IN THE HIGH COURT OF NEW ZEALAND
WELLINGTON REGISTRY

CIV 2009-485-1224

UNDER	the Tax Administration Act 1994 and the Income Tax Act 1994
BETWEEN	FOODSTUFFS (WELLINGTON) CO-OPERATIVE SOCIETY LIMITED Plaintiff
AND	COMMISSIONER OF INLAND REVENUE Defendant

Hearing: 22 October 2009

Counsel: G J Harley and R Harley for Plaintiff
H W Ebersohn and D Lemmon for Defendant

Judgment: 28 October 2009

JUDGMENT OF SIMON FRANCE J

Introduction

[1] This case concerns the issue of whether s GD 1 of the Income Tax Act 1994 ("the Act") requires a disposal at less than market value to have been between a transferor and a transferee before its provisions apply. In other words, can it apply when there is no recipient of the trading stock?

Background

[2] Foodstuffs ("the taxpayer") acquired all the shares in North Island Dairy Company Holdings Limited. It did so intending to amalgamate that company with

three others into one unit. It did this, and Kapiti Fine Foods Limited emerged as the new entity.

[3] Foodstuffs had acquired the shares for $2.3 million in late 2003. The amalgamation formally occurred on 1 January 2004, at which point the shares of North Island Company Holdings Limited ceased to exist. By operation of the amalgamation, they were cancelled. The form of amalgamation that was used requires that no consideration or payment is to be made in relation to the cancelling of the shares, and none was.

Tax treatment

[4] Section CD 4 of the Act provides that:

> The gross income of any person includes, any amount derived from the sale or other disposition of any personal property … if the property was acquired for the purpose of selling or otherwise disposing of it …

[5] The taxpayer took the position that its purchase of the shares fell within this section as it had bought the shares in order to dispose of them by way of the amalgamation process. This position had the effect of making the shares “trading stock” and “revenue account property”.

[6] Matching the earlier definition in s CD 4, trading stock is defined as:

> Any real or personal property where the business of the person by whom it is sold or disposed of compromises dealing in such property or <u>the property was acquired by the person for the purposes of sale or other disposal</u>.

[7] In its tax return for the year ending March 2004, the taxpayer claimed as a deduction the purchase price of this trading stock, being $2.3 million. It did not have an equivalent income entry attaching to the disposal of the shares by amalgamation.

[8] It is this aspect of the return that the Commissioner rejected. The Commissioner accepted the trading stock classification, but considered that s GD 1(1) of the Act applied to the disposal so as to deem the taxpayer to have received as income the value of the shares. That section provides:

> (1) Subject to subsection (2), where any trading stock is sold or otherwise disposed of without consideration in money or money's worth or for a consideration that is less than the market price of the trading stock at the date of the sale or other disposition,–
>
> (a) the trading stock is, for the purpose of this Act, treated as having been sold at and realised at its market price on the date of the sale or other disposition:
>
> (b) the price which under this section the trading stock is deemed to have realised shall be treated as gross income of the person selling or otherwise disposing of the trading stock:
>
> (c) the person acquiring the trading stock shall be deemed to have purchased the trading stock at the price which under this section the trading stock is deemed to have realised.

[9] The Commissioner assessed the market value of the shares to be $2.3 million, namely the purchase price. It is common ground that this is correct in the sense that the shares had not altered in value over the short period. The Commissioner also imposed a 20% penalty for an unreasonable tax position.

These proceedings

[10] The taxpayer challenges the Commissioner's reassessment. It says that s GD 1 does not apply to this type of disposal where the shares are not transferred to a transferee but rather are cancelled or destroyed. It also challenges the imposition of a penalty.

Issue one : does s GD 1 require a transferee?

[11] The point in dispute is of narrow compass. If one takes only the introductory words of s GD 1, then plainly the section would apply to the transaction. Section GD 1(1) begins:

> Subject to subsection (2), where any trading stock is sold or otherwise disposed of without consideration in money or money's worth or for a consideration that is less than the market price of the trading stock at the date of the sale or other disposition …

[12] The shares are trading stock, they have been disposed of, and the taxpayer received no money for them. That is in essence the Commissioner's argument. Prior to cancellation the shares were worth $2.3 million; the cancellation was a disposal and $2.3 million is the deemed income.

[13] I do not consider there is any doubt that on its face cancellation of the shares falls within the concept of "disposal". The holder of the shares has got rid of them; it has disposed of them. Nothing in the Act suggests that disposal is generally to be read narrowly.

[14] I do not understand Mr Harley to disagree. His submission is that the balance of s GD 1(1) colours the meaning of "disposal" by making it plain that the disposal must be to another person. In other words there must be both a transferor and transferee.

[15] The balance of s GD 1 reads:

> …
>
> (a) the trading stock is, for the purpose of this Act, treated as having been sold at and realised at its market price on the date of the sale or other disposition:
>
> (b) the price which under this section the trading stock is deemed to have realised shall be treated as gross income of the person selling or otherwise disposing of the trading stock:
>
> (c) the person acquiring the trading stock shall be deemed to have purchased the trading stock at the price which under this section the trading stock is deemed to have realised.

[16] Mr Harley submits that (c) in particular highlights that it is contemplated there is a vendor and a purchaser. The Commissioner says that (c) just ensures symmetry when there is one, but does not mean that there has to be one.

[17] The Commissioner points to examples that might not otherwise be caught – the farmer who consumes his own stock has always been treated as having received market value for that which he has eaten. Mr Harley agrees but says that is done by creating the fiction of the farmer as farmer, and the farmer as private person who is the nominal transferee of the stock (at market value).

[18] Another topic discussed was perishable food. Mr Harley pointed out that disposal of trading stock that has passed its use by date has never been regarded as engaging s GD 1. Mr Ebersohn agrees but says that is because the market value of the goods at the time of disposal is genuinely nil so no issue arises.

[19] The section has not had much judicial consideration. The sole New Zealand case is *Edge* v *CIR* [1958] NZLR 42. That confirmed that there could be no adjustment to a purchaser's assessment if there had not been a prior adjustment to the vendor. In other words there cannot be a transferee without a transferor. Mr Harley uses in support passages from the case that assume the presence of two parties; the Commissioner observes in reply that when using these examples the Court did not focus on whether there must always be two parties.

[20] Attention was also given to *Sharkey* v *Wernher* [1956] AC 58. That case concerned a horse breeder who decided to race some of her stock. What tax treatment if any was to occur when the horses went from the breeding account to the racing account? The House of Lords confirmed there must be an equivalent entry since trading stock had been disposed of. It decided 4–1 that the value to be attributed to the transfer was the market value rather than the acquisition price, but was unanimous that it was a disposal, and that it needed to be brought to account.

[21] The Commissioner emphasised the views of their Lordships that the transfer was a disposal, and that there must be account taken of it in the trading accounts of the breeding enterprise. Mr Harley noted it was an example of one person being treated as two.

[22] I asked Mr Harley why, if "disposes of" was limited as he argued to situations of transfer, that word or concept had not been used. In reply Mr Harley

pointed to the most recent manifestation of this provision – it is GC 1 in the 2007 Act. Mr Harley noted that GC 1 was not included in the list of sections intended to effect a substantive change to the previous Act but was just an example of using plainer wording. In other words it was perceived only as a plain English version of the same rule. It reads:

> **GC 1 Disposal of trading stock at below market value**
>
> *When this section applies*
>
> (1) This section applies if a person (the **transferor**) disposes of trading stock to another person (the **transferee**) for–
> (a) no consideration:
> (b) an amount of consideration that is less than the market value of the trading stock at the time of disposal.
>
> *Disposal treated as being for market value*
>
> (2) For the purposes of this Act, the consideration received by the transferor and provided by the transferee is treated as being an amount equal to the market value at the time.

[23] As now drafted, the section is limited in exactly the way that the taxpayer contends GD 1 of the 1994 Act should be read. In reply, Mr Ebersohn says:

a) it is not permissible to interpret the previous provisions by regard to the new, and the rule in s ZA 3 is that the old clarifies any ambiguity in the new, not vice versa;

b) GC 1 is a mistake which needs fixing.

[24] Focus was also given to the grammar used in s GD 1. Paragraphs (a) and (b) conclude with colons. This is said by the Commissioner to support the proposition that the paragraphs can operate independently and that there need not be a purchaser or transferee in order for the section to apply. The Finance and Expenditure Committee, in one of its reports, noted it had obtained advice from the drafter as to the significance of colons in tax legislation. The Report states:

> The colon is essentially intended to be interpreted as an indication that the statements in the items are not linked conjunctively or disjunctively, that is, would not be appropriate to link them with either an "and" or an "or". In some instances, each statement in a list that is punctuated with colons may

apply independently, without relying on the operation of the statements in the other items. If the items are statements representing preconditions for a statutory result, the effect of linking the item with colons is that the result will follow if one or more of the preconditions are satisfied. If such items were linked with "and", the result would follow where all the items were satisfied. If the items were linked with "or", the result would follow where only one item, but no more than one item, was satisfied.

We are informed that the use of colons in legislation drafted by the Inland Revenue Department is consistent with drafting guidelines developed by the Parliamentary Counsel Office. We understand that New Zealand legislation is unique in using the colon in this manner, but that other jurisdictions use the semi-colon in a similar manner. The Inland Revenue Department intends to issue a Tax Information Bulletin explaining this point, and we endorse this action.

[25] The Tax Bulletin referred to has been issued (February 2005).

Decision

[26] The starting point is that the taxpayer treated the shares as trading stock. The Commissioner accepted that and the assessment process proceeds on that basis.[1]

[27] If trading stock, they attract that label because they were bought for the purposes of disposition. Section GD 1 then uses exactly the same "disposition" formula that made the shares trading stock and in the first place which brought them within s CD 4. For the same reason, if the shares are treated as being within s CD 4 and being trading stock, then in my view s GD 1 must be applicable:

a) the property was acquired for the purposes of disposition and is trading stock;

b) it was disposed of because the taxpayer no longer has it;

c) it was disposed of at less than market value;

d) the trading stock is to be treated as having been sold at its market price on the date of disposition (when cancelled); and

[1] Mr Harley argues this was the Commissioner's error and that the shares should always have been treated as capital. I will return to this shortly.

e) the market price is deemed to be gross income of the person disposing.

[28] I do not see that it matters that there is not a purchaser or transferee concerning whom an equivalent adjustment is required. The purchaser is irrelevant to the need to adjust the accounts of the owner of the trading stock which has disposed of its property. The taxpayer bought the shares, chose to treat them as trading stock, chose to bring them within its “revenue account property” and claimed the deduction for the purchase price. When the taxpayer then chooses to dispose of the trading stock, there must be an adjustment to its tax position regardless of whether the method of disposal has further implications for a different taxpayer.

[29] To specifically address some of the arguments. I do not consider that paragraph (c) governs the interpretation of the introductory words of s GD 1; paragraph (c) sets out implications that flow from GD 1(1)(a) but does not necessitate that such a taxpayer exist before paragraph (b) or s GD 1 itself is applicable.

[30] The fact that in many of these situations the transaction is analysed or rationalised in terms of creating a transferor and transferee (the farmer as trading stock owner and the same farmer as private consumer) does not mean that every s GD 1 situation must be capable of such analysis to properly come within s GD 1. The farmer could be analysed in another way – he or she has acquired trading stock for which a deduction has been claimed; if he or she chooses to destroy the stock, it is to be deemed to be done at market value. What that market value is will depend on the reason why it is destroyed. If, for example, it is destroyed because the stock is worthless, or because no buyer can be found, then presumably the market value is nil so s GD 1 has no bite. If, however, it is healthy stock the farmer chooses to use for his own provision, then s GD 1(1)(a) and (b) are applicable without needing to describe the farmer as a private transferee of his or her own trading stock.

[31] The Commissioner raised concerns about the implications of the situation if the taxpayer here was right in its arguments. The implications are obvious. Mr Harley countered these by saying one need not be concerned because the simple

answer was not to accept the trading stock classification in the first place. The purchase of shares for amalgamation is, and should have been treated as, the acquisition of capital. If that was done, the issue would not arise. The taxpayer here will get a windfall but that is only because the Commissioner erred in the original step. There are no wider implications.

[32] Whether or not Mr Harley is correct in this, I do not consider it affects the reasoning. If correct, it certainly means one would not need to strain in the interpretation of s GD 1 to avoid the policy concerns raised by the Commissioner, but I do not consider that the interpretation I favour is straining the language. Mr Harley's point just means this situation is not likely to arise that often, and GD 1 will indeed usually arise in transferor/transferee situations. That is different from saying there must be such a transaction.

[33] Finally Mr Harley contended the shares had nil value, because the amalgamation decision and process required them to be cancelled without consideration being given. However, I accept the Commissioner's analysis that the correct point in time is prior to the change in value effected by the disposition option. Once cancelled they of course have no value, but prior to then they were worth $2.3 million and could have been sold until cancelled.

[34] For these reasons I accept that the Commissioner was correct to deem the taxpayer to have received gross income of $2.3 million from the disposition of the taxpayer's trading stock, namely the shares.

Issue two – an unreasonable tax position?

[35] On its face the taxpayer was seeking a windfall. It chose to call the shares trading stock with the express purpose of claiming a deduction, and knowing the shares would be cancelled.

[36] However, the scope of the section is far from settled. There is little authority on it, and I consider, with respect, that Mr Harley advanced a tenable argument.

Further, I cannot ignore that the wording of the 2007 Act either means I am wrong in my conclusions, or the drafters made the same mistake that the taxpayer has.

[37] In such circumstances I consider it incorrect to impose a penalty and accordingly I quash the penalty.

Conclusion

[38] The taxpayer's challenge to the adjusted assessment is rejected. The taxpayer's challenge to the imposition of a penalty is upheld. I will receive memoranda on costs if agreement cannot be reached. Given the outcome of the case, the parties may wish to call it a draw.

Simon France J

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