MONEYLENDING AND INCOME TAX ASPECTS OF DISCOUNTING OF INLAND BILLS OF EXCHANGE BY MERCHANT BANKS IN NEW ZEALAND

RESEARCH PAPER BY M.F. FLANNERY

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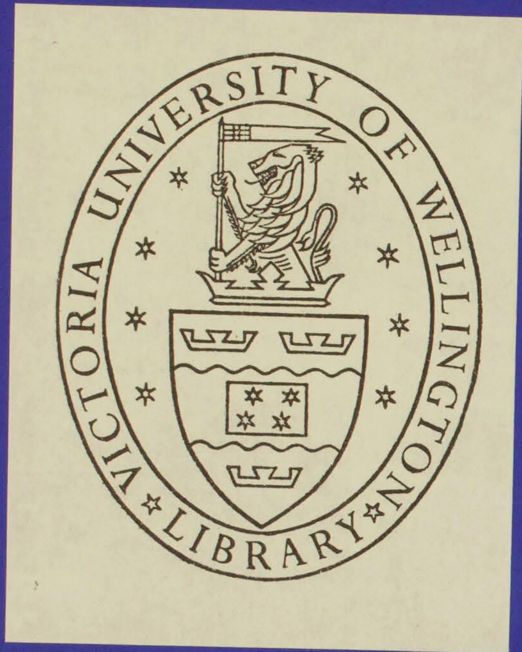
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"Moneylending and Income Tax Aspects of Discounting of Inland Bills of Exchange by Merchant Banks"

By

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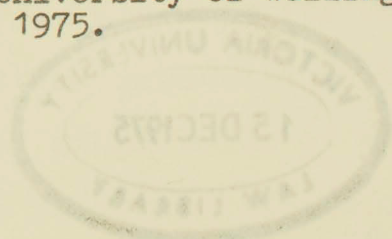

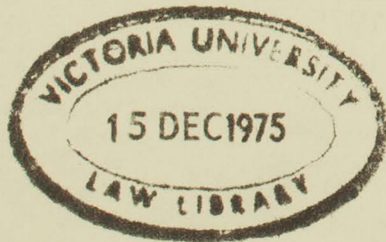

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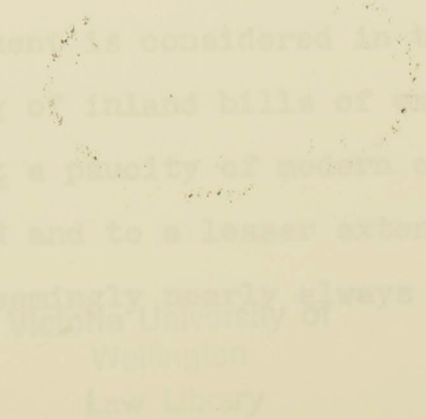

INTRODUCTION

Inland bills of exchange have become a major source of credit and finance in New Zealand consequent upon the development of discounting facilities of the emerging merchant banks.

Such bills continue to be used for a wide variety of purposes and often with the intention of avoiding the provisions of the Moneylenders Act 1908 (as amended) and with the hope of providing the discounter with some form of tax-free gain. That intention still prevails but that hope has been either totally or partially thwarted by the Legislature. Conceivably there remain means of mitigating against the effects of the income-tax liability.

This examination is confined, first, to an examination of the discounting of inland bills by merchant bills, principally, in the context of moneylending and, secondly, to an analysis of the income taxation liability attendant upon the purchase of bills by the discounter. (An inland bill is one drawn and payable in New Zealand or Australia or drawn thereupon some person rendent there. Any other bill is a foreign bill: section 4 Bills of Exchange Act 1908).

The very essence of a bill of exchange as a negotiable instrument lies in its inherent transferability. When that element is considered in the commercial context of discounting of inland bills of exchange there are manifest first a paucity of modern case-law authorities in New Zealand and to a lesser extent in England (for discount is seemingly nearly always peripheral, never

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central even in English decisions), secondly a meagreness of text-writer authority and finally an awareness of the Inland Revenue Department towards imposing either a tax liability on the whole of the allegedly capital gain or at least attempting to emphasise an inchoate or pre-existing liability on the amount of the discount received.

Inland trade bills provide many mutual advantages: Smith owes money to Jones; Robinson is indebted to Smith; Smith can draw a bill on Robinson in favour of Jones; Robinson by accepting the bill "pays" his debt to Smith; Smith can "pay" Jones with the bill; Jones (in addition to presenting the bill for payment) can either negotiate the bill to a creditor of his own or discount it with a merchant bank before it is due for immediate cash less a discount deduction. This is the object of discounting. The creditor can be assured of immediate payment by a certain day. The example given is simplified — and adequately illustrative when trading entities are substituted for the names Smith, Jones, Robinson.

Negotiability, then, characterises the bill. The property is transferable merely by delivery if payable to bearer or by indorsement and delivery if payable to order so that the holder for the time being of the instrument may sue those liable on it in his own name and with the effect that the property in the bill passes to the bona fide transferee for value devoid of any defect in title

of the transferor. Section 31 governs negotiation, and clearly it is that transaction which embraces the discount of a bill.

Negotiability brings into creation the holder's status, and holder is defined (section 2) as "the payee or indorsee of a bill or the bearer thereof", who is then able to sue in his own name (when exercising his right of recourse) any parties liable on the bill.

In the sale and purchase commercially of bills by way of discount one must often look but obliquely to the Act and directly at a plethora of old decisions of England (most of which concern insolvency and bankruptcy) delivered long before Sir MacKenzie Chalmers's Act of 1882.

It would be a brave commercial lawyer who would today contend that the Act reflects on able, working set of rules for the discount, negotiation and advance of money on bills of exchange. The fault is not totally the draftsman's: any conflict of the law cannot be totally attributed to the alleged shortcomings of the Act. The fault lies partly with the unfamiliarity of Counsel and the Judiciary in dealing with bills.

The Bills of Exchange Act 1882 (Imp.) is a declaratory code, and made but few alterations in the law relating to bills of exchange. The rules of the common law and law merchant relating to bills of exchange, promissory notes and cheques remain in force except so far as they are inconsistent with the Act.

The Bills of Exchange Act 1908 (N.Z.) is a consolidation of the Bills of Exchange Act 1883 (N.Z.) and its amendments. The New Zealand Act of 1883 was an adaptation of the United Kingdom Act which substantially codified the general law relating to bills of exchange. The New Zealand Act follows the latter Act closely and while the New Zealand Act is substantially a codifying one, the rules of common law including the law merchant save in so far as they are inconsistent with the provisions of the Act continue to apply: section 98(1).

Discount provides the incentive for the buying and selling of bills which represent rivulets of credit for banks (both the traditional trading banks and the emerging so-called "merchant banks" in New Zealand) and finance houses and institutions are able to canalise such funds into commercially productive activities.

The discount of a bill is neither more or less than the transfer of that negotiable instrument for a monetary consideration. The discount itself is the difference between the price paid and the face value of the bill. <u>This is the nature of discount</u>.

With the advent of "merchant banks" in New Zealand and an expansive economy, commercial paper has become a vital form of financing for trading companies and a significant investment instrument for both individuals and companies. The attractiveness is partly explicable by the fact that commercial paper is regarded by many as a low-risk investment carrying a somewhat higher yield than other money- and stock-market

investments.

Late in December 1974 the Reserve Bank (in pursuance of section 34A of the Reserve Bank of New Zealand Act 1964 as inserted by section 9 of the Reserve Bank of New Zealand Amendment Act 1973) made a non-binding request to the New Zealand finance houses and merchant banks that trade in bills of exchange for discount be restricted to a minimum amount of $20,000 and that total lending be maintained at a level of $180 million. The first part of this non-binding request was intended to end the practice of "splitting" bills among a number of contributories some of whom had been advancing sums as small as $1000 towards the investment. The second part of the request was not in effect met because by the end of December 1974 $187 million had been invested and represented the culminating point in the phenomenal growth in the bills market over the then preceding 18 months. Merchant banks (through their law advisers) soon realised that the non-binding request was non-mandatory but a number welcomed the ban on splitting because contributed investments entailed bother to them as to indorsements, particularly when single investors (essentially corporate) had large sums immediately available. No request was made to the dealers to reduce the effective rate of interest on bills. (Qv., subsection (4) of section 34A:

"The Governor-General may from time to time, by Order in Council, specify the rates of

interest to be paid to or by financial instructions (sic) (other than trading banks.").

Many law practitioners with clients interested in investing the now-current minimum of $20,000 are quite unfamiliar as to what eventuates on the purchase of a bill and for that reason some background must necessarily be given to the emergence of merchant banking in New Zealand and its role in discounting, and then to the nature of the whole transaction before examining discount and moneylending and finally the aspect of taxation on the gain of the discounter.

There has been a reported trend for some merchant banks to use 90-day trade bills to finance long-term property development (effected by a series of re-discounted transactions).

Potential discounters (and often their advisers) have been in a reported quandary as to what precisely they got upon making a purchase of a bill. Many appear to be under the impression that they had obtained some form of commercial security. The investment is unsecured.

The material may be conveniently divided into and then examined under the following heads:-

I EMERGENCE OF MERCHANT BANKING IN NEW ZEALAND AND ITS ROLE IN THE DISCOUNTING OF INLAND BILLS OF EXCHANGE

II NATURE OF DISCOUNTING AND AFFINITY TO MONEYLENDING

III EXAMINATION OF TAXATION LIABILITY

IV CONCLUSIONS, AND THEN SOME RECOMMENDATIONS

I EMERGENCE OF MERCHANT BANKING IN NEW ZEALAND AND ITS ROLE IN THE DISCOUNTING OF INLAND BILLS OF EXCHANGE

The merchant banks

The major expansion of merchant banking in New Zealand occurred in 1971 when the government allowed overseas companies to participate in their establishment. Merchant banks began to engage in their underwriting activities of new share issues, to advise on and finance mergers and takeovers and to lend money for expansion to growing companies. The year 1974 saw the merchant banks enter the bill of exchange discounting business in which commercial paper began nationally to be used for the financing of internal transactions.

New Zealand imported the term "merchant bank" from England but nothing of the type and extent of that activity as carried on by the prestigious merchant banks of the City. Edward J. Reid said in his presidential address entitled The Role of Merchant Banks Today (and reprinted in Journal of the Institute of Bankers 1963):

> "There is ... a group of houses in the city who are constituents of the Accepting Houses Committee and also members of the Issuing Houses Association to whom the description" (merchant bank) "is usually and indeed correctly applied and as this group is active and an essential part of the mechanism of the City it seems appropriate".

But, of course, New Zealand has nothing comparable to the accepting side (namely, the provision of credit for trade) and the issuing side (the provision of capital for industry) as both those terms are peculiarly known in the City; however, most merchant banks in New Zealand are either the subsidiaries of or are affiliated to major merchant banks in the City and to an acceptable extent they do perform somewhat comparable functions to make the adoption of the term "merchant bank" reasonably justifiable; but the equation of merchant banks in London with the emerging entities in New Zealand using the same name cannot be carried too far for the origin, traditions, functions and modes of operation of the former have no counterpart in New Zealand.

The Accepting Houses Committee perform an enormously wide range of services: maintain a money market; provide short -, medium - and long-term - funds to substantial clients; advise on corporate reconstructions, mergers and takeovers; underwrite both debts and equity issues; finance imports and exports; lease "large-ticket" items; manage investment portfolios and unit trusts; deal in foreign exchange and bullion; and maintain cheque facilities for clients.

The acceptance business in the City does not directly involve itself either borrowing or lending. Essentially it is the sale of the use of a name as effective guarantor that there will be no default on the bill of exchange. Such guarantee can only be effective if the accepting house is known to have

substantial assets including some so highly liquid that bills will invariably be not merely paid but paid at the proper moment. The accepting houses are today less active with trade bills (unless of a major amount concerning commercial and industrial undertakings) and deal principally with acceptance credits and the documentary letters of credit for the importation of foodstuffs and raw materials. In either event extra commission is paid to secure a good name on the bill which greatly increases the ease of discounting.

New Zealand merchant banking has no concept like the Accepting Houses Committee, and many of the latter's activities are by circumstance and necessity forbidden territory to merchant banks in New Zealand, particularly to overseas companies which require the consent of the Minister of Finance to participate in the establishment of merchant banks in New Zealand. (But there does not appear to be any impediment in the Banking Act 1908 (as amended) to a New Zealand-owned sharebroking firm carrying on substantially the business of merchant banking and eventually to maintain cheque facilities once banking becomes its real and substantial business (as distinct from an ancillary or incidental branch of another business): see State Savings Bank of Victoria v. Permewan Wright Co. Ltd (1915) 19 C.L.R. 457; and compare United Dominions Trust v. Kirkwood (1966) 1 All E.R. 968 in which the English Court of Appeal enumerated the characteristics usually found in a banker's business at the present time and in which Lord Denning, M.R. mentioned (at 975) the collection of cheques, crossed and uncrossed, and

the withdrawal of funds by cheque. Overseas companies established in New Zealand are subject to Part XII Companies Act 1955 and (if merchant banks) to the Capital (Overseas) Regulations 1965 as amended and to the requisite consent of the Minister of Finance.).

In New Zealand the stature of the company appearing on the bill as acceptor or accommodation party is the rudimentary and antipodean counterpart of the accepting house name on the bill. Indeed the names of companies appearing on merchant bank bills are household names in New Zealand which are invariably listed on the New Zealand Stock Exchange. The indorsement of the merchant bank provides a contingent liability ranking after the drawer. Occasionally an accommodation party signs the bill (as drawer , acceptor or indorser) without receiving value therefor and for the purpose of lending his name to some other party so that there is achieved a marked facility in negotiating the bill by way of discount. (It (the accommodation party) is liable on the bill to the discounter and it is immaterial whether when such holder for value took the bill, the discounter knew such party to be an accommodation party or not: section 28(2).

Most of the companies on the New Zealand bill market are so well established and well known that these two features invariably appear enough to influence the purchase of a bill by discount.

At the present time, then, the use of the words "merchant bank" in New Zealand is a misnomer but it is a convenient and differentiating label. Similar

functions have been carried on for many years in New Zealand by the major underwriting firms.

The role of discounting

Commercial bills, commercial paper, bills of exchange, or plain bills — all refer to the same instrument of credit, the bill of exchange as defined in the Bills of Exchange Act 1908.

Commercial paper consists of unsecured, short-term bills of exchange issued by trading and manufacturing companies and by the affiliates and subsidiaries of commercial and merchant banks. The notes are payable to bearer on a stated maturity date. Maturities range from 30 to 90 days and often to 180 days. When the paper becomes due, it is often "rolled over", that is, a new bill is issued, either to the same or a new discounter at the market rate ruling at the time of its maturity. The discounting procedure is still evolving among merchant banks in New Zealand.

There are two main types of bill:

(1) The trade bill is often related to a specific trading transaction and is used to raise credit for manufacturers, traders, finance companies, importers and the like. A manufacturer supplies a retailer with goods priced at $50,000. The manufacturer desires to have immediate cash and accordingly draws a bill on the buyer payable to order 90 days after acceptance. The buyer of the goods accepts the bill or gets his trading bank to accept it. The merchant bank then buys the bill and it is thereupon entitled to receive its face value on maturity. The

merchant bank then usually sells the bill by discounting it to an investor or the discounting bank may act also as the presentor. No interest is paid on the bill by any party for the effective cost of holding the bill is reflected in the discount below face value at which the bill is bought and sold. The manufacturer no longer holds a book debt but as the drawer of the bill it is carrying a contingent liability until the bill is met. (At least in one sense the purchase of the trade bill by the merchant bank equates in some ways to selective factoring, accompanied by recourse).

(2) The acceptance or accommodation bills are drawn under an acceptance facility extended by a merchant bank. These bills are often drawn on the merchant bank itself or upon a company affiliated with the drawer. Often there is no directly related trade transaction or there may be collateral mortgages and debentures in favour of the merchant bank. Such bills are purchased by the merchant bank and so funds are provided to the drawer.

In the first illustration at least three independent names appear on the trade bill and all are liable. In the second illustration the names of two independent companies (including the merchant bank) appear on the bill. Whatever pattern is adopted the merchant bank acts a fiduciary agent and intermediary in effecting the discount of the bill to a private

or corporate investor as purchaser.

At least one merchant bank in New Zealand signs its bills as the accepting party which of course is a direct undertaking to all other parties that the bill will be paid on due date. The majority of merchant banks, it appears, sign as indorsers (sometimes as guarantors) and the investors' recourse is then directly to the merchant bank but that, of course, does not preclude recourse first to both drawer and acceptor. The indorser of a bill engages that if it is dishonoured then it will compensate the holder or subsequent indorser which is compelled to pay. Sometimes bills contain extension clauses to allow for re-negotiation for additional periods and this trend has been detected in some 90-day bills which in reality have been intended to finance long-term property development and acquisition. The trend is not common. This continual issue of new (or occasionally the renewal of) bills is known as "rolling over" the bills.

Merchant banks sell the bills to discounters at face value.

The effective annual discount rate varies, of course, according to liquidity pressures ruling within the money market but for major companies bills are often discounted at a rate which, though normally higher than bank overdraft rate, is often substantially lower than the rate applicable to borrowings from a finance company and is often claimed to be normally lower than the total cost (including underwriting and

legal costs) associated with debenture borrowings. Such a rate is the total cost because usually there are no brokerage charges or legal costs.

Bills are currently used for financing medium to short-term cash requirements, usually as an adjunct to overdraft finance; though at least one merchant bank through successive re-discounting has attempted to use 90-day bills for long-term property development. Generally the use of bills enables a company to avoid the unnecessary use of long-term finance where the deficiency peaks of cash shortages are not long.

A bill of exchange is defined as "an unconditional order in writing addressed by one person to another signed by the person giving it" (the drawer) "requiring the person to whom it is addressed" (the drawee who when he signs becomes the acceptor), "to pay on demand or at a fixed or determinable future time a sum certain in money to or to the order of a specified person or to bearer" (the payee): section 3, Bills of Exchange Act 1908. The drawer and indorsers of a bill are jointly and severally liable to the holder for the due acceptance and payment; and so if the bill is dishonoured the holder may enforce payment from the drawer or an indorser or the acceptor or all or any of them. The drawer and all indorsers undertake a secondary liability.

By drawing a bill the drawer engages to pay the bill if the acceptor makes default but he may qualify the terms of that acceptance.

The payee is often the drawer because the

drawer often (at least initially) wants the money paid to himself or subsequently wishes to transfer it to a discounter who, of course, gives him value for it by his purchase.

The first holder is the payee. Pursuant to section 2 holder means the payee or indorsee of a bill who is in possession of it or the bearer thereof. "Holder" therefore may mean the discounter (as well as the payee or indorsee of the bill). "Holder" as a term is capable of shading off into two other significant terms and meanings for there may be a holder for value and a holder in due course.

The indorser is the person who signs the bill as part of the procedure of transferring a bill payable to order. He is similar to the drawer in that he must compensate subsequent parties (including the discounter) if the bill is dishonoured. He cannot avoid his liability by attacking the signature of the drawer or an earlier indorser. Any third party who signs a bill other than as drawer or as acceptor is liable as if he were an indorser whose liability upon signature is to all subsequent parties.

Discounter as holder in due course

For the holder (in this context the discounter) to qualify as a holder in due course he must have taken the bill in good faith and for value and at the time the bill was negotiated to him he must have had no notice of any defect in the title of the person who negotiated it to him: section 29(1)(b). The holder

who takes a negotiable instrument bona fide (that is, by giving value for it and having no notice at the time that the party from whom he takes it has no title) is entitled to recover upon it, even although he may at the time have had the means of knowledge of that fact of which means he neglected to avail himself: Raphael v. Bank of England (1855) 17 C.B. 161; 6 Digest 139, 916. (The discounter as holder in due course is considered more fully *post*).

II NATURE OF DISCOUNTING AND AFFINITY TO MONEYLENDING

Exposition of concept of discounting

A bill is discounted when it is transferred for a monetary consideration which is less than its amount by a sum representing a rebate of interest in respect of the period which is to elapse before it falls due for payment.

The discount is in effect the difference between the price paid and the actual amount of the debt, the evidence of which is transferred.

The actual charge made for discounting a bill is generally calculated by applying the appropriate rate of interest to the lifetime of the bill.

In a discounting transaction the bill is sold prior to due date for an amount less than its face value. The purchaser or discounter becomes the owner of the various rights against the signatories including the seller (either as drawer or indorser) whose liability continues pursuant to the express warranties in section 55 (unless, of course, the right of recourse against either drawer or indorser

~~whose liability continues pursuant to the express warranties in section 55 (unless, of course, the right of recourse against either drawer or indorser~~ has been restricted: section 16).

Discounting a bill is not equivalent to paying it, and so the acceptor may negotiate it to another person, and the drawer and indorsers may become liable to a subsequent holder even with notice: Harmer v. Steele (1849) 4 Ex. 1, 13.

To deal in bills of exchange is to traffic or trade in them, that is to buy and sell them, or to lend on them: London Provincial and South Western Bank v. Buszard (1919) 35 Times L.R. 142, 63 So.Jo. 246, followed in Garrioch v. Canadian Bank of Commerce (1919) 3 W.W.R. 185 (all of which are cited in Falconbridge, Banking and Bills of Exchange, 7th Edn., 1969).

Falconbridge adds (at 140) that a bill is discounted when in consideration of a sum paid by the bank, the transferor indorses it to the bank or when without indorsement, he becomes liable to the bank by agreement or custom in respect of the payment of the amount of the bill. The discount is the deduction or drawback made from an advance of money upon a bill; the difference between the price paid and the face value of the bill: In re Land Securities Co., ex parte Farquhar (1896) 2 Ch. 320.

Indorsements

Transfer to the discounter is vested in him by indorsement on the bill. Section 32 provides that an indorsement operates as a negotiation, when it is first

written on the bill itself and signed by the indorser but a simple signature on the bill or an allonge is sufficient; secondly it must be an indorsement of the entire bill; a partial indorsement does not operate as a negotiation of a bill; thirdly the indorsement must be of all the payees who are not partners unless one has authority to indorse for the others; fourthly where the payee or indorsee is wrongly designated or his name is misspelt he may indorse the bill as therein described: banks almost invariably require the proper signature to be added; and fifthly where there are two or more indorsements each is deemed to have been made in the order in which each appears on the bill unless the contrary is proved.

Discounter is a term not defined nor does it appear anywhere in the Act but absolute title is vested in him by indorsement and therefore the transfer by indorsement vests in both the discounter and the indorsee a right of action against all parties whose names are on the bill in case of default of acceptance or (and this is the appropriate eventuality for the discounter) payment and against an innocent discounter or indorsee for value, no prior party can set up the defence of fraud, duress, illegality, or absence of consideration: section 29 (Holder in due course); and Hamilton Finance Co. Ltd v. Coverley Westray Ltd (1969) 1 Lloyds Reports 53.

Mocatta, J. in Hamilton thought that the word "discount" was inapplicable to the case where the

party for whom the bill was discounted received the face amount of the bill from the discounting bank which then recovered the charges from the acceptor. "In these somewhat unusual circumstances it seems to me that the word 'discount' is a misnomer and that what in fact happened was that the second defendants bought the bills from the first defendants at their face value for a consideration passing to them from Nassauer". (The plaintiffs claimed against the first defendants (Coverley Westray) and the second defendants (Portland Finance Co. Ltd), drawers and indorsers and indorsers respectively of five bills accepted by Nassauer Bros. Ltd, wine and spirit merchants of which the plaintiffs were allegedly the bearers and holders in due course. The bills were dishonoured on presentation).

A bona fide holder for value of a bill of exchange without notice of any defect in the title of his transferor holds it free from equities affecting his transferor. Mocatta J. in Hamilton held (at 66) that the discounter of the bill of exchange which had been forged was entitled to recover from the innocent vendor as for a total failure of consideration. And at 67, he added:

> "In the ordinary case of the purchase of a bill of exchange the purchaser in my judgment expects to receive an instrument which then and there gives him a right to recover against the acceptor thereof on the due date of payment and, failing payment by the acceptor on the due date, a right to

recover against prior indorsers or the drawer. He is not to be left in a state of uncertainty as to his legal rights depending upon the generosity of the paying banker and its customer."

That statement is in effect an application of section 38 which provides that the holder in due course of a bill of exchange (of which the discounter is such) holds the bill free from any defect of title of prior parties as well as mere personal defences available to prior parties among themselves, and (more importantly as _Hamilton_ illustrates) may enforce payment against all parties liable under the bill.

In _Elliott_ v. _Bax-Ironside_ (1925) 2 K.B. 301, the indorsement was affixed by means of a rubber stamp and the acceptance handwritten.

In _Arab Bank_ v. _Ross_ (1952) 1 All E.R. 709, Denning L.J. (at 716) pointed out that three concepts should be differentiated when considering indorsements, namely their regularity for the purpose of holding in due course; their validity for the purpose of passing the property in the instrument; and their efficacy for the purpose of imposing liability. (Clearly all three are important as to discounting). The test of regularity is whether ex facie the instrument, it is apparent that the indorsement is that of the named payee (or indorsee or discounter upon re-discount). An indorsement is irregular whenever it is such as to give rise to doubt whether it is the indorsement of the named payee. Regularity is a different thing from validity. And in _Arab Bank_ the indorsement was

irregular (a note payable to the partnership - "F. & F.N. Co." being indorsed "F & F.N.") but valid for the purpose of passing property.

Regularity is different from liability. A person who makes an irregular indorsement is liable thereon notwithstanding the irregularity. If a payee who is wrongly described on the bill indorses it in his true name alone, that indorsement is likely to be irregular (Arab Bank (at 715))but is sufficient to impose liability. But a regular indorsement if it is forged or unauthorised will not impose any liability on the person whose indorsement it purports to be: Arab Bank (at 715).

An agent may be employed to get a bill discounted: he then has implied authority to warrant it a good bill but not to endorse it in the name of his principal: Fenn v. Harrison (1790) 3 Term Rep. 757; (1791) 4 Term Rep. The authority and duties of a bill broker entrusted with bills for discounting depend upon the course of dealing and usage of the particular place where such bill broker is employed, in the absence of instructions to the contrary: Foster v. Pearson (1835) 1 C. M. & R. 849. The rule laid down in this case that it was not unusual or unreasonable for bill brokers in the City of London to raise money for their employers by pledging the bills of different proprietors for one advance, was distinctly upheld and applied in the case of a pledge of securities en bloc by a stockbroker: London Joint Stock Bank v. Simmons (1892) A.C. 201; Fuller v. Glyn, Mills & Coy (1914) 2 K.B. 168; Bentinck v. London Joint Stock Bank (1893) 2 Ch. D. 120.

Negotiation and advance

Apart from the discount of a bill, negotiation and advance must be differentiated for a bank (merchant or trading) which negotiates the bill as a holder in due course and a bank which advances a percentage on the bill as a holder for value are quite separate. Section 27(1)(a) of the Bills of Exchange Act 1908 recites that valuable consideration for a bill may be constituted by, inter alia, any consideration sufficient to support a simple contract. The consideration for a bill need not necessarily (and rarely is) be equal to its face value and so a bank may be constituted a holder in due course even if it advances a small amount against it and similarly the payment to the seller of the bill's full amount will not by itself make the bank a holder in due course because that bank must be able to demonstrate that it obtained the bill in conformity with the conditions specified in section 29(1): the bill must be complete and regular on its face and so if the seller has been paid the full amount of an irregular bill, the bank will not be a holder in due course; and the bank must have taken the transfer of the bill and so if the bill is payable to the bank's own order and delivered by the seller then the bank is not a person who has taken the bill and accordingly cannot be constituted a holder in due course. The bank will be a holder for value and that status will be enhanced by the advancement of the full amount of the bill: Jones v. Waring and Gillow Ltd (1926) A.C. 670.

The expressions "holder for value", "holder who has taken for value" and "holder who has given value"

occur throughout the Bills of Exchange Act with no indication that they all or any two share a common meaning; but the current editions of Chalmers on Bills of Bills of Exchange and Byles on Bills of Exchange both suggest that no distinction is to be drawn between the expressions "holder for value","holder who has taken for value" and "holder who has given value" (see too National Westminster Bank Ltd v. Barclays Bank (1974) 3 All E.R. 834).

The effect of the negotiation of a bill (and in this context such negotiation is effected by the transferee purchasing the bill) is to give such transferee if he took the bill bona fide and for value a good title to the bill notwithstanding the defect in title of any prior parties. This is the hallmark of negotiability, and it is one which endows the title of the transferee who is a holder in due course. The original payee will not, of course be a holder in due course for the bill was not negotiated to him: R.E. Jones Ltd v. Waring and Gillow Ltd. A holder is a payee or indorser of the bill who is in possession of it, and hence will be the discounter. Not every holder is a holder in due course but he is deemed to be a holder in due course until the contrary is proved.

Under section 38 the holder of the bill may sue upon it in his own name; and if he is a holder in due course, then he holds the bill free from any defect of title of prior parties as well as from mere personal defences available to prior parties among themselves

and may enforce payment against all parties liable on the bill. But freedom "from mere personal defences available to prior parties among themselves" will not grant the discounter any impregnable position of security and safety if the discounter (as part of the consideration for his purchase of the bill) has been a party to any innocent misrepresentation: Kinsman v. Kinsman (1912) 5 D.L.R. 871 because subsection (b) is clearly concerned with defects in the title of prior parties and not with the instance given where the discounter as payee has placed himself in a vulnerable position because of his own volition concerning such a defect.

Discount must be distinguished from both the deposit of a bill for collection and the holding of a bill as security. The test does not depend essentially or exclusively on the existence of an indorsement but (on the one hand) the intention to effect an absolute transfer with resultant full power to go against all parties on the bill; or merely enabling the person with whom the bill is deposited to receive the amount from the other parties: Ex parte Twogood (1812) 19 Ves. 229; 34 E.R. 503 (which indicates that such indorsement is prima facie evidence of discount unless the object of mere deposit is manifest; or merely to allow the obtaining that part of the proceeds in repayment of the debt owing under the security: Reid v. Furnival (1833) 1 C and M 538; 149 E.R. 513.

Discount, collection and security, then, must all be distinguished. The prevailing presumption obtaining

in each of the above sets of circumstances is that the holder holds absolutely and not by way of security: Hills v. Parker (1866) 14 L.T. 107; Re Boys, Eedes v. Boys, ex parte Hop Planters' Co. (1870) L.R. 10 Eq. 467.

Discount is distinct from pledge, mortgage

Sometimes the terms "discounting" and "negotiating" are treated as synonymous but the better practice is to use the term "discounting a bill" to describe the sale of an accepted bill, by the payee or the holder (as the case may be) to a bank or private discounter. If the bill changes hands before it has been accepted this should properly be called the "negotiation" of the bill. In short, a bill is not ready to be discounted until it has been accepted.

Property does not pass until the bill is discounted: Dawson v. Isle (1906) 1 Ch 633 in which Warrington J. had to determine whether a bill of exchange entered in a company's books as a receivable bill and handed to the bank for discount remained a debt due to this company. Warrington J. (at 639) said:

> "It was in reality not an absolute indorsement intended to pass the property to the bankers at the moment but an indorsement which was intended to enable them to discount the bill, and when they discounted the bill then to pass the property; and it seems to me that until discounted the property in the bill did not actually pass to the bankers ...". That belonged to the company.

The decision is based on imputed intention of the company in handing the bill to the bank conditionally and for the purpose of its being discounted. The money due on the bill was a book debt the amount of which was to be considered in ascertaining the purchase price of the company's shares.

Distinction from moneylending

Buying bills at a discount, that is for their face value at date of purchase is well-known and quite distinct from moneylending: Chow Yoong Hong v. Choong Fah Rubber Manufactory (1962) A.C. 209 (P.C.) per Lord Devlin (at 215). (The question was whether buying bills at a discount constituted a loan of money to the vendor of the bill), Lord Devlin added:

> "Nowadays the buyer is usually a bank or a discount house but the fact that he cannot be put into either of those categories does not alter the nature of the transaction, neither does the designation of the discount as interest. There is here no loan of money and no promise of repayment. Their Lordships' conclusion on this point is in accordance with the decision of Branson, J. in Old Discount Co. Ltd v. John Playfair Ltd (1938) 3 All E.R. 275 that a purchase of book debts for a specific sum of money was not a moneylending transaction."

(In Playfair Branson, J. had to consider whether the assignment of book debts due or to become due under instalment contracts of sale in consideration of an immediate lump-sum payment (the value of the debts less a discount) amounted to a loan. The

assignor agreed to act as agent for the assignee to collect the debts from the purchasers and also to give a series of monthly bills to secure payment by such purchasers of their debts. He held that the transaction entered into by the parties was not a moneylending transaction at all and he reasoned that it was not sufficient to say that the defendant could have entered into such loan transaction if the same result could have been attained by effecting a sale).

Lord Devlin in Chow Yoong Hong strongly relied on the principle implicit in Playfair that it is the nature of the agreement and not its object at which the Court must look to decide whether any agreement was a moneylending one or otherwise. Playfair was a decision on the English Moneylenders Act 1927 and Chow Yoong Hong on the Malayan Moneylenders Ordinance. Neither of these statutes defines "loan" and so each question had to be answered on general principles. In most of the Australian States and the Australian Capital Territory the statutory definition of loan includes both discount and "every contract (whatever its terms or form may be) which is in substance or effect a loan of money", but not the New Zealand Moneylenders Act 1908 (as amended).

However, Finlay J. in Cash Order Purchases Ltd v. Brady (1952) NZLR 898 at 914 laid down what he held to be the correct approach:

"My conception is that we must find the pith and substance of the arrangements by a consideration of the documents, and then, if necessary, proceed to consider whether it is established by relevant evidence that the pith and substance as represented by the documents was not the true pith and substance, but that the documents were a mere cloak to conceal the true character of the arrangement. I have used the expression 'relevant evidence' because it is a question of fact to be established by evidence that the documents are a mask for another and different transaction".

(Cash Order is not concerned with the discount of bills of exchange, but with moneylending. However it contains an important enunciation of the law because the Full Court distinguished Playfair and held that the Court was entitled to inquire into the true and real nature of the transaction and that it could go behind the agreements whatever they purported on their face to effect. The Court was exercising its general jurisdiction and one which (it is suggested) could be strengthened by appropriate definition of "loan" to include the discount of a bill of exchange and with further provision that the Court be empowered to examine the intentions of the parties upon prima facie evidence appearing to the Court's satisfaction of a device (in the form of discount of bills of exchange) designed to avoid the provisions of the Moneylenders Act 1908 (as amended)).

Many transactions involving the purchase of chattels involve the drawing and discounting of trade bills, and with the retailer selling the goods to a finance company for the cash price (including the deposit which is paid directly to the retailer by the hirer) and with the finance company letting them on hire purchase to the hirer for the cash price plus the hire purchase charges, principally interest. In Playfair a series of monthly bills was given to secure the due payment of customers' instalments under the contracts of sale. In Chow Yoong Hong the vendor of the bills gave his own post-dated cheques for the same amount which were payable on the dates when the bills matured. Lord Devlin rejected (at 215) that the existence of this latter security pointed to the true nature of the transaction as being a loan:

> "Their Lordships are satisfied that the post-dated cheques do not affect the nature of the transactions. A buyer of a bill naturally wants to have recourse to the seller of it as well as to the drawer; and in the ordinary way he will obtain this because the seller will also be the indorser of the bill. If so it is difficult to see what added advantage the plaintiff got from the post-dated cheques, and in any event they could not have done more than put the defendants in the ordinary position of indorsees".

Playfair and Chow Yoong Hong both, then, mean that where there is a genuine sale and discount of bills (and too of instalment contracts of sale, hire purchase contracts and book debts) in consideration of an immediate lump-sum payment less than the value, the transaction does not amount to a loan and neither does the presence of the vendor providing security for the purchaser nor too where the vendor acts as the purchaser's agent for collection alter that conclusion.

Rowntree case

The terms "borrowing" and "lending" are subject to such permutations and combinations in the context of transactions at law that the precise meanings to which such words can be ascribed gained a new dimension in the little-celebrated Court of Appeal (English) decision of Inland Revenue Commissioners v. Rowntree & Co. Ltd (1948) 1 All E.R. 482 (C.A.) for it is a case which while dealing both with the discounting of bills of exchange and borrowing and lending has drawn no comment in Byles on Bills of Exchange (23rd Edn., 1972), Megrah and Ryder), nor in Paget's Law of Banking (8th Edn., 1972 Megrah and Ryder) nor in The Law of Moneylenders in Australia and New Zealand by C.L. Pannam (1965) nor in Benjamin's Sale of Goods (1st Edn., general editor, A.G. Guest).

There was present the usual tripartite arrangement with the third party being the acceptance house but the facts of the case are usual only in that respect and the decision constitutes an illuminating slant

on both moneylending and discounting generally, and indeed Rowntree provides a totally different attitude than the comments of Lord Devlin in Chow Yoong Hong in which reliance is placed (without any examination) on the dicta in Olds Discount that "... buying bills at a discount .... is quite discount from moneylending." That statement (it is suggested) is demonstrably not correct, at least at first face, for both are two commercially well-known methods of raising money. With respect it appears somewhat ingenuous to suggest that the business of each is quite distinct when the result of each is exactly the same: the raising of money. The method used should not be allowed to defeat the purpose of the Act.

Briefly in Rowntree the company raised money for its business by drawing sight bills, payable at four and six months on the acceptance house which accepted the bills in consideration of a commission paid to them by the company, and then as agents for that company discounted the bills on the market and remitted the proceeds to the company.

The arrangement was that the company was bound to put the acceptance house in funds shortly before maturity of the respective bills. Money was raised in this way.

The Special Commissioners held inter alia that in ordinary commercial usage the relationship among the company, the acceptance house and the holder of the bills was not that of borrower and lender nor were the transactions ones of loan. They therefore held that the money so raised was not "borrowed money"

(within the meaning of the English Finance (No. 2) Act 1939 and accordingly was not deductible.

(The case is admittedly a taxation one but its implications extend beyond Revenue matters because the Special Commissioners, the Court at first instance and then the Court of Appeal acknowledged that the words "borrowed money" had to be construed in accordance with commercial usage and demonstrably that embraces moneylending transactions).

Macnaghten J. came to a contrary view to that of the Special Commissioners and he dealt with the argument which had been advanced (1947) 2 All E.R. 474 before him in these words:

> "It is said on behalf of the company that, for there to be a borrowing of money, there must be a lender as well as a borrower, and that no-body lent any money to the company. For the Crown it is said that the money of which the company had the use for the period of the bills was lent either by the discount house or by Erlangers Ltd. I am unable to see how it can be said that the acceptance house lent any money. It is the function of an acceptance house, to lend its name as acceptor, but it does not lend any money to anybody. The acceptance house need not have any money at all, if the person for whom the acceptance house accepts the bill fulfils his obligation of providing cash to meet the bill when it falls due. It was the discount house which

provided the money of which the company had the use for the period of the bill and no longer".

Macnaghten J. therefore held that it was borrowed money in "the ordinary acceptation" of that word. The borrowers were the company and the lenders the discount house. His decision was reversed on appeal.

Somervell, L.J. held (at 487) that the Solicitor-General's definition was not an accurate one of lending when it was claimed that there is a lending whenever a person makes or undertakes to make available for another person money which that other person subsequently has to pay back to someone. He explained:

"The answer that I would give to that is that, in my view, that is not an accurate definition of lending. I think that the Solicitor-General's argument rather proceeded on the basis that any 'raising' of money must be regarded as a "borrowing" of money. There I think it fails, and I agree with the learned judge, for the reasons which he gives, that Erlangers cannot be regarded as lenders. Nor do I think (and here I disagree with the learned judge) that the discount house can be regarded as lenders. It seems to me that this case brings out very well that there are two ways at least (there may be more) of raising money. One is by borrowing it and the other is by discounting a bill of exchange. They are both quite well-known methods. One is borrowing and the other

is discounting a bill. The fact that in many cases they produce the same result of providing financial resources for carrying on a business does not mean that words which are apt to describe one must be construed as covering the other .... 'Borrowed' money is a familiar phrase. It is possible that in certain contexts it might have a rather wider meaning than it would have, say, in the strict context of a legal pleading, but looking at the transaction as a whole, I have come to the conclusion that these sums were not borrowed in any ordinary meaning which can be given to that expression ...".

Tucker and Cohen, L.JJ delivered concurring judgments.

It is common now for wholesalers and retailers selling goods under instalment contracts of sale and hire purchase agreements to obtain immediate cash in respect of the bills of exchange held by selling the bills at a discount (and sometimes with the necessary assignment of the contracts). Alternatively the bills or contracts may be assigned by way of mortgage and it is then clear that a loan has been effected. The transactions may be separate or be inter-related.

In <u>Olds Discount</u> Branson J. held (at 276-77) ".... that upon the face of these documents, it is perfectly clear that the transaction entered into ... was not a moneylending

> transaction at all, but a transaction under which the plaintiffs (the assignees of the bookdebts) purchased from the defendants certain bookdebts for certain payments .. there is no doubt that .. the agreement is a perfectly good and lawful agreement, notwithstanding that the operative reason in the minds of the defendants (that is the assignors) for entering into it was that they desired to raise money as a temporary matter in the same way as they would have raised it if they had merely entered into a transaction of loan."

And in Chow Yoong Hong, Lord Devlin explicitly approved (as already indicated) Olds Discount and (at 215) added:

> "The business of buying bills at a discount, that is for their value at the date of purchase, is well-known and quite distinct from moneylending".

Notwithstanding the statements implicitly meaning that discounting bills constitutes a lending of money made by Farwell J. in Litchfield v. Dreyfus (1906) 1 K.B. 584 which has been over-ruled by Olds Discount and more importantly by Chow Yoong Hong the dividing line between the transactions is thin and accordingly what Finlay J. said (at 914) in Cash Order represents demonstrably the more realistic approach and one calculated to give effect to the true intent, meaning and spirit of the Moneylenders Act (as amended) whenever the existence of discount is prima facie evidence of

lending.

The most frequently encountered manner of evading the requirements of the Moneylenders Act 1908 as amended is to substitute an intended loan by a sale and for the vendor to add: "I'll draw a bill on you for the amount of the 'sale' we thereby arrange" and for such bill to be subsequently discounted. The Courts have drawn a distinction between a loan on the one hand and the extension of credit concerned with a sale-by-way-of instalments on the other hand. The former clearly constitutes a moneylending transaction while the latter is not.

Much depends on the intentions of the parties and the surrounding circumstances. If they agree to arrange their transaction as a sale, then it is largely irrelevant that the same result could have been produced by borrowing or by lending money: Chow Yoong Hong (per Lord Devlin at 216-17).

(Indeed, it may not be too unfair to say that the words of Lord Devlin should not be given too great a weight of authority for his reputation was made not in his judgments on commercial law and indeed in Baker v. Barclays Bank Ltd (1955) 1 WLR 822 Devlin J. (as he then was) said (at 833) that he was not entirely clear how it benefits the bank to establish that the customer for whom they collected was a holder in due course. He does not appear to have acknowledged the existence of section 29(3) of the Bills of Exchange Act).

Chow Yoong Hong and Olds Discount both lean to a generous and (it is suggested) a some what unrealistic interpretation (and one which has found support in South

Africa in Tucker v. Ginsberg (1962) (2) S.A. (W.L.D.) 58) whereas Cash Order indicates an examination to determine the reality. Indeed it is mere playing with words to suggest first that the object of discounting and moneylending are the same and then in the same breath to say that the nature of the two transactions is fundamentally different. It is laudable for the Court not to stop short at accepting the terms used by the parties but instead to acknowledge the duty to go further to examine the true nature of the transaction. However the usefulness of that latter exercise is vitiated if the Court abandons any correct adjudication when it locates any element (whether principal or subsidiary) of discounting forming an integral part of a moneylending transaction for "the documents are", then, "a mask for another and different transaction", and it is the Court's duty to say what that transaction is and not to excuse itself by speaking of a "fundamentally different" transaction in the form of discounting. The Courts perform no discharge of public duty imposed upon them by the Moneylenders Act by such transparent rationalising. There is already sufficient uncertainty in commercial law which is partly attributable to the Moneylenders Act. If a transaction is prescribed by the law then it cannot be validated if achieved by one method and invalid (and therefore illegal) if achieved by another. There is need for certainty and that can be attained by unanimity concerning the test to be applied.

"Loan" should be defined in the Moneylenders Act as to include the discount of a bill of exchange and

to include every contract which is in substance or effect a loan of money.

Authorities are in conflict about the position at law arising from the transfer by a moneylender of a bill of exchange obtained under a harsh and unconscionable transaction (that is one which is "unreasonable and not in accordance with the ordinary rules of fair dealing": Samuel v. Newbold (1906) A.C. 461, per Lord Macnaghten at 470).

Under section 38(b) of the Bills of Exchange Act 1908 a holder in due course holds a bill of exchange free from any defect of title or prior parties as well as from mere personal defences available to prior parties among themselves and may enforce payment against all parties liable on the bill. Under section 29(1) a holder in due course is a party who takes the bill for value and without notice of any defect in title of the transferor.

The question arises (more academically than practically now) whether a finance house or a merchant bank is such a holder in due course. The Moneylenders Act 1908 is silent on this point.

In Stenning v. Radio and Domestic Finance Limited (1961) N.Z.L.R. 7 held that if a holder takes notes which he knows to be a security for a credit transaction, then he is deemed to have knowledge of any defect in the title of the transferor and cannot become a holder in due course.

Two Australian decisions take a different view : Scottish Loan Finance Co. v. Payne (1935) 52 W.N. (N.S.W.)

175; and Automobile Finance of Australia Limited v. Henderson (1928) 23 Tas. L.R.X. 9.

III EXAMINATION OF THE TAXATION LIABILITY

The law in New Zealand has paid scant attention to inflation (admittedly, the Judicature Amendment Act 1974 has empowered the Court to award interest up to 7½ per cent in place of the previous 5 per cent); and generally when it has, the result has often been proscriptive measures aimed ostensibly at its causes (the Property Speculation Tax Act 1973) and never to palliative measures directed at its effects which measures would allow the latent fertility of the process of judicial creativity to permit not only justice to be done but for the law to develop to cover a wide canvas of differing circumstances.

The most recent example of the former legislation is the Land and Income Tax Amendment Act (No. 2) 1974 which when in the Bill stage was prefaced by conflict and contradiction in Ministerial and departmental statements purporting respectively to justify and explain the need for and the meaning of the proposed legislation.

The new section 5 extends the meaning of section 88(1)(ff) of the Land and Income Tax Amendment Act 1969 (which related only to registered Treasury Bills) to include all "commercial bills" as defined in the new section 88(4).

The effect of the new section is that the assessable income of a taxpayer in the income year commencing April 1, 1975 (and in every subsequent year) is to include:-

* the amount received on the redemption of a commercial bill to the extent to which that amount exceeds the cost to the taxpayer of the bill;
* where the bill is not redeemed but disposed of by the taxpayer the value of the bill on the day of the disposal to the extent to which that value exceeds the cost to the taxpayer of the bill.

"Commercial bill" and "bill" are defined in section 88(4) culminating in the comprehensive paragraph (e) which includes any document or agreement which has substantially the same purpose or effect as any of the other items included in the definition which expressly does not include any debenture or bond for the payment of any security issued by any body corporate or any security in respect of land and which expressly includes any share or interest in any of the items mentioned in the definition.

The Explanatory Note to the Bill recited inter alia:

"At present the assessable income of a taxpayer includes the amount received on the redemption of a Treasury Bill to the extent to which that amount exceeds the cost to the taxpayer of the Bill. Where it is not redeemed but is disposed of by the taxpayer, his assessable income includes the value of the Bill on the day of disposal to the extent to which that value exceeds the cost to

him of the Bill. This clause (clause 4A) extends this provision to include all commercial bills ...".

The Bill (it is contended) was hasty and ill-conceived and one that attracted confused and inconsistent statements purporting to justify and explain its need and meaning.

The Minister of Finance: "Profits from trading in commercial bills could become taxable, the Minister of Finance, Mr Tizard, told Parliament last night. He said that the Inland Revenue Department was looking into the question. In the hands of individuals, the earnings were tax-free but where they were traded by firms and individual dealers they were liable to taxation ..." (The Dominion, October 24, 1974).

Merchant bankers and bill dealers: "Both said it was news to them that bills were not already taxable. 'We've never felt that there was a loophole there,' said one bill dealer. 'There is no way that they can be tax free,' said another merchant banker." (The Dominion, October 26).

Inland Revenue Department: "The deputy chief commissioner of the Inland Revenue Department, Mr T.M. Hunt, said his department had always maintained that these profits were taxable. However some doubt has been raised whether an individual dabbling once in the bill market might have to pay tax on the capital gain". (The Dominion, October 26).

"Profits made from short-term commercial bills are in all cases liable to income tax even under the old legislation, the Commissioner of Inland Revenue Department, Mr D.A. Stevens, said in a statement

today. He said tax-payers, whether they were dealers or had only taken up bills in isolated instances, should include commercial bill profits in their returns for the current tax year. Legislation passed last week had as its starting point profits on securities or documents sold or maturing during the year starting on April 1, 1975. The department felt obliged to advise taxpayers of its attitudes to profits made in the current year ending on March 31, 1975, Mr Stevens said even though the legislation will not then have taken effect. The facts in each particular case were important, Mr Stevens said. He listed specific circumstances in which discount profits would be assessable. These were:

> "In respect of mortgages, bills, bills of exchange, promissory notes and other such securities - assessable in all cases where maturity or sale is within two years from the date of acquisition.
>
> "In respect of mortgages discounted when the tax-payer had entered into more than one such transaction, or the expiry of the term of the mortgage is within two years from the date of acquisition, or the discount profit was greater than the interest receivable for the unexpired term of the mortgage.
>
> "There would be other types of cases in which profits would be assessable and the period of two years mentioned should be regarded as a general guide only". (The Dominion, November 9, 1974).

(Since the making of the statements by the Inland Revenue Department's commissioner and chief deputy commissioner, Mr D.A. Stevens retired as the commissioner on April 30, 1975 and Mr T.M. Hunt succeeded to the commissionership).

What is immediately apparent (before any detailed examination and comparison is made of the statements) that Mr Tizard's statement that "in the hands of individuals the earnings are tax free ..." is much too sweeping to be correct and that Mr Hunt's statement that his department had always maintained that these profits were taxable is again too comprehensive to be correct. The truth lies somewhere in between for neither speaker has acknowledged the meaning and effect of section 88(1)(c) which imposes liability if either the business of the tax-payer or the purpose of acquisition was the selling or otherwise disposing.

Each of the above quotations is worthy of attention first for what each particular statement says in itself and secondly for what each says when read in succession with the other statements.

Mr Tizard said initially that profits could become taxable and then later added that in the hands of individuals the earnings were tax-free. In the same statement after stating that the Inland Revenue Department was looking into the question, he subsequently said that banks and finance houses had been complaining about money being withdrawn to invest in bills "which often returned interest as

12 and 15 per cent." One principal motive for the Legislature to act to curb the then spiralling interest rates of bills is patently clear and at the time Mr Tizard spoke there had been no mention of the subsequent amendment to the Stabilisation of Prices Regulations which were invoked on December 19, 1974 to control profit and price controls of financial institutions. Regulation 6(6) specifically exempted "the selling or discounting of any credit instrument".

The merchant bankers and bill dealers reflected to some extent the then prevailing thought on the tax liability (dealt with fully post).

The two statements of the Inland Revenue Department are somewhat complementary but Mr Hunt's allows an exception in the case of "individual dabbling" whereas the Commissioner's is more a statement with legislative intent for it spells out fully the approach of the Inland Revenue Department (but not with any reference to or support from the enabling statute) and lists the specific circumstances in which discount profits would be assessable.

Neither the Minister's statements nor the Department's statements have any measure of consistency with each other and when all are read as a whole. The thought remained: was the amendment an initial attempt to dampen interest rates without more or were the statements delivered ex post facto with none of the speakers aware of the true intent and meaning of the amendment. Moreover, the matter reduces itself down to the question whether any change in the law was necessary and if the answer to that question is 'yes' or a qualified 'yes' then what form

should the proposed change have taken. These questions have necessitated a discussion first of the ramifications of discounting a bill of exchange, promissory note and so on, then an examination of what the law was before the 1974 Amendment and then what the law now is, and finally what the Legislature has achieved and what it might have achieved had the amendment not been so hasty and ill-conceived.

Statement of simplified effect of the Act

The dominant effect, then, of the Land and Income Tax Amendment Act (No. 2) 1974 considered in this context is the amendment of section 88 of the principal Act dealing with items included in assessable income. It provides in general terms that on the redemption or disposal of a bill any excess received over the cost of the bill is assessable. For example, say a 90-day bill is bought at a discount and on maturity is redeemed at its full value, in effect the discount is assessable income from the transaction. If the bill is not held till maturity but is sold for more than it cost, the profit will also be assessable. The new provisions apply for the income year commencing April 1, 1975; but the Inland Revenue Department apparrently does not regard them as suggesting in any way that profits on commercial bills made in earlier income years are not assessable, that is for the income year ending March 31, 1975, and for example, there already was section 88(1)(c) (considered above).

The former section 88(1)(ff) which had provided for some years that amounts above cost received on the

redemption of Treasury bills were assessable, is now extended to cover commercial bills. More particularly these may be stated to be:

* Bills of sale over chattels;
* Mortgages over chattels;
* Liens over chattels;
* Any other instrument creating or securing any charge over chattels for money owing or to become owing. These need not be registered documents.
  (The context includes the meaning given to chattels in the Chattels Transfer Act 1924).
* Bills of exchange within the meaning of the Bills of Exchange Act 1908;
* Any promissory note other than a bank note within the meaning of the Bills of Exchange Act 1908;
* Any registered Treasury Bill;
* Any document or agreement which has substantially the same purpose or effect as a bill, mortgage, lien, document, note or agreement referred to above.
  (Any share or interest in any such document is included).

The important <u>exclusions</u> are:

* Any debenture or bond for the payment of any security by any corporate body; and
* Any mortgage, charge or other security, legal or equitable, over land or any estate or interest in land

The significant feature of the above is:

* What in effect constitutes a commercial bill

The general rule is that the profit on a bill is included in the assessable income for the year of disposal. A bill is deemed to have been sold at a price equal to its value on the day of disposal, no matter what the manner of such disposal. If the owner of the bill dies, then the bill is deemed to have been sold on the day of his death and the trustee of the estate of that deceased person is deemed to have purchased it on that day at a cost equal to its value.

The need for clear and unambiguous language in all taxing legislation has been emphasised by the Courts again and again. The best-known words are those of Rowlatt, J. in Cape Brandy Syndicate v. I.R.C. (1921) 1 K.B. 64 at 71:

> "In a taxing Act one has to look at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in. Nothing is to be implied. One can only look at the language used".

Former law

The law prevailing at the time of the enactment of the new section 5 of the Land and Income Tax Amendment Act (No. 2) 1974 and obtaining when the Commissioner of Inland Revenue made his statement (the contents of which have been referred to supra;

the effects of which are considered post) is contained in subsection (1) of section 88, paragraph (f), paragraph (ff), paragraph (g), and in subsection (3) and (4) all of which may be recited hereunder to allow some analysis of their effect.

"88. Items included in assessable income: (1) Without in any way limiting the meaning of the term, the assessable income of any person shall for the purposes of this Act be deemed to include, save so far as express provision is made in this Act to the contrary ....

(f) All interest, dividends, annuities, and pensions: Provided that where any securities have been acquired by purchase or otherwise during the income year, the Commissioner may, where he considers it equitable so to do, apportion between the transferor and the transferee any interest due or accruing due at the date of the transfer and not then paid:

(ff) The amount received by a tax-payer on the redemption of a registered Treasury Bill owned by him to the extent to which that amount exceeds the cost to him of that Bill, or where the Bill is not redeemed by the tax-payer but is disposed of by him, whether by way of sale, gift, conversion or otherwise howsoever, the value of that Bill on the day of disposal to the extent to which that value exceeds the cost to the taxpayer of that Bill:

(g) Income derived from any other source whatsoever.

(3) For the purposes of paragraph (ff) of subsection (1) of this section:-

(a) Where a registered Treasury Bill is disposed of to a person by sale, gift, or otherwise howsoever, that person shall be deemed to have purchased it at a cost equal to its value on the day of disposal:

(b) Where a person who owns a registered Treasury Bill dies:

(i) He shall be deemed to have sold the Bill on the day of his death; and

(ii) The trustee of that person, or, where the Bill is owned by that person jointly with any other person or persons, the person or persons on whom it devolves by reason of the death, shall be deemed to have purchased it on the day of the death at a cost equal to its value on that day.

(4) For the purposes of paragraph (ff) of subsection (1) of this section and of subsection (3) of this section, the terms "registered Treasury Bill" and "Bill" include an interest in any such Bill".

No specific reference then is made to commercial bills but that absence does not of itself support or nullify any of the statements quoted above of Mr Tizard, The Commissioner of Inland Revenue Department, the

chief deputy commissioner, merchant bankers and bill dealers because the whole of the section must be examined and equally more importantly the terms of the contract evidencing the sale to the discounter.

If what constitutes interest received on maturity of the bill consequent upon its purchase by the discounter from the merchant bank and is declared to be interest either in the letter or deed of contract evidencing the sale, then that amount falls to be taxable under paragraph (f) of section 88(1) or (less likely) under paragraph (g) of the same section. That statement of liability to income tax is subject to qualifications and reservations.

There is no definition of "interest" in the Land and Income Tax Act 1954; but the fruit of the tree is not the same thing as the growth of the trunk. A payment or recompense made to the discounter because there is a risk that the money or some part owing under the bill of exchange may never be repaid is a consideration of a different kind and is, in fact, a provision both for possible capital loss and a provision against actual loss of purchasing power of the money upon repayment and therefore both such possible capital loss and actual loss of purchasing power may be considered to fall under the comprehensive heading of "capital depreciation". Clearly interest properly so called is taxable whereas provision against capital loss and depreciation is not taxable and clearly too, it is essential in the documents evidencing

the sale to the discounter that adequate differentiation be made so that a legitimate distinction can be made between the amount of interest which is taxable and the amount of money paid in acknowledgement of capital loss and depreciation which is not taxable. The first is the fruit of the tree; the second item is the growth - or the protection of the growth - of the trunk.

New law

The law intended to apply to the tax on income derived in the income year commencing April 1, 1975 (and in every subsequent year) is contained in section 5 of the Land and Income Tax Amendment Act (No. 2) 1974 which section provides:-

5. Items included in assessable income: (1) Section 88 of the principal Act is hereby amended by repealing paragraph (ff) of subsection (1) (as inserted by section 13(1) of the Land and Income Tax Amendment Act 1969) and substituting the following paragraph:-

(ff) The amount received by a taxpayer on the redemption of a commercial bill owned by him to the extent to which that amount exceeds the cost to him of that bill, or where, the bill is not redeemed by the taxpayer but is disposed of by him, whether by way of sale, gift, conversion, or otherwise, howsoever, the value of that bill on the day of disposal to the extent to which that value exceeds the cost to the taxpayer of that bill.

(2) Section 88 of the principal Act is hereby further amended by repealing subsections (3) and (4) (which subsections were added by section 13(2) of the Land and Income Tax Amendment Act 1969) and substituting the following subsections:

(3) For the purposes of paragraph (ff) of subsection (1) of this section:-

(a) Where a commercial bill is disposed of to a person by sale, gift, or otherwise howsoever, that person shall be deemed to have purchased it at a cost equal to its value on the day of disposal:

(b) Where a person who owns a commercial bill dies:-

(i) He shall be deemed to have sold the bill on the day of his death; and

(ii) The trustee of that person, or, where the Bill is owned by that person jointly with any other person or persons, the person or persons on whom it devolves by reason of the death shall be deemed to have purchased it on the day of the death at a cost equal to its value on that day.

(4) For the purposes of paragraph (ff) of subsection (1) of this section and of subsection (3) of this section, the terms 'commercial bill' and 'bill' include -

(a) Any bill of sale, mortgage, lien, or other document (whether or not registered under any Act) creating or securing any legal or equitable mortgage, charge, or other security

over any chattels (as defined in section 2 of the Chattels Transfer Act 1924) for the payment of money owing or to become owing; and

(b) Any bill of exchange within the meaning of the Bills of Exchange Act 1908; and

(c) Any promissory note within the meaning of the Bills of Exchange Act 1908, other than a banknote; and

(d) Any registered Treasury Bill; and

(e) Any document or agreement which has substantially the same purpose or effect as any bill, mortgage, lien, document or note of any of the kinds referred to in the preceding paragraphs of this subsection -

and also include any share or interest in any such bill, mortgage, lien, document, note, or agreement; but do not include any debenture or bond for the payment of any security issued by any body corporate or any mortgage, charge, or other security, whether legal or equitable, in respect of any estate or interest in land.

(3) The Land and Income Tax Amendment Act 1969 is hereby consequentially amended by repealing subsections (1) and (2) of section 13.

(4) This section shall apply with respect to the tax on income derived in the income year commencing on the 1st day of April 1975 and in every subsequent year.

The effects, then, of the new section would appear to be that the assessable income of a tax-payer will now

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always include in the income year starting April 1, 1975 and in every subsequent year the amount received on the redemption of a commercial bill to the extent to which that amount exceeds the cost to the tax-payer of the bill and where the bill is not redeemed but disposed of by the taxpayer then the assessable income of a tax-payer in the present income year starting April 1, 1975 and in every subsequent year the value of the bill on the day of disposal to the extent to which that value exceeds the cost to the taxpayer of the bill.

Commercial bill and bill are defined extensively in subsection (4) of section 5, and paragraph (e) of the same sub-section is drawn to include any document or agreement which has substantially the purpose or effect as any other items included in that subsection and also included is any share or interest in any such items; but it is expressly stated that the terms do <u>not</u> include any debenture or bond for the payment of any security in respect of any estate or interest in land. Subsection (3) makes consequential amendments to the Land and Income Tax Amendment Act 1969 by repealing subsection (1) and (2) of section 13.

The first point to note is that section contains no definition of interest, premium, dividend, or discount. It purports to include in the assessable income of the tax-payer the difference between the cost to the tax-payer of the bill and the amount received either on the redemption of the bill or (where the bill is disposed of) the value of the bill on the day of such disposal.

But the Legislature has <u>not</u> expressly and unequivocally said that "The amount received by a tax-payer ..." includes any or all of the sums representing interest, dividends, premium and/or discount, and so it does seem arguable that a tax-payer could point to a deed of covenant executed simultaneously with his purchase as discounter of a commercial note in which there was clearly delineated a variable payment separate from interest or discount calculated to provide for any appreciation or depreciation in the purchasing power of money and one which was governed (for example) by the price of gold, the revised consumers' price index, the stock market index or the annual rates of inflation (as included in the "New Zealand Official Vital Statistics" or "Monthly Abstract of Statistics") and that further, that such sum was declared to be in the nature of a capital sum making the provision one against capital loss and one against capital depreciation in the loss of purchasing power of the purchase money upon repayment. This matter is examined <u>post</u>.

The Legislature (had its intentions been such) could have given a definition in the section of the meaning to be ascribed to that otherwise nondescript phrase in subsection (1) "The amount received by a tax-payer ..." by simply reciting that <u>that amount includes all sums received by the tax-payer whether called a dividend or a premium or provision for risk of capital loss or provision against capital depreciation or by any other name whatsoever and any discount paid or given by a drawee or</u>

acceptor in addition to or instead of dividend or premium or provision for risk of capital loss or provision against capital depreciation or by any other name whatsoever and where any such sum or discount is paid or given in addition to interest it shall be treated as part of that interest for the purpose of determining the income tax liability of the tax-payer consequent upon the redemption and/or disposal of a commercial bill. Nothing has been done by the Legislature to express its purported intention. Clearly it is arguable that a provision against capital depreciation and a provision to provide for capital loss does in fact fall outside "the amount received by the taxpayer".

Again the Legislature has not made any provision to include such and for that reason it is submitted that the legislation was hasty and ill-conceived and one that elicited such a wide variety of opinions and consternation (outlined supra). Too much is in doubt the reason for which is at least part explicable by the fact that New Zealand conveyancers have in the past not clearly differentiated in (as suggested) simultaneously executed deeds accompanying the purchase by discounters of commercial notes, between the question of discount and interest from provisions for the risk of capital loss and against capital depreciation; but such doubt is not acceptable in a charging Act (such as the Land and Income Tax Act 1954). If the meaning of a charge is in doubt then it ought to be construed in favour of the subject:

<u>McGrath</u> v. <u>Commissioner of Stamp Duties</u> (1939) NZLR 950 and <u>Commercial Union Assurance Co. Ltd</u> v. <u>Inland Revenue Commissioners</u> (1937), 54 T.L.R. 36.

The exact operation and full meaning of the section are not capable of being grasped.

The second point to note is that the statement of the then Commissioner of Inland Revenue, Mr D.A. Stevens (indicated <u>supra</u>) is difficult to equate with any of the subsections in section 88 of the Land and Income Tax Act 1954 with which that statement was intended to advise "taxpayers of its" (the Inland Revenue Department's) "attitudes to profits made in the current year ending March 31, 1975, Mr Stevens, said even though the legislation will not then have taken effect" (<u>The Dominion</u>, Saturday, November 9, 1974) and it is equally difficult to reconcile that statement's provisions with section 5 of the new Act.

Basically, the specific instances indicated by Mr Stevens differentiated between mortgages, bills, bills of exchange, promissory notes and other such securities (assessable in all cases where maturity or sale is within two years from the date of acquisition) and mortgages (assessable where discounted when the tax-payer had entered into more than one such transaction or the expiry of the term of the mortgage was within two years from the date of acquisition or the discount profit was greater than the interest receivable for the unexpired term of the mortgage). The provision of "two years" was to be regarded as a general guide only.

Clearly the statement published in at least one morning newspaper in New Zealand is an example in effect of legislation or quasi legislation by the Inland Revenue Department. It did not appear in any of the periodic information bulletins issued by that department in 1974 and it was not until April 1975 that reference was made to the new section 5 of the Land and Income Tax Amendment Act 1974 accompanied by a repetition of the press statement (already quoted above) of Mr Stevens.

That newspaper announcement by the then Commissioner of Inland Revenue Department, then, was not in the form of regulations made pursuant to the Inland Revenue Department Act 1952 as amended as it should have been for its meaning and effect is not simply administrative; it is demonstrably legislative for it sets out specific circumstances and the conditions under which "discount profits would be assessable". There is a mandatory element in such conditions which varies according to the type of security or the elapse of time since the date of acquisition or the excess of the discount profit over the interest receivable. Then the statement concludes with a supposedly discretionary element: "There would be other types of cases in which profits would be assessable and the period of two years mentioned should be regarded as a general guide only."

The matter is a revenue one and the statement made purports first to say that "profits made from short-term commercial bills are in all cases liable to income tax ....", imposes a prohibition in effect by specifying the circumstances under which income tax

liability will be attracted and fails to detail or indicate all the other types of cases in which profits would be assessable. No provision ~~is made~~ in section 88 of the Land and Income Tax Act 1954 makes any mention about the period of acquisition or the frequency of the transaction and neither of these conditions appears in the new section 5 of the Land and Income Tax Amendment Act (No. 2) 1974. The statement is more than administrative for its meaning and effect are quite legislative and under its vague provisions the Inland Revenue Department may make and justify its assessments.

In the same words of McCarthy, P. (in Commissioner of Inland Revenue v. Gerard (1974) 2 NZLR 279 at 280-281 when referring to section 108 the words of which statement are applicable now) appears this statement:

> "One can only hope that the Legislature ..... will state in precise language not only what classes of transactions are to be struck down, but what are to be the results of that action".

The Legislature should define a test (or a series of tests) and/or provide a comprehensive list characterising the nature of various transactions such that the Courts can give rational judgments within such framework because the discretion must be sharply curtailed and clearly delineated; and only then can any aggrieved taxpayer point with reasoned arguments to his own case and relate it to the criteria provided by the Legislature. Press statements by departmental heads and then a belated departmental bulletin for public

perusal do not fulfil this function which must be exercised by the Legislature so that there can be certainty and authority.

Indeed, the effect (unwitting or otherwise) of the statement is declaratory initially that "profits from short-term commercial bills are in all cases liable to income tax even under the old legislation" and explanatory subsequently of "specific circumstances in which discount profits would be assessable"; and it is in this explanation that there has been introduced new elements ("within two years from the date of acquisition", "more than one such transaction", for example) which are clearly intended to catch transactions (but not all for "there would be other types of cases in which profits would be assessable ...") and imposes upon them liability for income tax. The immediate inconsistency between the declaration and the later explanation is that liability arises "... in all cases ..." which must make the "listed specific circumstances" superfluous for the initial declaration contains no such qualification whereas the circumstances listed each contains elements where the initial blanket liability so declared may possibly be relieved or mitigated, (where for example, two transactions had been entered into but one had been frustrated or where the condition of maturity or sale within two years has not been capable of fulfilment totally). Indeed the element of frequency of transactions in itself may allow the exercise of subjective criteria whereas the blanket statement of prohibition and dissuasion initially is quite unqualified and

devoid of any such reservations in its effect and meaning.

None of the above appears in or is warranted by "the old legislation" or section 5 of the 1974 Amendment Act but that omission from both Acts does not mean that the Inland Revenue Department will attempt to interpret both "as a general guide only", so general in fact as to allow an initial blanket statement of tax liability and then apparently discretion as to either exemption or partial relief with no indication of the grounds of such. (Possibly much of this might work in the taxpayer's favour, at least initially, but favours by the Revenue do not indicate good law).

The regrettable element is that the Commissioner has chosen to legislate in such manner (for the statement is legislative in effect and upon its provisions the Inland Revenue Department will act for as Mr Stevens said "the Department felt obliged to advise taxpayers of its attitudes to profits made in the current year ending on March 31, 1975 ... even though the legislation will not then have taken effect") and in such a way that precludes the Court from examining the statement because it is not in the form of a regulation, and because of the extraneous parts appearing unwarrantably such a statement in regulation form would not be held to fall within the four corners of the powers given by the Legislature. That contention is borne out by the fact that none of the detail appearing in the statement has been reproduced in the amending section 5 of the new Act.

Lord Greene, M.R., said in Carltona Ltd. v. Commissioner of Works (1943) 2 All E.R. 560, 564, (C.A.) and again in Point of Ayr Collieries Ltd v. Lloyd George (1943) 2 All E.R. 546, 547 (C.A.):

"All that the Court can do is to see that the power which is claimed to exercise is one which falls within the four corners of the powers given by the Legislature and to see that those powers are exercised in good faith. Apart from that the Courts have no power at all to inquire into the reasonableness, the policy, the sense or any other aspect of the transaction"

and

"It is the competent authority that is selected by Parliament to come to the decision and if that decision is come to in good faith, this Court has no power to interfere provided, of course, that the action is one within the four corners of the authority delegated to the Minister".

Those dicta were expressly approved by Sachs, J. (at 366) in Customs and Excise Commissioners v. Cure and Deeley (1962) 1 Q.B. 340 who (at 367) added:

"To my mind a Court is bound before reaching a decision on the question whether a regulation is intra vires to examine the nature, objects and scheme of the piece of legislation as a whole, and in the light of that examination to consider what is the area over which powers are given by the section under which the competent authority is purporting to act. In taking that view I respectfully apply the line

of approach adopted by Lord Greene in the above cited cases."

Legislation by regulation is acceptable provided that falls within the four corners given by the Legislature (in this case the Land and Income Tax Act 1954, section 88).

Legislation by newspaper announcement (notwithstanding issue in a departmental bulletin of information months later and the next year) which is ostensibly corrective of earlier statements both by the Minister of Finance and the then Deputy Commissioner but which is both advice to taxpayers and instruction to departmental employees of when discount profits will be assessable, is a lamentable device to avoid the necessity to have regulations and a denial of the Legislative process. The purported comprehensiveness of the Commissioner's statement has resulted in near-prohibitory quasi-legislation in effect in what otherwise might have been acceptable regulatory legislation.

Clearly, the comprehensive meanings latent in the term "tax avoidance" (used in subsection (1)(b)) superficially constitute a stumbling block to the use of clauses distinguishing pure, legitimate interest from provisions for loss of capital and against depreciation of capital because the consequences will be an alteration in the incidence of income tax or a minimisation of liability for income tax and clearly, too, such provisions could conceivably be drawn to constitute in effect a merely incidental purpose so that the dominant motive of the whole

transaction has been the purchase at discount of the commercial bill with the related provisions of ensuring a yield upon maturity and of ensuring at that time against loss of capital and against purchasing power.

Hitherto the leading case in New Zealand was Elmiger & Anor. v. Commissioner of Inland Revenue (1967) NZLR 161 (C.A.) in which the facts were that the appellant contractors set up a trust in favour of their wives and children and sold two earthmoving machines to the trust on terms which allowed the purchase price to remain owing as an interest-free loan payable on demand. At the same time a hiring agreement had been executed under which the trust could hire the machines to the contractor at hourly rates subject to a minimum monthly charge.

North, P. and Turner and McCarthy, J.J. were emphatic that the arrangement could not be explicable as an ordinary family or business dealing but only as a blatant attempt to effect a reduction in the tax which would otherwise be exigible.

But now the dominant judgment is that of the advice of the Privy Council in C.I.R. v. Wheelans; C.I.R. v. Ashton (1974) 1 NZTC 61, 161 (para. 80-021). Briefly on the dissolution of a chartered accountants practice, offices charges formerly paid by four finance companies for the partnership's doing their accounting work were now received by the trustees of two family trusts (set up by the accountants) and used for the purposes of the partners' family trusts. The Commissioner assessed the taxpayers not only on the income returned by them but

also on the income returned by their respective family trusts. He treated the scheme as void under section 108. The Court of Appeal confirmed that assessments and held that the arrangement was "highly artificial" and the transaction had been entered into with the principal purpose of altering the incidence of taxation.

The Privy Council affirmed that decision and held that the test to be applied in relation to section 108 was objective. The purpose of an arrangement must be determined by what the transaction effects. Tax avoidance need not be the sole purpose. If one purpose and one effect of the arrangement is the avoidance of the incidence of tax, then it matters not what other purposes or effects it might have. On this basis the arrangements must necessarily be labelled as a means to avoid tax and could not properly be regarded as "ordinary business or family dealing".

The income was in fact received by the taxpayers and because the trusts must be regarded as never having existed the taxpayers must be deemed to have received the income for which they must be held to be accountable to nobody. The Privy Council held that in fact the income had been derived by them.

The deed evidencing the discount of the commercial bill and executed simultaneously by all parties at the time of its purchase and containing therein a dissection of money in terms of pure, legitimate, interest, provision for capital loss and provision against capital loss related to an index speaks of a prudent investment which applies acceptable principles of accountancy in making provision for capital loss and against

depreciation of money attainable on maturity. The purpose or effect is not to avoid tax and admittedly it may be construed as having two or more purposes none of which is more than the merely incidental purpose of minimising tax liability and the more important of which are to preserve the capital and to ensure its continuity of purchasing power upon maturity.

Indeed for the Commissioner to attribute to the use of indexation as having the purpose or effect of tax avoidance would be to deny the acceptance and efficacy of escalation clauses in building and engineering contracts and in statutory regulations because, for example, the Wage Adjustment Regulations 1974 use the consumers' price index as an index for the making of cost of living orders by the Industrial Commission and the legitimacy of such device remains unchallenged. It would be stretching words and distorting motives to attribute to an investor the design to avoid tax when what he has done is what would be carried out by a business enterprise in making provision for depreciation and against risk of capital loss. It is surely legitimate for investors to guard against the effects of inflation and to do so as prudently as possible. Such provision would not disproportionately deprive the State of more than its share of the results of inflation for clearly the State is one of the principal beneficiaries.

Differentiation between capital and interest

Index clauses may be looked upon as a form of escalatory provision which initially found demonstration in the formation of collective labour contracts, and today's

such clauses transfer the effect (or at least the risk) of inflation from the creditor to the debtor. In times of persistent inflation (as the Western world is now experiencing) such clauses increase significantly the amount of money paid in discharge of monetary obligations and so can increase at the same time both purchasing power and inflation generally. Where inflation has become a standard part of a country's economy then an index clause may be constructed for the <u>sharing</u> of the risk and effects of inflation between both the debtor and the creditor.

In order to resolve the inflationary dilemma and its inherent social discord, widespread international consideration has been given to the establishment of a formal relationship between wage rises and price increases. The linking of earnings to an index reflecting the changing cost of living is known as "wage indexation". The coined word has received a wide currency of acceptance; but although it is often a proposed measure to restrain inflation, it is far from being a new policy instrument. In the early 1920s Australia used a system for adjusting the basic wage each quarter according to the movements in the preceding quarter's retail price index.

The New Zealand Shares Prices Index is designed to reflect changes in the aggregate value of holding of parcels of ordinary shares in representative selections of companies listed on the New Zealand Stock Exchange and trading in New Zealand. The frequency with which the shares are traded is used as a criterion for as

well as the value of the New Zealand shareholding.

The Consumers' Price Index has been completely restructured and revised and now the new all-food group index takes as its base the average prices ruling in the calendar year 1974 (equalling 1000) and on this basis the index figure for each quarter is calculated. The previous index used was based on 1965 prices.

The C.P.I. basically records changes in the prices of the goods and services included in the pattern of purchases which householders make. But to measure accurately the effect of price changes it is necessary from time to time to investigate what the average household budget consists of, so that each commodity or group of commodities can be given its proper importance. This is what statisticians call "weight". The "weighting" for the new index is based on the expenditure of all people living in private households rather than (as in the earlier indices) on their actual or notional consumption.

The Revised Consumers' Price Index 1974 retains the basic objective of providing a multi-purpose indicator of retail price changes of those goods and services which are purchased by New Zealand residents living in New Zealand. The previous Consumers' Price Index was revised in 1965. The weights in the Revised Consumers' Price Index are based on the patterns of expenditure of the population covered by the index rather than what is consumed by them. The selection of goods and services to be priced has

been widened in this revision to include more fields of expenditure and more pricing outlets to reflect more adequately both expenditure patterns of all residents living in New Zealand and the movement in prices of consumer goods and services.

There is no principle of law which prevents parties to a contract from adopting a fixed figure as the primary monetary expression of a liability and then proceeding to effect a substantive variation of that liability by providing that more or less money must actually be paid according as index-numbers evidence a variation of price levels, for that is only a method of measuring the actual liability contracted for: Stanwell Park Hotel Co. Ltd v. Leslie (1952) 85 C.L.R. 189 (H.C.A.).

The High Court of Australia (Dixon, Williams, Webb, Fullagar and Kitto, J.J.) in Stanwell clearly confirmed the legality of a contract for the sale of land which provided for the total purchase price, specified the deposit payable and the monthly instalments which were therein expressed to vary with the rise or fall of price levels in accordance with a specified series in the retail price index. The High Court's decision clearly amounted to an endorsement of contractual freedom to provide for the escalation of the purchase price corresponding to changes in economic activity as measured by one of the economic barometers.

Eight years later, Kitto J. in the High Court of Australia in Hall v. Busst (1960) 104 C.L.R. 206

cited with express approval what Bowen, L.J. said in Davies v. Davies (1887) 36 Ch.D. 359:

> "There is many a contract for example which, instead of fixing the particular time for payment, provides that the time is to be fixed by what is reasonable in the trade or in the business. In those cases you introduce the consideration of what measure reason will apply, because the measure which reason will apply tends towards certainty, and therefore enables you to make up for the absence of distinctness on the part of the contract by reference to a standard which the parties had in their minds, though they did not express it on paper, namely, the standard of reason".

Kitto, J. added that he had not found in the books any case in which an agreement for the sale of property at its value, or an agreement a term of which had been expressed by reference to reasonableness, had been held on that account to be too uncertain to constitute a binding contract.

Essentially, the litigation concerned an option to purchase land at a fixed price "to which shall be added the value of all additions and improvements to the said property since the date of purchase by the grantor ... and from which shall be subtracted the value of all deficiencies of chattel property and a reasonable sum to cover depreciation of all buildings and other property on the said land".

Dixon, C.J., Fullagar and Menzies, JJ., in the

majority opinion held that in such a contract it was not sufficient to specify price as "fair" or "reasonable" and leave this for subsequent agreement between the parties or failing such agreement by the Court.

Kitto and Windeyer, JJ., in the minority opinion held that the concept of what is "reasonable" was constantly applied by the law and was therefore capable of sufficient certainty to form the basis of such a contract for sale of realty.

(Some vindication of the minority view was subsequently provided in the much more recent case of Talbot v. Talbot (1968) Ch. 1, 704, in which the English Court of Appeal held that an option to purchase "at a reasonable valuation" was enforceable).

To fight inflation the restructuring of progressive income taxation schedules has been experimented with as a supplementary measure to wage indexation. The intent of such a revision is the assurance that only real income increases are taxed at higher rates. Canada has recently chosen to index-link the claims which can be deducted from taxable income rather than indexing the tax scales themselves. The United Kingdom Government announced late in 1974 details of a proposed scheme in which the return under index-linked bonds would be adjusted by movements in the retail-price index. Limits are to be placed on the amounts which can be purchased so that in effect the small investor is favoured.

There is already a plethora of overseas literature on the use and application of index and escalatory clauses designed for use in taxation contexts and which are intended to guard against the risk of capital loss upon investment and to provide for the decline in purchasing power of money upon maturity.

In the past the customs of merchants undoubtedly played a crucial role in the development of the commercial law; but today there seems but little scope for such custom to bring about changes in the general mercantile law. In England the last instance seems to have been in 1898 when debentures payable to bearer were held to be negotiable instruments by mercantile custom: Bechuanaland Exploration Company v. London Trading Bank (1898) 2 Q.B. 568.

There are, nonetheless, other and often more important means by which the influence of commercial custom may be brought to bear on law, and this is through the operation of commercial contracts. Terms may be implied into such contracts either by established trade usage in the strict sense or even by showing that it is reasonably necessary to the commercial efficacy of the contract to assume that it was entered into on the basis of some established practice of trade. In this way the current of decision of courts and of commercial arbitrators is able to absorb the effect of changes in business practices and customs, though how readily the Courts may be prepared

to pay regard to developments in the commercial community may depend largely on the professional traditions of the particular legal system. But the much more expeditious method in which the commercial community is able to impose in an almost quasi-legislative manner its own practices and requirements is the use of what are known as "standard-form contracts" which without violating the concept of freedom of contract (the party expected to execute is still free to do so or not) contain generally accepted and established practices under which the particular field of commercial activity is governed.

Optimistic obiter

Sympathy for the taxpayer penalised by the declining purchasing power of money was expressed by Buckley, J., in Secretan v. Hart (Inspector of Taxes) (1969) 3 All E.R. 1196 at 1197 and 1199 when he said (at 1197):

"He objects to the assessment because, he says between the time when be bought the shares and the time when he sold them the value of the pound had seriously decreased; and he has produced a letter from the Central Statistical Office which states that, taking the purchasing power of the pound to be 20s in 1932, which was the earliest year in which the taxpayer bought any of these shares, its value in 1967 July, which was a few months before he sold the shares, would be 5s 3d. So the taxpayer says that, instead of deducting the sum of 768 pounds only" (the aggregate price paid),

"in respect of the price he paid for the shares, from the price which he received, the figure of 768 pounds ought to be multiplied by a suitable factor to take account of the change in the value of the pound between the time when he paid the 768 pounds and the time when he received the proceeds of the sale of the shares in October 1967.

"It is a point of view with which, I think, any taxpayer would feel a certain degree of sympathy ...".

Buckley, J. nevertheless upheld the commissioner's finding and held that the sum on which capital gains tax was assessed was property computed. No cases are cited in the judgment.

The English Finance Act 1965 by virtue of section 19(1) introduced capital gains tax and made no provision in its assessment for any deduction or exemption to be made for the declining purchasing power of money; but the discounter of a commercial bill is at liberty to make his own bargain with the finance house or merchant bank and to insist that terms be written into the letter exchanged between them or into the actual contract itself (should one exist) differentiating the interest element from the money payable because of and attributable to the possibility of capital loss and the actual capital depreciation evidenced by the decline of purchasing power of the money upon receipt at its maturity.

New Zealand conveyancers (and their standard

reference books) appear to be oblivious to the possibility of escalating the price or value of amount payable in accordance with fluctuating economic conditions. But the High Court of Australia in *Stanwell Park* which concerned a contract for the sale of land under which the instalments were made to vary with the rise or fall of price levels according to a series in the Cost of Living Index, ~~and~~ held that there was no principle of law which prevented parties to a contract from adopting a fixed figure as the primary monetary expression of a liability and then proceeding to effect a substantive variation of that liability by providing that more or less money must be actually paid according as index-numbers evidenced a variation of price levels.

Best, L.J. (the High Court of Justice (King's Bench Division: Northern Ireland) in *Torrens* v. *Commissioners of Inland Revenue* (1931-34) Tax Cases Vol. XVIII 262 drew a clear distinction (at 268) between "interest ... the return given for the use of an advance whilst discount is the deduction made from the amount of the bill of exchange or promissory note by one who gives value for it before it is due". The High Court of two were *divided* on the question of whether an amount payable by a bank as discount on promissory notes at the expiration of three months could be regarded as a charge in the nature of interest.

Differentiation between capital and income

The decision of the House of Lords in Brown v. National Provident Institution; Ogston v. Provident Mutual Life Institution (1921) 2 A.C. 222 is admittedly concerned with the construction of the provisions of the (English) Income Tax Act 1842 and the resolution of the peculiar facts of the individual cases but it contains some pertinent obiter dicta on discounting transactions of Treasury Bills. The orders of the House in the two cases were in identical terms. Brown's case involved the use of the word "discount" as a noun in the phrase "profits on discounts" in the Income Tax Act.

Lord Sumner dismissed (at 256) the argument that there should be a differentiation between capital and income:

> " ... I see no warrant for trying to discriminate between the capital used in the transaction and the income obtained from its use. The statute says nothing about it. To discount a bill, even a Treasury Bill, you must have money or money's worth, but whether an accountant would say that it came out of or should be debited to capital or income makes no difference to the fact of discounting. The excess of what is got back tomorrow over what is put in today is profit, and it is rarely that even an economist can tell what is an appreciation of capital and what is not. The Act invites no such curious

inquiry as the Court of Appeal directed on this point".

(Prima facie, the same words might today be applied to section 88(1)(c): "All profits or gains derived from the sale or other disposition of ..."; and of course the measure of the profit will be increased or decreased by the rise or fall in inflated values of the property producing such; but clearly in making the outlay of money intended to produce such a risk has been taken as to its possible loss and upon its maturity as to the decline in its purchasing power).

And then (at 257) Lord Sumner made this statement: "It is a most wholesome rule that in taxing the subject, the Crown must show that clear powers to tax were given by the Legislature. Applied to income tax, however, this is an ironical proposition. Most of the operative clauses are unintelligible to those who have to pay the taxes and in any case derive such clarity as they possess from the judges who have to interpret them. After the puzzle has been solved no doubt the answer seems clear and the solution is arrived at as a matter of construction".

With respect to Lord Sumner it was not correct to say then (and most certainly not today) that "it is rarely that even an economist can tell what is an appreciation of capital and what is not". Since the turn of this century there have been a series of developing indices measuring the gold standard, export prices, import prices, production of the nation and

share prices all of which are today most capable of reflecting accurately movements in capital, its appreciation and depreciation. Nor is it correct to say that the "excess of what is got back tomorrow over what is put in today is profit .." for this ignores the simple arithmetical device of subtraction to show the difference between what has been put in and what is got back. At its most rudimentary level that difference is profit and notwithstanding that "there is no definition of discount in the statutes" (Lord Sumner at 254) any actuarially minded person with knowledge of economics would see that that profit is capable of further dissection into groups showing pure interest, provision for capital loss and provision against capital depreciation in purchasing power. The presence of inflation at the time of the Lords' judgment was no less significant that its pervasive reality today in the Western world. Indeed Lord Sumner's statement does (again with respect) completely overlook that index numbers to measure price fluctuation have been developed and calculated in England since the 18th century and that gold clauses have been one of the most consistently popular methods of acknowledging and protecting the intrinsic value of monetary obligations. It is only since the demise of the pound sterling that gold clauses have lost their use but when Lord Sumner spoke (1921) they were in current use; but it must be acknowledged that the then looming period of unemployment and economic recession must have both contributed to his cynicism, and this is understandable for almost comparable conditions prevail today.

The House of Lords in both Brown and in Ogston largely affirmed the decision of the Court of Appeal (National Provident Institution v. Brown; Provident Mutual Life Assurance Association v. Ogston (1920) 3 K.B. 35) the Court of Appeal judgments in which cases do (with respect) give much clearer insight into the kernel of the problem of differentiation between pure interest and provision against capital loss and provision for capital depreciation.

Lord Sterndale, M.R. said (at 49):

"The transactions in question consist of the purchase of Treasury Bills which are documents issued by the Government by which it undertakes to pay on the expiration of a term fixed in the bill a certain sum of money in consideration of a smaller sum paid down at once. The bills are therefore issued at a discount which is fixed from time to time by the Government ... In some cases the appellant held the bills until maturity in some cases they realised them, by sale, and in some cases they converted them into loans".

He dealt with each of the three transactions on page 50:

"... the case where the appellants hold the bill to maturity is a simple one. The transaction is that the Government borrow the money paid for the bill for a certain period and pay a larger sum at the end of that period, the difference between the two sums being the amount which they pay for the accommodation ... I think the amount is a

profit made by buying a security at a discount and therefore comes within the somewhat odd term "profits on discount" ".

And then in the next paragraph he indicates the effect of other variables on the second transaction and it is these considerations which are so apposite to the question of the differentiation between interest and provision against (for example) "the rise or fall in the value of money ..." for Lord Sterndale says:

> "The case where the bill is sold before maturity is not so simple. If all the other elements were eliminated the increased value of the bill would be regulated by the extent to which it had advanced towards maturity. But the other elements cannot be eliminated. The price of the bill in the market depends upon the state of the money market and the rise or fall in the value of money and any increased price attributable to these causes cannot be taxed as profit on a discount. In the case of a sale, therefore, I think that the only amount that can be taxed is the amount by which the Bill has increased in value by reason of its advance towards maturity and the consequent accrual of interest upon it. The amount of profit arising from the fluctuation in value of money does not arise from discount, i.e. the difference between the present value and the value at maturity, and does not come therefore within the words 'profit on a discount'."

Warrington, L.J. could see no difference in principle between the first transaction and the

second but there is explicit in his statement (at 55) that there may be "variation in the value of money, in the public credit and so forth." He explained:

> "When a holder, whether the original purchaser or not, realises during currency, he really receives a proportion of the total profit resulting from the fact that the bill was brought at a discount. It is true that that proportion may not bear an exact relation to the period of currency but may be determined by variations in the value of money, in the public credit and so forth. But it seems to me that the total of the profits received by the various sellers after deducting losses, if any, cannot exceed the difference between the price originally paid and the sum payable at maturity, and that the considerations I have referred to merely affect the distribution of that difference between the various holders."

Scrutton, L.J. took the matter considerably further for he said (at 59):

> "The case where the bill is sold during currency is a little more complicated. The interest or discount is accruing proportionately to the time expired since payment, but the market price may not simply be the price paid plus a proportionate part of the interest accrued at the original rate of discount or interest. The value of money may have fallen or risen, and this may affect the price of the

bill ... While in taxation of a trade the latter element" (how much the value of the promise to pay had altered by the rise or fall of the value of money) " would be included in the profits of the trade, in my opinion in the taxation of interest or discount it is not included, for it is appreciation or depreciation of the capital sum."

And he added (at 59 and 60):

"The result in the present case appears to be that where the Institution has been taxed in respect of the year when Treasury Bills mature, on bills held to maturity, on the difference between amounts paid and amounts received, it is rightly taxed; but that where the Institution is taxed on bills sold or discounted within the year on the difference between amounts paid and amounts received, it is wrongly taxed, for it is being taxed not only on interest or discount, but on an amount increased by appreciation or accretion, or decreased by loss, of capital. The amount of assessment should be, in the case of each bill, on the amount of interest which would be received if the bill were held to maturity, reduced by proportion to the time for which the bill was held as compared with the time of full currency."

In <u>Lomax</u> v. <u>Peter Dixon and Co. Ltd</u> (1943) 1 K.B. 671; (1943) 2 All E.R. 255, the Court of Appeal (English)

treated a discount or premium offered in a loan transaction on account of capital risk as being capital and not income. Lord Greene (at 677; 259) said:

"A good example of the difficulty is to be found in the contracts of loan which used to be made on a gold basis when the currency had left or was expected to leave the gold standard. In such contracts the amount to be repaid was fixed by reference to the price of gold ruling at the repayment date, and, if the currency depreciated in terms of gold, there was a corresponding increase in the amount of sterling to be repaid at the maturity of the loan. It could scarcely be suggested that this excess ought to be treated as income when the whole object of the contract was to ensure that the lender should not suffer a capital loss due to the depreciation of the currency.

"I refer to these problems not for the purpose of attempting to solve them, but in order to show that there can be no general rule that any sum which a lender receives over and above the amount which he lends ought to be treated as income. Each case must, in my opinion, depend on its own facts, and evidence dehors the contract must always be admissible in order to explain what the contract itself usually disregards, namely the quality which ought to be attributed to the sum in question."

Clearly, it would have been prudent before (and more importantly after the enactment of the Land and

Income Tax Amendment Act (No. 2) 1974 for documents evidencing the discount of a bill to have stated what was interest and what was the provision against capital depreciation and for capital loss; and for the accounting records of the discounter to maintain such differentiation. Lord Greene in Lomax made reference (dealt with post) as to how the true nature of discount may be determined or fixed by the contract.

Discounting a bill simply means the buying or selling of the bill before it is due for payment for the amount estimated to be its value at the date it is sold or bought. "In the discounting of bills of exchange, Exchequer bills etc., the discount is the reward and in the normal case (since such bills do not as a rule carry interest) the only reward which the person discounting the bill obtains for his money." Lomax v. Peter Dixon & Co. per Lord Greene, M.R., at 262.

Earlier in his judgment (at 258) (which was concurred in by MacKinnon, L.J. and Du Parqu, L.J., Lord Greene considered the proposition that if the premium or discount is offered because of the capital risk involved rather than as compensation for use of the lender's money, the gain accruing to the lender should be regarded as capital and not income and he made the following observations:

(1) If a loan is made at or above such a reasonable commercial rate of interest as is applicable to a reasonably sound security, then there is no presumption that a "discount" at which the loan

is made or a premium at which it is payable is in the nature of interest;

(2) The true nature of the "discount" or the premium (as the case may be) is to be ascertained from all the circumstances of the case;

(3) And in deciding the true nature of the "discount" or premium in so far as it is not conclusively determined or fixed by the contract, these matters (with any other relevant circumstances) are important to be considered: the term of the loan, the rate of interest stipulated, the nature of the capital risk, the extent to which (if at all) the parties expressly took or may reasonably be supposed to have taken the capital risk into account in fixing the terms of the contract.

Macnaghten, J., in Davies(Inspector of Taxes) v. Premier Investments Co. Ltd; Hewetson v. Carlyle (Inspector of Taxes) (1945) 2 K.B.D. 681 expressly applied the dictum of Lord Greene, M.R., in Lomax to the effect that a payment to be made on repayment of a loan, although described as a premium, is to be regarded as "interest of money" in the absence of circumstances indicating a contrary intention and cited with approval the propositions laid down (supra) by Lord Greene in Lomax.

Conveyancing procedure

Borrowers and lenders and more particularly discounters infrequently enter into their contracts in clear terms allowing the differentiation between pure interest and provision for capital loss and capital depreciation. In New Zealand the prevailing practice adopted by merchant

banks is for the discounting of the commercial bill to be initiated by the prospective investor with the merchant bank and for the matter to be finalised by a letter from the merchant bank setting out details of the bill purchased, the maturity date, and often both the acceptor's and drawer's name but there is no differentiation between interest and capital depreciation or any indexation with reference, for example, to the Consumers' Price Index or to the New Zealand United Trust Index or to the Share Prices Index.

Inquiries made from New Zealand to twelve of the major merchant banks (initiated through the New Zealand High Commission in London because merchant banks are wary about disclosing such information to non-clients for fear possibly of litigation) show that their contracts do not normally contain any clause distinguishing capital depreciation and capital loss from interest itself even though obiter dicta cited in cases (see Secretan) does indicate a degree of judicial sympathy.

Accurate conveyancing is essential in drawing the document executed simultaneously with the purchase by the discounter of the bill so that there is a clear differentiation between pure interest and provision against risk of capital loss and provision for the decline in purchasing power of money.

The plain ordinary meaning of the words is to be adopted in construing a document. The subject-matter may show, however, that the words have a different

meaning from their plain, ordinary or popular meaning, if they are used in connection with the usage of a trade or profession and thus have some special, technical meaning. They may even be used in a special or peculiar sense on a particular occasion if this construction would effect the intention of the parties as collected from the document: Odgers' Construction of Deeds and Statutes, 5th Edn., 1967 (Editor: G. Dworkin at 36). And as Asquith, L.J. said:

> "Where the language of a contract is capable of a literal and wide, but also of a less literal and more restricted meaning, all relevant circumstances can be taken into account in deciding whether the literal or more limited meaning should be ascribed to it: "
> Parkinson (Sir Lindsay) and Co. Ltd. v. Commissioners of Works (1949) 2 K.B. 632 at 662.

Extrinsic evidence to support the construction of the words is therefore admissible but the prime duty of the conveyancer is to ensure that the words he uses are unequivocal and exact so that they accurately fit the circumstances of the case. Clearly if the variable standard is to be a cost of living index, then consideration must be given either to its suspension or revision or substitution for otherwise the carefully drawn provision may prove nugatory.

New Zealand case

Buckley, J's sympathy in Secretan had already largely been anticipated in and the reasons for such extended by McGregor J's judgment in Felt and Textiles

of New Zealand Ltd v. Commissioner of Inland Revenue (1969) NZLR 491, for in the penultimate paragraph of his judgment he said:

> "... I am forced to the conclusion that here the dominant consideration is that the discount was offered as an inducement to subscribe for the debentures on the longest term offered ... It may have been a capital appreciation in the hands of the lender to offset any possible additional risk over the long term and the inability to predict the changing economic situations over a long period. It may have been an inducement to provide more liquidity to a subscriber who might desire to realise his debenture before maturity".

The facts of the case provide the background to understanding the meaning McGregor, J. gave to "interest" and "discount". The objector company agreed to purchase certain warehouse and factory premises. In re-arranging its finances to provide the balance of the purchase money owing, it issued debentures for that amount with interest at 6% per annum payable on the same due date as the balance purchase money and at the same time it issued further debentures (likewise payable on the same time) for the present value of the difference in interest for the remaining period of the term.

The Supreme Court held that the issue of the additional debentures was in satisfaction of the balance of the future interest and that they were in the nature of interest on money (or assets)

used in production of the objector company's assessable and were therefore deductible under section 111 of the Land and Income Tax Act 1954.

But the issue of the debenture to the public at a discount meant that the discount was not an additional payment or obligation for payment of interest on the money borrowed nor was it an expenditure incurred in the borrowing of money or part of the objector company's working expenses and therefore was not an allowable deduction under section 111.

(The objector company had issued debentures of 283,000 pounds to the public at a discount of one per cent, the amount involved being 2830 pounds).

McGregor, J. recited (at 498) details of this and then (at 499) he continued:

"In my opinion it cannot be said that such discount was an additional payment or obligation for payment of interest on the money borrowed. It has not the element of an annual payment for the use of money. If the debenture holder retains the debenture until maturity he receives 100 pounds for each initial subscription of 99 pounds. This accretion to the subscriber, it seems to me, is not the fruit of the tree, it is the growth of the trunk. It was granted as an inducement to subscribe to the long-term debentures. The subscriber's money was frozen for a long term and lost its ordinary liquidity. The subscriber was deprived of the use of his money for a long period except by realisation of the debentures at a problematical price. ... If debentures were issued at a premium of

103 pounds, the inducement therefore being a high rate of interest, the premium three pounds must, in my opinion, be regarded as a capital receipt in the hands of the recipient. Likewise the discount payable on maturity is an expenditure in the nature of capital. I cannot conceive that it can be regarded, in any way, as a payment or debit of interest over the period of the loan".

Several important points emerge from that partly quoted paragraph:-

- The discount is not regarded as or equated with a payment of interest nor is its accretion to be considered as the fruit of the tree for "it is the growth of the trunk". There is a clear differentiation between interest and the sum attributable to discount in the sale of the debenture and by analogy the same consequences must follow in the sale of a commercial note in which in a simultaneous deed of covenant there is clearly recited the amount of interest and a figure variable in accordance with the Monthly Consumers' Price Index, the Share Price Index, or the New Zealand United Trust Index to reflect the fluctuations in the appreciating or depreciating value of the measure of the commodity or commodities so selected.
- The subscriber's money had been frozen for a long term and so had lost its ordinary liquidity, and so too has the discounter's money for he too is deprived of the use of his money for a long period.
- The discount payable on maturity of the debenture is an expenditure and payment in the nature of

capital and not a payment or debit of interest over the period of the debenture and a _fortiori_ so too is the variable figure in the deed of covenant accompanying the purchase of the commercial paper in which deed is set forth the precise manner in which that figure may vary in accordance with movements of index numbers evidencing a change in price levels of consumer goods and services or of share price quotations or of any other relevant standard which is chosen.

There is every advantage to be gained from a deed of covenant to be executed by all parties at the time of the purchase by the discounter of the commercial paper to minimise the taxation liability which would otherwise be payable (and to obviate the wonder encountered by investors as to what they have purchased some of whom consider they have some form of commercial security).

The effects of section 108

The differentiation between provision for loss of capital and provision against capital depreciation on the one hand and pure interest on the other is, then, one that is novel in the discounting of commercial paper in New Zealand. In itself it has its roots grounded in economics and in actuarial science and certainly the High Court of Australia approved the use of an index clause in _Stanwell Park_ and the judgments of so strong a Court would clearly be of the most persuasive effect in New Zealand.

Caution must temper its introduction into New Zealand because of the potentially pervasive and

condemnatory effects of the recently amended (it was enacted on November 8, 1974) section 108 of the Land and Income Tax Act 1954; and the Privy Council's advice in C.I.R. v. Wheelans; C.I.R. v. Ashton (examined post) under the old section offers (prima facie) little hope of judicial creativity in ameliorating the statutory rigors of the application of that section.

Subsection (1) now provides:-

"Every arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the Commissioner for income tax purposes if and to the extent that, directly or indirectly -

"(a) Its purpose or effect is tax avoidance; or

"(b) Where it has two or more purposes or effects, one of its purposes or effects (not being a merely incidental purpose of effect) is tax avoidance, whether or not any other or others of its purposes or effects relate to, or are referrable to, ordinary business or family dealings, -

whether or not any person affected by that arrangement is a party thereto".

The definition of the terms "arrangement," "liability", and "tax avoidance" are given in subsection (6). The first two terms are defined so that the meanings ascribed to them adhere to the meanings of those terms in case law and "tax avoidance" includes the alteration of the incidence of tax, relieving from liability for tax and avoiding, reducing or postponing liability to tax.

It is not, therefore, necessary for tax avoidance to be the sole or principal motive for it is sufficient if it is a subsidiary purpose provided it is not a "merely incidental purpose". It is expressly stated that where there is a tax avoidance purpose present other than a merely incidental purpose then the arrangement is void whether or not _other_ purposes are referrable to ordinary business or family dealing.

If an arrangement is void under subsection (1) subsection (2) empowers the Commissioner to make an assessment to counteract the tax advantage obtained from or under the arrangement by any person affected by it.

Subsection (3) provides that where income is adjusted under subsection (2) so that it is included within a person's assessable income, it shall not be deemed to be derived by any other person.

"Liability" includes potential or prospective liability.

The commissioner has power to determine a taxpayer's principal purpose for entering into an arrangement which has a tax-saving element. If he finds that tax avoidance is the principal purpose or one of the principal purposes then he can invoke the section; if he finds that tax avoidance is merely an incidental purpose he can invoke the section.

A taxpayer may not be able to surmount the new provisions in the amended section by merely showing that the arrangement was ordinary business

or family dealing; but clearly with the increasing volume of overseas literature in accounting and law journals on the use of escalatory and index clauses designed for use in a world of inflation accounting and intended to guard against the risk of capital loss upon an investment being made and to provide for the decline in the purchasing power of money upon its maturity, the Commissioner will find it impossible to ignore such prudent provisions and to attempt to condemn the agreement as one designed to avoid or evade income tax liability. Important and ancillary purposes should never be treated notionally as the pre-dominant purpose so that additional liability is imposed. If such principles of inflation accounting are recognised by international accounting standards then they deserve recognition by the Inland Revenue Department.

Section 29 of the Inland Revenue Department Amendment Act 1960 provides that if the taxpayer desires to appeal to the Supreme Court from a decision of the New Zealand Taxation Board of Review on a question of law then he must within 30 days after the determination appealed from, file with the Board notice of such intended appeal; and the Court of Appeal decision in <u>Reckitt & Coleman (N.Z.) Ltd</u> v. <u>Taxation Board of Review</u> (1966) NZLR 1032 is the authority that the Commissioner of Inland Revenue has no power to waive those statutory provisions.

<u>Interest on Deposit Regulations</u>

The question remains whether the discount of

commercial bills are subject to the Interest on Deposits Regulations; but in any case the Regulations 1972 Amendment No. 1 contain such an extensive definition of the word "interest" that the thought lingers that if the Legislature had wished to remove any possibility of discounters differentiating between interest on the one hand and provision for capital loss and provision against capital depreciation, on the other hand, then it could have comprehensively said that:

> 'Interest' includes any sum (other than the amount received by the borrower), whether called a dividend or a premium or by any other name whatsoever, and any discount paid or given by a borrower in addition to or instead of interest, in respect of money borrowed under a contract of deposit, whether such sum or discount is paid or given before or after the receipt of the amount borrowed or on or after repayment of the whole of any part of the borrowed amount; and where any such sum or discount is paid or given in addition to interest, whether it is paid or given at the same time or not, it shall be treated as part of that interest for the purpose of determining the maximum rate of interest that may be paid under these regulations.

That definition includes discounts and premiums paid or given at any time, and clearly had the Legislature inserted a comparable definition in the Amendment Act 1974 then that would have removed the possibility of a discounter differentiating between

pure interest under the bill on the one hand and on the other provisions against capital loss and provision for capital depreciation. The above definition was available for suitable amendment and then inclusion in the 1974 Act and the failure of the Legislature so to do strengthens the argument that a legitimate distinction can be made between the varying sums all comprehensively falling under the all-embracing term "interest".

These two provisions against loss of capital and depreciation of the purchasing power of money must legitimately be differentiated from the element of pure interest but neither such provisions would constitute allowable deductions under section 111(a) which relates to loss incurred in the production of assessable income and section 112(1)(g)(i) which precludes deduction of interest "except so far as the Commissioner is satisfied ... it is payable on capital employed in the production of the assessable income". The reason for the non-deductibility is that in both cases what the discounter has received is demonstrably in the nature of capital and this is the prime reason for separating that receipt from the element of pure interest attributable to the discount.

It is erroneous to treat the whole of the discount as interest for a portion represents capital.

IV CONCLUSIONS, AND THEN SOME RECOMMENDATIONS

It is now possible to set down a number of conclusions (and then to draw from them some recommendations):

Conclusions

(a) Discount of an inland bill of exchange is its negotiation by way of transfer for a delayed monetary consideration called the discount which represents the rebate of interest for the period before it falls due for payment.

(b) Discounter is the transferee and the indorsement in his favour gives him an absolute title (as holder in due course) to the bill and thereby assigns to him rights of recourse against indorsers who can call upon the original drawer with the primary liability upon the bill remaining that of the acceptor.

(c) Discounter is a term loosely used and (it is contended) incorrectly applied notwithstanding usage: if the suffix were correctly spelt discount<u>or</u> then this would mean the party who transfers the bill by way of sale and discountee the party who buys the bill and becomes thereby the transferee. Such correction would then conform to the customary nomenclature of parties who indorse, mortgage, transfer, assign, charge and lease. Hence indorsee, mortgagee, transferee, assignee, chargee and lessee all indicate (by their uniform suffix) the parties <u>to whom</u> some right and/or interest in property is transferred.

(d) Distinctions between the <u>discount of a bill</u> and the <u>deposit of a bill for mere collection</u> and <u>the holding of a bill as a security</u> depend essentially not exclusively on the existence of

an indorsement but (on the one hand) the intention to effect an absolute transfer with resultant full power to go against all parties on the bill or merely enabling the person with whom the bill is deposited to receive the amount from the other parties: (Ex parte Twogood (1812) 19 Ves. 229; 34 E.R. 503 which indicates that such indorsement is prima facie evidence of discount unless the object of mere deposit is manifest) or merely to allow the obtaining of that part of the proceeds in repayment of the debt owing under the security: Reid v. Furnival (1833) 1 C & M 538; 149 E.R. 513.

(e) The prevailing presumptions obtaining in each of the above circumstances (discount, mere collection and security) are that the holder holds absolutely and not by way of security: Hills v. Parker (1866) 14 L.T. 107; Re Boys, Eedes v. Boys, ex parte Hop Planters' Co. (1870) L.R. 10 Eq. 467.

(f) The objects of discounting and moneylending frequently coincide in intention and result and the Courts fail to fulfil their duty under the Moneylenders Act 1908 (as amended) by tacitly acknowledging their potential identity or similarity and then in failing to explore such by examining the truth and substance of the documents.

(g) Parliament's authority and that of the Minister has been usurped by the Commissioner of Inland Revenue issuing legislative statements in the guise of departmental public information

bulletins which while purporting to be illustrative and explanatory of revenue Acts, both in effect and result declare and state the law and exceed the content of the appropriate Act and are therefore ultra vires and not of any legislative effect.

(h) Merchant banks in New Zealand are a rudimentary and antipodean counterpart to those established for many centuries in the City of London and while fulfiling some comparable functions, the title "merchant bank" is a misnomer for they are separate in origins, activities and tradition.

Recommendations

(i) THAT in any reformation of the Moneylenders Act 1908 (as amended) loan be defined to include the discount of a bill of exchange and that the discount of a bill of exchange or series of bills in appropriate circumstances be deemed to be prima facie evidence of a device to avoid the Act's provisions and that the Courts be enjoined to explore the intentions of the parties and to examine the nature of their documents purporting (or otherwise) to substantiate such intentions.

(ii) THAT in the next consolidation of the Land and Income Tax Act 1954 certainty be introduced by the inclusion of a definition of the word "interest" in relation (inter alia) to the discount of a bill of exchange.

(iii) THAT if it is the Legislature's intent to proscribe the use of escalatory provisions in the form of index clauses it should say so and that until such time the use of such be accepted to provide both for the risk of loss of capital and against depreciation of capital invested in the purchase at discount of bills of exchange.

(iv) THAT section 108 of the Land and Income Tax Act 1954 be amended to remove the wide subjective powers reposed in the Commissioner of Inland Revenue and to replace those with provisions requiring the Commissioner to demonstrate to the Court's satisfaction that not only is a transaction's ostensible purpose or effect one of tax avoidance or evasion but that it is also in denial of recognised and legitimate practices in the commercial world (including the acceptance of the efficacy of index and escalatory clauses designed to guard against the risk of capital loss and to provide against the declining purchasing power of money) and that both conditions must be fulfilled *in toto* before any transaction or arrangement be struck down wholly or partially.

(v) THAT the Commissioner of Inland Revenue be forbidden to issue press statements and departmental bulletins and brochures ostensibly intended to be explanatory of legislative enactments but which are in effect declaratory of the Commissioner's view of the law and of how the department interprets that law and intends to apply it

and <u>that</u> all such law-making functions be exercised pursuant to statutory regulations under the Inland Revenue Department Act 1952 (as amended) and <u>that</u> all legislative functions on revenue matters be exercised by Parliament and the Minister by delegated authority from Parliament and none by the Commissioner and his Deputy or Deputies.

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