The Court of Appeal Decision in *Accent Management Ltd* v CIR [2007] NZCA 230: Statutory Interpretation in New Zealand Tax Avoidance Law

Tut Than (0433297)

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Primary Supervisor: Chris Ohms

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CONTENTS

Abstract

In June 2007, the Court of Appeal in New Zealand disallowed the taxpayers appeal and decided that Trinity Scheme is a tax avoidance arrangement. The decision is significant not only for NZD3billion which is at stake but also for its jurisprudence on tax avoidance. This paper analyses the implication of *Accent* decision on the development of judicial approach on tax avoidance.

Purposive approach of interpretation is codified in New Zealand since mid-19th century. Although New Zealand courts are not reluctant in using purposive approach in judicial reasoning, the final decisions rarely depart from literal meaning of the Act.

The tension between general anti-avoidance provision and the specific provision within the Act has long been recognised by the court. The Court of Appeal in *Accent* proposed a judicial technique which would involve seeing tax avoidance cases in three different categories.

There are suggestions that fiscal nullity approach should be adopted in New Zealand to supplement s BG1. This paper outlines historical views of the court on fiscal nullity. An analysis is made on how the judicial approach in *Accent* could help explain the debate on the compatibility of fiscal nullity doctrine and general anti-avoidance provision.

"Tax-avoidance cases often leave as many questions open as they answer"[1]
Judith Friedman

1. Introduction

In June 2007, the Court of Appeal in New Zealand dismissed the appeal of the taxpayers in the *Accent Management Ltd* v CIR [2007] NZCA 230[2] (***Accent***). It has been the largest tax avoidance case[3] in New Zealand history with some NZD 3.7 billion[4] claimed as deductions by the Trinity investors.

In ruling *Accent* as tax avoidance, the High Court ruled that a scheme which complies with technical requirements in tax legislation could be regarded as avoidance if it does not make *commercial sense*. Although making a comment that *Accent* could be caught under avoidance rules without relying on commerciality issues, the Court of Appeal nonetheless confirmed that commerciality issues are of importance. By placing commerciality analysis at the forefront, are NZ courts being influenced by overseas avoidance doctrines such as economic substance doctrine and fiscal nullity doctrine?

This paper attempts is to compare the judicial approach in Accent with those in earlier cases. New Zealand has witnessed a couple of major tax avoidance cases in the last 30 years. Although the pendulum has swung back and forth between the Commissioner and the taxpayer during that period, the judicial reasoning has gradually and consistently developed along these cases. This paper critically analyses how the decision in *Accent* fits in to the judicial reasoning developed along these years.

Both the High Court and the Court of Appeal in interpreting the statutes reached a conclusion which was favourable to the taxpayer. If the Court were to simply interpret the statutory provisions in question (as the Court did in earlier part of its judgment)

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[1] Friedman, Judith (20050 – "Converging Tracks? Recent Developments in Canadian and UK Approaches to Tax Avoidance", Canadian Tax Journal Vol.53 No. 4
[2] *Accent Management Ltd v CIR* [2007] NZCA 230
[3] Trinity scheme was the largest tax avoidance scheme at the time the decision was laid down by the Court of appeal surpassing the-then largest tax avoidance case of ACTONZ which IRD won in 2003. Since then, Trinity case has been eclipsed by the structural dispute with the largest NZ banks which is still being in dispute. – Source: Scoop (13th June 2007) "Inland Revenue welcomes 'Trinity' court ruling" – available at <http://www.scoop.co.nz/stories/PO0706/S00176.htm> 20 Oct 2007
[4] Inland Revenue Department Press Release – 13th June 2007 www.ird.govt.nz 20 Oct 2007

the taxpayer could have come out winning the case. However, both the High Court and the Court of Appeal added tax avoidance analysis on top of the statutory interpretation.

Alternatively, the Court could look at the Trinity scheme as a whole and could have disallowed the taxpayer's claims by purposive approach alone. However, the judiciary in *Accent* did not take such a drastic approach despite the fact that Interpretation Act 1999 provided such an approach. The Court said it would use purposive approach only with s BG1 in mind. There arises a question of why the judiciaries in New Zealand are reluctant in piercing the veil of literalism? Judicial reasoning in *Alcan*, a milestone case in statutory interpretation in New Zealand is revisited to get better insight into judiciary's use of purposive approach in New Zealand.

Recent decisions of the House of Lords in *Barclays Mercantile*[5] suggested that the judiciaries in UK have put the break on the excessive judicial overlays of the Ramsay principle. Instead, the trend is shifted towards the conventional statutory interpretation approach. In Canada, the decisions in *Trustco* and *Matthew* indicated that a regime with general anti-avoidance provision would opt for a purpose test. Putting *Accent* into perspective of these changes might raise the question as to whether or not an avoidance case could be dealt with in New Zealand without the assistance of s BG1. Is there any convergence in the judicial approach towards tax avoidance?

New Zealand has adopted both Specific and General Anti-Avoidance Provisions to combat tax avoidance. The relationship between specific and general anti-avoidance rules had always been the contentious issue. The decision in *Accent Management* sheds some light on the role of the GAAP and its relationship with the specific provisions.

There are differences in academic opinion on whether or not a judicial approach such as fiscal nullity doctrine is compatible with s BG1. Factual analysis carried out by the High Court on the commerciality issues (which is not revisited but nonetheless endorsed in the Court of Appeal) suggests that fiscal nullity approach could be

[5] *Barclays Mercantile Business Finance Ltd* v *Mawson* [2005] STC 1; [2004] UKHL 51

applied as the antecedent of s BG1. Could a judicial approach similar to s BG1 be used as antecedent of s BG1?

The earlier part of the paper gives the descriptive accounts of *Accent* decision followed by the critical review of these decisions. Then, a comparison is made between *Accent* and earlier decisions. The compatibility of the fiscal nullity doctrine with s BG1 is also discussed at the later part of this paper.

2. Trinity Scheme: Factual Background

2.1 Summary of the Scheme

Trinity scheme was dubbed as the New Zealand's largest tax avoidance scheme. If the taxpayers' claims were successful, the Commissioner had to allow some NZD3.7 billion[6] as tax deductions to the Trinity investors[7]. Current operating budget of New Zealand government is around $2 billion per annum. It means total amount of the tax involved in Trinity scheme could pay for the money required to run the New Zealand government for one and a half year[8].

The scheme is a brain-child of Dr. Gary Muir[9], a partner in the law firm Bradbury and Muir. The scheme attempted to take advantage of the rules relating to allowable depreciation on deductions. The taxpayers took out a licence on the right to use land for a 50-year term and the premium is due only at the end of the lease term. By the time the cash payment for these premiums are due, as Venning J put it, both Dr. Muir and Mr. Bradbury will be in their late nineties, even if they lived through the tenure of the lease.

Investors in the Trinity scheme planted 5,000 hectares of pine trees in Te Anau in the Southland[10]. The licence gave investors the right to receive proceeds from the sale of

[6] Keating, Mark (2007) – "*Trinity Decision – Lessons for All*" – New Zealand Herald – Monday June 18, 2007
[7] Initially, IRD estimated total tax loophole could be as huge as NZD10 billion – Reported by Owen Poland in TVNZ news Aug 23, 2004 6:43 PM
[8] Total operating budget figure from the Department of Treasury – www.treasury.govt.nz
[9] Dr Muir is a tax specialist graduating from the University of Auckland with *Doctor of Jurisprudence* in 1992
[10] The southern most district in New Zealand at the southern tip of the South Island.

the pine trees at harvest. Investors issued a promissory note to pay a fixed fee for the licence in 50 years time. The licence fee greatly exceeded the value of the land at the time the investment was entered into.

Investors were also required to enter into an insurance arrangement under which an insurer assumed the risk for the decrease in the value of the forest at the time of harvest below an amount equal to the fee payable for the licence in 50 years. A small premium was payable upfront but payment of the majority of the premium was deferred until harvest. The investors issued a promissory note to the insurer to secure payment of the deferred premium at harvest.

The result of the scheme was that over 99% of the total expenditure claimed by the investors and 87% of the expenditure claimed in the first year was deferred for 50 years. However, investors claimed a deduction for tax purposes for the insurance premium in the first year on the basis that the premium had been "*incurred*" for tax purposes in that year. Investors treated the cost of the licence fee as "*depreciable intangible property*" (which includes a "right to use land") and sought to amortise the cost of the licence over the term of the investment. The money could be deducted up front at a rate of $41,000 a year. This meant the average investor with 25 hectares could claim more than $1 million a year, or a total of $51 million each over the next 50 years[11].

A draft business plan prepared for the insurer which was obtained by the Serious Fraud Office (SFO) stated that "the real benefits of the deal are tax concessions that can be obtained now by investors... The actual outcome of the deal in fifty years is not considered material".

2.2 Entities involved in the Scheme

The scheme involves a series of related forestry investments associated with Douglas fir forest in Southland. The taxpayers set up the Trinity Foundation as a non-trading charitable entity which has three subsidiaries namely: Trinity Foundation (Services No. 1) [Trinity 1], Trinity Foundation (Services No. 2) [Trinity 2] and Trinity

[11] Ibid, Reported by Owen Poland in TVNZ news

Foundation (Services No. 3) [Trinity 3]. Trinity Foundation receives distributions from its subsidiaries. The charitable trust is under the control of Dr Muir and his partner Mr. Bradbury.

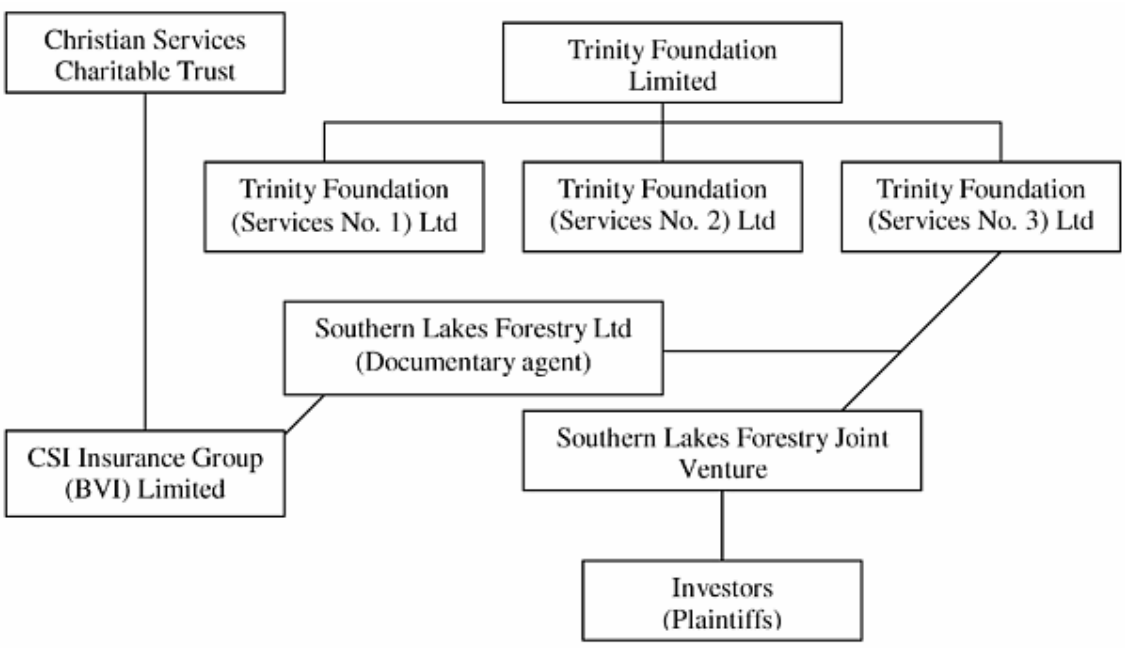
Dr. Muir and Mr. Bradbury incorporated a company called Trinity Services Ltd in December 1996 to carry out the start-up works for the Trinity Scheme including the initial purchase of the land to be subsequently transferred to Trinity Foundation.

Southern Lakes Forestry Joint Venture (SLFJV) was set up as a syndicate to acquire licence from Trinity 3 for the land owned by that company. Investors in the Trinity Scheme all invested in SLFJV either directly or through Loss Attributing Qualifying Companies (LAQCs) incorporated for the purpose of investment. LAQC was chose as the entity because the losses incurred by the company can be attributed to the shareholders based on their respective shareholdings. However, the legislation only allows a maximum of five shareholders per LAQC. Accordingly the LAQCs were arranged into a number of partnerships which in turn were linked in SLFJV.

In addition, Dr Muir incorporated Southern Lakes Forestry Ltd as SLFJV's documentary agent. CSI Insurance Group (BVI) Ltd (CSI) was incorporated by AMS Financial Services Ltd at the request of Dr Muir. AMS Trustees Ltd, a company within AMS groups held shares in CSI as nominee for Christian Services Charitable Trust (CSCT), a trust incorporated in Cayman Islands. The purpose of CSCT was to ensure that the ultimate proceeds received from the sale of the Douglas fir forests were free of tax because charitable trusts enjoy a tax-free status.

Figure 1: Entity Structure of Trinity Scheme[12]

[12] Entity structure of the Trinity Scheme as illustrated in the High Court judgment


Christian Services Charitable Trust
Trinity Foundation Limited
Trinity Foundation (Services No. 1) Ltd
Trinity Foundation (Services No. 2) Ltd
Trinity Foundation (Services No. 3) Ltd
Southern Lakes Forestry Ltd (Documentary agent)
CSI Insurance Group (BVI) Limited
Southern Lakes Forestry Joint Venture
Investors (Plaintiffs)

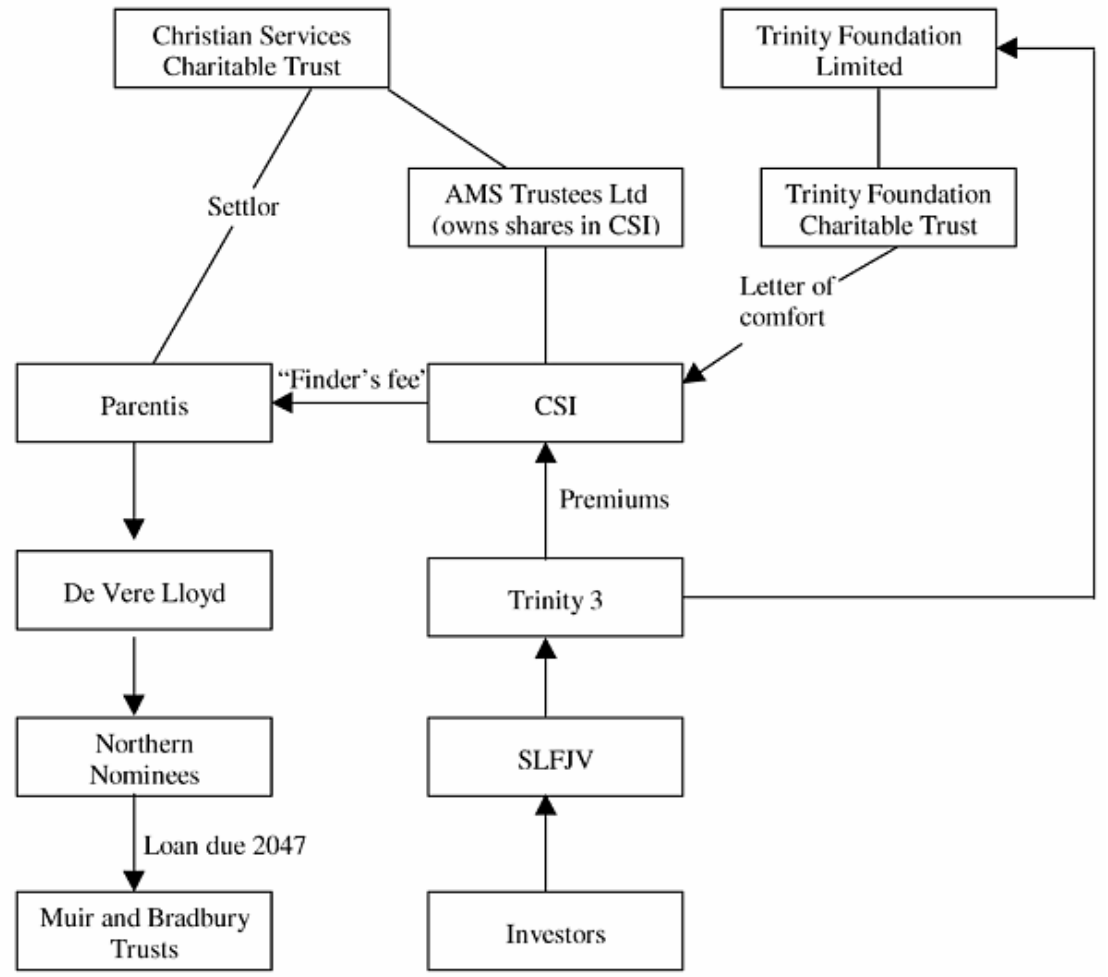
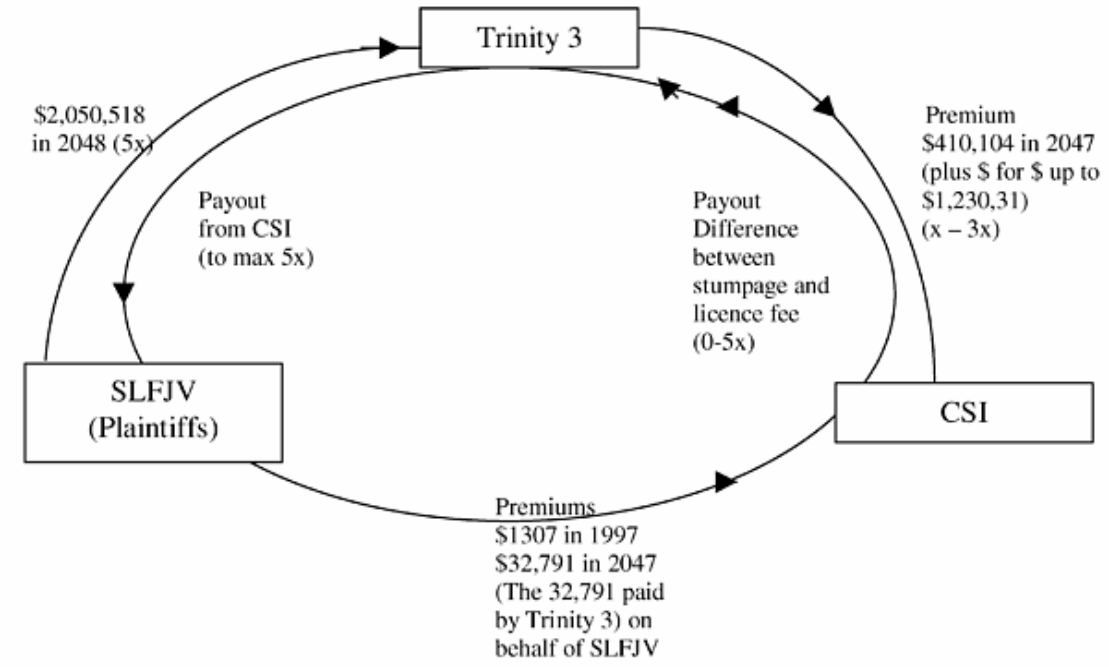

Christian Services Charitable Trust
Trinity Foundation Limited
Settlor
AMS Trustees Ltd (owns shares in CSI)
Trinity Foundation Charitable Trust
Letter of comfort
Parentis
"Finder's fee"
CSI
Premiums
De Vere Lloyd
Trinity 3
Northern Nominees
SLFJV
Loan due 2047
Muir and Bradbury Trusts
Investors

Figure 2: Flow of Insurance Premiums among entities involved in Trinity Scheme[13]

The analyses of the transactions between these entities show that the flows of funds are circular. SLFJV on behalf of Trinity 3 paid $1307/ per hectare in 1997 and $32,791 in 2047 to CSI insurance. In return, CSI will payout difference between the stumpage and licence fee up to 5 times in 2047. Under separate arrangement Trinity 3 will pay CSI as premium $410,104. The maximum liability of Trinity 3 to CSI was capped at 3 times of the premium in 2047. Upon receipt of the insurance payout from CSI, Trinity 3 will pay SLFJV up to a maximum of 5 times. SLFJV in 2048 has to pay Trinity 3 the amount of $2,058,518 which is equivalent to 5 times.

Although these transactions individually look as though they were separate arm-length agreements, looking holistically, the circularity of the transactions become obvious.

Figure 3: Circularity of Transactions in Trinity Scheme[14]



The Commissioner of Inland Revenue issued a Notice of Proposed Adjustment (NOPA) challenging the deduction of the insurance premium and the depreciation of

[13] As illustrated in the High Court judgment
[14] As illustrated in High Court judgment

the licence under the general anti-avoidance rules. *Accent* was the test case for 200 odd Trinity investors. Eighty-four investors out of 200 decided to dispute with the Commissioner.

3. Defining Tax Avoidance

Tax avoidance is somewhat bluntly defined by Wheatcroft (1955)[15] as the art of dodging tax without actually breaking the law. Tax avoidance is an art and it is impossible to exactly say what constitute tax avoidance. Each country has its own way of defining tax avoidance. Even within a jurisdiction, the demarcation between an acceptable tax minimisation and unacceptable abusive tax position is always a contentious issue. Most if not all tax avoidance cases are contested by trying to push the borderline between the acceptable tax mitigation and unacceptable tax avoidance.

Organisation for Economic Cooperation and Development (OECD) defines tax avoidance as:

> "an arrangement of a taxpayer's affairs that is intended to reduce his liability and that although the arrangement could be strictly legal it is usually in contradiction with the intent of the law it purports to follow"[16]

In New Zealand, common law definition of tax avoidance was laid down by Lord Templeman in the *Challenge*[17]

> "Income tax is avoided and a tax advantage is derived from an arrangement when the taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that reduction. The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had."

Above definition was later reaffirmed by Lord Nolan in *Willoughby*[18]

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[15] Wheatcroft G. S. A (1955) – "*The Attitude of the Legislature and the Courts to Tax Avoidance*" (1955) 18 M.L.R**.** 209

[16] *International Tax Terms for the Participants in the OECD Programme of Cooperation with Non-OECD Economies*, (Paris, OECD)

[17] *CIR (NZ)* v *Challenge Corporation Ltd* [1987] AC 155

[18] *CIR* v *Willoughby* [1997] 4 All ER 65 at p.73

> "The hall mark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be suffered by any taxpayer qualifying for such reduction in his tax liability. The hall mark of tax mitigation, on the other hand, is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the legislation, and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option."

In addition to above common law definitions of tax avoidance, s BG1 of the Income Tax Act 2004 outlines the statutory definition of tax avoidance. However, it is generally accepted that the courts in New Zealand rarely interpreted s BG1 literally in its full meaning. The courts traditionally give strained interpretation to s BG1. The interpretation of s BG1 by the courts depends on the individual case. As the judicial approaches keep developing, one needs to look at judicial approaches in all tax avoidance cases to have a grasp on the definition of tax avoidance.

The presence of following factors is considered as the indicator of a tax avoidance activity[19].

- the lack of economic substance (usually resulting from pre-arranged circular or self-cancelling arrangements), with the result that an apparently significant investment proves ultimately to be illusory, and, through various devices, the taxpayer remains insulated from virtually all economic risk, while creating a carefully crafted impression to the contrary;
- the use of tax-indifferent accommodating parties or special purpose entities, often referred to in the jargon as "washing machines";
- unnecessary steps and complexity, often inserted to prop up a claim of business purpose, or to disguise the true nature of a scheme or "as a device to cloak the tax shelter transaction from detection";
- inconsistent treatment for tax and financial accounting purposes; high transaction costs; fee variation clauses or contingent fee provisions;
- the use of new, complex financial instruments such as derivatives, hybrids and synthetic instruments which have made it possible for promoters to mimic almost perfectly the risks and returns attributable to more traditional

[19] South African Revenue Service (2005) – *"Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962)"* – available at www.sars.gov.za 15 Oct 2007

financial instruments such as equity shares or “plain vanilla” debt without incurring, at least in theory, the tax consequences typically associated with them; and

- the use of tax havens, particularly in the context of captive insurance companies, captive finance subsidiaries and intangible property holding companies.

However, the finding of any of the above would not necessarily deem particular activity tax avoidance. The final decision rests with the prevailing statutory provisions and the jurisprudence of the jurisdiction.

Different country resorts to different anti-avoidance measures. Australia, Canada and New Zealand resort to statutory provision where as the United Kingdom resorts to judicial techniques. Even among the countries that choose to have general anti-avoidance provisions, New Zealand and Australia tend to focus on the business purpose whereas Canada focuses on the economic substance. These various measures to avoidance indicate that different country sees tax avoidance from different perspective.

4. Statutory Provisions

Accent was contested on the issue of whether or not the general anti-avoidance rule s BG1 applies to a situation where taxpayer by literal interpretation is well within the provisions of specific deductions provisions.

New Zealand has both general and specific anti-avoidance rules. Specific anti-avoidance rules are embedded in some taxation regimes where as the general rules normally serves as a wider net for those avoidance schemes which are not struck down by specific rules.

4.1 General Anti-avoidance Provision

Section BG1(1)[20] provides that a tax avoidance arrangement is void as against the Commissioner for income tax purposes. Tax avoidance arrangement is defined in s OB1[21] as one which has tax avoidance as its purpose. Proof that seeking tax advantage is more than merely incidental purpose could turn a business plan into a tax avoidance arrangement. Existence of other business objectives could not be a sufficient excuse. Section GB1 allows the Commissioner to counteract a tax advantage that a person has obtained from or under a tax avoidance arrangement.

4.2 Specific Provisions

In *Accent*, the taxpayers claimed the tax deductions relying on certain specific provisions. Those provisions, according to the taxpayers, were provided by the Parliament to give incentive to the taxpayers. The taxpayers claimed that they were entitled to claim tax deductions for the amount of depreciations for any depreciable property owned by the taxpayer under s EG1[22] of the Income Tax Act 1994 (ITA 1994). The taxpayers claimed deductions for depreciation equivalent to one fiftieth of the licence premium.

[20] Section BG1 provides in full:

> (1) A tax avoidance arrangement is void as against the Commissioner for income tax purposes.
> (2) Under Part G (Avoidance and non-market transactions), the Commissioner may counteract a tax advantage that a person has obtained from or under a tax avoidance arrangement.

[21] Section OB1 provides in full:-

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

[22] Section EG1 of ITA1994 provides in full:

> (1) Subject to this Act, a taxpayer is allowed a deduction in an income year for an amount on account of depreciation for any depreciable property owned by that taxpayer at any time during that income year.

Depreciable property is defined in s OB1[23] of ITA 1994 as any property which might reasonably be expected in normal circumstances to decline in value while use in gaining or producing assessable income. Therefore, assets that are used in generating assessable income could be depreciated. However, s OB1 excludes financial arrangements are intangible property from the list of depreciable properties. Intangible property could not be depreciable property unless it is depreciable intangible property.

The taxpayers also claimed tax deductions for the insurance premiums. They relied on s DL1(3) which outlines the types of expenses on which a person who invests in forestry business could claim as deductions. Insurance premiums are prescribed in s DL1(3)(a)[24] as deductible expenditure.

The taxpayers also contended that if the insurance premiums did not fall within the ambit of s DL1(3) which is a specific provision for forestry regime, they nevertheless falls under s BB7 which is more of a general provision for deductible expenditure. Section BB7[25] provides the taxpayer to claims deduction for any expenditure or loss which is incurred in producing the assessable income.

The taxpayers also contended that insurance premiums which were due in 2047 were subject to the accrual regime. As a result, the taxpayers claimed a proportion of

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[23] Depreciable property is defined in s OB1 of ITA 1994 as
Depreciable property, in relation to any taxpayer, -
(a) Means any property of that taxpayer which might reasonably be expected in normal circumstances to decline in value while used or available for use by persons-
    i. In gaining or producing assessable income or
    ii. In carrying on a business for the purpose of gaining or producing assessable income but
(b) Does not include
    i. Financial arrangements
    ii. Intangible property other than depreciable intangible property

[24] Section DL1(3)(a) provides in full:
A person who carries on a forestry business on any land in New Zealand shall, in calculating the assessable income derived by that person in any income year, be entitled to deduct any expenditure incurred by that person in that business in that income year, being expenditure which is not deductible otherwise than under this section, -
(a) By way of … insurance premiums or other like expenses.

[25] Section BB7 provides in full:-
In calculating the assessable income of any taxpayer, any expenditure or loss to the extent to which it
(a) is incurred in gaining or producing the assessable income for any income year or

insurance premiums due in 2047 in the current tax year under s EF1[26]. Accrual expenditure[27] is defined in s OB1. However, financial arrangements[28] are excluded from the accrual regime. A contract of insurance is defined as excepted financial arrangement.

5. Interpretation of Taxing Statutes

Tax avoidance cases evolve around the interpretation of the taxing statutes. There are two broad approaches available to the judiciary in interpreting the statutes: 'literal approach' and 'purposive approach'. Some also refer these two approaches as 'form over substance' and 'substance over form'.

Literal approach is normally associated with the taxing statue for two reasons. Firstly, taxing statutes operate in a similar way to penal statutes[29]. Secondly, the taxpayer

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[26] Section EF1 provides: -

(1) where any person has incurred any accrual expenditure, that expenditure shall be deductible when it is incurred in accordance with this Act but the unexpired portion (if any) of that expenditure shall be taken into account in ascertaining the assessable income of the person for the income year in which that expenditure is incurred and subsequent income years.

[27] Accrual Expenditure provides in s OB1 in full:-

Accrual expenditure in section EF1 and FE4, in relation to any person, means any amount of expenditure incurred on or after 1 August 1986 by the person that is allowed as a deduction under this Act, or was deductible under the Income Tax Act 1976, other than expenditure incurred –

(a) in the purchase of trading stock; or
(b) in respect of any financial arrangement; or
(c) in respect of a specified lease or a lease to which section EO2 applies; or
(d) Under a binding contract entered into before 8:30 pm New Zealand Standard Time on 31 July 1986

[28] Financial arrangement provides in s OB1 in full:-

"Financial arrangement" –

(a) subject to paragraph (b)

(i) any debt or debt instrument

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

(iii) any arrangement which is of a substantially similar nature (including without restricting the generality of the preceding provisions of the subparagraph, sell-back and buy-back arrangements, debt defeasances, and assignments of income)

(b) In the definition of "residual expenditure" and in the life insurance rules, means a financial arrangement to which the accrual rules apply:

[29] R. T. Bartlett (1985) – "*The Constitutionality of Ramsay Principle*" – 6 British Tax Review 338 at 347

needs to know clearly why the tax has been charged for[30]. The long standing view is that people expect and regulate their affairs based on the clear & plain words of the code published by the Parliament[31]. The following words of Lord Cairns in *Partington v Attorney-General* portray the preference of literal approach in tax legislations:-

> "…, if there be admissible, in any statute, what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute"[32]

In *Accent*, the Trinity taxpayers put forward their argument relying on the literal approach of interpretation on deduction provisions. Their argument is that legislation provided that the insurance premiums could be claimed at the time it is incurred and that is exactly what they did.

Purposive approach is used when a clear meaning cannot be obtained from the statute. It is codified in New Zealand under s 5(2) of *Interpretation Act 1999* which allows the courts "to take into consideration of the indications provided in the enactment in ascertaining the meaning of legislation". In using purposive approach, judiciaries have to be mindful as their role is only to interpret the legislation and not to create a new legislation. As the judiciaries are only responsible for enforcing the law, any judicial activism which resembles the form of creating the law would be regarded as unconstitutional[33].

In practice, purposive approach is not a strait forward approach. Ascertaining the Parliament's intent is not possible for every scenario. Dyson (1997)[34] pointed out two common reasons for difficulty in finding the Parliament's intent on a particular statutory provision.

> "Even where the conditions for reference to parliamentary materials are satisfied, often nothing useful will be found to assist in interpretation. This may be for two reasons. First there

[30] Natalie Lee (1999) – "*A Purposive Approach to the Interpretation of Tax Statutes*" – Statute Law Review, Volume 20, Number 2, p. 124-133 at 126
[31] Oliver L.J in *I.R.C v Trustees of Sir John Aird's Settlement* [1983] All E.R 481 at 490
[32] *Partington v Attorney-General* (1869) L.R 4 E&I App. H.L. 100 at 122
[33] In the United Kingdom, the judicial activism under fiscal nullity doctrine has been criticized as unconstitutional. See R. T. Bartlett (1985) – "*The Constitutionality of Ramsay Principle*" – 6 British Tax Review 338.
[34] Jacqueline Dyson (1997) – "Interpreting Tax Statues" – "Legislation and the Courts" – p.43

> may have been no discussion of the relevant section, and second, even where there was debate, this may not elucidate the point of difficulty."[35]

However, there are different views towards the purposive interpretation. According to Kirby J in *FC of T v Ryan* suggests the role of the courts as independent institutions which is part of the check and balance system to the democratically elected government.

> "(The purposive approach) … is an approach proper, in my respectful view, to the relationship between modern democratically elected legislatures and the independent courts. The price that will be exacted for spurning the legislative instruction to give effects to the purpose of the legislation is increasingly complex and detailed statutory provisions, difficult for citizens to understand and for the courts to construe"[36]

5.1. Statutory Interpretation in New Zealand: The Historical Background

Long before the famous "*Duke of Westminster*" principle was established in 1935, New Zealand legislation has provided the use of purposive interpretation in courts. The earliest legislation in New Zealand on statutory interpretation is the s 3 of the *Interpretation Ordinance Act 1851* which provides:

> "The language of every ordinance shall be construed according to its plain import, and where it is doubtful, according to the purpose thereof."

Courts in New Zealand normally see the legislation in two broad categories: remedial and penal. Historically, courts in New Zealand interpreted tax legislation as penal[37] and interpreted it restrictively. In *Plimmer v CIR*[38], Barrowclough CJ cited with approval the following passage from *IRC v Ross & Coulter*[39].

> "If the provision is capable of two alternative meanings, the courts will prefer the meaning more favourable to the subject".

However, there were few occasions where the Court took the extreme and controversial approach in interpretation. In *CIR v West-Walker*[40], the Court of Appeal

[35] Ibid, Dyson (1997) at p.43
[36] FC of T v Ryan 2000 ATC 4079, 4095 (per Kirby J dissenting)
[37] Taxing statutes are penal
[38] [1958] NZLR, 147, 151
[39] [1948] 1 All ER, 616
[40] [1954] NZLR 224 (CA)

interpreted "every person" as including "every person other than the solicitor". Therefore, in 1963, Ward[41] observed that the scene of the New Zealand statutory interpretation as follows:

> "The result is chaos. It is impossible to predict what approach any Court will make to any case. The field of statutory interpretation has become a judicial jungle. It is only fair to say that the jungle has been inherited: but our Courts have been so busy cultivating the trees that they have lost sight of the pathway provided by Parliament in the Acts Interpretation Act.[42]"

The predecessor of s 5(1) of current Interpretation Act could be traced back to 1888. The relevant provision of the 1888[43] Act was later re-enacted (virtually unchanged) as the s 5(j)[44] of the Acts Interpretation Act 1924, which reads:

> "Every Act, and every provision or enactment thereof, shall be deemed remedial, whether its immediate purport is to direct the doing of anything Parliament deems to be for the public good, or to prevent or punish the doing of anything it deems contrary to the public good, and shall accordingly receive such fair, large, and liberal construction and interpretation as will best ensure the attainment of the object of the Act and of such provision or enactment according to its true intent, meaning, and spirit."

Section 5(j) was replaced by the s 5(1) of the Interpretation Act 1999 which reads:

> "The meaning of an enactment must be ascertained from its text and in light of its purpose".

Ward (1958)[45] criticized that in the process of interpretation, the Courts are not applying rules of law, but cannons of construction. Ward further asserted that the cases that applied s 5(j) are easier to follow than those that simply follow the common law rules of construction[46]. In *CIR v Alcan New Zealand Ltd*[47] *(Alcan)*, the case that revitalised the purposive approach in New Zealand, the Court strikes the balance between these two authorities of construction by utilising both the provisions of the section 5(j) of the Acts Interpretation Act 1924 and the common law rules of construction.

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[41] D.A.S. Ward (1963) – "*A Criticism of the Interpretation of Statutes in the New Zealand Courts*" – NZLJ 293
[42] Ward (1963), Ibid, at 296
[43] In s 5(j) of the Interpretation Act 1888
[44] The source of section 5(j) is regarded as a provision in Upper Canada enacted in 1949
[45] D.A.S. Ward (1963) – "*A Criticism of the Interpretation of Statutes in the New Zealand Courts*" – NZLJ 293,
[46] above n 30 at p.297
[47] (1994) 16 NZTC 11

Due to active application of scheme and purpose approach, New Zealand is regarded as second only to the UK in applying the purposive approach of statutory interpretation[48].

5.2. Scheme and Purpose Analysis

In *Accent*, the Court of Appeal stated that it applied scheme and purpose approach of interpretation to s BG1. The Commissioner contended that the deduction claimed by the taxpayers were out of quilter with the scheme and purpose of the Act. The taxpayers on the other hand contended that the Parliament has anticipated the timing difference in a long-term investment such as the forestry development and those deductions claimed by them are within the scheme and purpose of the Act.

The term "scheme and purpose approach" is used exclusively in New Zealand. It is in essence a branch of purposive approach of statutory interpretation. The term "purpose, context and sprit of the act" has been in use in statutory interpretation literature in England since *Heydon*'s case. The terminology "scheme and purpose" was first used in New Zealand by Richardson J in his lecture in the Monash University[49].

> "The twin pillars on which our approach to statutes rests are scheme of the legislation and the purpose of the legislation. Consideration of the scheme of the legislation requires a careful reading in its historical context of the whole Act including the long title, analysing it structure and examining the relationship between the various provisions and recognising any discernible themes and patterns and underlying policy considerations. It presupposes that in that way the study of the statute or of the group of sections may assist in the interpretation of a particular provision in its statutory context."[50]

Richardson J subsequently introduced the terminology into case law in *Challenge* case[51]. Although the terminology was introduced in the 1980s, the concept is not new. It is simply Richardson J's interpretation and application of s. 5(j).

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[48] Dabner, Justin (2000) – "*The Spin of a Coin – In Search of a Workable GAAR*" – Journal of Australian Taxation, May/June 2000 at 232
[49] Rt Hon Sir Ivor Richardson – "Interpretation of Statutes" (Paper presented for the Wilfred Fullagar Memorial lecture, Monash University, Melbourne, 1985)
[50] Richardson, above, 8
[51] C of IR v Challenge Corporation Ltd (1986) 8 NZTC 5, 001

> "the twin pillars on which the approach to statutes mandated by s 5(j) of the Acts Interpretation Act 1924 rests are the scheme of the legislation and the relevant objectives of the legislation."

The scheme and purpose approach proposes that in interpreting a statute the court should look at purpose and context of the legislation. Scheme and purpose analysis consists of two stage process. Scheme of the Act means the overall purport of the Act. The presumption is that there is some common tread in the Act which pervades the Act as a whole. The use of scheme of the Act as a guide to interpretation is to say that the scheme of the Act ought to be assumed to be consistent with one another as far as possible and interpreted accordingly.

Interpreting according the scheme ensures that if a word has a particular meaning in one section, it should be accorded similar meaning throughout the Act. To interpret a provision according to the scheme of the Act is not only to be consistent, but also to interpret in a manner which is likely to advance the object of the legislation. As Jeffries J stated in *Arataki Honey Ltd v Minister of Agriculture and Fisheries:*

> "In the complex task of wrestling the true construction of an Act, it cannot be compartmentalised and scrutinised molecularly."

5.3 Form and Substance: When the Court can depart the Form?

The courts are normally reluctant to depart from the literal interpretation in the tax cases. This is partly due to the jurisprudence that tax statutes are penal and thus judiciary needs to strictly adhere to what is in the statute. Therefore, it is said that tax is an island of literal interpretation.

The eminent economist, Adam Smith, in his work *An Inquiry into the Nature and Causes of the Wealth of Nations*[52] viewed "certainty' as one of the cornerstones of the principles of taxation. His views in this regard are summarized as follows by *Alley et al*, at pp 53 – 54:

[52] McCulloch (ed), Bk V, Ch II, Pt II, Ward Lock and Co, 1776, pp 653 – 655, quoted in *Alley et al*, p 53.

> "The tax which each individual is bound to pay, ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person.
>
> [Smith] cautions that the lack of certainty means that the taxpayer in one sense is "at the mercy" of the tax collector or revenue agency.
>
> Where it is otherwise, every person subject to the tax is put more or less in the power of the tax-gatherer, who can either aggravate the tax upon any obnoxious contributor, or extort, by the terror of such aggravation, some present or perquisite to himself. The uncertainty of taxation encourages the insolence and favours the corruption of an order of men who are naturally unpopular, even where they are neither insolent nor corrupt."

This principle of certainty is as important today as when it was originally enunciated by Adam Smith in the 1700's as illustrated by the English case of *Vestey v Inland Revenue Commissioners (Nos 1 and 2)* [1979] 3 All ER 976 (HL).

It was established in the *Duke of Westminster*[53] case that taxpayers are entitled to structure their affairs in accordance with the tax legislation so as to minimise their tax liabilities. Lord Tomlin stated in the House of Lords:

> "…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."

This general proposition has been reaffirmed by the Privy Council and the Court of Appeal on several occasions. However, the general application of the *Duke of Westminster* principle in the context of tax avoidance sections has been the subject of judicial comments in New Zealand, Australia and the United Kingdom.

Woodhouse J in *Elmiger v CIR* [54] aptly suggested that the *Duke of Westminster* does not override the GAAP of the Income Tax Act. While it can still be said that a taxpayer is required to pay no more than the correct statutorily imposed quantum of tax, it is also the case that under the Income Tax Act a taxpayer is not entitled to alter that proper statutorily impost by entering into a tax avoidance arrangement.

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[53] Ibid
[54] [1966] NZLR 683, 694

The judiciary in interpreting the taxing statute normally do not depart from the form. It means statutes are interpreted literally. However, there are occasions when the judiciary could opt for purposive approach[55].

- When sham is involved
- When s BG1 applies
- When fiscal nullity approach applies

Above has been the litigation strategy for the Commissioner in striking down the avoidance cases. When an avoidance scheme goes into litigation, the Commissioner usually challenge both on the grounds of sham and s BG1 with the intention that some schemes could be caught under sham argument. This is the same strategy adopted by the Commissioner in both the High Court and the Court of Appeal.

5.3.1 Sham

The concept of "sham" is closely associated to judicial approaches applied to tax avoidance. If a transaction or a series of transactions is found to be a sham, these transactions are void against the Commissioner. Therefore, it is not uncommon for the Commissioner to contest a transaction as a sham when trying to strike down an avoidance transaction.

The classic definition of a sham was given in Snook v London & West Riding Investments Ltd, where Diplock LJ said:

> "... that for acts or documents to be a 'sham', with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations which they give the appearance of creating."

A sham is the act done or document executed that is intended to mislead. In a typical sham transaction, the parties resort to a form of action or document which does not fit the real facts in order to deceive a third person. In *Mills v Dowdall*, Richardson J indicated two situations where sham could exist. First, where the documents do not reflect the true agreement between the parties; and second, where the documents are bona fide in inception but the parties have departed from their initial agreement while leaving the original documentation to stand unaltered.

[55] Arieli, T. N (2002) – "*The Law of Tax Avoidance in New Zealand*" – 31 Australian Tax Review 24, March 2002

A sham does not apply to transactions that are intended to take effect, and do take effect, between the parties according to their tenor, even though those transactions may have the effect of fraudulence. A sham will not be found to exist simply because a taxpayer adopts one legally available form over another.

There is no acceptance of the notion of a "halfway house" between a sham and an effective transaction. Therefore, in a situation where the documents record the intention of the parties however, the substance of the transaction can be interpreted so as to produce some different legal result, sham could not be established.

Sham plays more important role in combating tax avoidance in the days when "*the Duke of Westminster*" principle prevailed. In those days, existence of sham was the only reason for the Court to depart from the form approach. Nowadays, the court could depart from the form approach with the assistance of GAAP and fiscal nullity approach. Tax planning methods become more sophisticated and as a result present-day tax planners could better navigate their way in avoiding the sham net. Recent litigations in *Peterson* and *Accent* showed that it is very difficult for the Commissioner to challenge a scheme as a sham.

5.3.2 Section BG 1: General Anti-avoidance Provision

The court can also depart from the form when the transaction in question is a tax avoidance arrangement under s BG1. If a scheme is deemed to be a tax avoidance arrangement under s BG1, the court has the reconstruction powers under s GB1 so that all the tax advantage taken under avoidance arrangement could be nullified.

Since *Challenge* in 1986, New Zealand courts have been using the scheme and purpose approach in tax avoidance cases. However, New Zealand version of purposive approach, so-called scheme and purpose approach is much milder than purposive judicial approach used in the U.K.

In *Accent*, the Court of Appeal applied the purposive approach of interpretation first to prove that the taxpayer's interpretation of specific sections was not in accordance

with the scheme and purpose of the Act. Then only the Court used this as a reason to trigger s BG1.

Due to the broad wording of s BG1 and due to the severe consequences of its application, the courts in New Zealand tend to give strained interpretation of s BG1.

5.3.3 Fiscal Nullity Approach

The jurisprudence in the UK showed that the Court could depart from the form if it finds that a particular scheme is deemed to be a fiscal nullity. If circular transactions or inserted steps are found in a scheme, the Court would reconstruct the scheme by removing these inserted steps.

The House of Lords in *Burmah*[56] case ruled that the inserted steps are to be disregarded for fiscal purposes. However, Lord Hoffman in *MacNiven*[57] reinterpreted this statement as meaning that the steps should be disregarded for the purpose of applying the relevant fiscal concept. But that did not mean that the transaction be treated as if it never happened for tax purposes.

6 High Court Decision

The primary issue before High Court was whether the Trinity scheme was a tax avoidance arrangement. In particular, the Court had to consider whether Commissioner was entitled to disallow the deductions claimed by the taxpayers under the following reasons.

- The forestry investment is not a commercially viable investment.
- The insurance premium is not deductible
- The amortised licence premium is not deductible as depreciable property

[56] Inland Revenue Commissioners v Burmah Oil Company Limited. [1982] BTC 56
[57] *Macniven (Inspector of Taxes) v Westmoreland Investments Ltd* [2001] 2 WLR 377

The Commissioner's challenge focused the commerciality of the investment. The Commissioner asserted that on any independent analysis the forestry investment would not achieve the returns necessary in order to enable the taxpayers to pay the licence premium of $2,050,528 per hectare in 2048 as required. The Commissioner stated his position in the Notice of Proposed Adjustment (NOPA) and maintained this position throughout the case. In order to prove that the investment was not a bona fide commercial proposition, the Commissioner submitted expert witnesses and financial modelling computations to the court.

The Commissioner argued that deductions in relation to the licence and insurance premiums are not deductible under the specific statutory provisions relating to deductibility of such expenses as they do not meet the statutory criteria.

6.1 Judicial Approach of the Court

Venning J in the High Court approached *Accent* in two-step approach. His Honour construed the statutory provisions relating to the issue of insurance premiums and use-of-land right premiums. In construing those provisions, the court would look at the legal arrangements between the parties and give transactions a legal effect as prescribed in the contracts. The Court would not explore the commerciality and economic substance issues behind these transactions when interpreting these statutes. Those issues, according to Venning J, were for the analysis of tax avoidance[58].

Then, the Court continued with the tax avoidance analysis as a fallback. In his judgment, Venning J admitted that even if he got it wrong in interpreting the statutory provisions, the proof that Trinity scheme is a tax avoidance arrangement could still make the taxpayer deduction claims void[59]. In addition, the Court thought that the issue of avoidance is relevant because a finding of tax avoidance is a pre-requisite for the abusive tax position which is punishable by penalties[60].

[58] *Accent* (HC), Ibid, Para 185
[59] *Accent* (HC), Ibid, Para 263
[60] *Accent* (HC), Ibid, Para 264

6.3 Interpretation of the Specific Provisions

The High Court was faced with the question of whether or not tax deductions claimed for the depreciation and insurance premiums should be allowed to the taxpayers Venning J said that the role of the Court is not to determine the nature of the transaction by it overall economic consequence. The Court referred to Tipping J in *A Taxpayer v CIR*[61]

> "… Taxation issues should not be decided on the basis of the so called economic substance or reality of the transaction, or of the circumstances the taxpayer is involved."

Hs Honour said that the correct approach is to analyse the contractual agreement taken as a whole under which the payment was made, whether the true legal character accords with the relevant description.[62]. The question before the Court is the legal effect and not the economic consequences[63].

6.3.1 Depreciations

In *Accent*, the Court looked at the licence fees contract to see whether or not payment was for the right to use land. First, the Court found that the combined legal effect of the agreements that had been entered into did not provide a "right to use" land, as required by the legislation, but were agreements to provide a bundle of rights and obligations, one of which was to plant and harvest a forest. The license premium had been paid, therefore, to secure a right to share in the net proceeds of sale of the forest rather than for the use of the land. Secondly, the license premium could only be deductible under the depreciation provisions if it was paid in respect of property that might reasonably be expected to decrease in value over time whereas the value of the forest would normally be expected to increase as it neared maturity.

His Honour decided that licence premium is not deductible under s EG1. The Court interpreted that licence premium as described in Trinity scheme is not for the right to use land but for the right to share in proceeds of sale of the forest once harvested.

[61] (1997) 18 NZTC 13, 350
[62] *Accent* (HC), Ibid, Para 140
[63] *Accent* (HC), Ibid, Para 143

6.3.2 Insurance Premiums

In respect of the insurance premiums, the Court found that, this expenditure was deductible under the general deductibility provision because it met the test of being "incurred" in that the plaintiffs were definitively committed to this expenditure. They had made payment of the initial premiums in 1997 and were liable for the 1998 and subsequent payments under a promissory note. The Court accepted that the premiums are prima facie deductible under DL1(3).

6.4 Commerciality of the Investment

High Court judgment evolves around the commerciality of the scheme. In applying the scheme and purpose approach and in reaching to the conclusion that Trinity scheme was a tax avoidance arrangement, Venning J viewed that lack of commerciality was an important factor.

The Commissioner challenged the commerciality of the Trinity Scheme in the NOPA. The plaintiff taxpayers challenged this issue in the High Court. Although they could not see eye to eye on the issue, both the Commissioner and the taxpayers agreed that following variables determined the profitability of the scheme and thus the commerciality.

- the initial figure taken for stumpage in 1997
- the figure for log price growth over 50 years
- the average annual inflation rate over 50 years

One of the taxpayer's expert witnesses accepted that he had never seen a financial structure for a forestry investment that involved a fixed licence premium payable in 50 years time. A second unusual feature was the contractual arrangements between the land-owner and the joint venture taxpayers, which required the joint venture to plant, manage, and harvest the forest, for the landowner who retained the ownership of the trees. It is also unusual that the insurance arrangements which were designed to guarantee a price for the forest in 50 years time with a significant deferral of payment of the premium.

After having heard a number of expert witnesses, the Court applied the variables which were most favourable to the tax payers. Using this set of variables, the Court worked out the Net Present Value of the investment. Even with the variables most favourable for the taxpayers, the Net Present Value turned out to be negative. It means that the investment after having taken into consideration of the inflation will incur loss to the taxpayers.

His Honour said that he would use the findings on the commerciality to decide the purpose of the scheme.

> "… the forestry investment in Trinity 3 will not be a successful investment. … I consider that the prospect of a positive return from the forest at maturity is unlikely, but it cannot be ruled out. I will return to the issue of the impact of that on the issue of tax avoidance later in the judgment."[64]

6.5 Trinity Scheme: An Arrangement?

Venning J decided that Trinity scheme was an arrangement on the basis that even if the taxpayers were not parties to the arrangement, they were certainly parties affected by it. His Honour said that the taxpayers in the Trinity scheme knew the nature of the composite arrangement they agreed to enter and they knew they had joined up as signatories to the obligations under the agreement to grant licence.

His Honour said Accent needs to be looked at differently from *BNZ* because in BNZ there was a completely separate series of transactions downstream that the plaintiff taxpayer was not involved in. This comment is important. Accent in factual background is very similar to *BNZ.* By making this remark, His Honour was giving the reason why the judgment in *Accent* is different from *BNZ.*

6.6 Line Drawing

Venning J revisited the issue of "*line drawing*" in his judgment. In *Challenge*[65], Lord Templeman drew a distinction between tax avoidance and tax mitigation. According

[64] *Accent Management Ltd v CIR* [2007] NZCA 230 Para 109, 110
[65] *Challenge Corporation v CIR* [1986] 2 NZLR 513

to his Lordship, the then s 99 applied to arrangements involving tax avoidance but not to arrangements involving tax mitigation.

However, His Honour confirmed that "line drawing" from the tax mitigation perspective is not unhelpful in this instance by referring to Cooke P in *Challenge*[66].

> "The distinction between tax avoidance and tax mitigation is both authoritative and convenient for some purposes, but perhaps it can be elusive on particular facts. Whether it could solve all problems in this field may be doubtful…"

6.7 Scheme and Purpose Approach

According to Venning J the issue of whether there is tax avoidance in Accent requires consideration of the scheme and purpose of the Act as a whole and the specific statutory provisions in issue. A consideration is required on whether the arrangement

- Directly or indirectly alters the incidence of tax avoidance
- Directly or indirectly relieves any person from the liability to pay income tax
- Directly of indirectly avoids, reduces or postpones any liability to income tax

6.8 Purpose Test

The High Court also considered on the issue of whether the arrangement is a tax avoidance arrangement in that it has tax avoidance as its purpose or effect and that purpose if existed is more than merely incidental. The court decided that tax avoidance was more than incidental. Instead, it found that tax avoidance was the dominant purpose of the Trinity Scheme. Venning J emphasised that "*the purpose is to be ascertained on an objective basis*"[67].

It is interesting that Venning J referred to Woodhouse P in the Court of Appeal in *Challenge* when ascertaining the meaning of the phrase "merely incidental". His Honour focused on the commerciality issues in earlier part of his judgment. Therefore, by referring to Woodhouse P's comment, Venning J confirmed that

[66] Ibid
[67] *Accent Management Ltd* v CIR [2007] NZCA 230 at [301]

artificiality and contrivance were key considerations in objective approach to the purpose test.

> "When construing s 99 and the qualifying implication of the reference … to "incidental purpose" I think the question which arise need to be framed in terms of the degree of economic reality associated with a given transaction in contrast to artificiality or contrivance or what may be described as the extent to which it appears to involve exploitation of the statute while in direct pursuit of tax benefits."

> "the uncertainty of the profitability of the forest venture is in stark contrast to the certainty and the extent of the deductions and consequent tax advantages the scheme provided the plaintiff as investors."

Venning J cited the followings as the reasons for reaching a conclusion that tax avoidance was a more than a merely incidental purpose.

- The more likely scenario is that the investment will not achieve a positive return on capital and in some instances will not reach the nominal return required to satisfy the premium payment.
- The uncertainty of the profitability of the forest venture is in stark contrast to the certainty and extent of the deductions and consequent tax advantages the scheme provided the plaintiff as investors.
- The transaction overall cannot be categorized as a circular transaction in that the ultimate beneficiaries of Trinity 3 and Trinity Foundation are charities and the plaintiffs are on the other hand, investors, the degree of relationship and circularity between the payments or potential payments required by the principal parties to the arrangement including the plaintiffs is significant.
- Without the tax advantages that have been identified the Trinity scheme was inferior to an ordinary forestry venture
- While at law the CSI arrangements satisfy the requirements for insurance practically the insurance arrangements are highly unusual
- The admission in CSI business plan which was later discovered by the Serious Fraud Office that the real advantage from the scheme was the tax benefits and that the actual outcome of the deal in 50 years time was not considered material
- The unusual structure of the investment.

6.9 Sham

The High Court also deliberated on the question of sham. After having analysed the insurance contracts, the Court decided that the insurance contracts were entered into between arms-length entities. CSI existed and registered as insurance company. All contracts have all the characteristics of insurance contracts. Therefore, the Court ruled out the fact that Trinity scheme was a sham.

6.10 Significant Points from High Court Decision

High Court reached its decision by purposive interpretation. However, Venning J seemed to be reluctant to say that it was the basis of his decision. His Honour still took the assistance of the "purpose test" to prove that Trinity scheme was nevertheless tax avoidance arrangement.

In construing the specific provisions, His Honour analysed the underlying characteristics of the transactions. The contractual forms such as the right to use land were not taken on their face value. In carrying out the contractual analysis to get the true purpose of the transaction, Venning J had a difficult task of balancing between obtaining the true nature of transactions and taxing by economic equivalence. His Honour said that he would construe the deduction provisions purposively. However in doing so, he would exclude the commerciality and economic equivalence issues from the analysis.

> "Whether the insurance taken overall was "real and effective" or alternatively was without economic substance or commercial credibility seem in my view to be matters more relevant to the general avoidance issues, rather than the black letter law issue."[68]

At the time the High Court decision was released, the commentators predicted that the Court of Appeal would not support the decision in High Court[69] because Venning J's judgment is inconsistent with both the majority and minority judgment in *Peterson*[70]

[68] *Accent* (HC), Ibid, Para 185

[69] Dunbar (2005) in his seminal paper, which was written after High Court decision but before Court of Appeal decision suggested that the Court of Appeal will not endorse the High Court judicial reasoning. - Dunbar, David (2005) – *"Judicial Techniques for Controlling the New Zealand General Anti-avoidance Rule: A Case of Old Wine in New Bottles, from Challenge Corporation to Peterson"* – Victoria University of Wellington Working Paper Series, WP38 at 10.2 page 39

[70]

and also inconsistent with earlier Privy Council decisions in *Auckland Harbour Board* in *O'Neil*.

7. The Court of Appeal Decision

The Court of Appeal reaffirmed the decision in the High Court that Trinity Scheme was a tax avoidance arrangement. In its judgment, the Court concluded that the scheme was "*technically correct but contrived*" and was well and truly across the "line" of acceptable tax planning[71].

The main issue before the court is whether or not the Trinity scheme should be caught by the general anti-avoidance provision. In doing so, the Court did not revisit the "commerciality" issues decided in the High Court although it remarked that Venning J approach on commerciality issue is of importance and should be recorded. The Court of Appeal also reviewed the sham argument put forward by the Commissioner.

7.1 Taxpayers' argument

Claimant Trinity taxpayers contended that timing mismatches between the economic cost of expenditure and associated deductibility are thus to be expected and artificial business structures contrived to capture associated tax benefits are perfectly acceptable. The taxpayers maintain that there is no inconsistency between the deduction claimed and the scheme and purpose of the Act. According to the taxpayers, the Parliament contemplated the deliberate timing difference for a long-term investment (i.e. forestry).

The taxpayers also contend that the law should follow that established by English tax cases in the line of authorities which starts with *W T Ramsay v Inland Revenue Commissioners*[72]. The taxpayers also proposed the 'threshold question' approach which would give primacy to specific provisions and a secondary role to general anti-avoidance provisions.

[71] *Accent* (CA), ibid, Para 146
[72] [1982] AC 300 (HL)

The taxpayers also pointed out that High Court decided Trinity scheme was a tax avoidance citing elements of circularity. However, the taxpayers argued that the circularity relied on by the judge was not tied into reasoning why such circularity was offensive in a tax avoidance context.

The taxpayers also contended that they clearly intended to make a profit and it is not for the Commissioner (or the Courts) to tell a taxpayer how much should be paid for the business inputs. The fact that the taxpayer had possibly made a bad bargain was irrelevant. It is not material that the total deductions are greater than the commercial returns.

7.2 Analysis of the Court of Appeal

The Court of Appeal first deliberated on sham argument. When sham was not proved, the Court moved on to issue of interpreting the deduction provisions. In doing so, the Court simply reviewed the interpretation of the High Court.

After having analysed the behaviour in which the taxpayer took advantage of the specific provisions, the Court decided that this is a type of a case where s BG1 should be approached in conjunction with scheme and purpose approach.

7.3 Statutory Interpretation and Inconsistency between GAAR & SAAR

The court opens its discussion by recognising that the fundamental issue is of statutory and not contractual interpretation[73]. One of the issues before the Court of Appeal was the inconsistency between the general anti-avoidance rules and the specific anti-avoidance rules. The taxpayers relied on the specific depreciation rules which allow them to claim deductions for the licence fees payable in 2048.

The Court remarked that Trinity scheme could be caught even in the literal reading of general anti-avoidance provisions. At the same time, the Court seemed to be aware of the jurisprudence set in earlier cases that literal interpretation of a broadly drafted s BG1 could have undesirable effects. The Court acknowledged that the tax legislation

[73] *Accent Management Ltd v CIR* [2007] NZCA 230 Para 98

necessarily creates both incentives and disincentives and it would be perverse to hold that rational and intended taxpayer responses to such incentives (or disincentives) are caught by general anti-avoidance provisions despite being within their letter.

The taxpayers contended that specific provisions should take supremacy over the general provisions. It is a basic rule of statutory interpretation that the specific provisions override the general provisions. The Court responded such argument by stating that s BG 1 itself is specific in targeting the tax avoidance. Therefore, there is no issue of supremacy between s BG1 and specific provisions.

> "In a real sense, general anti-avoidance provisions are at least as "specific" in their targeting of tax avoidance as specific deductibility rules are in relation to deductions and thus there is no obvious reason why specific deductibility rules should occupy the whole or most of the ground."

The Court of Appeal acknowledged that there is a tension between general anti-avoidance provision and the specific provisions. On this issue, the Court still regarded Richardson J's approach in Challenge as the authority.

> "Section 99 thus lives in an uneasy compromise with other specific provision of the income tax legislation. In the end the legal answer must turn on an overall assessment of the respective roles of the particular provision and s 99 under the statute and of the relation between them. … Nevertheless, that emphasis on trying to discern the scheme and purpose of the legislation is likely to provide the legal answer to the relation between s 99 and other provisions of the Act that best reflects the intention of Parliament as expressed in the statute."

With this the Court of Appeal pronounced that it would use the scheme and purpose approach in *Accent*. The Court of Appeal made it clear that unless it could be shown that the deductions lay outside the scheme and purpose of the provisions of the Act which were invoked by the tax payers, the Commissioner's case failed[74].

After having weighed in the tension between the general anti-avoidance provision and the specific deduction rules, the Court handed down its decision as follows:

> "… the simpler way of resolving the inconsistency problem would be to give general anti-avoidance provisions a primacy that is displaced only when there is a discernible legislative intention that a particular type of transaction should not be subject to them"

[74] Ibid *Accent (CA)* Para 113

7.4 Purposive Interpretation

The key message of the Court is that when construing such specific rules and looking for their scheme and purpose, it is necessary to keep general anti-avoidance provisions in mind. The Court outlined three options available to a Court considering a tension between specific and general provisions. They are: -

(1) In some instances, the legislature must have intended to encourage particular types of behaviour. Behaviour of that type cannot be within the general avoidance provisions because the overall legislative purpose is that such behaviour should attract the tax consequences provided by the Parliament

(2) In some instances, the specific tax rules relied on were not intended to confer the tax benefit in issue. Such a case is likely to be decided simply by construing the relevant specific tax rules so as to accord with the legislative intent and without any need to resort to the general anti-avoidance provisions.

(3) Cases which lie in between above two extremes still raise a question of statutory interpretation but one which cannot be addressed solely by reference to the specific tax rules relied on by the taxpayer. The relevant general anti-avoidance tax rules are also relevant[75].

And the Court regarded *Trinity scheme* should fall into to category (3) above. However, the Court in its judgment did not clearly stated why Trinity case could not be category (2). By branding *Accent* as category (2), the Court could be implying that the behaviour in Trinity was not extremely unacceptable. It could also be possible that the Court was not confident in ascertaining the true legislative intent which is a key factor in applying category (2).

7.5 Application of s BG1

The Court of Appeal summarised the followings as the current authority on the application of s BG1.

(a) Transactions which are "technically correct but contrived",

[75] Ibid *Accent (CA)* Para 125 & 126 – These three categories will be referred to as category (1), (2) & (3) in this paper.

(b) Elements of pretence. In this context, “pretence” does not necessarily mean falsehood as the explanation given by Lord Templeman indicates.

(c) Although the tax system does not provide for taxation by economic equivalence, considerations of economic reality inevitably is material,

When a scheme has above characteristics the court should consider whether or not s BG1 should be applied.

7.6 Line-drawing

Having discussed the supremacy of the general anti-avoidance provisions over the specific provisions, the Court turned its discussion into the issue of tax avoidance. Tax avoidance cases are all about drawing a line between acceptable tax planning and unacceptable tax avoidance. Each country has its own way of drawing the line between acceptable and unacceptable tax position. And the border line keeps changing due to government policy, socio-economic condition and tax rates.

On the question of what would trigger the line-drawing process, the Court see that schemes which come within the letter of specific tax deductibility rules by means of contrivance or pretence are candidates for avoidance.

By quoting Richardson P in *BNZ*, the Court highlighted three elements of line drawing in the context of general anti-avoidance rule in New Zealand. They are:

- There must be an arrangement coming within the section
- The arrangement must have a more than merely incidental purpose or effect of tax avoidance.
- When above two ingredients are present, the assessable income of any person affected by the arrangement is adjusted so as to counteract any tax advantage obtained by that person from or under that arrangement.

The Court also tried to get the assistance from the definition of tax avoidance given by Lord Templeman in *Challenge*.

7.7 Purpose Test

The High Court used the purpose test in arriving its decision. The Court stated that the final and most important step is to determine whether the arrangement was undertaken with more than an incidental purpose of achieving tax benefits or advantages identified.

The Court concluded that tax avoidance was more than a merely incidental purpose of the arrangement known as the Trinity scheme. The court agreed with Lord Templeman in *Challenge* that general anti-avoidance provision would be useless if a mechanical and meticulous compliance with some other section of the Act were sufficient to oust the anti-avoidance provision.

When carrying out the commerciality analysis, the Court made a remark that it will use findings in this analysis in the purpose test. Consequently, the Court cited that making profit from the harvesting trees was never a purpose of the Trinity scheme.

> "It is clear that the real purpose of the arrangement is not the conduct of a forestry business for profit, but rather generation of spectacular tax benefits. The end result (i.e. the profitability or otherwise of the venture) was never seen as being material. The corollary of this statement is that there never was a "real" purpose of making a profit from the harvesting of trees."

7.8 Sham

The Court also reviewed the sham argument. In the High Court, it was decided that the insurance arrangement were not a sham. The Court of Appeal endorsed those findings.

8 Significance of Court of Appeal Decision: How it fits in to the Development of the Judicial Approach in Avoidance Cases

8.1 Judicial Approach on Tax Avoidance

The Court of Appeal took a different approach from the High Court although it reached to the same conclusion as to tax avoidance. In the High Court, statutory interpretation and the tax avoidance analysis were two separate processes. The High

Court carried out the tax avoidance analysis as an insurance policy to its statutory interpretation exercise.

The Court of Appeal regarded statutory interpretation and the tax avoidance analyses in a more integrated way. According to the Court of Appeal, the court will first carry out the scheme and purpose analysis on the taxpayer's use of the specific provisions. Upon completion of that analysis, the Court should end up one out of three scenario outlined below.

(1) use of specific provision in a behaviour contemplated by the Parliament. Section BG 1 does not apply.
(2) Use of specific provisions which were not intended by the Parliament to confer tax benefit in issue. Use purposive interpretation.
(3) Anything that fall between (1) & (2) above. Purposive interpretation of specific provisions with s BG1 steadily in mind.

Therefore, the Court of Appeal approach involves the application of scheme and purpose approach in two stages. First, the Court will approach a possible tax avoidance scheme and its use of specific provisions with a scheme and purpose analysis. At the end of the first round of scheme and purpose analysis, the Court should be able to assign the case into one of three categories mentioned above. If it turns out to be category (2) & (3), the Court will trigger another round of scheme and purpose analysis to reach to the final conclusion. This is the most significant contribution of the Court of Appeal towards the development in the tax avoidance jurisprudence. There are many questions that the Court needs to answer and a lot of clarifications needed. However, this approach could be the answer to many previously answered questions in New Zealand tax avoidance law.

It was Richardson J in *Challenge* who first pointed out the tension between general and specific provisions. His Honour said that it was not desirable for s 99 to override all other provisions in the Act. Likewise, it was equally undesirable for s 99 to be a dead letter being subordinate to all other specific provisions in the Act. Therefore, His Honour set out an approach which is later known as "Richardson's Middle Approach".

> "For the inquiry is as to whether there is room in the statutory scheme for the application of s 99 in the particular case. If not, that is because the state of affairs achieved in compliance with the particular provision relied on by the taxpayer is not tax avoidance in the statutory sense. Reading s 99 in this way is to give it its true purpose and effect in the statutory scheme and so to allow it to serve the purpose of the Act itself"[76]

Although it was not stated in the judgment, the approach of the Court of Appeal was likely to be motivated by Richardson J's middle approach.

With this approach, the Court has put the scheme and purpose approach of statutory interpretation ahead of the so-called "purpose test". Adopting this approach may cause taxpayers and the IRD to examine the underlying purpose or object of applicable provisions and tax regimes to assess whether the tax outcome of an arrangement is consistent with that purpose or objective of the legislation before analyzing whether the tax advantages of the arrangement were a more than merely incidental purpose or effect of the arrangement.

In other words, before invoking the s BG1, the Commissioner needs to assess whether a particular scheme or a tax outcome frustrates the scheme and purpose of the Act. If it could be proved that there was no such defeating of the scheme and purpose of the Act, the Commissioner will not be able to invoke s BG1 and as a result will not be able to go down the steps involved in a general anti-avoidance provision.

The IRD's traditional approach to applying general anti-avoidance rules is outlined in a Policy Statement released in 1990. The approach has been to analyse:

- the underlying scheme and purpose of the Income Tax Act as a whole and the specific regime and/or provision(s) under review;
- the arrangement, to ascertain its purpose or effect; and
- whether a fair and reasonable inference can be drawn that tax avoidance is a more than merely incidental purpose of the arrangement.
- Decide whether it can be inferred that the arrangement frustrates the underlying scheme and purpose of the legislation

[76] Richardson J in *Challenge* (CA), ibid at 549

In September 2004, IRD issued an Exposure Draft (ED) which outlined a renewed approach in the application of s BG1 (see Appendix (1) for the illustration of the Commissioner's approach in ED). The significance is that the scheme and purpose analysis was placed only in the 4th step. According to the ED, IRD would approach a possible avoidance scheme with an analysis of "arrangement" as set out in s OB1. Once identified an arrangement, it would proceed to the "purpose test" as outlined in s BG1. Only after this analysis does the IRD consider whether it can be inferred that the arrangement in question frustrates the underlying scheme and purpose of the legislation.

New Zealand Law Society (NZLS) in its submission to the Exposure Draft recommended that scheme and purpose analysis should be included as the first step in IRD's six-step approach as the case law in New Zealand supports such an approach[77]. *Accent* has been the first opportunity since the Exposure Draft to find out the judiciary's opinion on IRD's approach. The judicial approach in the Court of Appeal by putting scheme and purpose approach at the forefront seemed to have endorsed the calls from the NZLS and many others alike. In a way, *Accent* decision is a reminder to IRD that ascertaining the purpose of the Act is the most important and needs to be carried out as the first step.

8.2 Was the Court in Accent Reluctant in using Purposive Interpretation?

The Court of Appeal in its initial scheme and purpose analysis regarded Trinity scheme as category (3)[78] and thus a combination of purposive approach and s BG1 should be applied. It would be helpful if the Court outlined in detail why Trinity case should not be category (2). Therefore, following questions remain unanswered.

1) Category (2) involves analyzing the case from purposive interpretation alone. What was the reason the Court being reluctant in using purposive interpretation on its own?
2) Did the Court perceive that the assistance of s BG1 is required to strike down a scheme such as Trinity?

[77] New Zealand Law Society (2004) – "Comment on the INA0009: Interpretation of Sections BG 1 and GB 1 of the Income Tax Act 2004"

[78] As per 3 categories outlined by the Court. Those three categories are discussed in earlier part of the paper.

The legislation in New Zealand has provided the court to purposively interpret the statutes if necessary. And New Zealand version of purposive interpretation, so-called "scheme and purpose" approach, has been actively being applied by the courts since its conceptualization since early 1980s. However, the decisions in earlier cases suggest that there are problems for the court in effectively using the purposive approach. One of the reasons is the difficulty in ascertaining the legislative intent.

In order to find out whether the use of purposive approach alone (as outlined in category 2 in *Accent* [CA]), we will now look at few statutory interpretation cases in New Zealand tax law. *CIR v Alcan New Zealand Ltd*[79] (*Alcan*) is the milestone case. Scheme and purpose approach was first applied in *Alcan*.

Alcan New Zealand Ltd is incorporated in New Zealand. Alcan Australia owns 98% of Alcan New Zealand[80]. Alcan Australia did not derive any source income in New Zealand and it had no permanent establishment in New Zealand. Alcan Australia[81] sold aluminium ingots and billets to Alcan New Zealand with a margin. Alcan New Zealand in calculating its income for income year 1998 and 1999 deducted the margin of Alcan Australia from the value of its closing stock. There were changes of tax rates during those years. That in combination with the timing difference created a tax saving of $500K for Alcan New Zealand if the trading stock could be valued without Alcan Australia margin.

According to s 85(4) of the Income Tax Act 1976, Alcan NZ can value the stock at cost to other companies within the group. The rationale behind this provision is to protect the group being taxed if the stock is not sold outside the group. In other words, profit from the inter-group sales is the unearned profit from the group perspective. It is also in accordance with the existing generally-accepted accounting practices (GAAP). Alcan NZ could apply this provision only if the Alcan Australia is regarded as a group company.

[79] (1994) 16 NZTC 11
[80] Both Alcan Australia and Alcan New Zealand were owned by the holding company in Canada.
[81] In 1994, Alcan Australia was owned by Australian Aluminium which is a subsidiary of Alcan Aluminium Ltd of Canada.

The primary issue in the case is whether or not Alcan New Zealand and Alcan Australia are in the same group. As per section 191(3) only two-thirds of the shares are required. Alcan Australia owns 98% of Alcan NZ and thus they are effectively in a group.

The interesting twist in Alcan is that the Court applied the purposive approach extensively throughout the case but it eventually decided to construe the statute literally. The Court in its unanimous judgement decided that there is no sufficient basis for departing from the plain meaning of the words of s 191. It viewed that it was not necessary to read into those words some implied limitation as to do so would require speculation as to the legislative intent. As a result, the Court interpreted s 191(3) literally. In its decision, the Court of Appeal in *Alcan* made it clear that the purposive approach is preferable but the Court will not give effect of the purposive interpretation unless the legislative intent is clear.

The question is whether the decisions in cases such as *Alcan* constrained the New Zealand court to apply purposive approach of interpretation. On the other hand, the jurisprudence on s BG1 is well established and well proven.

Then the next question is why the Court did not use s BG1 and purpose test alone? Why the Court bother to outline three possible scenarios to deal with avoidance cases? Why the Court set out in category (2) that purposive approach is an option for the New Zealand courts in its own right?

It is the Court of Appeal that would have all the answers for these questions? However, we could at least say that Court of Appeal was aware of the "basic problem" inherent to general anti-avoidance rule. [82]

8.3 Reaffirmation of Choice Principle

In Accent, the Court of Appeal reaffirmed the "Choice Principle" laid down by the Australian courts in *WP Keighery Pty Ltd v FCT (Keighery[83])* is a valid jurisprudence.

[82] Richardson J in *Challenge* (CA), ibid at 549

In three categories of tax avoidance cases[84], category (1) clearly referred to "Choice Principle". However, the Court of Appeal decided that it regarded *Accent* as category (3) and thus Choice Principle did not apply.

The "Choice Principle" states that anti-avoidance rules should not apply to a transaction which is structured in a way that minimises tax if the legislation, upon its true construction, is intended to give the taxpayer the choice of minimising tax in that way. In other words, alternative courses of action provided for under specific provisions in the income tax legislation are not necessarily to be treated as invalidated by a GAAP such as BG 1. The taxpayer is argued to have simply exercised a choice expressly made available by Parliament.

Choice principle seemed to have developed from the concern that general anti-avoidance provision become so powerful that it will make other provisions in the Act defunct. Lord Wilberforce in *Mangin v CIR*[85] voiced a concern that:

> "[Section BG 1 fails] to specify the relation between the section and other provisions in the [ITA] under which tax relief, or exemptions, may be obtained. Is it legitimate to take advantage of these so as to avoid or reduce tax?"

This concern was later reiterated by Richardson J in *Challenge* and referred to in many other avoidance cases.

In *Keighery,*[86] the Court held that the general anti-avoidance provision was not intended to deny taxpayers any right of choice between alternatives provided under the Act, and the intention of section 260 was to protect the general provisions of the Act from frustration. This view was approved and applied in *Casuarina Pty Ltd v FCT.*[87]

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[83] *WP Keighery Pty Ltd v FCT*[83] (1957) 100 CLR 66 (HCA), - "The Keighery test has been customarily and conveniently referred to as the choice principle" – Richardson J in *Challenge - Challenge Corporation Ltd v CIR* (1986) 8 NZTC 5,001 (CA)

[84] See three categories of tax avoidance cases outlined by the Court in *Accent (CA),* Ibid, Para 125 & 126

[85] [1971] NZLR 591

[86] Ibid

[87] *Casuarina Pty Ltd v FCT* (1971) 127 CLR 62 (Full HCA)

In New Zealand, the choice principle has come under considerable debate in such cases as *Mullens*[88], *Slutzkin*[89] and *Cridland*[90]. In *Challenge* (CA)[91], Richardson J expressed the view that s 99 of the 1976 Act, should not override all other provisions of the Act so as to deprive the tax paying community of structural choices, economic incentives, exemptions and allowances provided for by the Act itself. Woodhouse P suggested that there can be opportunities open to a taxpayer to take one route rather than the other. In essence, both Judges recognised the tension between taxpayers arranging their tax affairs effectively and the need to protect the tax system from avoidance abuse.

While the *Challenge (CA)* decision was overturned by the Privy Council, their Lordships did not comment upon the *Keighery* choice principle. Thus, the Court of Appeal comments are still relevant in determining the scope of the application of this principle in New Zealand.

Fifteen years after *Challenge*, Richardson J repeated this approach in *CIR v BNZ Investments Ltd.*[92] Given what happened in *Auckland Harbour Board*, and the rejection in *Miller* of tax mitigation; this is likely to become the decisive interpretative technique. In summary, the reliance on a particular advantageous section of the Act does not automatically rule out the application of the GAAP. Nor does the choice principle apply in New Zealand in the form of a rigid rule such that taxpayers availing themselves of a specific provision will exclude the operation of s BG 1. The Commissioner considers the correct approach is to determine whether, having regard to the scheme, purpose, and language of the legislation, Parliament intends the specific provision, regime or the Act to apply to the arrangement (unhindered by the GAAP) or whether the arrangement frustrates rather than facilitates Parliament's intention.

In *Accent* the court recognised that the choice exists and s BG1 should not deter the taxpayer from such a choice.

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[88] *Mullens &Ors v FCT* 76 ATC 4,288 (HCA)
[89] *Slutzkin v FCT* 7 ATR 166 (HCA)
[90] *Cridland v FCT* 8 ATR 170 (HCA)
[91] Ibid
[92] CIR v BNZ Investments Ltd (2001) 20 NZTC 17,103 (CA)

> "legislation necessarily creates both incentives and disincentives and it would be perverse to hold that rational and intended taxpayer responses to those incentives (or disincentives) are caught by anti-avoidance provisions".

However, the Court in its final judgment decided that s BG1 should apply in *Accent*. According to (3) categories outlined by the Court of Appeal, the choice principle relates to category (1). The Court ruled that the Trinity scheme should fall into category (3). The Court did not explain in detail which factors denied Trinity taxpayers from the benefit of Choice principle and should belong to category (3).

8.4 Confirmation that the Court will respect Business Reality

The Court of Appeal decision recognizes that the reality that commerce is legitimately carried out through a range of entities and in a variety of ways. The court reaffirmed this by quoting the judgment of Richardson P in *BNZ* (CA)[93].

> Line drawing and the setting of limits recognise the reality that commerce is legitimately carried out through a range of entities and in a variety of ways;

Therefore, the court in drawing a line between acceptable tax planning and unacceptable tax avoidance will take into consideration of this reality. This has to be comprehended in the context of the *Duke of Westminster* principle. Modern courts would no longer honour the fact that the taxpayer can manage his tax affairs as he wished. Modern courts in dealing with a tax avoidance case are prepared to pierce the veil provided by the literalism in Duke of Westminster. In doing so, the court will not disregard the reality of the business world. Such sentiment is shown by the House of Lords in *Peterson*[94].

Although the Court in principle accepted that commerce carried out through a range of entities, it did not regard the complex entity structure in Trinity scheme as a business reality. There arises a question of how the Court would determine what constitutes a business reality. The Court of Appeal did not revisit this issue and thus there exists no proper guidance on this issue.

[93] Ibid
[94] Ibid

Commercial justification defense in tax avoidance cases have been rejected by the courts. In Australia, the Court rejected the commercial justification exception to the application of general anti-avoidance rule in *Spotless*[95].

Recent Jurisprudence in Other Countries

The *Accent* decision is also at odds with recent tax avoidance jurisprudence in UK. There are many similarities between *Barclays Mercantile* and *Accent*. The former invested in the pipelines and the later in the forestry.

In *Barclays Mercantile*[96], the House of Lords rejected the contention of the HM Revenue Department that if the scheme were looked at as a whole, as a result of the circular flows of funds Barclays Mercantile had not incurred any economic loss on the capital allowances that it claimed. Instead, the tax payers did not suffer any economic loss which the Parliament has intended before it was entitled to capital allowances.

The House of Lords rejected this line of argument, and determined that the focus of its enquiry should only be upon the acts and purposes of the finance lessor (BMBF) in relation to its entitlement to the capital allowances. It should not consider the acts and purposes of the finance lessee (BGE). "The statutory test was based on the purpose of the lessor's expenditure, not the benefit of the finance to the lessee".

> "So far as the lessor is concerned, all the requirements of section 24(1) were satisfied. Mr Boobyer, a director of BMBF, gave unchallenged evidence that from its point of view the purchase and lease back was part of its ordinary trade of finance leasing. Indeed, if one examines the acts and purposes of BMBF, it would be very difficult to come to any other conclusion. The finding of the special commissioners that the transaction "had no commercial reality" depends entirely upon an examination of what happened to the purchase price after BMBF paid it to BGE. But these matters do not affect the reality of the expenditure by BMBF and its acquisition of the pipeline for the purposes of its finance leasing trade."[97]

If the same jurisprudence were to apply in *Accent*, the Court of Appeal should not have disregarded the contractual relationships within different segments in the Trinity scheme.

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[95] *FC of T v Spotless Services Ltd* 96 ATC 5201
[96] Ibid
[97] *Barclays Mercantile* (HC), Ibid, Para 41

Accent decision is also at odd with recent Supreme Court of Canada decision in *Canada Trustco*[98]. In *Canada Trustco*, "cost" was given what Lord Hoffmann might have called in *Westmoreland* a "legal" meaning, and the mere fact that an economic or commercial purpose was not present was held to be insufficient to show that a transaction resulted in abusive tax avoidance.

[98] *The Queen v. Canada Trustco Mortgage Co.*, 2005 SCC 54

9. A Swing in the Pendulum

New Zealand has had only less than a dozen of major tax avoidance cases in the past two decades. From *Accent* to *Peterson*, the judicial approach seemed to have development in a consistent pattern towards one direction. The key messages sent out by the courts are that the judiciary will not interpret s BG1 literally in a way it would make all other provisions in the Act are subordinate to it; the judiciary will not decide tax avoidance cases by economic equivalence; and the judiciary will recognize that the business in reality is carried out in a complex structure and tax is an important factor in business decision making.

Accent decision clearly swung the pendulum to the Commissioner's favor. The judicial reasoning in *Accent* is inconsistent with previous decisions.

9.1 Challenge: the Emergence of Scheme and Purpose Approach

Challenge is regarded as the source of the modern tax avoidance law in New Zealand. *Challenge* has been quoted in all tax avoidance cases that come before the court especially scheme and purpose approach applied by Richardson J.

In *Challenge*, the taxpayer purchased all of the share capital of a loss company called Perth. There was apparently no commercial justifications for the purchase because Perth was a dormant company which was not trading at the time of purchase. In addition, Perth did not involve in any business activity after having purchased by Challenge. Perth owns no asset. The only asset in Perth was the available tax losses.

Following comment from the Richardson J in *Challenge* became the judicial guideline towards scheme and purpose approach.

> "On the analysis of the role of sec 191 in the statutory scheme, and of the terms of the provision itself, I am satisfied that to treat the arrangements carried through in this case as tax avoidance within sec 99(1) would defeat, not promote, the legislative purposes involved. The tax changes achieved in the transactions did not alter the incidence of income tax which the Act itself contemplated or affect Challenge's liability for income tax in the sense indicated by the Statute."

On the appeal, the Privy Council decided in favour of the Commissioner. Privy reached to the decision by purposively interpreting s 191. Lord Templeman reached

his decision by focusing on the original section 191 of the ITA 1976 and ascertaining that there was this natural unwritten law of grouping for companies which provided that if the profit company was not a member of the loss company's group at the time the loss company incurred the loss then the profit company could not utilize the loss company's losses.

The factual background in *Challenge* is similar to *Accent* to the extent that both cases require the judiciary to consider whether tax advantage obtained through the specific provisions should be disallowed using general anti-avoidance provision.

Accent decision sits uncomfortably with the judicial reasoning in *Challenge*. It is not compatible with the Court of Appeal decision in *Challenge* which decided that arrangement in Challenge left no room for s 99. It is also at odd with Privy Council decision which favours the Commissioner. Lord Templeman in Privy Council did not apply s BG1 to strike down the tax advantage obtained through s 191. His Lord purposively applied s 191 to disallow the taxpayer's claim.

Therefore, if the *ratio dicidendi* of *Challenge (CA)* were to apply to *Accent*, the taxpayers could have won. Even the ratio in *Challenge* in Privy Council were to apply to *Accent*, the court had to reach its decision by purposively interpreting s EH1 and EH2 and not invoking s BG1. One might recall that the Court of Appeal in *Accent* interpreted those provisions in favour of taxpayer. Therefore, the juridical approach in *Accent* needs clarification by the later courts (either at the Supreme Court if it goes for appeal or in a different case).

In his judgment, Richardson J said:

> "The nature of s 191 and these features of the scheme of the section at the material time do not in my view leave any room for the application of s 99 to these straightforward arrangements which did no more than bring the loss companies within a new group so as to satisfy the requirements of s 191."

The word "straightforward" in above judgment needs to be noted. Did the Court in Challenge reached to its decision because the arrangement was straightforward?

Would it reach to a different decision if the arrangement is as complex in contrived as in *Accent*?

9.2 Auckland Harbour Board

The Auckland Harbour Board (AHB) owned and managed local body financial arrangements. As a result of a impending government reform, they were required to transfer assets including $20million of government and local authority stock to the Auckland Regional Council (ARC). In order to avoid the forced transfer of some of the stocks at the time of the rule change, AHB formed a charitable trust and transferred those stocks to the trust at nil value. Consequently, AHB made a base price adjustment on this stock on the basis that nothing has been received for it. As a result, AHB claimed a deduction of $8.6million for the loss created under the base price adjustment.

The Commissioner contended that the transfer of the stocks at nil value had the effect of defeating the legislative intent and application of the accrual rules. The Commissioner also argued the accrual rules are premised on the basis that transfers of financial arrangements would be at market value. In its decision, the Privy Council made it clear to the Commissioner that the general anti-avoidance rules cannot be used to rewrite the statutes.

Auckland Harbour Board is similar to *Accent* in the sense that both tried to take advantage of a provision in the Income Tax Act. On both occasions, the Commissioner tried to interpret the statutory provision purposively citing s BG 1.

If the Court of Appeal in *Accent* were to follow the judicial reasoning in *Auckland Harbour Board*, the judgment should end at the point the Court of Appeal literally construed section EH 1. S BG 1 analysis should not be carried out.

On the other hand, the complex and artificially created entities in *Accent* gave the wrong impression to the Court. The letter later revealed by the Serious Fraud Office which showed that generating profit is not material in Trinity Scheme. Such factual circumstances might cause the Court to decide in the Commissioner's favour. As one

commentator put it "When the judge thinks one party is not telling the truth, it is very difficult to claw your way back"[99].

9.3 BNZ

In *BNZ*, the taxpayers BNZ used the money borrowed from its customers to subscribe for shares in BNZI. BNZI then used the proceeds of the share issue to subscribe for shares in CML, an arms length company. CML in turn subscribed in offshore equity companies. Those offshore equity companies took up equity in New Zealand tax loss companies. The purpose of the scheme was to take advantage of the then s CB10 of ITA 1994 which provided that all intercompany dividends were tax exempt.

BNZ was another case where s BG1 where the court narrowly interpreted s BG1. The message sent out by the court is consistent with *Auckland Harbour Board*. The Court will not apply s BG1 in its broad-based approach. The majority of the Court of Appeal found for the taxpayer. A fundamental prerequisite to the use of the general anti-avoidance provision against a taxpayer was that there must be a contract, agreement, plan or understanding in which the taxpayer was a participant. The Court regarded that no such understanding existed.

The circularity and the complex nature of in *BNZ* are similar to *Accent*. In BNZ, the court use a technique called "knowledge line". The court regarded that the taxpayers in BNZ were only aware of those transactions above the knowledge line and nothing else. The impact of knowledge line is that the taxpayers were not part of the arrangements in many of the transactions. As the taxpayers were not part of the first limb of the tax avoidance test, s BG1 could not be applied to the taxpayers.

In contrast, the Court in Accent decided that the taxpayers were part of the arrangement in Trinity scheme. According to the Court, if the taxpayers were not part of the arrangement, they are at least party to it.

[99] James Coleman in his lecture at the University of Auckland on 21 April 2006 commenting how the revelation by the SFO could seriously hurt Trinity investors in their case in the Court of Appeal. James Coleman was a junior counsel in *Accent*.

The judgment in BNZ is famous for its recognition for the following principles:

- The choice principle is available to the taxpayer
- The fact that the business is carried out in reality in a complex structure and where tax is an important consideration

The Court of Appeal in *Accent* recognized that those principles exist. However, the Court decided that the factual background in *Accent* is beyond the acceptable threshold of those principles. The Court in *Accent* failed to explain how and why *Accent* exceeds those acceptable limits.

9.4 O'Neil

In O'Neil, the taxpayers were shareholders in a trading company that participated in a scheme that involved a loss company controlled by JG Russell acquiring the trading company. The net profit before tax was paid to the loss company as an administration fee which was offset against the available losses of the loss company. The taxpayers received back the net profit in the form of the 'sale' price for the trading company they had sold to JG Russell. This was intended to constitute a tax-free gain. The timing of payment of the purchase price was linked to the underlying profitability of the company and the transfer of the gross profit (as a management fee) to the tax loss company. Finally, there was an option arrangement that enabled the taxpayers to repurchase their company back from the loss company for a normal amount.

The Commissioner considered that the purpose and effect of the arrangement in O'Neil was tax avoidance and applied the general anti-avoidance provision to void the arrangement and re-assessed the profit-making company tax they would otherwise have paid in the absence of this arrangement.

The Court of Appeal held that the Commissioner's reassessments were valid and the Privy Council upheld the Court of Appeal decision. The judicial reasoning in all the Courts was that the sale and repurchase of the business was inconsistent with the scheme and purpose of the Income Tax Act 1994.

9.5 Dandelion

In Dandelion, the taxpayer Dandelion Investments was a profitable manufacturing company. The taxpayer involved in a scheme which involved the taxpayers buying a shareholding in a company in the U.K which was financed by a loan of $2.8million. The U.K vendor of the target company lent the money to a Cook Island company which relent the money to three other Cook Islands company. Ultimately, the finance made its way to a New Zealand company which lent the money to the taxpayer to but the company.

Dandelion is similar to *BNZ* in terms of circularity. The only difference is that the circumstances in *Dandelion* did not fit into the "knowledge line" approach used in *BNZ.*

Dandelion and Accent are the only avoidance cases where the court found for the Commissioner. In both cases, the commerciality issues were raised at the High Court level. The findings on artificiality were not revisited at the Court of Appeal on both occasions. The Court of Appeal did not reject those findings either.

9.6 Peterson

In *Peterson*, the taxpayer made a passive investment of $2.7million in a film which was never released commercially. The taxpayers funded this investment by 43% of their own cash and 57% of the funds from the limited recourse loans. Irrespective of whether the film was to succeed or fail, an investor on a marginal tax rate will obtain a deduction of 66%. Assuming that taxpayer cost of using own cash is 43%, taxpayer still make a net cash profit between 66% and 43% which is 23%. The return on initial investment was 53% (i.e. 23% divided by 43%). The taxpayers could significantly multiply this effect by making the investment on the last day of the tax year (i.e. 31 Mar). As the turnaround for the tax refunds in New Zealand is about two months, the taxpayer could gain 53% return on investment (ROI) in two months time. In extrapolation, it is equivalent to annual return of 321% per annum. Actual cash investment of the taxpayers (i.e. only 43%) of the stated investment was used in the production of the film.

The Commissioner mainly challenged on the tax advantages associated with the limited recourse loan which was financed by means of a circular self-cancelling

transaction. It had an effect of leveraging the available deductions that were claimed by the taxpayers. The case was contested on the fact that those deductions claimed for the limited recourse loans were not eligible for deductions. To make his case, the Commissioner's could prove that tax refunds received from the IRD were recycled to the lender immediately after the receipt of the money.

Although *Peterson* was decided a year before *Accent*, it is the most contrasting from *Accent* in terms of judicial reasoning. In terms of factual background, *Peterson* has many similarities to *Accent*. Followings are the similarities between *Accent* and *Peterson*.

- Both *Accent* and *Peterson* involve taxpayers making use of the incentive schemes in the Income Tax Act. *Accent* in forestry and *Peterson* in Film.
- In both cases, the Commissioner challenged the commerciality of the scheme. In Peterson, the Commissioner claimed that "while there clearly was an underlying commercial activity with a potential for profit, the actual amount which was applied in that activity was only a small part of the investment for which tax relief was claimed."
- Both cases were contested on the issue of tension between general anti-avoidance rule and the specific provisions in the Act.

The Privy Council allowed the appeal from the taxpayer with the emphasis that taxation by economic equivalence is not acceptable. The Privy Council confirmed that it would follow the reasoning of Lord Diplock in *Europa Oil* that "it is not for the Court of the Commissioner to say how much a taxpayer ought to spend in obtaining his income"[100].

In Peterson, the taxpayers claimed depreciation allowance for the portion they funded by the limited recourse loan. The Privy Council decided that the taxpayers incurred the expenditure the Parliament contemplated.

If we applied the same reasoning to *Accent*, the Trinity investors claimed the deductions as the Parliament contemplated. One might recall that the Court of Appeal

[100] Lord Diplock in *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue* [1976] 1 NZLR 546 at p 556

in *Accent* identified it as category (3). If the Court in *Accent* did not regard that the taxpayers claimed the deductions in a way not contemplated by the Parliament. If so, the Court should have opted for category (2). Therefore, explanation is needed why the Court of Appeal in Accent created so-called category (3) in light of the decision in *Accent.*

10. What should be the Scope of Section BG1?

There are two main approaches in designing the general anti-avoidance provisions. The first approach focuses on the acceptability in a form of transaction in the context of the taxpayer's ultimate objective. The second approach focuses on tax payer's purpose. The general anti-avoidance rule in Germany reflects the first approach and Australia, Canada, New Zealand reflects the other[101]. Some countries embedded the purposive approach of interpretation into the general anti-avoidance rule. For example, Canada's s 245 contains a purposive element. Section 245(5) of Canadian GAAR requires an economic substance analysis of the avoidance transaction in order to assess the appropriate tax consequences[102].

In countries with general anti-avoidance provision, there is a continuing debate as to how wide the scope of the GAAP should be. The general anti-avoidance rule is naturally in conflict with the Duke of Westminster principle which allows the taxpayer to manage its own tax affairs. It is also in conflict with the "choice principle" which does not go as far as Duke of Westminster principle in giving autonomy to the taxpayer but still gives the taxpayer with a choice between different legislative provisions. Due to this tension between the two principles, many jurisdictions operate GAAP within the framework of the Duke of Westminster principle[103]. To deal with this tension, the courts tend to place a gloss using the judicial techniques such as scheme and purpose approach.

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[101] Dabner, Justin (2000) – "*A Spin of a Coin: In Search of a Workable GAAR*" – Journal of Australian Taxation May/June 2000 232 at 234

[102] Li, Jinyan (2006) – "*Economic Substance: Drawing the Line Between Legitimate Tax Minimization and Abusive Tax Avoidance*" - Canadian Tax Journal 2006 Vol. 54 No. 1

[103] Dabner, Justin (2003) – "*In Search of a Purpose to our Tax Laws: Can We Trust the Judiciary?*" – Journal of Australian Taxation 2003 (6) 32

In 1998, the Tax Compliance Committee considered this issue and recommended that current broad meaning of s BG1 should be maintained. New Zealand general anti-avoidance rule was drafted in a broad-brush style since its inception about a century ago. However, modern avoidance cases indicated that the judiciary has rarely interpreted s BG1 in its broad literal meaning. Instead, the judiciary had given a strained interpretation of s BG1.

If s BG1 were to interpret in its broad meaning, *Auckland Harbour Board*, *BNZ* and *Peterson* would have been decided in the Commissioner's favour. In *Accent*, the Court of Appeal acknowledged that Trinity scheme was caught in literal interpretation of s BG1. However, the Court did not decide the case using the literal interpretation of s BG1. Instead, it proposed its own judicial approach (i.e. (3) categories in this case) and applied that approach in reaching its decision.

From the policy perspective of protecting the tax base, it is beneficial for the tax base as a whole to have a widely-drafted s BG1. However, one needs to be aware of the opportunity cost deriving from uncertainty to businesses created by broad s BG1. There is something the courts could do to minimize this uncertainty and costs associated to it. That is keeping the consistent and clear judicial approach which is easy to follow by the business community. In this way, businesses could do their tax planning with clear certainty while the tax base is also protected by broad s BG1 which could sustain the passage of time. The fact that s BG1 has rarely changed from its predecessor legislation over a century ago is also due to its broadly-drafted style.

11. Concept of Commerciality, Artificiality & Contrivance and the Doctrine of Economic Substance

The issue of commerciality often arises in avoidance cases. The courts use commerciality analysis to assist with their line-drawing exercise. The term commerciality, artificiality and contrivance are used as interchangeable words in tax avoidance cases. Although New Zealand courts tend to use the word commerciality alone, the Australian courts tend to use commerciality, artificiality and contrivance as if it were an unbreakable string of words.

In his judgment in the High Court, Venning J questioned on the commerciality of the Trinity Scheme. Seventy eight paragraphs or approximately 20% of the judgment relates to "commerciality" argument. His Honour also pointed out that commerciality one of the key factors in reaching to the decision that Trinity Scheme is tax avoidance. In *Accent,* the Commissioner stated that commerciality of the transactions in Trinity scheme is his main concern in invoking s BG1.

The Court of Appeal in *Accent* did not revisit the commerciality arguments. The Court said in its judgment that it could reach to its decision without relying on the commerciality issues. However, the Court noted that the commerciality issue considered in the High Court are of importance.

> "Further, it also seems reasonable to assume that deductibility rules are premised on a legislative assumption that they will only be invoked by those who engage in business activities for the purpose of making a profit"

The Court of Appeal in *Accent* also remarked that contrivance could assist the court in its line-drawing exercise.

> "Schemes which come within the letter of specific tax deductibility rules by means of contrivance or pretence are candidates for avoidance."

It is not uncommon to see discussions on commerciality issues in tax avoidance decisions. As discussed in earlier part of this paper, litigation strategy of tax avoidance cases often start with attacking the scheme as a sham. Commerciality issue often is the focal point of sham argument. However, it is relatively rare for the court to consider commerciality issue in tax avoidance analysis. Only Dandelion[104] and Accent have been only two cases so far to be questioned on commerciality by the court. On both occasions, the discussion took place at the High Court. When the case went to appeal, the Court of Appeal did not revisit the issue.

Commerciality has been cited as a tool to detect existence of avoidance behaviour in many tax avoidance literatures. Tax Compliance Committee 1998 stated that lack of commerciality as the characteristic of a tax avoidance arrangement.

[104] Ibid

> "Abusive avoidance occurs if arrangements have as their principal purpose the gaining of a tax advantage, and the taxpayer's interpretation was not 'more likely than not' to be correct. Such arrangements are defined by characteristics such as artificiality, contrivance and lack of commerciality. They might also involve concealment of information."

New Zealand courts traditionally reject the taxation by economic equivalence. *Tipping* J *A Taxpayer v C of IR*[105] said that liability for income tax should be determined according to law, not according to elastic notions of economic reality albeit that in case of sham and avoidance a different approach may be required.

> "Taxation issues should not be decided on the basis of the so called economic substance or reality of the transaction, or of the circumstances in which the taxpayer is involved. "

In Australia, the perception towards artificiality is somewhat similar to New Zealand. Brennan C. J in *Spotless*[106] in stated how a court in Australia would view elements of artificiality in tax avoidance cases.

> "…must necessarily be whether the scheme is so attended with elements of artificiality or contrivance primarily directed to the obtaining of the tax benefit that any commerciality of the scheme is overshadowed".

In Australia, evidence of artificiality is normally required to prove a dominant tax-driven purpose. The norm is that if the transaction is a normal commercial transaction carried out in the usual way will not invoke Part IVA even if obtaining a tax advantage in the form of deductions is a significant aspect of the matter. To trigger the general avoidance provision, significant blatancy, artificiality or contrivance is needed.

In Canada, economic substance analysis is used to identify any artificiality in the scheme. The Supreme Court of Canada outlined in *Canada Trustco* how such analysis would be carried out.

> "A transaction may be considered to be "artificial" or to "lack substance" *with respect to specific provisions of the Income Tax Act*, if allowing a tax benefit would not be consistent

[105] (1997) 18 NZTC 13,350
[106] *F. C. of T. v Spotless Services Ltd* (1996)186 CLR 404 at 408

> with the object, spirit or purpose of those provisions. We should reject any analysis under s. 245(4) that depends entirely on "substance" viewed in isolation from the proper interpretation of specific provisions of the *Income Tax Act* or the relevant factual context of a case."[107]

Canada is the only country which has economic substance doctrine embedded in the general anti-avoidance provision. Li (2006) suggests that the courts in Canada should carry out the economic substance analysis in their line-drawing exercise.

The High Court in its decision in *Accent* might have been motivated by economic substance doctrine which was derived from *Gregory v. Helvering*[108]. As the *Gregory* is not accepted in New Zealand tax law, the High Court also emphasized in its judgment that it was aware of the fact that taxing by economic equivalence is not a valid law in New Zealand. Such a conflict might have been the reason why the Court of Appeal tried to reach its decision without relying on commerciality issue.

As the courts in New Zealand increasingly applied scheme and purpose approach (purposive approach), the commerciality analysis become more and more relevant in the analysis of tax avoidance cases. New Zealand courts should revisit this issue. A clear judicial guidelines need to be set out so that the business community could clearly know what is acceptable and what is not.

12. Fiscal Nullity Doctrine – Does It Have a Role in New Zealand?

The factual background of *Accent* is very similar to those cases struck down by judiciary in the UK in fiscal nullity cases. There is a circular flow of funds. Artificial steps or transactions were inserted. There are related/self-cancelling transactions. In *Accent*, the flow of money between Trinity 3, SLFJV and CSI is exceptionally circular.

Dr. Muir and Mr. Bradbury set the maturity date of their investment at a date when they would not be alive (in normal life-expectancy). This itself could be said as a

[107] *Queen v. Canada Trustco Mortgage Co* 2005 SCC 54 at Para 60
[108] 293 US 465 (1935)

fiscal nullity as the taxpayers will not be able to enjoy the return of their investment (if there is any).

When dealing with fiscal nullity cases, the judiciary focused on the commerciality of the transaction. Lack of commerciality has been the main factor leading to the High Court decision in *Accent*. Although the Court of Appeal did not deliberate on the issue of commerciality, it nonetheless recognises that it is of an issue of importance.

The Court of Appeal outlined three avenues of actions the Court would take in cases contested on tax avoidance. The Court outlined "pure" purposive statutory construction as an appropriate action (in category (2)) if the specific provisions are exploited in a behaviour which is against the sprit and purpose of the Act. In *Accent*, the Court did not elaborate on how it would carry out the purposive approach. However, it could not be different from a purposive interpretation applied in fiscal nullity cases.

In its report in 1998, the Tax Compliance Committee recommended that New Zealand should have both general anti-avoidance provision and a judicial approach similar to fiscal nullity doctrine. Did the Committee have a case such as *Accent* in mind when recommending this?

It is also worth noting that *Accent* is the first time that the Court suggested pure purposive interpretation as an option in dealing with an avoidance case[109]. Therefore, it is obvious that the Court is envisaging a scenario which does not fall neatly into the ambit of s BG1. Fiscal nullity approach has been suggested in many literatures as an alternative or a supplement to s BG1. We will now look at how fiscal nullity concept was received by New Zealand courts in the past.

12.1 Fiscal Nullity Doctrine[110]: A Brief Description

[109] "Scheme and purpose" approach has often been used in avoidance cases in conjunction with s BG1. However, New Zealand courts have never applied pure purposive approach (without s BG1) in avoidance cases.

[110] Fiscal nullity doctrine is also known as "the doctrine of disregard", "Ramsay doctrine" or "judge-made anti-avoidance weapon". These names have been given depending on one's own point of

Fiscal nullity doctrine emerged in 1980s following the popularity of mass-marketed tax schemes in the UK. Based on the decisions in the fiscal nullity cases in the last three decades, it could be said that fiscal nullity is a judicial approach used by the courts in interpreting the statutes. When the court is faced with a tax scheme which takes advantage of a particular tax statute, the court will first analyse the transactions of the scheme. Then the court will ascertain the parliamentary intent on the statute which the scheme is relied upon. Any end result achieved through any artificial steps inserted in the scheme will need to sustain the question of "did the parliament intend such a result at the time it promulgated a particular statute?". Any inserted steps or self-cancelling transactions which are included in the scheme are disregarded.

In fiscal nullity cases, the judiciary applied extra-statutory doctrine with the absence of the GAAP. In a typical fiscal nullity case, the court would look at the transaction as a whole and look for those steps inserted with no commercial purpose. Artificiality of the transactions (in other words, non-commerciality of transactions) has been the focal point in the courts striking down the avoidance schemes in the UK.

Earlier fiscal nullity cases took the form of excessive judicial overlay. *Furniss*[111] is regarded as the climax of the judge-made law in fiscal nullity cases. The scheme in *Furniss* was not circular and it has obvious long-term business consequences. Despite those findings, the Court pierced the veil of literalism citing those techniques used in United States[112] courts such as "end result test"

In the following cases, the court attempts to water down the judicial overlay. Especially in MacNiven Lord Hoffman tried to reconcile previous fiscal nullity cases with his approach. In doing so, His Lord tried to reinterpret the excessiveness in earlier cases. Since MacNiven, fiscal nullity doctrine is nothing more than a statutory

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preference on the doctrine. – See Halkyard, Andrew (2004) "*Common Law and Tax Avoidance: Back to the Future?*" – 14 Revenue LJ 19

[111] *Furniss (H.M. Inspector of Taxes) v Dawson & Ors.; Murdoch (H.M. Inspector of Taxes) v Dawson*. [1984] BTC 71

[112] United States have been using the purposive approach in tax cases since *Gregory v. Helvering*293 US 465 (1935) . The courts used judicial techniques such as 1) business purpose test 2) step doctrines 3) end result test and 4) mutual independence test. None of these techniques are adopted by the common law courts.

interpretation technique which uses purposive approach of interpretation. Such a trend was reaffirmed in recent decision in *Barclays Mercantile*[113] case.

12.2 Fiscal Nullity and New Zealand Avoidance Cases

The use of fiscal nullity approach has been considered in New Zealand taxation cases. Although it has been referred to in passing in major tax cases, it has not been fully considered in any tax cases. Academics and commentators have different opinions on the acceptability of fiscal nullity approach in New Zealand. Some have the views that it was not applied in any avoidance cases since *Challenge* and thus is not applicable in New Zealand courts.

In *Challenge*[114] in 1986, the Commissioner relied only upon s 99 to attack a tax-avoidance arrangement involving the purchase of tax loss companies. He expressly disclaimed reliance upon the fiscal nullity doctrine.

> "Most tax avoidance involves a pretence; see the analysis in *WT Ramsay v C of IR* [1979] 3 All ER 213 at p 214. In the present case Challenge and their taxpayer subsidiaries pretend that they suffered a loss when in truth the loss was sustained by Perth and suffered by Merbank.

Privy Council in *Auckland Harbour Board*[115] inferred that the concept is relevant in the construction of New Zealand tax laws and that reference can be made to both the fiscal nullity doctrine and anti-tax avoidance legislation. By doing so, it overruled the view of the Court of Appeal which considered the fiscal nullity approach was not applicable in New Zealand in the face of specific GAAR such as S BG1.

> "This is what is meant by defeating the intention and application of the statute. Some of the work such provisions used to do has nowadays been taken over by the more realistic approach to the construction of taxing acts exemplified by *WT Ramsay Ltd v IR Commrs* [1982] AC 300, although their Lordships should not be taken as casting any doubt upon the usefulness of such tax avoidance provisions as a long stop for the Revenue."[116]

[113] Ibid
[114] *C of IR v Challenge Corporation Ltd* (1986) 8 NZTC 5,219 (PC)
[115] Commissioner of Inland Revenue v Auckland Harbour Board (2001) 20 NZTC 17,008
[116] Commissioner of Inland Revenue v Auckland Harbour Board (2001) 20 NZTC 17,008

The comment of Thomas J in *BNZ* is the most favourable in reception of fiscal nullity concept in New Zealand. His Honour said that the doctrine is different from the language of the GAAP in New Zealand. However, His Honour recognises that fiscal nullity is a concept within GAAP.

> "The Courts in the United Kingdom have judicially created a general anti-avoidance concept, the fiscal nullity doctrine, but that doctrine does not equate with the language of s 99. Fiscal nullity is a concept within but not co-extensive with the scope of s 99. The section must prevail in New Zealand unencumbered by the influence of any such judicial doctrines."[117]

In *BNZ*, possible application of the fiscal nullity doctrine was considered by the Court of Appeal even though the Commissioner did not seek to rely upon it. After having considered the basis of the fiscal nullity doctrine against the facts in *BNZ*, Blanchard J decided that the doctrine does not apply to *BNZ*. His Honour commented that fiscal nullity doctrine proceeds on the basis that the legislature intended tax to be imposed by reference to the business substance of the composite of the transactions. Accordingly, artificial steps inserted for a tax purpose and having no commercial purpose are disregarded in applying particular taxing provisions[118]. His Honour also referred to Lord Keith of Kinkel in *Fitzwilliam*[119] who said that to apply fiscal nullity doctrine, it must from a construction point of view be possible realistically and intellectually to treat a series of transactions as one composite whole.

> "The *Ramsay* principle or, as I prefer to say, the *Ramsay* approach to ascertaining the legal nature of transactions and to interpreting taxing statutes, has been the subject of observations in several later decisions. These observations should be read in the context of the particular statutory provisions and sets of facts under consideration. In particular, they cannot be understood as laying down factual pre-requisites which must exist before the Court may apply the purposive, *Ramsay* approach to the interpretation of a taxing statute. That would be to misunderstand the nature of the decision in *Ramsay*. Failure to recognise this can all too easily lead into error."

Therefore, the overall message from *BNZ* is that His Honours did not apply fiscal nullity in *BNZ* because the transactions in *BNZ* could not be interpreted as one

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[117] Thomas J in *CIR v BNZ Investments Ltd* CA147/00 at Para 74
[118] Blanchard J in BNZ (ibid) quoting *Macniven (Inspector of Taxes) v Westmoreland Investments Ltd* [2001] 2 WLR 377
[119] *Inland Revenue Commissioners v Fitzwilliam* [1993] 1 WLR 1189,1204

composite whole. However, the court in *BNZ* confirmed that fiscal nullity could be used in avoidance cases because it is a concept within s BG1.

It is a commonly accepted convention that if a judge-made law is subsequently codified, that legislation supplants the related judge-made law. In *Oakey Abattoir Pty Ltd v FCT*[120] and *John v FCT*[121], the courts in Australia rejected fiscal nullity approach for this reason. Many people believe that the *Oakey Abattoir* and *John* cases apply in New Zealand, and that in New Zealand section BG1 supplants the fiscal nullity rule. According to this reasoning, fiscal nullity doctrine has no place in New Zealand because s BG1 exists.

Prebble[122] argues that above reasoning would not reconcile well with Cooke J in *Mills v Dowdall*[123]. According to Prebble, fiscal nullity is a common law rule and is available to courts as a tool against tax avoidance irrespective of the existence of general anti-avoidance rule. Prebble asserts that even if the reasoning of s BG1 supplants fiscal nullity doctrine is accepted, the courts could still trigger fiscal nullity for obvious tax evasion cases as s BG1 does not cover tax evasion.

12.3 Academic Opinion on Fiscal Nullity in New Zealand

The Court of Appeal decision in *Accent*[124] shows the classical example of avoidance cases which do not fall easily into either side of the "line-drawing". The fact that the Court of Appeal in *Accent* proposed three possible categories for tax avoidance indicates that tax avoidance cases do not neatly fall into a stereotype. This supports the calls that New Zealand should have more than one judicial approach to handle different scenarios of tax avoidance.

It has often been suggested that New Zealand should make fiscal nullity approach available as an alternative to general anti-avoidance rule. There are different views on

[120] (1984) 84 ATC 4718 (Fed Ct)
[121] (1989) 166 CLR 417 (H Ct)
[122] Prebble, J (n.d.) "*Criminal Law, Tax Evasion, Shams, and Tax Avoidance: Some Relationships*" – available at http://www.vuw.ac.nz/~prebble/publications_available/taxevasshamspart2.html#fn6 on 20 Nov 2007
[123] [1983] NZLR 154, 159 (CA).
[124] Ibid

whether the fiscal nullity approach is compatible with s BG1. Ohms (2001)[125] in his seminal essay proposed that Fiscal Nullity doctrine adopted in the United Kingdom could exist along side with the GAAR such as section BG1.

> "The Ramsay concept is simply a reflection of the way in which the Court identifies facts, construes legal relationships at common law and subsequently interprets and applies the taxing legislation to those facts and legal relationships.
>
> As such it is perfectly conceptually consistent with the presence of s BG 1 and involves an antecedent element in the process of judicial reasoning. Section BG 1 comes after this process."

Tax Compliance Committee Report in 1998[126] also recommended that New Zealand should adopt a system that would combat tax avoidance using both fiscal nullity approach and general anti-avoidance provision.

> "the committee **recommends** that first, the general anti-avoidance rule in sections BG 1 and GB 1 should be clarified to ensure that it is not interpreted to preclude the application of common law anti-avoidance rules, such as the fiscal nullity doctrine. Secondly, for the avoidance of doubt, the general anti-avoidance rule should be clarified to ensure that it applies automatically, and does not depend on action by the Commissioner. Finally, an amendment should be made to clarify that any reconstruction under section GB 1 applies from the date of the original arrangement[127]."

On the other hand, Green (1999)[128] while commenting on the contextual background of *MacNiven* asserted that applying anti-avoidance provision in fiscal nullity type cases would be inappropriate.

> "The basic application of the principle of construction would have determined that no such advantage had been obtained. The transaction was within the statute as properly interpreted. To seek to apply a general anti-avoidance provision in such circumstances would as highlighted by the Auckland Harbour Board case, be using

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[125] Chris Ohms [2001] - "*MacNiven v Westmoreland Investments Ltd: The role in New Zealand of Fiscal Nullity*" (2001) 3 New Zealand Journal of Taxation and Policy 195

[126] *Report to the Treasurer and Minister of Revenue by a Committee of Experts on Tax Compliance, December 1998* (Tax Compliance Report 1998)

[127] *Report to the Treasurer and Minister of Revenue by a Committee of Experts on Tax Compliance, December 1998* (Tax Compliance Report 1998), Chapter 6 <http://taxpolicy.ird.govt.nz/publications/files/html/coe/chapter6_1.htm#rule>

[128] Green R (1999) – "*Tax Avoidance: Pendulum and Pabulum*" – (ICANZ Tax Conference, Christchurch 4-6 November 1999)

> an anti-avoidance provision to legislate. This is clearly not permissible, a point confirmed in Macniven."

Clinton et al (2005)[129] agrees with Green suggesting that Ohms' proposal of fiscal nullity approach is the antecedent of s BG1 is incorrect.

> "With respect to the analysis undertaken by Ohms, the view put forward by Green appears the more correct."

We will now look at how the judicial approach in *Accent* sheds light on the debate above this debate. In *Accent*, the judicial approach of the Court involves two-stage process. The Court explored the contractual relationship between the various entities involved in Trinity scheme. The court also identified the facts. Following that analysis, the Court purposively interpreted the deductions disallowing the taxpayer's claims. Only after that step, the Court entered into the analysis of tax avoidance and s BG1.

The two-stage process applied by the Court in *Accent* seems to support that the argument put forward by Ohms is correct. In the first stage, the Court would analyse the factual background of the case and at the end of that analysis the Court would come up with what type of statutory construction approach is suitable to the case. Then as a second stage, the court would use either purposive approach or s BG1 or both based on their analysis in the first stage.

In category (2), one of three approaches proposed by the Court, purposive approach will be used on its own if the Court finds in his initial analysis that the use of specific provisions is not in a behaviour contemplated by the legislature. The Court did not apply that option in *Accent* and thus detailed framework of that option is not available. However, it is not difficult to envisage that it should not be too different from the purposive interpretation used in fiscal nullity cases.

Recent fiscal nullity cases such as *Barclays Mercantile*[130] suggests that fiscal nullity approach is nothing more than a purposive statutory interpretation techniques. If that

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[129] Alley et al (2005) – "*New Zealand Taxation: Principles, Cases & Questions*" – Thomson and Brookers 1st Edition at p 904

is the case, the fiscal nullity approach could serve as the antecedent of s BG 1 as proposed by Ohms and as proposed by the Court in *Accent.*

Ohms did not elaborate in his essay on how he envisages to use fiscal nullity approach as the antecedent of s BG1. However, there is another aspect that Ohms argument is possibly correct. The Court applies two-stage process in fiscal nullity cases. First, the court analyses the transactions involved in scheme. If circularity or inserted steps for tax purposes are proved, the Court went on to the second stage of purposively interpreting the legislative intent. It could be right to say that the Court treats the first stage as a question of fact and the second stage as a question of law. If Ohms is envisaging that the Court applies fiscal nullity approach to deal with the question of facts, such an approach is compatible with s BG1.

13. Conclusion

Court of Appeal decision in *Accent* swung the tax avoidance pendulum to the Commissioner's favour. Such a swing, especially after the *Peterson* muddles the path of judicial development for tax avoidance law in New Zealand.

In the U.K, the use of purposive approach has to be supported by the existence of the characteristics of fiscal nullity such as circularity of transactions or artificially inserted steps. In *Accent,* lack of commerciality proved in the High Court seemed to serve as the reason for the Court in piercing the veil of literalism. As the Court of Appeal did not revisit this issue, the public is still in the dark on the judicial guideline on this issue.

The Court's reasoning is not much helpful to those who want to find a consistent trend in judicial reasoning. The Court's approach is fundamentally different to other tax avoidance cases. In *Accent,* the Court of Appeal outlined a new approach which would use the scheme and purpose analysis to the scheme as a whole. At the end of this analysis, the Court would use one of three options to deal with the case.

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[130] Ibid

Three categories set out by the Court seem to be the modified version of Richardson J's middle approach. The first category is when the case involved the taxpayer taking advantage of the specific provisions in a manner as contemplated by the Parliament. Section BG1 does not apply in that scenario. The second category is when the specific tax rules being relied on were not intended to confer the tax benefit in issue. The Court could overcome this by construing the provisions purposively. The third category is those cases which lie in between the first and second categories. In those cases, the Court needs to construe within the scheme and purpose of the Act with general anti-avoidance provisions steadily in mind.

Upcoming tax avoidance cases will reveal whether or not the above judicial reasoning becomes part of tax avoidance law in New Zealand. If the judicial approach in *Accent* is accepted, *Accent* will go down in the history of tax avoidance law as a case that brings New Zealand tax avoidance jurisprudence to a new frontier. In the short term, the judgment in *Accent* saved the New Zealand tax base with NZD3billion.

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