COLLECTING TAXES

Geoff Harley*

> Whoever hopes a faultless tax to see, hopes what ne'er was, is not, and ne'er shall be
> - Alexander Pope

I INTRODUCTION

The American country and western singer Willie Nelson has come to know at first hand a lot about collecting taxes. So much so that, in the early 1990s, he entered into a settlement with the IRS to avoid declaring personal bankruptcy. The IRS had attached his property in respect of his investments in what were determined to be abusive tax shelters. He owed US$16.7 million. The sold-up property made hardly a dent. As part of the settlement (apparently less than 50 cents in the dollar) Willie Nelson recorded and marketed a new album, *Who'll Buy My Memories* (*The IRS Tapes*).[1] Of the price of $19.95 the IRS was to receive $3.00 for the back tax liability and another $2.00 on the album's profits.

With all this in mind a sympathetic American law professor referred to one of Nelson's songs, *Mamas Don't Let Your Babies Grow Up to be Cowboys*, in order to write an article about tax lawyers.[2] Professor Caron referred to the description of tax lawyers in popular culture: "tax geeks". A tax lawyer is "a person who is good with numbers but who does not have enough personality to be an accountant" and someone who is familiar with "a mere jumble of tax regulations, to be practiced with a slide rule".[3]

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* Partner, Russell McVeagh, Wellington.

1 Sony Records 1992.

2 Paul Caron "Tax Myopia, Or Mamas Don't Let Your Babies Grow Up to be Tax Lawyers" (1994) 13 Va. Tax Rev 517.

3 Taken from Note 6 of Caron's article. Professor Caron would be less dispirited if he were to read David Maister *True Professionalism: the Courage to Care About Your People, Your Clients and Your Career* (The Free Press, New York, 1997). He describes tax lawyers as the "brain surgeons" of the modern commercial law firm (at 123), which is a description I find very easy to live with:

> Suppose that you are a highly skilled tax practitioner who handles complex, frontier tax problems through creative, innovative thinking (ie you are a Brain Surgeon). A client comes along who wants to get some basic tax forms completed, to ensure compliance with all tax laws. Since this is your client, it's a tax problem - and, since you're a tax provider, it is tempting to conclude that you're the perfect person to help

The title of Caron's article is "Tax Myopia; Or Mamas Don't Let Your Babies Grow Up to be Tax Lawyers". The adapted words to Willie Nelson's song would be:

> Mamas don't let your babies grow up to be [tax lawyers].
> Don't let them pick guitars and drive them old trucks.
> Let them be doctors and lawyers and such.
> Mamas don't let your babies grow up to be [tax lawyers] cause they'll never stay home
> and they're always alone even with someone they love.

Caron goes on to explain the noble role of the tax lawyer in terms which, I confess, I find to be personally most satisfying. He adopts with approval the observations of one of the United States' most prominent tax lawyers, Martin Ginsburg, that:[4]

> Teaching basic tax is, I think, the most fun because it is an enormous challenge.

Learning "basic tax" has been both the "most fun" and it is an "enormous challenge". Let me explain why, mostly with reference to Rt. Hon Sir Ivor Richardson, but with some detours along the way.

II HOW IT IS THAT I BECAME A TAX LAWYER

Picture, if you will, Victoria University of Wellington's Law School in 1971. The subject for first year law students was then called "Legal System". One student at age 17 was me. One thing that I knew about tax law was that I had paid tax on my earnings in holiday employment. I knew that the tax laws were unfair (and so also was the Court of Appeal) because my father had lost his case on the deductibility of interest expense in relation to the farm land he had purchased in Nelson: see *Harley & Williams v CIR*.[5]

In Legal System we were introduced to "statutory interpretation". On that subject we had three different teachers in the space of probably 3-4 weeks. One was the Dean and Professor of Law, Professor Ivor Richardson; another was Professor George Barton. The third was Mr Lindsay McKay.

From the then Professor Richardson we learnt the importance of section 5(j) of the Acts Interpretation Act 1924; that the majority of the Judicial Committee in *Mangin v CIR*[6] ("*Mangin*") was correct to uphold the Commissioner's position, and that Lord Wilberforce's dissent was, regrettably, in error; that the Lord Wilberforce led majority of the Judicial

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> the client. Wrong! As a [b]rain [s]urgeon, you are probably high-priced, and your key talents are creativity and complex problem-solving.

4 "Interview with Martin D Ginsburg" (1992) 12 ABA Sec Tax'n Newsl 6.

5 *Harley & Williams v CIR* [1971] NZLR 482 (CA).

6 *Mangin v CIR* [1971] NZLR 591 (PC).

Committee in *Europa Oil (NZ) Limited v CIR*[7] ("*Europa Oil No 1*") was obviously right, and the minority was, again, in error. It seemed that Lord Wilberforce had promise in some areas of tax law but not in others. From Professor Barton we then learnt that Lord Wilberforce was correct to dissent in *Mangin*, but that his majority judgment in *Europa Oil No 1* was truly flawed.[8]

From Mr McKay (who later became Dean and Professor of Law) we learnt that Professor Richardson and Professor Barton were both wrong. Lord Wilberforce was wrong. Section 5(j) did not really exist. (If it did, only Professor Richardson knew of it. It would never arise in practice. We should just forget about it).[9]

As a result of attending these classes, which definitely were fun, I became both curious and certainly confused. I was rescued from the abyss by Professors Angelo and McLauchlan. I have always been truly grateful to them. It is not that I had already determined upon a career as a tax lawyer because of the obvious injustice in my father's case - I did not vow then to obtain revenge on the Commissioner of Inland Revenue. Some things did eventually sink in about taxes and tax laws: "No other branch of the law touches human activities at so many points".[10]

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7 *Europa Oil (NZ) Limited (No 1) v CIR* [1971] NZLR 641 (PC).

8 Dr Barton had argued *Marx & Carlson v CIR* [1970] NZLR 182 (CA) for the appellant taxpayers. Sir Ivor Richardson appeared for the Crown. Dr Barton had persuaded Sir Alexander Turner to dissent, where the Court's majority upheld the Commissioner's invocation of section 108 of the 1954 Act in the "paddock trust" case. The next case to the Court of Appeal was *Mangin*. In *Mangin*, in his dissent, Lord Wilberforce expressly preferred Turner J's approach in *Marx & Carlson*. Dr Barton went on to appear for the taxpayer in *Europa Oil (NZ) Limited (No 2) v CIR* [1976] 1 NZLR 546 (PC). Again, Sir Ivor Richardson appeared for the Crown. However, the majority of the Privy Council was persuaded by the taxpayer's case to take a different view of the relevant contracts, and so allowed the appeal. Lord Wilberforce was again a member of the Board, and he dissented on the basis that his opinion in *Europa Oil No 1* governed the outcome.

9 Sir Ivor Richardson was to prove Mr McKay wrong about the "purposive" approach and section 5(j). Richardson J effectively disinterred the section in his judgment in *Lowe v CIR* [1981] 1 NZLR 326 (CA). The approach to statutory interpretation of the Income Tax Act was expanded upon in his judgment in *Challenge Corporation Limited v CIR* [1986] 2 NZLR 513, 548-9 and which formed the basis for the Court of Appeal's approach in *CIR v Alcan NZ Ltd* [1994] 3 NZLR 439 (CA).

10 *Dobson v Commissioner* (1943) 320 US 489, 494-5 (SC).

And:[11]

> Taxation . . . is . . . life. If you know the position a person takes on taxes, you can tell their whole philosophy. The tax code, once you get to know it, embodies the essence of life: greed, politics, power, goodness, charity.

By 1974, Sir Ivor Richardson was moving from academic life into practice in a Wellington based commercial law firm. He was acknowledged as New Zealand's expert in tax law. There were at least two other significant events in his life in that year. One occurred in Mauritius: he had advised the Government on a new tax code to be introduced, including how to bring into being a PAYE system for wage and salary earners. The citizens of Mauritius may not have made paying taxes one of their core competencies. The new code had some features which the business community did not like. The proposed 1974 legislation prompted a business revolt, causing an employment "lock out". There was a cartoon in the daily newspaper which showed an American wild-west dressed man, with a gun. The cartoon referred to Sir Ivor's proposed new legislation under the caption "Author wanted, dead or alive".

The other event occurred in the Hunter Building. It involved *Playboy* magazine. As I had always assured my mother, "there are some very good articles" in that magazine. In our LLB Honours tax seminar, taught by Dr Robin Congreve with Sir Ivor Richardson, I produced *Playboy* magazine's interview with Professor Milton Friedman of the University of Chicago. Professor Friedman advanced the case for a single flat rate tax and the removal of all tax preferences. Professor Friedman urged the desirability of forcing legislatures to address the highly distortionate nature of income tax on business income. The seminar paper that I wrote advanced the flat tax thesis. I included the argument for a so-called negative income tax, to replace completely our social welfare system. The argument addressed "welfare" capture and the distortionary effects on behaviour. The paper did not earn applause from some of my fellow students. It nearly caused a riot. In that seminar, some of us gained an understanding of the passion that some people have about taxes, and their acute political nature.[12]

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11 J H Birnbaum and A S Murray *Showdown at Gucci Gulch: Lawmakers, Lobbyists and the Unlikely Triumph of Tax Reform* (Random House, New York, 1987) 289.

12 At that time, I can recall thinking about the so-called "Boston Tea Party" as a precursor to the American Revolution. I had never seen, however, the makings of a riot in a law school class, let alone provoked by what was intended to be a serious discussion about economics and the distortionary effects of differential rate structures. Some of us persisted in our arguments. Dr Congreve and I were, in 1987, part of a panel of private sector advisors on tax policy to the then Minister of Finance, Sir Roger Douglas (Don Brash *Report of the Consultative Committee on Accrual Tax Treatment of Income and Expenditure* (April 1987)). Sir Roger was persuaded to implement a flat income tax regime, announced on 17 December 1987. That announcement led to the split between

With teachers like these I was well on the way to becoming seduced by the subject. Of course, it was not only me who became caught up in the subject at Victoria University. Dr Congreve was one of the early colleagues and students of Sir Ivor. So also were Lindsay McKay and later Richard Green. Their classes and teaching methods were inspiring too. I could not help myself with teachers like these.

III HISTORY LESSON : TAXES AND BEHAVIOUR

In England, William Pitt the Younger introduced a tax on clocks and watches in 1796. The tax was to fund the costs of the war against France. This was one of a number of taxes in that period, during which taxes were also imposed on windows, carriages, game keepers and male servants.[13] The watch or timekeeper tax was an industry disaster. There was a wholesale move of the watch industry to Switzerland. The tax was repealed in 1798 (and replaced by a tax on armorial bearings). The damage to English watchmaking proved permanent. If that lesson had proven unclear, the English did it again with *Rolex* following World War I.

Rolex was founded in London, in 1905, by the 24 year old Wilsdorf. He was a German who became a British citizen after marrying an English bride. It was an era when national borders tended to define men's ambitions. Wilsdorf thought big from the beginning. In 1908, before the term "multinational" was common, Wilsdorf trademarked the word *Rolex*. It was a name that is easily pronounced in different languages and short enough to fit on a watch dial. Wilsdorf apparently dreamed up the word while riding in a London bus, having been inspired by the sound a watch makes as it is wound. *Rolex* did not leave England until after the First World War when an import tax hike of 33 percent was imposed. This was to protect other English manufacturers, often using converted munitions plants, and who were not using imported parts. The Swiss-made movements used by *Rolex* were immediately prohibitively expensive. *Rolex* migrated to Geneva.

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himself and the Prime Minister, Rt. Hon D R Lange, Sir Roger's exit from the Finance ministry and to disarray. Lord Lawson, in his political autobiography "*The View From No. 11; Memoirs of a Tory Radical* (Bantam Press, London, 1992) discusses the "Poll Tax" and its disastrous effects on the Conservative Government, in Chapters 45 and 46. It was initially introduced in Scotland in 1989, and in England and Wales in April 1990 (by which time Lord Lawson had resigned). Lord Lawson comments (at 583) ". . . [N]o new tax can be introduced and sustained that is not broadly acceptable to the majority of the . . . people. The Poll Tax failed this basic test in the most fundamental way imaginable". He goes on to state (at 584) that it ". . . was without doubt Margaret Thatcher's greatest political blunder throughout her eleven years as Prime Minister" and that it played a large part in her demise.

13 See Basil E V Sabine, *A History of Income Tax* (Allen & Unwin, London, 1966) 18-22. There was a tax on female servants from 1785 to 1791. This was repealed by Pitt. It was said that he was "averse to the female sex". Apparently he regarded the presence of females in a household as a liability. Because females were not an asset, they were not a fit object of the taxation power.

Hearth and window taxes provide older, but no less convincing, examples of the distortionary and potentially economically harmful effects of tax policies.

Hearth tax was first levied in England after Charles II was restored to the throne in 1660. By that time, it had been in use on the European continent for some time. The amount of tax payable was based on the number of hearths in a household. Visual inspection from the outside was inaccurate to determine the tax payable. The revenue authorities contracted out assessment and collection of the tax to private collectors, nicknamed "chimney men", who went through taxpayers' homes, room by room. There were various forms of avoidance of the tax. The lady of the house often concealed a hearth or barricaded herself against the front door to prevent entry. Hearth tax was a hated form of revenue collection, partially because it necessitated intrusion into taxpayers' homes. It was finally abolished after the "Glorious Revolution". In repealing the tax Parliament described it as:[14]

> In itself not only a great oppression to the poorer sort, but a badge of slavery upon the whole people, exposing every man's house to be entered into and searched at pleasure by persons unknown to him.

In the wake of the repeal of hearth tax, Parliament introduced a window tax in 1697. Revenue gathered by the tax was intended to be used to defray the expenses of a new royal mint. Window tax was levied proportionately to the number of windows and openings on houses which had more than six windows and whose rental value was more than £5 per annum.

Window tax was intended to be progressive. The rationale behind the tax was that wealthy taxpayers, who lived in larger premises containing more windows, would be taxed more than the poor. One advantage of window tax was that the amount of tax payable was relatively easy to determine. Unlike the hearth tax, window tax could be assessed without the need for tax inspectors to intrude into a taxpayer's private abode.

Because of the continuous increase in the level of tax (it was increased six times between 1747 and 1808), taxpayers resorted to numerous avoidance devices. Many poor and middle-class taxpayers boarded up some (or in some cases, all) of their windows with bricks or timber to avoid paying the tax. It was described by some commentators as a "tax on light" (hence the expression "daylight robbery"). Some taxpayers boarded up windows when tax assessors were in the neighbourhood and opened them when they left.

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14 Preamble to the Act of Parliament; cited in Charles Adams *For Good and Evil: The Impact of Taxes on the Course of Civilisation* (Lanham, Madison, 1993) 252.

Window tax brought out interesting behavioural responses toward tax inspectors too. Apart from showing the elasticity effect of the tax (when window sizes were altered), it also made life a form of "living hell" for tax collectors. Apparently, in the United States, where similar state taxes were levied, tax collectors had boiling water poured on them when they sought to measure the ground floor windows.

Contrast these types of taxes with, for example, New Zealand's pay-as-you earn ("PAYE") taxation regime, used to tax income derived from employment. The PAYE regime has been in place since the 1950s. It applies to income from salary and wages. Tax payable is withheld by the employer for the Commissioner's benefit from employees' wages before they are collected. There are very few exceptions to its application. This now translates into minimal dispute about the application of the regime. There is relatively low avoidance (the size of the "cash economy" and evasion is a different matter, but is also a significant behaviour response).

Historically, the primary area of dispute was in relation to deductions claimed for expenses incurred in producing income from employment. Numerous court decisions in the 1970s provided that such expenses were deductible if the ordinary tests for deductibility were met.[15]

The administrative costs in policing and litigating these and other claims for deductions led to the enactment of section 106(1)(i) of the Income Tax Act 1976. This prohibited deductions for expenses incurred in producing income from employment unless they were deductible under section 105. The effect of the two sections was to confine deductions to items listed in the Fourth Schedule of the Act.

The result was rather perverse. The Schedule itself operated as a prescriptive invitation to wage and salary earners to claim everything they could from the list in the Schedule. In turn, that invitation led to a large increase in the number of cases, sometimes referred to at the time as the "policeman's boots" cases (see *Quin v CIR*[16]). The ability of employees to

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15 In other words, if a sufficient nexus could be shown between the expenses incurred and the employment of the taxpayer. *CIR v Banks* [1978] 2 NZLR 472 (CA) and *CIR v Castle* (1971) 2 ATR 481 (SC) are well known examples of cases where courts have held that expenses incurred in maintaining home offices were deductible. An amusing example of the principle is *Case L64* (1989) 11 NZTC 1,374. The taxpayer was a building contractor who claimed deductions in respect of numerous expenses that he claimed were incurred in producing income from employment. For example, he claimed a deduction for the cost of feeding and maintaining two guard dogs "of German Pointer-Labrador extraction (trained to skin tax inspectors on sight)". Barber DCJ held that there was a sufficient nexus between the expenditure on the guard dogs and the business activity of the taxpayer. However, the Judge refused to hold that the taxpayer could deduct wages and interest paid to his pre-school son and primary school-aged daughter (and see now *R v Gill* (1999) 19 NZTC 15,526 (CA)).

16 *Quin v* CIR (1981) 5 NZTC 61,001 (HC).

claim employment-related deductions was removed completely with the enactment of what is now section BD 2(2)(c) of the Income Tax Act 1994.

PAYE operates now as a very close approximation of (and proxy for) an income tax. PAYE operates almost exclusively on cash flows or when the legislation provides a "deemed" value, and therefore flow, in a calculation base. (Housing accommodation to an employee is an example). Generally the flows between employer and employee are regular, periodically similar in amounts, predictable and easily measured, so much so that, now, PAYE operates as a "final tax" to the point that many people with employment income do not need to file income tax returns at all.

The income tax upon firms in business is quite different. Many firms do not have periodic or predictable cash flows. (A building firm is illustrative. It may have several houses under construction at one time. The firm does not know the price to be achieved on sale, or when any may sell. Two might sell on the same day, and then there could be a "drought" for months). The calculation of both the revenue and cost sides is far more complex. In many instances the calculation on both the revenue and cost sides requires predictions, estimations and valuations by reference to external market benchmarks (the accrual rules; trading stock, being examples). Income tax is an "annual" event. Firms must fit their measurement of revenues and costs to the income year, although both revenue and costs relate to prior periods, or future periods, outside of a particular income year.

Firms also have structural assets (capital). These assets (eg plant and machines) are employed in the production of the goods and services to be sold as stock-in-trade to customers. Firms depreciate such capital assets (within the depreciation regime rules), and expense their costs of production (labour, energy, interest expense, and raw materials as examples).

The firm itself is required to "self-assess" and to pay periodically provisional tax on its estimated annual income (regardless of cash flows for each of the three instalment dates). There is no "agency" as in PAYE, where the employer is the measurement "officer", and collection and payment "agent" for the Commissioner. The firm itself must estimate and pay.

For the purposes of what follows, it is necessary to understand the insecure conceptual foundation for the income tax base itself, as regards business income for a firm, in particular. While an economist will tell you that the tax ought to be imposed on the annual difference in the change in wealth of the taxpayer, whether realised or not, that is not the way income tax is either imposed or the way in which income is actually measured. (There are of course exceptions, such as the accruals regime, and the trading stock regime).

But what is fundamentally important is the historical nature as to how income tax has been developed and why capital gains were excluded. As Professor Ross Parsons put it:[17]

> The income tax is an institution whose policy, beyond the pursuit of revenue, was always obscure, an institution that borrowed a concept - income - from another institution, the trust, so as to spare its makers too much of a drain on their creative imaginations. In borrowing the concept, it left the tasks of definition very largely to the courts, with little to guide them beyond their own definitions already made in relation to trusts. Those definitions were directed to allocating between beneficiaries what, in a literal sense, "came in", in accordance with the actual or presumed intention of the person who created the trust. The definitions were never appropriate to determining in what items the State should share through a tax. A principle of trust law that would direct that in the circumstances an item should be allowed to the remainderman, because this was the presumed intention of the creator of a trust, is a strange basis for a conclusion that the item is not one in which the State should share through a tax.

IV LIFE'S AMBIGUITIES, "IN REALITY" AND GLIMMERS OF SUBSTANCE

The purpose of the examples from history is to make two points. First, taxes induce people consciously and subconsciously to change their behaviour. *Rolex* left England, either not to pay the relevant import tax, or to survive, depending entirely on the perspective of the person describing it. People changed the size of windows to protect their economic interests, or not to pay tax. Tax inspectors got boiling water poured on their heads, because some people do not like tax inspectors. It is not a question of whether one "likes" these kinds of behavioural response - they follow like the night and the day.

It states a simple, obvious, and important further truth to say that there is often a variety of different ways that a person can achieve the same economic outcome. One need only compare the formation of a company, where the company carries on the business, and the formation of a partnership, where the partners carry on the business, to illustrate. We tax a company as a separate entity, and we align that tax treatment of the company with its shareholders by way of the imputation credit regime. A person can borrow money by way of a bank loan. Alternatively, a person can enter into a bill discount facility with a finance company. These are different forms of contract, subject to different laws. For example, a bill facility is governed by the Bills of Exchange Act 1908 and where, at common law, the yield-to-maturity on a bill is not "interest" on a loan. This particular example is discussed in detail in Part VI.

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17 Ross Parsons "Income Taxation - An Institution in Decay" (1986) 3 Aust Tax For 233, 234.

The same points are demonstrated by a large number of tax cases. Either implicitly or explicitly, it is usually the Commissioner's argument that the taxpayer "in reality" achieved its outcome in a way that should be either taxable or the expense not deductible.[18] By having regard to the asserted "reality" rather than the contractual rights actually created, and in operation, the Commissioner seeks to establish a taxable consequence. The cases show that, often, judges are immediately bent to help that outcome (and an important question addressed later is, why?).

An early example involved Mr C Hart agreeing to pay the life assurance company a lump sum of £500, in consideration for the life assurance company agreeing to pay to him an annuity by monthly instalments and a lump sum payment on death. Further, Mr Hart had the option of borrowing from the life assurance company such sums as would not exceed what would be payable on the lump sum when he died; such loans were to be free of interest and were to be repayable on death by set-off against the lump sum payment due under the policy. He exercised that option to borrow. What then is the nature of the amounts that Mr Hart did in fact borrow from the life company? The trial Judge, Macnaghten J in *CIR v Wesleyan and General Assurance Society* ("*Wesleyan Assurance*") stated that: [19]

> A loan which carries no interest and which neither the borrower nor any other person can ever be under any obligation to repay seems almost too good to be true, and Mr Hart hastened to take advantage of that provision in the Bond.

The question in issue in each of the case-law examples, and the argument made for the Commissioner, would probably never arise but for the existence of income tax, and the very different result, depending on how the relevant contracts were construed.

The observation of Macnaghten J is striking; "almost too good to be true". The Judge might have stopped there, as it is not hard to predict that he would hold for the

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18 But not always is it the Commissioner pressing the point. In *Regent Oil Co Ltd v Strick (Inspector of Taxes)* [1966] AC 295, 320 (HL) Mr Borneman QC for the taxpayer said:

> It is said that an interest in land must be a capital asset and therefore that a payment in respect thereof must be a capital payment. But this begs the question unless the form alone of the lease and sublease agreement concludes the matter. The House is invited to put aside mere formalism and to pay regard to the commercial realities of the transaction, which are that this arrangement was merely a vehicle to enable a dealer to obtain rebates. Basically the arrangements which underlie both *Bolam's* and the present case are that rebates or discounts are paid by reference to the gallonage bought by the dealer.

The Lords rejected that approach. See also *AA Finance Ltd v CIR* (1994) 16 NZTC 11,383 (CA).

19 *CIR v Wesleyan and General Assurance Society* (1948) 30 TC 11, 14 (EWHC).

Commissioner. That he did not state the facts as to the relevant legal arrangements correctly, in terms of what the contract provided, and what Mr Hart's obligations were, is the reason his judgment was reversed by the English Court of Appeal (and its decision was affirmed by the House of Lords).

The "instant reaction" of Macnaghten J is common experience for a tax lawyer in arguing a case for a taxpayer in the High Court. To illustrate, consider the judgment of Fisher J in *Wattie & Lawrence v CIR*[20] ("*Wattie*"). In that case, the accounting firm of Coopers & Lybrand negotiated a new lease in a building in Auckland, for six floors, for a 12 year period in 1991. The would-be landlord was in a desperate position, with a 40+ floor building coming to completion, no tenants, and where the economy was in the most serious recession since the Depression period. The tenant exercised all of its market power to extract what it considered to be the most favourable terms. These included free naming rights, "free" hard and soft fit-out contributions, favourable carparking arrangements, favourable rent setting renegotiation clauses, a rent subsidy and, in addition a cash payment of $5 million paid when the lease was entered into. It was as if the firm Coopers & Lybrand had been invited to a smorgasbord, where the partners just took "the lot". The trial Judge, immediately at the commencement of the trial, took the view that the $5 million payment must be "effectively a rent subsidy" on the basis that:[21]

> In short it is the inevitable effect of the contract that matters, not the form or language in which the parties chose to express it.

Lord Greene MR in his judgment in the *Wesleyan Assurance* case said that there are "elementary principles which govern cases of this kind". His Lordship said that it happens frequently that there are different methods by which a person can achieve a particular financial result. Some methods will produce different tax consequences to others. Lord Greene instanced:[22]

> It is sufficient to refer to the quite common case where property is sold for a lump sum payable by instalments. If a piece of property is sold for £1,000 and the purchase price is to be paid in ten instalments of £100 each, no tax is payable. If, on the other hand, the property is sold in consideration of an annuity of £100 a year for ten years, tax is payable. The net result from the financial point of view is precisely the same in each case, but one method of achieving it attracts tax and the other method does not.

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20 *Wattie & Lawrence v CIR* (1996) 17 NZTC 12,712 (HC).

21 *Wattie & Lawrence v CIR*, above, 12, 719.

22 *CIR v Wesleyan and General Assurance Society*, above, 19 (EWCA).

In order to resolve the apparent ambiguity, Lord Greene reinforced the need to focus upon and to determine the true nature of the contractual bargain (and this becomes very familiar language). In doing so, he recognised the need to read and to construe the document itself. The choice of language in the contract cannot itself provide a conclusive answer. The proposition is simple - putting a label on a cat that says "dog" does not make it so. Lord Greene MR described the position by reference to a common form of property interest:[23]

> To take one example, where parties enter into a contract, though they describe it as a licence, but the contract according to its true interpretation creates the relationship of landlord and tenant, the parties can call it a licence as much as they like but it will be a lease. There are other cases in the books in which the parties have described a particular document as a lease when the relationship created by it is that of licensor and licensee. In those cases it is not a lease but a licence.

We all know this to be true. Yet, in tax cases, there is a constant search to transform transactions away from what the parties themselves say, into something which is different.[24]

Turning then to Mr Hart's life policy, Lord Greene MR reasoned that an interest free loan was a perfectly legitimate transaction. Such a loan, being free of interest, did not make it any the less a loan. The money advanced was recoverable only out of a named asset, upon the death of Mr Hart. Taking the Crown's argument, Lord Greene accepted the proposition that the life company's actuarial method which determined the various sums arrived at contemplated that Mr Hart would always exercise the borrowing right (it did

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23 *CIR v Wesleyan and General Assurance Society,* above, 19.

24 Curiously, Fisher J in *Wattie* used a very similar example to make exactly the opposite point. His Honour there said (1996) 17 NZTC 12,712, 12,720-12,721:

> Could it then make any difference if the lessor's payment is made in the form of a lump sum at the commencement of the lease rather than periodical payments during its term? I do not think so. At least in the financial world, lump sums and the right to a series of smaller payments over a defined period are inherently substitutable. The latter may be commuted to a lump sum by discounting the sum of the payments by the anticipated investment advantage of accelerated payment. A lump sum can always be used to purchase an annuity of equivalent value. The financial market provides a ready means for converting one into the other.
>
> For those reasons tax laws do not normally distinguish between lump sum payments and recurrent ones unless there are special reasons for doing so.

not make financial sense for him to do otherwise). Nevertheless, the contract provided that the benefit was by way of election:[25]

> Then Mr Jenkins [for the Crown] said that the contract was really of this nature. The Appellants, he said, were really contracting to pay at death what must be regarded as deferred payment of an annuity built up month by month, but not payable at death.

The Court of Appeal rejected that too, saying:[26]

> It seems to me quite inaccurate to refer to the sum which the company covenanted to pay at the death of the assured as a series or collection of monthly sums. ….
>
> The object of the argument, of course, was to get the character of a collection of monthly sums imprinted upon the sum payable at death in order then to say that, when the assured borrows a monthly sum against that, he is merely getting the prepayment of what, in its essence, is a monthly sum, and that stamps it with the character of an annuity. ….
>
> It seems to me to be re-writing this contract to be placing upon the legal relationship created by it something quite different to what the language imports.

Why did the argument arise at all? Lord Greene MR addressed that question saying:[27]

> Why the legal relationship which the parties have in terms created of lender and borrower in respect of those sums should not be given effect to, I fail to understand, unless it be that, by giving effect to what the parties have said, the transaction would avoid tax. I cannot think myself that, if it had not been for the existence of the Income Tax Acts, anyone would have dreamt of suggesting that this contract means anything else than what it sets forth. It is because, if effect is given to it according to its terms, tax will be avoided that the argument has come into existence. …

Another example involved a person contracted by his or her employer for a period of five years to "front" a television advertising campaign. The contract of employment provided for increasing levels of annual salary, depending upon the success and expected run-on effects of the campaign. By year three, after the campaign had enjoyed spectacular success, the business itself suffered a serious reversal. This necessitated a complete change in the way it promoted itself. The company could have agreed with the employee to pay out the contract for the remaining two years in a lump sum. Alternatively, the company could have agreed with the employee that the amount that would otherwise be due under the contract if it continued to term would be paid out, with an additional sum, but only on

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25 *CIR v Wesleyan and General Assurance Society,* above, 19.

26 *CIR v Wesleyan and General Assurance Society,* above, 21.

27 *CIR v Wesleyan and General Assurance Society,* above, 19.

condition that the person did not carry out any advertising work for any other employer in New Zealand. It is all a question of what the contract actually provides for.

The Court often cannot help itself when considering these questions. For example, in *CIR v Fraser*[28] the Court of Appeal put the proposition this way:[29]

> … [Counsel for the taxpayer submitted that] the assessment contained no assertion that the documents were a sham; that, therefore, the transactions must be characterised in accordance with the true nature of the agreements, there being no half-way house … and that the Commissioner is accordingly not entitled to put Mr Fraser to proof of the nature of the payments. In other words, the Commissioner, having failed to impeach the nature of the payments, must accept them for what they are stated to be, namely inducement and restraint of trade payments, **and cannot allege that they are not capital payments**. (emphasis added)

The Court went on to reject that argument. That is not very surprising, but it was not the argument that was being made. The Commissioner was perfectly free to, and did in fact, argue that the payments were not capital payments. No one said he could not make that argument, even if it was hopeless. What the correspondence showed was that he was arguing that the inducement and restraint of trade payments were not capital *because they were derived from an employment relationship*. The Commissioner not only failed to impeach the terms "inducement" and "restraint of trade" used in the contracts, but also he used those very terms in his correspondence to say why they should be treated as assessable income. The whole basis for the assessment was referenced to Mr Fraser's asserted employment (and where, on the facts, he was never employed by the Bank). It was the Court itself that was testing the true nature of the contracts and "helping" the Commissioner to make the argument.

V SIR IVOR RICHARDSON AND THE DUKE OF WESTMINSTER*: "ECONOMIC EQUIVALENCE" AND* EUROPA OIL

By the lights of some, His Grace the Duke of Westminster has an awful lot to answer for.[30] Lord Templeman continues to show his displeasure at the Duke's continuing influence in tax cases.[31] The Rt Hon Justice Thomas would not be far behind Lord Templeman, although Thomas J probably reserved his primary displeasure for Lord Hoffmann.[32]

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28 *CIR v Fraser* (1996) 17 NZTC 12,607 (CA).

29 *CIR v Fraser,* above, 12,610.

30 *IRC v His Grace the Duke of Westminster* [1936] AC 1 (HL).

31 See Lord Templeman's article "Tax and the Taxpayer" (2001) 117 LQR 575.

32 See Thomas J dissenting in *CIR v BNZ Investments Limited* (2001) 20 NZTC 17,103 (CA).

The Duke of Westminster entered into a deed with his gardener, Mr Frank Allman. The Duke covenanted to pay the gardener in his employment a sum of £1 18s per week for a period of seven years or during the joint lives of the parties. It was a term of the covenant that the payments were without prejudice to the remuneration that the gardener should be entitled to for the services he rendered. The Duke's solicitors wrote a letter to the gardener which said:

> There is nothing in the deed to prevent your being entitled to and claiming for remuneration for such further work as you may do, though it is expected that in practice you will be content with the provision which is legally made for you for so long as the deed takes effect with the addition of such sum, if any, as may be necessary to bring the total periodical payment while you are still in the Duke's service up to the amount of the salary or wages which you have lately been receiving.

The question was whether the Duke could deduct for tax purposes the annual payments. The Commissioners contended that the payments were non-deductible remuneration for services to the gardener. The House of Lords accepted that the purpose of the deed was to create "a device by which the respondent [The Most Honourable Hugh Richard Arthur Duke of Westminster, DSO] might avoid some of the burden of surtax". By a majority, the House of Lords upheld the Duke's position that the sums were not payments of salary or wages. He was entitled accordingly to deduct them as "annual payments". Lord Atkin dissented. The leading speech was delivered by Lord Tomlin where he said (accepting Sir Wilfred Greene's submission as Counsel for the Duke), in a passage now famous:[33]

> It is said that in revenue cases there is a doctrine that the Court may ignore the legal position and regard what is called "the substance of the matter", and that here the substance of the matter is that the annuitant was serving the Duke for something equal to his former salary or wages, and that therefore, while he is so serving, the annuity must be treated as salary or wages. This supposed doctrine (upon which the Commissioners apparently acted) seems to rest for its support upon a misunderstanding of language used in some of the earlier cases. The sooner this misunderstanding is dispelled, and the supposed doctrine given its quietus, the better it will be for all concerned, for the doctrine seems to involve substituting "the incertain and crooked cord of discretion" for "the golden and streight metwand of the law". Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.

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33 *IRC v Duke of Westminster* [1936] AC 1, 19 (HL).

> This so called doctrine of "the substance" seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable.

Sir Ivor Richardson appeared with the Solicitor General for the Crown in its appeal to the Privy Council against a unanimous Court of Appeal judgment in *Europa Oil No 1*. This was a "transfer price" case where the Commissioner was attacking the ability of Europa Oil to deduct the full costs of its imported petroleum products.

Europa Oil was in a strong bargaining position with its supplier, Gulf Oil. Mr Todd for Europa was determined to obtain some kind of price concession to reflect Europa's appetite for petroleum, of which Gulf had a relative surplus, as distinct from diesel. Gulf would not offer any price discount, apparently because it was considered likely that other purchasers would seek the same benefit.

In order to meet Europa's strong bargaining position, Gulf agreed to set up a contractual arrangement to share some of its refining profit with Europa. This was done by the incorporation of a company, called Pan Eastern, in the Bahamas, a tax haven. Contracts were entered into between the parties so that Pan Eastern "notionally" refined some of the relevant product. Pan Eastern made a predetermined profit. Europa, through a wholly-owned subsidiary called AMP, owned half of the shares in Pan Eastern. AMP was able to access the predetermined level of Pan Eastern's profit by way of inter-company tax exempt dividend on its shareholding.

The Commissioner's basis of attack was that Europa was to receive the "Pan Eastern" benefit as a collateral tax exempt return of part of the purchase price that Europa sought to deduct. The collateral return was contracted and was economically a form of price concession. The argument for the Commissioner was based, first, on the deductions section with reference to Europa's asserted price paid for its trading stock. The Commissioner sought to reduce the full price deduction by apportionment reducing the compound consideration paid by reference to the Pan Eastern benefit received tax exempt by AMP. The second argument, in the alternative, was to allege that the arrangements were "tax avoidance" within the meaning of what was then section 108 of the Land and Income Tax Act 1954 (and which is irrelevant for present purposes).

Lord Wilberforce's majority judgment in favour of the Commissioner is instructive, not particularly because of who won, but because of the close focus it has on the language used in argument before the Judicial Committee.

The Pan Eastern company was described as having a "notional" business and that its earnings resulted from "paper transactions"; it was a "mere repository".[34] It was a fact that Pan Eastern did not refine anything - it had no assets, or employees who were capable of doing anything. The Commissioner's case was put in different ways. It was said that the Pan Eastern benefit was "in effect discounts off the purchase price" or "equivalent to a discount". Alternatively, it was said that the price actually paid was in part incurred for the purpose of producing "a return to Europa through Pan Eastern". The taxpayer's argument was that all it purchased was petroleum products at a price and that there was no discount obtainable. Accordingly, the Pan Eastern benefit was said to be a "purely collateral benefit" which attracted its own tax incidence according to its character, as an exempt inter-company dividend.

Lord Wilberforce considered the words "paper transactions" (reflecting the nature of the arrangements between Gulf and Pan Eastern) by themselves were a generally reasonable description. However, they were "largely irrelevant" and "too imprecise to solve the problem".[35] The arrangements were not a sham and so could not be disregarded; they did in fact represent a genuine commercial operation so that Europa could obtain a share in the refining profits. Nor would Lord Wilberforce accept as accurate the Commissioner's description of the benefit as "in substance a discount or more ambiguously, as a price concession". Lord Wilberforce regarded that language, and the approach implicit in it, as inviting the court to disregard the separate corporate entities, and the legal form in which the price concession was embodied. This was contrary to the principle laid down in the *Duke of Westminster* case. Disregarding the nature of the contracts made and their effect was prohibited: "Taxation by end result, or by economic equivalence, is not what the section achieves".[36]

VI SIR IVOR RICHARDSON'S CRAFT AS A JUDGE IN THE COURT OF APPEAL - IN RE SECURITIBANK LTD (NO 2)*; AND THE OTHER "COMMERCIAL" CASES*

Shortly after Richardson J was appointed a Judge in the Court of Appeal, two differently comprised courts heard appeals in 1978 in *Re Securitibank Ltd (No 2)*[37] ("*Re Securitibank*") and *Buckley & Young Ltd v CIR*[38] ("*Buckley & Young*"). Richardson J delivered the judgment for the Court in *Buckley & Young* on the same day as judgment was given in

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34 *Europa Oil (NZ) Limited v CIR* [1971] NZLR 641, 647 (PC).

35 *Europa Oil (NZ) Limited v CIR*, above.

36 *Europa Oil (NZ) Limited v CIR*, above, 649.

37 *Re Securitibank Ltd (No 2)* [1978] 2 NZLR 136 (CA).

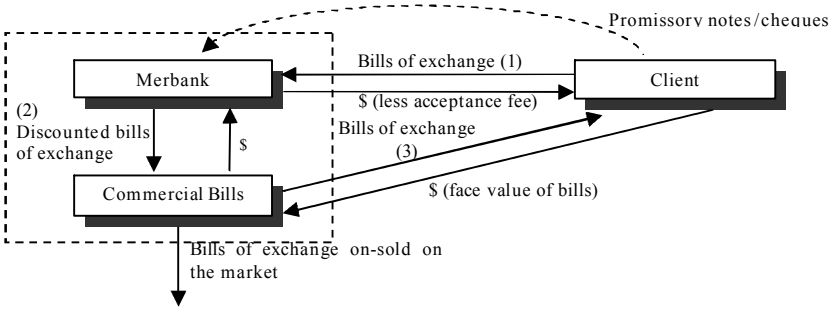
38 *Buckley & Young Ltd v CIR* [1978] 2 NZLR 485 (CA).

Re Securitibank. The judgments in both cases refer to a number of the same authorities, including *Europa Oil* and *Wesleyan Assurance*. Neither decision refers to the other.

I regard the judgment given by Richardson J in *Re Securitibank* as one of the most important His Honour has delivered in the Court. It reflects foundations that have been repeated in his subsequent judgments. The Court itself has referred to it in numerous other decisions that have followed. The decision reflects a strong adherence to precedent and also a strong appreciation of the economic costs of uncertainty in law, as it affects commercial life.

Securitibank in the mid 1970s was a prominent merchant bank, providing finance outside of what was then a highly regulated trading bank system. Clients sought alternative forms of finance for land development and commercial property projects. The clients sought finance by drawing bills of exchange. The bills of exchange were accepted by Merbank, which was a Securitibank group company, for an acceptance fee. The client bill was then discounted by Merbank to Commercial Bills, also a group company of Securitibank. The funds so produced were paid to the clients; some of the client bills were on-sold on market to members of the investing public.

The client entered into an "acceptance credit facility". The client was required to cover the acceptance of the bills by handing to Merbank a post-dated cheque for an amount that would cover the bills. The client would have to pay default interest if Merbank was not reimbursed at maturity. If a client needed term finance, the bills would be "rolled over" on maturity. New bills would be drawn, accepted and discounted on the same day as the old bills matured. The face value of the new bills would include the face value of the old, plus a further amount covering the discount to maturity on the new bill, and further acceptance fees.



Cashflows:
(1) Client draws bills of exchange. Merbank accepts bills and charges client an acceptance fee.
(2) Merbank discounts bills of exchange and sells them to Commercial Bills. Commercial Bills pays dollars to client via Merbank as agent.
(3) (On maturity date:) Commercial Bills redeems bills of exchange. Client pays Commercial Bills dollars equal to face value. (Note rollover option at maturity of bills; if seeking long-term finance)

Securitibank went into liquidation. Its liquidator sought directions from the Court as to the legality of the bill acceptance facilities, and whether they were unlawful, as regards the application of the Moneylenders Act 1908. The question was whether the client bills constituted loan transactions in contravention of that Act. In considering that issue, along with the other two Judges, Richardson J noted that financing could be arranged in various different ways, of which "the lending of money is only one". It was therefore insufficient to say that the bill acceptance facilities were to be characterised as transactions involved in "the raising of money". The "label" of "financing transaction" did not help to advance the argument. The Judge went on to say that the essence of a money lending transaction is that there is a payment of a sum of money on condition that at a future time an equivalent amount would be repaid.[39] Accordingly, it was necessary to focus directly on the nature of the payment made to the drawer of the client bill in respect of the discounting of that bill.

Taking that approach and looking at the contractual arrangements, the payment made to the drawer of the client bill, upon its discount, was a payment made by Commercial Bills. The client's obligation under its accommodation facility was to Merbank. There was no direct flow of funds between Commercial Bills and the client or between Merbank and the client. Accordingly, the argument in favour of the money lending contention could only succeed on the basis that:[40]

> The separate corporate status of each company in this respect had to be disregarded and Commercial Bills recognised as the alter ego of Merbank.

Harking back to the *Duke of Westminster* and to the decision in *Europa Oil No 1*, the Judge reminded himself of the need to have regard to the legal arrangements actually entered into and carried out and to eschew the "overall economic consequences to the parties". On that basis, Richardson J went on to state:[41]

> While then it is legitimate to take into account surrounding circumstances and to look at the documents as a whole, the documents themselves may be brushed aside only if and to the extent that the parties had a common intention that they were not to create the legal rights and obligations which they gave the appearance of creating and in that sense were shams. Finally, the concern is with the legal arrangements actually carried out. It is what the parties eventually did that counts, not what they may initially have agreed to do.

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39 *Re Securitibank Ltd (No 2),* above, 167.

40 *Re Securitibank Ltd (No 2)*, above.

41 *Re Securitibank Ltd (No 2)*, above, 168.

Having stated that principle, and in agreement with the other two Judges (Richmond P and Woodhouse J), Richardson J expressed his disagreement with the trial Judge, saying:[42]

> I consider there is no half-way house in this class of case where, as Barker J expressed it, there is "a situation where the documents indeed record the intention of the parties but which are considered by the Court not to express the pith and substance of the transaction". It is a matter of first ascertaining the true nature of the transaction by a consideration of the legal character of the agreement which embodies the transaction. It is only where the genuineness of the agreement evidenced by the documents is challenged that it is then necessary to consider whether the substance of the transaction as represented by the documents is not the true substance of the transaction and the documents themselves are a cloak to conceal its true nature.

This is the "no half way house" rule.

The learned Judge's analysis then turns to the submissions made to the Court for the respondent. The argument was that the payments to the drawers of the bills were in form in respect of the sale of the bills and, in that sense, constituted discounting transactions. But, as they were part of the overall arrangements for financing the client developers, it was said that they had to be regarded as loan transactions. In support, counsel argued that what "really happened" was that the Securitibank group paid money to the client who had approached the group for financial assistance in consideration for a promise by the client to repay the money, plus an amount deducted for costs and the capitalised interest at the conclusion of the agreed term.

The argument required the Court to disregard the separate legal existence of both Commercial Bills and Merbank. Consistently with the judgments of Richmond P and Woodhouse J, Richardson J would have none of that because:[43]

> … on the facts of this case there is no practical justification for declining to recognise the separate legal existence of parent company and subsidiaries reflected in the Companies Act 1955. There is no suggestion that there was any element of fraud, or sham, or breach of public policy in the establishment and operation of the separate companies, Commercial Bills, Merbank and Securitibank or, for that matter, the other companies in the Securitibank group. It is not argued that one was acting as agent for the other. It is not even as if each performed the same functions and it was a matter of indifference to the group whether a particular transaction was channelled through one company or another. On the contrary, each had its

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42 *Re Securitibank Ltd (No 2)*, above.

43 *Re Securitibank Ltd (No 2),* above, 171.

> own role and function. There was a deliberate and careful segregation of functions and in their inter-company transactions there was a strict accounting among those three companies.

The Judge went on to explain why, in his opinion, it was so important to accept the separate entity theory, on which the *Salomon* doctrine rests (*Salomon v Salomon & Co Ltd*,[44] and as applied by the Privy Council in the New Zealand case of *Lee v Lee's Air Farming*[45]).[46] Richardson J described the common commercial practice where diverse activities are conducted through subsidiary companies. His Honour explained that this could occur by deliberate policy decision or as a result of an acquisition of existing companies. He rejected the assertion that the separate companies were "simply vehicles" by which the Securitibank group achieved its commercial purposes. That was the case for "all participation in limited companies". It was therefore not possible to say that the bills were simply "machinery" any more than it was possible to say the same of a company. Accordingly:[47]

> ... there is no principle of law which allows deeming the parties to have entered into a legal arrangement of one character when they entered into and intended to enter into a transaction of a different character.

The conclusion was reinforced by what Richardson J considered to be a very important general consideration. He said:[48]

> One is that the approach contended for would, I believe, create undesirable uncertainty as to the application of our law. Commercial men are surely entitled to order their affairs to achieve the legal and lawful results which they intend. If they deliberately enter into a genuine commercial transaction intended to operate according to its tenor, what they ask of the law is the assurance, the certainty that their intentions will be recognised. Take the present case. On

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44 *Salomon v Salomon & Co Ltd* [1897] AC 22 (HL).

45 *Lee v Lee's Air Farming* [1961] AC 12 (PC).

46 The importance of recognising a company as a person, separate from its shareholders, has long been recognised in taxation matters. As Lord Sumner said in *Gas Lighting Improvement Co v IRC* [1923] AC 723, 740 (HL):

> . . . the business carried on is the business of that company, and the capital employed is its capital and not in either case the business or the capital of the shareholders. Assuming, of course, that the company is duly formed and is not a sham (of which there is no suggestion here), the idea that it is mere machinery for effecting the purpose of the shareholders is a layman's fallacy. It is a figure of speech, which cannot alter the legal aspect of the facts.

47 *Re Securitibank Ltd (No 2)* [1978] 2 NZLR 136, 172 (CA).

48 *Re Securitibank Ltd (No 2),* above, 173.

> the argument presented for the respondent, the discounting of these commercial bills would be moneylending if discounted by Commercial Bills, but sale if discounted by Security Discounters Ltd. It would be extraordinary if the decision made by the drawer of the bill as to with whom to discount it, determined the character of the transaction. Again, it was acknowledged that the approach contended for might lead to transactions involving the acceptance and discounting of client bills by associated companies of other merchant banks being characterised as moneylending. Yet this is a feature of the New Zealand commercial bills scene. And, leaving aside consideration of the protection given to holders in due course, it would create great uncertainty in the commercial world if the negotiation of bills identical in form could have a different legal character depending on whether or not the acceptance house and the discount house were associated in some way.

Over the years since *Re Securitibank* was decided, the Court of Appeal has returned to these issues on a number of different occasions, often outside of the taxation context.

In *Marac Finance Ltd v Virtue,*[49] the finance company entered into a conditional purchase agreement to provide finance to Virtue so that he could purchase a truck. The truck was stolen and later found burnt out; no insurance was recoverable. Marac sued. The contention was that the financing, in form a "conditional purchase agreement", was in law a money lending transaction; the Court of Appeal in agreement with the High Court held that on an analysis of the documents and what had occurred between Marac and the respondent there was a sham in result. Because Marac had not provided the requisite memorandum, the contract was unlawful. The question was whether the Court should provide relief to Marac. For the reasons given the finance company succeeded.

In *Mills v Dowdall*,[50] there was a marriage dispute. The husband's father sold 350 shares in a family company to the husband for $700. On the same day the father executed a deed for forgiveness of the whole debt. The husband's mother sold a house property to the husband for $47,500 and which was secured by a mortgage back. On the same day the debt was reduced by $4,000 by way of gift and there was a further gift about two years later. The Commissioner had treated the express consideration as inadequate and conveyance duty on higher values was paid. In the matrimonial property dispute, the issue was whether both items were excluded from the Act because they had been acquired by the husband "by gift from a third person". The Court held that both items had been purchased by the husband pursuant to binding financial obligations. In respect of each item, the gift had been of a monetary sum by way of forgiveness of the relevant debt, and

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49 *Marac Finance Ltd v Virtue* [1981] 1 NZLR 586 (CA).

50 *Mills v Dowdall* [1983] NZLR 154 (CA).

not of either the shares or the land. Both the shares and the land were matrimonial property accordingly.

Presiding, Sir Robin Cooke considered that the position concerning the shares was "a little less clear cut" (because of the same day release of the debt which arose from the sale). That Judge reasoned that if there was a prior arrangement giving rise to such an immediate forgiveness he did not think that "the Court would have to shut its eyes to reality". He considered that the two elements in the transaction could be seen to be so linked that they were to be treated as "inseparable" and cited *W T Ramsay Ltd v IRC* (**"***Ramsay*")[51] in support.[52] It seems clear from the judgment of Richardson J that he did not agree with that approach.[53]

Two other cases with a (non-tax) commercial flavour should be mentioned. In *NZI Bank Ltd v Euro-National Corporation Ltd*,[54] the issue was unlawful financial assistance proscribed by section 62 of the Companies Act. Euro-National faced a host of financial difficulties. One of its executive directors, who owned 10% of the shares and options for more, also had financial difficulties. He owed money to NZI and to DFC. To avoid the likely effect on share values if those lenders sought to dispose of the shares owned by the director, a scheme of "extraordinary complexity" was devised involving an employee unit trust. Some $3.2 million was paid in such a way that Euro-National gave financial assistance in connection with the contemplated acquisition of some of its own shares.

The trial Judge had stigmatised the arrangements as "a studied manipulation". The directors were "merely executing a series of documents" in an arrangement that was never bona fide, never directed to the aims … but concocted to evade the clear dictate of Parliament and which was "merely a contrivance" and a "cynical construct which had no reality".[55] The Judge said that it would be:[56]

> … an affront to commonsense and logic for the Court to accept the contention … I refuse to be the "Queen of Hearts" and allow words to mean whatever financial and legal advisers suggest they mean.

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51 *WT Ramsay Ltd v Inland Revenue Commissioners* [1982] AC 300 (HL).

52 *Mills v Dowdall* , above 160.

53 *Mills v Dowdall,* above.

54 *NZI Bank Ltd v Euro-National Corporation Ltd* [1992] 3 NZLR 528 (CA).

55 The findings of Robertson J are summarised in Richardson J's judgment: *NZI Bank Ltd v Euro-National Corporation Ltd,* above, 539.

56 *NZI Bank Ltd v Euro-National Corporation Ltd*, above, 533.

Richardson J condemned that approach. It was agreed that there was no sham. Richardson J went on in particular to state there was no basis for taking a different approach to ascertaining the true nature of a commercial transaction or to construing commercial legislation, in the context of section 62 of the Companies Act.[57] Nevertheless, the Judge's conclusion of breach of section 62 was upheld.

Attorney-General v Equiticorp Industries Group Ltd (In Statutory Management)[58] is also a section 62 case. The issue concerned the use of so-called "shelf companies" within the Equiticorp group of companies to purchase particular shareholdings. The argument for the Crown was that two separate contracts should be treated as one transaction, albeit that they involved different parties. This was in an attempt to limit the potential liability in damages by offsetting the value of assets in one contractual relationship against the loss which would arise in respect of the other contractual relationship. McKay J delivered the judgment for the Court presided over by Richardson J, and rejected the argument in emphatic terms:[59]

> Even if one were to accept the proposition that the two contracts were interrelated in the sense that one would not have been entered into without the other, this would not enable them to be regarded as a single transaction. The position is quite different where two documents, neither of which would be entered into without the other, are made between the same parties at the same time. In such a case the true intention of the parties must be ascertained from construction of the documents to ascertain whether there is one contract or two. If the documents show that separate contracts were intended, they will take effect accordingly. Here the parties are different, and the Crown accepts that they are separate contracts. It says they are interrelated, and are part of one transaction. That may be true, if one uses the word "transaction" in its wider sense, but it does not enable the Court to ignore their separate nature.
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> The essence of the argument is that a Court of Equity will ignore such matters in order to do justice. A Court of Equity will certainly look at the true nature of a transaction, and will not be deterred by a sham. There is no principle of equity, however, that empowers the Court to ignore the true nature of a transaction and substitute some other concept. To appeal to "justice" as a reason for such an approach is to a justice which is in the eye of the beholder, is unstructured and unprincipled, and is unreliable. The true principle is that stated by Richardson J in *NZI Bank Ltd v Euro-National Corporation Ltd*.

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57 *NZI Bank Ltd v Euro-National Corporation Ltd,* above, 539.

58 *Attorney-General v Equiticorp Industries Group Ltd (In Statutory Management)* [1996] 1 NZLR 528 (CA).

59 *Attorney-General v Equiticorp Industries Group Ltd (In Statutory Management)*, above, 537-538.

VII THE "NO HALF WAY HOUSE RULE" IN THE TAX CASES

Buckley & Young[60] is a sham case in the income tax context. The parties documented the basis on which a retiring managing director would leave the company. He was to continue to receive remuneration payments until age 60 "as a tax consultant to the company at a salary of $6,000 per annum". The Deed went on to record that the person covenanted that he would not engage in any kind of business in competition with the company. The Commissioner assessed on the basis that the payments styled as "remuneration" were, in fact, in consideration for the non-deductible restraint of trade covenants.

Payments in restraint of trade (being to protect goodwill) are at the far extreme of capital, on normal principles.[61] The Court referred to the trial Judge's finding that the "tax consultant" appointment was "illusory" and "concomitant misdescription", or simply a "veneer" as counsel for the company preferred. It was never intended that he would provide such services and putting the label "salary" over the payments was to create a sham. The payments were properly regarded as being made in restraint of trade.[62]

For the Court, Richardson J's judgment, on the approach to analysis, to determine the "true nature of the legal arrangements", rests upon the *Duke of Westminster*, *Wesleyan Assurance* and the *Europa Oil* cases.

Over the years, in tax cases the Court has returned repeatedly to the same theme - the issue being the correct approach to the analysis of contracts or documents. In *CIR v Smythe*,[63] the issue was whether Sir Reginald Smythe had received a "bonus, gratuity or retiring allowance" on his retirement, subject to 95% concessionary relief, when he received a lump sum in lieu of long service leave to which he was entitled but had not taken. The Commissioner's argument was that the payment was "salary" in respect of the long-term service. To answer the rival contentions, for the Court Sir Ivor Richardson stated the correct approach:[64]

> The first step in deciding the character in law of the lump sum payment in question is to determine the true nature of the legal arrangements pursuant to which the payment was made. It is that legal character of the transaction which is decisive - not the overall economic consequences to the parties, and not the legal consequences of an alternative transaction into

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60 *Buckley & Young Ltd v CIR* [1978] 2 NZLR 485 (CA).

61 See *CIR v L D Nathan & Co Ltd* [1972] NZLR 209 (CA) North P.

62 *Buckley & Young Ltd v CIR,* above, 495-496.

63 *CIR v Smythe* (1981) 5 NZTC 61,038 (CA).

64 *CIR v Smythe,* above, 61,040.

> which the taxpayer could have entered but chose not to do so. The true nature of the transaction can only be ascertained by careful consideration of the legal arrangements actually entered into and carried out. That requires consideration of the contract as a whole having regard to the surrounding circumstances. It is not necessarily determined by the nomenclature used by the parties.

By this time, it seems that the passage was part of the Judge's word-processor lexicon.

In *Marac Life Assurance Limited v CIR*[65] ("*Marac Life*"), the primary issue was whether so-called "Marac Life Bonds" were policies of life assurance, for the purposes of the Life Insurance Act 1908. If they were, the second question was whether the endowment amount (less the single lump sum premium paid) paid upon whether death or maturity and which included a guaranteed return, was "interest" under the relevant definition of the Income Tax Act 1976.[66]

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65 *Marac Life Assurance Limited v CIR* [1986] 1 NZLR 694 (CA).

66 The other issue was the so-called "Hansard Rule". The "interest" and "money lent" definitions were introduced by then Minister of Finance Sir Robert Muldoon in 1983. The Commissioner of Inland Revenue simultaneously prepared and published with Sir Robert's Budget a "Technical Policy Circular". This provided an extensive commentary on the legislation in bill form. It contained worked examples as to how it was to apply. The Minister referred to this document in his introductory speech to Parliament.

In the High Court, Ongley J held for the Commissioner: (1985) 9 TRNZ 201. That Judge took what he considered to be a literal language application. Intervening during submissions for the taxpayer, which made extensive reference to *Hansard* and the legislative policy materials, His Honour ruled that such references were improper. Moreover, said Ongley J, even if he were to have regard to such materials, the "Molesworth St Team" (being the Court of Appeal) would never accept such references as being legitimate.

On appeal, the Court consisted of Cooke, Richardson, McMullin, Somers and Casey JJ. As Ongley J had presciently observed, the *Hansard* based submission ran into immediate hostility on presentation. Cooke J, as the presiding Judge, simply would not allow the submission to be presented at all. His Honour's interventions with senior Counsel, Dr GP Barton, were unfortunate. When the *Hansard* submission followed, the atmosphere deteriorated further. However, there were two matters "going for the taxpayer" as it were. First, the submissions were in considerable detail, and were handed in. While the presiding Judge would not allow oral submissions, it was thought that curiosity might prevail. The hope was that the other Judges might read it all. Second, Counsel were aware that *Hansard* lined the corridors of the Judges' Chambers. It was always an open question as to why, if it were not permissible to read it!

As the Court of Appeal's five separate judgments show, this controversy in the Court itself was, in result, a non-event. No Judge refers to Cooke J's refusal to allow the submission. Sir Robin Cooke made extensive reference to the material, including the Minister of Finance's Budget speech in his own judgment (at 701):

> > It is noteworthy that the inference arising from the statutes themselves is confirmed by the Financial Statement presented by the Minister of Finance in the House of

The difference between the single premium and the guaranteed bonus payable upon death or maturity was called a "bonus". The "bonus" amount payable was calculated at percentage rates per annum. They were 8% for a one year bond, 9% for a two year bond; 10% for three, four and five year bonds and so on. The Commissioner argued that, by reference to Marac's advertising material in particular, the investment aspect overshadowed the life insurance content, so as to take the bonds outside of the normally understood concept of life insurance. This yield content was made even though, if the bond holder died at any time, including one day later, the full amount was immediately payable. Richardson J put the Commissioner's argument:[67]

> The next step is to determine whether all or any of the bonds in question are policies of life or endowment assurance for the purposes of the three statutes. [Counsel for the Commissioner] accepted that they all contained some elements of life or endowment assurance and that they were not shams. His submission was that they should nevertheless be regarded as essentially a contract for the investment of moneys with the added life insurance component being insufficient to justify labelling the contract as a policy of life insurance.
>
> The principal question must be whether the transaction is properly characterised as a contract of life insurance (or endowment insurance), not whether the expected or guaranteed return makes it a good investment if the investor survives to maturity when the return is compared with straight lending transactions. Investors are free to enter into whatever lawful financial arrangements will suit their purposes. They cannot be treated as having entered into a different arrangement which would or might have achieved somewhat similar economic advantages and whether or not they ever had that alternative in contemplation.

Responding to that, Richardson J restated the now familiar approach required of the Court to the "true nature of the transaction". His Honour rejected any "broad substance" or appeal to "overall economic consequences". He said:[68]

> But at common law there is no halfway house between sham and characterisation of the transaction according to the true nature of the legal arrangements actually entered into and carried out.

> Representatives on 28 July 1983 in moving the second reading of the Appropriation Bill. This, in the 1983 Budget, was referred to in argument before us by counsel on both sides, each claiming support from it. A governmental statement in the House could not be allowed to alter the meaning of an Act of Parliament in plain conflict with it; but in my view it would be unduly technical to ignore such an aid as supporting a provisional interpretation of the words of the Act, or as helping to identify the mischief aimed at or to clarify some ambiguity in the Act.

67 *Marac Life Assurance Limited v CIR*, above, 705.

68 *Marac Life Assurance Limited v CIR*, above, 706.

> All this is elementary and for recent discussions in this Court it is sufficient to refer to *Re Securitibank Ltd (No. 2)*, *Buckley & Young Ltd v Commissioner of Inland Revenue*, and *Marac Finance Ltd v Virtue*. I mention it only because at one point in his argument [Counsel for the Commissioner] seemed to suggest that a single non-severable contract could not be characterised as life insurance if on a wider assessment the Court concluded that the bonds were primarily designed and entered into as an investment but one containing an incidental insurance content.

Plainly established: there is "no half-way house" in tax cases or anything else. Again, the Court has restated this in several other tax cases: *CIR v McKenzies (NZ) Limited*[69] ("*McKenzies*"), *AA Finance Ltd v CIR*[70] and *Finnigan v CIR*.[71]

Notwithstanding the orthodoxy of the approach it was rejected by Thomas J shortly after his appointment to the Court of Appeal in August 1995.

In *Wattie*, the trial Judge, Fisher J, had upheld the Commissioner's approach to the $5 million inducement payment. The Judge had held that it was the "inevitable effect" of the contract which determined that outcome, and not what the contract itself provided for. His Honour had earlier described the way the documents were prepared as giving rise to the potential for fraud.[72] There was never any suggestion of that in the case in any of the evidence. The Judge simply made the observations on his own volition. The comment is revealing, however, of an attitude, a predisposition of suspicion and distaste for the way the bargain was negotiated and documented.

The majority of the Court of Appeal reversed that judgment; the opinion was delivered by Blanchard J and was joined by Richardson P; Gault, and Henry JJ.[73] The Court held that

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69 *CIR v McKenzies (NZ) Limited* [1988] 2 NZLR 736 (CA).

70 *AA Finance Ltd v CIR* (1994) 16 NZTC 11,383 (CA).

71 *Finnigan v CIR* (1995) 17 NZTC 12,170 (CA).

72 *Wattie & Lawrence v CIR* (1996) 17 NZTC 12,712, 12,715 Fisher J:

> The collateral agreement contained enough in the way of "inducements" to return the effective rental to actual market rates. These inducements could take a number of forms - lump sum cash payments, rent-free holidays, the underwriting of part of the leased space, rental subsidies, a contribution to the lessee's hard and/or soft fit-out, assistance with the lessee's relocation costs or the underwriting of the lessee's commitment in respect of existing leased premises. By keeping the existence and content of the collateral agreement confidential, the developers could delude financiers, investors and valuers into believing that the consideration provided by lessees, and hence the value of the building as a whole, was higher than it really was. No one seems to have thought of the possibility that in some circumstances this could have amounted to fraud.

73 *Wattie v CIR* (1997) 18 NZTC 13,297 (CA).

such an economic equivalence approach was prohibited, and was contrary to authority on negative premiums paid on the grant of a lease by a landlord to a tenant, in particular *Regent Oil Co Ltd v Strick* ("*Regent Oil*").[74]

The dissent of Thomas J is a curious mix. It is open to criticism on a number of different grounds. One is appropriate in the present context:[75]

> With due respect, I regard Counsel's argument [for the appellant taxpayers] as sophistic and am critical that it was proffered for the purpose of seeking to persuade members of this Court to conclude that the learned Judge adopted the wrong approach.

The Judge also criticised the four Judge majority of the Court for accepting it. The Commissioner did not contend that the division of the payments was a sham (namely the explicit rental subsidy; and the $5 million being separately stated as an "inducement"). Thomas J accepted that they were therefore genuine, but:[76]

> The fact it is not alleged the parties set out to devise an arrangement designed to convert income into capital, however, does not mean that the "sham or genuine, no halfway house" rule should take hold. The rule cannot withstand scrutiny. Transactions may be genuine but nevertheless contravene recognised doctrines such as, for example, the rule that the nomenclature used by the parties is not decisive in determining the legal rights and duties which were actually created by them. See *Marac Life Assurance* . . .

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74 *Regent Oil Co Ltd v Strick* [1966] AC 295 (HL).

75 *Wattie,* above, 13,314 (CA). The earlier discussion of Macnaghten J's approach in *Wesleyan Assurance* noted that the Judge did not correctly state the facts. When making the "almost too good to be true" remark, the Judge recorded that Mr Hart's loans against the policy did not have to be repaid. Of course, that was wrong - the loan amounts were repayable from the policy amount when Mr Hart died.

Likewise with Thomas J in *Wattie* when discussing the $5 million lease premium, paid by the landlord to the firm of Coopers & Lybrand. When discussing it in his dissent in *BNZ Investments* the Judge claimed (at 17,120-17-121):

> … the premium was commercially, financially and mathematically linked to the rental payments due from the lessee under the lease. Consequently, while the legal form of the payment was a premium, the payment was in substance a rental subsidy. **As no consideration moved from the lessee, the notion of a "negative premium" has subsequently been widely perceived as a contradiction in terms and essentially untenable**. **[**emphasis added**]**

The assertion that "no consideration moved from the lessee" is astonishing - and wrong. The firm entered into a 12 year non-assignable lease in a building which was empty at the time. It gave up its tenancy in another building, and its rights of renewal. Of course the firm as lessee gave consideration for the payment (and other benefits its received).

76 *Wattie,* above, 13,311 (CA).

And, His Honour continued:

> Nor need the fact the Commissioner has not alleged a sham in this case blind the Court to the ease with which the present arrangement could be utilised by other lessors and lessees to reduce the latter's assessable income. There is an obvious attraction in receiving a substantial inducement payment which can be treated as a non-taxable capital gain, and paying an inflated rent which then can be claimed in full as a deductible operating expense . . .

Two points can be made. First, if what the parties have done is genuine, and if their chosen form of expression accurately states what they meant, that is the end of the matter. *Marac Life* (along with *Re Securitibank*) is squarely authority for the proposition that there is "no half way house". Yet His Honour states that the rule "cannot withstand scrutiny". The second point is that the learned Judge revealed his "true colours" by referring to the tax avoidance potential. The Commissioner never suggested that he could rely on section 99 of the Income Tax Act 1976 to attack the arrangement. The evidence was that the firm considered the payment would be taxable.

Thomas J criticised the majority's reasoning, because the Court accepted that the approach to construction taken by the trial Judge was economic equivalence, and was contrary to authority, including *Regent Oil* and *McKenzies*. His Honour claimed that Lord Wilberforce's majority judgment in *Europa Oil* supported his view and, further, that his Lordship's speech in *Regent Oil* did too.

In *Regent Oil*,[77] the landlord (Regent Oil) paid a sum to the tenant as an inducement to enter into restrictive trade tie covenants. The Lords held that the payment was non-deductible to Regent Oil. Lord Wilberforce explicitly rejected any appeal to "commercial reality". One passage of his Lordship's speech directly confronted and contradicted Thomas J's approach, as both the Court of Appeal majority and Lord Nolan for the Privy Council in the *Wattie* appeal pointed out.[78] In that appeal, the argument made for the taxpayers, criticised by Thomas J as "sophistic", was described by Lord Nolan as "the crux of the matter" in favour of the taxpayers.[79]

On the record, then, in *Wattie* it is clear that Thomas J's views were in error. The learned Judge would not leave it at that. The Privy Council's judgment in *Wattie* was delivered in October 1998. The Court of Appeal gave judgment in November 1998 in

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77 *Regent Oil Co Ltd v Strick (Inspector of Taxes)* [1966] AC 295 (HL).

78 *CIR v Wattie* [1999] 1 NZLR 529 (PC).

79 *CIR v Wattie*, above, 537 (PC).

Peters v Rt Hon Sir Ronald Davison (No 3).[80] Thomas J, in a separate concurring judgment, said:[81]

> To my mind, the most significant of the alleged errors of law relate to the Commissioner's apparent misconception of the doctrine of form over substance. The Commissioner appears to have adopted an extreme version of the doctrine which, however prevalent it might be among tax advisers, is not supported by decisions of this Court.
>
> . . ..
>
> Rather, I believe he was adverting to what can happen in practice with the over-zealous application of the doctrine of form over substance by various corporate taxpayers and their advisers. The Commissioner [Sir Ronald Davison] was perhaps, not so much directing his remarks to the doctrine itself as at the culture it has spawned in certain sections of the community and the specialist tax advice industry which has grown up dedicated to extreme literalism and formalism in the application of the doctrine.
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> . . ..
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> The rationale for having regard to the substance of a transaction is simple enough. The objective of the Income Tax Act is to collect tax on income. Income is derived from the substance of a transaction, not its form. It is therefore necessary to have regard to the substance of a transaction and not just the form in which it is fabricated to determine the true income and the tax which is payable on that income. For either the tax authorities or the Court to do otherwise is to thwart the objective of the Act.

There seems to be something of a message here about taxpayers and their advisors and matters being "fabricated".

In the next case which raised the issue, *Auckland Harbour Board v CIR*[82] ("*Auckland Harbour Board*"), Thomas J (again dissenting) continued in the same vein. His Honour expressly referred to *Wattie* in the Privy Council and effectively refused to accept any correction of his views.[83]

Consistently, the Judge maintained the same approach in his (again dissenting) judgment in *Colonial Mutual Life Assurance Society Ltd v CIR*[84] ("*Colonial Mutual*"). Both

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80 *Peters v Rt Hon Sir Ronald Davison (No 3)* (1988) 18 NZTC 14,027 (CA).

81 *Peters v Rt Hon Sir Ronald Davison (No 3),* above, 14,027-14,028.

82 *Auckland Harbour Board v CIR* (1999) 19 NZTC 15,433 (CA).

83 *Auckland Harbour Board,* above, see particularly paras 94-96.

84 *Colonial Mutual Life Assurance Society Ltd v CIR* (2000) 19 NZTC 15,614 (CA).

Auckland Harbour Board and *Colonial Mutual* were appealed by the Commissioner to the Privy Council. In *Auckland Harbour Board,* the judgment for the Judicial Committee was given by Lord Hoffmann;[85] in *Colonial Mutual* it was given by Lord Nicholls (Lord Hoffmann being a member of the Board).[86] In both cases, the Privy Council upheld the majority of the Court of Appeal, the lead judgment for the Court in each being given by Richardson P.

The Court of Appeal gave judgment in *CIR v BNZ Investments Limited*[87] ("*BNZ Investments*") in May 2001, four months after the Privy Council gave judgment in *Auckland Harbour Board*. Thomas J's dissent in *BNZ Investments* contained a by now familiar theme. Indeed, His Honour criticised the approach taken by their Lordships in the following terms:[88]

> I do not doubt that the Privy Council's approach to tax cases has cost this country inestimable millions of dollars in tax revenue. See *Auckland Harbour Board v CIR*, supra, para [95]. The formalism of that approach has provided a fecund breeding ground for dubious schemes to avoid tax. The glosses, concepts, distinctions and doctrines are exploited and have created a commercial environment in New Zealand in which tax avoidance has been a significant feature.

Thomas J again justifies his preference for a "substance" approach, and his rejection of the proposition that such an approach would create untenable commercial lack of certainty in business affairs. The Judge then acknowledges that his approach is irreconcilable with *Wattie* (the Judge explains why, in his view, the Privy Council was wrong), and with the decision of the House of Lords in *Macniven v Westmoreland Investments Ltd*[89] ("*Westmoreland*"). In that case, a unanimous Appeals Committee rejected the Commissioner's appeal, which relied on the so-called "fiscal nullity" concept, when considering the meaning of the word "payment". Lord Hoffmann's speech is a "substantial tour" of the earlier decisions of the House of Lords, commencing with *Ramsay*. The leading speech in *Ramsay* was given by Lord Wilberforce, and where he described the basis of decision in the *Duke of Westminster* as being a "cardinal principle"[90] (and which is consistent with his treatment of it in *Europa Oil No 1*).

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85 *CIR v Auckland Harbour Board* [2001] 3 NZLR 289 (PC).

86 *CIR v Colonial Mutual Life Assurance Society Ltd* (2002) 20 NZTC 17,440 (PC).

87 *CIR v BNZ Investments Limited* [2002] 1 NZLR 471, para 70 (CA).

88 *BNZ Investments,* above, 471 para 70.

89 *Macniven v Westmoreland Investments Limited* [2001] 2 WLR 377 (HL).

90 *WT Ramsay Ltd v IRC* [1982] AC 300, 323 (HL).

Thomas J when discussing Lord Hoffmann's speech in *Westmoreland* expresses his admiration for its "intellectual acuity". His Honour then asserts that Lord Hoffmann's attempt at reconciliation "teeters on the brink of casuistry".[91] That His Honour completely disagrees with it becomes clear enough when he refers back to *Wattie*.[92] In his speech in *Westmoreland*, Lord Hoffmann refers to the example given by Lord Greene in the *Wesleyan Assurance* case as to the inherent substitutability of a £1,000 price, payable in 10 annual instalments of £100 each, or by way of an annuity. Lord Hoffman then instances *Wattie* as another example where a commercial transaction can be structured so as to produce either a capital or an income result, depending on method, and where the court has no power to "recharacterise" (Lord Hoffmann was a member of the Board in *Wattie*).[93]

What is curious about the discussion of *Westmoreland* is that Thomas J in *BNZ Investments* does not consider the facts of the case, and where in New Zealand the Commissioner would have had resort to the general anti-avoidance provision, section BG 1 of the 1994 Act. It is strongly arguable, having regard to that section, that the transaction in *Westmoreland* would not have survived such an attack. However, when referring to whether or not such an general anti-avoidance provision is undesirable, because of the inherent uncertainty created by it, the Judge expressly refers to Lord Templeman's judgment for the majority of the Privy Council in *Challenge Corporation Limited v CIR*[94] ("*Challenge*").

In the *Challenge* case, the Privy Council reversed the majority judgments of Cooke and Richardson JJ (Sir Owen Woodhouse P, dissenting). The essence of the reasoning of those two Judges in the case was that, because of the existence of a detailed, prescriptive and specific anti-avoidance provision, it was clear from the scheme of the act itself that an outright and permanent transfer of shares by way of sale, without "strings" could not be susceptible to attack by the general anti-avoidance provision. The reason for that was that such an attack would contradict and undermine the prescription created by the specific anti-avoidance rules. Lord Templeman for the majority of the Privy Council reversed that, and his reasons for that decision have proven problematic ever since.

Whatever else can be said about the reasoning of Lord Templeman in *Challenge*, two things are very clear:

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91 *BNZ Investments,* above, 471 para 108.

92 *BNZ Investments,* above, 471 para 112.

93 *Macniven v Westmoreland Investments Ltd* [2001] 2 WLR 377, para 61 (HL).

94 *Challenge Corporation Limited v CIR* [1986] 2 NZLR 513, 556 (PC).

First, His Lordship's introduction of the concept of "tax mitigation" (and which he made up, as it was no part of the case for either the Commissioner or the taxpayer before the New Zealand Courts or the Judicial Committee) has proven untenable. Lord Hoffmann put the sword to it when delivering the Privy Council's judgment in *O'Neil v CIR*.[95]

Second, the foundation of Lord Templeman's reasoning is built on sand, when regard is had to the discussion of the examples he gives of the distinction between "mitigation" and "tax avoidance". One such example concerns a taxpayer who executes a covenant in favour of another person, and so obtains a tax deduction for the payments paid under that covenant - the facts of the *Duke of Westminster*. His Lordship then goes on to contradict himself in the next part of his judgment where, with reference to the *Duke of Westminster* and its facts, His Lordship states that section 99 would have applied to the covenant.[96]

Lord Templeman strongly disapproves of Lord Hoffmann's revisionist ways in *Westmoreland*. Lord Templeman's article "Tax and the Taxpayer" criticises *Westmoreland* and restates his attraction to his concept of tax mitigation. But where His Lordship revealed himself most was in his speech in *Ensign Tankers (Leasing) Ltd v Stokes (Inspector of Taxes)*,[97] where he explicitly states his agreement with Lord Atkin, the dissenting Lord in the *Duke of Westminster*.[98] It must be taken that Lord Templeman all along considered the *Duke of Westminster* to be wrongly decided.

VIII THE "INSTINCTIVE" OR "PURE GUT" RESPONSE TO TAXES

Taxes provoke a "pure gut response" in people who are normally rational and careful in expression. In "Musings on Form and Substance in Taxation" Professor Joseph Isenberg explained why when he wrote a tribute to his former tax law teacher at Yale, Professor Boris Bittker.[99] In 1981 Bittker had completed his four volume treatise: *Federal Taxation of Income, Estates and Gifts*. Isenberg's article playfully masquerades as a book review, and where Bittker's work was rightly described as "staggering". The masquerade is soon dropped, and Isenberg moves on to his central theme:[100]

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95 *O'Neil v CIR* (2001) 20 NZTC 17,051, para 9 (PC); also reported as *Miller v CIR* [2001] 3 NZLR 316 (PC).

96 *Challenge Corporation Limited,* above 561.

97 *Ensign Tankers (Leasing) Ltd v Stokes* [1992] 1 AC 655 (HL).

98 *Ensign Tankers (Leasing) Ltd v Stokes,* above, 669.

99 Joseph Isenbergh "Musings on Form and Substance in Taxation" (1982) 49 U Chi L Rev 859.

100 Joseph Isenbergh, above, 863.

> Among the tax perennials, an especially persistent question is how the tax laws should be applied to transactions that appear designed to defeat them. Most major statutes raise problems of interpretation, of course, but the quest for "substance" through the distracting haze of "form" has attracted a particularly intense scrutiny in tax matters.

After discussing a number of the cases, and the US "tax sham" doctrine founded by the Judge Learned Hand of the Second Circuit Court of Appeals, in his opinion in *Gregory v Helvering,*[101] Isenberg refers to their "creative jurisprudence". He concludes that there is a reason why Judges often take a different approach to tax laws from that applicable to any other area of law:[102]

> One reason is that judges have aspirations. Little attention is drawn to those who hew narrowly to technical rules. The painstaking process of examining transactions and statutes to determine whether they concord promises little glory. In a society that has always looked to courts for strokes of statesmanship, it is easy enough to understand a judge's temptation to cut through, rather than unravel, the Gordian knot. A simpler variant of this attitude is the desire not to look naïve, to understand what is "really going on". Many of the judges who have written opinions in this area display the tone of one who wants very much not to be taken in.

Professor Isenberg describes this as "pure gut" response. One does not need to be a student of the subject in order to know that people have strong behavioural responses to taxes. "Pure gut" or otherwise, for many there is a choice in some circumstances to pay or not to pay. In popular language many talk about such responses as "tax avoidance". Willie Nelson did nothing new in seeking the benefit of a tax shelter and his distaste for the IRS has an impeccable history. Isenberg's essay is a tour of the American cases and what he regards as "made up" reasoning directed at stopping perceived "tax avoidance".

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101 *Gregory v Helvering* (1934) 69 F 2d 809 affirmed (1935) 293 US 465. Judge Learned Hand rejected the Tax Board's conclusion. The Board of Tax Appeals ruled against the Commissioner, where Judge Sternhagen's opinion rested on the principle that:

> a statute so meticulously drafted must be interpreted as a literal expression of the taxing policy and leaves only the small interstices for judicial consideration.

For the Second Circuit, Judge Learned Hand (in an opinion joined by Circuit Judges Swan and Augustus Hand) reversed. By way of preface, Judge Learned Hand acknowledged the Tax Board reasoning that "as the articulation of a statute increases, the room for interpretation must contract" and to which he added a very large "but" in saying:

> But the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create. The purpose of this section is plain enough . . .. To dodge the shareholder's taxes is not one of the transactions contemplated as corporate "reorganisations".

102 Joseph Isenbergh, above, 882.

Lord Templeman and Thomas J are, it seems, soul mates when it comes to how the law should treat tax matters. "I am for the Revenue, and against crime. Where do you stand?" seems very much the polemic. In various of his speeches in tax cases, Lord Templeman uses very strong language to scourge the taxpayer and counsel with colourful epithets. The high or low point, depending upon one's perspective, is perhaps his Lordship's strongly expressed dissent in *Craven v White*,[103] where he said:[104]

> I have read the drafts of the speeches to be delivered in these present appeals. Three of those speeches [Lords Keith, Oliver and Jauncey] accept the extreme argument of the taxpayer that *Furniss* is limited to its own facts or is limited to a transaction which has reached an advanced stage of negotiation (whatever that expression means) before the preceding tax avoidance transaction is carried out. These limitations would distort the effect of *Furniss*, are not based on principle, are not to be derived from the speeches in *Furniss*, and if followed would only revive a surprised tax avoidance industry and cost the general body of taxpayers hundreds of millions of pounds by enabling artificial tax avoidance schemes to alter the incidence of taxation. In *Furniss* Lord Brightman was not alone in delivering a magisterial rebuke to those judges who sought to place limitations on *Ramsay* because they disliked the principle that an artificial tax avoidance scheme does not alter the incidence of tax. In my opinion a knife-edged majority has no power to limit this principle which has been responsible for four decisions of this House approved by a large number of our predecessors.

As some of the passages referred to show, Thomas J is quite hostile and hectoring of those who advise taxpayers. Thomas J's unappreciative perspective of the role of the tax lawyer, acting for the taxpayer, is very clear too. Some of us are part of a "culture" which is a bad thing. Professor Isenberg's observations are a good explanation of the reasons why. It does seem to be instinctive.

IX CONCLUSION

The reader who has come this far will have appreciated that I am a firm admirer of the judgments of Sir Ivor Richardson. Equally, the "substance" and appeal to "commercial reality" does not gain favour. It is easy to be critical of the views of, for example, Lord Templeman and Thomas J. It is important to be able to say why.

In his essay,[105] Professor Richard Epstein (also of the University of Chicago Law School), argues that the role of the Judge is limited by institutional barriers. They must

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103 *Craven v White* [1989] 1 AC 398 (HL).

104 *Craven v White* , above, 491.

105 Richard Epstein "Economics and the Judges - The Case for Simple Rules and Boring Courts" (June 1996).

interpret statutes. Judicial construction should not be able to cure flaws in bad legislation. Epstein's proposition is that where a statute does not contain wisdom, it is not the role of the Judge to improve the law "in the guise of construction". He suggests that the correct question is whether it is the Judge who has "mangled a fine statute or whether it is the statute itself that is doing the damage".[106] It is almost as if Professor Epstein is familiar with the work of Lord Templeman and Thomas J when he says:[107]

> An easy mistake for a modern judge to make is to assume that the tools he or she possesses are capable of being put to good ends, and that it is possible to tell which of the parties in a given case are the "good guys" and which are the "bad guys". On those assumptions, it follows that the judge should tilt the scales of justice in favour of the more "deserving" individuals.

The strong emphasis in Epstein's thesis is that Judges should stick to rules, and not attempt "to second guess the preferences of other people" (and which is very much the process where Judges choose to "rewrite" or "reinterpret" what the parties have in fact done in their contracts or relationships). The consequence may well be more "boring courts" but a higher level of certainty in result. These are the values identified and articulated by Sir Ivor Richardson in his judgment in *Re Securitibank*.[108]

The Beatles in "*Tax Man*"[109] sang:

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106 Richard Epstein, above, 104.

107 Richard Epstein, above, 104.

108 While the Judge has continued to articulate those values, one cannot be too vigilant in guarding against revisionists. Take for example Jason Goodall "The Duke of Westminster's fall from Grace" (2002) 8 NZJTLP 7. Founding on *Westmoreland*, the author argues that the "strict legal rights" approach inherent in the *Duke of Westminster* can no longer be maintained, in the light of the so called "commercial approach" favoured by Lord Hoffmann. Goodall focuses closely on the *Europa Oil* cases, and asserts that the House of Lords decision in *Westmoreland* does not support the continued application of *Europa Oil No 1* (and, incidentally, relies on an article written by Geoff Harley "The Europa Oil No 2 Case" [1976] NZLJ 218). For reasons that I find surprising, the author further claims that the Privy Council's decision in *Wattie* also supports the "commercial approach" when analysing the nature of the lease premium, and concludes (at 32):

> > . . . one thing is clear. As the *Duke of Westminster* has been almost narrowed out of existence by the House of Lords in *Westmoreland*, the time has come to reconsider the strict legal rights approach, at least in the context of the general deductibility provision.

> It seems unlikely that Lord Hoffmann meant anything of the sort. In *Wattie* the Privy Council saw the payment from landlord to tenant as a negative premium in respect of a long-term lease of land. The Lords saw it as governed squarely in principle and authority by *Regent Oil*, and as the Court of Appeal had also. A lease premium is of course a legal conception *per se*.

109 On "*Revolver*", Capital Records 1966 (and, again, the reference is from Professor Caron's article).

If you drive a car I'll tax the street.
If you try to sit I'll tax your seat.
If you get too cold I'll tax the heat.
If you take a walk I'll tax your feet.

As the Beatles song suggests, these days the reach of the tax man is far-reaching and comprehensive. Willie Nelson could attest to the importance of paying taxes due under the charge imposed by the Statute. While tax may be comprehensive in design, it is still necessary that the person be within the actual charge itself. All that the *Duke of Westminster* tells us is that a "car" means a vehicle with an engine and wheels, which is used by people to travel on land. It does not mean an aeroplane because in "substance" it is possible to use aeroplanes for transport. Judges do not have any warrant in any area of the law, in the guise of interpretation, or by appeal to "substance", to change what the parties have in fact done, or what their contracts say, to meet perceived "avoidance" concerns.

I return to where I began. *Who'll Buy My Memories* was the title of Willie Nelson's IRS album. Memories affect Sir Ivor Richardson too. Through his career, Sir Ivor Richardson has faithfully and carefully applied the principles concerning the need to establish the true nature of the bargain by reference to the contractual terms actually used. His Honour has done so with great distinction, skill and consistency. His judgments rank with the same authority as those of Lords Greene, Radcliffe and Wilberforce in English law, and of Sir Owen Dixon of the High Court of Australia. These judgments are gold and continue to have an enduring benefit.