

Privy Council Appeal No. 14 of 1992

(1) Barry George Hadlee and
(2) Sydney Bridge Nominees Limited *Appellants*

v.

The Commissioner of Inland Revenue *Respondent*

FROM

THE COURT OF APPEAL OF NEW ZEALAND

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE
OF THE PRIVY COUNCIL, DELIVERED THE
1ST MARCH 1993

Present at the hearing:-

LORD KEITH OF KINKEL
LORD TEMPLEMAN
LORD JAUNCEY OF TULLICHETTLE
LORD BROWNE-WILKINSON
LORD MUSTILL

[Delivered by Lord Jauncey of Tullichettle]

The question in this appeal is whether an assignment by a partner of a part of his share in a professional partnership is effective to transfer the tax liability in respect of the income assigned from the partner to the assignees. The first appellant ("the taxpayer") is a partner in a firm of chartered accountants in Christchurch which firm is part of the national New Zealand partnership, Peat Marwick. The second appellants are a private company incorporated on 29th January 1981 for the purpose of acting as trustee of any *inter vivos* trust, and having as their first subscribers and directors partners in the Auckland office of the national partnership.

The contractual arrangements regulating the relations of the partners in the Christchurch office were contained in two documents, namely the national partnership agreement, to which all partners of the national firm throughout New Zealand were parties, and the local office regulations made thereunder to which the Christchurch partners alone were parties. In terms of the local office regulations the profits, capital profits and losses of the office were divided into 452 shares of which 32 were allocated to the taxpayer. It was provided in those regulations that each partner should "diligently attend to

the business ... and devote his whole time and attention thereto". The business year of the Christchurch office ended on 31st January.

On 29th January 1981 the taxpayer, as settlor, and the second appellants, as trustees, executed a deed of trust in a standard form wherein the primary beneficiaries were the wife and only child then in life of the taxpayer and the purposes were discretionary during the trust period. Suffice it to say that the trustees were empowered to pay the income to the primary beneficiaries. It should be explained that in New Zealand a spouse and children of a taxpayer are separately assessed to income tax. By deed of assignment of the same date the taxpayer assigned to the second appellants the percentage of his share in the partnership represented by 12.8 units (40%). The assignment was for a consideration in relation to which no question arises. The taxpayer covenanted to "use his best endeavours to comply with all the obligations on his part as a partner in the Partnership".

Notwithstanding the assignment the Commissioner assessed the taxpayer to tax on income attributable to 32 shares in the partnership for the years ending 31st March 1981 and 31st March 1982. The taxpayer and the trustees objected and a case was stated to the High Court. Eichelbaum C.J. decided that the Commissioner had correctly assessed all the income attributable to the 32 shares to the taxpayer. The Court of Appeal unanimously dismissed the taxpayer's appeal.

In order to understand the reasoning of the Chief Justice and the Court of Appeal it is necessary to refer briefly to certain sections of the Income Tax Act 1976. Section 38(2), which is the principal charging section, provides for the payment of income tax "by every person on all income derived by him during the year for which the tax is payable". Section 9 requires every taxpayer to make an annual return of his assessable income and section 10 makes provision for returns by partners, co-trustees and joint venturers. Without setting out in detail the somewhat complex provisions of section 10 it is sufficient to quote the words of Richardson J. in the Court of Appeal:-

"New Zealand tax legislation does not isolate partnership income as a separate source of income. In New Zealand law a partnership is not a separate tax entity. It is not a 'taxpayer' and partners make a return of partnership income only for the purpose of providing information on which their separate incomes are calculated."

Section 104 provides that, in calculating assessable income, expenditure or loss incurred in gaining or producing that income may be deducted from the income. Finally section 99 renders void as against the Commissioner an arrangement, one of whose purposes or effects is tax avoidance.

Eichelbaum C.J. rejected the taxpayer's submissions on three grounds, of which two were live issues in this appeal, namely:-

- (1) That income from personal services rendered by a taxpayer were incapable of assignment to the effect of shifting the tax liability from the assignor to the assignee, and
- (2) That the arrangement whereby the taxpayer assigned the fractional part of his share in the partnership to trustees was void by reason of section 99 of the Act of 1976.

The Court of Appeal affirmed the decision of the Chief Justice on both these grounds. Cooke P. approved the following dictum of Henry J. in *Spratt v. Commissioner of Inland Revenue* (1964) N.Z.L.R. 272 at page 277:-

"No taxpayer can, by way of assignment, escape assessment of tax on income resulting from his personal activities - such income always remains truly his income and is derived by him irrespective of the method he may adopt to dispose of it."

and held that it applied to the partnership earnings of the taxpayer. Richardson J. considered that the structure of section 10 of the Act of 1976 placed the liability for income tax in respect of partnership income on the individual partner and made it impossible for a partner to shift that liability by assignment while still remaining a partner. He was of the further opinion, agreeing with Henry J., that future wages and future receipts for personal services must be taxed in the hands of the earner and that any assignment thereof could only take effect after suffering tax in the hands of the assignor. Both Cooke P. and Richardson J. were of opinion that the arrangements fell within the ambit of section 99. The other three judges agreed with Cooke P. and Richardson J.

A good deal of the argument before the Board on either side was directed to the construction of section 10 and its effect on the assignment of a share in a partnership. However it is convenient to deal first with the taxpayer's argument that he derived partnership income not from his personal services or exertions but from the rights which he acquired under the partnership agreement. These rights amounted to a proprietary interest a part of which he had assigned and it was from this proprietary interest that the income flowed to the trustees. Mr. Thornhill, for the taxpayer, accepted that if he had merely assigned a right to income he could not have successfully transferred the liability to tax on that income to the assignee. It was therefore essential to the argument to establish the assignment of a proprietary interest.

The foundation stone of the argument was a case in the High Court of Australia, *The Commissioner of Taxation of The Commonwealth of Australia v. Everett* (1980) 143 C.L.R. 440, in which a partner in a firm of solicitors, with the consent of his partners, assigned to his wife a fraction of his share in the partnership with a right to receive an appropriate share of the profits. It was held that the income passing under the assignment was not taxable in the partner's hands. In the judgment of the majority of the High Court it was stated at page 452:-

"His Honour's remarks do not touch the case where an immediate trust is established of a proprietary right which yields or earns future income. Then the income is accurately described as income of a trust estate. For reasons which we have already given, this is the situation which obtains here."

Later in the judgment, after reference to the proposition that the taxpayer's remuneration was the product of his personal exertion, it was said at page 454:-

"But this is not true of partners in general or of the respondent as a partner in this case. The respondent's entitlement under the partnership agreement was to a proportionate share of the partnership profits as disclosed by the partnership accounts. The relevant proportion of the partnership profits was payable to the respondent because he was a partner and the owner of a share in the partnership. The respondent was entitled before the assignment to his proportionate share of the partnership profits, however much or however little energy he devoted to the practice, so long as the partnership remained on foot. Accordingly, it is a misnomer to speak of the respondent's share of the income as having been gained by his personal exertion."

This case, it was argued, demonstrated that the right of a partner in a professional partnership to share in the profits of the partnership depended upon his proprietary interest therein and not upon his personal exertions. It followed that the assignment of a share in a partnership carried with it a proprietary right which yielded future income (*Everett* page 452).

In evaluating this argument it is necessary to examine the taxpayer's rights under the partnership agreements and what he assigned by the deed of assignment. First of all as a matter of general law, to quote the words of Richardson J., he "does not have title to specific partnership property but has a beneficial interest in the entirety of the partnership assets and in each and every particular asset of the partnership. (*Lindley on Partnership* 15th Edition, page 516)". He can enforce this interest against his co-partners to the extent of seeing that the partnership assets are used for the benefit of the partnership but he cannot assign it to a non-partner. This beneficial interest, expressed in terms of its realisability, is in the nature of a

future interest taking effect in possession on (and not before) the determination of the partnership (*Lindley and Banks on Partnership*, 16th Edition, page 457). He has rights under the partnership agreements:-

- (1) to share in the annual profits in proportion to his share in the partnership,
- (2) to have his share purchased by the remaining partners on his resignation or retirement, and
- (3) to share in the surplus assets of the partnership on a dissolution.

Section 34 of the Partnership Act 1908, which corresponds to section 31 of the United Kingdom Partnership Act 1890 provides:-

"34. Rights of assignee of share of partnership -

(1) An assignment by any partner of his share in the partnership, either absolute or by way of mortgage, does not, as against the other partners, entitle the assignee, during the continuance of the partnership, to interfere in the management or administration of the partnership business or affairs, or to require any account of the partnership transactions, or to inspect the partnership books, but entitles the assignee only to receive the share of profits to which the assigning partner would otherwise be entitled, and the assignee must accept the account of profits agreed to by the partners.

(2) In case of a dissolution of the partnership, whether as respects all the partners or as respects the assigning partner, the assignee is entitled to receive the share of the partnership assets to which the assigning partner is entitled as between himself and the other partners, and, for the purpose of ascertaining that share, to an account as from the date of the dissolution."

The "property" carried by the deed of assignment was defined as including two components, namely the appropriate part of the right to share in profits and the right on dissolution to share in assets all in terms very similar to those used in section 34. The taxpayer assigned no revenue producing interest of a capital nature nor was he in a position to do so since he had no proprietary interest in any such asset. Thus the income which accrued to the assignee flowed not from a capital asset which was capable of assignment but from the performance by the taxpayer of such obligations as he was required to perform under the partnership contract.

Spratt v. Commissioner of Inland Revenue (1964) N.Z.L.R. 272 related to an employee but Henry J.'s dictum was applied to partners by Tompkins J. in

Johnstone v. Commissioner of Inland Revenue [1966] N.Z.L.R. 833 and by Woodhouse J. in *Kelly v. C.I.R.* [1970] N.Z.L.R. 161. In relation to these cases Cooke P. said at page 207:-

"In my opinion, however, these authorities should be accepted and it should be held that the dictum of Henry J. correctly states the law of New Zealand."

Richardson J. said:-

"There is no justification in principle for differentiating between salary and wage earners and professionals whose income is the product of their personal exertion. In either case the person whose personal exertion earns the income derives the income."

Their Lordships are in complete agreement with these comments and therefore conclude that the reasoning in *Everett (supra)* would not normally be applicable to the position of partners in New Zealand. Since no income producing proprietary interest was assigned by the taxpayer the argument fails. That is sufficient for the disposal of the appeal and accordingly their Lordships do not find it necessary to deal with the arguments as to the proper construction of section 10 insofar as it is relevant to the assignment of a share in a partnership.

In view of the fact that this Board has concluded that the deed of assignment by the taxpayer was ineffective to transfer the tax liability in respect of the income assigned to the assignees no question arises under section 99.

For the foregoing reasons their Lordships will humbly advise Her Majesty that the appeal should be dismissed. The appellants must pay the respondent's costs before their Lordships' Board.

