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Taxation of capital gains



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A topical issue of recent times has been what policy should be adopted for the tax treatment of capital gains/losses. Discussion has some way to go before the outcome will be known. This newsletter will not review the various lines of that debate. Instead attention will concentrate on a recent English case that brings into focus some of the concepts that underpin the discussion.

Assignment of rental income

The taxpayer in the *John Lewis Properties* case was the property owning entity of a corporate group that operated retail stores. The taxpayer leased its properties to the trading company in the group. The taxpayer entered into a rent factoring scheme acknowledged to be for the avoidance of tax.

The scheme entailed a bank making payment of £25.5m to the taxpayer in return for the right to receive the next

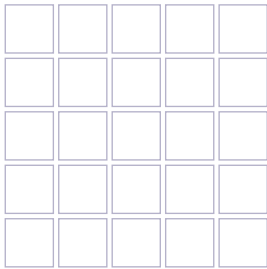
five years of rental payable under leases granted to the group trading company. That sum was calculated by applying a 7.56% discount rate to the rents due as at the date of assignment. At issue was whether the payment received was of an income or a capital nature.

For accounting purposes the taxpayer treated the assignment as a loan. It also showed the assigned rents as continuing to be payable. However, the Court was not influenced by the accounting treatment.

In support of its assessment the Revenue relied heavily on Australian case law. In the *Myer Emporium* case the High Court of Australia had ruled that a sum received for assignment of the right to future interest receipts was of an income nature. Future income was simply converted into present income. Similarly the *Henry Jones* case in relation to an assignment of future royalty income. The Revenue said that these precedents covered the present case.

In defending capital status of the receipt the taxpayer relied on the principle that sale of part of an asset, not being a sale in the course of trade, produces a capital receipt. Under conveyancing law principles the right to the payment of rental is an interest in land. The receipt was payment for impairment of assets and not compensation for loss of the recurrent produce of assets.

The English High Court found in favour of the taxpayer. There was earlier English case law drawing a distinction between the right to receive income in the future



Tax of capital gains (continued)

and the future income itself. The former is capital whilst the latter is, of course, revenue. The nature of the interest assigned in the present case fell into the former category. The Court added that a taxpayer is entitled to structure a commercial transaction so that a capital sum is received in place of an income receipt.

Impact on the debate

This case is pertinent to one area of the discussion on the possible taxation of capital gains. One of main props of the argument in favour of a capital gains tax centres on the anomalies and meaningless distinctions under a regime that seeks to differentiate between income and capital. Adherents to this school of thought point out that all too often the incidence of taxation turns on the minutia of legal concepts rather than a recognition of transactions for what they truly are. Turning to the *John Lewis* case, these advocates would assert that it is bizarre that a payment that was clearly a substitute for a future rental stream should receive a taxation profile different from that applicable to rental income. Defenders of the status quo are regarded as mere pettifoggers!

There is some merit in this point of view. However, some rebuttal can be made. First, it can be pointed out that the *John Lewis* case merely followed case law decided in 1938. Parliament did not see fit to overrule the earlier case until 2000 albeit after the transaction in issue. In all branches of the law it is possible for Judges to err by not recognising the true nature of a transaction. It is always the prerogative of Parliament to rectify judicial error.

Second and perhaps more broadly, the protagonists of reform seldom acknowledge the possibility of complexities with any replacement system. It is not as simple as discarding the existing system with all of its supposed anomalies.

A number of jurisdictions such as Australia, the United States and the United Kingdom maintain a capital gains tax regime. By all accounts an army of legal, accounting and other advisers are engaged in each of those countries in the never ending campaign to correctly quantify what is due. It is implausible to suppose that it will be any different in New Zealand. Tax regimes by their nature are complex albeit that individual

idiosyncrasies vary.

The point can be illustrated by an example that unfortunate investors may have experienced recently. The Government has made known its preference for a wealth tax on listed share investments. Under this concept a prescribed portion of the value of listed investments on measurement day would be deemed to be income subject to tax. The justification is that this would make the tax rules simpler, fairer and more effective.

It will be the case that some investors are victims of the "tech wrecks" that have afflicted stock markets in the last 12 months. Reports circulate of stock prices commonly dropping by 90%. Under a wealth tax system it is conceivable that an investor could pay tax on a value that is 90% greater than current realisable price. A regime with the potential to tax on the basis of what the investor only ever had on paper, and which may never reappear, may be thought by some to be no less anomalous than a failure to classify as taxable rental a lump sum paid as a proxy for the same. The tech wreck investor might vigorously contest the assertion that what is proposed is fair.

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