IN THE HIGH COURT OF NEW ZEALAND
AUCKLAND REGISTRY

Set I

M.1019/80

BETWEEN GRAEME TREVATHAN of Dunedin - Clerk

Objector

AND THE COMMISSIONER OF INLAND REVENUE

Respondent

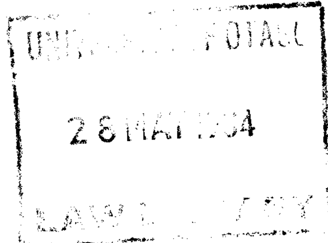
M.1712A/81

BETWEEN WESTERN DEVELOPMENTS LTD of New Plymouth

Objector

AND THE COMMISSIONER OF INLAND REVENUE

Commissioner



Hearing: 25th November, 1983

Counsel: Molloy for Objectors
Jenkin for Commissioner

Judgment: 29 February 1984.

JUDGMENT OF SINCLAIR, J.

These two cases stated were heard together as they have a common origin and arise as a consequence of the crash of Securitibank Limited and its associated companies.

So far as the case stated involving Mr Trevathan is concerned, that came before this Court by being referred by the Taxation Review Authority, and the agreed statement of facts revealed the following:

On the 25th November, 1976 a bill of exchange with a

face value of $1,541.59 was drawn by Commercial Bills Limited and accepted by Merbank Corporation Limited. It was issued to Safe Custody Nominees Limited for holding on behalf of Mr Trevathan until maturity. For that bill he paid Commercial Bills Limited $1,500. The bill had been due to mature on 25th February, 1977 but on 2nd February, 1977 Commercial Bills Limited, Merbank Corporation Limited and Safe Custody Nominees Limited were all ordered to be wound up by this Court.

On 28th February, 1977 formal advice of dishonour of the bill was given to Mr Trevathan by Commercial Bills Limited (in liquidation) and he has not received any payment in respect of that bill from either Commercial Bills Limited or Merbank Corporation Limited. As at, and since, date of dishonour there has been no reasonable possibility that the Objector, that is Mr Travathan, would recover more than 35 cents in the dollar of the moneys due under the bill and it is still impossible to know when he might receive this or whatever lesser amount finally becomes payable.

In his return of income furnished to the Respondent for the year ended 31 March, 1977 the Objector, in calculating his assessable income, claimed a deduction of $1,541.59.

Up to 31 March, 1977 this particular bill was the only commercial bill which at any time had been held by or on behalf of the Objector and his sole purpose in acquiring it had been to obtain on maturity payment in cash of the difference between its face value and the

amount he paid for it.

In relation to the case stated involving Western Developments Limited, the agreed statement of facts revealed as follows:

On 11 November, 1976 a bill of exchange with a face value of $6,284.90 was drawn by Commercial Bills Limited and accepted by Merbank Corporation Limited. It was likewise issued to Safe Custody Nominees Limited for holding on behalf of one Edward Elliott Riddick until maturity. That person paid Commercial Bills Limited $6,121.35 as consideration for the bill so issued and it had been due to mature on 11 February, 1977. On 16 November, 1976 a further bill with a face value of $7,723.22 was drawn by Commercial Bills Limited and accepted by Merbank Corporation Limited. It was also issued to Safe Custody Nominees for holding on behalf of Mr Riddick until maturity and he paid $7,522.24 for the bill. That bill had been due to mature on 16 February, 1977. On 22 December, 1976 Mr Riddick transferred both bills by endorsing them in favour of Western Developments Limited in consideration of an aggregate payment of $12,696. Again, the case stated repeats the fact that the three companies Commercial Bills Limited, Merbank Corporation Limited and Safe Custody Nominees Limited were on 2nd February, 1977 ordered to be wound up by this Court.

On 15th February, 1977 formal advice of dishonour of the first of the bills just referred to was given by Commercial Bills Limited (in Liquidation). On 16th February, 1977 similar advice was given in respect of the second bill

just referred to. On 15th September, 1977 Western Developments Limited transferred its right, title and interest under and by virtue of the said bills to one Roland George Chadwick, Chartered Accountant, in consideration of payment on that day of $100. The bills were duly endorsed and delivered accordingly.

The Objector had not previously received, nor because of the assignment just referred to was it any longer entitled to receive, any other payment in respect of the bills whether from Commercial Bills Limited, Merbank Corporation Limited or any other source.

In its return of income in respect of the year ended 30th September, 1977 the Objector claimed, in calculating its assessable income, a deduction of $12,596 being the difference between the price paid to Mr Riddick for the bills and the price received from Mr Chadwick. These two bills were the only commercial bills which had at any time up to 30th September, 1977 been held by or on behalf of the Objector and the Objector was not in the business of dealing with such bills. Its sole purpose in acquiring them had been to obtain on maturity payment in cash of the difference between their face value and the amounts it paid for them.

As a result of these cases stated three questions were posed for the consideration; these are as follows:

(1) To what extent, if any, is deduction of the losses incurred by the taxpayers as a result of the dishonour of the aforesaid bills prohibited by S.112(1)(a) of the Land and Income Tax Act 1954?

(2) To what extent, if any, were the losses incurred in gaining or producing the assessable income of the Objectors? This involves the consideration of S.111 of the aforesaid statute.

(3) If the aforesaid losses are not to be treated as losses of capital, but are to be treated as losses incurred in gaining or producing assessable income, when were the losses actually incurred?

In relation to the third question it was agreed between counsel that that matter should stand adjourned for further consideration. Accordingly I did not hear argument in relation to it. However, by reason of the conclusion I have come to I am of the view that an answer to the third question is not now required, but in case the matter should go further and another Court should be of a different opinion from myself, the third question will remain adjourned sine die to be brought on for hearing if and when it is necessary to do so.

I turn to the first question which involves a consideration of S.112(1)(a) of the Land & Income Tax Act 1954 which reads as follows:

> "Notwithstanding anything to the contrary in section 111 of this Act, in calculating the assessable income derived by any person from any source, no deduction shall, except as expressly provided in this Act, be made in respect of any of the following sums or matters:
>
> (a) Investment, expenditure, loss or withdrawal of capital; money used or intended to be used as capital; money used in the improvement of premises occupied; interest which might have

"been made on any such capital or money if
laid out at interest:"

Counsel for the Objectors submitted that the above provision of the statute does not make the loss or expenditure of every type of capital non-deductible and he contended that the subsection was concerned with fixed capital, not circulating capital. He referred to two decisions which he contended highlighted the difference between fixed capital and circulating capital, these being John Fairfax & Sons Pty Ltd v. F.C.T. (1959) 101 C.L.R. 30, to which reference was made by Beattie, J. in Europa Oil (N.Z.) Ltd v. Commissioner of Inland Revenue (1974)4 A.T.R. 455 at 499. The Australian decision was concerned with S.51 of the Australian statute which is not precisely the same as the New Zealand statute, but when one has a look at the actual decision in the Fairfax case, Dixon, C.J. at page 35 of the report said that the price paid for trading stock by a trader was clearly expenditure incurred in gaining or producing his assessable income and that seems to me to be the real basis on which the case proceeded. In other words money which is expended for trading stock which ultimately is resold and produces an income is properly to be regarded as expenditure associated with the production of the assessable income. But not all the cases seem to me to accept the notion of a distinction between the fixed capital and circulating capital. I instance the decision in Reynolds & Gibson v. Crompton (1950) 33 T.C. 288 and I quote from a portion of the judgment of Jenkins, L.J. at page 303 where he said:

> "But for my part I do not think the importation into the case of the somewhat debatable distinction between fixed and circulating capital really contributes anything to the solution of the question in issue. After all, if I understand the cases correctly, 'circulating capital' is simply an expression used to denote capital expended in the course of the trade with a view to disposal at a profit of the assets produced or acquired by means of such expenditure, and represented at different stages of its career by cash, assets into which the cash has been converted, and debts owing from customers to whome those assets have been sold."

In other words, the capital which is utilised in purchasing the trading stock in the course of a taxpayer's business is capital which on the sale of the stock will be re-invested in the purchase of replacement stock. That appears to me to be consonant with a submission made by Mr Molloy when he said that circulating capital remains deductible provided it represents expenditure or loss incurred in the production of income which, were it to arise, would be assessable, not exempt, income. He went on to contend that cases such as Edwards v. Bairstow (1956) A.C. 14 and Rutledge v. Commissioners of Inland Revenue (1928) 14 T.C. 490 were instances where taxpayers had expended capital in acquiring stock which he described as being of a quasi trading nature with the result that the capital involved could be really described as of the circulating type which resulted in the transactions in question being considered as being within the revenue laws.

In the Edwards v. Bairstow case the taxpayers purchased a quantity of machinery with the intention of making a quick resale which was eventually accomplished. The question then arose as to whether or not the profit was assessable for income tax purposes. The decision of the

House of Lords was that the facts inevitably led to the conclusion that the transaction was an adventure in the nature of trade and was assessable for tax having regard to the wording of the Income Tax Act 1918.

To the same effect is the decision in Rutledge's case and to my mind one must be very careful in attempting to use decisions such as those just referred to as being of universal application. Each case will depend on its own facts and each case will depend upon the appropriate statute law which is in force at the time of any particular judicial decision. Indeed, I feel that this will become clear as the matter is further considered.

On behalf of the Respondent four submissions were made, they being as follows:

(1) That by their nature the respective purchases of the bills by the Objectors were purchases of capital assets.

(2) That the introduction into the statute of Section 88(1)(ff) did not change the nature of the asset purchased.

(3) That the Objectors were neither dealers in commercial bills or similar securities nor were they in that type of business and, in consequence, there could be no suggestion that the bills became part of trading stock.

(4) That the Objectors undertook no profit-making, undertaking or scheme in relation to the bills.

For the purposes of argument it was accepted by counsel that where any bill holder of bills similar to those now being considered had been in business as a dealer in bills, his losses had been allowed by the Commissioner as deductions in calculating his assessable income.

I turn to consider the first proposition put forward on behalf of the Commissioner.

In Beasley v. Commissioner of Inland Revenue (1980) 10 A.T.R. 619, Casey, J. considered the nature of commercial bills and he accepted that which had been propounded in relation to such transactions by Lord Fraser in Willingale v. International Commercial Bank Ltd (1978) A.C. 834 when the learned law Lord said:

> "The solution to the problem depends in my opinion upon the true nature of what the Bank is doing when it discounts or purchases a bill. In my view it is acquiring an asset and, so long as it continues to hold that asset, it does not and can not, realise any profit or loss in respect of it."

The Beasley decision related to events which occurred prior to the enactment of S.88(1(ff) which first appeared in the statute in 1974. The facts in Beasley's case show that the taxpayers were trustees of some family trusts and had sold shares which had formed the major assets in those trusts. The trustees, therefore, had available to them some substantial amounts of cash and, whilst looking for long-term investments , decided to invest in the short term commercial bill market. Between September 1973 and January 1974 some 40 bills were purchased at discounted

rates and profits were made on their sale or maturity. For tax purposes the profits were treated as assessable income. It was held in this Court that the profits were liable to tax as they were the result of carrying on in business and were assessable under S.88(1)(a).

The decision shows quite clearly that the Court had regard to the pattern of purchases and quite clearly had there not been such a pattern and had there been but one or two isolated transactions, then the security or securities would have been held on capital account and any capital would have been a capital profit.

Mr Jenkin drew attention to the decision in Jones v. Leeming (1930) A.C. 415. This case concerned a person who had joined with three others in obtaining an option to purchase a rubber estate in the Malay Peninsula. As the estate was too small for resale to a company for public flotation they acquired a further option to purchase an adjoining estate. Ultimately the two estates were sold at a profit. The respondent was assessed for tax on his share of the profit and the Commissioners originally found that the respondent had acquired his interest with the sole object of turning it over at a profit and that he at no time had any intention of holding the property or interest as an investment and the assessment for tax was confirmed. When the case was referred back the Commissioner subsequently found that the transaction was not a concern in the nature of trade. The House of Lords held that having regard to the finding of fact that the transaction was not a concern in the nature of trade, and to its being an isolated transaction of purchase and resale of property,

the profits arising were not in the nature of income but were an accretion of capital. This is made plain from the speech of Lord Buckmaster at page 419 when he said:

> "Can the profits made in this case be described as income? Were the respondent a company promoter or were his business associated with purchase and sale of estates, wholly different considerations would apply, but this is negative; the transaction in this case stands isolated and alone. It is to my mind, in the circumstances, purely an affair of capital."

In reply Mr Molloy contends that in reality the House of Lords was faced with the finding of fact of the Commissioners and that in those circumstances there could be no other conclusion than that to which the House came.

However, the matter was referred to by the High Court of Australia in <u>Commissioner of Taxation v. Whitfords Beach Pty Ltd</u> (1982)56 A.L.J.R. 240. At page 241 Gibbs, C.J. had this to say:

> "In Jones v. Leeming, (1930) A.C. 415 it was held by the House of Lords that, assuming that there was no adventure or concern in the nature of trade within s.237 of the Income Tax Act 1918 (U.K.), the profit made on an isolated transaction of purchase and resale did not become income merely because the property was bought with the intention of reselling it at a profit. This decision did not involve any new question of law, as Viscount Dunedin pointed out, at p. 421. It depended on the finding of fact that there was no adventure or concern in the nature of trade. Prima facie, an accretion to the capital value of a security between the date of purchase and that of realisation is a capital gain (Colonial Mutual Life Insurance Society Ltd v. Federal Commissioner of Taxation (1946), 73 C.L.R. 604, at p.614), and the ground of the decision in Jones v. Leeming was simply that 'the profit on an isolated sale which is not a trading transaction' is a capital accretion and therefore not income: see per Lord Macmillan, at p.430. The case did not decide that the fact that the purchase and resale was an isolated transaction necessarily meant that it was not a

"trading adventure - many cases, before and since, including Californian Copper Syndicate v. Harris and Edwards (Inspector of Taxes) v. Bairstow, (1956) A.C. 14 are opposed to that proposition; what was held was that if, as a matter of fact, the transaction was not a trading transaction, the profit did not become income merely because the asset had been bought with the intention of making a profit on its resale. Jones v. Leeming was decided under English legislation the scheme of which is different from that provided by the Act. However, the conclusion that a profit made on the realisation of a capital asset does not become income by reason only of the fact that the asset was acquired for the purpose of profit-making by sale accords with ordinary concepts. Such a profit is ordinarily regarded as a capital gain, even though the asset was bought for the purpose of making the gain.

That quotation highlights that which I have already said: namely, that each case will inevitably turn on its own facts and on the law which is to be applied at the time the matter comes under consideration.

Two further decisions may be referred to. Firstly, there is the decision of Williams, J. in Modern Permanent Building and Investment Society (In Liquidation) v. F.C.T. (1958) 98 C.L.R. 187. In this particular case a building society which had been duly registered under the appropriate statute confined its business to making advances at interest to members and other persons upon the security of freehold land. Prior to going into voluntary dissolution it sold the outstanding loans to another building society at a price equal to the total of the loans less 10%. It claimed a sum equivalent to the 10% as a deduction from assessable income in the year in question. It was held that the sum involved was a capital loss and not allowable as a deduction. At page 192 the following was said:

"The appellant was really making a series of

> "investments for the purpose of deriving an income from the interest they produced. It intended to retain the loans during their currency and only to realise upon the security if it became necessary to do so in order to recoup itself for unpaid interest or principal or for unpaid fines or other payments owing by the borrower as a member. Moneys used to make advances of the character made by the appellant could not be said to be used in its trade. They could only be said to be used for the purposes of investment. Whatever the position might be if a profit or loss was made upon an assignment of one or more of the loans in the course of the appellant's business, a mass sale of them in order to put an end to that business could not be other than a sale of capital assets."

Very much to the same general effect is the decision of the full Court of the Supreme Court of this country in Union Bank of Australia v. Commissioner of Taxes (1920) N.Z.L.R. 649. In this particular case the Bank maintained for the purpose of its business a large reserve fund consisting partly of cash and partly of Consols and other securities which in the course of the Bank's business had to be realised from time to time. In the course of such realisation certain losses had been incurred and the Bank claimed to deduct these losses from its total income from the year in which they occurred. The Commissioner claimed that the losses were losses of capital and therefore not deductible. The Court held, however, that the losses referred to had to be treated as losses incurred as part of the ordinary business of the Bank. At page 653 Sim, J. had this to say:

> "The principle to be applied in determining whether an enhanced price obtained on realizing an investment is to be treated as a profit or not is thus stated in the Scottish case of California Copper Syndicate v. Harris (2):
> 'It is quite a well-settled principle in dealing with questions of assessment of income-tax that where the owner of an ordinary investment chooses

> "'to realise it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit in the sense of Schedule D of the Income-tax Act of 1842 assessable for income-tax. But it is equally well established that enhanced values obtained from realisation or conversion of securities may be so assessable where what is done is not merely a realisation or change of investment, but an act done in what is truly the carrying-on or carrying-out, of a business.' "

Mr Molloy replies that this decision turns on the fact that the Bank was carrying on a business and that the Court in the two cases stated is concerned not with an ordinary business investment, but three pieces of commercial paper. That may well be so, but it highlights to some degree the position of the Objectors in that they were not in the business of dealing with commercial bills and that the transactions truly fell within the isolated character. In neither case was there a series of transactions as occurred in Beasley's case and I am of the view that, setting aside S.88(1)(ff) for the moment, the bills purchased by the two Objectors were held by them on capital account and that any gain or loss in respect of them would have been a gain or loss of capital. In other words these isolated transactions, having regard to their character and nature, cannot be regarded as trading adventures.

This now brings me to the second submission on behalf of the Commissioner which is in relation to S.88(1)(ff) which provides:

> "....The assessable income of any person shall for the purposes of this Act be deemed to include .... the amount received by a taxpayer on the redemption of a commercial bill owned by him to the extent to which that amount exceeds the cost to him of that bill...."

This, it will be seen, is a deeming provision which results in the profit on commercial bills becoming income. In the absence of such a provision in the statute the difference between the purchase price and the realisation value would have been a capital profit in the hands of the holders of the bills unless, of course, they had been involved in a pattern of trading or a profit making scheme or undertaking in relation to those or similar types of securities.

I accept Mr Jenkin's submission that there is no justification for an implication that the commercial bill is to be held on revenue account. Parliament's intention was quite clear when it amended the statute in that it intended to ensure that the profit on the sale of even a single commercial bill should become income rather than capital, but that is the limit of the Legislative intention.

There is a parallel with S.88AA(1)(d) which is referred to by Richardson, J. in Lowe v Commissioner of Inland Revenue (1981) N.Z.L.R. 326 at page 342 when he said:

> "In short, the legislation has identified the gains which are deemed to be assessable income in terms which avoid the necessity for any discussion of how much planning or organising activity is required in such a case to constitute a commitment of assets to income earning capacity and so to determine what gains would, but for its provisions, constitute capital or income respectively."

Thus there is nothing in the nature of the investments made by the Objectors which is in fact altered by the provisions of S.88(1)(ff). The investments remained capital assets and any losses on realisation would be capital losses. I repeat it

is only the amount which is received on redemption and which is in excess of the cost of the bill which becomes taxable.

In support of his third submission Mr Jenkin really states what is obvious and which is accepted by both of the Objectors: namely, that neither was dealing with commercial bills or similar type of securities, nor was either carrying on a business which involved the purchase and sale of commercial bills as an integral part of that business. These, I repeat, were isolated transactions.

In support of his fourth submission Mr Jenkin submitted that there had been no profit making undertaking or scheme as was found to have existed in Beasley's case. Once again reference was made by him to Richardson, J.'s decision in Lowe's case (supra) at page 339 when he said:

> "Paragraph (d) requires the existence of an undertaking or scheme. There is an element of vagueness and elasticity inherent in both words and in the composite expression. In Commissioner of Inland Revenue v Walker (1963) NZLR 339, 357 Gresson P adopted the observation of Dixon CJ in Australian Consolidated Press Ltd v Australian Newsprint Mills Holdings Ltd (1960) 105 CLR 473, 479 that scheme connotes a plan or purpose which is coherent and has some unity of conception. Similarly an undertaking is a project or enterprise organised and directed to an end result."

He further referred to a small passage of the judgment of Windeyer, J. in Investment & Merchant Finance Corporation Ltd v. FCT (1970)1 20 C.L.R. 177 at page 188:

> "A scheme presupposes some programme of action, a series of steps all directed to an end result. Similarly an undertaking is an enterprise directed to an end result. Each word connotes

> "activities that are co-ordinated by plan and purpose - that whatever is done under the scheme or pursuant to the undertaking is done as a means to an end. There may, in one sense, be several transactions, but they are related because all directed to the attainment of the one end, profit."

I accept that so far as both Objectors were concerned neither was involved in a profit making undertaking or scheme of a kind which would bring the purchase of the commercial bills under consideration within the contemplation of S.88(1)(c) of the statute.

In summary, it is my view that both the Objectors expended capital when they purchased the commercial bills and that after their purchase the bills were held by the respective Objectors on capital account. The transactions were of an isolated nature similar to those referred to in the case of Jones v. Leeming (supra) and were made by persons who were not engaged in the business of dealing in commercial bills or like securities. I cannot and do not accept that the transactions which were entered into could be regarded as adventures in the nature of trade and I comment that those are words which appeared in the English statute which were considered in the two cases earlier referred to in this judgment. Nor do I think that the expenditure involved could be regarded as falling within what is generally understood by the term "circulating capital". As an aside I would comment that the capital did not circulate at all; it came to a dead end. Consequently any loss sustained by the Objectors as a result of their investing in the commercial bills now under consideration will be a loss of capital.

In view of the conclusion that I have come to there is now no necessity to consider the second question posed earlier in this judgment.

The Commissioner will be entitled to costs as against each Objector which I fix at the sum of $250 in each case.

SOLICITORS:

Grierson, Jackson & Partners, Auckland for Objectors
Crown Law Office, Wellington for Commissioner

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AUCKLAND REGISTRY

M.1019/80

BETWEEN GRAEME TREVATHAN

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Respondent

M.1712A/31

BETWEEN WESTERN DEVELOPMENTS LTD of New Plymouth

Objector

AND THE COMMISSIONER OF INLAND REVENUE

Respondent

JUDGMENT OF SINCLAIR, J.

Reserved Decision Delivered by me on the 29 February 1984, at 10am.

P.H. MILWARD
Deputy Registrar,
High Court. Auckland

Deborah Ross. S/N 29/2
McIlroy

Jenkin Solicitor notified