1932-33.

THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA.

FIRST REPORT

OF THE

ROYAL COMMISSION ON TAXATION.

Presented by Command, 8th December, 1933 : ordered to be printed, 12th January, 1934.

[*Cost of Paper.*—Preparation, not given ; 850 copies ; approximate cost of printing and publishing, £54.]

Printed and Published for the GOVERNMENT of the COMMONWEALTH of AUSTRALIA, by L. F. JOHNSTON, Commonwealth Government Printer, Canberra.

No. 199.—491.—PRICE 2s.

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COMMONWEALTH OF AUSTRALIA.

GEORGE THE FIFTH, by the Grace of God of Great Britain, Ireland, and the British Dominions beyond the Seas King, Defender of the Faith, Emperor of India.

To Our Trusty and Well-beloved :

The Honorable DAVID GILBERT FERGUSON, a Judge of the Supreme Court of New South Wales ; and EDWIN V. NIXON, Esquire, Chartered Accountant (Australia).

GREETING :

KNOW YE THAT We do by these Our Letters Patent, issued in Our Name by Our Governor-General in and over Our Commonwealth of Australia, acting with the advice of Our Federal Executive Council, and in pursuance of the Constitution of Our said Commonwealth, the *Royal Commissions Act* 1902–1912, and all other powers him thereunto enabling, appoint you to be Commissioners to inquire into and report upon the simplification and standardization of the taxation laws of the Commonwealth and of the States in so far as they relate to substantially the same subject matters of taxation, as for instance income tax, land tax and death duties ; and, in particular, to make recommendations for the purpose of obtaining uniformity in legislative provisions, including provisions relating to procedure and forms of returns :

AND WE APPOINT YOU the said DAVID GILBERT FERGUSON to be the Chairman of the said Commissioners, and as such to have a deliberative, and, in the event of an equality of votes, a casting, vote in all matters considered by the Commission :

AND WE REQUIRE YOU with as little delay as possible to report to our Governor-General in and over Our said Commonwealth the result of your inquiries into the matters entrusted to you by these Our Letters Patent :

IN TESTIMONY WHEREOF WE have caused these Our Letters to be made patent and the Seal of Our said Commonwealth to be thereunto affixed.

WITNESS Our Right Trusty and Well-beloved Counsellor, Sir ISAAC ALFRED ISAACS, Knight Grand Cross of Our Most Distinguished Order of Saint Michael and Saint George, Governor-General and Commander-in-Chief in and over Our
(SEAL). Commonwealth of Australia, this sixth day of October in the year of Our Lord One thousand nine hundred and thirty-two, and in the twenty-third year of Our Reign.

ISAAC A. ISAACS,
Governor-General.

By His Excellency's Command,
J. G. LATHAM,
for Prime Minister.

Entered on record by me, in Register of Patents, No. 60, page 67, this eleventh day of October, One thousand nine hundred and thirty-two.

J. G. McLAREN.

COMMONWEALTH OF AUSTRALIA.

FIRST REPORT OF THE COMMISSIONERS.

INTRODUCTION.

To His Excellency, the Right Honorable SIR ISAAC ALFRED ISAACS, *a Member of His Majesty's Most Honorable Privy Council, Knight Grand Cross of the Most Distinguished Order of Saint Michael and Saint George, Governor-General and Commander in Chief in and over the Commonwealth of Australia.*

MAY IT PLEASE YOUR EXCELLENCY :

We, the Commissioners appointed by Royal Letters Patent, dated 6th October, 1932 :—

"To inquire into and report upon the simplification and standardization of the taxation laws of the Commonwealth and of the States in so far as they relate to substantially the same subject matters of taxation, as, for instance, income tax, land tax, and death duties; and, in particular, to make recommendations for the purpose of obtaining uniformity in legislative provisions, including provisions relating to procedure and forms of returns."

have the honour to report as follows:—

2. In view of the terms of reference to the Commission, which involved consideration not only of Commonwealth, but also of State taxation, the Prime Minister communicated with the Premier of each of the States to invite his co-operation in the work of the Commission, more particularly through his Treasury and Taxation officers. We are pleased to report that this co-operation was freely given, and the Commission was afforded the fullest facilities for conducting its investigations.

3. As soon as possible after our appointment we met in Sydney to make the necessary preliminary arrangements for the inquiry. Our first meeting was held in Sydney on 19th October, 1932, and the first public sitting to take evidence on 21st November, 1932, also in Sydney.

4. As the Commission considered it necessary to obtain at first hand the views of witnesses in each State and a knowledge of local problems, public sittings have been held in the capital city of each State. The final public sitting was held in Sydney on 18th July, 1933, and immediately thereafter we commenced the preparation of this report.

5. We have examined 136 witnesses, and have considered a number of letters which have been addressed to us on the subject of our inquiry. Many of the witnesses who appeared before us represented important commercial and professional interests. The evidence we have heard, and the information placed at our disposal, have been voluminous and exhaustive. We had also the advantage of private interviews with the Commissioner of Taxation and with many of the witnesses, at which matters dealt with in their evidence were discussed in fuller detail.

6. No one who is conversant with the systems of taxation obtaining in the Commonwealth and States will have any doubt as to the difficulties of the task that confronted us. These difficulties are to an extent unavoidable in any system which is designed to assess a number of taxpayers whose circumstances and incomes differ considerably, and they are further complicated by the diversities of form, arrangement and language of the taxation laws of the Commonwealth and States. This is reflected in the evidence we have received.

7. In order to indicate to witnesses the nature and extent of the information required by the Commission, questionnaires relating to each of the subjects covered by our reference were prepared and circulated. These materially facilitated the presentation and classification of evidence.

8. We have to express our thanks to the witnesses who appeared before us. The compilation of the evidence submitted involved much care and thought, and it was given with due regard to the importance of the matters at issue.

9. The officers of the Federal and State Taxation Departments and the Collectors of Stamp Duty gave us invaluable help at every stage of our inquiry. The evidence of these gentlemen and their official memoranda were carefully and ably prepared and presented, and have proved of inestimable assistance to us.

10. During the course of our inquiries, Mr. J. A. L. Gunn, Chartered Accountant (Australia), being about to visit Great Britain, kindly undertook to inquire into the nature and operation of the Income Tax laws of Great Britain, and to report to this Commission the result of his inquiries. Not only did Mr. Gunn supply us with a great deal of information about income tax practice in Great Britain, but he was good enough to make available to us criticisms of the Commonwealth Income Tax Assessment Act and suggestions for its amendment which had been obtained by him from various recognized authorities on taxation in Great Britain. The information submitted by Mr. Gunn has proved of great value to the Commission.

11. A complete list of witnesses—representative, official, and individual—is set out in Appendix 6.

SECTION I.

THE SCOPE OF THIS REPORT.

12. The terms of our Commission require us to report upon two distinct subjects :—

(*a*) Simplification, and (*b*) Standardization of the taxation laws of the Commonwealth and States.

13. It does not appear to us to be advisable that we should refrain from presenting our report until we are in a position to submit our conclusions on all the matters covered by our reference. Our inquiries have convinced us that many of the existing complexities of the Commonwealth system are due to causes which are clearly identifiable. So far as these are concerned it is competent for the Commonwealth to act without reference to any State, and such action cannot prejudice subsequent consultation with the States upon the question of standardization.

14. After consideration of the evidence submitted, we have arrived at the conclusion that although the fundamental principles of the Commonwealth Income Tax Assessment Act are sound, some of its provisions are unnecessarily complicated, and difficult both to understand and apply.

15. Over-shadowing everything else is the method of taxing dividends from companies in the hands of shareholders. Further complications are caused by the method of allocating the statutory exemption and concessional deductions.

16. The opinion of informed witnesses is that the Act is too scientific, and that it strives to attain theoretical equity as between all classes of taxpayers and all individual taxpayers. That ideal is unattainable, and the attempt involves a sacrifice of simplicity and convenience out of all proportion to the value of the results achieved. There are of necessity many arbitrary elements in the taxation system. The rate of tax is arbitrary, the scale of progression is arbitrary, the exemptions and deductions are arbitrary, and it is idle to hope that a system based upon such a foundation can be theoretically equitable in all its parts. Even if theoretical equity were possible, it would be dearly bought if it could not be obtained without the complexities of the present system, which create great difficulty in administration and irritate taxpayers, with the result that the whole Act comes to be condemned as unintelligible and oppressive.

17. There are certain features of the Commonwealth law which call for early simplification, and which we think are capable of being simplified by a modification of the provisions of the present Act without materially departing from its basic principles. In this first report we shall deal only with those matters under the following headings :—

(1) The taxation of companies and dividends,

(2) The method of allocating the statutory exemption and concessional deductions,

(3) The operation of Section 21 (Insufficient distributions by companies), and

(4) The complications created by the Special Property Tax.

SECTION II.

CONSIDERATION OF THE VARIOUS METHODS OF TAXING COMPANIES AND DIVIDENDS.

18. There is no great difficulty in determining the profits of companies as such. The income of a company is arrived at in a similar manner to that of any other taxpayer. What has to be decided, however, is in what manner and at what rate such profits are to be taxed, and whether dividends are to be taxed in the hands of shareholders and, in that event, in what manner.

19. It is clear that a great deal of the dissatisfaction with the Commonwealth Act is due to the operation of those provisions of the Act which relate to the taxation and rebating of dividends in the return of a shareholder. Not one witness who appeared before us to give evidence on this subject expressed himself as satisfied with the present practice. Every one advocated either some modification of the system, or the adoption of another.

20. Before suggesting any modifications of the present system, we propose to consider the various systems of taxing companies and dividends that have been adopted in Australia.

Where the Company is taxed on its total profits at a flat rate, dividends being exempt in the hands of the shareholder.

21. To overcome the difficulties associated with the taxation of companies and dividends, some witnesses have suggested that the income of the company should be taxed in the hands of the company, that no tax should be levied on dividends in the hands of shareholders, and that no rebate of tax be given.

22. This is undoubtedly the simplest method of taxing the profits of companies. It is easy to apply and understand, and the shareholder is not much concerned with the rate of tax paid by the company, provided that it is not so high as to materially reduce the amount available for dividends.

23. It is, of course, inconsistent to separate part of the income of an individual and tax it at a flat rate without regard to his "taxable ability", which is determined by reference to his total income. Any flat rate that may be adopted must be inequitable to some shareholders. Those whose individual rate is below the flat rate pay more than they should, while those whose individual rate is higher than the flat rate pay less than they should. If no other reasons for consideration existed the system might be condemned at once on these grounds alone.

24. It must be recognized, however, that if companies were taxed at a flat rate equal to the present company rate there would be a serious loss of revenue. This would have to be made good either by imposing a higher flat rate or by a general increase in taxation. The imposition of a higher flat rate would, of course, emphasize inequity as between individuals and make the system less attractive to the shareholder with a small income.

25. This system may be applied without causing a serious loss of revenue or material inequity only if the following conditions exist :—

(1) The rate of tax payable by a company must not be higher than a shareholder with a small income might be expected to pay on his dividend.

(2) The maximum rate of tax payable on income from property must not be much in excess of the rate of tax payable by a company.

In these circumstances, it matters little to the revenue whether the tax is collected from the Company or the shareholders, for the amount received will not differ materially. Obviously it is more convenient to collect tax from the Company.

26. For these reasons the system has been found to operate satisfactorily in Victoria.

27. As these conditions do not apply in the case of the Commonwealth the system would either produce inequity as between shareholders or result in a material loss of revenue. For these reasons, we do not recommend its adoption.

Where a Company is taxed on its total profits at a graduated rate determined by the amount of such profits, dividends being exempt in the hands of the shareholder.

28. This system has not been advocated by any witness.

29. The arguments which are used to justify the imposition of tax at a graduated rate determined by the amount of income do not apply to a company. A company exists only to earn income which will ultimately reach its shareholders in the form of dividends. A company making a small profit may be owned by a few wealthy shareholders, and a company making a large profit may be owned by a number of shareholders in moderate circumstances. Graduation may, therefore, be properly applied to the incomes of those who receive the profits, but not to the machine which produces them.

30. A rate of tax graduated by reference to the amount of a company's income discourages the formation of large companies. If the range of graduation is small it results in the taxation of the majority of companies at the maximum rate.

31. Companies are taxed upon this system in New South Wales and South Australia. In New South Wales, the rate begins at 2s. and reaches the maximum of 2s. 9d. at £4,500. In South Australia the rate begins at approximately 1s. 2d. and reaches the maximum of 3s. 9d. at £5,000. In neither of these States, however, is the scheme applied exactly in the manner described in the head note, as dividends are also taxable in the hands of shareholders.

32. We do not recommend the adoption of this scheme by the Commonwealth.

Where the company is taxed on its total profits at a graduated rate based on the percentage which the profits bear to the capital employed—dividends being exempt in the hands of the shareholder.

33. This system is in force in Queensland, and we are indebted to the Commissioner of Taxes in that State for an explanation of the manner in which it operates.

34. In his evidence he stated—

> " The Queensland State method looks to the company not merely as a legal entity, but as a taxable entity. Once the company is assessed, the dividends are brought into the shareholder's assessment for rate purposes only.
>
> The modern trend as to the part of a company in commercial affairs justifies the State method, having regard to failure of the other systems. A company enjoys the protection of the State and other advantages afforded by the State in common with the rest of the community, and its contribution to the costs thereof, is, therefore, warranted.
>
> The way out is to recognize that a company, enjoying as it does all the protection and advantages afforded to the community generally, and becoming more and more an integral part of business life as apart from its constituent members, should contribute to the revenue according to its ability to pay. The most equitable test of that ability is that applied under the State Act.
>
> After all, it has been shewn that no company taxation measure taxes as if the company had not been interposed between the source of the income and the ultimate recipient thereof. Hence, the system of taxing, in effect, an investor (per medium of the company) according to the percentage profit which his investments might be stated to have earned, is a fair and proper graduation."

35. In our opinion, the status of the company is not in question. As we have previously stated the company exists only to earn income for its shareholders, who will eventually receive their income in the form of dividends. The test of ability is properly applicable only to the individual, and not to the machine which is used to produce his income. If a company as such is to be taxed in return for the protection and advantages which it enjoys, taxation at a flat rate is less likely to cause inequity than a graduated scale on absolute or relative profits. The argument that an investor should be taxed through the company according to the percentage profit which his investment has earned is fallacious. If it applies at all (which we do not admit) it can apply only to an original shareholder. It can have no application in the case of an investor who has purchased his shares at a premium. The return on his investment will obviously be lower than the percentage of profit on the capital of the company, and it is on the latter figure that the rate of tax payable by the company is determined, and not on the return to the shareholder.

36. If the principle of graduating the rate of tax according to the percentage of profit earned on the investment were sound, the rate applicable to individuals and partnerships should be determined in the like manner. So far as we are aware, no system of taxation attempts to do this.

37. After carefully considering the evidence and information furnished to us, the only advantage we can see in this system is that it facilitates the fine art of " plucking the goose with as little squealing as possible ". The shareholder will not object as strongly to pay a high rate of tax indirectly through the company as he would do if the same rate were imposed on the dividend when received by him.

38. Where the rate of tax is based on the percentage of profit earned on capital, the fundamental difficulty is to determine the capital really employed, where the goodwill, which has been created by the energy of the proprietor and not paid for in cash, is so firmly established that it may be almost regarded as an asset though not expressed in figures. Is such additional capital to be ignored ?

39. There are other companies in which the personal efficiency and energy of the proprietors play a far more important part than their capital. Under this heading are comprised companies formed to provide service and, generally speaking, those companies where the principal shareholders are employed in the business and are personally interested in its prosperity. The official reply to the complaint that this system presses heavily upon such companies is that as the principal shareholders are in a position to fix salaries commensurate with their services, no hardship is imposed upon the company by requiring that the balance of the profits shall be taxed in the manner prescribed. This explanation is not entirely convincing, because the power to determine a salary commensurate with the services rendered by a director is in fact vested in the Commissioner. The amount disallowed is added to the profits of the company and may result in an increased rate of tax.

40. We desire, however, to state that it was not suggested by any witness that this power has been exercised unfairly.

41. A further objection that may be taken to this system is that it may operate very inequitably in the case of an individual shareholder. For example, members of a private company earning a large income which represents a low return on the capital employed, are taxed at the lowest rate, and as there is no provision for compelling distribution, may pay no further tax on such profits. Even if such profits are distributed no further tax is payable thereon, as dividends are treated as exempt income in the hands of the shareholder. Conversely, the shareholders of another private company, all of whom may be in receipt of moderate incomes, are indirectly taxed at a very high rate if the profits of the company, though small in amount, represent a high rate of return upon the capital invested to produce it.

42. Another very practical objection is that the system introduces complications which are not experienced in any other Act which imposes tax on companies. It should be sufficient, for the purpose of taxation, to determine the taxable income of the company. When this has been done in Queensland, two other amounts must be determined—

(*a*) the profit to be used for determining the percentage of profits to capital;

This amount is neither the taxable income of the company nor the profit as shown by its profit and loss account, but is an amount determined by adjusting the latter by the allowance or disallowance of certain items which are not taken into consideration when arriving at the taxable income.

(*b*) The capital employed to earn the profits.

In this calculation questions arise as to variations in capital, and whether any portion of the capital has not been utilized in earning the profit used in determining the percentage. It was stated in evidence that at times considerable additional information has to be supplied to enable this calculation to be made, and one witness informed us that in some cases the supporting statements covered from 40 to 70 pages. This witness also stated that it was sometimes impossible for the average taxpayer, or even for the average taxation agent, to understand how the results had been arrived at by the Department.

43. An official memorandum from the Commissioner of Taxation, Queensland, explaining the operation of the system is reproduced as Appendix 5.

44. Our conclusions are that this system is capricious, and, at times, unfair in its incidence, that it violates all the equities of taxation, and is a penalty on efficiency. Its adoption by the Commonwealth would only substitute other complexities for those which now exist. For these reasons, we do not recommend it.

Where the Company is taxed on its undistributed profits only, and the shareholder on the dividends received by him without rebate. If subsequent distributions are made out of profits previously taxed to the Company—a rebate of tax to be made either to the shareholder or to the Company.

45. This was the scheme of the first Income Tax Assessment Act of 1915, which applied to companies and shareholders in respect of income derived prior to the 1st July, 1922. The Act was amended in 1923 to provide for a less expensive system and to bring it into greater uniformity with the State Acts, all of which taxed the Company on the whole of its profits.

46. We are informed that in this system many difficulties were encountered in arriving at the proper deduction to be allowed in respect of distributed income, particularly in the case of pastoral companies where the Departmental value differed from the book value of live stock.

47. It is claimed by those who advocate this system that it would eliminate the necessity for calculating and allowing rebates, and also that it would operate more equitably, inasmuch as each taxpayer would pay only at the rate applicable to his individual income.

48. Any scheme which appears to offer a solution of the rebate difficulty must, of course, be carefully considered, but after careful examination of the proposals, we fail to see that their adoption would obviate all of the complexities that now exist in connexion with rebates.

49. The fundamental idea upon which the scheme is based is that, as a company is merely an intermediary to earn profits for its shareholders, any exemption from tax allowed to the company must be carried through to the individual shareholders. It follows, therefore, that each dividend paid by the Company must be analyzed in order to determine the percentage of exempt income included therein, in order that the necessary adjustment may be made in the return of each shareholder. Further, if a dividend is distributed from accumulated income which has previously paid tax in the hands of the company, such dividend must also be analyzed to determine how much of that dividend has been paid out of the profits of a given year or years, and the rebate that should be allowed thereon to each shareholder in his individual assessment. It will be clear, therefore, that this system still involves analysis of the dividend, and determination of the appropriate rebate, and in these circumstances shareholders would have as much difficulty as at present in checking rebates allowed to them.

50. Another material argument which may be advanced against this proposal is that considerably less revenue would be collected from companies and shareholders. The present Federal scheme ensures that tax will be paid on the total taxable profits of a company at not less than the company rate, in part by the company on behalf of those shareholders who are not liable to tax, or who are taxable at less than the company rate, and in part by those shareholders who are liable to tax at a rate which is higher than the company rate. Now, if the company were taxed only on undistributed profits, and shareholders on the dividends which they receive, it follows that no tax would be collected on the dividends which are paid to shareholders who are not liable to tax, and less tax on the dividends paid to shareholders who are taxable at less than the company rate. This loss would have to be made good by an increase in the rate of tax payable on undistributed profits, or by all taxpayers.

51. At first sight it may seem reasonable that no tax should be collected from the company in respect of profits distributed to shareholders who are either not taxable or who are taxable at less than the company rate. But, in our opinion, there is no real justification for exempting such profits either wholly or partially from the tax that is now payable by the company. The shareholders of a company by their association in a corporate body get the benefits which under the law are incident to incorporation, and we think it not unreasonable that they should pay something for these privileges.

52. Our attention has also been drawn to the fact that if companies were not assessed on their total profits, they would have an undue trading advantage over businesses carried on by individuals or partners.

53. It would also be necessary to make the company liable to pay tax on dividends distributed to absentees. This was the practice prior to the amendment of the Act in 1923.

54. This scheme has also been submitted in a modified form, in which it is suggested that rebates becoming due on a dividend paid out of accumulated profits should be adjusted with the company and not with individual shareholders. It may be admitted that the adoption of this suggestion would minimize adjustments, but it would not entirely overcome the problems associated therewith. It would still be necessary to analyse the dividend for the purpose of determining the total rebate to be allowed.

55. In our opinion, this method of taxing companies and shareholders can be regarded only as a palliative, and not as a remedy for the complications of the present system, and we are, therefore, unable to recommend its adoption by the Commonwealth.

Where the Company is taxed on its total profits at a flat rate, and the shareholder on the dividend received by him subject to rebate.

56. This is the present Federal system, which was substituted for the taxation of undistributed profits in 1923. It applies to all income derived by a company after the 1st July, 1922. The scheme is a compromise. Tax is imposed at a flat rate on the total taxable income of a company. No deduction is allowed to the company for dividends distributed by it. Such dividends are taxable to the shareholder at the rate applicable to his total taxable income from all sources, but to prevent double taxation, the shareholder is allowed a rebate in his individual

assessment upon dividends included therein which are declared out of income on which the Company has paid or is liable to pay tax. If the rate of tax payable by the shareholder is higher than the Company rate, rebate is allowed at the company rate. If the rate of tax payable by the shareholder is less than the Company rate, rebate is allowed at the shareholder's individual rate.

57. The result in the latter case is that the tax payable by the shareholder on the dividend is refunded, and the dividend is, in fact, only brought in to determine the rate of tax on other income included in the return.

58. The scheme operates to produce two desirable results—

(1) The greater part of the tax payable by the Company and its shareholders is collected in the easiest and most convenient manner, that is from the Company.

(2) Tax is paid on the total taxable profits of the company at a rate not less than the company rate. The revenue also derives additional tax on dividends included in the income of shareholders whose individual rate is higher than the company rate.

59. We recognize, however, that the system must be modified in such a manner as to remove the causes of the existing complexities. We shall, therefore, endeavour to ascertain these causes, and shall suggest certain modifications that will simplify the system. We believe it is possible to do this without serious loss of revenue or inequity to the individual.

60. We are of the opinion that this method of taxing companies and shareholders is to be preferred to any of the other methods which we have considered, and we recommend, therefore, that it be retained subject to the modifications which we shall suggest.

SECTION III.

REASONS FOR THE EXISTING COMPLEXITIES IN THE METHOD OF TAXING DIVIDENDS IN THE HANDS OF SHAREHOLDERS.

61. Under the provisions of the *Commonwealth Income Tax Assessment Act* 1922–32, dividends are included as assessable income to the extent set out hereunder :—

(*a*) In the case of a resident shareholder—dividends distributed to him out of profits derived by the company from any source ;

(*b*) In the case of an absentee shareholder—that part of the dividend distributed to him out of profits derived by the company from sources in Australia.

62. But dividends distributed out of the following sources are exempt in the hands of the shareholder :—

(1) Ex-Australian profits to the extent specified in the Act ;

(2) Undistributed income accumulated prior to 1st July, 1914 ;

(3) Capital profits as defined in the Act ;

(4) Interest derived from specified Commonwealth Loans.

63. Subject to these specific exemptions, dividends are taxable in the hands of shareholders whether the profits out of which they are distributed are subject to tax in the hands of the company or not.

64. To obviate double taxation, the shareholder is allowed a rebate in respect of dividends included in his taxable income, provided that such dividends have been distributed out of income on which the company has paid or is liable to pay tax.

65. In practice, the application of these provisions involves a detailed analysis of each dividend distributed by a company, in order to ascertain how much of that dividend has been paid out of each of the following sources :—

(*a*) Ex-Australian income, distinguishing between income earned before and after the 1st July, 1929, and, in the latter event, taking into consideration the extent to which such income is, in the opinion of the Commissioner, not exempt from income tax (or royalty or export duty) in the country in which it was derived ;

(*b*) Undistributed income accumulated prior to 1st July, 1914; but it should be noted that an amount carried forward by a company in its profit and loss account, appropriation account, revenue and expenses account, or any similar account, is not deemed to be accumulated income. This, in effect, restricts the concession to dividends distributed out of reserves accumulated prior to 1st July, 1914.

(*c*) Profits arising from the sale or compulsory resumption for public purposes of assets which were not acquired for the purpose of re-sale at a profit.

(*d*) Income derived from tax free securities issued by the Commonwealth Government for the purpose of Commonwealth War Loans, or income derived from interest on conversion loans.

(*e*) Income upon which the company has paid or is liable to pay tax under Section 21 of the Act.

(*f*) Undistributed profits accumulated since 1st July, 1914, and not transferred to reserve—distinguishing between any amounts included therein upon which the company has paid or is liable to pay tax, and any amounts upon which the company is not liable to pay tax as, for example, interest on certain State loans issued prior to 31st December, 1923, and not converted.

When a dividend is paid out of profits at the credit of profit and loss appropriation account, the appropriation is made firstly from the last amount credited to the account. If this is insufficient the next preceding credit is then drawn upon. This practice follows the decisions of the High Court.

(*g*) Reserves created out of profits earned by the company since 1st July, 1914—distinguishing as in (*f*), between profits included therein upon which the company has paid or is liable to pay tax, and profits upon which the company is not liable to pay tax.

A dividend paid out of profits in reserve account (unless specifically appropriated by resolution of the directors) is taken proportionately from all profits credited to and still included in the reserve.

An example of the manner in which reserves are drawn upon for purposes of a dividend is shown in Appendix 1.

(*h*) Assessable income not taxed to the company.

For example, a company may have the right under its memorandum and articles to declare a dividend out of current profits without using those profits to make good past losses, but for income tax purposes the company has the right to deduct previous business losses in its current assessment. Such a company may declare a dividend out of its current profits. That dividend will be taxable in full in the hands of the shareholder, because the company has not paid tax on such profits, which have been applied in the company's assessment to set off the losses of previous years. The same result might be brought about if other deductions permitted by the Act exceed the amounts written off by the company in its accounts for the year in question.

66. Having ascertained the composition of each dividend paid by a company as shown by this analysis, it is next necessary to ascertain the rate of tax paid by the company in respect of the profits included under each of these headings, in order that the rebate to be allowed to the shareholder in respect of such profits included in his dividend may be computed.

67. The following table shows the rates of tax payable by a company during each of the years since the inception of the Act :—

TABLE OF RATES.

	s.	d.		s.	d.
1915	1	6	1924	1	0
1916	1	10½	1925	1	0
1917	1	10½	1926	1	0
1918	2	6	1927	1	0
1919	2	6	1928	1	0
1920	2	8	1929	1	2.4
1921	2	8	1930	1	4
1922	2	5	1931	1	4.8
1923	1	0	1932	1	4.8

68. The whole of these particulars, showing the analysis of each dividend and the rebate calculations based thereon, must be separately recorded for each company for each year in which a dividend is paid. When the assessment of each individual shareholder is being prepared, the assessor must use this information to ascertain the percentage of the dividend which is taxable, and the rates of rebate allowable thereon. He must then prepare a rebate statement for the information of the shareholder.

69. As a company may consist of many hundreds of assessable shareholders, it is obvious that the amount of work involved in the preparation of rebate statements is considerable. In the case of a taxpayer in receipt of dividends from several companies, the calculation of rebates to two places of decimals involves an expenditure of labour and cost grotesquely disproportionate to the resulting adjustment—perhaps a matter only of a few shillings.

70. An example of a rebate statement of the type referred to herein is shown in Appendix 2, and it will be noted that the net result of these intricate calculations is a rebate to the shareholder of 6s. 11d.

71. The foregoing explanation will give some idea of the complexity of the Commonwealth system, and the helplessness of the taxpayer, even one with an expert knowledge of taxation, to check his assessments as regards income from dividends and the rebates allowed thereon.

72. One witness, who is a public accountant and a taxation expert, stated that there are many of these assessments which he could not check. Another witness representing an important trustee company, and responsible for the preparation last year of over 4,750 income tax returns prepared on behalf of estates and clients, said—

> "We can say without fear of contradiction that three-fourths of the applications which are made by us to the Commissioner for adjustments of assessments are due to incorrect rebate calculations or to alterations subsequently notified in the rate of rebates applicable to the dividends from any company. In some cases we know that the amount of the rebates allowable in respect of the dividends of a company have been tentatively fixed for more than eighteen months whilst the company and the taxation authorities have been arguing as to the correct rebates allowable. When the rebates applicable to the dividends of any company are adjusted by the Commissioner of Taxation it is impracticable for the Commissioner to adjust the assessments of every shareholder, and very few receive the adjustment to which they are entitled."

73. Another public accountant who gave evidence stated that, in his opinion, the present system necessitates voluminous and intricate calculations quite incomprehensible to the layman, which must involve the Department in enormous clerical expense. He added—

> "In support of this I got permission from a couple of my clients to bring in certain returns. One is the case of a doctor who has shares in about twenty companies. I was able to check about half a dozen of these companies. The only correct way in which to do this is to write to the various companies asking if the proportions are correct. From the Bank of . . . . we got a reply which did not agree with the figure on the assessment. From the Bank of . . . . we got a reply stating that they could not reconcile our figures with their own figures, and they suggested we should see the Income Tax Commissioner about it. From another company we received a reply that there were certain matters in connexion with the company's assessment which had not then been finalized, but they would give us the information as soon as they were in a position to do so. Now, although these matters had not been finalized in the hands of the company, yet we had received our assessment. Another company stated that they advised us, in view of the complications, to accept the rebate. These are just instances showing that one never knows whether the rebate is correct or not . . . . "

74. From the evidence of another public accountant with great experience of income tax practice we extract the following statement :—

> "Whilst one cannot but express a most sincere admiration for the Commissioner's staff for the able way in which they discharge their difficult duties, it is idle to suggest that the work is always accurately performed. The system is so intricate that the possibility of error is great. Unfortunately, the taxpayer himself has no means of checking the percentages shown unless he is in a position to compare them with the company's return, or is advised direct by the company. The Department is debarred by the secrecy provisions of the Act from giving him any details of the company's assessment."

75. Perhaps the strongest condemnation of the existing system comes from responsible officers of the Department.

76. Mr. E. J. McMahon, State Commissioner of Taxation, and Federal Deputy Commissioner of Taxation in New South Wales, stated in evidence :—

"Difficulties arise in the assessment of dividends to shareholders. These may be stated as follows :—

(i) A correct rebate cannot be calculated in most cases until the company is assessed. If the company's assessment is in dispute, it may hold up a correct rebate calculation for a considerable time.

(ii) It is generally necessary to hold over the assessing of shareholders' returns for several months until sufficient company rebates have been calculated to allow of their being applied to shareholders' assessments.

(iii) In cases where final rebates cannot be calculated, it is necessary to assess on a tentative rebate. As a consequence thousands of incorrect assessments are issued. This causes annoyance to taxpayers and results in the lodgment of many objections. It also means the double handling of returns and assessments by departmental officers.

(iv) Owing to reduced earnings, many companies are distributing dividends out of past profits. In many cases it is impracticable to correctly trace the particular funds from which these dividends have been paid. Companies are put to a great deal of trouble furnishing details of accounts relating to back years. In some instances this proves most unsatisfactory, and in the end the Department has no alternative but to take a more or less arbitrary action in determining the funds from which distributions have been made.

(v) Shareholders are unable to check the percentages of their rebates."

77. In another portion of his evidence, Mr. McMahon stated—

"I propose to put in some of our rebate sheets, and you will see how complicated they are, and as the years go on they will become more difficult, and every year some new complication is arising. This all adds to our difficulties. I feel this about the rebates, that in a number of cases we cannot accurately get at the correct rebate. A tentative rebate has to be used, and sometimes there is not an opportunity of correcting the tentative rebate. Perhaps, one year a taxpayer may be advantaged, in another year he may be at a loss, so on the whole I do not know that he suffers much, but there is the fact that it is not the correct amount, and it is giving a tremendous amount of work in the Department.

One of the very great difficulties as years go on is to find the actual source of the dividend. The farther we get away from the earlier years, the more difficult it becomes ; at times it becomes impossible, and an arbitrary rate has to be fixed."

78. Mr. Joseph Adams, Federal Deputy Commissioner at Central Office, Melbourne, stated—

"One of the chief difficulties now encountered is the inability to obtain a prompt calculation of the correct rebates allowable on dividends paid during the year, particularly when those dividends are paid wholly or partly out of the company's income assessable for the same financial year. Companies balancing on dates subsequent to 30th June, and even large companies balancing on that date, would not lodge their returns until the end of the year. Frequently correspondence is necessary before the Department is in a position to calculate correct rebates. Meanwhile issue of assessments cannot be held up, and rebates based on the information available are applied pending calculation of the correct rebates.

These cases are, however, noted for review when the correct rebate is available, but, as a general rule, this review cannot take place until after the issue of the current year's assessments has been completed."

79. In reply to the question "Would it not be wise to draw a line and say from now on we will have to do something else ?" Mr McMahon replied—

"I think so, because sooner or later that will have to come about. I am quite satisfied about that. The curtain will have to be drawn across earlier years some way or other. It cannot go on indefinitely, because the taxpayer and the Department will become so muddled that the rebates will become inaccurate."

80. Mr. Adams in reply to the same question said—

"Yes, otherwise each year will be getting worse and worse."

81. Mr. R. W. Chenoweth, State Commissioner of Taxes and Federal Deputy Commissioner of Taxation, Victoria, stated—

"Perhaps I should now discuss the suggested modification of the Federal system, it being assumed that the present system must be changed in some way owing to its complexity, and dissatisfaction to shareholders. These complaints must increase in the future because of the successive years of tax, each carrying a separate rate of tax to the company, fluctuating, and requiring calculations in the future to be so exact, and to cover records of such long standing that its working will eventually become practically impossible, and arbitrary rates will have to be adopted."

82. The evidence we have quoted justifies the conclusion that under the existing system the taxpayer is irritated by receiving a complicated assessment which he cannot check or understand; that it imposes upon the Department a task which is growing more burdensome year by year, and that the time is fast approaching when it must break down under its own weight.

SECTION IV.

SUMMARY OF THE MODIFICATIONS SUGGESTED.

83. The explanation of the difficulties which now exist indicates very clearly the nature of the modifications which are required. Some method must be adopted which will not require an intricate analysis to ascertain the profits from which the dividend has been paid and, in consequence, the rate of tax appropriate to each part of the dividend for the purpose of computing the rebate allowable to the shareholder thereon.

84. In our opinion, the adoption of the principles set out hereunder would result in a material simplification of the present practice :—

(*a*) Dividends declared wholly and exclusively from any of the profits specified in this paragraph should be exempt from tax when received by any taxpayer whether resident or absentee—

(1) Reserves accumulated prior to 1st July, 1914;

(2) Capital profits as specified in the Act;

(3) Profits upon which the company has paid tax under the provisions of Section 21.

(*b*) A resident taxpayer should be liable to tax on the whole dividend distributed to him out of all other profits of a company whether such profits are taxable or exempt to the company.

(*c*) An absentee shareholder should be liable to tax on that portion of the dividend distributed to him out of profits derived by the company from sources in Australia (other than profits excluded by paragraph (*a*) hereof), whether such profits are taxable or exempt in the hands of the company.

(*d*) Rebate at a standard rate or at the taxpayer's own rate (whichever is the lesser) should be allowed on all dividends included in his taxable income.

(*e*) Where concessional deductions or the statutory exemption are deductible from income from property, the deduction should be made in the first place from property income other than dividends.

85. This scheme would have the following advantages :—

(1) It would deal with the taxation of dividends on a broad but simple principle;

(2) Shareholders would be able to check their rebates;

(3) Dissection of dividends would be necessary only in isolated cases.

(4) Administrative costs would be very considerably reduced. Shareholders' returns could be assessed without delay and independently of company returns, and tentative assessments due to the inclusion of incomplete rebates would be unnecessary.

The reason for each of these proposals will be set out fully in subsequent paragraphs.

SECTION V.

WHY THE WHOLE DIVIDEND (WITH CERTAIN EXCEPTIONS) SHOULD BE LIABLE TO TAX IN THE HANDS OF THE SHAREHOLDER.

86. It has been shown in earlier portions of this report that one of the main causes of the complications of the present Commonwealth system is the attempt to identify the dividends distributed to the shareholders with the actual assessed income of a company. If this could be done it would be ideal, but it is obvious that in practice it cannot be done.

87. It is impracticable to earmark a particular piece of exempt income and preserve its exemption through various changes in the ownership of it. In any case, it is not worth the trouble. The shareholder has got the benefit of the original exemption to the company, in that his interest in the company has been increased by reason of the fact that the company has not had to pay tax. That benefit will come to him ultimately either in the form of a dividend or an increased interest in the assets of the company. The complexity added to the system is a dear price to pay for the rebate to which in theory he is entitled.

88. A shareholder invests money in a company for the purpose of deriving income. It matters little to him how or where the company earns its profits so long as he obtains a good return for the investment. He is not concerned whether the greater part of that dividend is paid from profits earned locally, abroad, or from exempt sources. It does not seem unreasonable, therefore, that he should be assessable on the whole of the dividend received by him.

89. In support of this conclusion we quote portion of a paragraph contained in the Report of the Royal Commission on the Income Tax, Great Britain (1920) :—

> " We think that in that practical world which alone can be considered for the purposes of taxation, the income which represents the taxable faculty is not a mathematical abstraction but that net receipt which in the hands of its possessor is usually regarded as income, that is to say, as a receipt out of which current expenditure may be met. . . . . The normal man judges his ability to pay tax in any year not by actuarial calculations of the amount of his " pure " income, but by the amount of actual " spendable " income he receives. We are of opinion, therefore, that the income tax should have regard to the actual income enjoyed by any individual during the income tax year, rather than to an amount deduced from that income by a mathematical computation that must rest on very uncertain and variable data. . . "

90. Income may be exempt in the hands of the company receiving it, but when that income is merged in the general pool of profits of the company and paid out as a dividend to a shareholder it should not retain its exempt character. This is the practice in Great Britain, Canada, and the United States of America. There appears to us to be no sound reason why it should not be adopted in Australia.

91. It may be contended that this proposal violates the undertakings given to the holders of Commonwealth Loans who agreed to conversion during 1931. In our opinion, this contention cannot be maintained.

92. These undertakings were in effect, firstly, that the interest on Commonwealth loans which by the terms of the prospectus had been issued free of tax, should continue to be free of tax during the balance of the period for which they were issued, and secondly, that in respect of loans converted, the rate of tax payable in any subsequent year should not exceed the rate of tax payable in 1930.

93. Total exemption from tax on Commonwealth loans has been virtually abolished as a result of conversion, except in respect of a relatively small amount which is due for redemption at an early date.

94. Therefore it is necessary to consider only whether the proposal violates the undertaking that the rate of tax payable shall not exceed the rate of tax payable in 1930.

95. It should be noted that it is not suggested that the undertaking given should be varied in any case where the interest on such loans is received by any taxpayer, whether that taxpayer be an individual or a company. The first recipient of such interest will still continue to enjoy the concession granted by the Commonwealth Debt Conversion Act. The proposal relates only to dividends paid wholly or in part out of such interest.

96. A perusal of Section 20 of the *Commonwealth Debt Conversion Act* 1931, will show that it was intended that the limitation of the rate of tax payable should apply to the " interest derived by any person ". In accordance with Section 22 of the *Acts Interpretation Act* 1901–30 " person " includes a body politic, or corporate, as well as an individual.

97. Originally, no exemption was granted in respect of interest derived from converted loans included in any dividend, but as a result of representations made to the Government, the Act was amended in 1932 to provide that the concession granted to companies in respect of interest derived from such loans should also be extended to dividends distributed out of such interest.

98. In our opinion, the amendment of 1932 should be repealed. If the concession be restricted to the company first receiving the interest, and not extended to shareholders who receive dividends out of such interest, it cannot be said that either the letter or the spirit of the Commonwealth Debt Conversion Act is violated.

99. From information we have received it would appear that in Great Britain certain War Loans are taxable if held by a British company, but not taxable if held by non-residents. A non-resident shareholder in a British company is not exempt from tax on a dividend received by him which is derived wholly or in part from interest on such loans, although he would have been exempt if he had held the loan himself.

100. The Canadian Income Tax Act exempts interest derived from tax free government loans when received by a company, but does not extend this exemption to dividends paid out of such income, which are taxable in full.

101. The South African Income Tax Act also exempts interest derived from tax free government loans, but does not extend this exemption to such dividends as are liable to tax.

102. We see no reason why the principle enunciated in Section 90 of this report should not apply to dividends paid out of interest on these loans.

103. The trend of income tax legislation in recent years has been to limit the class of income which shall be exempt from tax, or to restrict the extent of that exemption. The amount of exempt income included in a dividend is, therefore, tending to become smaller. Without an exhaustive analysis it is impossible to indicate exactly the percentage of the whole of the dividends now paid by companies in Australia out of exempt income, but from information supplied by the Department we are of the opinion that it would not exceed 5 per cent. of the total.

104. We recommend, therefore, that the Act so far as it relates to the taxation of dividends (other than those referred to in Section VI. of this report), be amended to provide that exemption or partial exemption from tax should be limited to the company and not extended to dividends paid from such exempt or partially exempt income.

SECTION VI.

WHY CERTAIN DIVIDENDS SHOULD BE EXEMPT FROM TAX IN THE HANDS OF THE SHAREHOLDER.

105. Although the exemption of any dividend in the hands of the shareholder does not make for simplicity and, to some extent, therefore, is counter to the principles previously advocated, **we recommend that the dividends paid out of the sources referred to in this paragraph shall be exempt from tax when received by the shareholder subject to the reservations which follow :—**

(*a*) *Dividends paid out of reserves accumulated prior to* 1*st July*, 1914.

These profits were earned by the company before the Commonwealth Government imposed income tax. The company, therefore, was not under any liability to pay tax thereon. This consideration distinguishes dividends paid from this source from all other dividends.

In this connexion, it is interesting to note that the income tax laws of the United States of America provide that any earnings or profits accumulated prior to the inception of the Act may be distributed exempt from tax only if the earnings and profits accumulated after the inception of the Act have been distributed.

The Canadian Income Tax Act, which became operative as from 1st January, 1917, allowed companies a period of three years to distribute profits accumulated prior to that date. After the expiration of that period, no distinction is made in respect of dividends declared from that source.

We suggest that consideration might be given to the fixing of a time limit after which dividends paid from this source should be taxable in the hands of shareholders. A period of nineteen years has elapsed since the date from which the Act became operative, and companies have had ample time to dispose of these profits if they desired to do so. It is probable that the amount available for distribution from this source is not considerable.

(*b*) *Capital profits, i.e., profits arising from the sale or compulsory resumption for public purposes of assets which were not acquired for the purpose of re-sale at a profit.*

These profits are considered to be in a class quite distinct from the income of a company, and the distribution of a dividend from this source is regarded in effect as a distribution of capital to the shareholder and, therefore, not taxable.

(*c*) *Profits which have previously been taxed under Section 21 of the Act.*

This is a section designed to guard against the loss of revenue which would result from a company neglecting to distribute in the form of dividends a reasonable proportion of its annual profits. The undistributed profits would bear only the company rate of tax, and the revenue would lose the higher tax with which the dividends if distributed would have been chargeable in the hands of shareholders whose own rate is higher than the company rate. In such a case the section empowers the Commissioner to assess against the company the additional tax which would have been collected had a reasonable distribution been made. It is considered, therefore, that no other tax should be payable by the shareholder on such profits when received by him; but while averaging continues, it is necessary that they should be included with his other income for the purpose of determining his rate of tax.

106. While we recommend that the benefit of exemption in respect of dividends paid from any of these sources should be carried through to the shareholders, it must be recognized that this concession, if not qualified, would involve dissection of accounts and perpetuate the confusion and complexity which are features of the present system. To obviate these difficulties and preserve for the public and the Department the benefit of simplicity in shareholders' assessments, exemption should be allowed to shareholders only in respect of dividends which are paid *wholly and exclusively* from any of the sources mentioned in this paragraph after a date to be fixed, say, 1st January, 1934. If, however, any such profits are carried to a general account from which dividends are distributed, such dividends should be taxable in full to the shareholder.

SECTION VII.

BONUS SHARES.

107. Distributions by a company to its shareholders may be made either in cash or its equivalent, or by the issue of additional shares in the capital of the company. For convenience, we refer to such shares as " Bonus Shares ".

108. Now, the liability of the shareholder to pay tax on the value of bonus shares has been the subject of argument and litigation not only in Australia but elsewhere. Those who argue that bonus shares should not be taxable contend that the shareholder who receives them is no better off than he was before. The nominal value of his interest in the company has been increased, but the real value of that interest is unchanged. He has merely received a definite title to that which he always possessed, namely, a proportionate share in the reserves or undistributed profits of the company. Those who argue that bonus shares should be taxable, while unable to deny the force of these arguments, claim that the shareholder has derived a tangible benefit in that he has received a negotiable security of which he can dispose without reducing the value of his original investment. He should, therefore, be taxable on that benefit.

109. Now, each of these arguments is correct up to a point, but neither goes quite far enough. In our opinion, the question whether bonus shares should be exempt or taxable ought to be determined, not by reference to their effect on the income of the shareholder, but by reference to the source of the fund out of which they were created. If dividends distributed out of that fund would be exempt in the hands of the shareholder, bonus shares distributed therefrom should also be exempt. Conversely, if dividends distributed therefrom would be taxable in the hands of the shareholder, bonus shares should also be taxable.

110. It should not be possible for a company to take advantage of a method of distributing its profits which will enable its shareholders to escape their proper liability to tax thereon. That is not fair either to the shareholders of other companies which do not avail themselves of these means, or to taxpayers generally.

111. The provisions of the Act which relate to liability to tax on bonus shares are set out in Section 16 (*b*) (ii). For convenience, these may be summarized thus :—

The paid up value of shares distributed by a company to its shareholders is taxable in the hands of shareholders to the extent to which such paid up value represents the capitalization of the whole or any part of the profits of the company derived subsequent to 1st July, 1914, except profits—

(*a*) arising from the re-valuation, sale, or compulsory resumption for public purposes of assets which were not acquired for the purpose of re-sale at a profit ;

(*b*) which are not assessable income of the company ;

(*c*) upon which the company has paid or is liable to pay income tax for any year prior to 1st July, 1922 ; or

(*d*) to an extent not exceeding one-third of the profits derived by the company during any year subsequent to 1st July, 1922, and in respect of which the company is not required to pay tax (or if required has paid tax) under Section 21 of the Act.

112. A comparison of sub-paragraph (*a*) of the preceding paragraph with sub-paragraph (*b*) of paragraph 105 shows that distributions of " Capital Profits " are exempt in the hands of shareholders whether made in the form of bonus shares or dividends.

113. Distributions of other profits, however, if made in the form of bonus shares, are not treated in the same manner as they would be if they were dividends. The following variations are noted :—

(1) Distributions out of income which is not assessable to a company are exempt if made in the form of bonus shares, but taxable if made as dividends, unless such dividends are exempt by a specific provision of the Act ;

(2) Distributions out of profits accumulated prior to 1st July, 1922, are exempt if made in the form of bonus shares, but taxable if made as dividends ;

(3) Distributions out of that portion of a company's income, not exceeding one-third, on which it is not liable to pay tax under Section 21, are exempt if made in the form of bonus shares, but taxable if made as dividends.

(4) Distributions out of profits accumulated since 1st July, 1922, (other than distributions referred to in Sub-clause 3 above), are taxable whether made in the form of bonus shares or dividends.

114. We see no logical reason for these differentiations, and we think it is very desirable that the treatment of bonus shares and dividends should be uniform.

115. If bonus shares are created by the application of funds which, if distributed as a dividend, would be exempt in the hands of the shareholder, we consider the exemption should apply also to bonus shares. If they are distributed from a fund which, if distributed as a dividend, would be taxable in the hands of the shareholder, they should be taxed to the shareholder. Any other course will perpetuate some of the difficulties which now exist in regard to dividends.

116. It is improbable that any considerable amount will be distributed out of profits in the form of bonus shares for some considerable time to come. The present time, therefore, appears to be opportune to place these distributions on a logical basis.

117. In order, therefore, to achieve simplification and consistency, we recommend that bonus shares be treated in all respects in the same manner as dividends.

SECTION VIII.

THE REBATE THAT SHOULD BE ALLOWED.

118. It has been suggested in evidence that a shareholder is not entitled to any rebate. One of the arguments advanced to justify this contention is that a purchaser of shares does not take the rebate into consideration when estimating the probable yield on his investment.

119. If companies are taxed at a low rate there may be no inequity in requiring the shareholder to pay tax on his dividend without rebate. If a high rate of tax is payable by companies, equity may require that rebate be allowed.

120. In this connexion, we may mention that the present rate of tax payable by a company in Canada is approximately 2s. 4d. in the £1, and dividends are taxed in the hands of shareholders without rebate.

121. The scheme of the present Commonwealth Act is to allow the shareholder in his individual assessment some concession by way of rebate in recognition of the tax paid by the company on the profits out of which the dividend received by him is paid. Therefore, rebate is allowed at the rate applicable to the income of the shareholder, or at the rate actually paid by the company on such profits, whichever is the lesser.

122. It is not our intention to recommend that this concession should be withdrawn, but merely that the rebate allowed to a shareholder should be arrived at by a simpler method.

123. Many witnesses expressed the opinion that the shareholder who is not taxable should receive a refund of the amount of tax paid by the company on the portion of the profits included in his dividend, and that the shareholder who is taxable at less than the company rate should receive a refund of the difference between the amount paid by the company and the amount which he is liable to pay. As an alternative, it was suggested that where a taxpayer whose rate is less than that of the company has other income, he should be allowed the amount of the tax paid by the company on the profits included in his dividend as a rebate against his total tax up to the extent thereof.

124. It has been explained in paragraph 50 that the effect of the Act is that the revenue collects tax at not less than the company rate on the profits of a company, either directly from the company or in part from the company and in part from the shareholder. If, therefore, full rebate were allowed to a shareholder who is either not taxable or taxable at less than the company rate, this result would not be achieved. There would be a material loss of revenue which would have to be made good, either by an increase in the rate of tax payable by companies, or alternatively, by all taxpayers.

125. For the reasons given in paragraph 51, we consider that this claim is not justified.

126. As the effect of allowing rebate to the shareholder whose individual rate is less than that of the company is, in effect, to include the dividend in his income only for the purpose of determining the rate of tax on his other income, it was suggested that the work involved in the calculation of rebates might be reduced by omitting the dividends from the assessments of such shareholders.

127. This was the practice during the five years which ended on 30th June, 1927, when it was abandoned. Owing to the averaging provisions it produced freakish results, and created inequities as between shareholders who were taxable at less than the company rate and those who were taxable at a higher rate. A further advantage was gained by shareholders in the first group, because the exclusion of the dividend, by reducing the amount of income, increased the statutory exemption, with the result that a lower rate of tax was payable.

128. In our opinion regard should be had to the dividend in allowing the statutory exemption and determining the rate of tax payable. If the dividend is to be included in the assessment for these purposes, it would be preferable to include it for all purposes, and then proceed to allow rebate in the same manner for all taxpayers irrespective of the amount of their income.

129. It is clear that many of the difficulties incidental to the allowance of rebates are due to the attempt to ascertain the rate of tax actually paid by the company on each portion of a dividend. These difficulties must increase as the years go on, and, in our opinion, the time has now arrived when an arbitrary rate must be adopted.

130. A shareholder should be allowed rebate at the rate applicable to his own income or at a " standard rate " whichever is the lower. The " standard rate " we suggest is the rate payable by a company in the year in which the shareholder is assessed on his income from dividends.

131. In this connexion it is interesting to note that the Royal Commission on the Income Tax, Great Britain (1920), drew attention to the existence of the same problem in that country. At that time rebate might be allowed to a taxpayer in Great Britain at either of two rates, viz., the rate in force when the income subject to rebate was taxed, or, in certain circumstances, the rate in force at the time when the income was received by the taxpayer.

132. The existence of two rates gave rise to a certain amount of difficulty, which was disposed of by Section 39 of the *Finance Act* 1927, which provided that refund of tax was to be allowed at the rate in force at the time when the income was received by the taxpayer.

133. We think it desirable that the same principle should be definitely established in the Commonwealth Income Tax law.

134. It was suggested in evidence that the " standard rate " should be the company rate for the preceding year, because that would be the rate at which the greater portion of dividends distributed during any year would have been taxed in the hands of the company.

135. We desire to point out, however, that as the shareholder whose individual rate is less than the " standard rate " is to be allowed rebate at his own rate, which is, of course, the rate payable in the year in which he is assessed on his dividends, there does not appear to be any reason why the shareholder whose individual rate is higher than the " standard rate " should receive a rebate at the rate in force in another year.

136. Objection has been taken to the adoption of a " standard rate " on the ground that it would be unfair to deprive shareholders of the rebates to which they would be entitled if they receive dividends distributed out of accumulated profits.

137. It is, of course, impossible to state what proportion of future dividends will be distributed out of accumulated profits, but an estimate of the probable effect of our proposals may be arrived at by considering certain information which is available. For the purpose of this estimate, we assume the " standard rate " to be the company rate at which the profits of the year ended 30th June, 1932, were taxable, that is 1s. 4.8d.

138. Now, the first and most important point to be noted is that no shareholder whose individual rate is less than the " standard rate " would be adversely affected by the adoption of a " standard rate ". He would receive rebate at his own rate.

139. Reference to the Fifteenth Annual Report of the Commissioner of Taxation shows that for the financial year 1931–32, 96 per cent. of individual resident taxpayers were taxable at rates less than 1s. 4.8d.

140. There remains, therefore, only about 4 per cent. of the total number of individual resident taxpayers who might be adversely affected by the adoption of the " standard rate ". Let us now consider its probable effect on these. For convenient reference, the table of the rates of tax paid by companies in each year (paragraph 67) is repeated—

(*a*) Upon undistributed income accumulated up to 30th June, 1922—Rebatable under Section 20 (4)		(*b*) Upon total income earned after 30th June, 1922—Rebatable under Section 16 (*b*) (iii)—	
	s. d.		*s. d.*
1915	1 6	1923	1 0
1916	1 10½	1924	1 0
1917	1 10½	1925	1 0
1918	2 6	1926	1 0
1919	2 6	1927	1 0
1920	2 8	1928	1 0
1921	2 8	1929	1 2.4
1922	2 5	1930	1 4
		1931	1 4.8
		1932	1 4.8

141. Now, it is obvious that shareholders in this category will sustain no loss by receiving the " standard rate " in respect of dividends distributed out of profits accumulated after the 30th June, 1922. On the contrary, inspection of the table will show that the " standard rate " will be higher than the rate of tax paid by the company for each year of the period 1923 to 1930.

142. Such shareholders could be adversely affected only in regard to rebates allowed at the " standard rate " on dividends distributed out of profits accumulated prior to the 1st July, 1922, when the rate of tax paid by the company was in every year higher than the " standard rate ".

143. Some of the shareholders will be taxable at a rate which is higher than the standard rate, but below the rate paid by the company. In these cases rebate is at present allowed at the shareholder's individual rate, and not at the rate paid by the company. Therefore, the only shareholders who are now entitled to receive rebate at the maximum paid by a company (2s. 8d.) are those whose taxable income exceeds £2,370. The number of such shareholders would not exceed 1½ per cent. of the aggregate.

144. An important consideration is, of course, the amount of dividends likely to be distributed out of profits accumulated between 1st July, 1914, and 1st July, 1922. It is impossible to make a reliable estimate, but we are of opinion that the amount available for distribution from this source is comparatively small. Figures compiled by the Deputy Commissioner of Taxation, New South Wales, from the accounts of the largest companies paying dividends during 1931, show that the percentage of dividends paid out of such profits amounted to 4.6 per cent. of the total distributions. The loss of rebate on that percentage of the dividend income, even of a wealthy shareholder, cannot be considerable.

145. Another consideration which has influenced us in arriving at the conclusion that the shareholders who would receive the " standard rate " in respect of dividends paid out of profits accumulated prior to 1st July, 1922, would not be unfairly treated, is that many of such persons were not shareholders at the time when the company earned these profits. The shares which they now hold may have changed hands many times since the company paid tax. The value of the contingent right to rebate was not shown and could not be shown as an asset in the accounts of the company, and it could not, therefore, be taken into consideration when they purchased their shares. Their moral right to receive rebate at the rate paid by the company is, therefore, open to question.

146. We should point out that if our recommendations be approved, shareholders who might sustain any loss by the adoption of a " standard rate " will receive as a set off rebate on certain dividends upon which rebate is not now allowed. From information supplied by the Department we estimate that such dividends represent about 10 per cent. of the total distributions.

147. After careful consideration, we are convinced that the adoption of a standard rebate will not materially affect the revenue or operate unfavorably to the general body of taxpayers, and we recommend that rebate be allowed to a shareholder at the rate applicable to his own income or at a " standard rate " whichever is the lower. For the purpose of this recommendation " standard rate " means the rate payable by a company in the year in which the shareholder is assessed on his income from dividends.

148. Appendix 3 shows the simplification that would result if our recommendations were adopted in the case mentioned in Appendix 2. The rebate is increased from 6s. 11d. to 17s. 4d., a difference of 10s. 5d.; but the cost to the revenue would be far less even than this, because, owing to the other modifications recommended by us, the amount of tax payable would actually be reduced by only 9d.

SECTION IX.

THE EFFECT UPON REVENUE AND UPON THE TAX PAYABLE BY A SHAREHOLDER RESPECTIVELY OF TAXING THE DIVIDEND IN FULL AND ALLOWING REBATE AT A STANDARD RATE.

149. If detailed statistics showing the amount of dividends included in the income of taxpayers in each taxable group, and the extent to which such dividends were subject to rebate, were available, it would be possible to make a reasonably correct estimate of the effect of our proposals upon the revenue and the shareholder respectively. As these statistics are not available the subject can only be considered generally.

150. Revenue will benefit for the following reasons :—

(1) Exempt income included in a dividend which is not now subject to tax will be taxable. The amount of such exempt income is estimated at approximately 5 per cent. of the total distributions. (Paragraph 103.)

(2) The inclusion of exempt income will slightly increase the rate of tax collected on other income of the taxpayer.

(3) The standard rate of rebate on distributions out of profits accumulated between the 1st July, 1914, and the 1st July, 1922, will in some cases be less than the tax which the company has actually paid on such profits. The amount available for distribution from this source is not likely to be considerable, and for the reason set out in Section VIII. of this report, it is probable that any gain to the revenue therefrom will be small.

(4) It is reasonable to anticipate that administrative costs will be reduced.

151. Revenue will suffer for the following reasons :—

(1) Rebate will be allowable on exempt income referred to in Sub-paragraph (1) of the preceding paragraph.

(2) In the case of a taxpayer whose individual rate is less than the company rate, the rebate allowable to him will be on a slightly higher scale than at present, because of the increase in his rate resulting from the inclusion of exempt income.

(3) Rebate will be allowable on income which is now taxable in full to the shareholder, i.e., not subject to rebate. Such income is estimated to be approximately 10 per cent. of the total distributions. (Paragraph 146.)

(4) The rebate allowable to shareholders whose individual rate is higher than the company rate, in respect of dividends distributed out of profits accumulated between the 1st July, 1922, and 1st July, 1930, may, in some cases, be greater than the rate of tax actually paid by the company on such profits.

152. After careful consideration, we are of the opinion that the net effect upon revenue of these suggestions will be negligible, and any balance would probably be slightly in favour of the revenue.

153. The probable effect upon the amount of tax payable by an individual shareholder cannot be stated in such general terms. It will depend firstly upon the amount of the shareholder's total income, and next upon how much of that income is derived from dividends. Statistics issued by companies from time to time show that the average holding of each shareholder is small, probably because the shareholder usually prefers to spread his investments over several companies. It follows, therefore, that while he may suffer to a slight extent on the dividends he receives from one of these companies, he may benefit in respect of those he receives from others. The factor that will influence the amount of tax payable by the shareholder is whether his individual rate is above or below the company rate. It may be stated generally that a shareholder who is taxable at a rate less than the company rate will be very slightly affected either way by these proposals.

154. It was stated in Paragraph 139 that 96 per cent. of individual resident taxpayers were taxable at less than the company rate. The inclusion of the small portion of the dividend that is now exempt will slightly increase the rate of tax payable on other income, but to some extent this will be compensated for by the allowance of rebate at a higher rate than that to which they are now entitled, and also by the allowance of rebate on that portion of the dividend which is not now subject to rebate. **We think, therefore, that shareholders who are taxable at less than the company rate will have no reason for concern.**

155. The effect upon the shareholder whose individual rate is higher than the company rate will depend to a large extent upon the amount of dividends included in his income. If the dividends received by him include income which is now exempt, some additional tax will be payable, but as a set off he will receive rebate on the amount by which the inclusion of the exempt income has increased his dividends, and rebate on dividends which are now taxable in full, i.e., not subject to rebate. He may also derive some benefit from the standard rate of rebate on distributions made out of profits accumulated between 1st July, 1922, and 30th June, 1930, for the reasons set out in paragraph 142. Conversely, a very few of the shareholders included in the class referred to in paragraph 143 who receive dividends distributed out of profits accumulated prior to 1st July, 1922, may receive rebate at a rate less than that to which they are now entitled.

156. We have been supplied with figures relating to the assessment of 38 taxpayers selected at random from the files of Central Office. Each of these taxpayers was taxable at a rate higher than the company rate. These particulars are summarized below :—

			£
Total taxable income			104,260
Dividends included therein—			
	%	£	
Exempt	3·8	1,709	
Subject to rebate	88·3	39,647	
Not subject to rebate	7·9	3,550	
			44,906
Total tax assessed			22,312
Total tax which would be payable if total dividends were taxed, and rebated at the standard rate			22,486
Additional tax due to proposals			174

which represents 0·784 per cent. increase in tax.

157. Our general conclusion is that the effect upon taxpayers whose individual rate is higher than the company rate would be negligible.

SECTION X.

CONCLUDING REMARKS REGARDING THE TAXATION OF COMPANIES AND DIVIDENDS.

158. For the reasons we have already given in detail, we consider that the system of taxing the company on its total profits at a flat rate, and taxing the shareholder on the dividends received by him (subject to rebate), is preferable to any other. The complications that disfigure the system as at present applied are not necessarily inherent in it, and we believe that the adoption of the recommendations we have made will, to a very great extent, remove them. They are almost entirely due, in our opinion, to the meticulous analysis of every dividend, and the attempt to trace back each pound of it to the source from which it was originally derived.

159. We feel it our duty to say with great emphasis that until this attempt be abandoned it is hopeless to expect that any effective simplification of the present system can be looked for.

160. We desire to make it clear that the recommendations made in this report relating to the method of taxing companies and dividends in the hands of shareholders are intended to apply only to the Commonwealth. For reasons which will be set out fully in our subsequent report we recognize that the method of taxing companies and dividends which may be most suitable to the requirements of the Commonwealth may be inapplicable, or at least not entirely suitable, to the requirements of the States.

SECTION XI.

THE STATUTORY EXEMPTION.

161. After the assessable income of a resident taxpayer has been reduced by the allowance of all other deductions, the statutory exemption allowable is deducted from the balance. The amount of this exemption varies in accordance with the source of the income. If it is derived solely from personal exertion, the exemption is £250, if solely from property it is £200, diminishing in each case by £1 for each £2 by which the income exceeds £250 or £200 as the case may be.

162. Thus, in the case of an income of £400 from personal exertion (that is £150 in excess of the £250 exemption) the exemption is diminished by half of £150. It is, therefore, £250 less £75, leaving an exemption of £175.

163. Similarly in the case of a property income of £300 (£100 in excess of the £200 exemption) the diminution is half of £100, leaving an exemption of £150.

164. Where the income is derived partly from personal exertion and partly from property the calculations are more complicated. Section 24 (2A) of the Act provides that in that case—

> " (*a*) there shall be deducted from so much of the income as is derived from property a sum which bears to the amount of deduction which would have been allowed under this section if the income had been derived from property the same proportion as so much of the income as is derived from property bears to the income ; and
>
> (*b*) there shall be deducted from so much of the income as is derived from personal exertion a sum which bears to the amount of deduction which would have been allowed under this section if the income had been derived from personal exertion the same proportion as so much of the income as is derived from personal exertion bears to the income."

" Income " is defined for the purposes of this section as the residue of the assessable income of a taxpayer after allowing the deductions allowed by any other section of the Act.

165. The procedure for applying this sub-section is as follows. Two separate calculations are first made (1) to show what the exemption would be if the whole income were from property, and (2) what it would be if the income were all from personal exertion. The two figures thus obtained are then applied in this way. If the income from property is, say, one third of the total income, then one third of the first figure is taken as the exemption applicable to that part of the income, and two thirds of the second figure as that applicable to the income from personal exertion.

166. The following example shows the manner in which the apportionment is made in the case of a resident taxpayer who derives income partly from each source :—

——	Personal Exertion.	Property.	Total.
	£	£	£
Net Income	380	20	400
Statutory Exemption	166	5	171
Taxable Income ..	214	15	229

The Statutory exemption is calculated thus—

(*a*) Statutory exemption if income wholly derived from Personal Exertion—

$$£250 - \frac{150}{2} = £175$$

which is apportioned to income from Personal Exertion—

$$\frac{£380}{£400} \times 175 = £166$$

(*b*) Statutory exemption if income wholly derived from property—

$$£200 - \frac{200}{2} = £100$$

which is apportioned to income from property—

$$\frac{20}{400} \times 100 = £5$$

167. The result of this method is that so long as the total net composite income exceeds £200, there must always be some portion of the net property income remaining to be taxed at property rate. In all cases where the total net income is less than £600, two apportionments as shown in the above example must be made. If the net income is between £600 and £750, one apportionment is necessary to determine the personal exertion exemption.

168. This method of apportioning the statutory exemption confuses the taxpayer and materially adds to the cost of administration.

169. The first step towards simplification would be to fix the Statutory exemption on income from personal exertion and property at the same amount. The amount is, of course, a matter for Parliament to decide, and from the point of simplicity alone it is immaterial what amount be fixed, provided that it is the same for each class of income.

170. The second step would be to make the deduction first from one class of income, preferably income from property, because in the majority of cases this would be exhausted, and the balance of the income would be taxable at one rate.

171. The third step would be to deduct the statutory exemption in the first place from income from property other than dividends, resorting to dividends only if such other income from property is insufficient. This would obviate the necessity for one of the apportionments that must now be made.

172. The adoption of these suggestions would make it possible to ascertain the Statutory exemption allowable from the rate book, and to deduct it without apportionment successively from each type of income.

173. The following example shows how the statement in paragraph 166 will be simplified if the Statutory exemption be deducted in the first instance from income from property, and the balance from income from personal exertion :—

——	Personal Exertion.	Property.	Total.
	£	£	£
Net Income	380	20	400
Statutory Exemption	155	20	175
Taxable Income ..	225	..	225

174. For the purposes of this example we have assumed that the Statutory exemption allowed on income from property is fixed at the same amount as that allowed on income from personal exertion, viz., £250. This accounts for the increase of £4 in the Statutory exemption.

175. The effect of these proposals on revenue will depend upon two factors :—

(1) the amount to be allowed, and
(2) the method of apportionment.

176. The Statutory exemption now allowed on an income derived from personal exertion is £250, and if this amount also be allowed in respect of income from property, it is obvious that there will be a loss of revenue. The present exemption on an income from property is £200, and if that amount be fixed as the exemption to be allowed on income from personal exertion, revenue will, of course, benefit. If the amount be fixed at a sum between these two points revenue will probably not be affected to any material extent.

177. The effect of deducting the Statutory exemption in the first place from income from property will, of course, reduce the amount subject to tax at the higher property rate and thereby reduce revenue. If the amount be deducted in the first instance from income from property other than dividends, the amount subject to rebate will be increased, and this will further reduce revenue to some extent.

178. As a set off to any loss of revenue, however, it is reasonable to anticipate some reduction in the cost of assessment.

179. Generally speaking, the effect on the taxpayer will be the reverse of the effect on the revenue, for if one gains the other must lose. If the deduction be made in the first place from income from property other than dividends, the amount subject to rebate will not be reduced to the same extent as at present, and the taxpayer will benefit. In addition he will receive an assessment which he will be able to understand.

180. The effect of our proposals for the treatment of the Statutory exemption must, however, be considered in conjunction with those which we shall make for the apportionment of concessional deductions, and we shall therefore again refer to it in considering the latter.

181. We recommend that the Statutory exemption allowed on income from property and on income from personal exertion be fixed at the same amount ; that the deduction be made in the first place from income from property other than dividends, next from income from dividends, and next from income from personal exertion, and that if the deduction exceeds the income first resorted to, the balance be deducted from the other classes of income in the order stated.

SECTION XII.

APPORTIONMENT OF CONCESSIONAL DEDUCTIONS.

182. Expenditure directly applicable to a particular class of income is allowable as a deduction from that class. There are, however, a number of allowable deductions which are not incurred in gaining or producing assessable income, and which are commonly known as Concessional Deductions. The following table indicates the nature of these allowances and from what class of income they are deductible :—

Number.	Item.	Section.	How Deductible.
1	Life Assurance, Deferred Annuity and Fidelity Guarantee Payments	23 (1) (*c*) ..	Where the taxpayer's total assessable income consists partly of income from personal exertion and partly of income from property, the allowance is deductible from that class of income which is the greater—Sec. 23 (2) (*a*)
2	Superannuation and Friendly Society Contributions	23 (1) (*g*) ..	
3	Contributions to Department of Repatriation	23 (1) (*h*) (i) ..	
4	Gifts to Public Charities, Universities, &c.	23 (1) (*h*) (ii) ..	
5	Child allowance	23 (1) (*k*) ..	
6	Rates on private home or other non-income producing property	23 (1) (*b*) ..	The Commissioner has ruled that the deduction must be apportioned between personal exertion and property income in the ratio of the assessable income from those sources—Sec. 23 (2) (*b*)
7	Medical Expenses	23 (1) (*o*) (i) ..	
8	Funeral Expenses	23 (1) (*o*) (ii) ..	
9	Donations to Research Funds ..	23 (1) (*p*) ..	
10	Calls on shares in certain mining companies or syndicates and afforestation companies	23 (1) (*i*) ..	Firstly from property income

183. This table shows that certain concessional deductions are made from that class of assessable income which is the greater, that others are apportioned between each class of assessable income, and that one is deducted from a specified class of income.

184. The present procedure, which makes assessable income the standard for determining from which class of income certain concessional deductions are to be made, creates an anomaly. The assessable income of a business man from personal exertion is much greater than his net income, whereas the assessable income of a professional man more closely approximates his net income. Where each of these also derives income from property, the position might arise that although each had the same total taxable income, the business man would pay a larger tax, for the reason that in his case concessional deductions would as a general rule be made from his assessable income from personal exertion, because that is the greater. This inequality creates dissatisfaction.

185. In practice it is impossible to decide to which class of income concessional deductions properly relate. The Act provides that certain of these deductions shall be taken from the income which is the greater, but the concessional deduction may have no real relation to that income. In other cases, the amount is apportioned between both classes of income in the ratio which each bears to the total.

186. It is obvious, therefore, that these methods of treatment are to a large extent arbitrary, and in that event there is no reason why another arbitrary but simpler method should not be adopted. The present system does not appear to have any advantages which justify its continuance.

187. Much evidence has been given that the present method of apportioning these deductions confuses the taxpayer and adds materially to the cost of administration. For these reasons it is very desirable that a simpler method should be adopted.

188. We recommend, therefore, that all concessional deductions which cannot be directly attributed to a specific class of income be deducted in the first place from income from personal exertion, next from income from property other than dividends, and next from income from dividends, and that if the deduction exceeds the income first resorted to, the balance be deducted from the other classes of income in the order stated.

189. It is difficult to form an exact estimate of the probable effect on revenue of the proposals contained in the last paragraph. It will not necessarily make a material difference, because the present method of apportioning the concessional deductions applies some to each class of income.

190. We take the following information from the Fifteenth Annual Report of the Commissioner of Taxation. During the financial year 1931–32, the income derived by individual resident taxpayers was stated to be—

	£
(1) From personal exertion solely	22,733,727
(2) From property solely	20,018,297
(3) Composite incomes—	
(*a*) Personal exertion	26,866,461
(*b*) Property	13,944,192

191. The revenue derived from taxpayers in the first group cannot be affected. The deduction will still be made from personal exertion income, because they have no other income from which to deduct it. In the second group, there is no personal exertion income from which to deduct the concessional deductions and these must, therefore, be deducted from income from property—first, we suggest, from income from property other than dividends, and next from the income from dividends. The revenue would suffer thereby to some extent as the rebates would be allowable on a larger amount of dividend income than at present.

192. The revenue derived from taxpayers in the third group, who are in receipt of composite incomes, may be affected to some extent, but as the total income from personal exertion derived by these taxpayers is nearly twice the amount derived by them from property, it would seem that the deduction of concessional deductions from the personal exertion income will probably continue to a large extent the present practice.

193. Any gain which the revenue may sustain by the adoption of this method of apportioning the concessional deductions will be partly set off by the loss which may be expected to result if the statutory exemption is deducted in the first place from income from property.

194. We are inclined to think, therefore, that the net effect upon the revenue may not be considerable.

195. Taxpayers will, generally speaking, be affected conversely to the revenue. Those whose income is derived solely from personal exertion will not be affected in any way. In the case of taxpayers whose income is derived solely from property the deduction must, of course, be made from that income as it is at present. Therefore, these cannot be adversely affected. Those in this group who derive income from dividends may benefit to some extent, because the amount of dividend subject to rebate will be increased. The effect upon taxpayers in receipt of composite incomes would depend to some extent upon the composition of those incomes. If the income derived from personal exertion exceeds that derived from property, the effect should not be considerable. If, on the other hand, the income derived from property exceeds that derived from personal exertion, the major part of the deductions are now being made from income from property. If they be made from income from personal exertion, the amount of income subject to the lower rate of tax will be reduced, and that subject to the higher rate of tax will be increased, with the result that the taxpayer may be called upon to pay slightly more tax, but as a set off he will receive some benefit if the statutory exemption, where it is allowable, be first deducted from income from property as we have recommended.

196. If it were not for the existence of the special property tax, the combined effect of our recommendations for the apportionment of the concessional deductions and the statutory exemption would probably be small, but while this tax exists the deciding factor will be the net amount of property income subject thereto. It is obvious that this must be increased if deductions which are now made from income from property are in future made from income from personal exertion. While appreciating this, we do not think that it constitutes a valid objection to the acceptance of our recommendations. An amendment directed towards permanent simplification should not be rejected because of the existence of conditions which it is generally understood are intended to be temporary.

SECTION XIII.

THE ADDITIONAL TAX PAYABLE BY COMPANIES WHERE REASONABLE DISTRIBUTIONS OF PROFITS HAVE NOT BEEN MADE.

The Intention of Section 21.

197. The Commonwealth Income Tax Assessment Act taxes companies on their total taxable income at a flat rate. No deduction is allowed for dividends distributed, but the shareholder is required to include dividends in his income from property, which is taxed at the rate applicable thereto, less certain rebates which have been explained.

198. Now it is clear that if for any reason profits are not distributed, no further tax will be collected from those shareholders whose individual rate is higher than the flat rate of tax paid by the Company. Section 21 of the Act is designed to protect the revenue against this loss.

199. The Section provides that where a company (other than a private company to which Section 21A applies) has not within a certain period distributed to its shareholders at least two-thirds of its taxable income of any financial year, the Commissioner shall determine whether a sum or further sum not exceeding the difference between the amount distributed (if any) and two-thirds of the taxable income could reasonably have been distributed. If so, a tax is imposed on the company equal to the total additional tax, if any, which would have been payable by the shareholders had that sum been distributed to them.

200. The provisions of Section 21 have been the subject of much adverse criticism. Some of this is based upon ignorance or misunderstanding, but some rests upon a reasonable basis.

201. We shall first consider the objections made by those witnesses who disapprove in toto of the principle of the section. These may be summarized under several headings :—

(1) That it is an interference with the right of the Directors to manage the affairs of the company in the interests of its shareholders, and is contrary to the spirit of freedom of action which is characteristic of British Government.

(2) That by compelling distribution it militates against the conduct of the undertaking on sound business principles, and is destructive to the business life of companies.

(3) That it is an engine of oppression arbitrarily applied often with brutal indifference to the obvious impossibility of distributing the fictitious amount " determined " by the Commissioner.

202. Criticism of this nature may be shortly disposed of. That under the first and second heads is effectively answered by a quotation from a statement prepared by a witness who is a public accountant and experienced taxation expert.

> "It is sheer sophistry to say that the Section is designed to 'interfere with the directors' right to manage the affairs of the company in the interests of the shareholders'. The object of the Section is that, after making a substantial concession to companies which permits them to retain one-third of their taxable income without further tax, the companies and their owners must not be placed in a better position than other taxpayers by allowing the balance of the taxable income of the companies to bear tax at a relatively small flat rate, and so defeat the principle of progression which applies to all other taxpayers. The law simply says to a company—If you distribute two-thirds of your taxable income the shareholders will have to pay tax at progressive rates on the dividends; if you do not distribute that amount, then the company must bear the tax which the shareholders would have borne if such a distribution had been made. There is no question of interference with the right of directors to manage the affairs of the company in the interests of shareholders. But where a powerful modern instrument of progress is used for the purpose of escaping income tax, the law would fail if it did not provide for some means of counteracting the evil. The 'right of directors to manage affairs in the interests of shareholders' must not be allowed to inflict hardship on other taxpayers . . . . ."

203. The evidence we have received does not justify the conclusion that the complaints under the third heading have any real foundation.

204. The truth is that a provision of this nature is essential to any system which taxes the total income of an individual at a progressive graduated rate. If the safeguard to the revenue provided by the Section were removed there would be an appalling loss of revenue, as any taxpayer whose individual rate of tax exceeds the flat rate paid by a company, might convert his business into a company and defeat the whole principle on which the Act is based. Where the maximum rate of tax payable by an individual is so much higher than the flat company rate, the temptation to do so would be very great. If a section of taxpayers were permitted to put into operation a scheme of this nature for reducing their income tax, a greater burden would be thrown upon other taxpayers who were already contributing their just share of the public revenue.

205. The Section should, therefore, be regarded as a protection to the general taxpayer and as an attempt to do justice as between the various sections of the taxpaying community. Its mere existence acts as a deterrent and makes it necessary to apply it only occasionally. This is shown by the statistics relating to the latest year for which complete figures are available :—

FINANCIAL YEAR 1929–30.

(*Tax based upon the shareholders' assessments for* 1930–31.)

Total taxable companies	8,805
Number of cases in which the application of Section 21 was considered	615
Number of cases in which the Section was applied	505
Amount of tax assessed as a result of the application of the Section	£297,091

206. We may add that the necessity for a provision of this nature has been recognized in other countries which impose tax at a progressive graduated rate. Provisions of similar import are to be found in the taxation laws of Great Britain, Canada, South Africa, and the United States of America.

207. Other objections taken to various provisions of the section may be classified under two heads :—

(1) Those which relate to matters which the Commissioner must take into consideration before arriving at his determination whether a sum or further sum could reasonably have been distributed, as for example—

- (*a*) The constitution of the company,
- (*b*) The financial position of the company,
- (*c*) The allowance to be made for unrecouped losses of paid up capital, or of accumulated trading profits invested in the business,
- (*d*) The allowance to be made to meet losses which the directors consider were certain to arise during subsequent accounting periods.

(2) Those which relate to assessment after the determination has been made, as for example—

(*a*) The inability of the company to estimate the amount of the additional tax, or to check the assessment when received,

(*b*) The delay in making the assessment.

We shall consider each of these subjects in that order.

The Constitution of the Company and the Type of Company to which the Section should be applied.

208. In the view of the general law a company is an entity entirely distinct from the individuals by whose association and incorporation it is constituted. For the purposes of taxation, however, it may be regarded as being in substance merely the machinery through which its individual members combine to carry on operations so as to provide income for themselves.

209. The incidence of tax on the distributed profits of a company depends very largely upon the number of shareholders and the extent of their holdings, and the policy of the directors may be influenced by this consideration.

210. The dividend policy of a public company in which the public are substantially interested, and whose shares are dealt in on the Stock Exchange, is not likely to be affected by consideration of the amount of tax which will be paid by individual shareholders. The influence of shareholders will be exerted to induce the directors to distribute as much and not as little as possible, and its published accounts will show what profit has been earned, and how it has been appropriated. It cannot be said that a company of this type is formed for the purpose of avoiding tax by the retention of an unreasonable proportion of its profits.

211. A private company stands in a different position. An incorporated family partnership may be taken as a typical example. Such a company frequently carries on business after incorporation in exactly the same manner as the partnership did before. It is directly controlled by the individual members, who continue to be actively engaged in its business operations, and who are entitled to receive in salaries and dividends the same shares of the profits as they received as partners. It publishes no accounts, and only the shareholders know how its profits are disposed of. The dividend policy of such a company may be, and doubtless often is, framed with a view to the amount of tax payable by its individual shareholders on the distributions made to them.

212. In such circumstances a quotation from Marshall is pertinent " The State is under an obligation to go behind existing rights and to inquire which of them are based on a convention or accident rather than fundamental principles ".

213. We are informed that the section is rarely applied to public companies, and then only when control is centralized in a few wealthy shareholders who may personally benefit by non-distribution of profits.

214. Many responsible witnesses have, therefore, suggested that the operation of the section should be definitely restricted to private companies. Others have argued that to do so would amount to discrimination.

215. The contention that the restriction of the application to private companies would discriminate between the shareholders of public and private companies respectively is unsound. The amount undistributed does not necessarily affect the rate of tax which should be paid by individual shareholders. A large amount divided between hundreds or perhaps thousands of shareholders may have such a slight effect upon the income of each that no additional tax would be collected. In that case, there is no avoidance of tax and the section is not intended to apply, and in practice is not applied. But the undistributed profit of a private company, though relatively smaller, may materially increase the rate of tax that ought to be paid by each, or at least some, of the few shareholders who comprise it, and it is to that type of case that the section is intended to apply.

216. We think that consideration might be given to the proposal to amend Section 21 so as to limit its application to companies which are under the control of a limited number of persons, and which are not companies in which the public are substantially interested. This restriction would remove from its application the majority of companies whose shares are dealt in on the Stock Exchange. In Great Britain the section is applied only to companies of this type.

Considerations which Affect the Amount Available for Distribution.

217. At first sight it might seem unreasonable that the section should be applied to a company, if it can be proved either that cash was not available for distribution, or that it was in the circumstances inadvisable or even imprudent to make a distribution, because the amount was required to meet liabilities, recoup past losses, or provide for losses certain to arise in the future. But if the liability to tax of an individual is compared with that of a shareholder, this argument is found to be somewhat difficult to maintain.

218. The whole income of an individual, whether derived by him solely or from a partnership, is taxed at the rate applicable to its amount. No regard is had to his liabilities, capital losses, or possible losses in the future. The law does not inquire what use he makes of his income, what amount he draws from his business, whether he receives it in money, or whether it is capitalized or otherwise applied for his benefit. It is the amount of the income and not its distribution that is material.

219. Where all the shares of a company are of one class, the taxable income of a company belongs to its shareholders in proportion to their holdings. If it is all distributed in dividends, it bears tax in their hands at the rate applicable to their individual incomes. If it is not distributed, their interest in the company is increased. If the analogy of a partnership were applied, the share of each in the undistributed income of the company would be treated as part of his individual income and taxed accordingly.

220. If the tax due by a shareholder is to be determined on a different basis to that payable by a partner, some relevant distinctions between a trading partnership and a company must be established.

221. The first is that the partner is taxable at the personal exertion rate, whereas the shareholder is taxable on his dividends at the property rate. The second is that the revenue collects tax on the total profits of a company at a flat rate, and additional tax on that part of such profits which is distributed to shareholders who are individually taxable at a rate higher than the Company rate.

222. But as a concession all companies are allowed to withhold from distribution in every year one-third of their total taxable income. Shareholders are not liable for any personal tax on their share of the amount so withheld, which bears only the flat rate of company tax. This concession may be of great value to the members of a private company whose individual incomes are large, but practically negligible in the case of the small shareholders of a large public company.

223. If, therefore, the balance of two-thirds which normally should be distributed is to be again reduced by the allowance of other concessions, shareholders will obtain a further advantage over individual taxpayers. The arguments advanced to justify these concessions must, therefore, be considered critically.

224. Probably, the reason most frequently assigned for a failure to distribute is that cash is not available. Now, it cannot be too emphatically stated that a company is not required to distribute. It is required merely to pay tax based on the amount which would have been paid by its shareholders if a distribution had been made.

225. Directors may properly and wisely refrain from distribution if cash is not available, or if in their opinion it can be employed to better advantage in reducing liabilities or extending the business of the company.

226. Inability to provide cash suggests at once that the company's banker is not prepared to grant further accommodation. Even if that position has not been reached it may be desirable to reduce liabilities.

227. The existence of liabilities cannot be accepted prima facie as a reason for non-distribution. Some liabilities arise in the ordinary course of business, and if they cannot be met as they mature it is clear that the capital of the company is inadequate. Other liabilities may have been voluntarily assumed by the company as part of a scheme for the purchase of its undertaking or repayment of a loan. In many instances, these are bona fide and open to no objection except in so far as they relate to the obligation of the company to pay additional tax. In other cases there is reason to believe that the obligation has been entered into as part of a deliberate scheme to make a distribution impossible and thereby avoid additional tax. It has, therefore, been found necessary to provide both in the Commonwealth and British Acts that any part of a company's taxable income applied for the purpose of acquiring its undertaking or in redemption of capital or loans shall be regarded as income which could reasonably have been distributed.

228. An argument that has even less merit is that a company should not be required to distribute profits because it requires capital for the extension of its business. There is of course no reason why shareholders should not build up the capital of the company by allowing profits to remain in the business, but to accept this as a reason for exempting the company from the payment of additional tax would be a manifest injustice to the shareholders of other companies that are adequately capitalized, and to taxpayers generally. **If, therefore, either as the result of policy or other circumstances, companies lack the necessary cash with which to make distributions of profits to their shareholders, it does not appear that they should be excused from paying additional tax on the amount which, but for these circumstances, they would have been able to distribute.**

229. The next question to be considered is whether in determining the amount that could reasonably have been distributed, allowance should be made for unrecouped losses of paid up capital or of accumulated trading profits which had been invested in the business.

230. The provisions of the section in regard to these matters are not as wide as they might appear to be. In the first place, if such capital or profits are invested outside the business no allowance is made for any loss thereof. In the second place, if the company elects to recoup the loss in any manner other than by the appropriation of taxable income, the loss is not taken into consideration.

231. These distinctions suggest that the only losses considered are those which have arisen either directly or indirectly from trading operations, which the company is not in a position to recoup from any other source.

232. Now companies, in common with all other taxpayers, are allowed to deduct from the taxable profits of any year business losses sustained during the four years last preceding. But companies are granted the further concession that in applying Section 21 consideration must be had to any excess of trading losses over the losses of the preceding four years, and in addition any unrecouped loss of paid up capital. **This further concession, which is not allowed to any other class of taxpayers, does not appear to be justified and we recommend that it be withdrawn.**

233. The next question is whether in determining the amount which could reasonably have been distributed regard should be had to losses which the directors considered were certain to arise during subsequent accounting periods.

234. The allowance is restricted to cases where it can be proved that the directors, at the time of considering the distribution, had evidence in their possession which clearly indicated that such losses were " certain " to arise.

235. The concession holds out hope that is largely illusory, and thereby is responsible for a great deal of the present dissatisfaction with its operation.

236. We quote again from the statement referred to in paragraph 202—

> " Officials of companies sweat and strain to convince the Commissioner that at the time of considering the distribution the directors had contemplated all manner of probable future losses, and, in many cases, are able to prove that subsequent to the contemplated distribution events have occurred which justified the directors' decision. But without the above-mentioned evidence of certainty at the time when the distribution was considered their efforts are invariably fruitless . . . . . "

237. If directors are required to be prophets and say what losses are to arise in the future, an impossible task is thrust upon them. Directors of companies have probably foreseen all sorts of losses which have not in fact occurred. If it were known at the time when the balance-sheet was prepared that a loss was " certain to arise ", directors would be open to criticism if they then failed to make proper provision therefor either out of current profits or existing reserves. If, however, the loss could be then regarded only as probable, while provision might be made in the accounts, the actual loss should be considered for any purpose of taxation in the accounts of the year in which it actually occurs.

238. In either event the problem for the directors is no different from that which presents itself to an individual trader in the same circumstances, and we see no justification for continuing to the company a privilege which is denied to the individual.

239. Several witnesses expressed the opinion that if the distributions made by a company over a period of years exceed two-thirds of the distributable income, the amount distributed in excess of that proportion should be taken into account in considering the amount which might be deemed to be a reasonable distribution in a subsequent year. As the provisions of the section require that it shall be applied to the profits of each separate year, it is not now possible to make

any allowance for such excess distributions. It follows, therefore, that a company may have distributed a greater proportion of its distributable profits than it is required to do in each of several successive years and be liable to additional tax on the first occasion when, for any reason, the directors may be unable to make a distribution.

240. This may be shown by assuming that two companies A and B have the same distributable income in each year over a period of, say, five years—

—	Distributable Income.	Dividends.	
		Company A.	Company B.
	£	£	£
1st year	10,000	8,000	6,700
2nd year	10,000	8,000	6,700
3rd year	10,000	8,000	6,700
4th year	10,000	8,000	6,700
	40,000	32,000	26,800
5th year	6,000	..	4,000
	46,000	32,000	30,800

241. In the fifth year, the directors of Company A deem it inadvisable to distribute any dividend. In accordance with the section the company could be assessed to pay additional tax on a notional distribution of two-thirds of the profits of that year. Company B, having distributed two-thirds of its profits in each year of the period, would not be liable to be assessed. The result would be that although Company A had distributed over the whole period £1,200 more than Company B, it would be liable to pay additional tax on £4,000. If distributions in excess of the statutory proportion over a stated period of years were taken into account before applying the section, both companies would be assessed on the same basis.

242. We think that distributions made by a company during the four years last preceding the year in respect of which the assessment is made should be taken into account when applying the section. For this purpose "notional" distributions should be regarded as distributions in fact.

243. We recognize that this concession may result in some loss of revenue, but we consider that its equity cannot be disputed.

What Constitutes a "Reasonable" Distribution.

244. Over-shadowing all other problems which arise in the operation and administration of the section is the determination of the amount that is to be regarded as a "reasonable" distribution.

245. The evidence given by some witnesses seemed to be based on the idea that in every case where prudent directors acting in the interests of the company would think it right to set aside profits for any purpose, as for example to strengthen reserves or to reduce liabilities, the Commissioner was bound to hold that such profits were reasonably withheld from distribution. It would follow, therefore, that in every case where a company was under-capitalized or liable to any contingency, however remote, affecting the minds of the directors, insufficient distribution could never be established.

246. Such an interpretation would place such companies and their shareholders in a highly privileged position in comparison with other companies and taxpayers, and it is not easy to see on what grounds a like privilege should not be granted to the individual, so as to relieve him from taxation on that part of his income which he might wish to employ in his business or otherwise invest.

247. It should now be clear that entirely different considerations influence the mind of the director and of the official when each attempts to define the expression "reasonable distribution". The director defines it as "dividends", and in considering what dividend should be declared he must take into account many factors, including those which have been mentioned. He would be remiss in his duty if he failed to do so.

248. The first duty of the official is to consider the effect of a distribution on the incomes of the shareholders. He may give consideration to the factors that influence the minds of the directors only to the extent that he is permitted so to do by the provisions of the section. It is inevitable, therefore, that there must be a conflict of opinion between the director and the official. This arises from the attempt to reconcile " dividends ", which are determined on commercial principles, with " income ", which is determined in accordance with a legal concept which is not concerned with commercial principles.

249. When the principle of Section 21 was first incorporated in the Commonwealth Act no attempt was made to define the proportion of income which would constitute a reasonable distribution. If the Commissioner determined that the amount distributed was not " reasonable ", the difference between the amount distributed and the taxable income was treated as though it had been distributed to shareholders, and taxed on that assumption. But as the result of repeated representations to the Government of the day the Amending Act of 1922 fixed two-thirds of the taxable income as a reasonable amount. This amount was frankly a compromise offered in an attempt to give satisfaction to companies, and it is a privilege not conferred elsewhere. In all other countries where similar legislation exists, if a reasonable distribution has not been made the amount which may be notionally distributed is not limited to a fixed proportion. The Finance Act (Great Britain) provides that where a company has not made a reasonable distribution, the whole income of the company shall be apportioned between the shareholders and deemed to be their income. Under the tax laws of the United States a company which fails to make an adequate distribution for the purpose of avoiding the payment of sur-tax by its shareholders is liable to an additional tax of 50 per cent. of its net income, unless every shareholder includes in his return as part of his income his entire distributive share of the company's net income, whether distributed or not.

250. A distribution of two-thirds of the income cannot always be " reasonable ". If " reasonableness " were the only test, a private investment company with liquid assets might find it difficult to justify the retention of any part of its profits. Conversely, a trading company might be able to justify the retention of the whole. Between these extremes there are infinite graduations, and a distribution that in one case might be excessive and imprudent would in another case be too small. It cannot be established that companies as a whole retain or require to retain one-third of their income for investment in capital assets, such as buildings, plant, &c., or to increase reserves. And as we have shown, the application of a fixed proportion to the result of each separate year, without regard to previous distributions in excess of that amount, may operate unequally as between companies.

251. When the section was first enacted it was designed to compel companies to make a " reasonable " distribution of their income. But successive amendments have prohibited consideration of factors that ought to be taken into account if " reasonable " is to be the test. If the section is to be amended as we recommend, we approach the point when it is desirable to consider whether it should not be applied automatically. Several responsible witnesses suggested that this should be done.

252. It is probable that automatic application of the section, subject to the conditions specified in the next paragraph, would remove much of the existing dissatisfaction, which appears to be caused, to some extent at least, by the difficulty of reconciling the spirit of the expression " reasonable " with other provisions of the section.

253. If the section be applied automatically, we recommend—

(1) that the expression " distributable income " be defined to mean taxable income less certain deductions to be specified in the Section.

(2) that the amount subject to additional tax shall be the amount by which the statutory proportion of the " distributable income " (as defined) for the year of assessment and for the four years last preceding exceeds the actual and notional distributions of the company for the like period.

254. In our opinion, the only deductions which should be made from " taxable income " are taxes payable in Australia or elsewhere in respect of such income, which are not allowed as deductions for the purpose of determining the company's taxable income. We see no reason why deduction should be allowed for State income tax payable in respect of such profits, as this is subsequently allowed as a deduction in the company's assessment for income tax. The balance of the distributable income, as defined, upon which the company is not required to pay additional tax should be adequate to provide for any other expenses which may not be allowed in the company's ordinary assessment.

255. If this suggestion were adopted it is probable that companies would pay no more tax than at present. Their officers and advisers would be spared the time and effort now involved in attempting to prove that no distribution or no larger distribution could have been made. The application of the section could be vested in Deputy Commissioners in the State in which the return of the company is lodged. At present all cases arising under the section must be referred to the Commissioner for his determination. This causes delay, and in some cases expense to the taxpayer, and is considered by many witnesses to be unnecessary.

Method of Assessing the Tax.

256. When the Commissioner has determined that the company is liable to pay additional tax under this section an assessment is made. The present procedure is unsatisfactory for three reasons—the first is that the company cannot estimate the probable amount of the tax, the second that it is unable to check the assessment when received, and the third that a considerable delay occurs before the assessment is issued.

257. The inability of the company to estimate the amount of the tax and to check its assessment is due to the same cause. The additional tax payable in respect of the notional distribution is calculated by reference, not to the amount of the distribution, but to its effect upon the incomes of the individual shareholders. The calculation therefore involves knowledge of the amount of every shareholder's income, which is not available to the company, and which, by reason of the secrecy provisions of the Act, the department cannot supply.

258. In one important respect the operation of Section 21 creates a serious inequality in the treatment of shareholders. The amount payable by the company upon an assessment under the section is the aggregate of the additional amounts that would have been paid by the individual shareholders had there been an actual distribution. Each shareholder's interest in the company should properly bear a share of the whole amount equal to the amount that would have been added to his individual tax. Instead of that, the payment by the company indirectly charges him with a share proportionate to his holding in the company, a very different thing.

259. For example, if the tax assessed to the company under the section is equivalent to 3s. in the £1 on the notional distribution, every shareholder, whatever number of shares he holds and whatever his income, indirectly pays through the company a tax at that rate on the dividend that he is assumed to have received; whereas if he had actually received it, he might have paid very much more or very much less. He would have paid nothing if the rate of tax on his income is less than the flat company rate. A wealthier shareholder, on the other hand, might have paid at the rate of several shillings more in the £1. The tax that he should have paid, therefore, is to a large extent borne by those with smaller incomes.

260. We considered various proposals for overcoming these difficulties, and explored the possibilities of determining the additional tax payable by some other method. We have considered whether it might be imposed at a flat rate on that portion of the taxable income which, according to the determination of the Commissioner, might have been distributed, or whether it might be charged at a graduated rate based on that amount, or on the percentage which that amount bears to the total distributable income of the company.

261. Consideration of a number of examples supplied by the department shows that the additional tax imposed varied from 10.3d. on a deemed distribution of £3,000, to 65d. on a deemed distribution of approximately the same amount. Any flat rate which might be selected would, therefore, operate inequitably as between individual shareholders. Tests of a similar nature to see the effect of applying a rate of tax graduated by reference either to the amount or the percentage of the deemed distribution proved equally unsatisfactory.

262. Suggestions have been made that the difficulty could be overcome by requiring the shareholder to pay the tax. But the shareholder might not have the money to pay the tax on a distribution which he did not receive, and even if he had he might object. This was, in effect, the system originally adopted in the Commonwealth Act, but it was found necessary to amend it.

263. If at the time a company is assessed it were notified of the amount of the additional tax applicable to each individual shareholder, it would then be practicable for the company to arrange whether the shareholder or the company were to provide the amount. It is thought that this would not involve undue disclosure to the company of the private affairs of a shareholder, and the suggestion deserves consideration.

264. In present conditions it is virtually impossible to make an assessment under Section 21 for approximately two years after the close of the company's accounting period. The delay is due to the requirements of the section and not to dilatory administration. This will be clear from the following statement of the procedure.

265. Let it be assumed that the accounting period of the company ends on 30th June, 1929. In the ordinary course it will receive its assessment for income tax during the first half of 1930. If, subsequently, the Commissioner determines that a sum or further sum could reasonably have been distributed, it has been the departmental practice to assume that the notional distribution was made at the time when the company would usually make a distribution, that is, in most cases at the date of the annual general meeting next following the close of the accounting period. The amount of such notional dividend attributable to each shareholder is added to the amount of his other income for the year in which he would have received it if it had been distributed as dividend, in this case the year ended 30th June, 1930. Shareholders' assessments for that year would not be made until the first half of 1931, or, approximately, two years after the close of the company's accounting period.

266. In the case of Neal's Motors Pty. Ltd. *v.* The Federal Commissioner of Taxation, the High Court held that this practice was not in accordance with the Section. The facts of this case were briefly as follows :—The financial year of the company ended on 30th June, 1929. The assessment for Federal Income Tax purposes was issued on 26th February, 1930, and on 11th July, 1930, the Commissioner determined that the company had not before 10th July, 1930, distributed a reasonable amount of its income, and that a further amount could, in his opinion, reasonably have been distributed. In accordance with his practice he proceeded to assess tax on the basis that the distribution had taken place in the income year ended 30th June, 1930. The company appealed to the High Court, which decided that the date of the deemed distribution should be the day preceding that fixed by the Commissioner as the last day on which the company could have made a distribution—in this case, 9th July, 1930.

267. The result of this decision was that shareholders were assessed on the assumption that the notional distribution had been added to their incomes for the year ended 30th June, 1931. Unless the Act is amended it is possible that in some cases this decision will further delay assessments.

268. In Neal's Motors' case the company argued that the distribution should be deemed to have been made in the year in which the company earned its profits, viz., the year ended 30th June, 1929. The Department claimed that it should have been made in the year ended 30th June, 1930. The result of the decision of the High Court is that it will be deemed to have been made in the year ended 30th June, 1931. This position certainly calls for clarification.

269. We recommend that Section 21 be amended to provide that a notional distribution shall be deemed to have been made by the company and received by the shareholders on the last day of the company's accounting period in which the profits deemed to have been distributed were earned. This is the rule in Great Britain and South Africa.

Other Matters Arising out of Section 21.

270. We propose to deal with certain other matters which are involved in the operation of this section in our subsequent report when considering " Holding Companies " and " Objections and Appeals."

SECTION XIV.

THE COMPLICATIONS CREATED BY THE FURTHER INCOME TAX (GENERALLY DESCRIBED AS THE SPECIAL PROPERTY TAX).

271. Evidence has been given that this tax presses very heavily upon taxpayers. It is not our intention to refer to that aspect, but merely to point out the complications caused by the imposition of the tax in its present form.

272. The tax is levied upon all income from property, and upon some income which, for the purpose of normal income tax, is income from personal exertion. Hitherto, the Act has recognized only two classes of income, viz., income from personal exertion and income from property, but the differential treatment of a part of the former class of income modifies a

distinction which has previously been clear, and introduces further difficulties. It necessitates an analysis of personal exertion income which is not otherwise required, and also involves an apportionment of the deductions in order to determine what proportion thereof should be charged against the income subject to the Special Property Tax.

273. Further analysis is required in the case of dividends. The object of the section imposing this tax is that it shall be paid only once, either by the company or by the shareholder. If it is paid by the company, it is necessary to determine what proportion of each dividend is to be exempt from this tax in the hands of the shareholder. This analysis involves the calculation and allowance of rebates, and perpetuates some of the difficulties to which we have referred earlier in this report. Difficulties associated with the calculation of rebates at times involve the issue of tentative and subsequently amended assessments to shareholders. In a case brought under our notice, which affects from 400 to 500 shareholders, it was found necessary to amend the original assessments twice within a period of fourteen days.

274. An example of the special property tax rebates which are now required is shown in Appendix 4, and similar statements will be necessary while the tax is levied in the present manner. The modifications we have suggested for the simplification of dividends and rebates subject to normal income tax will not remove the necessity for these special rebates.

275. If it were practicable to raise the amount of revenue required from this tax by means of a surcharge on the normal rate of tax applicable to income from property, it would be possible still further to simplify the assessments of all taxpayers in receipt of income subject to Special Property Tax.

The other matters referred to us by Your Excellency will be dealt with in subsequent reports.

DAVID G. FERGUSON (Chairman),
EDWIN V. NIXON.

J. A. NEALE (Secretary),
Sydney, 28th August, 1933.

APPENDIX 1. (*See* § 66.)

EXAMPLE SHOWING THE MANNER IN WHICH DIVIDENDS PAID FROM RESERVES ARE APPROPRIATED THERETO, AND HOW THE REBATES ALLOWABLE IN RESPECT OF EACH PART OF THE DIVIDEND ARE CALCULATED.

Assume that the reserve fund out of which the dividend is declared has been built up since the year 1912, and prior to the declaration of the dividend the reserve was £40,000. The reserve fund must be carefully analysed and this means a consideration of the effect of the company's assessments for each year since the commencement of the Act in 1915. The fund may for illustration purposes, have been built up as follows :—

	£
(*a*) Profits in reserve prior to 1st July, 1914	10,000
(*b*) Profits on which the company has paid tax at 1s. 6d. in £	1,000
(*c*) Profits on which company has paid tax at 1s. 10½d. in £	3,000
(*d*) Profits on which company has paid tax at 2s. 6d. in £	2,000
(*e*) Profits on which company has paid tax at 2s. 8d. in £	5,000
(*f*) Profits which company has paid tax at 2s. 5d. in £	5,000
(*g*) Profits on which company has paid tax at 1s. in £	5,000
(*h*) Profits on which company has paid tax at 1s. 2.4d. in £	4,000
(*i*) Profits in respect of which the company was exempt from tax and which are also exempt when received by the shareholders	3,000
(*j*) Profits in respect of which the company was exempt but which are subject to tax when received by the shareholders	2,000
	40,000

A dividend of £10,000 is declared out of this reserve and the Departmental view is that it must be deemed to have been taken proportionately out of each addition to the reserve fund, so that the rebates in respect of £100 of dividends received by a taxpayer would be :—

(*a*) Ten fortieths, or 25 per cent. exempt from taxation.
(*b*) One fortieth, or 2.5 per cent., rebatable at 1s. 6d. in the £, or the taxpayer's own rate, whichever is the lower.
(*c*) Three fortieths, or 7.5 per cent., rebatable at 1s. 10½d. in the £, or the taxpayer's own rate, whichever is the lower.
(*d*) Two fortieths, or 5 per cent. rebatable at 2s. 6d. in the £, or the taxpayer's own rate, whichever is the lower.
(*e*) Five fortieths, or 12.5 per cent. rebatable at 2s. 8d. in the £, or the taxpayer's own rate, whichever is the lower.
(*f*) Five fortieths, or 12.5 per cent. rebatable at 2s. 5d. in the £, or the taxpayer's own rate, whichever is the lower.
(*g*) Five fortieths, or 12.5 per cent., rebatable at 1s. in the £, or the taxpayer's own rate, whichever is the lower.
(*h*) Four fortieths, or 10 per cent., rebatable at 1s. 2.4d. in the £, or the taxpayer's own rate, whichever is the lower.
(*i*) Three fortieths, or 7.5 per cent., exempt from taxation.
(*j*) Two fortieths, or 5 per cent., taxable without rebate, as the company did not pay tax on this account.

APPENDIX 2. (*See* § 70.)

Calculation of Rebates on Dividends as now required by the Act.

——	Dividend	Exempt.	—	Section 16 (*b*) (iii) Rebate.								Balance taxed in full.	Not subject to Supertax.	
				At 1/4.		At 1/4.8		At 1/2.4		At 1/-.				
	£	%	£	%	£	%	£	%	£	%	£		%	£
P. J. M. Co. Ltd. ..	19	26.28	5	73.5	14	..	..	.22	..	..	..	..	8.06	2
P. J. I. Co. Ltd. ..	26	..	..	41.9	11	40.46	11	..	..	..	..	4	33.76	9
S. F. Ltd.	15	..	..	50	7	50	8	..	..	..	..	..	13.	2
W. S. & P. Ltd. ..	14	..	..	48.83	7	49.04	7	..	..	..	..	..	33.17	5
B. C. Co. Ltd.	5	.02	..	59.58	3	37	2	..	..	..	..	..	12.43	1
T. & Co. Ltd.	20	..	..	..	..	94.25	19	..	..	..	..	1	47.7	10
T. Ltd.	21	..	..	50	10	36.13	8	..	..	..	..	3	25.85	5
T. S. Ltd.	3	..	..	50.61	2	49.39	1	..	..	..	..	..	100.	3
M. C. Ltd.	4	5.64	..	13.36	1	..	..	..	..	15.45	1	2	.7	..
B. M. Ltd.	5	9.55	..	..	..	..	..	..	..	79.57	4	1	..	..
N. C. Co. Ltd.	11	4.64	1	47.53	5	47.62	5	..	..	..	..	..	16.11	2
D. J. Ltd.	20	..	..	48.9	10	44.81	9	1.92	..	4.37	1	..	..	..
N. S. G. Co. Ltd. ..	15	..	..	1.96	..	36.59	6	..	..	..	..	9	1.01	..
H. J. C. Ltd.	17	83.4	14	..	..	16.6	3	..	..	..	..	..	16.6	3
D. P. Ltd.	37	..	..	77.4	29	22.6	8	..	..	..	..	..	8.1	3
A. N. Ltd.	31	..	..	63.55	20	36.45	11	..	..	..	..	..	86.24	27
	263	..	20	..	119	..	98	..	..	..	6	20	..	72

Section 16 (*b*) (iii) *Rebate*—Dividends rebatable .. .. £ ..223 (*a*)

Less deductions applicable .. .. (*a*) 223 / (*b*) 243 x 24 = 22 — 201

Less proportion of Statutory Exemption .. .. .. 201 / (*c*) 219 x 191 = 176 — 25 at 3.28d. = 6s. 11d.

Deductions—Unemployment Tax, £10.
Insurance, £14.
Statutory Exemption, £191.

(*a*) £223 = Rebatable Dividends.
= Gross Dividends (£263) minus Exempt portion (£20) minus portion taxable in full (£20)
(*b*) £243 = Assessable Dividends.
= Gross Dividends (£263) minus Exempt portion (£20).
(*c*) £219 = Assessable Dividends (£243) minus Deductions (£24).

APPENDIX 3. (*See* § 148.)

Calculation of Rebates on Dividends shown in Appendix 2 if effect be given to the recommendations made in this report (disregarding complications due to rebates allowable in respect of the special property tax).

Section 16 (*b*) (iii) *Rebate*—

	£	£
Dividends received		263
Less deductions	24	
Statutory exemption	181	
	——	205
		58

Rebate = £58 @ 3.58d. = 17s. 4d.

APPENDIX 4.

Calculation of Rebates on Dividends shown in Appendix 2, as it will appear while rebates are allowable in respect of the Special Property Tax.

Company.	Dividend.	Section 16 (*b*) (iii) Rebate. At 1/4.8.		Not subject to Supertax.	
	£	%	£	%	£
P. J. M. Co. Ltd.	19	100	19	8.06	2
P. J. I. Co. Ltd.	26	100	26	33.76	9
S. F. Ltd.	15	100	15	13	2
W. S. & P. Ltd.	14	100	14	33.17	5
B. C. Co. Ltd.	5	100	5	12.43	1
T. & Co. Ltd.	20	100	20	47.7	10
T. Ltd.	21	100	21	25.85	5
T. S. Ltd.	3	100	3	100	3
M. C. Ltd.	4	100	4	.7	..
B. M. Ltd.	5	100	5	..	..
N. C. Co. Ltd.	11	100	11	16.11	2
D. J. Ltd.	20	100	20	..	..
N. S. Co. Ltd.	15	100	15	1.01	..
H. J. C. Ltd.	17	100	17	16.6	3
D. P. Ltd.	37	100	37	8.1	3
A. N. Ltd.	31	100	31	86.24	27
	263	..	263	..	72

	£	£
Section 16 (*b*) (*iii*) *Rebate*—Dividends rebatable		263
Less deductions	24	
Statutory exemption	181	
		205

58 @ 3.58d. = 17s. 4d.

The above example is a continuation of the particulars of dividends set out in Appendices 2 and 3. Since the appointment of this Commission, however, an exemption of £250 has been provided in respect of income liable to Special Property Tax, so that the special tax would not now be payable in the instance shown. The dissection in respect of each dividend would be necessary, however, in all cases where the taxable income subject to the Special Property Tax exceeded £250.

APPENDIX 5. (*See* § 43.)

OFFICIAL MEMORANDUM SUBMITTED BY THE COMMISSIONER OF TAXES, QUEENSLAND, EXPLAINING THE OPERATION OF THE QUEENSLAND SYSTEM OF TAXING LIMITED COMPANIES.

(A) Ascertainment of the Taxable Income.

In principle, the basis of computation is similar to that for Federal. There would be the usual departures because of non-allowance of State or Federal Income Taxes paid and different values for depreciation, &c. In addition, we tax the writing-up or writing-in of assets (Section 10 (8) (*a*) and (*b*)), and also income arising from the forfeiture of shares (Section 10 (10)), or from premiums on new shares issued (Section 14 (1) (*b*)). These additional items are of infrequent occurrence.

The taxing of writing-up of assets or writing-in of assets is necessary because in its absence companies could avail themselves of this method of increasing their capital and thereby reduce the rate of tax. A similar argument applies to forfeiture of shares or premiums on shares as the income therefrom is carried to Reserve Accounts and Reserve Accounts rank similarly to paid-up capital in computing the capital on which the rate of tax is based. Moreover there is the additional fact that forfeiture of shares and premiums on new issues represent a gain to the company.

(B) Ascertaining of the Profit used for determining the percentage of Profits to Capital (Section 42 (1), and Section 43 (1)).

In many cases the net profit in Profit and Loss Account with adjustment for transfers to and from reserves gives the amount to be adopted. The aim is to determine what is really the true taxable profit as distinct from taxable income as the latter would include disallowance of actual expenses such as Income Taxes paid, donations, and legal expenses disallowed, &c., and would not reflect the true earnings of the capital. Depreciation as written off in the accounts is only adjusted when it is seriously in excess of the amount allowable for taxable income purposes and tantamount to the creation of a secret reserve. Adjustment would be made for any capital expenditure included in Profit and Loss Account, but such a position should not arise in a properly kept set of books. Income Taxes incurred in respect of the previous year's trading are allowed. Exempt income such as Commonwealth Loan Interests and Dividends is excluded. Casual profits are brought in at one-seventh, one-sixth, &c., of the amount of profit included in the taxable income according to the number of years the property sold was owned. The profit arising from the sale of an asset owned over seven years (non-taxable) would be excluded excepting that any necessary adjustment for excess depreciation allowed is adjusted.

A typical example is as under :—

	£	£
Profit as per Profit and Loss Account		12,400
Add Bad Debts Reserve		500
Income Tax Reserve		2,000
Alterations		400
		15,300
Deduct—		
Bad Debts w/o. Reserve	100	
State Income Tax Account, previous year's trading	1,500	
Federal Income Tax Account, previous year's trading	700	
		2,300
Profit for p/c. purposes		13,000

(C) Calculation of the Capital on which the Percentage of Profits to Capital is based (Section 43 (3)).

An example incorporating all the usual features is as under :—

X.Y.Z. Company Limited is an old-established company. Its capital at the 1st July, 1931, was £100,000, which was increased by the introduction of fresh capital during the year ended 30th June, 1932, as under :—

£10,000 on 1st October, 1931.
£10,000 on 1st January, 1932.
£10,000 on 1st April, 1932.

Reserves at 1st July, 1931, amounted to £50,000, and Profit and Loss Appropriation Account Balance at same date, £11,000. A dividend of £9,000 was paid on 30th September, 1931, and the balance transferred to Reserve Account, making same £52,000. Of this amount £10,000 had accumulated as at 30th June, 1918.

Tax due on account of the preceding year's income was paid on 1st February (State) and 1st March (Federal), 1932.

The total assets of the company at 30th June, 1931, amounted to £200,000 and at 30th June, 1932, to £220,000, and included therein were assets as under :—

(1) Goodwill paid for in shares, £20,000, both at beginning and end of year.
(2) Shares in other companies, £5,000, both at beginning and end of year.
(3) Commonwealth Loan Bonds, £5,000, at beginning of year ; £7,000 at end of year.

Computation of the capital applicable for percentage purposes would be made as follows :—

(1) *Paid-up Capital*—		£
Applicable for the whole year		100,000
Add increases during the year—		
£10,000 on 1st October, 1931, applicable for nine months : ¾ of £10,000		7,500
£10,000 on 1st January, 1932, applicable for six months : ½ of £10,000		5,000
£10,000 on 1st April, 1932, applicable for three months : ¼ of £10,000		2,500
		115,000
(2) *Reserves and Profit and Loss Account Balance Applicable*—		
Reserves at 1st July, 1931, applicable for the whole year	50,000	
Less portion of Reserves at 30th June, 1918, which have not paid full tax ..	10,000	
		40,000
Increase to reserve during year 1931–32 was £2,000 (£11,000 *less* dividend of £9,000). Tax paid 1st February, 1932. Therefore applicable for five months—		
5/12ths of £2,000		833
		155,833
(3) Deduct goodwill not paid for in cash, Section 43 (4) (iii)		20,000
		135,833

(4) Proportion of £135,833 which was invested in Assets of the Business producing Profits liable to tax. Section 43 (3) :—

	30.6.31	30.6.32.	Average.
	£	£	£
Total assets	200,000	220,000	210,000
Deduct assets not producing taxable profits—			
Shares in other companies	5,000	5,000	
Commonwealth Loans	5,000	7,000	
	10,000	12,000	11,000
Average Assets engaged in production of Taxable Profits			199,000

Capital applicable for percentage purposes is—

$$\frac{199,000}{210,000} \text{ of } £135,833 = £128,718.$$

Assuming that the profit for percentage purposes has been determined at £13,000, which is more than 10 per cent. but less than 11 per cent. of the capital applicable (£128,718), the rate of tax laid down for such a percentage is 3s. in the £ (Section 42 (1)). This rate would be applied to the taxable income, super tax of 20 per cent. of the tax so arrived at added (Section 44), and the assessment would be complete.

The ascertainment of the average amount of paid-up capital (£115,000—Step No. 1) calls for no further explanation, it being the average amount over a full income year of the paid-up capital as required by Section 43 (3) (*a*).

In regard to Step No. 2, it will be noted that it was mentioned that of the amount of £50,000 in Reserve Accounts £10,000 had accumulated as at the 30th June, 1918. This is excluded from the reserves allowed to rank as capital because Section 43 (3) (*b*) (ii) stipulates that the full amount of tax applicable to the year in which the profits were earned must have been paid or (Proviso (i)) that the company has paid the additional tax chargeable under Section 42 (6). Perhaps I should explain here that up to 1918 different rates of tax applied to distributed and to undistributed profits, the latter paying only a flat rate of 6d. in the pound up to 1914 and 9d. in the £ from 1915 onwards. When any company subsequently distributed such undistributed profits they were required to pay additional tax to the extent of the difference between the amount of tax that would have been paid if distributed and the flat rate that had already been paid. Section 42 (6) makes provision for companies to pay this additional tax without distributing same and the profits would then rank for capital purposes because full tax had been paid thereon. The additional tax would amount to 6d. in the £ up to and including 1914 profits and anything from 3d. to 1s. 3d. for later years according to the percentage which the profits bore to the capital.

The amount of £833 in Step No. 2 represents that portion of the profits of the previous income year remaining after the declaration of the dividend. The profits were £11,000 ; the dividend absorbed £9,000, and the balance—£2,000—is entitled to rank for capital as from the date on which tax was paid. This represented a period of five months, and five-twelfths of £2,000 equals £833.

Deduction of goodwill in Step No. 3 is in accordance with the provisions of Section 43 (4) (iii).

The objective of Step No. 4 is to ascertain the amount of capital which was invested in the assets of the business and used in the production of taxable income, assets which earn exempt income being excluded (Section 43 (4) (i)). By taking the assets at the beginning and at the end of the year provision is made for any increase or decrease therein.

Other provisions which I have not specifically mentioned are :—

Section 43 (4) (ii).—Providing that when a company has written down its capital, shares held at date of writing down and still held by the same shareholders shall be taken at the full paid-up value.

Section 43 (4) (iv).—Contains certain provisions which ensure that if companies resort to the methods referred to therein they will not thereby secure allowance of capital to which they would not otherwise be entitled.

Section 43 (4) (v).—Provides that if a company advances money to a person to buy shares and such person is still indebted therefor to the Company the value of such shares is taken at the paid-up value less the average amount of such person's indebtedness over the income year.

Section 23 (12).—This section protects the rate of tax from being adversely affected by the adoption of the practice of distributing profits in the form of bonuses, directors' fees, salaries, &c. The amount disallowed is added to the profit shown by Profit and Loss Account and the rate of tax determined on such amount. In the assessments of the directors the amounts disallowed are treated as dividends.

The effect of the Queensland system is that the company is taxed on the whole of its profits and dividends are treated as exempt income in the hands of the shareholders but are used to determine the shareholders' rate of tax (Section 38 (4) (i)), the Statutory Exemption (Section 20 (2)), allowance of business losses (Section 21 (1)), and the limits of income for allowance of medical expenses (Section 19 (1) (*w*)), and for allowance of dependants (Section 19 (l) (*c*) (iv)).

APPENDIX 6. (*See* § 11.)

LIST OF WITNESSES AND ASSOCIATIONS, ETC., REPRESENTED BY WITNESSES.

LIST OF WITNESSES AND ASSOCIATIONS, ETC., REPRESENTED BY WITNESSES—*continued.*

LIST OF WITNESSES AND ASSOCIATIONS, ETC., REPRESENTED BY WITNESSES—*continued.*

LIST OF WITNESSES AND ASSOCIATIONS, ETC., REPRESENTED BY WITNESSES—*continued.*

Printed and Published for the GOVERNMENT of the COMMONWEALTH of AUSTRALIA, by L. F. JOHNSTON, Commonwealth Government Printer, Canberra.