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INTER ALIA

Economic stabilisation

To many of those who were practising law in the 40s the Economic Stabilisation (Rent) Regulations 1976 will bring back memories of one sort or another and maybe bring about a dusting-off of long-forgotten third editions of Wily's Tenancy Legislation to recall just how it was that the Courts took into account the "economic stability of New Zealand" when assessing rents. For this standard is the same in effect as that used in the Economic Stabilisation Emergency Regulations 1942.

The regulation requires every Rent Appeal Board when assessing an equitable rent, to have regard not only to the matters set out in the Rent Appeal Act 1973 but also "as an overriding and predominant consideration, to the economic stability of New Zealand". At first reading this may give the impression that a landlord is faced with the daunting prospect of establishing that a rent increase will promote the economic stability of New Zealand. When faced with that argument in the 40s the Court of Appeal simply took the view that ". . . the words used are declarations of an established economic principle – namely, that fair rents are necessary to general economy . . ." and went on to consider the application in question on its merits. In effect it regarded the provision as requiring no more than that rents be set objectively rather than personally. As the present Rent Appeal Act already provides for that, nothing seems to be altered.

Indeed a further problem arises if any alteration is intended for it should not be overlooked that the regulation purports to override criteria laid down by statute. This lays it open to attack on the ground that it is repugnant to the provisions of the Rent Appeal Act and consequently invalid.

It has been suggested that the regulation is no more than budgetary window dressing. Kinder people feel sure that it must have some purpose but cannot quite put their finger on what it is. Whatever was intended, if the experience of the 40s is any indication the regulation is unlikely to do more than give scope to unnecessary argument as to whether meaningless criteria have been met in what has been up to now a straightforward practical inquiry.

References to "the economic stability of New Zealand" or "the economic . . . well-being of the people of New Zealand" are becoming more frequent in legislation and the formulae when following specific measures certainly provide a tribunal with a degree of flexibility in arriving at its decision. When however they are expressed to be of "paramount importance" or "paramount considerations" in the deliberations of tribunals dealing with such different matters as do the Rent Appeal Board and the Wage Hearing Tribunal it is not at all clear what is intended.

It could be thought to require that the matters specifically referred to in the statute or regulation be considered and then a decision reached that will promote the economic stability of New Zealand. Superficially attractive though that approach may be it still does not flesh the bones of "economic stability" and clarify how it is to be proved or how promoted.

Opinion differs on what measures promote economic stability as present politics indicate. To

use it as a standard is either to give a tribunal an extraordinarily wide discretion or to risk having lip service paid and the tribunal carry on as before. While on past experience the latter seems the more probable the former is always a possibility. If a government wishes to ensure that its economic measures are promoted it could do worse than leave tribunals charged with regulating various sections of the economy with clear guidelines rather than clouding their jurisdiction with vague and general, but overriding considerata.

Income tax avoidance

In this issue are three articles on the general topic of income tax avoidance, two of them dealing specifically with the Privy Council decision in *Europa (No 2)*. Indications are that this decision which some regard as irreconcilable with the Privy Council decision in *Europa (No 1)* will cause some confusion in the future application of the provisions relating to deductions and to tax avoidance. Not the least criticism concerns the way in which the Privy Council has stated the law in relation to tax avoidance with scant reference to the considerable volume of New Zealand case law on the topic.

The importance of the avoidance provisions cannot be minimised as these go to the very fairness of tax administration – fairness not only to those planning their affairs in the light of the taxation laws but fairness to all other taxpayers. It is probably true to say that perceived inequities in a tax system are hardly likely to encourage respect for it or to discourage others from sampling the fruits that a little tax avoidance or evasion may be able to finance.

It has been suggested that the present tax avoidance provision (s 108) has proved unsatisfactory because it is philosophically unsound. It is doubtful whether the 1974 Amendment has improved matters or made its application any more certain. The time is long overdue for its complete revision and clarification of its relationship to other provisions in the tax legislation. Fortunately there are indications that such a review is in the wind.

Tony Black

THE EUROPA OIL (No 2) CASE

I Introduction

The Privy Council's Judicial Committee delivered judgment on *Europa Oil (NZ) Ltd (No 2) v CIR* on 13 January 1976 ending the second round of an extraordinary contest. As in *Europa Oil (NZ) Ltd (No 1) v CIR* [1971] NZLR 641 (JC), a majority of their Lordships, has reversed a unanimous New Zealand Court of Appeal. In *Europa (No 1)*, the Court of Appeal was unanimous in reversing McGregor J, and ruled for the taxpayer. On the Commissioner's appeal their Lordships – led by Lord Wilberforce – reversed the Court of Appeal and upheld the Commissioner's assessments. In *Europa (No 2)*, the Court of Appeal agreeing with McMullin J in the Supreme Court and paying assiduous regard to *Europa (No 1)*, upheld the Commissioner. The Privy Council – this time Lord Wilberforce dissenting – reversed the New Zealand Courts and allowed the taxpayer's appeal.

The overall effect of *Europa Oil (No 2)* is to suggest that:

(a) the *Europa Oil (No 1)* test formulated by Lord Wilberforce was unsatisfactory and no longer good law; and

(b) once a deduction is allowed in terms of s 111, and is not expressly barred by s 112 or the like, the Commissioner cannot invoke s 108 to avoid the arrangement as a matter of principle.

It is necessary to examine both propositions.

By GEOFF HARLEY, *a Wellington practitioner –*

The judgments under discussion in this article are found in different law reports. For convenience they are tabled here, and referred to throughout as follows:

Europa Oil (NZ) Ltd (No 1) v CIR *[1970] NZLR 321 (McGregor J)*

Europa Oil (NZ) Ltd (No 1) v CIR *[1970] NZLR 363 (CA)*

Europa Oil (NZ) Ltd (No 1) v CIR *[1971] NZLR 641 (JC)*

Europa Oil (NZ) Ltd (No 2) v CIR *(1973) 3 ATR 512 (McMullin J)*

Europa Oil (NZ) Ltd (No 2) v CIR *(1974) 4 ATR 455 (CA) (interim judgment)*

Europa Oil (NZ) Ltd (No 2) v CIR *[1976] 1 NZLR 564 (CA) (final judgment)*

Europa Oil (NZ) Ltd (No 2) v CIR *[1976] 1 NZLR 546 (JC).*

II The facts

The essential common features of the facts in *Europa (No 1)* and *Europa (No 2)* are as follows:

(1) Europa Oil (NZ) Ltd was a wholly New Zealand owned company involved in the distribution and retailing of petroleum products throughout New Zealand.

(2) New Zealand had no indigenous supply of petroleum sources, nor any refining capacity, prior to 1956.

(3) Europa Oil, like all its competitors, had to import all its products for sale throughout New Zealand.

(4) Prior to 1956, Europa Oil had an import arrangement for its supplies through Caltex. In 1956 this arrangement came to an end.

(5) Mr Bryan Todd, Managing Director of Europa Oil, entered into negotiations with the Gulf Oil Corporation for supply of Europa Oil's petroleum products.

(6) Gulf Oil had huge resources of crude oil which it refined and sold through various outlets on a world-wide basis. Gulf had an adequate market for the "heavy" end products of the refining operation – fuel oil, diesel – but an inadequate market for "light" end products – gasoline.

(7) Europa Oil's operations were largely based on gasoline distribution and retail. There was little market for "heavy" end products in New Zealand.

(8) Gulf Oil and Europa Oil's operations were complementary as to product demand. Europa Oil was willing to participate in an arrangement whereby it purchased "light" ends from Gulf in their refined state. Since Europa Oil was taking Gulf's excess of light ends, and thereby doing Gulf something of a commercial favour, Europa Oil was in a position to insist on a share of the refinery profit derived by Gulf in the production and sale of the "light" ends.

(9) On this factual basis, Europa Oil and Gulf Oil entered into the 1956 contracts. Gulf's subsidiary in the Mid-East contracted to supply "light" ends to Europa Oil for 10 years at "posted prices". ["Posted prices" were prices posted for sales of products in the Persian Gulf and other supply points taken from industry reports.]

(10) Further to the products-supply contract there was an organisation agreement. This agreement involved the incorporation of the Pan-Eastern Refining Co Ltd (Pan-Eastern) in the Bahama Islands. The Bahamas are a tax haven. Pan-Eastern's capital was owned as to fifty percent by Gulf and as to the other fifty percent by a wholly owned subsidiary of Europa Oil – Associated Motorists Petrol Co Ltd (AMP).

(11) Gulf contracted with Pan-Eastern to supply crude – the quantity being just equal to the products requirements of Europa Oil – and to buy back or procure the sale of the products from Pan-Eastern. There were special price arrangements. The effect was that Pan-Eastern paid Gulf refining fees at 47.5 cents per barrel of crude. Pan-Eastern was able, on this formula, to retain about 50.0 cents per barrel being profit on refining crude to gasoline. Gulf and Europa shared this profit equally between them. It amounted to 2.5 cents per gallon of gasoline imported by Europa Oil into New Zealand.

(12) These contractual price formulae were subsequently altered to guarantee Europa Oil a minimum of 2.5 cents per gallon.

(13) By 1964 New Zealand had established its own refining facilities. Fresh contracts were negotiated.

Europa (No 1)

The Commissioner of Inland Revenue attacked the 1956 arrangements basing his case, firstly, on s 111, and secondly, in the alternative, on s 108.

It is necessary broadly to detail the effect of the arrangements in relation to New Zealand tax legislation. The legal arguments in relation to the 1956 contracts are identical with those involving the 1964 contracts on which Europa (No 2) was based. Accordingly the legal issues are discussed in the review of *Europa (No 2)*.

Pan-Eastern was incorporated in the Bahamas. There were three consequences from this:

(a) the profits which Pan-Eastern made were taxable as profits derived in the Bahamas. These islands are a "tax-haven" – there is no income tax payable.

(b) Pan-Eastern – being a company – declared dividends from its profits in relation to its shareholding. Europa Oil through AMP was entitled to half the profits as dividend income. The dividends formed part of Europa Oil's income. Europa Oil – a New Zealand based company – was taxable on its income according to New Zealand tax law.

(c) Europa Oil purchased its trading stock from Gulf. Europa Oil paid full market prices for the "light" end products and in turn Gulf paid the same prices to Pan-Eastern for the type and quantities of products involved. The price paid by Europa Oil did *not* reflect the price concession available because of Gulf's excess of gasoline as a result of its refining operations.

The legal effect of these arrangements was the basis of the Commissioner's case. The dividend income received by Europa Oil from Pan-Eastern

was prima facie not taxable in Europa Oil's hands. Section 86C (1) of the Land and Income Tax Act 1954 provides:

> "Dividends derived by any company that is resident in New Zealand from companies . . . shall be exempt from income tax."

The share in the refining profit of Gulf obtained by Europa Oil accrued, through Pan-Eastern dividends, as tax-free income to Europa Oil. These profits were in millions of dollars. The Pan-Eastern benefit received by Europa Oil substantially exceeded its net of tax income (see McMullin J, 3 ATR 512, 517–8). The Commissioner took the view that the purchase price of the trading stock sold by Gulf to Europa Oil was not the true sale price for the products alone; the price Europa Oil paid, so the Commissioner contended, was for those products and, in addition, to secure the benefit accrued through Pan-Eastern. Accordingly, the Commissioner based his case on the pre-1968 form of section 111 arguing the actual price paid by Europa Oil for its trading stock was not fully deductible for tax purposes. It was contended that the trading stock price paid was not expenditure exclusively incurred as consideration for petroleum products to provide ordinary trading gain. By majority – led by Lord Wilberforce – the Privy Council upheld the Commissioner's view. Their Lordships held that the price paid by Europa also related to the Pan-Eastern benefits and was not deductible to that extent. Accordingly, there was no need to canvass the Commissioner's alternative argument based on section 108. The Commissioner had argued that the Pan-Eastern arrangements were made to secure the tax advantages of the Bahamas legislation and s 86C of the New Zealand Act as to divided income; the arrangement's principal purpose was to facilitate tax avoidance.

Europa (No 2)

Europa (No 2) concerned the effects of the 1964 contracts made as a result of the establishment of the Marsden Point refinery. It was no longer necessary for Europa Oil to import fully refined products.

The 1964 contracts involved a further company called Europa Refining Co Ltd (Europa Refining). Europa Refining was the contracting party in relation to Gulf and Pan-Eastern in the 1964 arrangements. Europa Oil was not *directly* involved. (4 ATR 464–5). Europa Refining was not legally associated with Europa Oil in any way. It was not a subsidiary of Europa Oil nor was either company associated with the same parent. Each was, however, a member of the Todd group. Mr Bryan Todd was managing director of both companies and the Todd family had controlling interests in them.

In his dissent, Lord Wilberforce explained Europa Refining's position thus [1976] 1 NZLR 500:

> "Europa Refining was a paper company with no staff and a minimum organisation: it took no risks and made no profits. The reasons for its creation had mainly to do with requirements of New Zealand law [relating to the operation of the Marsden Point refinery]."

Thus it was Europa Refining which was a party to the 1964 supply contracts with Gulf. Europa Oil placed its orders with Europa Refining for trading stock as needed. Each order was followed automatically by a corresponding order by Europa Refining with Gulf. The same Pan-Eastern benefit arose from this arrangement. Instead of supplying gasoline as a refined product, Gulf supplied Europa Refining with naphtha. This is an unfinished "light" end product of the partial refining of crude oil. Its subsequent further refinement results in gasoline and by-products. In 1964 Gulf still had a large excess of "light" ends. The naphtha supply simply made use of the Marsden Point refinery (4 ATR 470).

The Commissioner of Inland Revenue took the same view of these arrangements as he had of the 1956 contracts. However, the facts of *Europa (No 2),* involving Europa Refining, complicated the Commissioner's argument and formed the basis of *Europa Oil's case* in objecting to the Commissioner's assessment. It was fundamental to the Revenue's case that the interposition of Europa Refining in the 1964 contracts was irrelevant; that Europa Oil was nevertheless able to secure from Gulf the Pan-Eastern benefit, and did in fact obtain it, and purchased its Gulf-supplied trading stock with that benefit in mind. The Commissioner claimed that this was the view of the majority of the Judicial Committee in *Europa (No 1).*

This was the basis of the Privy Council's judgment in *Europa (No 2).* It is convenient to deal first with three preliminaries which, ultimately, did not affect the case in the Privy Council.

The 1968 amendment to s 111

The taxpayer argued that the new s 111 – passed in 1968 – provided a broader deduction test than the pre-1968 form governing the facts of *Europa (No 1).*

The submissions of counsel are fully recorded in the judgments of McMullin J and the members of the Court of Appeal. (3 ATR 531–535; 4 ATR 485–6 McCarthy P, 493–497 Richmond J and 498–500 Beattie J.) The Court of Appeal emphasised limb (b) of the new section and justified a more favourable approach to apportion-

ment under that limb (to Europa Oil). It would seem that in the Privy Council Europa may have had to rest its case on limb (a) because, as the majority noted (p 552):

> "In the last four years of assessment the [Europa Oil] claim to the deduction is made under paragraph (a) of the amended section"

The Privy Council found it unnecessary to say more – Lord Diplock concluding (p 552): "[T]he amendment to the section in 1968 makes no difference for the purposes of the instant appeal".

The taxpayer's evidence

Mr Bryan Todd attempted to persuade the Court that the background to the 1964 agreements was different from that pertaining in 1956. Both parties agreed to put the evidence from *Europa (No 1)* in as evidence in *Europa (No 2)*. Mr Todd gave evidence in both cases. In the second case, he produced material which aided his company's case materially as did his explanations. The Commissioner took credibility as an issue contending that much of the explanation was made with the benefit of hindsight from *Europa (No 1)* and was plainly self-serving. In the Supreme Court, McMullin J said (3 ATR 522):

> "It seems to me that Objector in evidence given before me . . . sought to put upon events which had been traversed in evidence in *[Europa (No 1)]* a complexion or interpretation different from that attached by the Courts in the earlier case. In some cases the effect of the evidence given before me was to place a gloss upon what had been said previously and in other cases there was a more direct confrontation with the earlier evidence . . . I decline to place any construction on factual situations different from that taken previously and, where the evidence for the Objector is in conflict with that given in the first case, I accept that earlier evidence."

By s 20 of the Inland Revenue Department Amendment Act 1960 and s 32 (10) of the Land and Income Tax Act 1954 the onus of proof is on the objector. Mr Todd failed to discharge that burden. The Court of Appeal accepted McMullin J's views. (4 ATR 465–8).

The approach of the New Zealand Courts

McMullin J's Supreme Court judgment accurately records the course of argument and the conduct of the case. His Honour considered that *Europa (No 1)* was directly applicable and accepted the Commissioner's contention that Europa Refining's position was irrelevant.

The Court of Appeal gave judgment in two stages. In the first stage (4 ATR 455), the taxpayer required further findings – questions of fact and mixed law and fact – to prosecute its appeal. Where appropriate the Court made the rulings, and, on the basis of them, proceeded to deal with *Europa's* case. The learned Judges were basically in agreement with McMullin J as to the various submissions and dismissed the appeal.

Having disposed of the arguments, the Court moved on, uninvited by either party, to develop an approach of its own to the quantification of the disallowable portion of the expenditure. The approach taken by the Court was never contended for by Europa in argument. It is detailed by Richmond J (4 ATR 493–7). The effect was a broad compromise solution which reduced the Commissioner's assessments by something over one million dollars. The Court also refused to examine a principal argument in support of the Commissioner's case on that question of quantification. Their Honours claimed that submissions based on s 110A were advanced for the first time in the Court of Appeal (4 ATR 488, 497).

Not surprisingly, the Commissioner took issue with the Court – which he was able to do because the Court invited further argument on its compromise solution. Accordingly, there was a second stage ([1976] 1 NZLR 564). The Court was confronted with two contentions from the Commissioner:

(a) that *Europa's* case had been always argued on "an all or nothing" basis and it was not open to the Court to proceed to advance any other solution; the submission being supported by, it was argued, indistinguishable House of Lords authority – *Moriarty v Evans Medical Supplies Ltd* [1957] 3 All ER 718; and

(b) that the submissions based on section 110A were brief but made in the Supreme Court and the Commissioner was entitled to have the argument determined on its merits.

It is respectfully submitted that the Court's procedure in this context was unsatisfactory. The Court proceeded to resolve the case without the benefit of argument. The attempt to impose a solution, uninvited and without adequate information, was bound to lead both parties into further litigation.

In passing it may be assumed from the Privy Council majority's reference to Europa's claim to the deduction being based on paragraph (a) that, if it had upheld the Commissioner's argument on the main issue, it would not have supported the Court of Appeal's apportionment approach based on (b).

Lord Wilberforce's dissent in *Europa (No 2)* makes plain the bases for criticising the majority view. Like his Lordship's dissent in *Mangin v CIR*,

the opinion is concise and compelling. It rests on two features:

(a) that the majority failed to apply the "deductibility" test determined by the *Europa (No 1)* case and thus refused to follow precedent; and

(b) whatever the merits of the *Europa (No 2)* test for deductibility – plainly irreconcilable with *Europa (No 1)* – the majority failed to apply it to the facts of the case which, before their Lordships, were undisputed.

III Section 111

The rejection of Europa (No 1)

Lord Wilberforce succinctly stated the difference between the majority and minority in *Europa (No 1)* saying (p 559):

> "[T]he majority .... held that the expenditure was made in part in order to obtain the Pan Eastern benefit – and for that benefit. The decision of the majority thus involved an interpretation of s 111 and in particular of the words 'incurred in the production of the assessable income' which required the Court to examine and analyse the benefit or benefits gained by the expenditure. If what was gained was trading stock and nothing else, the expenditure is wholly deductible. If what is intended to be gained, and what is in fact gained, is some other advantage, the expenditure is not wholly deductible and a problem of apportionment arises. The minority judgment took a narrower view, holding, as I understand it, that it is not legitimate to look beyond the contract between the buyer and the seller, and that if the contract is nothing but a contract of sale, then (following the *Cecil Bros* case) the expenditure is wholly deductible."

Lord Wilberforce stated his view that the majority judgment as to s 111's interpretation in *Europa (No 1)* ought to govern *Europa No 2)* and proceeded to apply the facts of the case to the law as it was then declared. His Lordship considered himself bound by the unanimous findings of fact made by both New Zealand Courts which were unchallenged.

Accordingly, Lord Wilberforce moved directly to the basic proposition advanced by Europa in its appeal, which, it was argued, distinguished *Europa (No 1).* The proposition concerned Europa Refining. The taxpayer Company argued that it was not a contracting party with Gulf; it could not insist, because there was no legal relationship between Gulf and Europa Oil, on the Pan-Eastern benefit, and could not enforce its continuance.

His Lordship's treatment of this aspect of the case, is, it is submitted, devastating to *Europa Oil's* case. Lord Wilberforce said (p 561):

> "... [I]t would be to take too narrow a view of the *[Europa [No 1]]* majority judgment, and of s 111, to confine the decision to a case where the benefit obtained by the expenditure is contractually secured in the sense that as part of the ... contract, the seller agreed with the buyer to pay it. The words of the section 'expenditure-exclusively incurred in the production of assessable income' by contrast point to the disallowance of expenditure not so exclusively incurred ... What was the expenditure for? What was it intended to gain? What did it gain? What elements entered into the fixing and acceptance of it? These are the questions to be asked."

With these being the correct criteria – derived from *Europa Oil (No 1)* – his Lordship moved to the taxpayer's case. He dismissed the suggestion of the taxpayer that Europa Oil *simply* contracted with Europa Refining to purchase products. The reasoning is, in relation to the criteria considered appropriate, unanswerable. It was:

(i) Europa Refining's contract with Gulf *obliged* Europa Refining to buy from Gulf all the products needed to meet Europa Oil's New Zealand needs;

(ii) Gulf, at the same time, had the contract with Pan-Eastern replacing the 1956 contract which actually recited that Gulf had agreed to enter into a contract with Pan-Eastern, which provided the Pan-Eastern benefits for Europa Oil, in order to obtain the benefits of the supply contract with Europa Oil;

(iii) Europa Oil, while not an actual contracting party with Gulf, knew and contemplated that the moment it placed a products order with Europa Refining, Europa Refining would place an order with Gulf, which, in turn, would give rise to the Pan-Eastern benefit;

(iv) Europa Oil's orders from Europa Refining were for the specific purpose of initiating orders by Europa Refining from Gulf.

With these four factors, his Lordship's conclusion, the writer submits, is clearly correct. Lord Wilberforce said (p 562):

> "Europa Oil would never have agreed to pay 'posted prices' for the products had it not known that, related to these prices, for every gallon ordered, a benefit would arise for Pan-Eastern. In my opinion it cannot be said, in these circumstances, that Europa Oil's payments were for products and nothing else."

The majority took a wholly different view. Lord Wilberforce's dissent makes clear his view that the majority disregarded the *Europa (No 1)* precedent. The crux of the majority view in *Europa (No 2)* is contained in these passages of Lord Diplock's speech (p 554–5):

> "In contrast to the position under the 1956 contracts the taxpayer company was not a party to any of the 1964 contracts entered into with . . . [Gulf]. All its purchases . . . were made from Europa Refining under contracts of sale . . . entered into from time to time . . . All the feedstocks sold on by Europa Refining to [Europa Oil] had in fact been purchased by Europa Refining from [Gulf] under the 1964 supply contract to which the only parties were Europa Refining and [Gulf]."

From this statement his Lordship concluded (p 555):

> "It follows that whenever [Europa Oil] entered into a contract with Europa Refining for the sale . . . of feedstocks and thereby accepted an obligation to pay the . . . purchase price, the only right that it thereby acquired which was legally enforceable against anyone was the right to delivery of the feedstocks . . . The true legal character of the whole of the expenditure claimed to be deductible is that of the purchase price of stock-in-trade . . . and nothing else."

The majority view – based on the question of contractual enforceability – is a clear departure from *Europa (No 1)*. Lord Wilberforce who delivered *Europa (No 1)'s* majority opinion put his dissent on this basis. As his Lordship said, *Europa (No 1)* was not decided on enforceability but on the nature of the expenditure itself. Enforceability was *not* determinative.

The Court of Appeal took one sentence of Lord Wilberforce's *(No 1)* judgment as justifying its *(No 2)* approach. Lord Wilberforce said (p 648):

> " . . . [T]he [Revenue] is not bound by the taxpayer's statement of account, or by the heading under which expenditure is placed. It is entitled to ascertain for what the expenditure is in reality incurred."

It was emphasised by Lord Wilberforce then, and by all the Courts, including the majority, in *Europa (No 2)* that "in reality" did not mean, and did not allow, for an analysis of economic consequences. The question of enforceability was one reason for *Europa (No 1)'s* decision but a careful review of the majority opinion shows an underlying question quite separate from enforceability. Lord Wilberforce expressed it (p 649): " . . . s 111 does not enable the Crown to disallow expenditure genuinely made . . .". "Reality" was determined by "genuineness" and not economic consequences and this was the approach taken by both New Zealand Courts in *Europa (No 2)*. The majority of the Privy Council abandoned this approach substituting "enforceability" for "genuineness". Accordingly, the precedent set by Lord Wilberforce is contradicted. The *(No 2)* majority purported to base their reasoning on the judgments given in the High Court of Australia in *Cecil Brothers Pty Ltd v FCT* (1964) 111 CLR 430. Yet a reading of that case – and particularly the judgments of Dixon C J and Menzies J – shows that that Court was unable to enquire into the "genuineness" or "reality" of the expenditure. The High Court judgments show the decision to be based solely on a simple and unchallenged finding of fact in the Court below. Dixon C J said (p 438):

> " . . . [O]nce it was held that the payment . . . from the taxpayer company was paid for . . . stock in trade, there could, I think be no ground for excluding any part of [the expenditure] from the allowable deductions from assessable income."

As the Commissioner argued in *Europa (No 2)*, this finding made the cases clearly distinguishable. The Commissioner always accepted the authority of *Cecil Brothers'* case: he contended that Europa Oil's expenditure was made not only to obtain stock in trade, but also, and this is the essential distinguishing factor, the Pan-Eastern benefit. In *Europa (No 1)*, the majority of the Privy Council accepted this contention. It was a contention based solely on the facts. That Europa could contractually enforce the Pan-Eastern benefit was coincidental but, nevertheless, essentially irrelevant to Lord Wilberforce's majority opinion. (See esp p 651–2.)

If the *(No 2)* majority were relying on *Cecil Brothers* to support their judgment, and it would seem that they were, in the writer's view, the case is wrongly decided. It is submitted that the *Cecil Brothers* judgments are very clear that the decision was based solely on the particular finding of facts. Lest there be doubt about the ratio of *Cecil Brothers'* case, Sir Frank Kitto surely put the matter to rest. Sir Frank Kitto was a member of the High Court in *Cecil Brothers* and of the Privy Council in *Europa (No 1)*, and he agreed with Lord Wilberforce's majority opinion. That opinion refers to *Cecil Brothers* at some length and relies upon it. The inference is inevitable. Turner J saw it and relied upon it in *Wisheart McNab & Kidd v CIR* [1972] NZLR 319, (p 329): That learned Judge, in discussing *Europa (No 1)*, said:

> "[T]he ratio of the decision in *Cecil Bros'* case must be taken to have been that the judges of the High Court were of the opinion

that in that case the facts showed that the [expenditure] had in fact been 'genuinely' made and on this account immune from attack."

It is submitted that both the passages in the High Court judgments in *Cecil Brothers*, and the fact that one member of that Court actually agreed with Lord Wilberforce's interpretation of those judgments puts the matter beyond doubt. *Cecil Brothers* does not support *Europa (No 2)*. The difference in the findings of fact distinguish the cases.

The rejection of the findings of fact

Even if Lord Diplock's view – that enforceability is the proper enquiry, and not a factual enquiry into the benefits sought to be obtained – can be sustained on the basis of authority and logic, there is a further criticism which can be levelled at the majority decision.

At the outset there are two matters of appellate procedure to be noted. First, it is trite law that an appellate Court is loath to interfere with findings of fact made by a trial Court which has had the benefit of seeing and hearing the witnesses. Second, this principle is inevitably reinforced when a final tribunal is reviewing findings of fact unanimously accepted and, in *Europa's* case, reinforced, by an intermediate appellate body.

In the Privy Council's decision in *Keppel Bus Co Ltd v Ahmad* [1974] 1 WLR 1082 Lord Kilbrandon observed (p 1083):

"The judge's account of these facts was accepted by the Court of Appeal; there are therefore concurrent findings of these facts, which, in accordance with their usual practice, their Lordships would not review."

In the Court of Appeal, Counsel for Europa sought further findings of fact. In McCarthy P's judgment there is the following passage (4 ATR 465):

"C *Finding Sought:* Europa Oil is not a party to any one of the 1964 contracts with Gulf. The arrangements between it and Europa Refining were separate."

To this the Court responded:

"*Comment:* It is true that Europa Oil is not a party to any of the central 1964 contracts – "

The Court then examined the second part of the finding sought saying:

"... Europa Oil was a direct party to two letter agreements and an undertaking by Gulf which were contemporaneous with and formed part of the larger complex of the 1964 contracts.... [T]here was always a common understanding between Europa Oil and Europa Refining that Europa Oil would purchase products from Europa Refining and that but for this common intention, Europa Refining would not have entered into the feedstock supply contract. It is also clear that even if Europa Oil was not a *party* to most of the 1964 contracts nevertheless it was *privy* to them, as it would be fanciful to say that Mr Todd, when conducting the negotiations, was not representing Europa Oil as well as Europa Refining... [W]e do not believe that the contractual arrangements between Europa Oil and Europa Refining which arose whenever Europa Refining, with the obvious knowledge and consent and active assistance of Europa Oil, ordered cargoes from [Gulf], can be described as separate from the complex of arrangements..."

From this Lord Wilberforce concluded (p 562):

"These, and other factual details, carefully found by the Court [of Appeal], fully support [the] argument: the contract between Europa Oil and Europa Refining was not a normal contract of purchase and sale at all: the interested party was Europa Oil; the benefit to be gained was Europa Oil's; part of the benefit was the Pan-Eastern benefit."

Perhaps the strongest specific finding of fact in this respect was made by Richmond J. That learned Judge – with whom Lord Wilberforce expressly agreed – said (4 ATR 493):

"When Europa Oil... in the closest possible co-operation with Europa Refining, initiated the ordering of feedstocks, it was not just initiating orders by Europa Refining from any source. The orders were for feedstocks from [Gulf] under the 1964 supply contract."

The majority view ignores these plain findings of fact. Lord Diplock said (p 555):

"[W]henever [Europa Oil] entered into a contract with Europa Refining for the sale and delivery... of feedstocks, the only right that it thereby acquired which was legally enforceable... was the right to delivery of the feedstocks."

This view – unsupported by any consideration of the lower Court findings of fact – ignores evidence crucial to the Revenue's case. Much of the difficulty with the *Europa* case was caused by the intermixing of formal written contracts, memoranda and letter agreements with oral agreements. The New Zealand Courts were in agreement that the terms of those oral agreements could only be inferred from the written material and the circumstances surrounding the agreements. The New Zealand Courts made the necessary findings. The facts as found were that Europa Oil,– because of the whole complex of contracts written and verbal – was in a position to insist

upon, and, if necessary, enforce more than the mere right to delivery. Europa Refining had to pass Europa Oil's supply orders on – and to Gulf. Because of the rest of the arrangement – to which Europa Oil was at least privy – it was inevitable that the Pan-Eastern benefit would accrue, and accrue, as before, to Europa Oil. As Lord Wilberforce said, the price structure reflected, as with the 1956 contracts, the Pan-Eastern benefits.

If the same *type* of expenditure was held non-deductible under s 111 on the 1956 contracts, it defies logic as much as legal principle to hold that such expenses are deductible merely because the *direct* causal link between the parties is replaced by an indirect, but still enforceable, arrangement conferring, and designed to confer exactly the same benefit on the same parties. The facts of *Europa (No 2)* actually fail to meet the majority's test. The majority's reasoning fails to apply the facts.

IV Section 108

Introduction

Having rejected the Commissioner's case on section 111, the majority was required to examine the alternative basis of the assessment: section 108. Lord Wilberforce refused to comment. The majority's treatment of this aspect of the case is remarkable. Apart from making a series of sweeping statements of principle and in the process impliedly rejecting a great deal of case law on the section built up over a long period, the majority actually spent little effort attempting to apply the principles to the facts of the case, preferring to comment generally.

The dissent in *Europa (No 1)* – Lord Donovan and Viscount Dilhorne – described the Commissioner's case on s 108 as being "hopeless". In *Europa (No 2)* – in which Viscount Dilhorne again participated, this time as a majority member – the s 108 case was dismissed in correspondingly short fashion.

Before considering the majority judgment on this aspect it is necessary to set out the Commissioner's contentions and the conclusions of the Supreme Court and Court of Appeal. Broadly, it was argued that section 108 could be applied in one of two ways. The first – and most obvious – was to invoke the section against the whole plethora of contracts and avoid them all on the basis that they evidenced an arrangement such that: " . . . directly or indirectly, it has or purports to have the purpose or effect of . . . [avoiding] . . . income tax."

In this, the Commissioner was relying on two factors: (i) that there was such an arrangement with the purpose of avoiding income tax; and (ii) the arrangement was made so as to allow a "contrived" deduction under s 111; such deductions being subject to s 108.

The decided cases on s 108 – and s 260 of the Australian Act – have commonly been given three classifications. They are: (i) income splitting – such as *Mangin v CIR* [1971] NZLR 591 (JC) and *Ashton v CIR* [1975] 2 NZLR 717 (JC); (ii) conversion of income – and therefore taxable – gains to capital gains – such as *Bell v FCT* (1953) 87 CLR 548; (iii) contrived deductions – whereby ordinary business expenses are inflated – such as *Elmiger v CIR* [1967] NZLR 161 (CA) and *Wisheart's* case.

In essence, there is no effective difference between contrived deductions and income splitting. To have any value to the taxpayer, a contrived or inflated deduction must result in the diversion of the corresponding amount as income to some other person. The deduction cases – *Elmiger* and *Wisheart* – are, in form, modifications of the basic income splitting devices. The inflated deduction reduces the taxpayer's own assessable income and boosts the income of some related body taxed at a lower marginal rate, by benefitting them with payments for goods and services beyond their real market value. Hence "inflated" deductions.

This analysis is supported by the judgment of Woodhouse J in the Supreme Court in *Elmiger*. Dealing with the taxpayer's submission that s 108 cannot operate in order to prevent a deduction allowable in terms of s 111, that learned Judge said ([1966] NZLR 683, 693):

> "The question is not whether arrangements which promote deductions can fall within the ambit of the section; but whether, having so fallen, the section can then be applied in order to justify a reassessment of income tax. . . . If [removal of that arrangement] does [justify reassessment], then I think that it cannot matter whether the *quantum* of assessable income thereupon disclosed results from the removal of contrived outgoings for expenses or from the removal of some other manufactured transaction."

What is important – and especially so in *Europa's* case – is that deduction-oriented devices leave the Commissioner with a two-pronged line of attack. He can choose to attack just the deduction itself – and remove that – as was done in *Wisheart's* case. Alternatively, he can examine the arrangement in its income splitting context and proceed accordingly as in *Elmiger*.

The issues in Europa's case

At least *some* of the contracts made between the various parties were genuine. As Lord Diplock noted (p 556):

> "In order to carry on its business of marketing refined petroleum products in New Zealand the taxpayer Company had to purchase feedstocks from someone."

The problem with the Commissioner's case on the deductions argument is that it is difficult to label the money paid by Europa Oil for its trading stock as being "contrived" at an "inflated" level. All that could be contended was that the actual expenditure incurred was higher than need be in view of the Pan-Eastern benefit. The evidence clearly established – *Europa (No 1)* [1970] NZLR 337, 424 (CA), *Europa (No 2)* 3 ATR 520 – that Europa would never have agreed to pay "posted prices" without some form of discount.

The Commissioner had to point to an "arrangement" from which it could be predicated that – on the *Mangin* test – the "sole or at least the principal purpose" was tax avoidance. The reply of Lord Diplock – that the purchase of feedstocks was the end in view – is no answer to the question. What was under scrutiny – on the authority of *Newton v FCT* [1958] AC 450 (JC) – was the principal purpose of securing supplies of feedstocks *in that particular way.* Implementation was a vital consideration to the Commissioner's case. The majority ignored this feature.

In relation to income splitting, and also deductions, emphasis was put by the Commissioner on the positioning of Pan-Eastern in the Bahamas. If Pan-Eastern, as a company, was annihilated as a tax avoidance device to facilitate the non-assessability of income, the effect was:

(a) to destroy all contracts between Gulf and Pan-Eastern, and thus remove at a stroke the Pan-Eastern benefit;
(b) destroy the "dividends" characterisation of the Pan-Eastern benefit from Pan-Eastern.

The difficulty with this approach was caused by the shareholding in Pan-Eastern. Europa Oil did not *itself* own a share in Pan-Eastern. The Europa interest was held by Associated Motorists Petrol Company Ltd (AMP) which was a wholly owned subsidiary of Europa Oil. This has special relevance to the question of reconstruction. The income had to be left in a *taxable form* in Europa Oil's hands on avoidance of the arrangement. In addition, then, to annihilation of Pan-Eastern, the Commission had to either:

(a) annihilate, also, AMP,– which was never attempted; or
(b) point to some method whereby the protection afforded by s 86 C (1) of the Act could be removed from the dividends received by Europa through AMP from Pan-Eastern.

This was necessary so that the Pan-Eastern benefit – admittedly in Europa Oil's hands – was left unrelated to anything but the sale and purchase of trading stock; a revenue related benefit and a receipt capable of characterisation as income and assessable accordingly for tax.

The taxpayer's arguments in relation to the s 108 case were (3 ATR 535–6):

(i) a deduction otherwise allowable under s 111 could not be avoided by s 108 as a matter of principle;
(ii) that Pan-Eastern was a genuine Company serving a genuine commercial purpose and could not be annihilated;
(iii) that Pan-Eastern was not a New Zealand company; the Pan-Eastern benefit was income not derived in New Zealand and s 108 could not operate against foreign income sources;
(iv) Europa Oil was not a party to the supply contracts allowing for the "Pan-Eastern" benefit and s 108 could not apply to tax avoidance arrangements to which the taxpayer was not a party;
(v) the Pan-Eastern benefit related to a new income source and s 108 could only apply where there was a prior, comparable, taxation base existing which is changed so that tax is avoided.

McMullin J carefully but briefly expressed views on these points. It was unnecessary to go further as he had upheld the Commissioner's assessments of s 111. The learned Judge was clear that Pan-Eastern's resident status – a Bahamian company – was only reasonably explicable in terms of tax avoidance. His Honour rejected the s 108–s 111 relationship argument relying on the Court of Appeal's *Elmiger* and *Wisheart* decisions. The Court of Appeal in *Europa (No 2)* makes only a short reference to s 108. McCarthy P said (4 ATR 487, Richmond and Beattie JJ concurring):

> "... [T]he earlier judgment of this court *(Europa [No 1]* [1970] NZLR 387–9 per North P, 413–5 Turner J, 430–5 McCarthy J) and the opinions of Lord Donovan and Viscount Dilhorne (dissenting, [1971] NZLR 659) should be considered decisive."

The Privy Council

The majority's response to the s 108 argument can be seen in three parts. The first part was a statement of four principles governing the scope and operation of the section. The second was the statement that the finding that the expenditure was fully deductible under s 111 is incompatible with the contracts under which the expenditure was made being void as part of a tax avoidance arrangement. The third was confined to the

consequences of annihilation of some of the contracts.

The four general principles – (a) *Section 108 is not a charging section and if there is no taxable situation disclosed upon the avoidance of the arrangement, the Commissioner is unable to construct one.* (p 555–6). – This principle was first stated clearly and unequivocally by the Privy Council in its *Mangin* judgment. It was the basis of the Court of Appeal's decision in *CIR v Gerard* [1974] 2 NZLR 279. This "principle" is now covered by the 1974 amendment in s 108 (2).

(b) *Section 108 can apply only to arrangements affecting existing sources of income. The section does not strike at new sources or restrict the taxpayer's right to arrange his affairs in relation to new income sources so as to attract the least possible tax liability. Nor does it prevent a taxpayer from parting with a source of income* (p 556) – As to "new" sources, the point made by Lord Diplock had never been authoritatively discussed. It is surprising, then, that his Lordship's treatment was so brief. It arose in *Europa's* case because it was argued that the Pan-Eastern benefit was a new source.

It would appear that the new source argument is an extension of the submissions put forward by taxpayers firstly in *Marx & Carlson v CIR* [1970] NZLR 182 (CA) and later in *Mangin v CIR*. They are most clearly stated in argument in the Court of Appeal in *Marx*.

There are no reported cases where the Commissioner has invoked the section against "new sources". There are clear difficulties with any attempt to do so. On the plain wording of the section – including, it is submitted, the 1974 amendment – it is impossible to alter the incidence of tax, relieve one's self from liability to pay tax, or avoid income tax assessed from a source of income never held by the taxpayer. The section contemplates a change in position and a basis for comparison. A "new" source gives neither.

Whatever the merits of the "new" source argument are, in *Europa Oil's* case, there is a short answer. The Pan-Eastern benefit was not a "new" source at all. Lord Diplock said (p 557):

> "[T]he 1956 Organisation contract [which established the Pan-Eastern company] created a new source of income for [Europa Oil] which did not exist before . . ."

The fact is that Europa Oil was in the business – and had been for years prior to 1956 – of purchasing petroleum products for retail throughout New Zealand. The Pan-Eastern benefit – derived from refining operation profits – was just one way of adding to the profits of Europa Oil. It resulted from a change in supplier – from Caltex to Gulf – and not "source" of income. If Pan-Eastern never existed, and Europa Oil obtained the feedstocks at the lower price available because of Gulf's excess of "light" ends, Europa Oil would have been taxed on the increased profits as part of its ordinary income derived from its retail operations. Europa Oil was in business to make profits from retailing. The Pan-Eastern benefit was just part of that money-making operation. To exempt it on the "new" source argument is to overlook the fact that it was *additional*, but nevertheless part of, Europa Oil's ordinary business operations. Europa Oil could not have obtained the Pan-Eastern benefit had it not been in the business of buying petroleum products for retail in New Zealand. That benefit could never have stood alone as *a source* of income. It had to rest on Europa Oil's product purchases – which Europa had been making for years – and it is therefore an addition to Europa's profit and not a new source of profit.

Lord Diplock's statement that section 108 cannot prevent a taxpayer from parting with a source of income *presently existing* appears to be inconsistent with established authority. Take *Mangin's* case for example. The taxpayer leased parts of his farm to his family trust. These parts were used to grow crops. The taxpayer worked as an employee for the trust so that the profits from the crop went to the trust. There was, "hived off", as Lord Donovan put it, a source of income that would otherwise have been the taxpayer's. Lord Diplock cannot be taken to have suggested that Mangin was entitled to make such an arrangement if only because he cites the case as authority for later propositions.

His Lordship seems to overlook the fact that all the cases (including Mangin) emphasise the overall arrangement rather than the placing of special emphasis on one particular aspect of it. As has been said ([1974] NZLJ 560, 564):

> ". . . [E]ven an absolute transfer of land may involve such other factors as to the control of the income earning activity of the transferee and of the disposition and use of the income to justify the inference that the arrangement was entered into in that way for tax avoidance purposes."

The cases support such an approach – the most recent example being *Ashton & Wheelans v CIR* [1975] 2 NZLR 717 (JC) – where the taxpayers disposed absolutely of a source. The Privy Council upheld the Commissioner in invoking the section.

(c) *Section 108 is not concerned with the fiscal consequences of avoided arrangements in any jurisdictions outside New Zealand.* (p 556) – It is not entirely clear what Lord Diplock meant in this statement. On the face of it, it seems that the

majority were of the view that section 108 did not have application to arrangements, or parts thereof, having effect outside New Zealand. Lord Diplock said (p 556): "[T]he references in [s 108] to . . . 'income tax' are references to New Zealand income tax." It is difficult to take issue with this statement. If an arrangement avoids someone else's income tax, it is hard to see why the New Zealand Commissioner would be concerned. But if an arrangement made extra-territorially has the effect of avoiding income tax in New Zealand – as the Commissioner contended in *Europa's* – the implied references to New Zealand income tax do not prevent the Commissioner from invoking the section against that arrangement.

Whether Lord Diplock did mean to restrict the Commissioner's powers in this way can be questioned. In the subsequent discussion of the annihilation of Pan-Eastern and the supply contracts between it and Gulf, there is no mention of this "principle" as a reason for rejecting the Revenue's case. Moreover, there is clear Australian authority, long accepted as correct, which allowed the Commissioner to invoke section 260 against an arrangement whereby income gains were represented as a capital gain in Papua-New Guinea: *Bell v FCT* (1953) 87 CLR 548 approved by the Privy Council in *Newton.*

(d) *Section 108 does not strike down transactions which do not have as their main purpose or one of their main purposes tax avoidance* (p 556) – The authorities relied upon are *Newton* [1958] AC 450, *Mangin,* and *Ashton;* all Privy Council decisions. In *Mangin,* the Board expressly adopted Turner J's formulation of the *Newton* test; known as the "sole or principal purpose test". In *Ashton's* case – in which Lord Diplock participated as a member of the Judicial Committee – Viscount Dilhorne contradicted the *Mangin* formulation and stated the test to be [1975] 2 NZLR 717, 723):

> "If [tax avoidance] was . . . one purpose and one effect of the arrangement, it matters not what other purposes or effects it might have; s 108 applies."

In addition, Viscount Dilhorne said that if the effect of an arrangement was to avoid tax, that effect determined the purpose of the arrangement (p 723).

It is impossible to reconcile these statements. Lord Diplock's "one of the main purposes" is different from *Mangin's* "sole or principal purpose" test. Moreover, Lord Diplock, having agreed with Viscount Dilhorne in *Ashton's* case that the proper criterion was the "any purposes and effects" test, now, just six months after the judgment in *Ashton,* states the requirement as being "one of the main purposes". It is perhaps fortunate that the 1974 Amendment expressly provides for the proper test.

Does s 108 govern s 111? – Lord Diplock said (p 556):

> "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."

The question is, why? Is this, ie, that s 108 cannot be applied to allowable deductions under s 111, a general proposition or is it peculiar to the facts in *Europa Oil*?

The difficulty with these questions is caused by:

(a) the fact that the Privy Council gave no indication as to why the application of s 108 was "incompatible" with the findings of deductibility; and

(b) the two New Zealand decisions of the Court of Appeal, *Elmiger v CIR* approved by the Judicial Committee in *Mangin* [1971] NZLR 591, 595, and *Wisheart v CIR* in which the Court disapproved of *Cecil Brothers Pty Ltd v FCT* on the issue – which the Privy Council left open in *Europa (No 1)* [1971] NZLR 641, 649 – but endorsed in *Europa (No 2),* which hold that s 108 does govern s 111.

In *Elmiger v CIR* the question, having been decided in favour of the Revenue in the Supreme Court, was abandoned in argument by the taxpayer in the Court of Appeal.

In *Wisheart's* case the issue was fully argued. The taxpayer relied on what two Judges (Dixon CJ and Taylor J) said as to the application of the Australian form of s 108 to deductions truly allowable under s 51 of the Australian legislation. All three New Zealand Judges rejected the High Court's approach on the question ([1972] NZLR 319, 321, 327, 335,) and the reasons for so doing are clearly set out in the judgment of Turner J (327–330). The Court of Appeal regarded passages from Lord Wilberforce's majority judgment in *Europa (No 1)* as decisive in *Wisheart's* case. In *Europa (No 1)* Lord Wilberforce expressed the test for deductibility as whether the expense was "genuinely made". Turner J explained *Cecil Brothers* on that basis, after setting out the relevant extract of Lord Wilberforce's opinion, thus (p 329):

> "The word *genuinely* which I have [emphasised] in the foregoing quotation seems to

> me, as to the President [North P] to have its importance when one comes to apply the section, and indeed the ratio of . . . *Cecil Bros'* case must be taken to have been that the . . . High Court [was] of the opinion that in that case the facts showed that the disbursements had in fact been 'genuinely' made, and on this account immune from attack."

The application of this reasoning to *Wisheart's* case was fatal to the objection. Turner J said (p 329–330):

> "I am of the opinion that, at least in New Zealand, where that essential genuineness is lacking, the transaction may be attacked under s 108 – and, conceivably, even in a case in which, for one reason or another, it may survive attack under s 111."

Wisheart's case failed the "genuineness" test and the invocation of section 108 by the Commissioner was upheld.

In *Europa (No 2)* the majority do not say why the Commissioner's case based on s 108 was "incompatible" with the finding that the expenditure was deductible. There is no reference to Counsel's submissions, nor to any of the cases, except *Cecil Brothers.*

There are four points to be made in favour of the Court of Appeal's approach in *Wisheart.* The first is the language of s 111 itself. It is expressed to allow deductions "except as otherwise provided in this Act". On the other hand, s 108 applies to "every" arrangement having a purpose tax avoidance. The language is plain: section 111 is subject to s 108.

The second concerns the history of s 108. The taxpayer in *Mangin v CIR* argued that s 108 could not apply to income derived in the future. The argument pursued before the Privy Council was that section 108 applied to bar deductions from gross income derived thereby relieving the taxpayer from liability in respect of what would, but for the deduction, have been assessable income. The assumption implicit in the argument – that section 108 did govern s 111 – was never questioned.

The third concerns *Elmiger v CIR.* The taxpayer abandoned in argument the submission that section 108 could not govern section 111. The Court of Appeal's judgment in *Elmiger* was approved by the Privy Council in *Mangin.*

The fourth concerns the supposed distinction between income splitting and contrived deductions cases. As stated earlier, to have a tax avoidance effect, an arrangement based on inflated deductions, must have the wider purpose of income splitting. Both *Elmiger* and *Wisheart* clearly demonstrate the wider purpose of income splitting.

The most frequently cited authority for the "incompatibility" theory is *Cecil Brothers.* The High Court was bound by the finding that the expenditure was "genuine". The case was not decided on the basis that a deduction might be contrived as part of a wider tax avoidance arrangement. The deduction itself might be genuine enough. Indeed, it has to be allowable under section 111 before the wider purpose of income splitting can be achieved. The theory is based on a confusion of concepts. Section 111 is concerned simply with expenditure: who spent how much and for what purpose.

Section 108 goes much further: what is the effect of that expenditure; what is purchased and for what reason; and most importantly, what are the tax consequences of that expenditure. Where those consequences point to income splitting the Commissioner's jurisdiction to invoke s 108 is raised. What is important is the expenditure – the fact that it is made and the effect of it in the context of any discernible wider arrangement.

Consider, for example, a business which uses a large amount of office space. The proprietors of the business form family trusts which buy the building in which the business operates. Suddenly, the business pays double the rent for the same premises. Normally, one would have little difficulty in inferring an income-splitting arrangement. Prima facie the rent itself, however much there was, would be deductible. But when put in the context of who owns the building, the doubling of the rent, and the shifting of income from one source to the other, the deductibility of the expenditure is properly governed by section 108. So, too, with *Europa Oil.* The Commissioner was faced with an arrangement which:

(1) made use of a company situated in the Bahama Islands and paid no tax;
(2) did not take advantage of a commercial benefit deliberately obtained and enforced; and
(3) the net amount of that price concession just happened to appear through the Pan-Eastern Company in Europa Oil's hands tax free.

In the writer's view s 108 can properly be used against deductions allowable under s 111. It is submitted that *Wisheart's* case is correctly decided.

The consequences of annihilation – The Revenue's case on section 108 depended on the annihilation of Pan-Eastern and consequent on that annihilation being able to trace the Pan-Eastern benefit, through AMP, to Europa Oil in some taxable form. The removal of Pan-Eastern as a company removed also the contracts between it and Gulf.

The first question, then, was how to show

Pan-Eastern as a tax avoidance device. Lord Diplock said (p 557):

> "[T]he Court of Appeal [held in *Europa (No 1)* that] there were good commercial reasons, unconnected with . . . income tax, for incorporating Pan-Eastern and for selecting the Bahamas as its seat . . . In their Lordships' view there is no ground upon which [Pan-Eastern] could be treated as void under s 108."

It is the writer's submission that this conclusion is based on a failure to apply the *Newton* "predication" test. The Commissioner argued that looking at the Gulf-Europa arrangements – and, particularly, having regard to the overt acts by which those arrangements were put into effect – it could be predicated that the principal purpose was tax avoidance.

The Commissioner was able to point to several factors raising the inference of tax avoidance. Firstly, why was Pan-Eastern incorporated? The Company did no actual trading. It was simply a repository for the share of the refinery profits; limited liability was unnecessary. Pan-Eastern had no *commercial* activity. Second, why choose the Bahamas? The Islands are a well known tax haven and so described in many texts. As McCarthy J said in *Europa (No 1),* the choice of Nassau was not for its Bahamian charm ([1970] NZLR 430). With these, and other factors, involving evidence of other major oil companies placing special emphasis on the Bahamas and its tax status the Commissioner asked: Why was this *particular* arrangement set up in this *particular* fashion and so carried out? Why was the benefit provided by Gulf to Europa passed through what was really a paper company in the Bahamas? The Commissioner's answer was, tax avoidance.

In the Supreme Court, McMullin J supported the Commissioner's conclusions. McMullin J thought tax avoidance was the only answer. The selection of the Bahamas as the base for Pan-Eastern could only reasonably be explained in terms of tax avoidance. McMullin J said (3 ATR 535):

> "For the registration in that locale no satisfactory commercial reasons have been given. Pan-Eastern had no assets in the Bahamas and carried on no commercial activity there whatsoever. . . . If it be accepted that the choice of the Bahamas . . . as the residence of Pan-Eastern was made for tax considerations, and that is beyond argument it is no longer possible to maintain that the Pan-Eastern arrangement . . . was an ordinary commercial transaction."

At the very least, one of the reasons for the incorporation of Pan-Eastern in the Bahamas must have been to take advantage of the tax status. In *Europa (No 1)* Turner and McCarthy JJ so held ([1970] NZLR 415, 430 respectively). At this point a further major criticism can be made of the majority judgment on the basis of *Ashton's* case.

The *Europa* appeal was heard just days after the Board gave judgment in *Ashton's* case. That judgment materially aided the Commissioner's case. In *Ashton,* Viscount Dilhorne contradicted *Mangin's* principal purpose test and substituted for it "the effect determines the purpose" ruling. While *Europa's* "one of the main purposes" test is itself a retreat from the *Ashton* position, the facts of *Europa* clearly meet that test. Pan-Eastern should have been annihilated.

Even more remarkable is Lord Diplock's following statement (p 557):

> "So even if s 108 does entitle the Commissioner to treat as void for income tax purposes contracts to which the taxpayer himself is not a party and which do not give rise to any beneficial interest in him – *a question which it is not necessary to decide for the purposes of the instant appeal* – . . ." (emphasis added)

It was this very issue which was basic to *Ashton & Wheelans'* case. Neither taxpayer was a legal party to his family's trust. The taxpayers argued that s 108 could not apply to such arrangements. The Court of Appeal reviewed the conflict of authority in the New Zealand cases – *Wisheart* and *Udy* – and upheld the Commissioner in rejecting the argument. The Privy Council's judgment never refers to the issue. But to give judgment, as it did, in favour of the Commissioner, the Board had to reject the taxpayer's argument as to parties. To treat the argument as remaining open in *Europa* is inconsistent with *Ashton's* case.

If the Commissioner had been successful in invoking section 108 in *Europa's* case, the next step was to show a basis on which tax could be assessed on the Pan-Eastern benefit left in Europa's hands. To this, the Commissioner had two approaches. The simplest was to use s 108 to disallow the deduction. This was the method chosen in *Wisheart.* It has the somewhat drastic result of disallowing *all* the expenditure. This means Europa could have deducted nothing at all. The contracts under which the expenditure was made would be voided and so the basis for the deduction for the expenditure incurred under those contracts completely disappears. The Commissioner offered to make assessments as he had in *Wisheart* and allow the expenditure except for the amount of the Pan-Eastern benefit itself. If the Court regarded this approach as being unauthorised reconstruction, the Commissioner would have disallowed all the expenditure.

The alternative was more difficult. It involved treating the Pan-Eastern benefit – now no longer a dividend because Pan-Eastern was removed – as Europa's income. The problems here for the Commissioner involved reconstruction. AMP had in fact got the benefit – a wholly owned subsidiary of Europa Oil – and passed it to Europa Oil in dividend form. If the money was to be regarded as "income" then, because it was part of AMP's profits, it received the same dividend-tax protection from s 86C (1) as did the Pan-Eastern benefit itself. The Commissioner's approach – to put the benefit in a taxable form in Europa Oil's hands – was to say that as a consequence of annihilation all that was left were two features. First, there was a flow of goods from Gulf to Europa Oil for which money was paid. The inference from this was that those payments were only referable to the supplies. Second, Europa Oil had received large amounts of money through AMP which originated from Gulf. Again, the only inference was that the monies were referable to Gulf's supplies. Relying on *Newton* and *Peate v FCT* [1967] 1 AC 308 (JC), as well as several other Australian cases, the Commissioner contended that the AMP sums – received from Gulf – could properly be characterised as assessable income in Europa Oil's hands and that AMP's shareholding could be properly ignored as being without "reconstruction". Neither alternative is discussed by the Privy Council.

V Conclusions

The major criticism that can be levelled at *Europa's* case concerns the failure of the Privy Council to follow the test laid down in *Europa (No 1)*. Even if the Board considered that test to be inappropriate, and a more formal requirement for deductibility necessary, it was for the Legislature to intervene. The *Europa (No 1)* test was determined by this country's highest Court. If the Legislature regarded it as being unnecessarily strict it could have amended s 111 following the Privy Council's judgment. It did not make any change. It must follow that it is not for the Privy Council subsequently to refuse to follow its own precedent – albeit, in *Europa*, without actually saying so. There is the further criticism that, whatever the merits of the *Europa (No 1)* decision, and there is no discussion in the majority's opinion of them, there is a clear failure to apply the new test to the facts as found in the lower Courts.

The Commissioner's s 108 case was clearly contentious. In *Europa (No 1)* the Court of Appeal was unanimous that the section could not apply. The Commissioner, in *Europa (No 2)* had to overcome the opinions expressed by that Court. In *Europa (No 2)*, the Court of Appeal was of the view that McMullin J was persuaded by the Commissioner that s 108 did apply – that McMullin J saw a basis for departing from the Court of Appeal's earlier view. Whatever the merits of the various arguments, the real criticism of the Privy Council's judgment is the implied rejection of much of the case law on s 108 without any reference to or discussion of it. This kind of general approach to such a technically difficult section, the application of which is largely governed by case law decided over a long period of time, is bound to cause further problems for the Commissioner and taxpayers alike.

Finally, it is interesting to note Mr Todd's comments made in relation to the *Europa (No 2)* judgment. As he pointed out, taxpayers can pay over disputed tax, have their objection upheld, and get back the sum disputed greatly reduced in terms of purchasing power because of the effect of inflation. Whatever the merits of the interest claim in *Europa's* case it is submitted that if the Revenue requires disputed tax to be paid, a successful objector should not be in any worse position when he gets the money back. This necessitates a realistic rate of interest.

". . . When the lawyers are through
What is there left, Bob?
Can a mouse nibble at it and find enough to fasten
a tooth in?
Why is there always a secret singing
When a lawyer cashes in?
Why does a hearse horse snicker
Hauling a lawyer away?
The work of a bricklayer goes to the blue.
The knack of a mason outlasts a moon.
The hands of a plasterer hold a room together,
The land of a farmer wishes him back again.
Singers of songs and dreamers of plays
Build a house no wind blows over.
The lawyers – tell me why a hearse horse snickers
hauling a lawyer's bones."

Carl Sandburg

The Isle of Man – The oath of a deemster, or Judge, in the Isle of Man, takes the following interesting form: "By this book and by the holy contents thereof, and by the works that God hath miraculously wrought in heaven above and in the earth beneath, in six days and seven nights, I do swear that I will, without respect of favour or friendship, love or gain, consanguinity or affinity, envy or malice, execute the laws of this Isle justly betwixt our Sovereign Lady the Queen and her subjects within this Isle, and betwixt party and party, as indifferently as the herring's backbone lieth in the middle of the fish."

EUROPA CASE LAID TO REST

By ANTHONY P MOLLOY, *an Auckland barrister.*

The saga of the Europa Oil Company's dispute with the Commissioner of Inland Revenue *(a)* ended on 13 January 1976, with the delivery of the judgments of the Privy Council on the second phase of the case.

It began in 1956, when the company, a petroleum products wholesaler, entered into a series of contracts with an overseas company, the Gulf Oil Corporation. They agreed, in effect, that the Gulf Iran Company – a subsidiary of the latter – would supply the entire refined petroleum requirements of the taxpayer for the ensuing decade, at a discount on the posted world market price. The better to disguise this discount from the market, they agreed also to incorporate a Bahamian company, Pan Eastern Refining Co Ltd, in which, directly or indirectly, each held half of the shares. This company contracted to purchase, from the Gulf Oil Corporation, sufficient crude oil to yield all the requirements of the taxpayer over the relevant period; to have that crude refined, for a fee, by the Gulf Oil Corporation; and to resell the refined product to that Corporation. The latter then was to sell, and Europa to purchase from it, that product, at the posted world market price.

As a result of the business transacted pursuant to this 1956 series of contracts, the taxpayer company, through its indirect shareholding in Pan Eastern Refining Co Ltd, received a formulated return equal to two and one half percent of the cost of all refined end products purchased by it from the Gulf Oil Corporation. The prices at which the latter repurchased the refined products from Pan Eastern Refining Co Ltd were adjusted from time to time to sustain this guaranteed level of return.

Some years after those 1956 contracts, a New Zealand refinery was established, and the taxpayer had a substantial stake in it. Accordingly, in 1964, an associated company (called by the Courts, on the first round of the case, a wholly owned subsidiary), Europa Refining Co Ltd, entered into a replacement series of contracts with the Gulf Exploration Company – a subsidiary of the Gulf Oil Corporation.

Under these replacement contracts it was agreed that Pan Eastern Refining Co would purchase from the Gulf Oil Corporation sufficient crude oil to meet the requirements – in the sense, this time, not of its entire requirements, but only of the requirements from time to time made known by it to that supplier – of the taxpayer: both for refined end products beyond the capacity of the New Zealand refinery, and also for crude feedstocks for refining by it; that any necessary refining would be done, for a fee, as before, by the Gulf Oil Corporation; and that Pan Eastern Refining Co would resell to the Gulf Oil Corporation sufficient quantities to meet those requirements of the taxpayer at such prices as would assure Pan Eastern Refining Co of a profit of roughly 5 cents per gallon. Under a further contract, it was agreed that the Gulf Exploration Company, in turn, would sell those quantities at the post world market price to the taxpayer's associated company – Europa Refining Co Ltd.

Thus, under the second series of contracts, the taxpayer no longer was under contract to purchase its requirements from Gulf Oil Corporation, and neither was it bound to purchase any of its requirements from Europa Refining Co Ltd. In practice, it continued to do so, on the basis of purchasing individual cargo lots as they became available: there being no pre-existing or continuing contractual obligation to purchase any or all of these.

Consequently, the *economic* effect of these replacement contracts was to return refining profits to the taxpayer through its indirect shareholding in Pan Eastern Refining Co. However, the Judicial Committee of the Privy Council, before which the case came twice, ruled, in the course of its majority judgment on the second occasion, that:

"The question in both appeals can accordingly

(a) *Europa Oil (NZ) Ltd v CIR* (No 1) [1970] NZLR 321 (McGregor J); 363 (CA); *CIR v Europa Oil (NZ) Ltd* (No 1) [1971] NZLR 641 (PC); *Europa Oil (NZ) Ltd v CIR* (No 2) (1973) 3 ATR 512 (McMullin J); (1974) 4 ATR 455 (CA) (Interim Judgement); (1974) 1 TRNZ 1 (CA) (Final judgment); and (1976) 1 TRNZ 369 (PC). See Ludbrook "The Europa Oil Decision" (1972) 6 VUW L Rev 207.

be stated thus: Is the *legal* effect – as distinct from the economic consequences – of the provisions of the relevant inter-related contracts such that when the Taxpayer Company orders goods under the contract of sale and accepts the obligation to pay the sum stipulated in that contract as the purchase price, the Taxpayer Company by the performance of that obligation acquires a legally enforceable right not only to delivery of the goods but also to have some other act performed which confers a benefit in money or in money's worth upon the Taxpayer Company or some other beneficiary?

"If the answer is 'No', the full amount of the sum stipulated as the purchase price falls to be apportioned as to part to expenditure incurred in purchasing the goods and as to the remainder to expenditure incurred in obtaining performance of the other act, which in the instant case would not be deductible" *(b)*.

On the first round of the case, the taxpayer made a concession that it made no difference that its associated company, Europa Refining Co Ltd, and not the taxpayer itself, had been the party making the purchases, under the replacement agreements.

When that first round reached it, the Privy Council, by a majority of three to two, reversed the unanimous decision of the three Judges of the Court of Appeal *(c)* that McGregor J *(d)* had decided that case wrongly. The majority held that the original, 1956, contracts were integrated too well to permit either the isolation of the taxpayer's contract to purchase refined petroleum from the Gulf Oil Corporation at posted world market prices, or the consequent claim by the taxpayer that the expenditure incurred under that contract had been incurred "exclusively" *(e)* for the purchase of trading stock *(f)*. The return of 2.5 cents per gallon through Pan Eastern Refining Co Ltd also was part of the consideration for the expenditure by the taxpayer: which would not have entered into an agreement to buy from the Gulf Oil Corporation, at posted world market prices, without that return having been agreed upon.

Having been in the form of a dividend from another company, this return was non-assessable income *(g)*. In effect, the decision converted it into assessable income by disallowing, as a deduction, the amount by which it had reduced the purchase price: on the basis that a particular fraction of that price had not been incurred in producing the income of the taxpayer. Whatever the *economic result*, the *legal effect*, of the transactions pursuant to the original, 1956, contracts had been a reduction by this amount of the cost of the trading stock. Accordingly, the expenditure on oil supplies had been a compound consideration, and it had to be apportioned between the amount – not allowable – which came back, or was offset by, the dividend from Pan Eastern Refining Co Ltd, and the balance of that expenditure, which, representing the true legal cost of those supplies, was allowable.

Referring to the replacement set of contracts, and in the light of the concession mentioned earlier, the majority of their Lordships held that they fell to be treated identically with the earlier agreements: "on the footing that the Taxpayer Company was to be treated as the undisclosed principal on whose behalf Europa Refining had entered into the (replacement) contracts" *(h)*.

Accordingly, for the years covered by the initial case stated, 1959 to 1965, the objection failed.

After this failure, the taxpayer made further objections to the assessments on the replacement contracts for the years 1966 to 1971. Its contentions that the situation had changed were based partly on further evidence aimed at demonstrating that the contracting party in the replacement agreements, Europa Refining Co Ltd, was not, as the Courts in the previous case had been allowed – for lack of argument based on that further evidence – to call it, a wholly-owned subsidiary, but was, merely, an associate; partly on the fact that the concession made, in the previous case, that it made no difference that its associated company, Europa Refining Co Ltd, and not the

(b) (1976) 1 TRNZ 369, 377 lines 23-38. Emphasis added. See also ibid, 376 lines 28-32, where the majority emphasised "that it is not the economic results sought to be obtained by making the expenditure that is [sic] determinative of whether the expenditure is deductible or not; it is the legal rights enforceable by the taxpayer that he acquires in return for making it."

(c) [1970] NZLR at 363.

(d) Ibid 321.

(e) That was then the test, being amended to the present format in 1968. In the Privy Council, the second time around, the majority remarked: "In the last four years of assessment the taxpayer company's claim to the deduction is made under paragraph (a) of the amended section. In their Lordships' view the amendment to the section in 1968 makes no difference for the purposes of the instant appeal. The actual language of s 111, both before and after the 1968 amendment, is simple enough. It does not, in their Lordships' view, need any detailed exegesis." ((1976) 1 TRNZ 369, 376 lines 15-21. See also ibid 386, lines 51-53 per Lord Wilberforce, dissenting.)

(f) [1971] NZLR 641, 651 lines 13-19 per the majority.

(g) Land and Income Tax Act 1954, s 86C(1).

(h) (1976) 1 TRNZ 369, 375 lines 26-29 per the majority on the second round, epitomising the decision of the majority on the first round.

taxpayer itself, was the party to the replacement contracts, was not binding in the present litigation; and partly on the fact that, unlike the agreements they replaced, the new contracts embodied no formula for generating guaranteed refining profits in Pan Eastern Refining Co Ltd.

Both McMullin J *(i)* and the Court of Appeal *(j)* accepted that Europa Refining was not a subsidiary of Europa Oil, the taxpayer *(k)*, and also accepted that the reason the concession – that it made no difference whether the taxpayer was a party – had been made in the earlier litigation was that there then had been only a "limited monetary significance" in the distinction. Accordingly, it was common ground that that concession did not bind the taxpayer in this second case *(l)*. Nevertheless, both McMullin J and the Court of Appeal proceeded to hold that the "reality" test propounded by the majority of the Privy Council on the first round of the case, while emphasising the importance of enforceability, was concerned primarily with economic reality. Dissenting, in the Privy Council on the second round of the case, Lord Wilberforce agreed with them, holding that he derived support, by analogy, from the well-known dictum of Dixon J [as he was then], in *Hallstroms Pty Ltd v FCT* (1946) 72 CLR 634, 648, that what is an outgoing of capital and what is an outgoing on account of revenue depends on

> "what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured ... in the process".

However the majority of the Privy Council at the second hearing took a very different view of the true scope of the "reality" test, and held that it relates only to legal reality, and does not enable the taking into account of

> "economic benefits which would in fact accrue to the taxpayer otherwise than as a matter of contractual right" ((1976) 1 TRNZ 369, 376).

In this light, the decision of the majority of their Lordships on the second round inevitably was:

> "It follows that whenever the Taxpayer Company entered into a contract with Europa Refining for the sale and delivery of one or more cargo lots of feedstocks and thereby accepted an obligation to pay the sum stipulated in that contract as the purchase price, the only right that it thereby acquired which was legally enforceable against anyone was the right to delivery of the feedstocks by Europa Refining.
>
> "In their Lordships' view the result upon the Commissioner's claim under s 111 is that it must fail. The true legal character of the whole of the expenditure claimed to be deductible is that of the purchase price of stock in trade for the Taxpayer Company's business of marketing petroleum products and nothing else. As such it is deductible in full in calculating the Taxpayer Company's assessable income from that business" (ibid), 379).

Such a decision left no room for the question of apportionment which would have arisen had the taxpayer itself contracted, with the Gulf Exploration Company, instead of its associate. In such a case McMullin J, on the basis of his decision at first instance in the second round of the case ((1973) 3 ATR 512), would have disallowed a sum equal to the entire amount of the benefit the taxpayer had received from the Pan Eastern Refining Co Ltd. The decision by his Honour to make this dollar-for-dollar disallowance in respect of the fiscal years 1966 to 1968 – when the test under s 111 was whether the expenditure had been "exclusively" incurred in the production of assessable income – would have been rejected by the Court of Appeal, which, instead, would have disallowed only that proportion of the taxpayer's total fob expenditure on feedstocks which the Pan Eastern Refining Co benefit bore to the sum of that benefit plus the actual armslength long term market value of the feedstocks in respect of which that expenditure was incurred *(m)*. On this point, Richmond J referred to the fact that McMullin J in the Court below merely had come to the same conclusion as the Privy Council had reached, without contrary argument, in the previous phase of the case *(n)*. The learned Judge proceeded to hold that, in relation to the now superseded form of s 111:

> "Once expenditure which, on its face, is incurred for the purchase of trading stock, is demonstrated by the application of the 'strict test' to be dual purpose expenditure, then the process of apportionment involves no more than allocating a fair proportion of the expenditure to the acquisition of the trading stock and a fair proportion to the acquisition of the additional benefit.
>
> " ... [T]he only expenditure which requires

(i) (1973) 3 ATR 512.

(j) (1974) 4 ATR 455.

(k) (1973) 3 ATR 512, 523 lines 27-29; (1974) 4 ATR 455, 456 lines 19-21 per McCarthy P, lines 31-36 per Richmond J.

(l) See *Caffoor v Commissioner of Income Tax, Colombo* [1961] AC 584, 597-599 (PC).

(m) for example, see (1974) 4 ATR 455, 484 lines 38/485 line 5 per McCarthy P (Interim Judgment), and (1974) 1 TRNZ 1, 8 per the Court (Final judgment).

(n) Ibid, 493 lines 38-55.

to be apportioned is that portion of Europa Oil's fob invoices rendered by [the Gulf Exploration Company] to Euorpa Refining under the feedstock supply contract. This is because it is only the fob invoices which have the necessary close link with the amount of the Pan Eastern benefit – this benefit is not affected by the payment of freight invoices, insurance or harbour improvement levies. . . . [I]t is only the fob payments which should be regarded as having been made for the duel purposes of acquiring the feedstock cargoes and securing the Pan Eastern advantage" *(o)*.

But this left the 1969, 1970 and 1971 fiscal years, in respect of which the question was whether the amendment to s 111 in 1968 – substituting a more benevolent touchstone of deductibility – required a different result. At first instance, McMullin J held in the negative: ruling that, to the extent to which it related to the Pan Eastern dividend and not to the feedstocks, the taxpayer's expenditure on the purchase of feedstocks from its associate – Europa Refining Co Ltd – after the latter had purchased them from Gulf Exploration Company, had not been "necessarily incurred" within the second limb of the new enactment. Nor, to that same extent, the learned Judge held, was that expenditure deductible pursuant to the first limb.

"The expenditure incurred by the Objector, ostensibly as part of the purchase price over and above that which could have been obtained in an armslength transaction, is plainly not an expenditure actually incurred in the production of that income. To the extent that the expenditure was incurred as part of the price of feestocks it is deductible, but to the extent that it was paid for benefits over and above these feedstocks it is not deductible. The Commissioner's assessment recognises this. The extra amount paid cannot be said to be expenditure incurred in the purchase of feedstocks" *(p)*.

The Court of Appeal agreed with McMullin J that the test under the new first limb was no different from that under the section in its previous form. Richmond J, with whom McCarthy P agreed *(q)*, held that

"the new s 111 (a) is substantially the same as the old section, except that the word 'exclusively' has been omitted. I do not think that this alteration affects in any way material to the present case the principle that true dual purpose expenditure can be apportioned nor do I see any good reason why the apportionment should be carried out in any different way under the new s 111 (a) as compared with the old section" *(r)*.

Once again however, whereas the learned trial Judge had ruled that the expenditure which was not deductible under the first limb should be disallowed on a strict dollar-for-dollar basis, the Court of Appeal held that only that portion of the taxpayer's total fob expenditure on feedstocks which the Pan Eastern Refining Co benefit bore to the sum of that benefit plus the actual armslength long term market value of the feedstocks acquired should be disallowed.

On the second limb, though, the Court of Appeal held that the only relevant factor was what prices had been paid in fact *(s)*. It found these had been in excess of armslength market prices, although there was no evidence that better than market prices could have been obtained *(t)*.

"[T]he heart of the problem is – to what extent were the fob expenditures necessarily incurred as part of the process of acquiring feedstocks? It may be said that an apportionment should be made on the same basis which I have adopted in relation to the old s 111 and the new s 111 (a). This question has given me a great deal of concern. In the end I have come to the conclusion that a different approach has to be made under s 111 (b) in order to give proper effect to the language employed in relation to the realities of the circumstances in which Europa Oil was placed during the last three tax years. The truth is that Europa Oil could not in practice have acquired its feedstocks, either from Gulfex or anyone else, by merely paying about 80 percent of the overall fob expenditure. I have therefore formed the view that to an extent equivalent to arm's length fob long term market values the expenditure actually incurred by Europa Oil was necessarily incurred in the course of carrying on its business for the purpose of gaining or producing the assessable income. To produce that income had to get its feedstocks. It could not do so at better than the prices I have mentioned [it was of course not contractually bound to place orders with Gulfex]. Within the limits imposed by the word 'necessarily' the expenditure should be wholly deductible even though it may also have the purpose of gaining a non-taxable benefit.

"The conclusion at which I have arrived regarding s 111 (b) involves substantial amendment to the assessments for the last

(o) Ibid, 494 lines 7-12, 38-51.
(p) (1973) 3 ATR 512, 534 lines 11-20.
(q) (1974) 4 ATR 455, 487 lines 32-45.
(r) Ibid 496 lines 3-8.
(s) Ibid, 487 lines 9-25 per McCarthy P.
(t) Ibid, 487 lines 32-45.

three years. Instead of disallowing the entire amounts of the Pan Eastern benefit the Commissioner should disallow only the difference between actual fob payments and current market value" *(u)*.

Clearly the second limb test is more favourable, and, had the case not been decided by the Privy Council in the manner discussed earlier, it would have been necessary to examine evidence enabling calculations to be made on the basis that the claim of the taxpayer would have been disallowed only to the extent to which its fob costs in each year exceeded the actual armslength long term market values of the feedstocks in respect of which those costs had been incurred *(v)*.

Apart from his assessment pursuant to s 111, the Commissioner had attempted to assess the objector with the Pan Eastern profit which it had received indirectly, via a wholly-owned subsidiary. In this respect their Lordships held that their:

> "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 NZ 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 at p 434:
>
> > 'It is not for the Court or the Commissioner to say how much a taxpayer ought to spend in obtaining his income':
>
> 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" ((1976) 1 TRNZ 369, 380).

In so holding, their Lordships appeared to resile from the view – which they had expressed in the previous round of the case – that

> "s 111 does not enable the Crown to disallow expenditure genuinely made whenever it can be found that some economic advantage accrues to the trader as a result of making the expenditure: after all, the trader is taxed on his profits and if he succeeds in obtaining what are effectively profits in such a way as not to pay tax on them, *the Crown has other weapons*" ([1971] NZLR 641, 649).

The phrase italicised was taken by McMullin J, at first instance, in the second round of the case, to be a reference to s 108 *(w)* and it seemed that the effect of this had been to ratify the attitude expressed by Menzies J in *Franklins Self-Serve Pty Ltd v FCT* (1970) 1 ATR 673, namely that:

> "I should, perhaps, say that I do not regard *Cecil Bros Pty Ltd v FCT* (1964) 9 AITR 246; 111 CLR 430, as deciding that the operation of s 260 [the Commonwealth provision similar to s 108] cannot destroy, as against the Commissioner, the basis upon with a taxpayer claims a deduction" (ibid, 689).

However, that resilition was seeming rather than real, as their Lordships made clear in the following passage from their judgment in the second round:

> "The Commissioner must therefore be able to point to some other of the 1964 contracts the avoidance of which would have the legal effect of making the profits earned by Pan Eastern under the new processing agreements, or the dividends payable out of those profits to [the wholly-owned subsidiary of the taxpayer], part of the assessable income of the taxpayer company" ((1976) 1 TRNZ 369, 380).

That is, any wider arrangement of which it is part can be annihilated pursuant to s 108 (1), where appropriate, and the tax liability modified, pursuant to s 108 (2): even if, standing alone, one particular contract would be definitive as to that liability.

For example, if the objectors in *Elmiger v CIR* [1967] NZLR 161 (CA) or *Wisheart v CIR* (1971) 2 ATR 377 (CA) had simply hired their equipment from independent commercial sources, rather than selling it to their family trust and hiring it back, their claimed deductions for hire charges would have been unimpeachable. But, their arrangements being wider than simple hiring contracts, in so far as they each included the earlier sale of the same equipment to the, related, hirer; and, in contrast to the wider arrangement in *Grierson v CIR* (1971) 3 ATR 3 (Henry J), they each being incapable of explanation on any other ground that that of tax avoidance was more than a merely incidental purpose: s 108 overrode the deductions that were claimed under s 111.

So, if steps taken to inflate a deduction for stock in trade can be characterised as an "arrangement" or as part of a wider "arrangement": s 108 (2), going beyond the power

(u) *Ibid*, 496 line 36/497 line 2, lines 12-16 per Richmond J.

(v) (1974) 1 TRNZ 1, 8 per the Court (Final judgment).

(w) (1973) 3 ATR 512, 536 line 13.

conferred on the Federal Commissioner of Taxation by the provision at issue in *Cecil Bros Pty Ltd v FCT* (1964) 111 CLR 430 (FC), in effect will enable the purchase price paid pursuant to that arrangement or wider arrangement to be apportioned in such a way that the inflated part will not be deductible under s 111.

The existence of an arrangement in cases such as *Elmiger v CIR* and *Wisheart v CIR*, involving attempts to create a deduction, is easily discernible. Discovering one in a case such as *Cecil Bros Pty Ltd v FCT* is a different matter, for, in such a case, the deduction is not being created: it exists by virtue of the very nature of the business itself. While it is not necessary for a contractor or a lawyer to sell his machinery to a family trust and lease it back in consideration of payment of him of a rental, it is imperative that a trader purchase his trading stock. Thus, of the members of the Full Court in *Cecil Bros Pty Ltd v FCT*, Menzies J assumed, without deciding, that the dealings between the objector and the interpolated corporate family middleman constituted an arrangement within s 260 of the Income Tax Assessment Act 1936 (Cth) *(x)*; Taylor J found "great difficulty in identifying what, on the facts of the case, is said to constitute the contract, agreement or arrangement falling within s 260 . . . *(y)*; and Dixon CJ, with whose judgment Kitto and Windeyer JJ concurred without elaboration; did "not think that on the facts of this case there was any contract, agreement or arrangement to which the taxpayer was a party, falling within s 260" *(z)*. Only Owen J, at first instance, whose decision they reversed, held that there was an "arrangement" in the relevant sense; doing so on the basis that

> "regard must be had not only to the actual transactions between the taxpayer and Breckler Pty Ltd but also to the relationship between the two companies and their directorates and shareholders, and to the fact that the taxpayer could, to the knowledge of its directors, at all times have bought all its requirements from the manufacturers or wholesalers on the same terms as those on which Breckler Pty Ltd bought" *(a)*.

Because they decided on the ground that s 260, unlike s 108, is not a reconstructing provision, these dicta of the members of the Full Court are obiter. The view of Owen J was part of the ratio decidendi of his judgment. Moreover, it appears to align better with the way "arrangement" is defined in s 108 (6), namely as meaning

> "any contract, agreement, plan, or *understanding* (whether enforceable or unenforceable) including all steps and transactions by which it is carried into effect."

For these reasons, and while the matter is by no means beyond doubt, any attempt in New Zealand to inflate a deduction in respect of expenditure on trading stock – notwithstanding that some expenditure would have been incurred in any event – where the maker and the recipient of that inflated expenditure are related or associated; and where one of the evident purposes or effects actuating the attempt is that of splitting or spreading income between or over those parties with a view to minimising the overall tax liability: could be an arrangement subject to avoidance by s 108 (1). If so, the consequence of the application of that provision would be to bring into effect the power vested in the Commissioner, by subs (2), to so modify the position "as to counteract any tax advantage obtained".

However, since there was no evident purpose of tax avoidance in the present case, neither the old form of s 108, with which their Lordships were concerned, nor the present form, could have been applicable to defeat the deduction which had been claimed and upheld pursuant to s 111.

(x) (1964) 111 CLR 430, 440
(y) Ibid, 438-439.
(z) Ibid, 438.
(a) Ibid, 435.

"Coincidental condonation? – "Forgiveness and reinstatement involve matters of the mind. When men and women of self-control have intercourse in normal circumstances, there is a very strong inference that their bodies go with their minds and set the seal on reconciliation and forgiveness. But the Divorce Courts have to deal very often with persons who have little self-control, and those (? whose) minds and bodies are not always co-ordinated. In dealing with such persons one has to be careful not to cause injustice by drawing mental inferences more suitable to persons who are better co-ordinated and more self-controlled." *Blyth v Blyth* [1966] 1 All ER 524, 538 per Pearce LJ.

Eternal Disqualification – A disqualified driver sought, in a County Court, to obtain a limited licence. It included the right to drive to and from church each Sunday and this part was opposed by the Ministry of Transport. In giving his decision the Magistrate said "I would have expected the love and charity of the applicant's fellow parishioners to extend to taking him to church with them. However, in case it doesn't, I do not want to be responsible for what might be to the applicant the ultimate hardship, outside this jurisdiction and before a much higher authority".

The application was granted.

SECTION 108 AND THE ISSUE OF LEGISLATIVE PROPRIETY

By L McKAY, *senior lecturer in law, Victoria University of Wellington.*

Introduction

We have it on the authority of Dr I L M Richardson that the recently amended s 108 of the Land and Income Tax Act 1954 ". . . will continue to occupy the attention of practitioners and the Department, if not of the Courts, as much as it has over the last 10 years" *(a)*. This prospect is a sobering one in itself. Dr Richardson provides some indication of the quantum of litigation and taxpayer/Department disputes provoked by the pre-1974 section *(b)*: one would have hoped that the major revision undertaken in that year would, if nothing else, have prevented a repetition of that. If it has not – and would we not all agree that substantive issues abound under the new language *(c)* – it cannot have achieved much at all from the standpoint of certainty. Nor might it prove to have achieved anything at all in the long term for, as Dr Richardson also points out *(d)*, the section has become a political football and is likely to be amended yet again following the National Party's election to office.

It therefore seems both appropriate and legitimate to ask whether s 108 as recast, or as likely to be recast in the future *(e)*, is worth either the trouble or the price in terms of uncertainty which it demands.

The case for s 108

The assumption in much of the debate surrounding both the old and the new s 108 is that "general" anti-avoidance provisions are necessary to protect the Revenue from artful dodgers. Dr Richardson describes as the "classic" argument in their favour the observation of Menzies J. in *Peate v F C T* (1964) 111 CLR 443 to the effect:

> "As often as a particular loophole is closed through which it has been discovered that revenue is lost, another is likely to be found, so that as long as it confines itself to stopping gaps the Legislature is always a step behind the reluctant taxpayers and their ingenious advisors. It is not, therefore, surprising that Parliament has sometimes sought to anticipate tax avoidance by general laws rendering ineffectual against the Commissioner arrangements which are not shams but are entered into to avoid taxation obligations that would otherwise in due course be incurred"*(f)*.

Recognising that this argument defies historical reality in the New Zealand context *(g)* Dr Richardson provides what is a slightly different one in terms:

> "The widespread invoking by the Commissioner of s 108 does highlight the importance in a modern tax system of buttressing specific anti-avoidance provisions by a general provision"*(h)*.

With respect, neither line of argument is totally convincing. As to the latter, the Commissioner's decision to employ s 108 logically proves little more than that the Department understandably prefers broad provisions to narrow ones. What little beyond that it might prove is *not* that specific anti-avoidance provisions are inherently unsatisfactory – which the argument implies – but rather that the legislature has failed to provide or the Department has failed to press for more adequate and sophisticated provisions of the latter character. That in many significant respects the specific provisions are unsatisfactory cannot be denied: the fact that the judiciary has been required – without the scope of s 108 entirely – to erect principles of its own making to plug, or attempt to plug, gaping holes in the 1954 Act *(i)* is indication enough of that proposition. So too is

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(a) [1974] NZLJ 560 at p 565.

(b) Ibid, at p 560.

(c) See the discussion infra. See too the short discussion by Congreve in 6 NZULR No 2 at 311, 313.

(d) Supra, fn (a) at p 560.

(e) See for convenience Richardson, supra, fn (a) at p 565.

(f) Ibid, at p 445

(g) For an analysis of the history of the provision see *Elmiger v CIR* [1967] NZLR 161 at p 176 per North P; *Mangin v CIR* [1971] NZLR 591 at p 600 per Lord Wilberforce.

(h) Supra, fn (a) at p 561.

(i) In particular the "*Arcus*" and "personal services" principles: see a paper by the present writer in 6 NZULR No 2 140 at pp 156-160.

the most cursory comparison of New Zealand's specific provisions with those of, say, the United Kingdom or the United States. Take the vital *(j)* issue of retained controls as an example *(k)*. Section 105 is so woefully inadequate that a Taranaki tractor could be driven through it without a scratch. It makes no attempt to control the actions of the settlor as trustee *(l)*; it ignores any question of reciprocal trusts *(m)*; it treats as irrelevant the use to which income is put – even if for the benefit of the settlor. In another context the writer referred to it as "a minor irritation to the tax planner"*(n)*: it has been that, presumably to the Department's knowledge, for years.

Or take the general issue – of which s 105 "deals" with a specific aspect – of income splitting between husband and wife or spouses and children. With the repeal of s 104 *(o)*, which was extremely limited in any event, there is no longer any provision for the aggregation of family incomes in the usual splitting case apart from s 105. This is clearly inadequate: given the mutuality of interest usually prevailing between spouses and between spouses and children *(p)* and given the invitation to splitting proffered by New Zealand's individual-unit taxation structure *(q)* some measures to authorise aggregation are manifestly called for.

In both these respects our specific anti-avoidance measures are markedly less sophisticated than those of those countries earlier mentioned. Take the United States as an example. Interspousal transfers and family income-splitting are dealt with in an exhaustive manner in ss 672-676 of the Internal Revenue Code and the regulations thereto – "exhaustive" because almost every significant power that might conceivably be preserved to a settlor are the subject of detailed legislative treatment. There is no evidence in this case that "particularity breeds avoidance" *(r)*: rather, the provisions strike what is regarded in the United States as a reasonable balance between Revenue demands and those of estate planning *(s)*. It by no means follows that the substantive provisions of the Code should be duplicated in New Zealand *(t)*: the short point is simply that those provisions indicate the degree to which specific anti-avoidance provisions can be rendered both efficacious and sophisticated *(u)*. Before we refer to the "need" for general provisions such as s 108 should we not, logically, give the alternative a fair try?

But what of the argument of Menzies J? That learned Judge would have it that the merit of a general provision is that it prevents the Department from being for ever a step behind the ingenious devices of tax planners. It is submitted that this statement is of dubious weight for its presupposition is that a general anti-avoidance provision will always retain its generality. That, surely, is erroneous, for it disregards the inherent character of the New Zealand judicial process. *Elmiger v C I R* [1967] NZLR 161 (CA) was described by the former Minister of Justice as the "high-water mark" in the interpretation of s 108 *(v)*. And so it was. But the ebbing of the tide was not referrable – as the Minister implied – to a hostility towards the section on the part of the judges other than Wild CJ, North P and Woodhouse J, learned judges who played important roles in the saga of s 108, were as apparently favourably disposed towards the section as the former. No: the tide retreated because it is in the nature of the judicial process to hedge generality with specific rules, limitations and qualifications. *Elmiger* itself began that process *(w)* and it was carried forward in every significant decision up to and including the *Gerard (x)* decision of the Court

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(j) At least so regarded by the United Kingdom *Royal Commission on the Taxation of Profits and Income* Cmd 9474, London, 1955, at para 1019.

(k) For a summary of the United States provisions referred to at this point and infra see 7 VUW LR No 4 426 at pp 445-447. For the equivalent and in part more severe United Kingdom provisions see Income and Corporation Taxes Act 1970 (UK) ss 434-456.

(l) For the case in favour of regulating these in the same manner as pecuniary powers or powers held absolutely, see the article ibid, at pp 442-445.

(m) The adequacy of s 105 in relation to which is illustrated by *Kelly v CIR* [1970] NZLR 161.

(n) Supra, fn (k) at p 426.

(o) By Land and Income Tax Amendment Act 1973, s 10 (1).

(p) See the observations of the Supreme Court of the United States on this issue in *Helvering v Clifford* (1940) 309 US 331 per Douglas J at 337.

(q) For an observation on which see infra.

(r) A claim in favour of general anti-avoidance provisions by the Canadian *Carter* Commission: see infra.

(s) For a summary of the history, scope, and effect of the provisions, see Bittker, *Federal Income Taxation* (1974) 4th Ed pp 387-392; see too Yohlin, *The Short Term Trust – A Respectable Tax Saving Device* (1958) 14 Tax LR 109.

(t) See 7 VUWLR at p 448-454.

(u) It is true that these and other anti-avoidance provisions in the US Code are supported by a "substance" approach on the part of the judiciary, as to which see infra. The limited applicability of that doctrine in the areas discussed, however (ibid), renders the assertion in the text a justifiable one.

(v) For convenience see Richardson, supra (a) at p 565.

(w) By eg its adoption of the *Newton* ([1958] AC 450) "predication" test: see North P at 178; McCarthy J at p 189. That test in itself provides a considerable limation upon the literal ambit of the section: see infra.

(x) [1974] 2 NZLR 279.

of Appeal. The result, as Wilson J *(y)* and McCarthy P *(z)* noted in the last-mentioned case, was that the provisions of s 108 themselves ended up as having very little to do with s 108 litigation. What had a great deal to do with the litigation were the *specific* criteria and qualifications contained in the decisions themselves – "glosses placed by the Courts on the text" *(a)*.

The point is this. The history of s 108 is one of the growth of specificity out of generality. A by-product of that development was the developing emergence of "safe" avoidance devices, for with specificity came decisions against the Commissioner which would, absent s 108's repeal, undoubtedly have been relied upon in future cases. Take *Gerard*. With respect, the writer is of the opinion that it was correctly decided on the basis of then existing authority *(b)*. But it is suggested with equal respect that it served to open the doors to Messrs Marx and Carlson *(c)* and hundreds of other frustrated litigants to re-establish their paddock trusts in legal, unchallengeable, ways. Why? Because *Gerard* upheld the validity of a scheme substantially though not formally the same as those of their own earlier held ineffective. This process would, it is suggested, have been in time duplicated in other areas to which s 108 had been applied. Any decision against the Commissioner on a technical issue would have created a flood of schemes rendered immune by the same technicality.

In the light of these known, and probable developments, where then is the capacity of the section to "close the loop-hole" or "plug the gap" or "keep the Commissioner up with the play"? Slowly disappearing: eroded by the doctrine of precedent, hamstrung by a commendable judicial quest for certainty and precision out of uncertain and imprecise legislative language. Not totally gone to be sure, for the short life of the provision prevented the completion of the process, but vanishing nevertheless. Another decade of s 108 in its old form would have seen the emergence of a code analogous to specific anti-avoidance provisions.

The writer would suggest that this too will be the fate of the new provision, should it live long enough to be subject to the same process *(d)*.

If this is so, then the assertion of Menzies J suffers from a generality our own experience refutes. We do not have a provision which "anticipates" tax avoidance or keeps the Commissioner a step ahead. We have, rather, a general anti-avoidance declaration out of which the courts must make what they can and which is only "fully" – in the Menzie's sense – effective until the courts commence that task, from which point its effectiveness declines until another declaration in sufficiently general language to give the Commissioner a fresh start and make unsure what was previously settled *(e)* is necessitated. Far from freeing the legislature from the task of constant revision of specific provisions, sections such as s 108 can remain efficacious only by being subject to the self-same process.

What more can be said in favour of general anti-avoidance provisions? The *Royal Commission on Taxation in Canada (f)* – the Carter Commission – came down in favour of reasonably *(g)* broad anti-avoidance provisions on the basis of what it saw as the disadvantages of specific sections *(h)*. These defects were five:

(a) In the Canadian context they had been ineffective in countering some avoidance devices such as dividend stripping *(i)*;
(b) "Particularisation breeds avoidance" *(j)*;
(c) The draftsman of specific provisions may attempt to "cast his net very wide" and "thereby reach situations never intended to be reached" *(k)*;
(d) Particularisation assists the potential tax avoider "because it defines for him the obstacle that he must be ingenious enough to get around" *(l)*;
(e) Specific anti-avoidance legislation is often in "tortuous and obscure language of unrivalled complexity and difficulty" *(m)*.

Some of these arguments have a degree of substance; others are make-weights; others are more persuasive of the need to avoid provisions such as s 108 than in favour of it. Into the latter class the quoted portions of arguments (c) and (e)

(y) In *Gerard* in the Supreme Court: see (1972) 3 ATR 271.
(z) [1974] 2 NZLR 279, 280.
(a) Ibid, at p 280.
(b) For a short comment on the decision at first instance see a note by the present writer in 5 NZULR 383
(c) [1969] NZLR 464.
(d) See the observation supra.
(e) See infra.
(f) Queen's Printer, Ottawa, 1966.
(g) For *Carter's* discussion of tax avoidance see ibid, Vol 3, pp 537-575; for its recommendation see pp 573-575. It did not recommend a provision as broad as s 108, preferring a number of more specific provisions eg one relating to non-arms-length transactions (ibid 574); one disallowing "artificial" deductions (ibid 575).
(h) Ibid at pp 554-556. Compare the views of the United Kingdom Royal Commission, supra fn (j) at paras 1017-1019.
(i) Ibid, at p 554.
(j) Ibid
(k) Ibid, at p 555.
(l) Ibid, at p 556.
(m) Ibid.

must assuredly fall, McCarthy P says as much in substance in *Gerard (n)*, and it cannot be seriously contended that the descriptions are more closely applicable in the New Zealand context to s 108 than to any specific provision in the 1954 legislation *(o)*. Into the former category must be placed considerations (b) and (d), which appear to amount to the same thing. Without any doubt, particularisation poses a challenge to the potential tax avoider. That was not denied in the earlier discussion. The point made there, which warrants repetition here, is that our efforts at particularisation are often so woefully poor that their avoidance is inevitable, and the challenge to the tax planners an easy one to meet. The fact that the challenge is posed is, in itself, a spur to perfect *that* process rather than abandon it without serious attempts to render it efficacious.

Further: let it be assumed for a moment that whatever the degree of sophistication that could be reached, and however generally efficacious our specific provisions could be rendered, there will inevitably be a degree of leakage. It does not in any way follow that provisions of the generality of s 108 are required to counter those otherwise successful efforts. We do not logically require a provision which threatens an irrevocable disposition to independent trustees *(p)* to launch a successful anti-avoidance campaign against dividend stripping or paddock trusts. Indeed, one would expect that the considerations – from both policy and legal standpoints – applicable to these three situations would be sufficiently distinct to demand separate treatment and that any common denominator would be so vague as to be of little guidance in any particular case. If dividend stripping, or paddock trusts, or family splitting is a source of concern, why should it not be dealt with directly – even in language as broad as s 108 if that is the best our ingenuity can muster – rather than by means of a club that threatens totally unrelated transactions to which quite different considerations may apply? Surely we do not have to throw the whole practice of estate planning into confusion to counter specific areas of concern. Whatever the legitimacy of *Carter's* "particularity breeds avoidance" assertion counters of that effect are not validated by it.

What else then can be said for s 108? only to elevate to a pinnacle of virtue its inherent vagueness. In the words of one commentator:

> "Such uncertainty does not strike me as baneful; indeed the very uncertainty as to the precise scope of [provisions] *(q)* for debarring tax avoidance may have a positive, wholesome effect in discouraging many taxpayers from trying out devices which have no useful economic or family or personal purpose" *(r)*

Carter would probably agree. In regard to several of the then existing anti-avoidance provisions it suggested that although they were "vague" or "general" or "uncertain" their retention was justified on the basis of the deterrent value inherent in those qualities *(s)*. The deterrence assertion must be justified from our own experience: but that does not in itself establish the propriety of this approach. First, what is deterred? Only those arrangements which lack "usefulness"? Of course not. In the s 108 context at least, the "wholesome" uncertainty pervades all aspects of estate and taxation planning *(t)*. Secondly, what *is* a "useful" purpose and what, in *Carter* terms, *should* be deterred? Our individual opinions, those of the judiciary and that of the Commissioner would assuredly differ *(u)*, compounding the point immediately above. And thirdly, the argument as a whole has an ominous ring to it. Unquestionably, we would not tolerate vagueness in our criminal law or regard it as productive of a "positive" or "wholesome" effect. Some notion of the rule of law would prevent us doing so, whatever the "efficiency", "expediency" or "effectiveness" that generality might achieve. Tax planning – the phrase is deliberately chosen, for that is the area affected – should not be subject to different treatment until, at the very least, the alternatives are exhausted.

The case against s 108

The principle arguments against provisions as general as s 108, old or new, were summarised by the *Carter* Commission *(v)* in these words:

> "A person's liability to pay taxes should be imposed in explicit terms and with the authority of Parliament: ... this precept is not observed where control of tax avoidance is maintained through the use of some general declaration of principal governing tax avoidance and particularly where the application of that principle ... is left to ... some other body. If general or discretionary provisions

(n) [1974] 2 NZLR 279, 280-281.

(o) See the discussion infra.

(p) Analogous to *Deputy FCT v Purcell* (1920) 29 CLR 464, discussed infra.

(q) The actual term is "instruments": the discussion was one of judicially-developed anti-avoidance doctrines. The thrust of the argument is the same.

(r) Hellerstein, *Tax Avoidance*, Report of Proceedings of Canadian Tax Conference (1964) 62 at p 72. See too Pavenstedt, *The Broadened Scope of s 22 (a) – The Evolution of the Clifford Doctrine* (1941) 51 Yale LJ 213,

(s) Queen's Printer, Ottawa, Vol 3 at pp 574-575.

(t) See the discussion infra.

(u) See infra.

(v) Supra, fn (s), Vol 3 at pp 553-554.

> are enacted Parliament does not know when they will be applied or how far they may be extended."

Carter prefaced this observation with an "it may be argued that" *(w)* and did not fully accept every aspect of it. The writer would support it in its totality.

We surely cannot doubt that the opening proposition represents a fundamental principle of legitimacy not only in our taxation system but by analogy in our entire body of law. The notion it represents may be clothed in many guises: all however may be reduced to two propositions – first, the law must be known if it is to be obeyed; and secondly, that property should not be confiscated without clear authority from Parliament. The practical alternative to unqualified acceptance of these canons is, in the words of one commentator, a tax system built on the notion that "All taxpayers shall pay such taxes as the Minister... in his discretion considers appropriate" *(x)*.

To accept these principles we need not condone avoidance. The grand rhetoric of *Duke of Westminster (y)* and Lord Tomlin's famous defence of it *(z)* quite properly strike a false note to modern ears and can have little or no significance in a social structure as heavily dependent upon income tax as that of our own. But our changing views of the morality of tax avoidance should not blind us to the fact that clarity and legislative authorisation are principles which have inherent validity quite apart from our collective judgment on the former issue. We should not abandon public morality to counter the private immorality of individuals.

In the writer's opinion that lesson was forgotten in regard to the old s 108 and has been forgotten in the new. As to the old. To talk of s108 as having "imposed a liability" with "the authority of Parliament" is historical fantasy. Parliament did not "authorise" anything. The Commissioner and the Courts took a discarded relic of the land tax and tried to make it work *(a)*, making them and not the legislature "truly the lawgiver to all intents and purposes" *(b)*. That is, however, less serious perhaps than the failure of the "lawgiver" to render its commands explicit. For much of the life of the old provision all that was fully "known" about the section was that little was known and that what little certainty there was lay in past judicial performances *(c)*. That state of affairs should be intolerable to us in any area of the law: it is doubly unsatisfactory in one so central to both personal and collective interests as income tax and estate planning. We should not need to be reminded that:

> "The tax which each individual is bound to pay ought to be certain and not arbitrary" *(d)*.

All that the new provision has done, in essence, is to frustrate much of the certainty that was developing out of the old as the judicial process was applied to it. While several of the issues judicially resolved under the former provision will add some certainty to the new, and while redrafting has resolved others, different issues have arisen. Putting aside those that arise from the specific language of the amendment, there is the big query of the extent to which the Commissioner will try to take the provision. Clearly, far less blatant schemes than those to which he formerly gave his principal attention are at risk and it is a matter of conjecture how far and wide he will choose to strike before the arteries of the provision are hardened by both interpretation and general expectations borne of his previous areas of challenge. What of this scheme for instance: A transfers, irrevocably, a rental property producing $3000 income to trustees for the benefit of his children. No reversion or beneficial interest is retained. A is trustee with wide discretionary powers. Prior to the settlement A customarily gave $3000 a year out of tax-paid income as gifts to his children. Assuming that the *Newton (e)* predication test *(f)* continues to apply to the new provision this scheme does not necessarily fall without it. Will it be challenged? Of less concern than the specific answer, yes or no, is the compelling need that there *be* an answer and

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(w) Ibid.

(x) Vineberg, *The Ethics of Tax Planning* (1969) Brit TR 31 at p 36.

(y) *IRC v Duke of Westminster* [1936] AC 1.

(z) Ibid, at pp 19-20.

(a) See eg the comments of Lord Wilberforce in *Mangin v CIR* [1971] NZLR 591 at pp 600-601.

(b) The phrase is said to be that of Bishop Hoadly in the course of a sermon preached before the King in 1717 and is part of an assertion: "Whoever hath the absolute authority to interpret any written or spoken laws, it is he who is truly the lawgiver to all intents and purposes and not the person who first wrote or spoke them". Quoted by Sherbaniuk in *Tax Avoidance – Recent Developments* (1968-70) Report of Proceedings of Canadian Tax Conference 431 at p 433.

(c) 5 NZULR 383.

(d) Adam Smith, *The Wealth of Nations* Book 5 Chap II Part II. For a short discussion of this, Smith's Second Canon of Taxation, in an avoidance context see Wheatcroft, *The Legislature and Tax Avoidance* (1955) 18 Mod LR 209 at p 213 et seq.

(e) [1958] AC 450.

(f) "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." Ibid, at p 466 per Lord Denning.

that A does not have to wait for a decade of judicial interpretation to learn what it is.

The second limb of the quotation from *Carter* above *(g)* provides, to the writer's mind, an equally cogent reason for objecting to s 108 and the broad type of provision it typifies. As indicated in the preceding paragraph, the Commissioner possessed under the old and possesses under the new section considerable powers in regard to the determination of its overall ambit. The writer, has, personally, no objection whatsoever to the absolute transfer in the above example being struck down as against the Revenue: but it and other areas into which the former s 108 was never extended is a class of avoidance transaction so dissimilar from those previously attacked and one which raises such different legal and social issues that, it is submitted, it should be for Parliament and not the Department to condemn it if condemned it is to be. This and related issues are too important to be abdicated to the Commissioner. There seems little prospect that in the New Zealand context the power to make that broad determination will be used "vindictively" or so as to create "pure autocracy" – as others have feared of general provisions *(h)* – but the importance of the decisions in question are sufficiently weighty to compel the same conclusion as the implicit thrust of these assertions.

With respect, the same considerations apply with regard to the judiciary. There is no question but that judicial politics, philosophies and perceptions played an important role in the interpretation of the scope of old s 108. It seems highly probable that they will continue to do so with the amendment. The fact that such philosophies differ among the judges and in themselves cause at least initial uncertainties is concern enough; but more significant is that after a period of disagreement followed by one of synthesis and crystallisation it was, and will be, they to a far greater extent than the philosophies of the legislature that "represent" our societal standpoint on tax avoidance. It is not intended to display lack of deference to say that the personal philosophies of the members of the Court of Appeal are not the most satisfactory basis on which to rest a matter of that significance. Eighty-four Members of Parliament may not be perfect either: but is it either naive or discreditable to express an overall preference for the outcome of their deliberations on this question? Indeed: one may be and should be bolder than that. As a factor of its uncertainty and the considerable property interests to which that uncertainty extends the old s 108 prompted a rash of appeals to the Privy Council. It is probable that more will follow under the recast provision. What is true for our own Court of Appeal judges must it is suggested hold even more true for five of their Lordships in London. It cannot be unreasonable to object *(i)* to the rendering of important decisions affecting our overall stance on avoidance issues by a Court so constituted. That the personal philosophies of some of the Law Lords are far from those of our own judges and, more importantly, our legislature, should be clear inter alia from their recent decision in *Ransom v Higgs (j)* wherein the *Duke of Westminster* doctrine *(k)* – the guardian angel of the tax avoider *(l)*– was reasserted. If, as one commentator has gleefully suggested *(m)*, this decision is a further step backward to formalism, we should surely be wary of inviting a body so disposed to play a role of widespread national significance. And that is precisely what the broad and discretionary language of the recast provision does.

Can the latter assertion and those relating to the breadth of the discretions conferred upon the Commissioner and the judiciary be seriously doubted? The fundamental provision in the recast section is that arrangements for the "purpose" of "tax avoidance" are void as against the Commissioner. "Tax avoidance" is given an extremely wide interpretation: "altering the incidence of income tax" *(n)*, "relieving any person of his liability to pay income tax" *(o)* and "avoiding" or "reducing" or "postponing" *(p)* liability to pay income tax. The provisions are wider *(q)* than those of the former section, even as "interpreted" *(r)* by *Marx v C I R (s)*. The definition of "purpose" extends that given it by Lord Denning in *Newton v F C T (t)* by t explicit reference to "other than an incidental purpose" *(u)*. These two aspects of the width and breadth of the section make it necessary to conclude that the new section perpetuates the principal difficulty of

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(g) ie "If general or discretionary powers are enacted Parliament does not know when they will be applied or how far they may be extended."

(h) See *Carter*, supra, Vol 3 at 570.

(i) As did McCarthy P in *Gerard*, at p 282.

(j) [1974] 1 WLR 1594.

(k) *IRC v Duke of Westminster* [1936] AC 1.

(l) See the quotation from the judgment of Lord Tomlin referred to supra.

(m) Morcom, "Tax Avoidance – Turning of the Tide" 125 New Law J 83.

(n) s 108 (6) (a).

(o) s 108 (6) (b).

(p) s 108 (6) (c).

(q) Due to the insertion of "reducing" and "postponing" in the last-mentioned sub-paragraph.

(r) The scepticism is that of Lord Wilberforce in *Mangin v CIR* [1971] NZLR 591 at p 603.

(s) [1970] NZLR 182.

(t) [1958] AC 450.

the old – namely, in the words of McCarthy P, that it "cannot be given a literal interpretation" and that "the Courts must place glosses on the statutory language" as a result *(v)*. Why? Simply because there is scarcely any transaction of a commercial or family nature which is not carried out without more than an "incidental" purpose of achieving one of the objectives defined as "tax avoidance" in s 108 (b). As Rowlett J commented over 35 years ago:

> "Everybody who does anything ought to think, how are the Income Tax Acts going to affect this transaction which I am entering into?" *(w)*

This self-evident truism will make it essential for the Courts to limit the ambit of s 108 in the same way as they did in relation to its forerunner: to strike, in the words of McCarthy P once more, what is *their* perception off "a reasonable balance" *(x)*.

It might be argued that that balance has already been struck – by the Courts, to be sure, but struck all the same – by Lord Denning's "predication test" *(y)* which will carry over to the new provisions. For several reasons that argument is of doubtful validity. First, that test was redefined in *Mangin v C I R (z)* – by the Privy Council – in terms which are difficult to square with the notion forwarded in s 108 (1) (b) to the effect that a *minor* purpose of tax avoidance will suffice even though the *principal* purpose is ordinary business or family dealing *(a)*. Clearly, a redefinition – by the Privy Council again? – is called for to accommodate the amendment's change in emphasis. Secondly, as Lord Wilberforce has suggested, the test is an extremely difficult one to administer *(b)*. Certainly it is insufficiently precise to remove, even substantially, the margin for judicial predeliction. And thirdly, it would not be surprising if the Commissioner were to litigate the applicability of the criterion – redefined or otherwise – under the new provision. It is, clearly, judicial legislation which severely limits the literal ambit of the statutory language. It may be that the Department will be reluctant to see the prize weapon in its anti-avoidance arsenal circumscribed by it at the outset.

Are there not issues enough here to justify in themselves the assertions of uncertainty and excessive discretion, quite apart from the even more significant one earlier suggested? *(c)*

What should be done?

I. First, we should recognise that the fundamental evils of s 108 remain with us and that the redrafting exercise has failed to bring forth that hypothetical legislator who in the words of Kitto J:

> ". . . will take the trouble to analyse his ideas and define his intentions with precision before putting pen to paper" *(d)*.

Until that recognition is evidenced there is little prospect that the clarity and comprehensibility lacking in the first draft of the provision *(e)* will appear.

II. Secondly, we should not doubt that the phase "the fundamental evils of the old s 108" is more than idle rhetoric. It is a conclusion implicitly supported by Lord Wilberforce and McCarthy P and necessarily reached in the light of the manifest uncertainties prevailing under that section.

III. Next, it is suggested that the time is ripe to examine whether the reliance upon a provision as broad as s 108 which has characterised our taxation policy for the last decade is justified or, alternatively, whether as many benefits and fewer disadvantages might follow from the use of more specific avoidance provisions.

It has already been indicated *(f)* that several of our anti-avoidance devices of the more specific type are in a sad state of repair, and, not coincidentally, that those are the very provisions which in jurisdictions other than New Zealand would have been relied upon to counter most of the cases presently assuming a s 108 posture. Clearly, much can be done to make them more efficacious. Take s 105 as an example. Had that section provided, as would seem both consistent and reasonable, that income of a trust should be treated as that of the settlor if:

(a) It was, or could be, applied so as to directly or indirectly discharge in whole or in part any legal obligations of the settlor *(g)*; or

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(u) It has been clear since *Newton*, ibid, that avoidance need be only one of the purposes of the arrangement (ibid at p 467). Nevertheless, the avoidance purpose was usually said to be necessarily a "principal" or "paramount" one before the former s 108 applied. See for instance the judgment of Wild CJ in *Udy v CIR* [1972] NZLR 714, 717.

(v) [1974] 2 NZLR 279, 280.

(w) *Seaham Harbour Dock Company v Crook* (1930) 16 Tax Cas 333 at p 340.

(x) [1974] 2 NZLR 279, 280.

(y) See supra fn (f).

(z) [1971] NZLR 591.

(a) Referring to the predication test Lord Donovan said at p 598: "Their lordships think that what the phrase refers to is . . . 'a scheme . . . devised for the sole purpose or at least the principal purpose of escaping liability to tax'."

(b) [1971] NZLR 591 at p 603.

(c) Supra.

(d) *Newton v FCT* 96 CLR 578, 596 per Kitto J.

(e) See the comments of Richardson supra, at p 563.

(f) Supra.

(g) See IRC (US) s 677; Income and Corporation Taxes Act 1970 (UK) s 448.

(b) It was in whole or in part subject to any power of disposition by the settlor alone or in conjunction with any person *(h)*; or
(c) It was in whole or part payable to the settlor under any circumstances whether on a contingency or otherwise *(i)*; or
(d) The settlor was, or had the power to become, trustee either alone or in conjunction with any other person *(j)*;

and it was further provided that:

> "Settlor" for the purposes of this provision shall include any person whose personal services generate any portion of the income of a trust over which a power or right of the character described above;

then, it is suggested, the provision would be a more effective instrument against tax avoidance. Certainly, at least six of the cases disposed of under s 108 *(k)* would have been resolved in the Commissioner's favour under it. There are of course immediate objections to the latter assertion. One is that, quite obviously, had s 105 been drafted in these terms the deeds in *Marx, Carlson, Mangin* and the like would not have been executed at all and would therefore never have been in issue. Another is that not all would agree with the severity of the provisions proposed. That is quite legitimate. But three points appear, it is suggested to justify the claim of their "reasonableness" and "consistency". First, they have to varying degrees been relied upon to resolve s 108 cases. Secondly, they are by and large supported by United Kingdom and United States practice *(l)*. And thirdly, they appear, conceptually, to be extensions of the prohibitions already contained in s 105.

The third objection to the argument put forward is that, not only would *Marx* and the like not have been drafted in the way they were had s 105 been expressed in the terms proposed, but they would have been drafted in a manner which circumvented the specific prohibitions and regulations yet which clearly breached the "spirit" of the provision. That may be doubted. Provisions (a) and (b) coupled with the existing provisions of s 105 and, perhaps, a more explicit reference to powers of revocation would render income-splitting arrangements far less attractive to most taxpayers. Because they stand as absolute prohibitions a taxpayer wishing to avoid them would be forced to surrender the two aspects of control and/or benefit most valuable to him. If he chose to go ahead in any given case and gave up any control over the settlement – (b) – and gave up the right to have the income used to discharge his own obligations – (d) – he would achieve an effective settlement: but surely that is not to "avoid" the provision in any real sense. If we are unhappy with the result, more extensive prohibitions should be imposed, as they clearly could be *(m)*.

Let us suppose, however, that it is impossible to draft specific anti-avoidance provisions of the precision necessary to catch *all* those arrangements which breach the supposed "spirit" of the law. That raises the fourth general recommendation of this paper.

IV. As earlier indicated *(n)* the choice is not necessarily one between large scale avoidance and a general provision of the width of s 108. Some countries manage with no general provision at all *(o)*. Others "buttress" the specific sections with more general ones which nevertheless fall short of the scope of s 108 *(p)*. In the light of the considerations discussed in the earlier sections of this paper, the objective should be to isolate an approach which avoids the manifest defects of s 108 yet prevents "blatant" avoidance of specific prohibitions. Can one be found?

In the writer's view the answer is in the affirmative. What is proposed is a form of legislative enactment of and sanction for a limited variant of doctrine of substance.

That doctrine is one of approach to taxation matters *(q)*. It was roundly criticised by the House of Lords in the *Duke of Westminster (r)* decision, a viewpoint in part upheld in the more recent decision of the same body in *Ransom v Higgs (s)*. What does it do? In the words of one of its critics *(t)* it entitles the court applying it to substitute "a different legal right and liability . . . in place of the right and liability which the parties have created." And to what purpose? In the words of one of its

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(h) See IRC (US) s 674; I and C Taxes Act (UK) ss 445-447.

(i) See IRC (US) s 677; I and C Taxes Act (UK) s 448.

(j) See IRC (US) s 674 and Reg 1-674 (d) (2).

(k) *Elmiger v CIR* [1967] NZLR 161; *Marx v CIR* [1970] NZLR 222; *Carlson v CIR* [1970] NZLR 182; *Mangin v CIR* [1970] NZLR 222; *Udy v CIR* [1972] NZLR 714; *Gerard v CIR* [1974] 2 NZLR 279.

(l) See fns (g)-(j) supra and the text to which they relate.

(m) See 7 VUWLR 426, 448-454. See too s 2036-2038 (estate duty) of the US IRC and the Regulations thereto.

(n) Supra.

(o) eg the United States.

(p) eg Canada (see Income Tax Act 1971, s 15 (1) and s 245 (2)); United Kingdom (see Income and Corporation Taxes Act 1970, ss 460-461).

(q) See 6 NZULR 140, 156.

(r) [1936] AC 1.

(s) [1974] 1 WLR 1594.

(t) [1936] AC 1, 24 per Lord Russell.

advocates *(u)* to free the courts from "technical considerations, niceties of the law of trusts or conveyances or the legal paraphernalia which inventive genius may construct as a refuge from surtaxes." As is well known, it has been taken to its greatest point of refinement by the United States Federal judiciary. The Australasian courts are, however, not totally strangers to it *(v)*.

It should be conceded at the outset that as an anti- avoidance device the approach of substance in its "pure" form suffers, perhaps to an even greater degree than s 108, from vagueness, uncertainties, and intolerably wide discretions. The history of its introduction into the United States is, indeed, a sadder saga than is that of s 108 in our own *(w)*. In regard to two of the principal areas of its application, family trusts and family partnerships, widespread uncertainty and judicial discord characterised the doctrine for years. And such was not surprising. In 1940, for instance the Supreme Court decided *Helvering v Clifford (x)* on the basis, in essence, that the scheme therein *did* disclose "legal paraphernalia" used "as a refuge from surtaxes". Later courts were obliged, somewhat in the same way as our courts at the time of *Elmiger (y)* to make what they could out of this vague, general and contentious *(z)* declaration with few if any meaningful criteria to guide them. The result was, also as in the case of s 108, years of uncertainty *(a)*. Similarly with family partnerships. In *Tower (b)* and *Lusthaus (c)* the Supreme Court approved a substance approach as the criterion for determining the validity of such arrangements for tax purposes. That proved virtually unworkable, and the Supreme Court retreated to a *quasi*-substance criterion *(d)* which "produced chaos in the administration of the law, a pile up of cases in the courts, and unpredictable results."*(e)*

A doctrine achieving such results is obviously no improvement over s 108: indeed in a general sense, the degree of discretion afforded the courts under the latter makes them one and the same. But that "pure" form of the doctrine is not the only character it may manifest. Following the debacle of *Clifford* and *Tower* the legislature intervened to remedy the situation by the provision of more specific, detailed, and sophisticated criteria by which the future validity of the respective arrangements were to be judged – somewhat, in other words, like the course proposed in the immediately preceding section. In the family trust area that intervention largely adopted the philosophy of *Clifford* yet achieved at a stroke the resolution of the many subsidiary issues that had faced the courts in their attempted application of it. The doctrine of substance was not, however, abandoned by the Courts. While its ambit was narrowed by legislation *(f)* it remains today as a backstop to the statutory code, standing in the wings to catch the extreme case which, although without the terms of the statutory language, nevertheless represents a blatant avoidance device in manifest breach of the intendment of the statute. Take the case of *Furnan v Commissioner (g)* as an illustration. The scheme in that case involved a transfer of income producing property to a trust. The trustee was the wife of the settlor. The settlor continued to use the property as if it were his own, his wife being effectively his alter ego. The Tax Court struck the arrangement down on the ground that

> "It is always open for the Commissioner to assess deficiencies on the ground that regardless of regularity of form as a matter of plutological reality there was no substantial change in economic ownership" *(h)*.

and that

> "in an extreme case such as the present there is such a lack of economic reality as to nullify the existence of a valid trust for Federal income tax purposes *(i)*.

Furnan is typical of the application of the doctrine of substance as applied in the context of an established and detailed code of rules regulating the class of transaction in issue. In such a context specificity and clarity are provided by the particular anti-avoidance rules themselves and the

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(u) *Helvering v Clifford* (1940) 309 US 331 at p 334 per Douglas J.

(v) The "*Arcus*" and "personal services" principles may be construed as applications of it. So may much of the language in the early s 108 and s 260 decisions, particularly in the approach – disapproved of by the Privy Council in *Mangin* – typified by the query "Is this income *in truth* that of the taxpayer?" see eg *Mangin v CIR* [1970] NZLR 222 at p234 per North P.

(w) See generally Bittker, supra at pp 390-391. For a more detailed critism see Nash, *What Law of Taxation*? (1940) 9 Fordham LR 166

(x) (1940) 309 US 331.

(y) Supra, fn (k).

(z) The majority decision in *Clifford* drew a highly critical dissent from Roberts J: supra, fn (u) at p 338, pp 342-343. See too Nash, supra fn (w).

(a) Bittker, supra fn (w); Hellerstein, supra at p 71.

(b) (1946) 327 US 280.

(c) (1946) 327 US 293.

(d) In *Commissioner v Culbertson* (1949) 337 US 733.

(e) Hellerstein, supra at p 72.

(f) See IRC s 671 and its instruction – for the purposes of restoring some certainty to the law – that the Code in ss 672-677 provides the only basis for invalidity on account of retained "control and dominion".

(g) (1966) 45 TC 360.

(h) Ibid, 364.

(i) Ibid, 366.

doctrine of substance has but a limited role to play. More importantly, the doctrine cannot be exercised arbitrarily. By virtue of the process of particularisation the legislature has proved evidence of the general area of its concern *and* the considerations it regards as significant criteria to judge the validity of arrangements falling within that ambit. Sections 672-677 of the Internal Revenue Code for instance indicate, consistently with *Clifford*, an over-riding concern with retained controls of the settlor. They provide criteria by which the degree of permissible control – and that which is inpermissible – may be reckoned. They illustrate a clear legislative intendment that control of the degree *factually* exercised by the taxpayer in *Furnan* falls within the latter class. Also mitigating against an arbitrary application is the criterion of "economic nullity" itself. This limits the doctrine to extreme cases. It limits it to cases where the evidence is both clear and compelling as to breach of the legislative intendment deduced from the process of particularisation.

It is suggested that there is much in this approach that is worthy of consideration in New Zealand should it be determined that specific anti-avoidance provisions are inadequate if standing alone. Its benefits are obvious. It would proceed on an "area by area" basis and would not threaten estate planning generally as does an all-embracing all-pervasive provision such as s 108. It would provide more detailed criteria by which both estate planners and the Courts could gauge the area of legislative concern and regulate their respective conduct accordingly. It would force the legislature to define what *are* the areas of its concern and the propriety of the various schemes and devices that may operate within those areas.

On the other hand, the weaknesses in the suggestion are equally apparent. It does restore an element of uncertainty – not as great, it is suggested, as that created by s 108, but an element nevertheless – in an area where certainty is of paramount concern. Further, it presupposes a legislative commitment to specificity and the will to resist the urge to make the particularisation the approach demands less and less particular and the scope of the doctrine more and more like s 108. Further again, it is by definition incapable of avoiding blatant devices in an area where there is no specific legislative code. A word on each of these disadvantages is called for.

As to the first. The threat posed by the doctrine of the *Furnan* variety is not to the genuine estate plan. It is only the transaction which comes close to a sham *and* breaches the manifest intendment of the particular provisions that is jeopardised by it. Take an example. Suppose, within the context of a s 105 containing provisions such as those previously detailed *(j)* the Commissioner chose to attack a scheme in which the settlor's wife was named trustee. That fact alone could not be a basis for holding the scheme in breach of the "spirit" of the provision. While the degree of mutuality of interest that may be expected to exist between the settlor and his spouse *(k)* may raise issues of whether the legislature *should* have prohibited the latter from assuming that role, the criteria established by the hypothetical provision manifest a legislative concern only with powers and benfits retained by the settlor. The Court, in such circumstances, would take the approach that any change in the law to include powers or benefits conferred upon a spouse was an issue of sufficient substantiality and widespread significance so as to be a matter for *legislative* decision. When then would the doctrine be applied? Presumably on facts as extreme as those in *Furnan:* say

(a) The settlor's wife was trustee; and
(b) She passively acquiesced in his wishes; and
(c) The settlor had the unqualified power to fire and hire trustees; and
(d) The settlor retained wide non-dispositive powers of administration and investment exercisable in a nonfiduciary capacity; and
(e) He had exercised powers (c) and (d) to ensure dispositive acts bore his stamp and enured for his benefit *(l)*.

The difference in the two cases is clear and at the heart of the distinction between the doctrine of substance per se and that suggested as meriting consideration as an alternative to s 108. In the first case, a decision for the Commissioner would be legislation unsupported by, indeed contrary to, the criteria provided; in the second case a decision to similar effect is a particular holding of nullity in accordance with those criteria. There is, it is suggested, a difference in substance and not merely of degree between the two cases which is workable in practice without the creation of uncertainties of the existing magnitude.

As to the third defect. It is quite true that definitionally the approach suggested demands an existing code of specific anti-avoidance provisions and it could not be employed so as to counter what might be termed "new" avoidance devices. Is that, however, necessarily a "weakness"? The

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(j) See Supra.

(k) See the analysis of *Prouty v Commissioner* (1940) 115 F 2d 331 at p 337.

(l) For a discussion which favours the incorporation of some of these elements into s 105 in any event, see 7 VUWLR 426.

1952 United Kingdom Royal Commission *(m)* warned of any generalisations in the avoidance context on the basis that there "was no true equity" to support the proposition that it was *always* "evil" or in all cases "immoral" *(n)*. As new devices and arrangements arise which are totally outside the scope of existing legislation it arguably should be the legislature rather than the courts which determines the manner of their disposition and their overall propriety.

This proposal was introduced with the comment that the substantive approach at its centre should be adopted by the legislature. That, perhaps, is unnecessary and it might be sufficient for an authoritative declaration – such as that in the Report of the Carter Commission *(o)* – of its virtures coupled with an exhortation to the courts to apply it. It does, however, seem preferable to implement it more specifically than by that means. What is suggested is that in regard to each of the principal areas of specific statutory regulation of avoidance devices – say, in the first instance, trusts, deductions, dividend splitting and inter-family transactions – the legislature explicitly provides for an "economic nullity" approach and specifies the general criteria – different in each case of course – upon which an affirmative declaration to that effect would be founded.

V. These proposals relate to amendments to the prevailing approach that would retain the fundamentals of the existing tax structure. It would be unsatisfactory however to close this paper at that point, for, it is suggested, the saga of tax avoidance generally and s 108 in particular reveal manifest defects in that structure itself – defects which make any exercise that works within them bound, though to varying degrees, to achieves less than totally satisfactory results. The two most prevalent avoidance devices are those which, generally viewed, attempt to transform taxable income into non-taxable capital and, secondly, those which attempt to reduce overall family tax burdens by the artificial division of unit income among family members. Rather than attempt to devise anti-avoidance provisions which attempt to counter the beneficial *consequences* of those arrangements should we not give some thought to the propriety of those fundamental underpinnings themselves? If it is indeed "vaguely immoral" *(p)* to let capital gains escape the taxation net at the outset our efforts should perhaps be directed to the task of widening the tax base rather than preventing taxpayers taking advantage of an improper distinction; if it is "ludicrous" *(q)* to tax a group of individuals with interdependent and mutual interests in their unit income as if they were strangers our efforts would be better directed to the legal recognition of thatt de facto mutuality *(r)*.

Conclusion

This paper is not intended as an apologia for tax avoidance. Its thrust is, simply, that s 108, old or new, is not the most desirable way of countering it. Where its proposals are subject to attack is in its assumption that "desirable" does not mean the same as "easy" or even "efficacious". Yet the same might equally well be said of other notions the propriety of which are articles of faith and any attack on which would be vehemently resisted by us all.

(m) Cmd 9474, London 1955.

(n) Ibid, para 1017.

(o) Supra, Vol 3 pp 573-574.

(p) See the reported comment of Dean Griswold of the Harvard Law School in [1969] NZLJ at 351.

(q) *Carter* supra, Vol 3 p 118.

(r) For a more detailed discussion of this issue, see a paper by the present writer in the forthcoming issue of the Otago Law Review.

Good disputing – In *Cordell v Second Clanfield Properties Ltd* [1969] 2 Ch D 9, 16-17, counsel urged upon Megarry J to accept as persuasive a passage in a book of which the learned Judge was co-author. Said Megarry J: "The process of authorship is entirely different from that of judicial decision. The author, no doubt, has the benefit of a broad and comprehensive survey of his chosen subject as a whole, together with a lengthy period of gestation, and intermittent opportunities for reconsideration. But he is exposed to the peril of yielding to preconceptions, and he lacks the advantage of that impact and sharpening of focus which the detailed facts of a particular case bring to the Judge. Above all, he has to form his ideas without the aid of the purifying ordeal of skilled argument on the specific facts of a contested case. Argued law is tough law. This is as true today as it was in 1409 when Hankford J said: 'Home ne scaveroit de quel metal un campane fuit, si ceo ne fuit bien batu, quasi diceret, le ley per bon disputacion serra bien conus' (YB 11 Hen 4, Mich, fo 37); and these words are none the less apt for a Judge who sits, as I do, within earshot of the bells of St Clements. I would, therefore, give credit to the words of any reputable author in book or article as expressing tenable and arguable ideas, as fertilisers of thought, and as conveniently expressing the fruits of research in print, often in apt and persuasive language. But I would do no more than that; and in particular I would expose those views to the testing and refining process of argument. Today, as of old, by good disputing shall the law be well known".