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# The Ongoing Saga of the "Terrible Twins" : Observations on Hepples v FC OF T

## **Abstract**

This article attempts to unravel the complexities of the High Court's recent pronouncements on the scope of the capital gains provisions in Hepples v FC of T. While four members of the Court believed the subject receipts taxable, the Court nevertheless held in the taxpayer's favour.

## **Keywords**

capitals gains tax

## THE ONGOING SAGA OF THE "TERRIBLE TWINS": OBSERVATIONS ON *HEPPLES v FC OF T*



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*This article attempts to unravel the complexities of the High Court's recent pronouncements on the scope of the capital gains provisions in Hepples v FC of T. While four members of the Court believed the subject receipts taxable, the Court nevertheless held in the taxpayer's favour.*

### **Introduction**

The complexity of Part IIIA, the capital gains provisions of the Income Tax Assessment Act 1936, was recently reaffirmed in *Hepples v FC of T*.<sup>1</sup> These "extraordinarily complex"<sup>2</sup> provisions, described by Toohey J as "couched in terms ... unduly labyrinthine,"<sup>3</sup> have caused much bewilderment.<sup>4</sup> In particular the courts have been baffled by the unnecessary<sup>5</sup> complexity of s 160M(6) and (7).

Hopes for High Court clarification of the scope and impact of these subsections were dashed with the decision in *Hepples v FC of T*.<sup>6</sup> It is practically impossible to draw from the seven separate judgments any majority opinion, much less a consensus of thought. The High Court allowed the taxpayer's appeal despite a majority of the Court believing either s 160M(6)<sup>7</sup> or s 160M(7)<sup>8</sup> to be applicable to the subject facts.<sup>9</sup> Given the

1 (1991) 91 ATC 4808.

2 Ibid 4810 per Mason CJ.

3 Ibid 4823 per Toohey J.

4 Ibid 4810 per Mason CJ.

5 Ibid 4819 per Deane J.

6 Above n 1.

7 In summary, s 160M(6) deems there to be a disposal of an asset where that asset did not exist before the disposal (either by itself or part of another asset), but rather was created by the disposal. In such cases the subsection deems a zero cost base.

8 In summary, s 160M(7) deems there to be a disposal of a notional asset where, inter alia, there is an act, transaction or event, in relation to or affecting an asset. Again this section deems the disposed asset to have a zero cost base.

9 Mason CJ, Toohey, McHugh and Deane JJ (Brennan, Dawson and Gaudron JJ dissenting on this point) held s 160M(6) did not apply. Mason CJ, McHugh, Deane (just!) and Brennan JJ (Dawson, Gaudron and Toohey JJ dissenting on this point) held s 160M(7) did not apply.

(1991) 2 Revenue L J

divergence of thought even within members constituting the majorities<sup>10</sup> the Court determined the appeal should be allowed in favour of the taxpayer.

The purpose of this note is to attempt to unravel this tangle and provide a summary of the present position. While some comments are made as to the appropriateness of the Court's opinions, a more detailed analysis will have to await another day.

While the decision was a success for the taxpayer, the High Court's judgments are no cause for tax practitioners to celebrate.

## Facts

The taxpayer in the *Hepples* case was employed as the marketing director/general manager of the window furnishings division of Hunter Douglas Ltd.<sup>11</sup> In June 1986 the taxpayer entered into a restrictive covenant with Hunter Douglas in consideration of \$40,000. The taxpayer covenanted that for two years immediately following the termination of his employment he would not divulge any trade secrets or engage in competitive conduct.

## The Federal Court's decision

The Full Court of the Federal Court unanimously held<sup>12</sup> that the case did not fall within the scope of s 160M(6), but by a majority held s 160M(7) to be applicable.<sup>13</sup> The majority of the Court held the sum of \$40,000 to be a capital gain within Part IIIA. They believed there to be an act or transaction (the restrictive covenant) occurring in relation to, or affecting, an asset (Hunter Douglas' trade secrets, trade connections and goodwill) within s 160M(7) and thus the money received for entering into that covenant was taxable. The specific reasons for the decision are considered in the course of this note.

Three questions are considered in this note:

- the scope of s 160A (the meaning of Asset);
- the scope of s 160M(6); and
- the scope of s 160M(7).

## Asset

When first enacted there was much dispute as to the scope of s 160A, in particular the phrase "any other right". Section 160A defines "asset" as any form of property. The section then provides a non-exhaustive list of assets, including the phrase "any other right".

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10 That is, the members believing s 160M(6) not to be applicable and the four members believing s 160M(7) not to be applicable.

11 The division accounted for approximately two-thirds of the business activities of Hunter Douglas.

12 (1990) 22 FCR 1.

13 Lockhart and Gummow JJ, Hill J dissenting.

It is submitted it is now conclusively determined that using the maxim *esjusem generis*, s 160A is confined to "proprietary rights", to the exclusion of personal rights.<sup>14</sup>

All members of the Full Federal Court agreed, limiting the reference in s 160A to "any other right" to rights of a proprietary nature, excluding "personal"<sup>15</sup> and "popular"<sup>16</sup> rights. Gummow J stated the definition of "asset" in terms of property was exhaustive; the choice of words indicating asset "means" property, rather than "includes" property. Thus, in the absence of a clear intention otherwise,<sup>17</sup> s 160A should be confined to proprietary rights. Following the decision in *Rapistan Canada Ltd v Minister of National Revenue*,<sup>18</sup> Gummow J believed this limitation excluded from the reference in para (a) to "choses in action" those relating to personal rights,<sup>19</sup> such as the right to work. Such non-transferable contractual rights<sup>20</sup> were neither "property" nor "choses in action" for Part IIIA purposes.<sup>21</sup>

It appears the High Court no longer considered the interpretation of s 160A a major issue, few members of the Court even adverting to the question of its scope.<sup>22</sup> Again, the definition of asset in terms of "any form of property", led members of the Court to confine s 160A(1)(a) to forms of "corporeal property" such as debts, choses in action and goodwill.<sup>23</sup>

Following *Kirby v Thorn EMI Plc*,<sup>24</sup> Brennan, Toohey and McHugh JJ held the right to work/compete in the market was not a proprietary asset within s 160A.<sup>25</sup> This right could not legally be "owned",<sup>26</sup> was incapable of

14 For this distinction see, inter alia, *Commissioner of Stamp Duties (NSW) v Yeend* (1929) 43 CLR 235.

15 Such as the right to work.

16 Popular rights being non-technical rights which are merely seen as "rights" in some popular sense.

17 Gummow J believed "liability should not be inferred from ambiguous words", citing, inter alia, *Western Australian Trustee Executor and Agency Co Ltd v Commissioner of Taxation (WA)* (1980) 80 ATC 4567 at 4571.

18 (1974) 48 DLR 613.

19 Such as those relating to personal injury. Gummow J did not believe the express exclusion of compensation for personal injury in s 160ZB undermined this reasoning; the section being included out of caution, rather than "throwing any clear light upon the meaning" of asset in s 160A.

20 The general definition of proprietary rights being that capable of assumption by third parties: per Mason J in *The Queen v Toohey; Ex parte Meneling Station Pty Ltd* (1982) 158 CLR 327.

21 On the facts, however, Gummow J found a technical legal right to exist, that being Hunter Douglas' confidential information / trade secrets, trade connections and goodwill.

22 Though an acceptance of this reasoning was implicit in the judgments of the other members: see for example Toohey J, above n 1 at 4825.

23 Above n 1 at 4808 per Brennan J and at 4841 per McHugh J, following *Kirby v Thorn EMI Plc* [1988] 1 WLR 445, CA, at 452 per Nicholls LJ.

24 Ibid, where the English equivalent, s 22, was considered.

25 Above n 1 at 4813 per Brennan J; at 4841 per McHugh J; at 4827-4828 per Toohey J, following *Kirby v Thorn EMI Plc* above n 23 at 458 per Purchas LJ.

26 As stated by Nicholls LJ in *Kirby v Thorn EMI Plc* *ibid*, 452.

(1991) 2 Revenue L J

transmission<sup>27</sup> and would not be legally enforced by the courts.<sup>28</sup> They therefore concluded the covenant did not affect the ownership of any proprietary right of the taxpayer.<sup>29</sup>

### Scope of s 160M(6)

A far more difficult question was the interpretation of s 160M(6). Brennan, Toohey and McHugh JJ expressly adverted to the difficulty involved in construing s 160M(6) and the uncertainty the notion of a "disposal of an asset that did not exist . . . before the disposal" of necessity created.<sup>30</sup> McHugh J described the subsection as "obscure",<sup>31</sup> reiterating Hill J's earlier statement that it "is drafted with such obscurity that even those used to interpreting the utterances of the Delphic oracle might falter in seeking to elicit a sensible meaning from its terms".<sup>32</sup>

In interpreting s 160M(6), the Court adverted to three issues:

- was the asset referred to in s 160M(6) the asset owned by the taxpayer?
- was the asset carved from a pre-existing asset?
- did s 160M(6) contemplate a pre-existing disposal?

#### *Asset owned by the taxpayer*

The Commissioner had argued that s 160M(6) applied to any case where an asset was created by a transaction, whether or not the person allegedly liable for the tax was the owner of the asset.<sup>33</sup>

By contrast, the appellant submitted in the absence of a pre-existing asset<sup>34</sup> owned by the taxpayer prior to the "putative disposal",<sup>35</sup> the consideration the taxpayer received could not be characterised as a taxable capital gain.<sup>36</sup> This submission was supported by s 160L(1) and s 160C(1)(a). Section 160L(1) requires before Part IIIA to apply there to be a "disposal . . . of an asset . . . that . . . immediately before the disposal took place, was owned by . . . a person". Section 160C(1)(a) defines "taxpayer" to be "the person who owned the asset immediately before the disposal took place".

In light of these provisions Deane J<sup>37</sup> found Part IIIA was intended to apply only where the person allegedly liable to the tax was the owner of the

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27 Above n 1 at 4828 per Toohey J.

28 The law, Brennan J noted, will only remove an "unreasonable impediment upon the capacity to work": quoting Barwick CJ in *Forbes v New South Wales Trotting Club Ltd* (1979) 143 CLR 242 at 260-261.

29 Above n 1 at 4813 per Brennan J; at 4828 per Toohey J.

30 Above n 1 at 4815 per Brennan J, citing *Ord Forrest Pty Ltd v FC of T* (1974) 130 CLR 124 at 148 and 155; *FC of T v St Helens Farm (ACT) Pty Ltd* (1981) 146 CLR 336 at 349-350, 356-357 and 428; at 4826 per Toohey J; at 4839 per McHugh J.

31 Above n 1 at 4839.

32 In *FC of T v Cooling* (1990) 22 FCR 42 at 61.

33 Above n 1 at 4820.

34 Within the definition of s 160A.

35 Above n 1 at 4814 per Brennan J.

36 Above n 1 at 4814.

37 Of the majority on the applicability of s 160M(6).

relevant asset immediately before the actual or deemed disposal.<sup>38</sup> In the absence of such ownership, he believed there to be no "taxpayer" accruing a capital gain within s 160Z(1) or s 160ZC(1).<sup>39</sup>

Deane J rejected the Commissioner's submission, believing it to "[lie] ill with the ordinary meaning of the word [disposal] and with the general scheme of Pt IIIA".<sup>40</sup> To be applicable, he believed s 160M(6) must "involve something done by the suggested taxpayer as the actual or purported owner of something."<sup>41</sup> To tax a person who "owned no relevant asset before the deemed disposal" would, he said, give s 160M(6) a "pointless operation" contrary to the "plain and unqualified direction of s 160C(1)".<sup>42</sup>

While Brennan J<sup>43</sup> found Part IIIA was generally based on the hypothesis that the disposed asset was owned by the disponor immediately before the disposal took place and owned by the donee immediately after the acquisition took place,<sup>44</sup> he believed this interpretation did not apply to s 160M(6).

To confine s 160M(6) to disposals of pre-existing assets owned immediately before the disposal would, he said, deny the subsection of any practical effect.<sup>45</sup> Consequently Brennan J held there to be a fictional acquisition of the asset by the disponor immediately preceding the disposal which created that asset.<sup>46</sup> Accordingly, the person whose act created the asset will be deemed to be the owner of that asset immediately before the disposal for s 160L(1) purposes.<sup>47</sup>

This deemed acquisition allowed Brennan J to conclude s 160M(6) extended to the creation of an asset by the disponor which vested in another, the donee, even though the asset did not previously exist, nor was owned by the disponor.<sup>48</sup> Thus on the facts Brennan J believed that by the deed the taxpayer created an asset, the benefit of the covenant,<sup>49</sup> which was conferred upon Hunter Douglas and became part of its goodwill, this creation being within the scope of s 160M(6).<sup>50</sup>

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38 Per Deane J, above n 1 at 4820.

39 Above n 1 at 4820.

40 Ibid.

41 Ibid.

42 Ibid.

43 Of the minority on the applicability of s 160M(6).

44 Above n 1 at 4814.

45 Above n 1 at 4815.

46 Above n 1 at 4815-4816, adopting Hill J's comments in *FC of T v Cooling* above n 32 at 68.

47 Ibid.

48 Nor capable of owning it: above n 1 at 4815.

49 An assignable proprietary right: above n 1 at 4815.

50 Above n 1 at 4815.

(1991) 2 Revenue L J

*Pre-existing asset from which it is carved*

All members of the Full Federal Court in *FC of T v Hepples*<sup>51</sup> held s 160M(6) was confined to proprietary rights "carved out of or over existing<sup>52</sup> assets" which continue to exist after the disposal.<sup>53</sup> They concluded s 160M(6) was intended to provide that "where the same act or event both creates and disposes of an asset which emerges from a larger asset previously in existence, there is a notional disposal of the new born asset for the purposes of Pt IIIA".<sup>54</sup>

On appeal McHugh J found support for this interpretation in the examples provided in the explanatory memorandum; the granting of a lease and the granting of an option to purchase an asset at a future date.<sup>55</sup> While leases and options are governed by specific sections,<sup>56</sup> McHugh J believed this nevertheless indicated s 160M(6) was intended to cover cases involving the creation of rights out of the taxpayer's own existing asset.<sup>57</sup>

While it is submitted such an interpretation fails to give effect to the express exclusion in s 160M(6) of assets that previously existed as part of another asset, McHugh J held it was "not a misuse of language" to say leases, easements or profit a prendre "were not part of the land before their creation".<sup>58</sup> While the author disagrees with this comment, McHugh J's suggestion that this interpretation is probably the better of the competing constructions<sup>59</sup> is accepted.

Deane J also accepted the Federal Court's limitation, confining s 160M(6) to cases where the created asset "arises from, or involves the use or exploitation of, an existing 'asset'" of the taxpayer.<sup>60</sup> In the absence of any provision in s 160M(6) deeming the asset to have been owned by the taxpayer,<sup>61</sup> Deane J believed this construction of s 160M(6) was necessary in light of s 160L's confinement of the operation of Part IIIA to an asset that "immediately before the disposal took place, was owned by . . . a person".<sup>62</sup>

It is submitted, however, the minority of the High Court, Toohey and Brennan JJ, with whom Gaudron J agreed,<sup>63</sup> were technically correct in rejecting this limitation.<sup>64</sup> As Toohey J noted, the above view substantially

51 Above n 12 at 13 per Lockhart J; at 33-34 per Gummow J; at 36 per Hill J.

52 Thus Lockhart J required "an asset in existence before the occurrence of the act or event which gave birth to the new asset." Similarly Gummow J stated the asset must be "the product of a dealing with a pre-existing asset". Cf Gummow J in *FC of T v Cooling* above n 32 at 44.

53 Gummow J in *FC of T v Cooling*, above n 32, Hill J in *FC of T v Hepples*, above n 12 at 65.

54 Above n 32 at 13 per Lockhart J; quoted by Toohey J above n 1 at 4826.

55 Above n 1 at 4840.

56 Sections 160Zs and s 160ZZC respectively.

57 Above n 1 at 4840.

58 Above n 1 at 4841.

59 Above n 1 at 4840.

60 Above n 1 at 4821.

61 He did not believe s 160U(6) had the effect of deeming ownership for s 160C and s 160L purposes: above n 1 at 4821.

62 Above n 1 at 4821.

63 Above n 1 at 4828.

64 Above n 1 at 4816 per Brennan J; at 4827 per Toohey J.

rewrites s 160M(6)<sup>65</sup> and is totally contrary to the requirement that the asset not previously exist "either by itself or as part of another asset".<sup>66</sup>

Thus, it is submitted that while Hill J's examples<sup>67</sup> of the absurd scope<sup>68</sup> Part IIIA will have if a broad reading of s 160M(6) and s 160M(7) is adopted should not be ignored,<sup>69</sup> it cannot be denied that s 160M(6) expressly excludes from its operation assets which were previously part of another asset.<sup>70</sup>

Section 160M(6) does not, therefore, catch the disposal of an interest in pre-existing property. This is governed by s 160M(1) and s 160R(1).<sup>71</sup> Thus Hill J's suggestion that s 160M(6) be confined to *inter alia* the creation of easements and the conferral of a profit a prendre is not only too narrow, but fails to appreciate these "assets" are pre-existing rights stemming from the ownership of the underlying asset<sup>72</sup> and thus expressly excluded from s 160M(6).

The Federal Court had sought to avoid this difficulty by distinguishing an asset that was part of an existing asset, and therefore caught by s 160R, and an asset "carved out of" an existing asset.<sup>73</sup> The latter was confined to interests which could not be previously identified as distinct parts of the existing asset.<sup>74</sup> It is respectfully submitted those interests which the Court suggested fell within the latter category, such as easements or profit a prendre, are in fact "carved out of" the underlying land ownership and thus part of previously existing assets. It therefore appears this is merely a technical distinction utilised by the Federal Court to avoid giving effect to the possibly absurd consequences of an effective s 160M(6).

Deane J appears to agree with this criticism, asserting it was preferable to apply s 160R to these examples, which in reality involve a change of ownership of the "rights involved in the ownership of an asset . . .".<sup>75</sup> The

65 Above n 1 at 4826.

66 Above n 1 at 4826 per Toohey J.

67 *FC of T v Cooling*, above n 32 at 62; including the suggestion that a covenant to contribute to a charitable institution will trigger s 160M(6). McHugh J considered these examples in more detail: above n 1 at 4834.

68 Brennan J considered these later in his judgement, commenting that these "bizarre results" stem, not from the notion of a deemed disposal of a non-existent asset, but from s 160ZD(2) deeming a taxpayer who has not received consideration for a disposal to have received an amount equal to the market value of the asset: above n 1 at 4817. Toohey J also adopted these comments above n 1 at 4827. It is submitted, this fails to appreciate the results are in reality the result of a combination of s 160M(6) and s 160ZD(2).

69 According to the "Golden Rule" of statutory interpretation, provisions are to be interpreted to avoid absurdities. Cf Hill J in *FC of T v Cooling*, above n 32 at 64. See also Toohey J's comments above n 1 at 4827 where he suggested the legislature may have to reconsider s 160ZD(2) in light of this problem.

70 Possibly for this reason, McHugh J concedes even if Hill J's examples are correct, this only means s 160M(7) has an operation beyond what most people "would regard as the proper domain of a capital gains tax": above n 1 at 4835.

71 Cf Deane J, above n 1 at 4821.

72 Ie one of the bundle of rights acquired on the ownership of the underlying property.

73 Deane J refers to this distinction, above n 1 at 4821.

74 Above n 1 at 4821 per Deane J.

75 Above n 1 at 4821.

(1991) 2 Revenue L J

disposal of the pre-existing "right to use or exploit" the land would, he said, fall within the scope of s 160R and the taxpayer would therefore be able to take into account the "resulting diminution in the value of the subject property" when calculating the potentially taxable gain.<sup>76</sup> Deane J preferred to confine the operation of s 160M(6) to "the creation of a personal right"<sup>77</sup> in relation to the use of the taxpayer's pre-existing asset . . .<sup>78</sup>

### *Pre-existing disposal*

Prima facie s 160M(6) appears to be a tautology, deeming a disposal of the asset created by the disposal to be a disposal of an asset. If s 160M(6) is to make sense the word disposal must either be used in s 160M(6) to connote a transaction which would not constitute a "disposal within the ordinary meaning of the word",<sup>79</sup> or the section is premised on the pre-existence of a disposal under another provision of Part IIIA. Adopting the latter suggestion, the appellant in *Hepples* argued s 160M(6) was confined to cases where a disposal had already been deemed under provisions such as s 160M(7), s 160ZS(2)<sup>80</sup> and s 160ZZC(6).<sup>81</sup>

McHugh J, with whom Mason CJ agreed,<sup>82</sup> adopted this submission. McHugh J declared that if Parliament intended the creation of rights in another to "constitute a disposal of those rights by the person creating them," it would have expressly stated this to be so in s 160M(6).<sup>83</sup> Moreover, if s 160M(6) applied to every such act creating a right vesting in another,<sup>84</sup> he believed the section would have absurd consequences.<sup>85</sup>

For s 160M(6) to apply, McHugh J required the disposal of a right from the disponor to the donee, not the mere creation of correlative rights.<sup>86</sup> Thus when a taxpayer creates rights, such as a chose in action, in another, McHugh J was of the opinion that the taxpayer had not disposed of any asset of his/her own within s 160M(6). The taxpayer never had the right to sue

<sup>76</sup> Ibid. Unlike s 160M(6) where a zero cost base is imposed.

<sup>77</sup> I.e. a personal licence such as in *Yeend's* case: above n 14.

<sup>78</sup> Above n 1 at 4821. This suggestion, however, meets with the criticism that as personal rights are not assets within s 160A, the taxpayer will be taxed for the disposal of an asset outside the terms of s 160A. The existence of another asset within the definition of s 160A should not suffice, as the relevant asset, the asset the subject of the transaction, needs to be both an "asset" within s 160A and "disposed of" within some provision in Part IIIA: see the Court of Appeal in *O'Brien (Inspector of Taxes) v Benson's Hosiery (Holdings) Ltd* [1979] Ch 152.

<sup>79</sup> Cf Hill J in *FC of T v Cooling* above n 32.

<sup>80</sup> Which deems the grant of a lease to constitute a disposal by the lessor of an asset, the lease.

<sup>81</sup> Which deems the granting of an option to be a disposal of a new asset, the option.

<sup>82</sup> Above n 1 at 4810.

<sup>83</sup> Above n 1 at 4839.

<sup>84</sup> I.e. without an additional independent disposal. McHugh J noted the explanatory memorandum did not suggest s 160M(6) was intended to apply to every creation of a right: above n 1 at 4839.

<sup>85</sup> This would mean a person who borrowed money and agreed to repay such would for s 160M(6) purposes be seen as disposing of an asset, the promise to repay, and taxed on the whole amount of the borrowing: above n 1 at 4839.

<sup>86</sup> Above n 1 at 4839.

himself. The transaction merely created a correlative right in the donee.<sup>87</sup> Thus McHugh J held "neither legal parlance nor the ordinary meaning of the words 'disposal of an asset' could justify" the application of s 160M(6) to cases such as that before him where the subject asset is a "personal right to sue the grantor of that right".

Toohey J agreed with the taxpayer's general submission, asserting in the absence of express words deeming the creation of the asset to also constitute a disposal, a disposal of the created asset must be identified.<sup>88</sup> While Hunter Douglas obtained a proprietary right, a chose in action,<sup>89</sup> under the agreement, Toohey J believed the section was concerned with the "incorporeal property of the taxpayer."<sup>90</sup> Here the covenant affected the taxpayer's freedom to compete in the market place and, as noted above, Toohey J did not consider this an asset for s 160A purposes.<sup>91</sup> Toohey J concluded that as this right was not capable of transmission, there was no disposal of an asset by the taxpayer as the owner of that asset within s 160M(6).<sup>92</sup> All the taxpayer did was restrict his freedom to compete.<sup>93</sup>

If s 160M(6) was limited to cases where another provision of Part IIIA had deemed there to be a pre-existing disposal, the scope of s 160M(6) would be very limited. In essence it would only deem the asset to have a zero cost base. In light of this narrow scope and the different cost bases provided by s 160M(6) and sections such as s 160ZS, Brennan J, with whom Gaudron J agreed,<sup>94</sup> rejected the appellant's submission.<sup>95</sup>

### *Conclusion to s 160M(6)*

It is useful at this point to summarise the High Court's conclusions with respect to the applicability of s 160M(6).

The majority, Mason CJ, Toohey, McHugh and Deane JJ held s 160M(6) was not applicable on the facts. Toohey J rejected the applicability of s 160M(6) on the basis that there was no disposal of any proprietary asset of the taxpayer to Hunter Douglas.<sup>96</sup> Similarly, McHugh J, with whom Mason CJ agreed, found the asset acquired by Hunter Douglas, the right to sue, was not disposed by the taxpayer. McHugh J held the transaction to merely create correlative rights<sup>97</sup> and thus held s 160M(6) was not applicable.<sup>98</sup> Deane J's rejection of s 160M(6) was based on the absence of a pre-existing

87 McHugh J states the right only becomes a proprietary asset at the point that it vests with the donee: above n 1 at 4840.

88 Above n 1 at 4827.

89 The right to sue Hepples were he to breach the agreement.

90 Above n 1 at 4827.

91 Above n 1 at 4827, citing *Forbes v New South Wales Trotting Club*, above n 28 at 260 - 261.

92 Above n 1 at 4828.

93 Ibid.

94 Above n 1 at 4828.

95 Above n 1 at 4815.

96 Above n 1 at 4827 and 4828.

97 Above n 1 at 4839 and 4841.

98 Above n 1 at 4841.

(1991) 2 Revenue L J

asset owned by the taxpayer out of which the right created by the transaction was carved.<sup>99</sup>

The minority, Brennan, Dawson<sup>100</sup> and Gaudron JJ<sup>101</sup> found s 160M(6) applicable to these facts.

An asset, the benefit of the covenant, was created by the taxpayer's entry into the deed, and for Part IIIA purposes Brennan J believed the taxpayer was deemed to have acquired, and thus own, such asset immediately before he disposed of it to Hunter Douglas.<sup>102</sup> The subject asset was a proprietary asset within s 160A, the benefit of the covenant becoming part of Hunter Douglas' goodwill.<sup>103</sup> As s 160M(6) deems the asset to have a zero cost base, Brennan J held the \$40,000 received by Hepples to be a wholly taxable capital gain.

Gaudron J found Hunter Douglas had acquired a proprietary asset,<sup>104</sup> a chose in action, as a result of the transaction and this asset was created by the taxpayer making the promise.<sup>105</sup> She therefore held the making of the promise to amount to a disposal of this asset for s 160M(6) purposes.<sup>106</sup>

### Scope of s 160M(7)

On appeal, members of the High Court were equally critical of the complexity of s 160M(7), Deane J commenting the section could have an absurd scope, deeming any person who receives, or becomes entitled to receive consideration by reason of an act, transaction or event in relation to or affecting an asset to have disposed of an asset created by the disposal within Part IIIA.<sup>107</sup>

In relation to s 160M(7) the High Court considered four main issues:

- was s 160M(7) premised on the pre-existence of an asset?
- was the asset referred to in s 160M(7)(a) an asset owned by the taxpayer?
- what degree of connection between the act and the asset was needed?
- what degree of connection between the act and payment was needed?

### *Pre-existing asset*

Counsel for the taxpayer had argued that in the absence of an asset within the definition of s 160A prior to the "putative disposal",<sup>108</sup> the consideration the taxpayer received could not be characterised as a taxable capital gain.<sup>109</sup> This submission was again supported by s 160L(1) and s 160C(1)(a).

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99 Above n 1 at 4821.

100 Above n 1 at 4823.

101 Above n 1 at 4828.

102 Above n 1 at 4817 per Brennan J; at 4823 per Dawson J.

103 Above n 1 at 4815 per Brennan J.

104 Within s 160A: above n 1 at 4829.

105 Above n 1 at 4829.

106 Ibid.

107 Above n 1 at 4821.

108 Above n 1 at 4814 per Brennan J.

109 Ibid.

Unlike s 160M(6), Brennan J found that while s 160M(7) creates a notional asset upon disposal, the section only operates where there is an act, transaction or event affecting a pre-existing asset.<sup>110</sup> On the facts Brennan J, with whom Mason CJ agreed,<sup>111</sup> found the asset in relation to which the deed was entered, the benefit of the covenant, did not previously exist. In the absence of such pre-existing asset, in relation to which the deed was entered into, Brennan J concluded s 160M(7) did not apply.

Deane and McHugh JJ also believed s 160M(7) only applies where there is a pre-existing asset<sup>112</sup> at the time of the subject act, transaction or event.<sup>113</sup> While Deane J held s 160M(7) was not applicable as the suggested pre-existing assets, Hunter Douglas' goodwill and trade secrets, were not the taxpayer's assets,<sup>114</sup> McHugh J founded his exclusion of s 160M(7) on the absence of a real connection between the pre-existing asset, Hunter Douglas' goodwill, and the entry into the deed.<sup>115</sup>

### *Asset owned by the taxpayer*

As noted above, the majority in the Federal Court held the asset referred to in s 160M(7)(a) need not be the asset of the person who has received or was entitled to receive the consideration referred to in para (b). Thus on the facts, the majority held Hunter Douglas' assets, trade secrets, trade connections and goodwill, could provide the assets to satisfy s 160M(7)(a).

In his dissent, Hill J rejected this interpretation, stating s 160M(7) was directed at cases where there was not a disposal within the ordinary sense, but an act or transaction in relation to the taxpayer's asset. Hill J noted that as there had been no disposal of the taxpayer's asset in these circumstances, it was appropriate that a zero cost base be inferred by s 160M(7).

Along those lines adopted by Hill J, counsel for the taxpayer contended s 160M(7) only operated where the taxpayer received consideration as a result of some dispositive act in relation to an asset owned by the taxpayer, again relying on s 160C(1). Read as a whole,<sup>116</sup> it was suggested Part IIIA required the asset to be owned by the taxpayer, otherwise the subsection would give rise to absurdities<sup>117</sup> Parliament could not have intended.<sup>118</sup>

110 Above n 1 at 4816-4817, that being the asset referred to in s 160M(7)(a).

111 Above n 1 at 4810.

112 Above n 1 at 4836 per McHugh J.

113 While it had not been established that there were "any trade secrets, trade connection or goodwill of value" at the time the deed was entered into, McHugh J concluded it was proper to infer the existence of valuable goodwill: above n 1 at 4837.

114 Above n 1 at 4821.

115 Above n 1 at 4837-4838.

116 Reference was made *inter alia* to the new s 160M(7A) which appears drafted on the assumption that s 160M(7) only operates in respect to assets of the taxpayer: above n 1 at 4835. McHugh J rejected this submission, finding the terms of s 160M(7A) would not be inconsistent with s 160M(7) were it not confined to assets of the taxpayer: above n 1 at 4835.

117 Above n 1 at 4833. Note while McHugh J questioned the correctness of these examples of unintended absurdities, he said that even if they were correct this would not necessitate confining s 160M(7)(a) to assets of the taxpayer. Rather it would just mean Part IIIA had a scope beyond what "most people would regard as the proper domain of a capital gains tax": above n 1 at 4835.

118 Above n 1 at 4833.

(1991) 2 Revenue L J

Deane J rejected the majority of the Federal Court's conclusion, finding such an interpretation extended s 160M(7) to cases where the taxpayer was not the owner of the relevant asset and therefore not a "taxpayer" within s 160C(1).<sup>119</sup> It was not permissible, he said, to widen the scope of s 160Z(1), s 160ZC(1) and s 160ZO(1) in disregard of the express words of s 160C(1).<sup>120</sup> He consequently concluded s 160M(7) only operated where the taxpayer owned the asset immediately before the disposal and thus found the subsection to be inapplicable to the facts before him. As the suggested assets in this case were owned by the employer, Hunter Douglas, rather than the taxpayer, s 160M(7) could not apply.<sup>121</sup>

The only exception Deane J suggested was cases where the taxpayer, while not the owner, receives consideration for an "act purportedly done as such owner . . . or with the licence of the owner".<sup>122</sup>

Brennan J refrained from commenting on the correctness of the above assumption, preferring to base his decision on an absence of a real connection between the subject transaction and the Hunter Douglas' assets. Earlier comments, however, suggest he would require the asset to be the taxpayer's. Brennan J had noted with seeming approval that the English legislation<sup>123</sup> presupposes "that immediately prior to its disposal, there was an asset and that the disponor owned it".<sup>124</sup> Brennan J found on these facts the deed did not dispose of any asset, or more particularly any incorporeal property, owned by Hepples.<sup>125</sup> While the restrictive covenant affected the taxpayer's right to work, as noted above Brennan J held this was not a proprietary asset within s 160A.<sup>126</sup>

McHugh J was not convinced of the need to confine s 160M(7) to assets of the taxpayer. After dismissing several of counsel for the taxpayer's submissions, he held that given the broad language used in s 160M(7) and the ease in which Parliament could have expressly confined the subsection to assets of the taxpayer, s 160M(7) should not be so limited.<sup>127</sup> He believed the taxpayer's submission to involve reading the reference in s 160M(7)(b) to "a person [who] has received . . . consideration", as "the taxpayer or owner [who] has received . . . consideration".<sup>128</sup> This would, McHugh J said, be "a drastic rewriting of the subsection", amounting to unacceptable judicial legislation.<sup>129</sup>

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119 Above n 1 at 4821.

120 Ibid.

121 Ibid.

122 Ibid.

123 As found by the court in *Kirby (Inspector of Taxes) v Thorn EMI Plc*, above n 23 at 450.

124 Above n 1 at 4813.

125 Ibid.

126 It is unclear whether Mason CJ agreed with this restriction; concluding on the facts the subject deed did not relate to an existing asset of Hunter Douglas Ltd: above n 1 at 4810. Did he mean an existing asset of Hepples or did he also base his decision on the lack of connection between the transaction and Hunter Douglas' assets?

127 Above n 1 at 4837.

128 Ibid.

129 Ibid.

While Dawson J<sup>130</sup> did not find it necessary to consider s 160M(7), already concluding s 160M(6) to be applicable to these facts,<sup>131</sup> he stated he was of the view that the transaction did affect an asset for s 160M(7) purposes, that asset being Hunter Douglas' goodwill.<sup>132</sup> He saw no reason to restrict s 160M(7) to assets of the taxpayer.<sup>133</sup> As s 160M(7) gave rise to a deemed disposal of a notional asset, not the asset referred to in s 160M(7)(a), he saw no reason to confine the asset in s 160M(7)(a) to that of the taxpayer.<sup>134</sup> He believed "there is no reason to assume that the owner of the asset referred to in para (a) of s 160M(7) will also necessarily be the 'owner' of the fictitious asset"<sup>135</sup> deemed to have been disposed under s 160M(7).

Toohy J agreed with Dawson J's sentiments, adopting the majority<sup>136</sup> of the Federal Court's suggestion that the notional asset created by the disposal is different from the asset referred to in s 160M(7)(a) and need not be the taxpayer's asset.<sup>137</sup> If Parliament intended to limit s 160M(7) in such a way, Toohey J believed they would have done so expressly.<sup>138</sup> He consequently concluded Hunter Douglas' trade secrets, trade connections, goodwill<sup>139</sup> or even "rights under the deed"<sup>140</sup> were all proprietary<sup>141</sup> assets which could satisfy s 160M(7)(a).<sup>142</sup>

### *Connection between the act and the asset*

For s 160M(7) to be operable the act, transaction or event must be "in relation to" or "affecting" the asset. These words are very wide, seemingly requiring only a loose nexus between the transaction and the asset. This breadth was evidenced in the Federal Court's finding in *Hepples*, where it was held the act, the restrictive covenant, was "in relation to" Hunter Douglas' trade secrets and goodwill. All the majority required was the act to touch or concern the asset; there was no need for the act to alter the nature or character of the asset.

By contrast, Hill J in his dissent required some real relationship between the transaction and the asset:

In my view it would be a strange characterisation of a grant by an employee of a covenant in restraint of trading after the termination of his employment to

130 With whom Gaudron J agreed: above n 1 at 4829.

131 Section 160M(7) being stated as being "subject to the other provisions of this Part": above n 1 at 4823.

132 Above n 1 at 4823.

133 Above n 1 at 4824. He added that while s 160M(7)(b)(i) and (ii) seem to only cover instances where the taxpayer owns the asset referred to in s 160M(7)(a), these were not exhaustive instances when s 160M(7) was to apply: above n 1 at 4824.

134 Above n 1 at 4824.

135 Ibid.

136 Lockhart and Gummow JJ.

137 Above n 1 at 4825.

138 Ibid.

139 Expressly included in the definition of s 160A: above n 1 at 4825.

140 *Id.* chose in action.

141 Quoting Gummow J, above n 12 at 31-32; above n 1 at 4825. Thus Toohey J acknowledges the asset referred to in s 160M(7) must still be an asset within the terms of s 160A.

142 Above n 1 at 4825.

(1991) 2 Revenue L J

describe that transaction as one that takes place in relation to his employer's goodwill. It rather is a transaction which takes place in relation to the right of the employee to trade.

Moreover, he required the transaction to adversely affect the asset:

... [I]t is difficult to see how the transaction in any way affected the employer's asset. Rather the employer's goodwill remain perfectly intact and unaffected by the transaction except perhaps in a monetary sense that the goodwill may become more valuable as a result of the transaction.

On appeal, Brennan J appears to prefer Hill J's view, finding "there was no connection between the assets of Hunter Douglas and the appellant's entry into the deed ...".<sup>143</sup> He found the "asset created by the covenant in no way depended on the enjoyment by Hunter Douglas of its other assets".<sup>144</sup> Brennan J appears to also require the asset to be adversely affected, stating Hunter Douglas' assets were "wholly unaffected", the goodwill only benefiting from the covenant.<sup>145</sup> Seemingly a beneficial affect was not enough to attract s 160M(7).

Brennan J therefore concluded there was no real connection between the transaction and Hunter Douglas' assets.<sup>146</sup> The only asset sufficiently connected with the transaction was the benefit of the covenant. As this did not previously exist, Brennan J concluded s 160M(7) was inapplicable.

Similarly, McHugh J concluded that while the transaction enhanced Hunter Douglas' goodwill, this was not sufficient to establish there to be "an act or transaction [that] has taken place in relation to an asset or an event affecting an asset ...".<sup>147</sup> He thought it absurd to suggest Parliament intended transactions<sup>148</sup> merely enhancing or adding to existing sources of goodwill to be caught by s 160M(7).<sup>149</sup> Rather he believed the subsection to only be applicable where the transaction affected or changed a pre-existing asset of the business.<sup>150</sup>

McHugh J consequently concluded that just as the purchase of a new piece of machinery does not "affect or change those pieces of existing machinery," the subject covenant did not affect existing, but only future,<sup>151</sup> sources of goodwill.<sup>152</sup> The absence of an existing asset at the time of the transaction therefore prevented s 160M(7) operating in this case.<sup>153</sup>

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<sup>143</sup> Above n 1 at 4817.

<sup>144</sup> Ibid.

<sup>145</sup> Ibid.

<sup>146</sup> Ibid.

<sup>147</sup> Above n 1 at 4837.

<sup>148</sup> Such as payments towards research or training staff: above n 1 at 4837.

<sup>149</sup> Above n 1 at 4837.

<sup>150</sup> Ibid.

<sup>151</sup> As the covenant only operated after the termination of the taxpayer's employment: above n 1 at 4837. As noted above McHugh J required the subject asset be existing at the time of the transaction, thus the covenant's impact on Hunter Douglas' future sources of income did not suffice to trigger s 160M(7).

<sup>152</sup> The covenant may have provided a new source of goodwill, but did not affect pre-existing sources: above n 1 at 4838.

<sup>153</sup> Above n 1 at 4838.

By contrast, Dawson and Toohey JJ adopted the majority view<sup>154</sup> in the Federal Court, asserting the phrase "affecting an asset" did not require an adverse alteration of the nature or character of the asset.<sup>155</sup> Thus, on the facts they believed an enhancement of Hunter Douglas' goodwill sufficed to trigger s 160M(7).<sup>156</sup> They found a "direct, certainly a sufficient, connection" between the goodwill and the covenants<sup>157</sup> and held the taxpayer to be consequently liable to pay tax on the amount as a result of s 160M(7).

### *Connection between the act and payment*

The act, transaction or event relied upon must be the cause of the taxpayer's receipt of the subject consideration.

McHugh J suggested this requirement to be a major limitation of the scope of s 160M(7),<sup>158</sup> asserting that "merely because one event is a *causa sine qua non* of the other or because, in the widest sense, one event has contributed to the occurrence of the other . . .".<sup>159</sup> the subsection will not be satisfied. McHugh J believed the transaction must be the true cause or reason for the taxpayer to be entitled to the consideration.<sup>160</sup>

On the facts, however, McHugh J agreed with Dawson and Toohey JJ that here there was a "direct, causal connection between the entry into the deed . . . and the receipt of consideration" by the taxpayer.<sup>161</sup> The act, transaction or event by reason of which the taxpayer received the \$40,000 was the entering into the deed and the taxpayer's promise to observe the covenants therein.<sup>162</sup>

### *Conclusion to s 160M(7)*

In summary, a majority of the High Court, Mason CJ, Brennan, Deane and McHugh JJ, held s 160M(7) was not applicable on the facts.

Deane J held that for s 160M(7) to apply the relevant asset must be owned by the taxpayer immediately before the actual or deemed disposal. As the taxpayer did not own the suggested assets, the goodwill, trade connections and trade secrets, Deane J found s 160M(7) did not apply to this case.<sup>163</sup> Brennan J, with whom Mason CJ agreed, held there was not a sufficient connection between the transaction and Hunter Douglas' assets to trigger s 160M(7). Alternatively, it appears Brennan J would agree with Deane J that the asset<sup>164</sup> the subject of the transaction was not a pre-existing asset owned by the taxpayer and the transaction therefore outside the scope of s 160M(7).

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<sup>154</sup> In particular Gummow J's comments above n 11 at 32.

<sup>155</sup> Above n 1 at 4826 per Toohey J.

<sup>156</sup> Above n 1 at 4823 per Dawson J; at 4826 per Toohey J.

<sup>157</sup> Above n 1 at 4826 per Toohey J.

<sup>158</sup> Above n 1 at 4836.

<sup>159</sup> Ibid.

<sup>160</sup> Ibid.

<sup>161</sup> Above n 1 at 4824 per Dawson J.

<sup>162</sup> Above n 1 at 4836 per McHugh J.

<sup>163</sup> Above n 1 at 4820.

<sup>164</sup> In his eyes, the benefit of the covenant.

(1991) 2 Revenue L J

The fourth member of the majority, McHugh J, agreed with much of the minority's reasoning. However, while he believed the asset for s 160M(7)(a) purposes could be that of the payee, Hunter Douglas, he required the "act, transaction or event" to affect a pre-existing asset and found on the facts the covenant only affected future sources of Hunter Douglas' goodwill.

There was, therefore, no true consensus of thought amongst the majority as to the application of s 160M(7).

The minority, Dawson, Gaudron and Toohey JJ held s 160M(7) to be applicable to the subject facts.

Dawson J, with whom Gaudron J agreed,<sup>165</sup> believed both s 160M(6) and (7) were applicable on the facts. Dawson J found there was an act by the taxpayer, the entering into the deed, in relation to an asset, Hunter Douglas' goodwill, within the meaning of s 160M(7).<sup>166</sup>

Both Dawson and Toohey JJ stated it was not necessary for the asset referred to in s 160M(7)(a) to be the asset of the taxpayer and thus concluded the transactions impact on Hunter Douglas' assets could suffice for the operation of s 160M(7).<sup>167</sup>

## Conclusion

Thus four members of the Court, Dawson, Gaudron, Toohey and Brennan JJ<sup>168</sup> would have found the \$40,000 received by Hepples to be a taxable gain. Strangely, despite this majority, all members of the Court adopted the Chief Justice's order that the appeal be allowed with costs, the monies received by Hepples not being taxable by reason of s 160M(6) or s 160M(7). For reasons of justice, given the diversity of thought amongst this majority, this was probably the most appropriate course for the High Court to adopt.

The High Court also took the unusual course of making this decision to allow the appeal subject to receiving submissions from Hepples and the Commissioner of Tax on this conclusion. It is submitted it would be inappropriate for the High Court even to consider changing its decision upon the basis of such submissions.

The decision has in effect created more uncertainty as to the scope and operation of Part IIIA, only serving to highlight yet again the unnecessary complexity of this legislation.

It is submitted the one positive feature to be found in the case lies in Deane J's approach to the interpretation of Part IIIA. Deane J made no apologies for interpreting s 160M(6) and s 160M(7) in a fashion providing each with little scope.<sup>169</sup> Particularly in light of self-assessment, he stated it

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<sup>165</sup> Above n 1 at 4828.

<sup>166</sup> Ibid. Gaudron J preferred to find the covenant as affecting another asset, that being the taxpayer's earlier promises as contained in his contract of employment. Gaudron J held these to be varied by the subject covenant.

<sup>167</sup> Above n 1 at 4825 per Toohey J.

<sup>168</sup> Dawson, Gaudron and Toohey JJ under s 160M(7) and Brennan J under s 160M(6).

<sup>169</sup> Above n 1 at 4822.

was not the Court's role to construe the provisions to "give best effect to some dimly-perceived legislative intent".<sup>170</sup>

Any limitation of the scope of s 160M(6) and (7) is the result of the government's poor drafting, not a failure on the part of the Court. In light of the basic principle that an "intention to impose a tax . . . must be shown by clear and unambiguous language",<sup>171</sup> it is submitted as long as Part IIIA continues<sup>172</sup> to be so bewildering,<sup>173</sup> these provisions should be strictly construed in favour of the taxpayer.

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<sup>170</sup> Ibid.

<sup>171</sup> Rich and Dixon JJ in *Anderson v C of T (Vic)* (1937) 57 CLR 233 at 243, quoted by Deane J above n 1 at 4820. See also *Western Australian Trustee Executor & Agency Co Ltd v Commissioner of State Taxation (WA)* (1980) 147 CLR 119 at 126.

<sup>172</sup> These provisions are to be redrafted.

<sup>173</sup> As per Mason CJ, above n 1 at 4810.