IN THE HIGH COURT OF NEW ZEALAND
HAMILTON REGISTRY

28/10

M. 280/94

	BETWEEN	**THE COMMISSIONER OF INLAND REVENUE** Applicant
1656	AND	**RONALD WILLIAM BACKHOUSE** of Hamilton, Solicitor. First Respondent
	AND	**RICHARD SAUNDERS GARBETT** of Hamilton, Solicitor Second Respondent
	AND	**RICHARD HAVELOCK KNOX JERRAM** of Hamilton, Solicitor. Third Respondent
	AND	**LEX DE JONG** of Hamilton, Solicitor Fourth Respondent
[redacted]	AND	**MICHAEL ANDREW WARD** of Hamilton, Solicitor. Fifth Respondent

Hearing: 7 October 1994

Counsel: J.R. Eichelbaum for Applicant
R.S. Garbett for First Four Respondents
No appearance for Fifth Respondent.

Judgment 26TH OCTOBER 1994

RESERVED JUDGMENT OF PENLINGTON J

Solicitors for Applicant — **Crown Law Office Wellington**

Solicitors for the Respondents — **McKinnon Garbett & Co**

This is an application by the Commissioner of Inland Revenue for orders that the respondents' objections be referred directly to the High Court under s.33(4) of the Income Tax Act 1976 and that the proceedings be consolidated.

Each respondent is a solicitor. The first four respondents practise in Hamilton as partners in a firm which is known as McKinnon Garbett & Co.

The fifth respondent was at one time a partner in that firm. When the Commissioner's application was called on 7 October there was no appearance on behalf of the fifth respondent. As there was no proof of service I adjourned the Commissioner's application against this respondent sine die. The hearing of the application proceeded in respect of the other four respondents.

Background

On 1 April 1983 the first three respondents entered Matrimonial Property Agreements with their respective wives under s.21 of the Matrimonial Property Act 1976. Each respondent purported to transfer to himself and his wife as tenants in common in equal shares his share in the legal partnership.

The fourth respondent entered into a similar agreement on 1 April 1984.

During the years ended 31 March 1989, 1990 and 1991 the first four respondents paid part of the partnership profits to their

wives under the umbrella of the Matrimonial Property Agreements.

The allocations of partnership income were as follows:

Backhouse **Income Tax year ended 31 March**	**Income Allocated**
1989	$29,061
1990	$43,671
1991	$32,472

Garbett **Income Tax year ended 31 March**	**Income Allocated**
1989	$29,062
1990	$43,671
1991	$32,472

Jerram **Income Tax year ended 31 March**	**Income Allocated**
1989	$29,061
1990	$43,671
1991	$32,472

de Jong **Income Tax year ended 31 March**	**Income Allocated**
1989	$29,061
1990	$43,671
1991	$32,472
Total	$420,817

The Commissioner issued amended assessments to the first four respondents for the years ended 31 March 1989, 1990 and 1991. In each case the Commissioner assessed the respondents

for tax on the income referred to above. The total income in issue in respect of the first four respondents is $420,971. The tax in dispute is $147,584. This sum is made up as follows:

Backhouse	$36,896
Garbett	$36,896
Jerram	$36,896
de Jong	$36,896
	$147,584

The Commissioner issued amended assessments for the three years in question.

On 23 October 1993 the first four respondents objected to the amended assessments. The objections were disallowed by the Commissioner.

On 2 February 1994 the first four respondents requested the Commissioner to state a case to a Taxation Review Authority. The Commissioner responded to this request with the present application. It is brought under s.33(4) of the Income Tax Act. I now set out the relevant portions of s.33.

> "(1) Notwithstanding anything in this Part of this Act, where -
> (a) An objection to an assessment is made in accordance with section 30(1) of this Act or accepted by the Commissioner under section 30(2) of this Act; and
> (b) The objection is not wholly allowed by the Commissioner; and
> (c) The objection is one to which subsection (2) or subsection (3) of this section applies, -
> the objection may be referred directly to the High Court by way of case stated in accordance with this section.
> (2) Where an objection relates to a question of law only,-
> (a) The objector may, within 2 months after the date on which notice of the disallowance is given to him by or on behalf of the Commissioner, by notice in writing to the Commissioner require the Commissioner to state a case for the opinion of the High

Court, and shall specify in the notice the registry of that Court in which he requires the case to be filed:

(b) The Commissioner, in any case where under section 31 of this Act the objector has required the objection to be heard and determined by a Taxation Review Authority, may in his discretion, instead of referring the objection to a Taxation Review Authority, state a case for the opinion of the High Court, and shall notify the objector accordingly.

(3) Where an objection relates to a question of fact (whether or not it also relates to a question of law),-

(a) The objector may, within 2 months after the date on which notice of the disallowance is given to him by or on behalf of the Commissioner, give notice in writing to the Commissioner that he desires the Commissioner to state a case for the opinion of the High Court, specifying in the notice the registry of that Court in which he desires the case to be filed:

(b) The Commissioner may, in any case where the objector has under section 31 of this Act required the objection to be heard and determined by a Taxation Review Authority, notify the objector that he desires the objection to be referred directly to the High Court.

(4) Where any notice is given by the objector or the Commissioner under subsection (3) of this section, the objection shall be referred directly to the High Court if both the Commissioner and the objector consent thereto, or with the leave of that Court granted on the application of the objector or the Commissioner, as the case may be, upon the ground that in the opinion of the Court, by reason of the amount of the tax in dispute between the parties or of the general or public importance of the matter or of its extraordinary difficulty or for any other reason, it is desirable that the objection be heard and determined by the High Court instead of by a Taxation Review Authority."

Subsection (1) sets out the conditions for a referral of an objection by way of case stated to the High Court. Subsection (2) sets out the position where an objection relates only to a question of law. It is to be noted that under s. 33(2)(b) the Commissioner may in his discretion instead of referring such an objection to a Taxation Review Authority state a case for the opinion of the High Court.

Section 33(3) sets out the position where an objection relates to a question of fact whether or not it also relates to a question of law. It is common ground that that is the position in the present case. The first four respondents having given notice under s.31

that they require their objections to be heard and determined by a Taxation Review Authority, the Commissioner has invoked s.33(3)(b) and notified them that he desires the objections to be referred directly to the High Court.

Under s.33(4) the objections are to be referred directly to the High Court if both the Commissioner and the taxpayer consent or with the leave of this Court.

The taxpayers do not consent. Accordingly the Commissioner must obtain the leave of this Court for the objections to be heard and determined in this Court instead of by a Taxation Review Authority. Before making an order this Court must be persuaded, first, that one or more of the grounds set out in the subsection have been established; and secondly, that it is desirable that the objection be heard and determined by the High Court instead of by a Taxation Review Authority.

As to the grounds available under the subsection, they are:

1. The amount of tax in dispute between the parties.
2. The general or public importance of the matter.
3. The extraordinary difficulty of the matter.
4. Any other reason.

The first ground speaks for itself.

The second ground is couched in the same or similar terms to a number of statutory provisions that create a right of appeal with

leave. See for example, s.144(2), Summary Proceedings Act 1957, being the right of leave to appeal to the Court of Appeal from a determination of the High Court on an appeal from the District Court.

See also Rule 2(b) and (c) Privy Council (Judicial Committee) Rules Notice 1973.

The third ground also speaks for itself. It is to be noted that the "extraordinary difficulty" is not qualified in any way and accordingly difficult questions of both fact and/or law would be comprehended by those words.

Again, the wording of the fourth ground is to be found in a number of statutory provisions creating a right of appeal with leave. Once again, see s.144 of the Summary Proceedings Act in this regard which was considered by the Court of Appeal in ***Clifford v Commissioner of Inland Revenue (No.2)*** [1963] NZLR 897.

When one or more of the grounds set out in s.33(4) have been established the Court must also be of the opinion that:

> "It is desirable that the objection be heard and determined by the High Court instead of by a Taxation Review Authority."

In other words the Court retains a residual discretion. This view of the subsection is supported by ***McGovern v Commissioner of Inland Review*** [1964] NZLR 396 in which Barrowclough CJ considered s.32(4) of the Land and Income Tax Amendment

Act 1960, a virtually identical provision to the present s.33(4). At that time the Supreme Court was empowered to order that an objection be heard and determined in that Court rather that by a Taxation Board of Review. The learned Chief Justice referred to the decision of the Court of Appeal in ***The New Zealand Insurance Co. Ltd v Commissioner of Stamp Duties (No.2)*** [1954] NZLR 1011 and then went on to say at p.397:

> "In the present case I think that the matter ... is of public or general importance; but it still remains to be determined whether because of that and because of the amount of tax involved, the objection ought to be heard and determined by the Supreme Court instead of by a Board of Review."

The learned Chief Justice dismissed the application holding that there was a right of appeal from the Taxation Board of Review and that there were advantages in having the facts determined before the case came to the Supreme Court.

In ***Commissioner of Inland Revenue v Lyttleton Port Co. Ltd*** (1994) 16 NZTC 11,089, Holland J recently had occasion to consider the principles to be adopted under s.33(4). At p.11,091, Holland J said:

> "There appears to be little reported authority as to the principles to be adopted under s 33(4) of the Act. I was referred to ***Powell v C of IR*** [1963] NZLR 684 and ***McGovern v C of IR*** [1964] NZLR 396. ... They do little more than apply the words of the statutory provision to the circumstances existing in the cases. No mention was made in either case of there being any advantage possessed by the Authority because of its special and restricted jurisdiction."

His Honour then carefully traced the history of the Taxation Review Authority and earlier the Taxation Boards of Review which were originally established in 1960.

On the facts of the case, Holland J was satisfied that the amount in dispute was substantial, that there was an issue - the accrual issue - which was one of general and public importance, and that there were issues of fact and law arising from the accruals issue which were of extraordinary difficulty. Holland J then observed at p. 11,092:

> "...although I do not wish it to be considered that the difficulty is such that a Review Authority cannot competently deal with the question, it is clearly the purpose of s 33(4) that where those facts are established it will usually be desirable that the objection be heard and determined by the High Court."

Holland J then went on to hold that the accruals issue was one that it was desirable to have determined by this Court.

I now turn to the present case. The grounds of the Commissioner's application are as follows:

(a) That the cases concern assignments of interests in a partnership under Matrimonial Property Agreements and the effect of the application of the Income Tax Act 1976 on the income derived from those interests, which is a matter that has not previously been considered by a Court.

(b) The principle issue raised in the cases is comparable to that in ***Hadlee v Commissioner of Inland Revenue*** [1991] 3 NZLR 517 (CA), which case went to the Privy Council: [1993] 2 NZLR 385.

(c) The case has high precedential value being of importance to a large number of self-employed professional taxpayers and hence to the Commissioner.

(d) The amount of tax in dispute over the years in issue is not insignificant and further has potential to recur; and

(e) The dispute involves complex and difficult questions of both fact and law.

The relevant statutory provision is s.75 of the Income Tax Act 1976. The matters in dispute between the parties essentially concern two questions:

- First, whether in each case the respondent's right to participate in the profits of the legal partnership derive from his skill and personal exertion (personal services) or flow from his capital contribution to the partnership; and

- Secondly, whether the assignment of an interest in a partnership under a Matrimonial Property Agreement pursuant to s.21 of the Matrimonial Property Act 1976 has any effect on the application of the Income Tax Act.

The Commissioner contends that the respondents' income from the professional partnership is in the nature of personal services income which has been predominantly earned by the personal exertions of the partners and not from their share of the capital in the partnership which was the subject of the s.21 Matrimonial

Property Agreements. The notion that a taxpayer is precluded from splitting the income which he derives from rendering personal services was encapsulated by Henry J thirty years ago in ***Spratt v Commissioner of Inland Revenue*** [1964] NZLR 272 at p. 277 as follows:

> "No taxpayer can, by way of assignment, escape assessment of tax on income resulting from his personal activities - such income always remains truly his income and is derived by him irrespective of the method he may adopt to dispose of it."

The same point was clearly affirmed by Richardson J in ***Hadlee*** at pp 532 to 533, with particular reference to the personal exertion income of self employed persons who are in a professional partnership.

As the result of the allocation of partnership income to their respective wives, the total taxation paid on that income was reduced because the wives were taxed at a lower marginal rate than their husbands as their incomes were lower.

The Commissioner further contends that the splitting of the income of professional taxpayers under the aegis of s.21 Matrimonial Property Act agreements would inevitably undermine the marginal rate tax structure and would be inequitable as it is not available to salary and wage earners. See Richardson J in ***Hadlee*** at p.533.

The Commissioner further contends that there are a large number of taxpayers in New Zealand who derive their income from practising in a professional partnership and that if they were able

to avoid paying tax on part of their income by the use of Matrimonial Property Act agreements this would have an effect on the total revenue collected. For this reason the Commissioner says that the case will have a high precedential value.

Additionally, it is pointed out for the Commissioner that to date the use of the Matrimonial Property Act 1976 as a vehicle for effecting professional income splitting has not been the subject of litigation.

On the assumption that the Matrimonial Property Agreements will continue to be operative in the future their continuing use by the respondents will mean that potentially there is more at stake than the income of $420,817 which is the subject of objection.

The Commissioner further contended that the primary issue raised in the case is of comparable complexity and difficulty to that in ***Hadlee*** which ultimately went to the Court of Appeal sitting a full bench of five Judges, and thence to the Privy Council. It was submitted that because of the importance of the issues raised in the present case, it was likely to be ultimately decided at appellate level.

Arising out of the matters referred to in the last paragraph, Mr Eichelbaum for the Commissioner also raised a point of a practical nature. He submitted that the High Court is a specialist finder of fact and that it has available to it superior facilities for the taking of evidence. He pointed to the fact that regrettably there have been a number of cases which have been heard by a

Taxation Review Authority in which the recording equipment has failed leaving an indifferent or unsatisfactory record of the evidence. He cited ***CIR v Soma President Textiles Ltd*** (1994) 16 NZTC 11,313 in which case a rehearing was ordered in the High Court because of a break down of the sound recording equipment before a Taxation Review Authority. He also cited ***CIR v Henwood*** (1993) 15 NZTC 10,327, ***CIR v Dewavrin Segard (N.Z.) Ltd*** (1994) 16 NZTC 11,048, and ***CIR v BNZ Investment Advisory Services Ltd*** (1994) 16 NZTC 11,111. I could not help noticing that the same point was also referred to by counsel for the Commissioner before Holland J in the ***Lyttleton Port Company*** case. In passing, I observe that the frequent recurrence of the problem appears to cry out for some urgent administrative attention. In my view the possibility of an unsatisfactory record of proceedings before a Taxation Review Authority where it is likely that the case is destined for appellate consideration is a matter which could be comprehended within the words "any other reason" or, if that view is wrong, as a matter which might be relevant to the exercise of the Court's residual discretion.

The first four respondents oppose the Commissioner's application. They contend that the Commissioner has not established any one or more of the grounds contained in s.33(4) and that in any event the Court in the exercise of its residual discretion should refuse the application.

In particular the first four respondents contend that the present case does not raise issues of general or public importance or any matter of extraordinary difficulty. The first four respondents say

that the only issues to be determined are whether the Commissioner is limited to s.75 of the Income Tax Act and whether that section operates in his favour or in favour of the first four respondents. The latter rely on ***Commissioner of Inland Revenue v V.H. Farnsworth Ltd*** (1984) 6 NZTC 61,770. That case is authority for the proposition that at the hearing of an objection the Commissioner can only rely on the basis on which he arrived at his assessment and cannot rely on any other provision.

The first four respondents also rely on ***CIR v Farmers Trading Company*** (1982) 5 TRNZ 504, and ***CIR v Mitsubishi Motors*** (1994) 18 TRNZ 582.

The first four respondents' grounds of objection were contained in a letter to the Commissioner dated 28 October 1993. That letter stated:

> "1. The partnership share owned by each partner is matrimonial property and the Commissioner has failed to give full and proper recognition to a Matrimonial Property Agreement entered into pursuant to s.21 of the Matrimonial Property Act 1976, the effect of which is that the spouse of each partner earns income in accordance with the returns filed.
>
> 2. A spouse of each taxpayer is therefore entitled to receive the income in terms of the return files, and this right is recognised by s.34 of the Partnership Act 1908.
>
> 3. The partners have received full compensation for their personal exertion prior to the division of income from the partnership. In terms of the case ***Hadlee v CIR*** this is a case where an asset has been assigned from which income was later derived, such income not passing through the hands of the taxpayers.
>
> 4. s.75 of the Income Tax Act does not apply in this case because there is no money which can be said to be the income of the taxpayers which has been credited in account or reinvested, or accumulated, or capitalised; or carried to any reserve, sinking

> or insurance fund, or otherwise dealt with in the interest of or on behalf of the taxpayers."

Having examined the first four respondents' grounds of objection I am unable to accept their argument that the Commissioner is limited to s.75 of the Income Tax Act. The grounds of objection proceed on the basis that there was income from both personal exertion and from the respondent's share in the partnership (which was the subject of the Matrimonial Property Agreements). I am satisfied that the first four respondents' grounds of objection comprehend not only the application of s.75 but also the wider issues referred to in ***Hadlee***.

I therefore have no hesitation in holding that this case raises a matter of general or public importance. It concerns the transfer of a professional person's interest in a partnership under the Matrimonial Property Act and the question of whether the income of that person can then be split with his spouse on that account. Professional persons are a significant group of taxpayers. The decision on the issues raised in the case will have wide ramifications. I agree with the submission for the Commissioner that the case will have a high precedential value.

A significant amount of tax is involved. Potentially, a much greater amount of tax is involved because of the ongoing effect of the Matrimonial Property Agreements entered into by the first four respondents.

I find it unnecessary to decide whether the case involves any matter of extraordinary difficulty.

I now consider the question of whether it is desirable that the first four respondents' objections be heard and determined by this Court instead of by a Taxation Review Authority.

The first four respondents point out that for the three years 1986 to 1988 the Commissioner chose to state a case to the Taxation Review Authority; that that case was heard on 4 October 1994 and that the Authority reserved its decision. The taxpayers contend that the Commissioner is seeking to "relitigate issues which have already been before the Taxation Review Authority" and that there are rights of appeal to this Court from that decision.

I found that submission initially quite attractive but on reflection that view has receded. Mr Eichelbaum rightly argued that the Commissioner is entitled under s.33(4) to seek a High Court hearing in lieu of a hearing before a Taxation Review Authority in respect of the years 1989 to 1991 that each tax year is entitled to be separately considered and that litigation in respect of one year is not a bar to litigation in respect of another year.

Mr Eichelbaum informed me that the Commissioner had unsuccessfully sought an adjournment of the hearing on 4 October until the present application has been heard and determined. He frankly conceded that the Commissioner had found himself out of time to make an application under s.33(4) in respect of the 1986-88 income years and hence the reason why those years were before a Taxation Review Authority.

Mr Eichelbaum also indicated that there was no simultaneous transcription of the evidence taken at the hearing on 4 October and that a transcript of the evidence was not yet available so that its content and quality could be evaluated.

Having heard the respective arguments for the Commissioner and for the first four respondents concerning the 1989-91 years I exercise my residual discretion in favour of the Commissioner. In my view it is desirable that the objections be heard and determined by this Court instead of by a Taxation Review Authority.

For the reasons given I accordingly grant leave to the Commissioner under s.33(4) of the Income Tax Act 1976 for the first four respondents' objections to be referred directly to this Court by way of case stated.

The Commissioner also sought an order that the proceedings involving the first four respondents be consolidated. That application was not opposed. I therefore order accordingly.

The costs of and incidental to this application are reserved.

.....

P.G.S. Penlington J