 108 to be dividends.

9. In refusing the application by the taxpayer for the grant of special leave to appeal against the decision of the Full Federal Court adverse to him, the High Court noted that among the circumstances taken into account was the important fact that the judges in the Courts below had been of the unanimous opinion that the very particular facts of this case brought it within section 44.

RULING

10. While the decision turned on its own particular facts, the judgment of the Full Federal Court has clarified the requirement in paragraph 44(1)(a) that dividends be paid "out of profits" in the case of payments deemed by section 108 (as it stood prior to Act No.108 of 1987) to be dividends.

11. The Federal Court in the MacFarlane case accepted that certain amounts (comprising wages purportedly paid for wages, undisclosed proceeds of sale of petroleum and contributions to a superannuation scheme for non-existent employees) were properly to be treated as payments made by the company for the individual benefit of its shareholders for the purposes of the former section 108. The Court accepted that the payments were made out of the company's profits. According to Beaumont J. the actual source of the payments was the company's trading profits. Accordingly, the taxpayer was assessable under paragraph 44(1)(a) on the payments which section 108 deemed to be dividends.

12. The MacFarlane decision may also be seen as a particular application of the general principles laid down by Gibbs C.J. in the High Court decision of F.C. of T v Slater Holdings Ltd. (No.2) 84 ATC 4883; 15 ATR 1299, for the ascertainment of "profits" for the purposes of paragraph 44(1)(a). The limitation thought to exist, on the applicability of paragraph 44(1)(a), to dividends paid out of a profit fund or dividend fund only, following the decision in Rutherford v F.C. of T 76 ATC 4304; 6 ATR 542, may be treated as being of no effect. In any event Rutherford had been superseded by the decision in Slater Holdings.

13. Payments of the types involved in the MacFarlane case made by private companies on or before 4 June 1987 out of their profits to shareholders of the companies are deemed under sub-section 108(1) to be dividends paid on the last day of the year of income in which such payments are made.

14. The new section 108, which applies to amounts paid or credited or property transferred after 4 June 1987, deems certain payments, advances, loans and credits made by a private company to an "associated person" (in terms of sub-section 108(4)) to be dividends paid by the company out of profits to the associated person as a shareholder. In applying the new section 108 it is no longer necessary to make the sort of enquiry made in the MacFarlane case, namely, whether the payments, etc. made by the company were, for the purposes of paragraph 44(1)(a), paid out of profits derived by the company.

COMMISSIONER OF TAXATION
21 April 1988