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Taxation Of Gains From Banking and Insurance Businesses In New Zealand

Abstract

There has been major contest over the taxation of business income. Questions are twofold: the factual one of defining the boundaries of the business activity. Second, that of determining whether a particular gain comes within the ambit of 'business'.

Recent NZ cases have sought to apply the guiding principle - that it is not the size of the gain but the source of it that determines the taxation consequences.

Logically, this principle should apply to specialist businesses such as those dealing with banking and insurance. However, the NZ Commissioner has, until 10 years ago, argued that it is the size rather than the source of the gain that is the determining criterion. And since the questions of what is the scope of the particular business activity and whether the particular gain has arisen in the course of such activity are purely factual ones, they are to be guided by the facts of each case.

This article concludes that the decisions are indeed based on their particular facts. Further, it investigates how important it is for the taxpayer to ponder the strategy that is to underpin the particular business. The evidence of such strategy being in place and having the practical effect of guiding the decision making of the taxpayer company's business activities are highly significant in determining the taxation consequences of such decision making. The consistency with which such corporate strategy or policy is formulated and implemented tends to determine their taxation consequences.

Keywords

income tax, business gains, insurance business gains

TAXATION OF GAINS FROM BANKING AND INSURANCE BUSINESSES IN NEW ZEALAND

JOEL MANYAM¹

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INTRODUCTION

The consistent principle that has guided court decisions in this vigorously contested area of taxation law, has been that articulated by Lord Justice Clerk in *Californian Copper Syndicate (Limited and Reduced) v Harris*:²

It is quite a well settled principle in dealing with questions of assessment of Income Tax , that where the owner of an ordinary investment chooses to realise

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² (1904) 5 Tax Cases 159.

it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit in the sense of ... [being] assessable to Income Tax. But it is equally well established that 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 a business, and thereby seeking to make profits ...

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?³

Barwick CJ, dissenting in *London Australia Investment Co Ltd v Federal Commissioner of Taxation*,⁴ had to determine how the principle applied to the facts which dealt with gains made not from the business activity of investing in shares, but gains made from merely switching these investments to acquire shares which produced 'the best returns'.⁵

Discussion of the subject usually begins with a citation of the remarks of the Lord Justice Clerk in *Californian Copper Syndicate (Limited and Reduced) v Harris* (1904) 5 Tax Cases 159 at 166. The oft citation of the truism there expressed has given it a Delphic significance⁶. But, in truth, what was there said furnishes no criterion for determining such a question as is now before this Court in this case. Of course, what is produced by a business will in general be income. But whether it is or not must depend on the nature of the business, precisely defined, and the relationship of the source of the profit or gain to that business. Everything received by a taxpayer who conducts a business will not necessarily

³ Ibid 165-6. This passage from *Californian Copper* has been approved by the House of Lords on numerous occasion – see, eg, *Commissioner of Taxes v Melbourne Trust Ltd* [1914] AC 1001, 1010; *Ducker v Rees Roturbo Development Syndicate Ltd* [1928] AC 132, 140, and *Punjab Co-operative Bank Ltd, Amritsar v Income Tax Commissioner, Lahore* [1940] AC 1055, 1072. It has also been applied by the New Zealand Court of Appeal in *C of IR v Auckland Savings Bank* [1971] NZLR 569, in *AA Finance Ltd v C IR* (1994) 16 NZTC 11,383 and *CIR v National Insurance Co of NZ Ltd* (1999) 19 NZTC 15,135

⁴ [1976-7] 138 CLR 106.

⁵ Ibid 111.

⁶ Hill J in the Federal Court decision in *FCT v Employers' Indemnity Association Ltd* (1990) 90 ATC 4,787, 4,796: ' "Delphic" although the passage may be (cf *London Australia*(supra) per Barwick CJ at ATC p 4401; CLR 112) it provides some insight into the difficult distinction between income and capital gains where securities are realised'.

[sic] be income. As I have said, it must depend on the essential nature of his business and the relationship of the gain to that business and its conduct.⁷

Barwick CJ identified the *Californian Copper* principle for determining the taxation of business income or gains, but also expressed misgivings about what it meant. He provided his own test of what the principle for the taxation of business gains was and how was it to be applied. Implicit in Barwick CJ's comments is the difficulty, namely how to apply the *Californian Copper* principle - which is a factual test - to a given set of facts.

The Californian Copper principle

A recent example of the application of the principle to the taxation of business gains is *Rangatira Ltd v CIR*.⁸ The *Rangatira* decisions illustrate the importance of satisfying the factual test and the consequences of paying little regard to the importance of the test and its proper application to business gains for taxation purposes.

There the taxpayer, a corporate, carried on an investment business. The majority of the board of directors were independent businessmen with little or no shareholding in the company. The policy of the board over the years was undergirded by an objective to maintain the pool of capital that was available for investment, while being vigilant about ensuring it was invested to provide a regular stream of dividend income.

Over time, there were changes in the investment, but up until 1983 the Commissioner had not indicated that any part of the proceeds of realisation of investments was to be treated as taxable. Any gains were accepted as being on capital account. From 1983 onwards, the Commissioner adopted the view that the activities of the taxpayer could be regarded as amounting to a business relating to the sale of shares for the purposes of s 65(2)(a) of the *Income Tax Act* 1976.⁹ There were other statutory grounds on which the Commissioner sought to tax the gains, but they were not relevant to the issue of whether the gains were made in the taxpayer's business.

Although, at first instance before Gallen J,¹⁰ it was held that the taxpayer's business did not comprise the selling of shares and therefore any gains made on sale could not be categorised as business income, Gallen J's reasoning is significant. The Privy

⁷ Above n 4, 111-112.

⁸ *Rangatira Ltd v Commissioner of Inland Revenue (CIR)* (1994) 16 NZTC 11,197 (HC); *CIR v Rangatira Ltd* (1995) 17 NZTC 12,182 (CA) *Rangatira Ltd v CIR* [1997] 1 NZLR 129 (PC).

⁹ The equivalent provision in the *Income Tax Act* 2007 being s CB 1. The equivalent provision in the Australian *Income Tax Assessment Act* 1936-1941, being s 25(1).

¹⁰ *Rangatira Ltd v CIR* (1994) 16 NZTC 11,197.

Council decision in *Rangatira*¹¹ vindicated the finding of fact on which Gallen J had made his finding but which had been overturned by the New Zealand Court of Appeal.¹²

Gallen J referred to Lord Justice Clerk in *Californian Copper Syndicate (Limited and Reduced) v Harris (Surveyor of Taxes)* [1904] 5 TC 159.¹³ A significant aspect of the decision was the evidence of a Mr JD Steele,¹⁴ who had a thorough working knowledge of the taxpayer's business activities, having served as auditor of the company, Rangatira Limited, from 1965 and later as a director from 1975. His undisputed evidence was that the policy of the directors over the years had been to maintain the capital funds of the taxpayer and ensure there was a regular income stream by way of dividend yield.¹⁵

The taxpayer had consistently operated within the pattern which had been a deliberate decision to invest in a company which was regarded as sound and which could reasonably be considered as a long-term investment. Any subsequent dealings did not indicate any change in the company's stance, 'but which imposed upon it reactions and responses which do not indicate any change in policy or function and which should be seen as incidental to its continuing long-established pattern'.¹⁶

Gallen J reflected on the scope of the taxpayer's activities:

In coming to a conclusion as to the application of the provisions of s 65(2)(a), I am satisfied that the emphasis and pattern of activities of the Objector had not changed overall from its original focus. I accept at least up until 1981, the activities of the Objector brought it within the first of the alternatives formulated by the Lord Justice Clerk in the *Californian Copper* case and I do not think that the changes which occurred subsequently were sufficiently fundamental to indicate any real change in the philosophy or approach of the Objector from that to which it had adhered up until that point.¹⁷

The Commissioner appealed Gallen J's decision and, although the Court of Appeal judgment¹⁸ of McKay J overturned the High Court decision, McKay J's approach asked whether the gains in question could be characterised as business income:

¹¹ *Rangatira Ltd v CIR* [1997] 1 NZLR 129.

¹² *CIR v Rangatira Ltd* (1995) 17 NZTC 12,184.

¹³ Above n 10, 11,200.

¹⁴ Mr JD Steele, chairman of Rangatira, provided a detailed affidavit as to the history of the company and the reasons for particular investment decisions-see McKay J in *CIR v Rangatira Ltd* (1995) 17 NZTC 12,182, 12,187.

¹⁵ Above n 10, 11,199.

¹⁶ Above n 10, 11,200.

¹⁷ Above n 10, 11,204.

¹⁸ *CIR v Rangatira Ltd* (1995) 17 NZTC 12,182.

The question whether profits on the sale of shares are business profits depends on the nature of the business.¹⁹

It was implicit in these comments that the two fold test still applied, namely what was the nature of the business and secondly whether the gain in question arose as a result of that business activity.

The special case for banking and insurance businesses

The central issue which arises in respect of these types of businesses is whether, although they are treated as a special case for taxation purposes because of the type of business activity involved, the principles which apply in respect of the taxation of any gains that arise are similar in effect. They are broadly similar, in that gains from circulating capital will be taxed; while gains from fixed capital will not be taxed, as they cannot be considered to have arisen as a consequence of the business of either insurance or banking. The only difference is whether the gains are in respect of fixed capital or circulating capital. This distinction still applies for determining the tax consequences for gains made by banking and insurance businesses. It may not be as clear as may be desirable, particularly where the investments are all in parcels of shares. The Privy Council alluded to this difficulty:

The difficulty of distinguishing between profits which are of an income nature on the one hand and capital gains on the other tends to be more acute in a case, such as the present, where the assets in question are, for the most part, shares in listed companies.²⁰

The manner in which banking and insurance businesses generally operate was helpfully outlined by Jacobs J in *London Australia Investment Co Ltd v Federal Commissioner of Taxation*:²¹

The nature of a banking or insurance business, as part of its putting of money as circulating capital to use, involves not only occasional acquisition of property in satisfaction of advances ... but also and more commonly the purchase and sale of various kinds of property whereby moneys which are obtained as part of the business but which form no part of the original capital structure of the bank or insurance company, or of the structure enhanced by accumulated net profits, are put to use short term or long term. All profits arising from that activity are

¹⁹ Ibid 12,185. The Privy Council concurred: 'The question whether a particular business consists of or includes the buying and selling of shares for profits is indeed as much a businessman's as a lawyer's question. The answer depends entirely upon the evidence produced as to the nature of the business activity' per Lord Nolan in *Rangatira Ltd v CIR*[1997] 1 NZLR 129, 138.

²⁰ *Rangatira Ltd v CIR* [1997] 1 NZLR 129, 133 per Lord Nolan.

²¹ (1976-7) 138 CLR 106.

profits of the business of banking or insurance. At any time and from time to time the property acquired may need to be sold, in whole or in part, to meet the requirements of the banking or insurance business and the hope and expectation is that in the meantime not only will the property have earned income but that it will have risen in value ... But in so far as the original capital or 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 a sale thereof will not be profits of the business of banking or insurance.²²

Even in the early New Zealand decision of *Union Bank of Australia v Commissioner of Taxes*,²³ the approach articulated by Jacobs J in *London Australia* appears to have been adopted. Sims J concluded:

In order to carry on such a business properly it is necessary to have a large reserve fund. This fund is created out of profits, and is invested so as to be available immediately for meeting demands on the bank as they may arise. It is not treated as part of the capital of the bank, and the investments cannot be regarded as investments of capital. They are a use of profits for the purposes of the business of banking when conducted in the recognised and proper manner. The realisation from time to time of these investments appears to be part of the ordinary business of a banker, just as much as the realization of a security given by a customer in connection with an advance.²⁴

Sim J's opinion was endorsed by the New Zealand Court of Appeal in the most recent decision on taxation of receipts by both banking and insurance businesses, in *CIR v National Insurance Company of New Zealand Ltd*:²⁵

The principle expressed in the *Californian Copper Syndicate* case has been applied time and time again in considering the taxability of gains on the realisation of investments by banks and insurance companies. The nature of banking and insurance requires businesses in those fields to invest a substantial part of their funds in readily realisable investments in order to meet, in the case of banks, the demands of their customers and, in the case of insurers, the claims of policy holders. The realisation of such assets is a normal step in carrying on the banking (or insurance) business or in other words it is an act done in what is truly the carrying on of the business.²⁶

Eleven years ago, the New Zealand Court of Appeal observed that the *Californian Copper* principle has been applied, 'time and time again' in respect of the taxation

²² Ibid 129-130.

²³ [1920] NZLR 649.

²⁴ Ibid 655-6.

²⁵ (1999) 19 NZTC 15,135.

²⁶ Ibid 15,138.

consequences of gains by banks and insurance businesses. So why is there continuing contention in this area? The reason may be that taxability of gains made by such businesses is dependent on the facts of each case - and it is the application of the principles of taxation to particular facts that is the cause of the continuing desire to test the application of these principles. Lord Nolan in *Rangatira Ltd C of IR* points to the issue:²⁷

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

If the decision in *Union Bank of Australia* did not settle the position in New Zealand as indicated by the most recent decision in *National Insurance*, it raises a serious question relating to the more significant cases in this area regarding material aspects of the factual circumstances in a given case, particularly those which held that the gains were not taxable on the basis of the *Californian Copper* principle. As noted by Jenkins LJ in *Davies (Inspector of Taxes) v Shell Co of China Ltd*:²⁸

it is recognised that these questions between capital and income, trading profit or no trading profit, are questions which, though they may depend no doubt to a very great extent on the particular facts of each case, do involve a conclusion of law to be drawn from those facts.

NZ decisions on banking and insurance business gains

Twenty-eight years prior to *CIR v National Insurance Co of NZ Ltd*,²⁹ the New Zealand Court of Appeal addressed the question in *CIR v Auckland Savings Bank*.³⁰ The Auckland Savings Bank ('the Bank') furnished a return of income which did not include certain profits it had derived in the relevant income year on the maturity of investments in New Zealand Government Stock and in local body debentures.

The Commissioner assessed these gains to tax. The bank objected and argued that the profits in question were capital profits. It also argued that under the relevant provisions of the *Trustee Savings Banks Act 1948* the profits were not derived from any business and therefore were not assessable as business income under the then *Land and Income Tax Act 1954*.

The Commissioner's grounds for assessing the profits for taxation purposes were twofold. First, the gains were profits derived from a business and/or were assessable

²⁷ [1997] 1 NZLR 129, 138.

²⁸ (1951) 32 TC 133.

²⁹ (1999) 19 NZTC 15,135.

³⁰ [1971] NZLR 569.

as income under ordinary concepts. Haslam J upheld the Bank's argument and the Commissioner appealed. North P examined the background of savings banks. However, for the year relating to the dispute there seemed to be no provision in the *Land and Income Tax Act 1954* which could be construed as providing tax consequences for savings banks which were different from the taxation treatment for ordinary trading banks. The profits for savings banks were, as a matter of law, to be calculated in the same way as other banking type institutions,³¹ because of the similar manner in which both types of banking businesses operated.³²

If the essential character of the businesses were identical, the question for the Court of Appeal was whether this had been altered by the *Trustee Savings Banks Act 1948*. Section 26 had drawn a distinction between two kinds of profits, ordinary current profits and capital profits. North P said this distinction was material only for any investments made by the bank for the purposes of s 24 of the Act. The distinction was clearly to be restricted to the internal operations and record keeping of a trustee savings bank. The distinction could not extend beyond that strictly-confined scope of operation, so as to avoid being subject to the well established principles for the taxation of profits made by such businesses.

The question which affected the taxation of any profits from a trustee savings bank business was not whether the profits were capital or ordinary profits, pursuant to the 1948 Act, but whether the investments that yielded those profits, were held to meet the ordinary business obligations of such a business. If such 'capital' profits were used to meet the demands of its customers, then they were assessable as part of the trading operations of the business. It was not how the source of the profits was labelled, namely whether they were capital or ordinary profits, but whether those profits were used to meet the demands of customers which determined whether they were part of the ordinary business operations of a savings bank. Richmond J concurred.³³

Although the Court of Appeal unanimously rejected the taxpayer's argument, what was its reason for this narrow argument? It was immaterial whether the gains were described as capital or revenue for taxation purposes, as if the gains were used or formed part of the bank's business of meeting the demands of its customers, then the gains would be taxable. The taxpayer's argument sought to find an exception to taxation for the gains in the specific provisions of the *Trustee Savings Banks Act 1948*.

³¹ North P: 'In my opinion then, the essential functions of a trading bank and a savings bank are not dissimilar and in principle there is no justification at all for drawing any distinction between them for taxation purposes' - above n 30, 576.

³² North J commented on the similarities in the conduct of both trustee savings bank and trading bank businesses in *CIR v Auckland Savings Bank* [1971] NZLR 569, 575.

³³ Above n 30, 587-8.

This was the only argument that the taxpayer could credibly mount to seek to have the gains treated as capital. If the argument failed, as it did before the Court of Appeal, then under the ordinary principles for taxation of profits from banking businesses, the gains could not be treated as capital. There would have to have been much more cogent evidence that such profits would not form part of the business operations of the banking business. This more demanding test, which Auckland Savings Bank failed to satisfy, was impressively met by the taxpayer in the significant New Zealand High Court decision, a little over 20 years ago, in *State Insurance Office v Commissioner of Inland Revenue*³⁴ ('State').

State Insurance Office v Commissioner of Inland Revenue ('State')

An analysis of *State* is critical because it was not appealed. Secondly, it was followed in the latest New Zealand decision in *National Insurance Co of NZ Ltd v CIR*.³⁵ The *National Insurance* decision was decided against the Commissioner, and he unsuccessfully appealed in *CIR v National Insurance Co of NZ Ltd*.³⁶ *State* illustrates how the Commissioner argued that the gains in question were taxable as they were derived from the trading operations of an insurance business.

The State Insurance Office ('SIO') was established under the *State Insurance Act* 1963. It was in the business of selling general, fire, accident, motor vehicle liability and marine insurance. It expanded into new business ventures. The efficiency with which its operations were conducted through a wide spread of retail outlets enabled it to generate substantial business income. A proportion of this income was used in the normal course of SIO's business, which involved making payments to claimants under insurance policies they had entered into with SIO.

There was however, a statutory direction in the 1963 Act - that any moneys not required for the purpose of meeting insurance claims and the like, were to be paid into a Reserve Fund pursuant to the provisions of s 35(1). The payment of SIO's surplus profits into the Reserve Fund led to the 'building up [of] large reserves in the process'.³⁷

The 1963 Act also authorised the investment of moneys in the Reserve Fund, in securities approved by the Governor-General by Order in Council. Originally, the investments that were made were confined to Government stock and Treasury bills and were later extended to include first mortgage investments and debentures. The

³⁴ [1990] 2 NZLR 444.

³⁵ (1997) 18 NZTC 13489.

³⁶ (1999) 19 NZTC 15135.

³⁷ Above n 34, 448.

1963 Act authorised SIO, for the first time, to invest in ordinary shares of companies that were registered in New Zealand.

Another consequence of the 1963 Act was the operation of the State Insurance Investment Board, which empowered it to invest in public company shares. The 1963 Act also authorised SIO to invest in New Zealand or UK Government securities, deposits with New Zealand banks and savings banks, and in securities authorised by the Minister of Finance. Despite its legal authority to invest in company shares, there was no dramatic change in SIO's investment patterns. While the value of SIO's total investment at cost in 1966 was 9 million pounds, of which 7.7 million was in Government and local body securities, the remainder of 1.3 million was invested in debentures, mortgages, company shares and other investments. A mere sum of 329,604 pounds had been invested in shares, with the investment in company shares increasing to a value of 1.75 million pounds by 1970.

These investments from the Reserve Fund, were not realised or called in to meet the demands of the insurance business which included the paying out of claims. Even prior to the enactment of the 1963 Act, the same pattern had been evident in respect of such investments.

A significant feature of SIO's insurance business, was the accumulation of a vast reserve. The reserve was being added to regularly, as profits were generated by the business. This vast reserve generated a healthy income stream which Heron J described as, 'the considerable revenue generated by investments.'³⁸ This revenue stream was used to augment the cash flow of the insurance business. The healthy revenue stream, which would continue to increase, considerably reduced the prospect of any part of the share portfolio being called in to provide cash reserves for the business.³⁹

SIO had also extensively entered into reinsurance arrangements. This meant that SIO had strategically limited its liability to meet claims caused by catastrophes of one kind or another.⁴⁰ The effect of the reinsurance contracts was as significant as the revenue stream generated by SIO's investments from its reserves. The reinsurance arrangements also had the effect of creating an additional and significant buffer between the insurance business and the need to have any recourse to the investments that had been made from its reserves. As illustrated in the Southland flood claims in 1984, 'the recourse was had to current cash flow premium and investment income,

³⁸ Above n 34, 451.

³⁹ Ibid.

⁴⁰ So, eg, the Southland flood in 1984, which distinguished itself as the single biggest loss in that period, involved a total payout in claims by the SIO of approximately \$13 million of which \$10 million was recovered by reinsurance> See above n 34, 453.

special arrangements with reinsurers and a small borrowing on overdraft without recourse even to short term securities.⁴¹ This significant revenue stream from its investments coupled with the use SIO made of its reinsurance arrangements had the net effect of keeping the investment of its reserves much further removed from any prospect of being liquidated to meet the immediate demands from its insurance business.

In summary, the historical period over which SIO operated as an insurer was unique in that not only did its business operate within a particular statutory framework but also it had accumulated vast reserves which it invested. Its investments were so significant that they grossly exceed any demands made by claimants.⁴²

The pattern of SIO's insurance business operations 1981 to 1985, the year ended 31 December 1987, as well as the period prior to 1963, became apparent on the evidence.⁴³ SIO had gone to great lengths to avoid any inroads being made into its share investments. Such inroads would also be avoided, even if SIO was faced with claims due to extraordinary events such as 'disasters of considerable magnitude and catastrophic proportions'.⁴⁴

It was clear that there had been no trading in respect of any parcels of shares within the portfolio. The only question which remained was that if the evidence was so compelling that no shares had to be sold to meet short term liabilities of the insurance business, why had such sales occurred?⁴⁵

During the years in question, shares in SIO's share portfolio were exchanged for other shares or for other shares and cash. The effect of these exchanges was that SIO in turn received shares which exceeded the cost price of the shares exchanged. It was the value of this gain that was assessed to SIO as being a gain derived in the course of its business as an insurer. The disposal of the shares which occurred, was of a compulsory nature due to corporate takeovers and mergers of companies in which SIO had held these fixed investments. The proceeds of these share realisations did not form any part of the insurance business.⁴⁶ That the share realisations were

⁴¹ Above n 34, 453.

⁴² Above n 34, 453.

⁴³ There was much evidence given by a Mr Stirton, SIO's General Manager, with Heron J observing that, 'Mr Stirton was a witness of complete integrity'. See above n 34, 477.

⁴⁴ Above n 34, 476.

⁴⁵ As Heron J commented, 'It is the nature of the realisation rather than its occurrence which is central to this case'. See above n 34, 480.

⁴⁶ Heron J commented that, 'These realisations generally produced no cash which fell into revenue or played any part in cash flow'. See above n 34, 477.

actually triggered by the compulsory nature of the transactions was further indication that they could not have occurred as part of SIO's insurance business.⁴⁷

Heron J also addressed the level of formality required to provide a distinct dividing line between fixed and circulating assets in an insurance or banking business, where the line could easily be blurred or perceived as being non-existent. In SIO's case, Heron J said there was no need for a formal distinction to exist so long as the taxpayer could demonstrate that as a matter of substance, there was a distinction and that as a matter of practice it was being adhered to.⁴⁸

The decision of Heron J in *State* showed the contrasting approaches to ascertaining how the principles for the taxation of gains from insurance businesses were to apply. The Commissioner's approach was that so long as there was evidence of a disposal or realisation of shares whether from fixed or circulating investments of an insurance business, any resulting gains would have the character of business income. There did not appear to be any scope for considering that, for insurance businesses, a distinction could still exist between classes of assets. In the Commissioner's view, a quantum leap was permissible which first identified the occurrence of a share realisation and then proceeded to tax it as business income. This approach obviated any necessity to pose the further question when such a realisation occurred, namely why had it occurred and in what circumstances.

Heron J's approach in contrast was to accept that the question was very much one of fact. Further, that it was erroneous to proceed on the assumption that a thorough factual inquiry into the circumstances leading to the asset disposal is either optional or not necessary. Even in the case of an insurance business, a demarcation between fixed and circulating assets is one which can properly exist. To ignore the distinction in the case of insurance businesses is not supported in law. The distinction may or may not exist but it is erroneous to simply make a presumption either way. A thorough factual inquiry is warranted when considering the taxation implications of gains made by an insurance business.

One would have expected Heron J's approach to have been embraced by the Commissioner, but the Commissioner's approach had not changed as indicated by the decisions in *National Insurance*.⁴⁹ The manner in which the gains arose in *National Insurance*, which the Commissioner sought to tax, was almost identical to the factual situation in *State*. In light of the approach of Heron J in *State*, it is essential to ask first

⁴⁷ Above n 34, 477.

⁴⁸ Above n 34, 477.

⁴⁹ *National Insurance Company of New Zealand Ltd v CIR* (1997) 18 NZTC 13,489(HC) *CIR v National Insurance Co of NZ Ltd* (1999) 19 NZTC 15,135(CA).

what was the factual background which gave rise to the gain before addressing its taxation consequences.

The facts in *National Insurance*

National Insurance sold its 30% of the issued capital of South Pacific Merchant Finance Ltd (Southpac) for \$80 million. This resulted in a profit on the sale of \$67,151,671.40. The Commissioner assessed this gain as part of National Insurance's assessable income for the year ended 30 June 1990. This assessment was based on the grounds that the sale of the Southpac shareholding occurred as part of National Insurance's business as an insurance provider.

To address the significant legal issue that had to be determined, a substantial portion of Williams J's judgment was devoted to establishing the facts. This was primarily to determine how the Southpac shares had been acquired and the circumstances that led to their eventual sale.

National began business as a fire and general insurer and had become New Zealand's third largest domiciled fire and general insurer by the late 1960s. A fire and general insurer, such as National Insurance, operated on the basis of receiving premiums in advance. Fairly sizeable sums needed to be constantly kept either in cash or in readily realisable securities to meet claims which could also include claims from policy holders, who had obtained insurance cover in previous years as well as those claims which had been incurred but not yet reported. These readily realisable securities included Government and local body stock, as well as debenture stock issue by listed companies. Sums received were also invested in equities of publicly listed companies. However, National Insurance was a passive shareholder in these companies, having no board representation and thus not being in a position to influence the respective companies' direction. As noted by Williams J, 'The overriding feature was realisability if cash was required'.⁵⁰

However, National Insurance was considering making investments in a different kind of business, thereby diversifying its *business* and not simply diversifying its *investments*. This strategy to diversify explained its acquisition of shareholdings in Securitibank, Allied Mortgage Guarantee Co Ltd, Metropolitan Life Assurance Co of NZ Ltd, Trustee Executors and Agency of New Zealand Ltd, which National Insurance ended up completely taking over in 1978, in addition to other similar purchases. It was consistent with this pattern of acquiring other types of businesses, that National Insurance accepted an offer to buy a 15% shareholding in Chase NBA New Zealand, a subsidiary of Chase NBA Group of Australia, which was New Zealand's first merchant bank.

⁵⁰ *National Insurance Company of New Zealand Ltd v CIR* (1997) 18 NZTC 13,489, 13,493.

Later Chase Australia decided to sell its holding in Chase NBA and notified National Insurance of its intention to sell. At the same time, National Bank was the majority shareholder in Southpac, holding 70% of Southpac's capital, and was looking for an additional shareholder in Southpac. There had also been a merger proposal between Chase and Southpac at about the same time. An agreement was reached whereby National Insurance transferred its shares in Chase, in exchange for shares in Southpac. This enabled National Insurance to eventually acquire a 30% shareholding in Southpac with a commensurate right to appoint directors.

The principal reason for acquiring the Southpac shareholding was to enable National Insurance to diversify its shareholding.⁵¹ Mr Hendry, the then Secretary of National Insurance had given evidence that:

National Insurance saw the Southpac investment as being a long-term holding intended to provide profit and experience without thought of sale. It brought shareholder profits when underwriting was finding it increasingly difficult so to do.⁵²

This evidence was corroborated by other witnesses that also gave evidence in support of National Insurance. This objective of acquiring Southpac was in fact achieved for a number of years, with the 1985 report to shareholders expressly describing the Southpac and other similar acquisitions as a 'diversification of National's business'.⁵³

However, it was not until late 1985 that National Insurance began to experience a deterioration in its relationship with the National Bank. Both National Insurance and the National Bank then began negotiations designed to discomfort each other to improve their respective positions vis a vis Southpac. National Bank proposed a further substantial increase in Southpac's capital. National Insurance agreed to this increase to \$16 million and a further increase to \$36 million. In 1986, some consideration had been given to forming an employee share purchase scheme for Southpac and to float the company and list it on the Stock Exchange, but none of this eventuated. There were various abortive attempts to sell Southpac after which National Insurance's board accepted a recommendation that its shareholding in Southpac be sold for the following reasons;

as there was no realistic possibility of National being able to buy Southpac, there were the difficulties over flotation and he [Mr Hendry]⁵⁴ took the view that

⁵¹ Above n 50, 13,497.

⁵² Ibid.

⁵³ Above n 50, 13,498.

⁵⁴ Mr Hendry was one of National's nominees on the Southpac Board.

the value of the investment would reduce over time and better earnings for shareholders could be achieved by a sale.⁵⁵

Williams J also heard evidence of the National Insurance's reinsurance⁵⁶ arrangements. This was a significant step that National Insurance had taken to insure itself against claims which could exhaust its capacity to meet claims from its business reserves. The trial judge accepted evidence that the prospect of realising fixed assets to meet the demands of the insurance business was too remote to have even been in contemplation by the taxpayer.⁵⁷

A thorough appraisal of National Insurance's business was required before determining whether the sale of the Southpac shareholding was a sale of circulating capital or fixed assets. Despite Heron J's finding in *State* that an insurance business could hold fixed assets, counsel for the Commissioner in *National Insurance*, continued to base his argument on '*the insurance rule*'.⁵⁸ This was the identical line of argument that counsel for the Commissioner in *State* had also relied on.⁵⁹ The Commissioner had not shown any change in approach to on whether a gain made by an insurance business was one which arose in the course of conducting such business.

Williams J asked whether National Insurance had shown that the sale of its Southpac shareholding for more than its purchase price was not a profit or gain derived from National Insurance's business.⁶⁰ In Williams J's opinion, this factual question could satisfactorily be answered by examining the historical context in which the sale of the Southpac shareholding had occurred and 'in the light of the evidence and exhibits'.⁶¹

⁵⁵ Above n 50, 13,499.

⁵⁶ As noted by Williams J, 'Every insurer takes appropriate steps to reinsure its risks in order to manage its exposure to claims. Reinsurance is one of the major means employed by insurers to that end': above n 64, 13,510.

⁵⁷ Above n 50, 13,514.

⁵⁸ The essence of the rule being that profits from the sale of investments by insurers have virtually always been held to be on revenue account or treated as the ordinary income of an insurance business.

⁵⁹ The reappearance of this line of argument did not go unnoticed by Williams J in *National Insurance*, who in reference to Heron J in *State Insurance* observed as follows: 'The learned Judge [Heron J] ... in summarising counsel's submissions, noted that leading counsel for the Commissioner - as Mr Young QC did in this case - submitted that in no case other than *Scottish Automobile* had a Court been persuaded (at NZTC 7,062; NZLR 475), that profits on realisation of investments were not so inextricably linked with its business activities that they carried the stamp of capital profits, 'despite that possibility being raised by *Californian Copper*' - see (1997) 18 NZTC 13,489, 13,522.

⁶⁰ Above n 50, 13,527.

⁶¹ Above n 50, 13,527.

In Williams J's view, the evidence relating to the acquisition of and subsequent circumstances which arose in relation to the shareholding, coupled with the circumstances that prompted its eventual sale, were critical factors in determining how the final proceeds on sale were to be categorised. The approach of Williams J was in marked contrast to one which almost operated on a presumption that gains from such businesses were as a matter of principle subject to tax as business income.

The Commissioner appealed Williams J's judgment in *C of IR v National Insurance Company of New Zealand Ltd*.⁶² The question for the Court of Appeal was whether the conclusion by Williams J, that the gains in question were not business income, 'were or were not open to the Judge'.⁶³ The Court of Appeal was being asked to overturn a finding which was based on fact:

On an appeal against what is essentially a factual finding made in a trial of this nature, the Court must be careful not to lose sight of the picture which emerged from the evidence by a trial Judge in assimilating, day by day, the wealth of material presented to him ... we are not taken to the point where it could be said that this court should interfere with what ultimately were essentially findings of fact.⁶⁴

The implications of this are that if the Judge at first instance has a firm factual foundation on which to make a finding, then it would not have reached the required threshold of error which would warrant having the finding overturned on appeal. In fact, the validity of a factual finding of a trial judge which could be supported by a firm evidential foundation was directly addressed by the Privy Council.⁶⁵ Lord Nolan held that the finding of fact made by Gallen J at first instance in *Rangatira Ltd v C of IR*⁶⁶ could not be disturbed by the New Zealand Court of Appeal. In Lord Nolan's view, although the decision at first instance could have gone either way, this was not to say that the decision made by the trial Judge was wrong.

In their Lordships' view the decision of Gallen J was one which he was entitled to reach and one which should not have been reversed.⁶⁷

The significant lessons are, first, that for the taxpayer to succeed there must be a firm factual case that must be presented to enable the trial Judge to reach a finding. Secondly, to successfully achieve this, there must be thought at the outset, when an asset is introduced into a taxpayer's portfolio, as to whether it will form part of the circulating capital of the business or whether it will be treated as fixed assets. This

⁶² (1999) 19 NZTC 15,135.

⁶³ Ibid 15,142.

⁶⁴ Above n 62, 15,145 and 15,146.

⁶⁵ *Rangatira Ltd v CIR*[1997] 1 NZLR 129.

⁶⁶ (1994) 16 NZTC 11,197.

⁶⁷ Above n 65, 139.

distinction is also now firmly recognised as a valid one for purposes of New Zealand law, as it relates to businesses including banking and insurance businesses.

Australia's position on banking and insurance businesses

Numerous Australian court decisions have considered the circumstances in which gains made by both banking and insurance businesses will be considered as business income and subject to a tax impost. The *Californian Copper* principle has also been applied in the Australian jurisdiction⁶⁸ to determine whether gains have been made in the course of conducting such businesses, in which case they have been held to be taxable. Where gains have been derived by such businesses but have been from assets that are not part of the business in terms of being trading or circulating assets but from capital assets, the gains have not been held to be taxable. Davies J summarised the well established Australian legal position in *FCT v Equitable Life and General Insurance Co Ltd*; *Equitable Life and General Insurance Co Ltd v FCT*:⁶⁹

Thus it has been held that a bank's investments, wherein reside its circulating capital, are investments in which the bank deals and the profits and losses of such dealing form part of its annual profits and losses and its assessable income. See *Punjab Co-operative Bank Ltd, Amritsar v Commr of Income Tax, Lahore* (1940) AC 1,055, *National Bank of Australasia Ltd, v FC of T* 69 ATC 4042; (1969) 118 CLR 529, *Commr of Taxation v Commercial Banking Co of Sydney* (1927) 27 SR (NSW) 231.⁷⁰ A bank deals in money and makes profits from the money which it handles. Its profits and income therefore take account of share investments acquired for that purpose and the profits or losses from dealing in those investments. Similarly, an insurance company makes profits or losses from dealing with its circulating funds. See *Australian Catholic Assurance Co Ltd v FC of T* (1959) 100 CLR 502, *Producers' & Citizens' Co-operative Assurance Co Ltd v FC of T* (1956) 95 CLR 26, *Colonial Mutual Life Assurance Society Ltd v FCT of T* (1946) 73 CLR 604, *Chamber of Manufacturers Insurance Ltd FC of T* 84 ATC 4315; (1984) 2 FCR 455. It is an incident of an insurance business which receives premiums in

⁶⁸ The Australian Full Federal Court in *RAC Insurance Pty Ltd v FCT* (1990) 90 ATC 4,737, 4,740 observed: 'The principle to be applied was stated by the Lord Justice Clerk, the Right Honourable JHA McDonald in *Californian Copper Syndicate v. Harris* (1904) 5 TC 159'.

⁶⁹ (1990) 90 ATC 4,438 at 4,446-7.

⁷⁰ In the Supreme Court of NSW, Street CJ referred to the nature of a bank's dealing in short term investments: 'The purchases and sales of Government stock were made, ... in the course of carrying on the respondent's business as a bank, and it is manifest that what it did was to invest temporarily, and for purposes of profit, funds which it did not immediately require for other purposes, but which in the course of carrying on its business it might at any time require ... The money used was part of the respondent's stock-in-trade, it was used in an operation of business, and it was used in carrying out the respondent's scheme of profit making as a banker' (234-5).

advance, sometimes years in advance of the insured event occurring, that profits and income are made from the investment of the premiums. Insurance companies therefore deal or trade in shares and the like.

An example of the application of these principles in Australia is *RAC Insurance Pty Ltd v FCT*.⁷¹ The taxpayer insurance company was a wholly-owned subsidiary of the Royal Automobile Club of Western Australia ('the club'). The taxpayer provided insurance cover against damage to motor vehicles and against personal injuries from the use of motor vehicles.⁷² The policy of the taxpayer's board had been to meet insurance claims from its premium income. The board had also expected its premium income to exceed payments made by the taxpayer, in satisfaction of insurance claims. Surplus premium income, was invested in debentures, government or semi-government bonds, shares and in loans on first mortgage security. These investments were negotiable, they were medium to short-term in length and were not speculative in nature. The investments were generally held until maturity and often reinvested. However, the taxpayer had no policy in place whereby any fixed proportions of the investments were to be held in particular divisions of investment.⁷³ The taxpayer sold some of these investments for a gain of just under \$2 million for the four income years in dispute. In 1982, the taxpayer incorporated a wholly owned subsidiary company, to which it transferred its remaining investments.

The gains were treated by the taxpayer as capital and accordingly non taxable. The Commissioner considered the gains were business income of the insurance business and accordingly taxable. Lee J, at first instance, asked the factual question, namely how had the taxpayer held the investments in question, and undertook a thorough examination of the operations of the taxpayer's insurance business. He concluded that the investments that had been sold, were held as insurance reserves, to be liquidated if necessary for the purposes of the business. This conclusion was consistent with the actions of the taxpayer, which though owned by the club, had limited the dividend it would pay its club owner. By limiting the dividend payout, the taxpayer was clearly treating its investments as necessary reserves for its insurance business. Further, the manner in which the investments were held such as in negotiable securities for terms which usually did not exceed three years and certainly not in excess of five years, indicated that the investments were readily realisable in markets which traded in those securities.⁷⁴

⁷¹ (1989) 89 ATC 4,780.

⁷² Lee J observed that the business had later expanded to provide insurance cover for dwellings and contents, power boats, special risks and travel risks: *ibid* 4,782.

⁷³ Above n 72, 4,784.

⁷⁴ Above n 72, 4,786.

The actual operation of the insurance business had demonstrated that the taxpayer had thought no further than accumulating reserves to meet the demands of the business. If it was able to generate a surplus of premium income, such surplus was used either to enable cheaper insurance to be offered to members of the club or to make payment to the club by way of dividend distribution. As such, the investments had a sufficient connection with the insurance business so that any gains from their sale would be treated as income of the business.

Lee J also commented on how the taxpayer could have structured its investments so that any gains would not be treated as business income. The taxpayer needed to have taken additional steps such as identifying any portion of its insurance reserves which were surplus to its business requirements and then either apply or earmark it for the purchase of a new profit generating enterprise or structure that would expand the nature and content of the business.⁷⁵ Alternatively, Lee J opined, the taxpayer could have cordoned off any surplus funds from its reserves, by making a distinctive investment in order to clearly demonstrate that there was a clear demarcation of funds in the business. The demarcation would be between reserve funds used in the insurance business and a separate fund from which investments would be made but remain unrelated to the insurance business.⁷⁶

The taxpayer unsuccessfully appealed in *RAC Insurance Pty Ltd v FCT*.⁷⁷ The unanimous judgment of the Court was clear that the facts in *RAC Insurance Pty Ltd* did not sufficiently distinguish the holding of the investments in question, so as to excise them from the usual investments that had to be made by the insurance business. Had such separation been evident on the facts, it would have obviated the

⁷⁵ Above n 72, 4,789. In the Full Federal Court decision in *The Chamber of Manufactures Insurance Ltd v FCT* (1984) 84 ATC 4,315, 4,318, the example given was of funds of an insurance company being invested in the construction of a building to be used as a head office by that company. If the building was subsequently sold at a profit, the Full Federal Court expressed the view, that it would probably not attract income tax.

⁷⁶ Lee J had commented that the demarcation would indicate that the funds, 'had been excised from the normal run of investments maintained for the purposes of the business' - see above n 72, 4,789. In *The Chamber Manufactures Insurance Ltd v FCT* (1984) 84 ATC 4,315, 4,318-9, the Full Federal Court suggested that the result may have been different if the taxpayer had maintained two quite distinct funds. The first would operate as a reserve fund with sufficient reserves from which insurance claims and foreseeable contingencies would be met. The second would be earmarked as an investment fund. Any profits from the sale of investments in the second fund would be subject to taxation consequences on grounds quite unrelated to the conduct of the taxpayer's insurance business.

⁷⁷ (1990) 90 ATC 4,737.

application of the general principle for the taxing of gains from an insurance business to the particular gains in question.⁷⁸

A similar factual question arose for determination in *Employers' Mutual Indemnity Association Limited v FCT*.⁷⁹ The taxpayer, Employers' Mutual, was licensed pursuant to the *Insurance Act 1973*, to carry on its insurance business. The factual question in dispute, was whether gains made from the sale of investments by a general fund, under the control of the insurance company's directors, was business income of the insurance company. The argument before the Federal Court⁸⁰ and Full Federal Court centred on whether, in the words of Webb J in *Producers' and Citizens' Co operative Association Company Limited v FCT*,⁸¹ the gains were 'sufficiently related to the appellant's business of insurance to bring the profits into tax.'

Pursuant to the articles of association of the company, its insurance business was managed in two sections. Each of the two sections was required to maintain a separate bank account. In addition, the company was authorised to operate a third bank account which was called the general fund of the company. There was also provision made pursuant to one of the articles,⁸² that at the end of each year, all moneys which were surplus to the liabilities of the sections of the business would be credited to the general fund. An article⁸³ had also stipulated that the moneys so credited would be recorded as held in two designated Reserve Accounts for the two respective sections of the business. Each of the two sections was also permitted to obtain a refund from their respective Reserve Accounts in the general fund, if required, in order to fund any deficits that arose in their respective insurance business operations.⁸⁴ Investments were made from the general fund and such investing activity was controlled by the taxpayer's directors. The investments were initially in fixed interest investments or preference shares but later were increasingly in ordinary shares. There were sales of various investments made by the general fund, which gave rise to net gains. The question was whether these gains were taxable as they arose as part of the conduct of the insurance business. The Federal

⁷⁸ 'The facts of the present case are not sufficient to distinguish the circumstances from the general principle; indeed they are illustrative of it. In our opinion, therefore, the subject profits were profits of the business of a company carrying on an insurance business and were assessable as such' (emphasis added): *ibid* 4,744.

⁷⁹ (1991) 91 ATC 4,850.

⁸⁰ The decision of which was reported as *FCT v Employers' Mutual Indemnity Association Ltd* (1990) 90 ATC 4,787.

⁸¹ [1956] 95 CLR 26, 34.

⁸² Article 104.

⁸³ Article 105.

⁸⁴ The general fund was to be available to make up any such deficiencies pursuant to article 106.

Court concluded that in construing the articles of association, which represented the legal framework for the decision-making process, it had been contemplated that the sums in the general fund and the investments represented by them would be available to meet the insurance obligations of the taxpayer's insurance business. The general fund was not exclusively available as an investment fund. It may have been a fund of last resort for the insurance business's needs but this did not detract from the fact that it was still available if the need arose in the ordinary course of the insurance business. Hill J in the Federal Court decision went further to highlight 'another factor of considerable significance'.⁸⁵ Not only did the articles clearly envisage the insurance business having recourse to the general fund, but that, 'as a matter of fact such a claim was made in the 1980 year'.⁸⁶ This indicated that, as a matter of business practice, the general fund was being resorted to as part of the ordinary reserves of the insurance business.⁸⁷

The taxpayer unsuccessfully appealed against Hill J's decision to the Full Federal Court.⁸⁸ All three Judges⁸⁹ were consistent in their respective judgments, that the facts of the case fell short of establishing a clear demarcation between the investments in issue and the operations of the insurance business.⁹⁰

Insurance business assets sold within a company group for tax advantage

The Australian Full Federal Court decision in *GRE Insurance Limited v FCT; Unitraders Investments Pty Ltd v FCT*⁹¹ dealt with gains made on the realisation of securities, where assets, which formed part of the insurance business of one taxpayer, were transferred to its wholly owned subsidiary, purely to obtain a tax advantage. GRE Insurance Ltd ('GRE') operated a business as a general insurer. It was a member of

⁸⁵ Above n 81, 4,801.

⁸⁶ Ibid.

⁸⁷ Hill J concluded: 'There is, in my view, a sufficient nexus between the realisation of the assets by the respondent and its insurance business to require the conclusion that the net profits from realisation are income in ordinary concepts': above n 81, 4,801.

⁸⁸ *Employers' Mutual Indemnity Association Limited v FC T* (1991) 91 ATC 4,850.

⁸⁹ Sheppard, Burchett and Gummow JJ.

⁹⁰ Burchett J's comments were representative: '*The facts* of the present case ... fall short of establishing the fundamental separation of the investments in question from the business of the appellant which its case requires. Bearing in mind especially the statutory criterion of solvency and the terms of the appellant's own Articles of Association, there is no escape from the conclusion that the investments were to be counted in its reserve funds. Since their sale was therefore an integral part of the conduct of the appellant's business of insurance, the resulting gain was upon revenue account.' (emphasis added): above n 80, 4,857.

⁹¹ (1992) 92 ATC 4,089.

the worldwide Guardian Royal Exchange Insurance Group ('GREI group'). Unitraders Investments Pty Ltd ('Unitraders') was a wholly owned subsidiary of another member of the GREI group. GRE proceeded to purchase all the shares in Unitraders and, in doing so, acquired Unitraders as its wholly owned subsidiary. At the time that Unitraders had been acquired by GRE, Unitraders had held its own portfolio of shares. On acquiring Unitraders, GRE sold to it all the equities which GRE held in its investment portfolio. This transfer of equities occurred purely for taxation purposes - to enable Unitraders to obtain the benefit of rebates on dividends it received pursuant to s 46 of the *Income Tax Assessment Act 1936* (Cth). GRE transferred its equities to Unitraders, as GRE was not expecting to have any taxable income over a period of time because of the prospect of having to underwrite losses in its insurance business. Consequently, it was not expecting to be in a position to benefit from the rebate on dividends, as the rebate was available to offset any tax which would be payable.

In selling the equities in this manner, GRE derived profits and Unitraders, which also sold its shares, did so at a profit. The question of whether such profits were taxable had to be answered by determining whether the respective equities sold formed part of the insurance business. The unanimous Full Federal Court held that the profits made by both GRE and Unitraders were from the sale of assets which were part of the insurance business, and accordingly taxable. The transfer of assets from GRE to Unitraders related to assets which formed part of GRE's insurance business's investment portfolio. In the ordinary course of GRE's insurance business, any gains on their sale would be treated as profits of the insurance business. The fact that the sale transaction resulted in the shares being retained within the company group did not alter the fact that the gains were made from the sale of assets which formed part of the circulating capital of the insurance business. Once the assets had been transferred to Unitraders, there had been no practical change in the investment strategies and operations of the insurance business. The assets, after being transferred, continued to be held albeit indirectly as funds which formed the insurance reserves of the insurance business. The Full Federal Court said:

In our respectful opinion, however, the activities of Unitraders were an integral part of the insurance business conducted by GRE. Although the equities were held by the wholly owned subsidiary rather than by GRE directly, the equities indirectly formed part of the funds representing the insurance reserves and part of the circulating capital of the business.⁹²

A further indicator that the assets were sold in the course of the insurance business was the reason for the transfer of the equities. This was to enable Unitraders to take full advantage of the benefit provided by the s 46 rebate. The taxation rebate had

⁹² Ibid 4,093.

enabled the insurance business, in which GRE was an active participant, to increase its after tax profits.

Unitraders was introduced into the affairs of GRE solely to ensure that the benefit of the s 46 rebate would not be lost in the event that underwriting losses brought GRE to the position that it had no taxable income. Unitraders was a separate entity from GRE but its activities reflected, indeed formed part of, the overall business in which GRE was involved.⁹³

The gains made by Unitraders on the sale of its own shares were also taxable. While they were initially held by Unitraders before being acquired by GRE, Unitraders shares, after the company was bought by GRE, became part of the ordinary assets which were used in the day-to-day operations of the business of which both it and GRE were an integral part.⁹⁴

The Full Federal Court emphasised:

the facts of the present case do not show that the portfolio of equities was sufficiently dissociated from the ordinary and regular operations of the insurance business to comprise a capital asset having a character dissimilar from that of the circulating capital of such a business.⁹⁵ (emphasis added).

Dividing insurance business and non business assets in Australia

The decisions demonstrate the difficulties encountered by insurance and banking businesses in establishing that profits from the sale of assets do not form part of their business income. Similar to New Zealand, it is possible in Australia for banking and insurance businesses to hold assets as investments which will not form part of such businesses. The gains on sale of such assets will not be treated as business profits.

A recent instance where the taxpayer succeeded in arguing that gains from the sale of assets in an insurance business were not business income gains but capital in nature was in *AGC (Investments) Limited v FCT*⁹⁶ ('AGC'). Identical to *GRE Insurance Limited* ('GRE'), AGC involved a company in the insurance business that wholly owned a subsidiary to which it transferred a significant volume of investments. However, unlike in *GRE*, the gains on sale by the subsidiary in *AGC* were held not to be taxable.

The appellant was a wholly owned subsidiary of AGC (Insurances) Limited ('AGC (Insurances)'), with AGC (Insurances) itself being a wholly owned subsidiary of Australian Guarantee Corporation Limited ('AGC'). AGC (Insurances) carried on business as a general insurer. AGC (Insurances) transferred substantial sums of

⁹³ Above n 92, 4,094-5.

⁹⁴ Above n 92, 4,094.

⁹⁵ Above n 92, 4,095.

⁹⁶ (1992) 92 ATC 4,239.

money to the appellant, to enable the appellant to make investments including the acquisition of a portfolio of shares in publicly listed companies. The appellant taxpayer's share portfolio was managed by the company, Westpac Management. The portfolio included parcels of shares in approximately 51 such companies and had a market value of just under \$86 million. Shortly before the October 1987 sharemarket crash, the appellant decided to begin selling the portfolio and reinvesting the sale proceeds in fixed interest securities.⁹⁷ In the 12 month period ending 30 September 1987, the appellant sold its shareholding in just over 30 of the companies it had invested in, for the sum of just over \$79 million. The profit from the sale totalled just over \$45 million, which the Commissioner assessed for tax on the basis that it represented business income gains from an insurance business. The taxpayer objected to the Commissioner's assessment on the grounds that the profits were capital and not income in nature. This was because the shares which were sold were not trading assets but held as part of its business of investment. Its purpose in holding the shares, it argued, was as investments for the long term in order to produce a steady and growing dividend income stream. The taxpayer further argued that, when it acquired the shares, it did not do so with a profit-making purpose. The Commissioner, on the other hand, had strenuously argued that because the taxpayer was the wholly owned subsidiary of a general insurer, the assets of the subsidiary would inevitably be resorted to by the holding company, to meet liabilities in its insurance business.

The Full Federal Court observed that both the Commissioner and taxpayer had little difficulty in agreeing on the legal principle which applied to the dispute.⁹⁸ The Court was clear that the dispute was in respect of a question of fact and more particularly the inferences to be drawn from the primary facts of the case.

The central issue for determination was ascertaining the taxpayer's purpose in acquiring the share portfolio. The court's approach to ascertaining purpose is useful for the guidance it provides on the planning required to successfully attain the level of separation between trading and non trading assets in an insurance business. The court thoroughly scrutinised the evidence tendered in support of such purpose. This consisted of documentary evidence, affidavit evidence and oral evidence.

The affidavit and oral evidence, adduced at trial, included evidence from an employee of Westpac Management, who had managed the appellant's share portfolio over a seven year period. There was also evidence from former employees of the AGC Company Group. The documentary evidence included a memorandum by the appellant's General Manager, in which clear reference had been made to the

⁹⁷ Ibid 4,240.

⁹⁸ Above n 97, 4,250.

appellant's bank's recommendation for 'long term investments in the equity market'.⁹⁹ There was also evidence of an undated internal memorandum, from Westpac Management, which made reference under the sub-heading 'Aims'; to capital growth.¹⁰⁰

The affidavit evidence of an employee of Westpac Management, who had managed the appellant's share portfolio, was that the dominant consideration in managing the portfolio, 'was the present and prospective future yield on investment'.¹⁰¹ At no time had any account been taken of the capital gain which could arise if the investment were sold. The affidavit evidence of the employee was categorical. His instructions on managing the portfolio had expressly been that,

the investments were long term investments, not to be realised except in the event of some catastrophe affecting the company in which the investment was held or by reason of any event such as a takeover.¹⁰²

The court noted that it had also been significant that this affidavit evidence had not been subjected to cross examination.

Two former employees¹⁰³ of the AGC Group gave oral as well as affidavit evidence. They were both consistent in their respective testimonies that the General Manager of AGC Insurances, the taxpayer's parent company, had specifically stated that the investments by the taxpayer were to be treated as long term investments. The long term investments were made to generate long term dividend investment income and maximise potential asset growth. The underlying policy, which underpinned the investments made from the share portfolio, had been reflected in the actual low turnover in shares acquired by the taxpayer in publicly listed companies.

Evidence which had been given¹⁰⁴ and accepted by the Full Federal Court,¹⁰⁵ was that, of a total of 81 equity acquisitions, 26 had been held for a period exceeding 15 years,

⁹⁹ Above n 97, 4,241, where extracts of the memorandum dated 1 December 1966, written by the appellant's then General Manager to its Chairman of Directors, were referred to in the joint judgment of the Full Federal Court.

¹⁰⁰ The memorandum which dealt with the affairs of the appellant was in the opinion of the Full federal Court written after 30 September 1975 - above n 97, 4,241.

¹⁰¹ An extract from the affidavit evidence of a Mr Gates, who had been employed by Westpac Management from 1981 and had managed the appellant's portfolio between 1981 and 1987.

¹⁰² Above n 97, 4,243.

¹⁰³ The employees were Mr Robert Alick Robson and Mr Donald Duncan Crisp.

¹⁰⁴ The documentary evidence comprised a schedule of investments since 31 December 1970, as there did not appear to be records of the appellant's share sales prior to this date.

¹⁰⁵ The Full Federal Court noted the evidence and commented that it indicated a pattern of activity inconsistent with the purpose of the Insurance Division of the business - above n 97, 4,253.

20 had been held for a period of between 10 to 15 years, and an additional 14 had been held for between 5 and 10 years.¹⁰⁶ The employee of the manager of the appellant's portfolio had in correspondence with the appellant, expressed his concern for obtaining an increased dividend yield on the investments. There was also adduced in evidence a memorandum dated 29 May 1984,¹⁰⁷ on the investment strategies of the AGC Group company's Investment Division. This memorandum was also clear in its reference to seeking long term dividend producing shares.¹⁰⁸ It had mentioned the instruction that had been given to Westpac Management, that the share portfolio of the appellant was to be managed so that it could not be classed as a trader.¹⁰⁹ The documentary evidence also included correspondence between Westpac Management's employee who managed the appellant's share portfolio and Mr Crisp, an employee of the taxpayer's holding company. In the correspondence reference was made to, 'the long term interests of the portfolio'¹¹⁰ and that, 'the portfolio is comprised of companies that will demonstrate long term earnings and 'franked' dividend growth'.¹¹¹

The detailed nature of the evidence given at the trial of the dispute indicated that the essence of the dispute was about the correct inferences to be drawn from the facts. The Full Federal Court:

At the trial, there was no substantial dispute about the primary facts. The dispute between the parties centred on what inferences should properly be drawn from the primary facts.¹¹²

On appeal, the Full Federal Court said that the issue in dispute was a question of fact or inferences that were to be drawn from the relevant facts:

There is little, if any difference in the submissions put by the parties with respect to the legal principles applicable here. The central issue in the litigation at first

¹⁰⁶ Mr Gates, an employee of Westpac Management, who managed the appellant's share portfolio and prepared the schedule of the 81 share acquisitions, had also indicated that it was his practice not to sell ordinary shares which he purchased in the portfolio in circumstances such as a takeover or by occasional divestment.

¹⁰⁷ The memorandum was by a Mr Crisp who had been employed by the appellant's holding company, AGC Insurances, from 1966 in a range of capacities.

¹⁰⁸ The extract of the memorandum as made reference to by the Full Federal Court - above n 97, 4,247.

¹⁰⁹ Ibid.

¹¹⁰ This was pursuant to a letter to Mr Crisp, dated 25 November 1986, by a Mr Gates who had been an employee of Westpac Management.

¹¹¹ An extract from the contents of a letter dated 24 July 1987 by Mr Gates of Westpac Management (the appellant taxpayer's fund Manager) to Mr Crisp of AGC (Insurances), the appellant's holding company - above n 97, 4,247.

¹¹² Above n 97, 4,247.

instance and before us, was the true characterisation of the appellant's purpose in acquiring its share portfolio. *This is a question of fact, albeit of secondary fact.* There is no real dispute about the primary facts, and little appears to turn on the credit of the individual witnesses called on behalf of the appellant. *But the proper inferences to be drawn from the primary facts are contentious.* (emphasis added)¹¹³

In determining the question of fact, the Full Federal Court had to first determine the nature of the relationship between the taxpayer as a wholly owned subsidiary, and its holding company, AGC (Insurance), as it was the holding company that was engaged in the business of insurance. It had been well established, through numerous banking and insurance decisions, that to conduct an insurance business satisfactorily it was essential that continuous liquidity be maintained. Ascertaining the nature of the relationship between subsidiary and holding company was essential on the facts to reach an important factual conclusion. This being, whether the shares held by the appellant were necessary as part of the continuous liquidity requirements of the holding company. The Full Federal Court concluded that, despite the existence of a rather close corporate relationship between holding company and subsidiary, it did not follow that the portfolio of shares held by the appellant taxpayer subsidiary was necessary to maintain the liquidity of the holding company's insurance business.¹¹⁴ The question which then arose was regarding the precise role of the appellant in the Insurance Division of the AGC group of companies.¹¹⁵ To ascertain this, the Full Federal Court placed much reliance on an internal memorandum between the General Manager of the Insurances Division and the General Manager of the AGC Group.¹¹⁶ The memorandum which had as its subject, 'Insurances-Investment Strategies',¹¹⁷ was clear in stating its objective as the pursuit of long term dividend producing shares. There was also clear reference in it to instructions that had been relayed to Westpac Management as Manager of the investment portfolio. These instructions were that Westpac Management should manage the portfolio in a manner that would not suggest that the appellant was a trader in investments. Of significance was the specific reference to trading in liquidities being undertaken by a different company in the group, namely AGC Money Market Operations. The

¹¹³ Above n 97, 4,250-1.

¹¹⁴ Above n 97, 4,251.

¹¹⁵ Above n 97, 4,240.

¹¹⁶ The memorandum, dated 29 May 1984, which the Full federal Court found, 'illuminating for present purposes', was from Mr Crisp, as General Manager of the Insurances Division, to Mt Robson as General Manager of the AGC Group. Further, the Court found no reason to doubt that the memorandum was not a correct statement of the relevant position relating to the taxpayer - above n 97, 4,251.

¹¹⁷ Above n 97, 4,251.

memorandum concluded with a comment on the taxpayer's then existing strategy, which was to obtain 'a reasonable investment yield', thereby confirming the long term dividend producing nature of the investments earlier referred to in it.

The Full Federal Court concluded:

It must follow, we think, that it was not part of the corporate scheme that the appellant buy equities in order to maintain liquidity for the insurance operations of the AGC Group. The memorandum and the other evidence, documentary and oral, to which we have earlier referred, demonstrate that it was at all times intended that the appellant invest long-term. Its subsequent conduct was consistent with this intention. As we have noted, 26 of the equities acquired were held for a period exceeding 15 years, 20 for between 10 and 15 years and a further 14 for between 5 and 10 years. This pattern of activity is inconsistent with an objective or purpose of acquiring the shares in order to provide liquid funds for the Insurance Division ... The evidence demonstrates that, in fact, the securities now in question were acquired with a view to their long-term capital growth ... The evidence also indicates that insofar as liquid funds were required for the purposes of the insurance operations, they were found in sources other than the appellant's share portfolio.¹¹⁸

The Full Federal Court held that the documentary and other evidence, taken as a whole, indicated that Westpac Management, as fund manager, had been instructed to achieve and did in fact manage to achieve the objective of long-term capital growth in the appellant's share portfolio.¹¹⁹

The conclusion reached by the Full Federal Court in *AGC (Investments) Ltd*, is significant for a number of reasons. First, it illustrates the importance, as a matter of corporate policy, to have a clear decision from the outset on how a business will be structured. Secondly, it is important to ensure that the practical operations of the business are indeed consistent with the stated policy. Thirdly, provided the policy framework for the operation of the business and its practical adoption are consistent with each other, it is possible to successfully structure the operations of a business so that particular gains are not treated as insurance business gains and consequently not taxable as such. Fourthly, even in a company group operation, a subsidiary will be able to clearly demarcate the parameters of its business operations and have any non business gains treated as such. The recognition of such gains as not being business income will not be tainted by the nature of a subsidiary's parent's operations. Perhaps, as a fifth and final point, *AGC(Investments) Ltd*, is a salutary reminder that it is not the size of the gain, but the manner in which it is derived, that determines whether the gain is business income and consequently taxable.

¹¹⁸ Above n 97, 4,252-3.

¹¹⁹ Above n 97, 4,253.

CONCLUSION

Banking and insurance businesses also appear to be subject to the principle that not all gains made by them will be subject to taxation and that gains made by such businesses are not subject to taxation based on 'the insurance rule'. The significant principles that can be derived from notable Australian and New Zealand decisions is that, even in respect of gains from such businesses, the inquiry must first seek to establish the exact nature of the business and then proceed to inquire whether the particular gain was one which could properly be described as arising from the business as defined. The New Zealand *Income Tax Act 2007*, pursuant to s CB 1(2), excludes from business income amounts that are of a capital nature. This exclusion from business income clearly also applies in respect of businesses such as those engaged in banking and insurance. Since the finding of whether a gain made by these special kinds of businesses is very much a factual one, it provides much scope for banking and insurance businesses to plan their business structures. If there are assets which are fixed in nature and not liquidated for the purposes of the everyday business needs of either a banking or an insurance business, then any gains from the sale of such assets will take their character from the type of asset sold. The Australian and New Zealand decisions reaffirm the principle that it is not the monetary size of the gain that determines whether it is taxable, but whether it was a gain that could be said to have been generated by the business activities of the particular insurance or banking type business.