Privy Council Appeal No. 92 of 1926.

William Richard Doughty - - - - - - *Appellant*

v.

The Commissioner of Taxes - - - - - - *Respondent*

FROM

THE COURT OF APPEAL OF NEW ZEALAND.

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 21ST JANUARY, 1927.

Present at the Hearing:
THE LORD CHANCELLOR.
LORD SHAW.
LORD WRENBURY.
LORD PHILLIMORE.
LORD BLANESBURGH.

[*Delivered by* LORD PHILLIMORE.]

This is an appeal from the judgment of the Court of Appeal of New Zealand reversing the decision of Stout, C.J., on an application by the Commissioner of Taxes seeking to assess the appellant to income tax in the sum of £6,010 in respect of income for the year ending on March 31st, 1921.

On the proceedings taken in respect of this assessment a case was stated by the Commissioner which, according to the practice in New Zealand, was traversable and was accordingly traversed by the present appellant in his answer, and the matter came in the first instance before a magistrate and was decided in favour of the Commissioner. His decision was, however, appealable both on grounds of fact and law to a judge of the High Court, in this case Stout, C.J. The decision of the C.J. is final on fact, but not on a matter of law.

The circumstances are these. The appellant and one Arthur John George carried on business at Wellington as wholesale soft goods merchants and drapers in partnership. On the 25th June, 1920, they converted their partnership into a private limited

company, of which they were the only two shareholders. The company had a nominal capital of £175,000 in £1 shares, 100,000 of which were ordinary, 25,000 were A preference shares and 50,000 were B preference shares.

The arrangement, which was embodied in an agreement dated 25th June, 1920, was that the partners as vendors should sell to the company and the company should purchase as from 20th January then past, the goodwill of the business, the leaseholds, plant, machinery, book debts, the benefit of pending contracts, all cash bills and notes, and generally all property to which the vendors were entitled in connection with the business.

Part of the consideration for the sale was the allotment to the vendors of £76,000 paid-up shares, £30,000 ordinary shares to George and £30,000 to the appellant, and £16,000 B preference shares to George. The residue of the consideration was the undertaking by the company to satisfy all the liabilities and engagements of the firm.

The vendors contracted not to carry on the business of a draper independently of the company, and they stated that they had in certain proportions subscribed the memorandum of association for all the 175,000 shares in the company, each thus according to his proportion rendering himself liable to that extent for the debts of the company.

The last balance sheet of the old partnership stood as follows :—

Liabilities.	£	*s.*	*d.*	*Assets.*	£	*s.*	*d.*
Capital Account	... 48,774	12	0	Furniture and fittings .	513	18	4
Sundry creditors	... 10,366	17	5	Cash at bank ...	106	11	3
Deposits at interest	... 2,238	7	6	Cash on hand and customs	432	7	11
Bills payable current	... 36,053	12	2	Sundry debtors	... 45,151	17	0
				Bills receivable current	5,896	3	3
				War loans	1,974	12	6
				Stock in hand	... 43,357	18	10
	£97,433	9	1		£97,433	9	1

This should be corrected in one respect, as £7,800 was due for unpaid income tax, thereby reducing the capital account from £48,774 12*s.* 0*d.* to £40,974 12*s.* 0*d.*

The partners having fixed the price at which they sold, if it could be called a sale, their business to the company, it remained to adjust the figures on the last balance sheet in accordance with this arrangement, £76,000 being evidently more than the sum standing to the credit of the capital account ; and, in order to effect this, the item on the asset side " stock in hand £43,357 18*s.* 10*d.*," was replaced by an item " stock and goodwill £78,383 6*s.* 10*d.*"

It appears from the evidence of the accountant who made out these accounts that he suggested that the figure for goodwill might be taken as £20,000, and that this view was accepted by

the outgoing partners. This left as the residue of the item £58,383 6*s*. 10*d*., or £15,025 8*s*. 0*d*. as the difference between the value of the stock-in-trade as shown in the partners' last balance sheet and the value of the stock-in-trade as it might be deemed to be taken over by the company; and the Commissioner for Taxes claimed that this was a profit and to levy income tax upon it.

By the law of New Zealand each partner is severally liable to tax in respect of his share of the profits of a partnership, and the appellant Doughty's share of this supposed profit was fixed at £6,010, in respect of which he was assessed to income tax as already stated.

The appellant puts his case in two ways. He says (1) that if the transaction is to be treated as a sale, there was no separate sale of the stock, and no valuation of the stock as an item forming part of the aggregate which was sold, and (2) that there was no sale at all but merely a readjustment of the business position of the two partners, and an application for their benefit of the law of New Zealand allowing the formation of private companies with limited liability.

Income tax being a tax upon income, it is well established that the sale of a whole concern which can be shown to be a sale at a profit as compared with the price given for the business, or at which it stands in the books, does not give rise to a profit taxable to income tax.

It is easy enough to follow out this doctrine where the business is one wholly or largely of production. In a dairy-farming business or a sheep-rearing business, where the principal objects are the production of milk and calves or wool and lambs, though there are also sales from time to time of the parent stock, a clearance or realisation sale of all the stock in connection with the sale and winding-up of the business gives no indication of the profit (if any) arising from income; and the same might be said of a manufacturing business which was sold with the leaseholds and plant, even if there were added to the sale the piece goods in stock, and even if those piece goods formed a very substantial part of the aggregate sold.

Where, however, a business consists, as in the present case, entirely in buying and selling, it is more difficult to distinguish between an ordinary and a realisation sale, the object in either case being to dispose of goods at a higher price than that given for them, and thus to make a profit out of the business. The fact that large blocks of stock are sold does not render the profit obtained anything different in kind from the profit obtained by a series of gradual and smaller sales. This might even be the case if the whole stock was sold out in one sale. Even in the case of a realisation sale, if there were an item which could be traced as representing the stock sold, the profit obtained by that sale, though made in conjunction with a sale of the whole concern, might conceivably be treated as taxable income.

But upon the evidence in this case, it would appear that no such separate sale was effected. It was a transfer of all the assets of the partnership for 76,000 shares, some preference, some ordinary, all taken at their face value of £1 each, with an obligation, measured by a number of shares not paid up, to discharge the liabilities of the partnership. If these several items were not worth £76,000, then the shares were not worth their face value. Then as the vendors were the takers of the shares, they would gain nothing. They may have estimated in June that their stock was in the previous January worth more than the sum at which it had been put in their balance sheet, but they did not, by so estimating it, make it more.

So far as the matter is a question of fact, the judgment of the Chief Justice was conclusive, and if the question be to any extent a question of law, their Lordships desire to express their agreement with the conclusion drawn by the Chief Justice.

The authorities to which their Lordships have been referred, when carefully examined, show where the distinction is to be drawn between capital sales and sales producing income.

Some of these authorities are cases in which a company is dealing with land. In *The Commissioner of Taxes* v. *Miramar Land Co., Ltd.* (26 N.Z. Law Reports, p. 723, decided in the year 1907), a company was formed for the purpose of dealing in land; and it acquired one property, of which it immediately sold a small portion, and a few months afterwards sold the rest in one block, and then it went into liquidation. It was held that the business of the company was one of dealing in land, and that the profit ultimately acquired was none the less a profit upon dealing, because when the last part of the profit was acquired, the company ceased from carrying on business.

So in the case of *The Californian Copper Syndicate* v. *Inland Revenue* (reported in Scotch Sessions Cases, 5th Series, Vol. VI, p. 894, and also in 5 Tax Cases, p. 159, decided in 1904), a company formed to buy copper-bearing land in County California, bought the land for cash, improved it, and then re-sold it in two portions to the Fresno Company for 300,000 shares of the nominal value of £1 each. The whole capital of the Fresno Company was 400,000 shares, of which 75,000 were subscribed for in cash, 300,000 went to the Californian Company, and 25,000 were unallotted. It was held that the transaction was a sale in the line of the company's business, resulting in a profit, and not a mere change in the mode of investment, and therefore that the profit was taxable to income tax. In that case the Primary Commissioners said that it seemed clear to them that the property had been bought in order to be sold.

On the other hand, in *Tebrau (Johore) Rubber Syndicate, Ltd.,* v. *Farmer* (5 Tax Cases, p. 658, decided in 1910), this case was distinguished, and the particular transaction in this latter case was held to be a case of appreciation of capital and not one resulting in a profit taxable to income tax. The facts were that the company was formed to purchase land in Malay and develop it by

cultivating rubber trees. Two estates were bought, and much planting had been done; but the capital was insufficient, and the undertaking was (after existing for rather more than a year) sold to a second company (the old company being wound up). The consideration for the sale was £2,500 in cash and 36,000 £1 shares of the new company. It was held that the first company was not formed to deal in land as a business, and that this was a case of realisation of an investment.

Then there are some difficult cases where the business is anent breeding stock. In the Australian case of *The Commissioner of Taxation for Western Australia* v. *Newman* (29 Commonwealth L.R., p. 484, decided in 1921), a pastoralist put an end to his business and sold the whole station with stock and plant as a going concern, and it was held that the transaction was not the carrying-on of a business but the winding-up of a business, and that the profit made on the winding-up was not a profit taxable as income; and in another Australian case, *Hickman* v. *Federal Commissioner of Taxation* (31 Commonwealth L.R., p. 232, decided in 1922), another pastoralist who put an end to his business and sold his property, with all the improvements and the cattle upon it, was held not to be liable to the war-time profits tax in respect of the monies realised by the sale of his cattle, even though in that case a separate price was realised for the cattle. It is stated in the judgment of Stout, C.J., that these cases have been since covered by legislation.

In the case of *Anson* v. *The Commissioner of Taxes* (1922 N.Z. Law Reports, p. 330) the view of the Court was that Anson, who carried on a sheep farm, was carrying it on as a dealer in buying and selling sheep, and the Court said, "Every individual animal (with the negligible exception of the rams kept for breeding purposes) is part of the taxpayers' stock-in-trade. It is true that he does not, while his business is carried on, sell all his stock-in-trade at once; he always retains a part thereof. But in this respect his business is not different from that of other merchants. In the case of most trades it is only when the business is wound up or transferred that the entire stock-in-trade is disposed of. Normally a trader retains and carries over to the succeeding year a standard quantity of stock. But this permanent quality does not for that reason cease to be stock-in-trade. . . ." This being so in the view of the Court, it did not make any difference whether the stock-in-trade was sold progressively or all at once by way of clearing sale or otherwise in connection with a transfer or a winding-up of the business. Whether his profit was derived from a single sale of all his stock-in-trade at once, or from repeated sales in the ordinary way of his business, his profit was taxable income, and was assessable accordingly.

In that case the item of profit was arrived at by taking the value of the stock as it stood in Dr. Anson's books for one year and comparing it with the same item of value in the previous year, and it seems to have been assumed that this particular piece of

farming could be treated by itself, and that all the items of buying and selling of animals and profits, if any, from sale of wool, with the *per contra* items of wages and fodder and such like, could be taken as balancing each other, so that the difference between the values of the sheep stock in the two years represented the actual profit.

It would be difficult to arrive at the profit in this way if it were the case of a farmer in England; but the trade of a pastoralist is one with which the New Zealand Courts would be familiar, and which it would be more easy for the New Zealand Judges than for their Lordships to appreciate.

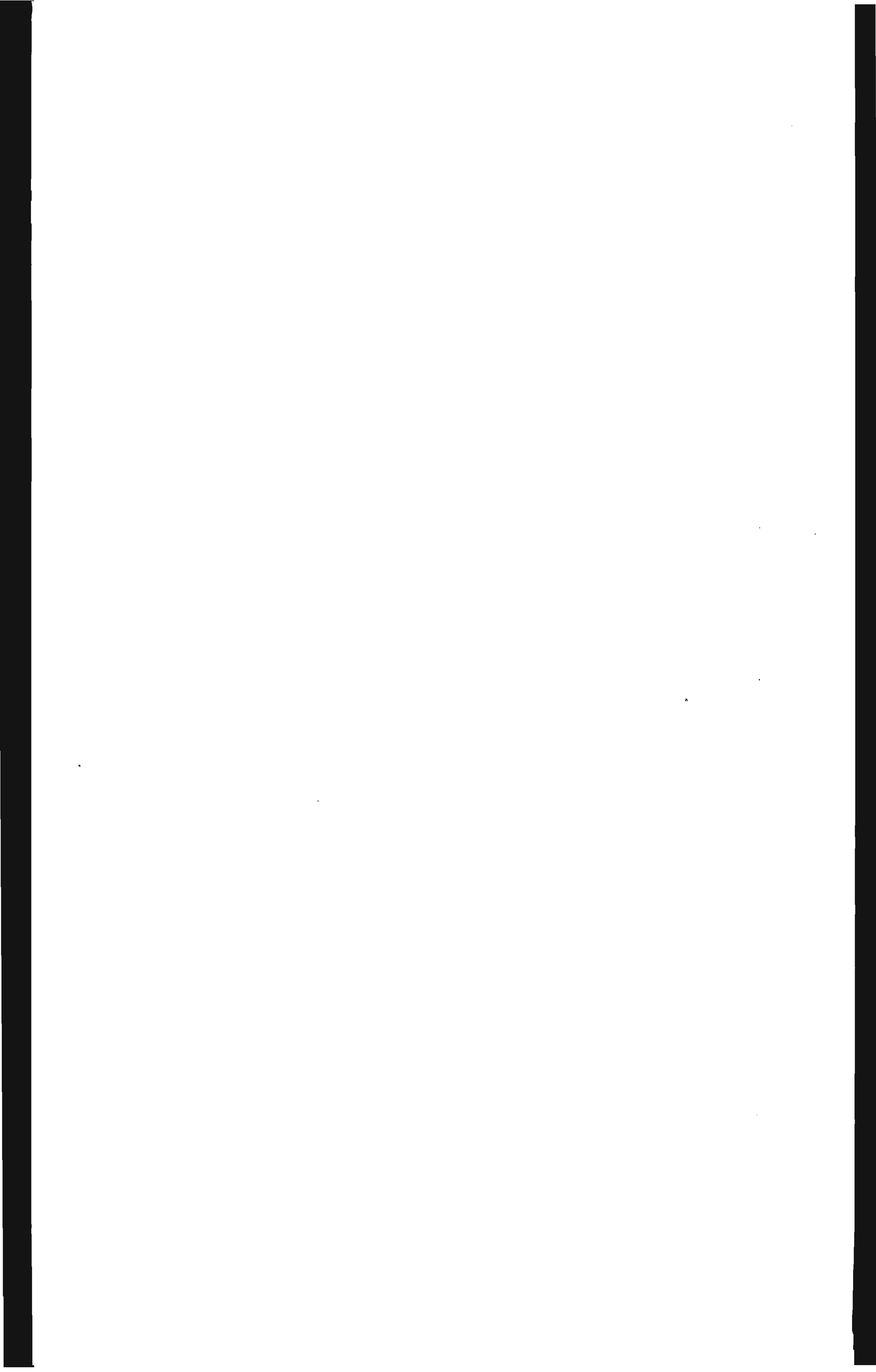
The reported cases on this branch of income tax law are so involved in detail that it is not always easy to see on which side of the line they fall. The case of *The Commissioner of Taxes* v. *The Melbourne Trust, Ltd.* (1914 A.C., p. 1001), is an authority for holding that in certain cases what seems like a distribution of assets, is in truth an application of profits. The case, however, nearest the present is that of *J. & M. Craig (Kilmarnock), Ltd.* v. *Inland Revenue* (1914 Scotch Sessions Cases, p. 338). There, on a transference from one company to another, one-third of the value of each item, other than stock-in-trade, as it stood in the books of the selling company, was treated as its value for transfer purposes, and the balance of a slump price, which, with an undertaking to discharge liabilities, formed the consideration, was inferentially attributable to the stock. It was held, however, in that case that no sum could be pitched upon as the actual price of the stock, and no claim to assess a profit could be based upon such a foundation.

Their Lordships would repeat that if a business be one of purely buying and selling, like the present, a profit made by the sale of the whole of the stock, if it stood by itself, might well be assessable to income tax; but their view of the facts (if it be open to them to consider the facts) is the same as that of Stout, C.J.—that is, that this was a slump transaction.

The other ground on which the appellant's case may rest is that the transaction which led to the claim for tax was not a sale whereby any profit accrued to the two partners. The case of *Craig* just referred to is an authority for saying that the Crown is not entitled to take a mere bookkeeping entry as conclusive evidence of the existence of a profit. The two partners made no money by the mere process of having their stock-in-trade valued at a high rate when they transferred to a company consisting of their two selves.

If they over-estimated the value of the stock, the value of the several shares became less. The capital of the company would be to this extent watered. As already observed, they could not, by over-estimating the value of the assets, make them more.

Their Lordships will humbly advise His Majesty that this appeal should be allowed, and that the judgment of Stout, C.J., should be restored, and that the appellants should have the costs below and of this appeal.



In the Privy Council.

WILLIAM RICHARD DOUGHTY

v.

THE COMMISSIONER OF TAXES.

DELIVERED BY LORD PHILLIMORE.

Printed by
Harrison & Sons, Ltd., St. Martin's Lane, W.C. 2.

1927.