IN THE COURT OF APPEAL OF NEW ZEALAND CA60/98

BETWEEN THE COMMISSIONER OF INLAND REVENUE

Appellant

AND RENOUF CORPORATION LIMITED

First Respondent

AND KIRKCALDIE & STAINS LIMITED

Second Respondent

AND RENOUF INDUSTRIES LIMITED

Third Respondent

**Coram:** Henry J
Thomas J
Blanchard J

**Hearing:** 22 July 1998

**Counsel:** J H Coleman and E J Norris for Appellant
G J Harley and F Ward for Respondents

**Judgment:** 28 July 1998

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JUDGMENT OF THE COURT DELIVERED BY BLANCHARD J

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**Introduction**

This is an appeal from a judgment of Doogue J delivered in the High Court at Wellington on 24 February 1998. He held that a payment of $2.75m received

by the first respondent, Renouf Corporation Limited (RCL), under an agreement dated 20 August 1985 was capital in nature. The Commissioner appeals.

**Facts**

RCL was the parent company of the Renouf group. On 30 November 1984 RCL and a property developer, Mainzeal Group Limited (Mainzeal), each took a 50% shareholding (fifty shares) in a shelf company, Wellington Tower Limited (WT), which acquired a development site in Jervois Quay, Wellington initially with funding provided by RCL.

Doogue J recorded that he was entirely satisfied that the property transaction was not the result of RCL's seeking a development opportunity for profit. Rather, it was for RCL a means of extricating itself from another investment. It is unnecessary to describe the antecedents of the transaction. It is common ground that RCL and Mainzeal were hoping that WT would make a profit from erecting one or more large buildings on the site and selling them. It is also common ground that the only way in which RCL anticipated accessing its share of any such profit was through the payment of a dividend by WT. Any such dividend would come from the after-tax profits of WT and be tax free in the hands of RCL.

Doogue J found that RCL was a true holding company which "did not seek to dabble in risk enterprises" and that such enterprises "were for its subsidiaries and companies such as Wellington Tower." He found on the basis of the unchallenged evidence of an executive director of RCL, Mr Curtin, that no thought was given by RCL when it took the WT shares to the possibility of selling those shares. They were held as an investment with a view to dividend income.

A written Joint Venture Agreement was entered into by RCL and Mainzeal on 2 April 1985. Particular features of it were:

1. RCL would arrange a third party loan for WT out of which the parties would be repaid existing advances.

2. Stage 1 of the project would encompass design and planning of the development and the arranging of finance and stage 2 the construction, tenanting and sale of the building(s). Stage 2 would not be proceeded with unless both RCL and Mainzeal were in agreement.

3. RCL would arrange finance for WT. Mainzeal would organise, design and arrange construction for WT.

4. WT's organisation and policy would be determined by its directors.

5. WT was to have an agreed set of Articles of Association. *Inter alia* these provided for designation of the shares held by each of the joint venturers as a group and for the right to appoint and dismiss directors to be vested in the holder or holders of each group.

6. The parties were to use best endeavours to carry out the agreement and cause their appointed directors to exercise their rights in such manner that the provisions of the agreement were carried out.

7. There was a restriction on transfer or disposal of shares in WT prior to the completion of stage 2 except to a related company (one in which respect of which the transferor could exercise 50% or more of the voting power or the right to appoint a majority of directors).

8. Neither party was to assign the benefit or burden of the joint venture agreement and/or its interest in the project without the prior consent of the other.

Later in 1985 RCL decided to take a minority participation in the public float of a property development company, Renouf Property Developments Limited (RPDL), and to transfer most of its property interests to RPDL. Included in these was to be the indirect interest, through WT, in the Jervois Quay site. Doogue J recorded:

> At this stage Renouf Corporation was still bound by its agreement with Mainzeal. Perhaps because of that or for other reason it was simpler for Renouf Corporation to transfer its

beneficial interest in Wellington Tower to Renouf Property Developments Limited rather than transfer the shares which it held in Wellington Tower, as the latter course might have involved Mainzeal because of the terms of Renouf Corporation's agreement with Mainzeal.

An agreement was executed under seal by RCL and RPDL on 20 August 1985. As it is central to the case it is set out hereunder in full:

WHEREAS

1. THE Corporation [RCL] and MAINZEAL GROUP LIMITED at Auckland (hereinafter called "Mainzeal") are joint venturers in a development project pursuant to a Joint Venture Agreement dated 2 April 1985 (hereinafter called "the Agreement")

2. THE Corporation and Mainzeal each is the holder of fifty (50) fully paid ordinary shares of One Dollar ($1.00) each in the capital of WELLINGTON TOWER LIMITED at Wellington (hereinafter called "Wellington Tower")

3. WELLINGTON TOWER is registered as proprietor of the estate and in [sic] the lands described in the schedule hereto (hereinafter called "the site")

4. THE parties hereto wish to participate together through Wellington Tower in the development of the site and any other site contiguous thereto which Wellington Tower may hereafter acquire.

5. THE Corporation pursuant to the provisions contained in the Agreement desires to assign unto Renouf [RPDL] the whole of its interest in the development project planned for the site on the terms and conditions hereinafter appearing.

NOW THEREFORE THE PARTIES HERETO AGREE AS FOLLOWS:

1. FOR the consideration of TWO MILLION SEVEN HUNDRED AND FIFTY THOUSAND DOLLARS ($2,750.000.00) the Corporation hereby assigns unto Renouf its rights under the Agreement to fifty per cent (50.0%) of the future development profits arising from the development of the site on the terms and conditions hereinafter appearing.

2 THE consent of Mainzeal to the within assignment shall be obtained by the Corporation by 30 August 1985.

3. THE consideration to be paid to the Corporation by Renouf shall be paid on 30 September 1985.

4. THE provisions contained in the Agreement shall mutatis mutandi apply to Renouf.

5. RENOUF if called upon shall indemnify the Corporation against any future or contingent liability which the Corporation may continue to have pursuant to the provisions of the Agreement.

The Commissioner claims that the consideration of $2.75m received by RCL is assessable income.

Also transferred to RPDL were the property interests of a subsidiary of RCL, Renouf Industries Limited. It was described in 1984 as "engaging in property development for ownership or for sale." In fact, it seems to have developed and sold one site only, retaining others as investments.

There is no suggestion that any of the recited transactions were not genuine.

**The Income Tax Act 1976**

Before Doogue J the Commissioner invoked the following provisions:

> **Section 65(2)**
> Without in any way limiting the meaning of the term, the assessable income of any person shall for the purposes of this Act be deemed to include...
>
> (a) All profits or gains derived from any business...
> ...
>
> (e) ...all profits or gains derived from the carrying on or carrying out of any undertaking or scheme entered into or devised for the purpose of making a profit.

**Section 191(4A)**

> Where subsection (4) of this section applies to any specified group and to any income year, and any profit or gain derived by any company in the group is not (apart from this subsection) assessable income of that company but, if the group were one company, would have been assessable income of that last-mentioned company, that profit or gain shall be deemed to be assessable income of the first-mentioned company.

(It is accepted by the respondents that subs(4A) applied to the Renouf group. But neither RPDL nor WT was a member of the specified group.)

In the High Court the Commissioner also sought to rely upon s65(2)(l) but that argument has not been pursued on appeal.

**The High Court judgment**

In this Court counsel for the Commissioner relied upon a combination of s65(2) and s191(4A). In the High Court the submissions seem to have dealt with them separately. Doogue J found that s65(2)(a) had no application. RCL was not a trading company. It held shares in WT. It was not a dealer in shares, nor did it have any intention of its own of developing the site. The only relevant business was that of WT.

As to s65(2)(e), the Judge said that he had been satisfied by the objectors that RCL's acquisition of shares in WT was with a view to deriving dividend income. RCL was not a party to WT's scheme to develop the site. What had occurred was the realisation of an investment, not an act done in the course of any larger scheme or in the course of a business.

Doogue J noted that the Minister had described s191(4A) on the second reading of the Income Tax Act Bill (No.2) 1977 as being intended

> to prevent undue advantage being gained through some profits being regarded as capital gains when received by a single company when in reality they are revenue profits in the context of the overall business activities of a group of commonly owned companies.

But, the Judge went on, the capital gain of RCL could not in any sense be said to be a revenue profit in the context of the overall business activities of the group. He was prepared to accept that at the time of the relevant transaction Renouf Industries was engaged in property development. But RCL in its involvement with the Jervois Quay site was not acting as a land developer. It was a purchaser of shares. The position would have been no different if Renouf Industries had been the purchaser of the WT shares, instead of RCL. It would not itself have been developing the property.

**Character of the agreement**

In this Court much emphasis was placed by the Commissioner on his characterisation of the transaction between RCL and RPDL. It was submitted that its true nature was an assignment of RCL's contractual rights under the joint venture agreement but not a sale of RCL's shares in WT, even of the beneficial interest therein. This was said to be indicated by the terms of the document of 20 August 1985 which made no mention of any share transfer or declaration of trust in respect of the shares. In contrast, Mr Coleman pointed out, when in 1986 the transaction was reversed and all rights sold to Mainzeal the shares were transferred. Counsel contended that all that passed to RPDL under the agreement with RCL in consideration for RPDL's payment of $2.75m was (a) RCL's rights under the joint venture and (b) a right to the expected dividend corresponding to one half of the distributable development profit earned by WT. That right to a dividend was severed from the shareholding, which remained entirely with RCL.

Mr Coleman argued that more than the mere shell of legal ownership was retained by RCL which remained free with Mainzeal to cause WT to carry out

further projects on other sites and that after 20 August there was nothing in the agreement preventing RCL from transferring its shares to a third party with the consent of Mainzeal, subject always to the obligation to account for the particular dividend.

In determining in a taxation case the true meaning and effect of a transaction which is not alleged to be a sham the Court examines and construes that transaction in the same way as it would do if the parties to it were in dispute about its meaning and effect. The Court assumes that the parties were intent on achieving a result which makes commercial sense.

When the matter is approached in this way we have no hesitation in rejecting the Crown's characterisation. It is not consistent with a commercial approach, nor with a reading of the document as a whole, and, in particular, the recitals. The agreement of 20 August 1985 contemplated that RPDL was to have the whole of RCL's interests in the planned development project (recital 5). It recognised that the participation would be through the holding of shares in WT (recitals 2 and 4). When therefore in the first of the operative clauses RCL assigned its rights under the joint venture agreement to 50% of the future development profits, that must have been intended to include the shares which were the sole means of accessing that profit share. There may have been good reason for not wanting to transfer the legal title to the shares themselves, which required the consent of Mainzeal, but, unless they were to be held beneficially for RPDL, that company was obtaining something inadequate for the recited purpose of giving it the whole of RCL's interest in the project. A right to step into the shoes of RCL under the joint venture agreement (with Mainzeal's consent) and to have an accounting for any dividend which might be declared was quite inadequate to protect the position of RPDL. RCL, on the Commissioner's argument, would have ceased to be bound by the joint venture agreement. A novation would have occurred when Mainzeal consented to the assignment of RCL's contractual rights. RCL would no longer be bound by its provisions. The right to transfer the shares would be governed solely by the Articles which

required the consent of the other shareholder. The affairs of WT were, under the general law and in terms of the joint venture agreement, in the control of its directors. They were appointed and could be changed by the holder or holders of the share group, not by whoever happened from time to time to be the joint venturer. Unless an interest in the shares was beneficially vested in RPDL, giving it a right to call on RCL to act upon its directions in relation to the shareholding, it was at the risk of being unable to ensure that WT applied its net profits in payment of a dividend rather than retaining them for working capital or simply investing them.

Mr Coleman was critical of counsel for the respondents' construction of the agreement, which we are in essence adopting, saying that it requires implying into the agreement a term relating to the shares which goes beyond the actual wording. But he himself, in order to support his own construction, had necessarily to do likewise, for there is no reference to a dividend, let alone to any assignment of dividend. In our opinion the implication of a transfer of the beneficial interest is necessary for commercial efficacy. The Commissioner's formulation falls short of that.

If a very unusual arrangement of the kind suggested by the Commissioner had been in the contemplation of the parties, it would surely have been carefully spelled out. As WT was acquired as the vehicle for the Jervois Quay project, no other transaction being proposed, and the agreement related to the whole of RCL's interest therein, it was most unlikely that RCL would consider pursuing further joint projects through it and, moreover, would do so after deliberately transferring its property development interests to RPDL

Properly construed, the agreement assigned to RPDL the beneficial interest in RCL's shares in WT along with all its rights under the joint venture agreement. RPDL stepped into RCL's shoes in all respects in relation to the Jervois Quay project.

**Was sale of WT shares pursuant to a scheme?**

Mr Coleman acknowledged that if that were the position his argument based on s65(2)(a) and s191(4A) had little prospect of success. He appeared to accept that if the transaction related to the WT shares it was structural in nature, not a contract in the course of business or revenue earning activities. But he argued that, nevertheless, the Crown could succeed under ss65(2)(e) and 191(4A) because the profit or gain to RCL on the sale of its interest in the joint venture and in the WT shares was derived from the carrying on or carrying out of a scheme or undertaking. It exhibited features giving it the character of a business deal (***McClelland v Commissioner of Taxation of the Commonweath of Australia*** (1970) 120 CLR 487, 495), with a plan of action, a series of steps directed to an end result (***Investment and Merchant Finance Corporation Ltd v Commissioner of Taxation of the Commonweath of Australia*** (1970) 120 CLR 177, 188-9). There was said to be a sufficient nexus between the scheme and the profit or gain to the taxpayer so that it can be said to have derived from the scheme (***Duff v Commissioner of Inland Revenue*** [1982] 2 NZLR 710) even though not actually arising in the manner originally intended by RCL.

It was submitted that the Judge was wrong to consider that this scheme involved only what counsel called the "bricks and mortar deal." Mr Coleman said that the scheme consisted of the following elements or steps:

a) Transfer of 50 shares each in WT to RCL and Mainzeal.

b) Entry into the joint venture agreement so as to co-ordinate the development project.

c) Sale of the project for profit.

d) Return of the profit by way of tax free dividend.

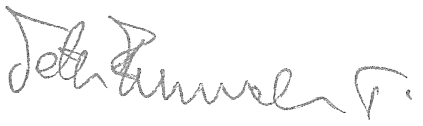
It was throughout intended that the developed site be sold to an institutional purchaser. Mr Coleman referred to the evidence of Mr Curtin which conceded that RCL had a "strong profit objective." Doogue J had found that the WT shares were held as an investment with a view to derivation of dividend. Mr Coleman suggested that in coming to this conclusion the Judge had been overly influenced by the tax free nature of that income source. He said that merely because a taxpayer intends to take the profit deriving from an asset in a manner which does not attract taxation, that does not mean that the asset in question is to be regarded as an investment on capital account in the absence of evidence that it is intended to be a long-term holding. In broad terms there can be acceptance of this last proposition. It may be difficult for the taxpayer to establish that he or she has made an investment, as opposed to an acquisition of trading stock or otherwise on revenue account, without evidence showing an intention to hold the asset in the longer term. However, here there was nothing to indicate that RCL and Mainzeal intended when they formed their joint venture to quit their WT shareholdings once the Jervois Quay project was completed and sold. The Commissioner has himself argued that WT could have been re-used as a vehicle for further property developments. RCL was a holding company with no history of dealing in shares; nor do other companies in the group appear to have done so.

More significantly, even if the Commissioner's opinion on the constitution of the scheme were to be accepted, and we are not persuaded that Doogue J was in error in the view he took, the fact remains that RCL participated only in steps (a) and (b). It sold its shares to RPDL before there was any sale of the project and prior to that sale it derived no income by way of dividend or the equivalent of dividend i.e a payment related to the earnings of WT. In these circumstances the sale of the WT shares and the interest in the joint venture did not produce any sum "derived from the carrying on or carrying out" of the alleged scheme. There cannot be said to have been a step in pursuance of the scheme when RCL sold its interests. Indeed, RCL withdrew from any such scheme by so doing.

Even when the matter is examined on the basis required by s191(4A), and account is taken of the activities of Renouf Industries as if they were undertaken by RCL, the position is the same. The character of the alleged scheme and of the WT share transaction does not alter. It remains an investment in a company which was not a subsidiary of RCL. The isolated development and sale which Renouf Industries had undertaken does not cast any different light upon what occurred with RCL's shareholding in WT merely because WT (which was outside the specified group) was itself engaged in a profit-making exercise on revenue account by way of property development. No pattern of relevant activity emerges in the Renouf group.

**Result**

The Commissioner's appeal is dismissed. The respondents are entitled to costs. Counsel may file memoranda on the question of costs.



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