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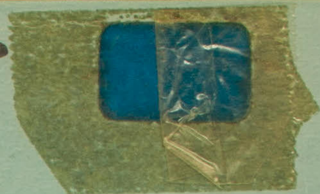

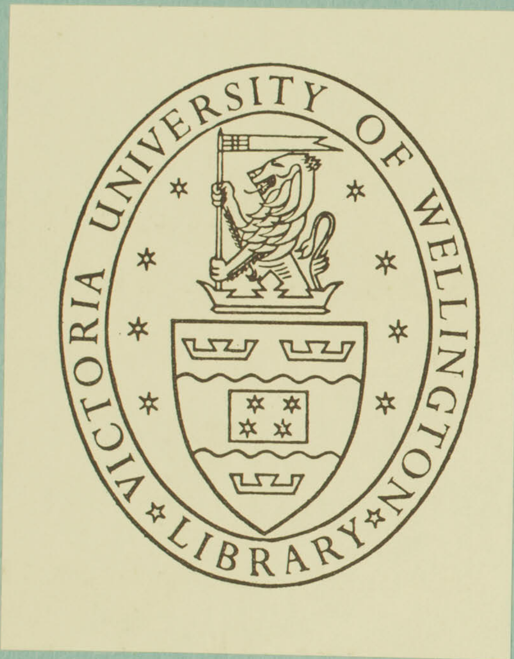
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HAMISH McDONALD

Section 99 of The Income Tax Act 1976:
What constitutes tax avoidance?

Research Paper for Taxation Law

LL.M. (LAWS 531)

Law Faculty
Victoria University of Wellington

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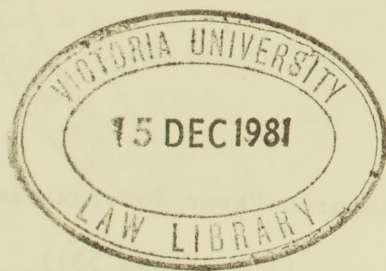

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I. INTRODUCTION

In 1974 a new anti-avoidance provision was enacted to replace the old section 108. The new section is our section 99. The former provision was roundly condemned by both Judges and commentators[1]. In C.I.R. v Gerard, McCarthy P. expressed this widely held criticism:[2]

> The section is notoriously difficult. It cannot be given a literal application, for that would, the Commissioner has always agreed, result in avoidance of transactions which were obviously not aimed at by the section. So the Courts have had to place glosses on the statutory language in order that the bounds might be held reasonably fairly between the inland revenue authorities and taxpayers. But no one suggests that this is satisfactory, especially as one result has been that the Privy Council has been forced in a number of cases to assume the task, rightly one for the Legislature, of providing the tests according to which people are taxed.

Although section 99 has been on our statute books for over six years now, it has not been considered by the courts yet. As a result the exact extent of its application has not been decided and whether it corrects all the defects of its predecessor is far from clear. Section 99, although far more detailed, has retained key phrases from the old section. There are also important new words and definitions, and a new power of reconstruction has been given to the Commissioner once a particular "arrangement" is declared void.

There are, therefore, important questions about the new section that need to be answered as to the extent the new section changes the old and, if any, the result of those changes. Also, as some words and phrases of

1 I will refer to the new section as section 99 and the old section as section 108.

2 [1974] 2 N.Z.L.R.279, 280.

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section 108 have been retained, how relevant are the glosses the courts adopted in relation to the old section?

From the taxpayers point of view it remains important for him to be able to know whether a particular transaction will be regarded as legitimate or as tax avoidance. The clarity of the legislature's intention as to what should be caught and what should not is crucial.

In his dissenting judgement in Mangin v C.I.R.[3] Lord Wilberforce stated four fundamental flaws with the old section, namely:

i) It failed to define the nature of the liability to tax,avoidance of which is attacked.

ii) It failed to specify any circumstances in which arrangements which had fiscal consequences might not be caught by the section.

iii) It failed to specify the relationship between the section and other sections of the Act under which tax advantages might have been obtained.

iv) It failed to provide for "reconstruction" once the arrangement had become void.[4]

It is important that the new section overcomes these criticims if it is to be regarded as successful. It is the purpose of this paper to see how the new section would probably be interpreted when it does come before the courts and to see how successful it is as an attempt to rectify the criticisms that were directed at its predecessor.

3 [1971] N.Z.L.R.591.

4 Ibid 602.

II. INTERPRETING THE SECTION

The principal rule of statutory interpretation is the literal rule which requires the statute's intention to be determined by the words alone given their neutral and ordinary meaning. This approach is to be departed from only when the literal interpretation is unreasonable.[5]

The starting point when interpreting section 99 should be with the words alone, independent from the old cases on section 108 giving them their natural and ordinary meaning.[6]

The question, then, is whether it is clear from the words the type of arrangement that will be caught. Section 99 includes new definitions of central concepts, but when these are closely examined it can be seen that they are very wide and vague and in fact do not define anything. "Arrangement" is defined in the section as meaning:

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

"Contract" would appear to be used in its strict legal sense since the definition also includes "agreement". "Agreement" is defined in the Oxford Dictionary as:[7]

> an arrangement between two or more persons as to a course of action; a mutual understanding.

"Plan" is defined as "a scheme of arrangement".

"Understanding" is defined as:

5 I.R.C. v Luke [1963] A.C.557.

6 Barrell v Fordree [1932] A.C. 676.

7 All definitions in this paper will be from The Oxford English Dictionary, Clarendon Press Oxford (1933).

A mutual arrangement or agreement of an informal but more or less explicit kind.

"Arrangement" is defined as:

a structure or combination of things arranged in a particular way or for any purpose.

As can be seen, these words in no way qualify the word "arrangement", but rather indicate that it is to be understood in its widest possible sense. The addition of "whether enforceable or unenforceable" seems slightly superfluous given the wide language already used, but it reinforces the conclusion that very little that produces some change in a person's circumstances could escape a literal interpretation of the definition.

"Liability" is defined in this section as including "a potential or prospective liability in respect of future income:" A potential liability is a possible liability. There is no indication what degree of possibility is required. As Lord Wilberforce put it, how hypothetical may this liability be? Is it "probably might or ordinarily might or conceivably might?"[8]

Similarly, the definition of "tax avoidance" in Section 99 is so wide as to be totally unhelpful. This includes:

a) Directly or indirectly altering the incidence of any income tax.

b) Directly or indirectly relieving any person from any liability to pay income tax.

c) Directly or indirectly avoiding, reducing, or postponing any liability to income tax.

Again some of the words used seem superfluous. Presumably to avoid tax

8 Mangin v C.I.R. [1971] N.Z.L.R. 591, 602.

a person must lessen the amount of tax he is paying. Thus it is difficult to see how a person can alter his income tax without reducing it. Similarly how can a person reduce his income tax liability without relieving himself of it, or relieve himself of his liability without altering it? The definition seems to cover every conceivable situation where a person's incidence of tax is diminished rather than indicating the type of situation that the section will regard as tax avoidance. By including in the definition both the words "altering" and "avoidance" the section gives no indication of any situation where a person's incidence of tax can be altered without being labelled as "avoidance". Furthermore, the inclusion in a definition of tax avoidance, "avoiding income tax" seems to be self defeating since that begs the question. Thus, the definitions in section 99 are no more than "catch all" clauses which achieve no purpose other than daunting one at the possible scope of the section. You are left with the main body of the section to determine the actual boundaries of the section.

One significant aspect of the new definition of "avoidance" is the inclusion of "postponing" liability to pay tax as avoidance. This is an extension of the old section and it is acknowledgement of the fact that tax postponed is tax saved. The new section extends the principle of avoidance to situations where derivation has been postponed and income has not yet even arisen.

The main provision in section 99 is subsection (2) which reads:

> Every arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the Commissioner for income tax purposes if and to the extent that, directly or indirectly, -
>
> a) Its purpose or effect is tax avoidance; or
>
> b) Where it has 2 or more purposes or effects, one of its purposes or effects (not being a merely incidental purpose or

effect) is tax avoidance, whether or not any other or others of its purposes or effects relate to, or are referable to, ordinary business or family dealings, -

whether or not any person affected by that arrangement is a party thereto.

The critical questions in respect of this provision are: how do you determine what the "purpose or effect" of an arrangement is; whether it has more than one "purpose or effect"; or whether a "purpose or effect" is "merely incidental"? The purpose of an arrangement is the "object for which it was made or for which it exists".[9]

All the definitions of "purpose" in the Oxford Dictionary involve an intention, a mental element. The fact that the section refers to the arrangements's "purpose" cannot change that. A mental element is still involved and must be that of the person who put the arrangement into being. As Lord Devlin stated in Chandler v DPP, "a purpose must exist in the mind. It cannot exist anywhere else".[10] How is this intention to be determined? There are two possible ways. Firstly, you could look solely at the arrangement and determine the taxpayer's intention from the objective facts of the arrangement. Alternatively you could try to ascertain his subjective intention, his motive.

There is little doubt that the courts will continue to determine the intention from the objective facts of an arrangement, even though this involves giving the terms "purpose" and "effect" a synonomous meaning. The New Zealand courts have consistently taken this approach with regard to section 108 and it is an interpretation that is supported by the fact that section 99 refers to the arrangement's "purpose or effect" not that of the taxpayer.

9 The Oxford English Dictionary; supra n.7.

10 [1962] 3 All E.R. 142, 155.

The section catches all arrangements which have one of its purposes as tax avoidance, provided that purpose is not a "merely incidental purpose". Therefore the whole scope of this section turns on the word "incidental". What is an "incidental" purpose? Incidental is defined as:

> Occurring or liable to occur in fortuitous or subordinate conjunction with something else of which it forms no essential part.

If an objective test is adopted then an arrangement will not have a fortuitous purpose; (that which happens accidentally). The purpose is what in fact is achieved. Subordinate is defined as, "of inferior importance, not principal or predominate; secondary; minor".

To establish that a purpose of tax avoidance was only a "subordinate" purpose involves establishing that there was another purpose which was the "essential", "predominate" or "principal" purpose; which was not a tax avoidance purpose. Before you can establish that the essential purpose of an arrangement is something other than tax avoidance, you need to know what constitutes tax avoidance. You need to know what type of purposes can exist; which have the effect of diminishing a person's tax liability without necessarily being labelled tax avoidance.

The Act clearly envisages that a person is able to transfer property to other persons, to trusts or to companies, and that such adjustments will have tax consequences. However, neither section 99, nor the Act generally, provides any framework from which it can be established what is a legitimate reduction and what is going to be regarded as tax avoidance.

As we have seen, the definition of "tax avoidance" is totally unhelpful. Establishing such a framework is essential before you can determine what the purpose of a particular transaction is.

It is precisely for this reason that section 108 was criticised and why

courts were forced to place glosses over the words. That section could not operate without basic assumptions being made as to what was legitimate and what was avoidance. The courts were forced to look beyond the sections of the Act to establish these assumptions. The test they applied was that "ordinary business and family dealings" incurred legitimate tax reduction. Anything that went beyond that was avoidance. Clearly there are just as many problems defining what is an "ordinary business and family dealing" and this is the reason why that test has been so vague and as a result criticised. However, the courts are again going to be forced to look beyond the words of the section to establish when tax reduction will be regarded as legitimate and when it will be regarded as avoidance.

III. THE APPLICATION OF THE ORDINARY FAMILY AND BUSINESS DEALINGS TEST

It will not be possible for the courts to interpret section 99 purely by reference to the words used, as argued in the earlier section. Therefore it becomes necessary to examine how the courts will interpet it and in particular whether they will adopt the approach used in the cases concerned with interpreting section 108. It would seem that the legislature by choosing to retain the words and phrases of the old section and by adopting words and phrases used by the Judges in interpreting the old section could have intended the interpretations of those old cases to apply.

The basic test which the courts practically substituted for the words of the section was first established in Newton v F.C.T.[11] That case was concerned with the Australian equivalent of our section 99 but the test laid down by Lord Denning was subsequently adopted by our courts. There Lord Denning stated:[12]

> In order to bring the arrangement within the section you must be able to predicate - by looking at the overt acts by which it was implemented - that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section.

In applying this test to section 99 the Privy Council has redefined it in three different ways. In Mangin Lord Donovan stated:[13]

11 [1958] 2 All E.R. 759.

12 Ibid, 764. This test is commonly known as the "Predication" test.

13 [1971] N.Z.L.R. 591, 598.

"Their Lordships think that what this phrase refers to is ... 'a scheme ... devised for the sole purpose, or at least the principal purpose, [of tax avoidance]'."

In Aston v C.I.R.[14] Viscount Dilhorne set out to restate the test in Mangin but in the process established a totally different test. He stated that where one of the purposes was tax avoidance then the arrangement is caught by section 99, and "it matters not what the other purposes and effects it might have".[15]

As one commentator states:[16]

His judgement was that, where a taxpayer effects an arrangement for any purpose which results in tax saving [the taxpayer] is presumed to have intended that result and the section operates.

A third test was set out by Lord Diplock in Europa Oil (NZ) Ltd. v C.I.R.(2):[17]

"... the section in any case does not strike down transactions which do not have as their main purpose or one of their main purposes tax avoidance. It does not strike down ordinary business or commercial transactions which incidentally result in some saving of tax.

It is certainly far from certain that the Newton test is going to remain as the basis for determining the scope of section 99. As J.Bassett explains:[18]

14 (1975) 2 N.Z.T.C. 61, 030.

15 Ibid, 61, 035.

16 G.Harley "The Privy Council's new approach to section 108". (1976) N.Z.L.J. 33, 36.

17 [1976] N.Z.L.R. 546, 556.

18 J.Bassett "Estate Plans and arrangements to avoid income tax". Estate Planning: selected aspects and developments edited by R.A.Green. Price Milburn for Victoria University Press (1979), 4, 8.

> ... by section 99's expanding the basis upon which the application of the former section proceeded so that ordinary family or business dealings may now be within the preview of the section, it might now be thought that the predication test itself is no longer the correct approach to take in the administration of the section.

This is the view taken by L. McKay[19]. He states:

> First, that test was redefined in Mangin v C.I.R. - 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. Clearly a redefinition - by the Privy Council again? - is called for to accommodate the amendment's change of emphasis. Secondly, as Lord Wilberforce has suggested, the test is an extremely difficult one to administer. Certainly it is insufficiently precise to remove, even substantially, the margin for judicial predilection. 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 can be seen that the words of the section do not allow the Mangin test to apply. But, as has been shown, that test has subsequently been changed on two occasions by the Privy Council. The latest test laid down by the Privy Council is the "one of the main purposes" tests in Europa(2).

This "main purposes" test is an appropriate test to use in respect to section 99. From its definition, "Incidental" can be seen as an

19 "Section 108 and the issue of legislative propriety" (1976) N.Z.L.J. 238, 244.

antonym for "Main". An incidental purpose is a "subordinate", "inferior" and "minor" purpose.[20] This is exactly the distinction the courts were trying to establish under section 108. In Elmiger v C.I.R. decided before the more restrictive test of Mangin was imposed, Woodhouse J. said that the purpose of tax avoidance had to be one of the "activating purposes of the transaction ... a goal in itself and not arising as a natural incident of some other purpose".[21]

In Europa (2) itself, Lord Diplock specifically used the term "incidental" in contrast to the "main" purpose. He stated:[22]

> [The section] does not strike down ordinary business or commercial transactions which incidentally result in some saving of tax .... In such cases the avoidance of tax will be incidental to and not the main purpose of the transaction or transactions which will be the achievement of some business or commercial object.

I accept McKay's second criticism that it is a test that is far too wide and uncertain. However, although the test severely limits the literal ambit of the statutory language this is necessary if the section is to have any practical operation. The section cannot be given a sensible meaning without reference to some broader notion of what constitutes legitimate tax reduction. If this test was not adopted, some other would have to be. No other test suggests itself, and as the language of the section itself seems to have been intentionally similar to the old section, it seems to be applicable. The inclusion of the phrase "whether or not any other or others of its purposes or effects relate to, or are referable to, ordinary business or family dealings", - in section 99(2) seems to make the "ordinary business or family dealings"

20 From the definition of "incidental" and "subordinate".

21 [1966] in N.Z.L.R. 683, 694.

22 [1976] N.Z.L.R. 546, 556.

test redundant. But when it is understood how the section applies this phrase actually supports the contrary conclusion. The section is not rejecting the relevance of whether there was a business purpose or a family dealing purpose. What the section is saying is that where there is a tax avoidance purpose which is not an "incidental" one, then the "tax avoidance purpose" is an independent purpose and not a necessary consequence of any other purpose. The arrangement is caught on that ground. This is precisely what was stated in Elmiger by Woodhouse J. He stated:[23]

> Accordingly it is my opinion that 'family or business dealings'will be caught by S. 108 despite their characterisation as such, if there is associated with them the additional purpose or effect of tax relief (in the sense contemplated by the section) pursued as a goal in itself and not arising as a natural incident of some other purpose.

By using the words "whether or not", section 99 indicates that an ordinary business or damily dealing is an independent and legitimate purpose. Therefore, the inclusion of that phrase gives strong support for the view that the basis for determining whether there has been tax avoidance is still going to be whether the arrangement achieves a "ordinary business or family dealing" purpose.

23 [1966] N.Z.L.R. 683, 694.

IV. WHAT EVIDENCE IS ADMISSIBLE TO PROVE THE PURPOSE OF AN ARRANGEMENT?

Despite the severe criticism of the predication test, it would appear that the courts will again be forced to adopt it to give any sensible meaning to section 99. Unfortunately by retaining this test we are again faced with the problems inherent in the use of such vague concepts. How do you determine what is an ordinary business or family arrangement from an extraordinary one? It is not a determination that is self evident, or where a person can point to specific factors which constitute an ordinary transaction. The nature of the test requires a subjective determination by the courts as to what constitutes an ordinary business or family dealing.

The cases on section 108[24] are of limited assistance in this respect since the courts have not been able to lay down any criteria and have in fact been inconsistent in their application of the test. The problem is further exacerbated by the fact that the new words in the section have got to be considered when applying this test.

The courts have consistently stated that the purpose of an arrangement is to be determined objectively from the arrangement and that the purpose is what the arrangement effects. However, there is confusion as to how far beyond the actual terms of an arrangement a court may look to help determine that purpose.

The Privy Council in Newton stated that to determine the objective purpose of an arrangement the court had to look at the "overt acts by which it was implemented".

24 To avoid unnecessary confusion, I will regard the old cases as discussing section 99 and refer to section 108 only when it is necessary to distinguish the two sections.

In the case of McKay v C.I.R.[25] Turner J. in interpreting the test stated:[26]

> But [it] is not to be read as meaning that once the existence and terms of an arrangement are proved nothing else but the facts of its implementation may be looked at to see whether the arrangement offends against the section,...

Turner J. then looked at two previous transactions which had been entered into by the taxpayer but had later been rescinded because they had been declared void by the Commissioner under section 99. Those two transactions were completely independent of the transactions actually in dispute. Turner J. nevertheless considered them relevant. He stated:[27]

> I think that the background provided by the 1963 transactions and by their rescission and the actual terms and effect of the 1966 transactions themselves, with the theme of income tax insistently recurring at every turn, are abundantly sufficient to bring these transactions plainly within [section 99].

The relevance of those previous transactions is suspect if the purpose of an arrangement is to be ascertained from seeing what an arrangement effects. As one commentator comments;[28]

> If the judges allow their interpretation of a separate and objectively valid arrangement to be influenced to a marked degree by inferences drawn from the taxpayer's past activities, then it is suggested that they are getting very near to deciding the case on the basis of the 'motive'.

25 [1973] N.Z.L.R. 592.

26 Ibid 598.

27 Idem.

28 B.Hansen "Family Trusts - 'normal dealing' or 'tax avoidance'" Vol.5 N.Z.U.L.R. 377, 379.

The Court of Appeal in Martin v C.I.R.[29] found the taxpayer's motive as decisive in determining the purpose of the arrangement. This can be seen from the following statement made by McCarthy P. when he was discussing evidence put by the taxpayer's lawyer, Mr Bradshaw:[30]

> Whilst there cannot be any doubt about the reliability of Mr Bradshaw's evidence, the fact that Mr Bradshaw saw the scheme he proposed as desirable in the interests of the appellant does not mean that those purposes which influenced his thinking were the ones that ultimately the appellant had in mind when he entered into the [arrangement].

The courts, then, have looked at the motive as relevant regardless of the fact that the Privy Council in Newton stated that it was an irrelevant consideration under the predication test.

The Privy Council most recently declared motive to be irrelevant in the case of Ashton. But in Halliwell v C.I.R.[31] decided subsequently by the Supreme Court in 1977 motive was again regarded as a consideration. Casey J. when considering the taxpayer's evidence, stated:[32]

> With respect, I find his account of his concern about Mr Kotoul's seniority and status unconvincing as a reason for setting up this arrangement.

Another aspect that the courts have in the past regarded as significant is the conduct of the parties once they have put their arrangements into effect. In Elmiger North P. thought it was significant that "there was no change in the practical operation of the partnership business:..."[33]

29 (1973) N.Z.T.C. 61, 067.

30 Ibid, 61, 069.

31 (1977) 3 N.Z.T.C. 61, 208.

32 Ibid, 61, 210.

33 [1967] N.Z.L.R. 161, 179 (CA).

Similarly in the case of Marx v C.I.R.[34] the court was influenced by the fact that the arrangement there did not change how the taxpayers in that case contributed to the productivity or even how they operated their bank account.[35]

However, in Ashton, Viscount Dilhorne stated:[36]

> If an arrangement has a particular purpose, then that will be its intended effect. If it has a particular effect, then that will be its purpose and oral evidence to show that it has a different purpose or different effect to that which is shown by the arrangement itself is irrelevant to the determination of the question whether the arrangement has or purports to have the purpose or effect of in any way altering the incidence of income tax or relieving any person from his liability to pay income tax.

When considering the effect of this decision by the Privy Council, I.C.F. Spry claims:[37]

> ... these statements should not be construed as justifying a view that in applying tax avoidance provisions the arrangement in question must be analysed in isolation. On any view an arrangement can be properly understood, and its effects ascertained, only by analysing it by reference to all the facts and matters to which it relates in accordance with general evidentiary principles.

On the contrary it is difficult to construe the Privy Council's decision in any other way but that the terms of an arrangement are to be looked at in isolation. It is an unequivocal statement from the Privy Council

34 [1970] N.Z.L.R. 182.

35 Ibid 192 per North P.

36 (1975) N.Z.T.C. 61, 030, 61, 034.

37 "A recent Privy Council decision on tax avoidance" (1975) Australian Tax Review, 220, 221.

that the purpose of an arrangement is determined only by reference to the terms of the arrangement and the purpose is what those terms of the arrangement effect.

Therefore if the terms of an arrangement have the effect of a tax saving the taxpayer is presumed to have taxsaving as a purpose and the only question that remains is whether that purpose was a "main" or an "incidental" purpose of the arrangement.

This is a much narrower application of the predication test than has previously been adopted by the courts. It means that the courts will need to specifically state what constitutes the terms of each arrangement. The definition of "arrangement" in the section is far too wide to be of any help. There is no indication of what constitutes a "plan" or an "understanding", and these will be questions that will take on critical importance.

The cases before Ashton are of limited assistance since the courts were not concerned with distinguishing the terms of the arrangement from the more general surrounding circumstances. But they perhaps indicate that the New Zealand courts will take a fairly liberal approach as to what they do consider to be a term of an arrangement due to the wide range of factors that have been considered relevant in determining the purpose of an arrangement. This must also be so due to the nature of the inquiry. As Spry claims:[38]

> It is contrary to both ordinary expectations and to legal practice to attempt to determine the nature of an act or omission without reference to the circumstances in which it is found and to which it relates. This must be so in particular when it is being attempted to establish the purpose that should be attributed to the material act or omission .

38 Section 260 of the Income Tax Assessment Act (Australia) (2 Ed, the Law Book Company Ltd, Sydney, 1976) 40.

Thus, as A. Molloy states:[39]

> ... while those purposes must be ascertained from the terms of the arrangement, the latter, or some of them, may have to be inferred from all the circumstances of the case. And it is apparent - as witness the judgment in Loader v C.I.R. - that the courts tend to consider the motives of the parties as part of the circumstances.

There is, therefore, a lot of uncertainty in what will be allowed as evidence to prove the terms of an arrangement.

It is also evident that with a taxpayer who has a more formal format to his arrangement, it will be harder to claim that informal conduct on his part should be considered as part of the terms of the arrangement. We could then have a strange situation where in two almost identical situations we have different results merely because one arrangement was more formally drafted than the other.

There is also confusion as to how much attention the courts will pay to this direction by the Privy Council in Ashton. In the subsequent case, Halliwell, the Supreme Court seems to have ignored this direction to look only at the terms of the arrangement and also the more specific statement that conduct subsequent to the arrangement is not to be relevant. In that case Casey J. stated:[40]

> ... I am satisfied that physically, Mr Kotoul carried on under the new arrangements no differently from what he had done under the partnership.... I am satisfied that the Trustees had no real say about his employment. It would be unrealistic to suggest that ultimate practical control over Mr Kotoul and his work rested with anyone other than Mr. Halliwell.

39 Molloy on Income Tax (Butterworths, 1976) 569.

40 (1977) 3 N.Z.T.C. 61, 208, 61, 210.

The Judge is obviously taking regard of factors that he sees as separate from the arrangement itself and which concern the conduct of the parties subsequent to the actual arrangement being set up.

V. WHAT ARRANGEMENTS ARE CAUGHT?

The cases are very unhelpful when it comes to trying to elucidate from them what factors will cause an arrangement to fail to be classified as an "ordinary business or family dealing". The court's approach to a family dealing is much the same as it is toward a business dealing, with slightly more latitude allowed because of the personal nature of the arrangement. This is well explained in Tayles v C.I.R.[41] where Jeffries J. stated:[42]

> In a dealing within a family it is common to find tempered the strict mercantile rules that are current in the market place. The modifications range from unalloyed generosity to slight mitigation of the strict rules .... [Thus] tempering, some risk, and some amelioration are acceptable in a family dealing, but not abandonment of commercial practice, apparent mercantile foolishness or market artificiality.

He however also states that the court is not able to give definite limits to the notion of "ordinary family business" and that they can only decide on each particular case.[43] This is the problem the courts have with the whole test.

There are however, a few factors which the courts have recurringly pointed to as relevant:

1) Control

The fact that the taxpayer retained effective control over the property in Elmiger was seen as an important factor indicating that the transaction could not be seen as an ordinary family arrangement. There two brothers in partnership sold machinery to a family trust set up by their

41 [1977] N.Z.L.R. 668.

42 Ibid 678.

43 Idem.

father. The trust hired the machinery back to the taxpayer. The taxpayers tried to deduct the cost of bailment against their income. The court held that this arrangement was void. One of the main reasons being that there was no change in the practical operation of the partnership business.

However, this was not found to be very relevant in Loader v C.I.R.[44] There the taxpayer, an earth moving contractor, incorporated his business and sold his equipment to a family trust set up by his father. The company hired the equipment back. The court held that since the taxpayer was controlling the property in a different capacity it was irrelevant that he had the same control. Cooke J. stated:[45]

> In any event the fact that trust and company were designed to and did work hand-in-glove, and doubtless under the effective control of the objector, does not mean that the arrangement was principally a tax avoidance device....the separate legal identities of company and shareholders and the separate legal existence of trusts are everyday elements in business and family dealings.

Although the arrangement in Loader was a lot more sophisticated than the one in Elmiger, the principle should be the same in both. If the company and the trust in Loader are to be accepted as two distinct entities for tax purposes, without regard to who actually controls the trust property, so should the trust and taxpayer in Elmiger. Further, the explanation that was accepted in Loader was that the arrangement was desirable

> to stabilise the objector's estate for duty purposes in the event of his death, and to transfer the more valuable income earning assets so that they would not be assets at risk in the ... business.

44 [1974] 2 N.Z.L.R. 473.

45 Ibid 478.

This explanation applies equally to both situations. The approaches in Loader and Elmiger are inconsistent with each other. This does not help when trying to apply the cases to interpret the new section.

2) Nature of Income Producing Activity

In the case Udny v C.I.R.[46] the taxpayer sold a hay bailer and a hay conditioner to a family trust. The taxpayer continued to operate his harvesting business as before, except that he was earning the money for the trust and the only compensation he got was free use of the machines to harvest his own hay. Wild C.J. held that the machinery was playing only a minor role in generating the income. He stated:[47]

> In truth the farm implements were useless without motive power and human labour. On the evidence I find it quite clear that the real power generating the income in question has been the exertions of the objector himself.

However, it would be wrong to regard the fact that machinery needs an operator to work it as meaning it has no value in itself as income producing. It does have an income earning capacity in its rental potential. This was implicit in the decision of Loader. The nature of the property is only one factor that is to be taken into account in conjunction with the rest of the circumstances, and it may or may not be relevant depending on how the whole arrangement works. It is not useful looking at it as an isolated factor.

3) The Term or Life of the asset transferred

It was considered relevant in Mangin that a paddock was transferred for one year at a time and that a different paddock was used each year being the one which was being used to grow the wheat in that particular year. Similarly, in Elmiger, the fact that the property would revert back to

46 [1972] N.Z.L.R. 714.

47 Ibid 717.

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the taxpayer was considered indicative of the arrangement being outside the range of an ordinary family arrangement.

The cases do show that a short term transfer of assets or the transfer of a quickly wasting asset are matters to be taken into account. But they have not required that it is essential that either aspect be absent for an arrangement to be acceptable under the predication test. Rather, the cases suggest that the courts should look at the impact that the arrangement has on the taxpayer's affairs. As Bassett claims:[48]

> Plainly [the court's] analysis does not postulate the absence of an "enduring benefit" as the pivotal notion upon which application of the section proceeds. Rather it is in the notion that the arrangement merely alters the disponer's tax burden without any noticeable change in the conduct of his affairs that the courts find an unacceptable degree of artificiality in the impugned arrangement.

Therefore, although it is possible to point to these individual factors that the courts have considered as significant in the past, the courts make it clear that because of the very nature of the test, the importance of these factors will vary.

They will vary depending on their significance, as the courts see it, in the whole scheme of the arrangement. It is also important to note that although the courts have indicated specifically that these aspects are relevant, it is by no means certain that there are no other factors that they will regard as indicating a tax avoidance purpose. Thus a taxpayer can be wary of allowing any of these factors mentioned from being included in any arrangement he initiates, but it is not possible for him to know the precise scope of the section.

48 "Estate plans and arrangements to avoid income tax", supra n. 18, 16.

VI. NEW SOURCES INCOME

Section 108 only applied to arrangements that affected "existing" sources of income and not those that were set up in relation to "new" income sources. This distinction was first established by the Privy Council in Europa(2) where Lord Diplock stated that the application of the section[49]

> ... presupposes the continued receipt by the taxpayer of income from an existing source in respect of which his liability to pay tax would be altered or relieved if legal effect were given to the contract, agreement or arrangement sought to be avoided as against the Commissioner. The section does not strike at new sources of income or restrict the right of the taxpayer to arrange his affairs in relation to income from a new source in such a way as to attract the least possible liability to tax.

It is very unfortunate that section 99 does not state whether this distinction between "new" and "existing" sources of income should continue. It would have been so easy for the Legislature to have done so and by so doing they would have eliminated any uncertainty.

On the grounds of policy there is no justification for this distinction. Whether a taxpayer sets up an arrangement that directs income into a trust before he organises the source of income or whether he does it afterwards should be irrelevant. It is difficult to see why the timing should change the purpose of the arrangement.

The question, however, is whether the words of section 99 are wider than those of section 108 to allow new sources of income to be covered as well.

49 [1976] N.Z.L.R. 546, 556.

Section 99 contains new definitions, one of them being that of "liability". That is defined as including "a potential or prospective liability". But it is difficult to see how this definition could extend the section to cover new sources of income since it would not be possible to know if a taxpayers incidence of tax had been reduced by an arrangement unless the potential to pay existed before the taxpayer entered into the arrangement. As one commentator states:[50]

> ... 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.

Subsection (3) of section 99 uses language that would clearly cover both existing and new source income. There the Commissioner in reconstructing an arrangement is able to take account of the income.

a) That person would have, or might be expected to have, or would in all likelihood have, derived if that arrangement had not been made or entered into; or

b) That person would have derived if he had been entitled to the benefit of all income, or of such part thereof as the Commissioner considers proper, derived by any other person or persons as a result of that arrangement.

But this subsection only comes into operation once an "arrangement" is void in accordance with subsection (2). Thus it would not be correct to use subsection (3) to help interpret subsection (2).

As a result the distinction between new sources and existing sources will most likely continue under section 99.

50 G.Hartley "The Europa Oil(No.2)Ltd Case" (1976) N.Z.L.J. 218, 227.

When the test was first introduced in Europa(2) Lord Diplock made no attempt to explain what income would be regarded as new source income. The only other case where a New Zealand court has addressed the question of new source income is in the case of Halliwell. Casey J. held that the fact that Mr Halliwell bought out his father's share in their partnership did not amount to creating a new source of income. He made the following observation:[51]

> The interest a partner may have can vary from an insignificant share of the profits on the one hand, to virtually total ownership of the capital and profits on the other, and the amount of work he does can also be as varied. If the former acquires sole ownership of the business, it is unrealistic to describe him as merely continuing an existing source of income. If the latter did so, the opposite description could be equally unreal.

Casey J. held that Mr Halliwell's position fell into the latter situation and prescribed the following test to help determine the issue:[52]

> I think the answer to the question of whether there is an existing or a new source of income (to which the arrangement under attack relates) depends on a common-sense appraisal of the physical source itself, as well as of the taxpayer's interest in it, and any other relevant circumstances. The onus is on the taxpayer ...

If the courts do adopt this "common-sense appraisal" it will be very unsatisfactory from the taxpayer's point of view, since it would be a highly subjective evaluation by the courts that would be very difficult to anticipate. Casey J. also leaves open the factors that can be taken into account. The result is that we have a very unhelpful test that has the possibility of widely varying conclusions. Nor does Casey J.

51 (1975) 3 N.Z.T.C. 61, 208, 61, 216.

52 Idem.

explain what he means by an "appraisal of the physical source itself". The reason why Casey J. and also Lord Diplock in Europa do not seem to give any helpful indication of what will constitute a new source of income stems from the fact that neither has given any explanation of why the distinction exists in the first place. The reason for the distinction, as has been shown earlier, is that there must be a situation existing before the arrangement is entered into which creates the potential tax liability, that is subsequently avoided by the arrangement. Only once this is realised does it become clear what it is you are trying to ascertain by looking at the physical source of the income. What has to be established is whether the new arrangement is merely redirecting the same source of income or whether it has made such fundamental changes that it must be considered a different income source.

This line of inquiry, though making more sense of the test than Casey J. set out in Halliwell, does not make it any easier in knowing where the line will be drawn or what factors the court will regard as creating that fundamental change necessary to create a new source of income.

The basis for Casey J's decision that section 99 applied was that Mr Halliwell's interest in the partnership had not changed significantly. Implied in his judgement was that if Mr Halliwell's initial interest in the partnership had been much smaller changing to complete ownership then the new business would have been a new source of income and section 99 would not have applied to the deductions he claimed. That would not be a correct result however. On the facts of the case Mr Halliwell bought the partnership interest off his father first and then he sold the equipment to the family trust. Thus when Mr Halliwell sold the equipment to the trust he did have an existing source of income with a potential liability to pay tax on his new business interest. The new source argument should have been irrelevant in

Halliwell. For the new source argument to have been possible the partnership would have to have sold the equipment to the family trust before Mr Halliwell bought his father's share in the partnership.

Hartley claims that the Privy Council in Europa Oil(2) were wrong in their decision that there was a new source of income on the facts. He claims:[53]

> 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 .... 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 therefore an addition to Europa's profit and not a new source of profit.

This argument seems to misconstrue the Privy Council's decision. The Privy Council did not conclude that the Pan Eastern benefit was a new source of income independent from the profit earned from the petroleum purchased from Gulf. Lord Diplock stated:[54]

> ... the 1956 organisation contract created a new source of income for the taxpayer company which did not exist before the 1956 processing contract came into force.

Hartley interprets this statement as meaning that the source created by the 1956 contracts was the Pan Eastern company. However the 1956

53 "The Europa Oil(No.2)Case", supra n.50, 227.

54 [1976] N.Z.L.R. 556, 557.

contracts involved more than just setting up the Pan Eastern company. Part of the 1956 contracts was the long term 'products contract' which secured the sale of oil from the Gulf to Europa Oil. What the Privy Council most probably was saying is that by changing suppliers from Caltex to Gulf (the 1956 contracts embodying that change), Europa Oil was creating a new source of income. The relevant source being the supplier, Gulf, not the Pan Eastern company. If Gulf was a new source the Pan Eastern benefit would have to be seen as coming from the new source and Europa Oil could not be taxed for it because it had never been received by Europa Oil as assessable income. There was no basis of comparison to treat it as anything other than a tax free dividend. Therefore the statement by Lord Diplock is doing no more than stating that by changing suppliers, even if you are purchasing the same product, a taxpayer is creating a new source of income.

The Australian decision of Mullens v. Federal Commissioner of Taxation[55] when applying the new source principle to section 260 adopted an extremely limited interpretation as to what would constitute an "existing" source of income. The court in Mullens was not concerned with a new source of income but with a new basis of deduction but found the new source principle relevant. A firm of stockbrokers had entered into an arrangement that enabled them to deduct the price they paid for some shares from their assessable income under a particular section of the Australian Act.[56] Sir Barwick C.J. adopted the new source argument and stated:[57]

> It seems to me that the parity of reasoning S. 260 may be said not to be concerned with the right to a deduction which the only

55 (1976) 6 A.T.R. 504.

56 Section 77A, which has since been repealed.

57 (1976) 6 A.T.R. 504, 510.

> relevant transaction between the parties would produce in the future ... Just as there must be income, not derived from the impugned transaction but derived from the antecedent transaction between the parties which, when that transaction is struck down, is exposed as producing assessible income, so in my opinion, in relation to a deduction, the avoidance of the transaction must disclose a transaction or situation which did not entitle the taxpayer to a deduction.

The effect of this case is that unless an arrangement is a rearrangement of a pre-existing relationship between the parties, that arrangement will create a new source of income. This approach is unlikely to be adopted with relation to section 99. It is not necessary for there to have been an analogous earlier arrangement between the same parties to establish a potential liability to pay tax that has been avoided by the taxpayer. That potential liability could have been created from one source and have been redirected to a third party. Thus such an interpretation would be an unwarranted restriction on the words of section 99.

The Court of Appeal case of Martin is an example where a New Zealand court has found a tax avoiding purpose under section 99 and where there was no antecedent transaction between the parties concerned.

The reason why the Australian courts have adopted a more restrictive approach to new sources than the New Zealand courts can be explained by the different approach they take to their general anti-avoidance provision as a whole in its relationship to the rest of the Act. This is explained later in section VIII of the paper.

VI. THE "CHOICE PRINCIPLE"

Another aspect that the Legislature could so easily have resolved when redrafting section 99 was how it relates to other sections in the Act. That the Legislature did not is an unfortunate oversight and has resulted in conflicting opinions.

The Australian courts have made it clear that section 260 has no operation where the arrangement comes within the ambit of another section of the Act. This is known as the "choice principle". Where the taxpayer chooses to bring his arrangement within another section of the Act that purports to regulate that particular transaction, then section 260 does not apply regardless of the purpose of that arrangement.

This principle was first established in W.P.Keighery Pty v F.C.T. [58] The rationale behind the choice principle is well explained by Cribb J. in Patcorp Investments Ltd. v F.C.T. [59] His Honour explained that:[60]

> The presence of section 260 makes it impossible to place upon other provisions of the Act a qualification which they do not express, for the purpose of inhibiting tax avoidance. In other words it is not permissible to make an application which does what section 260 fails to do in preventing the avoidance of tax. If it is suggested that a taxpayer has engaged in a device to secure a fiscal advantage, and the relevant provisions of the Act do not expressly deal with the matter, the case depends entirely on section 260.

In New Zealand the situation is far from clear. In McKay, the Court of Appeal considered the relationship between section 96 and section 99. Section 96 governs the transfer of rights to income and sets out certain

58 (1957) 100 C.L.R. 66.
59 (1976) 6 A.T.R. 420.
60 Ibid, 429.

criteria which need to be met. If they are not, the section deems that the income is derived by the transferor and not the transferee.

The Court of Appeal found that section 99 would not normally apply if the person transferring the right to income complies with the requirements in the section but went on to qualify this by stating:[61]

> But [section 96] certainly does not prevent the Commissioner, in the proper case, from applying to such assignments the provisions of [section 99].

The court made no reference to what would constitute a "proper case". It is apparent, though, that the Court of Appeal did not regard section 99 as automatically restricted by the application of section 96. Molloy states that the test should be that, where there had been a "simple" use of a section of the Act by the taxpayer, where the taxpayer was merely pursuing an alternative choice open to him by the Act itself, section 99 does not apply.[62] But "where the choice does not stand alone, but is part of a wider arrangement, it will fall with that arrangement".[63]

However, the decision in McKay may have been overruled by necessary implication by the Privy Council's decision in Europa(2). This will be considered later on. Most of the cases in New Zealand that have relevance to the "choice principle", are concerned with the relationship between section 99 and section 104. Section 104 allows a taxpayer to deduct from his total income for the year any expenditure or loss incurred in producing his income. The main Australian case regarding

61 [1973] N.Z.L.R. 592, Per Turner J, 600.

62 "Recent Tax Developments - The Scope of Section 108" (1976) Recent Law, 289.

63 Ibid 290.

the relationship between section 260 and section 51, the Australian equivalent to section 104, is Cecil Bros. Pty Ltd. v F.C.T.[64] Adopting the "choice principle". Dixon C.J. stated:[65]

> I have great difficulty in seeing how [section 260] could apply to defeat or reduce any deduction otherwise truly allowable under S. 51.

Dixon C.J. gave no explanation for this comment and there seems to be no particular reason why section 51 should exclude the operation of section 260 if the deduction is found to be part of a tax avoiding arrangement. The decision in Cecil Bros. was accepted in the subsequent decision of Franklyn's Self Service Pty Ltd v F.C.T.[66] But in the case of Hooker-Rex Pty Ltd v F.C.T.[67] decided in the same year, Menzies J. suggested that section 260 was able to avoid a deduction even if it was a valid deduction under section 51 where the deduction was not an ordinary business dealing.

The New Zealand courts have been similarly inconsistent in their approach. In Elmiger Woodhouse J. disagreed with the conclusion of Dixon C.J. preferring to follow dictum from the case of Jaques v F.C. of T.[68] where Rich J. said:[69]

64. (1964) 111 C.L.R. 430.

65. Ibid, 438.

66. (1970) I.A.T.R. 673.

67. (1970) I.A.T.R. 642.

68. (1924) 34 C.L.R. 328.

69. Ibid, 338.

> The Legislature has permitted the deduction where it is the legitimate result of a call arising from the ordinary situation of a shareholder in a mining company. But [section 260] in my opinion also excludes a deduction which is not the result but the animated purpose of a call deliberately incurred, as this as, for the purpose of the deduction.

Woodhouse J. applied this reasoning to section 99 and concluded:[70]

> 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.

The Court of Appeal in Europa Oil (1)[71] however, accepted the conclusion of Dixon J. in Cecil Bros and affirmed that section 99 had no application at all to deductions which a taxpayer is entitled to claim under section 104.[72] This point was not decided when the case was on appeal to the Privy Council. Lord Wilberforce for the majority decided that the deduction was not permissible under section 104 and preferred not to express an opinion on whether section 99 could have applied if it had been an allowable deduction.

In Mangin the Privy Council was concerned with an arrangement whereby a taxpayer sold farm equipment to a family trust and leased it back claiming a deduction for the leasing cost against the income he earned. The Privy Council avoided the arrangement under section 99 without even addressing themselves to the problem of the relationship between section 99 and section 104. However the decision in Mangin "necessarily implies rejection of the primacy of section 104".[73]

70 [1966] N.Z.L.R. 683, 693.

71 [1970] N.Z.L.R. 363.

72 Per North P. and Turner J. 389, 414.

73 Basset "Estate plans and arrangements to avoid income tax" Supra n.18,620.

The Court of Appeal in Wisheart expressly rejected the approach taken in Cecil Bros. The decisions of North P. and Turner J. make no reference to the fact that they are taking a totally contrary view to that which they expressed in Europa(1).

Up to this point there is strong authority for the view that Malloy takes with regard to deductions claimed under section 104 which reduce a taxpayer's incidence of tax.[74] He states that the taxpayer has expressly been given the choice as to how to arrange his affairs by the Act. If he arranges his affairs so as to create a deduction that reduces the tax he pays, then that is a simple exercise of that choice which cannot normally be classified as tax avoidance. Section 99 does however have effect when the creation of a deduction goes beyond merely taking advantage of the option allowed by the Act. As he explains:[75]

> ... the line between a mere tax advantage, in this sense, and "tax avoidance" in the sense contemplated by [section 99] is crossed at the point where such a transaction takes place, not in isolation, but in the wider context of an arrangement aimed at splitting the business income with a purchaser who is an associate, a relative, or a trustee for a relative; who is not going to put up cash to free the capital locked up in the asset, but merely is agreeing to pay the purchase price on demand, with the idea that it will either be paid out of income derived from the vendor's rent, or will be forgiven by the vendor in instalments.

This approach is also consistent with the actual words used in the sections. The right to claim a deduction under section 104 is expressly restricted by the words "except as otherwise provided for by the Act".

74 "Malloy on Income Tax", Supra n.39, 620.

75 Idem.

section 99 applies to "Every Arrangement". Not allowing section 99 to operate when a deduction is allowable under section 104 is to reject a literal interpretation of the words. This approach suggested by Malloy is also consistent with the approach taken in McKay as to the relationship between section 99 and section 96. This would appear to be the most logical interpretation with regards to the extent of section 99.

But the Privy Council's decision in Europa(2) creates an enormous obstacle in adopting such an interpretation. Their Lordships were obliged to decide on the relationship between section 99 and section 104 since they had previously found that the deduction in consideration was a legitimate deduction under section 104.

Lord Diplock giving the decision of the majority stated:[76]

> Their Lordships' finding that the monies paid by the taxpayer company to Europa Refining is deductible under [section 104] 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 [section 99].

Lord Diplock gives absolutely no explanation for this statement and it is very unclear as to what he considers gives rise to this incompatibility between section 99 and section 104. Was it because the two are inherently incompatible because Lord Diplock took the same view as that in Cecil Bros.? Alternatively, did Lord Diplock regard the application of section 99 as incompatible on the particular facts of the case? Bassett claims that the latter explanation is appropriate. (20) He suggests:[77]

76 [1976] N.Z.L.R. 546, 556.

77 "Estate plans and arrangements to avoid Income Tax", Supra N.18, 35.

> ...that the way open to interpret the opinion of the Board is to hold that the view of their Lordships was directed to the facts of that particular case. Hence the "incompatibility" spoken of by the Board may be said to be occasioned by the present matter being a case of "expenditure genuinely made" [The test propounded by the majority in Europa(1) for applying section 104], in which case that characteristic would make the transaction a matter of ordinary business dealing and therefore necessarily safe from impeachment under section 99.

This explanation does not however restrict the decision of Europa(2) to its facts in any way. Any expenditure must be genuinely made to fall within section 104. Thus if all expenditure genuinely made is necessarily an ordinary business dealing then section 99 would have no effect over any deduction once it is regarded as an acceptable deduction for the purposes of section 104.

The point Bassett seems to miss is that the court is involved in two different enquiries when it is considering section 99 and section 104. In respect of section 104, the court is looking only at the particular expenditure; at what was paid and what was received and whether what was paid was in actual fact paid for what was received. This is clear in both Europa(1) and Europa(2). In Europa(1) Lord Wilberforce stated:[78]

> For a claim to disallow a portion of expenditure incurred in purchasing trading stock to succeed the Crown, in their Lordships' judgement, must show that, as part of the contractual arrangement under which the stock was acquired some advantage, not identifiable as, or related to the production of, assessable income was gained, so that a part of the expenditure, which can be segregated and quantified, ought to be considered as consideration given for the advantage.

78 [1971] N.Z.L.R. 641.

Lord Wilberforce elaborated on this statement in his dissenting judgement in Europa(2); where he stated that what the court is concerned with when applying section 104 is:[79]

> 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?

In Europa(2) the Privy Council adopted an even narrower test asking what the legal effect of the expenditure was; what the expenditure entitled the taxpayer to as performance of the contract. In both cases the Privy Council was concerned only with the actual expenditure and not with the wider question of why the expenditure was created. Section 99 on the other hand is concerned with this wider question of whether the expenditure was created so as to avoid tax, and looks beyond the actual expenditure to the relationship between the parties before the expenditure was made. It must be an expenditure within a wider arrangement to be able to fall within section 99. The Privy Council in Europa(2) was looking only at the actual expenditure and not at the wider relationship. The Privy Council, therefore, could not be interpreted as deciding that the deduction was not caught since it was an ordinary business dealing in terms of section 99. The Privy Council also cites Cecil Bros. as authority for its decision without making any reservations at all.[80] Thus Casey J. would appear to be correct when he states his view about the decision in Europa(2). He stated in Halliwell:[81]

> ... the majority were expressing a general principle about the relation of [section 99] to [section 104] , and not merely confining themselves to a finding on the specific facts before them,...

79 [1976] N.Z.L.R. 546, 561.

80 Ibid, 552.

81 (1977) 3 N.Z.T.C. 61, 208, 61, 214.

The result is that Europa(2) constitutes a departure from both the literal effect of the words of section 99 and from well established authority. However, Casey J. did not leave the matter there, he went on to distinguish Europa(2) and hold that section 99 does have some application to deductions that are acceptable for the purposes of section 104. He claimed:[82]

> Where the need for the expenditure can be regarded as a normal incident of the business or undertaking forming the source of the taxpayer's income, then he may select his own means of incurring it, and may spend what he thinks fit. So long as the expenditure conforms with [section 104] , it cannot be attacked under section 99 . But [section 99] can still apply where the need for such expenditure has been contrived in any existing source of income, as part of arrangement having tax avoidance as one of its main purposes, and which is not a usual business or family dealing.

As J. Prebble points out, Casey J. is blending the two separate tests in Europa(2); the new sources argument and the statement that allowing a deduction under section 104 is 'incompatible' with a claim that the deduction can be avoided under section 99.[83] Put simply the result of the test propounded by Casey J. would be that:[84]

> ... deductions conforming with [section 104] will be safe, but only if they are in respect of new sources of income or, one assumes by parity of reasoning, in respect of expenditure.

On examination, the decision in Halliwell is incorrectly decided. Casey J.

82 Ibid, 615.

83 "Tax avoiding arrangements that comply with Section 104, Income Tax Act 1976" Vol.8, N.Z.L.L.R. 70.

84 Ibid, 72.

is not able to distinguish Europa(2) on the grounds that Halliwell concerns existing income. The Privy Council made a series of separate statements; two of them being:

a) that section 99 does not apply to new source income.

b) that the application of section 99 to avoid deductions is incompatible with allowing those deductions under section 104.

There is no justification for connecting these statements to form his hybrid test. In the situation of new source income, the question of compatibility between section 99 and section 104 does not arise. Section 99 just does not apply whether the deduction falls within section 104 or not. By using the term "incompatibility", the Privy Council must surely have been considering a situation where both sections had the potential to apply. That situation had to involve an existing source of income.

What the test of Casey J. does do is to acknowledge that section 104 and section 99 are directed at different issues. By stating that section 99 can apply when an allowable deduction is "continued", Casey J. is looking at the wider question of how the deduction came into being. This approach is moving back to the situation accepted in Mangin and Wisheart.

Europa(2) must be seen as an endorsement of the Cecil Bros. approach which is not concerned with the wider issue involved in section 99. By choosing to create a deduction that falls within section 104, the taxpayer eliminates the operation of section 99. This approach is difficult to accept in logic when it is apparent that the two sections ask fundamentally different questions.

Although Europa(2) is concerned with the relationship between section 99 and section 104, the decision may extend generally to the application of section 99 to arrangements that fall within other sections of the Act.

Thus it could overrule the decision in McKay with respect to the relationship between section 99 and section 96.

But as Hartley explains, there is a fundamental difference in principle between applying section 99 to section 104, and to section 96. Section 96 cannot be seen as a self sufficient provision.[85] "It effectively tells a taxpayer what he cannot do. It does not 'allow' anything."[86]

85 Settlements of property for tax purposes. LLM Thesis, V.U.W. (1976) Para. 4-10.

86 Idem.

VIII. THE EXTENT OF THE CHOICE PRINCIPLE

If Europa(2) is interpreted as adopting the choice principle as accepted in Keighery and Cecil Bros. the exact application and extent of this principle assumes great importance.

The Australian courts have taken a very generous view of the choice principle and by doing so have given their section 260 an extremely limited application. In Slutzkin v F.C.T.[87] the court held that the choice principle applied not only where the Act specifically gave the taxpayer a choice to bring himself within a particular section of the Act but also where the taxpayer is given a choice by the general scheme of the Act.

Aitken J. outlined the principle as follows:[88]

> To adopt a course which produces a result outside the scope of the Act is not to alter the incidence of tax, or to defeat any liability to tax or to prevent the operation of the Act, notwithstanding that such a course is adopted with full knowledge of the provisions of the Act and with a conscious intention that the proceeds should not fall within the operation of the Act.

Similarly Barwick C.J. stated:[89]

> ... the choice of the form of transaction by which a taxpayer obtains the benefit of his assets is a matter for him; he is quite entitled to choose that form of transaction which will not subject him to tax, or subject him to less tax than some other form of transaction might do.

87 (1977) 7 A.T.R. 166.

88 Ibid, 174.

89 Ibid, 169.

The effect of the decision is Slutzkin in Australia is outlined by Spry. He states:[90]

> ... It appears that almost invariably when section 260 is attempted to be invoked by the Commissioner it will be held that no improper "avoidance" of a liability has taken place, nor an improper alteration of the incidence of tax, since the Act must be taken to contemplate that what has been done to the parties to the relevant arrangement should be open to them; and the incidence of tax that the Act contemplates in those circumstances must be the incidence that arises on the basis that the transaction has been carried out.

The only exception will be the one established in Mullens case where there has been an analogous earlier transaction which establishes a liability that was subsequently avoided.

This extremely narrow view of the concept of avoidance is not a necessary extension of the choice principle as set out in Keighery and Cecil Bros. It goes further than deciding which of two sections prevail over the other. Bassett points out that this extension of the principle in Slutzkin involves a particular conception of what constitutes tax avoidance which is based outside the actual provisions of the Act:

> [This] aspect, propounded in Slutzkin, is essentially rooted in the concept of laissez-faire though it also involves a value judgment as to the perceived extent of the tax base.

This approach would make the "ordinary family or business dealings test" redundant. It is probably unlikely that the New Zealand courts will adopt the approach taken in Slutzkin. It is certainly not a necessary

90 "Section 260 of the Income Tax Assessment Act", Supra n.38.

extension of the choice principle as originally established, and our courts have shown that they take a different approach to the extent to which a taxpayer can arrange his affairs with impunity. The courts have recognised that there are interests other than the taxpayer's to be considered and that there is a social obligation to pay a certain amount of tax. Slutzkin relies on the famous dicta in Inland Revenue Commissioners v Duke of Westminster[91] to justify their conclusion. In that case Lord Tomlin stated:[92]

> Every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then however unappreciative the Commissioners of Inland Revenue or his fellow taxpayer may be of his ingenuity, he cannot be compelled to pay an increased tax.

Woodhouse J. considered this dictum in Elmiger and stated:[93]

> I naturally appreciate that this forceful argument has the support of the highest authority. And I well recognise that the courts will always be careful to protect citizens against any demands of the Revenue which cannot be supported by some statutory provision. Nevertheless, since the House of Lords was obliged to consider the highly beneficial arrangements which were able to be made in 1930 on behalf of the Duke of Westminster, there has been a growing awareness by the Legislature and the Courts alike that ingenious legal devices contrived to enable individual taxpayers to minimise or avoid their tax liabilities are often not merely sterile or unproductive in themselves (except perhaps in respect of their tax advantages for the taxpayer concerned), but that

91 [1936] A.C. 1.

92 Ibid, 19.

93 [1966] N.Z.L.R. 683, 686.

> they have social consequences which are contrary to the general public interest.

This passage indicates that the New Zealand courts have taken a different approach to determining the scheme of the Act. There is also very recent authority in support of the courts reading down the decision of Duke of Westminster as Woodhouse J. has done. The House of Lords in J.W.Ramsey Ltd v IRCs; Elibeck (Inspector of Taxes) v Rawling[94] places their previous decision of Duke of Westminster in context. Lord Wilberforce stated:[95]

> Given that a document or transaction is genuine, the court cannot go behind it to some supposed underlying substance. This is the well-known principle of Inland Revenue Commissioners v Duke of Westminster ... This is a cardinal principle but it must not be overstated or over-extended. While obliging the court to accept documents or transactions, found to be genuine, as such, it does not compel the court to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs. If it can be seen that a document or transaction was intended to have effect as part of a nexus or series of transactions, or as an ingredient of a wider transaction intended as a whole, there is nothing in the doctrine to prevent it being so regarded; to do so is not to prefer form to substance, or substance to form. It is the task of the court to ascertain the legal nature of any transactions to which it is sought to attach a tax or a tax consequence and if that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded.

94 [1981] 1 ALL E.R.865.

95 Ibid, 871.

There is, then, no necessity for the New Zealand courts to adopt the approach taken in Slutzkin and there is absolutely no indication in the cases that they intend to.

IX. CONCLUSION

Section 99 appears at first glance to make significant changes to its predecessor. It seems more detailed, more comprehensive and more precise. When it is subject to closer scrutiny, however, the section fulfils none of these preliminary expectations. Section 99 in fact has to be regarded as a failure as an exercise in legislative drafting.

The section fails to correct all but one of the criticisms directed at section 108 by Lord Wilberforce[96]. The section now does provide for reconstructing arrangements once they are avoided. This provision does eliminate a serious limitation which existed before. But that correction is basically an improvement in the mechanics of the section. It in no way helps in trying to understand when the section actually applies. There is still no helpful concept of what constitutes tax avoidance. This failure ensures that uncertainty about the section will still exist. The new definitions add nothing to the clarity of the section in this regard. As a result the courts are going to be forced to look beyond the Act to establish a notion of tax avoidance. This will necessarily require the courts placing glosses on the words of the section.

The history of cases concerning section 108 has shown the difficulty and uncertainty of trying to establish a test that helps ascertain the purpose of an arrangement. The "ordinary business and family dealings" test which the courts adopted will probably be the one they have to rely on again to give the section any sensible meaning. It is a test that has been widely recognised as deficient and one which will not enable a taxpayer to know, with any degree of certainty, what his tax liability is. There is confusion as to what may be taken into account to determine the purpose of an arrangement. There is confusion as to how precisely you determine the purpose of an arrangement.

96. Mangin [1971] N.Z.L.R. 591, 602. These are outlined in the Introduction.

The section does not clearly explain its limits. It does not state whether "potential liability" involves liability for potential income from a potential source or whether it is restricted to potential income from a source that is already established. Of greater concern, the section does not explain the relationship of the section with other sections of the Act.

Section 99 is clearly going to be the subject of litigation in the courts for some time to come. Some of the confusion in the cases will be able to be resolved by the courts, but there will always be a degree of uncertainty as to the exact application of the section due to the vagueness inherent in the concepts of "tax avoidance" and "ordinary business or family dealing".

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