Privy Council Appeal No. 13 of 1973

Duncan Holden – – – – – *Appellant*

v.

Commissioner of Inland Revenue – – – – – *Respondent*

and

Maurice Campbell Menneer – – – – – *Appellant*

v.

Commissioner of Inland Revenue – – – – – *Respondent*

FROM

THE COURT OF APPEAL OF NEW ZEALAND

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 6TH MAY 1974

Present at the Hearing:
LORD WILBERFORCE
LORD DIPLOCK
LORD CROSS OF CHELSEA
LORD SALMON
SIR ERIC SACHS
[*Delivered by* LORD WILBERFORCE]

These appeals are from a judgment of the Court of Appeal of New Zealand which, by a majority, Turner P. dissenting, dismissed an appeal from a judgment of the Supreme Court of New Zealand. The issue is identical with that previously raised in *Commissioner of Inland Revenue v. Hunter* [1970] N.Z.L.R.116. In that case the Court of Appeal by a majority, Turner J. dissenting, allowed an appeal from a judgment of McGregor J. in the Supreme Court in favour of the taxpayer.

In each of the cases now under review the taxpayer, a resident in New Zealand, became entitled to sterling funds in the United Kingdom. He wished to convert these assets into New Zealand currency available in New Zealand, and instructed his sharebroker to make the necessary arrangements. The sharebroker arranged in New Zealand a price in New Zealand currency for selected United Kingdom securities on a particular day, and instructed his agent in London to buy these securities with the sterling funds and simultaneously to sell them for New Zealand currency. The result of these transactions was that the taxpayer received in New Zealand more New Zealand currency than he would have received if he had remitted his sterling funds to New Zealand for exchange into New Zealand currency through the banking system at the official rate of exchange. In fact, whereas for each £100 sterling at the official rate,

he would have received approximately N.Z.£100.7.6, he obtained through the transactions in securities an amount which varied from N.Z.£105 to N.Z.£113.

The Commissioner of Inland Revenue, in each case, assessed the taxpayer to income tax on the difference between the two resulting amounts, and the question for decision is whether these assessments were correct in law.

The assessments were based upon s.88 (1) (*c*) of the Land and Income Tax Act 1954 which is as follows:

> "(1) Without in any way limiting the meaning of the term, the assessable income of any person shall for the purposes of this Act be deemed to include, save so far as express provision is made in this Act to the contrary—
>
> . . . .
>
> (*c*) All profits or gains derived from the sale or other disposition of any real or personal property or any interest therein, if the business of the taxpayer comprises dealing in such property, or if the property was acquired for the purpose of selling or otherwise disposing of it, and all profits or gains derived from the carrying on or carrying out of any undertaking or scheme entered into or devised for the purpose of making a profit:".

The Commissioner relied on the second limb of paragraph (*c*) so that he set out to show

(1) that the amounts in question constituted a profit or gain derived from the sale of personal property.

(2) that the property was acquired for the purpose of sale.

The validity of each of these steps was contested by the appellants.

Their Lordships deal first with the second point, and do so briefly since they are in agreement with the Court of Appeal, which on this point was unanimous in these cases and in Hunter's case, that the Commissioner's contention is correct. It is clear that the relevant enquiry is for what purpose was the property acquired, and if there was more than one purpose, what was the dominant purpose (see *Commissioner of Inland Revenue v. Walker* [1963] N.Z.L.R.339). In the present cases it is not relevant to enquire what was the dominant purpose, since the only purpose for which the securities were bought was that they should, immediately, be sold. The appellants argued that this purpose was only incidental to the wider and more essential purpose, which each taxpayer set out to achieve, namely to remit funds from the United Kingdom to New Zealand but that, in their Lordships' opinion, is irrelevant. There can be only one answer to the question for what purpose the securities were bought, and the fact that the purchase and sale were part of a wider objective cannot affect that answer. Walker's case (*u.s.*) on its facts and *ratio decidendi* is clearly distinguishable from the present.

Their Lordships turn to consider the first point, which raises a question of some difficulty, and on which the Court of Appeal was divided in opinion. It is necessary first to refer in more detail to the evidence. It is not disputed that, although the Commissioner set out his view of the facts in a Case stated, it is open to the Courts to consider the actual evidence which was adduced before him. Moreover, although for convenience some essential points were embodied in an agreed statement of facts (set out in the judgment of Haslam J. in the Supreme Court), each side reserved their right to make "limited submissions on the facts" and to raise "such contentions as might be open on the evidence." There was, in fact, no essential difference between the evidence of the various witnesses, and there is really no room for difference in the interpretation to be placed

upon the critical passages in the testimony. It should be mentioned that the evidence in the present cases was in some respects fuller than that in *Hunter's* case, and indeed was directed to fill some lacunae which that case had revealed.

It is clear that, at all material times, there were three ways in which sterling funds in the United Kingdom belonging to a New Zealand resident could be turned into New Zealand currency. Each of these was legitimate, and was known to the authorities.

1. The funds could be remitted to New Zealand through the banking system at the official rate of exchange.

This rate was fixed by the Minister of Finance in accordance with the Reserve Bank of New Zealand Act 1964 and the evidence was that, prior to November 1967 when a devaluation took place, the £NZ was overvalued in the sense that it could not have been maintained without a system of controls. In 1965 and 1966 the official telegraphic transfer buying rate was £100 sterling = N.Z.£100.7.6. There was no other legal means of effecting straight currency-to-currency exchange, *i.e.*, there was no separate " commercial " or " financial " rate. If any black market rate existed, there was no evidence of it, and no argument was based on the existence, if any, of such a rate.

A counterpart of this was that New Zealand residents were severely restricted in the purchase of sterling currency in London. One of the witnesses—Mr. J. W. Rowe—said indeed that if a New Zealand resident wished to purchase sterling, he would have to operate the method referred to in (3) below in reverse, *i.e.*, to purchase U.K. securities at a premium and to sell them for sterling, because that was the only way he had.

2. The fund could be sold to another New Zealand resident for New Zealand currency provided that the sale was effected at the current official rate of exchange.

3. The funds could be used to purchase foreign assets which could then be sold for New Zealand currency in New Zealand.

The evidence was that the third of these methods (in fact used by each of the appellants and by the taxpayer in Hunter's case) was most commonly adopted, in the case of sterling funds, by the purchase of sterling securities. Considerable amounts of such securities were purchased and sold. The working of these transactions and the manner in which a " premium " was obtained is well explained by Mr. J. W. Rowe, an expert witness called by the taxpayers. He said

> " On the one hand there were many people in New Zealand anxious to purchase assets overseas in excess of those they might acquire with foreign currency via the banking system because of the restrictive exchange controls then in force, and such people were prepared to pay a significant margin in order to do so. On the other hand there were people with assets in the United Kingdom, Australia and elsewhere who wished to exchange these assets for New Zealand currency and they were naturally not unwilling to do so at a rate more favourable than that available via the banking system. The existence of such a *de facto* exchange rate of course indicates that the volume of funds seeking to leave New Zealand was greater than the reverse flow would have been at the official exchange rate (in the absence of exchange controls) and the difference at any one time reflected the relative magnitude of the two flows."

Evidence was also given that the great majority of purchases of sterling securities were made for this purpose, *i.e.*, as a means of remitting funds, rather than for investment.

Elsewhere in his evidence Mr. Rowe described these operations as producing a " well-known alternative *de facto* but legal exchange rate ", and as a " legal double (or multiple) exchange rate in respect of foreign property-to-local currency transactions ". The word " multiple " was used because transactions of this kind took place in Australian shares, and also in motor cars, producing separate, and possibly different, " premia ". Moreover, even as regards sterling securities there might be slightly different premia according to the stock selected: it was the task of the broker to select the security best suited to the operation and to the demand in New Zealand.

The essence of this factual situation is, in their Lordships' opinion, undisputed. Because the " official rate " placed too high a value on New Zealand currency, and because of the large demand by New Zealand residents for sterling currency, which could not be satisfied by exchange through banking channels, there had developed, and there was extensively used, the alternative method through the purchase and sale of sterling securities, which both enabled New Zealand residents to obtain sterling funds and also enabled New Zealand holders of sterling funds to obtain New Zealand currency. Because of the working of supply and demand, the former class had to pay and the latter class obtained the " premium ". The amount of the current premium could be ascertained by reference to market quotations; at the relevant time it was about 12–13%. All of this was legitimate, and was known to the authorities. There was in evidence a letter of the Inland Revenue Department referring to the " then ruling " premium on sterling in terms which show that buying and selling of securities was both established and accepted practice. The Bulletin of the Reserve Bank of New Zealand in July 1966 contained this passage:

> " . . . the proceeds from the sale of overseas securities, interest and dividends on overseas securities, immigrants' funds and legacies could either be retained overseas or transferred to New Zealand through a security transaction. The banking system was used to only a moderate extent for such transfers because of the premium to be obtained on the security market."

It is not necessary to refer in greater detail to the evidence since the difficulty of this case does not lie in the facts, but in the legal consequences which ought to follow from them. The question is, whether, in relation to the transactions described above, the taxpayers derived any profits or gains from the sale of the purchased securities.

At first sight, it would appear that this could not be so. It is difficult to understand how a profit can be derived from the sale of property, made instantaneously after its purchase, when the property as such—*viz.* the securities—neither rises nor falls in value. Particularly in the case of a quoted security, the presumption is that the purchaser paid for it precisely its value, and not something less than its value: no question of profit, or loss, could seem to arise. Moreover if one considers the substance of the transaction, it can be said that all that the taxpayers were doing was to exchange one currency for another. Admittedly more New Zealand currency was obtained by using the particular method adopted than would have resulted from using the official rate—but merely to choose one of two available rates of exchange does not, it could be said, bring the section into play, or bring about a profit.

On the other hand the taxpayers, in choosing the method they did, adopted one which involved the purchase and sale of securities: and since they did this, it is legitimate, even necessary, to examine the purchase and sale and see if a profit was made on the sale. A profit on a sale arises if the sale proceeds exceed the purchase price: the sale proceeds

are known, *viz.*, the amount of New Zealand currency, including the "premium" which the taxpayers obtained: the only question is as to the value of the purchase price.

The argument of the Solicitor-General as to this was simple. The purchasers, he contended, paid a price expressed in sterling: there is only one way in which to ascertain its value in New Zealand currency, and that is by converting it at the official rate. Thus: each £100 sterling was worth £N.Z.100.7.6, not more. Since, on the sale, the taxpayers received, for each £100 sterling, £N.Z.112–3, the difference represents the profit. This argument, which has an attractive clarity, in substance was accepted by the majority in the Court of Appeal. It was forceably put in the judgment of Richmond J. in these words:

> "However the vital question seems to me to be this. Can one properly to go one extra step and say that the *particular sterling funds owned by the appellants* were, as such, worth more than their value at the official rate? There is no doubt that they carried with them the potential of eventually realising a larger figure in New Zealand currency if they were utilised in the purchase of United Kingdom stock. There can also be no doubt that United Kingdom stock commanded a particular value to persons able to purchase it for New Zealand currency. As I see it however, the particular funds owned by the appellants (prior to their investment in United Kingdom stock) commanded no special value in themselves to any New Zealander anxious to acquire sterling. As such they were inaccessible to such a person except at the official rate of exchange or in breach of the Regulations."

The opposite view was expressed by Turner P. whose words repay quotation:

> "In this case it is necessary for the Commissioner to show a *profit* or *gain* on the sale of the Consols. What they realised in New Zealand currency is certain. What is not so certain is what the taxpayer gave for them, *measured in New Zealand currency.* We know, of course, what he gave for them *measured in English currency.* To say that the value of this English currency, measured in New Zealand currency, must be its value at the official rate, seems to me entirely to beg the question before us. I think that these English funds in England were worth in New Zealand (as everything else is always worth) what they would bring on the market. If there had been only one market—*i.e.* only one feasible way of realising them, viz. the official channel, via the Reserve Bank— the question would answer itself. But there were in my opinion two methods of realisation—*i.e.* two markets—open to the taxpayer. Both were completely legitimate, both were in fact open to the taxpayer, and both were being used daily by large numbers of persons with the open approval of the authorities. These two methods were (*a*) the official method of remission through the Reserve Bank and (*b*) the method followed by the taxpayer, and by many other taxpayers, which furnished an *alternative* market for the funds. Where there are two markets and the question is what is the value, the economists tell us that the question is begged by selecting arbitrarily one of the available markets rather than the other. In such case the value is the value in the market *actually used*, or, if neither is yet used, the value in the higher of them".

In their Lordships' view, the opinion of Turner P. is to be preferred. Looking at the matter broadly, there can be no doubt that this corresponds more closely to the reality of the transaction. The taxpayers were in truth making use of what had come to be established as an alternative or parallel rate of exchange. This had become so current, that

the official method of transfer through the banking system was hardly used. The taxpayer or his adviser knew in advance what " rate ", under the alternative method, in New Zealand was going to be obtained—there was in fact a market rate—and all that the taxpayer had to do was to instruct his broker to arrange remittance in this way and at this rate. That this corresponded to the official view of the matter is shown by a passage from the Bulletin of the Reserve Bank of New Zealand for July 1966:

> " It should be remembered that all sales of sterling securities in the free market in exchange for New Zealand currency represent the transfer of a New Zealander's overseas assets into New Zealand currency, but without benefit to the official reserves."

But their Lordships accept, as the Solicitor-General contended, that, in a matter in which taxation is involved, it is insufficient to look too broadly at the " substantial result " of what was done. Analysis must be made of the method actually chosen by the taxpayer. If he has made use of a method which brings him within a taxing provision, then the tax attaches. But this analysis does not, in their Lordships' opinion, lead to any different result. The essential fallacy of the Commissioner's argument, in their Lordships' opinion, lies in valuing the sterling funds, which it was sought to remit, at the official rate. The argument that they should be so valued may be answered in the words of Turner P. by saying that the funds must be valued for what they were worth in the better market, in fact in the market which was used, and that, on the evidence, there was a better market in a real sense. Another way of putting it is to say that sterling funds in London had a premium value to a New Zealand resident. This in fact they had, otherwise the premium would not have existed, for a New Zealand resident could only have obtained them by operating the taxpayers' method in reverse—*i.e.* by purchasing United Kingdom securities with New Zealand currency, at a premium, and then selling them for sterling. Funds available in London must be treated as having, for a New Zealand resident, the same value as he would have had to pay to obtain them.

The point was clearly made by a banker witness—Mr. G. A. Lau—in these words:

> " As a result of the foregoing overseas assets held by a New Zealand resident attained a new value at the time the Government measures were first announced. As indicated, this did not apply only to securities held by overseas residents but also funds held in Banks or on loan, as they were immediately convertible into overseas securities which could be sold in New Zealand at the rate applicable to such securities."

This is really the point at which their Lordships respectfully differ from Richmond J. The funds owned by the appellants did, in truth, have a special, *i.e.* premium, value to a New Zealand resident. And so far from their being inaccessible except at the official rate, they were inaccessible, in the sense that they could not have been bought, at that rate. They were only accessible if he paid the premium. To treat them, therefore, as having only their official rate value, is to disregard the fact that they were freely available for external use, and for that reason, commanded a premium value. Thus they had the same value (disregarding brokerage etc.) as the purchased securities. No profit was made on the sale.

Their Lordships were referred to two United States cases, *Phanor Eder et al. v. Commissioner of Internal Revenue* 138 F.2d 27 and *Edmond Weil, Inc. v. Commissioner of Internal Revenue* 150 F.2d 950, both

cited in *Mann on The Legal Aspect of Money* 3rd ed. 475, but these relate to different situations from those with which their Lordships are concerned.

Their Lordships will humbly advise Her Majesty that the appeals be allowed. Since there may be other contentions bearing on the cases which have not been disposed of, the cases will be remitted to the Court of Appeal of New Zealand for final disposal.

The respondent must pay the costs of the appellants before the Board and in the Courts below.

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v.

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and

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