

THE EVOLUTION OF THE APPROACH OF THE NEW ZEALAND COURTS TO TAX AVOIDANCE

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I GENERAL ANTI-AVOIDANCE PROVISIONS IN NEW ZEALAND

Although there have been anti-avoidance provisions in New Zealand tax legislation since 1878,¹ they were not seriously invoked by the Commissioner until the 1960s.² At this time, s 108 of the *Land and Income Tax Act 1954* was in force. It provided:

Every contract, agreement, or arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void in so far as, directly or indirectly, it has or purports to have the purpose or effect of in any way altering the incidence of income tax, or relieving any person from his liability to pay income tax.

This language was very similar to that used in s 260 of the *Income Tax and Social Services Contribution Assessment Act 1936–1950* (Cth) of Australia (the Australian Act)³ and the New Zealand courts (including the Privy Council) saw the two sections as having the same meaning. This meant that the Privy Council decision in *Newton v Federal Commissioner of Taxation*,⁴ a case concerned with s 260, was applicable to s 108.⁵

In response to judicial criticism,⁶ s 108 was amended in 1974 and, as amended, was re-enacted as s 99 of the *Income Tax Act 1976* (NZ). The 1976 Act was replaced by the *Income Tax Act 1994*, which in turn was replaced by the *Income Tax Act 2007*. In that Act, s BG 1 is the general anti-avoidance provision. I am going to say a little about the background to s 99 of the 1976 Act and, in doing so, will discuss briefly the principal respects in which it differed from s 108 of the 1954 Act. One of these which I should mention now is that the 1974 amendment, and thus s 99 of the 1976 Act, provided for a power of reconstruction, the absence of which had earlier sometimes resulted in tax-avoiding taxpayers succeeding against the Commissioner. Generally, however, I do not propose to devote attention to the shifts in language between the original s 108 and the current s BG 1. When discussing cases

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¹ The legislative history is explained in *Mangin v Commissioner of Inland Revenue* [1971] NZLR 591 at 594–5 (PC).

² The only earlier case is *Timaru Herald Co Ltd v Commissioner of Taxes* [1938] NZLR 978 (CA), where the Commissioner lost in the Court of Appeal on (among other things) an argument as to the application of s 170 of the *Land and Income Tax Act 1923*.

³ The shared legislative history of the two provisions is set out in *Mangin*, above n 1, at 594–5 and 598.

⁴ *Newton v Federal Commissioner of Taxation* [1958] AC 450 (PC).

⁵ See Part IV below, text near footnote 23.

⁶ See, for instance, the dissenting judgment of Lord Wilberforce quoted in Part V.

I will identify the particular provision⁷ in issue, and when addressing the sections more generally, I will refer to them collectively as the GAAR (general anti-avoidance rule).

II AN OVERVIEW

In a number of the early cases, the difficulty of giving practical and principled effect to the GAAR in the context of the tax system as a whole encouraged counsel to advance arguments which, if accepted, would have deprived the GAAR of substantial effect. It was thus argued that:

- (a) It caught only transactions which were shams (the 'applicable only to shams argument').
- (b) It applied only between the parties to transactions, had no fiscal effect and, therefore, could not be relied on by the Commissioner (the 'no fiscal effect argument').
- (c) It affected only tax liabilities which had accrued at the time of the arrangement (the 'accrued liabilities only argument').

The rejection of these arguments meant that the courts were required to address directly the potential tension between the GAAR and the provision or provisions relied on by the taxpayer.

The scope for tension was substantially reduced by the exclusion for ordinary business or family dealings adopted in *Newton*.⁸ This exclusion meant that the GAAR would not apply to situations where tax consequences are the inevitable consequence of a straight-forward 'ordinary' transaction, such as, for instance, the 'clean' transfer of an income producing asset from one person to another. On this basis, many, and perhaps most, of the hypothetical examples often postulated to establish the impracticality of a GAAR can be brushed aside. The ordinary business or family dealing exclusion thus operated as a sensible filter on the operation of the GAAR. But in relation to cases not filtered out, it did not provide a comprehensive or principled mechanism for determining whether the GAAR should prevail over the tax provision relied on by the taxpayer. In such a case, there thus remained scope for tension between the GAAR and the tax provision relied on by the taxpayer.

If the resolution of this tension were approached as involving orthodox statutory interpretation principles, the answer might be thought to depend on one, other or both of:

- (a) application of the *maxim generalia specialibus non derogant*⁹ as between the GAAR and the tax provision relied on; or
- (b) scheme and purpose analysis as to whether the GAAR or that provision prevailed.

Neither approach, however, provides a sure route to a principled and predictable outcome. When tax avoidance is in issue, the question whether the GAAR or other provision should prevail is always particular to the facts of the case at hand and, at least to my way of thinking, thus involves application as much as interpretation. In such cases it is almost always open to

⁷ Albeit slightly loosely. I will refer to s 108 of the 1954 Act, s 99 of the 1976 Act (which I will treat as encompassing s 108 as amended in 1974) and s BG1 of the 2007 Act (which I will treat as encompassing the equivalent provisions in the 1994 Act).

⁸ *Newton*, above n 4.

⁹ 'General things do not derogate from specific things': Bryan A Garner (ed) *Black's Law Dictionary* (9th ed, St Paul (MN), 2009) at 752.

question whether it is the GAAR or other tax provision which is the particular provision (and which, in accordance with the maxim, should prevail). As well, with the rejection of these two arguments, the basic premise of the GAAR is that it applies to avoid tax arrangements which, but for the invocation of the GAAR, would be effective. On this basis, an arrangement which is voidable under the GAAR is in a twilight zone; sufficiently within the scheme and purpose of the provision relied on by the taxpayer to be valid unless the GAAR is invoked; but insufficiently so to withstand the application of the GAAR. In such a twilight zone, orthodox scheme and purpose interpretative analysis provides little illumination.

There is scope for debate as to the analysis just offered. The minority judgment in *Ben Nevis Forestry Venture Ltd v Commissioner of Inland Revenue* proceeds on the basis that 'specific statutory allowances under the Income Tax Act are not in potential conflict with the general anti-avoidance provision' and that there is thus no need for 'reconciliation'.¹⁰ That approach appears to be inconsistent with the twilight zone I have postulated. I set out later in the paper the key passages from that judgment.¹¹ For present purposes, it is sufficient for me to say that I think that my analysis, right or wrong as it may be in terms of principle, is consistent with the drift of the cases, including, significantly, the most recent New Zealand Supreme Court judgments.

Another way of attempting to resolve, or at least mitigate, the tension between the GAAR and other tax provisions is to restrictively interpret the former; that is by limiting it in respects which go beyond the ordinary business or family dealing exclusion. I see this line of approach as exemplified:

- (a) reasonably well, in the cases which suggest that tax avoidance involves the non-incurring of the economic consequences which the legislature envisaged as the correlative of the tax benefit claimed; but
- (b) not so well, in the view that tax avoidance involves the 'crossing of a line' or other very generalised concepts.

A further approach is to see the mischief of tax avoidance as the use of general or particular features of the tax regime to obtain tax advantages of a kind not intended to be conferred by the legislature and to apply the GAAR accordingly. This is the 'parliamentary contemplation' test which the New Zealand Supreme Court has adopted. Where the taxpayer has not incurred the economic consequences envisaged by the legislature as the correlative of the tax benefit claimed, the scheme will fail the parliamentary contemplation test. The parliamentary contemplation test can thus be seen as being largely a generalised reformulation of approach (a) above.

The parliamentary contemplation test has some advantages. As just mentioned, it addresses directly what most see as objectionable with tax avoidance. It enables tax outcomes closely tailored to the facts of the cases at hand. It is consistent with the view that the legislative purpose of the GAAR is to fill in gaps which the legislature may have inadvertently created. As well, and assuming my twilight zone analysis is correct, it also avoids the use of inapt principles of statutory interpretation to resolve a sui generis problem which involves both interpretation and application.

¹⁰ *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289, at [2].

¹¹ See final paragraphs in Part XI and, for the minority, final paragraphs in Part XIII.

Orthodox statutory interpretation is concerned with meaning.¹² Although meaning may be determined by reference to legislative purpose,¹³ such purpose is conventionally addressed largely objectively. When interpreting a statute a judge does not inquire as to what the legislature might have enacted if the facts of the case at hand were before it – an exercise which, as I will show, has from time to time been carried out in tax avoidance cases. The parliamentary contemplation test thus looks unorthodox. As well, the bespoke outcomes it produces can be viewed as contrary to the principle that laws should be of general application.

In this paper I discuss the background to the adoption by the Supreme Court of the parliamentary contemplation test. In doing so, I will pick up on some of the ideas just touched on. As well, I will give two examples of the application of the test, one by the High Court and the other by the Court of Appeal.

III MY STARTING POINT – *NEWTON V FEDERAL COMMISSIONER TAXATION*

From the early years of the last century, Australian revenue authorities (Federal and state) relied on anti-avoidance provisions and this gave rise to a number of reported decisions. In contrast, in New Zealand, the GAAR was not seriously invoked by the Commissioner until the 1960s. By this stage, the Privy Council had decided *Newton v Federal Commissioner of Taxation*.¹⁴ So when the New Zealand courts came to grapple with s 108, *Newton* was very much their starting point.

As has been mentioned, *Newton* concerned s 260 of the Australian Act.¹⁵ The companies involved in the scheme had substantial undistributed profits. If not distributed by year end, the companies would have been taxed on them (at 15 shillings in the pound). If those profits were distributed as dividends, the shareholders would have been taxed at the same rate. The purpose of the scheme was to permit the bulk of those funds to be retained by the companies pursuant to recapitalisations carried out in a way which attracted comparatively little tax. The Privy Council decision dismissed the applicable only to shams, no fiscal effects and accrued liabilities only arguments.

Lord Denning explained the operation of s 260 in this way:¹⁶

In order to bring the arrangement within the section you must be able to predicate – by looking at the overt acts by which it was implemented – that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section. Thus, no one, by looking at a transfer of shares cum dividend, can predicate that the transfer was made to avoid tax. Nor can anyone, by seeing a private company turned into a non-private company, predicate that it was done to

¹² See s 5 of the *Interpretation Act 1999* (NZ).

¹³ Section 5(1).

¹⁴ *Newton*, above n 4.

¹⁵ *Income Tax and Social Services Contribution Assessment Act 1936–1950* (Cth).

¹⁶ At 8.

avoid [the relevant] tax: see *W. P. Keighery Pty. Ltd. v Commissioner of Taxation*

...

Lord Denning seems to have approached s 260 on the basis that, with the exclusion in relation to ordinary business and family dealings, there was no unacceptable tension with the rest of the Act and, in particular, that s 260, once engaged, would prevail over whatever other tax provisions the taxpayer might rely on. If this is so, his reference to, and approval of, *WP Keighery Pty Ltd v Federal Commissioner of Taxation*¹⁷ introduced a distinctly discordant element. His brief description of the arrangement in *Keighery* ('a private company [being] turned into a non-private company') did not do justice to the detail of an arrangement which was plainly predicated substantially, and perhaps solely, on the avoidance of tax. *Keighery* stands for the choice principle much relied on by taxpayers¹⁸ and the Privy Council's apparent endorsement of *Keighery* in *Newton* created problems not resolved in New Zealand until *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* and *Penny and Hooper v Commissioner of Inland Revenue*.¹⁹

IV *ELMIGER v COMMISSIONER OF INLAND REVENUE*

When s 108 was first relied on by the Commissioner, a narrow approach was favoured.²⁰ In 1966 there was, however, a distinct change in course with the judgment of Woodhouse J at first instance in *Elmiger v Commissioner of Inland Revenue*.²¹

Elmiger concerned the tax affairs of a partnership involved in earthmoving. The partners transferred earth moving machinery to a trust which they controlled but which, while it operated, was for the benefit of their wives and children. The trust was to terminate after some five and a half years and its assets were to revert to the partners unless they otherwise directed. As first struck, the trust gobbled up entirely what would otherwise have been the annual profit of the partnership. This resulted in the partners in their dual capacity as partners and trustees reducing the rent; but, even so, it still represented approximately half of what would otherwise have been the profit of the partnership. For practical purposes the money generated by the business activities of the partnership was subject to the control of the partners and dealt with as they wished.

Woodhouse J made short work of the argument that the differences between s 260 of the Australian Act and s 108 of the 1954 Act were material.²² So he concluded that *Newton* was controlling. He rejected the argument that s 108 was applicable to shams only, no fiscal effect and accrued liabilities only arguments.²³ He also concluded that s 108 could be invoked so as to disallow a deduction which, but for s 108, would have been allowed under s 111, the general

¹⁷ *WP Keighery Pty Ltd v Federal Commissioner of Taxation* (1957) 100 CLR 66.

¹⁸ In *Keighery* Dixon CJ, Kitto and Taylor JJ observed at 92: 'Whatever difficulties there may be in interpreting s. 260, one thing at least is clear: the section intends only to protect the general provisions of the Act from frustration, and not to deny to taxpayers any right of choice between alternatives which the Act itself lays open to them.'

¹⁹ *Ben Nevis*, above n 10; and *Penny and Hooper v Commissioner of Inland Revenue* [2011] NZSC 95, [2012] 1 NZLR 433. See Part IX below.

²⁰ *Lewis v Commissioner of Inland Revenue* [1965] NZLR 634 (SC).

²¹ *Elmiger v Commissioner of Inland Revenue* [1966] NZLR 683 (SC) [*Elmiger* (SC)].

²² At 689.

²³ At 689-92.

deductibility provision, of the 1954 Act.²⁴ In doing so, he was not moved by the indication given by Dixon CJ in *Cecil Bros Pty Ltd v Federal Commissioner of Taxation*²⁵ that s 260 could not be relied on to disallow a deduction otherwise permitted. As to this he noted:²⁶

In any event it is my opinion that s. 108 is part of the law to be applied and must be given its appropriate place in the statute ... I can see no reason why s. 111 should act in such a way as to override the effect of s. 108, and with all respect, I think this last section will operate to exclude a deduction if this arises as the result of an arrangement of the type struck at by s. 108.

More generally he observed:

The section is not designed to prevent ordinary commercial, or family, or charitable dispositions. Nevertheless this is a general provision aimed at otherwise legal methods of tax avoidance. It is designed, as I stated earlier, to forestall the use by individual taxpayers of ordinary legal processes for the deliberate purpose of obtaining a relief from the natural burden of taxation denied generally to the same class of taxpayer. Accordingly it is my opinion that family or business dealings will be caught by s. 108 despite their characterisation as such, if there is associated with them the additional purpose or effect of tax relief (in the sense contemplated by the section) pursued as a goal in itself and not arising as a natural incident of some other purpose.

This judgment was upheld by the Court of Appeal.²⁷ For the purposes of this paper it is sufficient to say that in dismissing the appeal the Court of Appeal largely adopted the approach taken by Woodhouse J.

The *Elmiger* approach gave practical effect to s 108. However, it did so primarily on the basis of *Newton*, effectively along the lines that providing a sensible and practical approach was taken to what amounted to tax avoidance – that is, what was truly within the scope of s 108 – any priority issue as between s 108 and other provisions resolved itself (in favour of s 108). Woodhouse J's explanation as to why s 108 prevailed over s 111 is limited and, as expressed, rather conclusory, albeit that it was based on Australian authorities to which he had earlier referred.

In the years that followed *Elmiger*, s 108 was often in issue in the courts. Taxpayers on occasion succeeded because of the absence of a power of reconstruction but in most cases the courts struck down the challenged transactions.²⁸ Save in cases which turned on the absence of a reconstruction power, application of the *Elmiger* approach was largely unproblematic (albeit that there was, on occasion, a diversity of judicial opinion as to outcome). For the purposes of my paper, these cases are of limited significance and the next important decision is that of the Privy Council in *Mangin v Commissioner of Inland Revenue*,²⁹ to which I now turn.

²⁴ At 692–3.

²⁵ *Cecil Bros Pty Ltd v Federal Commissioner of Taxation* (1964) 111 CLR 430 at 438.

²⁶ *Elmiger* (SC), above n 21, at 693.

²⁷ *Elmiger v Commissioner of Inland Revenue* [1967] NZLR 161 (CA).

²⁸ The cases are reviewed in detail in the judgment of Richardson J in *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (CA) [*Challenge* (CA)] at 546–7.

²⁹ *Mangin*, above n 1.

V MANGIN V COMMISSIONER OF INLAND REVENUE

Mangin involved a 'paddock trust', an income-splitting device reasonably similar to that adopted in *Elmiger*. Once again the 'no fiscal effect' and 'accrued liabilities only' arguments were rejected,³⁰ as was the taxpayer's appeal. The case, however, was far from an unqualified victory for the Commissioner as is apparent from the following passage from the judgment of the majority:³¹

In their Lordships' view [Lord Denning's discussion of predication in *Newton*], properly interpreted, does not mean that every transaction having as one of its ingredients some tax saving feature thereby becomes caught by a section such as s 108. If a bona fide business transaction can be carried through in two ways, one involving less liability to tax than the other, their Lordships do not think s 108 can properly be invoked to declare the transaction wholly or partly void merely because the way involving less tax is chosen. Indeed, in the case of a company, it may be the duty of the directors vis-à-vis their shareholders so to act. ... The clue to Lord Denning's meaning lies in the words 'without necessarily being labelled as a means to avoid tax' ... Their Lordships think that what this phrase refers to is, to adopt the language of Turner J in the present case 'a scheme... devised for the sole purpose, or at least the principal purpose, of bringing it about that this taxpayer should escape liability on tax for a substantial part of the income which, without it, he would have derived.'

This suggests that a taxpayer may elect the most tax-effective way of implementing a bona fide transaction, with the GAAR inapplicable unless the sole or principal purpose was tax avoidance (in which case, it would presumably not be a bona fide transaction). This was a substantially watered down version of the predication test from that adopted in *Elmiger* (which applied if there was an 'additional purpose' of tax avoidance 'pursued as a goal in itself')³² and thus left considerable scope for the operation of the choice principle.

Also significant for the purposes of my paper is the dissenting judgment of Lord Wilberforce. He identified four unsatisfactory features of s 108:³³

(a) It fails to define the nature of the liability to tax, avoidance of which is attacked. Is this an accrued liability, a future but probable liability, or a future hypothetical liability? Is it one which must have arisen but for the arrangement, or which might have arisen but for the arrangement, and if 'might', probably might or ordinarily might or conceivably might?

(b) It fails to specify any circumstances in which arrangements etc which in fact have fiscal consequence may be outside the section, and, if such exist, to specify on whom the onus lies, and to the satisfaction of whom, to establish the existence of such circumstances. The taxpayer is left to work his way through a jungle of words, 'purpose', 'or', 'effect', 'purported purpose', 'purported effect' which existing decisions have glossed but only dimly illuminated.

(c) It fails to specify the relation between the section and other provisions in the Income Tax legislation under which tax reliefs, or exemptions, may be

³⁰ At 594–6.

³¹ At 598.

³² See Woodhouse J's more general observations in Part IV above, in quotation immediately before footnote 28.

³³ *Mangin*, above n 1, at 602.

obtained. Is it legitimate to take advantage of these so as to avoid or reduce tax? What if the only purpose is to use them? Is there a distinction between 'proper' tax avoidance and 'improper' tax avoidance? By what sense is this distinction to be perceived?

(d) It gives rise to a number of extremely difficult problems as to what hypothetical state of affairs is to be assumed to exist after the section has annihilated the tax avoidance element in the arrangement

He then went on:³⁴

In Australia and New Zealand the Courts have endeavoured to remedy some of the statutory deficiencies. In *Newton v Commissioner of Taxation* ..., this Board gave some fresh life to the Australian section by instancing transactions 'capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax', a suggestion profitably generalised by Kitto J in the words 'capable of explanation by reference to ordinary dealing such as business or family dealing ...' (*Hancock v Commissioner of Taxation* (1961) 108 CLR 258, 283) but it could hardly be claimed that these are indications of precision. They have in turn been 'interpreted' in the majority decision in this case. But one difficulty leads to another, and the Courts are now having to decide how 'ordinary' a transaction must be to escape. In the present case, the Judges have, not surprisingly, reached differing conclusions: Wilson J thought the transactions were ordinary: the Court of Appeal found that they were extraordinary.

...

It is because I believe that the limits of judicial interpretation, however liberal or common sense the process may be claimed to be, are passed when one comes to attempt to apply the New Zealand section to this present case that I cannot agree with the Board's decision. I think that we have here a rusty instrument which breaks in our hands and is no longer capable of repair.

I have set out in full the problems identified by Lord Wilberforce even though his (a) was addressed in part to the accrued liabilities only argument and his (d) to the absence of a reconstructive power argument. These problems were addressed (although as to (a) perhaps only in part) by the 1974 amendments to s 108 and thus in s 99 of the 1976 Act, to which I am about to turn. Points (b) and (c) were not, however addressed by the legislature in 1974 and remain unaddressed to this day.

VI THE LEGISLATURE RESPONDS

Section 108 had been amended in 1968 so as to make it clear that the section had fiscal effect.³⁵ As I have noted, s 108 was amended in 1974³⁶ and the amended provision was

³⁴ At 602.

³⁵ By inserting after the words 'absolutely void', the words 'as against the Commissioner for income tax purposes': see s 16(1) of the Land and Income Tax Amendment Act (No 2) 1968. In *Mangin*, above n 1, the majority concluded at 595 that this merely confirmed the existing law.

³⁶ By s 9 of the Land and Income Tax Amendment Act (No 2) 1974. The immediate trigger for the amendment appears to have been *Commissioner of Inland Revenue v Gerard* [1974] 2 NZLR 279 (CA) where the Commissioner's case had failed for want of a power of reconstruction.

carried through into the 1976 Act as s 99. The revised section conferred on the Commissioner a power of reconstruction.³⁷ It also made it clear that it was applicable in respect of arrangements affecting 'potential or prospective liability in respect of future income'.³⁸ And finally, there was a response to the majority's judgment in *Mangin*, in that the amended section declared that it applied to an arrangement if:³⁹

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

(b) *Where it has 2 or more purposes or effects, one of its purposes or effects (not being a merely incidental effect) is tax avoidance, whether or not any other or others of its purposes or effects relate to, or are referable to, ordinary business or family dealings ...*

It is sometimes said that this represented an abrogation of the predication test.⁴⁰ I have distinct reservations whether this is so. In *Newton*, Lord Denning acknowledged that the avoidance of tax was not the sole purpose of the arrangements in the cases at hand. But he then went on to say:⁴¹

But nevertheless the section can still work if one of the purposes or effects was to avoid liability for tax. The section distinctly says 'so far as it has' the purpose or effect. This seems to their Lordships to import that it need not be the sole purpose.

This is consistent with the approach adopted in *Elmiger* but not with the sole or principal purpose view advanced in *Mangin*. I therefore prefer to see this amendment as a repudiation of this aspect of the *Mangin* judgment.

Although the 1974 amendment and thus s 99 of the 1976 Act did not address points (b) and (c) as identified by Lord Wilberforce, they made it clear that the legislature expected the GAAR to be an effective part of the tax system.

VII *EUROPA OIL (NZ) LTD v COMMISSIONER OF INLAND REVENUE*

The argument that s 108 could not prevail against s 111 (the general deductibility provision) was adopted by the Privy Council in *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue*.⁴² In issue was the deductibility of the full cost to the taxpayer of acquiring its stock-in-trade. The payments for which deductibility was sought enabled the taxpayer to derive not just the stock but also benefits of a non-taxable nature which mitigated the economic burden of the cost of the stock purchases. The taxpayer was successful in the Privy Council for reasons which included priority being accorded to s 111 over s 108:⁴³

Their Lordships' finding that the monies paid by the taxpayer company ... is deductible under s 111 as being the actual price paid by the taxpayer company for its stock-in-trade under contracts for the sale of goods entered into with Europa

³⁷ Section 9(2).

³⁸ Section 99(1), definition of 'liability'.

³⁹ Section 99(2).

⁴⁰ See for instance *Ben Nevis*, above n 10, at [81] per Tipping, McGrath and Gault JJ.

⁴¹ *Newton*, above n 4, at 10 (emphasis original).

⁴² *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue* [1976] 1 NZLR 546 (PC).

⁴³ At 556 per Lord Diplock for the majority.

Refining ... is incompatible with those contracts being liable to avoidance under s 108. In respect of these contracts the case is on all fours with *Cecil Bros Pty Ltd v Federal Commissioner of Taxation* (1964) 111 CLR 430 in which it was said by the High Court of Australia 'it is not for the Court or the commissioner to say how much a taxpayer ought to spend in obtaining his income' (ibid p 434).

This limited view of the GAAR was inconsistent with that adopted in *Elmiger* albeit that this was not adverted to in the judgment. This surprisingly casual approach to over-ruling earlier authority was soon to be repeated, only this time in relation to this passage in *Europa*; this occurring in the next case I wish to discuss, *Challenge Corporation Ltd v Commissioner of Inland Revenue*.⁴⁴

VIII CHALLENGE CORPORATION LTD V COMMISSIONER OF INLAND REVENUE

This involved a scheme under which the taxpayer acquired from Merbank (a failed financier) a company (Perth) with tax losses and claimed under s 191 of the 1976 Act to offset those losses against the income of profitable subsidiaries. That section contained a specific but limited anti-avoidance subsection (s 191(1)(c)(i)) in relation to arrangements of a temporary nature. This subsection was not engaged and the conditions for grouping specified in s 191 (which were required to be satisfied on the last day of the income year) were all satisfied. The effect of the arrangement, entered into near the end of the income year, was to allow Challenge to take advantage of tax losses previously incurred by Perth, that is, at a time when it had no association with Challenge. Section 191 did not make earlier association a pre-condition to grouping.

It was clear that the whole purpose of the transaction was to obtain a tax advantage. The same, however, was true of any arrangement involving the grouping of tax losses, including those well within the spirit, as well as the letter, of s 191. The predication approach thus did not provide a mechanism for distinguishing between objectionable and unobjectionable grouping arrangements.

The Commissioner was unsuccessful at first instance⁴⁵ and in the Court of Appeal.⁴⁶ That Court comprised Woodhouse P, and Cooke and Richardson JJ. For the purposes of this paper, I propose to focus on the approaches adopted by Woodhouse P and Richardson J. Cooke J agreed in the result and largely with the reasons of Richardson J.

Woodhouse P noted the criticisms of s 108 advanced by Lord Wilberforce in *Mangin* and then went on:⁴⁷

But the *Mangin* case was heard and disposed of by the Board in 1970, about four years before Parliament took legislative steps to meet at least some of the judicial criticisms of s 108. And I think there can be no doubt that when the provision was amplified and given its present statutory form by Parliament in 1974 the deliberate decision was then taken that, because the problem of definition in this elusive field could not be met by expressly spelling out a series of detailed specifications in the statute itself, the interstices must be left for attention by the

⁴⁴ *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (PC) [*Challenge* (PC)].

⁴⁵ *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (HC).

⁴⁶ *Challenge* (CA), above n 28.

⁴⁷ At 534.

Judges. ... It can be said, I think, ... that inherent in the approach taken by Parliament is an assurance that some expressed judicial misgivings as to the proper role of the Court concerning the earlier legislation have been misplaced. Most certainly it was open to Parliament to take this approach and I do not accept the view that any of the supposed problems of construing s 99 should persuade the Courts that they cannot be resolved by judicial interpretation and so must be left for yet further legislative attention.

He roundly rejected the choice principle⁴⁸ and then went on to consider whether s 191 should prevail over s 99:⁴⁹

For a number of reasons I am unable to accept these arguments. First, it would be quite extraordinary, ... for the draftsman to carefully prevent a tax advantage because the shareholding was 'of a temporary nature' and yet consciously decide that Parliament would wish to give its blessing (and then only by implication) to a manufactured and barely tangible association of the kind under review. ... I think it far more likely that after drawing express attention to the obvious tax avoidance implications that could arise from shareholdings 'of a temporary nature' he decided that all other tax avoidance situations should properly be left for attention by s 99. It may even be that these other matters were not in mind or the subject of any deliberate decision ...

This leads to the second point. Paragraph (c)(i) could be construed as filling the avoidance field in so far as s 191 is concerned only on the basis that the much wider provisions of s 99 were excluded by an implication. I do not think such an important gloss can be read into the paragraph and against the plain language of s 99 recognised by counsel ... as 'a central pillar of the income tax legislation'.

Finally it needs to be remembered when construing s 99 beside s 191 that s 191 does not open with such words as 'Notwithstanding the provisions of s 99 ...'. If Parliament had intended that s 191 should stand quite independently of and unaffected by the earlier section it would have been a simple matter to say so in express terms.

...

For the foregoing reasons I think that s 99 is of general application, that s 191 is subordinate to it, and that it is intended to operate as a kind of proviso to other provisions of the Act wherever the issue of tax avoidance may seem to have relevance. Accordingly I am of the opinion that the appeal should be allowed and the assessment of the Commissioner reinstated.

In part, Woodhouse P was applying the *generalia specialibus* maxim in favour of s 99. What he did not spell out, however, is why, if s 99 was 'a kind of proviso' to s 191, it would not invalidate every grouping arrangement, including those within the spirit of s 191. With what is no doubt the benefit of hindsight, I am inclined to see in the italicised passages a possible explanation in terms of what are at least hints of an embryonic parliamentary contemplation test.

⁴⁸ At 538–539.

⁴⁹ At 539 (emphasis added).

Richardson J was distinctly more sympathetic to the choice principle than Woodhouse P. He expressed his general interpretative approach in this way:⁵⁰

Section 99 ... lives in an uneasy compromise with other specific provisions of the income tax legislation. In the end the legal answer must turn on an overall assessment of the respective roles of the particular provision and s 99 under the statute and of the relation between them. That is a matter of statutory construction and the twin pillars on which the approach to statutes mandated by s 5(j) of the Acts Interpretation Act 1924 rests are the scheme of the legislation and the relevant objectives of the legislation. ...

Certainly the scheme and purpose approach to statutory analysis will not furnish an automatic easy answer to these interpretation problems. Tax legislation reflects historical compromises and it bears the hands of many draftsmen in the numerous amendments made over the years. It is obviously fallacious to assume that revenue legislation has a totally coherent scheme, that it follows a completely consistent pattern, and that all its objectives are readily discernible. There is force in the thesis that in many respects the tax base is so inconsistent and contains so many structural inequities that a single general anti-avoidance provision such as s 99 cannot be expected to provide an effective measure by which to weigh the exercise of tax preferences.... Nevertheless, that emphasis on trying to discern the scheme and purpose of the legislation is likely to provide the legal answer to the relation between s 99 and other provisions of the Act that best reflects the intention of Parliament as expressed in the statute.

He applied this approach in this way:⁵¹

Section 191 is a complex provision which has been changed, developed and refined by legislative amendment over a number of years. Basic to its operation is the establishment of common shareholdings, voting power or entitlement to profits (and, in the course of full grouping, of an identical pattern of shareholding) at particular times. The only requirement in that regard applying ... [at] the material time was that the test be satisfied on a particular day — at the end of the income year. ... A specific anti-avoidance provision, obviously drafted with the language of the old s 108 in mind, was directed and confined to temporary changes of shareholding for the purpose or effect of altering the incidence of income tax or relieving any company from its liability to pay income tax by excluding any company from or including it in any group of companies in relation to that income year.

The nature of s 191 and these features of the scheme of the section at the material time do not ... leave any room for the application of s 99 to these straightforward arrangements which did no more than bring the loss companies within a new group so as to satisfy all the requirements of s 191. It is no answer to say that the purpose of the arrangement was to save tax for that is the purpose of every offset of a loss in one company against a profit in another, which is the only reason for the presence of s 191 in the statute ...

On this analysis of the role of s 191 in the statutory scheme and of the terms of the provision itself I am satisfied that to treat the arrangements carried through in this

⁵⁰ At 549. The 1924 Act referred to in this passage preceded, and was repealed by, the *Interpretation Act 1999*, referred to in Part II above, text near footnotes 13 and 14.

⁵¹ At 555 (emphasis added).

case as tax avoidance within s 99(1) would defeat, not promote the legislative purposes involved. The tax changes achieved in the transactions did not alter the incidence of income tax which the Act itself contemplated or affect Challenge's liability for income tax in the sense indicated by the statute.

Richardson J addressed priority as between ss 99 and 191 in general terms – that is in terms of whether s 99 or s 191 should prevail where the predication test is satisfied. Since (a) the predication test is always satisfied where tax losses are grouped and (b) the legislature nonetheless intended that tax losses could be grouped, the predication test was not, in itself, an answer to the taxpayer's argument. So I agree with Richardson J that the case was not susceptible to resolution on the basis that s 99 always trumped s 191. Where I differ from him – and again with the benefit of hindsight – is that I do not regard the case as turning on a general issue priority (or subordination) as between ss 99 and 191. Instead I see it as turning on whether, *on the facts of the case at hand*, s 99 or s 191 prevailed – a sui generis issue of both interpretation and application and not susceptible to sensible resolution simply on the basis of a straight-forward 'scheme and purpose' legislative analysis as to general priority between the two sections.

The Privy Council allowed the Commissioner's appeal in a majority judgment delivered by Lord Templeman.⁵² This was expressed in terms distinctly unsympathetic to taxpayers. Lord Templeman summarily rejected the contention that s 99 could not apply if s 191 was satisfied.⁵³

Tax avoidance schemes largely depend on the exploitation of one or more exemptions or reliefs or provisions or principles of tax legislation. Section 99 would be useless if a mechanical and meticulous compliance with some other section of the Act were sufficient to oust s 99.

The position advanced in *Cecil Bros* and adopted by the Privy Council in *Europa* was thus rejected; albeit with an absence of reference to the conflicting authorities corresponding to the failure of the Privy Council in *Europa* to refer to *Elmiger*.

Lord Templeman likewise rejected the contention that s 191(1)(c)(i) excluded the operation of s 99. He paraphrased the argument advanced by the taxpayer in deliberately unpersuasive terms:⁵⁴

Parliament must have intended that any permanent form of tax avoidance or any other form of tax avoidance except the particular form prescribed by s 191(1)(c)(i) should be permitted to succeed.

He then, unsurprisingly, rejected the argument:⁵⁵

In the opinion of the Board this argument attributes to Parliament a benevolent attitude towards tax avoidance by companies which is unlikely and unnecessary.

A likely explanation is that Parliament was indifferent to or unmindful of any overlap between the general provisions of s 99 and the particular provisions of s 191(1)(c)(i) or that, in view of the well-known difficulties encountered in the formulation and enforcement of effective anti-tax avoidance provisions,

⁵² *Challenge* (PC), above n 44.

⁵³ At 559.

⁵⁴ At 559.

⁵⁵ At 559 (emphasis added).

Parliament thought that an overlap might be useful and could not be harmful. Parliament may have had in mind two different tax avoidance positions. There could be tax avoidance in the introduction into a group of companies of a company which had already made a loss; any tax advantage obtained as a result of that introduction would fall foul of s 99. There could also be tax avoidance in the manipulation of the shareholdings or constitution of a company in order to obtain temporary compliance with the conditions specified by s 191; that manipulation would fall foul of s 191(1)(c)(i). The possibility that such manipulation might also be frustrated by the operation of s 99 does not lead to the conclusion that Parliament must have intended to permit permanent tax avoidance schemes to exploit s 191. The provisions of s 99 are of general application and, in the absence of an express direction by Parliament excluding s 191 from the ambit of s 99, their Lordships consider that s 99 must be applied in the present circumstances.

Lord Templeman also gave some explanation as to why s 99 would not always trump s 191:⁵⁶

It was argued that if this appeal by the Commissioner succeeds a purchase of shares in a company which becomes part of a specified group will always be void under s 99. But a purchase of shares will only be void in so far as it leads to tax avoidance and not tax mitigation.

In an arrangement of tax avoidance the financial position of the taxpayer is unaffected (save for the costs of devising and implementing the arrangement) and by the arrangement the taxpayer seeks to obtain a tax advantage without suffering that reduction in income, loss or expenditure which other taxpayers suffer and which Parliament intended to be suffered by any taxpayer qualifying for a reduction in his liability to tax.

...

Most tax avoidance involves a pretence; see the analysis in *WT Ramsay Ltd v Inland Revenue Commissioners* [1979] 1 WLR 974, 975 (CA). In the present case Challenge and their taxpayer subsidiaries pretend that they suffered a loss when in truth the loss was sustained by Perth and suffered by Merbank.

The judgment is very much along the same lines as the current parliamentary contemplation test. Certain economic effects were seen by the legislature as warranting the benefit in question. If those economic effects had been suffered, s 191 would have prevailed. But Challenge had not suffered those economic effects. It was thus seeking to obtain a tax benefit in circumstances other than those intended by the legislature. Therefore s 99 prevailed, on the facts of the case, against s 191.

This does not look like orthodox scheme and purpose analysis in that it was not concerned with the meaning of s 191, which, in this respect, was plain enough. The premise of the case is that, absent the invocation of s 99, the scheme was effective and s 191 was complied with. The practical effect of the decision was that, with s 99 engaged, the entitlement to group losses was dependent upon the companies concerned having been associated at the time the losses were incurred; this despite such a condition not being specified in s 191.

⁵⁶ At 562 (emphasis added).

IX INCOHERENCE AND INDETERMINACY

In the aftermath of *Challenge*, the *Cecil Bros/Europa* view that the GAAR could not be invoked to disallow a tax consequence created by some other provision of the Act was never revived. But the view of Woodhouse P that the GAAR was a trumping provision was likewise not adopted. The choice principle was still in play but its scope was uncertain. The expression 'line drawing' came into vogue. More generally, the law was characterised by incoherence and indeterminacy.

The position was summarised by Richardson P (writing for himself, Keith and Tipping JJ) in this way in *Commissioner of Inland Revenue v BNZ Investments Ltd*:⁵⁷

[39] For the reasons discussed in the cases ... s 99 as the expanded successor of the old s 108 of the Land and Income Tax Act 1954 is perceived legislatively as an essential pillar of the tax system designed to protect the tax base and the general body of taxpayers from what are considered to be unacceptable tax avoidance devices. By contrast with specific anti-avoidance provisions which are directed to particular defined situations, the legislature through s 99 has raised a general anti-avoidance yardstick by which the line between legitimate tax planning and improper tax avoidance is to be drawn.

[40] Line drawing and the setting of limits recognise the reality that commerce is legitimately carried out through a range of entities and in a variety of ways; that tax is an important and proper factor in business decision making and family property planning; that something more than the existence of a tax benefit in one hypothetical situation compared with another is required to justify attributing a greater tax liability; that what should reasonably be struck at are artifices and other arrangements which have tax induced features outside the range of acceptable practice – as Lord Templeman put it ... most tax avoidance involves a pretence; and that certainty and predictability are important but not absolute values.

[41] The function of s 99 is to protect the liability for income tax established under other provisions of the legislation. The fundamental difficulty lies in the balancing of different and conflicting objectives. Clearly the legislature could not have intended that s 99 should override all other provisions of the Act so as to deprive the taxpaying community of structural choices, economic incentives, exemptions and allowances provided by the Act itself. Equally the general anti-avoidance provision cannot be subordinated to all the specific provisions of the tax legislation. It, too, is specific in the sense of being specifically directed against tax avoidance; and it is inherent in the section that, but for its provisions, the impugned arrangements would meet all the specific requirements of the income tax legislation. The general anti-avoidance section thus represents an uneasy compromise in the income tax legislation.

[42] Line drawing represents the legislature's balancing of the relevant public interest considerations. ...

At times a conservative approach to the GAAR was proposed or applied. Thus in *Commissioner of Inland Revenue v Auckland Harbour Board*⁵⁸ Lord Hoffmann referred, in

⁵⁷ *Commissioner of Inland Revenue v BNZ Investments Ltd* [2002] 1 NZLR 450 (CA).

⁵⁸ *Commissioner of Inland Revenue v Auckland Harbour Board* [2001] UKPC 1, [2001] 3 NZLR 289.

passing, to s 99 as a 'long stop for The Revenue'.⁵⁹ And although the long-stop view was not expressly referred to in the later Privy Council decision, *Peterson v Commissioner of Inland Revenue*,⁶⁰ it might be thought to be consistent with the result. The case concerned non-recourse loan financing of film investments. The non-recourse loan was referred to in the judgment as '\$y' whereas as the money directly paid by the investors for production costs was referred to as '\$x'. Ostensibly each investor had paid a total of \$x+y for production costs.

There was, as one might expect, circularity in relation to the no-recourse loan which did not represent 'real' money.

In allowing an appeal by Peterson from a finding in favour of the Commissioner, the majority observed:

[44] The leverage obtained by use of a non-recourse loan meant that the investors did not sustain an economic loss after the tax deduction is taken into account. Their Lordships suspect that it is this feature of the scheme which has most exercised the Commissioner. But a moment's reflection shows that what Lord Templeman had in mind [in Challenge] was expenditure or loss before any tax advantage is taken into account. ... The fact that the investment was funded by a non-recourse loan did not alter the fact that the investors had suffered the economic burden of paying the full amount of \$x+y. It was not and could not be suggested that either loan was on terms which meant that it was unlikely ever to be repaid. The investors have repaid one of the loans in whole or in part, albeit out of the film receipts; and they incurred a liability to repay the other if the film generated sufficient receipts, as it was hoped it would.

[45] The circular movement of money sometimes conceals the fact there is no underlying activity at all. But each of the payments in the circle must be examined in turn to see whether it discharged a genuine liability of the party making the payment. It does not matter whether external funds were introduced into the circle or whether cheques were handed over and duly honoured. If the money movements did not discharge a genuine liability the introduction of external funds will not save it; if they did, their absence will not affect it. ... On the way in which the Commissioner put his case the relevant payments were those by which the investors received the non-recourse loan and paid it out to the production company. Subsequent payments through the circle of which the investors were unaware and which they could not control or prevent did not alter the fact that they had borrowed \$y and used it towards the discharge of their liability to pay \$x+y to the production company, thereby suffering the loss or incurring the relevant expenditure for which the depreciation allowance is granted.

[46] The \$x+y was ostensibly paid as consideration for the acquisition of the film, and while the Commissioner was at pains to argue that it was never 'truly' paid, it was no part of his case at any stage that it was paid for any other purpose. Before the Board he conceded that it was paid as consideration for the making of the film. Their Lordships consider that this concession, which was inevitable from the way in which the Commissioner has conducted the case throughout, is fatal to his case.

All in all *Peterson* represented a very tolerant approach to tax avoidance. But in the meantime, back in New Zealand, a rather different approach was beginning to develop.

⁵⁹ At [11].

⁶⁰ *Peterson v Commissioner of Inland Revenue* [2005] UKPC 5, [2006] 3 NZLR 433.

X BEN NEVIS FORESTRY VENTURE LTD V COMMISSIONER OF INLAND REVENUE

*Ben Nevis Forestry Venture Ltd v Commissioner of Inland Revenue*⁶¹ concerned the Trinity scheme. This involved a series of related forestry investments associated with a substantial Douglas fir forest which had been planted and was growing in Southland. The taxpayers were members of syndicate which took a licence from a Trinity company over the land in issue and were required to make payments as follows:

- (a) On 21 March 1997, \$1,350 per plantable hectare to establish the forest.
- (b) Also on 21 March 1997, \$1,946 per plantable hectare. The primary purpose of this payment was to acquire the land in 2048 for 50 per cent of its then value.
- (c) Also on 21 March 1997, \$1,000 each, in relation to a lease option.
- (d) \$50 per annum per plantable hectare by way of licence fee.
- (e) On 31 December 2048, \$2,050,518 per plantable hectare as a licence premium.

In return for this, the taxpayers were to receive the net stumpage derived from the sale of the forest and an option to acquire the land for 50 per cent of its then value.

The profitability of the venture depended on whether the net stumpage which the taxpayers should receive on the sale of the forest would cover the costs (including the time value of money) of their investment. In relation to the requirement to pay the licence premium of \$2,050,518 in 2048, the risk of insufficient stumpage was addressed by an associated insurance arrangement under which the taxpayers paid or agreed to pay to an insurer, CSI, per plantable hectare:

- (a) in 1997, \$1,307; and
- (b) by 31 December 2047, \$32,791.

CSI was established in the British Virgin Islands on the instructions of the scheme architects. A draft business plan for CSI noted:

The real benefits of the deal are tax concessions that can be obtained now by the investors and the foundation. One of the conditions required to gain the tax relief is that the insurance must be in place. The actual outcome of the deal in 50 years time is not considered material.

The tax benefits sought by the taxpayers were substantial. For the 1997 year, for each plantable hectare, the taxpayers expended a little under \$5,000 and ostensibly achieved a deduction in excess of \$37,000. For the 1998 income year – and leaving aside silviculture costs – the corresponding figures were \$50 (expenditure) and \$41,000 (deduction).

The case might be thought to have involved accrual issues, albeit that these were not fully ventilated in the main tax litigation, a point which itself has been subject to much later litigation.⁶² The case was thus argued as to black letter compliance with the provisions relied on by the taxpayers and the impact of s BG 1. The taxpayers were generally successful on the technical compliance issues and the case was determined under s BG 1.

⁶¹ *Ben Nevis*, above n 10.

⁶² *Commissioner of Inland Revenue v Redcliffe Forestry Venture Ltd* [2012] NZSC 94, [2013] 1 NZLR 804.

The taxpayers were unsuccessful at first instance⁶³ and appealed to the Court of Appeal.⁶⁴ In the course of delivering the judgment of that Court dismissing the appeal, I expressed an approach which I thought to be then available on the authorities as to inconsistency between the GAAR and the specific provisions relied on by the taxpayers:⁶⁵

[125] Obviously, there is a need to recognise that in some instances the legislature must have intended to encourage particular types of behaviour. Behaviour of that type (being the sort of behaviour which was within the contemplation of the legislature) cannot be within the general avoidance provisions because the overall legislative purpose is that such behaviour should attract the tax consequences provided for by Parliament. Likewise, it may sometimes be obvious that the specific tax rules relied on were not intended to confer the tax benefit in issue. Such a case, however, is likely to be decided simply by construing the relevant specific tax rules so as to accord with the legislative intent and without any need to resort to the general anti-avoidance provisions.

[126] Cases which lie in between the two extremes just identified still raise a question of statutory interpretation but one which, in our view, cannot be addressed solely by reference to the specific tax rules relied on by the taxpayer. The relevant general anti-avoidance provisions are also relevant. ... When construing such specific rules and looking for their scheme and purpose, it is necessary to keep general anti-avoidance provisions steadily in mind. On this basis, it will usually be safe to infer that specific tax rules as to deductibility are premised on the assumption that they should only be invoked in relation to the incurring of real economic consequences of the type contemplated by the legislature when the rules were enacted. Further, it also seems reasonable to assume that deductibility rules are premised on a legislative assumption that they will only be invoked by those who engage in business activities for the purpose of making a profit. Further, schemes which come within the letter of specific tax deductibility rules by means of contrivance or pretence are candidates for avoidance...

As will be apparent, this is very largely founded on Lord Templeman's judgment in *Challenge*, albeit expressed in terms which are reasonably consistent with orthodox interpretation principles. I also expressed a tentative preference for the more direct and simple approach of according the GAAR a primacy over other tax provisions to be 'displaced only when there is a discernible legislative intention that a particular type of transaction' should not be subject to the GAAR.⁶⁶ I considered, however that adoption of that approach was beyond the role of the Court of Appeal, given recent authority, and in particular *Peterson*.⁶⁷

The case went on appeal to the Supreme Court and the appeals were dismissed. The essence of the approach is captured in the following passage from the judgment of Tipping, McGrath and Gault JJ:⁶⁸

[107] When, as here, a case involves reliance by the taxpayer on specific provisions, the first inquiry concerns the application of those provisions. The

⁶³ *Accent Management Ltd v Commissioner of Inland Revenue* (2005) 22 NZTC 19,027 (HC).

⁶⁴ *Accent Management Ltd v Commissioner of Inland Revenue* [2007] NZCA 230 (2007) 23 NZTC 21,323.

⁶⁵ Emphasis in original.

⁶⁶ At [114].

⁶⁷ At [115].

⁶⁸ *Ben Nevis*, above n 10.

taxpayer must satisfy the court that the use made of the specific provision is within its intended scope. If that is shown, a further question arises based on the taxpayer's use of the specific provision viewed in the light of the arrangement as a whole. If, when viewed in that light, it is apparent that the taxpayer has used the specific provision, and thereby altered the incidence of income tax, in a way which cannot have been within the contemplation and purpose of Parliament when it enacted the provision, the arrangement will be a tax avoidance arrangement. ...

[108] ... A classic indicator of a use that is outside Parliamentary contemplation is the structuring of an arrangement so that the taxpayer gains the benefit of the specific provision in an artificial or contrived way. It is not within Parliament's purpose for specific provisions to be used in that manner.

[109] ... The ultimate question is whether the impugned arrangement, viewed in a commercially and economically realistic way, makes use of the specific provision in a manner that is consistent with Parliament's purpose. If that is so, the arrangement will not, by reason of that use, be a tax avoidance arrangement. If the use of the specific provision is beyond Parliamentary contemplation, its use in that way will result in the arrangement being a tax avoidance arrangement.

XI *PENNY AND HOOPER V COMMISSIONER OF INLAND REVENUE*

In *Penny and Hooper v Commissioner of Inland Revenue*⁶⁹ the taxpayers were orthopaedic surgeons who practised through companies. In each case, the company was owned by a family trust or trusts and the taxpayer was the sole director. After the top personal rate of income tax was increased from 33 to 39 per cent in 2000, the companies paid (a) salaries to the taxpayers materially lower than had previously been fixed; and (b) dividends (taxed at 33 per cent or less) to the family trusts which were correspondingly higher.

Being of the view that these arrangements constituted tax avoidance, the Commissioner recalculated the surgeons' incomes by attributing to each what he considered to be a 'commercially realistic salary'. The facts of the case were remarkably similar to those in *Peate v Federal Commissioner of Taxation*,⁷⁰ albeit that, and oddly, the judgment of the High Court of Australia was not referred to until the hearing before the Supreme Court.⁷¹

The taxpayers were unsuccessful in the Supreme Court for the reasons explained by Blanchard J. He set the scene in this way:⁷²

[33] ... The structure both taxpayers adopted when they transferred their businesses (orthopaedic practices) to companies owned by their family trusts was, as a structure, entirely lawful and unremarkable. The adoption of such a familiar trading structure cannot per se be said to involve tax avoidance. It was a choice the taxpayers were entitled to make. Nor is there anything unusual or artificial in a taxpayer then causing the company under his control to employ him on a salaried basis. What is said by the Commissioner to constitute tax avoidance

⁶⁹ *Penny and Hooper*, above n 19.

⁷⁰ *Peate v The Commissioner of Taxation of the Commonwealth of Australia* (1962) 111 CLR 443.

⁷¹ As noted by Blanchard J at [38], the subsequent Privy Council decision (*Peate v Commissioner of Taxation of Commonwealth of Australia* [1967] 1 AC 308 (PC)) was referred to in passing in written submissions.

⁷² References omitted.

is the fixing of the salaries at artificially low levels whereby the incidence of tax at the highest personal rate was avoided. It can hardly be a coincidence that this was done as soon as that personal tax rate was increased to 39 cents in the dollar, and not before that change was made by Parliament. But, again, there was no failure to comply with any express requirement of the Act in the setting of the salaries, since there is none. This is therefore a case in which, compliance in other respects being accepted, it is possible to move straight to s BG 1 and to ask whether the use of the structure which was adopted when the salaries were fixed was beyond parliamentary contemplation and resulted in a tax avoidance arrangement. ...

After referring to and discussing *Peate*, Blanchard J went on:⁷³

[47] Although the New Zealand tax statute and some business practices have changed considerably in the intervening period [since the 1960s], Parliament has deliberately preserved, and in fact enlarged, the New Zealand general anti-avoidance provision which corresponded to s 260 in *Peate*. It continues to have work to do whenever a taxpayer uses specific provisions of the Act and otherwise legitimate structures in a manner which cannot have been within the contemplation of Parliament. The policy underlying the general anti-avoidance provision is to negate any structuring of a taxpayer's affairs whether or not done as a matter of 'ordinary business or family dealings' unless any tax advantage is just an incidental feature. ... Woodhouse P said in *Challenge Corporation Ltd v Commissioner of Inland Revenue* that there must be a weapon able to thwart technically correct but contrived transactions set up as a means of exploiting the Act for tax advantages. That is what the artificially low salary settings did in this case. They reduced each taxpayer's earnings but at the same time enabled the company's earnings (derived only because of the setting of the salary levels) to be made available to him through the family trusts. In reality, the taxpayers suffered no actual loss of income but obtained a reduction in liability to tax as if they had, to adapt Lord Templeman's dictum in *Challenge*.

XII SUBSEQUENT LITIGATION

More recent major tax avoidance cases which did not reach the Supreme Court provide examples of the application of the parliamentary contemplation test.

Two of the cases involved repo deals entered into by BNZ and Westpac. At a preliminary stage of one of the cases, I explained the transactions in issue in this way:⁷⁴

(a) A subsidiary of the BNZ (the BNZ subsidiary) would acquire from a counter-party an equity or trust interest in an overseas entity (the issuer) on the basis that the counter-party would repurchase that interest (at the same price, subject to adjustments) at a specified time (usually five years) with the counter-party's parent company guaranteeing performance. In economic substance, the BNZ subsidiary was thus providing funding to the counter-party. The BNZ subsidiary's initial return was in the form of distributions from the issuer.

(b) The return to the BNZ group and the overall balance of advantage between the bank and the counter-party is a function of the agreed distribution to be made by the issuer to the BNZ subsidiary, the interest rate swap arrangement, the

⁷³ References omitted.

⁷⁴ *BNZ Investments Ltd v Commissioner of Inland Revenue* [2007] NZCA 356, [2008] 1 NZLR 598 at [7].

guarantee procurement fee (the GPF) (at 2.95 per cent of the purchase price) paid by the BNZ subsidiary for procuring the performance guarantee from the parent company of the counter-party, and the bank's borrowing costs.

(c) The BNZ group would deduct its cost of borrowing, the GPF and the net cost of the interest rate swap and treat distributions from the issuer as either: (i) exempt from tax on the basis that the distributions were received by an overseas owned company (as the BNZ subsidiary) from an overseas company (as the issuer would be) under the 'conduit' tax relief rules; or (ii) relieved from tax under the foreign tax credit rules on the basis a foreign tax credit was available for foreign tax paid by an overseas company (being the issuer) resulting in a full credit claimed under the foreign tax credit provisions.

In both cases, the Commissioner successfully contended in the High Court that that the transactions were devoid of commercial purpose other than the exploitation of a tax asymmetry, provided a mechanism by which the economic benefits of that exploitation could be divided up between the bank and counter-parties and should be avoided under s BG 1.⁷⁵ Appeals against the High Court judgments were later compromised. The cases are too complex for me, in this paper, to do justice to the reasoning. There is, however, one aspect of them which I should mention.

In the *BNZ* case, Wild J analysed carefully the conduit regime, including the pre-existing controlled foreign company (CFC) and dividend withholding payment (DWP) rules.⁷⁶ Income within the CFC rules attributed to New Zealand residents was taxed as it was earned. In cases where the New Zealand resident was owned by a non-resident, the effect was to tax the non-residents on foreign-sourced income. The conduit regime was intended to mitigate this consequence. If the New Zealand resident passed on the income to its non-resident owner, this would attract non-resident withholding tax. It is reasonably clear that those who promoted the conduit regime assumed that this would happen and such assumption is, at least to some extent, reflected in the legislative requirements as to the 'conduit tax relief accounts' which taxpayers must establish. (It is also implicit in the word 'conduit', at least if it is taken to refer to the income rather than capital flows.) What is significant for present purposes is that because the repo deals were all loss-incurring on a pre-tax basis, they never generated a profit which could be passed back to the non-resident owner of the BNZ. So no non-resident withholding tax was ever paid.

Entitlement to conduit tax relief was not conditional upon income being passed on to non-resident owners. As well, even when such income is passed on there will necessarily sometimes be mismatches in time and amount between the non-resident withholding tax which is paid and the relief obtained under the conduit regime. Wild J nonetheless felt able to conclude that:⁷⁷

The requirements [of the regime] are consistent only with Parliament contemplating that some of the conduit relieved income would in due course be passed on the foreign owner. Otherwise those requirements are pointless. It is also

⁷⁵ *BNZ Investments Ltd v The Commissioner of Inland Revenue* (2009) 24 NZTC 23,582 (HC) [*BNZ Investments* (HC)]; and *Westpac Banking Corporation v Commissioner of Inland Revenue* (2009) 24 NZTC 23,834 (HC).

⁷⁶ *BNZ Investments* (HC), above n 75, at [206]–[243].

⁷⁷ At [235].

difficult to conceive of a foreign owner not requiring some return on the foreign investment it made through its New Zealand subsidiary.

In this respect the judgment is similar to *Challenge* in that its effect was to make entitlement to a tax benefit subject to a condition (in this case, the eventual passing on to the foreign owner of all or some of the relieved income) additional to the conditions stipulated by Parliament.

The other case is *Alesco New Zealand Ltd v Commissioner of Inland Revenue*.⁷⁸ Alesco NZ acquired two other New Zealand companies. Those acquisitions were funded by Alesco NZ issuing a series of optional convertible notes (OCNs) to its Australian parent (Alesco Corp) for which it received \$78 million. In substance this was an interest free loan of \$78 million which was to be repaid at the expiry of 10 years. But on maturity Alesco Corp also had the option of converting the notes into shares. This option was of no practical utility as Alesco Corp already had 100 per cent ownership of Alesco NZ and it was therefore a distinctly artificial feature of the scheme.

Under the financial arrangement rules and the Commissioner's Determination G22,⁷⁹ the OCNs were split into debt and equity components with \$40 million of the \$78 million attributed to the option and \$38 million to the debt component. The debt component was treated as a bond issued for \$38 million with a redemption value of \$78 million. Leaving aside the effect of s BG 1, Alesco NZ was entitled to deduct the difference (\$40m) over the life of the OCNs. The redemption of the advance would not involve any Australian tax liability for Alesco Corp which was nonetheless entitled to full deductibility in respect of the debt taken on to fund the payments to Alesco NZ. There was thus a tax asymmetry which the scheme exploited.

A vanilla version of the funding arrangement in the form of an interest bearing advance from Alesco Corp to Alesco NZ would have resulted in tax deductions for Alesco NZ which would not have been less, and may well have been more, than those claimed. For this reason and given the tax advantages derived by Alesco Corp in Australia, it was argued that the Australian tax system was the primary target of the scheme. Arguments around these issues were addressed and rejected by the Court of Appeal. These arguments and the reasons the Court of Appeal gave for rejecting them are interesting but not material to the theme of this paper and I therefore leave them to one side.

Although referable to the need to fund business acquisitions and in that sense, in terms of purpose, bona fide or genuine, the transactions were contrived as to structure. Alesco NZ suffered no economic loss corresponding to the tax deduction claimed and the OCN documentation was itself artificial in relation to the optional conversion of the notes.

The Court of Appeal posed for itself the following questions:⁸⁰

[W]e are able to narrow the scope of debate at this stage of the inquiry to what appears to be the one decisive question: that is, if it is established that Alesco NZ did not incur either a legal liability to pay interest or any economic cost on the loan, did its use of the financial arrangements rules and G22 to claim income tax deductions for expenditure incurred fall outside Parliament's contemplation when

⁷⁸ *Alesco New Zealand Ltd v Commissioner of Inland Revenue* [2013] NZCA 40, [2013] 2 NZLR 175.

⁷⁹ An instrument issued by the Commissioner to provide a method for assessing income and costs on debt instruments.

⁸⁰ At [56] (references omitted).

enacting the rules? Or, expressed slightly differently, did Alesco NZ obtain a tax advantage without bearing the interest expense which Parliament intended to be suffered in order to fall within the deductibility provisions? Or, expressed differently again, should the anti-avoidance provisions be applied in a way which ignores the economic reality of the OCNs as contemplated by the deductibility provisions and G22?

In applying the parliamentary contemplation test, the Court commented:⁸¹

[71] In our judgment, the financial arrangements rules were intended to give effect to the reality of income and expenditure – that is, real economic benefits and costs. They were designed to recognise the economic effect of a transaction, not its legal or accounting form or treatment. The question is whether the taxpayer has ‘truly incurred the cost as intended by Parliament’. This construction is reinforced by the relevant addition, in three critical provisions, of the word ‘incurred’ ...

[72] These features suggest that Parliament did not intend that a taxpayer would be entitled to use the financial arrangements rules as a basis for claiming deductions for interest for which the taxpayer was not liable or did not pay. The rules were intended to operate as a net regime – that is to bring to tax the amount yielded after deducting the entire economic cost from a taxpayer’s entire economic benefit. In the absence of a liability a taxpayer claiming the benefit of a deduction for interest payments would be purporting to incur that liability without suffering the economic burden. We are satisfied that the intended purview of the rules is to exclude notional transactions.

The Court concluded on this aspect of the case in this way:

[110] Mr McKay [who was counsel for the taxpayer] submits that Alesco NZ simply chose the OCN structure as one among a range of means when carrying out economically rational transactions. The company was seeking to promote the genuine commercial goal of funding the acquisition of two businesses. In this context it was free to structure the transactions to its best tax advantage. And the evidence shows that the taxation benefits were primarily Australian in character. That is because a deduction would have been available for Alesco NZ in New Zealand whether the company chose to fund the acquisitions by way of issuing notes or by incurring interest bearing debt.

[111] Mr McKay says that Alesco NZ’s choice of the OCNs had an underlying commercial rationale. The company adopted this structure as a mechanism to fund existing financial obligations. This feature contrasts with other tax avoidance cases where the transactions would not have been entered into but for the tax benefits to be achieved. Alesco NZ’s acquisitions were not driven by tax considerations. The OCNs were an intermediate step along a pre-ordained commercial path.

[112] However, this distinctive factor does not protect Alesco NZ. The question is whether the particular arrangement, regardless of whether it was the originating or intermediate step, had the purpose or effect of tax avoidance. A structure whereby the parent provided funding to its subsidiary of \$78m for 10 years on an interest free basis, in exchange for the subsidiary issuing to it optional convertible

⁸¹ References omitted.

notes, cannot possibly have been chosen for a predominantly commercial purpose. Mr McKay has not identified one, and nor could he.

[113] There is only one available inference: Alesco NZ adopted the OCNs solely in pursuit of the goal of tax avoidance, to obtain a taxation benefit whereby the advantage of interest deductions was totally disproportionate to the economic burden. The benefit did not naturally attach to or was not subordinate or subsidiary to an identifiable concurrent commercial purpose or effect. Nor was the benefit merely incidental to an underlying commercial purpose or effect; it was the only identifiable purpose and effect of adopting the OCN structure. We are satisfied that, but for that benefit, the OCN structure would not have been chosen.

XIII ANOTHER APPROACH

Critical to the approaches taken in the cases to date has been the understanding that the GAAR operates to avoid tax arrangements which, but for the invocation of the GAAR, would be effective. The twilight zone to which I have referred⁸² is premised on this understanding.

As noted above,⁸³ in *Ben Nevis* the Chief Justice and Anderson J were reluctant to accept that there is a twilight zone of the kind postulated:⁸⁴

[2] We write separately to express reservations on aspects of the reasoning adopted by Tipping, McGrath and Gault JJ, not essential to their conclusions on the application of s BG 1 and the consequences. We differ from them in being of the view that the specific statutory allowances under the Income Tax Act are not in potential conflict with the general anti-avoidance provision and that the two do not need reconciliation. Rather, both are to be purposively and contextually interpreted If the use of a specific provision falls outside its intended scope in the scheme of the Act, the use is not authorised within the meaning of the specific provision. ... On this view, we do not think that there are stark differences between the general approach to statutory interpretation of specific tax provisions in New Zealand and in the United Kingdom ...

...

[4] In a fiscal statute the terms and concepts used may, depending on purpose and context, be used in a business or accounting sense. It would be wrong to start with any preconception that 'ordinary meaning' or 'legal meaning' is to be preferred to the meaning a term has in business or accounting. Similarly, where the substance of an arrangement needs to be gauged in application of the provision of a tax statute, a purposive construction of the provision may indicate that it is legal substance which is in issue or it may indicate that the statute is concerned with business substance. The provisions of a tax statute apply to many different

⁸² Part II, text near footnote 10.

⁸³ In Part II, text near footnotes 11 and 12.

⁸⁴ *Ben Nevis*, above n 10 (references omitted). The quoted text as to the 'critical question' in [5] of the passage reproduced here is from *Barclays Mercantile Business Finance Ltd v Mawson* [2005] 1 AC 684 at [32] per Lord Nicholls; while the *Ramsay* decision referred to in the same paragraph is *WT Ramsay Ltd v Inland Revenue Commissioners* [1979] 1 WLR 974, 975 (CA), discussed by Lord Templeman (see Part VIII above, text near footnote 57).

financial structures. It may use, according to the context, legal, commercial or accounting terminology ...

[5] The meaning of any term used by the statute in a particular provision must be contextually accurate. We do not therefore accept that when considering the application of a specific tax provision, and before considering the question of avoidance, the Court is concerned primarily with the legal structures and obligations created by the parties, and not with the economic substance of what they do. It depends on the context. The critical question is whether 'the relevant provision of the statute, upon its true construction, applies to the facts as found'. Those facts must be viewed 'realistically' because, as Lord Wilberforce put it in *Ramsay*, tax is 'created to operate in the real world, not that of make-believe' ...

[6] The taxpayers here had claimed allowances in respect of amortisation of a licence fee for use of land for forestry purposes and in respect of premiums for insurance against the risk that the forest would not yield a specified return. It is not necessary in the present case to determine whether these claims were properly made under the specific provisions of the Income Tax Act ...

What is proposed looks like the fiscal nullity approach, albeit one which is GAAR-enhanced. I have set out what was said because I suspect that it reflected discomfort on the part of the judges concerned with the parliamentary contemplation test. That test, however, was adopted in the majority judgment in *Ben Nevis* and in the unanimous judgment in *Penny and Hooper v Commissioner of Inland Revenue*.

XIV A FINAL WORD – FOR NOW

As I have endeavoured to explain, the parliamentary contemplation test was largely premised on the judgment of Lord Templeman in *Challenge*. So it is not devoid of support in the earlier authorities. It enables the courts to grapple directly with what most would see as objectionable about tax avoidance. That it is not obviously reconcilable with conventional scheme and purpose interpretation is a function of the view – my twilight zone view – that the relationship between the GAAR and rest of the tax system raises issues of interpretation and application which are sui generis. Perhaps most significantly, it provides a reasonably straight-forward approach to the determination of tax disputes.

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