APPLICATION OF CHOICE DOCRTINE: THE LESSONS LEARNT FROM *TRINITY*.

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I. ATTESTATION OF AUTHORSHIP

I hereby declare that this submission is my own work and that, to the best of my knowledge and belief, it contains no material previously published or written by another person (except where explicitly defined in the acknowledgements), nor material which to a substantial extent has been submitted for the award of any other degree or diploma or a university or other institution of higher learning.

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Aradhana Lal

II. ABSTRACT

In this dissertation the author discusses the complexities involved in applying the doctrine of choice. The rationale behind its existence appears to be a good one – it is a judicial tool used to provide the balance between legitimate tax mitigation and illegal tax avoidance. The concept behind this doctrine is that it provides the taxpayers with some guidelines as to when a transaction will or will not be caught under the tax avoidance rules. Although theoretically choice doctrine was created to provide taxpayers some relief and certainty from the apparently harsh tax avoidance rules, the practical *application* of the doctrine is considerably uncertain because of the nature of its existence.

The problematic aspect of this doctrine is that it is not legislated. It is a creature of statutory interpretation and its application lies in understanding the scheme and purpose of a particular provision. In this dissertation the author discusses the issues facing the application of the choice doctrine. It is important to understand *when* choice doctrine should be applied. Furthermore, it is essential to understand *how* this principle is applied in New Zealand. In recent cases, the judges have applied this doctrine and the tax avoidance rules quite differently to what is considered the 'traditional legal approach'. The author intends to expound upon the effect and consequence of the current judicial approach towards the legal methodology used in the application of the tax avoidance rules and the choice principle.

III. ACKNOWLEDGEMENTS

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IV. INTRODUCTION

"In this world nothing can be said to be certain, except death and taxes". (Franklin)

Although this is a very famous saying and is often quoted, maybe Benjamin Franklin did not know about the possibilities created by tax avoidance schemes. Tax is levied under tax rules that are very complicated and sometimes very ambiguous. Nevertheless, it is cardinal principle of tax law that taxpayers should be certain about what taxes they are *obligated* to pay. Therefore, it is not a question of how much tax they *should* pay – after all the incidence of tax is not determined by morality.

It is common sense that genuine tax avoidance is bad for society as a whole. However, the question then arises – *exactly what tax avoidance legislation is meant to do?* At an intuitive level it seems fair that a line must be drawn between legitimate "tax mitigation" and genuine tax avoidance. The debate in relation to choice doctrine is an important part of this discussion.

It is also an important aspect of our legal system that Parliament makes laws and its intention has to be adhered to when applying laws. In a tax law context, Parliament has given us a somewhat crude instrument in section BG 1. It is general in nature. It is possible that the generality can lead to results in some cases that Parliament had not intended. This is especially the case where Parliament's intention is to give choices to taxpayers. Is this nevertheless tax avoidance? It would just be wrong to say that *every* choice by taxpayer which leads to less tax than otherwise would be paid amounts to avoidance, (even though at one level every such choice leads to depletion in the revenue base available to the government).

The purpose of this paper is to understand the conceptual underpinnings of the choice doctrine. Specifically, what is choice doctrine and when it is considered acceptable for it to apply? However, to understand the doctrine of choice it is essential to understand tax avoidance.

Hence tax avoidance is introduced in the next section. In discussing the conceptual underpinnings of the choice doctrine, it is essential to analyse the body of jurisprudence in this area of taxation law.

Accordingly this paper is structured in four broad parts:

1. The first part introduces tax avoidance and describes the statutory framework of tax avoidance in New Zealand

2. The second part describes the historical aspects of the choice doctrine – the origins and expansion of the choice doctrine in Australia.

3. The third section discuss the introduction and development of the choice doctrine in New Zealand

4. Lastly, I propose to review the recent judicial trends in this area and conclude by conveying my findings.

V. TAX AVOIDANCE

Lord Templeman has described 'a tax-avoidance scheme' as one where "the taxpayer plans and implements a scheme which includes one or more artificial steps which have no commercial purpose except the avoidance of tax which would *otherwise* be payable."[1]

Whether or not tax is "otherwise payable" by a taxpayer can be problematic to ascertain where the relevant income tax statute provides for incentives to encourage taxpayers to invest in certain areas of the economy. In this context, tax minimisation is the tool by which the legislature seeks to achieve its economic goals. Logic would suggest that taking advantage of these incentives does not constitute tax avoidance. Or does it?

An issue also arises where the statute contains structural inequities, whereby two sets of provisions are applicable to a taxpayer – one of which is more advantageous to the taxpayer than the other. If the taxpayer orders its affairs to come within the more advantageous provisions, does this amount to tax avoidance?

Lord Wilberforce summed the matter up quite well when he noted in *Mangin v CIR*[2] that the then applicable general anti-avoidance provision failed to:

> "[Specify] the relation between the section and the other provisions in the income tax legislation under which tax reliefs, or exemptions, may be obtained. Is it legitimate to take advantage of these so as to avoid or reduce tax? What if the only purpose is to use them? Is there a distinction between "proper" tax avoidance and "improper" tax avoidance? By what sense is this distinction perceived."

Taxpayers operate in a real world where they have choices. Each choice may lead to different levels of tax being paid. For example, a taxpayer that decides to be self-sufficient instead of being in paid employment pays no PAYE and yet will enjoy some (if not all) of what s/he would have bought with employment income. However, it would clearly be wrong to say that every choice, which leads to less tax being paid,

[1] Templeman, *Tax and the Taxpayer*, (2001) 117 LQR 575 at 576
[2] [1971] NZLR 591 (PC) at 602

constitutes tax avoidance. This principle was confirmed in *IRC v Duke of Westminster*[3] where Lord Tomlin observed:

> "Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in so 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."

The Privy Council made similar comments in *Europa Oil (NZ) Ltd v CIR*[4] where Lord Diplock noted:

> [GAAR] does not strike down ordinary business or commercial transactions that incidentally result in some savings of tax. There may be different ways of carrying out such transactions. They will not be struck down if the method chosen for carrying them out involves the payment of less tax than would be payable if another method was followed.

Despite the above comments, the general anti avoidance rules (GAAR) is clearly a restriction on the ability of taxpayers to choose the most tax-efficient structure.

In essence, the crux of this issue is how section BG 1, the anti-avoidance provision of the Income Tax Act 2004 [ITA] relates to the other provisions, which determine the tax liability of taxpayers. It is from this issue that the so-called "doctrine of choice" has arisen.

[3] [1936] AC 1 at p 19.
[4] [1976] 1 NZLR 556.

VI. STATUTORY FRAMEWORK

This section looks at the conceptual underpinnings of tax avoidance and choice doctrine. The choice doctrine has its basis in the tax avoidance legal framework.

The General Anti Avoidance Rule (GAAR) is found in section BG 1. The 2004 Income Tax Act section BG 1 provides:

(1) A tax arrangement is void as against the Commissioner for income tax purposes

(2) The Commissioner, in accordance with Part G (Avoidance and Non-Market Transactions), may counteract a tax advantage obtained by a person from or under a ***tax avoidance arrangement***

The definition for 'tax avoidance arrangement' is found in section OB 1 of the Income Tax Act 2004. Basically it states that for a 'tax avoidance arrangement' to exist **three elements** must be present; an *arrangement* that has either the sole *purpose or effect*, or one of the purpose or effect (must be more than incidental), of *tax avoidance*. [5]

Since the Privy Council decision in *O'Neil v CIR*,[6] a **fourth element** called the choice principle has been added to the definition of tax avoidance arrangement. Choice Doctrine acts as an exception to the prima facie application of the three elements. This exception is created by firstly analysing the scheme and purpose of the applicable provision of the Income Tax Act and then determining if a choice is available to the taxpayers to conduct their transaction.[7]

It is crucial to understand how these elements must be applied. Professor Ohms[8] states that in effect the following four elements must be satisfied under section BG 1:

1. There must be an arrangement;
2. There must be tax avoidance;

[5] Ohms C, Income *Tax Law in New Zealand*, Thomas Brookers, 2004, Chapter 26, Page 1068
[6] (2001) 20 NZTC 17,051
[7] Ohms C, Income Tax Law in New Zealand, Thomas Brookers, 2004, Chapter 26, Page 1068
[8] Ohms C, Income Tax Law in New Zealand, Thomas Brookers, 2004, Chapter 26, p 1069

3. One of the purposes of the arrangement, which is more than incidental, must be tax avoidance; and

4. The arrangement must not be one intended by Parliament to be undertaken, not withstanding the prima facie application of the first three elements. This approach is the choice principle.

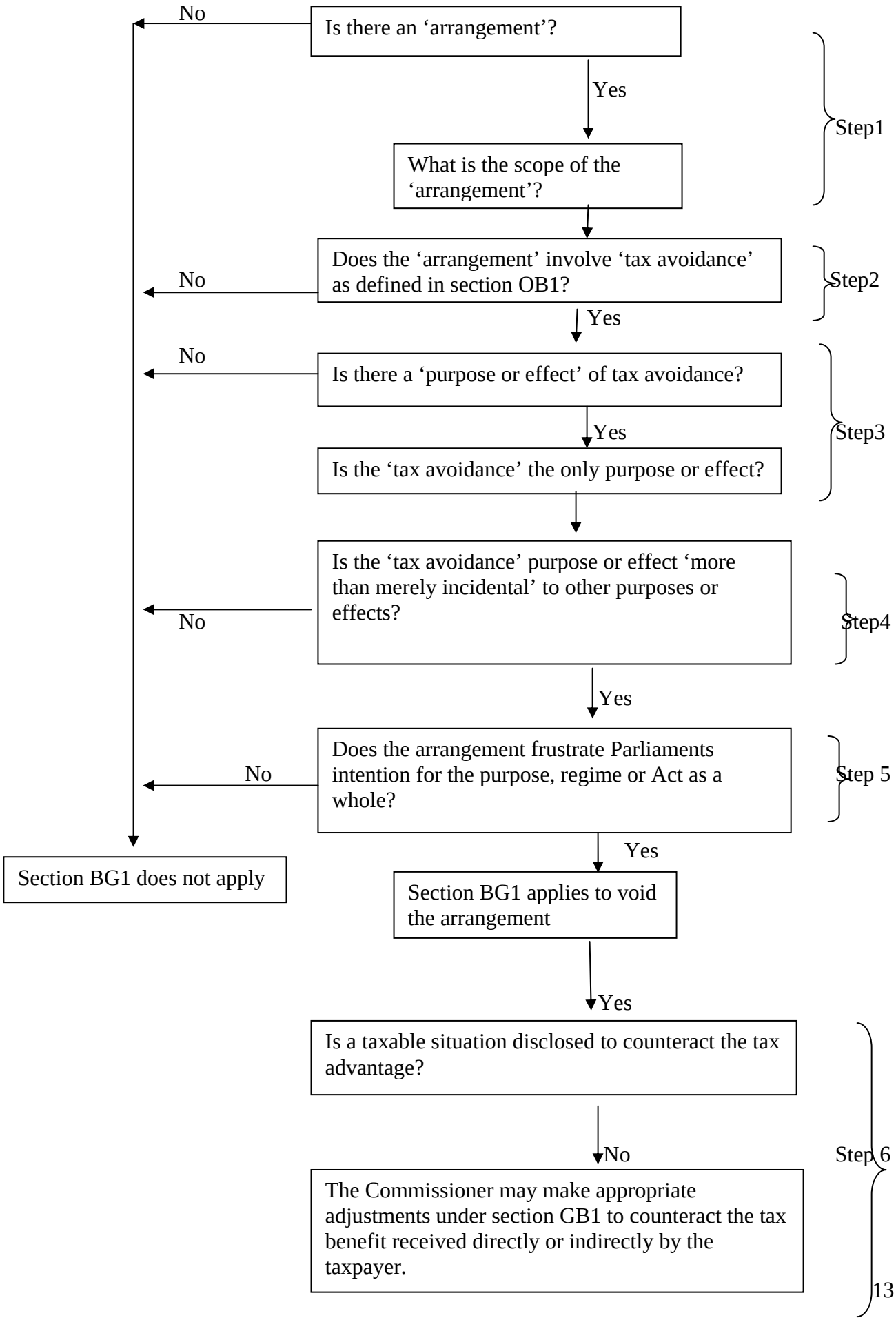
Ohms further notes[9] that the first three elements of section BG 1 are applied cumulative of the fourth element. He states "the arrangement will only be rendered void if the necessary state of mind is proven and the arrangement is not excepted by virtue of the choice doctrine".

Professor Ohms also points out that section BG 1 is applied only *after* considering the fiscal nullity concept. This means the initial step is to look at the choice concept within the specific provision before even considering the general anti avoidance rule. The courts must first consider if the specific provision allows the action to be taken by the taxpayer. If the transaction is not allowed under the specific provision than the matter ends there and there is no need to consider tax avoidance.

The Inland Revenue Departments 'Exposure Draft for Interpretation of Section BG 1 and GB1 of the Income Tax Act 2004' provides an excellent summary of how the elements of BG 1 should be applied. This exposure draft contains a flow chart (see below) intended to provide a reference guide to the steps and principles involved in considering the application of section BG1 and GB1.[10]

[9] Ibid 1069
[10] Exposure Draft for External Consultant, *Interpretation of Section BG1 and GB 1 of the Income Tax Act 2004*, Inland Revenue Department

THE FLOW CHART - Application of BG1 and GB1



The flowchart above firstly summarises the three elements that are contained in section BG 1 (and the associated definition). These three elements combined are the black letter approach as discussed by Baragwanath J in *Miller*[11]. The application of the elements of section BG 1 discussed in the *Miller* High Court is an exceptional judgment in that it provides a "pure" description of the legal methodology that should be used by judges when dealing with avoidance. The black letter approach and the propriety test combined have the same effect as described in the IRD's interpretation statement above.

The flowchart emphasises (as does Baragwanath J) that the story does not end there – it is just that the terminology used is different. The flowchart states (in step 5 above) that regard should also be had to whether the scheme and purpose of the legislation has been frustrated, which describes the propriety test described by Baragwanath J. It is at this stage of the application of BG 1 that the choice doctrine is considered. Therefore it is timely to introduce the concept and the history of choice principle.

[11] *Miller (No.1) v CIR; McDougall v CIR* 18 NZTC 13,001 (HC) p 13,031

VII. THE DOCTRINE OF CHOICE

Judge William Young P has recently said in the *Trinity* case that:[12]

> "Obviously there is a need to recognise that in some instance the legislature must have intended to encourage particular types of behaviour. Behaviour of that type (being the sort of behaviour which was within the contemplation of the legislature) cannot be within the general anti-avoidance provisions because the overall legislative purpose is that such behaviour should attract the tax consequences provided for by parliament. Likewise, it may sometimes be obvious that the specific tax rules relied on were not intended to confer the tax benefits in issue. Such a case however, 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." [Emphasis added]

This is all good and well in theory but how does the taxpayer community decide what the legislature's intention was on a case-by-case basis. The application of choice doctrine is all about the interpretation of parliament intent.

In fact the doctrine of choice is a creature of statutory construction – from the Latin maxim *"generalia specialibus non derogant"*, whereby a general provision (such as section BG1) cannot override a specific provision[13]. As such, it deals with the complex issue of the relationship of section BG 1 to other substantive provisions of the Income Tax Act 2004. More importantly, it deals with the issue of whether section BG 1 applies absolutely so as to override the other provisions of the Income Tax Act.

Parsons[14] explains the choice doctrine as:

> "A doctrine that precluded the operation of [a general anti-avoidance provision such as section BG1] if the tax consequences of the arrangement in question were consequences that the policy of the relevant provisions of the Act would approve." (Emphasis added)

While the above principle is not difficult to comprehend at a theoretical level, its practical application is problematic. In essence, the difficulty arises in determining the exact ambit of the choice doctrine – the circumstances in which it applies. Moreover, in what circumstances can it be said that a choice *is* offered by the Act.

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[12] *Accent Management Ltd v CIR* [2007] NZCA 230; (2007)23 NZTC 21,323, para 124
[13] *New Zealand Income Tax Law and Practice*, CCH, 551,501
[14] R W Parsons, *Income Taxation in Australia*, (1985) paragraph 16.29

VIII. THE DEVELOPMENT OF CHOICE DOCTRINE

A. Birth of the Choice Doctrine – Keighery

1. Facts and Judgment

In *W P Keighery Pty Ltd v FCT*[15], Aquila Steele Pty Ltd (ASPL) was a private company that had substantial sums of undistributed profits. If the status quo continued, the taxpayer company would have been liable to pay additional tax (excess retention tax ["ERT"]) under Division 7 of the Income Tax Assessment Act 1936 (Cth Aust). Moreover, if the retained profits were distributed, the individual shareholders would have had to pay increased rates of tax on the amounts received. Furthermore, public companies (as defined) were not subject to the additional tax regime under Division 7. With this in view, the company was incorporated as a non-private company. This company was to be interposed between APSL and the Keighery's (the shareholders of APSL).

Dixon CJ, Kitto and Taylor JJ[16] found that this arrangement was planned solely with the object (and therefore the purpose) of enabling ASPL to distribute its retained earnings without incurring Division 7 tax. Furthermore, the assessable incomes of the Keighery's would remain constant. However, the Full High Court was of the opinion that section 260 (New Zealand's equivalent of section BG 1) of the Income Tax Assessment Act 1936 (Cth Aust) had no application based on the circumstances of the case. The Court held that the Act expressly provided for alternative bases of liability for income tax. The alternative bases were offered depending on how the taxpayer company chose to structure itself – whether as a private or public company as defined in the Act.

The Full High Court observed[17]:

> "Whatever difficulties there may be in interpreting section 260, one thing is clear: the section intends only to protect the general provisions of the Act from frustration and *not to deny the taxpayers any right of choice between alternatives which the Act itself lays open to them.* It is therefore important to

[15](1957) 100 CLR 66
[16] Ibid 92
[17] Ibid 92 - 93

> consider whether the result of treating the section as applying in a case such as the present would be to render ineffectual an attempt to give a company an advantage which the Act intended that it might be given."

Crucial to the judgment was the Court's interpretation of Division 7. For the ERT liability to exist the vital element was for the taxpayer to possess certain characteristics on a particular day. This characteristic was that the taxpayer be either a private or public company. However, *before* that particular day, the shareholders of the shareholder company had total control in deciding and determining if in fact the taxpayer company should possess these certain characteristics at the relevant date. The Full High Court held that if the shareholders took steps to change the status of the company, then this is a legitimate choice (based on how they choose to structure their company) and thus outside the scope of section 260.

The Court noted[18]:

> "If [the shareholders] so alter the relevant facts that, when the last day of the income year arrives, the company will not be a "private company", their action cannot be regarded as tending to defeat a liability imposed by the Act; it is one which the Act contemplates and allows."

The facts of the *Keighery* case play a crucial role in determining the conceptual underpinning and the scope and extent of the choice doctrine as explained in that case.

2. Analysis

The *Keighery* judgment laid the basis for considerable controversy within academia and the judiciary. The controversy arises in relation to two distinct issues:

As Ohms[19] submits, the first area of controversy is the fundamental issue of whether the choice doctrine is a legitimate legal doctrine at all.

Beaumont[20] cites the dissent of Webb J in the *Keighery* case to argue against the validity of the choice doctrine. His Honour was of the opinion that in the event the *Keighery*

[18] Ibid
[19] C M Ohms, *General Income Tax Anti-Avoidance Provision: Analysis and Reform,* (PhD Thesis, University of Auckland, Unpublished, 1994) 389
[20] B A Beaumont, *Legal Avoidance of Taxation and Section 260: Newton v FCT,* (1959) 3 Syd Law Rev, 153 at 159.

arrangement had not been entered into, either Division 7 tax would have become payable or a "sufficient distribution" would have had to be made. Therefore, by choosing to do what the Keighery's did, they used the arrangement to get out of liability under Division 7. His Honour felt that this arrangement was *prima facie* within the application of section 260. Furthermore, section 260 was not expressed to be subject to any other provisions of the Act.

Beaumont argues that *Keighery* was indistinguishable from *Bell's Case*[21]. In *Bell*, it was held that *because of* section 260, capital receipts remained taxable as income in the particular year in which the arrangement was made that had legally and effectively converted them into capital receipts. As such, Beaumont argues that section 260 did apply in *Keighery*. However, he submits that the majority view *can* be rationalised on the broad ground that, although section 260 did apply here, the circumstances of the case were such that the general policy of section 260 did not warrant a finding against the taxpayer. As such, the analysis is brought *back into* the ambits of section 260.

It is in my submission that the Beaumont analysis is flawed because of its somewhat unnecessary adherence to the doctrine of *stare decisis.* Instead, the focus should be on analysing the true conceptual underpinning of the *Keighery* judgment. The *Keighery* judgment in my opinion did recognise that the choice doctrine analysis takes place outside section 260.

The second area of controversy relates to the scope and extent of the choice doctrine. In essence, the question is: "In what circumstances can it be said that a choice *is* offered?"

Ohms'[22] submits that within this issue there is a difference in opinion. On the one hand it is argued that the majority view in *Keighery* can be rationalised on the grounds that the application of section 260 to Division 7 has disregarded the scheme and purpose of the Income tax Assessment Act 1936. This is the so-called "explicit choice" variation of the doctrine. Crowhen[23] notes that an explicit choice is available where:

[21] *Bell v FCT* (1953) 87 CLR 548
[22] CM Ohms *General Income Tax Anti-Avoidance Provisions: Analysis and Reform* PhD Thesis, University of Auckland, Unpublished, 1994, p389
[23] G Crowhen, *Arrangements to Avoid Income Tax – s99 of the Income Tax Act 1976"* (1986) 30 NZCT 177 at 180

> "[The] statute expressly conferred two distinct alternatives with different tax consequences deriving from each."

Spry[24] explains that the *Keighery* judgment reach the heart of how section 260 should really be applied and its relationship with the choice doctrine. He argues that the doctrine applies only where the relevant taxing legislation expressly considers alternative tax liability regimes.

Similarly, Santow[25] observed:

> "If the *Keighery* test still has a place, it will probably be limited to the case where in the relevant circumstances the Act offers *explicitly* a particular tax advantage to a particular defined category of taxpayer, such as a "public company" or "primary production". (Emphasis added)

Lehmann,[26] who agrees with this view, cites the following passage in the judgment:

> "The very *purpose or policy* of Division 7 is to present the choice to a company …" (per Dixon CJ, Kitto and Taylor JJ at p93).

In my opinion, Lehmann is arguing that it is the role of the judges to interpret the facts of a particular case in light of the intention of the legislature to find out whether a choice is being offered. Moreover, this is done using the various rules of statutory interpretation (particularly the scheme and purpose approach).

Lehmann notes that in the *Keighery* [27] case the High Court stated that:

> "Section 260 was only intended to protect the *general* provisions of the legislation."

As such, if section BG1 is held to be general in nature in relation to another, more specific provision, then the choice doctrine applies because of the Latin maxim *generalia specialibus non-derogant.* However, Lehmann notes that determining the boundaries between the general and specific provisions of the Act is a difficult process especially in tax law.

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[24] I C F Spry, *Arrangements for the Avoidance of Taxation,* The Law Book Company, 1978.
[25] G F K Santow *Book Reviews,* (1973) 5 Fed LR 318 at 321
[26] G Lehmann, *The Income Tax Judgments of Sir Garfield Barwick: A Study in the Failure of the New Legalism,* (1983) 9 Monash ULRev 115 at 133
[27] *W P Keighery Pty Ltd v FCT* (1957) 100 CLR 66 at 92 - 93

Thus it is submitted that the general/specific approach may not be sufficient in ascertaining the intention of the legislature. Relying solely on *generalia specialibus non-derogant* to ascertain the intention of the legislature would not be applying the scheme and purpose approach to its fullest extent. Whenever the relationship of section BG1 to any other provisions of the Income Tax Act is to be determined, the whole body of the statutory interpretation rules must be used to come to the right answer. Viewed in this way, the intention of the legislature is theoretically not limited to just where the Act *expressly* provides for alternative regimes of tax liability. It is, of course, the role of the judiciary to ascertain the legislative intent. As such, it should be open to the judiciary to find choices that the legislature may have "implicitly" provided for in the Act. Legal semantics such as the general/specific approach merely serve as guidelines to the ultimate goal. This was in fact the finding in *FCT v Casuarina Pty Limited*[28].

B. Growth of the Choice Doctrine – Casuarina

1. Facts and Judgment

The Stenberg family operated a business, which was incorporated as a private company. The company had substantial undistributed profits that would attract excess retention tax under Division 7 if left undistributed. To avoid this, the taxpayer company Casuarina was incorporated whereby of the 100 shares issued in the company. 49 were issued to Mr. and Mrs. Sternberg and the balance to a Forum Ltd. (which in turn was the subsidiary of a number of public companies). As such, Casuarina became a subsidiary of Forum and a public company in its own right under section 103A Division 7 of the Act. However, the 51 shares issued to Forum were redeemable preference shares. Therefore, effective control of the company remained vested with the Sternbergs. The structure enabled the undistributed profits to be channelled through the taxpayer in such a way that a substantial portion of the undistributed profits went back to the Sternbergs.

Walsh J delivered the leading judgment, deciding in favour of the taxpayer. His Honour noted:[29]

[28] (1971) 127 CLR 62
[29] *FCT v Casuarina Pty Limited* (1971) 127 CLR 62 at 103

> "[If] certain facts should exist at a particular time, a company would be liable to be taxed on the basis that it was a private company and it could arrange matters so that those facts were changed in such a way that it was taken out of the category, it would be liable on a different basis."

2. Analysis

Ohms'[30] submits that the *Casuarina* judgment advocates an extended form of the doctrine whereby it does not apply just to cases where an explicit choice is offered by the Act. It would also apply to those express provisions of the Act that operated by reference to a specific status or state of affairs of the particular taxpayer.

Viewed in this way, the focus shifts back to the *form* that the taxpayer structures itself in. It is submitted that there is a very real danger in focusing on this alone because it may lead to the attention being taken away from the overarching and fundamental principles of the scheme and purpose approach. If the true conceptual underpinning of the choice doctrine *is* the scheme and purpose approach, then a broader line of reasoning is needed. There may well be cases where the taxpayer is able to take advantage of the complexities of the Income Tax Act to structure itself differently. But this does not mean that we can "imply" that a legitimate choice is being offered. Only a proper application of the rules of statutory interpretation will reveal what the legislature intended (i.e. what legitimate choices are contained within the Act).

As Dunbar and Smith[31] note:

> "*Casuarina* is authority for the proposition that any defect in the legislation will be seen by the Australian Courts as a *deliberate policy decision* to give the taxpayer a choice, rather than as a mere drafting oversight." (Emphasis added)

With respect, it is submitted that the judgment of his Honour Walsh J, is much influenced by judicial policy-making and unnecessary adherence to *stare decisis*, rather than determining the true conceptual underpinning of the choice doctrine.

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[30] CM Ohms *General Income Tax Anti-Avoidance Provisions: Analysis and Reform* PhD Thesis, University of Auckland, Unpublished, 1994, p397

[31] D G Dunbar and A M C Smith, *Section 99 and the Choice Principle: Is It Good Law In New Zealand?* (1985) 29 NZCT 295 at 296

Interestingly, Barwick CJ did not play a major role in the *Casuarina* decision. However, the choice doctrine was about to experience a fundamental jolt under his Honour's leadership of the Full High Court.

C. The Doctrine Misunderstood - Barwickian Period

1. The Trilogy - Mullens, Slutzkin and Cridland.

Barwick CJ led an era of destruction in relation to section 260. His decisions would have made the strongest and bravest pro Revenue Commissioner cringe in this day and age. Lehmann and Coleman's[32] argument in relation to the Barwickian judgments are particularly interesting. They present an analysis of *why* the choice doctrine developed under the leadership of the Chief Justice as the way it did. They submit that the key to understanding these judgments were his Honour's pro-taxpayer policies (perhaps because Barwick CJ was the lawyer for the unsuccessful party in the famous *Newton*[33] case). Furthermore, they state that when arguing the Barwick judgments, one should be confused by the methods the Chief Justice used to rationalise his decisions (particularly literalism), however ingenious they may be.

2. Mullens – Facts and Judgment

In *Mullens v FCT*[34], the issue concerned section 77A (3) of the Income Tax Assessment Act 1936 (Cth) which allowed for the deduction of capital investments in the petroleum exploration industry.

A company Vam Limited proposed to engage in a venture in relation to prospecting for natural gas in certain natural gas fields. Vam incorporated a new company, Vamgas, as the vehicle for inducing investment towards the new venture. Two million of the shares in Vamgas were reserved for clients of the underwriting brokers and two other share brokers. These shares could not be transferred but was required to be taken up by the shareholders of the clients themselves.

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[32] G Lehmann and C Coleman, *Taxation in Australia*, (1986) Law Book Company.
[33] *Newton v FCT* [1958] CLR 1
[34] (1976) 135 CLR 290

Mr Close was one such shareholder, but he was not interested in taking advantage of section 77A (3). The taxpayer and Mr Close entered into an arrangement whereby the taxpayer would take the beneficial interest in the shares but subject to an option for Mr Close to re-purchase the shares some months later. Meanwhile, the taxpayer sought a deduction under section 77A (3), which stated:

> "Subject to this section, a petroleum exploration company may … before the expiration of one month after the end of a year of income of the company in which the company has received monies paid on shares or within such further time as the Commissioner allows, lodge with the Commissioner a declaration in writing signed by the public officer of the company that the company has expended, or proposes to expend, such of those moneys as are specified in the declaration in carrying on prospecting or mining operations in Australia for the purpose of discovering or obtaining petroleum or on plant necessary for carrying on such operations."

Barwick CJ found for the taxpayer, holding that the arrangement could not be said to have "altered the incidence of tax". His Honour noted:[35]

> "[There] will be no relevant alteration of the incidence of tax if the transaction … conforms to and satisfies a provision of the Act even if it has taken the form in which it was entered into by the parties in order to obtain the benefit of that provision … *It would have been otherwise if there had been some* ***antecedent transaction*** *between the parties, for which the transaction under attack was substituted in order to obtain the benefit of the particular provision …*" (emphasis added)

An *antecedent transaction* would include any contract, which had been amended, novated or cancelled with the effect of shifting the incidence of income tax or avoiding it.

The Chief Justice also stated that even if the shares were taken up solely to obtain the benefit of section 77A, it did not necessarily mean that section 260 applied. The policy behind section 77A was to encourage investment in petroleum investment. The Chief Justice was of opinion that once a taxpayer has made the investment, the policy is satisfied – the section did not specify or regulate what happened subsequent to the shares. The Chief Justice noted that if Parliament had intended to regulate, than section 77 would have stated a requirement to hold the shares for a certain period of time.

[35] *Mullens v FCT* (1976) 135 CLR 290

3. Slutzkin – Facts and Judgment

Slutzkin v FCT[36] was a dividend stripping case in which the shares of Francis Richard Holdings Pty Limited were held on trust for the children of Alan Slutzkin. By 1968, this company was no longer suitable for the purposes for which it was set up (which included providing a vehicle for retaining the profits of a holding company). It was decided that the assets of the company be realised and reinvested.

Instead of liquidating the company (the receipts of which would have constituted a dividend), the shareholders transferred their shares to Cadiz Corporation Pty limited for a cash price substantially equivalent to the value of the company's assets. Cadiz was essentially a dividend company.

The Chief Justice ruled that the choice of the form of a transaction by which taxpayers obtain the benefit of their asset is a matter for them to choose. Moreover, the taxpayers are perfectly entitled to choose that form of a transaction, which does not subject them to greater tax liability instead of another form that does.

4. Cridland – Facts and Judgment

Cridland v FCT[37] concerned a particularly artificial scheme. Here a student sought to take advantage of provisions that allowed for income averaging for investors in the primary production business. The taxpayer acquired a mere $1 share in a unit trust set up to take advantage of the income averaging provisions.

Mason J (with whom Barwick CJ agreed) held that not only was the taxpayer entitled to choose between two alternative regimes in the Act, but he or she may also create a situation by entering into transactions, which attract the tax consequences that are specifically provided for in the Act.

[36](1977) 140 CLR 314
[37] (1977) 140 CLR 330

5. Analysis – Development of the Antecedent Transaction Doctrine

Ohms'[38] submits that *Mullens* represents a shift in the conceptual basis of the choice doctrine because of the antecedent transaction doctrine. The basis of the doctrine in the Chief Justice's view was that if the taxpayer makes a choice which is allowable under the specific provision then there is no place for section 260. In order words, the *time* the taxpayer makes the choice, if he or she is not under a present liability for income tax, then whatever choice that taxpayer makes so as to bring the taxpayer within the requirements of a specific charging provision is a legitimate one and does not alter the incidence of tax.[39]

There is a fallacy in this argument. It assumes that private bargaining may somehow change an existing tax liability. This would be contrary to the very meaning of the word "liability".

As Trebilcock[40] points out:

> "Once a [tax] liability has been incurred by a taxpayer, there is nothing else he can do, by private bargaining or otherwise to displace it."

The *Slutzkin* decision represented a further expansion of the choice principle in that even "absolute" choices were now permitted. A taxpayer could simply remove his or her affairs from the scope of the Income Tax Act irrespective of the fact that the *only* reason for this course of action is based on a blatant tax avoidance purpose.[41]

Lehmann[42] had doubts about the effectiveness of this proposition, noting:

> "[In] *Slutzkin* … Aickin J was of the view that the [choice] principle applied to transactions where the taxpayer's action "produced a result outside the scope of the Act". Taken literally this dictum meant that the choice principle, which was *merely judge-made law*, required no other statutory provision to defeat the operation of section 260. As such, it was an extraordinary proposition." (Emphasis added)

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[38] CM Ohms *General Income Tax Anti-Avoidance Provisions: Analysis and Reform* PhD Thesis, University of Auckland, Unpublished, 1994, p399
[39] I C F Spry, *Section 260 of the Income Tax Assessment Act*, (1978, The Law Book Company) 51
[40] M J Trebilcock, *Section 260: A Critical Examination*, 1964, 38 ALJ 237 at 238
[41] See n 36, p400
[42] G Lehmann, *Judicial and Statutory Restrictions on Tax Avoidance*, in Krever R E, *Australian Taxation: Principles and Practice* (1987, Longman Professional) p307

Thus it is submitted that the "absolute" variant of the choice principle has *nothing* to do with applying the scheme and purpose of the Act.

Spry[43] agrees with the line of reasoning in *Slutzkin*, noting:

> "[The] carrying out of a transaction that prevents a liability from arising … is not affected by section 260, since the Act *should* be taken to contemplate that the appropriate incidence of tax is the incidence based upon the carrying out of that transaction."[Emphasis added]

The misleading notion in Spry's argument can be seen in the use of the word "should" above. Inherent in this argument is the suggestion that judicial policy-making *is* appropriate. Absent is any reference to look at the Act as a whole and then determining its scheme and purpose. Moreover, Spry's arguments seem to imply that judicial policy making is paramount to the express words of an anti-avoidance provision.

As Lehmann [44] points out, the very existence of a general anti-avoidance provision is clearly indicative of a legislative intent to counter tax avoidance and, as such, to some extent look at the reality of transactions. If Parliament approved of judicial policy-making in this area, it would have refrained from enacting provisions such as section BG 1.

Lehmann and Coleman[45] submit that judicial policy-making is the root of the problem and that the "legal formalism" and "literalism" techniques used by Barwick CJ to rationalise his decisions merely serve to disguise this policy-making.

Barwick CJ, in developing the choice doctrine, placed considerable emphasis on the literalism expounded in *IRC v Duke of Westminster*[46], where Lord Tomlin said:

> "Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Act is less than it would otherwise be."

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[43] I C F Spry, op cit, p52

[44] G Lehmann, *Judicial and Statutory Restrictions on Tax Avoidance,* in Krever R E, *Australian Taxation: Principles and Practice* (1987, Longman Professional) at 296

[45] Ibid

[46] [1936] AC 1. This case essentially concerned the Duke paying his gardener an annuity (which was deductible) instead of wages (which was not deductible. However, the Duke remained commercially at risk to pay the full amount of the wages.

Lehmann and Coleman argue that the *Duke of Westminster* case had very simple facts and using this case in the area of modern and sophisticated tax-avoidance schemes is false. In the above case, the Duke was always commercially at risk. This is to be contrasted with modern schemes where the very reason of the scheme is to obtain tax benefits *without* bearing the corresponding risk. If we contrast this against the aim of the Income Tax Act, which is to tax people according to their financial capacity, it is not hard to see why Parliament enacted section BG1. It is directed at preventing schemes that defeat the aims of the Act (by using the word "purpose"). Logically the promoters of these schemes will change the form of their transactions to bring them outside the scope of the Act – this would be their preferred methodology. But this is *exactly* what the legislature intends to prevent by enacting section BG1. Thus it is submitted that the "absolute" choice argument is circular – to get out of section BG1, it uses the very thing that section BG1 is aimed at preventing.

This is especially so when one has regard to section 5 (1) of the Interpretation Act 1999, which confirms the modern purposive approach to statutory interpretation and states that the meaning of an enactment must be ascertained from its text and in light of its purpose.

D. The Maturity of the Doctrine - Gulland

FCT v Gulland, Watson v FCT and *Pincus v FCT*[47] essentially concerned medical practitioners who entered into arrangements to sell their practices to a family trust. A contract of employment was drawn whereby the taxpayers would provide employment services to the trust and receive salaries accordingly.

FCT v Gulland concerned a Dr Gulland who initially created a family trust, the trustee of which was his former partner, Dr Brindall, and the beneficiaries included Dr Gulland, his wife and children. The family trust essentially functioned in a service capacity for Dr Gulland by employing staff and providing the other facilities required to operate the medical centre. The Gulland Medical Unit Trust was subsequently established and its trustees were Dr Gulland and Dr Brindall. Apparently the reason for the establishment of the trust was to facilitate the creation of a superannuation fund to provide for Dr Gulland's death or retirement.

[47] *Pincus v FCT* (1985) ATC 4,765

Watson v FCT concerned Dr Watson, a specialist surgeon, who was practising in partnership with four other surgeons. In 1979 the partnership was dissolved and the practice was sold to a unit trust, the trustees of which were Dr Watson and his four former partners. As with the *Gulland* scenario, the unit trust was supposedly set up for the superannuation reasons.

Pincus v FCT also concerned the dissolution of a partnership and the setting up of trusts. Again, the superannuation factor was the alleged reason for the setting up of the trusts.

The first issue facing the Full High Court was the status of the antecedent transaction doctrine. Gibbs CJ and Dawson J were both prepared to accept that section 260 would apply to cases where there was no antecedent transaction (as determined in *Mullens*, per Barwick CJ). Therefore, their Honours brought section 260 "back to life" by re-enlarging the ambits to which section 260 applied. Previously in effect the antecedent transaction doctrine had nullified section 260 because any taxpayer that did not have a present tax liability could enter into any tax avoidance arrangement, no matter how artificial it was. It could be entered into *solely* for the purpose of avoidance but that was acceptable because there was no antecedent transaction.

However, the more substantial issue was the scope of the choice doctrine. Gibbs CJ explained that the choice doctrine applied where[48]:

> "[The] Act offers to the taxpayer a choice of *alternative* tax consequences, either of which he is free to choose … the choice of the advantageous alternative … does not mean that section 260 is attracted."

As such, the Chief Justice was rejecting the "absolute" variant of the choice doctrine adopted in *Slutzkin*. This is evident from the Chief Justice's statement that the choices must be *alternative*. In this context, the mere compliance with the technicalities of a particular provision will not be sufficient to give rise to the existence of alternative choices.

[48] Ibid 4,767

The crucial aspect of this case was the purported separation of income by the taxpayers in favour of the trust. The medical practitioners submitted that what they did was merely a choice offered by the Act, noting:[49]

> "[It] is simply not right to say that the Act allows a taxpayer the opportunity to have his own income from personal exertion taxed as though it were income derived by a trust and held for the benefit of a number of beneficiaries."

Norman[50] pointed out that the Chief Justice clearly stated that any income earned from personal exertion was incapable of separation. However, Norman submits that if this is the critical reason why Gibbs CJ found against the existence of a choice, then the proposition is to be doubted. This is because in *Everett v FCT*[51], the High Court had ruled that personal exertion income *was*, in certain circumstances, capable of alienation.

Having described the choice doctrine in the above manner, the Full High Court then discussed the issue of the relationship of the choice doctrine to the *Newton* predication test.

Gibbs CJ and Brennan J explained that the predication test was subject to the choice doctrine. Dawson J also recognised that the choice doctrine did have an impact on how section 260 operated. However, his Honour illustrated that the starting point is always reconciling section 260 to the other provisions of the Act (i.e. first construe the Act as a whole to determine *where* the incidence of tax should fall). As such, his Honour was reversing the order and making the choice doctrine subject to the predication test. As Norman[52] points out, this represented a change in how section 260 was operated.

The *Newton* predication test is the basis of the application of section BG 1 in New Zealand. Hence, the doctrine is widely accepted and employed using the method reflected in *Gulland* by the New Zealand judiciary system.

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[49] Ibid 4,768
[50] P J Norman, *Gulland, Watson and Pincus in the High Court*, 20 Taxation in Australia, 639 at 641
[51] (1980) ATC 4,076
[52] P J Norman, *Gulland, Watson and Pincus in the High Court*, 20 Taxation in Australia, at 644

IX. APPLICATION OF CHOICE DOCTRINE IN NEW ZEALAND

A. Challenge

In New Zealand the origins of choice principle can be traced back to the 1985 Court of Appeal decision of *Challenge Corporation Ltd v CIR*[53]. Baker J accepted the doctrine quoting the Australian cases. This is the crux of how the principle became ingrained in the core of the tax avoidance legislation in New Zealand.

1. Facts and Judgment

In *Challenge*[54], the taxpayer company, Challenge Corporation Ltd, had several subsidiary companies with substantial profits. On the other hand the liquidator of the failed Securitibank Group was looking for options regarding the losses accumulated by two companies in the group – Perth Property Developments and Security Real Estate.

Challenge and the liquidator entered into scheme whereby shares in Perth and Security were sold to the Challenge Group. The quid pro quo for this was Securitibank receiving half of the tax benefits that were to accrue to Challenge by virtue of its newly acquired shareholding in Perth and Security. However, Challenge had to first satisfy the requirements of section 188 (the loss carry-forward provision) and section 191 (the grouping provision) of the then Income Tax Act. Both of these provisions had specific anti-avoidance provisions. Due to the complex definition of "shares", Challenge was able to manipulate the shareholdings in Perth and Security so as to get out of the specific anti-avoidance provisions.[55] Challenge accepted that its purpose in relation to the above scheme *was* tax avoidance. However, it relied on the technical compliance with section 188 and 191 to argue that the choice doctrine precluded section 99 (earlier version of BG 1) from applying. Specifically, Challenge submitted that technical compliance with sections 188 and 191 was a "choice" provided to taxpayers as per the *Keighery* case.

[53] [1986] 2 NZLR 513; (1986) 8 NZTC 5,001; (1985) 9 TRNZ 81 (CA)
[54] *Challenge Corporation Ltd v CIR* [1986] 2 NZLR 513
[55] For further details of the scheme, see K D Kilgour, *Purchase of Tax Loss Company – Operation of s99*, (1984) 28 NZCT 265

In the High Court, Barker J found that the arrangement was within the application of section 99, on the basis that the only credible explanation for the set of transactions was tax avoidance. His Honour then considered the applicability of the choice doctrine.

His Honour found that the choice doctrine did not apply, noting:

> "Neither the loss carry forward provisions nor any other provision of the Act, having been shown to reveal a parliamentary intent to bar the appellant from entering into such a binding transaction and to make the payments here in question. Once the tax loss concept is included in the statute, the revenue collector is exposed to the chance, if not the flexibility, of the reduction of future tax collections to the extent that a credit is granted for past losses."

Barker J placed considerable emphasis on the fact that the loss carry forward and offsetting provisions had specific anti-avoidance sections, and that these sections had been amended in 1980 to counter the sorts of transactions that Challenge had entered into.

The decision was appealed in the Court of Appeal. Richardson J recognised that the root of the problem was the structural inequalities in the Act and the incoherent way the objectives of the Act were laid out. The fundamental difficulty was reconciling the often-conflicting objectives.

His Honour noted:[56]

> "Clearly the legislature could not have intended that section 99 should override all other provisions of the Act so as to deprive the tax planning community of structural choices, economic incentives, exemptions and allowances provided for in the Act itself."

However, his Honour said that section 99 could not be allowed to be subordinate to all the specific provisions of the Act as it clearly would be contrary to statutory principles. His Honour approved the *Keighery* principle. He explained that the answer to the problem is to be found via an overall assessment of the respective roles of any particular provision and section 99. As such, it is a matter of statutory construction and (as per section 5(1) of the Interpretations Act 1999) the answer is to be found by examining the scheme and purpose of the relevant tax legislation.

[56] *Challenge Corporation Ltd v CIR* [1986] 2 NZLR 548

Furthermore, the scheme of the Act is to be understood by appreciating the historical context of the Act, and analysing its structure and examining the relationships between the various provisions and recognising any discernable themes and patterns and underlying policy considerations.[57]

2. Analysis

Be that as it may, it is respectfully submitted that his Honour's application of the above law to the facts of the case is problematic. His Honour placed emphasis on the scheme of section 191, noting that section 191 required a group structure to exist by virtue of common shareholding, voting power or entitlement to profits. His Honour explained that section 191 only identified a state of affairs existing *at that point in time*. Furthermore, his Honour noted that the specific anti-avoidance provision in section 191 was aimed at temporary shareholdings only. The changes in the present case were permanent. This, according to Richardson J, was indicative of a legislative intent that permanent changes in shareholdings that complied with the technicalities of section 191 were not capable of annihilation under section 99. As such, it did not "avoid the incidence" of tax liability.

All this begs the question: "Did Parliament really intend that a *technical* compliance with section 191 be enough to bring the arrangement outside the scope of section 99?"

It is submitted that although Richardson J described the law on the choice doctrine in terms of the *Gulland* judgment, his Honour's application of the law better fits a position that is between the "implicit" and "absolute" variants. This is because of the considerable emphasis on the *form* that Challenge adopted to structure itself in, while not quite bringing itself outside the scope of the Act. Temporary changes in the shareholding would be the most common way section 191 would be used in a tax-avoiding scheme. It is perhaps with this in view that Parliament gave *specific* attention to temporary changes. But this does not mean that Parliament's prudent attention to temporary changes is indicative of any intent to exclude permanent changes from the operation of section 99 (as was pointed out in the dissenting judgment of Woodhouse

[57] *Challenge Corporation Ltd v CIR* [1986] 2 NZLR 549

P). Section 191 was merely an exception to the rule whereby some legal entities (such as subsidiaries) are taxed separately.

Nevertheless, the decision of Richardson J is very significant as far as the application of choice doctrine in New Zealand is concerned. It is arguably the *first* time a Court of Appeal judge in a New Zealand case has explicitly stated that the choice doctrine applies in New Zealand.

B. Tax Mitigation

Challenge appealed to the Privy Council where the advice of the Board was delivered by Lord Templeman:[58]

> "Section 191 (of the 1976 Act) was intended to *give effect to the reality* of group profits and losses." (Emphasis added)

In the writer's opinion Lord Templeman's judgment should be assessed in two parts. First the scheme and purpose approach, which was articulated by Richardson J in the Court of Appeal, (which his Lordship did not appose to). Secondly he introduced the distinction between tax avoidance and tax mitigation.

1. Scheme and Purpose

The first hurdle that their Lordships had to overcome was *Challenge's* argument that it complied with the requirements of section 191. The presence of section 191 (1) (c) meant that the arrangement was outside the scope of section 99. Interestingly, in finding for the Commissioner, his Lordship did not refer at all to the well-established jurisprudence on the choice doctrine – *Keighery* et al.

His Lordship noted that *most* tax avoidance schemes depended on the exploitation of some exemption, relief or provisions or principles of the Income Tax Act. However, a mechanical compliance with provisions such as section 191 would render section 99 ineffective and therefore it is imperative that the legislative *intent* is determined.

Furthermore, his Lordship rejected the section 191 (1) (c) argument, noting:[59]

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[58] *Challenge Corporation Ltd v CIR* [1986] 2 NZLR 513 at 558

> "[This] argument attributes to Parliament a benevolent attitude towards tax avoidance by companies which is unlikely and unnecessary."

Ohms'[60] submits that in this case Lord Templeman rejects the concept of the choice doctrine.

However, it is crucial to analyse the conceptual underpinnings of his Lordship's reasoning up till this point of the judgment. Challenge put forward three arguments in its submissions. *All three* were rejected using the scheme and purpose approach. This methodology is crucial. It is submitted that this is a direct application of the choice doctrine as per *Gulland.* There, too, the scheme and purpose approach was used to reject the taxpayers' arguments. In rejecting Challenge's arguments, at no point does Lord Templeman refer to the tax mitigation concept – that comes later. His Lordship could have ended the judgment at this point, as the result was imminent. However, he did not.

As in all cases that end up in Court there are *two* distinct questions – a question of law and a further question of applying the law to the case on hand. It is submitted that the *law* that Lord Templeman expands on up till this point in the judgment sits on all fours with the choice doctrine approach used by Richardson J in the Court of Appeal. It is implicit in his Lordship's judgment that there could be choices in the Act. After all, why would his Lordship use the scheme and purpose approach? If his Lordship were of the contrary opinion, he would have simply stated that section 99 was paramount to all the other provisions of the Act and rejected Challenge's arguments on *that* basis. His Lordship did not.

It is merely on the application of the *facts* to the law that Lord Templeman and Richardson J differ – the latter specifying that a choice did exist and the former stipulating the contrary. Their basic premise is the same.

This case serves to illustrate how vague concepts such as "scheme and purpose", "legislative intent" and "rules of statutory interpretation" are.

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[59] Ibid 559
[60] CM Ohms *General Income Tax Anti-Avoidance Provisions: Analysis and Reform* PhD Thesis, University of Auckland, Unpublished, 1994, 426

2. Tax Mitigation

Lord Templeman then introduced the tax mitigation and tax avoidance dichotomy, noting:[61]

> "Income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitles him to a reduction in his liability."

This is the problematic aspect to the judgement. However, his Lordship appears to water-down the above test when he notes (on the same page):

> "Section 99 does not apply to tax mitigation where the taxpayer obtains a tax advantage by reducing his income or by incurring expenditure in circumstances in which the *taxing statute affords a reduction in tax liability.*
>
> Section 99 does apply to tax avoidance. 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." (Emphasis added)

Thus, when describing tax mitigation, his Lordship does make reference to the "taxing statute" (i.e. the other provisions of the Act) and thereby bringing with it the issue of statutory interpretation. However, his Lordship does not do so when describing tax avoidance, implying judicial policy making on his Lordship's part. Logically, tax mitigation should be the consequence of tax avoidance – both must be premised either on the taxing statute itself or on the judicial policy making. Thus it is submitted that there is conceptual incoherence within the tax mitigation / tax avoidance dichotomy.

This leads to a more fundamental problem. It can be illustrated by considering the following scenario: "What if Lord Templeman *had* accepted one of Challenge's three submissions (i.e. that section 191 did provide means for the non-application of section 99)?" Where would that leave the mitigation/avoidance dichotomy? It must always be borne in mind that the dichotomy comes later in the judgment – the tool that his Lordship uses to dismiss the submissions is the scheme and purpose approach. The crux of the matter is to determine which takes precedence – the statutory interpretation approach or the mitigation/avoidance dichotomy?

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[61] See n 56, p 561

If his Lordship *had* accepted one of Challenge's arguments, the arrangement would still be tax avoidance on the mitigation/avoidance approach. Regrettably, his Lordship did not deal with the issue in his judgment.

However, in a recent article, Lord Templeman noted the following in relation to the difference between tax avoidance and tax mitigation[62]:

> "The difference between tax avoidance and tax mitigation is that tax avoidance involves steps which have no commercial purpose apart from the avoidance of a liability to tax which in the absence of those particular steps would be payable; in tax mitigation on the other hand each of the steps involved has a commercial purpose apart from tax advantage although singly or jointly those steps may also result in reducing the burden of tax."

It is submitted that the above commentary by Lord Templeman is inconsistent with his comments in the *Challenge* judgment. In the judgment, His Lordship had premised the mitigation concept on the taxpayer obtaining a tax advantage in circumstances in which the taxing statute permits a reduction in tax liability. In this context, the mitigation concept would summarize the choice principle. This is because under the choice doctrine, a taxpayer may obtain relief *even though* the requirements of section BG 1 may have been satisfied. The relief is obtained because the taxing statute permits the reduction in tax liability by providing a choice for the taxpayer.

However, in his commentary, Lord Templeman describes the mitigation concept as one where each of the steps involved has a commercial purpose apart from tax advantage although singly or jointly the steps may also have the effect of reducing the tax liability. In this context, tax mitigation is a much narrower concept than his Lordship's earlier description of the concept. This is because the latter description is premised on one of the requirements of section BG 1 itself (i.e. purpose) and is not on what the taxing statute does or does not permit. As such, the latter description has no room for the choice doctrine.

Further reservations have been expressed on whether the distinction between tax mitigation and tax avoidance is a complete answer to all problems that may arise in the context of 'tax avoidance". In *Hadlee* (CA) Cooke P said:[63]

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[62] Lord Templeman, *Tax and the Taxpayer*, (2001) 117 LQR 575 at 579
[63] *Hadlee and Sydney Bridge Nominees Ltd v CIR* (1991) 13 NZTC 8,116 (CA) p 8,1:22

> "The only difficulty in this part of the case arises from the part of the judgment of the majority of the Judicial Committee of the Privy Council in *Challenge Corporation Ltd v Commissioner of Inland Revenue* (1986) 8 NZTC 5,219 at pp 5,223 - 5,225: [1986] 2 NZLR 556 at pp 560 – 563, which distinguishes between tax mitigation and tax avoidance and on which the appellant seeks to rely. The judgment does not mention any of the earlier Privy Council decisions just cited and I cannot think that it was intended to overrule them. 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 the problems in this field may be doubtful and none of the cases collected by Lord Templeman at pp 562 – 3 of the report is closely in point. "

In *Miller*, Baragwanath J referred to the issue of tax mitigation and said:[64]

> "I am nevertheless of the respectful view that […] the distinction between tax mitigation and tax avoidance, [..] describes a conclusion rather than providing a signpost to it."

More recently Lord Hoffman in the Privy Council decision in *O'Neil & Ors v CIR*[65] concurred with this opinion. Lord Hoffman stated:

> "There are, however, two points in the thoughtful analysis of Baragwanath J. which require comment. The first is that [their Lordships] are in complete agreement with his observation that the distinction between tax mitigation and tax avoidance is unhelpful: as the judge pithily said, it 'describes a conclusion rather than providing a signpost to it.."

C. Miller and O'Neil

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

This position on the choice principle is supported by the comments of Lord Hoffmann in *O'Neil* [66] where he said:

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[64] *Miller (No.1) v CIR; McDougall v CIR* 18 NZTC 13,001 (HC) p 13,031
[65] (2001) 20 NZTC 17,051 p 17,057
[66] Ibid

> "On the other hand, the adoption of a course of action which avoids tax should not fall within section 99 if the legislation , upon its true construction, was intended to give the taxpayer the choice of avoiding it in that way."

O'Neil[67] was a major anti-avoidance decision of the Privy Council. The impact of this case ensured that the choice doctrine was accepted and well settled in New Zealand. It became clearly evident that the courts now recognised the doctrine as the fourth element of section BG 1.

1. Facts and Judgments

Although *O'Neil*[68] went to the Privy Council, the origins of this case lie in the judgment of Baragwanath J in *Miller & Ors v CIR*[69]. This case involved a complicated tax saving template scheme operated by a J G Russell. In essence, it involved Mr Russell firstly acquiring companies with accumulated tax losses. These companies were structured as part of a group controlled by Mr Russell. Directors of profitable companies would sell the shares in their company ("Company A") to a company within the tax loss group ("Company B"), lending it the full amount of the price. Company A would remain controlled by its former shareholders, who were still recorded in the Companies Office as owners. They executed declarations of trust in favour of Company B. Profits subsequently earned by Company A were set-off against the losses accumulated by the loss group. Mr Russell's management company received a consultancy fee equivalent to five percent of the profits of Company A.

The judgment of Baragwanath J in the High Court is significant in that it recognised that the issue of the applicability of section BG 1 entails two steps. His Honour noted:[70]

> "[In] addition to the criteria [in section 99] the Court in exercise of its function to implement the general legislation in specific cases will require infringement of a **norm of "impropriety"** before deciding that an arrangement is to be annihilated under section 99(2). Its right and duty to do so result from its constitutional responsibility to give effect to Parliament's presumed intention – **to maintain the tax base while permitting the operation of normal business techniques which section 99(2)(b) contemplates are in general acceptance**. By employing such general language Parliament has delegated to the Court the responsibility of achieving a fair and just result in particular cases." (Emphasis added)

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[67] Ibid
[68] Ibid
[69] (1997) 18 NZTC 13,001
[70] Ibid 13,031

Later, in *KJ Cummings v CIR*[71], Baragwanath J noted:

> "I have attempted to express the effect of the appellant's jurisprudence by applying a twofold **black letter** and propriety test."

As such his Honour approves of the *Newton* predication test as the *first* step in the analysis (together with the other two elements in section BG 1). It is submitted that the second step (i.e. propriety test) is merely variant of the choice doctrine. The crux of the propriety test is that it recognises that the merely application of the "black letter" of section BG1 may in some circumstances result in an outcome that was not intended by Parliament. Therefore, as a concept, the propriety test is an extremely wide one that focuses on the scheme and purpose of the legislation. As noted above, the intention of the legislature is found not just in "explicit" choices. As such, the propriety test is wide enough to allow "implicit" choices.

The author considers that the *Miller* High Court judgement is an exceptional one in that it provides a "pure" description of the legal methodology that should be used by judges when dealing with avoidance. Inland Revenue Department seems to follow the similar methodology in its application of the elements of section BG 1. The flowchart (given in its Exposure Draft as seen earlier in this paper) summarised the three elements that are contained in section BG 1 (and the associated definition). These three elements combined is the black letter approach. However, the flowchart emphasises (as does Baragwanath J) that the story does not end there and that regard should also be had to whether the scheme and purpose of the legislation has been frustrated, which describes the propriety test.

The *Miller* case was appealed. However, the Court of Appeal judgment is insignificant as far as the doctrine of choice is concerned since the propriety test was not referred to. The Court of Appeal decision was largely about judicial review issues.

The case eventually found its way to the Privy Council, albeit by different appellants. In *O'Neil* [72], the Privy Council dismissed the taxpayers' appeal.

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[71](1998) 18 NZTC 13,549
[72]*O'Neil & Ors v CIR* (2001) 20 NZTC 17,051

Lord Hoffman noted that their Lordships were in complete agreement with the observation of Baragwanath J that the distinction between tax mitigation and tax avoidance is not helpful. His Lordship cited with approval the statement by Baragwanath J that the distinction between tax mitigation and tax avoidance "describes a conclusion rather than providing a signpost to it."[73]

However, the more significant part of the Privy Council decision is the rejection of the propriety test. His Lordship noted[74]:

> "[Their Lordships] doubt the wisdom of using the concept of "impropriety" instead [of the distinction between tax avoidance and tax mitigation]. This suggests a moral judgment which their Lordships think is inappropriate and has been constantly repudiated in cases on tax avoidance schemes in England and New Zealand."

2. Analysis

This part of the judgment may appear to be rejecting the choice doctrine outright. However, this is not the case. His Lordship is merely rejecting the label used by Baragwanath J to describe the choice doctrine. His Lordship's judgement is also significant because it rejects any purely subjective elements creeping into the choice doctrine analysis, as is evident from the following passage:

> "In many (although by no means all) cases, the legislation will use terms such as income, loss and gain, which refer to concepts existing in a world of commercial reality, not constrained by precise legal analysis. A composite transaction like the Russell scheme, which may appear not to create any tax liability if it is analysed with due regard to the juristic autonomy of each of its parts, can be viewed in commercial terms as a unitary arrangement to enable the company's net profit to be shared between the shareholders and Mr Russell. … Their Lordships consider this to be a paradigm of the kind of arrangement which s99 was intended to counter-act. On the other hand, the adoption of a course of action which avoids tax should not fall within s99 if the legislation, upon true construction**, was intended to give the taxpayer the choice of avoiding it in that way.**"

Although these comments are merely *obiter,* they are very significant because of the clarity with which the Privy Council states the conceptual underpinnings of the choice doctrine. It points out that in relation to a particular taxpayer, the fundamental query

[73] *Miller & Ors v CIR* (1997) 18 NZTC 13,001 at 13,031
[74] *O'Neil & Ors v CIR* (2001) 20 NZTC 17,051 at 17,057

was whether Parliament had intended that the taxpayer be given the choice of avoiding tax in the method adopted by the taxpayer. Whether or not a choice exists is a matter of statutory construction.

Later in the *CIR v BNZ Investments Limited*[75] decision, the judge placed significant emphasis on the relationship between choice principle and the scheme and purpose of the legislation. This aspect grounded the statutory interpretation rules in New Zealand that were initially considered as the basic fundamentals of choice principle.

[75] (2001) 20 NZTC 17,013

X. RECENT NEW ZEALAND DEVELOPMENTS

A. BNZ Investments

1. Facts and Judgment

In 2001, the Court of Appeal delivered its decision in *BNZ Investments.*[76] In this case the taxpayer, BNZ Investments Limited ["BNZI"], was a wholly owned subsidiary of BNZ Limited. BNZI made a series of redeemable preference share ["RPS"] investments in entities provided by Capital Markets Limited ["CML"], a member of the Fay Richwhite group. BNZI funded these investments through share capital taken by BNZ.

Four "varieties" of transactions were used by CML. Using a complicated set of transactions, the economic effect of the four "varieties" was that:

1. The funds invested by BNZI using RPS were deposited with prime overseas banks.
2. Interest earned on these deposits was ultimately repatriated to BNZI as exempt dividends.
3. The dividends were calculated according to a method under which the tax advantages were shared between BNZI and CML.
4. As intended, the RPS' were eventually redeemed.

Each "variety" involved two types of transactions:

Firstly, the "upstream" transactions which involved the borrowing of funds by BNZI, the incorporation and capitalization of BNZI, and the investment of those funds by BNZI in RPS in entities provided by CML.

Secondly, the "downstream" transactions where the funds were passed through by the entity which had issued the RPS' to BNZI, then to downstream entities and the ultimate deposit of the funds with the prime overseas banks.

[76] Ibid

One of BNZ Investments' arguments was that the general anti-avoidance did not apply in relation to the downstream transaction on the basis of the doctrine of "new source" drawn from *Europa Oil (NZ) Limited v CIR (No 2)*[77]. The gist of the "new source" doctrine was that the anti-avoidance legislation was directed towards arrangements having the affect of "altering the incidence of taxation". If no alteration had taken in the sense that a change was made to an *existing* source of income, then the general anti-avoidance section had no application.

In the High Court, McGechan J stated that the "new source" based argument did not apply to New Zealand because the current form of the general anti-avoidance provision had been expanded since the inception of the "new source" argument.

His Honour stated that the choice of structure by the taxpayer would not reduce the application of a general anti-avoidance purpose unless the structure chosen does not constitute an "arrangement" as defined. The choice of structure may also dampen the application of the anti-avoidance rules if the transactions undertaken by which tax is avoided involve the application of statutory concessions and a **true alteration of the taxpayers' financial position**. This latter element is determined in accordance with the approach taken by the approach taken by the Privy Council in the *Challenge* case. As such, McGechan J approved the notion that tax mitigation did not amount to tax avoidance.

The High Court decision was appealed, and although the Court of Appeal upheld the decision of McGechan J, several comments made by Richardson P are fundamentally significant.

Richardson P recognised that there is a valid distinction between legitimate tax planning and improper tax avoidance, noting[78]:

> "The function of s99 is to protect the liability for income tax established under other provisions of the legislation. The fundamental difficulty lies in the balancing of different and conflicting objectives. Clearly the Legislature could not have **intended** that s99 should over-ride all other provisions of the Act so as to deprive the taxpaying community of structural choices, economic incentives, exemptions and allowances provided by the Act itself."

[77] [1976] 1 NZLR 546 (PC)
[78] *CIR v BNZ Investments Limited* (2001) 20 NZTC 17,103

2. Analysis

The above passage points out once more that the conceptual underpinnings of the choice doctrine lies in ascertaining the intention of the legislature. The intention, in turn, can be ascertained only after applying rules of statutory interpretation.

In order to apply the general anti-avoidance principle to a particular set of facts, the courts must undertake an analysis of an integrated statutory interpretation. This essentially in my mind is the crux of embracing the choice principle. More importantly, consideration of other more specific provisions will need to be considered as well as the overall context of the statutory regime. An added point to bear in mind is that the New Zealand Courts have constantly stated that a general anti–avoidance principle (GAAP) is not to be given a broad literal interpretation. This was clearly evidenced by the following observation of Woodhouse P in *Challenge*[79]*:*

> "In New Zealand the Courts must now ensure that the anti-avoidance provision as it stands is given that the purposive construction which will enable it to do its work in the balanced but effective way intended for it".

McGechan J also quite clearly endorsed the purposive construction of the general anti-avoidance principle (GAAP) in *BNZI.* Specifically, GAAP cannot be applied literally (i.e. GAAP cannot *automatically* apply whenever the three elements have been satisfied). Therefore, the choice doctrine must be an essential element of any anti-avoidance analysis to ensure that Parliamentary intention is not ignored.

However, the devil lies in the detail. The difficulty is that applying these statutory interpretation guidelines to the Income Tax Act in the context of the choice doctrine can produce mixed results. Identifying where and in what circumstances a choice exists can be relatively simple in some cases (for example the *Qualifying Companies*[80] regime), but other, more "implicit" choices, may be difficult to identify.

This level of difficulty is clearly evident in the recent tax avoidance cases in New Zealand. It is thus submitted that the application of the choice principle is far more complicated then the theoretical concept suggests.

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[79] *Challenge Corporation Ltd v CIR* [1986] 2 NZLR 513, p534
[80] Refer subpart HG of the Income Tax Act 2007

B. Peterson

One of the key focuses of this research was to identify 'how and when to apply the doctrine of choice?' My finding thus far has determined that the doctrine is a silent part of the avoidance legislation. Hence it would not out of line to suggest that the judicial committee by now recognise the correct legal methodology and when to interpret and apply the scheme and purpose of a provision. This should be the end of my research. The answers have been found. The muddy waters have been cleared. The confusion behind the application of the anti avoidance rules solved. The answer to my research question should state as follows: in New Zealand when dealing with avoidance cases the judges first apply the three elements of section BG 1 to the facts of the case and then consider whether the choice doctrine applies. Essentially they would recognise that there are four elements, and apply each element to the facts of the case separately. In applying the elements they would consider where appropriate the scheme and purpose of the relevant provision.

However, far from recognising the correct legal methodology or interpreting the scheme and purpose of the provisions correctly, instead the recent judicial decisions can be likened to murky waters. Recently judges have seemingly applied cases instead of elements to facts. Furthermore, when interpreting the scheme and purpose of the relevant provisions they have applied incorrect facts. In other words, instead of following what the legislature says, they followed what the previous cases have generically said about avoidance. This is for the reason as you will see in Peterson81 and in the latest Trinity decisions (further on in this paper) that the application of these elements is nowhere as easy as it seems. The practical applications are very complicated and even the highest judicial authority struggle to grasp these legal concepts.

1. Facts

Peterson[82] is about the tax incentives available in New Zealand in regards to film production. The taxpayer was a member of a syndicate of investors that acquired two films ('The Lie of the Land' and 'Utu') in two separate transactions. 'Utu' was a commercial success. However, the 'Lie of the Land' in which the taxpayer and a

[81] *Peterson v CIR* [2006] 3 NZLR 433; (2005) 22 NZTC 19,098
[82] Ibid 19,098

number of other investors invested a total of $2.760 million was never released commercially.

However, the investors did not lose any money in this deal. Even more so, they made a profit due to the way in which the producers had structured the investment. The resulting tax consequences of that investment shifted an expenditure of a capital nature (where no deduction was allowed) to a 100% deduction for expenditure (as per the incentive provision allowed for film production).

The investors were falsely led to believe (by the production company) that the cost of the films was $x plus $y. The investors paid $x amount and $y was obtained from a non-recourse loan from a third party lender connected with the production company. The investors were treated as if they received $y by the way of a loan which (was treated as if) they had paid it together with $x out of their own resources to the production company in the discharge of their contraction liability under the production contract. The production company then applied $x to the cost of producing the films. They did not use $y to make the film. They paid $y back to the lender immediately after it was received.

The actual tax and cash consequences of the above structure were as follows:

Total expenditure deducted by the taxpayers		$2.760m
Cash (43% paid by the taxpayers)	$1.200m	
Limited Recourse Loan (57% from lender)	$1.560m	
Tax saving - 66% of total expenditure of $2.760m		$1.820m
Less cash investment paid by the taxpayers		($1.200m)
Net Cash Profit		$0.620m

As seen above the key attraction to an investor was obviously the tax benefits. Clearly as far as an investment opportunity is concerned, by investing in this film the investors and Peterson could only gain regardless of the success of the film.

The Commissioner disallowed the $y portion of the deduction claimed by the taxpayer on the grounds that it did not represent the expenditure incurred by the partnership.

In regards to the 'Lie of the Land', the TRA and the High Court rejected the Commissioners claim that loan was sham. The Commissioner claim under section 99 (anti avoidance provision of the Income Tax Act 1976) also failed.

In the case of "Utu", the TRA ruled against the Commissioner stating that the taxpayer did not borrow the finances. However, the High Court held that the Commissioner was entitled to adjust the taxpayer's income under section 99 of the relevant Income Tax Act.

The Court of Appeal in regards to both cases above held for the Commissioner that the arrangement was subject to the general avoidance provision and that Commissioner had rightly adjusted the tax advantage under section 99.

The taxpayer appealed the Court of Appeal's decision to the Privy Council.

2. Judgment and Analysis

The judgment of the Privy Council was a spilt decision of 3:2. The majority comprised of Lord Millet, Baroness Hale of Richmond and Lord Brown of Eaton–under-Heywood. The majority found in favour of the taxpayer. [83]

The judgement is somewhat controversial because their Lordships found for the taxpayer despite finding that there was an "arrangement" that had the purpose or effect of avoiding tax. One would expect that their Lordships would have stopped here and found for the Commissioner after these findings.

However, their Lordships went on to ascertain whether the tax advantage was an "acceptable tax advantage". Their Lordships used the much criticised judgement of Lord Templeman in the *Challenge* Privy Council decision, especially the tax mitigation concept. The basis for that concept was that not every tax advantage comes within the intended scope of section 99. A tax advantage would be considered "acceptable" (and therefore not subject to anti-avoidance provisions) if the taxpayer's reduction in liability to tax was brought about by incurring a loss or expenditure.[84]

[83] Ibid 19,098
[84] Ibid p 19,109, para 36.

So the key issue in the case was *exactly how much* expenditure had the investors incurred in acquiring the rights in the films?

In this regard, the taxpayer was assisted by "own goals" scored by the Commissioner during the case. The majority indicated that the result may have been different had the Commissioner argued his case differently. They commented that the Commissioner had discharged the weaponry of anti-avoidance with bad marksmanship, in terms of arguments and concessions made by the Commissioner. They noted that it was never challenged, and was now conceded by Inland Revenue, that the investors had paid $x **plus $y** to acquire the film.

Having decided that the "arrangement" and "purpose" elements were satisfied in this case, the majority then considered whether there was something in the *scheme* of depreciation provisions which *otherwise* saved the taxpayer.

This is where the Commissioner faced an uphill battle. The majority considered the *purpose* of the statue in allowing taxpayers depreciation deductions. They noted that the investors *had* incurred the expenditure which the "Parliament contemplated should entitle them to the depreciation allowance which they claim"[85].

In the view of the majority, it was enough if the investors had paid an amount to acquire an asset. This in their mind made up the cost of the asset and in return was the amount that the investors should be able to depreciate. This view was based on their understanding of the purpose of the depreciation regime which they stated was to allow a deduction over time for *cost* of capital applied in earning income. The majority noted:[86]

> "..The statutory object in granting a depreciation allowance is to provide a tax equivalent to the normal accounting practice of writing off against profits the capital costs of acquiring an asset to be used for the purposes of a trade ..."
>
> Consistently with the statutory purpose, it is not only necessary but also sufficient that the taxpayer should have incurred capital expenditure in acquiring an asset for the purposes of trade. The focus is on the party who acquires the

[85] Ibid 19,109, para 39
[86] Ibid p 19,110

> asset. It does not matter what the party who disposes of the asset does with the money…"

In the writer's opinion, two points come out from the majority judgement in a choice doctrine context:

Firstly, the outcome reached by the majority does not appear to be correct. The judgement is based on a very narrow interpretation of the depreciation provisions and their relationship with the treatment under accounting rules. The minority also considered the scheme and purpose of the depreciation provisions and came to a different conclusion as to what the purpose of these provisions was.

They stated a depreciation claim *cannot* fall within the purpose of the depreciation regime where the cost of producing a film was met by the proceeds of a non-recourse loan, which was not applied to the cost of production. They went on to state that the effect of this arrangement could not be reconciled with the 'statutory purpose of encouraging investment in the production of films'. They did not believe that the statutory regime intended to assist or encourage the sort of cost where the cost of *acquisition* of the film was inflated solely to qualify for a higher depreciation deduction[87].

However, the second point is more significant. Both the majority and the minority appear to have correctly applied the choice doctrine framework. Both firstly considered the elements of BG 1 and came to the conclusion that they applied. They then went on to consider whether the purpose of the depreciation provisions otherwise saved the taxpayer (i.e. whether the choice doctrine applied) and came to completely different interpretations.

This decision shows how delicate the issue of interpreting the scheme and purpose of the specific provision is. The delicate balance was further frustrated in *Peterson* as noted by Ms Williams in her article[88] in which she states that, "*…it is not surprising that there was a disagreement between the majority and the minority as to the correct interpretation of the depreciation provisions, as it appears that the actual authority for*

[87] Ibid 19,120, para 91
[88] Williams N, *Privy Council Delivers Final Tax Avoidance Decision: Peterson v CIR,* NZJTP, V11, September 2005, p 284

the deprecation claim which the investors sought to make was not clear to their Lordships."

She further states that "*given that the majority and the minority are testing whether different depreciation provisions are frustrated by the arrangement; it is not surprising that they have come to different results."*

Furthermore, this issue highlights that more weight lies on the 'frustration' element of the anti avoidance methodology. This concept is troubling and was also reflected in *Trinity* which is discussed in detail further in this paper.

The author agrees with Williams' comments[89] that "*this illustrates that the crux of an avoidance case is the interpretation of the provision under which the taxpayer is seeking the tax advantage."*

This decision effectively clears the way for New Zealand's new Supreme Court to examine the anti-avoidance in ways other than the approach set up by previous judicial authorities. New Zealand has already seen examples of new approaches and methodology being used in the *Trinity* case. It will be very interesting to see how the Supreme Court decides on the *Trinity* case in light of this judicial behaviour.

Such close split in the decision illustrates that the crux of an avoidance case is based on the interpretation of the provision. In *Peterson* this relates to the specific provision under which the taxpayer sought to take the tax advantage as apposed to section BG 1. Up till now section BG 1 seemed to be the accepted way of determining existence of tax avoidance. This is very interesting as this seems to suggest that the main burden of avoidance seems to lie on the fourth element of BG 1 being the doctrine of choice which demands the interpretation of the specific provision. In the authors view the judgment in this case opens up problematic options as seen later in the *Trinity* judgment.

[89] Ibid 288

XI. TRINITY

A. Is Trinity Setting a New Trend?

The Court of Appeal's recent judgment in the Trinity [90]case is proving to be somewhat controversial. Interestingly, the controversy is not about the outcome of the case, instead about the approach that the Courts have adopted to determine whether or not the scheme amounted to tax avoidance. This case is now on appeal to the New Zealand Supreme Court.

1. The Court of Appeal Judgment

Much criticism has been aimed at the way William Young P provided the judgment:[91]

> "**In a real and tangible sense, there is a business** (namely the growing of a Douglas fir forest). It is likely enough (although not certain) that this forest will be maintained until harvest and that some revenue will be produced. It is even possible that this revenue will be sufficient to provide an actual return for the investors. All of this leaves plenty of arguments based on the taxpayer autonomy and choice, with the taxpayer maintaining that it is irrelevant that they could have made other more commercially advantageous (although less tax effective) forestry investment. A forestry venture with its long timeframes necessarily involves the possibility of mismatches between the actual incurring of expenditure and receipt of proceeds on the one hand and, on the other, tax recognition of expenditure and income. So the Trinity scheme is clever. But, this cleverness should not be allowed to obscure the reality that this particular emperor has no clothes.
>
> It is clear that the real purpose of the arrangement is not the conduct of a forestry business for profit, but rather a generation of spectacular tax benefits. The end result (that is, profitability or otherwise of the venture) was never seen as being material. The corollary of this statement is that there was never was a "real" purpose of making a profit from harvesting of trees".

One such criticism is mirrored by Eugene Trombatis in his recent article[92] where he states:

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[90] *Accent Management Ltd v CIR* [2007] NZCA 230; (2007) 23 NZTC 21,323
[91] Ibid para 140 and 141
[92] E Trombitas, "Trinity Exposed: Does the Emperor Really Have No Clothes or is He Wearing an Unusual Silver Rugby Jersey? – The Latest News from the GAAR Front", (2007) Vol 13 *New Zealand Journal of Taxation Law and Policy* 583

> "it is respectfully submitted that the overall approach in paras 140 and 141 falls a long way short of answering the 'threshold question'…. and it is also illogical. Once all of the things in the first part of para 140 are recognised, the author is at a loss to explain the basis for the Court's conclusion at para141. Something else must be going on. ….**it seems to be a case of judicial instinct saying 'this is too good to be true' or a case of "we don't like this"** [Emphasis added]

The criticism of Trombatis is not entirely unfounded. It is a result of the legal methodology adopted in this case. The lack of analysis and support for the judgement comes from incorrectly applying the anti avoidance rules. Accepted that tax avoidance is very difficult to identify and no doubt the courts have struggled with this concept over time, it is still the duty of the courts to interpret and implement an existing law using the correct legal approach and not judge based on gut feelings and instincts.

This case has produced a raft of inconsistencies in regards to the application of the general anti avoidance rules (GAAR). However, before discussing these factors lets have a brief look at the facts of the 'Trinity Scheme'.

2. Factual Context

The case concerned investments made through Trinity Foundation (Services No. 3) Ltd (Trinity 3). Investors in the Trinity scheme were granted a 50 year licence to use land in Southland to plant pine trees. The licence gave investors the right to receive proceeds from the sale of the pine trees at harvest. Investors issued a promissory note to pay a fixed fee for the licence in 50 years time. The licence 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 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 was claimed by the investors and 87% of the expenditure claimed in the first year was deferred for 50 years. The 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 fees 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. A total of $3.7 billion of tax revenue was at risk if the scheme had run to maturity. A draft business plan prepared for the insurer stated that *"the real benefits of the deal are tax concessions that can be obtained now by the investors….. The actual outcome of the deal in fifty years is not considered material"*. [93]

The Commissioner of Inland Revenue challenged the deduction of the insurance premium and the depreciation of the licence under the general anti-avoidance rules.

The Court of Appeal acknowledged that the scheme was clever but commented that *"this cleverness should not be allowed to obscure the reality that this particular emperor has no clothes"*. Hence the scheme was ruled as Tax Avoidance.

3. The Correct Legal Approach

Based on the process laid out earlier in this paper, it is agreed that that the correct methodology for applying BG 1 can be summarised in the following 5 steps:

1. Check if the specific provision allows the transaction in question. This is the fiscal nullity concept. If yes, then only does the question of anti avoidance arise and the next step is to be applied.

2. Apply the three elements of BG 1 (in accordance to the legislative requirement and statutory interpretation rules discussed above) in the order of: 'is there an arrangement' and

3. 'Is there 'tax avoidance' and

[93] www.bellgully.com Bell Gully update. The Trinity Case: Tax Avoidance or No More Than the Law Intended Aug 2007

4. Is ‘one of the purposes of the arrangement, which is more than incidental, tax avoidance?

5. If the answer to all three elements above is yes then apply the choice principle.

The accuracy of this legal approach is based on the principles introduced in *Elminger* and *Newton* in regards to the application of the three elements of section BG 1. The basis of these principles is grounded in the statutory interpretation rules and the law of legal precedent.

It is essential that the judges use the legal methodology correctly when applying section BG 1. This is because the judges are not law makers. The law is created by the Parliament. The function of the courts is to interpret and apply the legislation to the best of the judges’ ability. The judges have guidelines and they are bound by the law of legal precedent and the statutory interpretation rules when applying legislation.

Correctly understanding the statutory interpretation rule provides guidance towards the legal approach that *must* be used to interpret and apply section BG 1. This in turn reduces the uncertainty attached to the avoidance tax law and allows taxpayers to conduct their affairs with the requisite degree of certainty. In the ideal world, the expression in a statute would clearly record the Parliaments’ intention. Unfortunately this is not practical if GAAR is to aptly protect the tax base. Hence the judges rely on the guiding principles found in the statutory interpretation rules and the law of legal precedent (These principles are expounded upon in the next section of this paper).

In this section the author aims to elucidate *how* the elements of section BG 1 *must* be applied to an avoidance transaction. Earlier on, the author expounded upon the *correct order* in which the elements in section BG 1 must be applied. The four elements are applied literally one after another, step by step. However, in order to explain and discuss the ‘legal approach’ taken by the judges in *Trinity* is it essential to understand what the ‘correct legal approach’ is. Understanding the difference between how the legal approach must be applied and how it was applied in *Trinity*, will help the reader appreciate the difficulty an ‘incorrectly applied” legal methodology can pose in the area of avoidance in New Zealand and what effect its application can have on the future of the anti avoidance rules.

As you will see below the 'correct legal methodology' has been considered in light of the precedents laid out in previous cases and the parliament's intention behind the creation of the anti avoidance rule. This approach also takes into account the reason for the creation of the choice doctrine and its role in the avoidance ambit. Over the years the New Zealand Courts guided by the statutory interpretation rules have established a correct legal approach in applying section BG1. The scheme and purpose approach is the heart to interpreting the '*Newton*'s predication test' and 'choice doctrine'. Taking the *correct* legal methodology into consideration one would have expected the judges in *Trinity* to approach the elements in section BG 1 as follows:

4. Arrangement

Identification of an arrangement is the first thing that must be done when applying BG 1 because the detection of all the other elements centres on how the arrangement is actually identified on the facts of the particular case.

The leading decision on the definition of 'what is an arrangement' is found in *Newton v FCT* [94]: where Lord Denning stated that:

> "Their Lordships are of the opinion that the word "arrangement" is apt to describe something **less than a binding contract or agreement**, something in the nature of an **understanding between two or more persons - a plan** arranged between them which may not be enforceable at law. But it must in this section comprehend, not only the initial plan, but also all the transactions by which it is carried into effect - all the transactions, that is, which have the effect of avoiding taxation, be they conveyances, transfers or anything else. It would be useless for the Commissioner to avoid the arrangement and leave the transactions still standing." [Emphasis added].

Newton refers to section 260 of the Australian Tax Act at the time (the Income Tax Assessment Act 1936 (Cth)) which was largely same as the current section BG 1. This interpretation of arrangement by Lord Denning formed the basis for the current definition in section BG 1. *Newton* brings to attention two concepts while defining an arrangement: *contracts or agreement* and *plan or understanding.*

[94] *Newton v FCT* [1958] AC 450, 465

1. Contract or agreement was described as follows[95]:

> A 'contract' is a technical word and implies an agreement enforceable by law."

In other words this could represent a standard contract which includes the four elements of offer, acceptance, consideration and intent.

2. Plan or understanding was described as[96]:

> "…something less than a binding contract ... something in the nature of an understanding between two or more persons – a plan arranged between them which may not be enforceable at law ..."

Hence an arrangement does not need to be a formal contract. The concept of a plan or understanding includes three key elements of: an initial plan, steps and end or effect.

The leading New Zealand case for arrangement is *Elmiger v CIR*[97] . In the High Court Woodhouse J in identifying the arrangement stated:[98]

> "There actually is … a series of transactions which have been applied in a concerted way as part of a predetermined routine. ……. There clearly was an overall plan preceding the individual steps taken and clearly the intention was that those steps should take effect as a whole"

In *Elmiger*, the presence of tax avoidance was determined by identifying that a wider arrangement existed. The Commissioner argued that there were 5 steps to the arrangement and not 2 steps as per the defence counsel. The judge agreed with the Commissioner and analysed the purpose of each step and concluded that:

- steps 1 and 2 were indicative of a normal family trust, but the
- steps 3 to 5 were indicative of tax avoidance as being the main objective.

5. Tax Avoidance

The second element of a tax avoidance arrangement is that 'there must be tax avoidance'. First thing to do is to look at the definition in section OB 1 of the Income Tax Act 1994 which states that tax avoidance includes[99]:

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[95] *FCT v Newton* (1957) 96 CLR 577, 630.
[96] Ibid at p465
[97] *Elmiger v CIR* [1966] NZLR 683 (HC).
[98] Ibid 694

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

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

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

The first and second limbs generally relate to arrangements that attempt to shift the incidence of tax from one taxpayer to another. The first limb was discussed by Turner J in the Court of Appeal decision of *Marx v CIR.*[100] The second limb was addressed by Lord Donovan in *Mangin v CIR.*[101]

Lord Denning in *Newton*[102] outlines the third limb as actions taken by a taxpayer to get out of a future tax liability. This concept is not like limb one and two where the liability has already incurred but it refers to an arrangement which has the effect of preventing a future liability from arising.

6. Purpose

The third and possibly the most difficult element of tax avoidance arrangement is that 'one of the purposes or effects, which is more than incidental, must be tax avoidance'.

Purpose and effect is not defined in the Income Tax Act. The leading case law for identifying purpose (known as the predication test) is found in *Newton,* where Lord Denning stated:[103]

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

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[99] OB1 definition, Income Tax Act 1994
[100] *Marx v CIR* [1970] NZLR 182
[101] *Mangin v CIR* [1971] NZLR 591 (PC)
[102] *Newton v FCT* [1958] AC 450, 465
[103] *Newton v FCT* [1958] CLR 1 at 8; ALJR 187

The 1974 Amendment Act added a new paragraph which provided that every arrangement was void for tax purposes:[104]

> "(b) where it has two or more purposes or effects, one of its purposes or effects (not being merely incidental purpose or effect) is tax avoidance, **whether or not any other or others of its purposes or effects relate to, or are referable to , ordinary business or family dealing."** [Emphasis added]

This now means that the *Newton* Predication test is of 'ordinary business or family dealing' is no longer considered an automatic defence.

In regards to *Trinity* the key point is that the above amendment now means that not only must an arrangement exists which has the effect of tax avoidance but the dominant purpose of the arrangement must be to achieve the tax avoidance benefit. It looks at the mental state (the reason) for a course of action.

This was also stated in the Court of Appeal decision in *Tayles v CIR* [105] where McMullin J concluded, in relation to section 108, that the phrase "purpose or effect" had been typically construed synonymously to refer to the objective of the taxpayer.[106]

This amendment arguably led to the development of the scheme and purpose approach.

7. Choice Doctrine

The concept of a Choice is also linked to the scheme and purpose approach. Courts have to look at the scheme and purpose of the specific provision to determine if the application of section BG 1 will frustrate the very purpose of the creation of the specific provision. It is important to realise that specific provisions are not always established to achieve tax liabilities. They are mostly designed to promote social and economic objectives. This reasoning needs to be applied when looking at the scheme and purpose of the specific provision. If the transaction in consideration is meeting the underlying scheme and purpose of the specific provision than obviously section BG 1 cannot be applied, as Parliament would not have created the specific legislation if it had intended for BG 1 to overwrite it. That would be absurd.

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[104] Section 99 (2) (b) Income Tax Act 1976
[105] *Tayles v CIR* [1982] 2 NZLR 726, 734 (CA)
[106] Ohms C, Income Tax Law in New Zealand , Thomas Brookers, 2004, p1107

In applying the fourth element of choice, the courts are guided by concepts which direct the judges to consider certain things. The existence of these concepts is essential. They make up the package that is called the 'correct methodology' in the application of the four elements of section BG 1, including choice. The kinds of concepts the judiciary must consider and apply are the statutory interpretation rules, the doctrine of legal precedent and *per incuriam.* The next part of this paper explains these guiding principles in context of *Trinity* and how it applies to that case.

B. Guiding Principles

1. Statutory Interpretation Rules

Since the introduction of the concept of choice principle in *Challenge,* the scheme and purpose approach is considered paramount. Basically if the transaction in consideration of section BG 1 meets the underlying scheme and purpose of the specific provision then obviously section BG 1 cannot apply. The Parliament surely cannot have meant for section BG 1 to prevail in such instances otherwise they would not have created that specific legislation. That would be absurd. Hence the judiciary need to look at the statutory interpretation rules in order to apply the scheme and purpose approach to a transaction.

Statutory interpretation rules are found in the Interpretation Act 1999. There are two provisions in that are vital in interpreting provisions of the Income Tax Act.

Firstly, the over-aching provision in section 5(1) of the Interpretation Act 1999, which states:

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

Secondly, section AA3(1) of the Income Tax Act 1994 which states:

> "The meaning of a provision of this Act is found by reading the words in context and, particularly, in light of the purpose provisions, the core provisions and the way in which the Act is organised."

These provisions codify the modern purposive approach described in *Donselaar v Donselaar*[107], where Somers J noted:

> "The function of the Court in relation to a statute is to discover the intention of the legislature. That intent is to be ascertained from the words it has used. But the richness of the English language is such that the same words or phrases may convey different ideas depending upon the context and circumstances in which they are used. So it is that the words used in an enactment are to be considered in the light of the objects which the statute as a whole in intended to achieve. In modern legal parlance that is called a "purposive" construction. But it has still to be stressed that the inquiry is not what the legislature meant to say but as to **what it means by what it has in fact said in the framework of the Act as a whole**." (Emphasis added)

Earlier in *Mangin v CIR*[108], the Privy Council stated that the interpretation of an income tax statute was governed by four broad principles:

> "First, the words are to be given their ordinary meaning. They are not to be given some other meaning simply because their object is to frustrate legitimate tax avoidance devices…
>
> Secondly, one has to look merely at what is clearly said. There is no room for intendment. There is no equity about a tax. There is no presumption as to tax. Nothing is to be read in, nothing to be implied. One can only look fairly at the language used.
>
> Thirdly, the object of the construction of a statute being to ascertain the will of the Legislature it may be presumed that neither injustice nor injustice was intended…
>
> Fourthly, the history of an enactment and the reasons which lead to its being passed may be used as an aid to its construction."

In *CIR v Alcan New Zealand Limited*[109], McKay J further noted that the context in which the words are used is also an important factor.

Hence, in applying section BG1 the judges need to take into account the words of the statute. In doing so it is widely accepted that the results will be absurd and definitely not one intended by the parliament.

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[107] [1982] 1 NZLR 97 at 114
[108] [1971] NZLR 591
[109] (1994) 16 NZTC 11,175

Therefore the only way to correctly apply section BG 1 is to **recognise the intention of the Parliament** behind the creation of the section (section 99 which is now section BG1).

This (intention) was indicated by Dr Finlay[110] in the speeches in Hansard that this policy (Section 99) is designed to make the previous provision (section 108 of the Land and Income Tax Act 1954) more effective. Dr Finlay referred with approval to the judgment of Woodhouse J in *Elmiger v CIR* [111]*:*

> "I think its (Section 108) meaning and operation is determined by the general principles laid down by the Privy Council in *Newtons*[112] case"

Woodhouse J further states[113] that:

> "It (GAAR) is designed to forestall the use by taxpayers of ordinary legal processes for the *deliberate purpose* of obtaining a relief from the natural burden of taxation denied generally to the same class of taxpayer"[Emphasis added]

It is clear that in New Zealand the application of section OB 1 is influenced by *Elmiger.* The Parliament confirmed in its intention that the method prescribed in *Newton* is the correct approach to use when applying GAAR. *Newton* applies the three elements of section BG 1: arrangement, tax avoidance and dominant purpose.

2. Doctrine of Legal Precedent

The second guiding principle for the judges is the doctrine of legal precedent. The basic rule is *stare decisis* [114]which means that prior courts must be recognised as precedents. Hence the decisions in higher courts will be binding to lower courts.

The choice principle is a classic example of this. This concept is not legislated but the courts irrefutably consider it as the fourth element of section BG 1. The choice principle

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[110] Dr AM Finlay, *Land and Income Tax Amendment Bill (No 2),* NZPD Vol 393, 1974, p4,191
[111] [1966] NZLR 683
[112] *Newton v FCT* [1958] AC 450, 465
[113] *Elminger v CIR* [1966] NZLR 694
[114] Website – Wikipedia *stare decisis*

was considered in *Challenge* and endorsed in the Privy Council judgment of Lord Hoffmann in *O'Neil,* where his Lordship held:[115]

> "Their Lordships consider this to be a paradigm of the kind of arrangement which s99 was intended to counteract. On the other hand, the adoption of a course of action which avoids tax should not fall within s99 **if the legislation, upon its true construction,** was intended to give the taxpayer the choice of avoiding it in that way". [Emphasis added].

Thus under the law of legal precedence the doctrine of choice is now binding in the New Zealand Courts and as has become a standard part of the application of section BG1.

3. Per Incurium

The two principles (of statutory interpretation rules and the doctrine of legal precedent) must work hand in hand and should compliment to each other. If this is not happening then it may be correct to assume that one of these principles have not been applied correctly. In the case of GAAR, the statutory interpretation rules require that the principles introduced in *Elmiger* and *Newton* **must** be applied when considering section BG 1.

In recent New Zealand avoidance *cases,* the Courts have ignored the principles laid out in *Newton* and new legal precedents have been set for the application of GAAR. This is exactly what happened in *Trinity.*

This is due to bad decision making in Privy Council. The Doctrine of Legal Precedent can be ignored if there is bad judgment. The judges have to power to invoke *'per incurium'* and set the legal approach in the right direction.

New Zealand judges need to recognise this and go back to applying the principles laid out in *Elmiger*. This will set the legal methodology straight and will bring back the much needed consistency to GAAR.

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[115] *O,Neil v CIR* (2001) 20 NZTC 17,051; also reported as *Miller v CIR* [2001] 3 NZLR 316 (PC). P17,057, pp326-327, para10.

C. The Approach taken in Trinity

The best word to describe the manner in which Venning J applied section BG 1 of the Income Tax Act 1994 in the High Court is 'inconsistent'.

His Honour stated that the tax advantages obtained by the taxpayers were more than incidental. He explained said section BG 1 was applicable to the deduction related to insurance and license premiums due to the tax advantage associated to it:[116]

> " .... the reason they invested in this particular investment, the *Trinity* scheme, was the tax benefits associated with the scheme. Without the benefits of the *Trinity* scheme it was less attractive than other investments....."

This statement is inconsistent with the rulings in *BNZI*[117] and *Auckland Harbour Board*[118]. There were similar structures in these cases and none of the dealings was at arms length. However, the tax advantages here were not treated as more than incidental to the purpose of the business dealings.

The above High Court judgement follows through to the Court of Appeal and this inconsistency is not corrected at any stage. Instead in the Court of Appeal the judge approaches the issue of 'whether this scheme is void for tax avoidance" as follows:

1. Choice Doctrine

The key consideration of the Court of Appeal was 'whether or not the arrangement frustrated the scheme and purpose of the Act'. The judges treated this issue as the first and most fundamental step in the application of the general anti-avoidance rules. This approach is the first flaw in the legal approach. Choice is the fourth element in section BG 1 not the first.

Furthermore on paragraph 109 his Honour concludes that:

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[116] *Accent Management v CIR* (2007) 23 NZTC 19,077 Para 321

[117] *CIR v BNZ Investments Ltd* [2002] 1 NZLR 450 (CA)

[118] *CIR v Auckland Harbour Board* (2001) 20 NZTC 17,008; [2001] 3 NZLR 289 (PC)

> "there is not much difficulty in concluding that the Trinity scheme is caught by a literal reading of the general anti-avoidance provision"

It seems his Honour is trying to say that all the three elements of BG 1 have been satisfied in this case. The problem is that a fuller analysis should have been undertaken by his honour to confirm that the three elements had been satisfied. His Honour then notes that the case raises a reasonably familiar problem:

> "which part of the act takes priority, the general anti- avoidance provision relied on by the Commissioner or the specific tax rules relied on by the taxpayers."

By framing the issue in these terms his Honour has flawed his approach because he ignores the role of section BG 1 in the tax framework. GAAR must be used as a backstop and be applied where taxpayers enter into ingenious tax schemes to avoid tax. If the approach of William Young P is correct then we would surely be adopting the approach that Barwick CJ[119] took to essentially nullify the application of GAAR.

On the other hand if William Young J was attempting to apply the so called choice principle then this clearly shows that his honour has misunderstood the conceptual underpinning of the choice principle which does not deal with priority but with structural inequities created by incentives and disincentives in the legislation.

His Honour appears to get back on the right track in paragraphs 113 and 114 in noting that these incentives and disincentives has confounded this area of the law and by giving the anti avoidance provisions a primacy. However a lot of confusion is created in explaining the threshold test.

The real issue for *Trinity* is that in adopting the above approach the judges have created a whole new method of applying section BG 1. This method examines 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', before analysing 'whether the tax advantages of the arrangement were more than merely incidental purpose or effect of the arrangement'. Basically element four is considered before element three.

[119] G Lehmann and C Coleman, *Taxation in Australia*, (1986) Law Book Company

2. Elements

With all due respect his Honour in applying the four elements of section BG 1 appears to have lost direction and jumps from element to element in no prescribed order. For example after looking the doctrine of choice in paragraph 141 he discusses the predication test. His Honour mentions that the 'real purpose' is tax avoidance by looking at the overt acts. However, the actual predication test is not carried out as prescribed in *Newton* anywhere. It is either ignored or forgotten.

Then in paragraph 142 the scope of arrangement is discussed. There is talk about 'understanding' but arrangement is not looked at any further.

From paragraph 143 the judgement concentrates on the doctrine of choice. Discussion is based on the business not being genuine and that there is existence of too much artificiality and pretence. His Honour says these factors cannot be neglected while accepting that the taxpayer has a choice to choose their business. The overall scheme and purpose of section BG 1 is too combat these levels of artificiality in a transaction as it makes no commercial sense.

Obviously the next discussion (paragraph 144) is more on choice where the focus is on the underlying scheme and purpose of the specific provision.

Suddenly mentioned (paragraph 146) is 'purpose', stating that the dominant purpose is tax benefits based on the *BNZI*[120] test of crossing the line and that this scheme has well and truly crossed the line.

3. Commerciality

Furthermore, his Honour makes no comment to the way in which the high court approached the application of section BG 1 but instead follows through with its reasoning that the:

1. Transaction has no commerciality if it were not for the tax relief obtained
2. Venture was not a successful investment.

[120] *CIR v BNZ Investments Ltd* [2002] 1 NZLR 450 (CA)

Neither of these considerations is required when applying section BG 1. Section BG1 should not automatically apply because the taxpayer chose the most efficient alternative. As per Woodhouse P in *Challenge:*[121]

> "Many taxpayers when considering a course of action are likely to appreciate and welcome an opportunity provided by the Act for achieving some tax benefit as an aspect of it. But this should not bring the transaction automatically within the avoidance provisions of section [BG 1]. By itself conscious recognition and acceptance that a commercial transaction will be accompanied by a degree of tax relief is not the issue."

On the second point, his Honour devoted a significant amount of judgment on the future valuation of the forest and the fixed license premium concluding that the venture was not a successful investment. This finding used to invoke section BG 1 is fundamentally flawed. There is no requirement in section BG 1 for a transaction to be tax avoidance because the business is unprofitable.

4. Purpose

His Honour seems to occasionally confuse the word 'purpose' and mix the third element with choice doctrine. Although both require the scheme and purpose approach in determining its existence there is distinct difference between element 3 and 4 (of section BG 1). This is confirmed in paragraph 95, where the defence argued that:

> "The judge confused the purpose for the making of the license premium payment.....with the overall purpose of the taxpayers"

5. Reconstruction

The final step of GAAR is reconstruction. The legislation relevant to *Trinity* is covered under section GB 1, Income tax Act 1994.

His Honour said that the entirety of the deduction was considered void and was reversible under this act. This approach is inconsistent as earlier on his Honour had agreed that there was existence of a normal business venture and expenses had incurred

[121] *Challenge Corporation v CIR* (1986) 8 NZTC 5,001 col. 2 at pg, 5,006

in conducting the business. If there was a normal business venture then was not there a chance that part of this deduction had actually incurred and should not have been treated as void?

6. Overall Reasoning

The overall reasoning provided by the Courts for tax avoidance was that the structure made no commercial sense at all. The taxpayers had provided the funds required to purchase the land and buy the forest. There was no commercial reason to pay another $2 million per hectare for using the land which they had already funded for. Prospects of profit were remote. The Court felt that individuals behind the company could walk away from the liabilities. The insurance arrangements also made no commercial sense [122].

Based on the above facts the Courts concluded that although the deductions were technically correct they were contrived. There was no suffering of the pre – tax economic burden (as apposed to the legal liability) which must be present as per the Parliaments intention (by looking at the underlying scheme and purpose of the specific provision) to be able to make the deductions. As such there was no business purpose and the only purpose was the availability of deductions which in turn produced the tax reduction. [123]

With all due respect, the above conclusion is not consistent with the Courts decision that there is no sham and that economic equivalence is impermissible. Not having sham means that the Courts have accepted that the legal form of the transaction was correct. Therefore it can be correctly assumed then that the judgment is based on the lack of economic suffering and future profitability of the venture.

A similar problem occurred in *Hallstrom*[124] where Dixon J discussed about what one should do as apposed to what the documents says. This case was also in regards to the deductibility issues (Capital versus Income). This approach is problematic. The approach looks at exactly what happened and it does not apply the legal analysis. The discussion is based on common sense not the legal concept. This is where the *Peterson* and this *Accent* cases have gone wrong.

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[122] *Accent Management v CIR* (2007) 23 NZTC 19,077 Para 143
[123] Ibid 144
[124] *Hallstrom PTY Ltd v FCT* [1946] para 125

D. Why was the approach in Trinity Incorrect?

So why is the above approach incorrect?

While the Court of Appeal did not have any difficulty in deciding that the *Trinity* scheme was a tax avoidance arrangement, the court's approach to that issue was based on choice doctrine as apposed to the four elements discussed earlier in this report. It appeared as though the judges had pre-determined that the transaction was avoidance and did not give much regard to the application of the elements.

This 'attitude' is clearly reflected in the final judgement where his Honour agreed that the transaction was perfectly normal commercially, however there was tax avoidance. It is apparent that the judiciary (based on the evidence of the draft letter) had already decided that the dominant purpose of the transaction was tax avoidance and as a result the use of the correct approach or legal reasoning then became irrelevant in the eyes of the judgment makers.

However, the real tragedy lies in the manner in which the elements (of section BG 1) have been applied in light of the Doctrine of Legal Precedent. In following the *stare decisis*, the statutory interpretations rules have been ignored and the "intention of the parliament" has not been considered.

1. Arrangement

A classic example is the methodology used in *Trinity* to apply 'what constitutes an arrangement' According to William Young P, if taxpayers were "affected" this was enough to be considered as a party to the arrangement. This decision was based on the *'ratio decidendi'* of the Privy Council cases of *Peterson* and *Challenge.*

In *Peterson*, their Lordships are satisfied that the 'arrangement" had the purpose or effect of reducing the investor's liability to tax and that, whether or not they were parties to the arrangement or the relevant part or parts of it, they were ***affected*** by it. Their Lordships did not consider that the 'arrangement' required a consensus or meeting of minds. The taxpayer need not be a party to 'the arrangement' and in their view he need not be privy to its details either.

This point prefers the dissenting judgment of Thomas J in *BNZ Investments Ltd.* With respect, one might say that the courts have gone off the rail with "is there an arrangement?"

This aspect of the case overturns the judgement in *BNZI* where Richardson P said:[125]

> ".....it presupposes there are two or more participants who enter into a contract or agreement or plan or understanding. They arrive at an understanding. They reach a consensus. This now means the anti-avoidance provision can apply where a tax advantage is enjoyed by someone who is not a party to the arrangement or by a taxpayer who has no knowledge of the details of the arrangement".

If GAAR is supposedly based on the *Newton* approach, then the approach in *Peterson* is fundamentally flawed as it is in direct contrast to the *Newton* principle of what is the scope of an arrangement. In *Newton* an arrangement should be planned not random.

In *Elmiger,* the judge said that one step cannot be isolated. It looked at the wider scheme so as to not confuse it with every type of family dealing. The focus was on the purpose not on the *effect* of the arrangement.

The recent court decisions have lost sight of this. If we take the word of the Parliament when it says in the Hansard that section BG1 is based on *Elmiger* than *Trinity* cannot be correct.

The *effect* must be read down. For example if an item is inflated to value at the market price as opposed to the cost price, this is not avoidance because the accounting rules require a true and fair position and to meet the requirements of IFRS, the asset value needs to meet the market cost.

The legal analysis in *Trinity* poses the question of 'does this now mean that if the investors receive an end result but they did not participate in the plans and/ or steps, that would make them party to the arrangement?'

[125] *CIR v BNZ Investments Ltd* (2001)20 NZTC 17,301 (CA) para 43

2. Tax Mitigation or Tax Avoidance

The degree of economic reality is not a consideration of section BG 1. *Peterson*[126] adopted this approach based on the tax mitigation approach in *Challenge*[127] where Lord Templeman said the difference between tax mitigation and tax avoidance is that:

- Section 99 (BG 1) is not applicable to tax mitigation. Tax mitigation is were tax labiality is achieved from economic loss is suffered by the taxpayer in the form of reduction of income or incurring expenses
- Section 99 (BG 1) is applicable to tax avoidance. Tax avoidance is where tax liability is reduced but the taxpayer suffers no economic loss.

The argument in *Challenge* of economic loss is not definite and cannot be used to describe tax avoidance. There are instances where the taxpayer suffers no economic loss but is able to reduce tax liability for example using the LAQC provision. This cannot be treated as tax avoidance.

Not surprisingly, a degree of confusion arose after this decision of the Privy Council in *Challenge.* Lord Templeman appeared to depart from the traditional approach found in *Newton*.

Subsequently, in *O'Neil*[128], Lord Hoffman seemingly rejected the approach of the previous Law Lord and returned to the *Newton* model.

In *Hadlee,*[129] his Honour also invoked *'per incuriam'* and rejected Lord Templeman's definition of tax avoidance stating it cannot be used in all cases. He preferred the analysis of Richardson J in *Challenge's* Court of Appeal decision.

3. Purpose

A major shortcoming in *Peterson* is the approach to determine more than incidental purpose or effect. It does not follow the predication test as prescribed in *Newton.*

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[126] *Peterson v CIR* (1986) 8 NZTC 5,001 para 33
[127] *Challenge Corporation v CIR* [1986] 2 NZLR 513, 560-563
[128] *O,Neil v CIR* (2001) 20 NZTC 17,057
[129] *Hadlee v CIR* (1991) 13 NZTC 8,116, 8,112

In *Trinity*, his Honour stated that the tax advantages obtained by the taxpayers were more than incidental. He explained said section BG 1 was applicable to the deduction related to insurance and license premiums due to the tax advantage associated to it:[130]

> " .... the reason they invested in this particular investment, the Trinity scheme, was the tax benefits associated with the scheme. Without the benefits of the Trinity scheme it was less attractive than other investments....."

However, *BNZI*[131] and *Auckland Harbour Board*[132] had similar structures and none of the dealing was at arms length but the tax advantages here were not treated as more than incidental to the purpose of the business dealings.

The ideal test for incidental purpose as per Parliament's intention for section BG 1 was to implement *Newtons* purpose test as discussed in *Elmiger* and used in *BNZ Investments Ltd*. This point was entirely missed in *Peterson* and *Trinity.*

In *Elmiger*, his Honour said to look at the arrangement as a whole to determine the purpose of the arrangement.

In *Peterson*, his Honour said that purpose could be determined by looking at the arrangement in single, part or whole and by looking at the end result. The courts have gone of the track by ignoring this point in Hansard.

However, this element of tax avoidance is not easy to implement. Part of the problem is the definition in section OB 1 including the words "purpose or effect". In *Tayles v CIR*, the term purpose or effect was considered to be the same.

It is thus submitted that the word 'effect' should be removed. Effect means the end result regardless of the purpose. "Not merely incidental" should also be removed. The way the definition is worded, the meaning cannot be applied literally, it makes no sense.

4. Analysis

The approach of William Young J is fundamentally flawed. He jumps from the predication test to analysing the scheme and purpose of the underlying provision then

[130] *Accent Management v CIR* (2007) 23 NZTC 19,077 Para 321
[131] *CIR v BNZ Investments Ltd* [2002] 1 NZLR 450 (CA)
[132] *CIR v Auckland Harbour Board* (2001) 20 NZTC 17,008; [2001] 3 NZLR 289 (PC)

back to predication test. This is not consistent with the traditional approach which states that the four elements need to be applied step by step. Hence, the approach is not consistent with the *statutory interpretation rules* which require that the wording of the legislation cannot be ignored and as such the elements must be applied in order as stated in the legislation.

The correct legal approach must be used to maintain consistency. This is not to say that if they would have applied the traditional approach (in *Trinity*) the ruling would not have been tax avoidance, it may or may not have resulted in the same outcome. The danger associated in applying new approaches to tax avoidance is increasing the inconsistency in the legislation. *Trinity* opens up a whole lot of new and difficult issues for an already existing overflowing Pandora's Box of very complicated tax avoidance issues. Section BG1 is already ambiguous. The effect of this ambiguity is quite serious for the taxpayers. It makes the tax law unclear and creates uncertainty in the tax community.

Another danger is that this degree of disregard of the legal approach (as shown in *Trinity*) has the ability to further frustrate the already difficult relationship between the specific and general provision within the Income Tax Act. When dealing with the structural inequities, it is essential to follow a set framework. Choice Doctrine is a dangerous slippery slop which could lead to absurd results that where made in the Barwicken Era.

Since, tax avoidance is a 'grey' area the statutory construction demands that there is a need to look beyond the words and to look at the Parliamentary intent of the legislation. This is hard work but is compulsory and needs to be done rather than to rely on emotional theories or subjective judgements to decide on the outcome. In the more complex cases, where the intention of Parliament is inadequately or imperfectly expressed, the Court's role in determining the ambit of a GAAR becomes crucial. The balancing act for the Court is to decide whether there is a role for the GAAR to apply in a way that protects the overall tax base discerned from Parliament's *evident* intention and *not to* re-write (or make up) legislation.

XII. THE CURRENT POSITION POST TRINITY

At the start of this paper, it is noted the choice doctrine is derived from the Latin maxim *"generalia specialibus non derogant"*, whereby a general provision (such as section BG1) cannot override a specific provision in the same legislation. As such, the basis of the doctrine is that section BG 1 does not apply absolutely so as to override the other provisions of the Income Tax Act. In the authors view it is important to adopt this doctrine in New Zealand because only then taxpayers would be able to arrange their affairs on the premise that the law will apply with "certainty" and that they will be taxed only when the conditions for liability under statute are met.

With these comments in mind the expectations from the Court of Appeal in *Trinity* were three-fold:

1. To re-affirm the statements made by the Privy Council in *O'Neil* that the choice doctrine is applicable to New Zealand.

2. To confirm that the correct place of the doctrine in the anti-avoidance methodology is that it is to be applied as a separate element.

3. To discuss the circumstances in which a proper "choice" can be said to arise (i.e. where Parliament's intention is that section BG 1 should not apply despite the three elements being satisfied).

Sadly the Court of Appeal's judgement is disappointing on all three counts. Of particular concern are the second and third issues stated above.

The issue of legal methodology absolutely is of grave concern. As unfortunate as this situation is however until any amendment takes place in section BG 1 (this is a separate issue that may be applicable for future research) one can only hope it is fixed in a future case being the Supreme Court decision in *Trinity*.

Given that it takes a brave person to mention the issue of certainty and tax in the same sentence, many would argue that this concept is a theoretical dream as opposed to a

practical solution. "Choices" are not always explicitly stated in the specific provisions, they may be implicit. It is the roles of the judges to rule on the circumstances in which choices exist. This role of the judges is a double edged sword. As evident in the Barwickian era where Barwick CJ interpreted "choice" in such wide terms that almost anything became a "choice". This problem exists because the fourth element is not covered in statute. Maybe section BG 1 should be amended to this effect so that it gives judges some explicit guidelines on ascertaining "choices". This would prevent another Barwick from confusing the conceptual underpinnings of the choice doctrine.

XIII. CONCLUSION

The choice doctrine has come through quite a journey since the early days of the *Keighery* decision. The first hurdle was the legitimacy of the choice doctrine itself. Since the doctrine is not legislated for, the doctrine has always been at the mercy of judges to give it legitimacy. In New Zealand, the applicability of the doctrine was confirmed in the *O'Neil* case. However, uncertainty has existed on where the choice doctrine sits in the anti-avoidance legal methodology. There have been suggestions that the choice doctrine is merely a sub-set of the predication test. However, in this dissertation I have sought to show that this is not correct. The choice doctrine should in effect be the fourth element in any anti-avoidance analysis. In this regard the recent Court of Appeal decision in the *Trinity* case has been extremely disappointing. It is hoped that the Supreme Court will lay this issue to rest once and for all.

Another significant issue with the choice doctrine has been its conceptual underpinnings. It is clear from the more recent Australian and New Zealand cases that the bullish approach towards the choice doctrine taken in the Barwickian era is no longer applicable. While the classification used by the Courts to describe the doctrine of choice has varied to include terms such as "impropriety" and the "doctrine of new source", the conceptual underpinning of the choice doctrine has become relatively clear in recent years.

Income tax is imposed by statute. Unlike common law principles, which are often explained in detail by judges in cases that expound these principles, the intent and purpose of statutory provisions are often difficult to determine by merely reading the "black letter" of statutory provisions. To this end, various statutory interpretation rules have been employed. The doctrine of choice is part of these interpretation techniques. The doctrine aids in determining the intention of Parliament by ascertaining the scheme and purpose of the legislation.

Therefore, the choice doctrine can be seen as a safety measure, which prevents the situation from arising where the application of the general anti-avoidance provision leads to taxpayers not being able to take advantage of concessions that Parliament had intended to be offered. As such, while the conceptual underpinning of the choice doctrine is relatively simple, its practical application can be problematic. However the

guidelines provided by Richardson J in *Challenge*[133] are as close to the mark as one can get.

Fortunately the tax mitigation concept was rejected in *O'Neil*. The courts have recognised that applying tax mitigation to New Zealand is unsuitable because it is not conceptually coherent with the statutory elements of section BG1. Tax mitigation is an ill-defined concept, which does not fit very well into the statutory framework of a general anti-avoidance provision such as section BG1. It also causes confusion and introduces a subjective element in the anti-avoidance analysis. The *O'Neil* decision is significant because it confirms the objective basis of the choice doctrine.

Although the legal methodology used in *Trinity* is problematic, it nevertheless confirms that the choice doctrine is now settled in New Zealand and its conceptual basis is founded in the scheme and purpose approach to interpreting tax legislation.

The *Trinity* judgment also may persuade the Commissioner to re-consider his approach when determining tax avoidance. The Commissioner will probably need to first consider whether a tax advantage claimed under an arrangement is in fact an advantage intended to be conferred upon the taxpayer despite the fact that the taxpayer may have entered into the arrangement with a view to obtaining that advantage. (This issue can be treated as a subject of future research). Until then we look forward to the Supreme Court judgment in *Trinity* to see where this journey leads to.

[133] *Challenge v CIR* (1986) 8 NZTC 5,001at 5019 - 5020

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