



Is it time to tax gains on share realisations?

Gurdayal Singh

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Primary Supervisor: Nigel Smith

Table of Contents

I.	Attestation of Authorship	5
II.	Acknowledgements	6
III.	Abstract	7
IV.	Introduction	8
A.	<i>Individual</i>	9
B.	<i>Investment Companies</i>	10
C.	<i>Banks & Insurance</i>	10
V.	History	11
A.	<i>Section CB 3</i>	12
B.	<i>Section CB 4</i>	13
C.	<i>Section CB 5</i>	14
D.	<i>Capital or Revenue Account</i>	15
VI.	New Zealand Cases	16
A.	<i>Individual</i>	16
B.	<i>Investment Companies</i>	21
C.	<i>Banks</i>	29
D.	<i>Insurance</i>	33
VII.	Canadian Cases	38
A.	<i>Individual</i>	38
B.	<i>Investment Companies</i>	40
C.	<i>Banks</i>	47
D.	<i>Insurance</i>	48

VIII. United Kingdom Cases.....	49
A. <i>Individual</i>	49
B. <i>Investment Companies</i>	52
C. <i>Banks</i>	55
D. <i>Insurance</i>	60
IX. Australian Cases.....	61
A. <i>Individual</i>	61
B. <i>Investment Companies</i>	68
C. <i>Banks</i>	74
D. <i>Insurance</i>	75
X. Comparison to Other Investments	78
A. <i>Foreign Investment Funds (FIFs)</i>	78
B. <i>Land Transactions</i>	79
XI. Recent Developments.....	81
XII. Should We Change?	86
XIII. Conclusion	88
XIV. Bibliography	93
A. <i>Articles</i>	93
B. <i>Newspaper</i>	93
C. <i>Conference papers and working papers</i>	94
D. <i>Books</i>	95
E. <i>List of Cases</i>	95
1. <i>New Zealand</i>	95
2. <i>Canada</i>	96

3.	<i>United Kingdom</i>	96
4.	<i>Australia</i>	97
5.	<i>India</i>	98
6.	<i>Hong Kong</i>	98
F.	<i>IRD Publications</i>	98
G.	<i>Other Sources</i>	98
H.	<i>Legislation</i>	99
I.	<i>Websites</i>	99

I. Attestation of Authorship

“I hereby declare that this submission is my own work and that, to the best of my knowledge and belief, it contains no material previously published or written by another person (except where explicitly defined in the acknowledgements), nor material which to a substantial extent has been submitted for the award of any other degree or diploma of a university or other institution of higher learning.”

.....

Gurdayal Singh

II. Acknowledgements

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III. Abstract

A casual investor who buys and sells shares¹ on the share market is generally of the view that the only tax they will have to pay is on dividends as they did not acquire shares with the purpose to resell. The investor may purchase shares in order to enjoy the income from them, albeit in the expectation that at some future time they will be sold at a profit if and when an opportune occasion presents itself. They are of the view that they should not be taxed on any gains made on shares traded. Investment companies regularly buy and sell shares with the intention of generating dividend income and preserving the capital of the company. They will claim that the dominant purpose of acquiring the shares was to generate dividend income and buying and selling of shares was the mechanism of achieving that purpose.

The realisation or switching of investments by banks and insurance companies are normally regarded as acts done in carrying on the banking or insurance business and any profits arising therefrom will be treated as income. However there are exceptions to this theory.

It is difficult to conceive of any case where shares are purchased, in which the purchaser does not have at least some intention of disposing of them if their value appreciates to the point where their sale appears to be financially desirable. The heart of the inquiry is whether or not the taxpayer has acquired the shares for the purposes of disposal. This paper will endeavour to highlight the difficulties faced by individuals and corporate entities in what the writer believes is a “murky” area when establishing whether gains made on share realisations are taxable. The Courts have emphasised that no general tests can be laid down. In the writer’s view, the legislation is vague and it is difficult to ascertain where one stands in terms of the law, which makes it difficult to apply in practice.

¹ Income Tax Act 2007, s YA 1 defines a share as any interest in the capital of a company.

IV. Introduction

There continues to be uncertainty as to whether gains made on the disposition of personal property² fall under capital gain or ordinary income (or loss, as the case may be). When shares are purchased, the intention to sell for a profit is almost invariably present if circumstances should arise that would make it financially more beneficial to sell the investment than to continue to hold it. Are the profits made on the sale of shares income or are they capital gain amounts? There is a considerable body of case law that qualifies and refines the basic rules, but the boundary between capital and revenue account remains blurred in some cases. As a result it is difficult to apply in practice.

Unlike most OECD³ countries, New Zealand does not tax capital gains on shares, unless the share investment was undertaken with the intention of realising capital gain income. Despite the fact that New Zealand does not have a capital gains tax, there are circumstances where gains made on share realisations can be taxed as income. Unfortunately it is a situation where the tax system could be accused of taxing gains in a somewhat *ad hoc* manner. The distinction between what is capital profit or income is more significant when it involves buying and selling shares. The guidelines provided on this matter are unclear which has added to the confusion.

It is common knowledge that a share is an interest in the capital of a company. The profits or loss made on the sale or other disposal of shares is on capital account and generally not assessable or deductible. In *Commissioner of Inland revenue v Inglis*⁴ Cooke P said: “Ordinarily, in the event of selling the shares, he or she will neither incur liability for tax on any profit nor be entitled to deduct any loss”.⁵

However there are exceptions to the general rule if the taxpayer’s activities fall under any of the three limbs, specifically where the gains are derived in the business of dealing in shares⁶; if the taxpayer acquired the property for the purpose of resale or

² Income Tax Act 2007, s CB 4.

An amount that a person derives from disposing of personal property is income of the person if they acquired the property for the purpose of disposing of it. Shares are personal property.

³ W. Steven Clark *Taxation of Capital Gains of Individuals: Policy Considerations and Approaches OECD Tax Policy Studies No. 14* (2006) ch 1 at 30.

⁴ *Commissioner of Inland Revenue v Inglis* (1992) 14 NZTC 9,180 (CA).

⁵ *Ibid*, at 9,182.

⁶ Income Tax Act 2007, s CB 5.

other disposition,⁷ and if the gains were derived from carrying out of any undertaking or scheme for the purpose of making a profit.⁸ In *Inglis*,⁹ the Court of Appeal held that losses incurred on the sale of shares are deductible if the taxpayer would have been taxed on any profit from the sale of those shares. Cooke P said: “This conclusion produces symmetry between taxability of gains and deductibility of losses”.¹⁰

The difficulty in distinguishing between profits which are of an income nature on one hand, and capital gains on the other tends to be more critical in cases where the assets in question are, for the most part, shares in listed companies. The general theory is that if you make an investment with the intention of holding on to for the long-term, the gains derived will not be taxable. In saying that, proving a taxpayer’s intention at the time of acquisition has been a difficult and costly exercise. The intention of the taxpayer at the time of disposal of shares is irrelevant.

The purpose of this paper is to gain a thorough understanding of the manner in which gains from share transactions are treated for taxation purposes in New Zealand. The outcomes will be compared to the Canadian, United Kingdom and Australian tax jurisdictions. The findings will explain the difficulties that the judgments have had and the uncertainty surrounding the law in this area. In particular, tax cases from the following three categories will be examined: Individual; Investment Companies, Banks and Insurance Companies.

A. Individual

An individual who invests in shares with a broker requests that their investment generate a certain level of dividend income while preserving the capital. Will the buying and selling of shares as a result of generating income for the individual constitute a business? If not, are any gains/losses in the value of shares taxable/deductible?

⁷ Income Tax Act 2007, s CB 4.

⁸ Income Tax Act 2007, s CB 3.

⁹ Income Tax Act 2007, s DA (1).

¹⁰ *Commissioner of Inland Revenue v Inglis*, above n 4, at 9,186.

This was the case in *Estate of King and Ors v Commissioner of Inland Revenue*¹¹ where it was held that ss CB 3, CB 4 and CB 5 were not applicable to the estate as the shares were acquired and sold for the purpose of generating dividend income. This outcome contrasts with the legal principles outlined in *Commissioner of Inland Revenue v National Distributors Limited*¹² where it was held that the gains were taxable, even though the Director in *National Distributors* was trying to preserve the capital of the company. The Courts have determined the outcome by establishing the purpose and motive of the taxpayer at the time the shares were acquired. However this approach has led to different outcomes as detailed above.

B. Investment Companies

In practice, it is difficult to determine when profits from investment companies will constitute business profits. The Courts have found that not all gains will be taxable as there is a distinction between investment holding and investment dealing companies. But how does one determine this? Establishing the collective purpose in the minds of those in control of those decisions is critical in establishing the purpose of the acquisition of shares. The Courts have taken the approach by differentiating between the taxpayer's 'motive' and 'purpose', (Marx, 1990).¹³ This approach was endorsed in two leading tax cases, *Rangatira Ltd v Commissioner of Inland Revenue*¹⁴ and *National Distributors*, resulting in different tax outcomes.

C. Banks & Insurance

Generally it has been found that gains made by banks and insurance companies from share realisations are taxable. Part of bank and insurance companies business involve the making and holding of investments in order to meet the claims of insured persons, or meet the withdrawals by depositors, thus the income from the investments are part of its overall trading receipts. This was confirmed in *Auckland Savings Bank v Commissioner of Inland Revenue*.¹⁵ However in *Commissioner of Inland Revenue v National Insurance*

¹¹ *Estate of King & Ors v Commissioner of Inland Revenue* (2008) 23 NZTC 21,729 (CA).

¹² *Commissioner of Inland Revenue v National Distributors Limited* (1989) 11 NZTC 6,346 (CA).

¹³ Richard Marx "Shares resold for a purpose" New Zealand Tax Planning Reports (1990) NZ Tax Planning Reports (online CCH) <<http://intelliconnect.wkasiapacific.com>>.

¹⁴ *Rangatira Ltd v Commissioner of Inland Revenue* [1997] 1 NZLR 129; (1996) 17 NZTC 12,727 (PC).

¹⁵ *Auckland Savings Bank v Commissioner of Inland Revenue* [1971] NZLR 569 (CA).

Company of New Zealand,¹⁶ it was found that the sale of the shares was the disposal of a capital asset and not part of the insurance company's trading business.

D. Methodology

The compilation of this research project has been primarily based on an in-depth analysis of the secondary data. After setting the introduction (Part IV) and legal history (Part V), Part VI looks at the cases from New Zealand.

Parts VII, VIII and IX looks at the Canadian, United Kingdom and Australian tax cases respectively.

Part X compares other investments; Part XI looks at recent developments in this area; Part XI discusses whether we need changes in the manner in which the legislation treats gains on share transactions, Part XIII summaries the findings and Part XIV covers bibliography.

V. History

The origin of the rules relating to the taxation of personal property transactions may be traced as far back as 1916. Section 85(c) of the Land and Income Tax Act 1916 (LITA) provided that the assessable income of any person included "profits or gains derived from the sale or disposition of land or interest therein, if the business of the taxpayer comprises dealing in such property, or if the property was acquired for the purposes of selling or otherwise disposing of it at a profit."¹⁷

The provisions only taxed profits derived from sale of real property, and not those derived from personal property.¹⁸ In 1951, the section was amended to include personal property. In addition, the amendments also provided the inclusion of profits or gains derived from undertakings or schemes entered into for the purpose of making a profit as

¹⁶ *Commissioner of Inland Revenue v National Insurance Company of New Zealand* (1999) 19 NZTC 15,135 (CA).

¹⁷ CCH *New Zealand Tax Law and Practice* (online looseleaf ed, CCH) <<http://intelliconnect.wkasiapacific.com>> at [80-010].

¹⁸ Personal property comprises all forms of property, moveable or immovable, tangible or intangible, other than real property (e.g. land). The most common type of personal property is shares.

an additional basis for taxation. These were later consolidated into s 88(c) of the LITA 1954.

The rules governing the taxation of personal property transactions remained intact as the subject of s 88(c) of the 1954 Act. These were later consolidated into section 65(2) of the Income Tax Act (ITA) 1976, and then into section BB 4(c) of the ITA 1994. The Taxation (Core Provisions) Act 1996 relocated a revised version of section BB 4(c) into CD 4 of the ITA 1994 with almost identical wording, whereas the earlier provisions had referred to “profits or gains derived”, section CD 4 referred to “amount derived”.

Section CD 4 was later re-enacted under the ITA 2004 as ss CB 2-CB 4. These sections were then carried through to the ITA 2007 as ss CB 2-CB 5 with identical wording.

In particular, the paper discusses the interpretation of sections CB 4 and CB 5. The key words (in italics) of each of the sections are discussed below.

A. Section CB 3

An amount that a person derives from carrying on or carrying out an *undertaking or scheme* entered into or devised for the purpose of making a profit is *income* of the person.

Whether an undertaking or scheme exists is a question of fact. The words “*undertaking*” and “*scheme*” are not defined in the Act. In *Lowe*,¹⁹ Richardson J, at p 61,018 defined the words “scheme or undertaking” as follows:

... 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.

Case law over the years has set down some basic rules in determining whether a receipt is “*income*” in its ordinary sense. Income is something which comes in.²⁰ In *Reid*,²¹ Richardson J considered that there were two factors to take into account when

¹⁹ *Lowe v Commissioner of Inland Revenue* (1981) 5 NZTC 61,006 (CA).

²⁰ *Tennant v Smith* [1892] AC 150 (HL).

²¹ *Reid v Commissioner of Inland Revenue* (1985) 7 NZTC 5,176 (CA).

determining whether a particular receipt is income, namely the regularity or recurrence of the receipt, and the quality of the receipt in the hands of the payee.

B. Section CB 4

An amount that a person derives from disposing of personal property is income of the person if they *acquired* the property for the *purpose* of disposing of it.

A person's purpose is to be determined at the date of the acquisition. If the person "*acquired*" the property for the purpose of disposing it, section CB 4 will be applicable. If there is more than one purpose, the disposition must be the dominant purpose for the section to apply. There is no requirement for the person to be in business or to make a profit. In *National Distributors Richardson J* stated:²²

It is well settled that the test of purpose is subjective requiring consideration of the state of mind of the purchaser as at the time of the acquisition of the property.

In considering the taxpayer's dominant purpose, Richardson J noted:²³

Where subjective purposes are in issue the statements of the taxpayer, or of someone who can speak for the taxpayer, are obviously important evidence. But for obvious reasons they must be assessed and tested in the totality of the circumstances which will include the nature of the asset, the vocation of the taxpayer, the circumstance of the purchase, the number of similar transactions, the length of time the property was held and the circumstances of the use and disposal of the asset. Action may speak louder than words and the totality of circumstance may negate the asserted purpose of the purchase.

The New Zealand Courts have long held the view that there is a distinction between purpose and intention. In *Plimmer*,²⁴ the taxpayer sought to acquire control of a company by purchasing all of the company's issued ordinary shares. A condition of the purchase required the taxpayer to purchase all of the preference shares in the company as well. The preference shares (unwanted by the taxpayer) was bought and sold, and the taxpayer made a profit from the sale. The Commissioner assessed the taxpayer on the profit.

²² *Commissioner of Inland Revenue v National Distributors Limited*, above n 12, at 6,350.

²³ *Ibid*, at 6,351.

²⁴ *Plimmer v Commissioner of Inland Revenue* [1957] NZLR 147 (SC).

The Court held that the profit was not assessable as no purpose of sale existed. Barrowclough CJ considered that the purpose of obtaining the preference shares needed to be established. His Honour described what is meant by “purpose”:²⁵

A man’s purpose is usually, and more naturally, understood as the object which he has in view or mind. One can scarcely have a purpose of selling without having also an intention of selling, but, in ordinary language, purpose connotes something added to intention and the two words are not ordinarily regarded as synonymous. Though purpose may sometimes mean intention, the Court should hesitate to adopt that more restricted meaning unless the statute clearly evidences such an intention.

Essentially, the preference shares were not the object the taxpayer had in mind when the shares were acquired. The intention was to sell the shares, but the purpose of acquiring the shares was to control the company. Thus intention in this context relates to the taxpayer’s short term plan, while purpose related to a longer term plan, which is what the taxpayer wanted to achieve right from the very beginning.

C. Section CB 5

An amount a person derives from disposing of personal property is income of the person if their *business* is to *deal* in property of that kind.

In the leading case on what is meant by the term “business”²⁶, *Grieve v Commissioner of Inland Revenue*,²⁷ Richardson J concluded that the decision as to whether or not a taxpayer is in business involves a two-fold inquiry:

- a) The nature of the activities carried on; it must amount to a profession, trade, manufacture or undertaking, in other words, an organised and coherent activity, which is directed to an end result; and
- b) The intention of the taxpayer in engaging in those activities – the intention must be that it is carried on for pecuniary profit.

²⁵ *Ibid*, at 151.

²⁶ Income Tax Act 2007, s YA (1) Business - (a) includes any profession, trade, or undertaking carried on for profit ...

²⁷ *Grieve v Commissioner of Inland Revenue* (1984) 6 NZTC 61,682 (CA).

The stated intention is an objective test and can be determined by considering the intentions of the taxpayer, the period over which they are engaged in, the scale of the operations, the volume of transactions, the commitment of time, money and effort, the pattern of activity and the financial results.

The term “dealer” was described by Woodhouse J in *Raine v Police*:²⁸

... is one who buys or sells some form of merchandise, or who trades in some commodity, and to carry on as a dealer suggest the organisation of some dealing activity into a course of conduct, even if only for a short period in terms of time. The purpose for which the business is conducted will arise, not so much from individual transactions, but from the overall operations.

D. Capital or Revenue Account

Once you have established that a business is in existence, the profit from sale of shares will be gross income and therefore assessable pursuant to s CB 1.²⁹

The principles expressed in *Californian Copper Syndicate Ltd (Limited and Reduced) v Harris (Surveyor of Taxes)*³⁰ have been applied time and time again in considering the taxability of gains on the realisation of investments. The company bought land with mineral rights in 1901 and split the land in to two lots and sold them in 1902 and 1903 in exchange for shares. The company argued that the transactions were investments and not trading because the share exchange in lieu of cash showed an intention to invest.

It was found that the property purchased by the company was acquired with the object of being resold and that by the purchase and resale of their property, the company carried on a business. Lord Justice Clerk held that:³¹

... 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. The simplest case is that of a person or association of persons buying and selling lands or securities speculatively in order to make gain, dealing in such investments as business, and thereby seeking to make a profit. There are many companies which in their very

²⁸ *Raine v Police* [1963] NZLR 702.

²⁹ Income Tax 2007, s CB 1 Amounts Derived From Business

CB 1(1) INCOME - An amount that a person derives from a business is income of the person.

³⁰ *Californian Copper Syndicate (Limited and Reduced) v Harris (Surveyor of Taxes)* (1904) 5 TC 159.

³¹ *Ibid*, at 165-166.

inception are formed for such a purpose, and in these cases it is not doubtful that, where they make a gain by a realisation, the gain they make is liable to be assessed for Income Tax.

What is the line which separates the two classes of cases may be difficult to define, and each case must be considered according to its facts; the question to be determined being – Is the sum of gain that has been made a mere enhancement of value by realising a security, or is it a gain made in an operation of business in carrying out a scheme for profit-making?

The above quotation has stood the test of time, having been repeatedly cited with approval in numerous cases.

There will be instances where a person will enter into transactions totally different to its core business activity. Often, such transactions may have tax implications. One must therefore assess whether the transaction is an ordinary part of the business of the person or an ordinary incident of the business of the person. If the answer to the above is no, then it is unlikely that the person is carrying on a business.

VI. New Zealand Cases

A. Individual

Traditionally, the purchase and sale of shares on the sharemarket is usually considered an affair of capital and any gains or losses are treated as capital. The distinction between capital item (that generates dividend) and income item is largely factual, as a result of which the cases cannot be easily reconciled. The burden of proof lies with the taxpayer and they have a bigger hurdle to overcome to substantiate their position. This was the case in *Estate of King & Ors*,³² where it was held that the gains made on numerous share transactions were not assessable.

1. Estate of King & Ors

i). Facts and Judgments

³² *Estate of King & Ors v Commissioner of Inland Revenue*, above n 11.

The taxpayers³³ engaged the services of a stockbroker to manage their offshore investments. The stockbroker was instructed to achieve a return of £600 per month for each family member under their individual share portfolios. In the 20 month period between 1989 and 1990, the total number of transactions bought and sold across the three portfolios was 131. The sharebroker admitted that in some instances, shares were held for only a matter of days, and on three occasions only overnight. He explained that some of the shares were sold for various reasons, for example to avoid the perceived risk of the new management or it was an unsuitable investment for the portfolios. It was not disputed that the portfolios were actively managed with the sole focus of preserving the capital.

The Court of Appeal agreed that the matter was finely balanced. On one hand, there was a reasonably high volume of transactions carried out on a regular basis. The share portfolios were actively managed which involved buying and selling shares in a systematic manner. On the other hand, the taxpayer provided explanations as to why the majority of the shares were sold. Taking this into account, the Court held that the taxpayer's activity did not amount to a business of dealing in shares.³⁴

... The nature of the activity was investment. The scale and nature of the activity across the portfolios was not such as to meet the test for business when the transactions are analysed taking into account Mr Cloake's [stockbroker] explanation for them. It cannot be said that the taxpayer's intention was to conduct a business.

The Court concluded that there was nothing about this case which suggested a business activity rather it fell squarely within the dicta of Lord Justice Hansen in *Californian Copper Syndicate*. The stockbroker was engaged throughout in "merely a realisation or change of investment" necessary to preserve the capital base of the funds in order to produce the required dividend income.

³³ The taxpayers, Mr King (husband, now deceased and represented by his estate), his wife (Mrs King) and daughter (Ms King's); in 1984 the investments were placed in a controlled foreign company (CFC), AMCE Jersey registered in Jersey. Prior to 1 April 1988, the taxpayer's were not required to pay income tax in New Zealand on either capital or income gains from the sale of their investments. The CFC regime was introduced in 1988 which in effect required any income arising from CFCs to be attributed to the taxpayers in New Zealand.

³⁴ *Ibid*, at 21,743.

However in the High Court,³⁵ John Hansen J held that the taxpayers were dealing in shares. His Honour based his decision on a combination of factors, namely the number and frequency of transactions; the stockbroker as the taxpayer's agent was in the business of buying and selling shares on behalf of the taxpayers; some shares were held for only a matter of days; the time and effort expended by the stockbroker on a daily basis as well as the significant profits made over the period. These characteristics were synonymous with a person carrying on a business of dealing in shares.

The length of time the shares were held was one of the fundamental factors Justice Jansen relied on in determining that the taxpayer's conduct amounted to business. His Honour referred to the comments made by Richardson J:³⁶

Ordinarily, too, the length of time the shares are held before being sold is regarded as of particular importance. If shares are held for a matter of months only, then in the absence of special reasons occasioning an earlier than contemplated sale, it is difficult to escape the conclusion that they were purchased with a view to the gain likely to arise on resale rather than with a view to reliance on the dividend income. If they are held for a period of years during which time the market has moved upwards and downwards, that is a factor tending to displace the proposition that the shares were acquired for the purpose of sale.

The taxpayer stated that it never intended to trade in shares and the only purpose was to preserve the capital of the portfolios. In concluding that the stockbroker was in the business of share dealing, his Honour referred to *Piers*³⁷ where Temm J observed:³⁸

While evidence of the taxpayer's intention as to financial transactions is admissible and relevant when deciding whether share dealings are covered by the first limb of s 65(2)(e)³⁹, that is not decisive because the issue has to be decided objectively and not subjectively. No doubt the trustees, as they said, did not wish to trade in shares, and no doubt also their intentions throughout were to meet their obligations to act prudently, and to protect the fund from erosion. But Westpac's many share transactions made on the trustee's behalf lead me to the conclusion that the fund was dealing in shares within the meaning of s 65(2)(e) during the three years in question.

³⁵ *King & Ors v Commissioner of Inland Revenue* (2006) 22 NZTC 19,691(HC).

³⁶ *Commissioner of Inland Revenue v National Distributors Ltd*, above n 12, at 6,352.

³⁷ *Piers v Commissioner of Inland Revenue* (1985) 17 NZTC 12,283 (HC).

³⁸ *Ibid*, at 12,293.

³⁹ Income Tax Act 2007, s CB 5.

Justice Hansen was also of the view that the sale of the shares was income under the second limb of s 65(2)(e)⁴⁰ as the shares were acquired by the taxpayer's agent for the purpose of disposing them for a profit.

In respect of the second limb, the Court of Appeal rejected the High Court's decision and agreed with the findings of the TRA.⁴¹ Willy DCJ held that whether the property was acquired for the purpose of sale was a subjective test requiring consideration of the state of mind of the stockbroker at the time the shares were acquired.⁴² It was found that the stockbroker's subjective intent was to preserve the taxpayer's capital in such a way as to produce the required dividend income and the shares were held for their potential income yield.

Willy DCJ also stated that in order to tax gains under the second limb, it is not acceptable to treat the buying and selling globally. The test is to consider each investment on an individual basis as within the totality of the sales and purchases, some shares may be bought for the purposes of resale and some not. It is only those in the former categories which are subject to tax or give rise to deductible losses. It was concluded that the stockbroker did not intend to speculate in shares by purchasing them for the purpose of resale. Consequently the taxpayer had discharged the burden of proof:⁴³

In those circumstances the Court is left with the evidence of Mr Cloake [stockbroker] contained in the case stated, his written briefs and cross examination. He has exhaustively analysed each transaction in the light of the prevailing sharemarket conditions. He explains the reason which motivated each transaction, and, with the possible exception of the Charter Hall purchase, nowhere does one find any evidence of acquisition for the purpose of resale at a profit. Rather there are, as one would expect given the terms of his instructions, a wide number of disparate reasons for each transaction, all of which come under the general umbrella of prudent capital protection for the primary purpose of "potential income yield."

ii) Analysis

⁴⁰ Income Tax Act 2007, s CB 4.

⁴¹ *Case W 44* [2004] 21 NZTC 11,405 (TRA).

⁴² *Ibid*, at 11,418.

⁴³ *Ibid*, at 11,419.

The difficulty the writer has with the Court of Appeal's decision is that the stockbroker admitted that some of the shares were bought and sold within a very short timeframe for a profit, yet it was found that the gains were not assessable income. It is not disputed that the second limb requires one to establish the dominant purpose in acquiring each individual investment; accordingly on this finding the taxpayer surely should not have escaped the tax liability on the gains. For example, the reasons for selling some of the shares were due to - "before drop in price"; or "or bought with the intention to sell", these actions are synonymous with a share trader.

It appears that the Court of Appeal has approved that some level of buying shares with the purpose to resell within a larger portfolio of shares is acceptable and any gains made will not be taxable. If the intention of the stockbroker was for dividend yield, then one would expect that the shares (or at least a majority of the shares) would be retained for a longer period of time.

The manner in which the Court analysed the words "purpose" and "motive" was unclear. The Court appears to have confused the purpose of resale with the motive of preserving the capital. *Holden*⁴⁴ brings out the importance of drawing appropriate distinctions between motives and intentions and purposes which is material to this case. In *Holden*, the taxpayer argued that the purpose was only incidental to the wider and more essential purpose which was to remit the funds to New Zealand. In rejecting the argument, Lord Wilberforce for the Judicial Committee did not need to explore the shades of difference between motive and purpose. His Honour simply said:⁴⁵

There can be only one answer to the question for what purpose the securities were bought and sold, and the fact that the purchase and sale were part of a wider objective cannot affect that answer.

In short, if resale is proposed it matters not that it is only the means to an end.⁴⁶ As Campbell Pentney⁴⁷ said:

⁴⁴ *Holden v Commissioner of Inland Revenue; Menneer v Commissioner of Inland Revenue* (1974) 1 NZTC 61,138 (CA).

⁴⁵ *Ibid*, at 61,147.

⁴⁶ *Commissioner of Inland Revenue v National Distributors Ltd*, above n 12, at 6,350.

⁴⁷ Campbell Pentney "Share Trading Revisited: The *King* Case and Tax Implications for Share Trading" Thomson Brokers Taxation Today (July 2008) 19 at 22.

In *CIR v National Distributors Ltd* the Court warned against confusing motive with purpose. While the taxpayer's motive in that was to protect its savings from inflation, its purpose relating to that motive was to sell the shares. As the Court was concerned with purpose rather than motive the taxpayer's share sales were subject to tax. One could equally argue that while Mr Cloake's motive was to maintain a certain yield from the investments, to effect this it would be necessary to sell shares, and that was his purpose.

This was a borderline case and the decision could have gone either way, which the Court of Appeal acknowledged. The key point here was that the Court had established that the shares were not initially acquired for the purpose of resale. In respect of some of the shares, this finding is questionable.

B. Investment Companies

The fundamental issue with investment companies is whether the buying and selling of shares amounts to business, an issue that has been considered in a number of cases. What emerges most clearly from these cases is that the character of the transaction is not always easy to determine. Each case must depend very much upon its own facts.

For example, an investment company will proclaim that when the dividend yield is low, the practice is to sell the shares when they had reached their peak price. They may claim that the action is carried out as a hedge against inflation which, quite rightly, is a prudent course to follow. However that does not necessarily indicate that the taxpayer is carrying on a business of dealing in shares. The issue is whether the gains from share realisations are ordinarily income, and therefore taxable (or loss, as the case may be), or is treated as capital gain.

1. National Distributors

i). Facts and Judgments

One of the leading cases dealing with this issue is *Commissioner of Inland Revenue v National Distributors Ltd*⁴⁸ where the company carried on a business of dealing in real property. The managing director of the company decided that the company's excess fund should be invested in the share market to make capital gains from share accretion. Occasionally the director reviewed the company's shareholding and made the decision regarding the buying and selling of shares.

⁴⁸ *Commissioner of Inland Revenue v National Distributors Limited*, above n 12.

From 1978 to 1981, the company made 24 purchases and 14 sales resulting in a net gain of some \$40,000. On average, the shares were held for a little over 19 months. There were various circumstances which triggered the buying and selling of shares, for example some of the shares were sold to obtain funds for family members.

The High Court⁴⁹ found that the purpose in acquiring the shares was not for resale but for management of a portfolio in such a way as to keep pace with inflation. Quilliam J saw no reason to discredit the evidence of the director and held that the shares were regarded as long-term investments. His Honour further commented that any private investor in shares is likely to follow the movements of the Stock Exchange and will sell at a favourable time, which will involve changing their portfolio but this does not indicate that the shares were purchased with the purpose of sale. In respect of business of dealing in shares, his Honour observed:⁵⁰

Upon consideration of all the evidence I am satisfied that the company has shown that the share transactions were carried out in a somewhat haphazard manner and, while there were some capital profits, there is nothing to suggest that this was because this was truly the carrying on or carrying out of a business. I think it was no more than rather intermittent attention given to the need to avoid shareholdings falling out of line with inflationary trends and that the unsystematic way this was done is an indication of the fact that Mr Sutherland [Managing Director] regarded these transactions as incidental to the main purpose of the company.

His Honour distinguished the case from *London Australia*⁵¹ on the basis that the company here was not regularly reviewing its holdings to produce the required level of dividend income. There was no coherent pattern in these transactions that indicated that there was a systematic policy of sale and purchase. Furthermore, the value of the share portfolio was small and insignificant in comparison with the total assets of the group of which the company was part of. His Honour placed greater emphasis on the evidence given to the effect that there were no regular periods of sales or purchases and some sales and purchases were linked to the personal requirements of the company shareholders.

⁴⁹ *Commissioner of Inland Revenue v National Distributors Limited* (1987) 9 NZTC 6,135 (HC).

⁵⁰ *Ibid*, at 6,141.

⁵¹ *London Australia Investment Company Limited v Federal Commissioner of Taxation* (1977) ATC 4,398 High Court (FCAFC).

The Court of Appeal, by a majority overturned the decision of the High Court on the basis that the taxpayer's dominant purpose of acquiring the shares was to sell them in the future at a price which, allowing for inflation, corresponded with or was better than its price at the time of the purchase. Except for two parcels of shares, the remaining six were found to satisfy the statutory requirement which was to sell the property, even though the motive was to protect savings from inflation. In respect of whether the taxpayer was carrying on a business, it was held that the level of activity and the lack of systematic consideration of shareholdings did not amount to a business of investing or dealing in shares.

Therefore where the purchase of shares is only capable of producing a profit when resold (rather than the production of, say dividend income) it would seem that this was the purpose for which it was bought. Richardson J concluded that the taxpayer had failed to discharge the burden of proof⁵² that the shares were not acquired for the dominant purpose of selling them. His Honour further commented that the company's shareholdings were held for only a short period of time and was sold when they had reached their peak prices, which indicates that the focus was on achieving the maximum market price as opposed to widening the dividend potential. In respect of the application of the second limb, His Honour commented:⁵³

The mere fact that at the time of purchase of the property the taxpayer did not expect to hold the property for ever and contemplated the possibility of sale does not attract the application of the second limb...the dominant purpose of the purchaser must have been the resale of the property...If the investment policy is to provide and enlarge the dividend income and to buy (and sell) with that as the dominant consideration, there can be no basis for invoking the second limb.

While the director's purpose was to obtain a dividend return, nonetheless, his dominant purpose was to sell the shares for a profit when the shares had reached their potential. At the time the shares were purchased, it was evident that the company did not have a dividend policy to maximise its dividend return (as this would indicate that the shares were purchased as long-term investments), there was no system of regular share reviews, thus pointing to the fact that the purpose was to sell the shares when the price was right.

⁵² Tax Administration Act 1994, s 149A.

⁵³ *Commissioner of Inland Revenue v National Distributors Limited*, above n 12, at 6,351.

Richardson J illustrated the importance of the distinction between “motives”, “purpose” and “intention”. His Honour referred to the *Hunter* and *Holden* cases where the purpose of the purchase of the stock was for sale. This was to be distinguished from a wider motive to remit funds to New Zealand. His Honour said:⁵⁴

...Both [referring to *Hunter* and *Holden*] concerned with the assessability in circumstances where government stock had been purchased in England for sterling and immediately sold in New Zealand for dollars, rather than transmitting the funds to New Zealand through the banking channels. In *Hunter* at p 125 Turner J observed that the motive which inspired the transactions was no doubt that they provided an advantageous method of remitting funds from England to New Zealand, but that in acquiring the stock the taxpayer had done so for the purpose of selling it again.

His Honour also mentioned that assets such as shares can scarcely be regarded as intended for private use or enjoyment and that:⁵⁵

... a person buying such an asset does so with a view to investment for the income it will return, or with a view to realising a profit on disposal sooner or later and while logically these “purposes” of retention or resale are not mutually exclusive, it will generally be possible to say that one or the other is predominant at the time when the purchase is made.

ii). Analysis

It is interesting to note the comments of Doogue J who dissented from the reasoning of Richardson J. His Honour was of the view that notwithstanding the limited period of time the shares were held, the company had not acquired any of the shares for the purposes of resale. The dominant purpose of purchasing the shares was to generate income in order to avoid the loss in the company’s purchasing power, i.e. to hedge against inflation and not for the purposes of profit or gain. This statement suggests a view that an asset should only be treated as being acquired for the purpose of disposal where it is purchased with a view to profit, rather than some other reason which may also result in disposal.

It was not disputed that the taxpayer never deviated from its initial purpose of buying shares for long-term gain, yet it was found that the dominant purpose of acquiring the shares was to resell for a profit. The Court held that determining the dominant purpose could become complicated if different purposes were seen to be more significant depending on what the focus is on, such as short term, medium term or the ultimate object. According to the

⁵⁴ Ibid, at 6,350.

⁵⁵ Ibid, at 6,351.

judgment, the focus should be on what was truly important to the taxpayer at the time of purchase.

To say that the shares were very attractive long-term investments describes the taxpayer's motive, but it does not answer the statutory question posed by the second limb, namely, were they purchased for the purpose of resale? The view taken by the Court of Appeal was that where a taxpayer's dominant purpose in acquiring property is to sell it in the future, the underlying motive is irrelevant. This is consistent with the decision reached by the Privy Council in *Holden and Hunter*. Furthermore, keeping pace with inflation does not immune the taxpayer from being taxed on the gains as profit is the difference between dollars expended and dollars received,⁵⁶ inflation is not taken into account.

This case has also confirmed that where shares are purchased and sold due to exceptional circumstances, the gains derived from the sale will not be taxable. For example the IBM shares were purchased for family reasons and Richardson J considered that these shares were in a 'special situation' and the profits were not income. In this respect, it appears that the best defence for taxpayers to escape tax is to show that at the time they acquired the shares, they had numerous purposes of profiting from the purchase which was to be achieved in some unformulated or vague manner. As long as they can demonstrate that these purposes can be achieved without the sale of the shares being shown to be the dominant purpose.

The lack of systematic professional monitoring will generally indicate that the shares were purchased as long term investment unless the monitoring is carried out for maximising income, as was the case here. Furthermore, consideration of dividend potential is important as transactions directed towards achieving a certain level of dividend would indicate that profit on sale was incidental.

2. *Rangatira*

i). *Facts and Judgments*

Then again it has been found in a number of cases that an investment company can hold shares on capital account. One of the leading cases dealing with this issue is *Commissioner*

⁵⁶ *Lowe v Commissioner of Inland Revenue*, above n 19, at 61,017.

of *Inland Revenue v Rangatira*,⁵⁷ an unlisted public investment company owned predominantly by charities. The company was established in 1937 and had invested in shares on a long term basis. From time to time there were changes in investments but at least until 1983 the Commissioner had not suggested that any gains from the sale of the company's equity investments were taxable.

However, between 1983 and 1990, the company made substantial gains resulting from the sale of approximately 41 share transactions. It was noted that during the 1980s, the company was involved in a large number of sales and the length of time that particular investments were held had decreased by comparison with the general pattern which appeared from the earlier activities. The Commissioner assessed the company on the gains on the basis that the company was carrying on a business of dealing in shares or that the shares were bought with the purpose of selling them for a profit.

Gallen J⁵⁸ found that the company was not carrying on the business of buying and selling, or dealing in shares, and as a result the profits were not taxable as the company was not carrying on a business of dealing in shares. His Honour relied on the director's evidence that provided detailed explanation of the circumstances which led to the sale of the shares. It was found that the gains made on these transactions were used by the company to purchase shares in another company, commonly known as "switching" of investments. This indicated that the company never intended to deal in shares or bought the shares with the purpose of selling for a profit. Gallen J considered that *Rangatira's* situation could be distinguished from that in *London Australia* as *Rangatira* was not buying and selling shares pursuant to a fixed policy designed to achieve a specific outcome.

However, his Honour considered that only three groups of share transactions were taxable under the second limb of section 65(2)(e) as the company had clearly departed from the practices which it had developed over the earlier years. For example, the company purchased 200,000 shares in Industrial Equity Pacific Limited (IEL) and the discussions from the board meetings revealed that the company had two purposes in respect of the purchase; firstly to maintain the position of IEL and the other to sell sufficient shares to

⁵⁷ *Rangatira Ltd v Commissioner of Inland Revenue*, above n 14.

⁵⁸ *Rangatira Ltd v Commissioner of Inland Revenue* (1994) 16 NZTC 11,197 (HC).

provide the equivalent return. This indicated that at the time the shares were acquired, the company intended to sell 50% of its shareholding. This was not disputed by the company.

The Commissioner appealed to the Court of Appeal⁵⁹ where it was held that, at least from April 1985, the company was selling shares as part of its ordinary business and the profits and losses from this activity were to be included in the company's assessable income. McKay J held that the company was seeking to enhance its position by making the gains from the sale of shares and stated:⁶⁰

... looking at the totality of the facts of the present case, ... at least from April 1985 *Rangatira* was selling shares as part of its ordinary business, or as an ordinary incident of its business. The sales were not merely a realisation or change of investment, but were done in what is truly the carrying on of a business.

The company operated a wholly owned subsidiary as a vehicle for dealing in short term share transactions and its activities were taxed accordingly. However in this regard, the Court of Appeal found that these transactions had tainted all other share transactions:⁶¹

The sales of shares in the Brierley group to supplement income, and the TKM transactions, were held to be income within the second limb of s 65(2)(e). We think they would also fall within s 65(2)(a) as being "acts done in what is truly the carrying on of a business", and as "part of the ordinary business of the taxpayer.

They were not identified as part of some separate and distinct business. They inevitably colour the other transactions, such as sales to fund the purchase of other shares, and the sales made to fund the major acquisitions in respect of the James Cook Hotel and the investments in Government Stock.

As a prudent investor, *Rangatira* clearly reviewed its portfolio of investments and from time to time changed them. When one looks at the totality of the transactions, it is difficult to resist the inference that in selling shares the company was seeking to enhance its position, not merely by achieving a balance portfolio of income producing investments, but also by making the gains from the sales themselves.

ii). Analysis

It was expected that The Privy Council would at last provide a definite ruling in this contentious area of law, namely when profits from share realisations are taxable. There were a number of transactions bought and sold by the company over the years, yet the Privy Council agreed that the company was not in the business of dealing in shares.

⁵⁹ *Rangatira Ltd v Commissioner of Inland Revenue* (1995) 17 NZTC 12,182 (CA).

⁶⁰ *Ibid*, at 12,191.

⁶¹ *Ibid*, at 12,190 - 12,191.

The basis for The Privy Council reversing the Court of Appeal decision was on a relatively narrow procedural issue. Smith⁶² states that two major points came from the decision. First, that certain groups of shares were liable for tax, but overall the company had not changed its business emphasis. Second, The Privy Council found that the Court of Appeal should not have overturned the High Court decision unless that fact was found to be wrong, which it had not been. For example, the sale of IEL related shares were exceptional and by no means reflected a change in the company's investment policy, or in the nature of its business as a whole.

Many of the company's investments were sold because of a change in economic conditions, and some parcels of shares were sold to purchase another long term capital asset, similar to the change of investment referred to in *Californian Copper Syndicate*. The Privy Council saw no reason to question the findings of Gallen J in respect of the credibility and reliability of the witness, Mr Steele, the director of the company. Nevertheless, The Privy Council reflected that the High Court decision could have gone either way, however, that was not a reason why it could be held to be wrong. In this regard, Lord Nolan commented that:⁶³

The question whether a particular business consists of or includes the buying and selling of shares for profit is indeed as much as a businessman's as a lawyer's question. The answer depends entirely upon the evidence as to the nature of the business activity.

The Privy Council's decision does provide some useful guidance. For example, the Privy Council rejected the Commissioner's argument that the making of profits through the selling of shares formed an incidental part of the business of the company, and therefore all such profits should be regarded as taxable. The Privy Council said that this would abolish the well-established distinction between investment holding and investment dealing companies.

The Privy Council suggested that the Commissioner may have been more successful if it had argued that all the share sales, including those before 1983, were part of a business activity. This way, the whole investment portfolio of the company would become appropriated to the business of dealing and thus move from a capital account to

⁶² Nigel Smith "The Rangatira Decision" Chartered Accountants Journal of New Zealand (February 1997) 35 at 36.

⁶³ *Rangatira Ltd v Commissioner of Inland Revenue*, above n 14, at 12,735.

an income account at that time. Their Lordships considered that the Commissioner had assessed on an incorrect basis. Quite clearly, this particular statement, if anything, poses more questions than answers when it comes to establishing the tax treatment as to whether the gains from share dealings are taxable.

In the writer's opinion, the most important aspect of the judgment was that The Privy Council accepted the notion that assets which are held on capital account can be transferred to be held on revenue account (and vice versa) without tainting other capital assets. The taxpayer's business activity would not change from an investment business to a dealing business as contended by the Commissioner. It allows taxpayers to buy and sell shares without the gains being taxed as long as they provide detailed explanation of the circumstances which led to the selling of the shares.

Furthermore if the buying and selling of shares is secondary to another activity, such as investing in shares for a long-term, then the taxpayer's will most likely escape the tax liability on any gains derived from the realisation. In these circumstances the assets would transfer from one account to another at their market value on the date of appropriation.

These cases have underlined the difficulty of distinguishing between profits which are income on one hand and capital gain on the other, particularly where the assets in question are, for the most part, shares in listed companies. In this respect Smaill⁶⁴ said:

... it is difficult to determine the dividing line between merely investing in shares and carrying on a business of dealing in shares. This will always be primarily a question of fact. In the absence of clear evidence that there was an intention at the time of acquisition to dispose of particular shares at a particular time or on the basis of defined and systematic criteria, it will prove difficult for the Commissioner to establish that sporadic share investment activities give rise to assessable income. In other words, it is wise to be, and to be seen to be, haphazard.

C. Banks

As always, each case brings up the never-ending discussion as to what is meant by capital and what is meant by income. It is well established in *Punjab Co-op Bank Ltd v*

⁶⁴ Graeme Smaill "Assessability of Share Profits Examined" (1987) NZ Tax Planning Reports (online CCH) <<http://intelliconnect.wkasiapacific.com>>.

*The Commissioner of Income Tax*⁶⁵ that any profit or gain realised on a change in the investment portfolio of a bank was part of its ordinary business profits. The Bank realised a number of Indian Government securities which it held so that it could pay the claims. The Bank contended that it had treated the investments in shares and securities as a reserve for emergencies, and had resorted to their sale because it had to meet heavy withdrawals. As noted by Viscount Maugham:⁶⁶

If, as in the present case, some of the securities of the bank are realised in order to meet withdrawals by depositors, it seems to their Lordships to be quite clear that this is a normal step in carrying on the banking business, or, in other words, that it is an act done in what is truly carrying on of the banking business.

1. *Auckland Savings Bank and AA Finance Limited*

i). *Facts and Judgments*

This principle was held to apply in New Zealand by the Court of Appeal in *Commissioner of Inland Revenue v Auckland Savings Bank*,⁶⁷ where the bank was required to bring to revenue account any gains derived from the realisation of securities to meet the withdrawal requirements of its customers. The bank derived profits on realisation at maturity of investments in Government stock in local body debentures. North P said:⁶⁸

... it is a well settled principle in dealing with questions 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 a profit assessable to income tax. But on the other hand it is equally well established that enhanced values obtained from realisation or conversion of securities may be so assessable when 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 ...

In their judgments, Turner and Richmond JJ both agreed that the bank was assessable on the profits on the basis of the principle enunciated in *Californian Copper*. It is worth mentioning the comments made by Richmond J as to why the profits from the sale of shares were taxable:⁶⁹

⁶⁵ *Punjab Co-Operative Bank Ltd, Amritsar v Income Tax Commissioner, Lahore* (1940) AC 1055 (PC).

⁶⁶ *Ibid*, at [23].

⁶⁷ *Commissioner of Inland Revenue v Auckland Savings Bank*, above n 15.

⁶⁸ *Ibid*, at 573.

⁶⁹ *Ibid*, at 585.

In any event it seemed to me that the reserve fund is required for the ultimate protection of the depositors and that it would be impossible to say that the investment of depositor's funds is part of the business of banks whereas the investment of its accumulated profits is not.

*AA Finance Limited v C of IR*⁷⁰ concerns the tax liability on the sale of Government stock which the company was required to hold in terms of regulation and trustee requirements. The company was set-up to serve the needs of members of the Automobile Association, mainly lending on motor vehicles. Although a finance company, the principles articulated in the banking and insurance cases is similarly applicable in this case as the company's activity involves borrowing and advancing funds.

The company was required to meet the ratio requirements of the Investment Regulations involving the compulsory acquisition and holding of Government stock. Its Government stock fell below the purchase price which had affected its overall borrowing ability and possible breach of ratio requirements. As a result, the company disposed of the stock.

From 1984 to 1990, the company made 173 realisations of stock of which 166 were in the 1984 to 1987 period. There were 50 realisations on maturity, 51 by selling stock once the restrictions were lifted in February 1985, and the remaining 65 holdings were disposed of due to the need to keep within the borrowing ratios under the company's trust deed. The sales of the Government stock were dealt with by the company and reported to its shareholders and to investing public in prospectuses as realised gains on Government stock.

Both the High Court⁷¹ and the Court of Appeal found that the gains on realisation of Government stock were assessable income as part of the ordinary business of the taxpayer, or as an ordinary incident of the business activity of the taxpayer. The Government stock transactions were of the same nature as the rest of the company's business of profit making. The purchase of the Government stock was intimately linked to the company's business activity of borrowing and lending money that it could not be regarded as separate from or merely incidental to its business. In this respect, Richardson J stated:⁷²

⁷⁰ *AA Finance Limited v Commissioner of Inland Revenue* (1994) 16 NZTC 11,383 (CA).

⁷¹ *AA Finance Limited v Commissioner of Inland Revenue* (1993) 15 NZTC 10,171 (HC).

⁷² *AA Finance Limited v Commissioner of Inland Revenue*, above n 70, at 11,391.

... There were multiplicity of transactions... Clearly the appellant exercised commercial judgment in deciding what stock to buy having regard to maturity date, coupon interest rate, available parcel size and available discounts on the face value; and what parcels of stock to sell. Those investment decisions were not demonstrably different decisions from the decisions made in any business of maximizing returns from the deployment of money albeit in restricted securities.

In respect of the relationship between the acquisition and disposition of the Government stock parcels and the company's business activity, his Honour commented:⁷³

The appellant's business depended, amongst other things, on its ability to raise borrowings ... It was a selling point to investors that, as the prospectuses regularly stressed, the Government stock was recorded as prime refundable assets which attracted high percentage borrowing reflecting the assets security value and how long it would take for it to be realised.

ii). Analysis

It was clear that the Government stock played an integral part in the company's business activity of attracting new customers as it was essential to the business that the company had access to substantial borrowings to on-lend to customers. It was an integral part of the process by which the company earned its income. At the same time, the Government stock was available as a "buffer" in order to meet claims of lenders to the company should it be called upon. As a matter of fact, the company in its prospectus boasted the availability of the Government stock to meet such requirements, relying on their implicit worth and security as a means of gaining business and providing an attraction by virtue of the fact they were prime refundable assets.

The Government stock did not represent a separate investment rather it was connected with the company's ordinary trading activities as was found in *Waylee*.⁷⁴ To the contrary, the Government stock was required to be included in the totality of the borrowing by the company's Trust Deed and the Finance Companies Regulations. Hence the principle established in *Waylee* was not applicable in this case. *Waylee* is discussed later, but briefly it was held there that the gains made were not taxable as the shares were held by a separate subsidiary company incorporated for the purpose of holding shares, which was consistent with the bank's policy in terms of holding of long-term assets.

⁷³ Ibid, at 11,393.

⁷⁴ *Waylee Investment Ltd v Commissioner of Inland Revenue* (Hong Kong) [1990] BTC 543 (HL).

This case has confirmed that the investment of the funds by a finance company, albeit in a controlled pattern is essentially part of the company's business activity. Quite clearly, the Government stock in question was not permanent or long-term investments as they were disposed of or held to maturity. The characteristics are not similar to a business investing in shares for long-term dividend yield. The transactions under consideration giving rise to the gains made were essentially just a repetition of that, and another form of its business activity, i.e. deriving profit from the borrowing and lending of money. In *Auckland Savings Bank*, Richmond J agreed with the conclusion of the Board of Review in *Case 75*⁷⁵ and held:⁷⁶

That where in the prudent management of its portfolio a savings bank realises government securities on sale and maturity the resulting profit arises as much from an act or operation of business as would a similar profit in the hands of a trading bank.

D. Insurance

The Courts have noted that the nature of an insurance business requires the investment of substantial funds in realisable securities in order to meet the claims of policyholders. The realisation of such assets is a normal step in carrying on the insurance business, or in other words it is an act done in what is truly the carrying on of the business.⁷⁷ Where such investments are realised to maintain an insurance reserve, this would be an act done in carrying on of the insurance business.

The principles established in *Californian Cooper Syndicate* have found similar application in the case of insurance companies to render as taxable gains made on the realisation of investments held to meet the obligations of its customers. In *Liverpool and London and Globe Insurance Co v Bennet*,⁷⁸ Lord Mersey explained the rationale in this way:⁷⁹

It is well known that in the course of carrying on an insurance business, large sums of money derived from premiums collected and from other sources accumulate in the hands of the insurers, and that one of the most important parts of the profits of the business is derived from the temporary investment of these moneys. These temporary investments are also required for the formation of the reserve fund, a fund created to attract customers and to serve as a stand-by in the event of sudden claims being made upon the insurers in respect of the losses.

⁷⁵ *Case 75* (1964) 11 CTBR (NS) 437.

⁷⁶ *C of IR v Auckland Savings Bank*, above n 15, at 585.

⁷⁷ *Punjab Co-Operative Bank Ltd, Amritsar v Income Tax Commissioner, Lahore*, above n 65, at 1072.

⁷⁸ *Liverpool and London and Globe Insurance Co v Bennet* [1913] AC 610, 619 (HL).

⁷⁹ *Ibid*, at 621.

However, on the other side of the equation, profits derived from selling shares will not necessarily be taxable as Jacobs J put it in *London Australia Investment Co Ltd v Federal Commissioner of Taxation*:⁸⁰

... in so far as the original capital of that capital enhanced by accumulated profits is laid out in investments in property and not in the business activity of banking or insurance, the investments will have the character of capital and profits or losses on sale will not be profits of the business of banking or insurance.

1. National Insurance Company

i). Facts and Judgments

The exception was applicable in *Commissioner of Inland Revenue v National Insurance Company*⁸¹ where it was found that the sale of the shares was a disposal of a capital asset, not part of the insurance company's business. By way of background, the insurance company is a fire and general insurer and in early 1970s, it began to look for opportunities to diversify into other business complementary to its business insurance. It acquired 15% of the shares in another NZ merchant bank, Chase NZ Ltd in May 1972. The shares were swapped in 1982 for a 30% share in Southpac.

In 1987-88, the company sold its 30% share-holding for \$80m. The profit on sale was \$67m and the Commissioner included this amount as assessable income on the basis that the purchase and subsequent sale of the shares was part of the ordinary business of the company. Alternatively the Commissioner considered that the profits were assessable under section 65(2)(e)⁸², the second limb.

As always, whether the gains produced in a business are revenue or capital depends on the nature of the business and the relationship of the transactions producing the gain to the conduct of the business.⁸³ Even though it was found that there was a nexus between the income generated by the shares and the operation of the business, there was no nexus between the realisations which occurred here and the method of the business.

As a key authority and for a discussion of the principles of law applicable, the Court referred to the *National Distributors* case with regards to section 65(2)(e). The Court held that the

⁸⁰ *London Australia Investment Co Ltd v Federal Commissioner of Taxation* [1977] 138 CLR 106, at 130 (HCFC).

⁸¹ *Commissioner of Inland Revenue v National Insurance Company*, above n 16.

⁸² Income Tax Act 2007, s CB 4.

⁸³ *Commissioner of Inland Revenue v National Insurance Company*, above n 16, at 15,138.

evidence provided by the company's directors indicated that it never purchased the shares with the purpose to sell, or to trade in shares. They were purchased at the time when the company was facing stiff competition and it was decided to look for long-term investments in other companies to broaden the investment policy from its surplus funds. The Court found that the only reason the shares were sold was that its relationship with the major shareholder, National Bank had deteriorated and for practical reasons, after all the pressure from National Bank, it was decided by the board to sell the shares. Richardson P declared:⁸⁴

There were features of the Southpac transaction distinguishing it from the general run of investments inherent in the nature of the company's insurance business which we think allowed a conclusion that it was, albeit an investment, a move into another area of business which when, for supervening reasons, it became commercially desirable to terminate. By the time of disposition the shareholding could be seen as part of the capital structure of that company's business.

ii). Analysis

It is important to note that in relation to the application of section 65 (2)(a)⁸⁵ ('business profits'), the Court appeared to accept the application of the principles of law normally applying to this area, i.e. *Californian Cooper Syndicate; Punjab Co-operative Bank Ltd; Auckland Savings Bank*, though with an important condition. The condition was that business of a bank or insurance involves the investment in 'readily realisable securities'. This is a significant departure from the banking and insurance cases which have held on more than one occasion, that profits derived from the sale of property intended to be held long term or indefinitely, and held for more than a number of years, were assessable.

A major issue put to the Court was the distinction between the phases "diversification of business" and "diversification of investment". Williams J in the High Court had not made a distinction between the two phrases, if anything his Honour used the two phrases interchangeably. The Court of Appeal was silent on this point. The company did have investments in non-listed securities which were sold from time to time. The question, based on the facts, was whether this was a diversification of the existing share portfolio or was it a new business venture, as found by the Court of Appeal? Diversification of investment would have attracted tax on the gains as it was part of the ordinary incident of the company's business activity.

⁸⁴ Ibid, at 15,146.

⁸⁵ Income Tax Act, s CB 5.

It could be contended that this was simply a diversification of an already existing share portfolio on the basis that as the insurance business became competitive during the 1980s, the company's profitability was largely dependent on its portfolio investments rather than returns from underwriting. Furthermore, the evidence revealed that the company envisaged a possible sale of the shareholding well before both the eventual sale in mid 1987 and the issues it had with National Bank.

One other key factor here was that when City Realities took over the company in 1985, there was a change of attitude with profit being "more aggressively sought", with a need for the Group to obtain maximum return and for cash to meet debt servicing obligations. One could claim that the sale of its investments was done as an ordinary incident of its insurance business available to meet customer claims or failing that, the shares were purchased with the purpose of selling for a profit.

Moreover, the company continued to increase its stake in Chase NZ Ltd with the knowledge that the dividend yield would be quite small and resale in order to enjoy the true benefits of the purchase must have been intended. In this respect, one could say that this was a speculative purchase. Another critical factor that supports this view was that the company's general funds were taken into account in assessing the solvency levels and for ratio purposes. The fact that this particular investment was available to meet unexpected underwriting losses does indicate that the dominant purpose was to generate a gain, if and when called upon.

2. State Insurance

i). Facts and Judgments

Another case where it was found that the realisation of securities did not form part of the business of an insurance company was *State Insurance Office v Commissioner of Inland Revenue*.⁸⁶ State, a fire and general insurer had over the years built up large reserves, including holding of shares in listed companies. From 1981-85 inclusive, there were substantial share sale profits made by State as a result of compulsory acquisitions resulting from company takeovers. The investment portfolio was kept separate from the rest of the business and there were between 2-6 sales per annum and up to 13 in 1986. The reserves from the investment portfolio had never been called on except in the event of a catastrophe.

⁸⁶ *State Insurance Office v Commissioner of Inland Revenue* (1990) 12 NZTC 7,035.

Judge Heron concluded that whilst there was a nexus between the income generated by the shares and the operation of State's business, there was no nexus between the realisations which occurred and the method of operation of the business. His Honour found that the share sales were "sporadic isolated transactions". His Honour held that the gains were made without the intention of meeting the needs of the "insurance" business or the desire to realise any investment. The likelihood of State needing to call on any of these investments for its day-to-day business was incredibly remote. To that extent, they were at least not motivated by business considerations. The dominant purpose of State's acquisition of the shares was to hold, not to sell.

ii). Analysis

In arriving at this conclusion, Heron J noted that State's case was an unusual one. His Honour stated:⁸⁷

It will be seen from the conclusion I have reached that State's case is an unusual one brought by quite unique considerations and as a result departing from the outcome of most of the banking and insurance cases. The dividing line between income and capital gains is hard to see, a criteria acknowledged to exist but not well-defined. I think these transactions were in all respects to capital account.

Judge Heron's decision turns to a large degree on his findings of fact, such as the finding that State is unique in the way it operates its business. The matter was decided on the basis of the unique capital structure and methods of business adopted by State. Nonetheless it needs to be pointed out that his Honour accepted that the sale of the shares had some connection with the business because the income fell into the cash flow. However there was no nexus between those sales and the method of operation of the business.

Furthermore, his Honour concluded that dividing assets into separate portfolios was not essential to establishing that certain shares were held on capital account. In saying that, the writer is of the view that at a bare minimum, it must be objectively possible to differentiate between the shares that are asserted to be held on capital account and other trading investments. This onus rests with the taxpayer.

These cases have shown the difficulty in determining whether the shares were purchased with the purpose to sell for a profit or whether the taxpayer is in the business of share

⁸⁷ Ibid, at 7,065 – 7,066.

dealing. As always, it is a question of fact. The cases have also highlighted that not all gains from realisation of investments by insurance companies are income. As will frequently be the position when such an issue arises for determination, there is no clear cut answer and the Courts have acknowledged this. There will be indicators supporting a conclusion favourable to the taxpayer, and others against its contention.

VII. Canadian Cases

A. Individual

There continues to be uncertainty as to whether any gains made on the sale of property fall under capital gain or ordinary income. The introduction of tax on capital gains has, to some extent, reduced some uncertainty amongst taxpayers. The “guaranteed capital gain election”⁸⁸ is aimed at reducing the uncertainty as to the tax consequences of dispositions of Canadian securities.⁸⁹ The effect of such an election is that all Canadian security dispositions in the year of election and all subsequent years must be given capital gains or loss treatment.

However the election does not apply to disposition of a Canadian security by a taxpayer, who, at the time the security is disposed of is, amongst other, a trader or dealer in securities.

The intention of the taxpayer is not the sole determining factor in deciding under which category the transaction must fall. The Courts look at the taxpayer's whole course of conduct in determining the tax treatment. Whether an asset was acquired for investment purposes is to be determined by all the facts of a particular case, including the conduct of the taxpayer, the nature of the subject property, the probability of the asset producing income without the need to be turned over and the similarity of the transaction in question to a trading transaction.⁹⁰

1. Donald Preston McLaws

⁸⁸Income Tax Act Revised Statutes of Canada (ITA) 1985 (5th Supp.), s 39(4).

⁸⁹Income Tax Act Revised Statutes of Canada (ITA) 1985 (5th Supp.), s 39 (5) defines Canadian security - includes security that is a share of the capital stock of a corporation resident in Canada.

⁹⁰*Happy Valley Farms Limited v Minister of National Revenue* [1986] DTC 6,421 (FC).

i). Facts and Judgment

Gains made by an individual involved in buying and selling shares could be considered of a capital nature as was the case in *Donald Preston McLaws v Minister of National Revenue*.⁹¹ The taxpayer, a barrister was also involved in buying and selling shares listed on the stock exchange. All of the shares were speculative in nature. The taxpayer instructed his broker to buy and sell shares and as a result, he incurred a loss which he claimed to be loss arising from actively engaged in stock trading operations.

It was found that the taxpayer was not a stock trader. A 'trader' is one whose business is trade or commerce, of someone engaged in trading, say a dealer. Thus it would be expected that a stock trader is someone who promotes or underwrites any stock issues, advertises his business, someone who actively and continuously builds a clientele base and spends a significant chunk of their time in studying the movement of stock prices on the stock exchange. These characteristics were absent in this case as the taxpayer only dabbled in the stock market with funds borrowed from the bank and made some unfortunate purchases that resulted in a loss. Under the current legislation, the loss falls squarely under the CGT regime and can only be utilised by the taxpayer to offset any future gains from share transactions.

2. Harold Donald Smith

i) Facts and Judgments

However, continued repeated investments can constitute business of trading in shares as was found in *Harold Donald Smith v Minister of National Revenue*.⁹² From 1963 to 1972, the taxpayer was a commissioned stock salesman as well as bought and sold some 19,000 shares. He did not include any profits or claimed any losses from these transactions. Since 1969, the taxpayer embarked on an extensive program for profit through speculating on his own account. In 1969, 18 purchases (containing 10,500 shares) and 14 sales were made; in 1970, made five purchases and four sales which were of high dollar value. Funds were obtained from his family and bank.

⁹¹ *Donald Preston McLaws v Minister of National Revenue* (1965) DTC 1 (Tax Appeal Board).

⁹² *Harold Donald Smith v Minister of National Revenue* (1973) DTC 5,526 (FC).

The Court found that the taxpayer's conduct did amount to a business and was allowed to claim the losses. Prior to 1969, the transactions were relatively few and small in amount and he used his own money to fund the activity. Since 1969, the purchases and sales were very extensive, both in number and volume when compared to the previous years. Majority of the shares purchased related to new companies with no expectation of any dividends and were speculative, in that it was sold within a short period of time.

The fundamental difference between these two periods was that prior to 1969, whilst still having the intention to sell the shares for a profit, what changed since 1969 was that the taxpayer carried out a systematic and extensive scheme for profit making purposes that had taken on the character of an adventure in trading of a business. The course of the conduct and the volume and nature of the transactions supported the taxpayer's subjective intention of embarking upon a trading business.

ii). Analysis

While it is often difficult to distinguish between a capital gain and business income in particular circumstances, there appear to be certain factors that the Courts have considered in determining whether a taxpayer has realised an investment (capital in nature) or has been carrying on a business (income receipt) when engaging in a particular transaction. The Courts look at the taxpayer's whole course of conduct in determining the tax treatment. There must be clearer indications of trade, if not, just because the purchase was speculative, in that the taxpayer did not intend to hold the shares indefinitely, but intended, if possible, to sell them at a profit cannot be said to have engaged in an adventure in the nature of trade.

For taxpayers, there remains uncertainty where in some circumstances the shares may be a true investment and treated as capital, in others, it may be speculative venture in trade. As is so often the case in tax matters, it is necessary, in characterising the activities of a taxpayer, to weigh all of the surrounding facts and circumstances which bear on the matter.

B. Investment Companies

The heart of the issue is whether the gains from share realisations from investment companies are ordinary income, and therefore taxable (or loss, as the case may be), or is treated as capital gain. An investment company will claim that the shares were not acquired with a view to, or with the intention of making a profit, or for subsequent disposal thereof, and that their sale was the result of disposing the assets acquired for the purpose of providing a safe investment haven for funds until they could be re-invested.

Their obligations are to manage the original investment which includes continuously monitoring the market conditions and substitutions in the shares might be necessary to preserve the balance in the investments. They will contend that their course of conduct is thoroughly consistent with good investment practice, and therefore the profits realised on the sale do not constitute trading profits, but capital gains arising from the mere realisation of investments.

Many cases have dealt with the question, i.e., trading vis-a-vis investing, and tests have been laid down by Courts, which are helpful in reaching a conclusion; for instance, the question of intention, the doctrine of Charter powers (company's memorandum/director's resolution) and the whole course of conduct of a taxpayer. The fact that the company claims that the shares would be sold does not indicate that they would be sold for a profit or that they had been acquired to be sold for a profit. On this point, Lord Buckmaster said in *Leeming v Jones*:⁹³

...; an accretion to capital does not become income merely because the original capital was invested in the hope and expectation that it would rise in value; if it does so rise, its realisation does not make it income.⁹⁴

In the same case, Lord Dunedin observed:⁹⁵

The fact that a man does not mean to hold an investment may be an item of evidence tending to show whether he is carrying on a trade or concern in the nature of trade in respect of his investments but *per se* it leads to no conclusion whatever.

Whether the gain is capital or income, such a decision cannot depend solely on the number of transactions in the series, or the period of time in which they occurred, or the amount of

⁹³ *Leeming v Jones* (1930) 15 TC 333 (HL).

⁹⁴ *Ibid*, at 367.

⁹⁵ *Ibid*, at 360.

profit made, or the kind of property involved. Nor can it rest on statements of intention on the part of the taxpayer. The question in each case is what is the proper deduction to be drawn from the taxpayer's whole course of conduct, viewed in the light of the circumstances? The conclusion in each case must be one of fact. The fact that a company has the power to invest in, sell or otherwise deal shares or any kind or nature of security or personal property whatsoever is not itself sufficient for concluding that a business is in existence. At most, it creates a *prime facie* presumption which can be rebutted. In *Anderson Logging Company*,⁹⁶ Duff J commented:⁹⁷

The sole raison d'etre of a public company is to have a business and to carry it on. If the transaction in question belongs to a class of profit-making operations contemplated by the memorandum of association, prima facie, at all events, the profit derived from it is a profit derived from the business of the company.

The 'whole course of conduct test' is looking at the taxpayer's business in totality and the issue can only be decided by establishing what has happened viewed in light of all the circumstances. For example if some investments were sold for the purpose of buying other shares, or selling to pay substantial income taxes, these in itself do not indicate that the intention was to enter into a scheme for profit making. The transactions represent mere change of investments.

1. Irrigation Industries Ltd

i). Facts and Judgments

This was illustrated in *Irrigation Industries Limited v The Minister of National Revenue*.⁹⁸ In February 1953, the company purchased 4,000 common shares of Brunswick Mining and Smelting Co. Ltd which was funded from a bank loan. The company had no dealings in securities other than the purchase and sale of the 4,000 shares. The company saw this as an excellent opportunity to invest in a company that had a lot of potential to grow and develop into a large mining operation.

In March 1953, the company sold the shares due to pressure from the bank to reduce the loan, and shares in June were sold as the price of shares had risen to such a point that it ceased to be in accordance with sound judgment to continue to hold on the investment. As a

⁹⁶ *Anderson Logging Company and His Majesty the King* [1925] 45 (SCC).

⁹⁷ *Ibid*, at 56.

⁹⁸ *Irrigation Industries Limited v The Minister of National Revenue* [1962] DTC 1,131 (SCC).

result, the company realised a considerable profit. Brunswick Company did not own an operating mine and the likelihood of it paying a dividend were remote.

The Court held that as the company had purchased only 4,000 out of a total issue of 500,000 shares, this would not be indicative of an adventure in the nature of trade. The nature of trade, per say, is that the company purchased shares of a corporation which represent an interest in a new corporation which is a recognised method of investing capital in a business. The company subsequently disposed of its interest which is common when one is making an investment. Its purchase was not an underwriting and neither did the company promote the sale of the shares to the public. Relying on the principle enunciated in *Californian Copper Syndicate*, the enhanced price here was not profit from the investment.

Martland J who rendered the judgment for the majority of the Court found that the transaction was not subject to tax:⁹⁹

However, assuming that the conclusion was correct that this purchase was speculative in that it was made not with the intention of holding the securities indefinitely, with a view to dividends, but made with the intention of disposing the shares at a profit as soon as reasonably possible, does this, in itself, lead to the conclusion that it was an adventure in the nature of trade?

The learned Judge held:¹⁰⁰

The only test which was applied in the present case was whether the appellant entered into the transaction with the intention of disposing of the shares at a profit so soon as there was a reasonable opportunity of so doing. Is that a sufficient test for determining whether or not this transaction constitutes an adventure in the nature of trade? I do not think so, standing alone, it is sufficient.

The intention to sell the shares at a profit is not by itself a test of whether the profit is subject to tax. The intention to make a profit may be just as much the purpose of an investment transaction as of a trading one. Whether a particular transaction is an adventure in the nature of trade depends on its character and surrounding circumstances.

ii). Analysis

However, it could be contended that the transaction was an adventure in the nature of trade. The word adventure is defined to include “a commercial enterprise in which there is

⁹⁹ *Californian Copper Syndicate (Limited and Reduced) v Harris (Surveyor of Taxes)*, above n 30, at 350.

¹⁰⁰ *Ibid*, at 355.

considerable risk of loss as well as change of gain”, which is what had happened here. The next question is whether the transaction was “in the nature of trade” - it was as the company’s transaction involved dealing in mining shares. In *Edwards v Bairstow*,¹⁰¹ Lord Radcliffe said: “Dealing is, I think, essentially a trading adventure, and the respondent’s operations were nothing but a deal or deals in plant and machinery.”¹⁰² The profits realised was not the enhancement in price of an ordinary investment but rather a gain made in an operation of business in carrying out a scheme for profit-making, as stated by Justice Cartwright following the principle in *Californian Copper Syndicate*.

It is accepted that increases in market value accrue while securities are retained, and as such they are not taxed. The issue for all taxpayers is how to account for the profit made on selling. In respect of jurisprudence, for an asset to qualify as an investment, the object purchased must be at least susceptible of generating an annual return as rental, dividends or interest. The existence of a company's power and objects as stipulated in its memorandum does not determine as to whether the profits realised from the sale of the shares are taxable. Locke J in *Sutton Lumber and Trading Company Limited*¹⁰³ observed:

The question to be decided is not as to what business or trade the company might have carried on under its memorandum, but rather what was in truth the business it did engage in. To determine this, it is necessary to examine the facts with care.

In *Tweddle v FC of T*,¹⁰⁴ it was stated that it is not “the function of the Act to those who administer them to dictate to taxpayers in what businesses they shall engage, or how to run their business profitably or economically. The Act must operate on the results of a taxpayer's activities as it finds them.”¹⁰⁵

2. *Gairdner Securities Ltd*

1). *Facts and Judgments*

As mentioned earlier, a taxpayer’s whole course of conduct is the most important test, for example in *Gairdner Securities Limited v Minister of National Revenue*,¹⁰⁶ the company’s nature of activity was dealing in securities. From 1938 to 1946, the

¹⁰¹ *Edwards (Inspector of Taxes) v Bairstow* [1955] AC 14 (HL).

¹⁰² *Ibid*, at 38.

¹⁰³ *Sutton Lumber and Trading Co. Ltd. v Minister of National Revenue* [1953] 2 (SCC) 77.

¹⁰⁴ *Tweddle v Federal Commissioner of Taxation* (1942) 7 ATD 186 (HC).

¹⁰⁵ *Ibid*, at 190.

¹⁰⁶ *Gairdner Securities Limited v Minister of National Revenue* [1954] DTC 1,015 (SCC).

company claimed to have discontinued dealing with securities for the public and to have confined its activities to the realisation of securities which it retained, i.e. to operate the company as an investment company.

Between 1938 and 1946, some 124 purchases and 200 sales took place. In respect of the eight purchases amounting to 32,920 shares, 17,180 were sold on the same day, 2,475 within one month, 5,000 within two months, 5,000 within three months, 1,000 within four months and 2,265 within eighteen months. Of nine purchases made after 1946 amounting to 22,260 shares, 2,000 were resold on the same day, 1,000 in one month, 2,500 in two months, 3,500 in six months, 2,000 within one year, 9,260 within two years and 2,000 within three years.

The company (with other associates) obtained control of Dominion Malting Company in 1944. The purchase of the shares was funded by the Royal Bank. The purpose of the purchase was to provide management experience for the taxpayer's sons. Mr Gairdner on behalf of the company became a member of the Board of Directors of Dominion Malting and through his efforts the plants were substantially upgraded and improved, thus indicating the intention to retain a permanent interest therein. The only reason the taxpayer sold the shares was as a result of pressure from the other two associates. Subsequently in 1948, the company sold a large number of shares, realising a healthy profit.

The Court determined that true nature of the transaction is to be determined from the taxpayer's whole course of conduct, viewed in the light of all the circumstances and held that the gains were taxable. The buying and selling was essentially of the same character as the taxpayer had previously engaged in and one which it was specifically empowered to do, i.e. to acquire and hold, and to sell and exchange shares as one of its essential features of its business.

The whole scheme was an ordinary commercial transaction entered into for the purpose of making a profit. Over 11,000 shares were sold at a substantial profit and in view of the fact that the shares were steadily rising in value, which enabled the company to pay-off the bank loan by borrowing the funds from the parent company and thereby retain

its shares. All the steps carried out by Mr Gairdner (such as splitting of common shares to make them more marketable, the expansion of the business and the marketing of the new issue of bonds and shares by the associated company) point to the fact that what was planned for and what was achieved was an enhancement in the value of shares to be purchased and the making of a profit intention.

Cameron J¹⁰⁷ mentioned that a substantial number of shares sold in 1944 were a trading transaction. His Honour stated that it cannot be said that the sales made in 1946 of the remaining shares acquired under precisely the same circumstances do not constitute an ordinary trading transaction. His Honour observed that the retention of shares for a period of eighteen months was not significant or that Mr Gairdner had in mind that if the venture was successful, the company would retain some of the shares for the purpose of advancing the interests of his sons. In this respect, his Honour referred to *Anderson Logging Company v The King*:¹⁰⁸

The appellant company is a company incorporated for the purpose of making a profit by carrying on business in various ways including, as already mentioned, by buying timber land and dealing in them. It is difficult to discover any reason derived from the history of the operations of the company for thinking that in buying these timber limits the company did not envisage the course it actually pursued for turning these limits to account for its profit as at least a possible contingency; and, assuming that the correct inference from the true facts is that the limits were purchased with the intention of turning them to account for profit in any way which might present itself as the most convenient, including the sale of them, the proper conclusion seems to be that the assessor was right in treating this profit as income.¹⁰⁹

ii). Analysis

By reviewing the findings of the Court, it is clear that this was an exceptional transaction which was to achieve control of Dominion Malting Company in order to enable Gairdner to introduce his sons to industrial management. However this was at least one of two purposes, the other was that if at any time a sufficiently favourable opportunity to sell arose it would be carried into effect.

The Courts have taken the view that a business is a scheme involving a series of transactions of one or more modes of dealings, more or less repetitive, with the aim of making a profit from the total activities. In this instance, the particular transaction was part and parcel of the

¹⁰⁷ Ibid, at 1,177.

¹⁰⁸ *Anderson Logging Company v The King*, above n 96.

¹⁰⁹ Ibid, at 49.

general trading operations of the company conducted from 1938 to 1946. It was a course of action pursued with a view to making a profit through their ultimate result. The taxpayer's whole course of conduct is the most important test when dealing with cases of this nature, which is a question of fact only.

It was also agreed by the Court that taxpayers who are in the business of investments look primarily to maintain annual return in dividends or interest. This would involve substituting one parcel of securities for another, but they are designed to further that primary purpose and are subsidiary to it. In that case, the gain on realisation will amount to capital gain, however there was no such dominant purpose here.

C. Banks

As always, each case brings up the never-ending discussion as to what is meant by capital and what is meant by income. Earl of Halsburn, L.C. in *Dovey v Cory*¹¹⁰ stated:

There is no hard and fast rule by which the Court can determine what is capital and what is profit. The mode and manner in which a business is carried on, and what is usual or the reverse, may have a considerable influence in determining the question.¹¹¹

1. Credit Foncier

i). Facts and Judgments

Generally profits made on the sale of shares by the banks are treated as assessable income. However this was not the case in *Credit Foncier Franco-Canadian*.¹¹² In 1954, the company amended its charter which allowed it to purchase shares in Canadian companies. The purpose to purchase shares was to protect its capital by diversifying in well-chosen investments. Shares were purchased from capital, accumulated profits and reserves. The company held on to them for a long period of time and sold some to buy others. From 1963 to 1965, the company bought some 77,000 shares and sold over 67,000 of the shares. All of the shares earned dividends which indicate that the company was after returns as opposed to speculative gains.

The Board held that company was not in the business of buying and selling shares as all it did was purchase the shares from the stock exchange as an investment and waited for a rise

¹¹⁰ *Dovey v Cory* [1901] AC 477 (HL).

¹¹¹ *Ibid*, at 486.

¹¹² *Credit Foncier Franco-Canadian v Minister of Revenue* [1970] DTC 1,609 (Tax Appeal Board).

in the market. Maurice Boisvert, Q.C. stated that the company “did not play the market”, something which is common with a trader in securities. Hoping for a profit does not in itself create a business, *Lemming v Jones*.¹¹³

The company had sufficient working capital to run its business operations and used its surplus capital and reserve funds to purchase and sell shares in the hope that the capital would grow, at the same time earning dividend income. Relying on the principles established in *Californian Copper Syndicate*, it is clear that taxpayers can make investments, change them and realise them. On the other side, if the taxpayer is a speculator in stock or debentures with the intention of making a “quick buck”, the profits will be taxable.

The difference between this case and *Punjab Co-operative Bank Limited* was that in the latter, the co-operative bought and sold government bonds to counter the withdrawals made by the depositors. Noticeably if the bank had invested part of the deposits entrusted to it in debentures and shares, it was adding to its business an operation made necessary by its business and that operation formed part of the overall operations. In this respect, the gains from share realisations will be taxable as it forms part of the bank’s business operations.

D. Insurance

1. La Societe Mutuelle

i). Facts and Judgments

When it comes to insurance companies, the gains made from sale of shares are treated as assessable income as they form part of its business operation. For example, in *La Societe Mutuelle d' AssurancesGenerales de L'U.C.C. v Minster of National Revenue*,¹¹⁴ the taxpayer was carrying on a mutual insurance business. From 1947 to 1951, the excess premiums were used to generate income from investments and profits were derived in each of the taxation year. The interest from the investments was credited to the general operating and administration funds.

The reserve fund was not used for investment purposes, rather the amounts at the end of each fiscal year had come from unearned premium, unsettled claims and funds from the taxpayer. The income generated from investment was also used for marketing purposes so

¹¹³ *Lemming v Jones* [1930] 15TC333 AC 415.

¹¹⁴ *La Societe Mutuelle d' AssurancesGenerales de L'U.C.C. v Minster of National Revenue* [1955] DTC 561 (Tax Appeal Board).

as to attract new clients, which enabled the taxpayer to increase its investment. The gains from the investments were used, in full to pay for the costs incurred by the taxpayer in carrying on the business.

Chairman Fabio Monet Q.C., found that the gains made from the investments which was used by the company to meet its operating costs was income and therefore taxable. The Chairman commented:¹¹⁵

As a result, when the assets of the mutual association are distributed, the members will receive not only the unused portion of their contributions, but also the income produced by such contributions. This income is taxable.

...

In conclusion, I will say that if a mutual association limits itself to handling the funds derived from the contributions of its members it has no taxable income, but if the funds it has on hand produce income, such income is not exempted by any provision of the Act and remains taxable income.

Thus if the purchase, resale and exchange of shares are investment operations, the gains are not taxable but such operations give rise to an increase in the capital engaged in such operations. However, if the purchase, resale and exchange of shares are commercial operations of the business, there is no doubt whatsoever that the gains and losses must be included in the computation of profit.

VIII. United Kingdom Cases

A. Individual

As an individual, when you sell or dispose shares or stocks in a company, you are liable for CGT at 18% on the profit from the transaction. However if the overall gain is below the annual tax free allowance (“Annual Exempt Amount”), which is £10,100, there is no capital gains to pay. In situations where a gain made is in excess of the annual exempt amount, taxpayers are allowed to use the losses from earlier years to reduce the overall gain.

The question of whether an individual is trading in shares is a question of fact. The tax cases have provided some useful guidance but there is no definitive checklist for

¹¹⁵ Ibid, at 569.

determining whether or not an individual is trading. If the taxpayer is carrying on a trade on a commercial basis with a view to and reasonable expectation of making a profit, then it is trading income (or trading loss, as the case may be). There are circumstances where it can be difficult to establish whether a trade is in fact being carried on by the taxpayer.

1. Salt

i). Facts and Judgments

The HM Revenue & Customs (HMRC) generally take the view that ‘transactions by individuals in shares and securities are not generally trading transactions.’¹¹⁶ This was explained in *Salt v Chamberlain*,¹¹⁷ where the taxpayer during the period January 1969 to March 1973, bought and sold some 200 shares on the Stock Exchange. In some instances the shares were bought and sold within a short period of time. The taxpayer did not conduct such a scheme commercially because of the costs and obtained funds from banks and personal savings. In 1969 and 1970, the profits in each year were returned at nil but in 1973, the taxpayer claimed a loss on his buying and selling on the Stock Exchange.

Clearly by looking at the facts, the activity of the individual has displayed all the features of the “badges of trade.”¹¹⁸ The Commissioner, while accepting this concluded that the transactions merely point to activities which fall under the CGT legislation and are not trading activities.

Generally the Courts take the view that where a person is involved in speculative buying and selling, then it is a question of fact whether the person can be said to be engaged in a trade or vocation in respect of these purchases. On the evidence provided, the Court held that, as a matter of fact, the individual was not ‘trading in securities’. Most importantly, the Court also emphasised that even if the individual had traded in a large volume of transactions with a profit making intention, the frequent and repetition

¹¹⁶ Includes the subject matter of the realisation; the length of period of ownership; the frequency or number of similar transactions by the same person; supplementary work on or in connection with the property realised; the circumstances for realisation; and motive.

¹¹⁷ *Salt v Chamberlain* [1979] 53 TC 143(EWHC).

¹¹⁸ Factors such as profit seeking motive; number of transactions; nature of assets; existence of similar trading transactions; changes to the asset; source of finance; interval of time between purchase and sale and method of acquisitions.

of Stock Exchange transactions merely point to activities which fall under the CGT legislation.

ii). Analysis

Then again by looking at the volume of the transactions and the intention of the individual, it appears that not only was the Court's finding one of law but that it was one which involved the application of what is clearly a debatable proposition of law. What is the line that separates the degree that is required of whether shares are a subject matter capable of being dealt with by way of trade? It appears that shares are not a subject matter which can be dealt with by way of trade if the dealing is carried out by an individual on his own account. As Lord Wilberforce said in *Ransom v Higgs*¹¹⁹: "Everyone is supposed to know what "trade" means; so Parliament, which wrote it into the law of income tax in 1799, has wisely abstained from defining it".¹²⁰

2. Manzur

i). Facts and Judgments

Even where the volume of transactions is significant, it has been found that an individual is not in the business of share dealing. This was the case in *Manzur*¹²¹ where a retired surgeon had invested £160,000 in shares and stocks over a period of 2 years and sustained losses of £81,553. The taxpayer wanted to use the losses to offset his general income for the year as he was of the view that he had acquired the shares for trading purposes.

It was found by the tribunal that the transactions carried out by the taxpayer were not trading transactions, rather they were the management of an investment portfolio which required one to buy and sell shares. The taxpayer undertook the transactions on a part-time basis which suggests a peripheral activity but this alone is not conclusive of being trading or investment. This case has clearly highlighted that share dealing by an individual is more likely to give rise to a CGT charge.

¹¹⁹ *Ransom* (H.M. Inspector of Taxes) *v Higgs* [1974] 1 WLR 50 TC 1 (HL).

¹²⁰ *Ibid*, at 245.

¹²¹ *Dr K M A Manzur* [2011] TC 00830, [2010] UKFTT 580 (TC).

B. Investment Companies

When a company derives investment income from a fund which is used in the business, the investment income is taxable as a trading receipt. Whether income from investments held by a business is trading income must ultimately depend upon the nature of the business and the purpose for which the fund is held. If the holding of investments was integral to the business, as in the case of insurance companies or banks, and if the company had excess funds and used these in its trading activities, then the income could be regarded as trading income. This supplicates the question - when does investment income amount to a trading receipt of the taxpayer? The statute provides little or no guidance on the matter beyond recognising that it can sometimes do so. It must be a question of fact.

1. The Dunn Trust

i). Facts and Judgments

One of the leading cases, *The Dunn Trust Limited v Williams*¹²² looked at whether the profits made from sale of shares were realisations of investments or from trading transactions? The company was incorporated in 1927 and one of its objectives was to invest in securities. The director provided part of the funding, whilst the bank provided an overdraft which was secured by the deposits of shares belonging to the director, who passed away in 1945.

In 1938, the company was successful and was in a position to finance its trading from its own resources. The director had become indebted to the company and in 1940 the company purchased from the director shares worth £15,000 which were used on behalf of the company as security for its overdraft. These shares were from various companies involved in oilfields, transport, motor company and a restaurant. The company's intention was to find an investment for a portion of its reserves and not with the intention of dealing in stocks and shares. In 1943, it traded in securities and the profits derived from those transactions were business profits and taxed accordingly, this was completely separate to the shares purchased by the company from its director.

¹²² *The Dunn Trust Ltd. (in vol liq) v Williams* (H.M. Inspector of Taxes) (1946-1950) 31 TC 477 (HC).

Shares that belonged to its director were sold due to various reasons, such as shares in the motor company were sold because the company had appointed new directors and it was decided not to continue to hold on to these shares. After the death of the director, shares in the oil company were sold as they were not suitable investments. The shares were sold during 1945-46. The company contended that the purchases of stocks were made as an ordinary investment and not with a view to dealing. The sale of the stocks was realisations of ordinary investments.

Justice Vaisey held that the company had never deviated from its object and intention in respect of the shares purchased in 1940. The shares were not purchased with the intention of dealing in but with the object of finding an investment by using the company's reserves. His Honour further added that the reasons given as to why and how and for what purpose the shares were sold was not synonymous with companies that trade in shares. They were simply sold due to the presence of the extenuating circumstances. The main business of the company was of moneylending and while it has in its memorandum of association the power of dealing in shares, this was only a 'side-line activity'.

ii). Analysis

The fact that the company was dealing in other stocks and shares as part of its trading activity did not affect the character of the purchases in 1940, nor did they affect subsequent realisations. The transactions did not taint all transactions and a line separated the gains as trading income and capital income, as was the case in *Rangatira*. The conditions existing at the time the shares were purchased were not decisive. Rather one has to look at the overall picture, taking into account the company's subjective intention and weigh this with the evidence in order to establish what actually did happen. The circumstances in which the shares were sold pointed to the fact that they were realisations of investments and not trading transactions, as stated by Lord Justice Clerk in *California Copper Syndicate*.

2. *Liverpool & London*

i). *Facts and Judgments*

Then again, gains made on selling of shares by investment companies have been categorised as assessable income as was found in *Liverpool & London & Globe Insurance*.¹²³ The company had large sums of money invested in various securities in United States of America, Canada and Australia. The company was obliged to invest in securities within those countries respectively a sum to answer liabilities on its policies and other engagements. The funds compulsorily invested could not be removed until the liability in respect of the said policies or engagements had run-off. The interest was re-invested in those countries or remitted to Great Britain. The issue here was in relation to the sums not remitted to Great Britain.

The House of Lords, upholding the decisions of the trial judge and the Court of Appeal, held that the income constituted trading receipts. The fact that the company could not have traded in those countries without making investments abroad and the interest arising on the investments necessarily made for the purposes of the trade is part of the gains of that trade. Earl Loreburn said:¹²⁴

The only question here is whether the interest and dividends before us are profits or gains of this company's trade, manufacture, adventure, or concern in the nature of trade, within the meaning of the 1st Case. I think they are, upon the facts found by the Commissioners-whatever may have been the source from which the invested moneys were originally derived, and whether the investments were compulsory or not ...

Thus the interest from investments was part of the company's business transactions and forms part of the income.

3. *Bank Line*

i). *Facts and Judgments*

However, if the capital of the company is not risked in the business, the income generated is unlikely to constitute trading receipts. In *Bank Line v Commissioners of Inland Revenue*¹²⁵, the company carried on a trade of owning and operating ships. The

¹²³ *Liverpool and London and Globe Insurance v Bennett* (Surveyor of Taxes), above n 78.

¹²⁴ *Ibid*, at 378.

¹²⁵ *Bank Line Ltd. v Commissioners of Inland Revenue* [1975] 49 TC 307 Court of Session (First Division).

company set aside additional sums of money not required in business out of its profits which it had invested in Government securities and short-term deposits with local authorities. In 1969, the company had £19.1 million as investments. This was done to meet company's requirement for ship replacement as it was the company's policy to finance the replacement of its ships from its own generated funds.

The heart of the inquiry was whether the ship replacement fund could properly be said to have been 'employed and risked' in the company's business activity, which could only be determined by establishing whether the funds were essential to the carrying on of the business.

The Court found that the company did not trade in buying and selling ships and as such the receipts were not receipts of trading, rather they were from the investments of sums which had been withdrawn from trade and set aside to be drawn upon replacement of its fleet of ships. There is no doubt that the company could not carry on business without ships, but all they did here was set-up a "nest-egg" from which the funds were to be used to purchase vessels as they become obsolete. It was an isolated fund the primary purpose of which was to provide for future events. The investments were insulated from the demands of the company's trade liabilities and the statute is very clear that it taxes receipts of trading in the trade of the company.

These cases have highlighted that in determining whether the profits are trading income or investments, there is no magic formula that can be applied, rather the taxpayer's overall trading activities need to be taken into consideration in deciding whether the income is from investments or part of trading receipts.

C. Banks

1. Frasers (Glasgow)

i). Facts and Judgments

In *Frasers (Glasgow) Bank Ltd v Commissioner of Inland Revenue*,¹²⁶ the company was incorporated in 1936 and was carrying out a bona fide, albeit a somewhat restricted banking business compared with the procedure of ordinary banks. Its primary business

¹²⁶ *Frasers (Glasgow) Bank Ltd v Commissioner of Inland Revenue* [1963] 40 TC 698 Court of Session (First Division) (HL).

was to receive small deposits from employees of House of Fraser Ltd (its primary customer in its trade) and from a few retail customers of that business. The company was entitled by its memorandum to either hold any shares it purchased, or to realise them. There were some 300 depositors and about 80 customers who had current accounts in the company, including the Fraser Group. The company had an overdraft facility with its bankers, The National Bank of Scotland Ltd.

In 1948, the controlling shareholder of the company acquired stock in House of Fraser Ltd, its parent company, and gave instructions to register the stock in the name of the company. The basis for this was that in 1947, the share price of House of Fraser was falling on the Stock Exchange and it was the controlling shareholders view to support the price of the stock by purchasing it. A further purchase of stock was carried out in 1952 which was funded by National Bank of Scotland. In 1954, some 55,000 shares were purchased in listed companies and the shares were registered in the company. No dividends were received during this period.

Its bankers requested that the company reduce its indebtedness. In 1958, the company sold some of the stock in House of Fraser Ltd, using the funds to pay the debt. As result of this transaction, the company made a surplus and the issue was whether the surplus constituted a profit on capital account or part of the company's trading activity.

Although there were only four purchases of stocks and shares made by the company in special circumstances, it was found that the shares in question were bought and sold by the company in the course of carrying on its trade. The holding of the House of Fraser shares was a vital part of the banking activity that enabled the company to borrow and lend, and so formed part of its trading activities and the stock was sold because of the requirements of its trade. Clearly the only reason for the company to purchase the House of Frasers shares was to support their shares in the market, the success of which the whole trading operations of the company depended. This tends to support the view of a trading activity rather than a capital operation. All the company did was lay money aside to be available and necessary for meeting its obligations to depositors, something that is common with any banking operation.

The funds borrowed from the National Bank were used to purchase shares. Subsequently, National Bank demanded that the company reduce its indebtedness, meaning that the company had to find cash from its trading activities. This was achieved by realising its investments that had gone up in value from the time it was acquired. The increase in value on the investment so realised forms part of the profits of the business as carried on and was therefore liable to tax. In *Punjab Co-operative Bank Ltd*,¹²⁷ Lord Maugham held:

If, as in present case, some of the securities of the bank are realised in order to meet withdrawals by depositors, it seems to their Lordships...quite clear that this is a normal step in carrying on the banking business, or, in other words, that is an act done in “what is truly the carrying on” of the banking business.

ii). Analysis

Then again one could contend that the purchases were made to maintain the value of the House of Fraser stock in the market, which is completely separate from the normal activities of the company. The realisation of the stock was not made to meet the demands of customers as part of an ordinary banking business rather it was made to meet the demand of its bankers to reduce the overdraft. One needs to consider the circumstances in which an investment was made as well as those in which it has been realised in order to decide whether a realised surplus on sale is a profit of trade.

To expand on the findings, a tradesman may sell his house to enable him to meet the demands of his trade creditors; does the purchase and sale of his house constitute transactions carried out in the course of his trade? Surely the profits made on the sale of the house are profits on the realisation of a capital asset.

2. Westminster Bank Limited

i). Facts and Judgments

Whether the exchange of securities constitutes a realisation of securities was discussed in *Westminster Bank Ltd. v Osler (Inspector of Taxes)*.¹²⁸ The bank was holding National War Bonds which were surrendered in exchange for conversion loan and war loan and the value of the stock received in exchange was greater than the cost to the bank of the National War Bonds.

¹²⁷ *Punjab Co-Operative Bank Ltd, Amritsar v Income Tax Commissioner, Lahore*, above n 65, at 1073.

¹²⁸ *Westminster Bank Ltd. v Osler (Inspector of Taxes)* (1933) 1 ITR 65 (HL).

The question was whether the excess amount could be regarded as profit of the banker's trade for the purpose of income tax. On behalf of the bank it was argued that the nature of the transaction was equivalent to a mere exchange of item in the stock-in-trade of the trader and that there was no realisation of profit. It was a mere accretion of capital value which could not be brought into account until in fact it had been realised. Dealing with the said contention, Lord Buckmaster¹²⁹ stated:

The exchange effected in the present case was in fact the exact equivalent of what would have taken place had instructions been given to sell the original stock and invest the proceeds in the new security. The investment represented by the original War Bonds came to an end as soon as the new securities were taken in its place, when a new venture was begun in relation to the new holding, and the fact that this transformation took place by the process of exchange does not in my opinion avoid the conclusion that there has been what is described as a realisation of the security.

3. *Waylee*

i). Facts and Judgments

In situations where shares are acquired as part of a rescue operation, any gains made upon realisation will usually not give rise to a tax liability. In *Waylee Investment Ltd v Commissioner of Inland Revenue*,¹³⁰ the company was a wholly-owned subsidiary of the Hong Kong Shanghai Banking Corporation (the bank). One of the bank's largest customers, Hutchison International Ltd (HIL) was under severe financial stress and in urgent need of capital to avert imminent collapse. It was agreed between the parties that the bank would purchase 150m HK\$1 ordinary shares in HIL and take effective control over the management of the company.

The chairman stated that the purpose of the purchase was to rescue an important customer but had concerns with its board. For the bank to protect its interest, it had to take control of the management board and steer the company in the right direction. It was made very clear that the particular transaction would not indicate that the bank was entering the field of trading in shares rather its intention was to reduce its shareholding as soon as the business conditions permit, i.e. to sell the shares.

In accordance with the bank's policy regarding its long-term investments, the company purchased the shares which were financed by an interest free loan from the bank. HIL

¹²⁹ *Ibid*, at 68.

¹³⁰ *Waylee Investment Ltd v Commissioner of Inland Revenue*, above n 74.

merged with another company and as a result, the company received 90m ordinary and preference shares. Some \$61m in dividends was received by the company which was paid to the bank. In 1979, some four years after the shares were initially purchased; the company received an offer from another Hong Kong company to purchase 90m ordinary shares. The shares were sold resulting in a profit to the company of HK\$517m which was paid to the bank as dividends.

In the Privy Council, Lord Bridge of Harwich concluded that this was not a normal banking transaction or a normal transaction falling with the business of the bank. It was held that the company was not engaging in trade or in a venture in the nature of trade but was making a long-term investment. While accepting that the purposes of the bank and the company were indistinguishable, the sale of the shares would have been the sale of the capital assets even if it had been sold by the bank. The Board observed that there will be times when a bank will buy shares in a customer for perfectly sound banking reasons, but the subsequent sale of the shares would not necessarily attract income tax.

ii). Analysis

Here, the bank never intended to trade the shares as part of its stock in trade, the purchase of shares was in line with the bank's policy (i.e. long-term investment) and it was never available to meet depositor's demands. In actual fact when HWI was trading profitably, the company had received dividend income but it never put itself in a position to sell the shares, apart from the opportunity of receiving and later accepting the unsolicited offer to sell part of the investment for a profit. Effectively, the Privy Council approached the case as if the subsidiary did carry on a banking business.

This draws us to the comments made from the chairman, "the shares or the majority of them were intended to be sold at a profit as soon as conditions permit". Is the statement sufficient to attract tax on profits? It needs to be pointed out that while HWI traded profitably, at no time the declared intention of the company to reduce the shareholding was implemented, meaning that the intention was to hold on to the shares for a longer term. Furthermore, the bank did not want to be seen as involving itself on a long-term basis in the management, which was qualified by the condition that the reduction of the investment should not be effected in such a way as to distort the market. Intention by

itself is not sufficient to determine the outcome; rather the taxpayer's whole course of conduct needs to be taken into consideration to determine the outcome.

It has always been a contentious area of law in differentiating between trading stocks and capital assets. In the course of the judgment, the Privy Council mentioned:¹³¹

Many authorities have been referred to in the course of argument, but it has to be recognised that the law has never succeeded in establishing precise rules which can be applied to all situations to distinguish between trading stock and capital assets. The stock in trade of a bank is money and securities readily convertible into money. But it is equally clear that a bank, like any other trader, may hold investments as capital assets. The clearest indication that an investment was acquired as a capital asset would be an indication that the bank intended to hold the investment as such for an indefinite period. The clearest indication that an investment was acquired as trading stock would be an indication that it was held by the bank as available to meet the demands of depositors whenever necessary.

D. Insurance

1. The Royal Insurance Company

i). Facts and Judgments

Determining whether the loss made on compulsory share exchange is deductible was considered in *The Royal Insurance Company Ltd v Stephen*.¹³² The company carried general insurance business and held large investments, including a variety of British railway securities. There was no issue with respect of the realisation of the investments, as any gain was part of the company's profits and any loss was deductible from the company's profits. In 1921, the Railways Act was passed into law which meant that the company had to substitute the securities held in the old companies for shares in the new companies, as part of amalgamation. On the date of exchange, the new securities were worth less than the old securities which the company had surrendered and as a result, the company claimed the difference should be allowed as a deduction in computing its profits as there was a loss on the original purchase price.

The question was whether the old securities were realised or was the company writing down the book value of its investment? The loss was realised notwithstanding the fact that the old securities were not sold for cash. Realised profit is not solely determined by how much cash was paid, but where something that could be turned into cash is paid for

¹³¹ Ibid, at 547.

¹³² *The Royal Insurance Company Limited v Stephen* (H.M. Inspector of Taxes) [1928] 14 TC, 22 No. 681(HC).

the original investment. The company realised the loss by surrendering its old securities for the new ones, at this very point they brought an end to their initial investment in British railway which was realised by getting the new securities.

It has long been settled that investment income of companies carrying on the business of insurance is a trading receipt. In essence, Justice Rowlatt stated that the exchange of securities constitutes a realisation of securities and the profit or loss on realisation is assessed by reference to the value of the investment received in exchange. The law in this matter was laid down in the case of *Californian Copper Syndicate* where it was held:

“... the difference between the purchase price and the value of shares for which the property was exchanged is a profit (or loss) assessable to income tax.”

The company was carrying on a trade and once it was established that this was a business transaction, whether it is a realisation or whether it is a conversion, it may be assessable to income tax in respect of the enhanced values obtained, or losses as the case may be, principle correctly stated in *Californian Copper Syndicate*.

In essence, the question whether particular operations were acts done in carrying on the taxpayer's trade is not one that can be answered by applying any definitive rule or criterion. The answer must depend on consideration and evaluation of the entire criterion.

IX. Australian Cases

A. Individual

In Australia, you are either considered a share trader when you are in the business of earning income through buying and selling shares or a shareholder who buys shares with the intention of earning dividends and receipts. Gains made by a shareholder are subject to the CGT regime and any losses made from sale of shares can only be used to offset against any future capital gains made from the sale of the shares.

When it comes to individuals, the issue that needs to be addressed is whether the taxpayer is a sharetrader as distinct from an investor, i.e. did the various shares held by the taxpayer constitute trading stock? Were the shares acquired for the purpose of reselling at a profit in a trading transaction? Ultimately, the “test” as to whether a

taxpayer is in business, as Webb J pointed out in *Martin v FC of T*¹³³ involves a combination of both subjective and objective factors, and:

It is made regarding the nature and extent of the activities under review, as well as the purpose of the individual engaging in them, and, as counsel for the taxpayer put it, the determination is eventually based on the large or general impression gained.¹³⁴

1. Case 9/94

i). Facts and Judgments

The ‘test’ as stated above was described in *Case 9/94*.¹³⁵ The taxpayer, a surgeon bought and sold significant number of shares through his brokers and as a result of the trading, the taxpayer suffered significant losses and was declared bankrupt in 1986. During this time, the taxpayer borrowed funds from the trustee of the family trust for the purpose of buying more shares in order to earn money and pay the receiver for all outstanding debts. The taxpayer stated that the shares were purchased for the purpose of reselling at a profit in a trading transaction.

In his tax returns for the years ended 1988-90, the taxpayer treated all newly acquired shares as trading stock and claimed the losses from the said activity. It was not disputed that prior to his bankruptcy, the taxpayer’s business involved buying and selling shares.

It was found that since 1987, the taxpayer’s activities displayed none of the characteristics which, when viewed objectively, could be characterised as a business of trading in shares. Deputy President Gerber stated that while the taxpayer purchased some 74,000 shares in four companies, the only reason some of the shares were sold was to reduce the debt. The President pointed out that in August 1987, the taxpayer made a ‘paper’ profit of sum \$55,000, yet he resisted the temptation to sell the shares, pointing to the fact that taxpayer’s strategy in 1987 had changed substantially from his frenetic activities of buying and selling shares in the earlier years. The President also made note of the fact that the taxpayer’s commitment and interest in the market was markedly less in and after 1987 than it was in 1983.

¹³³ *Martin v Federal Commissioner of Taxation* (1953) 90 CLR 470 (HCA).

¹³⁴ *Ibid*, at 474.

¹³⁵ *Case 9/94*, 94 ATC 154 (Administrative Appeals Tribunal).

ii). *Analysis*

It is interesting to note that the taxpayer's earlier activities in respect of buying and selling shares did not colour his current activities. For example, during July 1982 to January 1983, the taxpayer bought USD\$1.6m worth of shares and sold them for around USD \$1.4m, yet this trading activity had no bearing in the present circumstances. The fact that the bulk of the taxpayer's shares, all purchased within a few days of each other but held for a number of years, and sold for reasons unconnected with trading does not bear the footprint of a continuing business enterprise. The matter was put succinctly by Stephen J in *A C Williams v FC of T*:¹³⁶

I should, I think, first decide whether the taxpayer's assessable income derived from his share transactions can more appropriately be ascertained by treating him as conducting a business of dealing in shares ...

The former course would involve treating as trading stock at least those shares which the taxpayer acquired as a dealer in shares; it would treat his transactions as having the character of a continuing business enterprise the results of which could meaningfully be reflected by the process of annual accounting (at ATC p 4167; CLR p 655).¹³⁷

Although the taxpayer had the intention and purpose to sell the shares, the purported intent was not borne out by the objective surrounding circumstances. The taxpayer's present conduct clearly deviated from his past trading activities as he had abandoned any intention to engage in share dealing either regularly, routinely or systematically.

Therefore the conduct of the taxpayer indicated that he did not obtain the shares with the purpose of profit making by sale. The taxpayer's attitude and actions did not reflect that of a share trader but reflected the purpose of a long-term investor. The tribunal made it clear, relying on *John v FC of T*,¹³⁸ that it was a question of fact whether a person was a trader or not. The High Court in a joint judgment stated:¹³⁹

Whether or not a person is a trader seems to us to be a question of fact, albeit in some cases the determination of that fact may depend on questions of impressions and degree. If trading has not commenced or if there is no discernible trading pattern, the question of intention or purpose may be relevant in a sense that if there is an absence of intention or purpose to engage in trade regularly, routinely or systematically then the person may well not be a trader. *A fortiori* if some contrary or inconsistent intention or purpose is present. But if trading has commenced and the activities reveal a discernible trading

¹³⁶ *A C Williams v Federal Commissioner of Taxation* (1972) ATC 4,157 (HC).

¹³⁷ *Ibid*, at 4,167.

¹³⁸ *John v Federal Commissioner of Taxation* (1989) 166 CLR (HC).

¹³⁹ *Ibid*, at 429-430.

pattern, then it seems to us that the motive for undertaking the activities or for undertaking a particular transaction cannot serve to characterise the person engaging in those activities as a non-trader in relation to a particular transaction.

2. *Case F29*

i). Facts and Judgments

A share trader is someone who buys and sells shares on regular and systematic manner with the intention to make a profit, as was found in *Case F29*.¹⁴⁰ The taxpayer conducted a catering business through a private company. In November 1969, in his personal capacity, the taxpayer saw an opportunity in the share market field and believed that dealing in options could offer favourable prospects. From July 1969 to June 1970, the taxpayer had accumulated 277 transactions relating to some 40 companies and had funds available which could be applied to the purchase of shares. The taxpayer had regular meetings with his stockbroker and kept detailed notes of the long-term options and prevailing prices. All business records such as broker's statements and contract notes were also kept by the taxpayer.

The Board of Review found that the taxpayer was carrying on a business of share dealing. Their decision was based on a number of factors; namely the number of transactions carried out; the time and effort committed by the taxpayer; the transactions occurred on a repetitive and regular basis; keeping of business records as well as having sufficient capital to carry on the business. As always, the question of whether a taxpayer is carrying on a business is one of fact. It is the function of the Court to evaluate those facts and determine whether they establish the existence of a business, as said by Webb J. in *Martin v FC of T*:¹⁴¹

The test is both subjective and objective: it is made by regarding the nature and extent of the activities under review, as well as the purpose of the individual engaging in them, and, as Counsel for the taxpayer put it, the determination is eventually based on the large or general impression gained.

However the situation gets a little murky where within a portfolio of shares, the taxpayer contends that a particular group of shares were purchased as long-term investment. The taxpayer may rely on the fact the receipt of regular dividends supports

¹⁴⁰ *Case F29*, 74 ATC 15 (Board of Review).

¹⁴¹ *Martin v FC of T*, above n 133, at 474.

their contention that these particular shares had been acquired for the purpose of investment. As always, where the intention of the taxpayer is involved, “it must be tested and received with the greatest caution” – remarks of Cussen J in *Cox v Smail*.¹⁴²

3. Case S33

i). Facts and Judgments

The Courts have established that it is important to examine the activities and financial standings of the company concerned over the years and to reconcile the findings with the taxpayer’s subjective intention. This was the issue in Case S33,¹⁴³ where the taxpayer was involved in 70 transactions embracing shares in 17 companies all of which transpired from July 1977 to June 1981.

Three of the companies were engaged in profitable undertakings, paid regular dividends and the taxpayer claimed that the shares had been purchased as investments. These were subsequently sold in 1982. The remaining shares, except for shares in a company involved in mining were purchased with the motive to sell for a profit. The purpose for purchasing the shares in the mining company was the potential dividend income and it was a secure investment. The shares in the company were purchased and sold in 4 allotments from 1969 to 1980, resulting in a loss in 1970 and gains in 1973, 1979 and 1980. All along, the taxpayer’s husband, a qualified accountant carried out systematic appraisal of all available material and provided assistance.

In determining whether the taxpayer is engaged in a business, Barwick C.J. said in *Gauci & Masi v F.C. of T*¹⁴⁴ at p 158 that the question in the legislation is not whether the taxpayer, when purchasing, hoped that at some time in the future he could sell the asset at an enhanced value. The question is whether he was then intending to sell at a profit, doing so as a matter of ‘business’. In determining whether a business was conducted, attention should be focused on the nature and extent of the activities as well as the purpose of the individual engaging in them. The criteria to be applied in cases of

¹⁴² *Cox v Smail* [1912] V.L.R. 274, at 283.

¹⁴³ *Case S33* [1985] ATC 297 (Board of Review).

¹⁴⁴ *Gauci & Masi v Federal Commissioner of Taxation* (1975) ATC 4,257 (FHC).

this kind were outlined in the joint judgment of Bowen C.J. and Franki J. in *Ferguson v F.C. of T.*¹⁴⁵

There are many elements to be considered. The nature of the activities, particularly whether they have the purpose of profit-making, may be important. However, an immediate purpose of profit-making in a particular income year does not appear to be essential. Certainly it may be held a person is carrying on business notwithstanding his profit is small or even where he is making a loss. Repetition and regularity of the activities is also important. However, every business has to begin and even isolated activities may in the circumstances be held to be the commencement of carrying on business. Again, organisation of activities in a businesslike manner, the keeping of books, records and the use system may all serve to indicate that a business is being carried on.¹⁴⁶

There was no doubt that the taxpayer purchased the shares in the company as an investment and not for resale at a profit. Firstly the Board examined the company's activities and financial standing and found that right from its inception the company's business activity was viewed as highly speculative venture, thus indicating that a profit motive triggered the purchase of shares in 1969 and 1970. Furthermore in 1978, the company acquired shares in another company with the sole purpose of increasing its profitability which caused the taxpayer to purchase further shares in the company. These shares were sold in 1979 resulting in a gain.

In 1979, the directors of the company notified its shareholders that two large mining companies offered to acquire a majority interest in the company which caused the taxpayer to purchase an additional 5,000 shares. The companies' interest was subsequently acquired by a group company that held a strategic holding in a coal mining company with proven reserves. The reserves were transferred to the company which caused its share price to increase quite significantly and as a prudent investor, the taxpayer sold her shares and realised significant gain. These particular shares were sold within a short period of time which infers that they were purchased for the purpose, or at least the dominant purpose, of resale at a profit.

The Board concluded that on the balance of probabilities, the dominant purpose of purchasing the shares in the company was for the purpose of profit making by sale. As

¹⁴⁵ *Ferguson v Federal Commissioner of Taxation* (1979) ATC 4,261 (FCA).

¹⁴⁶ *Ibid.*, at 4,265-4,266.

established in *Steinberg v F.C. of T*,¹⁴⁷ the purpose referred to in the legislation refers to the dominant purpose which induced the original procurement of the property. The taxpayer's conduct, particularly in respect of the 1979 transaction gives the impression of business dealing. The Privy Council in *McClelland v F.C. of T*¹⁴⁸ commented that the transaction of acquisition and resale must exhibit features which give it the character of a business deal.

In respect of all other shares, it was concluded that the taxpayer had the motive to sell the shares for a profit. The transactions occurred on a repetitive and regular basis, the fact that the shares were purchased in a systematic manner and the volume of operations and the capital employed was substantial. All of which pointed to the fact that the taxpayer was in the business of share trading. The taxpayer failed to discharge the burden of proof and its conduct pointed more towards a share trader as opposed to a shareholder.

ii). Analysis

It appears that the Board, to some extent was influenced by the fact that the taxpayer's husband was also involved in buying and selling shares in the same period. It held that the intentions of the husband was a factor (but not decisive) in considering the intention of the taxpayer, as found in *Tilley v F.C. of T*.¹⁴⁹ Interesting to note that the Board had accepted that the taxpayer had other purposes for entering into the transaction yet concluded that the dominant purpose was to sell the shares for a profit. It was clear that the Board decided that the shares in the company was indistinguishable from the other share transactions which amounted to a business in share dealing, and the profit derived was part of the taxpayer's normal trading activities.

It is difficult to reconcile the finding as it has been found in numerous cases that taxpayer's can be involved in trading in shares as well as investing in shares. The taxpayer's argument had some merits as in any commercial environment no one should be expected to hold onto shares when the prices go beyond reality. But here, the Board focused on the taxpayer's attitude throughout the series of transactions and reached the conclusion.

¹⁴⁷ *M. Steinberg v Federal Commissioner of Taxation* (1973) ATC 4,030 (HC).

¹⁴⁸ *McClelland v Federal Commissioner of Taxation* (1970) ATC 4,115 (PC).

¹⁴⁹ *Tilley v Federal Commissioner of Taxation* (1977) ATC 4,027 (SCSA).

B. Investment Companies

Generally, gains made by public investments companies on the realisation of shares have been held by the Courts to be assessable income, where what is done is not merely a realisation or change of investment but is an act done in the carrying on of a business. However gains arising on the realisation of investment shares at an enhanced price are not income and therefore not assessable unless they fall within the capital gains regime. The treatment of gains made by investment companies is not clear which to date possess significant challenges to taxpayers. The companies will claim that the dominant purpose to purchase and sell shares is not for profit making but rather to preserve the capital of its shareholders, which is the very essence of its existence.

1. London Australia Investment

i). Facts and Judgments

One of the leading cases dealing with this issue is *London Australia Investment Company Limited v Federal Commissioner of Taxation*.¹⁵⁰ The company was set-up with the primary object of its investment activities to produce dividend income from investing in the Australian Stock Exchange which it could distribute to its shareholders who were residents of the United Kingdom. The company was interested in growth potential of shares with the expectation of greater dividend yield. Regular meetings were held to review the company's holdings. The shares were never acquired for the purpose of profit-making by sale or for the purpose or with the intention of selling them.

Where the shares acquired had not produced a dividend yield¹⁵¹ of 4% or better, the company ended up selling the shares and replacing them with another portfolio of shares which had growth potential. The company's purchases and sales were on a continuous large scale. Under this strategy, it was likely that the shares would increase in market value, but if the dividend rate did not correspondingly increase, the dividend yield would fall which caused the company to sell the shares at a higher price. During 1967 to 1969 tax years, the company made surpluses in excess of \$1.3m.

¹⁵⁰ *London Australia Investment Company Limited v Federal Commissioner of Taxation*, above n 51

¹⁵¹ Dividend yield is the return on the shares calculated as a percentage of their market value: Annual Dividend Per Share/Price Per share.

The High Court, by a majority, held that the surpluses were income. Gibbs J said that the principle established in *Californian Copper Syndicate* is applicable to any business and if the sale of the shares is an act done in what is truly the carrying on of an investment business, the profits will be taxable. His Honour cited the statement in *Californian Copper* and said:¹⁵²

... that if the sale in question is a business operation, carried out in the course of the business of profit-making, the profit arising on the sale will be an income character.

It was accepted that the company's business was to invest in shares with the primary purpose of obtaining income by way of dividends which required the share portfolio be given regular consideration. The shares were frequently sold when the dividend yield dropped, which for practical purposes usually meant when the shares went up in value. The switching of investments was desirable to produce the best dividend returns and was indeed necessary to meet the company's primary object of investing in shares with growth potential. His Honour explained why the gains were assessable:¹⁵³

The taxpayer systematically sold its shares at a profit for the purpose of increasing the dividend yield of its investments. The sale of the shares was a normal operation in the course of carrying on the business of investing for profit. It was not a mere realisation or change of investment.

Jacobs J was also of the view that the profits were income under ordinary concepts and expressed the view that the activity of the taxpayer constituted a business. His Honour declared that an investment policy which envisages regular and frequent sales of the shares acquired requires its operations to be conducted on such a very large scale. The only proper conclusion is that the acquisition and disposal of shares was part of a business that includes the buying and selling of shares. The crucial point is that a taxpayer can have a business of investing for the purpose of deriving dividends and the share sales made in the course of such a business may be assessable as an ordinary incident of that business. As long as the taxpayer has a purpose of resale, and that purpose need not be the sole or dominant purpose, it need only be one of the purposes.

¹⁵² Ibid, at 4,403.

¹⁵³ Ibid, at 4,404.

Later in the judgment, his Honour observed in the context of a discussion of whether the taxpayer was carrying on a business:¹⁵⁴

I do not think that a conclusion on scale by itself provides the answer; but it is very important evidence tending to show a business of acquiring and disposing of shares and it was some evidence from which a purpose of thereby making a profit might be inferred. It was for the appellant to rebut the latter reference. In my opinion it has not done so. It has in its favour the very important circumstance that the source of the funds was the subscribed capital of the company. But this is only part of the evidence.

The evidence taken as a whole strongly support a conclusion that a purpose or intention or expectation implicit in the carrying into effect of its investment policy was that shares acquired would be resold if and when an occasion arose which would make it desirable so to do and an element of desirability was that there would be greater financial benefit in disposing of the shares at an enhanced value than in retaining them...The massive scale of the activities in the years in question practically compels the inference that the investment policy was one which in its inception and throughout the course of carrying it into effect would in the expected state of the rising market require frequent and regular realisations of shares whenever they arose in market before dividends from them were increased.

In respect of the significant dividend income received by the taxpayer, his Honour observed:¹⁵⁵

The fact that enlargement of dividend income was the dominant purpose does not gainsay the existence of a concurrent purpose of resale if and when that resale would throw up a profit which could be used to enlarge the dividend income...The dealings took place on a market which was regarded by the company as having growth potential. A rising, not falling, market was expected and it was on that expectation that the investment policy was based.

Barwick CJ dissented. His Honour stated that it was not part of the business to deal in shares and neither were they acquired with the purpose of making profit by their resale. He stated:¹⁵⁶

... as the maintenance of the subscribed capital and of a consistent yield upon it was also the essence of the company's business, realisation of shares from time to time became necessary or advisable. Market conditions and the fortunes of companies in which shares were held determined whether or not realisation should occur. Those realisations could be said, in my opinion to be a result of the nature of the company's business but not part of that nature. It would indeed be surprising, in my opinion, if the company could successfully claim deductions from its dividends income losses incurred by it on realisation of unwanted investments.

¹⁵⁴ Ibid, at 4,411.

¹⁵⁵ Ibid, at 4,412.

¹⁵⁶ Ibid, at 4,402.

His Honour further stated that this was an accretion to capital solely derived from the sale of an asset not forming part of circulating capital and not purchased or held as a trading asset. Relying on the principle enunciated in *Californian Copper Syndicate*, the action of the company was a mere realisation of an asset. His Honour quantified that the conduct of the company was in contrast to businesses in the banking and insurance industry. Referring to *C. of T v The Commercial Banking Co. of Sydney*,¹⁵⁷ where it was found that the gains made from share trading activities were used by the bank in its business activity and were part of the banks stock in trade used to meet the demands of its depositors. Here, the realised shares never formed part of the company's stock in trade, rather the money invested in shares formed part of its capital from which it derived dividend income.

Consequently if shares are purchased as part of the business so that the gains on realisation are made in the ordinary course of the business, the gains will be income. If the gains are made otherwise than in the ordinary course of the business, then the gains could not be income unless the acquisitions are made with the intention or purpose of making profit, as was in found in *FC of T v Myer Emporium Limited*.¹⁵⁸ It is necessary to determine the nature of the business as there is a distinction between a business of investing, and an investment business, as was the case in *London Australia*.

2. *AGC (Investments) Ltd*

i). *Facts and Judgments*

However there have been decisions favouring taxpayers that have been involved in buying and selling shares specifically to preserve the capital of the company, as was found in *AGC (Investments) Ltd v FC of T*.¹⁵⁹ The company, a wholly-owned subsidiary of an insurance company was incorporated as a vehicle for the investment of funds of its parent.

Over a period of time, the parent advanced substantial amounts to its subsidiary to acquire a portfolio of shares in listed public companies. The company's practice was not to sell the shares acquired except during a takeover offer or by occasional

¹⁵⁷ *C. of T. v The Commercial Banking Co. of Sydney* (1927) 27 SR (N.S.W.) 231.

¹⁵⁸ *Federal Commissioner of Taxation v Myer Emporium Limited* (1987) ATC 4,363 (HC), at 4,366-4,367.

¹⁵⁹ *AGC (Investments) Ltd v Federal Commissioner of Taxation* (1992) ATC 4,239 (FCA).

divestment. Shares acquired were held for a period of between 5 to 15 years. The portfolio was managed by Westpac Management and in 1986; it included shares in some 51 companies with a market value in excess of \$85m. In September 1987, the taxpayer believed that the sharemarket was overvalued and instructed Westpac Management to commence selling the portfolio of shares and to reinvest the proceeds of sale in fixed interest securities. The surplus realised from sale of investments was in excess of \$45m.

It was held that the shares were not acquired with the intention that they subsequently be realised at a profit. Based on the evidence produced by the company, the Court was of the opinion that the taxpayer had discharged the statutory onus of demonstrating that at the time of acquisition, the shares in its portfolio were not acquired with an intention that they be realised subsequently at a profit. The conduct of the taxpayer pointed to the fact that the shares were acquired with a view to long-term investment. His Honour distinguished the case of *London Australia* and affirmed:¹⁶⁰

...it appears that the appellant was not instructing Westpac Management to become a trader in shares; nor was it giving instructions that a system of 'switching' securities in a regular organised and large scale fashion, as was done in *London Australia*, be embarked upon. Rather, against the background of the standing instructions to aim for capital growth in the long term, the appellant was making the point that if stocks were sold, it was not necessary to go into the market immediately to replace those stocks for their own sake; rather, regard should be had to "cyclical fluctuations" in deciding on what action to take and when to take it. These instructions are consistent with an objective of long-term capital growth.

ii). Analysis

It is interesting to note that the Court did not place considerable emphasis on the role of the taxpayer as the investment vehicle of the parent company which was involved in the insurance industry. Despite the fact that the taxpayer is a subsidiary of an insurance company, is administered as part of that company and most importantly, the assets of the taxpayer were regarded by the parent as part of a reserve fund to be available to meet the liabilities.

In this respect, his Honour distinguished the case from the usual circumstances of an insurance company or bank where there is the need to buy and sell shares on a regular

¹⁶⁰ Ibid, at 4,253.

basis in order to maintain liquidity. This justifies the conclusion that it is a normal step in carrying on a banking or insurance business, with the consequence that the profits so earned are regarded as income. The evidence supports the conclusion that there was no need for the taxpayer to buy the shares in order to maintain the liquidity in its parent company.

In essence, the Court examined liquidity and inferred that the liquidity of an insurance company could only be maintained by a regular turnover of easily realisable assets. This was also recognised in *RAC Insurance Pty Limited v FC of T*¹⁶¹ where the Federal Court acknowledged that an asset acquired in the course of carrying on insurance business must “be available for realisation as and when required.”

The Courts have recognised that there is to be a distinction between a subsidiary company and its parent company, however it does not detract from the fact that the circulating capital of the subsidiary may still be available to the parent insurance company. Woodward J in *CMI Services v F C of T*¹⁶² recognised that this could be the case. However, Woodward J also accepted that where an insurer’s surplus funds are used to set-up and run another business which is distinct from its insurance business, the assets of that business cease to be stamped with the identity of assets available to meet insurance claims and this is even so if the second business is an investment business.

However, that conclusion can only be reached once an enquiry is made of the relationship between the subsidiary and its parent and ‘whether the assets have genuinely ceased to be part of the reserves of the insurance company.

However at the trial,¹⁶³ Hill J was of the view that the taxpayer was carrying on a business, that business being integral to the insurance business of its parent, and in the course of this business it acquired a portfolio of shares having at the time of acquisition a profit making purpose in so doing. It realised a large part of that portfolio to preserve the gain which had accrued to it, and the profits it made were income.¹⁶⁴ His Honour further stated that the taxpayer’s desire for dividend yield did not exclude a purpose of

¹⁶¹ *RAC Insurance Pty Limited v Federal Commissioner of Taxation* (1989) ATC 4,780 (FCA).

¹⁶² *CMI Services Pty. Ltd. v Federal Commissioner of Taxation* (1989) ATC 4,847 (FCA).

¹⁶³ *AGC (Investments) Limited v Federal Commissioner of Taxation* (1991) ATC 4,180 (FCA).

¹⁶⁴ *Ibid.*, at 4,194.

profit making by sale; provided the investment is made with the knowledge that the sales may be required to provide funds for the purpose of the insurance business of its parent. This is particularly so when the taxpayer's funds were all provided on a short term basis of loans repayable on demand. All of the investments were viewed by the parent company as part of the reserve fund, although they were held in a separate legal entity.

Hill J accepted that the company was not in the business of trading in shares. However, the taxpayer's affairs were administered as part of the parent company and its reserves were available to meet the liabilities of the insurance company. As a result, this justified the inference of a profit-making purpose in undertaking the investment scheme.

C. Banks

The realisation or switching of investments by banks and insurance companies will normally be regarded as acts done in the carrying on of the banking or insurance business and any profits arising therefrom will be treated as income. The general rule, as it applies to a bank, was stated by the Privy Council in *Punjab Co-operative Bank*:¹⁶⁵

In the ordinary case of a bank, the business consists in its essence of dealing with money and credit. Numerous depositors place their money with the bank, often receiving a small rate of interest on it. A number of borrowers receive loans of a large part of these deposited funds, at somewhat higher rates of interest. But the banker has always to keep enough cash or easily realisable securities to meet any probable demand by the depositors. No doubt there will generally be loans to persons of undoubted solvency which can quickly be called in, but it may be very undesirable to use this second line of defence. If, as in the present case, some of the securities of the bank are realised in order to meet withdrawals of depositors, it seems to their Lordships to be quite clear that this is a normal step in carrying on the banking business, or, in other words, that it is an act done in 'what is truly the carrying on' of the banking business.

1. National Bank

i). Facts and Judgments

The exception to the above relies upon the complete separation of an investment activity, or the holding of investments which was made clear by Kitto J. in *National*

¹⁶⁵ *Punjab Co-operative Bank, Limited, Amritsar v Commissioner of Income-Tax, Lahore*, above n 65, at 1,072-1,073.

*Bank Australasia Limited v F.C. of T.*¹⁶⁶ In 1948 the taxpayer merged with a Queensland bank and as a result, acquired certain shares owned by that bank in a pastoral company. The purpose of the acquisition of the shares was partly a desire to retain as customers the pastoral company, a desire to be identified with rural interests in Queensland and to receive dividends from its investments.

In 1963 the taxpayer accepted an offer for the purchase of the share and made a profit of some £527,000. It was held that the profit making by sale had not been a purpose of the acquisition of the shares and that the sale had not been part of the carrying out of a profit-making scheme. The purchase and sale involved changes on the profit earning structure of the taxpayer and were not part of the profit earning activities within the structure.

In dealing with the question whether the profit on the sale should be considered as bearing an income character, Kitto J said:¹⁶⁷

The purchase of the shares bore no resemblance to an investment of banking funds, made to earn income pending a need for their deployment in the making of advances and the like; it bore no resemblance to an investment by way of erecting a second or third line of defence against a time of stringency or emergency. It was an acquisition, not of the kind that might be repeated in the course of the profit-making process, but made once and for all for the sake of enhancing, even if only for the time being, the profit-earning potential of the enterprise as a whole...The acquisition of those shares did not follow any pattern of investment that the National Bank had followed; it is to be accounted for solely as part and parcel of the take-over of the Queensland National Bank's whole undertaking, so that in respect of purpose it was, as I have suggested, akin to a purchase of goodwill rather than a purchase of property to be turned over in the course of business. As the purchase of the shares stood outside of the banking business, the sale of them likewise stands outside it.

D. Insurance

The usual position which prevails in relation to taxpayers which carry on the business of insurance is well settled. The nature of the undertaking of insurance companies requires it to deal in money and in the investment of money; and its investments are an integral part of its business. The acquisition and subsequent realisation of investments is a step in carrying on the insurance business. It is an incident of an insurance business which receives premiums in advance of the insured event occurring, that profits and

¹⁶⁶ *National Bank Australasia Ltd v Federal Commissioner of Taxation* (1969) ATC 4,042 (HC).

¹⁶⁷ *Ibid*, at 4,048.

income are made from the investment of the premiums. Insurance companies therefore deal or trade in shares and the like. This was confirmed in *Colonial Mutual Life Assurance Society Limited v F.C. of T.*¹⁶⁸

... profits and losses on the realisation of investments of the funds of an insurance company should usually be taken into account in the determination of the profits and gains of the business.¹⁶⁹

However where investments of an insurance company are separated from its business of insurance, realisation of those investments has been found to be on capital account. In *The Chamber of Manufactures Insurance Ltd v F.C. of T.*¹⁷⁰ it was found that the profits from the sale of the investments were assessable on the basis that amongst other things, the taxpayer had failed to show that it had maintained two separate funds. The Court drew a distinction between different kinds of funds which might be maintained by insurance companies.

The first would be acknowledged as a reserve fund to meet the insurance claims and expenses in all reasonably foreseeable contingencies. The second fund could be categorised as an investment fund separated from its business of insurance. However whether the profits from the sale of investments on the second fund are taxable would depend upon factors unrelated to insurance such as those referred to in *London Australia*.

1. Equitable Life Insurance

i). Facts and Judgments

In situations where insurance companies cease its business activity but retain its share portfolio, the gains made from the realisation of the shares have been found to be capital profits. In *FC of T v Equitable Life and General Insurance*,¹⁷¹ the taxpayer was a member of the QBE Insurance Group. For many years prior to 1977 it had carried on a life insurance business and was assessed for tax as a share trader. Between 1977 and 1984 the taxpayer retained an investment portfolio which was bought and sold from

¹⁶⁸ *Colonial Mutual Life Assurance Society Limited v Federal Commissioner of Taxation* (1946) 73 C.L.R. 604 (HC).

¹⁶⁹ *Ibid*, at 618.

¹⁷⁰ *The Chamber of Manufactures Insurance Ltd. v Federal Commissioner of Taxation* (1994) ATC 4,315 (FCA).

¹⁷¹ *Federal Commissioner of Taxation v Equitable Life and General Insurance Co Ltd* (1990) ATC 4,438 (FCAFC).

time to time and the purpose was to enhance the capital value of the portfolio. Some of the funds were borrowed from the parent company however the needs of associated companies played a small part in the buying and selling of shares.

In respect of the sales pattern, in 1978 shares in three companies were sold; in 1978 shares in eight companies were sold; in 1979, 15; in 1980, 12; 1981, 20; in 1982, 11; in 1983, 7 and in 1984, 23. In 1984, the funds were required elsewhere in the group and as a result the portfolio was liquidated, resulting in the derivation of a substantial profit. In some instances, shares were sold as a result of take-over offers or were the sale of rights; however the amounts of money involved was substantial.

The majority of the Full Court held that neither the 1983 or 1984 profits were assessable as the activities of the taxpayer were consistent with long-term investment and the profits derived were profits from ordinary investments. Referring to *Trent Investments Pty. Ltd. v F.C. of T*,¹⁷² Mahoney J stated that:

Investments, in the sense to which I have referred, does not cease to be such merely because it is done systematically and skillfully. It may do so if, as a matter of fact, the activities of a taxpayer are such that he is carrying on a trade.

Referring to the remarks of Lord Justice Clerk in *Californian Copper Syndicate*, the proceeds obtained from selling the shares were a mere realisation or change of investment or from an enhancement of capital and were not income. The share transactions here were not an incident of an insurance business. There were no management plans directed to maintaining dividends which generally involves buying and selling shares on a regular basis. Furthermore, Justice Davies placed considerable weight on the concession made by the Commissioner that the taxpayer was not a share trader. His Honour said:¹⁷³

As the taxpayer...was not a trader in shares and did not carry on a business of or involving dealing or trading in shares, it follows from the principles I have outlined that the profits made from its investment activities do not form part of its assessable income. Its profits were capital profits derived from an activity of investment that was not a business.

¹⁷² *Trent Investments Pty. Ltd. v Federal Commissioner of Taxation* (1976) ATC 4,105 (SC).

¹⁷³ *Ibid*, at 4,447.

His Honour distinguished *London Australia* on the grounds that the taxpayer invested in securities for the purpose of producing dividend income. It did not purchase securities with the intention of realising profits on their sale, but during relevant financial years, it engaged in continuous activity in buying and selling of shares to pay dividends to its shareholders, involving switching of investments which constituted a business of investing for profit. In the present case the taxpayer's strategy was to buy for capital gain and dividend income was not the priority, thus it lacked the character of a business operation.

Pincus J was of the view that the gains realised from the sale of the investments were assessable on the basis that the taxpayer was willing to sell particular portfolio of shares from time to time having regard to the performance of the shares and the price available. The strategy here was to preserve capital and achieve capital profits and in this respect His Honor stated that the strategy could have been achieved without the need to generate sales. Furthermore, the volume and frequency of transactions carried out by the taxpayer demonstrated that the activity was a normal operation in the course of carrying on the business of investing for profit.

X. Comparison to Other Investments

A. Foreign Investment Funds (FIFs)

A FIF is an offshore investment, typically involving shares in a foreign company held by a New Zealand resident taxpayer who does not hold a controlling interest in foreign entities. The regime was enacted to prevent New Zealand residents from accumulating wealth in offshore countries, particularly tax havens, and avoid paying New Zealand income tax on those investments.

Where the total cost of the FIFs is below NZ\$50,000, the investment is permanently excluded from the FIF regime and taxable income is calculated according to other methods which largely follow when the income is derived. If there are foreign tax credits, these can only be claimed to the extent to which New Zealand income tax is payable on that income.

Under the FIF rules, an investor is required to calculate income and expenditure from their FIF investments using one of the prescribed calculation methods. The fair dividend rate method may be the most commonly adopted calculation method, where the FIF income is calculated at 5% of the FIF interest at the start of the tax year. In situations where FIF interests are bought and sold by the taxpayer within the income year (“quick sale”), the fair dividend rate method creates FIF income for 5% of the lesser of the cost of the sale or the gain realised from the purchase and sale. A deduction cannot be claimed for a loss on the quick sale investment, although some methods allow losses from FIF investments as a deduction to the investor.

The regime can be quite harsh as people are not only taxed on their income but also on the value of their foreign assets even though they have not received any income from the investments. As an investor this could potentially cause cash flow problems as cash will not have been realised from investments to pay tax. Whilst the FIF rules may be complex for most taxpayers to come to grips with, nonetheless it is precise in terms of establishing the tax liability and does not distort investment behaviour as it applies to all FIFs interests. Under this regime, the purpose or motive or intention of the taxpayer is irrelevant in determining the tax liability.

B. Land Transactions

Profits or gains from land transactions are gross income where the taxpayer had an intention or purpose of resale at the time of acquiring the land.¹⁷⁴ In the absence of a general capital gains tax, profits on disposal of land which is generally a capital asset are taxed as income where, in effect, the land is treated as if it is a trading asset.

In this respect, comments made by McKay J in *Inglis*,¹⁷⁵ is applicable to land and share transactions. In *Inglis* the taxpayer made a loss on share transactions acquired for the purpose of disposing of it. In allowing the deductions, his Honour accepted that the legislation changed the classification of shares for resale from fixed capital to circulating capital. The taxpayer’s share transactions were, according to ordinary concepts, probably capital in character however by deeming the gains as assessable

¹⁷⁴ Income Tax Act 1994, s CD 1; currently under Income Tax Act 2007, s CB 6(1).

¹⁷⁵ *Commissioner of Inland Revenue v Inglis*, above n 4.

income, the shares were consequently held on revenue account and had made the cost of purchase of the shares deductible.

The statutory test is to judge the taxpayer's purpose or intention at the time of acquisition which must be ascertained on a subjective basis, as established in *National Distributors Ltd.* The intention is tested objectively, taking into account the totality of circumstances associated with the relevant asset sale. Hence, a person who buys the property for investment or business purpose will not be caught simply because at the time of purchase they considered that it may be convenient or necessary to dispose of the land at some future time. As stated above, the onus of proof is on the taxpayer to demonstrate that the Commissioner's assessment is wrong, why it is wrong, and by how much it is wrong.

When establishing whether the taxpayer's business constitutes dealing in land, the principles established in share dealing cases are applicable. The exception is that a taxpayer can be held to be in the business of dealing in land if the land was sold within 10 years of acquisition. This is only applicable provided the taxpayer was dealing in land and irrespective of whether or not the actual property sold was purchased outside of the business.

There are similarities in establishing the tax liability when dealing with shares and land transactions. For example, the number of sales and the short periods are not, based on the facts likely to attract the application of section CB 6, i.e. the gain on sale of land will not be income. The taxpayer may have sold the land due to exceptional circumstances similar to what was found *Rangatira*.

Moreover, if the taxpayer bought the property with the purpose to sell, there is no tainting of other transactions under section CB 6 (1) whereas there is if the taxpayer is in business of dealing in land.

The uncertainty about the tax treatment of capital gains is not confined to cases involving the sale of shares. For example, gains from land sales or sale of second hand goods may or may not be subject to tax – depending on whether the seller is carrying on a business of dealing, or the seller's purpose at the time of purchase.

The analysis has concentrated on the purpose or intention upon acquisition of the asset, which is an onerous task for the Commissioner, but alleviated to some extent because the onus rests on the taxpayer to prove on the balance of probabilities that they did not have a purpose or intention of selling or otherwise disposing of the land at the time it was acquired.

XI. Recent Developments

Having reviewed the various cases, it is imperative to review any recent developments in this area, particularly involving individuals and investment companies. What is becoming evident is that there may be no apparent basis for distinguishing the different lines of cases.

*Case 5/2011*¹⁷⁶ is a recent case that considered whether a husband and wife partnership, which carried on a medical practice business, was entitled to claim the losses on share transactions. The partnership purchased shares with the intention to sell for a profit but not with the intention to carry out a business of dealing in shares. From 1999 to 2001, over a period of 22 months, the partners purchased some 450,000 shares made up of 12 transactions and sold some 9,500 shares, involving 2 transactions.

The shares, in companies based in USA were sold by so called “broker vendors” based in Thailand using “sophisticated high pressure selling techniques”. These companies were unstable and the shares were sold to the partners at grossly inflated prices. In 2003, the partners had difficulty getting the share certificates and later discovered that they had been the victim of fraud on the part of their share brokers. They lost all their money and investments.¹⁷⁷

The writer agrees that the partners purchased the shares with the intention of selling it as soon as the shares became publicly listed on the American Stock Exchange. Thus the cost of purchase is on revenue account (*Inglis* and *Stockwell*) even though, prima facie, the partners

¹⁷⁶ *Case 5/2011* [2011] 25 NZTC 1,005 (TRA).

¹⁷⁷ The present case is distinguished from *Calkin v CIR* [1984]1 NZLR 440 (CA). The transactions were fictitious as Mr Calkin’s business agent was a fraudster and had misappropriated the funds. It was held that in the absence of any actual purchases and sales, the intended business had not commenced, hence it was a capital loss.

were purchasing an item of capital. In respect of whether the partners were in the business of dealing in shares, Judge Barber stated:

...it seems to me that the partners could be imputed with the necessary intention for their activities to constitute a share trading business. Even though they did not give thought to that and so had not formulated such an intention, they intended to regularly acquire and dispose of shares for profit. Their share investment capital was circulating meant to be circulating capital. Their actions strongly suggest that they were in business.

To say that the partnership's actions suggest that they were in business is, respectfully, questionable. It's true that each case is different and has to be judged on its own facts. However this judgment contradicts with the views expressed by Justice Hardie Boys in *Stockwell*, where His Honour stated the following in respect of business of share dealing:¹⁷⁸

The buying and selling of shares is typical of many activities that may or may not be a business according to the individual circumstances. Carried on merely to supplement an adequate income from other sources or to provide interest or excitement, it is unlikely to be a business. That the person may regard himself as a "trader" is of little assistance. One would normally expect to find a considerable number of purchases and sales over an appreciable period of time before he could be regarded as dealing in shares and a substantial capital investment before one would take the next step if regarding him as in the business of dealing in shares...

It is clear from the above that the Court of Appeal emphasised that no general tests can be laid down. Hardie Boys J mentioned that the taxpayer needs to have a considerable number of purchases and sales over a period of time and invest in a substantial amount of capital in order to be in the business of share dealing. This was not the case here.

In *Rangatira*, The Privy Council whilst agreeing with the decision of the High Court that the gains from share realisations were not assessable income, did not approve their findings as such. The Privy Council made it clear that the decision could have gone either way and their Lordships commented that "it does not follow of course, that another judge hearing that evidence would have given the same weight". Dunbar states:¹⁷⁹

¹⁷⁸ Taxpayer spent \$73,000 purchasing 13 parcels of shares in six companies and held them for two to eight months and subsequently sold them at a loss.

¹⁷⁹ David Dunbar "Taxation of Equities- *Rangatira v CIR*": The Unanswered Questions (Smart Tax, Brokers Ltd 2007) New Zealand Journal of Taxation Law (January 1997) 45 at 54.

Arguably the Privy Council have left it open for a different Judge to reach the opposite conclusion in a similar case, namely the revenue account transactions can taint the whole portfolio with taxable characteristics.

KPMG tax partner Chris Abbiss said that the “*Rangatira* case was really won on technicality rather than a “hard-core” analysis of capital and income, and it would not mean much for the tax paying community”.¹⁸⁰

In *Kings*, the Court emphasised that the principles enunciated in *Californian Copper Syndicate* is seen as good law when it comes to establishing as to which side of the line a particular set of transactions fall. This view is also supported by the Canadian, UK and Australian tax jurisdictions. Commentaries have been made that the outcome of this case does provide some relief to individual taxpayers who purchase shares for long-term investment, but on occasions indulge in buying shares to resell.

The writer has some reservations simply because the Commissioner was invited by the Court of Appeal to consider whether specific shares were bought with the purpose of resale. The Commissioner did not seek to have the matter remitted to the Authority to determine whether specific shares were bought for the purpose of resale. Had this been the case, it was likely that the *Kings* would have been assessed for gains made on some of the share parcels as they were bought with the sole purpose of disposing of it.

In *Kings*, it was found the scale and nature of the activity across the portfolios was not such as to meet the test for business. This decision is in contradiction to the outcome established in *Piers & Ors v Commissioner of Inland Revenue*.¹⁸¹ The taxpayers were trustees of the Alexander Pension Plan, a superannuation fund. The fund was an employer run pension with approximately 60 members set up to provide long term retirement benefits. From 1984 onwards Westpac Investment Management managed the fund’s investments. Since 1998-91 some 176 dealings in shares took place. Westpac contended that these dealings were undertaken to minimise risk and to maximize protection of the fund’s long term investments.

¹⁸⁰ Cathie Bell “Capital Gains Ruling Favours Rangatira” *The Dominion Post* (New Zealand, 4 December 1996) at 23.

¹⁸¹ *Piers & Ors v Commissioner of Inland Revenue*, above n 37.

In the High Court Temm J found that the trustee's activities did not amount to a business (s CB 1) on the basis that they had no customers and their sole purpose was to act prudently in managing the fund. However his Honour concluded that the taxpayer's business comprised dealing in shares (s CB 5). The Court took this position based on the frequency of transactions and the fund was dealing in shares. The duty of the stockbroker in *Kings* was similar to that of the trustees in *Piers*, yet these cases had different outcomes.

In saying that, it is, with respect, difficult to reconcile the findings established in *Piers* that somehow one can be in the business of selling shares without being in "business". Whether the investment activities of the trustees could constitute the carrying on of a business, McKay commented as follows:¹⁸²

"In my view, any proposition which suggests that trustees are by virtue of their fiduciary duty to be judged by different criteria in determining taxation liability is quite untenable."

In this respect, if the taxpayer is found to be in business of dealing in property,¹⁸³ then it is likely that the property is sold as part of that business.¹⁸⁴ As both of the sections use the term "business", the principles established in *Grieve* must be followed in establishing the existence of a business. The property must be sold as part of the dealing activities before the profit or loss upon sale will be assessable. Whilst these provisions do overlap, they are distinct from each other.

In the writer's view, the decision in *Kings* contradicts with the findings in *London Australia* (where the company had to achieve a level of dividend yield), and to some extent, *National Distributors* (shares were sold to keep pace with inflation). The essence of the test is as set out in *Californian Copper Syndicate*. The Courts have accepted that where the line is to be drawn can be a difficult question and it is ultimately one of fact and degree. The matter must be looked at in context and the frequency of transactions and continuity of effort are primary considerations, however those matters cannot be viewed in isolation. The taxpayer's circumstances, including explanations in which the transactions take place are equally important.

¹⁸² Lindsay McKay "Capital/Revenue Distinctions" New Zealand Society of Accountants Tax Conference (1995) at 12.

¹⁸³ Income Tax Act 2007, s CB 5 – refers to a business of dealing "in property of that kind",

¹⁸⁴ Income Tax Act 2007, s CB 1 - an amount derived from business is income

In respect of losses, legislative changes incorporated into the Income Tax Act 1994 for “revenue account property”¹⁸⁵ following the *Inglis* and *Stockwell* decisions mean that if the shares are revenue account property, the person is allowed a deduction for the cost of the shares.

Section DB 23¹⁸⁶ applies to revenue account property and allows the taxpayer a deduction under the general deductibility provision. Although the cost of purchasing personal property is often capital in nature, and therefore prohibited from being allowable deductions, s DB 23(3) clarifies that the cost of revenue account property is not a capital cost and overrides the capital limitation as stipulated in s DA 2(1).¹⁸⁷ However the other general limitations still apply.

There is no clear line between deductibility and non-deductibility as each case depends on its own facts.¹⁸⁸ A loss generated on disposal of shares can be offset against other income of the person without restriction in these circumstances. Other associated costs such as interest and brokerage costs are allowed as a deduction. Having determined that the shares are held on revenue account, any loss is only deductible in the income year of disposal.

Pursuant to s EA 2,¹⁸⁹ the deduction cost of the shares is allocated to the earlier of the year of disposal or the year in which the property ceases to exist. This is a timing issue designed to ensure the matching of income and deduction. However this section does not apply if the property is trading stock dealt with in s EB 2.

¹⁸⁵ Income Tax Act 2007, s YA 1 – Revenue account property, for a person, means property that –

(a) is trading stock of the person.

¹⁸⁶ Income Tax Act 2007, s DB 23 Cost of Revenue Account Property
DB 23 (1) Deduction

A person is allowed a deduction for expenditure that they occur as the cost of revenue account property.

¹⁸⁷ Income Tax Act 2007, s DA 2(1) Capital Limitation

A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the capital limitation.

¹⁸⁸ *CIR v Banks* [1972] 2 NZLR 472 (CA).

¹⁸⁹ Income Tax Act 2007, s EA 2(2) TIMING OF DEDUCTION

A deduction for the cost of revenue account property of a person is allocated to the earlier of –

(a) the income year in which the person disposes the property; and

(b) the income year in which the property ceases to exist.

XII. Should We Change?

The income tax legislation includes within “income” many forms of gain that in the absence of specific legislation would generally be considered capital gains. Nevertheless the tax legislation seeks to tax all profits provided the taxpayer had the intention, at the time the assets were acquired to resell for a profit. In the case of capital assets which are purchased with the intention of sale, our taxation laws treat such profits as ordinary business profits and not capital gains. In this respect, Casey J in *National Distributors* stated:¹⁹⁰

That provision [referring to s 65(2)(e); currently s CB 4] brings within the meaning of “assessable income” profits or gains which in the ordinary commercial understanding would be regarded as accretions to capital. What Parliament has done by it is to impose a limited form of capital gains tax.

Similarly McKay J in *Inglis* agreed that the taxpayer’s share transactions were, according to ordinary concepts, probably capital in character, however by deeming the profits or gains as assessable income pursuant to section 65(2)(e), the shares were therefore held on revenue account and had made the cost of purchase of the shares deductible.

After all the discussion from various jurisdictions, it is plainly obvious that there are challenges for parties concerned in establishing the correct tax treatment relating to share transactions. Of particular interest are cases involving individuals and investment companies. Quite simply you should not have a situation whereby gains from share realisations involving two investment companies are treated differently for tax purposes, *Rangatira* and *National Distributors*. In this respect, Wilkinson and Tooley (1998) said:¹⁹¹

Clearly, then, there remains considerable uncertainty in respect of the tax position of investment companies. The exact manner in which the de facto capital gains tax applies to investment companies remains a mystery, albeit a costly one in terms of impact on the broader economy.

The uncertainty where some capital gains are taxed and others are not can distort savings and investment decisions. This paper does not intend to delve into whether New Zealand should introduce some form of a CGT regime as a mechanism to tackle this issue. In saying that, the writer is of the view that the introduction of CGT regime will provide taxpayer’s

¹⁹⁰ *Commissioner of Inland Revenue v National Distributors Limited*, above n 12, at 6,355.

¹⁹¹ Brett Wilkinson and B Stuart Tooley “Gains from Share Realisations: Is It Time For a Legislated Capital Gains Tax?” (1998) 6 WLR 57 at 83.

certainty, clarity, and avoid significant litigation and economic costs. For example, taxing shares on a realised basis could be considered, a method which is the norm in the rest of the OECD¹⁹² countries. At the same time any losses made from sale of shares can only be used to offset against any future capital gains made from the sale of the shares, (Burman & White, 2009).

Another form of CGT worth exploring is taxing capital gain income “on accrual basis”, that is, on gains arising on year-to-year basis rather than when assets are sold. If gains and losses are taxed as accrued, there should be no limits on using the losses to offset other income.

Another method would be to treat the gains and losses from share realisations under the financial arrangement rules. In general, the financial arrangement rules relate to debt arrangements, rather than equity arrangements and require all income to be accounted for in each income year, whether it has been received or accrued. A share is an excepted financial arrangement and is generally outside the scope of the “financial arrangement rules.”¹⁹³ However, an excepted financial arrangement may form part of a wider financial arrangement (for example, a financing arrangement involving the sale and repurchase of shares),¹⁹⁴ or when debt converts to equity, the excepted financial arrangement (the share) may remain part of the financial arrangement (the original debt).

One way of achieving this would be to remove shares as an excepted financial arrangement and deem income from the gains made on share realisations on cash basis during the income year. A cash basis person simply accounts for income physically received and expenditure physically incurred under the financial arrangement rather than accruing the amounts. Any loss of capital on a financial arrangement is deductible when a taxpayer is in business of share dealing. Where the shares were acquired with the purpose of disposing of it, the cost of share purchase should be allowed as a deduction. In principle, this would bring the tax system closer to taxing comprehensive economic income rather than the current *ad hoc* approach.

¹⁹² Leonard Burman and David White “Taxing Capital Gains in New Zealand: Assessment and Recommendations” (2009) CAGTR Business Links Seminar at 19.

¹⁹³ The relationship between financial arrangements and excepted financial arrangements is dealt with in s EW 6.

¹⁹⁴ Income Tax Act 2007, s EW 6(1).

Whether a CGT will “ease” the ambiguity in this area can be summed up by Canadian Revenue Agency, where the introduction of tax on capital gains has, to some extent, reduced some uncertainty amongst taxpayers. The purpose of the introduction of the “guaranteed capital gain election” was aimed at reducing the uncertainty as to the tax consequences of dispositions of Canadian securities. By not taxing capital gains, a type of income return is removed from the income tax base in a rather *ad hoc* fashion. The analyses of other tax jurisdictions outlined in this paper have some form of CGT involving share transactions.

As with any change, there are practical challenges and efficiency implications of introducing a CGT regime which need to be balanced. The cost of administering such a regime versus compliance costs need to be at the forefront when devising such a regime, something for the policymakers to contemplate. The solution is not as simple as that but the thought of having a CGT regime, whilst not new is worth another look. While a CGT regime is not the panacea to the problem, nonetheless a consistent regime that tax capital gains comparably with other income would be good for the economy and would significantly reduce the opportunities for arbitrage. Keeping in mind that NZ already embraces the partial taxing system of capital gains, this proposal is only an extension and not a full introduction of the CGT regime. The writer believes this would be easier to implement than a full CGT regime.

XIII. Conclusion

It is clear that the manner in which New Zealand’s Income Tax Act applies to gains from share realisations is confusing. At the same time, establishing the correct tax treatment seems to be a common problem across all jurisdictions as highlighted in some of the cases. Nevertheless the CGT regime has, to a degree, reduced this uncertainty in the other jurisdictions, particularly with individual taxpayers.

The examination of the tax cases has highlighted two contentious areas in the tax legislation when establishing whether gains made on shares are income. These include establishing whether the taxpayer is in the business of share dealing and whether the taxpayer acquired the shares for the purpose of disposing of it. The law to date has been unable to succeed in establishing precise rules which can be applied to all situations to distinguish between trading stock and capital assets. The legislature to guide which category a particular

investment belongs to have become increasingly ambiguous, inconclusive or even conflicting.

In respect of whether the taxpayer is in the business of share dealing, the decisions in *Stockwell*, *Rangatira*, *National Distributors* and *Kings* makes it clear that the “business test” will be applied relatively stringently. For example, in *National Distributors*, it was held that the level of activity did not amount to a business of investing in or dealing in shares.

However there have been situations where a single transaction can be in the nature of trade as to make it a business venture. In *Californian Copper Syndicate* there was one isolated transaction giving rise to a profit and the Court held that the profit was income. In *Myer*,¹⁹⁵ it was held that a receipt may constitute income even if it arose from an isolated business or commercial transaction entered into otherwise, than from the course of carrying on the taxpayer’s business. This is applicable so long as the taxpayer entered into the transaction with the intention or purpose of making a relevant profit or gain from the transaction.

It seems that a concerted commercial activity of buying and selling shares over an extended period of time can more appropriately be described as the carrying on of a business in the ordinary sense of the word. Other factors such as regular monitoring of the share portfolio, the existence of a system according to which shares are sold, commitment of time, money and effort, the pattern of activity, the scale of operations, and the financial results also feature.

At the end, it is a question of fact in each case as to whether or not a particular taxpayer is carrying on business. The characters of the transactions are not always easy to determine which makes it difficult to apply in practice.

In respect of whether the taxpayer acquired the shares for the purpose of disposing of it, the language of the section has led to many of the problems relating to its application. The inquiry under this section is as to the purpose of the taxpayer at the time of the acquisition. Whilst subsequent events assist in ascertaining that purpose, they do not determine it. This section is directed at the subjective purpose of the taxpayer rather than the readily

¹⁹⁵ *Federal Commissioner of Taxation v The Myer Emporium Ltd*, above n 158.

ascertainable financial consequences of acquisition and subsequent resale. The Courts have established that the stated intention must be tested against the objective factors such as the number of similar transactions, the length of time the shares were held, the circumstances of the purchase and the subsequent disposal are important considerations.

The subjective nature of the inquiry can also be difficult. The Court must decide whether to accept the taxpayer's assertions, and assess their credibility. The objective evidence is not direct evidence of the truth of the subjective assertions and may end up being irrelevant to the question of what a particular taxpayer intended.

The concept of "intention" is not the same as that of "purpose". A taxpayer may have various intentions about resale rather than that purpose. However, it is clear from *Inglis* that acquiring shares not only to obtain dividends but also with the expectation to capital growth is an investment of capital. This is distinguished from buying shares for resale which changes the character from fixed to circulating capital and the shares themselves as trading stock and held therefore on revenue account.

Establishing a taxpayer's intention or purpose has remained a challenging and difficult exercise. In a recent article, The Treasury commented on this very issue and lobbied hard for a CGT on property and shares. It said:¹⁹⁶

... it would replace the current "intention test" that required proof a property was bought with the intention of sale before any gains can be taxed. In practice, this has been difficult to apply because it is difficult to prove intention, other than having the taxpayer to admit it.

What is clear from the review of the cases and the law is that gains from share realisations are taxed in a somewhat *ad hoc* manner. The fact that some investment gains are taxable and others are not causes uncertainty in the tax system. The problem of taxing gains on share realisations is embedded in law that gains should be taxed only on shares held for the purpose of resale. It is absurd that someone can disguise a transaction where there is a clear intention to sell for profit as "intended to hold it for the long term" and avoid paying tax.

¹⁹⁶ Vernon Small "Treasury pushed hard for capital gains tax" *The Press* (New Zealand, 9 July 2010) at A5.

The lack of clear guidelines on this matter has added to the confusion. The result is that the law is ambiguous making it very difficult to apply in practice.

If anyone engaged in as many transactions in land as *Rangatira* and *National Distributors* did in shares, that person would unquestionably be treated as in the business of dealing in land. To what this administrative difference in treatment between land and shares is attributable is not entirely clear. It seems that tax on share transactions is applied, if at all, in a lackadaisical way. The Privy Council in *Rangatira* noted the difficulties raised by such cases:¹⁹⁷

... Most of the decided cases in this area are concerned with profits on sale of land, an asset whose character in the hands of the vendor can often be judged by its suitability for speculation on the one hand, or long term investment on the other. In the case of shares, particularly small parcels of shares in listed companies, such an indication is frequently lacking. For many shareholders it makes little difference (tax considerations apart) whether the shares yield a profit by way of dividend or by way of a gain on re-sale. But for the shareholder who is carrying on a business, the question for taxation purposes remains the same, namely, whether the particular profit is income from capital assets held as part of the business, or from dealing with those assets as what may conveniently be called trading stock.

As the sharemarket goes through its periodical booms and busts, won't taxpayers' argue in boom times they're share investors and in downturns they're share dealers, or they purchased shares with the intention of selling it? With the current economic downturn and the numerous finance companies that have "gone belly-up", it is likely that taxpayers will argue their losses are of revenue nature.

The ever evolving case law is unclear and has, at times led to inappropriate precedents. The rules for taxing gains on shares are more complex than they have ever been. The dealer and purpose provisions in relation to shares date back to 1951 and since then, a good deal of effort has been spent on policing the boundary between revenue and capital. For taxpayers with substantial investment income, the current regime is arguably more complex because the boundary between capital and revenue is so idiosyncratic, Burman & White (2009).¹⁹⁸

The writer has proposed that it is time we re-visit the idea as to whether we need partial introduction of a CGT regime. A full review of the capital/revenue spectrum is outside the

¹⁹⁷ *Rangatira Ltd v Commissioner of Inland Revenue*, above n 14, at 12,729.

¹⁹⁸ Leonard Burman and David White "Taxing Capital Gains in New Zealand: Assessment and Recommendations" (2009) at 21.

scope of this paper. The arguments for and against a CGT regime depends on how it is applied, for example, accrual, realisation, or a combination of both. The writer's view is that taxing capital gains more like other income would enhance efficiency and fairness and will reduce some of the problems from the current, *ad hoc* approach, problems as highlighted in respect of gains made on share realisations by individuals and corporate taxpayers.

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