IN THE SUPREME COURT OF NEW ZEALAND

SC 43/2007
[2008] NZSC 115

BETWEEN	BEN NEVIS FORESTRY VENTURES LTD, BRISTOL FORESTRY VENTURES LTD, CLIVE RICHARD BRADBURY, GREENMASS LTD, GREGORY ALAN PEEBLES AND ESTATE OF THE LATE KENNETH JOHN LAIRD Appellants
AND	COMMISSIONER OF INLAND REVENUE Respondent

SC 44/2007

AND BETWEEN	ACCENT MANAGEMENT LTD, LEXINGTON RESOURCES LTD AND REDCLIFFE FORESTRY VENTURES LTD Appellants
AND	COMMISSIONER OF INLAND REVENUE Respondent

Hearing: 23 - 27 June 2008

Court: Elias CJ, Tipping, McGrath, Gault and Anderson JJ

Counsel: C R Carruthers QC, R B Stewart QC and G J Harley for Appellants in SC 43/2007
C T Gudsell QC, M S Hinde and R J Southall for Appellants in SC 44/2007
D J White QC, R J Ellis and J H Coleman for Respondent

Judgment: 19 December 2008

JUDGMENT OF THE COURT

A The appeals are dismissed.

B The appellants are ordered to pay costs to the respondent (for which the appellants will be jointly and severally liable) of $75,000 together with reasonable disbursements to be fixed if necessary by the Registrar.

REASONS

	Para No
Elias CJ and Anderson J	[1]
Tipping, McGrath and Gault JJ	[11]

ELIAS CJ AND ANDERSON J

[1] We have had the advantage of reading in draft the reasons of Tipping, McGrath and Gault JJ. We agree with their conclusion that the Trinity scheme is a tax avoidance arrangement. It is void as against the Commissioner for income tax purposes under s BG 1 of the Income Tax Act 1994.[1] The Commissioner was therefore entitled to counteract the tax advantage obtained by the appellants even when they were not parties to the arrangement entered into by their loss attributing qualifying companies. They are "persons affected by that arrangement" within the

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[1] Section BG 1(1) makes a "tax avoidance arrangement" void as against the Commissioner for income tax purposes. The definitions contained in s OB 1 must be read with it. They define "arrangement" as "any contract, agreement, plan or understanding (whether enforceable or unenforceable), including all steps and transactions by which it is carried into effect". "Tax avoidance" is defined as including "directly or indirectly altering the incidence of any income tax", "directly or indirectly relieving any person from liability to pay income tax" and "directly or indirectly avoiding, reducing or postponing any liability to income tax". "Tax avoidance arrangement" is defined as one:

> whether entered into by the person affected by the arrangement or by another person, that directly or indirectly -
> (a) Has tax avoidance as its purpose or effect; or
> (b) Has tax avoidance as one of its purposes or effects, whether or not any other purpose or effect is referable to ordinary business or family dealings, if the purpose or effect is not merely incidental.

meaning of s GB 1 of the Income Tax Act.[2] We also agree that in acting on the arrangements the taxpayers have adopted an abusive tax position within the meaning of s 141D of the Tax Administration Act 1994. It follows that the penalties provided by that Act, as adjusted where applicable by s 141FC to prevent doubling up of the penalties through their application to both the investors and their loss attributing qualifying companies, properly attach to the taxpayer appellants.

[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, as is required by s 5 of the Interpretation Act 1999[3] and s AA 3 of the Income Tax Act.[4] Recourse to the general anti-avoidance provision is not necessary "to prevent uses of the specific provisions which fall outside their intended scope in the overall scheme of the Act".[5] 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. This approach is in our view required by settled principles of statutory construction. It avoids the distortion of overuse and unnecessary expansiveness in application of the general anti-avoidance 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, at least since *W T Ramsay Ltd v Inland Revenue Commissioners*[6] and *Furniss (Inspector of Taxes) v Dawson*.[7] The rejection of literal interpretation

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2 Which permits the Commissioner to adjust the calculation of the taxable income of "any person affected by that arrangement", so as to counteract any tax advantage obtained by that person.

3 Which provides that the meaning of an enactment must be ascertained from its text and in the light of its purpose and makes it clear that the matters to be considered include the indications contained in the enactment including by its organisation.

4 Section AA 3(1) provides a "principle of interpretation":

> (1) The meaning of a provision of this Act is found by reading the words in context and, particularly, in light of the purpose provisions, the core provisions [which include s BG 1] and the way in which the Act is organised.

5 Compare para [106] of the reasons of Tipping, McGrath and Gault JJ.

6 [1982] AC 300.

7 [1984] 1 AC 474.

described by Lord Steyn and Lord Cooke in *Inland Revenue Commissioners v McGuckian*[8] applies equally in construing the New Zealand specific tax provisions.

[3] The first question is whether the claimed allowance or deduction falls within the meaning of the specific provision, purposively construed. If it does not, the Commissioner can disallow the claim and, if of the view that it is itself a tax avoidance arrangement (because its purpose or effect is to alter the incidence of tax), can treat it as void under s BG 1. If the claim is within the meaning of the specific tax provision, purposively interpreted, an arrangement on which it is based may nevertheless constitute tax avoidance if it has the purpose or effect of altering the incidence of tax. If however the basis of claim is not, in itself or as part of a wider scheme, an arrangement with the purpose or effect of altering the incidence of tax, it is not tax avoidance under s BG 1.

[4] In a fiscal statute the terms and concepts used may, depending on purpose and context, be used in a business or accounting sense.[9] 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 financial structures. It may use, according to the context, legal, commercial or accounting terminology. There is no general rule. Lord Millett, writing extra-judicially, thought that the purposive approach to the interpretation of tax statutes, affirmed in *Ramsay* and the cases which followed it, had destroyed two "allied and dangerous myths".[10] The first was "that in tax cases to an extent unknown in other areas of law, form prevails over substance".[11] The second was that "the substance of a transaction, and

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[8] [1997] 1 WLR 991 at p 1000 per Lord Steyn and at p 1005 per Lord Cooke (HL).

[9] So in *Commissioner of Inland Revenue v Mitsubishi Motors New Zealand Ltd* [1995] 3 NZLR 513 at p 517 per Lord Hoffmann the Privy Council expressed the view that the context of a taxing statute makes a term like "incurred" more likely to be used in its commercially accepted meaning rather than in a more general sense.

[10] Millett, "Artificial Tax Avoidance: The English and American Approach" (1986) 6 British Tax Review 327, p 333.

[11] Millett, p 333 – 334.

the only thing to be regarded, is its legal effect".[12] When interpreting the specific provisions of tax legislation, care should be taken not to resurrect either myth.

[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.[13] 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".[14] Those facts must be viewed "realistically"[15] because, as Lord Wilberforce put it in *Ramsay*, tax is "created to operate in a real world, not that of make-believe".[16] In *Barclays*, the House of Lords quoted with approval[17] the explanation of Ribeiro PJ that the ultimate question is whether the statutory provisions "construed purposively, were intended to apply to the transaction, viewed realistically".[18] To similar effect, Lord Cooke in *McGuckian* considered the "ultimate question" to be "the true bearing of a particular taxing provision on a particular set of facts".[19]

[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, ss EG 1 and OB 1, and ss DL 1 and OB 1 respectively. We agree that they were part of a wider tax avoidance arrangement, and that is sufficient to determine the appeal. But we would not want to be taken to accept, as Tipping, McGrath and Gault JJ are prepared to do, that the claims "satisfied the ordinary meaning of the specific provisions relied on to claim

12 Millett, p 334.
13 Compare para [47] of the reasons of Tipping, McGrath and Gault JJ.
14 *Barclays Mercantile Business Finance Ltd v Mawson* [2005] 1 AC 684 at para [32] per Lord Nicholls, delivering the single opinion of the House of Lords.
15 As emphasised by Ribeiro PJ in *Collector of Stamp Revenue v Arrowtown Assets Ltd* (2003) 6 HKCFAR 517 at para [35].
16 At p 326.
17 At para [36].
18 In *Collector of Stamp Revenue v Arrowtown Assets Ltd* (2003) 6 HKCFAR 517 at para [35].
19 At p 1005.

the deductions".[20] We think it doubtful that the claims fell within the scope of the relevant specific statutory provisions, properly construed. In that connection, we doubt that *Commissioner of Inland Revenue v Glen Eden Metal Spinners Ltd*,[21] referred to by Tipping, McGrath and Gault JJ at paras [117] – [119] without endorsement, should be followed as generally applicable. Whether expenditure is incurred for fiscal purposes when promissory notes are granted, depends on whether such obligation is within the purpose of the tax provision. In a fiscal context, the *Glen Eden* approach would be unusual, as the Privy Council suggested in *Commissioner of Inland Revenue v Mitsubishi Motors New Zealand Ltd*.[22]

[7] As already indicated, we do not see the specific tax provisions and the general anti-avoidance provision as potentially conflicting. In *McGuckian*, Lord Cooke described a purposive approach to the construction of specific tax provisions as being "antecedent to or collateral with … general anti-avoidance provisions such as are found in Australasia".[23] We agree with that view of the relationship between the specific tax provisions and the general anti-avoidance provision. The specific provision is antecedent in application to the general anti-avoidance provision if the arrangement is not within the purpose of the specific provision. It is collateral if, in addition, it is entered into with the purpose or effect of altering the incidence of tax. This sequencing and co-operation between the provisions does not seem to us to place less emphasis on the application of the general anti-avoidance provision than in the past.[24]

[8] In application of the general anti-avoidance provision contained in s BG 1 we agree with the reasons why Tipping, McGrath, and Gault JJ conclude that the scheme, including the licence fee component and the insurance premium, constituted tax avoidance. We consider it plainly established that fiscal advantage was the purpose or effect of the arrangement. Nor was this object merely incidental to a business purpose. It was a principal object in itself. Although it does not affect the disposition of the case, we should not be taken to accept that the composite term

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20 Compare para [156] of the reasons of Tipping, McGrath and Gault JJ.
21 (1990) 12 NZTC 7,270 (CA).
22 [1995] 3 NZLR 513.
23 At p 1005.
24 Compare para [100] of the reasons of Tipping, McGrath and Gault JJ.

"purpose or effect" can be collapsed into "effect". In *Tayles v Commissioner of Inland Revenue*,[25] McMullin J (with whom the other members of the Court of Appeal expressed agreement) applied the approach adopted in *Newton v Commissioner of Taxation of the Commonwealth of Australia*[26] that:

> The word 'purpose' means, not motive but the effect which it is sought to achieve – the end in view. The word 'effect' means the end accomplished or achieved. The whole set of words denotes concerted action to an end – the end of avoiding tax.

More recently, Sir Anthony Mason, sitting in the Hong Kong Court of Final Appeal, has also said of the application of tax legislation purposively construed to a transaction or arrangement that it is concerned with "the aim or end in view".[27] In this case it is not necessary to revisit that approach. Applying it, "effect" is part of a composite term so that the general anti-avoidance provision is concerned with arrangements having the "intended effect" or object of altering the incidence of tax. That is not to say that purpose is to be equated with the motive of the taxpayer or the motives of the architects of the arrangement. It is well established that motive is not determinative, although it may be evidence which sheds light on a purpose of tax avoidance and so is not wholly irrelevant.[28]

[9] Tax avoidance occurs when the object or end in view or design of an arrangement is alteration of the incidence of tax and that object is not incidental to a business purpose. Such assessment does not entail reconstruction of the arrangements entered into. It requires realistic assessment of their purpose or effect. The evaluation required is a "question of mixed fact and law", as Lord Cooke suggested in *McGuckian*.[29] The fact that some business effect is also achieved does not prevent a conclusion that the purpose or effect of an arrangement is to alter the incidence of tax. As s BG 1 makes clear, an arrangement tips into tax avoidance if the fiscal effect intended is more than "merely incidental" to the business or family purpose. The fiscal implications of an arrangement that is "merely incidental" to a business purpose may in some cases be substantial and still within the statutory

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[25] [1982] 2 NZLR 726 at p 734.

[26] [1958] AC 450 at p 465 per Lord Denning (PC).

[27] *Shiu Wing Ltd v Commissioner of Estate Duty* (2000) 3 HKCFAR 215 at p 238.

[28] As Sir Anthony Mason NPJ thought to be the case in *Shiu Wing Ltd* at p 238.

[29] At p 1005.

scheme and purpose. "Merely incidental" may properly be contrasted with the end in view, the "purpose or effect".

[10] We would dismiss the appeal, with the consequences proposed by Tipping, McGrath and Gault JJ.

TIPPING, McGRATH AND GAULT JJ
(Given by Tipping and McGrath JJ)

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Introduction

[11] New Zealand has had a general anti-avoidance provision in tax legislation since 1878. The Commissioner's active reliance on it began during the 1960s, leading to extensive litigation over the scope and effect of the provision in force at that time.[30] Judicial criticism of its terms and their limits led to its expansion by Parliament in 1974.[31]

[12] The expanded provision, and its successors, did not, however, explicitly resolve a central issue that had arisen with s 108 of the 1954 Act. That was the relationship between the general anti-avoidance provision and the many "specific provisions" that allow tax concessions, principally through authorising deductions and depreciation allowances. Taxpayers enter into many transactions which have been structured with the purpose of taking advantage of specific provisions in order to reduce tax. While the general anti-avoidance provision is expressed broadly, its purpose cannot be to strike down arrangements which involve no more than appropriate use of specific provisions. On the other hand, strict compliance with the requirements of specific provisions cannot have been intended to immunise all arrangements involving their use against being categorised as tax avoidance arrangements, which it was the purpose of the general provision to avoid.

[13] The present appeals are the first occasion this Court has had to consider when use of specific provisions will amount to proscribed tax avoidance.[32] There is little explicit guidance in the legislation and the current case law has become complex, through being encumbered by considerations and tests that the legislation does not specify. Through a process of interpretation of all the relevant statutory provisions, we must identify a means for determining where permissible use of specific provisions ends and tax avoidance begins.

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[30] The general anti-avoidance provision at that time was s 108 of the Land and Income Tax Act 1954.

[31] See s 9 Land and Income Tax Amendment Act (No 2) 1974. The amended s 108 was the model for its successor, s 99 of the Income Tax Act 1976. The anti-avoidance provisions relevant to the present appeals are ss BB 9 (1997 year), BG 1 (1998 year) and GB 1 of the Income Tax Act 1994.

[32] The appellants in this case were unsuccessful in both the High Court and Court of Appeal: *Accent Management Ltd v Commissioner of Inland Revenue* (2005) 22 NZTC 19,027 (HC); *Accent Management Ltd v Commissioner of Inland Revenue* (2007) 23 NZTC 21,323 (CA).

Facts and contractual terms

[14] The nine appellants are investors, or loss attributing qualifying companies (LAQCs) of investors, in a syndicate that has been involved in the development of a Douglas Fir forest project as part of what is known as the Trinity scheme. The forest has been planted in Southland. Douglas Fir has a 50 year rotation and the forest is due to be harvested by 2048.

[15] The contractual arrangements for investment in the forestry project are complex. The scheme, including its contractual aspects, was devised and set up by Dr Garry Muir, who is a tax lawyer. At the relevant time he was the partner of a Mr Bradbury in the law firm Bradbury & Muir, which acted in the establishment and implementation of the scheme. Dr Muir and Mr Bradbury were both also investors. Mr Bradbury and the LAQCs of both Dr Muir and Mr Bradbury are appellants.

[16] The initial steps in the implementation of the Trinity scheme were taken early in 1997 when an agreement was entered into for the purchase of the land on which the forest was to be established. Investors did not at any stage acquire ownership of the land. Rather, title was acquired and retained by three subsidiaries of Trinity Foundation Ltd, a company owned by the Trinity Foundation Charitable Trust. The issues which are the subject of these appeals concern that part of the forest that is situated on land owned by one of the subsidiaries, Trinity Foundation (Services No 3) Ltd, which we will refer to as Trinity 3. It owns Lot 3 of the property known as Redcliffe Station. Lot 3 comprises 538 hectares on part of which the forest was planted.

[17] The investors in the Trinity 3 part of the Trinity scheme all became members of a syndicate through which they made their investments. It is called the Southern Lakes Joint Venture. A company, Southern Lakes Forestry Ltd, was formed to act as the contracting or "documentary" agent of the joint venture. We will refer to that company as Southern Lakes Forestry and to the joint venture as the syndicate. On the syndicate's behalf Southern Lakes Forestry entered into the various contracts, which constituted the scheme.

[18] Trinity 3 and Southern Lakes Forestry entered into an agreement for the grant of an occupation licence to the syndicate and, later, a licence agreement. The two agreements are to be read together along with a subsequent modification agreement entered into by the parties.

[19] The first of these agreements provided for Trinity 3, as owner of the land, to grant a licence to the syndicate to use Lot 3 "for the purpose of carrying on [the syndicate's] forestry business on the property". This agreement required the syndicate to pay a premium for the licence on the expiry of its term. The licence premium is stipulated to be the sum of $2,050,518 multiplied by the number of plantable hectares in the licensed land. Under the second agreement, the licence term commenced on 24 March 1997 and expired on 31 December 2048. Ultimately 484 of the 538 hectares, which were the subject of the agreements between Trinity 3 and the syndicate, were certified as plantable.

[20] The second agreement confirmed the terms of the licence grant. Under it the syndicate had an obligation, at its own expense, to establish, manage and protect a Douglas Fir forest on the licensed land in accordance with sound forestry principles. The modification agreement required the syndicate to enter into a Forestry Planting and Management Agreement with Pine Plan New Zealand Ltd (Pine Plan), which is a forestry management company.

[21] As well, the second agreement requires the syndicate to arrange for the sale of the forest on the basis that cutting and extraction should be completed during the period of four years prior to expiry of the term of the licence in 2048. Purchase monies recovered are to be applied by the land owner towards first GST, secondly costs of the sale, and thirdly payment of promissory notes given by investors covering their obligations to pay an insurance premium, shortly to be discussed, and the licence premium. The balance of the net stumpage proceeds is to be paid to the syndicate on 31 December 2048.

[22] Under the licence agreements the syndicate investors were also obliged to pay Trinity 3, on 21 March 1997, $1,350 per plantable hectare for the establishment of the forest, $1,946 per plantable hectare for an option to purchase the licensed land

in 2048, and $1,000 each, irrespective of hectares taken, for a lease option. They were also required to pay a $50 annual licence fee during the term of the licence. These payments are in addition to the obligation to pay the licence premium in 2048.

[23] In this manner, the scheme involving Trinity 3 was structured so that the investors effectively met the initial costs of buying the land and planting the forest and the continuing costs of its future maintenance and management. The syndicate does not at any point during the term of the licence become owner of the land or the trees. It did, however, obtain an option to acquire the land the subject of the licence in 2048 from Trinity 3 for half of its then market value.

[24] The agreements contemplated that the syndicate would have the net proceeds of the sale of harvested trees at the end of the period of 50 years applied to its liability to pay the licence premium. There was, however, on the face of these arrangements a risk that the net proceeds would be insufficient to meet the liability for the premium. One further aspect of the structure of the contractual arrangements is seemingly directed to this potential gap. It is an arrangement for insurance to be taken out by individual syndicate members, through Southern Lakes Forestry, and Trinity 3.

[25] To this end Dr Muir caused CSI Insurance Group (BVI) Ltd to be incorporated in the British Virgin Islands. We will refer to the company as CSI. It is licensed in the British Virgin Islands to conduct business as an insurer. In broad terms, cover under the policy is triggered by an event or events having the effect of preventing the market value of stumpage of Douglas Fir from reaching $2,050,518 per plantable hectare during the period between occurrence of the event and 31 December 2048. The insured are the members of the syndicate and Trinity 3.

[26] For this cover the syndicate was obliged to pay two insurance premiums to CSI. The first was of $1,307 per plantable hectare in 1997. The second is of $32,791 per plantable hectare payable on or before 31 December 2047. Trinity 3 is also obliged to pay an insurance premium of $410,104 per plantable hectare on or before 31 December 2047. That premium is subject to increase up to a maximum of

$1,230,311 per plantable hectare, dollar for dollar, to the extent that the market value of stumpage at 31 December 2047 is less than $2,050,518 per plantable hectare.

[27] Therefore, CSI insured Trinity 3 and the investors up to $2,050,518 per plantable hectare in the event that the net stumpage did not reach this value. However, as a result of the increasing premiums to be paid by Trinity 3 as well as the premiums to be paid by the investors, the maximum CSI would have to pay would be $787,416 per plantable hectare. This would be in the worst case scenario where the net stumpage value was zero. If the net stumpage value reaches $787,416 per plantable hectare, CSI will not have to pay anything at all on the policy. Likewise, cover does not attach if fewer than 300 trees mature, that being an event when cover would, seemingly, be most needed.

[28] Syndicate members provided promissory notes to cover their obligations to pay the licence premium of $2,050,518 per plantable hectare in 2048 and to meet their liability to pay the insurance premium in 2047. Trinity 3 likewise provided a promissory note for its 2047 insurance premium liability. Debentures creating charges over the assets and undertakings of the syndicate and Trinity 3 secured the money payable under the promissory notes. Their overall effect was to give CSI first rights over the forest until its value exceeded the deferred portion of the insurance premium. Trinity 3, and the syndicate, had second ranking priority covering the obligations each had to the other.

[29] Investors took up proportionate shares in the syndicate by reference to a number of plantable hectares. In the 1997 year they claimed the following deductions from assessable income in their tax returns:

(a) $34,098 per plantable hectare for the insurance premiums. This figure was made up of the sum of $1,307 paid in March 1997 and $32,791 to be paid in cash terms in 2047;

(b) A small proportion of the licence premium of $2,050,518 per plantable hectare, payable in 2048. The proportion was claimed as a depreciation allowance. The sum reflected amortisation of that cost over the 50 year

period and, in the 1997 tax returns, the fact that the transaction had been entered into only ten days before the end of the financial year.

[30] In the 1998 year the investors claimed in their tax returns the amortised licence premium figure for a full year of about $41,000 per plantable hectare.

[31] None of the expenses claimed related to the costs to the syndicate of planting and tending trees. No issue has arisen concerning the tax treatment of those costs. Putting them aside, in order to qualify for the deductions and allowances claimed, the investors had to spend in cash terms a little under $5,000 per plantable hectare in the 1997 year. In the 1998 year they had to spend only the $50 per plantable hectare licence fee.

Sham issues

[32] The Commissioner argued that the insurance arrangements were a sham so far as they involved the LAQCs associated with Dr Muir and Mr Bradbury, and Mr Bradbury himself. Those investors were distinguished from the other investors on the basis that through Dr Muir and Mr Bradbury their intention could be more confidently established than that of other investors who were not so closely implicated in the setting up of the mechanics of the Trinity scheme. Both Venning J and the Court of Appeal, the latter "by a narrow margin", rejected the Commissioner's sham argument.[33] He has raised the point again in this Court.

[33] There is no need for us to engage in any extended discussion of what constitutes a sham for present purposes. In essence, a sham is a pretence. It is possible to derive the following propositions from the leading authorities.[34] A document will be a sham when it does not evidence the true common intention of the parties. They either intend to create different rights and obligations from those

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[33] At paras [225] of the High Court judgment and [63] of the Court of Appeal judgment.

[34] *Snook v London & West Riding Investments Ltd* [1967] 2 QB 786 (CA); *Paintin and Nottingham Ltd v Miller Gale and Winter* [1971] NZLR 164 (CA) and *NZI Bank Ltd v Euro-National Corporation Ltd* [1992] 3 NZLR 528 (CA).

evidenced by the document or they do not intend to create any rights or obligations, whether of the kind evidenced by the document or at all. A document which originally records the true common intention of the parties may become a sham if the parties later agree to change their arrangement but leave the original document standing and continue to represent it as an accurate reflection of their arrangement. A sham in the taxation context is designed to lead the taxation authorities to view the documentation as representing what the parties have agreed when it does not record their true agreement. The purpose is to obtain a more favourable taxation outcome than that which would have eventuated if documents reflecting the true nature of the parties' transaction had been submitted to the Revenue authorities.

[34] It is important to keep firmly in mind the difference between sham and avoidance. A sham exists when documents do not reflect the true nature of what the parties have agreed. Avoidance occurs, even though the documents may accurately reflect the transaction which the parties intend to implement, when, for reasons to be discussed more fully below, the arrangement entered into gives a tax advantage which Parliament regards as unacceptable.

[35] We consider the Courts below were right to reject the Commissioner's sham argument. Even if it were possible to sever the Bradbury and Muir LAQCs and Mr Bradbury himself from the other investors for present purposes, we are of the view that despite what can be said about the insurance arrangements for avoidance purposes, the documents evidencing them did not misrepresent the nature of the rights and obligations which the parties to them intended to enter into. Nor can it be said that the insurance arrangements were entered into, even by the Bradbury and Muir LAQCs and Mr Bradbury himself, without any intention of creating legal rights and obligations of the kind purportedly created.

[36] There is no need for us to traverse in any detail the reasons of the High Court and the Court of Appeal which led those Courts to this conclusion. The essence of the Court of Appeal's reasoning was as follows:[35]

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[35] At para [65].

> Although the issue whether the contracts between the taxpayers and CSI were truly by way of insurance did not loom large in the arguments before us, we should say that we see no reason to differ from the conclusion of the Judge. No doubt the purpose of the arrangement (at least when viewed from the point of view of the architects of the scheme) was not mitigation of risk and, as well, the arrangements made for CSI meant that it incurred no practical risk in relation to the wash up transactions. But the contract did nonetheless, as Venning J recognised, satisfy the requirements for an insurance contract at law. As well, while there were no doubt other mechanisms which would have been cheaper and at least as effective for mitigating the risk the taxpayers were taking as to the value of the forest on maturity, the actual mechanism that was chosen was insurance. We see no reason to treat this as mislabelling.

[37] Venning J's conclusion was expressed in this way:[36]

> In the present case CSI exists. It has been issued with a licence to provide insurance. Contracts have been signed between CSI and Southern Lakes Forestry Limited for SLFJV. There is a Douglas Fir forest growing in Southland. The initial insurance premiums of $1,307 per hectare have been paid. It may be that CSI is not particularly sound financially, and also that Dr Muir (in particular) and Mr Bradbury had their own reasons for incorporating CSI and for fixing and controlling the insurance premiums to be paid to it but those reasons, while they may be relevant to other factors in the case, particularly the issue of whether the insurance arrangements are part of a tax avoidance arrangement, do not themselves support a finding of sham.

[38] The Courts below correctly applied the law and arrived at concurrent findings with which we agree. In short, we consider it has not been shown that the parties to the relevant documents were intending to deceive the Commissioner as to the nature of their arrangement in respect of insurance or as to their intention to implement the insurance arrangements according to their tenor. The fact that the insurance arrangements were constructed in a way that, as will later be demonstrated, materially contributed to the whole Trinity scheme being characterised as a tax avoidance arrangement does not, according to proper principles of law, mean that the insurance aspect of the whole scheme was a sham. The fact that the insurance arrangements were put in place with the purpose or effect of obtaining a tax advantage does not mean they were a sham.

[39] The shifting nature of the Commissioner's allegations of sham as this litigation proceeded, and the contradiction which derives from the Commissioner's

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36 At para [225].

acceptance that the initial premium was prima facie deductible, makes it difficult for the Commissioner to sustain the proposition that the insurance arrangement was a sham. An allegation of sham, being akin to an allegation of fraud, should not be lightly made. Those engaging in a sham are in reality seeking to deceive others as to the true nature of what they have agreed and are intending to achieve. That is not shown here.

Specific tax concession issues

Licence premium and its deductibility

[40] Venning J held that, under the applicable legislation, the syndicate was not able to deduct as an expense in the 1998 year the amortised portion of the licence premium of $2,050,518 per plantable hectare. The Court of Appeal decided to the contrary, holding that the licence premium was deductible under the relevant specific provision, but subject to avoidance issues.

[41] The basis on which the deduction was claimed was that the licence premium was a payment for a capital asset for which depreciation could be claimed under the tax legislation. Section EG 1 of the Income Tax Act allows a taxpayer a deduction in an income year on account of depreciation for any "depreciable property" owned by the taxpayer during that year.[37] Section OB1 defines "depreciable property" as meaning property of the taxpayer which may reasonably be expected to decline in value while being used in deriving gross income or in carrying on a business for that

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[37] **EG 1 Annual Depreciation Deduction**
(1) Subject to this Act, a taxpayer is allowed a deduction in an income year for an amount on account of depreciation for any depreciable property owned by that taxpayer at any time during that income year.

purpose. The definition, however, excludes "intangible property" unless it falls within the defined category of "depreciable intangible property".[38]

[42] The licence premium meets the requirements for deduction as long as the licence it relates to is "depreciable intangible property". That term is defined to mean "intangible property of a type listed in Schedule 17" of the 1994 Act.[39] That schedule covers certain intangible property that, in broad terms, is described in the legislation, first, as having a finite useful life that can be estimated with reasonable certainty on its creation or acquisition, and secondly, which is at low risk of being used in tax avoidance schemes if made depreciable. One type of property specified in Schedule 17 is "the right to use land".[40] Accordingly, the deductibility of the licence premium turns on whether it was to be paid for "the right to use land". That phrase is not governed by, but must be interpreted in light of, the statutory description of "intangible property" of a type listed in Schedule 17.[41]

[43] Reading the definitions in this way, and putting aside at this stage the question of tax avoidance, which must be considered separately, we are satisfied that the effect of the legislative provisions is that the licence premium payable by the syndicate is depreciable property and deductible if, on the proper meaning of the words, the payment is for the "right to use land". The words of description in Schedule 17 do not add any gloss to that meaning.

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[38] Section OB 1 states:

"Depreciable property", in relation to any taxpayer, —

(a) Means any property of that taxpayer which might reasonably be expected in normal circumstances to decline in value while used or available for use by persons —
  (i) In deriving gross income; or
  (ii) In carrying on a business for the purpose of deriving gross income; but
(b) Does not include
  …
  (iv) Intangible property other than depreciable intangible property.

[39] Section OB 1 states:

"Depreciable intangible property" means intangible property of a type listed in Schedule 17, which Schedule describes intangible property that has —

(a) A finite useful life that can be estimated with a reasonable degree of certainty on the date of its creation or acquisition; and
(b) If made depreciable, a low risk of being used in tax avoidance schemes.

[40] Clause 4 of Schedule 17.

[41] *Trustees of the Simkin Trust v Commissioner of Inland Revenue* [2003] 2 NZLR 315 at para [18] (CA).

[44] The Commissioner contends that the syndicate is obliged to pay the "licence premium" for the right to share in the proceeds of the net stumpage and not for the right of the syndicate to gain access to the land. Mr White QC emphasised the obligatory nature of what the syndicate had to do in relation to establishing and maintaining the forest on the land. He submitted that these obligations were inconsistent with giving the syndicate a right of access to the land, in consideration for a substantial premium, in order to do this work. Access to the land was wholly incidental to the syndicate's obligations and it did not make commercial sense for a premium to be paid for the right to enter the land to carry out obligations to the owner. These arguments reflected and developed the reasoning and conclusions of Venning J in the High Court.

[45] Mr Carruthers QC on the other hand argued that the Court of Appeal was right on this point. He submitted that, under the syndicate's contracts with Trinity 3, the licence premium payment was for purposes that were capital in nature. The syndicate had the expectation that it would derive income through carrying out business operations under the licence. He submitted that the High Court had recharacterised the payment, in the guise of interpreting the contract in order to make commercial sense of it, and had done so wrongly by reference to concepts of economic equivalence. The High Court had thereby sought to transform what the syndicate was obliged to do into something different from what had been agreed, and on that basis had decided that the legal character of the licence premium was not for the use of Trinity 3's land at all. Counsel submitted it was not open to the High Court to determine the nature of the payment for tax purposes in that way.

[46] Under the legislation the licence premium is deductible if it is for "a right to use land". Whether that is the legal character of the payment of $2,050,518 per plantable hectare which is to be made in 2048 requires an analysis of the nature of the arrangements actually entered into. The Court must construe the relevant documents, in their commercial context, to ascertain the parties' obligations to each other, as if it were determining a dispute between them over the meaning and effect of their contractual arrangements.[42]

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[42] *Commissioner of Inland Revenue v Renouf Corporation Ltd* (1998) 18 NZTC 13,914 at p 13,919 (CA).

[47] In proceeding in this way, the Court must also respect the fact that frequently in commerce there are different means of producing the same economic outcome which have different tax consequences. When considering the application of a specific tax provision, before reaching any question of avoidance, the Court is concerned primarily with the legal structures and obligations the parties have created and not with conducting an analysis in terms of their economic substance and consequences, or of alternative means that were available for achieving the substantive result.

[48] On the other hand, it is the true meaning of all provisions in a contract that will determine the character of a transaction rather than the label given to it. The label "licence premium" is accordingly not what is important in the present case, but rather the true contractual nature of the legal rights for which payment is to be made and the effect of applying the tax legislation to a payment of that character. Once the nature of the contractual rights and obligations has been determined in this way, the specific provision can be applied.

[49] In the present case, Trinity 3, and Southern Lakes Forestry, as agent for the syndicate, entered into what they called an "Agreement to Grant Licence and Options" on 28 February 1997. They also entered into a "Licence Agreement" on 21 March 1997 and a "Modification of Agreement to Grant Licence and Options" on 25 July 1997. These three documents together set out the parties' respective obligations in relation to the establishment, management and harvesting by the syndicate of the forest on the land.

[50] By clause 3.1 of the first of these agreements, in consideration for the syndicate's agreement to pay the licence premium, Trinity 3 agreed:

> to grant [the syndicate] a licence to use the Property for the purpose of carrying on the [syndicate's] forestry business on the Property for a term and on the conditions set out in the Licence Agreement.

[51] Clause 17 of the second agreement precluded any use of the land except for purposes of establishing and maintaining a Douglas Fir forest and generally carrying out the syndicate's forestry business on the land.

[52] Under the agreements, Trinity 3 retained ownership of the land and the trees at all times. The syndicate became obliged to enter into a management agreement with Pine Plan for the supply and planting of the forest. Pine Plan also assumed the role of managing the forest for the first five years. The agreements also provided for the licence premium of $2,050,518 per plantable hectare to be paid in 2048 and for the term of the licence and the annual licence fee.

[53] As the Court of Appeal pointed out,[43] it would have been open to the parties to set up their joint venture to produce the same economic consequence in a more straightforward way, which simply reflected that in return for planting and maintaining a forest on the land of Trinity 3, the syndicate was to receive a share of the eventual stumpage proceeds and certain options.

[54] The ultimate question on this aspect of the appeals is whether, under the agreements, the licence premium is paid for the right to use land in terms of the specific provision. The transaction has been set up on the basis that the syndicate assumes obligations to establish and maintain a forest on the land which remains in the ownership of Trinity 3. The syndicate receives the net proceeds when the forest is harvested but the payment of the premium is not linked to this benefit under the terms of the contracts. The licence provides the syndicate with the necessary access to Trinity 3's land to perform its forestry obligations, for which it incurs the licence premium as a cost. To treat the agreement as linking the premium payment to the right to share in profits or the options would be to allow overall economic consequences to dictate the character of the payment. That character is plain on the terms of the documents. That the access is to enable the syndicate to perform obligations to the land-owner does not in any sense contradict the contractual terms. Nor does it make the legal construct something other than what on its face it is – a right of the taxpayer to go onto land to conduct an aspect of its business. In these circumstances the character of the payment, which the parties called a licence premium, is a "right to use land" within the terms of the specific provision. It follows that, subject to the issue of avoidance, the payment is deductible as depreciation on depreciable property.

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[43] At paras [100] – [101].

Insurance premiums: deductibility and spreading

[55] It will be recalled that the syndicate members were contractually obliged to pay CSI an initial premium of $1,307 per plantable hectare in 1997, and a second premium of $32,791 per plantable hectare on or before 31 December 2047. At the time s DL 1(3) of the Income Tax Act provided that a person carrying on a forestry business in New Zealand could deduct, for the purpose of calculating assessable income, expenditure "by way of … insurance premiums … or other like expenses".[44]

[56] After considering the evidence and the legal nature of an insurance contract, Venning J held that both premiums were prima facie deductible under s DL 1(3).[45] The transactions were not shams and liability for the second premium had been "incurred" in 1997.[46] Hence, subject to avoidance and spreading issues, both premiums were deductible in 1997. For the reasons he gave, Venning J concluded that no spreading of the second premium throughout the period from 1997 to 2047 was required. The Court of Appeal differed from Venning J on this last point and held that the second premium could not be deducted in one sum in 1997 but had to be spread over the 50 year period of the policy.

[57] Absent sham, the Commissioner did not challenge Venning J's prima facie deductibility conclusion in the Court of Appeal. The taxpayers have challenged in this Court the Court of Appeal's spreading conclusion. Hence two aspects of the insurance premium issue are live in this Court: the spreading issue, which is a matter of statutory interpretation, and the contribution, if any, which the insurance arrangements make to the avoidance issue. This section of our reasons is concerned with the spreading issue, the practical implications of which will depend on the ultimate avoidance determination.

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44 Section BB 7 of the Act was a wider deduction provision to the same effect but does not require separate discussion.

45 At para 186].

46 At para [194].

[58] The spreading issue turns on whether the second premium was "accrual expenditure" within the meaning and purposes of s EF 1[47] in the light of s EH 2. Accrual expenditure is defined in s OB 1. If the insurance premium comes within the s OB 1 definition, the premium could not be deducted in full in 1997. Rather, it had to be spread, with 2 per cent being deductible in each of the 50 years during which the policy ran. Spreading would, of course, heavily reduce the deductible amount in year one from 100 per cent of the premium to 2 per cent, and hence substantially reduce the amount individual investors could deduct in that year against their other income, either directly or through their LAQCs.

[59] Section OB 1 provided that accrual expenditure, that is, expenditure which had to be spread, meant any deductible expenditure other than expenditure incurred in respect of any financial arrangement.[48] So, to avoid spreading under s EF 1, the taxpayers had to show that the insurance premium was expenditure in respect of a financial arrangement.

[60] Financial arrangement was defined in s OB 1:

> "Financial arrangement"—
>
> (a) Subject to paragraph (b), means—
>
> (i) Any debt or debt instrument; and
>
> (ii) Any arrangement (whether or not such arrangement includes an arrangement that is a debt or debt instrument, or an excepted financial arrangement) whereby a person obtains money in consideration for a promise by any person to provide money to any person at some future time or times, or upon the occurrence or non-occurrence of some future event or events (including the giving of, or failure to give, notice); and

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[47] **EF 1 Accrual Expenditure**
(1) Where any person has incurred any accrual expenditure —
(a) That expenditure is allowed as a deduction when it is incurred in accordance with this Act; and
(b) The unexpired portion of that expenditure at the end of an income year shall be included in the gross income of the person for that income year and shall be allowed as a deduction in the following income year.

[48] "Accrual expenditure", in sections EF 1 and FE 4, in relation to any person, means any amount of expenditure incurred … by the person that is allowed as a deduction under this Act … other than expenditure incurred —
…
(b) In respect of any financial arrangement;

> (iii) Any arrangement which is of a substantially similar nature (including, without restricting the generality of the preceding provisions of this subparagraph, sell-back and buy-back arrangements, debt defeasances, and assignments of income);—
>
> *but does not include any excepted financial arrangement that is not part of a financial arrangement*: [emphasis added].

[61] A contract of insurance comes within paras (a)(i) and (a)(ii). So the effect of the final words we have emphasised is crucial.

[62] As the Court of Appeal said:[49]

> The double negative at the end of this definition obscures the meaning intended by Parliament. Further, the definition does not seem to make sense unless the word "wider" is interposed before "a financial arrangement". We treat this part of the definition as if it read:
>
>> but does not include any excepted financial arrangement unless it is part of a wider financial arrangement.

[63] The expression "excepted financial arrangement", as defined, included a contract of insurance. Hence a contract of insurance was an excepted financial arrangement. The effect of the crucial words is, however, that a contract of insurance is not included within the definition of financial arrangement when it is entered into in isolation of any wider financial arrangement. But it is common ground that the contract of insurance in the present case was entered into as part of a wider financial arrangement. That being so, the present insurance contract is not excluded by the crucial words from the definition of financial arrangement. It is a financial arrangement for the purposes of s OB 1. It is therefore outside the reach of the definition of accrual expenditure and the spreading rules do not apply to it.

[64] In summary, insurance contracts are within the principal definition of financial arrangement. They are then taken out of that definition because they are excepted financial arrangements. But they are brought back in again if they are, as here, part of a wider financial arrangement. The end result is that the insurance contracts in this case were within the definition of financial arrangement and

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[49] At para [69].

therefore excluded from the definition of accrual expenditure. Hence the premium did not have to be spread.

[65] The Court of Appeal nevertheless concluded[50] that the insurance premium was not excepted from the definition of "accrual expenditure" in s OB 1 because of the application of s EH 2, which states:

> **EH 2 Excepted Financial Arrangement that is Part of Financial Arrangement**
>
> The amount of the gross income deemed to be derived or the expenditure deemed to be incurred by a person in respect of a financial arrangement under the qualified accruals rules shall not include the amount of any income, gain or loss, or expenditure, that is solely attributable to an excepted financial arrangement that is part of the financial arrangement.

With respect the Court of Appeal's approach is not correct. There are two accrual regimes in the Act. One is provided by s EF 1, requiring spreading on a straight line basis, ie 2 per cent per year over the 50 years. The other is the Financial Arrangements "qualified" accruals regime in Part EH of the Act that requires the yield to maturity approach. When these separate regimes are kept in mind, the logic of the exclusions is more easily appreciated.

[66] Section EF 1 relates to defined "accrual expenditure". The definition in s OB 1 is expressly for the purposes of ss EF 1 and FE 4 (not part EH) and excludes expenditure incurred in respect of any financial arrangement. That exclusion from the application of s EF 1 is understandable because there is a separate accruals regime for financial arrangements. That part EH regime, however, does not apply to "excepted financial arrangements" as defined in s OB 1 to include a contract of insurance.

[67] As part of his argument the Commissioner contended that s EH 2 negated the operation of the exclusion for financial arrangements in the definition of "accrual expenditure" for the purposes of s EF 1. But s EH 2, in its express terms, is directed to the Financial Arrangements "qualified" accruals regime and merely maintains the exclusion from that of excepted financial arrangements, even when part of a wider

[50] At paras [71] and [72].

financial arrangement. We do not see s EH 2 as relating in any way to the definition of "accrual expenditure" in s OB 1. We consider the Court of Appeal erred in accepting the Commissioner's argument to this effect.

[68] It is unnecessary to go into the competing arguments in any greater detail as the whole spreading issue in this case is rendered moot by the conclusion, to which we come later, that the insurance contracts were part of a tax avoidance arrangement. Hence the insurance premiums were, for that reason, not deductible on any basis.

Tax avoidance: legislative provisions

[69] Section BG 1 is currently the principal general anti-avoidance provision in the 1994 Act. It provides:

> **BG 1 AVOIDANCE**
>
> *Arrangement void*
>
> (1) A tax avoidance arrangement is void as against the Commissioner for income tax purposes.
>
> *Enforcement*
>
> (2) The Commissioner, in accordance with Part G (Avoidance and Non-Market Transactions), may counteract a tax advantage obtained by a person from or under a tax avoidance arrangement.

This section must be read with the definitions in s OB 1 of "arrangement", "tax avoidance" and "tax avoidance arrangement":

> "Arrangement" means any contract, agreement, plan, or understanding (whether enforceable or unenforceable), including all steps and transactions by which it is carried into effect:
>
> "Tax avoidance", in sections BG 1, EH 1, GB 1, and GC 12, includes—
>
> (a) Directly or indirectly altering the incidence of any income tax:
>
> (b) Directly or indirectly relieving any person from liability to pay income tax:
>
> (c) Directly or indirectly avoiding, reducing, or postponing any liability to income tax:

> "Tax avoidance arrangement" means an arrangement, whether entered into by the person affected by the arrangement or by another person, that directly or indirectly—
>
> (a) Has tax avoidance as its purpose or effect; or
>
> (b) Has tax avoidance as one of its purposes or effects, whether or not any other purpose or effect is referable to ordinary business or family dealings, if the purpose or effect is not merely incidental:

[70] Closely associated with these provisions is a provision conferring consequential powers of reconstruction when an arrangement is void. Section GB 1 relevantly provides:

> **GB 1 Agreements purporting to alter incidence of tax to be void**
>
> (1) Where an arrangement is void in accordance with section BG 1, the amounts of gross income, allowable deductions and available net losses included in calculating the taxable income of any person affected by that arrangement may be adjusted by the Commissioner in the manner the Commissioner thinks appropriate, so as to counteract any tax advantage obtained by that person from or under that arrangement, and, without limiting the generality of this subsection, the Commissioner may have regard to —
>
> (a) Such amounts of gross income, allowable deductions and available net losses as, in the Commissioner's opinion, that person would have, or might be expected to have, or would in all likelihood have, had if that arrangement had not been made or entered into; or
>
> (b) Such amounts of gross income and allowable deductions as, in the Commissioner's opinion, that person would have had if that person had been allowed the benefit of all amounts of gross income, or of such part of the gross income as the Commissioner considers proper, derived by any other person or persons as a result of that arrangement.

In these reasons we refer to these provisions in combination as "the general anti-avoidance provision". The case was argued, and we proceed on the basis of the general anti-avoidance provision as it stood following the Taxation (Core Provisions) Act 1996.[51]

[51] The provision that applied in the 1997 year was s BB 9 rather than s BG 1 but counsel were agreed that there was no meaningful difference.

Tax avoidance: legal principles

Legislative history

[71] As mentioned in our introduction, there has been a general anti-avoidance provision in New Zealand tax legislation since 1878.[52] For some years the focus of successive legislative provisions was on agreements having the purpose or effect of defeating or evading land tax. In 1891 that was extended to cover income tax.[53] In 1916 tax evasion was addressed separately and a redrafted provision was directed to tax avoidance.[54] The form of the 1916 provision was followed without material change until 1974.

[72] The provision in force, when the Inland Revenue Department began actively to enforce the provision in the courts during the 1960s, was s 108 of the Land and Income Tax Act 1954 which 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.

[73] In 1958 the Privy Council delivered its judgment on the equivalent Australian provision in *Newton v Commissioner of Taxation of the Commonwealth of Australia*.[55] Two of its findings were of particular importance to the ensuing New Zealand decisions on s 108. First, the Privy Council considered what the Australian provision meant when referring to "the purpose or effect" of an arrangement:[56]

> The word "purpose" means, not motive but the effect which it is sought to achieve – the end in view. The word "effect" means the end accomplished

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52 Section 62 of the Land Tax Act 1878.

53 Section 40 of the Land and Income Tax Assessment Act 1891.

54 Section 162 of the Land and Income Assessment Act 1916.

55 [1958] AC 450. The advice of the Judicial Committee was written by Lord Denning. The Australian provision was s 260 of the Income Tax and Social Services Contribution Assessment Act 1936 – 1951 (Cth). This provision was replaced in 1981 by Part IVA of the Income Tax Assessment Act 1936 (Cth). This new scheme is significantly more elaborate and detailed than the earlier s 260.

56 At p 465.

> or achieved. The whole set of words denotes concerted action to an end – the end of avoiding tax.

[74] Second, in relation to concerns over the type of transactions that might be caught by such breadth of meaning, Lord Denning, for the Privy Council, said of the words of the Australian provision:[57]

> They show that the section is not concerned with the motives of individuals. It is not concerned with their desire to avoid tax, but only with the means which they employ to do it … 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.

[75] An early and influential judgment in New Zealand at first instance was that of Woodhouse J in *Elmiger v Commissioner of Inland Revenue*.[58] Woodhouse J pointed out that difficulties arose in determining the general limits of s 108's application because the legislature adopted a "method of general proscription".[59] He went on to say:[60]

> This is, of course, a problem of definition and one which is peculiarly complicated by the fact that nearly all dispositions of property or income must carry with them some consequential effect upon income tax liabilities. In relation to s 108 it is necessary, therefore, to find some suitable way of testing the purposes and effect of contracts, agreements or arrangements, against the words of the section; and this is not a need which can be resolved by a possibly over-confident belief in some intuitive capacity to place a particular arrangement on one side of the line or the other.

[76] In applying the approach adopted in *Newton* he said:[61]

> [I]t 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. If this were not so I suppose an appropriate legal window dressing could still be devised to defeat the general objects of the section.

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57 At pp 465 – 466.
58 [1966] NZLR 683 (SC).
59 At p 687.
60 At pp 687 – 688.
61 At p 694.

[77] The Judge applied s 108 because at least one purpose of the transaction was to diminish income by facilitating deductions and thereby reducing liability to tax. This approach was generally upheld by the Court of Appeal,[62] which decided that s 108 operated fiscally as well as between parties.[63] It also decided that it applied to both accrued and future liabilities.[64]

[78] In a dissenting judgment delivered in 1970 in *Mangin v Commissioner of Inland Revenue*,[65] Lord Wilberforce made a number of criticisms of the drafting of s 108 which he said had created difficulties in the interpretation of the section. His general criticism was that the section, which had been drafted initially to deal with land tax, had to be approached "without any predisposition to believe it adequately embodies or gives effect to modern fiscal policy".[66] It had been abbreviated in 1916 with the result that it arguably covered less ground than the more comprehensively expressed Australian provision. With only minor changes from its original form, it had to confront all the sophistications of modern tax avoidance.[67]

[79] These criticisms of the legislation were echoed in the Court of Appeal in 1974 by McCarthy P.[68] He described s 108 as being "notoriously difficult", adding:[69]

> It cannot be given a literal application, for that would … result in the avoidance of transactions which were obviously not aimed at by the section. So the Courts had to place glosses on the statutory language in order that the bounds might be held reasonably fairly between the Inland Revenue authorities and taxpayers.

The President called on the Legislature to state in precise language what classes of transactions should be struck down.[70]

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62 *Elmiger v Commissioner of Inland Revenue* [1967] NZLR 161.
63 At pp 181 – 182 per North P, at pp 187 – 188 per Turner J and at p 190 per McCarthy J. This conclusion was later confirmed by the Privy Council in *Mangin v Commissioner of Inland Revenue* [1971] NZLR 591 at p 595.
64 At p 182 per North P.
65 [1971] NZLR 591 (PC).
66 At p 601.
67 At pp 601 – 602.
68 *Commissioner of Inland Revenue v Gerard* [1974] 2 NZLR 279.
69 At p 280.
70 At pp 280 – 281.

Legislative change in 1974

[80] Changes effected to s 108 in 1974[71] went some way to addressing the judicial concerns. They confirmed that s 108 had fiscal effect by stating that the arrangement was absolutely void as against the Commissioner for income tax purposes.[72] The Commissioner was also empowered to adjust the assessable income of any person affected by the arrangement so as to counteract any tax advantage obtained by that person under the arrangement. This solved two problems. First, it provided the Commissioner with reconstruction powers after s 108 had been used to defeat an arrangement. The lack of such powers had caused problems in *Commissioner of Inland Revenue v Gerard*.[73] It also confirmed what had been decided in *Commissioner of Inland Revenue v Ashton and Wheelans*,[74] that s 108 applied whether or not the taxpayer was a party to the arrangement.[75]

[81] The changes to s 108 went some way towards clarifying the types of transactions that the section was intended to cover. The tax avoidance definition was extended to cover a wider range of tax advantages that could amount to tax avoidance, largely bringing it into line with the Australian provision.[76] The section also expressly included future income and potential liability, reflecting one of Lord Wilberforce's criticisms.[77] The new definition of "tax avoidance arrangement" included an arrangement where one of its purposes was tax avoidance, that not being a "merely incidental" purpose. At the same time the legislation dispensed with Lord Denning's predication test in *Newton* by stating that an arrangement could amount to tax avoidance whether or not other purposes or effects of the arrangement were referable to ordinary business or family dealings.

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[71] By s 9 of the Land and Income Tax Amendment (No 2) Act 1974.

[72] As decided in *Elmiger* (CA) and in *Mangin* (PC). See para [77] above.

[73] [1974] 2 NZLR 279 (CA).

[74] [1974] 2 NZLR 321 at p 329 (CA).

[75] Turner J had expressed a contrary view in *Wisheart, Macnab and Kidd v Commissioner of Inland Revenue* [1972] NZLR 319 at p 327 (CA).

[76] This resolved issues raised in *Elmiger* (CA) and *Mangin* (PC).

[77] In *Mangin* (PC) at p 602 and earlier in *Elmiger* per North P at p 182 (CA).

[82] One of four particular concerns raised by Lord Wilberforce in *Mangin*, which he saw as contributing to the uncertainty in the meaning and application of s 108 was:[78]

> (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 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?

[83] The amendments to s 108 in 1974 did not, however, explicitly address how to discern the relationship between allowing tax concessions for certain arrangements and the general anti-avoidance provision, which struck down arrangements having a purpose of tax avoidance that was not merely incidental. The amended form of s 108 was substantively carried through to the subsequent general anti-avoidance provisions, initially as s 99 of the Income Tax Act 1976 and currently as ss BG 1 and GB 1 of the Income Tax Act 1994. The result is that this difficulty remains, and is the central issue in this case.

Challenge Corporation and purposive interpretation

[84] The first real opportunity for the Court of Appeal to address the effect of the 1974 changes to the general anti-avoidance provision was in the 1985 decision of *Challenge Corporation Ltd v Commissioner of Inland Revenue*.[79] Woodhouse P directly considered these changes. He concluded that s 99(2) was designed to catch an arrangement having a tax avoidance purpose, even if it had another real purpose which was not tax avoidance.[80] Where, however, tax avoidance was a "merely incidental" purpose of an arrangement, the statute provided that it should be disregarded in applying s 99. As Woodhouse P saw it, s 99 was reconciled with the operation of relevant specific provisions as long as any purpose of tax avoidance was "merely incidental" to a taxpayer's other purpose. This required that it be necessarily linked, without contrivance, as a natural concomitant of the other

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78 At p 662.
79 [1986] 2 NZLR 513 from p 529.
80 At p 533.

purpose.[81] Woodhouse P saw the breadth of those qualifying words and the ambit of the section, as raising a question of fact and degree in each case.[82]

[85] In *Challenge Corporation* the arrangement involved the taxpayer taking into its group an unconnected company with no assets or debts but having a large deductible loss. The loss was then transferred, using a specific provision, to other subsidiaries in order to reduce the assessable income of the group. Woodhouse P concluded that the sole purpose of this arrangement was to obtain a tax saving. Accordingly he decided it was caught by s 99. Woodhouse P's approach was based on the view that the legislative response in 1974 to the question of when it was legitimate to take advantage of specific legislative entitlements to avoid tax, lay in the exclusion of "merely incidental" purposes.

[86] Richardson J's judgment in *Challenge Corporation* took a different view of s 99(2). He accepted that the 1974 legislation had confirmed the central importance of s 108 in the scheme of New Zealand tax legislation,[83] but concluded that the 1974 amendment had not resolved earlier uncertainties in the application of the general anti-avoidance provision. In particular, the legislation had not defined its relationship with specific deduction provisions. It remained the task of the Court to resolve the question whether there was a distinction between proper and improper tax avoidance.[84] He accepted that the influence of taxation considerations in many ordinary business activities could never be regarded as a "merely incidental" purpose or effect.[85] The qualification in s 99(2) excluding arrangements in which the tax avoidance purpose was "merely incidental" did not apply to this issue.

[87] Richardson J saw the problem as requiring reconciliation of provisions in tax legislation which were in tension. He said:[86]

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81 At p 533.
82 At p 534.
83 At p 545 Richardson J said that the 1974 legislative changes indicated that s 108, re-enacted as s 99, was 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".
84 At p 548.
85 At pp 548 – 549.
86 At p 549.

> Section 99 thus 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. Consideration of the scheme of the legislation requires a careful reading in its historical context of the whole statute, analysing its structure and examining the relationships between the various provisions and recognising any discernible themes and patterns and underlying policy considerations.

Later he added:[87]

> For the inquiry is as to whether there is room in the statutory scheme for the application of s 99 in the particular case. If not, that is because the state of affairs achieved in compliance with the particular provision relied on by the taxpayer is not tax avoidance in the statutory sense. Reading s 99 in this way is to give it its true purpose and effect in the statutory scheme and so to allow it to serve the purposes of the Act itself. It is not the function of s 99 to defeat other provisions of the Act or to achieve a result which is inconsistent with them.

Later again he observed in relation to the type of liability that s 99 attacked:[88]

> A complicating fact is that every financial transaction of the taxpayer may effect a tax change and it is not to be supposed that the potential or prospective liability in respect of future income to which the definition refers was intended to have that reach. On the contrary, if the analysis of which I have been speaking leads to the conclusion that there is no room for the application of s 99, that is because the tax change which has occurred has not affected the liability to income tax which the Act itself contemplates.

[88] In *Challenge Corporation*, Richardson J decided that taking advantage of the statutory provisions in relation to the tax treatment of subvention payments was consistent with the very specific scheme and purpose of the statutory provisions relating to grouping of companies and treatment of losses. These provisions had no purpose but to allow an offset for tax purposes. The transactions contemplated were simply tax concepts which had no reality except in relation to income tax.[89] Parliament could not have intended that s 99 would deprive taxpayers of a specific structure provided for by the Act. Richardson J held, in effect, that literal compliance

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[87] At p 549.

[88] At p 550.

met the statutory purposes and it was not necessary for him to take into consideration the circumstances in which the loss company became part of the group. It was not consistent with the statutory purposes to treat such subvention arrangements as tax avoidance.[90]

[89] The effect was to reconcile conflicting provisions by reading down the scope of s 99 so that it did not operate on arrangements that complied with the particular specific provision in the legislation. The scheme and purpose of the legislation required that s 99 be read in the context of the special concession provisions which were dominant.

[90] Cooke J agreed with the judgment of Richardson J in the result, but not on the scope of s 99. Cooke J considered s 99 to be more extensive in its wording and effect than the old s 108, especially in the breadth of the defined term "tax avoidance".[91] He would have applied the general anti-avoidance provision but for the effect of a further specific, but confined, anti-avoidance provision, which displaced s 99 in relation to the specific provisions in issue.[92]

[91] On appeal, the Privy Council[93] took a view which differed from that of the majority on the impact of the specific anti-avoidance provision. The Court of Appeal's judgment was reversed and s 99 was applied to avoid the transaction. The Board treated the case as one of "tax avoidance" in contrast to "tax mitigation".[94] A tax avoidance arrangement was one where a taxpayer derived a tax advantage from a transaction without suffering the reduction in income, loss or expenditure which Parliament intended those qualifying for a reduction in tax liability to suffer.[95]

[92] As well, in delivering the judgment of the majority of the Privy Council, Lord Templeman rejected an argument that satisfaction of the requirements of the specific statutory provisions concerning subvention payments excluded s 99:[96]

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89 At pp 552 – 554.
90 At p 555.
91 At p 541.
92 At p 543.
93 *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 from p 555.
94 At pp 560 – 561.
95 At p 561.
96 At p 559.

> That argument cannot be correct. 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. Richardson J, giving judgment in the Court of Appeal in favour of Challenge, nevertheless recognised that "s 99 would be a dead letter if it were subordinate to all the specific provisions of the legislation".

[93] Finally, the Privy Council took a different view of the outcome of the application of the scheme and purpose approach. Lord Templeman classified the circumstances as tax avoidance, and not tax mitigation, because the Challenge group "never suffered the loss … which would entitle them to a reduction in their tax liability".[97] Earlier, the Privy Council had said that s 191 of the 1976 Act, the specific provision, "was intended to give effect to the reality of group profits and losses".[98] The reality was that the Challenge group did not make a loss. There was, therefore, a failure to construct the transaction in a way that met the purpose of s 191. It was that element in the transaction that meant s 99 applied to strike down an arrangement which otherwise complied with s 191.

[94] The Privy Council majority accepted the central importance of the scheme and purpose of the specific provision. But it differed from Richardson J's conclusions on the application of that approach to the case. The Privy Council did not accept that on a purposive approach the application of s 99 could be limited in a way that ignored the economic reality of the transaction as contemplated by the specific provision. For a profitable company to buy into the shareholding of a loss company outside its group, and then to offset those losses, involved "pretence". When a taxpayer sought to obtain a tax advantage without suffering the cost Parliament intended be suffered, this would amount to tax avoidance.[99]

[95] Subsequent case law generally has proceeded, sometimes implicitly, on the basis of this scheme and purpose approach, but consistently with the underlying reasoning of the Privy Council by paying attention to whether the commercial reality of a transaction is consistent with its legal form. The distinction between tax mitigation and tax avoidance is now seen as conclusory and unhelpful. The

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97 At p 562.
98 At p 558.
99 At p 562.

underlying reasoning of the Privy Council was later encapsulated by reference to the "commercial" meaning as against the "juristic" meaning of a specific provision.[100] Whatever terminology is used, the important aspect of *Challenge Corporation*, however, is the underlying approach.

[96] The subsequent approach taken in New Zealand is consistent with the application of this kind of scheme and purpose approach. In *Commissioner of Inland Revenue v BNZ Investments Ltd*, Richardson P, Keith and Tipping JJ in their joint judgment said:[101]

> [39] For the reasons discussed in the cases (eg *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 at p 545), 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.
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> [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 in *Challenge* at p 562, most tax avoidance involves a pretence; and that certainty and predictability are important but not absolute values.

[97] On this approach, it is only if a specific provision on its true construction and application was intended to give the particular transaction the tax benefit claimed that it will fall outside the area of application of s 99. As the passage we have emphasised makes plain, whether an arrangement is an artifice or involves a pretence will often be highly relevant to whether there is an arrangement that has a purpose of

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[100] See *Commissioner of Inland Revenue v Auckland Harbour Board* [2001] 3 NZLR 289 at para [11] (PC) and *Miller v Commissioner of Inland Revenue* [2001] 3 NZLR 316 at para [10] (PC).

[101] [2002] 1 NZLR 450 (emphasis added).

tax avoidance. This truism is also reflected in the Privy Council's judgment in *Miller v Commissioner of Inland Revenue*.[102]

[98] The Privy Council judgments in *Peterson v Commissioner of Inland Revenue*[103] are consistent with a scheme and purpose approach. Both the majority and minority judgments expressly endorse it.[104] Both judgments were focused on determining whether the taxpayer had truly incurred the cost as intended by Parliament. For example, Lord Millett, on behalf of the majority, stated:[105]

> If the commissioner had shown that the features on which he relied, singly or in combination, had the effect that the investors, while purporting to incur a liability to pay $x+y to acquire the film, had not suffered the economic burden of such expenditure before tax which Parliament intended to qualify them for a depreciation allowance, then he could invoke s 99 to disallow the deduction.

[99] It follows that a scheme and purpose approach does not simply require the Court to focus on the specific provision in isolation of wider considerations. This approach was applied in the second *Miller v Commissioner of Inland Revenue*.[106] The need for a wider perspective also gains support from both s 5 of the Interpretation Act 1999 and the general principle of interpretation in s AA 3(1) of the 1996 Act.[107]

Reconciling the legislative policies

[100] There has, however, also been a recent judgment of the Privy Council in a tax avoidance case which, while generally endorsing a scheme and purpose approach,

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102 [2001] 3 NZLR 316 at para [10] per Lord Hoffmann; see also *Dandelion Investments Ltd v Commissioner of Inland Revenue* [2003] 1 NZLR 600 at para [85] (CA) applying *BNZ Investments Ltd*.

103 [2006] 3 NZLR 433.

104 At paras [36] – [37] per Lord Millett and at para [61] per Lord Bingham and Lord Scott.

105 At para [42]. See also paras [39] – [40], [43] and [45] per Lord Millett and paras [65] and [91] per Lord Bingham and Lord Scott for further examples of the Privy Council approach in *Peterson*.

106 [1999] 1 NZLR 275 at pp 298 – 299 per Blanchard J, giving the judgment of the Full Court of Appeal.

107 **AA 3 Interpretation**
Principle of interpretation
(1) The meaning of a provision of this Act is found by reading the words in context and, particularly, in light of the purpose provisions, the core provisions and the way in which the Act is organised.
The "core provisions" appear in Part B of the Income Tax Act and include s BG 1 under "Avoidance" in Subpart G.

appears to have placed significantly less emphasis on the application of the general anti-avoidance provision than did the majority judgment in *Challenge Corporation*.[108] The Privy Council has suggested that its role may be as a longstop.[109] There is therefore continuing uncertainty about the inter-relationship of the general anti-avoidance provision with specific provisions. That makes it desirable for this Court to settle the approach which should be applied in New Zealand.

[101] In doing so we keep in mind that the present form of the general anti-avoidance provision remains largely the same as that adopted in 1974, when Parliament chose, in reframing the then s 108, not to specify with any particularity the kind of arrangements to which it would apply. This was left to the courts to work out. Parliament did not regard it as inconsistent with the judicial function for the courts to decide which arrangements, having a purpose or effect of saving tax, would be caught by the amended general anti-avoidance provision. Of greater legislative concern was that however carefully the general provision might be drafted, the results of taxpayers' ingenuity in adapting the forms in which they did business could not be predicted.[110]

[102] It is accordingly the task of the Courts to apply a principled approach which gives proper overall effect to statutory language that expresses different legislative policies. It has long been recognised those policies require reconciliation.[111] The approach must ensure that the particular case before the court is examined by reference to the respective legislative policies. It must enable decisions to be made on individual cases through the application of a process of statutory construction focusing objectively on features of the arrangements involved, without being distracted by intuitive subjective impressions of the morality of what taxation advisers have set up.

[103] We consider Parliament's overall purpose is best served by construing specific tax provisions and the general anti-avoidance provision so as to give

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108 *Auckland Harbour Board*.
109 *Auckland Harbour Board* at para [11] per Lord Hoffmann.
110 As Cooke J affirmed in *Challenge Corporation* at p 541.
111 See *Gerard* at p 280 per McCarthy P and *Challenge Corporation* at p 549 per Richardson J.

appropriate effect to each. They are meant to work in tandem. Each provides a context which assists in determining the meaning and, in particular, the scope of the other. Neither should be regarded as overriding. Rather they work together. The presence in the New Zealand legislation of a general anti-avoidance provision suggests that our Parliament meant it to be the principal vehicle by means of which tax avoidance is addressed. The general anti-avoidance regime is designed for that purpose, whereas individual specific provisions have a focus which is determined primarily by their ordinary meaning, as established through their text in the light of their specific purpose.[112] In short, the purpose of specific provisions must be distinguished from that of the general anti-avoidance provision.

[104] Parliament must have envisaged that the way a specific provision was deployed would, in some circumstances, cross the line and turn what might otherwise have been a permissible arrangement into a tax avoidance arrangement.[113] Ascertaining when that will be so should be firmly grounded in the statutory language of the provisions themselves. Judicial attempts to articulate how the line is to be drawn have in the past too often been seized on as if they were equivalent to statutory language. Judicial glosses and elaborations on the statutory language should be kept to a minimum.

[105] The key statutory concept in the general anti-avoidance provision is of a tax avoidance arrangement, as Parliament has defined it. By means of the definition of tax avoidance, a tax avoidance arrangement includes an arrangement which directly or indirectly alters the incidence of any income tax. It is arrangements of that and allied kinds which are void against the Commissioner under s BG 1(1). An arrangement includes all steps and transactions by which it is carried out. Thus, tax avoidance can be found in individual steps or, more often, in a combination of steps. Indeed, even if all the steps in an arrangement are unobjectionable in themselves, their combination may give rise to a tax avoidance arrangement.

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112 As established in terms of s 5 of the Interpretation Act.

113 The appellants' "threshold" argument accordingly cannot be correct. That argument was to the effect that once the ordinary meaning of a specific provision was satisfied there could be no tax avoidance.

[106] Put at the highest level of generality, a specific provision is designed to give the taxpayer a tax advantage if its use falls within its ordinary meaning. That will be a permissible tax advantage. The general provision is designed to avoid the fiscal effect of tax avoidance arrangements having a more than merely incidental purpose or effect of tax avoidance. Its function is to prevent uses of the specific provisions which fall outside their intended scope in the overall scheme of the Act. Such uses give rise to an impermissible tax advantage which the Commissioner may counteract. The general anti-avoidance provision and its associated reconstruction power provide explicit authority for the Commissioner and New Zealand courts to avoid what has been done and to reconstruct tax avoidance arrangements.

[107] When, as here, a case involves reliance by the taxpayer on specific provisions, the first inquiry concerns the application of those provisions. The 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. For example the licence premium was payable for a "right to use land", according to the ordinary meaning of those words, which of course includes their purpose. But because of additional features, to which we will come, associated primarily with the method and timing of payment, it represented and was part of a tax avoidance arrangement.

[108] The general anti-avoidance provision does not confine the Court as to the matters which may be taken into account when considering whether a tax avoidance arrangement exists. Hence the Commissioner and the courts may address a number of relevant factors, the significance of which will depend on the particular facts. The manner in which the arrangement is carried out will often be an important consideration. So will the role of all relevant parties and any relationship they may have with the taxpayer. The economic and commercial effect of documents and transactions may also be significant. Other features that may be relevant include the duration of the arrangement and the nature and extent of the financial consequences

that it will have for the taxpayer. As indicated, it will often be the combination of various elements in the arrangement which is significant. 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] In considering these matters, the courts are not limited to purely legal considerations. They should also consider the use made of the specific provision in the light of the commercial reality and the economic effect of that use. 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.

[110] English decisions provide limited direct assistance. To the extent that they have, over recent decades, adopted a more purposive approach to interpretation of tax legislation, they provide helpful insights.[114] They are not, however, concerned with the reconciliation of potentially conflicting provisions. United Kingdom tax legislation has never had a general anti-avoidance provision. As a result of this difference it has been suggested that the English purposive approach involves considerations that are somewhat removed from the wording of the New Zealand statute.[115] A purposive approach is, in any event, limited in the extent to which it can avoid arrangements on its own. Such an approach is, however, reinforced in New Zealand by the presence in our legislation of the general anti-avoidance provision. Care must, therefore, be taken when applying English cases in the different New Zealand context in which the meaning and scope of the general anti-

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[114] See for example, *Furniss (Inspector of Taxes) v Dawson* [1984] AC 474 at p 527 per Lord Brightman; *Inland Revenue Commissioners v McGuckian* [1997] 1 WLR 991 at p 1005 per Lord Cooke and pp 999 – 1000 per Lord Steyn (HL) and *MacNiven (HM Inspector of Taxes) v Westmoreland Investments Ltd* [2003] AC 311.

[115] Freedman, "Interpreting Tax Statutes: Tax Avoidance and the Intention of Parliament" (2007) 123 LQR 53, p 65.

avoidance provision, as well as that of specific provisions, must be addressed and applied.

[111] The appellants made a sustained plea that the courts should not deprive commercial and other parties of tax beneficial choices. On the approach we have set out, taxpayers have the freedom to structure transactions to their best tax advantage. They may utilise available tax incentives in whatever way the applicable legislative text, read in the light of its context and purpose, permits. They cannot, however, do so in a way that is proscribed by the general anti-avoidance provision.

[112] The appellants also argued that tax avoidance legislation should be interpreted in a way which gives taxpayers reasonable certainty in tax planning. But Parliament has left the general anti-avoidance provision deliberately general. That approach has been retained despite the introduction of a civil penalties regime in relation to taxpayers who take certain types of incorrect tax position. The courts should not strive to create greater certainty than Parliament has chosen to provide. We consider that the approach we have outlined gives as much conceptual clarity as can reasonably be achieved. As in many areas of the law, there are bound to be difficult cases at the margins. But in most cases we consider it will be possible, without undue difficulty, to decide on which side of the line a particular arrangement falls.

[113] Before concluding this section of our reasons, we should recognise that para (b) of the definition of a tax avoidance arrangement refers to cases where the tax avoidance purpose or effect of an arrangement is "merely incidental". If that is so, the arrangement is not a tax avoidance arrangement. It is apparent therefore that the use of a specific provision which alters the incidence of tax is permitted in two situations.

[114] The first is when the specific provision is used in a manner which is within Parliamentary contemplation, as discussed above. The second is when the tax avoidance purpose or effect of the arrangement is "merely incidental". It will rarely be the case that the use of a specific provision in a manner which is outside Parliamentary contemplation could result in the tax avoidance purpose or effect of

the arrangement being merely incidental. In the present case the appellants did not seek to rely on the merely incidental concept, so nothing more need be said on that subject.

Appraisal for avoidance purposes

Introduction

[115] The arrangement in this case includes all steps taken to enable the appellants to claim deductions in respect of the licence and insurance premiums under the specific provisions of the Act. While much was made of the charitable element, it does not bear on individual taxpayers' positions. On the approach we have outlined, it is necessary for the appellants, on whom the burden of proof lies, to persuade the Court that the arrangement is not a tax avoidance arrangement. To do that the appellants must show that the steps they have taken were within the purpose and contemplation of Parliament when it enacted the specific provisions they rely on.

The licence premium

[116] The tax effect of the licence premium aspect of the arrangement was that in the 1998 year the appellants individually claimed a deduction of approximately $41,000 for each plantable hectare in which they had invested. This was on account of a depreciation allowance, for the whole year, of one-fiftieth of the licence premium of $2,050,018 per plantable hectare. In that year the appellants' actual cash expenditure was only $50 per plantable hectare (on a licence fee).[116]

[117] The appellants contend that the expenditure on the licence premium was incurred when the promissory notes were executed. The legal principles on which the appellants rely were stated by the Court of Appeal in *Commissioner of Inland Revenue v Glen Eden Metal Spinners Ltd*:[117]

[116] The effect of the licence premium in the 1997 year was minimal as the deductions only reflected ten days of the year. Nevertheless any findings made in relation to the licence premium also affect those deductions.

[117] (1990) 12 NZTC 7, 270 at p 7,271 per Richardson J.

> An expenditure is incurred in an income year although there has been no actual disbursement if in that year the taxpayer is definitively committed to that expenditure. … There must be an ascertained liability but it is not necessary to constitute a definitive commitment that that liability is indefeasible: the taxpayer is equally committed whether or not its present liability may subsequently be diminished or avoided by the action of others. In marginal cases the distinction between a defeasible liability under which a taxpayer is definitively committed, and a contingent liability under which it is not, may not be easy to draw.

[118] In *Commissioner of Inland Revenue v Mitsubishi Motors New Zealand Ltd*,[118] the Privy Council pointed out that this construction involved a jurisprudential rather than a commercial meaning of "incurred" and was an unusual approach in a taxing statute. Nevertheless, the approach in *Glen Eden Metal Spinners* was upheld.[119] Reinforcing it in the present case is the technical rule that a contractual debt may legally be discharged by consensual substitution of a promissory note.[120]

[119] We are content to proceed on the basis of that approach, without endorsing it.[121] We acknowledge that it carries with it a potential for the characterisation of expenditure as incurred, when in commercial terms that is not the case. The commercial aspects must, however, be considered because the context is suggestive of tax avoidance. In part that is because requiring that promissory notes be given, before the expenditure was to be incurred in reality, introduced an artificial element into the arrangement. From a business point of view the promissory note was a gratuitous mechanism. We do not accept the appellants' argument that it secured or facilitated the payment of the licence premium by the syndicate in 2048 in any real sense.

[120] Two other features of the arrangement, in relation to what the Court of Appeal called the "unusual" nature of the licence premium are also relevant. They are first, the real risk that the Trinity scheme will never be a profitable one. The second is the effect of the timing mismatch between when expenditure is legally incurred and the point when it is required to be paid in an economic sense.

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118 [1995] 3 NZLR 513.

119 At p 517 per Lord Hoffmann.

120 See *Byles on Bills of Exchange and Cheques* (28th ed, 2007), para [31-001] and the cases there cited, in particular *British Russian Gazette and Trade Outlook Ltd v Associated Newspapers Ltd* [1933] 2 KB 616 at pp 643 – 644 per Scrutton LJ (CA).

121 The point was not the subject of argument in this Court.

[121] In 1997 the appellants had paid $1,946 per plantable hectare for the option to acquire the land in 2048 for half its then value. The land had been acquired by Trinity 3 for approximately $580 per plantable hectare. Accordingly, the syndicate funded the purchase of the plantable land in 1997, by paying over three times its cost, in return for an option to acquire ownership of the land at half of its then value in 2048. As well, the appellants, along with other syndicate members, agreed to pay a licence premium of $2,050,018 per plantable hectare for the use of the same land over the term of the licence. These features of the arrangement in themselves raise questions over whether the transaction will be profitable in business terms for the appellants when they receive the net stumpage following harvesting and are obliged to pay the licence premium in 2048.

[122] Venning J heard evidence from experts on this issue and found that it was possible but unlikely that the net proceeds of harvesting the trees would exceed the cost of the premium.[122] The Court of Appeal found that the prospects of a profit were remote.[123] The issue of profitability is complicated by the fact that the value of money in 2048 in relation to 1997, and indeed the value of Douglas Fir stumpage, is unknown. We agree with the findings of the High Court and Court of Appeal that the ultimate profitability of the business side of the arrangement is unlikely. As the Court of Appeal pointed out, there is no apparent commercial reason for the syndicate to pay $2,050,518 per plantable hectare for the use of land, the purchase of which it had already funded. The relevance of this is that it raises a serious question over whether the appellants had a true business purpose, as distinct from a tax saving purpose, in entering into the arrangement with regard to the licence premium. The clarity of the tax advantages was in marked contrast to the obscurity of the prospect of any ultimate commercial profit. This leads us to the conclusion that the primary if not the sole purpose of the promissory note, with its link to the licence premium obligation, is to generate a tax deduction for the licence premium. It is an artificial component of the arrangement which we are satisfied was included for the purpose of tax avoidance.

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[122] At para [110].
[123] At para [143(a)].

[123] Combined with other factors indicating tax avoidance discussed below, the facts raise a real doubt as to the profitability of the Trinity scheme. It is also useful to point out that, even on the appellants' approach as to how the licence premium figure was determined, it appears it was never intended that the forest would make a profit.

[124] There was no evidence that the amount of $2,050,518 per plantable hectare was fixed on any assessment of the value of the land or of its use. It was not suggested that it was a per hectare proportion of a global figure fixed for the use of the 484 plantable hectares or the total licensed area of 538 hectares. Just how it was fixed emerged in the course of the argument.

[125] In his reply Mr Carruthers, for the appellants, took us to a document headed "Formula for projecting a future value based on present value and expected inflation and real price growth". That document was the subject of cross-examination of Dr Muir and of a specific finding against Dr Muir by Venning J.[124] After setting out a formula, it is applied to specific figures. They are of a present value of $125,000, an inflation rate of 3.50 per cent and a real price growth of 3.00 per cent. These are projected across 50 years. Dr Muir was unable to explain the precise calculation but thought it likely that his wife had done it (she did not give evidence). The result of the calculation is a projected value after 50 years of $3,060,474.31. That is then multiplied by 0.67 to give the amount of $2,050,517.79 which is rounded to the nearest dollar as $2,050,518. The starting figure is the present value per hectare of a mature Douglas Fir forest in 1997 and the result of the calculation is the estimated value in 2047 of the forest to which the scheme relates. Venning J found that the 0.67 multiplier was adopted to give an after tax amount. The compelling inference is that the amount of $2,050,518 was the after tax amount the mature forest was expected to yield. While it might be said that this was a minimum or conservative figure, after reviewing the extensive evidence given before him, Venning J, with whom the Court of Appeal and we agree, determined that the investment would likely return in nominal dollars less than the $2,050,518 per plantable hectare in year 50.

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[124] At para [315].

[126] If the expected after-tax returns to the investors only equalled the amount of licence premium to be paid out of the proceeds (and would not meet the insurance premiums similarly payable), the perceived benefits to the investors would be only the tax deductions to be enjoyed.

[127] The other feature of the arrangement which supports this conclusion is the timing difference between the incurring and the commercial payment of the licence premium. In the present case there is a 50 year gap. A consequence of the length of time that must elapse is that the appellants or their successors may not actually pay the premium in 2048 for which they claim to have secured a depreciation allowance. The LAQCs are corporate entities which may not still be in existence.[125] Their shareholders have no personal liability and are unlikely to be alive in 2048. There is likely to be mutual benefit for the taxpayers and Trinity 3 in their unwinding the arrangements well before 2048 on a basis that allows the appellants and their LAQCs to walk away from their obligation to pay the premium with Trinity 3 taking the net stumpage proceeds. It is not just the extreme difference in time that is important. It is the fact that under the arrangement the appellants will receive the benefits of tax deductions but probably never incur the real expenditure. The absence of securities over other assets or personal guarantees from shareholders indicate that actual payment of moneys over and above the net stumpage proceeds was clearly not of commercial concern to Trinity 3. In marked contrast, security was given through debentures over that source of funds to pay the licence premium.

[128] All this arises from the manner in which the specific provision has been used. Execution of promissory notes has created a timing mismatch between the dates for legal and economic payment. While the law treats the relevant costs as incurred, and shareholders are not generally held personally liable for a company's obligations, the Court is permitted, when considering the question of tax avoidance, to examine the commercial nature of the incurred cost and any factors that might indicate that the expenditure will never be truly incurred.

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125 Accent is not an LAQC, and is a company of substance but, given the length of the timeframe, its position is no different.

[129] We have already characterised the promissory note as an artificial element of the transaction. Legally it is correct, as Mr Carruthers emphasised, that the obligations of the LAQCs or individual taxpayers under the promissory notes will remain absolute and enforceable, until discharged at the end of the term of the licence. It is also correct that the use of companies and trusts as separate taxpayer entities will normally be an acceptable mechanism for taking advantage of concessions available under specific provisions, being within what Parliament must have contemplated in enacting them. In that context, the obligations will be those of the entities which incur them under any arrangements and not others such as shareholders. But the present circumstances are not an instance of the Commissioner seeking to ignore separate legal personality.

[130] The timing mismatch is not justified by the fact that harvesting would have taken place 50 years after planting of the trees. The giving of the promissory note had no necessary business connection with that period. It introduces a distortion which is inconsistent with the purpose of the provisions for depreciation-based deductions. It puts a different stamp on the nature of the obligation to pay the licence premium so that, as a matter of commercial reality, its discharge is dependent on the proceeds of the stumpage. There are so many contingencies around events that may occur prior to 2047 that the obligation to pay the licence premium lacks real force. The effect of the arrangement (if permitted) would be to provide a tax concession in circumstances where the commitment to make the payment is dependent on stumpage proceeds and otherwise is illusory. The result of this use of the specific provision is to take the arrangement, insofar as it depends on the licence premium promissory note, outside of the scope of the provision allowing for a deduction for depreciable property and to make what the investors entered into a tax avoidance arrangement.

Insurance arrangements

[131] We are of the view that the insurance dimension of the Trinity scheme[126] was included for two main reasons. First it was adopted in an attempt to give comfort to

[126] Details of which have already been set out in paras [25] – [27].

potential investors in the scheme and second it was included because it gave rise to substantial tax advantages, particularly by way of deducting the second premium in one sum in the first year. While there may have been some element of risk management involved, we consider this dimension was subsidiary to the other two reasons, especially having regard to the terms on which cover would cease to attach.

[132] CSI was incorporated and registered in the British Virgin Islands, a well known tax haven. It is not necessary to traverse all the detailed evidence that was called in relation to its formation. It is sufficient at this point to observe that the formation of a special, single purpose, company to undertake the insurance risk, and its location in a tax haven give rise to immediate issues about the true purpose of what was being done.

[133] The genesis of CSI's involvement came about when Dr Muir was advised by a friend to contact an organisation in the British Virgin Islands called AMS Financial Services Ltd. In early correspondence with this organisation Dr Muir referred to an initial premium of $1,027 per plantable hectare or $2,772,900 for 2,700 hectares. He recorded that "almost all of this sum will either be paid in non resident withholding taxes, or as introduction fees". So only a small part of the initial premium was intended to remain with the insurer, CSI. Furthermore, it is significant that the premium amount originated with Dr Muir. There does not appear to have been any independent assessment of the cost of undertaking the risk. Mr Mitchell, a friend of Dr Muir, writing to him in December 1996, suggested that he contact an insurance person called Nigel Bailey, to whom Mr Mitchell had already spoken.

[134] Mr Mitchell advised Dr Muir that Nigel could be "a bit too technical", so he needed to be "made to understand" that there was "no real risk in the whole thing". Later on, in January 1997, AMS wrote to Dr Muir about a business plan that was required for CSI as an aspect of its being formed and registered. In further correspondence AMS suggested to Dr Muir that in order to add "substance" to CSI various further steps could be taken such as installing phone and fax lines, preparing stationery and renting a dedicated "office" within AMS's overall office. Obviously those advising Dr Muir in the British Virgin Islands had concerns at the apparent

flimsiness of CSI, even from a tax haven perspective. In cross-examination Dr Muir, whose evidence did not impress the trial Judge, expressed the optimistic view that it was "most unfair" to suggest that an insurance company without any office, telephone line, employees or stationery was "a little unreal".

[135] On 16 January 1997 Dr Muir wrote to AMS instructing them to proceed with the formation of CSI. AMS was to provide the initial shareholders and directors but on the basis that those chosen would act on a trustee/nominee basis. Hence, as he accepted, Dr Muir reserved the right to decide who would own CSI's shares beneficially and who would control it.

[136] AMS sent the proposed business plan for CSI to Dr Muir under cover of a letter of 29 January 1997. The draft was based on information supplied by Dr Muir. It contained the following highly significant statement:

> 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.

[137] In a letter of 31 January 1997 Dr Muir proposed a number of amendments to the draft but none to this passage. One of the amendments made reference to "an irrevocable letter of comfort" to be supplied to CSI by the Trinity Foundation Charitable Trust, as the beneficial owner of the shares in Trinity Foundation Ltd, providing that:

> should CSI be unable to meet any obligations to the Trinity Foundation Limited in 2048, the Trinity Foundation Charitable Trust will donate to CSI such sum as CSI is required to pay to The Trinity Foundation Ltd.

[138] Dr Muir also noted that this letter of comfort would not be needed if at some stage CSI was able to place the risk on the "commercial" market. No mention was made of reinsurance and the evidence was that no reputable reinsurer would undertake the risk. Unsurprisingly there was no suggestion that CSI had been able to place the risk on the commercial market. When cross-examined about the letter of comfort, Dr Muir said that as "there was never any risk to CSI in that situation" the letter of comfort was "a nothing". These observations suggest that CSI was not

intended to be anything more than a pro forma vehicle for obtaining the anticipated tax benefits.

[139] The letter of comfort was signed on 3 February 1997. It was provided to CSI by the Trinity Foundation Charitable Trust with a warranty that it was lawful and intended to create legally binding obligations. An AMS brochure sent to Dr Muir about this time indicated that AMS specialised in "captive insurance management" and in opportunities "to reduce, defer or avoid taxes".

[140] In early February Mr Mitchell of AMS inquired of Dr Muir why he required "extra confidentiality" for the arrangements being discussed. In mid February a solicitor acting for a number of investors in the syndicate obtained advice from Minet Archer Ltd, a firm of international insurance brokers, that CSI was likely to be "a captive insurance company set up for the forestry investors". On 20 February Dr Muir responded to an inquiry from the solicitor by advising that CSI was "an arms length" party which was not prepared to write the risk "other than on the terms provided". To describe CSI as being at arms length was hardly accurate in the circumstances.

[141] In early March Dr Muir wrote to AMS in connection with how the initial premium was to be utilised. He explained that $632,588 ($1,307 x 484 hectares) would be paid to CSI to cover various fees and the bond of US$200,000 required to uplift the insurance licence issued by the British Virgin Islands authorities. The balance was to be held "for onward investment". On 21 March 1997 Southern Lakes Forestry executed a promissory note in favour of CSI for $15,870,844 in respect of the second insurance premium due to be paid no later than 31 December 2047. This promissory note, having a due date 50 years subsequently, will be the subject of further discussion below. The position reached as at 31 March 1997 is of significance as that date marked the end of the income tax year in respect of which the investors claimed deductions not only for the initial premium paid on 20 March 1997 but also for the second premium said to be expenditure incurred during that year but not actually payable in cash terms until 50 years later.

[142] As at 31 March 1997 CSI was formally incorporated and registered in the British Virgin Islands. It had been incorporated and registered there on the instructions of Dr Muir, the architect of the Trinity scheme. Dr Muir was instrumental in formulating CSI's business plan which must be good evidence of the purpose for which CSI was established. It is not unreasonable to say that CSI was a single purpose company, without any independent substance, brought into being to provide pro forma insurance cover in terms of which the investors in the scheme could achieve substantial tax advantages by deduction of the second premium, without suffering any corresponding economic outlay.

[143] Dr Muir rejected the proposition that CSI might undertake other insurance business. He would not allow its modus operandi to be disclosed when inquiries were made by persons interested in how it was operating. He went as far as directing AMS that CSI's structure was highly confidential and that "no suggestion should be made that it was "a 'captive', nor should any reference be made to it or what has been done in relation to it". This emphasis on secrecy is hardly consistent with CSI being an arms length insurer.

[144] Out of the initial premiums CSI paid a total of US$3,589,246 by way of commissions and introduction fees to a company called Parentis which was also under the control of Dr Muir. This amount constituted 90 per cent of the initial premiums paid by Trinity 3 investors. This same amount was then on lent by Parentis to the family trusts of Dr Muir and Mr Bradbury on terms providing for the loans not to be repayable until 2047. Whether this was justifiable in strictly legal terms is not our present concern, but it demonstrates the extremely unorthodox nature of what was going on.

[145] It is of significance too that Dr Muir was at pains to try to avoid disclosing to the Commissioner and the Court the true substance of what CSI was doing. There were the strict instructions for confidentiality earlier mentioned. Documents were removed from the New Zealand jurisdiction. There were failures to produce documents to the Commissioner and the Court. Dr Muir did not fully disclose the substance of CSI's involvement when interviewed by Inland Revenue Department officers. Documents sent to the British Virgin Islands were not adequately disclosed

on lists of documents sworn for the purpose of discovery. Some important documents only became available as a result of a Serious Fraud Office investigation and, when faced at trial with important documents he had failed to disclose, Dr Muir seemed most reluctant to acknowledge their obvious significance.

[146] The letter of comfort dated 3 February 1997 given to CSI by the Trinity Foundation Charitable Trust, which was the ultimate beneficial owner of the Trinity Foundation, demonstrates that although technically CSI was at risk, it was, at least in part, an indemnified risk leading to a substantial element of circularity in the whole insurance arrangement. It is a strong inference from this fact alone that the insurance was simply a method whereby substantial tax benefits could be obtained by deducting in one lump sum in 1997, a premium not payable in commercial terms until 2047.

[147] This is a convenient place at which to revert to the promissory note. The syndicate was contractually liable to pay the second premium in 2047. Payment of that premium was secured by debenture. The execution of the promissory note by the syndicate's documentary agent was said to have been done to give CSI a readier means of enforcing payment than if it had simply been left to sue in contract. Counsel submitted that the rationale was greater ease of recovery. We do not accept this as being the principal purpose of the promissory note. Its true purpose was to enable the contractual debt for the premium to be treated as discharged by the giving of the promissory note. By this means the premium payable in 2047 could be said to have been paid in 1997. As already mentioned,[127] this is technically correct in law, but, in substance, the debt remains unpaid. There is no transfer of real value to the creditor by substituting one form of obligation for another. Hence the promissory note was an artificial payment implemented for taxation purposes. The simple fact is that the second premium was not paid in any real sense by means of the promissory note. The use of the promissory note as an aspect of the whole arrangement reinforces its artificiality. CSI undertook no real risk and was simply a vehicle to achieve the deductibility of a premium which was not truly paid. The purported payment did not give rise to any economic consequences on either side.

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[127] See para [118].

[148] It is inherent in all we have said on this topic that we regard the insurance dimension of the Trinity scheme as both artificial and contrived. The payment of the second premium by means of the promissory note was, in commercial terms, no payment at all. The economic impact of the payment was deferred for 50 years, that being an extreme use of the proposition that a commitment to pay is equivalent to payment, with the time value of money being ignored. The insurance arrangement was, at least in substantial part, circular as a result of the letter of comfort. As Mr Mitchell rightly said, "there was no real risk in the whole thing". Very little of the first premium actually remained in the hands of CSI. The premiums were not fixed on any genuinely independent basis and CSI, as the insurer, was controlled by Dr Muir. It was certainly not in any sense an arms length insurer. The insurance arrangements, as constructed, cannot have been within the contemplation of Parliament when it enacted s DL 1(3). In short, the insurance dimension is a material contributor to making the whole Trinity scheme a tax avoidance arrangement.

Accent Management's new point

[149] Mr Gudsell QC, on behalf of Accent Management Ltd, endeavoured to persuade us to entertain a new point raised for the first time in this Court. After hearing submissions from him and Mr White, the Court ruled that the new point could not be taken nor could any subsidiary point, based on acceptance of the primary one. We indicated that our reasons would be given later. These reasons now follow.

[150] In summary, Accent Management wished to argue that the agreement to grant the licence and options was an agreement for sale and purchase of property and fell within para (b) of the definition of financial arrangement in s EZ 45 of the Income Tax Act 2004.[128] The agreement was said to constitute a deferred property settlement because payment was not made in full at the time when the first right in the specified property was transferred. This represented an attempt to have

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[128] Which for present purposes has retrospective effect.

deduction and spreading issues determined in accordance with Subpart EZ of the 2004 Act, or Subpart EH of the 1994 Act as it then was.

[151] We declined to accept this line of argument as it had not been raised at any earlier stage of the proceeding. It cannot be said that the grounds upon which leave was granted to appeal to this Court contemplated or authorised the argument. Hence the first basis of our declining to consider it was the simple one that leave had not been granted to raise the point and it would not be appropriate to give leave at the hearing in the face of the Commissioner's understandable opposition. The more is this so because the proposed new point was contradictory of the stance previously taken by Accent Management and inconsistent with the claimed deductions, the Commissioner's objections to which are being challenged in these proceedings.

[152] There was a further reason for the ruling we gave, based on the way in which taxation disputes and litigation are designed to be handled. There are two aspects of the procedures laid down for the resolution of taxation disputes in Part 4A of the Tax Administration Act 1994 which are significant for present purposes. First, firm time limits are imposed for raising and responding to disputes and second, the grounds upon which each side takes its position must be specified with some precision.[129] These requirements are obviously designed to assist in resolving tax disputes in a timely and focused manner. They can be waived only in limited circumstances.

[153] A notice of proposed adjustment (NOPA),[130] which either the Commissioner or the taxpayer may give to the other in defined circumstances, must contain sufficient detail of both fact and law to identify the issues and inform the recipient of the notice of the giver's case.[131] There are similar requirements for a notice of response (NOR) which the recipient of a NOPA may give in reply[132] and for the provision of statements of position (SOP).[133] Those issuing NOPAs, NORs and SOPs are generally limited by their terms as regards what may be argued at any later stage of the dispute or challenge process. Although it was decided on earlier

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129 Section 89A(1)(c) states that the purpose of Part 4A is to promote the early identification of the basis for any dispute; para (d) makes reference to the issues and evidence in similar vein.
130 Sections 89B, 89C, 89D and 89DA.
131 Section 89F.
132 Section 89G.
133 Section 89M.

legislation, the leading case on what can be argued at a hearing is *Commissioner of Inland Revenue v V H Farnsworth Ltd*.[134] In that case the Court of Appeal emphasised that the disputes process is not a general inquiry into the taxpayer's liability to pay tax and the amount of that liability. It is an inquiry focused on and by the terms upon which the dispute is raised and responded to. That approach has been reinforced by the terms of Part 4A.

[154] There is therefore limited scope for the introduction of new points as the disputes process proceeds through the judicial system. NOPAs, NORs and SOPs are the equivalent of ordinary civil pleadings in the taxation field. Indeed, because of the requirement to specify the legal basis upon which a party takes its stance, NOPAs, NORs and SOPs require a more precise legal articulation of a party's case than is conventional with ordinary civil pleadings.

[155] It is not necessary for present purposes to go into the jurisprudence in this area in any greater detail. It is sufficient to reiterate that in the present case the taxpayer sought to introduce an entirely separate and distinct basis for assessing the tax payable and sought to do so for the very first time on second appeal. It would be quite contrary to the scheme and purpose of Part 4A to allow this to be done. If we had been willing to entertain a wholly new point in the circumstances of this case, it would be difficult to refuse a similar request at any earlier stage of the disputes process. To accede to the present request would undermine the whole point of the relevant statutory provisions.

Tax avoidance: conclusion

[156] The appellants all entered into an arrangement which gave rise to expenditure by them on a licence premium and an insurance premium through the mechanism of promissory notes. They all claimed deductions based on this expenditure in their tax

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[134] [1984] 1 NZLR 428 (CA).

returns for the 1997 and 1998 tax years. In each case the expenditure satisfied the ordinary meaning of the specific provisions relied on to claim the deductions. The appellants were, however, also required by the general anti-avoidance provision to show that the specific provisions they relied on had been used in a manner which was within Parliament's purpose and contemplation when it enacted them. Having regard to the various features of the arrangement we have discussed, our conclusion is that the appellants' use of the specific provisions was not within Parliament's purpose and contemplation when it authorised deductions of the kinds in question. The appellants altered the incidence of income tax by means of a tax avoidance arrangement which the Commissioner correctly treated as void against him.

Participation

[157] The appellants raise an issue concerning the scope of the arrangement in which they have participated in terms of ss BG 1 and GB 1. They do not dispute that on becoming members of the syndicate they were participants in an arrangement involving use of promissory notes which caused expenses, that were not required to be the subject of cash payments until 2047 or 2048, to be treated for tax purposes as incurred in 1997 and 1998. What they take issue with, however, is the contention that the arrangement they each entered into included either the statement in the CSI business plan that "the real benefits of the deal are tax concessions" or the letter of comfort from Trinity Foundation Charitable Trust to CSI. The Court of Appeal concluded that this undertaking was binding in law on Trinity Foundation and created additional circularity in the insurance element of the arrangement.[135]

[158] The appellants (who did not include the principal designer of the Trinity scheme, Dr Muir) argued that these features were not part of the arrangements they entered into with Trinity 3 and that whatever those features might indicate about there being a tax avoidance purpose in the structuring of the Trinity scheme, that could not result in the reassessment of the appellants under the general anti-avoidance provision.

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[135] At paras [28] and [29].

[159] We have concluded that all appellants entered into a tax avoidance arrangement simply by becoming members of the syndicate and parties to the agreements with Trinity 3. It is therefore strictly unnecessary for us to address Mr Harley's argument in relation to those other features. It is appropriate, however, in order to clarify the statutory requirements, that we address the legal proposition on which it was founded. The central premise of the argument for the appellants was that the Commissioner was not able to exercise the reconstruction power under s GB(1) of the Income Tax Act to counteract a tax advantage obtained by a person from or under a tax avoidance arrangement unless that person was a participant in the arrangement that gave rise to the tax advantage. Mr Harley argued that the decision of the Court of Appeal in *BNZ Investments* supported this proposition.

[160] There are three steps in determining whether an arrangement is void by reason of tax avoidance under ss BG 1 and GB 1. The first step is to decide whether there was an arrangement. In terms of the statutory definition this means "any contract, agreement, plan or understanding". In the *BNZ Investments* case, the majority of the Court of Appeal held:[136]

> [A]n arrangement involves a consensus, a meeting of minds between parties involving an expectation on the part of each that the other will act in a particular way.

That consensus had to encompass the dimension amounting to tax avoidance.

[161] The Privy Council in *Peterson* differed from the Court of Appeal majority in *BNZ Investments* on this point,[137] but it is unnecessary for us to decide whether to depart from that aspect of the Privy Council's judgment in *Peterson* in this case. We will assume, without deciding, that the arrangement entered into by the appellants did not include the admission concerning "the real benefits of the deal" in the CSI business plan or the letter of comfort.

[162] The next step is to decide if there is a "tax avoidance arrangement".

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[136] At para [50].
[137] At para [34] per Lord Millett and at para [93] per Lord Bingham and Lord Scott.

[163] Once the Commissioner has satisfied both those requirements the arrangement is void under s BG 1. The third step concerns the reconstruction power in s GB 1, under which the amount of income, deductions and losses "included in calculating the taxable income *of any person affected by that arrangement*" may be adjusted so as "*to counteract any tax advantage obtained by that person from or under that arrangement*".

[164] On the ordinary meaning of the emphasised language in s GB 1, once the existence of a tax avoidance arrangement has been established, all those taxpayers who have benefited from it may be subject to corrective adjustments by the Commissioner in the exercise of the reconstruction power. No question of mutuality or even awareness by a benefiting taxpayer is a necessary element.

[165] Mr Harley, however, argued that to have a tax advantage obtained "from or under the arrangement" in terms of s GB 1(1), a taxpayer must be a participant in the arrangement. Counsel contended that the majority judgment in *BNZ Investments* supports this position. The Court in that case was addressing s 99 of the 1976 Act. Section 99(2) avoided tax avoidance arrangements "whether or not any person affected by that arrangement is a party thereto". However, the passage relied on by Mr Harley in the majority judgment in *BNZ Investments*[138] is concerned with what is necessary to establish an *arrangement*, emphasising in that context the necessary element of consensus and mutuality. It is not directed to the question of the taxpayers against whom an arrangement is void.

[166] In s 99(2) of the 1976 Act, the concluding words clearly brought in persons who were *not parties* but who were made part of a group against whom the arrangement (which others may have entered) is void. Mr Harley also invoked a passage of the separate concurring judgment of Blanchard J.[139] He said that when making the adjustment to counteract the tax advantage under s 99(2) the rule is that an adjustment can be made against both the party to the arrangement and a person

[138] At para [50].
[139] At para [175].

affected, not necessarily a party. But that is only where the non-party has obtained a "tax advantage" under the arrangement. In that context Blanchard J said:[140]

> The Commissioner therefore cannot make an adjustment against someone who is not a party merely because that person has received a payment subsequent to the operation of an arrangement but outside the arrangement.

[167] We read this passage in its context as saying no more than that an advantage, received by someone other than a party, must be received under the arrangement in question before it can be avoided. The observation reflects the "two arrangements" situation in *BNZ Investments*. Contrary to Mr Harley's submission, Blanchard J did not suggest that a person must be a party to an arrangement to be subject to the reconstruction provisions.

[168] It follows that the argument based on *BNZ Investments* does not assist the appellants. Mr Harley was not able to point to any other authority, or aspect of purpose or context in the legislation that supported his argument.[141] It is true that the restrictive approach to s GB 1, which Mr Harley proposes, would catch taxpayers "affected" who, while strictly not parties to the arrangement, were responsible for orchestrating it. This would address the deficiency that Turner J saw in his criticism of the old s 108 in *Wisheart, Macnab and Kidd v Commissioner of Inland Revenue*.[142] But acceptance that the provision was redrafted to address the problems with s 108 that were perceived in that case does not assist in determining the scope of the remedial provision. On the ordinary meaning of the language used, Parliament did not confine the reach of what is now s GB 1 to those who were *involved* in the arrangement without being parties. Rather coverage extends to *any person affected* by the arrangement. A taxpayer who claims a deduction in terms of a tax avoidance arrangement can hardly claim not to be affected by the arrangement. There is no principle of interpretation that warrants a reading down of the language used. The position therefore is that this section is to be applied according to its ordinary meaning. On that meaning, even if the Trinity scheme were to be struck down because of matters that are outside the arrangement in which the appellants, or

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140 At para [175].

141 In *Peterson* Lord Millett recognised that an arrangement which affected the investors "whether or not they were parties to it" could be counteracted under s 99.

142 [1972] NZLR 319 at p 327 (CA).

some of them, participated, the Act operates so as to allow the Commissioner to treat the arrangement as void against them.

Reconstruction

[169] The Commissioner's reconstruction powers under s GB 1 arose because there was an arrangement which was void in accordance with s BG 1 and the appellants were persons affected by that arrangement. The Commissioner was entitled to adjust the amounts included in calculating the appellants' taxable income "in the manner the Commissioner thinks appropriate, so as to counteract any tax advantage obtained … under that arrangement". That general power under s GB 1(1) was supplemented by a specific power vested in the Commissioner[143] whereby he could have regard to such gross income, allowable deductions and available net losses as he considered the appellants "would have, or might be expected to have, or would in all likelihood have, had if the arrangement had not been made or entered into".

[170] In the present case the appellants' challenge in respect of reconstruction is concerned only with the licence premium aspect of the arrangement. The Commissioner disallowed the whole of the licence premium as a deduction. The appellants argued that this effectively meant that the Commissioner was treating the investors as able to use the land on which the forest was growing free of charge over the whole 50 year period. They argued that this was a commercially untenable premise for the Commissioner to have based his reconstruction on. The investors, however, had already effectively paid for the land and all the Commissioner did was to disallow the deduction claimed. In those circumstances the appellants have not established that the Commissioner adopted a reconstruction which was outside the scope of his powers.

[171] Furthermore, when taxpayers challenge an assessment based on a reconstruction adopted by the Commissioner, the onus is on them to demonstrate, not only that the reconstruction was wrong, but also by how much it was wrong. Unless the taxpayer can demonstrate with reasonable clarity what the correct

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143 Under s GB 1(1)(a).

reconstruction ought to be, the Commissioner's assessment based on his reconstruction must stand. This is settled law.[144] In this case we are of the view that the appellants have not shown that the Commissioner's assessment based on his reconstruction was wrong. Even if they had shown that to be so, they have not shown on any reasonably clear basis to what extent it should be varied. The appellants did not submit any specific proposed reconstruction of their own, the validity of which the Court could then have evaluated. The Commissioner's assessment must therefore stand.

Penalties

General

[172] In 1996 a new regime of civil penalties for failures by taxpayers to comply with their tax obligations in relation to self-assessment was introduced in the Tax Administration Act 1994.[145] Part 9 of that Act was repealed and substituted by the new provisions.

[173] Having concluded that they had each taken an abusive tax position resulting in a tax shortfall, the Commissioner assessed the appellants with a penalty of 100 per cent of the tax shortfall in the 1998 year. The legislation empowering the imposition of penalties did not apply to the 1997 year. The imposition of these penalties was challenged in the High Court where Venning J addressed a number of wide ranging arguments. He decided that the appellants had incorrectly claimed deductions for the licence premium and insurance premium in their relevant returns and that the tax position they had taken did not meet the statutory standard of being "about as likely as not to be correct" at the time of filing the return.[146] He also held that the incorrectness of the position taken was due to the general anti-avoidance provision and that the appellants entered the Trinity scheme with the dominant purpose of tax

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[144] *Buckley & Young v Commissioner of Inland Revenue* [1978] 2 NZLR 485 at p 498 (CA). See also to the same effect *Commissioner of Taxes v McCoard* [1952] NZLR 263 (SC).

[145] By s 43 of the Tax Administration (No 2) Act 1996.

[146] At para [365].

avoidance.[147] It followed that the Commissioner's assessment was a lawful exercise of his powers and the appellants' challenge was dismissed. Venning J's judgment on this point was upheld by the Court of Appeal on the general anti-avoidance ground.[148]

[174] The scheme of Part 9 is to impose civil penalties on taxpayers who take an incorrect tax position which results in a tax shortfall. The provisions impose specified penalties, based on varying percentages of the resulting tax shortfall, which are set by the statute itself, according to the relative culpability of the taxpayer. At one end of the scale are instances where the taxpayer has not taken reasonable care where the penalty is 20 per cent.[149] Where the taxpayer is grossly careless, the penalty is 40 per cent.[150] At the other end is evasion where the penalty is 150 per cent.[151] In the appellants' case the penalties were imposed under s 141D which applies where the taxpayer has taken an "abusive tax position". The penalty in such cases is 100 per cent of the tax shortfall.

[175] Section 141D states as follows:

> **141D Abusive Tax Position**
>
> (1) The purpose of this section is to penalise those taxpayers who, having applied an unacceptable interpretation to a tax law, have entered into or acted in respect of arrangements or interpreted or applied tax laws with a dominant purpose of taking, or of supporting the taking of, tax positions that reduce or remove tax liabilities or give tax benefits.
>
> (2) A taxpayer is liable to pay a shortfall penalty if the taxpayer takes an abusive tax position (referred to as an **abusive tax position**).
>
> (3) The penalty payable for taking an abusive tax position is 100% of the resulting tax shortfall.
>
> (4) This section applies to a taxpayer only if —
>
> (a) The taxpayer's tax position involves an unacceptable interpretation of a tax law; and

147 At para [370].
148 At paras [168] and [170].
149 Section 141A.
150 Section 141C.
151 Section 141E.

(b) The tax shortfall arising from the taxpayer's tax position exceeds $10,000.

(5) Section 141B(6) applies for determining the time when a taxpayer takes an abusive tax position.

(6) A taxpayer's tax position may be an abusive tax position if the tax position is an incorrect tax position under, or as a result of, either or both of —

(a) A general tax law; or

(b) A specific or general anti-avoidance tax law.

(7) For the purposes of this Part, an **abusive tax position** means a tax position that, —

(a) At the time at which the taxpayer's tax position is taken, involves the taking of an unacceptable interpretation of a tax law; and

(b) Viewed objectively, the taxpayer takes —

(i) In respect, or as a consequence, of an arrangement that is entered into with a dominant purpose of avoiding tax, whether directly or indirectly; or

(ii) Where the tax position does not relate to an arrangement described in subparagraph (i), with a dominant purpose of avoiding tax, whether directly or indirectly.

[176] There are three requirements to be met before a taxpayer will be found to have adopted an "abusive tax position". First, a taxpayer must have taken a tax position which involves an "unacceptable interpretation of a tax law".[152] An unacceptable interpretation is an interpretation or application of that tax law which "fails to meet the standard of being … about as likely as not to be correct" when viewed objectively.[153] Whether an interpretation is unacceptable is determined at the time the tax position is taken by the taxpayer.[154] In the case of positions taken in tax returns, the tax position is taken when the taxpayer provides the return.[155] Secondly the tax position must be one that, viewed objectively, is taken by the taxpayer in respect, or as a consequence, of an arrangement that is entered into with a dominant purpose of avoiding tax, whether directly or indirectly.[156] Alternatively, where there

152 Section 141D(4) and (7)(a).
153 Section 141B(1)(b).
154 Section 141B(5).
155 Section 141B(6).
156 Section 141D(7)(b)(i).

is no arrangement, the tax position itself must be taken by the taxpayer for that dominant purpose.[157] Thirdly, the provision imposing a penalty for taking an abusive tax position applies only if the tax shortfall arising from the taxpayer's tax position exceeds $10,000.[158] That requirement is satisfied for all appellants in the present case.

[177] The penalty provisions, particularly at the higher end of the scale, are onerous. This reflects Parliament's statement of the purposes of Part 9, which are:[159]

> (a) To encourage taxpayers to comply voluntarily with their tax obligations and to cooperate with the Department; and
>
> (b) To ensure that penalties for breaches of tax obligations are imposed impartially and consistently; and
>
> (c) To sanction non-compliance with tax obligations effectively and at a level that is proportionate to the seriousness of the breach.

[178] The broad statutory goal of the penalty provisions is to secure compliance by taxpayers with their legal obligations in relation to the positions they take regarding their tax affairs. Part 9 supports the integrity of the tax system in its dependence on voluntary compliance by taxpayers with their responsibility to inform the Revenue concerning their tax affairs in a proper and accurate way. It provides sanctions which increase in severity according to the gravity of the circumstances of what the legislation treats as inappropriate tax positions. These sanctions create strong incentives for taxpayers to meet standards of conduct in their tax affairs, in particular in relation to tax positions that may be characterised as involving tax avoidance or evasion.

[179] The Act imposes penalties under Part 9 if the statutory requirements are met. In deciding whether those requirements are met, the Commissioner exercises a judgment, which is akin to making findings based on evidence, as to whether the elements of, in this case, an abusive tax position are made out. The limited role for discretionary judgment in the Commissioner's decision-making on penalties reflects

157 Section 141D(7)(b)(ii).
158 Section 141D(4).
159 Section 139.

the purpose of ensuring there is impartiality and consistency in the imposition of penalties.[160]

[180] The standard of proof in civil proceedings relating to the imposition of penalties is the balance of probabilities.[161] The penalties under Part 9 are, however, severe, particularly for those taking incorrect tax positions at the more serious end of the scale. This includes the penalties for those taking an abusive tax position. The evidence required to meet the standard will accordingly reflect the seriousness of the circumstances of the particular case.[162] We also agree with an academic writer that when it is considering whether penalties have been correctly imposed, a court must give the matter the careful consideration appropriate in a penal context.[163] Subject to that, the penalty provisions must be read in light of the statement of statutory purposes for Part 9.

Unacceptable interpretation

[181] Applying these principles, the first issue in deciding if the appellants took an abusive tax position in their 1998 year returns, is whether the interpretation of tax law on which those returns were based was an unacceptable one. The term "unacceptable interpretation" is defined in the legislation:

> **141B Unacceptable Interpretation**
>
> (1) For the purposes of this Part, an unacceptable interpretation of a tax law is, in relation to a tax position taken by a taxpayer, an interpretation that —
>
> (a) Involves the interpretation or application of that tax law; and
>
> (b) Fails to meet the standard of being, viewed objectively, about as likely as not to be correct.

[182] We have decided, in relation to the claims for deductions with respect to the licence premium and insurance premium, that the expenditure in each case satisfied the ordinary meaning of the specific provisions relied on. Satisfying the specific

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160 As set out in s 139(b).
161 Section 149A(1).
162 *Z v Dental Complaints Assessment Committee* [2009] 1 NZLR 1(SC).
163 Griffith, "Tax Penalties" [2008] NZLJ 223.

provisions on their own, however, was not enough. The appellants were unable to show that they had been used in a manner consistent with Parliament's overall purpose in enacting them. There were features in the arrangement which led us to conclude that the arrangement was clearly a tax avoidance arrangement. The effect of this conclusion in terms of s 141D(6) is that the appellants in their returns took an incorrect tax position under a general anti-avoidance tax law.

[183] The next question in relation to the abusive tax position issue is whether the incorrect interpretation failed to meet the standard of, objectively, being "about as likely as not to be correct". If so, the incorrect tax position will involve an "unacceptable interpretation" under s 141B(1).

[184] On its terms this standard does not require that the appellants' tax position had a 50 per cent prospect of success but, subject to that qualification, the merits of the arguments supporting the taxpayer's interpretation must be substantial. The stipulation of an objective test means that the taxpayer's belief that the position taken was correct, or not unacceptable, is irrelevant.

[185] There is a helpful observation of Hill J concerning the statutory standard made in the context of a similar provision in Australian legislation:[164]

> The word "about" indicates the need for balancing the two arguments, with the consequence that there must be room for it to be argued which of the two positions is correct so that on balance the taxpayer's argument can be said to be one that while wrong could be argued on rational grounds to be right.

Whether a taxpayer's interpretation meets the standard in any case accordingly comes down to a judgment of the weight of the arguments that support the taxpayer's position in the application of the law to the relevant facts. The Act requires that the application of all tax laws, including the general anti-avoidance provision, be taken into account in making this judgment.[165] As well, discussions of the courts and Taxation Review Authority on the interpretation of relevant tax laws must be considered.[166]

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164 *Walstern Pty Ltd v Commissioner of Taxation* (2003) 138 FCR 1 at para [108] (FCA).
165 Section 141B(7)(a).
166 Section 141B(7)(b).

[186] On behalf of the appellants, Mr Harley put the argument that the appellants' tax position was based on an interpretation of tax law that met the "about as likely as not to be correct" standard in this way. The first premise was that the expenses for which deductibility was claimed, being the licence premium and insurance premiums, met the terms of the specific deductibility provisions. This Court has accepted that premise to be correct. The next premise is that the expenses were genuinely incurred in a business in the years in issue, with the consequence, on the authority of the Privy Council's judgments in the two *Europa Oil* cases,[167] that the general anti-avoidance provision did not override those specific provisions for deductibility. Much emphasis was placed by Mr Harley on the key passage in the *Europa 2* judgment, said to be directly in point:[168]

> Their Lordships' finding that the monies paid by the taxpayer company to Europa Refining 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 Refining, is incompatible with those contracts being liable to avoidance under s 108. In order to carry on its business of marketing refined petroleum products in New Zealand the taxpayer company had to purchase feedstocks from someone. 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, 434), to which their Lordships would add: it is not for the court or commissioner to say from whom the taxpayer should purchase the stock-in-trade acquired by him for the purpose of obtaining his income.

As well, the appellants rely on the Privy Council judgment in *Peterson*, arguing that it endorses what Lord Diplock said in *Europa 2*.[169]

[187] In the event that this Court decides not to accept Mr Harley's submission based on this passage in *Europa 2*, the appellants argue in relation to penalties that they reasonably relied on that judgment as a statement of New Zealand tax law at the time they entered into the syndicate's investment. They made their statements of position in their tax returns on that basis. They say that in this complex area, where

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[167] *Commissioner of Inland Revenue v Europa Oil (NZ) Ltd* [1971] NZLR 641 (*Europa 1*); *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue* [1976] 1 NZLR 546 (*Europa 2*).

[168] At p 556 per Lord Diplock.

[169] Reliance is placed on paragraphs [43] and [44] of the Privy Council judgment in *Peterson*.

the Privy Council and New Zealand Court of Appeal Judges have commonly differed on the application of the general anti-avoidance provision, their position was based on an interpretation of the law that met the stipulated standard of being acceptable. They also say it was not the purpose of Part 9 of the Tax Administration Act to penalise a position taken in these circumstances. They emphasise, and it is common ground, that a finding that a tax interpretation was wrong, does not of itself contradict their argument.

[188] It is accordingly necessary to identify the state of New Zealand tax law in relation to the application of the general anti-avoidance provision as at 1998 when the tax returns were filed by the appellants and to consider in relation to it the interpretation advanced to justify the appellants' position.

Decision in Europa 2

[189] The principle that the appellants draw from the *Europa 2* judgment is that if it is shown that a legal entitlement gained under a contract from expenditure qualifies that expenditure for deductibility under tax law, a general anti-avoidance provision cannot apply to bar the deduction.

[190] It was, however, by no means clear from its judgment that the observations of the Privy Council were intended to state such a broad proposition that would be applicable in all situations. Prior to the Privy Council's judgment the New Zealand courts had held in *Elmiger*[170] and *Wisheart*[171] that the Commissioner could apply s 108 to avoid arrangements involving contrived deductions in artificial situations which had the principal end of reducing tax otherwise payable, even though on a purely legal analysis of the arrangement the expenditure in issue was deductible under a specific tax provision. In *Mangin*, the Privy Council appeared by its general approach to have approved the opinions expressed in the Court of Appeal's judgment in *Elmiger*.

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170 At p 179 per North P in the Court of Appeal confirming the approach of Woodhouse J in the Supreme Court.

171 At p 324 per North P and at pp 328 – 330 per Turner J.

[191] In adopting the *Cecil Bros Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia*[172] approach in *Europa 2*, the Privy Council made no reference to its earlier approval of *Elmiger* in *Mangin*. Nor did it refer to the Court of Appeal judgment in *Wisheart* refusing to apply *Cecil Bros* in a case involving a highly artificial arrangement. The Privy Council's conclusion of incompatibility rested on the factual finding that the taxpayer had actually paid the price claimed as a deduction. The judgment did accept that there might be wider considerations in other cases that would lead to a conclusion of tax avoidance. This suggests that the Privy Council was not overruling the earlier New Zealand decisions and did not intend its observations to be read as applicable to arrangements of a contrived or artificial kind.

[192] Consistently with this narrower view of Lord Diplock's observations in *Europa 2*, Casey J held in 1977[173] that the Privy Council had not determined that s 108 could never apply to deductions falling within s 111. He concluded that there was an area in which s 108 continued to operate in appropriate cases to avoid deductions conforming with s 111. After referring to passages in *Cecil Bros* and *Europa 2*, Casey J explained how s 108 should be applied in deduction cases:[174]

> Where the need for the expenditure can be regarded as a normal incident of the business or undertaking forming the source of the taxpayer's income, then he may select his own means of incurring it, and may spend what he thinks fit. So long as that expenditure conforms with s 111, it cannot be attacked under s 108. But s 108 can still apply where the need for such expenditure has been contrived in an existing source of income, as part of an arrangement having tax avoidance as one of its main purposes, and which is not a usual business or family dealing.

[193] In *Challenge Corporation*, Richardson J addressed the argument concerning the limited scope of the general anti-avoidance provision in the course of his discussion of s 99: [175]

> Clearly the legislature could not have intended that s 99 should override all other provisions of the Act so as to deprive the tax paying community of structural choices, economic incentives, exemptions and allowances provided for by the Act itself. …

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172 (1964) 111 CLR 430.
173 In *Halliwell v Commissioner of Inland Revenue* [1978] 1 NZLR 363 (SC).
174 At pp 372 – 373.
175 At pp 548 – 549.

> On the other hand s 99 would be a dead letter if it were subordinate to all the specific provisions of the 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. In some cases then the section imposes an additional requirement. In others, this is a common application of the section in cases where trusts and companies are employed for planning purposes, while the use of that machinery is regarded as perfectly legitimate and not on its own affected by s 99, it may be only one element in a wider arrangement which is caught by the section.

[194] In the second paragraph above, Richardson J rejected the argument that the application of the general anti-avoidance provision was incompatible with specific provisions.[176] What he said was approved by the Privy Council in *Challenge Corporation*.[177]

[195] In *Hadlee v Commissioner of Inland Revenue*,[178] decided in 1991, the Court of Appeal distinguished *Europa 2*, saying that the judgment:[179]

> contains nothing to suggest that their Lordships intended the taxpayer to be free to produce income from the source by his own exertions, yet treat the product for tax purposes as not derived by him.

[196] In a judgment delivered in the High Court in 1997, the scope of the application of the anti-avoidance provision in deductibility cases was further clarified. In *Miller v Commissioner of Inland Revenue*[180] Baragwanath J referred to *Europa 2* and said that Lord Diplock's reference to "incompatibility" appeared to turn on the Privy Council's reluctance to review decisions that may be justified on commercial grounds. After observing that the Privy Council in *Challenge Corporation* had declined to treat s 191 (a specific anti-avoidance provision) as establishing a code independent of s 99, Baragwanath J, in an observation which we consider accurately summarised the legal position reached at the time said:[181]

> It is a section that deals with transactions altogether lawful in terms of the general law and the general provisions of the Income Tax Act but which

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176 Earlier, at pp 546 – 547 of his judgment, Richardson J had referred to the argument that the general anti-avoidance provision could not apply to bar deductions otherwise allowable as one of the constructional arguments "designed to constrict the scope and application of the old s 108".

177 At p 559.

178 [1991] 3 NZLR 517 (CA).

179 At p 524.

180 (1997) 18 NZTC 13,001 (HC).

181 At p 13,027.

> nevertheless infringe its terms. Section 99 does concern reality and lawfulness, but in a sense quite different from the general provisions. It begins to bite when their operation is complete.

[197] The appellants' tax returns for the 1997 and 1998 years were filed and their tax positions in relation to the Trinity scheme taken against these interpretations of the relevant tax laws. Even in 1976, while objectively tenable, it was by no means clear that the Privy Council had intended its observations to apply to cases of contrived deductions or artificial situations lacking any apparent commercial purpose. But by the time the tax positions were taken in the present case, the proposition that the New Zealand courts, including the Privy Council, would have reverted to the simplistic and very restrictive approach to the application of s 99, based on a literal reading of *Europa 2*, was remote, given the less than sympathetic treatment that case had received subsequently.

[198] Nor would it assist the appellants if the Court were to consider the later decision in *Peterson*. The Court of Appeal discussed the principles in *Cecil Bros* and *Europa 2* and observed:[182]

> But we find nothing in the judgments in those cases precluding the Commissioner from declining to recognise costs not truly incurred.

[199] Our approach to *Europa 2* is consistent with the judgment of the Privy Council in *Peterson*, although the taxpayer's appeal was successful in that case. In *Peterson* the Privy Council, by a majority, applied the approach it had taken to trading expenditure in *Europa 2* to capital expenditure incurred to acquire rights to a film.[183] The taxpayer in *Peterson* had claimed a depreciation allowance based on the total sum he was contractually required to pay to acquire the interest in the film. Part of the consideration was a contrived sum, which was financed by a non-recourse loan, that had no relationship to production costs and indeed was immediately repaid to the lender. The majority, in the judgment of Lord Millett, decided the appeal on the basis of a concession of fact made by the Commissioner that contractually the taxpayer had paid the full consideration to acquire the film, there being no additional

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[182] *Commissioner of Inland Revenue v Peterson* [2003] 2 NZLR 77 at para [46].

[183] At para [43].

purpose. In these circumstances, the majority applied the *Europa 2* principle to determine the appeal in favour of the taxpayer.

[200] But the majority's judgment turned on the concession. Lord Millett went on to say that, in general, where parties stipulate a single consideration for supply of two or more goods or services, the Commissioner can go behind the allocation agreed on by the parties and reallocate the consideration on a proper basis.[184] The effect is that taxpayers must show that the economic purpose of the entire expense incurred, rather than simply the legal benefit, relates to the income earning process. Otherwise only the appropriate proportion will be deductible. As well, and importantly, the majority went on to indicate that the Commissioner could have contended in the alternative that:[185]

> the arrangement by which the production company allocated the payment of $y as part of the consideration for acquiring the film instead of as consideration for the procurement of the loan (which affected the investors whether or not they were parties to it) could be counteracted under s 99.

[201] The conclusion we reach is that the appellants' argument that, by satisfying the specific provisions for deduction of the licence and insurance premiums in their 1998 returns, they were free from the application of the general anti-avoidance provision, would have been a highly speculative one at the time. The law had been considerably developed since the 1976 decision on which the argument relies. While *Europa 2* has not been expressly overruled on this point, there is nothing in the case law directly addressing the case, nor other tax jurisprudence available in 1998 that supports a finding that the appellants' argument has a sufficient rational basis to be one that at the time would have had close to a 50 per cent prospect of success.

[202] On general principles concerning the application of the general anti-avoidance provision, the points made earlier concerning the highly contrived nature of the whole arrangement, in conjunction with the mismatch of timing between when

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184 At paras [47] – [53]. The passages are discussed in Prebble, "The *Peterson* Case and its Impact on the Rules in *BNZ Investments Ltd* and *Cecil Bros*", in Sawyer (ed), *Taxation Issues in the Twenty-First Century* (2006), pp 122-124.

185 At para [52].

deductions were claimed and payments were to be made, always meant this arrangement was highly likely to be set aside.

[203] Accordingly the appellants' tax position failed to meet the standard of being about as likely as not to be correct and was an unacceptable interpretation of tax law.

Dominant purpose

[204] The second requirement for the appellants to have taken an "abusive tax position" is that, under s 141D(7)(b)(i), the appellants took their tax position:[186]

> In respect or as a consequence, of any arrangement that is entered into with a dominant purpose of avoiding tax, whether directly or indirectly.

[205] The appellants' submission is that this provision requires that *their* dominant purpose in entering into the relevant arrangement must be considered, rather than, as the Courts below decided, the dominant purpose of the arrangement itself.

[206] Mr Harley argued that the statute required an objective assessment of each appellant's dominant purpose in entering the arrangement. The proposition that the concept relates to the taxpayer's mind may on first impression appear arguable, but we are satisfied that there are allied provisions within the section which make it untenable. Our conclusion is that s 141D(7)(b)(i) refers to a tax position that is taken by a taxpayer by means of an *arrangement* which has a dominant purpose of avoiding tax.

[207] The qualification in s 141D(7)(b), "viewed objectively", substantially answers the appellants' argument. It directs attention to features of the arrangement rather than intentions of a taxpayer in taking a tax position linked to the arrangement. Subpara (ii) of s 141D(7)(b) reinforces this interpretation in its reference to "an *arrangement* described in subpara (i), *with a dominant purpose*". This makes it clear that it is the purpose of the arrangement itself, not the purpose in the mind of the

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186 See para [175] above for the full provision.

taxpayer, that is referred to in s 141D(7)(b)(i). This aspect of the definition of an "abusive tax position" is concerned with the means employed rather than intentions of taxpayers in taking a tax position. The section requires that the arrangement itself be examined to ascertain its dominant purpose from its terms, irrespective of what may be known or inferred concerning the motives of individual investors.

[208] Mr Harley referred us to observations of the Federal Court of Australia[187] concerning construction of the equivalent penalty provision in the Commonwealth Income Tax Assessment Act 1936 (Cth). That provision does not have the direction in s 141D(7)(b) to view the provision objectively and the dicta referred to are of no assistance in this case. As the Commissioner's written submissions point out, the provision read in this way is consistent with the objective test for tax avoidance first articulated in *Newton*.[188]

[209] It follows that the appellants each took an abusive tax position and, subject to particular arguments advanced by Ben Nevis, Greenmass and Redcliffe, are liable for the 100 per cent penalty imposed by the legislation. We turn to consider these appellants' arguments concerning their positions.

Tax shortfall – Ben Nevis and Greenmass

[210] Ben Nevis and Greenmass contend there was no relevant tax shortfall in the case of their LAQCs. The Commissioner's approach has resulted in penalties being separately imposed on those companies as well as on the shareholders with the result that two penalties of 100 per cent have been imposed in respect of one tax shortfall.

[211] The issue here arises from the terms of the definition of "tax shortfall" in the Tax Administration Act:[189]

> **Tax shortfall**, for a return period, means the difference between the tax effect of —

[187] *Federal Commissioner of Taxation v Starr* (2007) 164 FCR 436.
[188] At p 465.
[189] Section 3.

> (a) A taxpayer's tax position for the return period; and
>
> (b) The correct tax position for that period, —
>
> When the taxpayer's tax position results in too little tax paid or payable by the taxpayer or another person or overstates a tax benefit, credit, or advantage of any type or description whatever by or benefiting (as the case may be) the taxpayer or another person.

A "tax position" is defined as:

> **Tax position** means a position or approach with regard to tax under one or more tax laws, including without limitation a position or approach with regard to —
>
> …
>
> (g) The incurring of an amount of expenditure or loss, or the allowing or denying as a deduction of an amount of expenditure or loss:
>
> (h) The availability of net losses, or the offsetting or use of net losses.

[212] The Court of Appeal concluded that the LAQCs each took a tax position in their returns as to the losses claimed, and that the tax effect of their positions differed from the correct tax position for the relevant return period. The end tax position of the LAQCs was no different from the correct tax position, as the losses they returned were negated. The appellants associated with the LAQCs alone carried the losses through to their end tax position.

[213] In these circumstances the imposition of tax shortfall penalties on the LAQCs as well as the appellant taxpayers involved a double penalty. The Court of Appeal, however, thought this was the inescapable consequence of the plain meaning of the legislation and in particular the words "or another person" which covered LAQCs.

[214] The appellants submitted that the penalty regime operated to treat LAQCs as accounting vehicles which "attribute" tax losses which effectively pass through them to shareholders.[190] While that is the way LAQCs are treated in respect of gains and losses, the Tax Administration Act is not so specific as to penalties associated with unacceptable and abusive tax positions. The Court of Appeal was of the view that the language of the definition of "tax shortfall" covered the position of each LAQC

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190 See s HG 1 of the Income Tax Act.

whose tax position resulted in a relevant tax shortfall associated with the tax payable by their shareholders. We share the view that this is the effect of the ordinary meaning of the words used in their context and do not see that the general scheme of subpart HG of the Income Tax Act provides a context that enables the Court to read down the words of the definition.

[215] This does not, however, conclude the matter as s 141FC of the Tax Administration Act, enacted in 2003, provides a mechanism for relief against double penalties imposed from 1 April 1998. The section applies where an LAQC has attributed a loss to a shareholder and, as a result of the subsequent disallowance of one or more deductions, penalties have been imposed on both the LAQC and the shareholder. Under the mechanism for relief, the shortfall penalty on the shareholder must be reduced where the LAQC pays in full the amount of the shortfall penalty and the shareholder requests application of the section. The penalty must be reduced by a specified amount which it is unnecessary to go into. At this point the mechanism has not been triggered but if that eventuates, the element of double penalty will disappear.

Redcliffe position

[216] Ms Hinde argued that Redcliffe Forestry Venture Ltd, a syndicate member, had taken a correct tax position in its return so that there was no tax shortfall in its case that could result in penalties. Counsel emphasised that Redcliffe ultimately made a "nil" return of taxable income or net loss. She said the return correctly recorded what had been calculated and attributed in respect of its investment, the relevant sums being passed through to shareholders.

[217] In its return for the 1998 year Redcliffe recorded that it had incurred a gross loss of $1,208,382, largely being due to its share of the amortised licence premium of $41,000 per plantable hectare. The return showed that Redcliffe was an LAQC and that it had allocated the sum of $1,208,382 to its shareholders with the result that

it had no income (or loss). The three shareholders in Redcliffe, who included Dr Muir, returned attributed losses in proportion to their shareholdings.[191]

[218] The definition of "tax position" is very broad. It covers any position or approach with regard to tax under any laws. These include "without limitation" any position or approach with regard to the incurring of a loss, the allowing of a deduction of an amount of loss or the availability of losses or the offsetting or use of net losses. What Redcliffe did in its return in our view is caught by these provisions. Redcliffe recorded its share of the loss under the Trinity scheme and claimed status as an LAQC to facilitate the attribution of the losses to its shareholders and the proportionate claims made by Dr Muir and others. In doing so Redcliffe took an incorrect tax position in relation to itself, giving rise to a tax effect different from the correct tax position for the period. It is not in point that its own ultimate position did not claim a loss. Viewed as a whole, which is what the Act requires, Redcliffe's return involved taking a tax position in relation to the Trinity scheme which resulted in too little tax being paid by Redcliffe's shareholders. That was a tax shortfall which resulted in Redcliffe being correctly held liable to a shortfall penalty.

Outcome

[219] In the light of our conclusions, the appeals must be dismissed. The appellants must pay costs to the respondent (for which the appellants will be jointly and severally liable) of $75,000 together with reasonable disbursements to be fixed if necessary by the Registrar.

Solicitors:
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Crown Law Office Wellington for Respondent

[191] In the 1998 year Dr Muir claimed $966,705 as his share of the loss attributed by Redcliffe. In the previous year he had claimed a loss of $897,869.