IN THE SUPREME COURT OF NEW ZEALAND

SC 24/2009
[2010] NZSC 89

BETWEEN	GOVIND PRASAD SAHA Appellant	
AND	COMMISSIONER OF INLAND REVENUE Respondent	

Hearing: 27 October 2009

Court: Elias CJ, Blanchard, Tipping, McGrath and Wilson JJ

Counsel: G J Harley and R P Harley for Appellant
M S R Palmer and M T Lennard for Respondent

Judgment: 23 July 2010

JUDGMENT OF THE COURT

A The appeal is dismissed.

B The appellant is ordered to pay the respondent costs of $15,000 and reasonable disbursements.

REASONS

Introduction

[1] This appeal raises the single issue of whether the appellant can claim a deduction for the market value of shares which were forfeited while subject to the Foreign Investment Fund ("FIF") taxation regime. The issue is however of more general importance because it could arise whenever an asset which is subject to a trading stock regime is forfeited.

Facts

[2] The appellant, Dr Saha, was a New Zealand partner in the consultancy business of Ernst & Young. In 2000 Ernst & Young International sold that business to a French company, Cap Gemini SA ("Cap Gemini"), with the proviso that its constituent national firms were free to decide whether to participate. The New Zealand partners of Ernst & Young opted to sell.

[3] The consideration for the acquisition by Cap Gemini of the New Zealand consultancy business of Ernst & Young was the allotment of shares in Cap Gemini. Dr Saha was allotted 7566 of these shares pursuant to a Deed of Covenant by which Dr Saha agreed to become an employee for five years of a New Zealand subsidiary being established by Cap Gemini. The shares allotted to Dr Saha and the other transferring partners were to be released to them progressively over that time. Provision was made for the sale of shares in advance of their release date, provided that the proceeds of sale were held in escrow until the release date. The unreleased shares and any proceeds of sale thereof were expressed to be liquidated damages which were payable in certain eventualities, including the voluntary cessation of employment of the transferring partner by the New Zealand subsidiary of Cap Gemini. In that event, 50 per cent of the unreleased shares or the proceeds of sale thereof was payable to Cap Gemini and the balance of the shares was to be transferred to other employees of the New Zealand subsidiary. Payments of liquidated damages were to be made "free and clear of all deductions, withholdings, set-offs or counter-claims whatsoever".[1]

[4] In the High Court, Dr Saha, the former New Zealand Chief Executive of Ernst & Young, and the New Zealand legal advisers to Dr Saha and Ernst & Young explained that the release and forfeiture provisions were intended to be a purchase price adjustment, whereby the price paid by Cap Gemini to purchase the New Zealand consultancy business of Ernst & Young would be reduced to reflect the reduction in the value of the goodwill being acquired if the transferring partners did not remain with the business for five years.

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1 Clause 2.4 of the Second Schedule to the Deed of Covenant.

[5] Dr Saha commenced employment with Cap Gemini's New Zealand subsidiary in mid-April 2000. A dispute arose over the interpretation of his employment contract. On 31 May 2001 a tripartite settlement was reached between Dr Saha, Cap Gemini and its New Zealand subsidiary. The terms of settlement were recorded in a Deed of Settlement. They included agreement that Dr Saha would resign as from 30 June 2001 after charging completed work and would be paid by the subsidiary a specified sum as a payment for the termination of his employment contract.[2] The parties further agreed that 2095 shares, representing 50 per cent of the 4190 shares then unreleased, would not be forfeited but that the other 2095 shares would be transferred to Cap Gemini or as directed.[3] In other words, Dr Saha forfeited only 50 per cent of the shares which, under the terms of the Deed of Covenant, would have been lost by him upon his cessation of employment by the New Zealand subsidiary at that time.

[6] Dr Saha claimed a deduction of $602,938 as the market value of the 2095 shares which he forfeited to Cap Gemini. The Commissioner of Inland Revenue disallowed that deduction and these proceedings resulted.

[7] It is common ground that the 2095 shares which were forfeited were subject to the FIF rules. It is also common ground that the purpose and effect of the FIF was to determine what tax is payable or what deduction is claimable by a New Zealand tax resident arising out of the ownership of shares in an overseas company. The FIF rules gave the taxpayer four options for bringing the ownership of the shares to tax by attributing to the taxpayer a proportionate share of the income or losses of the company. Dr Saha chose what the Income Tax Act 1994 referred to as the "comparative value" method. In general terms, under that method any increase in the value of the shares during an income year was treated as income, even though the increase might not be distributed to shareholders, and any decrease as a deduction.

[8] More specifically, s CG 18 of the Act provided at the relevant time that:

> Where and to the extent that a person uses the comparative value method in relation to an interest in a fund held by the person in an income year, the

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2 It is common ground that tax was payable, and was paid, on that sum.
3 There were at that time no unreleased proceeds of sale in escrow.

> foreign investment fund income or loss of the person in relation to the interest in the income year shall be an amount calculated as at the last day of the income year in accordance with the following formula:
>
> (a + b) – (c + d)
>
> where–
>
> a is the market value of the interest as at the end of the income year (which value shall be nil to the extent that the interest is not then still held by the person as an interest subject to the comparative value method); and
>
> b is the aggregate of all the gains derived ... by the person during the income year with respect to the interest; and
>
> c is the market value of the interest as at the end of the preceding income year (which value shall be nil to the extent that the interest was not then held by the person as an interest subject to the comparative value method); and
>
> d is the aggregate of all expenditure incurred by or on behalf of the person in acquiring the whole or any part of the interest during the income year.

[9] In practical terms, the effect of this formula is that a taxpayer, on acquiring an asset, may claim a deduction for the cost of acquisition, actual or deemed. At the end of any income year while the asset is owned, the taxpayer pays tax on any increase in value during that year or obtains a deduction for any decrease in value, after allowing for any gains derived or expenditure incurred during the year. On disposition, the taxpayer must account for the proceeds. Accordingly, tax will be payable on any increase in the value of the shares between the date of their acquisition and the date of their disposition.

[10] In declining the deduction claimed by Dr Saha, the Commissioner relied on two provisions in the Act, ss CG 23(5) and CG 14(2). They read as follows:

> ... where ... a person disposes of any ... interest ... in a ... [FIF] with respect to which the person uses the comparative value method ... for no consideration or for consideration which is less than the market value of the property at the time, the person shall be deemed to have derived from the disposition consideration equal to the market value of the property at the time. (s CG 23(5)).

> For the purposes of the FIF rules, where any gain is derived in kind and not in money, the amount of the gain shall be equal to the market value of the gain derived in kind, measured as at the time derived. (s CG 14(2)).

High Court and Court of Appeal

[11] Before Simon France J,[4] the Commissioner succeeded on s CG 23(5). While the Judge had "no doubt that what occurred is properly seen as a purchase price reduction",[5] "there was no fresh consideration for the forfeiture" and s CG 23(5) was therefore "directly engaged".[6] Because the 2095 shares were disposed of "for nil consideration", s CG 23(5) deemed that disposal to be at market value.[7]

[12] The Commissioner succeeded again in the Court of Appeal, but on the s CG 14(2) ground.[8] The Court took the view that the Deed of Settlement varied the effect of the Deed of Covenant by permitting Dr Saha to retain half the shares which would otherwise have been forfeited.[9] He thereby obtained a gain, "but it was a gain in kind and not in money".[10] Section CG 14(2) therefore applied.[11]

Section CG 18

[13] As the uncontested evidence in the High Court demonstrated, and as Simon France J found, the forfeiture provisions constituted a purchase price adjustment. The effect of the forfeiture of the 2095 shares was to reduce retrospectively the price which Dr Saha received for the sale to Cap Gemini of his share of the consultancy business, and conversely to reduce the price which Cap Gemini paid. After the shares were forfeited, they no longer had any value to Dr Saha. Whereas the day before forfeiture Dr Saha owned shares with a value of some $600,000, on the day

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4 *Saha v Commissioner of Inland Revenue (No 2)* (2009) 24 NZTC 23,015 (HC).
5 At [48].
6 At [51].
7 Ibid.
8 *Saha v Commissioner of Inland Revenue* [2009] NZCA 76 per Chambers, O'Regan and Arnold JJ.
9 At [30].
10 At [32].
11 At [33].

after forfeiture he did not own the shares and was therefore worse off by that amount. Dr Saha was therefore in materially the same position as a purchaser under an unconditional contract who does not complete and therefore forfeits a deposit, or an owner who loses the value of a fishing boat which is forfeited to the Crown because of breaches of the fisheries legislation.

[14] Applying this analysis to the formula in s CG 18:

(a) Because Dr Saha no longer owned the shares at the end of the income year during which they were forfeited, their value at that time was nil;

(b) Dr Saha derived no gains during the year "with respect to" those shares (his "interest" in a FIF) because their forfeiture resulted in loss to him;

(c) The market value of the shares at the end of the preceding income year was $602,938; and

(d) No expenditure was incurred during the income year in acquiring the shares.

[15] The relevant calculation is therefore (nil plus nil) less ($602,938 plus nil), resulting in a deemed loss to Dr Saha of $602,938. Therefore, if s CG 18 were the only relevant section, the deduction which he claimed would have been correctly claimed and his appeal would succeed.

Section CG 23(5)

[16] But that is not the end of the matter. Section CG 18 is subject to ss CG 23(5) and CG 14(2) and, as noted above,[12] the Commissioner relies on those provisions.

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12 At [10].

[17] Before s CG 23(5) could apply, it would be necessary to establish that the 2095 shares which were forfeited were disposed of for no consideration, or for consideration which was less than their market value at the time of disposition.

[18] It could not possibly be said that, in becoming a party to the Deed of Covenant, Dr Saha was agreeing to dispose of the shares which he was acquiring for no or inadequate consideration. To the contrary, he did agree to dispose progressively of those shares if he left the employment of Cap Gemini's New Zealand subsidiary within five years but, in consideration of that covenant, he was receiving very substantial consideration in the form of the shares in Cap Gemini which were being allocated to him. There is no basis for concluding that Dr Saha would have agreed to sign the Deed of Covenant if the benefits which he was acquiring thereunder were less than the obligations which he was assuming.

[19] Likewise, there is no basis for concluding that the benefits which Dr Saha acquired under the Deed of Settlement were less than any disadvantage which might have resulted to him. More specifically, he acquired the substantial benefit of retaining 2095 shares which prima facie would have been forfeited under the Deed of Covenant upon his leaving the employment of Cap Gemini's New Zealand subsidiary. On the evidence before it, the Court cannot possibly conclude that that benefit, together with the termination payment made by the subsidiary, was inadequate compensation for the forfeiture of the other 2095 shares.

[20] Accordingly, whether the extent of the consideration is assessed by reference to the Deed of Covenant or the Deed of Settlement, or both, it cannot be said that Dr Saha disposed of his interest for no or inadequate consideration. The Commissioner cannot therefore rely on s CG 23(5).

Section CG 14(2)

[21] That leaves s CG 14(2). In order to rely upon this provision, the Commissioner must establish that, as a consequence of the forfeiture, Dr Saha derived a gain "in kind and not in money". If so, the amount of the gain is deemed to be the market value of the gain.

[22] The phraseology "in kind and not in money" implies that any non-monetary benefit is caught by s CG 14(2). More specifically, the additional words "and not in money" make clear that any gain other than the receipt of money comes within s CG 14(2). The provision cannot therefore be construed as applying only to gains in the form of the acquisition of goods or services. Section OB1 defines "gain", for the purposes of the FIF, as including "all forms of gross gain". It is therefore clear that, in quantifying the "gain", there is to be no deduction for any concurrent loss to the taxpayer. It is also significant that the section applies to "any" gain. Indirect as well as direct gains are therefore covered.

[23] As Blanchard J pointed out, when delivering the joint judgment of Richardson P, Gault and Henry JJ and himself in *Wattie v Commissioner of Inland Revenue*,[13] it is necessary when quantifying any profit or gain to ascertain "what is it to be measured against". That measure must in this case be the agreement of Dr Saha and Cap Gemini, embodied in the Deed of Covenant, that if Dr Saha left the employment of Cap Gemini at the time he did he would forfeit 4190 shares, as liquidated damages, without any form of deduction, set-off or counter-claim.

[24] If, when Dr Saha left the employment of Cap Gemini's New Zealand subsidiary, the purchase price adjustment had been effected in full by the forfeiture of all his 4190 shares as prescribed by the Deed of Covenant, Dr Saha would not have derived any gain, in kind or otherwise. Section CG 14(2) would have had no application and Dr Saha would not have been required to bring to tax any part of the value which the shares had to him prior to their forfeiture. The Deed of Settlement did however modify the Deed of Covenant so that Dr Saha, although forfeiting 2095 shares (a partial price adjustment), retained the other 2095 shares. He thus derived a benefit "in kind", namely the retention of 2095 shares which would otherwise have been forfeited. Dr Saha was, as a result of the bargain struck in the Deed of Settlement, better off than he would have been if the Deed of Covenant had been fully enforced against him. That bargain gave him a gain "in kind".

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13 *Wattie v Commissioner of Inland Revenue* (1997) 18 NZTC 13,297 at 13,309.

[25] The amount of the gain is deemed by s CG 14(2) to be the market value of the shares which were retained. It is common ground that the market value of the forfeited shares was $602,938. Because the retained shares were an identical parcel, their market value must have been the same.

Result

[26] The effect of s CG 14(2) is that Dr Saha is deemed to have derived a gain of $602,938 from the forfeiture of the shares. That sum therefore becomes input (b) into the s CG 18 formula. The resultant calculation is (nil plus $602,938) less ($602,938 plus nil), namely nil. It follows that the Commissioner's assessment that Dr Saha was not entitled to claim a deduction of $602,938 was correct, and his appeal must therefore be dismissed.

[27] Dr Saha must pay the Commissioner costs of $15,000 and reasonable disbursements, to be fixed if necessary by the Registrar.

Solicitors:
Quigg Partners, Wellington for Appellant
Crown Law, Wellington for Respondent