IN RE REDDY, P. L. The Court of Appeal on section 108.

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THE COURT OF APPEAL ON SECTION 108 -

an examination of Judicial Attitudes

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The cases discussed in this paper are tabled here, and referred to throughout as follows:

Elmiger v CIR [1966] NZLR 683 (Woodhouse J.)
Elmiger v CIR [1967] NZLR 161 (CA)
Marx v CIR [1969] NZLR 464 (Wild (C.J.)
Marx v CIR [1970] NZLR 182 (CA)
Mangin v CIR [1970] NZLR 222 (Wilson J.)
CIR v Mangin [1970] NZLR 229 (CA)
Mangin v CIR (1969) 1 ATR 835 (PC)
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)
CIR v Europa Oil (NZ) Ltd (No.1) [1971] NZLR 641 (PC)
Wisheart v CIR (1969) ATR 434 (Wild C.J.)
Wisheart v CIR [1972] NZLR 319 (CA)
McKay v CIR [1972] NZLR 723 (Wild C.J.)
McKay v CIR (1972) 3 ATR 379 (CA)
Martin v CIR [1972] NZLR 340 (McMullin J.)
Martin v CIR (1973) 3 ATR 707 (CA)
Gerard v CIR (1972) 3 ATR 271 (Wilson J.)
CIR v Gerard [1974] 2 NZLR 279 (CA)
CIR v Ashton [1974] 2 NZLR 321 (CA)
Ashton v CIR (1975) 5 ATR 411 (PC)
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)
Europa Oil (NZ) Ltd (No.2) v CIR [1976] 1 NZLR 546 (PC)

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Introduction

This paper is concerned with assessing the influence of the attitudes of the members of the Court of Appeal in the interpretation of s.108 of the Land and Income Tax Act 1954, in the period 1966 to 1975. During this period the provision read as follows:

> "Every contract, agreement, or 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) in so far as, directly or indirectly, it has or purports to have the purpose or effect of in any way altering the incidence of income tax or relieving any person from his liability to pay income tax."

The words shown in brackets were inserted in the section in the amending Act of 1968.

It appears that the main reason for the repeal of this section in 1974 and insertion of a new, much more detailed, provision was because of the confusion and inequities which had resulted from the line of cases attempting to interpret it.

Before examining the effects the differing attitudes of the members of the Court of Appeal who heard these cases it should be noted that these attitudes should in theory be irrelevant in any tax case. This is because taxation is imposed solely by statute. There is no common law or equitable doctrine imposing any obligation upon any person to pay taxes. Thus in construing a revenue provision it is clear that the Courts should have regard to nothing but the text of the Act in question.

It is, however, generally accepted that this theory bears no resemblance to the practice which has developed. Not only have the personal attitudes of the judiciary been ascertainable from their judgments, but also those attitudes have apparently changed in the course of the ten year period. That this is undesirable has been recognised by the repeal of the section. Nevertheless the question still remains whether the blame for the development

of a 'world of fiscal phantasy' noted by McCarthy P. in Gerard (p.280 - 281) rests with the members of the Court, for allowing personal attitudes to influence their approach, or in the section, which defied interpretation on any other basis.

PART I

THE INTERPRETATION OF s.108, UP TO THE PRIVY COUNCIL DECISION IN MANGIN

(1.01) Decisions Prior to Elmiger

Although a general anti-avoidance provision had been present in New Zealand income tax legislation since 1891 it was not until the mid 1960s that the Commissioner seriously sought to invoke it. This has led one commentator to suggest that: [1]

> "To talk of s.108 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, making them, and not the legislature truly the lawgiver to all intents and purposes."

Certainly the first two attempts by the Commissioner gave little indication of the impact the section was to have.

In Lewis v CIR /1965/ NZLR 634 the Commissioner sought to challenge an arrangement whereby a partnership of solicitors provided their wives with finance to buy a bookkeeping machine which they then hired back at realistic hiring rates. The appellants sought to deduct the hire charges from the income returned by the partnership. However, the Commissioner refused to allow the deductions and added to the assessment of each appellant the amount of his wife's income from the hire charges. Hardie-Boys J. upheld the appellant's objection, stating (p.637):

> "I am satisfied that, unless, as a matter of law, the transaction with the wives can be set aside as a sham, it cannot be attacked under s.108."

The learned Judge purported to reply on decisions relating to the Australian equivalent sections and also on the famous 'laissez-faire' decision in IRC v Duke of Westminster /1936/ AC 1 but the decision does not stand up to critical analysis.[2]

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1. L. McKay. Section 108 and the Issue of Legislative Propriety/1976/NZLJ 238 at 242.

2. Transactions which are mere shams have always been open to attack by the Revenue, without express statutory authority.

There does, however, seem to be some basis for the inference that the learned Judge's sympathies lay in the first instance with the taxpayer who simply chose one (legal) method of arranging his affairs which attracted less tax than another, albeit unusual.[3]

Purdie v CIR (1965) 9 AITR 603 concerned a veterinary surgeon who created a charitable trust with which he formed a partnership. The appellant loaned money on interest free terms to the Trustees who bought premises for the partnership. The trust was thereby entitled to a one-fifth share in the profits. Wilson J. held that any diminution of the appellant's income was merely incidental to the charitable purposes of the appellant and thus the arrangement did not fall within the "predication" test enunciated by Lord Denning in Newtown v C of T [1958] AC 450 at 465. However, he went on to hold that the appeal would also succeed on the basis that the section can only apply to present liabilities, because of the difference in the wording of our section from s.260 of the Australian Act.[4] It is this second conclusion which is the most significant. In reaching it, Wilson J. made no reference to the purposes of the provision, or the effect such a construction would have on its application. As far as can be ascertained from the judgment, he was solely concerned with interpreting the plain and literal meaning of the words used, uninfluenced by the policy arguments for and against such legislation. Neither of these cases was taken further by the Commissioner and at this stage it appeared that his 'new' line of attack would be virtually ineffective.

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3. Note the two hypothetical cases Hardie-Boys J. discusses at pp636-637 which he considers to be unquestionable.

4. s.260 of the Commonwealth of Australia Income Tax and Social Services Contribution Assessment Act reads:

> Every contract, agreement or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly -
>
> (a) altering the incidence of any income tax;

(b) relieving any person from liability to pay any income tax or make any return;

(c) defeating, evading or avoiding any duty or liability imposed on any person by this Act; or

(d) preventing the operation of this Act in any respect,

be absolutely void as against the Commissioner, or in regard to any proceeding under this Act, but without prejudice to the validity as it may have in any other respect or for any other purpose.

(1.02) Elmiger In The Supreme Court

In Elmiger v CIR s.108 was successfully invoked by the Commissioner for the first time, seventy years after the first general anti-avoidance provision relating to income tax was enacted in New Zealand. The arrangement in that case had many similar features to that unsuccessfully challenged in Lewis v CIR. The appellants, who worked in a partnership as earthmoving contractors, sold earthmoving machinery to a family trust, the purchase price being by way of interest free loan payable on demand. The appellants contemporaneously agreed to hire back the machines for minimum monthly charges. The appellants deducted from their assessable income the amounts so paid. Thus the arrangement resulted in income splitting between the taxpayers and their family trust by means of contrived deductions which gave the trust an annual income taxed at a lower rate, and effectively reduced the appellants' tax by reducing their assessable income.

The case was heard in the Supreme Court before Woodhouse J. His approach provides a valid contrast with that taken by both Wilson J. and Hardie-Boys J. in the two earlier cases. His judgment contains a thorough analysis of decisions on the Australian equivalent section, but of greater significance is the clear expression of his attitude towards tax avoidance arrangements and general anti-avoidance provisions such as s.108.

While the previous two decisions demonstrate an attitude towards tax avoidance similar to the laissez-faire approach exemplified in the statement of Lord Clyde in Ayrshire Pullman Motor Services v IRC (1929) 14 TC 754 at 763

> ".....no man in this country is under the smallest obligation, moral or other so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores."

Woodhouse J's approach has been described as one more attuned to the type of society in which we live.[1] His attitude

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1. I.L.M. Richardson. Attitudes to Income Tax Avoidance Inaugural address VUW 18 Apl 1967, at p.1.

is apparent in this statement (p.686):

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

In considering general anti-avoidance provisions the Judge later stated (p.687):

> "I think these provisions are intended to forestall deliberate attempts by individuals to obtain tax advantages denied generally to the same class of taxpayer. That the Legislature should attempt to anticipate these manoeuvres is not surprising; nor can it be thought unfair to those affected if the method adopted by the Legislature should be, as in the case of [this section] the method of general proscription."

Having clearly indicated his position, the learned Judge declined to follow Lewis v CIR and held that s.108 applied to real as distinct from sham transactions. He then went on to deal with the objections raised by the taxpayer's Counsel to the applicatio of the section to the facts involved.

He dismissed the contention that s.108 could operate only in respect of arrangements altering the incidence of or liability for tax on income already derived on the basis that the word 'relieve' had the same meaning in s.108 as 'avoid', as used in s.260 of the Australian Act.[2] His Honour thus disagreed with the conclusion reached by Wilson J. in Purdie v CIR and his reasons for so doing appear to be influenced by the desire

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2. In Newton the argument was presented to the Privy Council that the liability to which s.260 applied was a liability which had already accrued. The Privy Council rejected this argument on the basis the paragraph (c) of s.260 referred, by use of the word 'avoid', to anticipated or future liability.

that the section be effective. Woodhouse J. said (p.692):

> "/The/ whole purpose /of s.108/ appears to be to effect a general proscription of schemes which would have the effect of diverting potentially taxable income outside the ordinary operation of the Act and thus preventing a liability for tax on that income from coming into existence. I find it impossible to interpret the section in terms of some illogical intention to confine it to existing liabilities."

The taxpayers' objection that s.108 cannot apply to bar deductions otherwise allowable under s.111 was also dismissed. Woodhouse J. distinguished Cecil Bros. Pty Ltd v C of T (1964) 111 CLR 430 and stated (p.693):

> "I can see no reason why s.111 should act in such a way as to override the effect of s.108."

Woodhouse J. thus saw s.108 as applicable in the circumstances, and effective to enable the Commissioner to disallow the deductions relating to the hiring charges. He saw the section applying to avoid even family or business dealings (p.694):

> "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."

Elmiger's case is of vital importance in any discussion of the case law on s.108, not only because it was the first case argued before the Court of Appeal on s.108, but because of the judgment of Woodhouse J., which clearly evinced a new approach in New Zealand to tax avoidance arrangements, and significantly influenced the decisions of the Court of Appeal in that case and those which rapidly followed it. The former Minister of Justice, Dr Martyn Finlay, said of Elmiger that it represented the high point in the Court's interpretation of s.108 from which they have since tended to retire.[3] Woodhouse J's forceful support for the effectiveness

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3. (1974) NZPD 4193

and desirability of general anti-avoidance provisions such as s.108 is a striking indication of the movement to a broader and less literal interpretation of revenue legislation. This approach must inevitably involve applying moral precepts as it is based on the individual Judges conception of what the taxpayer "ought" to pay. The literal approach meant that this obligation was determined solely by the strict construction of the relevant taxing provision. The "broader" approach which is epitomized in Woodhouse J's judgment in Elmiger requires the Judge to have some preconceived idea of the "purpose" of the Legislation which he applies in the absence of clear guidelines within the statutory provision.

Woodhouse J's judgment in Elmiger is undoubtedly a well written and forceful opinion. In view of the case law which followed, it also must be seen as being unquestionably sound in law, but each of the major issues offered an alternative approach which the words of the section could equally well have supported.[4] The Australian case law could easily have been distinguished.[5] But having unequivocally expressed his views that tax avoidance schemes are contrary to the general public interest and that anti-avoidance provisions designed to thwart these are to be expected, it is not surprising that he chose the interpretations which gave the section the most effect and potency. The fact that his conclusions were followed in the Court of Appeal and indeed by the Privy Council in Mangin v CIR may mean that they were correct, or it may mean that similar attitudes were held by the majority of Judges who heard those cases. The true position may be, however, that any interpretation of s.108 which could be made inevitably required that the judge adopt a standpoint from which to evaluate the facts in issue. The words of the section were so broad and discretionary that they simply could not be given a literal translation.[6]

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4. These alternatives are discussed in para (1.03) in relation to the Court of Appeal's judgment.

5. s.260 is clearly different because of the two extra limbs which do not appear in s.108.

6. A view later expressed by McCarthy P. in Gerard (p.281).

(1.03) The Court of Appeal in Elmiger

The Court which heard the appeal from Woodhouse J's decision in Elmiger was composed of the same members - North P., Turner and McCarthy J.J. - who heard the following three appeals relating to s.108. Individually their impact was even greater than collectively. North P. was President of the Court in the first five of the ten cases which were heard concerning the application of s.108 in the period 1966 - 1976. Turner J. was a member of the Court on six of those occasions. McCarthy J. heard eight of the appeals, being absent from the Court on the fifth and sixth occasions that the section was argued.

The influence of these three Judges, both as a Court and individually, was clearly an integral part of the development of the "glosses" placed by the Courts on the provision:

> " ..... it is in the nature of the judicial process to hedge generality with specific rules, limitations and qualifications. Elmiger itself began that process and it was carried forward in every significant decision up to and including the Gerard decision of the Court of Appeal. The result ..... 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." 1

The approach of the members of the Court of Appeal in Elmiger thus set the scene for the decisions to follow. The Court was faced with a provision cast so wide that the language could reasonably be construed either to be inapplicable to all but a restricted (and unlikely) class of transactions, or to apply to almost all business and family transactions in which tax factors are a significant element. It is thus left to the Court to confine the

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1. L. McKay [1976] NZLJ 238 at 239.

provision within reasonable limits, if it was to find it applicable to all. This process is clearly more suited to the Legislature as it must involve consideration of moral and policy factors. Although in Elmiger the Court could at least turn to the decisions on the equivalent Australian section this in itself involved making some sort of moral judgment as there was ample justification for refusing to consider them at all.[2] By adopting the tests they did, the members of the Court provided convenient guidelines and 'tests' for the later Courts to follow if they chose, and spared them from the clearly distasteful process of deciding openly on subjective moral criteria alone.

The individual judgments in Elmiger thus require consideration, not so much in order to determine the principles enunciated therein, as to find the basis (if any) upon which those principles were selected.

Submissions made for the Appellants

The first ground of appeal was that s.108 operated inter partes and not fiscally, since liability to pay income tax does not arise until an assessment is made by the Commissioner and no agreement can possibly relieve the tax payer of this liability as against the Commissioner.

It was also argued that s.108 applied only to arrangements which affect an accrued liability for income tax. It was submitted that the Australian decisions to which Woodhouse J. referred, and which applied s.260 to avoid arrangements affecting future liability, relied on, or were at least coloured by, limb (c), which uses the word 'avoid'. The words 'relieve' and 'alter' were referable to a later point in time, namely once liability had accrued.

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2. See Turner J. at p.185, McCarthy J. at p.189

A third submission, that s.108 could not apply to bar deductions otherwise allowable under s.111, was abandoned in argument.

(1.04) The Judgment of North P.

The President agreed with Woodhouse J. in dismissing the appellants' arguments. He saw the Privy Council decisions in Newton and Peate as directly applicable and the difference in the wording of the provisions of no importance in the case in issue.

Having summarised the history of the provision, North P. examined the Australian cases of Newton, Hancock v Federal Commissioner 108 CLR 258 and Peate v Federal Commissioner 111 CLR 443 (HCA) in order to discover the interpretation placed by the Courts on the Australian section. He concluded that if the New Zealand provision was to be interpreted in the same way, then the Commissioner had acted correctly. He stated (p.179):

> "I /̄come/̄ unhesitatingly to the conclusion that the appellants adopted this arrangement for the primary purpose or object of avoiding income tax. In my opinion, if I may adopt the words of Kitto J. : 'The arrangement bears ex facie the stamp of tax avoidance.' The facts speak not in a whisper but in a loud and clear voice."

His rejection of the submission that s.108 could only apply inter partes does not deal with the reasoning put forward by counsel, that liability to pay tax does not arise until an assessment is made. The second submission of the appellants was also emphatically rejected. North P. saw the reasoning of Lord Denning in Newton as applicable despite the different words used. Perhaps his real reason for taking this approach appears from this sentence (p.182):

> "In my opinion, to adopt the suggested construction would stultify the section."

If North P. decided to reject the alternative argument simply because to do otherwise would prevent s.108 having its "intended" effect it is submitted he was clearly influenced by his personal view of what the Legislature intended to prevent. One may perhaps point to s.5(j)

Acts Interpretation Act 1924 to show that this approach is sanctioned and indeed required by the Legislature, but Judges have not, in other circumstances, been unwilling to find a construction of a statutory provision which renders the provision of limited or no effect.[1] As Rowlatt J. pointed out in Cape Brandy Syndicate v IRC [1924] IKB 64 at p.71:

> "In a taxing Act one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used."

The conclusion at which North P. arrived may well be the 'proper' one, but the approach he took can be seen as influenced by the sorts of considerations Woodhouse J. expressed in his judgment.

(1.05) Turner J. in Elmiger

Although Turner J. also dismissed the appeal and upheld the Commissioner's assessment, his judgment proceeds on rather different grounds than that of the President. He began by expressing his view that the facts "demonstrate overwhelmingly" that the principal purpose of the arrangement was the deduction from the appellant's income of substantial sums by way of hire for the plant.[1] He then proceeded to consider whether the section was effective to avoid an arrangement having this purpose. He rejected the proposition that s.108 could not apply fiscally on the ground that s.77 imposes liability to pay tax whenever income is derived, and thus before an assessment is made.

As to the second submission of the appellants, Turner J. saw 'relieve' as applying at least to situations

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(1.04) 1. Auckland Medical Aid Trust v A.G. - unreported 24 Sep. 1975

(1.05) 1. at p.183

where a taxpayer enters into an arrangement whose purpose and effect is to reduce the burdens of tax which would otherwise be payable on the income which he actually derives, although he left open the question whether s.108 could apply if the taxpayer actually derived less income and thus less tax.

In contrast to the approach taken by North P. His Honour did not consider the Australian cases because of their reliance on the word 'avoid' appearing in limb (c) of s.260. He did nevertheless adopt the test from Newton[2], widely known as the "ordinary business or family dealing" test and concluded that, applying this test (p.188):

> "I have not the slightest doubt ..... that the transaction under consideration emerges as one contravening the section."

Turner J. was rather more careful to relate his conclusions to what was actually said in the provision, rather than what was intended to be said, but it may be that the test that he adopted, that of determining whether the arrangement is capable of ordinary business or family dealing, requires in itself some application of subjective criteria by the Judge. If the arrangement is to be considered "ordinary" by reference to how often the same arrangement occurs in other dealings of that kind, then Elmiger should have won. The arrangement was widely used at that time - Elmiger was a test case. If, on the other hand, the test is to be applied according to what the Judge sees as "proper" ordinary business or family dealing, moral precepts are then surely applied.

(1.06) McCarthy J. in Elmiger

McCarthy J. began his judgment by dismissing the applicability of the Australian cases, stating that the Court should have strict regard to the facts. He did, however, see the test to be applied to determine the purpose and effect of the arrangement as that enunciated in Newton and also adopted by Turner J. In applying this test he stated (p.189):

"I view what happened here as an obvious

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2. as enunciated by Lord Denning at p.466.

> and deliberate attempt by the appellants
> to rid themselves of the payment of tax."

The use of the words 'obvious' and 'deliberate' suggest that such an arrangement, whether or not legally effective, is at least morally wrong. The section required the Court to ascertain whether the purpose or effect of the arrangement was to in any way alter the incidence of income tax or relieve any person from his liability to pay income tax. The Newton test, which McCarthy J. purported to adopt,[1] provides that such purpose or effect is ascertained by looking at the arrangement itself, irrespective of the motives of the parties. One wonders then why McCarthy J. considered it necessary to label the arrangement as 'obvious' and 'deliberate' unless he was in fact passing some sort of moral judgment on the appellants.

With regard to the appellants' submission that one cannot alter the incidence of income tax before liability to that tax has accrued through assessment, McCarthy J. acknowledged that the argument may have some validity where the income itself is not derived by the taxpayer, but said that in Elmiger's case the argument had no merit as the income was derived by the appellants. His Honour considered the arrangement was invoked once income was derived, and at that point one could truly say the effect of the arrangement was to relieve the appellants from tax they would otherwise have to pay. Thus he implicitly followed Turner J. in holding that liability for tax arises not on assessment but on derivation of income.

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1. at p.188

(1.07) Marx v CIR, Carlson v CIR

Because of the similarities in the issues raised by these two cases, they were, by consent, heard together. It is sufficient to look only at the facts of Marx for the purposes of this discussion.

In discussing Elmiger it was noted that both Turner J. and McCarthy J. expressly reserved the questions as to whether s.108 would apply where, pursuant to the arrangement attacked by the Commissioner, the taxpayer did not derive the income at all. Two years later Marx v CIR, heard before the Chief Justice in the Supreme Court, brought this point directly into issue.

A trust had been created for the benefit of Marx's wife and children, the trustees being a public accountant and a local farmer. By a contemporaneous agreement the taxpayer leased his farm, implements and dairy herd to the trust for two years at a realistic rental and the trustees purported to engage the objector as manager of the farm at a realistic salary.[1] He was also authorised to operate the Trust's bank account. As a result of this arrangement the profit from the farming operations which had previously been included in the taxpayer's assessable income was now derived by the Trust. The taxpayer derived only his salary, the rental for his farm from the trust, and profit from pigs which he ran on his own account. The Commissioner attacked the arrangement under s.108 and declared that by virtue of its provisions the arrangements made between the trustees and the objector were void.

The Chief Justice upheld the Commissioner's assessment on the basis that (p.469):

"No one would regard these arrangements as capable

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1. found by Wild C.J. p.468

> of explanation as ordinary business dealings. Nor would I have thought them capable of explanation as ordinary family dealings."

He considered that even if they were so regarded, the end in view was relief from the taxpayer's liability to pay income tax and thus the arrangements were void. He saw the income as assessable to the taxpayer on the basis that the taxpayer in fact earned the income "by the sweat of his own brow" and once the Commissioner had successfully avoided the arrangements he was entitled to assess the taxpayer (p.473):

> "On the income he would have received if the arrangements coming within s.108 had not been made."

The Appeal was heard by the same Judges who heard Elmiger, and the arguments put forward by Counsel for the appellants bear some resemblance to those put forward in that case. They related primarily to the effectiveness of s.108 to annihilate arrangements which avoid future liability to tax, particularly where the income in question is itself not derived by the taxpayer. It was also contended that if the arrangements were avoided, no taxable situation would arise because all the moneys in question were paid directly into the trust's bank account and never passed through the taxpayer's hands.

From Elmiger it appeared that the Court was not prepared to "stultify the section" and, for this reason at least, decided that it was effective to avoid arrangements which relieved the taxpayer from paying income tax on income actually derived by him. However, as two of the members of the Court of Appeal [2] had clearly limited their consideration to this situation only, Marx provided ample opportunity for the Court to find s.108 ineffective to catch situations where the income itself was not in fact derived by the taxpayer.

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2. Turner J. and McCarthy J., see paras (1.05), (1.06).

(1.08) North P. in Marx

At the outset the President re-iterated his view that the difference in the language of the New Zealand section as compared with the Australian section had no practical significance despite the absence of limbs (c) and (d).

After giving a brief summary of the facts he stated (p.192):

> "In my opinion there is no doubt at all that both these arrangements would have been caught under the Australian section and, likewise, would have been caught under the earlier New Zealand section. I reject out of hand the submission of counsel for the appellants that these arrangements can be regarded as a permissible form of family arrangement."

Presumably North P. was here referring to the Newton test which was adopted in Elmiger and which excepted from the operation of the section those arrangements which were ordinary business or family dealings. As mentioned earlier in this paper, it seems doubtful whether this test can be objectively applied as it depends upon how one determines what is an "ordinary family dealing". In Marx's case evidence was given to show that this type of arrangement was very common in the area in which the appellant lived. If frequency of occurrence does not make an arrangement 'ordinary' it is difficult to see what would. Also, North P. talked of "permissible" family arrangements. Permitted by whom? If this means legally permissible then it would seem that North P. was arguing in circles. In order to determine whether an arrangement is legally effective (that is, whether it survives annihilation by s.108) it must first be determined whether it is legally permissible. If, on the other hand "permissible" means morally acceptable, this is clearly not a judgment that the Court is entitled to make.

With regard to the lengthy and detailed submissions

made on behalf of both the appellant and respondent as to the application and effect of s.108 once a tax avoidance scheme is revealed, North P. stated (p.194):

> "Surely, simply as a matter of common sense it is plain that the arrangements were directed to altering the incidence of income tax for which they otherwise in due course would become liable and consequently resulted in their being relieved from their liability to pay income tax. In my opinion the argument of /counsel for the appellants/ to the contrary involved critical refinements and subtle distinctions which should be avoided and the obvious and popular meaning of the language should be preferred."

By adopting a "common sense" approach North P. considered that it was "but a short step"[1] from the decision in Elmiger to say that the words of s.108 also applied to the case where the taxpayer, by operation of the arrangement, derived neither the income nor liability for tax on that income. Because the money was derived by the appellant's family, whom he would otherwise be required to support out of his own net income, North P. concluded (p.195):

> "..... in my opinion, he is reducing the burden of income tax on what is really in truth his income and thus has not only altered the incidence of income tax, but, has relieved himself of his liability to pay income tax."

The other major obstacle for the Commissioner was the problem of the consequences of annihilation of the arrangements. S.108 clearly did not allow any reconstruction, so that the annihilation would only be effective if it left the income in question in the taxpayer's hands and thus taxable to him. In Elmiger there was no difficulty as the income was in fact derived by the taxpayer, but in Marx, the money never passed through the taxpayer's hands, the profits from the farm were paid straight into the trust's bank account.

North P. was content to adopt the reasoning of

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1. at p.188

the Chief Justice who, by following Peate's case, considered that the Commissioner was entitled to assess the taxpayer on the income he would have derived had the arrangements not been entered into. North P. added (p.197):

> "I think in point of fact it was established that the income in question throughout was under the control of the appellants and to that extent might be said to have passed through their hands."

Accordingly he dismissed the appeals.

It is submitted that here, even more clearly than in Elmiger, North P. determined whether or not the arrangements should be struck down on the basis of whether or not they were morally acceptable. As in Elmiger, his decisions may well be justified in legal terms, but this is not apparent in his judgment. For the reasons that both Turner and McCarthy J.J. gave in Elmiger it was not really acceptable to consider the Australian cases as applicable and thus sufficient authority upon which to decide the present case. Further, if one is to take a "common sense" view and interpret words according to their "popular and obvious meaning" surely one is colouring them with the sorts of moral considerations the Courts try to avoid.

North P. relied heavily on the Australian cases, particularly Peate and Newton, to support his approach. Ignoring for a moment the difference in wording of the two sections, it is interesting to note how the 'moral' determinations made in one case become 'legal' justification for a later one.

(1.09) McCarthy J. in Marx

In Elmiger McCarthy J. expressly reserved his opinion on whether s.108 could apply to arrangements whereby the taxpayer actually derives less income, inferring that he considered such arrangements would probably be outside the ambit of the section. Here he changed his mind, stating (p.218):

"I believe that the discussion regarding the

> different nuances of the time element involved in the verbs 'alter,''relieve' and 'avoid' has clouded the real purpose of the section and obstructed the way in which it must be regarded."

Yet it is because of those very differences in meaning that McCarthy J. excluded consideration of the Australian cases.[1]

As further support for his change of heart, the learned Judge formulated a new approach to interpretation of the section. Instead of looking at the arrangement in question at the time when it was entered into he suggested that the correct approach was to look at the arrangement at the end of the income year and compare the result with what would have happened had the transaction not been entered into.

The difficulty with this approach is that any transaction which resulted in a taxpayer paying less tax would fall within it. Thus McCarthy J. recognised that the Newton predication test would also need to be fulfilled. In relation to this secondary test his Honour stated (p.218):

> "By introducing this later test the Privy Council gave life and reasonableness to the section, and when that is fully appreciated, there is no need, I think, for involved considerations based on individual words in the section."

If, in this statement, McCarthy J. was asserting that by applying the test one no longer needed to have regard to the words of the section, his reasoning would seem questionable. A judicial test, particularly one based on the Australian provision recognised by the learned Judge himself as being materially different from s.108, should not become a replacement for the words of the section.

Having stated his view that the appellants were within

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1. at p.215

the scope of the section, McCarthy J. commented (p.219):

> "Such a reading conforms to what I conceive to be a commonsense view of the section, one which takes into account its nature and its purpose. The tide is running strongly these days in favour of a commonsense as opposed to a purely technical reading of income tax legislation."

If one accepts that it is a judicial role to interpret this legislation, then what 'tide' was McCarthy J. referring to? It seems to be an extreme application of the doctrine of stare decisis to feel bound to follow judicial attitudes as well as decisions.

McCarthy J. continued:

> "It is, I think, unlikely that the Legislature in the midst of a most expensive war would have intended to restrict the operations of the section by confining it to accrued liabilities to tax, and would have intended to release such an obvious way of reducing the impact of tax as we are here concerned with."

With respect, this argument provides no support whatever for the approach of the learned Judge. Firstly in 1916, when the provision was amended to its present form, the sophisticated tax planning techniques which have become prevalent in recent years would not have been in contemplation, as taxation rates were not high enough to provoke them. Thus the Legislature certainly would not have intended to restrict the operations of the section, but they might simply not have anticipated that result.

Further, the Court should not interpret legislation according to the supposed intentions of Parliament. As Lord Wilberforce asserted in Mangin v IRC (p.845):

> "There are suggestions in the Court of Appeal that the truncated section may be construed according to a supposed legislative intention not to weaken a tax position in the middle of a major war. But I cannot accept this as a legitimate method. ..... We must take the section as we find it: If it is weaker than the Australian counterpart, at least it may create less difficult cases."

Having thus determined the effectiveness and applicability

of s.108 McCarthy J. concluded with only brief discussion that the appellants' transactions satisfied his 'predication test' and could thus be avoided. His Honour recognised that reconstruction was necessary in order to make the income taxable to the appellants, however he cited both Peate and Newton as authorities approving (p.221)

> "of the principle of assuming that what was not in fact received, had been."

It is interesting to note how McCarthy J. was prepared to retreat from his attitude in Elmiger, where he recognised that s.108 might not be effective to catch precisely the type of arrangements he found within the ambit of the section in this case.

(1.10) Turner J. in Marx

Turner J's dissenting judgment in this case provides a vivid contrast with those of the other two members of the Court. His dissent related solely to the application of s.108 to arrangements whereby the taxpayer does not derive the income upon which the disputed tax is payable at all. He accepted without discussion that were s.108 identical with the Australian s.260 then the arrangements would be caught and that the Newton 'predication' test was satisfied. However the learned Judge considered that both limbs of the New Zealand section were effective only to catch arrangements whereby the taxpayer actually derives the income though he alters or relieves his liability for tax thereon. Turner J. stated (p.201):

> "..... no duty is cast upon anyone by the statute to derive any specified amount of income, or indeed any income at all; if he choose to derive no income ..... he is in breach of no statutory duty. And, so ordering his life, he will be under no liability to pay income tax."

Turner J. considered in detail the different possible interpretations which could be given to the words of s.108. He divided the types of arrangements which the Commissioner sought to avoid into three main classes. The 'deduction'

cases he saw as clearly within the terms of both limbs of s.108. The 'conversion' cases he expressed no definite opinion on, though he inferred (p.204) that they also would be within the 'relieving' limb of the section. The third class to which His Honour referred are the 'spreading' cases, of which Marx was one. Because in this class the taxpayer does not in fact derive the income Turner J. considered that s.108 was inapplicable and that the Australian cases in this class were decided solely on the 'avoiding' limb of their statute.

Both North P. and McCarthy J. referred to the history of the New Zealand legislation and used their interpretation of it as support for their conclusions. Turner J. found support for his (dissenting) view in his interpretation. He stated (p.208):

> "The history of the sections appears ..... to demonstrate that the Legislature, for reasons to it seeming good, deliberately decided in 1916 to delete from the Act that phase on which alone, up to the date of these appeals, it has proved possible successfully to contend that a transaction can be avoided because by virtue of it a taxpayer fails to derive income which, but for it he might have derived."

It is submitted that this quotation embodies the essential difference in approach of the members of the Court. McCarthy J. found support for his contrary view because he was prepared to deduce a legislative intention from the above facts.[1] So too was North P.[2] On the other hand, Turner J. here recognised that the only intention which one could infer was that arising from the fact that an amendment took place, that it was not for the Court to decide why it occurred.

Having dealt with the issues under consideration, Turner J. went on to give his views on the correct judicial

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1. at p.219.

2. at p.193

approach to the interpretation of revenue statutes. He stated (p.208):

> "I have been brought up in the belief that moral precepts, admirable as they are as a guide to private conduct, have no place in the determination of liability to pay income tax, It may be held morally or ethically wrong, no doubt, to evade or avoid a liability to pay income tax which the statute imposes; but I know of no moral or ethical principle by virtue of which it can be said that every citizen ought to bear his 'proper share' of the burden on tax, or that it is 'wrong' or 'unfair' or 'unjust' to avoid incurring a liability to pay income tax which is not imposed by the statute in the circumstances which in the events occur."

and later, (p.209):

> "To avoid liability for income tax, in a word, is not 'wrong', 'unfair', or 'unethical' per se: it may be morally wrong, unjust or unfair, if, and because it is a breach of the revenue laws, but if it is not a breach of the revenue laws such words as 'unfair,' or 'unjust', cannot properly be used of it."

The learned Judge went on to show the dangers of approaching a revenue statute with a preconceived notion that the avoidance of tax is wrong or unfair. He stated (p.210):

> "This is arguing in a circle, and involves assuming one's conclusion as a commencing proposition ..... These cases cannot be approached by postulating that it is morally wrong to escape payment of tax by transactions the result of which is to minimise or escape liability. The approach must be to see whether such transactions are clearly and unambiguously forbidden by the words of the statute. Where this is so the effect will be to levy tax upon the taxpayer, notwithstanding the transactions - not because he has 'wrongly' or 'unfairly' attempted to escape tax, but because he has done so in breach of the statute."

That Turner J. was moved to make these statements is noteworthy, firstly as a forceful and unequivocal expression of his opinions of the judicial role in statutory interpretation, but more importantly as a reflection of his concern at the approach taken by the other members of the Court.

(1.11) CIR v Mangin

The Court of Appeal delivered judgment in Mangin's case on the same day as the judgment in Marx was delivered. The facts were in many respects very similar, the only material differences being that in Mangin the taxpayer leased only one paddock of his farm to the family trust, and only for one year, so that the following year he could lease another. The proceeds from the sale of the crops grown on the paddock were in each year received by the taxpayer who then accounted for them to the trustees.

In the Supreme Court Wilson J. found in favour of the taxpayer on the basis that the overt acts did not compel the conclusion that they were devised as a means of relieving him from his liability to pay income tax.[1]

In the Court of Appeal this decision was reversed. The arguments relating to the application of the section had been covered by the extensive discussion given by the Court in Marx, thus the only point which was considered was whether Wilson J. was correct in concluding that the arrangement was capable of explanations by reference to ordinary family dealing and thus was not necessarily a means to relieve any person from liability to pay income tax. The important features were that the respondent leased only wheat paddocks, on an annual basis, to the trust and that the trustees were at virtually no risk in accepting the lease. The members of the Court unanimously agreed that this was not an ordinary family dealing. North P. stated (p.234):

> " ..... I find it quite impossible to accept the argument for the respondent that the arrangement was capable of explanation as an ordinary business dealing. No sensible farmer would dream of entering into an arrangement of such a nature. Can it be capable of explanation as an ordinary family dealing? In my opinion it certainly cannot."

Turner J., who reiterated his opinion that s.108 was

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1. /I9707 NZLR 222 at 227.

not apt to catch the transactions for the reasons he gave in Marx, agreed with the Presidents' view of the purpose and effect of the arrangement and concluded, (p.236):

> " ..... that the only proper inference to be drawn from the facts of the arrangement, and of the profits resulting therefrom, is that this scheme was devised for the sole purpose, or at least the principal purpose, of bringing it about that this taxpayer should escape liability on tax for a substantial part of the income which, without it, he would have derived."

(1.12) The Privy Council in Mangin

The respondent then appealed to the Privy Council, providing the Judicial Committee with their first opportunity to consider s.108 and thus reject or approve the approach taken by the Court of Appeal. Although the appeal was dismissed, some of the statements made by Lord Donovan in the majority opinion significantly altered the approach of the New Zealand Courts in the later cases.

At the outset Lord Donovan restated the principle cited by Turner J. in Marx that moral precepts are not applicable to the interpretation of Revenue Statutes. The applicability of the Australian cases was reinforced, as it was stated that (p.839):

> "In the ordinary use of language one 'secures relief from tax' if one 'defeats' it or 'evades' it or 'avoids' it; and their Lordships think that the true reason for the omission of these words from the present s.108 ..... is probably that they were regarded as tautologous. Moreover, to construe s.108 as referring only to liabilities which had already accrued would be to deprive it of almost all effect...."

This was clear support for the approach adopted by North P. and McCarthy J. in Marx. With respect to the tests enunciated by the Court of Appeal as to when s.108 could apply, their Lordships adopted the proposition

stated by Turner J. in Mangin, to become known as the 'sole or principal purpose test.' (p.841)

One of the most important conclusions of the Board concerned the consequences of annihilation. While considering that the case in issue did not give rise to any problems because of the fact that the taxpayer did receive the income in his hands, they noted that in a situation where this did not occur (such as in Marx) the Judges must refuse to fill the gap, as this would amount to unauthorised reconstruction. Thus Lord Donovan stated (p.841):

> "..... strictly the question is not whether the diverted income 'was really in truth his income' but whether s.108 had the effect of making that which was not in truth the appellant's income, but instead that of the trustees, nevertheless, become the appellant's income for the purposes of the 1954 Act."

The Majority opinion of the Judicial Committee thus left the decision of the Court of Appeal in Marx open to question.

The most significant consequence of the Privy Council decision in Mangin was its influence on the approach of the Court of Appeal in the cases which followed. Apart from the annihilation/reconstruction point, their Lordships had simply given support to the conclusions of North P. and McCarthy J. in the Court of Appeal, though they expressly approved of the approach of Turner J. However these formulations and interpretations of s.108 had now become unquestionably 'legal' tests and interepretations, whatever the original reason for their use. For this reason the approach of the Court of Appeal changed. The application and technical effectiveness of the section was now determined and the Judges became increasingly more concerned with examining the taxpayer's purpose.

PART II

POST MANGIN : ORDINARY BUSINESS AND FAMILY DEALING AND THE CONSEQUENCES OF ANNIHILATION

(2.01) Wisheart v CIR : The facts

The next case concerning s.108 to reach the Court of Appeal after the Privy Council decision in Mangin was Wisheart v CIR. The approach of the Court was notably different from that taken in the earlier decisions.

> "In the cases decided in the mid-1960s and up to Mangin in 1970 the New Zealand Commissioner faced one technical argument after another attempting to constrict the scope of the section. After Mangin the contest in the Courts tended to focus on the annihilation consequences of the section and the application of the Newton and Mangin tests in specific fact circumstances, although arguments as to the scope of the section continued to be raised." [1]

In the Supreme Court the case was heard by Wild C.J., who discussed the facts in some detail. (p.435) The important features of the arrangements under attack were as follows: The appellants were solicitors in partnership. One of the appellants and his wife had earlier formed a company, Marlborough Developments Limited, which had never operated. Shares in this company were transferred to family trusts set up for the benefit of the appellants' families. Three separate arrangements were then entered into which the Commissioner considered were void under s.108.

The first arrangement concerned the hire, by Marlborough Developments Limited of two dictating machines from Trafalgar Supplies Limited (a quite separate and independent company). These machines were then rehired by the appellants at an amount slightly higher than that paid by Malborough Developments Limited, thereby creating a profit in the company's hands. The appellants sought to deduct the amounts so paid from their gross income.

The second arrangement involved the resignation of

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1. I.L.M. Richardson 'And now the New Section 108'[1974] NZLJ 560 at 562.

the appellants from an insurance agency which, at their request, was transferred to Marlborough Developments Limited. The appellants continued to do all the work involved in the agency without charge to the company.

Under the third arrangement the appellants assigned to the company the lease of their office premises, sold to it their furniture, library and equipment, and terminated the employment of their staff. Marlborough Developments Limited agreed to supply the appellants with premises, furniture, equipment and staff for an amount which exceeded by fifteen per cent the amounts which the appellants had previously paid for those services.

The taxpayers' contentions were that the arrangements were not within s.108, being capable of explanation by reference to ordinary business or family dealing. In the alternative they argued that even if s.108 did apply, no taxable situation could be found without reconstruction. They also contended that s.108 could not apply to bar deductions otherwise allowed by s.111 - the argument which had been abandoned on appeal in Elmiger, though possibly resurrected in the Court of Appeal's judgments in Europa (No.1)[2]

The Chief Justice found no difficulty in upholding the Commissioner's reassessment. He considered that all three arrangements had as their sole or principal purpose, tax avoidance. In respect of the first two arrangements he stated (p.440):

> "I need waste no words on these. Each was patently a scheme of tax alteration and relief as surprising, when found within the legal profession, as it was bold."

Neither did the Chief Justice find any problem in revealing a taxable situation once the arrangements were annihilated.

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2. Note p.389 per North P., p.430 per McCarthy J.

Applying Peate, he held that the Commissioner was entitled to assess the taxpayers on the basis of what their income would have been had the arrangements not been made.[3]

(2.02) The Court of Appeal and the 'Ordinary Business or Family Dealings Test'

In between the Supreme Court and Court of Appeal decisions in Wisheart the judgment of the Court of Appeal in Europa (No.1) had been given, as had the opinions of the Judicial Committee in both Mangin and Europa (No.1). The effect of the Mangin decision was to put to an end further debate on the technical effectiveness of s.108, affirm the use of the Newton 'predication' test - though with Turner J's 'sole or principal purpose' test as an added criterion - and reopen the question of the consequences of annihilation.

The appellants in Wisheart thus reasserted their argument that their arrangements were referable to ordinary business or family dealing and thereby not within the scope of s.108.

This contention was dismissed in remarkably short and unequivocal fashion by all three of the Judges. North P. considered the arrangement was "patently a scheme of tax alteration." There are two features worthy of comment which appear from the learned President's discussion of this point. Firstly he adopted the words of the Chief Justice,[1] referring to the scheme as being 'as surprising as it was bold when found within the legal profession'.[2] It is not immediately apparent why both of these Judges found it necessary to mention the appellants' profession. It cannot have been because such arrangements are less likely to be found in the legal profession than in any other profession or type of business, as many legal firms have leasing arrangements,

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(2.01) 3. It must be noted that Wild C.J. gave his judgment in Wisheart in June 1969, while the Privy Council opinion in Mangin was not delivered until October 1970.

(2.02) 1. Quoted in para (2.01)

2. at p. 320

often with family companies. The irresistible inference is that both Judges found the arrangement undesirable and especially so because it was entered into by members of their own profession.

This inference is supported by the second feature of note in North P.'s comments on the purposes of the arrangements. As was noted in earlier discussion of his judgment in Elmiger,[3] North P. in that case referred to 'permissible' family dealings. In Wisheart he stated (p.321):

> " ..... I reject out of hand the submission of /counsel for the appellants/ that this arrangement can be regarded as a permissible form of family arrangement."

As was noted earlier, such an alteration of the Newton test cannot be justified by the words of the section, nor can it be justified in the light of the Privy Council's adoption in Mangin of the unadulterated 'ordinary business or family dealings' test. It would appear that North P. took little heed of Turner J's warning, repeated by the Privy Council, that moral precepts have no place in the interpretation of taxing statutes.

Turner J. only briefly mentioned the Newton test, holding that the 'inference is irresistible' (p.330) that the arrangement was entered into so as to avoid tax.

Haslam J's comments, in his first and only judgment in the Court of Appeal on s.108, gave a clear indication of his views. He stated (p.335):

> "It is not surprising that in his discussion of the facts, the learned Chief Justice considered that the guile and persistence of the appellants merited some degree of censure, since their long term objectives were obvious on the face of the whole series of transactions."

His Honour then referred to the comment of Lord Donovan in Mangin, that words in revenue statutes are to be given their plain meaning. That Haslam J. found it necessary to censure the appellants in such outspoken terms is in itself surprising. The learned Judge continued (p.336):

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3. para (1.03)

> "With all the astuteness inherent in this transaction, it cannot be justified as an ordinary business dealing."

One wonders whether Haslam J. considered that 'business dealings' necessarily exhibit a lack of astuteness.

As Lord Wilberforce stated in his (dissenting) opinion in Mangin [4] the problem for the courts, following the formulation of this test, was to decide how 'ordinary' a transaction had to be to escape. The test did nothing to alleviate the problem of subjective determination, as can be seen from the approaches taken by North P. and Haslam J. in Wisheart.

(2.03) The Section 108/Section 111 Relationship.

The appellants argued that a deduction which is allowed by virtue of s.111 could not be attacked under s.108. In the Court of Appeal in Europa (No.1) North P. appeared to accept this proposition (p.389), as did McCarthy J. (p.430). The Judicial Committee did not express an opinion on this issue, and in Wisheart North P. considered that he was free from any binding authority on the point - perhaps overlooking his comments in Europa (No.1). He dismissed the argument without discussion (p.323).

Turner J. distinguished Cecil Brothers Pty Ltd v Federal Commissioner of Taxation (1964) 111 CLR 430 on the basis that the deductions in that case were genuinely made. He stated (p.329):

> "I am of 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."

Thus Turner J. decided that s.108 governed s.111.

This conclusion, it is submitted, was the correct one,

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4. at p.846

inescapable on a reading of the words of both sections.[1] The problem lies with his use of the word 'genuine'. As s.108 clearly operated to avoid 'actual' transactions, he was not using it to distinguish 'sham' arrangements. In Wisheart the deductions were 'genuine' in that, they were paid out, thus the 'genuineness' to which Turner J. was referring must relate to the nature of the arrangement - whether it was a 'proper' one. Presumably a 'sole or principal' purpose of tax avoidance would destroy the 'genuineness' of a deduction.

The conclusion of the Court on this point seems justified, however one wonders why the point could not have been made earlier in Europa (No.1) instead of opening it up for reargument when it had been emphatically dismissed in Elmiger by Woodhouse J.

(2.04) The Consequences of Annihilation

It was here that the effect of the Privy Council's decision in Mangin was most evident. North P. considered that, in view of the comments made in Mangin, what was said in Peate's case amounted to unauthorised reconstruction. With respect to the two deduction arrangements the only problem which arose was that once the arrangements were avoided the appellants lost the right to claim any deductions at all. Turner J. noted this difficulty (p.330) but did not feel bound to decide the point as it was not argued.

The arrangement concerning the insurance agency was more difficult. Even if the appointment of Marlborough Developments Limited to the agency was avoided, this did not restore the agency to the appellants as the Insurance Company was free to cancel and appoint whomsoever they chose. North P. held also that mere proof of physical receipt of the income by the appellants was not sufficient (p.326).

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1. s.111 is expressed to allow deductions 'except as otherwise provided in this Act.'

   s.108 applies to 'every' arrangement having a purpose of tax avoidance.

This was a clear change of position from that taken in Marx and Mangin, and led one commentator to suggest that s.108 would be deprived of all effect on income-splitting arrangements as a result.[1]

Turner J. went further, holding that s.108 could not operate to avoid arrangements to which the taxpayer was not a party (p.327). This limitation does not seem justified by the words of the section, and was not followed by the Court in CIR v Ashton. The reason why Turner J. saw it necessary or desirable to enunciate this qualification is not apparent. He certainly did not need to make it, as the 'unauthorised reconstruction' argument was sufficient to decide this point against the Commissioner.

(2.05) Wisheart - Conclusions

Wisheart's case showed firstly that technical arguments relating to the scope of s.108, although limited by Mangin were not exhausted. Turner J. added fuel to this fire by his new 'legal party' test. It also showed that the crucial problem of determining when s.108 applied was still as subjective a question as before, in which the Judges were inevitably influenced by 'moral precepts.' Finally it showed that the consequences of annihilation had suddenly become a vital issue, on which it seemed, the Courts were prepared to adopt a strict approach.

The reasons why the Judges were prepared to take a strict approach in considering annihilation but not when considering what type of arrangements to which the section applied, are not immediately apparent. It may have been because the 'annihilation' question was a straight forward factual determination for which they had 'legal' authority. On the other hand, although they now had 'legal' support for the Newton/Turner test, this did not really solve the problem, but simply opened up new ones.[1]

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1. D.W. McLauchlan. Section 108 : Further Problems for the Commissioner 5 NZULR 72 at 75

1. see Lord Wilberforce in Mangin (p.846) and earlier para 2.02.

(2.06) McKay v CIR : The facts

The taxpayer was a solicitor and a member of a partnership. In 1963 a new partnership was formed and the taxpayer assigned half of his share of the income of his partnership capital to a family trust which he had just formed. Subsequent to the decision in Johnstone v CIR [1966] NZLR 833, where a similar assignment made by one of the taxpayer's partners was held ineffective, the taxpayer exercised a power of revocation which he had reserved in the deed of assignment.

The partnership was dissolved in 1966 and a new partnership was formed. By a series of contemporaneous transactions the taxpayer lent money to the family trust, interest free and repayable on demand, which the trust on-lent to the partnership at interest of ten per cent.

In 1967, when it appeared that the Commissioner would attack the arrangement, the taxpayer called up his loan and lent the money directly to the partnership, assigning absolutely to the trust the income therefrom.

The case concerned the effectiveness of the second and third transactions.

(2.07) The Application of the 'Purpose' Test

The appellant's principal contention in the Court of Appeal was that the arrangements attacked by the Commissioner were referable to ordinary business or family dealing. No argument was made as to the consequences of annihilation, thus the main question in issue was the application of the Newton/Turner test as approved by the Privy Council in Mangin.

The appellant argued that the overt acts in the impugned transactions were referable to ordinary business or family dealing. Turner P. accepted, with respect to the 1966 transaction, that the dissolution of the partnership, the advances by the partners and the interest of ten per cent to be paid upon those advances, were so referable and thus could not be attacked. However he considered that the fact

that the appellant provided the advance by way of a family trust was not acceptable. He stated (p.597):

> "I cannot find, in the evidence, or in my own experience, or in any submission made by Counsel, any firm ground on which to stand in finding this group of transactions explainable by ordinary business or family dealing, and I think that they speak of income tax so loudly and clearly as to be brought compulsively within the purview of the section."

Once again, no indication is given as to what is required to make a transaction 'ordinary.' The Judge's 'own experience' can hardly be a desirable gauge.

In the Supreme Court Wild C.J. had considered these transactions to be capable of explanation as ordinary business dealing (p.734), but he concluded that they were nevertheless caught by reason of the way in which the transactions were implemented. Turner P. expressly disagreed with this approach (p.597). His Honour saw the background provided by the previous transactions and the actual terms of the later ones as sufficient to bring the transaction within s.108.

It is interesting to consider the 'background' to which Turner P. referred. In 1963 the appellant had assigned to the trust one half of the income which he would derive from the use of his share of the partnership capital. He reserved a power to rescind the assignment, which meant that the arrangement was within the scope of s.105(2)(b). When the Commissioner successfully attacked a similar arrangement made by McKay's partner on the basis that it was an ineffective assignment[1] McKay exercised his power and rescinded the settlement.

Turner P. commented throughout his judgment that the

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1. Johnstone v CIR [1966] NZLR 83

1963 transactions were attacked under s.108, which they clearly were not. He stated (p.602):

> "I am willing to notice, as a relevant fact, that when the Commissioner decided to attack the 1963 transactions under s.108 they were at once rescinded ..."

It would seem that the background which Turner P. saw as giving evidence of a 'persistently recurring' theme of tax avoidance was misunderstood. The 1963 transaction was never attacked by the Commissioner under s.108, nor was the possibility of such an attack the reason for the appellants' rescission of it. Once this background is removed the question arises as to whether the evidence was sufficient to dismiss the contention that the arrangements attacked were ordinary business or family dealing.

The decision in McKay may well be correct. As Speight J. noted, (p.604) the attacked transactions in themselves may not be explicable as ordinary business or family dealing. However the approach of Turner P. detracts from his conclusion. He went out of his way to disagree with the Chief Justice, thus basing his main reason for finding s.108 applicable on the background of the prior transactions. The 'implementation' test of the Chief Justice was fully justified both by precedent[2] and the facts under consideration, and is less open to criticism.

(2.08) Conclusions

The other argument for the appellant was that s.108 could not operate to avoid assignments of income which were not caught by s.105. Turner P. quickly disposed of this argument, - correctly, it is submitted - on the basis that s.105 is not cast in a positive form and thus

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2. In Newton implementation was considered of utmost importance - note Denning's test.

does not 'permit' anything. It is silent as to the assignment of income for more than seven years, thus leaving s.108 to govern those transactions.

A final point of interest in McKay's case concerns the appellant's submission that the 1967 transaction should be allowed because it was an absolute irrevocable gift of income. Turner P. appeared to accept this argument, yet he considered he was unable to decide in the appellant's favour. He stated (p.601):

> "..... A gift of income only, reserving the capital to the assignor, is one which is different in its nature from a gift of capital .....
> At one time I was not so firmly of this opinion; but the correction administered to my former views by the majority of the Judicial Committee in Mangin .....
> is one which I must loyally accept."

Thus the importance of McKay's case in the development of the judicial glosses on s.108 lies in the apparent disapproval of considering 'implementation' to determine the purpose of the transaction, and assertion of the importance of looking at the 'background' to determine that purpose. Such a test, it is submitted, requires an overly subjective consideration. The Judge must himself determine what is the 'background' to be taken into account, and further, what complexion is to be put on it. Turner P. considered this approach justified on the basis that the three transactions were part of an overall tax plan. Yet at any one time only one arrangement was in existence and they were each totally independent. Such an approach can be seen as a serious infringement on the rights of a taxpayer to organise his activities as he likes, so long as he remains within the Act:

> "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 'motive.'" [3]

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3. Hansen 'Family Trusts - Normal Dealing or Tax Avoidance' 5 NZULR 377 at 379.

(2.09) Martin v IRC

This case was heard in the Court of Appeal by McCarthy P., Richmond and White J.J. The facts are set out in detail in McMullin J's judgment in the Supreme Court, [1972] NZLR 340, but do not warrant discussion here.

The appeal was based on one general proposition, that the arrangement attacked by the Commissioner was not effected for the sole or principal purpose of tax avoidance. The Court dismissed the appeal, a result which would appear justified on the facts of the case. However the approach of the Court was suspect. McCarthy P's judgment apparently relied on the motives of the appellant rather than the purpose of the transaction. The learned Judge stated (p.709):

> "It is not surprising, having regard to the features of the evidence which I have just outlined and the plainly unsatisfactory reasons which the appellant gave in evidence ..... that McMullin J. felt unable to accept the appellant's testimony in many important respects ..... I think that credibility was fundamentally involved in the basic conclusions upon which McMullin J's judgment is founded. ..... In my view this Court cannot, in the light of the evidence, upset those conclusions, and in particular that relating to the purpose with which the scheme was undertaken."

This approach is plainly contrary to the formulations of the test thus far propounded by the Courts, which all emphatically reject the possibility of considering the motives of the taxpayer in order to ascertain the purpose of his arrangement. McCarthy J. himself recognised this by adopting in Elmiger and again in Marx, the Newton predication test in order to determine 'purpose.' In Ashton's[1] case McCarthy P. recognised the fallacy inherent in this reasoning, although he was not prepared to accept that the approach he took in Martin was wrong.

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1. for further discussion of this point, see infra, para [2.11]

(2.10) CIR v Gerard - A change of Heart

The facts in Gerard's case bear a close similarity to those of both Marx and Mangin. The arrangements attacked by the Commissioner involved the lease of various paddocks to a family trust, as in Mangin. The taxpayer was employed by the trustees to manage the paddocks, however he was careful not to ever himself receive the income, which was paid directly to the trustees.

In the Court of Appeal the respondent accepted that the arrangement must be seen as a device for avoiding tax by reason of the decisions in Marx and Mangin, thus he restricted his arguments to the consequences of annihilation. This involved two questions : firstly, what steps were to be rendered void, and secondly, what were the consequences of that avoidance.

The first question involved consideration of Turner J's 'legal party' argument. The Commissioner contended that the family trust should be avoided, but the respondent argued that as he was not a party to the deed of trust it could not be set aside. McCarthy P. found it unneccessary to decide the issue, preferring to reserve his opinion for another case (p.282).

McCarthy P. considered that once the arrangements were avoided the trustees were left with the proceeds of the crops. The respondent could be regarded as having a right of action for restitution of the proceeds but could in no way be said to have derived the income and thus was not taxable on it.

The Commissioner contended that in the circumstances a constructive trust could be implied. McCarthy P. rejected this on the basis that it was an equitable remedy and that to find a trust would be unjustifiable legislating.

However, of more relevance is the apparent change of approach

of the Court of Appeal, and notably of McCarthy P. While in Marx and Mangin he was prepared to adopt a "commonsense" approach he appears in Gerard to have completely reversed his stand. The reason he gives for this change of heart is the Privy Council's judgment in Mangin, as interpreted in Wisheart. The consequence of this interpretation seems to be that:

> ".... the - perhaps coincidental - decision on the part of the payers as to whom to send the cheques is decisive when in all other respects the arrangement, its purpose and its implementation are virtually the same." [2]

It is submitted that McCarthy P's change in approach was not completely referable to the precedent of Mangin and Wisheart, but was also influenced by his growing impatience with the failure of the legislature to assist the Courts by remedying the defects which had so often been pointed out. He stated (p.281):

> "The section is notoriously difficult. It cannot be given a literal application, for that would .... result in the avoidance of transactions which were obviously not aimed at by the section. So the Courts 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 our people are to be taxed. As Wilson J. points out, arguments on the application of s.108 are now rarely, if ever, based on the text of the section itself; they are mainly, if not wholly, centred on the glosses placed by the Courts on the text."

It does seem illogical that Gerard's case arrives at a completely opposite result than Marx did, on almost

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2. L. McKay. Section 108 - Yet More Problems for the Commissioner 5 NZULR 383, 387.

identical facts and without any express reference to the inconsistency.

Perhaps McCarthy P. realised that if anything were to be done to alleviate the Courts' problems, the Commissioner would have to fail in his campaign. On the other hand, perhaps the difference in the approach of the respondent was of significance. As noted earlier, the respondent did not attempt to argue that his transactions did not have the required 'purpose.' This meant that the Court was only required to look at the 'legal' questions of annihilation, which did not require the application of the subjective considerations inherent in answering the purpose/effect issue. With the question thus limited perhaps the Court felt 'safer' in using the strict approach to statutory interpretation evident in other cases.

It is submitted that this latter explanation may be closer to the truth, especially when the decision of the same Court in Ashton v CIR, delivered in the next week, is considered.

(2.11) CIR v Ashton

Briefly, the facts were that Ashton and Wheelans were accountants in partnership. They had, as a source of income, an arrangement with some finance companies whereby the accountants received commissions and office charges for organising and overseeing financing arrangements. The arrangement was altered by the respondents so that the commissions and charges became payable to family trusts of the taxpayers. Mr Ashton and a solicitor were trustees for Mr Wheelan's family trust and vice versa. The Commissioner attacked this arrangement.

In the Supreme Court Wilson J. found for the appellants on the basis that the arrangements were referable to ordinary family dealings and were not entered into for the principal purpose of avoiding tax.

The Court of Appeal reversed the judgment of Wilson J. That Judge had determined the dominant purpose of the taxpayers on the basis of the evidence they gave. McCarthy P. held that such evidence was irrelevant, that 'purpose' must be determined by what the transactions effected, without regard to evidence of the taxpayers.

This approach seems contrary to that taken by McCarthy P. in Martin, where he appeared to place great weight on the respondents' testimony.[1] Indeed, in Ashton itself he appeared to have regard to the evidence given by the respondent. He said (p.326):

> "Of more importance, however, is the evidence given by each objector as to the use made of the funds which he received from the relative family trust."

and later,

> "In particular this piece of Mr Wheelans' evidence is of some importance."

In both these instances the learned President relied on

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1. This point is discussed more fully supra, para (2.09)

the evidence to draw an inference adverse to the appellants, as he did in Martin. One wonders then, if the Court is only to have regard to the taxpayer's evidence if it does not believe him, or if it is disadvantageous to him.

McCarthy P. recognised (p.328) that the rearrangement of the partnership activities in itself could be considered 'ordinary,' or at least not 'uncommon in professional experience.' However he stated (p.328):

> "The question we have to decide however is whether it can be predicated from the way the transaction was implemented that it was entered into for the purpose of avoiding tax."

This appears to be exactly the approach of which Turner P. expressly disapproved in McKay.[2] For the Court in Ashton it was the way the transaction was implemented which made it 'highly artificial' and open to attack under s.108, despite the fact that the background gave evidence of a desire on the part of the respondents to provide for their families as a principal purpose. Had Turner P. been a member of the Court in Ashton it may have been that the decision would have been different.

(2.12) The Consequences of Annihilation

Once the Court had decided that the transactions in Ashton fell within the scope of s.108 the question of annihilation had to be dealt with. The first objection raised was the proposition first enunciated by Turner J. in Wisheart,[3] that s.108 could only apply to avoid arrangements to which the taxpayer was a legal party. The Court refused to accept this proposition, stating (p.329):

> "We see no reason to restrict /s.108's/ operation, in cases when documents are involved, to those documents to which the objector is a party. We read it as extending to others, if it be shown that the document was procured by or with the connivance of the taxpayer and as a step in the whole scheme. The reciprocal trust deeds here are within that test - they were the key documents in the tax-avoidance arrangement."

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2. See para (2.07)
3. Discussed supra para (2.04)

This approach may be preferable on a plain reading of the section. However, there would appear to have been a clear majority in the Wisheart Court - if not unanimity - deciding the legal party issue in favour of the taxpayers. Generally the Court of Appeal considers itself bound by its previous decisions. Further, if one considers the attitude the Court was prepared to take nine days earlier in Gerard in refusing to find s.108 effective it seems curious that they did not here again in very similar circumstances, seize upon the chance to show the defects of the section.

Even with the Ashton trust deeds annihilated the Commissioner still faced major difficulties in showing that the income was in fact derived by the respondents. They never received or had the money passing through their hands. Each was trustee, with the solicitor, for the other's family trust. Once the transactions and trusts were avoided there was no basis on which the commissions could be seen as being payable to, or derived by, the taxpayers in that capacity. The situation can be compared with that in Gerard. McCarthy P. considered that the fact that the taxpayer had not received the income himself at any stage was conclusive in his favour.

However, in Ashton the Court came to the opposite conclusion. They were prepared to ignore the fact that not only did each taxpayer receive (as trustee) the money for the other's family trust, but also that the solicitor was named as a payee on the commission cheques. This in itself seems remarkable, but what is far more astounding is the fact that they did so without comment. The first seven pages of the judgment are devoted entirely to a discussion of the facts and the 'purpose' issue. The problem of the annihilation consequences is dealt with in half a page. McCarthy P.

stated (p.329):

> "We come now to the troublesome question of annihilation. The crucial documents in each case here are the deed of trust, the revocation of the old appointment, and the new appointment. If these are eliminated, then for the reasons which we have already given the income received by the two respondents and their solicitor or agent must be treated as having been derived by them and taxable accordingly." (emphasis added)

The striking feature which arises from this statement is that at no earlier stage in his judgment did McCarthy P. refer to annihilation or the consequences which would follow it. For the reasons mentioned earlier the annihilation problem was by no means a straightforward one. In fact, it would seem to have been the strongest point in the respondents' favour. To have dismissed this argument in this fashion is inexplicable, especially in view of the decision the same Court gave in Gerard a few days earlier. McCarthy P. must be taken to have impliedly followed the approach of Peate's, case, which North P. had labelled as 'unauthorised reconstruction' in Wisheart, and which McCarthy P. himself had rejected in Gerard.

(2.13) Conclusions

In looking at Gerard and Ashton together it is difficult to credit that exactly the same Court, dealing with identical issues argued by experienced Counsel, could produce such different results. Certainly, Ashton was argued on two fronts - both applicability and annihilation - whereas Gerard concentrated on annihilation. There is no logical or 'legal' explanation apparent. If there is a 'reason' it must lie with the attitudes of the Judges themselves. That the Judges were unaware of the change - from Gerard to Ashton - is unlikely. If that is accepted, it is remarkable that the attitudes could change in nine days, and in all three Judges. No two section 108 cases provide such a vivid, and legally inexplicable, contrast between approaches taken to the section.

(3.01) The Europa Cases

Discussion of the decisions in Europa (No.1) and Europa (No.2) has been thus far omitted from this paper. This is because the decisions, as far as they relate to s.108, are inconsistent with the developing line of cases, and are even difficult to reconcile with each other. Europa(No.1) was heard in the Court of Appeal after Mangin. All three Judges dismissed s.108 with the minimum of discussion and virtually no attempt to apply the section to the facts of the case. Both North P. (p.389) and McCarthy J. (p.430) expressed doubts as to whether s.108 could apply to bar deductions otherwise allowable under s.111. This argument had been abondoned by counsel for the taxpayer in Elmiger and was subsequently emphatically denied by North P. and Turner J. in Wisheart.[1] Turner J. suggested (p.414) that the incorporation of a company could not be an arrangement and thus avoided by s.108. Yet in Peate's case the Privy Council had avoided a company without any such doubts.

McCarthy J. appeared to dismiss the application of s.108 on the basis that the arrangements did not result in a loss of New Zealand tax and did not have the prescribed effect for that reason. This is overlooking the point that the deductions made by Europa under s.111 could be attacked - they were clearly part of an arrangement 'resulting in a loss of New Zealand tax.'

In Europa (No.2) facts were adduced to show that under the 1964 contracts Europa could have insisted upon a commercial benefit rather than continue Pan Eastern benefit.[2] However, McCarthy P. saw s.108 as still completely inapplicable and he dismissed the issue without discussion.

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1. See supra, para (2.03)
2. Recognised in Europa (No.1) McCarthy J. p.424.

It is certainly curious that the same Court which painstakingly considered the operation of s.108 in Elmiger and Marx could in the Europa cases, dismiss it in such an off-hand and superficial manner. There were many similarities between the Elmiger and the Europa facts, yet the reasoning of the Court in these cases is poles apart.

It would seem that the essential difference lies in the fact that the Europa decisions concerned commercial 'arms-length' transactions and the Court of Appeal could not accept that s.108 could apply to these. It is notable that none of the other cases on s.108 involved 'business' dealings - all concerned family arrangements.

There is nothing in the wording of s.108 which would support the exclusion of commercial arrangements from its ambit. Thus here again the distinction must be found in the attitudes of the Judges themselves. As Lord Upjohn stated in IRC v Brebner [1967] 2 AC 18, 30 that:

> "..... when the question of carrying out a genuine commercial transaction .... is considered, the fact that there are two ways of carrying it out, - one by paying the maximum amount of tax, the other by paying no, or much less tax - it would be quite wrong as a necessary consequence to draw the inference that in adopting the latter course one of the main objects is, for the purposes of the section, avoidance of tax. No commercial man in his senses is going to carry out commercial transactions except upon the footing of paying the smallest amount of tax involved."

This attitude seems to have found favour with our Court of Appeal. Instead of starting with the attitude that the arrangements were 'obvious and deliberate' tax avoiding schemes the Judges saw astute business dealing. Their approach in deciding whether s.108 could then apply was thus from a completely different position.

In this paper it has been suggested that interpretation

of s.108 inevitably involved the Judges applying their own subjective attitudes to tax avoidance. The difference between the approach taken in the cases discussed in this paper and the approach taken in the Europa decisions is a clear example of the effect the judicial attitudes have had.

Conclusion

In considering these ten Court of Appeal decisions involving s.108 it becomes apparent that both the section itself and the decisions made on the section are hard to justify.

There can be lengthy debate as to whether the fault lies with the legislature or with the Courts. Dr I.L.M. Richardson considers that a general anti-avoidance provision such as s.108 is necessary to protect the taxation system. He states (30 NZ Journal of Public Administration 1, 10):

> "/s.108/ is of a ..... general nature and is in my view some recognition of the need in a modern tax system to buttress specific anti-avoidance provisions by a general provision."

It is not the purpose of this paper to decide for or against this argument. Whatever the benefits of a general anti-avoidance section in a tax system, s.108 simply did not provide any of them.

> "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 ..... 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 .... they to a far greater extent than the philosophies of the legislature that represent(ed) our societal standpoint on tax avoidance." [1]

There is no doubt that, as McCarthy P. himself pointed out in Gerard, s.108 simply became non-justiciable. The judgments of the Court of Appeal initially exhibited some enthusiasm in the Judges in grappling with the section,

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1. L. McKay /1976/ NZLJ 238 at 243.

but this turned to frustration. Much of the blame for this can be attributed to the Legislature, for forcing the Courts to attempt to interpret on a legal basis a section which in many respects defied such interpretation. The Commissioner was also at fault in his approach to the section. Elmiger was clearly a test case. It was painstakingly selected from hundreds of other possible tax avoidance schemes as the one most likely to arouse distaste in the Judges and persuade them to invoke s.108. Once such a landmark decision had been given, the Commissioner should have followed with the other cases in rapid succession. The effect of the delays between the cases contributed to the growing frustration and inconsistencies which resulted.

Another culprit in the demise of s.108 was the Privy Council. The Court of Appeal has almost always faithfully attempted to follow the opinions of the Privy Council, and did so with respect to s.108. However, it makes a mockery of the whole judicial system when the Privy Council feels able, as it did in Ashton and Europa (No.2), to disregard the line of New Zealand authorities and even its own earlier opinions.[2]

However, in the writer's opinion, some of the blame must rest with the Judiciary itself. Firstly, although in all but one of the cases the Court of Appeal was unanimous, in only Ashton's case was a single judgment delivered. It is submitted that much of the confusion which resulted from the cases occurred because the differing attitudes of the Judges shone through in their judgments and thus although the conclusions reached were the same, the steps taken were open to different interpretations.

Take Elmiger for example. The Court agreed that the arrangement was caught. If a single judgment had been

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2. for a critical analysis of these two Privy Council decisions see /1976/ NZLJ 33, and 218.

delivered in that case much of the uncertainty and the differences in approach exhibited there and argued in later cases would have been avoided. It has already been commented[3] that the precedent system allows moral judgments in one case become legal tests in another. Perhaps this could have been effective to confine s.108 within defined and certain limits if the Judges themselves had presented, whenever they agreed on a result, a united front.

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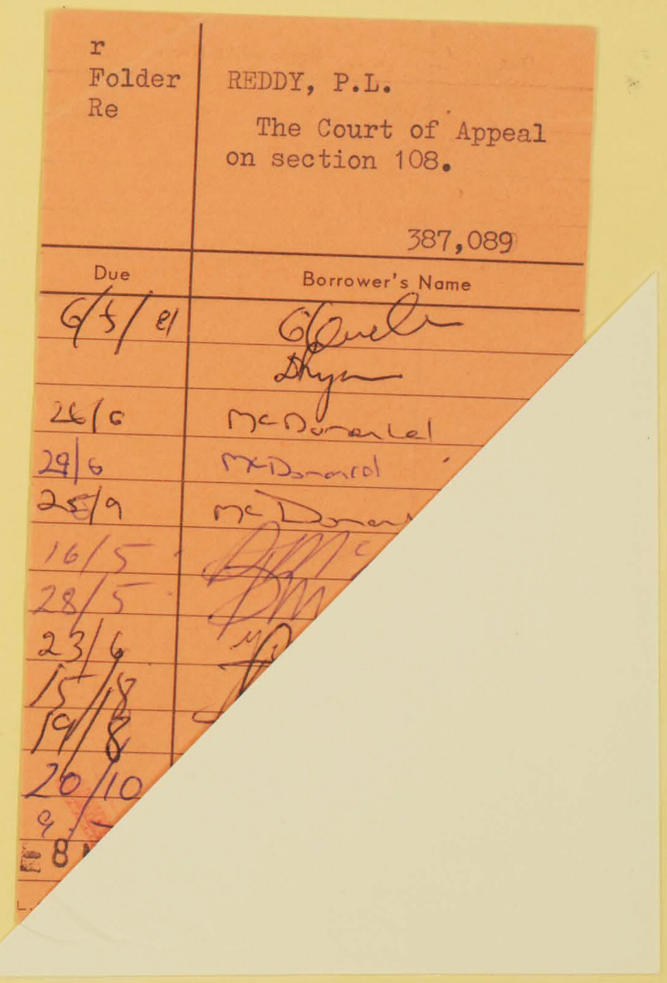
3. supra, para (1.08)



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