IN THE SUPREME COURT OF NEW ZEALAND SC 62/2010

[2011] NZSC Trans 19

BETWEEN **IAN DAVID PENNY**

First Appellant

AND **GARY JOHN HOOPER**

Second Appellant

AND **COMMISSIONER OF INLAND REVENUE**

Respondent

Hearing:	27-29 June 2011
Court:	Elias CJ Blanchard J Tipping J McGrath J William Young J
Appearances:	G J Harley and C E Bibbey for the Appellants D J Goddard QC, H W Ebersohn and D Lemmon for the Respondent

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CIVIL APPEAL

ELIAS CJ:

Yes, Mr Harley.

MR HARLEY:

I understand, Ma'am, that we are running until five?

ELIAS CJ:

Yes, is that convenient for counsel?

COUNSEL:

Yes.

ELIAS CJ:

So we'll take a short adjournment at 3.30.

MR HARLEY:

In the appellant's application for leave to appeal, the permitted terms as to the issues were three. The first and substantial issue is whether the Commissioner can apply section BG 1, the anti-avoidance provision, to an employment contract between a taxpayer as the employee of his or her family company on the basis that the employee is required to derive a level of employment income as, what is referred to in the materials at a commercially realistic salary level, reflective of what is otherwise the company's after-tax business income from medical services. Because that business income results, so the Commissioner says, substantially from the personal efforts of the employee.

In that regard, and in making such an assessment, the question then is whether the Commissioner is correct that the roles of the person as the employee, the governing or sole director of the company and/or, as may be the case, the co-trustee of its trust owner as shareholder, is such as to provide a level of control of the remuneration level that is said by the Commissioner to be artificial and contrived, as that language is used within the tax avoidance jurisprudence.

We say that the Act does not contain any commercially realistic salary concept as part of its scheme and purpose at all, and the second issue then becomes whether it was open to the Commissioner in relation to the taxpayer, Mr Penny, to seek to support his BG 1 assessment by reference to what are loan advances made by the relevant family trust to Mr Penny during the years in issue; that arises in the context of section 138G of the Tax Administration Act, and that issue will be argued discretely and separately by Ms Bibbey.

The third issue that arises is the criticism in the Court of Appeal of the content of some of the witness briefs for the taxpayers, that is of Mr Shewan, where he expressed his opinion that there is within the Act no commercially realistic salary concept as he understands it, and in that context, and importantly for the purposes of argument, it's accepted that the taxpayers bear the onus of proof and in that particular context the onus of proof is on them in the negative. That is, they need to

assert a negative proposition. The commercially realistic salary concept is fundamental to the Commissioner's assessment.

Just in terms of an administrative matter, it will be agreed between my friend and us that the Court of Appeal has incorrectly disregarded what were agreed cost arrangements in that Court. The position is that if the taxpayers do not succeed on appeal in this Court, there is no issue as to costs in favour of the Commissioner by agreement in this Court, but that if the taxpayers succeed on appeal in this Court they are entitled to their costs in this and both Courts below. That's just not going to arise further from just simply clearing the decks there.

It's a convenient place to introduce the appeal, your Honours, if I could take you to the short dissenting judgment of Justice Ellen France. There are at least three versions of it before you, there's the longhand version in the case on appeal, there is in volume 1 of the Supreme Court leave terms the CCH version, and this morning, in what is the turquoise volume I handed in under tab 1, the New Zealand Law Reports volume. I am happy to deal with any one of those three, but the orthodox –

ELIAS CJ:

Well, if you just refer to the paragraph numbers, I think Judges have probably noted their versions, that should be all right.

MR HARLEY:

Yes Ma'am. Justice France expressed her general agreement endorsing the approach of Justice MacKenzie in the High Court, and essentially expressed herself as to three specific matters. At [166] she addressed the Personal Services Attribution Rules, or PSA rules as we refer to them, and their relevance to the concepts of artifice and contrivance. Her Honour made the point that she saw nothing ingenious as to the appellants' incorporation of their businesses and that Parliament must have contemplated the use of family companies in this way. While I adopt that approach, which does reflect generally the approach of Justice MacKenzie in the High Court, I make an additional submission and go a good deal further than either Judge was prepared to discuss. I explain the scope of the Personal Services Rules, particularly by reference to their attribution scope from the company to the taxpayer, and I refer, in particular, to the exemption within those rules for companies that contain what are referred to in the legislation as substantial business assets. Both these companies, that is for Mr Penny, his company owned assets, that is substantial

business assets, at over three times the level of specified exemption in the rules. Mr Hooper, his company did not own assets directly in that way, instead it had access to assets in excess of that level by virtue of a license agreement with a company called Leinster Orthopaedic Centre, which was shared between him and four other medical practitioners.

I'll come to the detail of that argument shortly, but the second aspect of Justice France's dissent refers, at paragraph 170, to the effect of the *Hadlee v CIR* [1993] 2 NZLR 385 (PC) case. Like Justice MacKenzie, Justice Ellen France saw *Hadlee* as dealing with an assignment of income by a professional person, whereas this case deals with the derivation of income by companies. She and the Judge both saw the concepts as being entirely different as a matter of law, and that's at [171].

Again, while I adopt that approach and the much more fully detailed reasoning of Justice MacKenzie in the High Court, my submission also goes further than either Judge was prepared to discuss. It is simply wrong, as a matter of fact, for the Court of Appeal majority to have said that the appellants' personal exertions produced all of the practice company's business income. Justice Randerson said that at [13] and [29] and Justice Hammond at [157].

I object to the Commissioner's paragraph 3.6 in his written submission, particularly –

TIPPING J:
Is the emphasis on the "all"?

MR HARLEY:
Yes, yes it is Sir. In respect of the Commissioner's paragraph 3.6, last sentence, my submission to you –

ELIAS CJ:
Sorry, what are you referring to now?

MR HARLEY:
The Commissioner's written submissions.

ELIAS CJ:
Yes.

MR HARLEY:

Paragraph 3.6, last sentence, and it's convenient also, in respect of that paragraph your Honours, if you turn to the Commissioner's structure diagrams that are at the end of his written submission. I object to them as being misleading as well.

As we'll see, both companies have substantial business assets, or access to them in Hopper's case, which are omitted from the diagram. The diagram also omits any reference to the existence of several employees of both companies and, in the case of Hooper's company, also employees of the Leinster Orthopaedic Centre. It is simply not correct that these companies derived their business income solely by reference to the personal services skills of the two surgeons.

McGRATH J:

Would you accept it was predominantly so derived?

MR HARLEY:

Yes, I would. Justice MacKenzie uses two different measures of that, one of which, to be honest, I don't quite understand the relevance of, the other I do. He uses a measure of each company's expenses and explains the expense ratio at 40% or more being attributable to what I'd call the others. In making that percentage adjustment, he's backed out the salary that was actually paid to the two surgeons. So it's a true measure, at 40% or more, and so when you use the word "predominantly" your Honour, at 60% or so, yes.

McGRATH J:

Just like to find out, to get your submissions a bit more precise. Thank you.

MR HARLEY:

No one would say that these two men aren't absolutely key and extraordinarily skilled in terms of what they do, plainly they are. Plainly, equally, their patients go to them because of who they are, not because of who their employees are, or because of any particular affectation, or wish to have a look at the equipment that they use, but it still is clear that the entire apparatus of the company, including the people, all the people, are part of the engine room that produces the business income of the company.

We wouldn't say, for instance, that the genius that is Bill Gates means that the entire operation of Microsoft is attributable to him. Not even he would say that, in respect of

90-odd thousand other employees and a lot of money sitting in the balance sheet. The third point that I'll develop with respect to Justice France's dissent is with reference to the commercially realistic salary concept, where she refers to that at [173].

By way of introduction, it needs to be understood that the Commissioner's commercially realistic salary concept is not the same thing as arm's-length pricing methodology. Arm's-length pricing governs all other aspects of the Act's recharacterisation, provisions for items such as excessive remuneration payments to employees of Family Companies, salary payments to spouses and to cross-border transactions.

Arm's-length pricing is generally based on objectively observed market values. The commercially realistic salary concept that's been used here by the Commissioner and his expert Mr Lyne reflects an historical, after the event, adjusted expense model of what is actual performance, year to year, of the companies. It's hindsight based. It does not purport to reflect what would be an open market, willing seller, willing buyer salary, which is arm's length pricing methodology. So a point that I will develop is that the method that's been used here is inconsistent with the architecture of the Act in respect of recharacterisation provisions generally.

In expanding on that, the difficulties that arise with it were well explained by Mr Shewan in his witness brief and elaborated on in his oral evidence, and we rely on that witness brief as being admissible in its entirety, as Justice MacKenzie correctly held. In this regard, Justice Randerson, at [97], disagreed, and with that disagreement Justice Ellen France joined him at [175]. Apart from the illustrations that are given by Mr Shewan in his witness brief and oral evidence, the submission that I will make is that the difficulties with the commercially realistic salary concept are now very well illustrated in what I'd call real life, by reference to the facts and circumstances of the case involving Dr White and the Commissioner, which is now on appeal from the High Court judgment of Justice Heath to the Court of Appeal and which is also in the turquoise volume.

On this third matter, Justice France considered that the taxpayers asserted control over their salary level, following as a matter of law in respect of the *Lee v Lee's Air Farming Limited* [1961] NZLR 325 (PC) doctrine, where she accepted, as did Justice MacKenzie, that the judgment of Sir Robin Cooke, sitting as a Supreme Court trial

judge in *Loader v Commissioner of Inland Revenue* [1974] 2 NZLR 472 (SC), was significant as to the everyday element of the family relationship and the dealing terms between the company and its governing director/employee and between the trust and the company, and that such relationships were not artificial, as Justice Cooke explained in *Loader*, and that's also in the turquoise volume.

The distinction that Justice Randerson made in his judgment of *Loader* is wrong on the facts. The case cannot be distinguished on the basis explained by Justice Randerson, that is to say that there was no element of low salary. When you look at the table in Justice Cooke's judgment, you'll see that the salary was adjusted from $6,000 odd dollars per annum to take up the entire income that was actually returned by the trust in the company. The level of adjustment ranges between four and eight times, depending on the year-to-year profitability. It's a perfect illustration of the same concept, albeit the same language, commercially realistic salary, isn't used by Justice Cooke.

BLANCHARD J:

Are you going to take us to that in *Loader*?

MR HARLEY:

I can do that now, Sir, or I can do it when I actually get to *Loader*, whichever you prefer?

BLANCHARD J:

Whichever is convenient.

MR HARLEY:

I'll do it now. If you go to *Loader*, which is tab 3 of the blue volume. Could I just get your Honours also, in respect of the front page, to just recognise a stupid typographical error on my part. I didn't mean to refer to the Commissioner's TAB number 8, it's his Tax Information Bulletin, TIB, I'm sorry. Back to *Loader* at 3. You'll see the facts in the judgment set out by Justice Cooke at 474, in the table in the middle. You can take it from me that when you add up the numbers, they do add up. If you take the second lot of numbers in the second table, for the 1969 year, the salary and directors' fees of $6,200, added to the trust's bailment income of $7,164, added to the company's income of $5,666, add to $19,025. So that the total amended income is the combination of the three elements.

TIPPING J:

You say those three added together come to $19,025, do they?

MR HARLEY:

Yes, they do, Sir.

TIPPING J:

Right.

MR HARLEY:

Just taking another random illustration, let's take 1971, but the numbers still add up. The two numbers, the trust income of $10,976 and company $10,871, sum to $21,847, when added to the directors' income and salary that's the $29,347. So I'm simply making the point that the basis on which Justice Randerson said this case could be distinguished is just unsound.

TIPPING J:

Was any attention given to the column which in '69 has the $6,200 figure in it, was anything turned on, or any issue about the commercial, if you like, viability of that figure?

MR HARLEY:

There's no discussion of it in the terms that you've just put to me but the whole –

TIPPING J:

So it doesn't really touch on the present point?

MR HARLEY:

Well it does, Sir, because the whole purpose of the amended assessment, on the Commissioner's approach, was that the taxpayer was obliged to return the lot.

TIPPING J:

The lot?

MR HARLEY:

The lot. That is, the company –

TIPPING J:

Well that's a sort of full attribution approach.

MR HARLEY:

Yes, it is. Yes, it is.

TIPPING J:

Well no one's suggesting a full attribution here, are they?

MR HARLEY:

I've slightly misled you. No, it is not a full attribution. The depreciation calculation in the plant trust was allowed to the plant trust, so there's an adjustment. Your Honour, they come at this in a slightly different way, but when you look at the adjustments, the overall methodology and principle is indistinguishable.

TIPPING J:

Well we'll leave it at that for the moment, Mr Harley.

MR HARLEY:

Yes. If I could now really get to the heart of what is in contention here, about taxpayer choices and how they can or may not be exercised. Could I ask your Honours to read the Commissioner's written submission, paragraphs 5.10, 9.29 and 10.3?

ELIAS CJ:

Say that again please, 5.10.

MR HARLEY:

Yes, 5.10, 9.29 and 10.3.

ELIAS CJ:

Do you want to tell us the point that you'd like –

TIPPING J:

How long have we got to complete the exercise Mr –

ELIAS CJ:

– I was wondering whether you were going to interrogate us then Mr Harley. What's the point that you're asking us to take from these paragraphs?

MR HARLEY:

That they are breathtaking in their generality, width and question-begging nature.

ELIAS CJ:

All right.

MR HARLEY:

Because here the Commissioner is constantly referring to his yardstick of commerciality. The Commissioner's paragraph 5.10, properly understood, is a fail-fail proposition for any taxpayer with a family company. For the reasons that the relationships between the employer and employee, owner and company, are not governed by commercial considerations, generally speaking. They are governed by the existence of the family relationship. So the relationship, not being effected or negotiated for real economic consequences, as the Commissioner has it in the sense of using or asserting market values, will almost always be able to establish a disconnect between the legal form and the economic and commercial reality when family members deal with each other.

If we look at the individual family member, it is almost always the case that that person will not seek to negotiate to maximise personally their profit-making purpose. So that by the Commissioner's definition, family members will be engaged in artifice or contrivance because they don't use market values to govern all aspects of family dealings. Many family relationships will fail the market value assertion and so fail the Commissioner's maxim for that reason.

ELIAS CJ:

Why does it matter? That might be right, but how does it affect the incidence, or what's the appropriate incidence, of tax? Why should it?

MR HARLEY:

The Commissioner asserts, as a general proposition, in respect of a family company, that the principal employee governing director must derive a commercially realistic salary and I say, in the context of a relationship between that person and a family

company, that generally is not so and will not be so for a number of different reasons. So the yardstick is a misplaced maxim. It doesn't have application because it doesn't recognise the fundamentally different nature of the relationship between a family member and their enterprise and whoever deals with Telecom, or Fonterra, or what have you, and has an independent, arm's-length, profit-maximising purpose. So the whole premise of the Commissioner's case, I say, is false.

McGRATH J:

Would your observations not perhaps be more true in the case of a family company that employed several members of a family in producing the income, as opposed to a company which has one principal figure in control, albeit other family members who, through trusts and other matters, are shareholders?

MR HARLEY:

That's an awkward question, and I don't want to duck it. The answer to the question is that that it may be, or it may not be, it depends entirely on the circumstances that affect the person, his or her relationship with the company and the company's relationship with other members of the family.

TIPPING J:

Mr Harley, if I want to be generous to my family, does it necessarily follow that I must also be treated generously by the revenue, if I can use the word generous on both sides of the equation? I mean, I may want to be generous to my family, and what you say is perfectly sound in that respect, but why does that mean that the revenue has got to treat me differently from if I was in a commercial – ?

MR HARLEY:

If the revenue wishes to treat you differently, then it will find an arm's-length standard rule or principle for tax purposes that establishes the proposition, and the starting place will be that it will need to establish the proposition that a person needs to earn income at all. There is no principle of taxation that says a person has to earn anything. Never has been.

TIPPING J:

I think I'd be constrained to agree with that, but when you do earn income and this it maybe said to beg the question –

MR HARLEY:

I understand the question though.

TIPPING J:

Yes. Why does, for tax purposes, the fact that you're wanting to be generous to your family have this weight that you're attaching to it?

MR HARLEY:

If the enterprise, to talk generally, is generating assessable income, then the rules will apply to tax that assessable income to the enterprise that actually derives it.

TIPPING J:

I understand entirely the difference between assignment and derivation, to go back to *Hadlee*, but if the derivation is part of an overall arrangement which ends up saving tax, or altering the incidence of tax to be more precise, is that not a highly material factor, that that seems to be the effect of this? Never mind subjective purpose for the moment, but the effect of it is to alter the incidence of tax. I don't think –

MR HARLEY:

Arithmetically that can't be doubted.

TIPPING J:

It can't be denied.

MR HARLEY:

No, it can't, and the Judge got that right and there was never any – there was just no discussion about it, it was obviously right.

BLANCHARD J:

Do you put it as high as saying that if it had suited their family purposes, Mr Penny and Mr Hooper could have forgone any salary at all?

MR HARLEY:

Yes, I did and yes, I do.

TIPPING J:

I think you have to.

MR HARLEY:

Yes, I did and yes, I do.

WILLIAM YOUNG J:

Well why would they want to work for no salary, unless they wanted to ensure that their generosity came out of pre-tax, rather than post-tax, benefits of the sweat of their brow, brows?

MR HARLEY:

My answer to that question is because of the relationship between them and the owners.

WILLIAM YOUNG J:

Yes but why, at a broader level, should their generosity not be post-tax rather than pre-tax?

MR HARLEY:

Well, let's start with no tax. They work for a company to build the value of the business for all possible efforts, all hours of the day and night, and the company in fact derives little or no assessable income but its capital value continuously increases from those endeavours. Eventually the person who is doing that will seek, in a rational sense, to share the reward, of course they will, and they may do that either by way of their governing relationship with the company, or alternatively, as shareholders or with an interest in the shareholding through the trust, but there's no rule, for income tax purposes, that will tell you which way they have to go or how, it all depends on the nature of the enterprise and, indeed, on the nature of the relationship between the person and his or her family.

WILLIAM YOUNG J:

You haven't really answered the question, the very high-level question I've asked you, which you – because you have been talking at a pretty high level. Why should generosity be, as it were, addressed pre-tax with the revenue providing some of the bounty?

MR HARLEY:

Well, I –

WILLIAM YOUNG J:

I mean, if I want to be generous to my children, I can give them money on tax-paid income.

MR HARLEY:

Sure.

WILLIAM YOUNG J:

Why should I be and I can't, why should I be generous, forego some of my salary for their benefit, giving them the advantages of a lower tax rate? I mean it really, at that level, it's just like *Hadlee*, isn't it?

MR HARLEY:

No. No, it's not. You can be generous to your family. Let me give you an example of where you might be, where you will have exactly the effect you've described. You own an interest-bearing bank bond –

WILLIAM YOUNG J:

Yes, and I transfer it to them and that's fine.

MR HARLEY:

You transfer it?

WILLIAM YOUNG J:

The interest bond to them, that's fine. I transfer the income-earning asset to them, that's fine.

MR HARLEY:

Pre-tax?

WILLIAM YOUNG J:

Yes.

MR HARLEY:

Generosity.

WILLIAM YOUNG J:

No, it's not, because I bought the bond with presumably tax-paid money because I'm a law-abiding chap and I would – it's my money which I give them and what they do with it, which is hold it an income-earning capacity, as it were, below the line as far as the Commission is concerned.

MR HARLEY:

But what you have disposed of is an asset that carries with it pre-tax yield and when you work for your family company, with the same generous attitude, you are exercising the same generous power, or capacity, in terms of conferring the benefit to the company, or the trust, as it –

WILLIAM YOUNG J:

Well that's the question, isn't it?

MR HARLEY:

But that is the answer to your question. You will not find in the Act this subliminal generosity standard, as you've raised it, where the court is invited, or the Commission is invited, to exercise some kind of yardstick as to what kind of generosity is permitted and what isn't.

ELIAS CJ:

Well you're drawing a distinction, though, between family companies and others. I don't understand that.

MR HARLEY:

I am saying to you, Ma'am, that because of the family relationship between the person who is employed in the family company and his family, or her family, that person will not necessarily have any profit-maximising sense at all and the Act doesn't impose one. It's not commercial because the relationship is not commercial, and indeed we know that this is the case because the Act prescribes rules in terms of associated person relationships and tells them the circumstances in which they must deal with each other on arm's-length terms. This is not one of them, except if you happened to perform the services that are involved here in Australia, in which case you would be required, under the arm's-length rules, to be remunerated at market value terms, but we are not cross-border.

So, all of the rules dealing with associated persons cast a very detailed landscape in terms of where market values must be used for associated persons. This isn't one of them. What it does do is say, in three specific provisions, that the Commission can properly challenge amounts that are too high, not too low. So where there are excessive remuneration payments paid, for instance to children, or to the spouse of the owner of the business, or other relatives, then the Commission is entitled to apply an arm's-length standard to adjust that excessive salary level down.

TIPPING J:

So family companies, family trusts and so on, are a kind of alsatia into which the realms of commerciality must be allowed to enter?

MR HARLEY:

I don't say "must not be allowed to". I say generally, the relationship between the parties involved is not commercial, is family and is usually donor driven.

TIPPING J:

Well I think your submission is, or I understood it to be, you can't impose commerciality into an ex hypothesi non-commercial relationship.

MR HARLEY:

Indeed. Absolutely.

TIPPING J:

Can't –

WILLIAM YOUNG J:

There are big, sorry, there are big chunks of a commercial load. I mean, there's the income-earning aspect of the deal that's pretty commercial. It's just the non-commerciality comes into how the benefits are divvied up.

MR HARLEY:

And I didn't intend, and I don't believe I did, to say anything different. I'm focusing solely on the relationship between the people, in respect of the enterprise. I'm not talking about their customers, or anything else.

ELIAS CJ:

But where do you derive that criterion from in the legislation?

MR HARLEY:

Which criterion, Ma'am?

ELIAS CJ:

The concentration on the relationship between the people?

MR HARLEY:

Oh easily. Take a family trust. The normal language, in respect of a family trust, is one of trust, trustee and beneficiary.

ELIAS CJ:

But I'm talking about the tax legislation.

MR HARLEY:

And so am I. In respect of a trust, trustee and beneficiary, the language of the Act refers to beneficiary. Now, we pay or apply trust income to a beneficiary and it is the effect of a disposition of pre-tax income to that person. It's the perfection of a gift. There is no commercial relationship, in terms of that relationship at all. The very nature of trustee and beneficiary is one of donation. It's inherent in the word beneficiary. That's not to say that a beneficiary can't and doesn't deal with a trust on commercial terms, on arm's-length terms, because sometimes they do. But in terms of the disposition of the benefit of the trust, it's inherent in the nature of the trust itself that there will not be such a commercial or arm's-length relationship and we know, when we get to the end of the perpetuities period, there is going to be a disposition perfected in favour of the then-surviving beneficiaries. Nothing commercial about it all. It's the perfection of the donor's bounty. The principle's not different in respect of the relationship between a person who works for his or her family company for precisely the same reasons.

BLANCHARD J:

I'm not quite sure I understand that. In the case of a, what you called a donation made pre-tax between trustee and beneficiary, the Act specifically allows that doesn't it?

MR HARLEY:

Ah, no –

BLANCHARD J:

The income is derived by the trustee but the trustee can allocate the income to the beneficiary. It's taxed –

MR HARLEY:

Yes.

BLANCHARD J:

– at beneficiary's rate –

MR HARLEY:

Yes.

BLANCHARD J:

– so the Act –

MR HARLEY:

Yes it does, sorry.

BLANCHARD J:

– the Act recognises that. There is no equivalent between somebody in the position of Mr Penny and Mr Hooper on the one hand and the beneficiaries of the trusts which hold the shares on the other hand.

MR HARLEY:

Correct. There's a prior point in what I was trying to explain, which is that just as the person makes the gift of the bank bond, as I was putting to his Honour Justice Young, there's no reason why a person can't make a gift of his or her time, skill, efforts, whatever, to the family company. There's no provision in the Act that says you can't do that, and there never has been, and so to re-echo the proposition, as summarised by Justice Tipping, the entire basis of this commercial yardstick on my argument is it's false, it's a false premise.

WILLIAM YOUNG J:

Do I take it that your argument goes this far, that where there is a business which is founded on the provision of personal services and it is able to be and can be carried out through a company, the person who provides those personal services can, by the corporate and trust structures associated with the enterprise, split the income up as many ways and into as many small slices as he or she chooses?

MR HARLEY:

No.

WILLIAM YOUNG J:

So what's the difference between that and the answer you gave to Justice Blanchard a little while ago, that Messrs Penny and Hooper could have worked for their companies for nothing.

MR HARLEY:

I see them as entirely consistent, but I understand the question. The company is the, is the vehicle that derives the business income and, apart from its own expenses, its after tax profits will always be taxable to the company and so the after-tax retained earnings of the company are the property of the company. Now, the governing director can only appropriate those after-tax earnings to one person and that's the shareholder.

WILLIAM YOUNG J:

So you say it's controlled by the excessive remuneration provisions?

MR HARLEY:

And by the rules relating to the use of company property that are within the Act that prevent, I'm just trying to think of a –

WILLIAM YOUNG J:

Can't the company pay, how would it work if the company distributes all its income to the trust that's in behind it?

MR HARLEY:

As they did here. The company distributes imputed dividends to the trust. The trust derives as its taxable income the dividends. It's treated as having paid tax and then

the trustees have an election in terms of accumulation, in which case the amount is treated as trust capital corpus, or by way of application to the beneficiaries. If the beneficiaries are less than 16 years old, then they have to pay tax on the distribution of 33 as a deemed rate, and if they are –

WILLIAM YOUNG J:

Well, a corporate tax rate will set a sort of a minimum tax rate that has to be paid.

MR HARLEY:

Yes.

WILLIAM YOUNG J:

But beyond that it can be split up, pretty much any way the server, the person who provides the service chooses?

MR HARLEY:

Well, the answer to your question bluntly is yes, but I draw a line between the amount that is received by the trust as the dividend and then its use of what is trust property and how it is appropriated, and it has a different character in the hands of the trust. It's not the trust's business income, it's the trust's return on capital.

TIPPING J:

In the example my brother's just discussed with you, the money that is at the free disposal, if you like, of the professional man is that amount by which the personal tax rate is in excess of the company tax rate, isn't it. You've made the valid point that the company has to pay. If I work for a company for nothing that increases the profits of the company by what I would otherwise be paid.

MR HARLEY:

You'd hope so.

TIPPING J:

You'd hope so. It might not be such a –

ELIAS CJ:

The example should probably be avoided.

TIPPING J:

Yes, Chief Justice.

MR HARLEY:

I share your interest in your endeavour, Sir.

TIPPING J:

Well, maybe I'll finish this one and avoid it for the future. I've almost lost my period of thought now, but you see where I'm, it's going to be the difference that you've saved in tax, isn't it?

MR HARLEY:

Sir, you're talking about what the Judge describes as the rate advantage –

TIPPING J:

Yes.

MR HARLEY:

– which is the 39 or 33, the six-cent difference.

TIPPING J:

And this is what this case is all about.

MR HARLEY:

And that's what the case is about, yes.

TIPPING J:

So, in effect, by doing it, and I'm not making a moral judgement or a legal conclusion here, I'm just saying the effect of it is to shift that amount from the professional's pocket to the beneficiary's pocket?

MR HARLEY:

Yes, and the amounts are tabulated year by year from Mr Lyne's tables in Justice MacKenzie's judgment.

TIPPING J:

And there is not the slightest doubt that the professional, particularly if it comes round the back and back into his pocket, is saving the amount of the differential, is gaining the amount of the differential.

MR HARLEY:

Because of the round the back to his pocket, that has to be right, but as a general proposition, the rate advantage between 39 and 36 is a direct result of the person not deriving the CRS and –

WILLIAM YOUNG J:

It's 39 to 33, isn't it?

MR HARLEY:

Pardon?

WILLIAM YOUNG J:

39 and 33.

MR HARLEY:

Isn't that what I said?

WILLIAM YOUNG J:

No, 36 but –

MR HARLEY:

Sorry, 39 and 33.

BLANCHARD J:

I thought you were suggesting a compromise.

MR HARLEY:

It's not my nature, Sir.

TIPPING J:

Does that mean that by forming a company, any sweat of the brow labour, you can save tax in this way?

MR HARLEY:

Yes it does. And that has a consequence. It's not your money, it's the company's.

TIPPING J:

That doesn't damnify the proposition though?

MR HARLEY:

No, no.

BLANCHARD J:

It is the company's because you elect not to derive it yourself by taking a salary?

MR HARLEY:

Yes. No, it doesn't defeat –

TIPPING J:

If you get it out of your discretionary trust, round the back, if I can so inelegantly put it, then that just feels a little unsatisfactory to me, Mr Harley, and no doubt you'll be able to drive that thought out of my head.

MR HARLEY:

But your Honour, it's a direct result of the ownership of the company by a different person.

TIPPING J:

Yes I know, but it still feels a bit unsatisfactory because it, in a sense it is circular, you are denying yourself the salary so as to get the benefit of the differential and tax rate back into your pocket.

MR HARLEY:

Indeed, and that will take a much more extreme example. The person who is in this enterprise is a business genius.

TIPPING J:

Is a what?

MR HARLEY:

A business genius. And in the year of an endeavour, he or she is able to cause the enterprise to generate $100,000,000, and because they do that first as an individual they would have paid tax at 39 cents, or if the business genius is exploited by the company, the company will pay tax at 33. On the Commissioner's theory, the commercially realistic salary is the entire $100,000,000 which ever way you cut it.

TIPPING J:

Well subject to any external or other expense, but yes, I'm with you broadly.

MR HARLEY:

Yes. So –

TIPPING J:

The Commissioner is losing $6,000,000 in that example –

MR HARLEY:

Yes.

TIPPING J:

– and someone, someone is gaining it.

MR HARLEY:

The wealth is accumulated by the owner of the company and that is a function of the shareholder-company relationship, which is different from the relationship between the business genius and the firm. That they may co-incide is no more than a reflection of the family relationship.

TIPPING J:

Yes, I understand your point.

MR HARLEY:

And it is why when the rate structure was altered in 2000, Parliament took specific steps to introduce the Personal Services Attribution Rules to deal with the very point you've just made, which we'll get to.

TIPPING J:

There's a sense that I'm hearing this reference to the PSA rules, in the sense that because there are, is a specific avoidance provision and you don't fit within it, you're all right. Is that the essence of the argument?

MR HARLEY:

I wouldn't say because you are not subject to the Persona Services Attribution Rules therefore you all right, but you've got a good start, and for reasons –

TIPPING J:

Well, you've got the start that you're not subject to the rules. But you – what does that say for the general avoidance?

MR HARLEY:

It says two things. Firstly in respect of the Commissioner's theory, here, that this is personal services exertion income, Parliament has recognised what that theory is and defined it for itself and it's not this. Secondly, and importantly in my submission, in respect of a different exemption, the substantial business assets exemption, by creating that concept Parliament has defined this company's income as not being personal services in nature at all. Because there's no point in having the substantial business assets exemption if that were not the case, and it's the reason that I took up in the introduction the fact that about 40% in one company, and I think it's higher in the others, the operating costs are not reflective of personal services attributes at all.

BLANCHARD J:

I haven't studied those rules at all, but I was under the impression that they were brought in with a view to stopping somebody who was an employee of an existing company from simply interposing his own or her own company between themselves and the original employer, rather than dealing with the kind of thing that we're looking at here.

MR HARLEY:

Your Honour, the primary focus of the rules can't be improved on in terms of your formulation, that is exactly the primary focus, but in respect of that focus the exemptions that are provided are, what's called the 80% concentration test, which is the customer that provides 80% or more of the source to the interposed company.

BLANCHARD J:

Mmm.

MR HARLEY:

Well, we've got hundreds of customers here, so that 80% test is nowhere near germane, but the emphasis I'm putting on is the second part of the exemption, the substantial business assets exemption, where in respect of the very example you gave me, if the person with the company interposed has the substantial business assets in that company then the company is not an attributing company at all, even in the circumstance that you're talking about.

TIPPING J:

But that's not the case here.

MR HARLEY:

Yes it is, on the second leg of the double.

TIPPING J:

It's not – I thought it was common ground that the PSA rules don't apply to –

MR HARLEY:

They don't apply because of both exemptions. We don't have the 80% concentration and nothing within a bull's roar of it.

TIPPING J:

You've got to satisfy both, have you?

MR HARLEY:

No, you can satisfy either, and in this case these companies do satisfy, I'm sorry that's not strictly accurate. Penny's company clearly satisfies the personal services exemption for substantial business assets, Hooper's company did not itself directly own that level of assets. It had access to them by the licence agreement, and just to be absolutely accurate about it, that is not within the exemption as it's cast. But my point is a broader one with respect to Justice Tipping, when you look at the policy that is being reflected by that concept, the policy that's being reflected is that this type of business income in a company is not the subject of attribution because of the substantial business assets that are used in its endeavour. And therefore the

personal services theory that the Commissioner's advancing here is not a proper reflex of the scheme of the Act properly understood in respect of those rules.

BLANCHARD J:

But if they weren't aiming the PSA rules at anything like this type of situation, then they're not of that much relevance are they?

MR HARLEY:

Well, your Honour, there's about a million pages of stuff in Hansard about what was and what wasn't, and the simple shorthand version is that Parliament had before it a whole lot of stuff about plumbers, electricians, IT companies, all this sort of stuff at the time the rules were being debated, and so it knew perfectly well that there was a large number of private companies that would not be brought within the attribution rules and this sequence, if I can put it that way, is what was contemplated as not being within them.

TIPPING J:

So don't do it through the GAAR, that is the plea isn't it, if –

MR HARLEY:

Yes it is, yes.

TIPPING J:

– Parliament's intent not to bring in attribution through the rules, don't do it through the general avoidance.

MR HARLEY:

It's not a perfect answer, but that's the reason that I'm putting also the emphasis on the arm's length rules because they paint, in a very detailed way, the circumstances in which the Commissioner is directed to interfere, and this isn't one of them.

ELIAS CJ:

Why do you say it's not a perfect answer? I mean, it seems rather modest.

TIPPING J:

Well, he didn't want to say it wasn't an answer.

MR HARLEY:

I've had more than enough experience, your Honour, in this Court and others, to what we would call a gruyere cheese treatment –

ELIAS CJ:

Mmm.

MR HARLEY:

– and so overstepping the mark, in terms of a proposition, is unhealthy and unwise and so – not just for self-protection but in principle. The law is clear and has been since *McKay v CIR* [1973] 1 NZLR 592 (CA) was argued in the Court of Appeal, that the satisfaction of anti-avoidance, specific anti-avoidance or other rules in the Act in and of itself doesn't necessarily exclude s BG 1.

So we are at the second level of inquiry, in terms of *Ben Nevis Forestry Ventures Ltd & Ors v Commissioner of Inland Revenue* [2008] NZSC 115; [2009] 2 NZLR 289 (SC) which is, what is the scheme of the Act as a whole in respect of a myriad of different provisions that are applicable to the taxation of companies and related parties in these circumstances. What I was trying to say in terms of what is a detailed word picture, if I can put it that way, describing a painting with a lot of detail and layers in it, there's not much left, and ultimately I'll get to Justice McGrath's favourite expression, echoing Sir Ivor Richardson in *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (CA), which is that when you take into account all those elements there's no room left to move, but that is a conclusion as a result of the construction of the Act and all of the elements of it that I'm identifying. It is not an assertion that simply because the PSA Rules don't apply, therefore I get the big tick.

McGRATH J:

Was that really decided in *Challenge* and by the Privy Council?

MR HARLEY:

That there was no room to move?

McGRATH J:

No, that in essence a specific provision will not defeat the operation of the general anti-avoidance provision?

MR HARLEY:

Justice Richardson himself said it in *Challenge* too.

McGRATH J:

Yes.

MR HARLEY:

He got the tick on that part, and then the cross in terms of whether or not the introduction to the group was within the contemplation of the scheme and purpose of the specific rules.

McGRATH J:

Yes but is it – well then it's both Courts, or both the final Courts in *Challenge*, Court of Appeal and Privy Council.

MR HARLEY:

Yes.

McGRATH J:

It's really on account of what they said in relation to the lack of impact of the specific provision, or compliance with the specific provision, of the general anti-avoidance provision. That's really why you're being cautious in how far you will go, because you recognise that it's been decided that the general anti-avoidance provision can still operate because the specific provision will not necessarily cover all the ground. In fact, will not cover all the ground.

MR HARLEY:

Yes and I'm going another step too, trying to pick up really the idea reflected in Justice Blanchard's judgment in the Court of Appeal in *Miller v Commissioner of Inland Revenue* [1999] 1 NZLR 275; (1998) 18 NZTC 13, 961 (CA), which of course didn't involve specific anti-avoidance rules, or indeed specific rules in the way that we're dealing with them here. Instead the Judge, for the Court, attacked the construct that was adopted in the *Miller* template as to whether or not there was truly a sale of shares on capital account.

Your Honour will be familiar with the passage because you use it also in *Dandelion Investments Ltd v Commissioner of Inland Revenue* [2003] 21 NZTC 18,010 (HC),

but the articulation of the concept is that, for income tax purposes, we generally treat shareholders as holding their shares in private companies as being on capital account and that when those shares are sold we would generally treat the sale proceeds as being capital because there is a sale. The explanation in the case is when you look at the detail of the template, this isn't really a sale at all on capital account. What it is, is a tax-loss transfer that had a temporary appearance of a sale, and then you'll remember the option reset and let's do it again when we've run out of losses, kind of stuff.

Lord Hoffmann, in upholding that judgment, he adopted that reasoning, I think somewhat unfairly Sir, without attributing the idea of sale to you, he adopted it as his own and then exported it into his speech in *McNevin*, but the idea is well anchored and the point in terms of architecture of the Act, if I can put it that way, is when you're dealing with these kinds of issues it's important to reflect them against the overall architecture of the Act, not necessarily confining yourself just to specific rules. I think that's well understood in terms of the anti-avoidance cases that have developed, really since the *McKay* case, and they're all consistent and *Ben Nevis* adopts all those passages and refers to those judgments in those terms.

That's a convenient time for me, if it's acceptable to your Honours, to move on to focusing on what was the tax avoidance arrangement that was made void by the Commissioner in this case. This picks up the appellants' written submissions from paragraph 17 to 22, and attempts to deal with the Commissioner's first part of the response, in his paragraphs 6.4 and 6.6. The Commissioner's response at 6.4 is that the submission for the appellants is said to be a straw man. For the reasons that I will now outline, it not only isn't a straw man but it is indeed the actual argument that founds the Commissioner's assessments.

If I could ask your Honours to go to the light blue large volume 3 of the case on appeal, to tab 20 at page 287. I've got 18 different paragraph cross-references here and so I'm just going to be very selective, because they're all consistent internally in the document. If we could start at 8.6. You'll see the Commissioner asserts the arrangement by reference to the actual salary and the market salary, and then refers to case *W33* at paragraph 38 and the reference is correct. *W33* is in the materials, we don't need to go there, that's a judgment of Judge Barber of the Taxation Review Authority and Justice MacKenzie overruled it. In TRA case *W33* Judge Barber adopted the commercially realistic standard, salary standard, as the basis of his

judgment. Then, if you move to 8.10, you'll see the same thing, 8.11 the same thing for Mr Hooper, 8.13 is another reference to *W33*, and also case *V20*. Case *V20* is the same case but the year prior, also a decision of Judge Barber. We then get, in 8.14, the reference to Mr Lyne and the commercially realistic salary valuations as he then formulated them. In 8.18 then we've got the actual comparison that the Commissioner is making for Hooper, picking up Justice Tipping's point about the rate difference at 39 cents in 8.19, and then in 8.21 you'll see it repeated again.

TIPPING J:

This, of course, is just one side of the ledger, isn't it? They haven't credited the company tax?

MR HARLEY:

No, not yet.

TIPPING J:

No, not yet, because that's under the reconstruction, presumably?

MR HARLEY:

Yes, and he says in this document later, which I'll find, that that's what he intends to do. He actually has not yet done it, but we don't need to be disturbed by that. I think we would be disturbed by it if it actually didn't happen –

TIPPING J:

Oh, quite.

MR HARLEY:

– but that's…

TIPPING J:

Well, he can't have his cake and eat it.

MR HARLEY:

The Commissioner?

TIPPING J:

No.

MR HARLEY:

Oh, he generally can.

TIPPING J:

Well, not in this instance.

ELIAS CJ:

But you're not suggesting he's trying to –

TIPPING J:

He's not trying –

MR HARLEY:

No, no, that was a bad joke. I'll move on to 9.6.

BLANCHARD J:

Just while you're jumping over, 9.4 refers to the decision of the High Court of Australia and the decision of the Privy Council in *Peate.* Will you be dealing with *Peate* at some stage?

MR HARLEY:

Yes. 9.6 deals with the artificiality and the salary, in terms of the concept of commercially realistic, and 9.7 another reference to *W33* –

TIPPING J:

Isn't the first sentence of 9.6 very, very important? But it's not the structure per se, but the way it's being used.

MR HARLEY:

And the Commissioner says that repeatedly.

TIPPING J:

Yes. But that is highly important as to where the focus of the attack on the Commissioner –

MR HARLEY:

Yes.

TIPPING J:

– should come.

MR HARLEY:

Yes, and –

TIPPING J:

And I suspect, with all due deference to the lower Courts, particularly the High Court, that point may not have been fully factored into account.

MR HARLEY:

Oh, yes, it was.

TIPPING J:

All right, well –

MR HARLEY:

The Judge understood that very well. It's the commercially realistic salary –

TIPPING J:

Well, he –

MR HARLEY:

– that is the basis of attack.

TIPPING J:

That's it, yes.

MR HARLEY:

Yes.

TIPPING J:

Not the structure –

MR HARLEY:

Correct.

TIPPING J:

– within which that took place.

MR HARLEY:

Correct.

TIPPING J:

Yes.

WILLIAM YOUNG J:

But it's also, isn't it, a factor in the Commissioner's case that there weren't any other obvious very good reasons for Messrs Penny and Hooper not maximising their incomes, other than tax?

MR HARLEY:

Well, he disregarded the asserted asset protection, ACC medical misadventure rationale that was said to explain –

WILLIAM YOUNG J:

Yes.

MR HARLEY:

– why they did what they did.

TIPPING J:

But none of those, or none of them in combination, could make tax merely incidental, I would have thought.

MR HARLEY:

And there's not claim in an arithmetical sense, of that nature. The difference in terms of the rate advantage for, one of the companies, I think, is 24,000 and the other's a bit over 30, per year.

TIPPING J:

If we get to the point, you're not asserting merely incidental?

MR HARLEY:

Not on an arithmetical, no.

TIPPING J:

Well, on any basis, are you?

MR HARLEY:

No.

WILLIAM YOUNG J:

So, you accept that tax avoidance was a purpose or effect of the scheme?

MR HARLEY:

In respect of Mr Penny –

WILLIAM YOUNG J:

Yes.

MR HARLEY:

– no, I don't accept that at all. He set up his incorporation in 1997 and he could not possibly have known, unless he was clairvoyant –

WILLIAM YOUNG J:

But the scheme that's relied on isn't a 1997 scheme alone, it's a scheme that incorporates in 2000, doesn't it?

MR HARLEY:

And what happened in 2000 is no different from what happened in 1997, the arrangement's the same.

ELIAS CJ:

I thought the salary had changed?

MR HARLEY:

It did change in several years, including 1998 and nine, and it did change later in respect of one or two of the years that are in context, but my point in terms of Penny is that when he set up his incorporation in 1997 he adopted as his yardstick that he

would pay, he would derive income from the Christchurch District Health Board on the basis of his tenths employment – I think it was $119,000 per year – and he set the salary on the same basis from the company. Now, then, as the company's actual performance in two of those years was highly profitable because of extra contract work, he paid himself a bonus, and then it was reduced.

TIPPING J:

He used the structure, without alteration, as a structure, but the crucial integer or ingredient of the structure was materially different, ie it was a lower salary.

MR HARLEY:

No, Sir. The lower salary started in 1997, and he continued to derive lower salary than the CRS level in every year.

TIPPING J:

But it's nothing to do with his personal motivation, is it? It's the effect objectively of the arrangement.

MR HARLEY:

Your Honour, you just asked me a different question –

TIPPING J:

No, no, I've asked you a supplementary question, in the light of your answer to the first question.

MR HARLEY:

If the focus of the section BG 1 is on arithmetical effect, judged in outcome by hindsight, the taxpayer loses.

WILLIAM YOUNG J:

Well, according to the Court of Appeal decision, the salary allocated to Mr Penny in 1999 was $302,000. It dropped $125,000 in the year 2000.

MR HARLEY:

That's correct, because he paid himself a bonus in the prior year because the company had had a very successful contract with the local health authority to do extra work for hips and what have you.

WILLIAM YOUNG J:

Well, yes, but that accounts for $40,000-odd of the $302,000, doesn't it?

MR HARLEY:

Well, your Honour, I don't have the detail of the –

WILLIAM YOUNG J:

Well, I'm looking at para [27] of the Court of Appeal judgment.

MR HARLEY:

But I know that what I said to you is correct, that is what he did. I can find it, I think it's in Justice MacKenzie's judgment.

TIPPING J:

There's no doubt whatever that that's what he did but, as my brother says, the uplift was only $40,000 by way of the bonus, wasn't it?

MR HARLEY:

No, no, it was much more, no.

TIPPING J:

No?

MR HARLEY:

No, it was much more than that.

TIPPING J:

Was it?

MR HARLEY:

If we go back to the statement of position at tab 25, paragraph 2.36, on page 379.

ELIAS CJ:

Sorry, where are you going to?

MR HARLEY:

Paragraph 2.36 in tab 25.

TIPPING J:

Yes, well, there's a director's bonus, 42, I'm sorry, I was a little loose at 40.

MR HARLEY:

I'm sorry, I was looking at the hundred thousand in the line before. It explains why the amount's adjusted up and down, it's because of the directors' bonuses. Now, it happens also that in the subsequent period, I think in the years in question, Mr Penny engaged in a matrimonial dispute with his wife and he reduced the salary level payable by the company to him in respect of that also.

TIPPING J:

Well, it remained the same in the '01, '02, '03 and '04 years, according to this table.

MR HARLEY:

I know that's what the table says, but I'm pretty sure that what I said to you is factually correct and I'm pretty sure I can find it and show you that it's factually correct.

TIPPING J:

I don't want to distract you on arithmetic, Mr Harley, because this isn't going to turn on precise arithmetic, I don't think, is it?

MR HARLEY:

No, but what –

TIPPING J:

And I'm not suggesting it will.

MR HARLEY:

– what I, where you and I sort of parted company was the proposition as to whether – I'm sorry, it was Justice Young, as to whether or not I was entitled to start time, as it were, with Penny in respect of 1997.

WILLIAM YOUNG J:

On the face that something significant happened at the end of the 1999 tax year?

MR HARLEY:

Yes.

TIPPING J:

Which just happened to coincide with the change in the rates?

MR HARLEY:

And which just happened to coincide with the level of the profitability of the company.

WILLIAM YOUNG J:

Well if you look at page, para [26] of the Court of Appeal judgment, if I understand the figures correctly the best year was 2002.

MR HARLEY:

I agree that's what the table shows.

WILLIAM YOUNG J:

And then if you look at para 2.36 at tab 25, there's no reflection of that good year in Mr Penny's income. He just gets the same as he'd got the previous year, or previous two years, and about half of what he had, a bit more than half of what he had received in 1998.

MR HARLEY:

The proposition you put to me, Justice Young, is that something significant happened in the year 2000.

WILLIAM YOUNG J:

At the end of the 199– well, between 1999 and 2000.

MR HARLEY:

Yes, he separated from his wife.

WILLIAM YOUNG J:

And the tax change.

MR HARLEY:

Yes.

TIPPING J:

I don't recall the separation from his wife featuring very much in Justice McKenzie's judgment. Did it feature at all?

MR HARLEY:

Yes it did.

TIPPING J:

Perhaps we can come back to that after the adjournment.

MR HARLEY:

It's actually a convenient point to just inform the Court that those identifying details in respect of Mr Penny and Mrs Penny are the subject of standard Family Court suppression orders, and the Judge was circumspect about that, as was the Court of Appeal. Yes, the Judge did refer to it carefully.

TIPPING J:

I must have overlooked it, Mr Harley.

ELIAS CJ:

You might like to take us to that when you take us to the judgment, but we'll take the afternoon adjournment now for 15 minutes. Thank you.

COURT ADJOURNS: 3.34 PM

COURT RESUMES: 3.49 PM

MR HARLEY:

Really just for housekeeping purposes, your Honour Justice Tipping, you'll find the passage in Justice MacKenzie's judgment about Mr Penny's matrimonial position in about two sentences in paragraph [66] of the judgment, and to be fair to you he's discussing the goodwill payments and that Mrs Penny was a beneficiary of what turned out to be something of an own goal.

WILLIAM YOUNG J:

Sorry, what paragraph number?

MR HARLEY:

Paragraph [66]. He refers to the *Newman v Newman* [1999] NZFLR 839 case and then to *P & P* (2005) 24 FRNZ 407, and then in [66] refers to the goodwill paid to Mr Penny on the sale of the business which, of course, is relationship property and which Mrs Penny was able to share the benefits of.

BLANCHARD J:

Was it, did the reduction in salary have anything to do with the matrimonial breakup?

MR HARLEY:

Yes it did. The next references, to the pink volume 2, at tab 15, Mr Penny's direct evidence is at page 164, paragraph 56.

WILLIAM YOUNG J:

So 164?

MR HARLEY:

It's 162, paragraph – no, 164 at 56, sorry. And the next reference is –

WILLIAM YOUNG J:

Why would he be concerned not to accumulate assets in his name after separation because they would be separate property?

MR HARLEY:

I don't know.

WILLIAM YOUNG J:

Well on the face of it it doesn't make much sense. I mean there may be some sense behind it, but if there is it's not explained.

MR HARLEY:

Well I don't know, Sir. It's his evidence and that's what he said and he explained it a little more in the cross-examination. He referred to the marriage dissolution at page 181 at line 10, and at 182 he referred to the lump sum payment to, he's now talking about ex-wives in relation to marital dissonances in the middle of the page.

WILLIAM YOUNG J:

But you can't – I take it you're not suggesting that there is a logical correlation between the breakup of his marriage and wanting to keep assets out of his name for the future?

MR HARLEY:

I think it's not this wife that he's now concerned about. I think he's concerned about his future prospects in going through the same experience again.

TIPPING J:

The "once bitten" principle.

MR HARLEY:

Yes, unfortunately for him, but that's life.

BLANCHARD J:

Well he doesn't actually say that, does he?

TIPPING J:

He uses the word "wives" in the plural I noticed.

MR HARLEY:

Yes.

BLANCHARD J:

Ex-wives in the plural.

TIPPING J:

Ex-wives in the plural, maybe he's got even greater problems.

WILLIAM YOUNG J:

Well if that was a substantial purpose it might have been – sorry, and I know it's not really subjective, but if there are objective considerations around it that concerned him they might have been spelt out a bit better.

MR HARLEY:

What he says here is spartan in respect of this, and I hope it's not taking advantage of the Court to say this is a subject that he has very strong views about and which we –

BLANCHARD J:

What, tax avoidance?

MR HARLEY:

No, matrimonial property experiences, and which we endeavoured to keep out of the Court, and my friend was helpful in that regard too.

WILLIAM YOUNG J:

But if it's, the, as it were, the lynchpin of this case it's probably not a good idea to keep it out of the Court.

MR HARLEY:

Sir it's going too far to say it's the lynchpin of this case. It's something that he's concerned about and obviously is experienced with. I'm still endeavouring to focus attention on what the Commissioner's basis of assessment was, and to do that if I could take you now to the Commissioner's adjudication. It never gets better put, in terms of the summary, you'll find this in the yellow volume, tab 1. If your Honours would look at 1.6 through 1.9 it's crystal clear that the focus is the commercially realistic salary identified by the Commissioner's valuer Mr Lyne, it is adjusted, and that consequential adjustments will be required to the deductions claimed by the company.

WILLIAM YOUNG J:

So this is 1.6?

MR HARLEY:

That's 1.9. 1.6 to 1.9 say the same thing four different times, and the whole of the rest of the document is consistent with it and it's entirely consistent also for Mr Penny, the word processor has been at work.

TIPPING J:

But of course, but for this factor there wouldn't have been any alteration in the incidents of tax, so it's not really surprising that the focus is primarily on this.

MR HARLEY:

And that is the tax avoidance arrangement that has been voided, yes. The submission then in reply to the Commissioner is that the focus on the commercially realistic salary as his basis of assessment is not a straw man and the Judge picks this up in his judgment, first reflecting the submission I made to him, which he records at paragraph [13] of his judgment, and then he reorients himself after considerable discussion of the points that were raised by my friend in support of the assessment, the Judge comes again to the tax avoidance arrangement at paragraph [56].

TIPPING J:

Is there any dispute that this salary level, I'll put it that way to try and be neutral, is an ingredient of the arrangement?

MR HARLEY:

No. No, no we –

TIPPING J:

Is there any –

MR HARLEY:

No, we didn't disagree on –

TIPPING J:

Is there any dispute that the salary level gives rise to an alteration in the incidents of tax?

MR HARLEY:

No. And the Judge so recorded. You'll find the Judge recording that in paragraph [24]. And then he reframes the issue in terms of whether that alteration was avoidance for the purposes of section BG1 in paragraph [25].

WILLIAM YOUNG J:

So it's not contended that the purpose or effect of altering the incidents of tax is merely incidental, it's rather that it's not within the concept of tax avoidance as discussed in *Ben Nevis*?

MR HARLEY:

Yes, Sir.

WILLIAM YOUNG J:

So it doesn't really matter much what Mr Penny thought about the Relationship Property Act?

MR HARLEY:

Or about a number of other things.

WILLIAM YOUNG J:

Yes, all right. Because that wouldn't be enough to displace the purpose or effect if we got that far?

MR HARLEY:

Yes.

WILLIAM YOUNG J:

Okay, thank you.

MR HARLEY:

So I'm now taking the Court to Justice MacKenzie at [56], where he nails the arrangement and the avoidance arrangement, as asserted, in terms of the commercially realistic salary, and he makes the point, your Honour Justice Young, exactly as you've put it to me, in terms of the last part of that paragraph – I'm not saying that you agreed with him, but that the proposition is as he states it there –

WILLIAM YOUNG J:

Right.

MR HARLEY:

– and as he upheld and, for obvious reasons, I say he's right. The reason for focusing particularly on this paragraph is really to respond to Justice Tipping, in terms of the earlier exchange, "Did the Judge identify the tax avoidance arrangement that was said to be the subject of BG 1 and GB 1 counteracting?" Yes, he did, and that's where he did it.

TIPPING J:

Is there a typographical or other – no, there must be. Sorry, I won't trouble you with that, Mr Harley. I was just referring to the line 35 on 549 that seems to be, the reference to "derived in the income", but that must just be an error of expression, it must be just "derived the income" I think.

MR HARLEY:

I hadn't noticed and I think you're right, it's an error.

TIPPING J:

I don't think it's –

MR HARLEY:

No. That, then, takes me back to how the Judge got there and why he was right, and he took three steps in terms of constructing his judgment and his reasoning. The first part is commencing at paragraph [23], where he discusses the formation of the company and the architecture of the Act in respect of the taxation of companies and their business income. And the real focus or point that's being developed here is the concept of derivation of business income by the company. There's a lot of very detailed explanation and reasoning in [24] through paragraph [30] in respect of these – let me just attempt to summarise very quickly the key points.

He picks up *Salomon v A Salomon & Co Ltd* [1897] AC 22 and says, "We all know about separate entity theory and we all know that we distinguish between the role of a person who is the governing director of a company and who also may be the shareholder, as distinct from the person who is the director employee, and he refers from *Salomon* to *Lee v Lee's Air Farming*, which your Honours will all be familiar with in terms of the top-dressing pilot who crashed and then there was the dispute as to whether or not his estate was entitled to worker's compensation under the old form. He goes on then to record again, in [29], that the literal reading of BG 1, the alteration

of the ownership of the business alters the incidence of tax, and then goes on to discuss whether or not the corporate form itself is a legitimate form of business enterprise for the purposes of businesses of this sort. And he comes to the very conclusion in respect of paragraphs [29] and [30] that he sees nothing within the scheme of the Act that tells you that a company can't derive income of this nature, indeed, makes the point by reference to section CD 3, which is the business income limb that it is applicable to anybody, including a company.

It's in the nature of tax lawyers, then, to make tax lawyers' points about that kind of discussion, but he might also have noticed that the Act specifically identifies other types or source of income that will tell you the nature of the person who has to derive it, and the obvious example is an employee: an employee can only derive employment income; in respect of a shareholder, only a shareholder can derive dividend income. And so the contrast here is source rules of general application, regardless of the type of taxpayer, as distinct from others where there are specific identifying features because of the nature of the property or the person.

He then introduces the Commissioners' first plank, in terms of the argument said to be based on *Hadlee's* case, derivation and assignment.

TIPPING J:

Is this the second step, or is this part of the first step?

MR HARLEY:

Well, it's really both. They're integrated in terms of how he constructs his reasoning. I assume that your Honours are reasonable familiar with *Hadlee* and the personal services assignment doctrine, and this is a pretty neat summary of the principles, and the principal architect of the exposition of the theory is Justice Richardson in his judgment in *Hadlee's* case, and which was set out by Justice MacKenzie, and then he notes also that that part of the judgment was upheld on appeal by the Privy Council, the point being that *Hadlee's* case is an assignment case, not a derivation case.

Now, it is important before I get then to paragraph [36] in *Loader*, just to remind your Honours of how we got to where we are in terms of this argument. You will see in the Commissioner's statement of position and, indeed, in his adjudication, that the primary proposition that was argued for in making the assessment was that an

employment contract was the same as an equitable assignment of income in respect of these people. Now, the adjudication report rightly made short work of that and said, "It's wrong." But what we now have is an elision from that concept and the principled application of it as a matter of strict law in terms of part 1 of the adjudication report, to a BG 1 analogy, where the principles in respect of derivation and assignment are conflated. And the Judge, for the reasons that he sets out in [36], was right to expose that as being unsound and why it was wrong. Relatedly, he picked up the submission that was made in reliance on *Loader's* case as to the types of relationship that I put considerable emphasis on in terms of family companies. The summary of *Loader's* case is a pretty fair reflection of Justice Cooke's reasoning, but your Honours have the full copy of the case. The point about Justice Cooke's judgment in *Loader* is, contrary to the language that's replete in the Commissioner's submission, and, indeed, in the judgment of Justice Randerson, Sir Robin Cooke saw nothing artificial or contrived or unusual about "one-man companies", to coin the phrase, where the person has the dual control of the company and the employment relationship and, in *Loader* also, was a co-trustee of the trust. So the asserted artifice and all the rest of it didn't ring home with Justice Cooke and it certainly didn't here with Justice MacKenzie.

Paragraph [40] is a very important part of the Judge's reasoning, and he poses three rhetoricals, one of which comes into real life now because of *White's* case. The Judge summarises this position by reference to the scheme of the Act which he's discussed. There is no general intention to distinguish between business income that's the product of personal exertion and that which is not so far as derivation is concerned.

He refers again to CD3 and so-called proprietors of one-man businesses, and then says, "Any principle that a particular category of business income can be derived only by individual taxpayers would have to be clearly prescribed by the legislation. Such a principle cannot properly be derived from an inference which could only be based on some general notion of morality or equity." He then goes on to restrictions and says in his rhetorical questions, "Would the restriction apply only to those professions or trades where the add-on under personal exertion reflected in the fees charged by the business was high? Would it extend to cases where the fees charged also have a significant component for the use of capital or equipment such as the earthmoving contractor in *Loader* and would the restriction be confined to one-man businesses or

would it extend to cases where two or more professionals chose to practice through a company rather than a partnership?"

And all those questions sound, in my submission, both in the Personal Services Attribution Rules themselves, which reflect the substantial business assets kind of concept, which he reflects in terms of the discussion about *Loader*, but interestingly in terms of his one-man business. In relation to Mr Hooper, his company had two medical practitioners working for it, Dr Lee Hooper being one of them, and so the theory in terms of the personal exertion income being wholly attributed from the company to Mr Hooper seems to miss out her role and her expertise in terms of that relationship. We see the same thing arising in terms of *White's* case, which I'll come to, but the Judge says that answers to those types of questions would be essential to establish what the contemplation and purpose of Parliament would be, and in his view the lack of those answers suggest that there is no principle of the sort that the Commissioner contends for.

He then, that is Justice MacKenzie, moves on the Personal Services Attribution Rules themselves. I've already criticised the Commissioner's diagrams and referred to the important factual elements in respect of these two companies, but for Penny it's not just him, he's got a surgical assistant, a practice nurse, he has secretarial services and other employees, two with substantial medical skills. So when you look at the questions that the Judge is posing rhetorically, the submission is that the scheme of the Act in terms of the taxation of business income, for family companies of this sort, you simply can't answer those questions, and without the ability to answer them then the theory can't be sustained. And I adopt the Judge's reasoning for that reason.

I then go onto the Personal Services Attribution Rules, which I've explained in outline, and if your Honours wish we can go to the legislation itself.

McGRATH J:

Whereabouts are you, at [41] of the judgment now?

MR HARLEY:

Yes I am. The rules are – at least they start off as being mercifully brief, they don't last that long. The key point, you'll find this in tab 1.

WILLIAM YOUNG J:

Of what?

MR HARLEY:

Of the large white volume, volume 1. The fourth white page in you'll see on the right-hand side GC14B attribution rule for personal services, and the rule is cast in the role of three people, A, B and C. The last time I explained this I got the role of the people around the wrong way so I'll try to get myself oriented correctly.

TIPPING J:

Did my brother Blanchard put it correctly to you – I hesitate to ask such a provocative question – because I could understand that.

ELIAS CJ:

He did agree with it.

MR HARLEY:

And given the way you've put that question, Sir, the answer is, it has to be, of course.

TIPPING J:

This is where you're an employee and you interpose a company between yourself and your employer?

MR HARLEY:

And the customer.

TIPPING J:

And the customer, yes.

MR HARLEY:

So person A is the customer, person B is the company and person C is the employee. So the customer buys services from the company and pays money to the company, which is person B, and person B employs person C, who is the employee, and pays the wages. And the criteria for attribution in GC 14B, subsection (2), is the 80% concentration test in terms of who the customer is. And predictably the drafting has worked out that if you split up who the customer is then you can get below the

concentration test, so that's not allowed through the associated persons test, there's a combination rule reflected there too.

ELIAS CJ:

And it's D that's the calculation, isn't it? Can you translate that for me? What does it mean, is it a commercial rate or is it –

MR HARLEY:

No.

ELIAS CJ:

No, it's simply –

MR HARLEY:

It's the result –

ELIAS CJ:

Yes.

MR HARLEY:

Subject to –

ELIAS CJ:

But you don't start with a commercial –

MR HARLEY:

No. Well, your Honour, actually that answer is, Mr Goddard is going to tell you it's not quite right, and so I should deal with it. I can hear him now. He would say, correctly, that you would take the earnings of the company as accounted for, the result. You would allow the relevant expenses and you would attribute the pre-tax profit from the company to the person and that is very similar to Mr Lyne's commercially realistic salary approach. It is not the same thing as saying that person can earn that salary in the market, which is the point that I was making in terms of –

TIPPING J:

It's an extrapolation rather than a starting point?

MR HARLEY:

I say it's the hindsight or result orientation, and when you look at the rest of the detail of it it's pretty evident as to why that's so.

TIPPING J:

But in the broadest of senses it equates?

MR HARLEY:

Yes. He's just invited me to address your Honours in terms of his whole argument, and it's very tempting to say how misconceived it is. He really wishes to withdraw and apologise. I don't think it's going to be quite that simple. The rules that I was referring to earlier by way of introduction again the next page over in terms of the criteria, GC 14B(2) then has the substantial business assets exemption, and I put quite a lot of stress on that language in three elements –

ELIAS CJ:

Sorry, where are you, s GC 14B(2) –

MR HARLEY:

D, little d, paragraph (d), so we're at the top of 41702. Substantial business assets are not a necessary part of the business structure that is used to derive the gross income referred to in paragraph (a). I take three elements in terms of that. First, what's meant by substantial business assets. The second bit, a necessary part of the business structure used to derive the income. And the importance of the three parts is this. he substantial business assets have to be necessary in terms of the quality of the income that is being attributed. If they're not related then you can't use them in order to get yourself out of the attribution rules. Secondly, they have to be part of the business structure, that is they have to be part of the actual business itself, they can't be a different investment, like let's take an electrical contractor who has 100,000 shares in Telecom. They're not related to the business that's the subject of the attribution, they don't count. And then the third part is the use of the assets in the derivation of the attributed income.

Now the policy in respect of these provisions is as set out by Justice MacKenzie in the passage quoted in the Finance and Expenditure Select Committee, and then he goes on to discuss the significance, or otherwise, of these rules. And I draw on and rely on as reasoning, particularly in paragraphs [42] and [43], as to why these rules

are significant, but I am putting an emphasis on the substantial business assets aspect that the Judge did not identify or discuss.

The submission I'm making in respect of this reflection of these ideas is this. By their very name the PSA Rules are an attribution concept from company to employee. What is derived by the companies in this case on these facts is not such income in terms of its quality. The default position then is the scheme of the Act generally, it's respected as business income of a company and the submission is that the policy that's reflected in the attribution rules is actually directly contradictory of the Commissioner's basis of assessment. The submission is then in support of the Judge's reasoning.

ELIAS CJ:

So you're saying it's not a gap, it's a, the Commissioner's position, it's contradicted by the policy of the legislation?

MR HARLEY:

Yes Ma'am. The consequence therefore, which follows, is that the scheme of the Act respects the business income of these types of company, that is I mean the Hooper/Penny type of company, and that the company's revenue is derived by the company as its business income, which is subject to the normal regime of company tax on business income. It therefore follows in principle, and under the scheme of the Act, and this really comes back to the exchange I had with Justice Young earlier, the after-tax earnings may be retained by the company, for whatever purpose the company wishes to retain them, or alternatively as imputed dividend income they can be declared to shareholders and the shareholders can do what they like with that dividend income when and if they choose. I would say that under that approach the shareholders applying the imputation regime to the company income have received dividend income in their own hands, fully imputed, which within the scheme of the Act treats them as having colour of right in their hands.

And so I adopt Justice MacKenzie's reasoning at [44] in respect of that and further the Judge's reasoning at [47] in terms of the nature or type of company that is involved, and I understand [47] really to be a reflection of the earlier discussion I took you through in terms of *Loader* and *Lee v Lee's Air Farming* and the classic illustrations of company taxation.

TIPPING J:

Is there anything in the materials which would give any indication as to whether those formulating these PSA rules were directing their attention to either too great or too little a salary level?

MR HARLEY:

No, not to too great or too little a salary level, but to – I suppose we should be respectful of the quality of debates that are in Parliament but the protagonists, who were really arguing that the Minister of Finance was wrong to be raising the personal rate from 33 to 39, were putting to him what I call horror stories about engineers, electricians, blah blah blah, and he was coming back and saying, I can deal with this with the PSA Rules and I will and I'm not interested in the horror stories because we can deal with them, and focus the remedy in the way that Justice Blanchard described.

ELIAS CJ:

Isn't the answer, though, to Justice Tipping's question to be found in the calculation in GC 14B isn't – isn't that –

MR HARLEY:

Well that's the attribution.

ELIAS CJ:

Yes, but –

MR HARLEY:

We've gone through the quality and identity of the person –

ELIAS CJ:

But you were asked was there anything in this that indicated what would – whether too much salary or too little salary was affected. There is a calculation as to what is appropriate.

MR HARLEY:

Not only that, Ma'am, but it's everything.

ELIAS CJ:

Yes.

MR HARLEY:

As a starting point, yes, everything.

TIPPING J:

But my point was not quite the same as that. It was, I'm just wondering whether, and this is, I'm very much in counsel's hands there, whether or not there really was a focus in these PSA Rules on the problem that we've actually got in this case?

MR HARLEY:

The answer is yes, there was in the general sense that Members of Parliament were raising all these other types of entity and saying, what are you going to do about them. And the answer, as we see in the legislation, is nothing. We have the focus here in terms of what we are trying to deal with.

BLANCHARD J:

Do we have the debates?

MR HARLEY:

I do, your Honour. Believe me you really don't want to read them. There's literally hundreds of pages of this stuff and it's –

TIPPING J:

Well, the motives of those raising the issues, which no doubt have been focused, well motive is not a very good word, but the purpose would be focused elsewhere. This is a very much more sophisticated point than they would have been addressing I would imagine.

MR HARLEY:

Yes and the – it's important not to go outside what is public record but the submissions to the FEC Committee dealt with this stuff ad nauseam.

TIPPING J:

Well, we've basically, then you're saying we've just got the rules on the face of them and we've just got to do the best we can to extrapolate whether or not they really do give guidance for this particular problem from their face?

MR HARLEY:

Yes Sir, and with a confession I'm really the person who encouraged New Zealand Courts to have resort to and regard to Hansard in the *Marac Life Bonds* case and I've since reflected on the wisdom of –

ELIAS CJ:

Well you're not taking us to it, and Mr Goddard may or may not, and if he doesn't perhaps we can simply draw the inference that it's not helpful.

MR HARLEY:

That's what I'm saying to you, yes.

ELIAS CJ:

Yes, I understand that you say that, yes.

MR HARLEY:

And if I could have found a gem, believe me it would be here.

TIPPING J:

Well, where are we in the Judge's steps at the moment? I'm glad there's not 39 of them, but are we still on step 1 or have we – being a sort of analytical sort of beast, Mr Harley?

MR HARLEY:

That then gets me to the judgment, where Justice MacKenzie deals with the commercially realistic salary concept, and whether there was anything of the kind by reference to the evidence and submissions, but particularly the evidence of Mr Shewan. Now that part of the discussion starts at [50], where the Judge introduces the Commissioner's witness, Mr Lyne, and Mr Lyne's approach to formulating the commercially realistic salary tables that are in evidence.

TIPPING J:

He wasn't espousing the theory, he was just doing his best on the a priori basis that this is what you have to do. Is that a fair reading of the Judge's introductory three lines in [50]? In his evidence he said that his instructions were to express his opinion on the commerciality of the arrangement whereby –

MR HARLEY:

Your Honour, I'd have to go back and reread Mr Lyne, and reread Mr Lyne in the context of case *V20* and *W33*, but I think it is accurate to say that the architecture is his.

TIPPING J:

What architecture?

MR HARLEY:

The commercially realistic salary concept.

TIPPING J:

Oh. I read this as though someone else has told him this is what you did. Not that it may matter, but –

MR HARLEY:

I think he is co-architect of the methodology, but I'll have to go back –

ELIAS CJ:

Is it Mr Lyne you're talking about?

MR HARLEY:

Yes. I'll come back to you on that, Sir.

TIPPING J:

It may not matter, Mr Harley.

ELIAS CJ:

We're not so interested in attributing blame as in determining whether it's what the statute –

MR HARLEY:

Sound.

ELIAS CJ:

Yes.

MR HARLEY:

And Mr Lyne then sets out his methodology, acknowledging that he did not have the access to third-party market information. Now he said that in evidence but he was actually incorrect in what he was saying. He had access to the best source of such information that is available in New Zealand, if he'd chosen to ask for it, which is from the Commissioner of Inland Revenue himself. Which is the point that he actually acknowledged in cross-examination, as did Shewan in his oral evidence. So the point in terms of the methodology is he didn't go to the best source of information in terms of arm's length information, he used what he acknowledged was a default method to construct the commercially realistic salary concept from the information from the company's accounts that he did have. And the Judge gave an accurate account of how he went about that in terms of paragraphs [50] and [51]. The essential adjustment that was made by Mr Lyne was a recognition that the owner of a company like this would expect a level of return on its capital as distinct from the business profits of the enterprise.

TIPPING J:

Is this a kind of fallback argument? I thought your attack was on the concept as a concept, never mind how it plays out in the field.

MR HARLEY:

Correct. That is, the attack is on the concept and I'm simply explaining what it is.

ELIAS CJ:

Is this directed at the artificiality in the question of tax avoidance in the salary or is it – I mean are you using it more than that?

MR HARLEY:

Yes I am. I'm saying that the method is a construct that is false and that it has no rationality and therefore the Commissioner can't validly use it. It's unlawful.

ELIAS CJ:

But I didn't understand it to be really in dispute that the salary was artificially depressed.

TIPPING J:

They both said in their evidence that they've never worked outside for anything like this salary.

MR HARLEY:

Correct. That is what they said.

ELIAS CJ:

So does it really matter very much the methodology that's used? I can see that it matters when you come to determine what the basis of tax should be, what the reconstruction should be, but why does it, why are we getting too hung up on it in determining whether there's tax avoidance?

MR HARLEY:

Because on my submission the Commissioner's fundamental approach is to say that the tax avoidance arrangement in this case was the failure of these taxpayers to derive what he said was a commercially realistic salary.

BLANCHARD J:

Well they agree that they didn't.

MR HARLEY:

And –

BLANCHARD J:

The question is whether the Commissioner is entitled to take that position.

MR HARLEY:

Correct.

BLANCHARD J:

But we're not going to get into the detail of, if he was entitled to take it, whether he's got the ultimate calculation correct for purposes of reconstruction.

MR HARLEY:

Correct.

BLANCHARD J:

I'm getting puzzled as to where you're going here?

MR HARLEY:

Can I take you to paragraph [52] of the judgment of Justice MacKenzie, where having referred to Mr Lyne's evidence the challenge of the taxpayers is at a more fundamental level. They contend the concept of the commercially realistic salary is a concept not known to tax law, not a concept that provides a basis for determining whether or not a particular arrangement constitutes tax avoidance, that's the submission.

BLANCHARD J:

Yes.

MR HARLEY:

The taxpayers advance that proposition in two parts. One by submission and one by expert evidence, and I'm now turning to Shewan. In respect of Shewan's evidence, which I need to go to in a little detail, the summary in [53] is correct in terms of the overall effect of that evidence. Shewan said he'd never heard of the concept and he expressed the opinion that it didn't exist. Now the Commissioner objected to the admissibility of some of that, and you'll find it in the pink volume 2 at tab 13. Mr Shewan qualified himself as an expert, started with the Commissioner's adjudication report, paragraphs I've already taken you to, and then records what his instructions were and then summarises his opinion in paragraph 20 of the brief. The Commissioner's objections, as argued before Justice MacKenzie, were specified to be at paragraphs 28 and 29, 36 to 40 and 45 to 48. His objection as written was broader than that, but those are the paragraphs that were focused on in terms of argument. So, taking the Court quickly through the brief, paragraph 22 which was not objected to, is where Mr Shewan set out his reasons as to why a family company would not pay a commercially realistic salary, and he gave different examples and then explained in his experience why that was so, which is set out on page 6, in terms of the various aspects of asset protection, the accumulation of company profits within trusts and a keenness on the part of the shareholders not to have assets in his or her own name.

BLANCHARD J:

Can I just clarify, Mr Shewan was not disputing that there is such a thing as a commercially realistic salary, but he was disputing that there is such a thing for the purpose of the income tax legislation?

MR HARLEY:

Yes.

TIPPING J:

In the context of a family company?

MR HARLEY:

Yes

TIPPING J:

Para 20, page 5?

MR HARLEY:

Yes. So, he set out the various illustrations of retention policy, asset protection, the companies in terms of strengthening balance sheets, reinvesting profits and tax considerations at F.

TIPPING J:

Would it be fair to say that all his examples A through to F are where there are objective, commercial reasons for not paying a commercially realistic salary?

MR HARLEY:

No, I would say these are a subset of, your Honour. You don't know why the company did not pay a commercially realistic salary until the shareholder or proprietor tells you the reasons. Objectively, what you do know is reflecting Young J's position – as an effect, you've altered the incidence of tax by the accumulation.

TIPPING J:

Well, I would be provisionally minded to accept that if there was, objectively, a good commercial reason or reasons for not paying a commercially realistic salary, that would not amount to tax avoidance, because it can be justified and the tax saving can then be properly regarded as merely incidental. But if there are not sufficient

objective commercial reasons to render the tax saving merely incidental, then you've got a different situation.

MR HARLEY:

And I understand the first part and we don't need to argue about that, but the second part, the submission in this case is whatever the reasons are, are irrelevant and it picks up Blanchard J's point to me earlier, you've got to say that not paying any salary at all is of no consequence and that is what I'm saying and it doesn't matter what the underlying rationale for that is or isn't, what does matter is what the scheme of the Act is in terms of telling you how companies are taxed in a scheme and purpose fashion.

WILLIAM YOUNG J:

Can I ask you a question from that, which I'd be perhaps grateful if you could answer tomorrow: in *Ben Nevis* there is the specific and very detailed statutory scheme, which the taxpayer sought to invoke, balanced against and in the end outweighed by the general anti-avoidance regime. In this case there isn't really anything that corresponds to the specific regime invoked by the tax payers in *Ben Nevis*, there's simply the structure of the Act that some entities are taxed at 33% and some taxed at 39%, is that really the sort of tension which the approach in *Ben Nevis* was intended to address? I mean is there really a scheme and purpose argument here at all or is it possibly the case that we can just go directly to section BG 1?

MR HARLEY:

I'm happy to answer that question now. I'm also happy to answer it tomorrow.

WILLIAM YOUNG J:

Well, I really just wanted to give you a decent go at answering it, either now or tomorrow and you've probably thought about it anyway, I guess.

MR HARLEY:

Just a bit.

WILLIAM YOUNG J:

It's not really dealt with in the submissions, is it?

MR HARLEY:

Well, I believe it is.

WILLIAM YOUNG J:

Yes.

MR HARLEY:

The scheme and purpose analysis, in terms of the specificity à la *Ben Nevis* is one form of scheme and purpose analysis, and I agree with everything that you said in terms of the outline of the approach and reasoning of the Court, but there are other instances where scheme and purpose analysis is perfectly appropriate by a reference to features of the Act or policies that are reflected in it, that don't find themselves necessarily in a particular specific provisioning, particularly an anti-avoidance specific provision. Take, for instance, Justice Blanchard's analysis in *Miller* as to sale. You can go through the Act itself and you will not find a statutory definition or reflection of the idea of sale or capital profit in the terms that I described the rationale of that case, but the Court of Appeal, upheld by the Privy Council, was able to describe the scheme of the Act in terms of how it applied to the sale of capital assets and how it treated realised capital gain amounts, reflected against the tax loss offsets and the arrangements that were purportedly managed by Mr Russell.

WILLIAM YOUNG J:

I'm looking at, for the sake of a point of reference, page 24 of Mr Goddard's submissions, para 10.2, simply because it contains a reference to *Ben Nevis* which identifies the point I've raised. In para [113] at the last sentence, "It is apparent therefore that the use of a specific provision which alters the incidence of tax is permitted in two situations," now what I'm interested in, and you've probably given me an answer, is whether the structure of the Act as a whole, the different tax rates, the different entities, the graduated tax regime itself, can be treated as a specific provision which requires this adjustment in terms of scheme and purpose that's referred to in para [114] and following, and you say yes?

MR HARLEY:

Yes, I do, and I also referred to imputation, the taxation of dividends in the hands of the trust as shareholder, the taxation of trusts, the relationship between trusts, trustees and beneficiaries and the age of beneficiaries in terms of their ability to enjoy

trust distributions, and I say in terms of a scheme and purpose analysis for the purposes of this case, you have to have regard to the whole lot.

WILLIAM YOUNG J:

Any tax avoidance arrangement will have to, to some extent, engage with the general structure of the Act, so any challenge under section BG 1 will necessarily involve coming up with a result which is other than that which would apply but for the intervention.

MR HARLEY:

Yes, your Honour.

WILLIAM YOUNG J:

Do you say that there is always, in that sense, a specific provision that s BG 1 has to be set off against and with the tension resolved on scheme and purchase arrangement, rather than just within the language of section BG 1 itself?

MR HARLEY:

Well, I can't think of a single instance where that is not the case. I used *Miller* because it's – I don't mean this to be disrespectful to Justice Blanchard and the reasoning, but it is an outer edge, if I can put it that way, of explanation because it imports into the construction of the Income Tax Act what I would call life, as distinct from art, reflected in some of these arcane concepts such as license fees and premiums on the ground of licences and all that sort of stuff, and it's perfectly legitimate, in fact it's orthodox in terms of a jurisprudential approach because of course the Income Tax Act is a reflection of what happens in the income-earning process of people in the community. So it invites into it a reflection of life, and the idea of sale is something that, in all kinds of circumstances, we all know, understand the elements of and appreciate, and the reasoning in *Miller* translates that to a structured approach reflecting the various aspects of the rules dealing, as it happens, with realised capital gains amounts and with losses.

The answer to your question is, you have to be avoiding something for s BG 1 to apply. What is it that's being avoided and how do you identify it, and you can only do that within the scheme of the Act itself.

ELIAS CJ:

I think this point is one that you will have to return to tomorrow. I have some questions on it myself but it would be convenient to take the adjournment for us now, if that's suitable for you.

MR HARLEY:

I'm entirely in your hands, Ma'am, and I'm about to run out of voice.

ELIAS CJ:

All right. We'll take the adjournment, we'll resume tomorrow at – what sort of progress do you think we're making?

MR HARLEY:

I was just going to say. In terms of progress, subject to unleashing Ms Bibbey on you, in terms of what is quite a narrow point, I'm very confident that we would be finished before one and on current progress, pretty well before one.

ELIAS CJ:

All right.

MR HARLEY:

I can't promise the morning adjournment but we're making pretty rapid progress through the submission.

ELIAS CJ:

All right, thank you. We'll take the adjournment now.

COURT ADJOURNS: 4.54 PM

COURT RESUMES ON TUESDAY 28 JUNE 2011 AT 10.07 AM

MR HARLEY:

Before I continue with the substance of the submission that I commenced yesterday, if I could just ask your Honours to note the other part of Mr Penny's evidence about matrimonial concerns, which are in his evidence in the pink volume, the passages that I am referring to are at page 169 and 170, which is his evidence-in-chief, which I led from him orally So, from line 10 he explains the circumstances with his former wife and the million dollars arising from the goodwill, records that he has strong views on the matter, considers the debt to be very real and then at the bottom of the page goes on to explain his understanding of the reality of the debt and the protection that it offered to him in relation to both litigators or partners in a matrimonial dispute. So, this is simply for completeness.

In terms of completing the submission this morning, yesterday I was at the close starting to refer to Mr Lyne's, evidence and then I'll go on to the evidence of Mr Shewan and his reputation. Following that I intend to deal with *White's* case, then return to Young J's conceptual question and face your Honours' interrogation in relation to that, then deal with *Peate's* case; the benefit of the money, which is the third section of Justice MacKenzie's judgment, which will be dealt with by Ms Bibbey and then finish the submission.

Going first to Mr Lyne, and really to respond to your Honour Justice Tipping yesterday, as to the basis on which he did give evidence, it's quite clear in his written brief, there are two of them, but for present purposes, they're materially identical except for the arithmetic in respect of Penny, so I'm just going to take you through the Hooper brief. If you go to tab 17 of the pink volume, at page 187, he introduces himself by reference to his expertise. In paragraph 7 he records that he was the Commissioner's witness in case *W33* and then goes on to outline his instructions in paragraph 12 where the Crown Law office, on behalf of the Commissioner, has asked me to express his opinion on the commerciality of the arrangement that he's asked to consider whether the salary paid by the company to Hooper for the years was commercially realistic, and then in paragraphs 19 through 23 he offers what is his overview, which is the description of the historical performance of the private practice of Mr Hooper, then his evaluation and his opinion, being that the amounts received by Mr Hooper from Hooper Orthopaedics was significantly less than what he assesses is the realistic salary.

MCGRATH J:

What page were you on just then?

MR HARLEY:

191.

MCGRATH J:

Thank you.

MR HARLEY:

After reviewing a whole lot of financial material, all of which is not in dispute, the witness then goes on at page 201 to explain his approach to assessment of the commercially realistic salary. At the foot of 201 he records that he's unable to establish market information that would give him the information for comparative purposes, and he explains that in paragraph 70, 71 and 72, and then moves to what I described as the default method, which is to explain the commercially realistic salary concept. He starts off with the proposition in 74, that if it weren't for the fact that Hooper Orthopaedics was owned by related interests Mr Hooper would not have accepted the salary at the level that he did, and that in the absence of market information he then goes on to look at the earnings that could be derived in private practice and comparing it with what a third party might do at arm's length. He expresses the opinion that it's appropriate to allocate all of the earnings to Mr Hooper, because he expresses the opinion that none of them are attributable to the roles of employees and doesn't refer to any of the equipment, that's paragraph 77.

TIPPING J:

If you're doing it for my benefit, Mr Harley, the benefit is exhausted. If you're doing it for other purposes, that's fine.

MR HARLEY:

I'm in your Honour's' upper hands if I can put it that way, then, I just wanted to make one further point, the witness refers to his understanding of matrimonial law, particularly in respect of medical practices and whether there is or isn't goodwill attributable to the person or to the practice, he explains that at 78 onwards through to 81 and he acknowledges that he's taking up a hindsight view, and then through the rest of the brief he makes the same point in terms of ignoring goodwill in 89. He sets

out his calculation of the return of capital and then he forms his assessment of the commercially realistic salary by reference to the historical position and you can see those tables on page 210.

Now coming to Mr Shewan's evidence in reply. The evidence is at tab 13 of the pink volume. I mentioned yesterday that is argued before the Judge, the objections that were argued were to paragraphs 28, 29, 36, 40 and 45, 48, but in the written memorandum the objections were broader than that and practically encompass the balance from 20 through to 48. In Mr Shewan's brief he sets out in 21 what he refers to as the classic kiwi model for businesses that are owner-operated, and that is it often the case that the principal person would not derive what the Commissioner would treat as a commercially realistic salary, and he refers to the various instances from builders, plumbers, electricians, corner dairies, et cetera.

MCGRATH J:

You say owner-operated businesses, he uses the term family company, do you equate those two terms?

MR HARLEY:

Yes, I would've generally, Sir, yes. In 22 he outlines the reasons as to the circumstances in which a family company would not pay a commercially realistic salary, ranging from it not being financially successful through to the kinds of circumstances where the person simply doesn't want the money in their own name, wishes to distribute profits to the family company shareholders such as the trust, and then deals with other instances such as strengthening the balance sheet, and he expresses the opinion that for the purposes of the Income Tax Act there is no such concept. He justifies that opinion then in respect of the paragraphs that my friend objects to and in doing so, he explains his understanding of the various concepts within the Act, in terms of the taxation of companies and their shareholders. He explains from paragraphs 30 through to 35 the history of the taxation of companies in New Zealand and the relationship accorded to them and the shareholders through that history. So he notes at 32 that until 1997 we had for almost 100 years a graduated rate scale for companies, that it was replaced by a flat scale in 1977. He refers to the introduction of group company rules and single joint assessments to prevent income splitting amongst several companies and then goes on to explain what was a paradigm shift in terms of the introduction of full imputation in paragraph 33. He compares that with the classical system, that is the double taxation

of company income and dividend income in 34, and the incentives on the part of companies to pay out pre-tax profits to employees who are shareholders and circumstances in which family companies might be incentivised to retain profits. He explains the legislative response in 1939 to the excessive salary rules and in 1959 to the excess retention tax rules to deal with obviously the excess retention of profits by companies so that they were not paid to employees in the higher rate scales. He explains the position in terms of those rules and their relevance, in paragraphs 37 and 38, via reference to arm's length standards and then goes on to explain his understanding of the personal attribution rules in paragraphs 40 and their impact through 42 to 46.

Justice MacKenzie was right to accept the admissibility of all of that, largely historical fact –

TIPPING J:

Well, does it matter, I mean counsel could've said it anyway. Does this really gain any strength by being a piece of evidence? It's submissions on the legal and historical background, so I don't know why we're having this argument.

WILLIAM YOUNG J:

You could put it in as an addendum to your submissions, if we weren't too tough on the page limit.

BLANCHARD J:

I'm not criticising you, Mr Harley. Objection has been taken but, frankly, I never follow why objections of this kind are taken in the first place.

MR HARLEY:

Can I leave the point this way, Sir. The proposition that is being asserted for the taxpayers here is the negative, that there is no such concept within the scheme of the Act or its operation of a commercially realistic salary. That's all there is to it, in terms of –

BLANCHARD J:

And that's your submission?

MR HARLEY:

Yes.

BLANCHARD J:

Yes, which you're entitled to make.

MR HARLEY:

With that then, can I move on to the discussion on the part of the Judge as to why he accepted that submission in his judgment. This part of the reasoning commences from paragraph [56] of Justice MacKenzie's judgment, and in [56], now focusing on what was the tax avoidance arrangement, his Honour notes the starting point is the proposition already discussed and that's section [24] to [30] of his judgment, "that, in situations such as the present, a taxpayer who is conducting a business which consists wholly or principally of a profession, trade or calling, involving the provision of services ... without infringing the scheme and purpose of the Act, can choose to conduct that through a taxpaying entity other than the individual."

He makes the point that, "The incidence of tax as provided for in the Act is consistent with that scheme and purpose. The business income is that of the entity which conducts the business and is subject to the incidence of tax," and indicates that that result of itself is not avoidance. Then it goes to the next relevant proposition that, "Except in specific defined circumstances, the Act doesn't dictate the level of income that a particular person has to earn."

He goes on to elaborate on that with his reasons in [57] and says that, "Generally the level of payments from employer to employee will be determined by market forces. There's no express provision in the Act that that must apply," and then he records that, "Mr Lyne says that he wasn't able to use market forces to establish what the third-party salary might be."

In [57] and [58], the Judge then discusses the provisions in the Act that do specify the circumstances in which remuneration between related people has to be altered, that is, if it's excessive. The rules don't apply in the reverse if there's an inadequate consideration, and then deals with the personal services attribution rules. He might also, for the reasons that I discussed yesterday, have made reference to the cross-border rules, where the arm's length rules apply. If Mr Hooper, for instance, were

conducting any part of his business in Australia, he would have to derive a market salary in respect of the performance of those services.

He then goes on to discuss, in [60], Mr Lyne's approach to the CRS level and says, for the reasons that he gives in [60], that he doesn't consider that the premise is right, in terms of the two elements that he identifies. The Judge then goes on to take the point, concerning Mr Lyne's evaluation, as to whether or not goodwill is or isn't relevant for the purposes of the formation of the two companies. He discusses the treatment of the goodwill, first in Mr Hooper's company, and then secondly he discusses it with reference to Mr Penny's company. The Judge explains the value of goodwill, that it's commonly recognised in transactions between persons selling businesses and that he does not accept the proposition that Mr Lyne advances, that goodwill should be ignored.

I've noted in my written submission that there's a basic contradiction between what Mr Lyne's treatment is and the submission for the Commissioner, in respect of goodwill. On the one hand Mr Lyne says you should ignore goodwill. On the other, Mr Goddard for the Commissioner, asserts that the amount of the consideration realised on the sale of these businesses was insufficient. Now that's a point that's taken up by Justice Randerson in his judgment, and I just want to deal briefly with Justice Randerson and what he says, with his dismissal of the proposition, that the goodwill in the case of Mr Penny was not real and wasn't sufficient. The business, in relation to the 10-year employment contract, wasn't sufficient to justify such a large goodwill figure. That's at [124] to [125] of Justice Randerson's judgment.

The background to the criticism that I'm making of this reasoning is that Penny's evidence was that at the time he reconstructed he took external advice as to the appropriateness of the consideration and he applied it. So the Judge is now saying, that is Justice Randerson, that the amount can't be justified. By way of response to that, I would say this –

ELIAS CJ:

Sorry which paragraph are you referring to again?

MR HARLEY:

Paragraph [124].

ELIAS CJ:

Thank you.

MR HARLEY:

The employment contract we know, from historical information, will produce a commercially realistic salary in the order of $640,000 per annum, on Mr Lyne's calculations. Now accepting that calculation, for present purposes, over 10 years that's $6.4 million pre-tax. If we apply a 39% tax rate to it for the whole 10 years, that's four and a half million dollars after tax over the 10-year period. If we use a 50% discount rate applicable to that sum over the period, the amount is $2.25 million, and if we use a much more extreme discount rate of 67%, it's $1.5 million. On any evaluation logically, a million dollars is more than justified on that approach.

BLANCHARD J:

Did the company insure Mr Penny?

MR HARLEY:

For business profits?

BLANCHARD J:

To protect its investment?

MR HARLEY:

I think the answer to that is yes, but I'd have to check the record. I think I asked him that. I'll have to come back to that.

BLANCHARD J:

The significance is obviously that, in the real world, no one is going to pay this sort of goodwill if they're at risk that the person who is going to be the source for the payment, from personal exertion, might die, or become incapacitated.

MR HARLEY:

And I asked exactly those questions of some of the witnesses in terms of, for instance, the value of their hands, which are obviously core elements of their trade, if I can put it that way. So the point in respect of the goodwill as reasoned by Justice MacKenzie, I would submit, is sound and Justice Randerson's dismissal of it can't be justified on the evidence or as a matter of the logic. He expresses therefore his

conclusion at [67], that there is no commercially realistic salary concept for the purposes of the Act, in support of his conclusion that the failure to pay one can't be treated as part of a tax avoidance arrangement, and I adopt that reasoning.

That then takes me back to the real-life example of *White's* case, which illustrates some of the difficulties with this concept. *White's* case is in the turquoise volume at 4.

ELIAS CJ:

This is a case on appeal is it?

MR HARLEY:

Yes, it is.

ELIAS CJ:

Is it necessary to go into the case, I mean you're using it as an illustration, can you not just simply tell us what you're taking from it?

MR HARLEY:

That's what I was intending to do, Ma'am.

ELIAS CJ:

All right. By reference to the case, I'm just really wondering whether it could be stated more shortly.

MR HARLEY:

I've got the message, Ma'am.

ELIAS CJ:

Yes, thank you.

MR HARLEY:

Dr White, anaesthetist, transfers her business and her husband transferred his business, which was in quantity surveying, to a company called Wharfedale and they both become employees. In addition, Wharfedale acquires interests in two different avocado properties, one is called Hawken and the other is called the home property. The home property is a smaller one, as in start-up, and in the first year requires 330

trees to be planted on it. It can't possibly generate income and it didn't. The Hawken property had a crop on it, but it belonged to the family trust, not to Wharfedale, and in that context, in the first year, which is March 2003, the company made losses. In the second year, the company made more substantial losses. The Judge, that is Judge Barber, accepting that they were unanticipated, and so the argument for the Commissioner, upheld by Judge Barber, was whether or not it was a tax avoidance arrangement for Dr White to receive no income at all, because the company used all of her income to fund itself in terms of its, at that point, unsuccessful operations. A better choice of language would be unsuccessful activities. Judge Barber applied the same reasoning as he did in *V20* and *W33* for the reasons that are set out in the judgment of Justice Heath that the failure to pay a commercially realistic salary was an artifice, unreal and a tax avoidance arrangement.

Justice Heath reversed that decision, essentially taking up the proposition offered by Justice Randerson in the Court of Appeal. This passage is really reflected in Justice Heath's reasoning at [60], where he refers to Justice Randerson's proposition in [126] of the Court of Appeal judgment, where there are legitimate reasons such as those discussed at [98] above, for adopting a salary markedly below commercial levels, a challenge may be unlikely to succeed and Justice Heath in the *White* case said, "This is one of those circumstances." Without being unduly critical of Justice Heath, because he, of course, is required to apply the Court of Appeal's decision in this case, the submission I'm making is that what the Court is indulging itself in is selective approval of activity that it thinks is worthy in comparison to activity that it considers not worthy and that there is no place for such an objective evaluation of what the taxpayer may or may not be doing in the conduct of his or her enterprise.

TIPPING J:

Where do you get the idea of worthiness from, Mr Harley?

MR HARLEY:

From Justice Randerson's –

TIPPING J:

I thought that the essence of it was that Justice Heath found that there were good commercial reasons for not paying a full or any salary?

MR HARLEY:

Mhm.

TIPPING J:

Which is what Justice Randerson seems to me to have been hinting at.

MR HARLEY:

Yes.

TIPPING J:

Or more than hinting at it in his para [126].

MR HARLEY:

And [98].

TIPPING J:

Yes. [98] picks up Mr Shewan's –

MR HARLEY:

Yes, yes it does.

TIPPING J:

I don't understand where this concept of unworthiness comes from?

MR HARLEY:

Yes, it comes from –

TIPPING J:

I only tackle you because it seems to be rather important to your thesis.

MR HARLEY:

It is, very.

ELIAS CJ:

Well, aren't you treating worthiness as commercially realistic? A decision as to whether something is commercially realistic?

MR HARLEY:

No, I'm taking the concept further than that, Ma'am.

ELIAS CJ:

Are you?

MR HARLEY:

Yes, I am.

WILLIAM YOUNG J:

Well the pejorative component and the usual words were applied, artificial, contrived and so on. Is that what you're referring to?

MR HARLEY:

Yes, and I'm saying that the Court has no business in choosing enterprises that it considers should be entitled, for instance, to offset losses and income in the way that's involved with Dr White, in comparison with, for instance, a company that decides that it'll pay out 100% of it's after-tax profits. There's nothing in the Income Tax Act that tells you that one of those is better or more commercial or more worthy or whatever kind of language you want to put on it, than the other. People are entitled to conduct the company for the benefit of the shareholder in a way that suits their, maybe completely idiosyncratic purpose, and it's no function of the Court then to pick and choose which it regards is acceptable in the context of this debate than any other. Now, I support that submission –

BLANCHARD J:

Well, what it regards is artificial in a particular context.

MR HARLEY:

Yes, and I support that submission particularly in the present context, relying on Lord Hoffman's judgment in the *Auckland Harbour Board* case, where your Honours will be familiar with this passage, he took the Commissioner to task in terms of the failure to recognise within the scheme of the Act and the accrual rules particularly that there was a number of detailed associated person market value rules, none of which were applicable to the particular facts of that case, and then using an avoidance provision to write over the top of those rules what Parliament had not, itself, prescribed. Those paragraphs are in paragraphs [13] and [14] of Lord Hoffman's judgment in that case,

and your Honours are no doubt familiar with them, but the point that he's making is as applicable to the *Auckland Harbour Board* case and the regime as it is here, given, in my submission, the existence of all these other rules that direct us in terms of arm's-length relationships and pricing, none of which are applicable to the present circumstances.

I have now dealt with the submissions in support of Justice MacKenzie's first two parts of his judgment, which then leaves us with the benefit of the money at [68]. I was intending, at this point, to go on and complete the balance of the matters that I indicated earlier, but if your Honours want the use of the money dealt with first before I finish the submission, Ms Bibbey can do that, I'm in your hands, which is the –

ELIAS CJ:

No, no, I think you can carry on.

MR HARLEY:

I was to return to Young J's conceptual questions yesterday. The proposition he was putting to me, as I understood it, in the context of *Ben Nevis* was, in that case, the existence of a number of different specific provisions and regimes and the Court's evaluation of whether the arrangement adopted by the taxpayer foresters in that case essentially abused the scheme of those provisions, and the question then was whether there was a proper basis for taking a different approach where those kinds of provisions were not in play, and in order to deal with that more fully, the first part of my response was to go to *Miller's* case and identify particularly a passage of the reasoning of Justice Blanchard for the Court, and your Honours have got a copy of the *Miller* case in front of you, and there's a lot of paper there, but the only two pages that need concern is, really start at page 299 and go through to 301.

The submission of counsel starts by referring to the structure of the *Russell* template and the use of options to acquire assets of the company once the first tranche of losses had been used. The Court then explains the basis of that submission and the difficulties with it, recording its patience in listening to the argument with the delightful, which may be thought to have been audacious, and then moves on to observe that the Court was no more persuaded than the Commissioner, the Taxation Review Authority or Justice Baragwanath that this wasn't a blatant tax avoidance scheme. With that introduction, the passages I was referring to are commencing from 30 and go through over the other side of the page, where, for the

Court, Justice Blanchard is explaining the rationale for not treating the *Russell* template as a capital transaction involving sale shares, and he articulates the propositions there which, in my submission, are as much a scheme of the Act analysis in respect of a sale, capital profits and the use of losses, as the kind of analysis that was implicit or explicit in *Ben Nevis*.

In order to demonstrate the soundness of that approach and also its authority, it's useful to compare that kind of approach with –

ELIAS CJ:

Well, sorry, are you saying that it is not sound, that approach, you're not saying that, are you?

MR HARLEY:

No, I'm saying it to demonstrate the soundness of it.

ELIAS CJ:

Yes, yes.

MR HARLEY:

Apart from anything else, Ma'am, you joined with Lord Hoffman in endorsing it, so it must be right.

TIPPING J:

Well, so did I.

MR HARLEY:

Which nails it, Sir.

TIPPING J:

Not necessarily, Mr Harley, at the moment I'm with keen anticipation to see where this is ending up.

MR HARLEY:

Well, moving on from the *Miller* case, yesterday also referred to the same kind of analytical approach taken for the Court of Appeal by Justice McGrath in *Dandelion*,

I'm not going to take you to that, but if we take a larger and more conceptual approach to the issue –

ELIAS CJ:

Is that all you want us to look at *Miller* for?

MR HARLEY:

Yes.

TIPPING J:

I wonder if it would be possible if you were to tell us what you're ending up with, so that we, at least I can understand what these submissions are in support of?

MR HARLEY:

Yes.

TIPPING J:

Because at the moment I'm rather at sea I have to confess, you're addressing my brother Young's point.

MR HARLEY:

Yes.

TIPPING J:

And you're, what is the proposition for which you're contending on that point, because it would be helpful to understand that to see how the detail fits in with it.

MR HARLEY:

The proposition is that for the purposes of seeking to apply s BG 1, the hypothesis for the Commissioner in establishing his tax avoidance assessment, is what the taxpayer would be expected to have done and to have been taxable upon but for the arrangement that is being avoided.

WILLIAM YOUNG J:

How does that address the question I raised? Well, my question and it is simply really an information-gathering exercise, and it is, does the approach in *Ben Nevis* apply, that is the scheme and purpose approach, apply where there isn't a specific

regime but where the taxpayer has simply invoked, in a particular way, some general aspect of the law of taxation?

MR HARLEY:

Yes.

WILLIAM YOUNG J:

Maybe differential tax rates, maybe distinctions between capital income and so on?

MR HARLEY:

Yes, and my answer to you was yes, and I'm now endeavouring to try to explain why. –

WILLIAM YOUNG J:

Well, how does this passage in *Miller* deal with that?

MR HARLEY:

It deals with it by reference to the idea of what is a sale and a capital transaction. The Act doesn't tell you that but in terms of applying it, the Act and its scheme, we have to have a framework to identify what is a sale for business purposes and how we would expect it ordinarily to operate.

WILLIAM YOUNG J:

Okay, I understand.

MR HARLEY:

Now, with that idea, if I could take you to Justice Richardson's –

ELIAS CJ:

Sorry, just what is the idea in this case? Is it income, realistic salary, what is the idea if you're transposing this line?

MR HARLEY:

The answer is the derivation of business income by a company, separate and distinct from the person who works in the company and who is set to have these attributes.

TIPPING J:

I would've thought the higher level idea is, is this a contemplated use of the differential tax rates?

MR HARLEY:

I'd say that's the same idea, differently expressed.

TIPPING J:

Oh, right.

MCGRATH J:

Mr Harley, is this another way of really saying before you get to any tax avoidance case, to looking at s BG 1, you have to engage in an analysis of the Income Tax Act in relation to the particular facts, but the concepts of the Act and the objectives of the Act, applying in relation to the facts, before you can answer the question to whether or not there has been tax avoidance.

MR HARLEY:

Yes, yes and yes, and that's my understanding of your judgment in *Ben Nevis*.

McGRATH J:

Yes, and it would also be your understanding of the approach that Justice Richardson has consistently taken in relation to tax over the years as well, is it not?

MR HARLEY:

Absolutely.

McGRATH J:

Mmm.

MR HARLEY:

And, your Honour, I was going to take you to the particular passage of *Challenge* where he spells this out. I'm not attempting for a moment to start arguing about who was right or wrong in *Challenge*. That's not my point. It's the conceptual basis of analysis which he expressed in his judgment. You'll find this in the white volume,

number 1, the tab number is 7, and your Honours will all be familiar with this particular extract, so I can speak to it rather than labour the detail of it.

It starts on page 548, where the Judge has set out the text of the section by reference to Lord Wilberforce's criticisms in *Mangin v Commissioner of Inland Revenue* [1971] NZLR 591 (PC) before it was redrafted, and then he refers to the new section and immediately observes from 30, "Thus it is not saved by the old predication test of ordinary business dealing if any purpose other than a merely incidental purpose is tax avoidance." Then he goes on and records the submission of counsel in respect of "commercial decisions being inevitably influenced by tax implications, the vast range of ordinary business activities being conducted where minimising tax and saving tax could never be regarded as merely incidental. In the circumstances, it becomes particularly important to determine the relation between section 99 and the other specific provisions of the legislation under which tax changes may occur. The legislation having failed to provide the tests, it falls to the Courts to do so as a matter of statutory construction."

Then, your Honours, he goes on to explain the scheme and purpose methodology conceptually over the next two pages, which I can speak to, but by way of introduction, in respect of this particular passage, when it was referred to before their Lordships in *Peterson v Commissioner of Inland Revenue* [2006] 3 NZLR 433, Lord Bingham described it as a masterly exposition of the proper approach to statutory construction in the context of avoidance issues.

With that, the Judge introduces section 99, noting that it's not a charging provision, that its function is to protect the liability established under the other provisions of the Act. The fundamental difficulty is the reconciliation. He then goes on and refers to the framers of the system making special provisions for trusts, partnerships and companies, the taxing of trustees' income and beneficiaries' income, the role of family property planning involving the use of trusts and so on. Your Honours are familiar with this so I can move quickly.

He makes the point, on page 549, that Parliament can't have intended what's now BG1 to have overridden those kinds of structural provisions, and then says, but on the other hand BG 1 would be a dead letter if it was subordinate. So he explains that there's a common application of the section in cases where trusts and companies are employed for planning purposes where the use of the machinery is perfectly

legitimate and not affected by the section but it may be one element in a wider arrangement that is caught.

He goes on and talks about the uneasy compromise. Refers to what was section 5J of the Acts Interpretation Act 1924, and then goes on and expresses the view that consideration of the scheme of the legislation requires a careful reading in its historical context of the whole statute, analysing its structure, examining the relationship between the various provisions and recognising discernible themes and patterns in the underlying policy considerations.

He makes specific reference, and this is the second reference to the *McKay* case, where again he records a specific anti-avoidance provision will be highly relevant but not necessarily determinative, and then goes on and makes the point the enquiry is whether there is room in the statutory scheme for the application of BG 1 in the particular case. If not, that's because the state of affairs achieved in compliance with the particular provision relied on is not tax avoidance in the statutory sense. This gives effect to s BG 1. It's not the function of BG 1 to defeat other provisions or to achieve a result which is inconsistent with them.

Then over the page, your Honour Justice McGrath, you'll find the no room to move language that was expressed by Justice Richardson. So –

McGRATH J:
And it's his language.

MR HARLEY:
Absolutely.

McGRATH J:
I think you were suggesting it might have been mine, but it's his language, isn't it?

MR HARLEY:
It is his language. I wasn't suggesting it was yours, but what I was putting back to you, hopefully both persuasively and gently, was that as a result of the journey that I have taken you through in terms of all of the provisions of the Act, you should conclude, as a matter of reasoning, BG 1 has no room to move in these circumstances because the Act itself has prescribed what is a permitted outcome.

That's the conclusion that I submit you should adopt. I am not saying that because there is specific compliance with any one of a myriad of provisions here, that's the answer to the case. It plainly isn't.

TIPPING J:

It's the scheme and purpose that gives rise to a permitted outcome.

MR HARLEY:

Yes.

ELIAS CJ:

Yes, and that is the exclusion of BG 1 to this case.

MR HARLEY:

Yes.

ELIAS CJ:

Yes. My question was on scheme and purpose, because I wonder whether you can summarise shortly and tell us what are the provisions of the Act that you say exclude BG1 here. I mean, I've noted a few but I want to make sure that I'm not overlooking any. The attribution rules, the differentiated tax rates for different taxpayers. There's no assistance in the legislative history. Can you summarise the provisions of the Act that you're relying on?

MR HARLEY:

Yes.

ELIAS CJ:

Yes.

MR HARLEY:

I would start first with the business profits charging provision to make two points. It's of general application, not particularised as to what type of person is taxable on business profits, and the Judge makes that point at the beginning of his judgment too. The second point I would make is in respect of employment income, where the charging provision refers specifically to the relationship between employer and employee, which is the derivation of employment income, to make the point that

we're distinguishing between the derivation of the company's income, business income and the person's employment income.

BLANCHARD J:

Can you give us a reference on that, a section reference?

MR HARLEY:

CB – it's a function of age, these have changed so often now, I can never remember which is which.

ELIAS CJ:

I don't think anyone could be blamed for not remembering the sections here.

MR HARLEY:

That's very kind of your Honour, thank you.

ELIAS CJ:

It's self-preservation.

MR HARLEY:

CD 3 is business income.

ELIAS CJ:

And the business profits charging provision, while you're at it?

MR HARLEY:

Is CD 3.

ELIAS CJ:

Oh, they're not separate provisions you're referring to, you said first is the business profits charging provision, second is the charging provision dealing with employment income.

MR HARLEY:

Which is a separate section.

ELIAS CJ:

Yes. Don't worry, Mr Harley, if they're separate sections, we'll look at the Act and find them.

MR HARLEY:

It's either CF or CH, I forget which.

ELIAS CJ:

That's fine, leave it.

MR HARLEY:

We'll find it between us.

ELIAS CJ:

Yes.

MR HARLEY:

Attempting to maintain logic, yes. The next provisions that I would point to encapsulate the relationship between company and shareholder. First is to dividends and the treatment of dividends paid by the company to the shareholder, and I would lift in the entire chapter in the Act dealing with the full imputation. I would then go to the provisions as to deemed dividends within the company regime, where the use of property of a company by a related person without adequate consideration will be treated as a deemed dividend and can also be subject to fringe benefit tax. In respect of both of those regimes, the Act is looking to whether or not the person has received the value of the property, truly as a shareholder, or in order to obtain the benefit of the use of the property on non-market terms, in which case will have a deemed dividend or a fringe benefit tax charge.

TIPPING J:

At market rate.

MR HARLEY:

Yes, or the actual value of whatever it is.

TIPPING J:

Yes.

MR HARLEY:

There's a level of generality in what I've said to you that is safe to rely on, there's a number of very detailed, intricate rules that underpin the propositions, but the general propositions are sound. Next, I would look at the status, if I can put it that way, of the shareholder. If the shareholder is a person, I mean an individual person, then notwithstanding full imputation the rate structure applies, so that the dividend received by the person is taxable to them at the personal rate structure applicable to that person; in the present context, if the shareholder were Mr Penny or Mr Hooper, then the personal rate structure would apply to the dividend in their hands at 39 cents, that they'd get the benefit of the 33 cent imputation credit. If, however, the shareholder is an entity, such as another company –

ELIAS CJ:

Or a trust.

MR HARLEY:

Or a trust or a charity, then that type of characterisation affects the nature of the charge to tax in respect of the dividend, and so for a charity it would be exempt, but the charity doesn't get the benefit of imputation credit in that sense, there was a tax outcome if I can put it that way. The trust, I'll deal with a company. The company will receive the amount as an imputed dividend and there will be economic exemption if I can put it that way. If the dividend is not imputed, it is taxable to the recipient company as it is to the person, the individual person, not to the charity. It is to the trust, so the trust takes the dividend, this isn't an elegant use of the term, but as a proxy to start with, and the trustees have a decision to make within a specified period as to what they would do with the dividend. If they retain it as trust property, then it will be received by them as imputed dividend income but there's no further tax to pay and it will become capitalised forming part of trust corpus. If they elect to distribute –

BLANCHARD J:

I don't know that we need to detail. I understand the point you're making, but I don't think we need an explication of all the detail.

ELIAS CJ:

The point is the overall architecture, because your submission is that it leaves no room for BG 1.

MR HARLEY:

Yes, and I've described the overall architecture.

ELIAS CJ:

Okay, is that it, that's as far as there's nothing else you want to refer to in there?

MR HARLEY:

Thank you. The employment provision is CH 2.

ELIAS CJ:

Thank you.

MR HARLEY:

I can't remember where I –

TIPPING J:

I think the PSA Rules have to be brought into this overall.

MR HARLEY:

I was just going to say, I can't remember whether I've referred to related party rules, but they are certainly a very important part and I would step through them from the spouse rule to the close company employee rule to the Personal Services Attribution Rules, and to the cross-border rules, and I'm confining myself to those four because they deal with people, not property.

TIPPING J:

The PSA Rules, I would've thought ,are high up in the list of things that you would say are indicative of no room to move. Am I wrong in that? Because I thought your submission –

MR HARLEY:

No, I'm happy with that description in terms of emphasis. I put considerable emphasis on them and –

TIPPING J:

I thought your argument essentially was that the PSA Rules give rise to an implication, but if you're not attributed under them you're all right.

MR HARLEY:

In that regard, the particular selection within those rules of the substantial –

TIPPING J:

I don't want the detail, Mr Harley, I just want to understand –

MR HARLEY:

The proposition is right, it's absolutely right, yes.

TIPPING J:

Yes, that is your point or view or fundamental proposition.

MR HARLEY:

Yes it is.

WILLIAM YOUNG J:

But is your proposition that the way the tax system is designed means that choices made by taxpayers as to which entities derive income are sacrosanct and can't be challenged under section BG 1?

MR HARLEY:

That's going too far.

WILLIAM YOUNG J:

Yes, but how far do you go, or what's the difference between your proposition and what I've just put to you?

MR HARLEY:

Well I think it's exemplified by the facts and circumstances in *Ben Nevis*. The –

WILLIAM YOUNG J:

Well, yes, but *Ben Nevis* is a specific provision case.

MR HARLEY:

Well, it's more than that your Honour, with respect.

WILLIAM YOUNG J:

Sorry, but is it just possible to explain what the proposition is before you exemplify, where does your argument differ from the sort of free proposition I put to you, that any choice legally made as to where income is derived is exempt from challenge?

MR HARLEY:

Having regard to the identified tax avoidance arrangement, the question is whether what the taxpayer has done is an abuse of the scheme of the Act and it may be an abuse of a particular provision, or combination of provisions, or it maybe an abuse of a concept that is implicit or explicit in the Act. In those circumstances, where the Court forms the view, or the Commissioner forms the view, that what the taxpayer has done is a misuse of the architecture of the Act, then the section is applicable.

WILLIAM YOUNG J:

So why couldn't it apply here?

MR HARLEY:

For –

WILLIAM YOUNG J:

I mean, oh, I suppose I'm sort of dodging the issue myself, but I'm still finding a little elusive the proposition you're advancing, based on the general architecture of the Act. Do you say that there's some particular primacy placed on the core principles, the taxes, income tax, the tax on income derived by an individual and the reality that there are differential rates? Is that what you're – are you placing primary emphasis on that, or are you placing, I don't know, emphasis on the fact that this is a rather ordinary transaction, or these are comparatively ordinary transactions?

MR HARLEY:

This will strike you as a somewhat weird response, but I like the first part of the proposition you put to me better than I'd adopt the second. My starting place is that BG 1 is not a charging provision.

WILLIAM YOUNG J:

Yes.

MR HARLEY:

So I'm trying to –

WILLIAM YOUNG J:

Well, it sort of is now, isn't it, because under the reconstruction provisions, I mean, it was one of the problems with section 108, was that it wasn't a charging provision but don't the reconstruction provisions in effect make it a charging provision?

MR HARLEY:

Well, Justice Richardson in *Challenge* says no, because the first step is to get the section to bite, and in using that language we've identified a tax avoidance arrangement by whatever its constituent elements are and we've voided it.

TIPPING J:

Well it's not of itself a charging provision, but it opens the door to a reconstruction which creates a charge.

MR HARLEY:

By using the other provisions in the Act, which is in the Australian High Court in general anti-avoidance law, they now talk about the counterfactual.

TIPPING J:

Oh, don't use that word.

MR HARLEY:

Well I'm glad I introduced it by blaming them. I won't.

WILLIAM YOUNG J:

But section GB 1, which is a charging provision, is it not?

MR HARLEY:

It fixes the liability by reference to the other provisions of the Act.

WILLIAM YOUNG J:

Yes.

MR HARLEY:

And the reason for it being there is that in the old 108 cases, as you know, that was the problem with it, you were only left with scorched earth.

TIPPING J:

Well that was Lord Donovan's problem in *Peate*.

MR HARLEY:

And Lord Wilberforce in *Mangin*. So, Justice Young, to complete the circle to the best extent I can, at the general level the Court is concerned with whether the scheme of the Act has been misused to achieve an outcome that is not contemplated in the statutory sense of the Act as a whole and, for all the reasons that I've gone through now in detail, my submission is in this case the Court is unable to come to that view –

McGRATH J:

What you're saying is that Parliament could not have contemplated that the particular provision would be used in that way.

MR HARLEY:

Well that is what you said in *Ben Nevis*.

McGRATH J:

And that's what you're saying now, is it not?

MR HARLEY:

Yes, yes.

TIPPING J:

Well, you're saying Parliament did contemplate.

MR HARLEY:

Well it's the mirror image, isn't it?

TIPPING J:

Yes, yes.

McGRATH J:

Mr Harley, I don't know about this no room to move, and I wonder whether *Ben Nevis*, in its criticisms of the way Justice Richardson was applying scheme and purpose, hasn't gone beyond no room to move and is suggesting that the matter should be looked at differently and, indeed, in the way we've just been phrasing, was the particular use of the provision in the case something that was within what Parliament had contemplated. If it is, fine; if it's not, then the anti-avoidance provision will almost certainly come into play, but the idea of no room to move, I wonder, whatever it was, whatever that idea was, it is a rather elusive concept I've found, thinking about it on an earlier occasion, not this one. I wonder whether that's of any assistance now, but seeing you're endeavouring to reawaken it, I thought I better put that to you.

MR HARLEY:

I was reawakening it in the gentlest possible way by reference to a conclusion as a result of the discussion I've just had with Justice Young. I accept what you have just put to me, which is not only a reflection of the Privy Council's response in *Challenge* but also to your own judgment in *Ben Nevis* because, putting aside the debate about who really is right, the authority of the case is that Justice Richardson was wrong to conclude that the specific grouping provisions defined the tax loss concept exclusively and the Privy Council, for the reasons it gave, said BG 1 was applicable because, on its view, those rules were misused and it labelled the loss offset claim as a pretence because, on its views, there was no loss truly suffered by the Challenge Group.

McGRATH J:

Yes, and on a more general basis Lord Templeman for the Privy Council said that the anti-avoidance provision could not be ignored.

MR HARLEY:

Correct, and so the Board parted company with Justice Richardson on that very basis. I'm not attempting to either resurrect or re-explain at all –

McGRATH J:

That's fine, that's fine. That's all I really need to know because it's not then, I suspect, that the no room to move is some term of art that you're wanting to –

MR HARLEY:

No, no, no, no.

McGRATH J:

– it was just a gentle way of referring to a matter and that's fine. I'm happy to leave it at that, if you are.

MR HARLEY:

As am I, thank you.

McGRATH J:

Could I just ask you one thing, and if you've concluded your list of the matters that can be drawn from the Act, isn't the fact that within the Act a feature is that personal tax operates on a graduated rate basis a key principle to be drawn from the Act?

MR HARLEY:

Until 1986, that's undoubtedly correct. For 20 years following no, it wasn't. We had an aligned rate structure and then in 2000, April 2000, we misalign to 39.

WILLIAM YOUNG J:

You mean between corporate and individual tax?

ELIAS CJ:

You were being asked about personal.

WILLIAM YOUNG J:

Because it's always graduated. It may not be as quite as many bands as before, but it has always been graduated, hasn't it?

MR HARLEY:

Yes there was a 19.5 first band, and then it moved to 24 and then 33.

WILLIAM YOUNG J:

Yes.

MR HARLEY:

And that rate structure continues through from 1986 to 2000. From 2008 it's altered again, but only the bands are altered. The concept hasn't.

McGRATH J:

So how do you respond to the suggestion that it is an important feature of the Act, that it should be recognised as such, along with the other matters you're referring to.

MR HARLEY:

I accept that in respect of personal income –

McGRATH J:

Personal income tax was the way I put the question.

MR HARLEY:

Yes.

McGRATH J:

And, of course, one consequence of that rate structure is that if you can legitimately, as a person creating income – I'll keep away from the word "earn" – creating income, cause it to be derived by a number of taxpayers, you're in a fairly good position to reduce the overall tax bill paid.

MR HARLEY:

Correct.

McGRATH J:

It just seems to me that that's one of the factors in the Act that has some importance in trying to work out what the Act's overall fundamental underlying assumptions are, as was recognised by Justice Richardson in *Hadlee v CIR*.

MR HARLEY:

Yes, and in *Challenge* too; however, Parliament itself has created certain types of instrument that negate that rate structure for individuals, and Mr Shewan's cash PIE for example is a classic, in terms of prescribing, at the time, a fixed 28% rate regardless of who you were.

TIPPING J:

But specific exemptions from that don't suggest a wholesale exemption at the taxpayer's election.

MR HARLEY:

And I wouldn't advocate that either, but the cash PIE example is an illustration, in my submission, of the same effect in respect of a person who incorporates the family business.

TIPPING J:

Well there's no specific exemption for someone who incorporates the family business. I don't see them being the same at all. One Parliament has directly recognised, the other Parliament hasn't addressed.

MR HARLEY:

Parliament has –

TIPPING J:

It specifically.

MR HARLEY:

Well, with respect, your Honour, I'd submit that's not correct. In respect of the cash PIE, Parliament has created a structure and stuck a 28% rate on it.

TIPPING J:

Yes.

MR HARLEY:

Parliament has recognised the taxations of companies and stuck a 33% rate on it and, for the reasons that are given by Justice MacKenzie in his judgment, it's not possible, in logic, to discern that the personal rate structure is any more important than the company rate structure depending on who you are.

TIPPING J:

If by the sweat of someone's brow they earn into the 39% bracket, they say, "Oh dear, I don't like this. I'll form a company and I'll pay myself just enough to stay within

the 33% bracket and everything else the company can earn." Isn't that exactly what we've got here? Not arithmetically but conceptually.

MR HARLEY:

Conceptually, yes.

TIPPING J:

And that's a perfectly – that's within the contemplation you say of all these factors woven together.

MR HARLEY:

Yes.

TIPPING J:

Right, I understand the argument.

MR HARLEY:

And I go one step further. Suppose the person did it on day one.

TIPPING J:

You mean the first day that the rates diverged.

MR HARLEY:

No, the first day the person commences business they incorporate.

TIPPING J:

Yes.

MR HARLEY:

So, they have no personal services income in that sense, ever.

TIPPING J:

Well they're doing it – maybe they're doing it in anticipation.

MR HARLEY:

Let's assume that they are.

TIPPING J:

Yes.

MR HARLEY:

My example yesterday, they assume that they're going to earn a hundred million in the first year and incorporate immediately. There is no, in that sense, avoidance of an existing position.

TIPPING J:

But it says "purpose or effect."

MR HARLEY:

Yes.

TIPPING J:

It's the effect that matters, not the subjective purpose, *Glenharrow.*

MR HARLEY:

Well I understand the –

TIPPING J:

I know you understand it. I wasn't intending to be pejorative.

McGRATH J:

Sorry, have you finished?

TIPPING J:

Yes.

McGRATH J:

Mr Harley, can I just come back to this question of the graduated scale, personal graduated scale. I'd suggest that what happened in *Hadlee* was that that underlying feature of the Act gave rise to a conclusion that it was implicit that income could not be assigned by a professional earner, personal exertions, personal services, all of those sort of features, couldn't be assigned through anticipatory arrangements to avoid derivation of that income by the person who created it. Now is it – that seemed to be implicit in the Income Tax Act at the time was it not? *Hadlee*, pages 531.

MR HARLEY:

That's the ratio of the case.

McGRATH J:

And if that – that policy of the law was also seen as implicitly proscribing any attempts by an employee to preclude the employee deriving income. So it wasn't just for the, firstly, individual earner, professional earner –

MR HARLEY:

Correct.

McGRATH J:

It was for any employees. You couldn't put in your anticipatory structure.

MR HARLEY:

Correct.

McGRATH J:

Now, what I'm wondering is that if all of this derived from the Act, in this case, of course, we're not dealing with an assignment of income but in a sense we are dealing with the assignment of an income-earning structure, and I'm really wondering whether there isn't some linkage from the reasoning that was being adopted by Justice Richardson into the particular situation we're dealing with here. That is, a professional person earning from his own exertions, who transfers his sole practitioner business to a company. He's transferring, it seems to me, an income-earning structure. Why doesn't the policy of the law we've seen in the other two elements apply here?

MR HARLEY:

The income-earning structure that you have described is the business.

McGRATH J:

It is, I agree.

MR HARLEY:

And it's the business that's sold to the company. It is an outright sale for consideration and it's paid for. It is different in nature from an assignment.

It's conceptually a separation of the income-earning structure from the person him or herself because of the separateness and the legal identity of the company that operates it.

McGRATH J:

I have no problem with the separate legal personality issues. That's clearly understood, and I have no problem with the transfer being effective in commercial and legal terms, but so were the assignments in *Hadlee.* In the end, there was a bit of a scrap about that, but in the end everybody was happy that the assignments were legally effected.

MR HARLEY:

Yes.

McGRATH J:

So those features, it seems to me, can't be the basis of a distinction.

MR HARLEY:

But an assignment of the futurity of income is fundamentally different from the sale of a business to a separate person, where the separate person, thereby, is constituted as the owner of the business and the deriver of the income.

McGRATH J:

Well, that's certainly a distinction in the facts, but I suppose what I'm wondering is whether there is a more general legal policy to be derived, whereby the Courts have taken in New Zealand – I know it's not necessarily the same in Canada and other places – but where New Zealand has taken a rather strict attitude to what the Act inherently permits once you're dealing with professional income created by individuals. And I'm confining myself very much to that area.

MR HARLEY:

As a matter of history, the propositions as you've articulated are right, and in response to them my answer is that the Act does not allocate a preference to one form of taxpayer and the nature of the income they derive over another, and so my proposition is that the sale of the business to the legal entity is the answer in terms of what are two separate but parallel universes within the Act, and MacKenzie J, for the

reasons he gave in respect of that part of his judgment, I say his reasoning is meticulous, accurate and correct, and you should endorse it.

McGRATH J:

Thank you.

ELIAS CJ:

Does that conclude your submission?

MR HARLEY:

I was going to respond briefly to Justice Blanchard in terms of *Peate v FCT* [1967] 1 AC 308 (PC). It will take me about three minutes.

ELIAS CJ:

We'll take the adjournment.

COURT ADJOURNS: 11.32 AM

COURT RESUMES: 11.52 AM

MR HARLEY:

Just before I get to *Peate*, if I could complete the answer that I should have given to Justice McGrath, I should have made the additional point, Sir, that the submission in response to the proposition that you put to me is that at the time Parliament realigned personal rates to 39% from the company rate at 33, it recognised the policy question with respect to personal services income and its attributes, and it chose to define and reflect that policy with reference to family companies in the way I've described as to the Personal Services Attribution Rules.

For the reasons that I have submitted, the concept that was recognised doesn't reach to these companies and these employees in respect of the facts of these circumstances.

McGRATH J:

Thank you.

MR HARLEY:

And that is really the first part of my response as to why *Peate's* case is immediately distinguishable from the present circumstances.

I'd go further in respect of *Peate*. I can't speak from personal experience because I wasn't particularly aware of the concepts in the mid-1950s of high graduated scale rates for individuals or for separate rates for company taxation, and I certainly didn't understand the difference between imputation and the classical double taxation of companies and their income. But *Peate's* case, in that historical context, is decided against that background, and we are now in – I suspect, Justice Tipping, you'll say you hate this word too – in a paradigm that is completely different. The shift in taxation policy in the mid-1960s in this country – in the mid-1980s in this country, is just profound in terms of its scope and effect. It's been lauded around the world by tax policy specialists and by the OECD because of its reflection of the economic principle of tax neutrality, so that practically any income, from any source, however and whoever derives it, should bear the same incidence of tax, and by so doing that the structure of our Act not only reflects the economic tax neutrality principle that economists espouse, but the basis for a large number of tax avoidance arrangements involving trusts, individuals, bailments, short-term leases of property, and so forth, is all swept away.

I have already referred to the fact that we revised completely the taxation of trusts regime at the same time, so that it was a very different regime from that pertaining in *Peate* in respect of the distribution of pre-tax income to beneficiaries.

And so for those reasons, I would submit that *Peate's* case is not in point and I am fortified in that submission by some observations that were made recently in an Australian context when introducing the newly published text *Tax Avoidance in Australia*, written by Justice Pagone, as he now is.

The foreword to the book concludes with these observations, "Justice Pagone, with his extensive knowledge of the theory and practice of revenue law, has produced in this book an invaluable analysis of Part 4A and its counterparts in other Australian tax laws. The difficulties of legislating on the problem of tax avoidance can never be resolved to complete satisfaction. The difference between a blatant, contrived and artificial scheme and prudent fiscal planning may be easy to recognise at the extremes but not at the margins. Yet the same applies to the difference between

night and day. Furthermore, what is explicable by reference to ordinary business or family dealings changes over time? How many Australians nowadays receive a medical bill that is not issued in the name of a corporate entity? Fifty years ago a doctor's bill that identified the creditor as a corporation would have borne the stamp of tax avoidance. Now it bears the stamp of wise superannuation planning. Parliament itself deliberately creates fiscal benefits to promote certain forms of business activity. The Act contains provisions designed to encourage taxpayers to act in a particular way. Responding to such encouragement, if that is all there is to it, is normal business planning." Those observations are from the author of Part 4A, former Chief Justice of the High Court, the Honourable Murray Gleeson, written in April 2010.

The other point I'd make in respect of *Peate's* case is that it is a *Newton* predication case, which is the context in which he says the world has shifted in the 50-year period. Those are the submissions that I wish to make, which now would get us to Justice MacKenzie's third part of his judgment, the use of the money, which, if it's acceptable to your Honours, I'd ask my junior, Miss Bibbey, to deal with.

ELIAS CJ:

Yes, thank you. Thank you, Mr Harley.

MS BIBBEY:

May it please your Honours. If I could ask your Honours to turn to the respondent's submissions on appeal, at page 27, paragraph 2.2 to 2.5, 12.2 to 12.5. I'm not asking your Honours to read this in any detail. What I am saying is that it's never been argued by us that the evidence exclusion rule is relevant in relation to the salary and cash flow decisions in each year.

The appellants' argument, in relation to the cash flow decisions in each year, relates to whether or not there is such a concept of an ambulatory tax avoidance arrangement and that issue has been dealt with in our oral submissions. It's also dealt with at paragraph 20 of the written submissions, so it's not something I want to dwell on here but I just want to point out that as far as the evidence exclusion rule is concerned, that isn't an issue for us. What is an issue for us, in relation to the evidence exclusion rule, is the Penny advances being classed as part of the tax avoidance arrangements.

It is accepted that the dividends that were paid to the trust, Mr Penny's trust I'll refer to it as, is part of the arrangement. It's also accepted that the loans were recorded in the accounts of both the – of the trust. So it's not asserted before the Court that those loans were not in evidence before the Court, they were. The statement of position listed the financial accounts of the trust as being evidence relied on by the Commissioner and those financial accounts recorded the advance to Mr Penny.

It's also accepted that the statement of position needs only – contained and outlined the facts in evidence, but if you read section 138 properly and in this regard can I refer your Honours to the bundle of authorities at tab 2, section 138G, section (1), subsection (a). The limitation there is that the Commissioner and the disputant can raise in the challenge only the facts and evidence and the issues arising from them.

The word "issues" isn't used in isolation. Rather, it's the issues arising from the identified facts and evidence. As I said, it's accepted that in evidence were Mr Penny's loans. The issue in this case, and in any case, identifies the basis of the disputable decision. The disputable decision in this case is whether or not there was a tax avoidance arrangement.

The Commissioner himself, in his submissions, says at paragraph 7.1 that, "The starting point, when applying section BG 1, is to identify the relevant arrangement." That starting point, in my submission, is a legal basis upon which the Commissioner takes his stand. This was identified in *Ben Nevis* and if I can refer your Honours to *Ben Nevis*, tab 5 at paragraph [154]. That's at page 341 of the judgment.

It's an important paragraph, and although your Honours were obviously, some of you were Judges in this case, I am going to read it to emphasise the point. At [154] it said that, "Therefore, limited scope for the introduction of new points as the dispute procedure proceeds through judicial system. NOPAs, NORs and SOPs are the equivalent of ordinary civil proceedings in the taxation field. Indeed because of the requirement to specify the legal basis upon which a party takes its stance, NOPAs, NORs and SOPs require a more precise legal articulation of a party's case than is conventional with ordinary civil proceedings."

If I can now refer your Honours to – I don't think I need to actually, the definition of arrangement in the Commissioner's statement of position. In the Commissioner's statement of position, the loans to Mr Penny are not recorded, they're not mentioned

at all. There's a very specific definition of arrangement for the purposes of the statement of position. The Commissioner alleged that that arrangement constituted a tax avoidance arrangement.

Justice MacKenzie in his judgment found that the loans weren't recorded by the Commissioner as being part of the arrangement, very specifically defined. He said this at paragraph [69] of the judgment. However, he didn't go on to decide whether or not the Commissioner was barred from raising this point in case the matter went any further. In any event, he attached little weight to the ultimate receipt, if it could be called that, of the funds by Mr Penny.

He said, at paragraph [68], in relation to the derivation of the practice income of the company and the choice of salary paid to the surgeon, they were the only factors relied on in support of the conclusion that this was a tax avoidance arrangement. Mr Goddard, in this Court, relies on a wider range of matters. The Commissioner, in the submissions in this Court, maintains that the Penny advances form part of the arrangement and, even if they do not, they are admissible to establish the artificiality and pretence involved in the low salaries paid to Mr Penny, and saying this was the approach taken in the Court of Appeal. That's at paragraph 12.1 of the Commissioner's submissions.

With respect, that might have been the approach that Justice Randerson said he was going to take in the Court of Appeal, but that's not the approach he took in fact. If I can refer your Honours to paragraph [82] of Justice Randerson's judgment. Justice Randerson said, "In his statement of position, the Commissioner did not rely on the loans to Mr Penny as constituting part of the arrangement, and there was no specific reference made to them." Going on, he said that, "While he accepted that some latitude maybe extended to the Commissioner or disputant, in terms of section 138G, as the Supreme Court noted in *Ben Nevis*, the disputes process is not a general enquiry into the taxpayer's liability to pay tax and the amount of that liability. The enquiry must be focused upon the terms of the dispute, as raised and responded to by the taxpayer."

So it was on that basis that Justice Randerson held the Commissioner was unable to rely on the loans as falling within the arrangement, given the very specific definition of arrangement and the relevant statement of position. So your Honour, at that point, identifies the answer to the question and that should have been the end of the

matter, as to whether or not the loans will be part of the arrangement. It clearly wasn't an issue arising from the facts as outlined in the Commissioner's statement of position. Justice Randerson then, however, went on to say that the loans being in evidence could be used to support the submission that the arrangement as defined was contrived or artificial. That was at paragraph [85]. However, notwithstanding all of this, later in his judgment, his Honour, in his conclusion, treats their loans as part of the arrangement. I am referring now to paragraph [113] of the judgment.

The Judge referred to two striking features of the arrangements adopted by the respondents. The first, he said, was reduced salaries in the company's structure, and those were discussed further by the Judge at paragraphs [114] to [117]. And he addressed another issue, that's the next issue. He didn't specifically say that this is the second issue, but it was the only other issue being addressed. This was where the company profits went.

In each – at paragraph [117], he said that in each case the surplus profits were transferred by way of dividend to the respective family trust as shareholders. This allowed the respondents to obtain the lower company tax rate while still enjoying the full benefit of the income of the companies for themselves, personally, and their families. He said this was particularly marked in Mr Penny's case because of the unsecured interest-free loans with no specific terms. And then he followed that up by saying that there can be no doubt that all these arrangements were achieved by the adoption of the company trust structures.

In my submission, the Commissioner still argues that the loans are part of the arrangement. In fact they're a major part of the four components of the Commissioner's current definition of the tax avoidance arrangement. It was used in the Court of Appeal as well. The Commissioner's current definition of the tax avoidance arrangement in this case is contained at paragraphs 7.4 and 7.5 of his submissions.

If your Honours turn to that at 7.5, the tax avoidance arrangement in respect of each income year for Mr Penny is made up of four parts. And the third part of it is in each year channelling profits of OSCL, being the company, to the trust, allowing Mr Penny to have access to such funds and to benefit from them without deriving funds as income. Mr Penny would access such funds mostly through loans charged without interest and with no fixed term of repayment. As I've outlined before, there's no

mention of the loans in the very specific definition of arrangement and Mr – the two statements of position issued by the Commissioner in relation to Mr Penny.

WILLIAM YOUNG J:

What about para 9.20 of the statement of position? Page 401 of the case, volume 3.

TIPPING J:

Nine point?

WILLIAM YOUNG J:

9.20. It's rather elliptical.

ELIAS CJ:

Sorry, what page was it?

WILLIAM YOUNG J:

Para 401. Page 401. Para 9.20, where it says "Although an artificially low salary was paid to the tax payer – was paid, to the tax payer, having control of the income of the company, he still got the use of the income of the company from other avenues, dividends to the family trust." Mustn't that – I know it doesn't say, "Which in turn were lent to him" but somehow or other that must be implied because he wouldn't otherwise have the benefit of the income.

MS BIBBEY:

Yes, and that's certainly something the Commissioner still raises as a reason for the loans being included in relation to the statement of position. My answer to that is that the plain meaning of that is to look to the potential benefits to Mr Penny or the same said actually in relation to Mr Hooper of being a beneficiary in a trust in which he has assets. This is a far cry from looking to transactions between the trust and Mr Penny.

WILLIAM YOUNG J:

How did he otherwise get the use of the income? The fact that it's paid to a trust doesn't give him, without more, the use of the income.

MS BIBBEY:

The, the long –

WILLIAM YOUNG J:

Something has to happen between him and the trust for him to get –

MS BIBBEY:

Yes, yes Sir. The loan –

BLANCHARD J:

Well, the significance is possibly the words that they used.

MS BIBBEY:

The loan is not a distribution of trust property. In an industry –

BLANCHARD J:

It's a use, it's a use of income. If there'd been a distribution to Mr Penny as a beneficiary, you wouldn't describe it as a use.

MS BIBBEY:

Well he did –

BLANCHARD J:

He would have then had it as his own.

MS BIBBEY:

Well he did require, describe it as a use in relation to Mr Hooper. The exact same comment in that paragraph is recorded in relation to Mr Hooper at page 292 in relation to one of the statements of position issued by, to Mr Hooper, at paragraph 9.20. So he's saying –

WILLIAM YOUNG J:

A bit of a template here, obviously.

MS BIBBEY:

So what's said in relation to Mr Hooper, that he's still got use of the income of the company from other avenues, dividends to the family trust. That's exactly what's said in relation to Mr Penny, referring to dividends paid to the family trust.

TIPPING J:

Ms Bibbey, there's one point that I need some help from you on. What is the difference between it being part of the arrangement on the one hand and not part of the arrangement on the other, but a consequence of the arrangement, on the other?

MS BIBBEY:

I think the difference is fundamental to the Commissioner's assessment. The Commissioner makes an assessment based on there being a tax-avoidance arrangement and defines that arrangement and as your Honours – as the decision in *Ben Nevis* identified, the identification of the issues gives the tax payer some understanding of what they're responding to.

TIPPING J:

But let's assume you're right, that it's not adequately pleaded as part of the arrangement but it's clearly sufficiently signalled to be prayed as a factor, as a consequence of the arrangement. I just have some difficulty in understanding where the two, how that actually helps your client in the end.

MS BIBBEY:

I have some difficulty with the proposition that it's significantly signalled as being part of the arrangement. On what basis –

TIPPING J:

Well that paragraph my brother Justice Young referred to said, it actually doesn't plead it as part of the arrangement. It pleads it as the outcome of the arrangement.

MS BIBBEY:

That the use that that provision, or that part of the statement of position, refers to heading, used to the money by virtue of the dividends to the family trust. But I – in my submission, they are very separate issues. A transaction between a trustee and a beneficiary of an industry loan is quite a different proposition from dividends to a family trust. It becomes a decision made as to what is enough to constitute, to put the tax payer on notice that the statement or that the Commissioner's assessment is based on a definition of –

TIPPING J:

He's still got the use of the income of the company from other avenues. Not a model of particularity, but still clear enough.

MS BIBBEY:

Well, with respect, Sir, from other avenues, coal and dividends to the family trust, it seems to me to be referring to the dividends to the family trust, not bringing in other transactions that are completely unrelated.

WILLIAM YOUNG J:

It's rather a technical point, isn't it?

MS BIBBEY:

It is a technical point, and it may not get to this level, and the Court would like to take an overall approach and consider the dispute in its round. However, if you go back to the aims and objectives of the disputes process as enacted, it was to enable the Commissioner and the taxpayer to lay their cards on the table at an early stage, for decisions to be made by taxpayers as to whether or not they would continue with the dispute and, as the Commissioner himself says, it's fundamental and a starting point in any tax avoidance case to identify the tax avoidance arrangement and if you look at the Commissioner's submissions in this Court and in Court of Appeal, where now the definition of arrangement is narrowed down to four aspects and one of those essential aspects is the loans, which were not referred to in the statement of position, and the statement of position is at the point in time at which the axe comes down, in terms of defining the dispute, and it's also the point in – ultimately, after adjudication, it's the basis upon which the assessment is made, and I know we don't have much time, but your Honours can take it from me that the adjudication report also made no mention of the loans and endorsed the definition of "arrangement" as taken from the statement of position.

TIPPING J:

Well, you would like us to view it not as part of the arrangement but as the result of the arrangement, is that the substance of the argument?

MS BIBBEY:

What I'm asking the Court to do is to –

TIPPING J:

You're not asking us to ignore it altogether?

MS BIBBEY:

I am asking the Court to ignore it altogether. The Court is considering the basis of the Commissioner's assessment. Now, the loans did not play any part in the basis of the Commissioner's assessment and, in this regard, where it is asserted by the Commissioner that the loans were only uncovered for the first time in the discovery process, that is wrong. The loans –

WILLIAM YOUNG J:

Does the Commissioner say that?

MS BIBBEY:

Yes, the Commissioner does say that in submission.

WILLIAM YOUNG J:

I thought the Commissioner was simply saying that, because it came out in discovery and there's a general incorporation of basically everything else we've forgotten to mention in the SOP, they can rely on it. I'm look at para 12.9 of the respondent's submissions.

MS BIBBEY:

Sir, I disagree with that because the evidence in respect of the loans wasn't obtained due to the discovery, the Commissioner had that evidence because the Commissioner had the financial accounts of the trust.

WILLIAM YOUNG J:

But was – I know that, but was there not discovery?

MS BIBBEY:

Yes, there was, but –

WILLIAM YOUNG J:

And were the loans not re-disclosed on discovery?

MS BIBBEY:

But that's not obtained, that's, I mean, we only notice them, if you – so you would say that the evidence in respect of the loans to Mr Penny was only noticed by the Commissioner in discovery.

WILLIAM YOUNG J:

I don't think that's what Mr Goddard's saying there.

MS BIBBEY:

Well, the – it's incorrect to say the evidence in respect of the loans was obtained through discovery. The Commissioner had the, was aware of and had evidence of the loans prior to the statement of position stage, from the financial accounts of the trust.

WILLIAM YOUNG J:

Yes, I understand that, I really do.

MS BIBBEY:

Yes. So what – it is, I think it's incorrect to say they were obtained through discovery.

TIPPING J:

Do you mean, they were already known?

MS BIBBEY:

They were already known, they were specifically listed as evidence relied on by the Commissioner in the Commissioner's statement of position and, if it assists your Honours, I could take you to that page.

TIPPING J:

No, I accept that from you.

MS BIBBEY:

Thank you.

TIPPING J:

If it's not accepted on the other side you may, or Mr Harley may, have to come back to it, if the point is of any moment.

WILLIAM YOUNG J:

It's pretty general. I mean, at page 388 the Commissioner refers to "All other relevant financial informant."

MS BIBBEY:

Sir, but that's only in relation to the evidence. He doesn't have to refer to all the other financial information, because the evidence of the loans is already in there.

TIPPING J:

I can understand your point, that if it's not pleaded as part of the arrangement, it cannot be –

MS BIBBEY:

Yes, Sir.

TIPPING J:

– taken as, but what I am having more difficulty with is that it can't be referred to at all.

MS BIBBEY:

Yes, it's not an issue arising from the facts.

ELIAS CJ:

Well, the fact of receiving the use is referred to. Why is that not sufficient?

MS BIBBEY:

We may vary in our approach there to our reading of paragraph 9.20, where my reading is that the "use" in this case was referred to as a dividend for the family trust, not any other use of the money, and that is consistent with the definition of "arrangement" in the statement of position as earlier defined by the Commissioner.

ELIAS CJ:

But it doesn't really go far enough, because it doesn't describe how the use comes to the taxpayer, so…

MS BIBBEY:

Yes.

ELIAS CJ:

But the gravamen of it is the allegation of use, isn't it?

MS BIBBEY:

In my submission, paragraph 9.20 has to be ready in the light of the definition of "arrangement" as already defined earlier on in that statement of position, where all the Commissioner refers to are the dividends to the family trust.

ELIAS CJ:

Sorry, which other paragraph are you referring to, the earlier one?

MS BIBBEY:

The paragraph in terms of the definition of "arrangement" that I'm referring to is page 395, where it describes the distribution by the company of net dividends to the shareholder, the AC Penny Trust, the receipt of those dividends by the trustees, and also records that the AC Penny Trust made no distribution to the beneficiaries.

WILLIAM YOUNG J:

Well, then, how could he have the use of it, other than by loans? How could that proposition at 920 be accurate –

MS BIBBEY:

Sorry, how could the –

WILLIAM YOUNG J:

– and we know it is accurate, unless it's a reference to the loan?

MS BIBBEY:

It's a – well, it's a standard paragraph that the Commissioners used in both statements of position –

WILLIAM YOUNG J:

Well, he got in wrong in the case of Mr Hooper, but why should we say that he's got it wrong here too?

MS BIBBEY:

Well, how's he got it wrong in relation –

WILLIAM YOUNG J:

Because Mr Hooper didn't, he didn't get loans.

MS BIBBEY:

No, but he never asserted in relation to Mr Hooper that he did get loans. The concern for Mr Hooper was that Mr Hooper had access to the trust funds, and in this regard, I'm only just going to note this in passing, one of the issues for Mr Hooper was that the trust concerned was established in 1991 and, at that time, income-producing assets were transferred into Mr Hooper's trust, yes, so, as was his house, and one of the issues for Mr Hooper, as identified by the Commissioner, when we refer to Mr Hooper's use of the funds flowing through from the dividends paid to the trust, was that he did get use of the trust's assets, but no attempt is made by the Commissioner there to decide what part of the trust assets were attributable to the earlier transfer of income-producing assets to the trust or the earlier distribution of his house to the trust. I only say that in passing because that's not relevant to evidence, the evidence exclusion for Mr Penny, but that is, it shows in relation to Mr Hooper there is some consistency, the dividends to the family trust increase the assets of the trust and the trust was able to make decisions in terms of purchases, although some of those purchases were obviously made a long time before the business was transferred.

BLANCHARD J:

We're still, surely, able to look at what use was made by the trust of the income that it received, and the use in Mr Penny's case was to lend it to Mr Penny.

MS BIBBEY:

That's an interpretation of – but if you say, "well, we're still entitled to look at the use", isn't that just widening the arrangement or calling it part of the arrangement?

BLANCHARD J:

No, it's widening, it's not necessarily widening the arrangement. The arrangement came to an end at a point where the trustees received the money, but we're entitled to look at the use that they made of it, even if that isn't part of the arrangement.

TIPPING J:

It's part of the effect of the arrangement, perhaps.

BLANCHARD J:

It's part of what would be said by the Commissioner to be the artifice of the arrangement.

MS BIBBEY:

Yes, and that brings me to the written submissions where, at paragraph 7, I say, "As the loans were not part of the arrangement, their nature for the proceedings, artificial, contrived or otherwise, is irrelevant." And I say that the established law is that the element, it's the elements of the arrangement which the courts look to to determine whether or not an arrangement is tax avoidance, is a tax avoidance arrangement. Now, it's those elements that may be contrived or artificial and, in my submission, that's such an obvious position that the cases merely adopt this approach without the need to specifically say they're doing so, and I refer to the *Ben Nevis* majority judgment, when they refer in a number of instances to "arrangements", and I'm not going to take your Honours to each particular reference. They are referenced in the footnotes. But a couple of extracts from *Ben Nevis*, we have arrangements defined as being applicable to arrangements of a contrived or artificial kind, whether an arrangement is an artifice or involves pretence will often be highly relevant to whether or not there is an arrangement that has a purpose of tax avoidance, the component funds arrangement viewed in a commercially and economically realistic way.

The Commissioner says he's also entitled to rely on the benefit to Mr Penny personally as a response to the proposition advanced by Mr Penny that the trust was for the purpose of asset protection yet the advances mean that if Mr Penny was bankrupted, an asset of the trust was lost. And this comes into your Honours' point about it's not part of the arrangement but we can still consider it because it might be artificial and there might be artifice involved. The answer to this is that this view is again hindsight-based and the Commissioner's scorn for Mr Penny's use of trust advances as being in conflict with his asset protection purposes is misplaced and not a fair reflection of the evidence.

In this regard, it's not, it's well established that Mr Penny's company and trust were set up in 1997 when he was married with a young family. Mr Penny acknowledged in cross-examination that if it wasn't for the breakdown of his marriage and lump sum payments to his wife, there would have been no need for him to have been in debt to the trust and the relationship property case for Mr Penny is in the authorities at tab 29. I don't need to take you there. What I can tell you is that it records that as a

result of the 2003 judgment, Mr Penny had to pay his former wife the sum of $1,431,000, and that is at paragraph 14, page 1 of the judgment. That amount was increased by $138,000 in the 2005 Court judgment. Also, the unpaid balance, as at December 2003, of $660,000 bore interest at 6% as at March 2005.

Going to the point raised earlier, just touching on it briefly in relation to the evidence in respect of the loans being obtained through discovery, and as I've said earlier that's not true. What's also relevant in terms of the Commissioner's assertion as to artificiality and pretence is that the Commissioner asserts at paragraph 2.1.6 of his submission that the loans from Mr Penny were undocumented. That's clearly not correct, the financial accounts of the company refer to the advance of Mr Penny in the relevant years as current assets in the trust. This again is another point relevant to the alleged artifice or contrivance if you can say the loans are brought in to be considered on that basis.

In summary, Justice Randerson with –

ELIAS CJ:

Sorry, the terms of the loans are not recorded.

MS BIBBEY:

The terms of the loans aren't recorded and I think –

ELIAS CJ:

So you're saying they're documented because they're shown in the –

MS BIBBEY:

The trust books of accounts.

ELIAS CJ:

In the trust books.

MS BIBBEY:

In my submission, that would be commonplace in relation to many family trusts.

ELIAS CJ:

I wonder whether that's –

TIPPING J:

Wouldn't there be a trustee's resolution and terms? Anyway, I think we're really –

MS BIBBEY:

Sir, yes that was an issue, that was an issue that –

TIPPING J:

Anyway, we're miles away from the crunch of this case.

MS BIBBEY:

Yes. That was an issue that Justice MacKenzie looked at. He had no difficulty with the document, the loans being real loans giving rise to real obligations.

TIPPING J:

I don't think, I think we're very, very peripheral here.

MS BIBBEY:

Yes we are. So in summary, Justice Randerson with Ellen France concurring was right to conclude that the loans to Mr Penny were not specified in the Commissioner's statement of position as part of the tax avoidance arrangement as defined, and on that basis it's respectfully submitted that Justice Randerson was wrong to use the loans to Mr Penny as being part of the arrangement considered.

ELIAS CJ:

Thank you Ms Bibbey. Yes, Mr Goddard?

MR GODDARD QC:

Your Honour. With a view to keeping myself to a logical structure and to signposting where I am, I've prepared a two-page road map of my submissions for the Court, if I could hand that up through Madam Registrar. And much of this I'm going to cover very briefly.

I will begin in section 2 of the written submissions for the Commissioner. The central issue is obviously the finding that this was a tax avoidance arrangement, the Commissioner says that the Court and majority of the Court of Appeal was right to find that it was tax avoidance within the meaning of section BG 1, for each appellant put in place arrangements involving the use, and I stress the use, of a family trust

and company structure in itself obviously not objectionable, the mere adoption of that structure, but the use of the structure, pursuant to which in each relevant year the surgeon continued to conduct his practice on a day-to-day basis in exactly the same manner as if he remained a sole practitioner.

He had full control, he was on both sides of this not particularly difficult negotiation in relation to salary. He reserved full control of the salary that he was paid by the family company in that year and decided in each year to set that salary at a level very substantially below the practice income for that year and very substantially below a commercial or market salary. I'll come back to whether those are different concepts of the work performed without, to pick up your Honour Justice Tipping's point, any objective commercial reason for doing so. The doctors were cross-examined about whether they needed to make any large capital investments or have any particular calls on funds within the practice and the answer was no in both cases. So no objective commercial reason for doing so.

Third, the bulk of the practice income was retained as income of the company and paid as dividends to the family trust, and fourth, and there's no dispute about this, the result was the portion of the practice income that was retained by the company was taxed at the marginal rate of 33% rather than the doctor's personal marginal rate of 39% and that, in turn, reduced the total tax payable in respect of the practice income by 10s of thousands of dollars in each year – about $65,000 for Mr Hooper over the three years in question and about $103,000 for Mr Penny over those three years.

At the same time, each retained effective control of the entire practice income, including the portion treated as company income and paid to the family trust, and that income was applied for the same personal and family purposes that one would expect a professional's personal income to be used for, for the same purposes that one uses one's personal income for. And again in Mr Penny's case, personally receiving from the company in terms of cash flow, he, as Mr Lyne said in his evidence, effectively used the company account as if it was his own and from the trust as undocumented, the terms undocumented as your Honour clarified, zero-interest loans in terms of bookkeeping, all or most of the funds generated by the practice and again applied those for personal and family expenditure.

Now the striking thing here is that for most people, and many judges know this, a reduction in income of around 80% would be a painful experience, but the reduction

in income experienced by the appellants was not a concern for them. They didn't go home and say, "Oh dear, my income is 20% of what it was yesterday" because the reduction in their income wasn't real. It was an artifice, it was a pretence. The full practice income was still controlled by them and was still available to be used for the benefit of themselves and their families, with the added advantage of a tax saving. Critically, the case of the Commissioner is that it's not open to a professional, it is not a choice offered by the Act, it is not within the contemplation of Parliament, for a professional, or other self-employed person, to choose how much of his or her practice income will be taxed at the currently applicable marginal tax rate, while still retaining the full benefit of the whole of the practice income for themselves and their families. The general anti-avoidance rule prevents the use of uncommercial, artificial, contrived arrangements to reduce or eliminate the application of the marginal tax rate.

The appellants have founded their case on a criticism of the commercially realistic salary concept. That attacks a straw man. The Commissioner is not arguing that the Act requires every family company to pay its working director a market salary in each year. A range of factors will be relevant to – will properly influence a decision about what to pay. The Commissioner's case, in respect of these two taxpayers, is founded on the uncommercial and artificial nature of the arrangement seen as a whole, and it's those uncommercial and artificial features of the arrangements, including each appellant deciding to pay himself a commercially silly, to quote from the evidence, salary, while still maintaining control over the whole of his practice income and deriving a benefit from the practice income, which support a finding of tax avoidance.

This is not a groundbreaking case, that's my next point, 2.5. There are numerous cases where similar income-splitting transactions have been held to be tax avoidance and it just can't matter whether what's interposed between the practice income, or the farm income, or the insurance broker income, and the taxpayer is a company or a trust, family trust, or a unit trust. There are numerous cases where similar income-splitting transactions with a person interposed and a low salary being paid to the person whose efforts result in the income being generated –

TIPPING J:

Should it matter whether it's an assignment or a transfer, using a neutral word "transfer", of another kind?

MR GODDARD QC:

No, not under BG 1, and that's why, and I'll come to this later, his Honour Justice McGrath is exactly right to say that one identifies the basic architecture of the Act, which in the case of the New Zealand Income Tax Act includes the graduated scale, and then ask whether the arrangement seen as a whole produces a result inconsistent with what Parliament would have contemplated as the application of that scale. Of course, the particular technique used by the taxpayer, or the taxpayer's sophisticated advisors, to product that can't matter. The question is whether the result that is produced, by means of one tool or another, is inconsistent with what Parliament contemplated.

McGRATH J:

Do you confine that argument to income of this kind, the income that's created, professional services, personal exertion, as opposed to other types of business income?

MR GODDARD QC:

It's necessarily a proposition that relates to the income of natural persons, to which the graduated rate scale applies, but it's no more confined than that.

ELIAS CJ:

So the inventor, Mr Harley I think was talking about a Bill Gates and start-up mode, or something like that, it's just the individual?

MR GODDARD QC:

One looks at the nature of the arrangement between that individual and the entity for which they are working and asks whether it's a genuine commercial arrangement which allocates the benefit of those endeavours in a particular way, and if there's an employment arrangement, which is commonly the case, provides for the employer to retain what the employee generates and that's a genuine commercial in advance arrangement, certain results would drop out of that, but that's not this case and it's because one has to look at the whole arrangement and the relationships between the parties and the way in which it's given effect.

As this Court said in *Ben Nevis*, one ends up concluding that overall this particular approach is contrived and artificial and produces a result inconsistent with what Parliament contemplated.

McGRATH J:

On what you're saying, unearned income, investment income, if derived personally would be covered, as opposed to earned income, in the sense that I was trying to do it. I just question, is that what you mean?

MR GODDARD QC:

At the level of generality at which your Honour asked me, which is what is the scheme of the legislation, I think the answer is that the scheme is the same for both earned and unearned income of both. I think the case for saying that Parliament can't have contemplated this sort of diversion of earned income is especially strong, for the reasons that Justice Richardson explores in *Hadlee*, and I think that might be what your Honour has in mind –

McGRATH J:

My impression, and it may well be wrong, was that Justice Richardson was confining it to earned income, he saw special characteristics in earned income, particularly professional income.

MR GODDARD QC:

Which make the case very clear and so, for example, I don't think that his Honour had in mind the sort of situation raised in a question by his Honour Justice Young, of the gift of shares or bonds, or it might have been raised by my learned friend in response to a question I think. If one genuinely gives away to a family member some shares which produce a dividend stream in the future, then that would not be tax avoidance because you have genuinely substantively parted with the asset and the use that the person makes of it – whether they sell those shares, whether they retain them, derive the dividends and then account for them – is entirely up to them.

What I want to be careful about is narrowing the very general proposition I'm making about the architecture of the Act, because one could imagine a different result being arrived at if, for example, I were to give a large block of shares to my infant child, transfer them into their name but continue to control the income and apply it in exactly the same way as before, that is a question that one would then have to ask, is that consistent with what Parliament contemplated, and I don't want to exclude the possibility of that enquiry.

McGRATH J:

All right, if that's the way you want to put it. I mean, I can understand that, it may be as we go on we might want to come back and explore it further.

MR GODDARD QC:

This case can be dealt with on a narrower compass because we are concerned with income which was, before the formation of these companies, practice income of a self-employed professional and the indications in the Act –

TIPPING J:

You can't detach from yourself as an individual your income-earning capacity, whereas you can detach from yourself as an individual the ownership of capital that produces income.

MR GODDARD QC:

Yes, and that's why the arrangements are most likely to seem artificial and contrived because the detachment isn't real.

TIPPING J:

Well it may not be real. It will depend, as you yourself accept.

MR GODDARD QC:

Yes, your Honour's exactly right.

TIPPING J:

Yes, yes.

WILLIAM YOUNG J:

Well, if the shareholders in the companies were entirely unrelated to Messrs Hooper and Penny and had complete control over the surplus income, well then it would be real.

MR GODDARD QC:

Yes.

WILLIAM YOUNG J:

But they wouldn't have done it.

MR GODDARD QC:

Yes, I did cross-examine both of them to see whether they would come to work for Goddard Orthopaedics Limited on similar terms, because I thought I might have stumbled across a retirement plan, but both, in the course of cross-examination, spurned that offer.

WILLIAM YOUNG J:

So effectively this gets to the point that was – was it picked up in *Peterson* and some of the English cases, and I think in *Ben Nevis*, that there's a black-letter transfer but the economic consequences are not in accordance with what one would expect of such a transfer.

MR GODDARD QC:

That's exactly right, and that links back into what I said at my 2.2, that for most people a reduction in income of this magnitude would be a significant adverse event but for them it wasn't because the economic consequences were not the economic consequences that the rest of us would face.

One of Mr Shewan's examples, I think it's certainly one of my learned friend's examples, was willingness to work for a charity at a salary well below market. If one agrees to work for a charity at a salary well below what one could command in the market, and the charity retains the benefit of those endeavours, including billing for some of the services provided, then that's exactly what your Honour hypothesised a moment ago, it's a genuine foregoing of the economic benefit of the surplus generated over and above the salary, the consequences are genuine and the tax consequences will follow. But here there's a mismatch between the form and the underlying economic reality.

The other issues that arise on this appeal, the scope of the arrangements and the admissibility issues, won't detain, I won't detain the Court with long – my learned friend, Mr Ebersohn, will deal with the section 138G issue later.

I'm not going to spend time on the facts, except to respond to my learned friend's oral submission about paragraph 3.6, the last sentence, which my learned friend suggested was misleading, that there's never been any suggestion that fee income was generated by the provision of separate services by any other employee. It's clear from the evidence and has, I think, been common ground throughout, that the

other staff provided support for the provision of services by the surgeons. There's no evidence of independent generation of fee income, and that's the point that's meant by the "separate services" there. But secondly, and perhaps more importantly – and this is 2.2 of my little note – the role of the other staff did not change from the sole trader context. So, just in the same way that they had provided support to the surgeon when conducting practice as a sole trader, so they continued to do so through the vehicle of the company. And this was an argument run in *Hadlee*, and I'll take the Court to it when I go through that case, but the Chief Justice there did not see the generation of significant income from leverage within an accounting practice as having any bearing on that question of whether that was income of the kind to which, which was generated through the professional services, the personal services of the partners.

Turning then to the relevant principles. These are dealt with in sections 4 and 5 of the submissions. I'm not going to go through those, I just want to take the Court to a few passages that I think are particularly helpful in *Challenge, Ben Nevis* and *Glenharrow. Challenge* is in volume 1 of the authorities under tab 7, and we can pass over the High Court decision and turn to page 530, where the judgment of the President begins. And after outlining the facts and the origin of section 99 and referring to his Honour's own earlier decision at first instance, in *Elmiger & Anor v Commissioner of Inland Revenue* [1966] NZLR 683 (HC), his Honour turns at 532 to consider the facts of that case in the light of section 99. The third line says, "Unnecessary to dwell on the direct implications of para B, the incidental effect. On the facts of this case, a share purchase arrangement cannot be regard in any way as falling within that paragraph. Here, the sole and only purpose of the arrangement was achieve a tax saving," and so his Honour proceeded to test the issue against paragraph A and made the point that if the matter was considered for the moment without reference to any countervailing influence claimed for the income grouping provisions of section 191, it would be difficult to find a more obvious example of a subsection 2(a) tax avoidance arrangement.

And this really links back to a question of your Honour Justice Young's earlier about, earlier, to my learned friend, "Can we move straight to the application of BG 1 in the absence of a provision pointing in another direction?" and I'll come back to that because I think that's a very important question and it's one which Justice Woodhouse touches on there, says, "So, if there wasn't this countervailing influence claimed for the income grouping provisions of 191, it would be difficult to

find a more obvious example," goes on to consider, his Honour goes on to consider, "Merely incidental purpose or effect," identifies the criticism levelled at section 99 that, "On its face, the language is so encompassing when read literally that major qualifications must be read into it if various deduction and other provisions of the Act are to be left effective," and that was very much what Justice Richardson was saying in the passage to which my learned friend took the Court, "Cannot have been the purpose of the legislature," so it's said "to import into the Income Tax Act a general provision so spacious in operation that other sections would be virtually impotent," and some examples of particular deductions were given. At line 37, "If section 99 really carried such sweeping implications, one might be affected by these arguments but I do not think the section does, and for reasons in part related to the words of subsection 2(b), which excuse a merely incidental tax avoidance purpose, I think the level of anxiety is unwarranted. But, be that as it may, section 99, obviously a central pillar of the income tax legislation" – just pausing there – as this Court noted, in *Ben Nevis* the interpretation of the Act is required, of the current Act, is required to be guided, among other things, by the core provisions, and the core provisions include s BG 1.

So we now have formal confirmation that BG 1 is a central pillar, by its identification in the Act as a core provision. "And a reflection of the firm and understandable conclusion of Parliament that there must be a weapon able to thwart technically correct but contrived transactions set up as a means of exploiting the Act for tax advantages," and his Honour then refers to *Elmiger* and the discussion of section 108 in that case, the United States authority saying that taxes, according to a legislative plan, raised funds to carry on government, "The purpose here is to tax earnings and profits, less expenses and losses. If one or the other factor in any calculation is unreal, it distorts the liability of the particular taxpayer to the detriment of the entire taxpaying group," and that theme of obtaining a tax advantage at the expense of others similarly situated is one that recurs throughout challenges and important to the Privy Council, and it's one which I will come back to at a number of points in these submissions, because it really goes to the heart of the purpose of section 99.

So, in continuing the *Elmiger* quote, where Justice Woodhouse said, "In my opinion, the broad purpose of section 108 and the equivalent Australian section are to be discerned in problems of this sort. I think these provisions are intended to forestall deliberate attempts by individuals to obtain tax advantages denied generally to the same class of taxpayer," very much the theme of the Privy Council, as we'll see in a

moment. And his Honour went on to say, “the legislature’s attempt to anticipate these manoeuvres is not surprising, nor can it be thought unfair to those affected if the method adopted by the legislature should be, as in the case of these sections, the method of general proscription. If there seem to be difficulties in this last area, they should be related not to anticipated injustices to the body of taxpayers but to the problem of discovering the intended limits of any general embargo. This is, of course, a problem of definition and one which is peculiarly complicated by the fact that nearly all dispositions of property or income carry with them some consequential effect upon income tax liabilities.”

McGRATH J:

Does it really help to bear in mind that the anti-avoidance provision is intended to forestall attempts to obtain advantages denied generally to the same class of taxpayers, when you sometimes have legislation that allows just that?

MR GODDARD QC:

And that, I think, takes one back to the Parliamentary contemplation test and whether the particular provision was contemplated by Parliament as providing the opportunity to obtain that sort of advantage to that class of taxpayer.

McGRATH J:

Now I’m with you.

MR GODDARD QC:

Yes.

McGRATH J:

But I think it is an important –

MR GODDARD QC:

It is.

McGRATH J:

– thing to remember, when you're looking at these general comments.

MR GODDARD QC:

There are provisions in the Act which specifically offer a tax advantage, perhaps as an incentive to engage in particular forms of behaviour, incentives for petroleum exploration or the farming of goats or whatever it is that Parliament might want to encourage at a particular stage. Responding to those incentives in a way that is neither artificial nor contrived, and that is the very thing that Parliament intended to encourage, is not tax avoidance, but seeking to deploy provisions of that kind or use them in a way which would not have been within Parliamentary contemplation is, and it's drawing that line that lies at the heart of this exercise.

ELIAS CJ:

Mr Goddard, do you want –

MR GODDARD QC:

It's one, your Honour, yes.

ELIAS CJ:

Is that all right?

MR GODDARD QC:

Absolutely.

ELIAS CJ:

Yes, we'll take the adjournment and we'll resume at 10.00 tomorrow. You think we're on track?

MR GODDARD QC:

Absolutely. We have the whole of tomorrow, I think, your Honour?

ELIAS CJ:

Yes.

MR GODDARD QC:

Well on track. I will – we will finish, I think, in the course the morning, very comfortably, so there'll be plenty of time for a reply.

COURT ADJOURNS: 1.00 PM

COURT RESUMES ON WEDNESDAY 29 JUNE 2011 AT 10.01 AM

MR GODDARD QC:

Your Honours. I was looking at the relevant principles, section 3 of my little road map, and I was just going to go to a couple more pages, very quickly, of *Challenge*, which is in volume 1 of the authorities, under tab 7. I had begun looking at a couple of passages in the judgment of the President which began at page 530, and I just want to draw attention to a couple more paragraphs on page 533 and then move on to the rest of the judgment.

The Court will remember that at the foot of 532 and over to 533, his Honour was referring to the judgment in *Elmiger*, one of the very early income-splitting cases in New Zealand that his Honour heard at first instance, and I'll go to that later.

His Honour was then looking at the scheme of, then section 99, noting at line 14 and following that there are some problems of definition, but his Honour said, "At least to the extent the language is clear. It must not be read down simply because its broad purposes might seem to inhibit some other provisions. In approaching the issue that way, it must be kept in mind the section is concerned not with outright impropriety but with finding a line between what is acceptable and so unaffected by it, and what is undeserving and so for tax purposes made void."

Then, down at line 44, his Honour considers the phrase "merely incidental" and adopts an approach to it which enables it to do a lot of the work that some other judges have, I think, suggested needs to be done by reading down s 99, and what his Honour said was that the phrase "merely incidental purpose or effect", in the context of s 99, points to something which is necessarily linked and without contrivance, to some other purpose or effect so that it can be regarded as a natural concomitant, and then his Honour goes on to consider the level of attention that can be and is ordinarily paid to tax, as a concomitant of different commercial choices rather than being a driver of the transaction in question.

Coming over to 535, at the top of the page, his Honour summarises his analysis at that point and says, "When construing section 99 and the qualifying implications of the reference in subsection (2)(b) to incidental purpose, I think the questions which arise need to be framed in terms of the degree of economic reality associated with the given transaction in contrast to artificially or contrivance or what maybe described

as the extent to which it appears to involve exploitation of the statute on indirect pursuit of tax benefits." I think there's a direct lineage really from that passage through to this Court's analysis in *Ben Nevis.*

His Honour goes on to distinguish between "the prudent attention on the one hand that can always be given sensibly and quite properly to the tax implications likely to arise from a course of action when deciding whether or not to pursue it, and its pursuit on the other hand simply to achieve a manufactured tax advantage."

His Honour then turns to an issue which was central to *Challenge*. The issue on which the Court of Appeal divided and on which ultimately it was reversed by the Privy Council, and an issue which has a close parallel here, which is the significance of s 191 and the express anti-avoidance provision in s 191 in relation to temporary transfers of ownership of a company.

After setting out section 191 and identifying the argument for *Challenge* at 537, line 13 and following, where it was suggested that section 99 can't be used to defeat other provisions such as section 191 or to prevent a result which any of them contemplate, his Honour turns, at 539, to address that argument. This begins at line 19, reference to the words of 191(1)(c)(i) which are concerned with "the situation where the proportions of shareholdings which bring companies into association are of a temporary nature." Then at line 33, "Counsel submitted in effect that para (c)(i) is a particular provision designed as the comprehensive answer to tax avoidance for the purposes of section 191," and, of course, that has its echo in my learned friend's submissions at paragraph 66, where he says, "Here Parliament has exercised his powers prescriptively and completely in relationship to the PSA Rules." So it's essentially the same argument.

"Designed as the comprehensive answer to tax avoidance for the purpose of section 191 to the exclusion of the wider and general terms of section 99. If this were not so," it was said, "then section 99 would defeat the very specific terms of the paragraph because the italicised words *of a temporary nature* would be rendered otiose," and again, the parallel here is my learned friend's submission that the asset threshold and the 80% income threshold would be rendered otiose in the PSA Rules if s BG 1 were to be able to apply where those criteria are not met.

At 41, "For a number of reasons I'm unable to accept these arguments. First, it would be quite extraordinary I think for the draftsman to carefully prevent a tax

advantage because the shareholding was of a temporary nature and yet consciously decide that Parliament would wish to give its blessing and then only by implication," as here, "to a manufactured and barely tangible association of the kind under review. Considered in terms of commercial animation, Perth was lifeless on arrival."

Next sentence, "I think it far more likely that after drawing express attention to the obvious tax avoidance implications that could arise from shareholders of a temporary nature he decided that all other tax avoidance situations should properly be left for attention by section 99." After looking at the expressio unius principle, over the page at 540 we have, "This leads to the second point. Paragraph (c)(i) could be construed as filling the avoidance field in so far as section 191 is concerned only on the basis that the much wider provisions of section 99 were excluded by an implication," and that's really, again, what my friend's arguing here. "I do not think such an important gloss can be read into the paragraph and against the plain language of section 99 recognised by counsel, as already mentioned, as a central pillar of the income tax legislation." Now, of course, as a core provision. "Finally, it needs to be remembered when construing section 99 beside section 191 that section 191 does not open with such words as 'Notwithstanding the provisions of section 99...'. If Parliament had intended that section 191 should stand quite independently of and unaffected by the earlier section it would have been a simple matter to say so in express terms."

So, at line 28, "For the foregoing reasons I think that section 99 is of general application, that section 191 is subordinate to it and that it is intended to operate as a kind of proviso to other provisions of the Act wherever the issue of tax avoidance may seem to have relevance." So his Honour considers the appeal should be allowed. Justice Cooke considered that s 191 filled the field, as did Justice Richardson and my learned friend has taken the Court to that.

If we turn over to the advice of the Privy Council, which was delivered by Lord Templeman for the majority, beginning at 556. The relationship between section 99 and section 191 grouping of losses was at the forefront obviously of the appeal. The few passages I want to take the Court to really begin at 558, line 33. Section 191 was intended to give effect to the reality of group profits and losses, and then the absence of reality of the loss in that case is discussed. At the foot of the page, "Stripped of pretence, one taxpayer, Challenge, was purchasing the tax benefit of a loss sustained by another taxpayer, Perth. If successful, Challenge would obtain a tax advantage of $2.85 million by means of an arrangement and the benefit of

that tax advantage would then be divided between Challenge and Merbank. A clearer case for the application of section 99 cannot be imagined. If such an arrangement were not caught by section 99 and were recognised by the Courts for tax purposes, income tax would only be collected from those profitable companies which failed to come to terms with loss making companies."

And here too the consequence of my learned friend's argument is that income tax at the top marginal rate would only be collected from those professionals and self-employed people who failed to take the elementary steps of setting up the sort of structure that the taxpayers, in this case, set up and used.

"The response of Challenge to this analysis is threefold." First, the suggestion that section 191, "confers a specific exemption," and it's said at line 10, "Section 99 does not apply where the conditions specified in section 191 are satisfied. That argument cannot be correct," the famous passage, "Tax avoidance schemes largely depend on the exploitation of one or more exemptions or reliefs or provisions or principles of tax legislation. Section 99 would be useless if a mechanical and meticulous compliance with some other section of the Act were sufficient to oust section 99." Here ensuring that the specific criteria in the PSA Rules are not met.

Then, "Secondly, Challenge say that section 191 contains its own particular tax avoidance provision and by necessary implication excludes the general anti-tax avoidance provisions of section 99. The provisions of s 191(1)(c)(i) enabled the Commissioner to disregard any temporary alteration in the shareholding or constitution of a company where the purpose or the effect of the alteration is tax avoidance. Therefore, it is said, Parliament must have intended that section 99 should not apply to a group of companies seeking to operate section 191. Parliament must have intended that any permanent form of tax avoidance or any other form of tax avoidance except the particular form proscribed by s 191(1)(c)(i) should be permitted to succeed." Pretty much my learned friend's argument here.

"In the opinion of the Board this argument attributes to Parliament a benevolent attitude towards tax avoidance by companies which is unlikely and unnecessary." And, critically, the next passage, "A likely explanation is that Parliament was indifferent to or unmindful of any overlap between the general provisions of section 99 and the particular provisions of section 191(1)(c)(i) or that, in view of the well-known difficulties encountered in the formulation and enforcement of effective anti-

tax avoidance provisions, Parliament thought that an overlap might be useful and could not be harmful."

A couple of different tax avoidance positions are discussed, and at line 40, "The possibility that such manipulation might also be frustrated by the operation of section 99 does not lead to the conclusion that Parliament must have intended to permit permanent tax avoidance schemes to exploit section 191. The provisions of section 99 are of general application and, in the absence of an express direction by Parliament excluding s 191 from the ambit of s 99, their Lordships consider that s 99 must be applied in the present circumstances."

And again that theme continues over the page at 560, line 23, "There was at no time any pressing need to prevent an overlap of general and specific anti-tax avoidance measures. It was better to be safe than sorry. An overlap between s 99 and s 191 cannot be unfair to the tax avoider but a construction of s 191 which silently repeals s 99 would be unfair to the general body of taxpayers." And then their Lordships agreed with the observation of the President below, to which I took the Court a moment ago.

And then the third argument deployed, perhaps I shouldn't use that word, by Challenge, and also in support of the second argument, is to consider line 35 and following, the argument that, "Commercial transactions and family arrangements would be fraught with uncertain, capricious or harsh fiscal consequences and will be vulnerable to action by the Commissioner," if the appeal were not, were to succeed.

And at line 50, "The frequent argument by the tax avoider that he seeks to protect the interests of a taxpayer who does not indulge in tax avoidance requires serious but sceptical consideration," and it then proceeds to receive that serious but sceptical consideration in the following page.

The conclusion is that, really the same as the President's below. That the fear is much overstated and is no more than is a necessary consequence of the use of a general proscription in section 99. The line that is drawn by his Lordship refers to the distinction between tax mitigation and tax avoidance. It's, of course, I think generally accepted now that tax mitigation is more of a conclusion than a guide, but nonetheless I think the distinctions that are drawn are illuminating and helpful.

The point that's made at line, over on 561 at line 18 and following, "Income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to reduction in his tax liability. Section 99 does not apply to tax mitigation because the taxpayer's tax advantage is not derived from an 'arrangement' but from the reduction of income which he accepts or the expenditure which he incurs." His Lordship goes through and explains how that applies to similar situations are considered in relation to the seven year covenant issue which was argued. I see it points out at line 28, "If the settlement is irrevocable and satisfies certain other conditions the reduction in income reduces the assessable income of the taxpayer. The tax advantage results from the reduction of income." The taxpayer really earns less. But, by contrast, at line 41, section –

TIPPING J:

Was that an interpolation by you, Mr Goddard?

MR GODDARD QC:

Yes that was, Sir. But –

TIPPING J:

I'm not suggesting it was inapt.

MR GODDARD QC:

I think it's what – yes, no, it's me not Lord Templeman, but I think it is –

TIPPING J:

Well there's a reference to reality or the concept throughout all this.

MR GODDARD QC:

Yes. It's pervasive, and the concepts of most, the point that most tax avoidance involves a pretence is made just over the page on 562. So, yes, it was an interpolation, Sir, but I think consistent with the theme of what's being said here. I hoped that I was simply explaining rather than expanding. At line 41, "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. The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had." So that's that reality theme.

The present case is discussed at 50 and following, the *Challenge* case, and over at line 10, "In an arrangement of tax avoidance the financial position of the taxpayer is unaffected (save for the costs of devising and implementing the arrangement) and by the arrangement the taxpayer seeks to obtain a tax advantage without suffering that reduction in income, loss or expenditure which other taxpayers suffer and which Parliament intended to be suffered by any taxpayer qualifying for a reduction in his liability to tax."

Then His Lordship goes through some of the well known cases. The *Duke of Westminster's* case, his Lordship says at line 19, that by "substituting an annuity for a wage payable to his gardener ... the Duke gained a tax advantage over other taxpayers who paid wages to their working gardeners."

In *Black Nominees Ltd v Nicol*, the "actress sought to avoid income tax by reducing her assessable income without reducing her income ... converted her earnings into instalments of capital by a number of transactions each designed to take advantage of some specific exemption or relief provision of the taxing statute. She attempted to obtain a tax advantage over other actresses and other taxpayers who paid tax on their earnings."

And perhaps to pick up your Honour Justice McGrath's point yesterday, one could add "in the manner contemplated by Parliament". Then *Chinn v Hochstrasser*, the punch line at line 32, "The beneficiary attempted to obtain a tax advantage over other beneficiaries who paid capital gains tax when they became entitled to trust property."

Ramsay, "the taxpayer attempted to obtain a tax advantage over other taxpayers who paid capital gains tax on chargeable gains."

Then at line 48, "Most tax avoidance involves a pretence," see *Ramsay*, "In the present case Challenge and their taxpayer subsidiaries pretend they suffered a loss when in truth the loss was sustained by Perth and suffered by Merbank. In New Zealand section 99 would apply to all the cited English cases of income tax

avoidance", all those ones referred to above. "Section 99 also applies where, as in this case, the taxpayer alleges that he has achieved the magic result of creating a tax loss by purchasing the tax loss of another taxpayer. In order to escape s 99, a transferable loss must be sustained by a member of a group which suffers the loss." So, a theme that comes through pervasively of the taxation legislation is that Parliament contemplates that similarly situated taxpayers will pay, an important theme of horizontal equity and, I'd suggest, ensuring that fairness and horizontal equity which enhances the legitimacy of tax legislation and ensures that it's reliance on voluntary compliance is likely to be sustained. And so –

McGRATH J:

That's really what you're adding, is it –

MR GODDARD QC:

Yes.

McGRATH J:

– to it. I mean, I just –

MR GODDARD QC:

Again, I hope that what I'm doing is teasing out a theme which is implicit in it, that the words are mine, but when one looks at the repeated reference to certain persons who have, his Lordship says, engaged in tax avoidance, obtained a tax advantage over other taxpayers who did what Parliament contemplated –

McGRATH J:

Well, that's the *Julie Christie* case, wasn't it, in particular, but the *Black* case?

MR GODDARD QC:

Yes, but all of the cases listed –

McGRATH J:

Well, just, it's, I understand that that's part of your arguments, and you've been taking us – and I certainly understood why you took us to the specific anti-avoidance provision –

MR GODDARD QC:

Yes.

McGRATH J:

– discussion, which is important, but I'm not quite seeing the linkage between the submissions you're making and what Lord Templeman was saying, and you're saying it's implicit, I think, rather than direct?

MR GODDARD QC:

Yes. Your Honour is right, there are two things I am seeking to take from *Challenge.* One is the relationship between the specific provision and the general, and I think that's enormously helpful on that point. The other is that his Lordship really emphasises issues of pretence and artifice versus reality, and identifies that the concern to which s 99 is addressed, which is itself an important part of the scheme and purpose of the legislation, part of the architecture of the Act, is to prevent people obtaining by artificial means a tax advantage over those persons who organise their affairs in the manner contemplated by Parliament, and that, in my submission, is a very important, indeed fundamental, part of the policy that underpins our Act, given the emphasis it puts on voluntary compliance, and that of course is a theme that was also picked up in the context of penalties by this Court in *Ben Nevis.* "And so," his Lordship concludes at 563, line 9, "Whatever the circumstances or complications, if a taxpayer asserts a reduction in assessable income or if a taxpayer seeks tax relief without suffering the expenditure which qualifies for such relief, then tax avoidance is involved and the Commissioner is entitled and bound by s 99 to adjust the assessable income of the taxpayer so as to eliminate the tax advantage sought to be obtained," and those are the two themes that I've just mentioned that I really seek to draw from this case.

I'm not going to spend much time on *Ben Nevis* or *Glenharrow* because they are of course very familiar to the Court, but I would just like to highlight a couple of paragraphs of particular relevance to this case. *Ben Nevis* is under tab 6 of the same volume – let me try that again: tab 5 – and although I refer in my note to paragraphs [91] to [99], I think I can skip over the discussion of *Challenge,* since I've gone through that already, and jump straight to [99], where the Court notes that "a scheme and purpose approach does not simply require the Court to focus on the specific provision in isolation of wider considerations ... The need for a wider perspective also gains support from both s 5 of the Interpretation Act 1999 and the general principle of

interpretation in AA 31 of 1996 Act", and that's footnote 107, which refers to, interpreting other provisions "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", with the core provisions being those which are in Part B of the Act, including s BG 1.

WILLIAM YOUNG J:

Sorry, what paragraph are you at now?

MR GODDARD QC:

I'm at [99] of *Ben Nevis* and footnote 107.

WILLIAM YOUNG J:

Thank you, yes.

MR GODDARD QC:

There's quite a lot going on in footnote 107, but it's a very important footnote, so I wanted to go to it. And then the Court discusses how the legislative policies are to be reconciled, at [100] and following, the critical paragraph at [103], that Parliament's overall purpose is best served by construing specific tax provisions and the general anti-avoidance provision so as to give appropriate effect to each, and they work in tandem, neither regarded as over-riding. "The presence in the New Zealand legislation of a general anti-avoidance provision suggests that our Parliament meant it to be the principle vehicle by means of which tax avoidance is addressed. The general anti-avoidance regime is designed for that purpose, whereas individual specific provisions," like the PSA rules, "have a focus which is determined primarily by their ordinary meaning, as established through their text in light of their specific purpose. In short, the purpose of specific provisions must be distinguished from that of the general anti-avoidance provision." Reference in [104] to the way Parliament envisaged "that the way a specific provision was deployed", or used, "would, in some circumstances, cross the line and turn what might otherwise have been a permissible arrangement into a tax avoidance arrangement," and the emphasis on grounding that test in statutory language, and a caution about judicial glosses and elaborations on the statutory language. Worth perhaps noting, because of the submissions that my learned friend makes about hindsight, [105], which discusses the key statutory concept of a tax avoidance arrangement, "a tax avoidance arrangement includes an arrangement which directly or indirectly alters the incidence of any income tax. It is

arrangements of that and allied kinds which are void against the Commissioner under s BG 1(1)," and this is important, in terms of the definition, "An arrangement includes all steps and transactions by which it is carried out. Thus, tax avoidance can be found in individual steps or, more often, in a combination of steps. Indeed, even if all the steps in an arrangements are unobjectionable in themselves, their combination my give rise to a tax avoidance arrangement."

Now, here, and also down in [108], the Court, when discussing the matters that can be taken into account, refers among other things to the manner in which the arrangement is carried out, it says that will often be an important consideration, and I just wanted to emphasise that not only is it not impermissible to have regard to the way in which an arrangement is carried out, but it is actually required by the definition of arrangement, which refers to the steps or transactions by which it's implemented.

There is a possible, at least in the perception of some people, tension between that point and a comment made in *Glenharrow*, which it might be helpful just to pick up at this stage. *Glenharrow*, which is under tab 8, refers at page 382 – it's paragraph [51], which begins on the previous page, page 381 – discussing the arrangement in that case and the payment of the price, and over at 382, line 6, the Court emphasises that the analysis that's just been carried out "does not depend upon hindsight. It looks at the matter as it would have appeared to an objective observer at the time when the arrangement was entered into. The arrangement is not being judged, impermissibly, on the basis of what actually happened afterwards", and I wonder, with respect, whether it's really impermissible to judge an arrangement on the basis of what happens afterwards in circumstances where the statute expressly directs our attention to the steps by which it's given effect.

The authority that's cited for that is *Ashton* – it's a small digression but I think it's probably worth doing now while we're here – at page 722, and it's worth just going to the case. *Ashton* is under tab 12 of this same volume and, unhelpfully, it's the Weekly Law Reports version, not the NZLRs, but the page reference here is 1621, and in between letters C and D there begins the very famous passage about if an arrangement has a particular purpose and that will be its intended effect, "If it has a particular effect, then that will be its purpose and oral evidence to show that it has a different purpose or different effect ... is irrelevant."

The passage of Lord Denning's from *Newton* is set out and then there's the passage which I think the Court is referring to at F. "If Lord Denning meant that one can

derive guidance as to the purpose or effect of the arrangement from the conduct of the parties after it has been made their Lordships cannot agree", and the Privy Council then refers to *Whitworth Street Estates*, where the House of Lords held that in construing a contract to ascertain the intention of the parties it was not proper to have regard to their conduct after the contract had been made. Lord Reid is saying, "I must say that I had thought it is now well settled that it is not legitimate to use as an aid in the construction of the contract anything which the parties said or did after it was made."

A couple of things about that. First, of course, this Court has cast doubt on whether that is the law of New Zealand in relation to the interpretation of contracts in cases such as *Gibbons Holdings and Wholesale Distributors*, and at the least there is now, I think, strong support from this Court for the proposition that to the extent that subsequent conduct sheds light on how the parties must have expected the arrangement to operate, it can be received in evidence and taken into account. But, much more importantly, *Ashton* was decided in 1975. It concerned transactions in the 1960s under the old version of section 108, which did not include the definition of arrangement that was introduced in 1974, the expanded definition to include all steps and transactions by which it is carried into effect. So in my submission for two reasons the expanded definition of arrangement, introduced in 1974, that's why, for example, at 1619, just above letter H, their Lordships refer to section 108 at the relevant date because it underwent a huge change in 1974. It became much more like the provision we're familiar with today rather than the rather terse provisions set out on 1619.

So because of that expanded definition of "arrangement" to include the steps by which it's given effect, and because one cannot, I think, assume that the principle of contract interpretation which *Ashton* relied on remains good law in New Zealand, it seems to me that a little caution about what's impermissible in judging the purpose and effect of a transaction is required, and that at least when assessing the purpose and effect of an arrangement one can look at two things. First, the steps and transactions by which the arrangement is given effect. The statute tells us to –

BLANCHARD J:

But that's part of the arrangement. You're making too much of the statement in *Glenharrow*.

MR GODDARD QC:

I'm delighted to –

BLANCHARD J:

If the arrangement includes the steps by which it's given effect, then that's not what's being mentioned here.

MR GODDARD QC:

I think it's the reference to *Ashton* that may have caused some confusion, your Honour, because that very clearly was saying there's a moment in time at which the contract arrangement understanding is arrived at and whatever happens after that cannot be referred to.

BLANCHARD J:

Well *Ashton* is still true, it's just that what is the arrangement has expanded by statute.

TIPPING J:

And I think the word "actually" in the penultimate line of that paragraph is quite important. Not to be judged beyond the basis of what's actually happened afterwards. It's intended to focus on the purpose or effect of the arrangement per se.

MR GODDARD QC:

And as long as that includes all steps by which it's carried into effect –

BLANCHARD J:

Well it has to, it has to, because that's what the statute says.

MR GODDARD QC:

Yes, then I don't think that –

WILLIAM YOUNG J:

Are you troubled by the exclusion rule, evidence exclusion rule, is that what this argument is addressed to?

MR GODDARD QC:

It's partly addressed to that, but it is also more generally addressed to the question of whether one can look at downstream steps taken to give effect, for example, cash

flows in cases such as this, to understand the original arrangement. So it comes into play at two points, Sir. And I think as long as arrangement is understood in that way that's – there is then no tension between the two. That's not how it's invariably been understood, which is why I –

TIPPING J:

Yes, I can understand there might have been, to the imaginative, room for difficulty.

MR GODDARD QC:

Yes. I will accept being put in that box for today, Sir.

TIPPING J:

No, no, no. I'm not saying you're in the box, Mr Goddard, I'm just saying that if you wanted to cause that sort of trouble you could do it.

MR GODDARD QC:

Yes, I think that's what been happening.

TIPPING J:

Yes.

MR GODDARD QC:

That's why I wanted to flag that. I was back in *Ben Nevis*. I'd gone to [108] and I do want to emphasise that "the manner in which the arrangement is carried out will often be an important consideration. So will the role of all relevant parties and any relationship they may have with the taxpayer. The economic and commercial effect of documents and transactions may also be significant." Various other factors, and the Court points out that it's often the combination of various elements in the arrangement which is significant.

"A classic indicator of a use that is outside Parliamentary contemplation is the structuring of an arrangement so that the taxpayer gains the benefit of the specific provision in an artificial or contrived way. It is not within Parliament's purpose for specific provisions to be used in that manner." Reference at [109], the courts are to be looking not merely at legal considerations but also economic. At 11 –

TIPPING J:

Well I think, with respect –

MR GODDARD QC:

Yes, I don't need to go through –

TIPPING J:

Well no, I wasn't saying that Mr Goddard. I think, what is extremely important in [109] is the references to the commercial reality and the economic effect.

MR GODDARD QC:

Yes, yes.

TIPPING J:

Those are the two things that people tend to get hung up on legal structures, but you've got to go behind them.

MR GODDARD QC:

Exactly, your Honour, and look at the commercial and economic reality of what's happening. So, hence my basic submission, that one has to ask have these taxpayers really suffered an overnight loss of 80% of their income or is it still effectively controlled by them and available for the benefit of them and their families in a way that as a matter of economic substance is no different from before –

TIPPING J:

That encapsulation was designed to bring in all the jurisprudence about reality.

MR GODDARD QC:

Yes, and that, with respect, seems to me is exactly what it does, and the result is that that is the litmus test that needs to be applied to transactions when seeking to understand the extent to which they involve a departure from what must have been contemplated by Parliament. So here, the question –

TIPPING J:

Well, Parliament works in the real world.

MR GODDARD QC:

Yes.

TIPPING J:

It doesn't work in the world of pretence or –

ELIAS CJ:

This world.

MR GODDARD QC:

The real world, the world of life, not the world of pretence, artifice and formal structures.

TIPPING J:

Yes. Well that's not a judgment on this case necessarily. It is simply the line that has to be drawn.

MR GODDARD QC:

Yes, for all the policy reasons discussed by the President Justice Woodhouse in *Challenge* and picked up by the Privy Council. In that case, the impossibility of specifying every variation on a them that might be used to do an end run around the charge to tax.

TIPPING J:

Well, the ultimate question, it's the next sentence that really carries all the weight. The ultimate question is whether, et cetera.

MR GODDARD QC:

Yes, "whether the impugned arrangement, viewed in a commercially and economically realistic way, makes use of the specific provision in a manner that is consistent with Parliament's purpose," and to that I would add the point made in [115] about approach, your Honour, which is after describing, making the point, the arrangement includes all steps taken. Then, "On the approach we have outlined, it is necessary for the appellants, on whom the burden of proof lies, to persuade the Court that the arrangement is not a tax avoidance arrangement. To do that the appellants must show that the steps they have taken were within the purpose and contemplation of Parliament when it enacted the specific provisions they rely on."

So I think there's a very important relationship between the conceptual approach in [109] and the practical operation of the regime in [115], which is that, especially in a case, as here, where my learned friend has accepted that the arrangement included the salary levels, that the arrangement altered the incidence of tax and that effect was not merely incidental. There's then a very, I would say, significant burden on the taxpayer to show that nonetheless the way in which the specific provisions have been used or deployed is within the purpose and contemplation of Parliament, that we shouldn't be worried about the fact that the arrangement has altered the incidence of tax, and that that's not merely incidental because all they're doing is exactly what Parliament contemplated that they ought properly to do, and I think that might tie in with, to some extent with your Honour Justice Young's question to my learned friend yesterday about how the scheme and purpose analysis plays out where there isn't a specific incentive provision in play. It seems to me that where there is a specific provision in the Act that positively seeks to encourage particular conduct on the part of taxpayers by providing for specific tax consequences if that desired conduct is engaged in, then it is precisely within the contemplation of Parliament to engage in that activity, being mindful of seeking to obtain that tax outcome, but that where there is no provision of that kind which positively seeks to encourage conduct of a particular kind, but rather simply the general architecture of the Act in relation to the identification of taxpayers and the calculation of income and the calculation of losses, it's rather difficult to suggest that using it one way rather than another, but nonetheless achieving an alteration of the incidence of tax which is not merely incidental, is what Parliament contemplated.

McGRATH J:

So if it's the ordinary charging provisions, the ordinary provisions that tax is charged to separate legal persons and so forth, if they are operated, you're saying it's hard to draw any particular conclusions as you can with incentive provisions?

MR GODDARD QC:

Yes, it's really –

McGRATH J:

So just –

MR GODDARD QC:

Yes.

McGRATH J:

If that's what you're saying, can I go further and say that you may actually be able to reach back to some underlying principles in the Act nevertheless that can be important in guiding what Parliament contemplated could be done with the ordinary charging and taxpayer entity provisions?

MR GODDARD QC:

Yes, I think I can go further in this case and show that what has been done is actually inconsistent with fundamental aspects of the scheme of the legislation, and I have in mind, of course, those aspects –

McGRATH J:

You'll come to that in due course.

MR GODDARD QC:

Hadlee, that's right, and the graduated rates scale.

WILLIAM YOUNG J:

But are you saying that while you can do that there is really only one question and that's section BG 1, not two questions?

MR GODDARD QC:

Yes.

WILLIAM YOUNG J:

Is this outside the scheme and purpose of the Act and, if so, let's go to section BG 1?

MR GODDARD QC:

Yes, I think that here one can actually read the section, identify on the basis of my learned friend's concessions that all the criteria are met, and then say so what really have the taxpayers pointed to, to show that what they are doing is positively contemplated by Parliament, is simply what Parliament sought to achieve, and pointing to completely neutral structural features like the charge to tax, the provision for calculating income and losses, just doesn't get one there, in my submission.

So there is, I suggest, really picking up your Honour's theme, possibly a rather shorter route in cases such as this one to the same conclusion.

TIPPING J:

You mean you could apply a single step –

MR GODDARD QC:

Yes.

TIPPING J:

– rather than two steps?

MR GODDARD QC:

Yes, exactly.

McGRATH J:

But that single step would really be the first step, would it not, in *Ben Nevis*, because you'd be saying that the black-letter provisions, including what's implicit in the Act, don't actually entitle you to the tax concession that you've set up.

MR GODDARD QC:

No, I'm not.

WILLIAM YOUNG J:

No, the first step is simply apply section BG 1 as meaning what it says.

MR GODDARD QC:

Yes. So the black-letter result does deliver the consequence that the taxpayers are contending for here, but what I say is that the next step, applying BG 1, can actually be done just by reading the provision and avoiding unnecessary judicial glosses, while bearing in mind that if in a particular case a taxpayer can point to an invitation, not a neutral provision, that provides for calculation of income and calculation of losses, but a positive invitation to take advantage of a particular tax incentive, then, of course, that is not going to be a tax avoidance arrangement and the scheme and

purpose analysis needs to be undertaken, but we're just not in that space in a case such as this one, and concern about discouraging orthodox commercial and family arrangements can be met, as Justice Woodhouse suggested in *Challenge*, by reference to the merely incidental test. It's within BG 1. You don't need to do anything else.

That's not my primary argument, which is situated squarely within the analytical framework suggested by the Court in *Ben Nevis*, but I'm simply suggesting, in response to his Honour's question yesterday, that this may well be the sort of case, where no specific incentive provision is present, where there is a simpler and shorter route to the same end that just involves applying BG 1 and saying the taxpayers haven't, in the words of [115] of *Ben Nevis*, shown that the steps they've taken were within the purpose and contemplation of Parliament when it enacted the specific provisions they rely on. You can't do that simply by pointing to a whole range of neutral architectural features of the Act, and then the overlay on that, as your Honour rightly pointed out, as I say, in fact they are not neutral architectural features. When one looks at the architecture it positively seeks to tax income derived by the efforts of an individual – produced, I should say, neutrally by the efforts of an individual on a graduated scale.

TIPPING J:

When you say the black letter does deliver the consequences sought by the taxpayer, that is that in black letter, and we eschewed that terminology in *Ben Nevis*, but I do think it's actually quite helpful, the black letter requires you to treat the salary level as it is.

MR GODDARD QC:

Yes.

TIPPING J:

It's only when you get to the avoidance, the second step, if you like, that you can then look at the commercial reality –

MR GODDARD QC:

Yes.

TIPPING J:

– of the salary level. Is that the line of thought, Mr Goddard –

MR GODDARD QC:

That's what I'm saying exactly.

TIPPING J:

Yes.

MR GODDARD QC:

Exactly, Sir. It's a very common complaint from the taxpayers to whom BG 1 is applied that the Commissioner is seeking to ignore separate legal personality and prevent the use of orthodox structures, and the Court's already identified in an exchange with my learned friend that the Commissioner's case is not that it's impermissible to carry on businesses of this kind through a company or for that company to be owned by a family trust, it's the use of the structure that's made that's challenged, and precisely the same issue, of course, or a variation on that theme arose in *Ben Nevis* itself, and I thought I might just draw the Court's attention to paragraphs [128] and [129], reference to the manner in which the specific provision's been used, looking at the commercial nature of the incurred cost, and then at [129], second sentence, "Legally it is correct, as Mr Carruthers emphasised, that the obligations of the LAQCs or individual taxpayers under the promissory notes will remain absolute and enforceable, until discharged at the end of the term of the licence. It is also correct that the use of companies and trusts as separate taxpayer entities will normally be an acceptable mechanism for taking advantage of concessions available under specific provisions, being within what Parliament must have contemplated in enacting them. In that context, the obligations will be those of the entities which incur them under any arrangements and not others such as shareholders. But the present circumstances are not an instance of the Commissioner seeking to ignore separate legal personality." There's no tension between respecting separate legal personality but nonetheless asking those questions about underlying commercial and economic effect, and that's what the Commissioner is doing here and that's what the Court did, in my submission, in *Ben Nevis*.

McGRATH J:

It's what you do with the separate legal person –

MR GODDARD QC:

Yes.

McGRATH J:

– that counts.

MR GODDARD QC:

Exactly. It's a tool that can be used in a range of different ways, and what we're interested in is how has the tool been used.

I don't think I'll go to the other paragraphs I refer to in *Ben Nevis*. What I wanted to do very quickly next is jump to *Glenharrow*, which is under tab 8, and I want to do that mainly because, in my submission, this is a striking example of the Court looking, not to the scheme and purpose of an individual provision, but seeking to understand the fundamental structure and economic purpose of a tax statute and measuring an arrangement against that. So what I'm going to be saying to the Court in a moment is that there's a direct parallel between what's done here in relation to the GST legislation and what Justice Richardson did in *Hadlee* in relation to the graduated rate scale, which is to look not to individual provisions but really to the basic scheme of the legislation and ask what it's intended to achieve and use that as the benchmark for asking what was contemplated by Parliament.

So, I think, beginning at paragraph [33], the discussion of s 76 begins, and the relevant principles are set out. [38], I think, is helpful, referring to *Newton v Commissioner of Taxation* [1958] AC 450 (HC), "What Lord Denning was emphasising was that the general anti-avoidance provision was concerned not with the purpose *of the parties* but the purpose *of the arrangement*. That is a crucial distinction. Once you put the purposes of the parties to one side and seek by objective examination to find the purpose of the arrangement, you must necessarily do that by considering the effect which the arrangement has had – what it has achieved – and then, by working backwards as it were from the effect, you are able to determine what objectively what the arrangement must have taken to have had as its purpose." And again, that, in my submission, is exactly what we need to do here.

We look at what the arrangement has achieved and work backwards to identify that that was its purpose. And, of course, this was an unusual case, as the Court points out at [39], because the evidence was that GST wasn't considered at all but that

finding was not determinative, "Just as the taxpayer's state of mind concerning taxation is not determinative," so an absence of state of mind cannot be. "The purpose of the arrangement may be deduced entirely from the arrangement and its effect," how it actually plays out. And this parallel jurisprudence, unsurprising in the Commerce Act area in relation to section 27, the reference to, "The purpose, effect, or likely effect of a provision." Cases such of *Port Nelson Ltd v Commerce Commission* [1996] 3 NZLR 554 or *ANZCO Foods Waitara Ltd v AFFCO New Zealand Ltd* [2006] 3 NZLR 351, for example.

Then paragraph [40], "The application of an arrangement of tax legislation such as s 76 of the Act is concerned with the 'aim or end in view' of the arrangement. It is to be objectively assessed. And the assessment will principally be a matter of inference from the arrangement and its effect. The purpose of the arrangement will be deduced from the arrangement itself and its effect. The intention of the Act will be defeated if an arrangement has been structured to enable the avoidance of output tax or the obtaining of an input deduction in circumstances where that consequence is outside the purpose and contemplation of the relevant statutory provisions." And what the Court then does to understand the purpose and contemplation of the relevant statutory provisions is go at paragraphs [41] and following to an understanding of what GST is, how it's meant to operate.

In paragraph [42] at line 18, the scope for tax avoidance opportunities at certain boundaries is expressly identified and, of course, here too what we're concerned with is a tax avoidance opportunity at the boundary between the way in which an actual person's taxed and companies and trusts are taxed. And that's why we still have in our income tax legislation, as in the GST legislation, a general anti-avoidance provision.

[43] explains how GST operates and what happens with registered persons, not themselves being subject to GST's economic incidents, footnote 56. And then at the top of 379, that is, of course, consistent with the neutrality and efficiency of the revenue collection rationales that underlie the Act. The corollary is that registered persons should, by the same token, not obtain unacceptable windfall gains from the regime. So it's that basic structure and what it is and is not expected to produce in the way of broad outcomes that is identified in answering the question posed at [40] about whether the consequences are outside the purpose and contemplation of the

relevant statutory provisions. The answer that's given is, of course, that it was outside contemplation.

At [47], paragraph [47] of *Glenharrow*, "Does it follow from the provision" – again here there was, of course, the issue that certain transactions in relation to second-hand goods were expressly identified as transactions that should be measured against a market value yard stick. Transactions where the parties are associated and what the Court asked at [47], "Does it follow from the provision made concerning sales of secondhand goods between associated persons that if parties who are not associated, one being registered and the other not, enter into a transaction which is not a sham and in which the latter buys secondhand goods from the former, the Commissioner is bound to accept the terms they agree upon as regards price and payment? Can it be suggested that those terms (that part of their arrangement) none the less defeat the intent and application of the Act so as to allow the use of s 76? In our view it can. The whole premise of the Act generally and of the secondhand goods provisions in particular is that transactions will be driven by market forces: that their commercial and fiscal effects will be produced by those forces and will not contain distortions which affect (that is, defeat) the contemplated application of the GST Act. It is when market forces do not prevail that s 76 is available to the Commissioner."

Now my learned friend says here, but you're trying to apply market standards in circumstances where there's no express provision for that in the Income Tax Act. Look, there is in all these other provisions. There's reference to market value, to arms-length dealings. There isn't here so it's wrong to import it, but, in my submission, that is exactly what the Court did in *Glenharrow* where it said that those specific references are actually just manifestations of an underlying assumption, an underlying expectation that transactions will be driven by market forces and their commercial and fiscal effects will be produced by those forces and won't contain distortions that defeat the contemplated application of the GST Act.

The concern about uncertainly produced by such a provision is identified and responded to in [48], and the impossibility of using precise definitions to respond to the policy concern to which anti-avoidance rules are addressed is identified.

And then at [53] and [54] the Court starts its conclusions and again, helpfully, distinguishes between routine forms of transaction which will not, in and of

themselves, amount to tax avoidance, and particular use of such structures which may. So at [53] the Court makes it very clear that, "This is not to say that an exchange of cheques accompanied by a transfer of property and a mortgage back to the vendor can ordinarily be regarded as an artificial procedure." No more can the pursuit of a business or a professional practice through a company. "The contrary is true. Ordinarily an exchange of cheques, with accompanying conveyancing documentation, is a routine commercial procedure which does not give rise to an impermissible tax advantage. However, in this case that procedure was inserted into a 'pay as you go' transaction so as to produce an artificial effect with consequent tax advantage, contrary to all economic reality." That is the test.

And so at [54], because we do have a general anti-avoidance provision, "... and on an objective view of the present case, the effect of the structure, given the gross disparity between the price and the size of the purchaser and given, particularly, the shrinking value of the asset, with its very limited practical life, was to produce a GST refund totally disproportionate to the economic burden undertaken by Glenharrow or the economic benefit obtained by Mr Meates." And down to line nine, "The end in view was a distortion which very plainly defeated the intent and application of the Act," at that general structural level, "It cannot be said that, looked at objectively, the tax advantage was merely incidental to the commercial decisions of the parties to the arrangement."

So those are the key principles, and I'm in my road map at item 4, the arrangements. I don't think I need to go to those submissions at all except to note that the arrangements in this case had, as a significant component, the level of the salary set in each year, including, of course, any bonuses that were paid in that year. That significant component was determined in each year, generally, retrospectively at the end of it, and that must mean either that there was a new arrangement in each year or, alternatively, a continuing arrangement which was amended, modified in a significant respect each year. Either way, whether it's a new arrangement in each year because the salary level fell to be decided each year, or whether it's a significant term that was changed at various points, you can't assess the purpose and effect of the arrangement, including the steps which give an effect, without looking at that term from time to time, which means you need to look at it in –

TIPPING J:

It may have a different purpose and effect depending on the level of salary.

MR GODDARD QC:

Exactly. So the idea that you take a snapshot for Mr Penny in 1997 and then never revisit the question of what its purpose and effect was, even though a very significant term was changed in subsequent years is, in my submission, untenable and that's all I wanted to take from that section of my submissions.

McGRATH J:

I suppose it's the – you're emphasising the level of salary and that it's set each year but implicitly, I suppose, the other key feature is that control is retained by the director of the company as to what salary he will pay himself.

MR GODDARD QC:

Yes, from zero through to the whole of the proceeds of the practice, and then control over whether that would be paid out by way of a dividend or not, or retained within the company, and then control, and very direct control in Mr Penny's case, less direct but nonetheless present in Mr Hooper's case, in relation to subsequent cash flows.

I turn then to the point that the arrangements avoided tax, and I do want to go very quickly to *Elmiger,* and I want to go to it both because it's a very helpful illustration of the way in which the tax avoidance provisions apply to income splitting, in circumstances where assets were transferred, but also because of course, as the Court of Appeal, well, as Justice Thomas noted in *BNZI*, when our current tax avoidance provision took on something more or less like its present shape in 1974 through amendments to the 1954 Act, *Elmiger* was expressly referred to in debate in Parliament by Dr Finlay, the then-Minister of Justice, with approval of exactly what was sought to be achieved through this sort of provision, and I provided the reference to *BNZI,* which includes the Hansard reference.

So, a decision of Justice Woodhouse in 1966. At first instance it was, the appellants were brothers who carried on business in partnership as agricultural contractors and the business involved the use of heavy machinery, they owned substantial assets of that type. They held discussions with their solicitor and accountant considering the reorganisation of their affairs, a trust was set up, the immediate beneficiaries of which were their respective wives and children, "The trustee gave them extraordinarily wide, even arbitrary powers, of controlling and dealing with the trust assets and income and contained," his Honour said, "a rather remarkable provision, that at the termination of the trust in 1968 the trust capital should revert to themselves … they

sold to the trust two of their earthmoving machines at a price of some $5,000, treated as an interest-free loan payable on demand, and they hired back the two machines at certain hire charges, with outgoings to be borne by the taxpayer so that, for all practical purposes, the amounts received for hire can be regarded subject to depreciation as net profit to the trust. This being the case, it's clear the minimum monthly charges were able to produce an annual income for the trust of £5,100 upon a capital outlay of £5,250, the minimum trust income can be compared with a net business income of the partnership for the year preceding the transactions of approximately £9,300," so about half of it was moved into the trust.

The submissions of Mr Richardson for the Commissioner, set out at 685 and following, and the appellant's submissions that these were real and genuine and not shams, at 686, that's accepted, but, at the foot of 686, since the *Duke of Westminster* case "there has been a growing awareness by the Legislature and the Courts alike that ingenious legal devices contrived to enable individual taxpayers to minimise or avoid their tax liabilities are often not merely sterile or unproductive in themselves (except perhaps in respect of their tax advantages for the taxpayer concerned), but they have social consequences which are contrary to the general public interest. There is the problem, too, that the Legislature usually is lagging several steps behind the ever-developing arrangements worked out by experts in this field on behalf of their taxpayer clients."

And then at the foot of 687, the passage that his Honour set out in *Challenge*, "these provisions are intended to forestall deliberate attempts by individuals to obtain tax advantages denied generally to the same class of taxpayer," I won't go through that again. I'll skip across to 694, after going through the cases, including *Newton* and others, and the Australian cases, and at 694, line 15, his Honour summarises the *Newton* predication test and says, at line 24, "The section is not designed to prevent ordinary commercial, or family, or charitable dispositions. Nevertheless, this is a general provision aimed at otherwise legal methods of tax avoidance. It is designed, as I stated earlier, to forestall the use by individual 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. Accordingly it is my opinion that family or business dealings will be caught by s 108 despite their characterisation as such, if there is associated with them the additional purpose or effect of tax relief (in the sense contemplated by the section) pursued as a goal in itself and not arising as an natural incident of some other purpose. If this were not so, I suppose an

appropriate legal window dressing could still be devised to defeat the general objects of the section."

There's reference to the Australian courts concentrating "some attention upon the extent to which the taxpayer concerned has retained in his own hands the effective use and disposition of the moneys in question," and, "a series of transactions applied in a concerted way as part of a predetermined routine." It's my opinion that both these elements apply and are to be found in the present case.

His Honour summarises again the steps that were taken and says, over on 695, at line 8 – sorry, beginning at line 5, "the claim is made that this should be regarded as one of those normal family transactions described by Lord Denning, I am quite unable to accept this submission. The absence of any change in the practical operation of the partnership business; the emphasis on the income aspects of the transaction; the extraordinarily wide powers given to the appellants as trustees; and provision that any remaining capital should revert to them in 1968; and the other features of the transaction which I have described – all this puts it outside the range of any normal disposition for family purposes." There was a dominant, a general purpose of obtaining a disposition of income in the guise of business expenses, and then, at 21, "I think, therefore, that looking at the transactions themselves, there is a clear inference to be drawn that one at least of the designed purposes was to diminish income receipts by factitious deductions, and by this process achieve a favourable alteration in the incidence of income tax, and have the effect for the appellants of relieving them from some part of their liability to pay income tax."

So, I think a very nice illustration of the many different ways in which one can seek to bring about that conclusion, and there, although there was a disposition of assets to the family trust, it was the temporary nature of that, coupled with the control that was retained over the income generated through those assets, that was seen as bringing the arrangement within the scope of tax avoidance.

And we come then to *Hadlee*, a case which is important for a couple of reasons – that's in volume 2 – and the High Court judgment, the judgment of the Chief Justice, Justice Eichelbaum, is under tab 20, a case involving a partner in a large accounting firm and the assignment of some of that partner's units in the partnership, by reference to which partnership profits were divided to a family trust. And a few features that it's worth going to: first of all, his Honour describing the trust at page

450, notes at line 40 that, "The primary beneficiaries of this trust –" oh, sorry, the division of units is set out a little further up, at 450, for the two years before the Court, Mr Hadlee was entitled to 30 units, 32 units, and those were split 19.2 to 12.8 between himself and the trust. Then down at line 40, "Primary beneficiaries," of the trust, of those 12.8 units, "the first objector's wife and (then) only child," and the "eligible beneficiaries" is that wider family group, the assignment was set out, the partnership agreement described, and then his Honour turned, at 456, to the first of the issues before the Court, the mere expectancy issue and the question of whether it was possible to assign the right to receive partnership income, and at page 548, lines 37 and following, his Honour concluded that "the presence of consideration is insufficient," the assignment was "effective in equity but not at a point of time sufficiently early to prevent the income from being regarded, however fleetingly, as that of the assignor." The income passes to the assignee through the conduit of the assignor, not an approach that was adopted in the Court of Appeal but that was one of the grounds on which the Chief Justice concluded this was ineffective, an ineffective assignment.

Perhaps worth noting that in discussing the nature of this income, the point of leverage and support staff was raised. At the foot of 459 there's reference to Mr Hadlee's evidence, emphasising the part played by staff in the earning performance of beneficial effect of a staff/partner ratio. In comparison with professional partnerships, his Honour said, "these aspects, in my opinion are only matters of degree. I am satisfied the elements of input of personal effort by partners and their presence in providing decision making, leadership, supervision and control are as essential in the case of a large staff as with a small one, although the proportion of time ... and its relative importance, may differ considerably from firm to firm. I am unable to regard the aspects emphasised in the objectors' evidence as materially affecting the relationship between his personal exertions and ... the partnership income."

And that, I think, is an answer to my learned friend's submission about the presence of staff in the practices of these taxpayers as well. It really is a bit of a red herring.

Over at 463, having gone through all of this, his Honour finds that the Commissioner succeeded on the expectancy issue at line 23 and following for a number of reasons, essentially that the assignment was never effective, it wasn't effective to alienate the income from the assignor to the family trust. There then came the personal services

ground, the Commissioner's argument that income from personal services is incapable of assignment per se, was always derived by the earner. It began at 463, this, it is said, is a principle applicable only for tax purposes, based on *Spratt v Commissioner of Inland Revenue* [1964] NZLR 272, and after discussing that principle at 464 and over into 465 his Honour concluded that the Commissioner succeeded on that ground also, at line 11, and my friend is right to say that that is the primary basis on which the case was decided, here and elsewhere, that as a matter of tax law, wages and salary can't be effectively assigned.

There's an issue about s 96 we don't need to look at, but importantly the Commissioner presented and had an alternative argument based on s 99 which was intended to be relied on if all the other arguments were rejected. So if this was not a case about derivation, if it genuinely was the position as a matter of law that the income associated with the 12.8 units was derived by the family trust and only the trust and there was no instant, no Augenblick during which it was the accountant's own income; nonetheless, the Commissioner said this was a tax avoidance scheme. And after setting out the elements of s 99, his Honour said at line 21, "I do not doubt that what occurred here properly comes within the definition. The assignment was one step in a –

ELIAS CJ:

Sorry I'm lost, what page?

MR GODDARD QC:

466, your Honour, sorry. Line 21. "I do not doubt that what occurred here probably comes within the definition. The assignment one step in a package or scheme, properly seen as a 'plan', prepared for the benefit of those partners who wish to take advantage of it encompassing the following steps:" establishing a family trust, incorporation of the company to act as trustee, and execution of the assignment.

A question of purpose or effect discussed at line 33 and following a reference to *Newton* and *Ashton.* Over on 467, at line 28, "the scheme showed a high degree of integration between the trust, the company and the partnership," that's explained there. At the foot of the page, another echo of this case, line 53, "The aspect on which much emphasis was laid in evidence was mitigation of the risk that a partner's personal assets might be subject to claim in the event of some disaster affecting the partnership" or, I suppose one might add, their romantic life. "I accept that such

hazards, to which of course all professional partnerships are subject, are exacerbated in the situation of a large national partnership. Some of the more obvious factors are that the size of the enterprise increases the exposure to risk, the partners not as well known to one another ... and the measure of oversight and control exercised in one office may not necessarily be achieved in another. Further, these general considerations had been underlined by some specific experiences relating to the objector's firm or its clients."

The reference to the expansion to the concept of negligence, line 10, "Although to the extent that this evidence sought to have the Court place reliance on Mr Hadlee's subjective motives I must disregard it, I can take it into account as part of the factual background against which the documents have to be read. I think it is possible to read the arrangement itself as having as one purpose and effect the creation of opportunity to establish assets in the hands of the objector's dependants which would be beyond the reach of any claimants against the partnership. It is difficult, however, to view this as the sole or even a dominant purpose. Other equally effective means of removing assets from risk would be available. To the extent the evidence called by and on behalf of the objector sought to lead me to the inference that this aspect is the sole or dominant purpose or effect of the arrangement, I decline to draw that inference. The tax advantages of the arrangement, if successful, were obvious. A significant proportion of the objector's income would be alienated to a trust where it would be taxed at lower rates. In the relevant tax years the tax scale had five steps or graduations," from 14.5 cents to 60. "For the three previous years the objector's share of partnership income had exceeded $22,000 so that putting matters at their simplest, the scheme opened the way for income in excess of $22,000 to be taxed at lower rates of the scale." That was the 60 cent cut-off, of course. "Calculations submitted showed that on the assumption the objector's wife had no significant separate income … the potential tax saving in the year ended 31 March was in excess of $6000 and in the following year more than $8000. If Mrs Hadlee had significant personal income then substantial savings could have been effected by the trustee allocating the trust income to the child so that he obtained the benefit of the reduced tax rates."

His Honour goes through the definition of section 99, *Challenge* and *Ashton*, and then I think identifies at page 469, lines 38 and following, the other peculiar factors of the transaction: inadequacy of the consideration for the sale of so much of the objector's future earning capacity, 40% for a relatively low consideration of – and

his Honour noted at 470, lines 3 and following, “Examination of the return obtained by the trust on its investment confirms the inadequacy of the consideration. In the first year operation it was $20,016, representing a return of 123% on the purchase price ... Second year, the return of $25,000-odd amounted to 159%. The inadequacy of the consideration answers any suggestion this could be viewed as an arm’s length transaction.”

Now I’ll come back to goodwill, but basically the Commissioner’s submission is two-fold. Firstly, that the inclusion of goodwill in this transaction was, itself, an artificial feature of the transaction – I’ll explain why a little later – but, second, that if it were not artificial to have any provision for goodwill, the relationship between the goodwill paid and the income derived by the companies in the present case shows the same sort of extraordinary return that his Honour identified here, again pointing to artificiality, lack of commerciality.

At line 13 on page 470, “Mr Barton submitted that the assignment conformed in general terms with the normal incidents of an assignment of a share in a partnership. I accept that in many respects that was so. Counsel said that since all the indicia of an assignment were present, there was nothing to indicate the purpose and effect was tax avoidance ... it was at most a case of tax mitigation. I am unable to accept these latter propositions. First, the objector undertook, post assignment, to contribute 100% of his working time for 60% of the remuneration otherwise receivable.” Here, more like 20%. “Second, the result of the arrangement, if effective, was that the objector still had available to him, through the vehicle of the trust, the whole of the partnership income subject (so far as the assigned income was concerned) to the provisions limiting its application to the specified beneficiaries. They, however, with himself, comprised the family group for whose primary benefit one would expect the objector to have expended the income prior to the establishment of the arrangement. But as demonstrated, the total tax liability generated by the income was reduced significantly. It is plain that the arrangement relieved the objector from liability to pay tax, or avoided or reduced the liability, or altered the incidence of his tax. Those conclusions would have followed under the previous s 108, as interpreted in *Mangin v Commissioner of Inland Revenue*, without the need to resort to the more explicit definitions contained in the new section. In my opinion the purpose and effect of the arrangement was tax avoidance. Even if it were possible to regard that as one purpose and effect only (the other being to enable the objector’s dependants to

accumulate assets which would be secure from the risk of claims against the partnership), I cannot view it as 'merely incidental'."

A very important passage. "The potential tax benefits were too significant and obvious. I agree with the submission on behalf of the Commissioner, that it would require a considerable degree of naivety to conclude that they played merely an incidental part in the scheme. Accordingly, on the assumption that (contrary to my earlier findings)," in other words if this wasn't a derivation case, "the assignment was effective to alienate the income prior to its receipt by the objector, I hold that pursuant to s 99, the arrangement was void against the Commissioner for tax purposes."

The same result was of course reached in the Court of Appeal and in the Privy Council, but the Court of Appeal judgment is important because of the light it sheds on the Parliamentary compilation sitting behind the graduation rates scale. That's under the next tab. The judgment of the President, Justice Cooke, begins at 519. His Honour sets out, at lines 43 and following, the three grounds given by the Chief Justice for finding in favour of the Commissioner: the assignment point, the personal services rule for tax purposes, and section 99.

Turning to the effect of the assignment in equity. It was said that it's at once apparent that the first ground given by the learned Chief Justice is unsustainable. The reasons for that are set out at 521.

His Honour turned to income from personal services, set out the *Spratt* dictum and the American authorities to similar effect, and his Honour concluded that, at the top of 523, that adopting this approach, his Honour said, and this is I think helpful, at line 4, "is essentially an illustration of the approach of making the statute work, which this Court constantly tries to follow." In other words, that's identifying the underlying themes and objectives of the Act, and it was said that implying this rule into the Act was making the statute work, was giving effect to its underlying policy as conveyed by its language. Even though that involved them applying a rule that was nowhere explicit in the Act.

McGRATH J:

It was an exercise in statutory interpretation.

MR GODDARD QC:

Yes, and that of course involves identifying the underlying purpose of the Act then giving it effect. So it's necessarily implicit in his Honour's approach that not permitting personal exertion, personal services income to be alienated ran counter to the purpose of the Act and that therefore a rule precluding that was appropriate.

Tax avoidance. His Honour went on to say that, "While of opinion that the judgment under appeal should be affirmed on the second ground as a matter of statutory interpretation," and your Honour's question answered there, in the very next sentence in fact, "I also think that, so far as may be necessary, it is justified by s 99 ... the width and tenor of that section, an enlarged version of the old s 108 ... can be underestimated if one does not keep its terms prominently in mind," his Honour sets it out.

McGRATH J:

So where are we – oh yes, no, I'm with you, I'm with you. Thank you.

MR GODDARD QC:

Then over at 524, Sir, line 3, the Chief Justice "held that the section applied, in the part of his judgment at pp 465 to 470. I agree with and adopt everything that he there says." So the analysis I took the Court to about it, requiring a considerable degree of naivety to think that tax avoidance had been seen, was adopted by the President.

"Without limiting the generality of that agreement, I attach particular weight to the fact that in return for a relatively minor monetary consideration, some $16,000, most of which was actually paid out of partnership drawings, the partner at the age of 39 surrendered to his family trust 40% of his future earnings in a leading accountancy practice of international stature, yet covenanted to continue diligently to attend full-time to the partnership business. The return to the trust in the first two years represented 123% and 159% of the monetary price. The following passage towards the end of the judgment under appeal (at p 470) sums up the position accurately." So his Honour expressly sets out the passage from the Chief Justice's judgment on which I also put particular emphasis.

And at line, underneath that, his Honour says that, "In the light of the approach of the Privy Council ... I have no doubt the arrangement in the present case transgresses the section." Some of the leading cases are referred to, and at line 39, "It should be mentioned that, although the majority judgment delivered by Lord Diplock in the

second *Europa* case stated at p 556 that s 108 did not prevent the taxpayer from parting with a source of income, it contains nothing to suggest that their Lordships intended the taxpayer to be free to produce income from the source by his own exertions, yet treat the product as for tax purposes not derived by him. It should also be noted that the Australian tax avoidance section broadly corresponding to s 99 was not argued in *Everett*."

Over at 525, line 8, "As Lord Templeman analysed *Nicol*," the actress converting earnings into capital case in *Challenge*, "'She attempted to obtain a tax advantage over other actresses and other taxpayers who paid tax on their earnings. That too was seen as a case to which s 99 would apply. As I see it, the present case is not materially distinguishable. The partner is trying to obtain a tax advantage over other chartered accountants and professional people and other earners who pay tax on their earnings." One might say, in accordance with the graduated rate scale, because that's implicit, I think. "That is contrary to the intent of the Act as a whole and s 99 in particular. It is true that he is doing so by diverting from himself income from his personal exertions to which ordinarily he'd be entitled beneficially; but it must not be overlooked that the 'liability' which by virtue of s 99 cannot be avoided includes 'a prospective or potential liability in respect of future income'. In my opinion, what has been done here falls squarely within those words."

So, I think it's a very helpful analysis of s 99. Turning to the judgment of Justice Richardson, and his Honour hardly looks at s 99, the emphasis of the judgment is very much on the personal exertion, personal services rule, but because that's a matter of statutory interpretation, making the statute work, it's necessary to look at the policy of the statute, its scheme and its text, and so his Honour launches in by looking at that issue and begins, "The graduated rate structure is a basic feature of the New Zealand income tax system. If the income from an income-earning activity can be divided between two or more taxpayers the total tax may be significantly less than had it been derived by one taxpayer." His Honour provides an illustration. So, "if the assignment in this case were effective for tax purposes, the appellant stood to reduce the tax on the income affected by around 50%. Hence the attractiveness in tax planning of income splitting within the family by means of assignments and trusts of income-generating property and of rights to future income. Tax planning in this area relies on the conventional application of established principles of law of properties, trusts and equity. That leaves as the next question, and the crucial question in this case, how the income derived in terms of those

arrangements is to be taxed. It involves analysis of the scheme and language of the 1976 Act and of the relevant underlying objectives", I think I'd emphasise the underlying objectives.

The arrangements are described at 526 and following, his Honour considers the effect in equity of the assignment and disagrees with the Chief Justice on that point, and that conclusion is set out on 529 in lines 10 and following. There is then an issue about the tax treatment of partnership income which I don't think we need to be distracted by. Over at 531, personal exertion income and the distinction that the legislation has drawn for many years between earned and unearned income, and then his Honour turns to employment income and looks at the whole PAYE structure, which his Honour says at 40 "proceeds on the premise that income of that kind is derived by the employee concerned," explains how that works. 50, "That important feature of legislation must, I think, be based on a statutory assumption, underlying the derivation of income for tax purposes. The assumption is that the person whose personal exertion earns the income under the contract of employment derives that income and pays the tax", and thus at line 7 on the following page, "In policy terms, too, to allow individual employees to opt out well out of the application to their salaries and wages of the graduated rate structure, would undermine that basic feature of legislation. That it could not have been contemplated by Parliament is confirmed by the manner on which the PAYE structure was superimposed." And then after having dealt with employees, his Honour turns at line 45 to personal exertion income of the self-employed. The next question is whether similar overriding considerations preclude recognising income splitting of other personal services income.

MCGRATH J:

You don't regard Justice Holmes as having some contribution in all of this?

MR GODDARD QC:

Oh, absolutely, your Honour, I was rather treating it as so fundamental that it could be taken as a given.

MCGRATH J:

No, I don't want to interrupt, you do rely on that passage as well?

MR GODDARD QC:

I absolutely rely on that passage. I suspect also, to be honest, that I was looking at the time and skipping a little faster than I should have, I wonder if it's more sensible, your Honour, to pause and then finish the last couple of pages of this important case after the adjournment rather than rush?

ELIAS CJ:

Yes, that's fine. Where are you going to take us after *Hadlee*?

MR GODDARD QC:

After *Hadlee* I'm coming back to my roadmap, I'm going to go to one more case, which is *Peate*, and I'm going to do that extremely briefly and then –

BLANCHARD J:

Are you going to look at *Peate* in the High Court of Australia?

MR GODDARD QC:

Yes. I think.

BLANCHARD J:

Which is perhaps more germane than *Peate* in the Privy Council.

WILLIAM YOUNG J:

In the Privy Council tax avoidance was conceded, wasn't it? It was the –

BLANCHARD J:

It was assumed, anyway. It was the reconstruction argument at that stage.

WILLIAM YOUNG J:

The real interest in *Peate* is in the High Court of Australia, which has got some interesting stuff about assignments.

MR GODDARD QC:

It does. So, I'm going to go to *Peate.*

ELIAS CJ:

Yes

MR GODDARD QC:

And then I'm going to, I haven't got any more cases to go to, I'm going to run very quickly through section 6 of my roadmap, which I think will take about half an hour. I'm going to talk for one and three quarter minutes about admissibility of evidence, mostly to explain why the objection was taken in response to the Court's questions yesterday, and then my learned junior will deal with the evidence exclusion briefly, so we're well on track, your Honour.

COURT ADJOURNS: 11.32 AM
COURT RESUMES: 11.47 AM

MR GODDARD QC:

Your Honour, I was looking at *Hadlee* in the Court of Appeal under tab 21 of volume 2, and I just finished looking at Justice Richardson's discussion of the treatment of employment income under the Income Tax Act 1976 and the statutory assumptions that underpinned that. His Honour then turns, on page 532, to personal exertion income of the self-employed. And the question his Honour poses is whether similar overriding considerations preclude recognising income splitting of other personal services income. The dictum from *Spratt* is set out and his Honour says, at the foot of the page, "in policy terms the same general considerations that lead to the conclusion that the Income Tax Act requires wage and salary earners to pay the tax on their earnings, must apply equally to the earnings of the self-employed from their personal exertions. The character or quality of the income which arises is the same in either case. Future wages and future receipts for personal services do not arise without that work. Personal exertion income has been deliberately distinguished from income from property in our legislation and in the legislation of other countries," and that remains the case in the rush to PAYE, of course, for employees, "because of that perception that they are quite different in character. If the income is the product of personal exertion that stamp requires that it be taxed accordingly, and that any disposition of a related property interest should take effect subject to that charge for tax. In such cases, and whether the taxpayer is employed or self-employed, attaching the label of a property right to an assignment does not change the character of the income that is thereafter derived. The contract is merely the vehicle through which earnings by personal effort are obtained."

There's reference to "cases where entitlement to professional or business income is not dependent on personal energy input; one partner may contribute labour, another capital," and, "More often, while capital assets may play some part in the derivation of income, the element of personal exertion is clearly predominant," and that's, I think, relevant to this in the light of my learned friend's emphasis on the assets used in these practices. "In some circumstances it may be necessary to analyse the particular income-earning activities in some detail ... But common experience confirms that, in general, working professionals earn their incomes from their exertions," sad but true, "and if they do not perform they may be fired by their partners. There is no justification –

McGRATH J:
Or clients.

MR GODDARD QC:
Absolutely, it's only the master that changes when one leaves a firm. It's still the case that you're only as good as what you do yesterday, or possibly this morning. If they do not perform they may be fired by the relevant person. "There is no justification in principle for differentiating between salary and wage earners and professionals whose income is the product of their personal exertion. In either case the person whose personal exertion earns the income derives the income," and then an important sentence I think, "It would be wrong to impute an intention to Parliament that income splitting with its inevitable undermining of the graduated rate structure should be widely available to professional and commercial taxpayers, although denied to salary and wage earners." And if it's wrong to impute that intention to Parliament, then it's wrong to suggest the adoption of a mechanism designed to bring precisely that about as within Parliamentary contemplation. So that links directly into the question here. There's then a discussion of the partnership earnings in that case, and his Honour concludes that the partnership income was derived by the appellant and taxable in his hands.

Over at 534, line 5, his Honour Justice Richardson said, "In light of my conclusion that under the provisions of the tax legislation the partnership income was derived by the appellant and taxable in his hands notwithstanding the assignment, it is perhaps unnecessary to go on to consider the anti-avoidance provisions of s 99. However, in agreement with the President, I am in no doubt that what was attempted here falls squarely within the section. I would dismiss the appeal", and that's hardly surprising,

given what his Honour had concluded on the previous page about the basic scheme of the legislation.

McGRATH J:

Mr Goddard, just if we – bearing in mind the passage you've just read, and going back to page 533 and the concluding part at line 30, it is, as I think you said, the case isn't it that Justice Richardson was deciding *Hadlee* not on s 99, other than in the most incidental way, almost an afterthought, he was really deciding it on the basis that tax law precluded you gaining the type of tax benefit that you have sought to gain here, for these policy reasons that are implicitly reflected in the legislation, there is a legislative bar on you using the provisions in this way because of the importance of the graduated personal income tax scale, is that the way you understand it?

MR GODDARD QC:

That's exactly how I understand Justice Richardson's judgment. But, of course, if the –

McGRATH J:

And Justice Cooke agrees with him on this, does he not?

MR GODDARD QC:

Justice Cooke agreed on that point, yes, but went further of course, and separately considered –

McGRATH J:

He decided it on two bases.

MR GODDARD QC:

Yes, that's right. Conversely, of course, Justice Richardson expressly agrees with Justice Cooke, in relation to section 99, over at 534, so –

McGRATH J:

What I want to put to you is that, really, the first basis on which Justice Richardson is deciding it, the principal basis on which he's deciding the case, can really be equated to the first question in *Ben Nevis*, he decides the matter on that basis and doesn't

have to go to whether s BG 1 applies, though he does. I'm using the modern – it was section 99, of course, in those days.

MR GODDARD QC:

I agree with that with one qualification, and that qualification is that Justice Richardson was not interpreting a single provision to ascertain whether what was done fell within the scope of that single provision. Rather, Justice Richardson was engaged in identifying an implicit principle in the Act that emerged from its deep scheme and purpose, that precluded giving effect to the black-letter consequences of the transaction entered into. So, in a sense, although it failed at the first step because, by virtue of this implicit principle, Mr Hadlee was treated as still deriving his income, there was no specific provision that had that effect. Rather, what Justice Richardson was concluding was that it was so fundamental to the statute that he who generates personal exertion income will pay tax on that income, so fundamental to the statute that there was a principle which should be given effect, almost as if it were a specific provision of the Act –

McGRATH J:

It's a rule, isn't it?

MR GODDARD QC:

It's a rule, which is implicit in the scheme of the Act, making the Act work, and if it's so clear in the Act, that principle, that it can be described as a rule, it seems to me that a fortiori it's the sort of schematic feature, architectural feature, that this Court has emphasised we must look to in the tax avoidance context that, for example, underlay this Court's analysis in *Glenharrow*, understanding how the GST Act worked and was meant to work.

McGRATH J:

I can certainly understand that this principle is relevant if you decide that, on these specific provisions or the general scheme of the tax Act, that what was done qualifies, and you then move to tax avoidance. What I suppose I'm questioning is whether, in fact, Justice Richardson hadn't decided this case on the basis that he didn't have to go to tax avoidance, and that the basis on which he did so, that really raises the question of whether this case fits within the rule that he articulated in *Hadlee*. It would need some extension of the rule, I think, and I don't want to gainsay that, but it is an issue as to whether the rule should be extended.

MR GODDARD QC:

Yes, but the approach the Commissioner has adopted in this case, without seeking to extend the rule, is to say that the same analysis of the scheme of the legislation informs the application of s BG 1, so that there are –

McGRATH J:

Of course, of course.

MR GODDARD QC:

Yes, and I do want to emphasise that all five Judges agreed with the President's judgment, which included the explicit discussion of the tax avoidance issue and the express adoption of the Chief Justice's reasoning on s 99 below –

McGRATH J:

Yes, well, all five Judges also agreed with Richardson J, if I can put it that way.

MR GODDARD QC:

Yes, but that's because these are not mutually exclusive routes –

McGRATH J:

Oh, no, I appreciate that, yes.

MR GODDARD QC:

– to the same end. Quite the contrary, it seems to me that the same understanding of what is important about the Act, that initial paragraph of Justice Richardson's judgment, that, "The graduated rate structure is a basic feature of the tax system," and that if you can split income you reduce its application, takes us inevitably to the conclusion reached on both limbs of the case.

McGRATH J:

Thank you, that's been helpful.

TIPPING J:

Well, I'd just like to pursue it, because this strikes me as being pretty important.

MR GODDARD QC:

Yes.

TIPPING J:

Is it quite clear that the Commissioner is not trying to, as it were, eliminate the company from this case? In other words, the Commissioner is not analogising from *Hadlee* that you simply have to take the view that the doctors are earning the income themselves and there's nothing they can do about it?

MR GODDARD QC:

No, the Commissioner's assessment has proceeded on the basis of an analysis of a number of factors, including not just the creation of the structure but, critically, the way in which it was used, and that combination of the way in which the salary was set, the retention of control –

TIPPING J:

You needn't go on, you needn't go on.

MR GODDARD QC:

Yes.

TIPPING J:

You're not seeking to apply *Hadlee* directly to this case –

MR GODDARD QC:

I'm not seeking –

TIPPING J:

– in the sense of saying, "Well, it's personal income, exertion income, so that's the end of it, they can't shed it, by any manner of means"?

MR GODDARD QC:

I'm not seeking to apply that limb of *Hadlee*, no.

ELIAS CJ:

You're not saying it's an attribution?

MR GODDARD QC:

No, I'm saying that at the first step of the *Ben Nevis* analysis, the taxpayer does show that he earned, if we take Mr Hooper's $120,000 and the company earned –

TIPPING J:

Well, I thought that's what you were saying but I just wanted in the light of your discussion to make it absolutely clearly in my mind, and also for Mr Harley's benefit too.

MR GODDARD QC:

Yes, but the same –

TIPPING J:

I understand the point about the same line of thought leads you to the same result.

MR GODDARD QC:

Yes, and that's what I'm –

TIPPING J:

But you're going down, in effect, the BG 1 route.

MR GODDARD QC:

And only the BG 1 route, but with the same underlying inspiration, and I do rely directly on *Hadlee* as relevant authority, because there were two grounds on which the Court of Appeal unanimously, five Judges, decided the case.

MCGRATH J:

But you're only wanting to rely on one of them?

MR GODDARD QC:

Because that's all that's been invoked by the Commissioner in this case.

MCGRATH J:

Are you saying you're precluded in some way?

WILLIAM YOUNG J:

Oh, he must be, because in the SOP you've only invoked s BG1.

MR GODDARD QC:

The adjudication report rejected application of the first limb of *Hadlee* and in those circumstances –

MCGRATH J:

So it was an issue?

MR GODDARD QC:

It was an issue, but internally the Department decided not to pursue it in the adjudication report but rather to pursue the BG 1 route.

MCGRATH J:

In or after the adjudication report?

MR GODDARD QC:

As a consequence, in and as a consequence of, the adjudication report.

MCGRATH J:

Right, thank you.

MR GODDARD QC:

My learned junior keeps me on the straight and narrow on these things and confirms I'm right.

TIPPING J:

But you're just simply not arguing it, you're not giving, expressing any view as to whether it would've been signed, had it been argued?

MR GODDARD QC:

No, it's just not before the Court.

TIPPING J:

No, it's just not before the Court.

MR GODDARD QC:

It wasn't before the High Court, it's not before the Court of Appeal, it's not before this Court.

ELIAS CJ:

Thank you, that is helpful.

MR GODDARD QC:

That brings me to *Peate*, and I am going to go both to the Privy Council and the High Court of Australia, and because the High Court decision was omitted from the bundle but is being brought down now. I'm going to do it backwards if that's all right.

ELIAS CJ:

I have it.

MR GODDARD QC:

How many copies would the Court need?

ELIAS CJ:

Just one, just me, thank you.

MR GODDARD QC:

We're working off a number of different versions, so what we have here is the appeal. The Commonwealth Law Reports version, and if we begin, first of all, with the judgment of Justice Menzies, this was, of course, a case involving a partnership of doctors, the partnership was dissolved, companies were formed, the doctors were each employed by their family company and a single company was formed, which rendered all the bills and then in turn service fees were charged to that company by the family companies who, in turn, employed the doctors, and the judgment of Justice Menzies begins at page 445 of the report and, as the Court noted before the adjournment, there are some interesting broader observations throughout the judgment and, "It is perhaps inevitable in an inquisitive society that taxation is regarded as a burden from which those who are subject to it will seek to escape by any lawful means that may be found. This is generally called tax avoidance and it is successful if by reason of what is done what is potentially taxable is put outside the effective operation of the revenue laws. Furthermore, in the absence of a special law a genuine transaction does not loose its legal effect because it was carried out to avoid, limit or postpone tax. It is the recognition of this that accounts for the legislature casting its net wide to frustrate the attempts of those confronted with tax liabilities to get round the law. As often as a particular loophole is closed through

which it has been discovered that revenue is lost, another is likely to be found, so that as long as it confines itself to stopping gaps the legislature is always a step behind reluctant taxpayers and their ingenious advisors. It is not therefore surprising that Parliament has sometimes sought to anticipate tax avoidance by general laws rendering ineffectual against the Commissioner arrangements which are not shams but are entered into to avoid taxation obligations that would otherwise in due course be incurred. Such a law is s 260 ..."

"A further observation of a general character is relevant. As the law stands, taxpayers who are in business as employers or employees have found it easier than those who are not to reap advantages from some of the deductions from assessable income that are allowed in the calculation of the taxable income upon which tax is assessed", with reference to superannuation schemes, reference to a wide variety of amenities from which employees obtain non-taxable benefits, fringe benefits, holiday pay, and then beginning at "Such benefits," about eight lines from the bottom. "Such benefits, real enough as they are in ordinary circumstances, would, however, obviously be of far greater value if it could be so arranged that they should accrue to taxpayers who would in substance employ themselves in the sense that their salaries, amenities, superannuation payments etc would come from their own earnings. Cases such as *Lee v Lee's Air Farming Ltd*," my learned friend's favourite case here, "illustrate how incorporation maybe used to effectuate what can be loosely described as self-employment. So long as the employer and the employee are separate ... the costs of benefits must be borne by the employer." It's different if a person were to provide themselves with those benefits.

And then eight lines down. "A further refinement would, however, bring even greater advantages to a family man, who, it is established, cannot achieve taxation immunity by the simple expedient of assigning his earnings to his wife and family ... If, for instance, it were possible for a man to rearrange his affairs so as to work for his wife and his family as he previously worked for himself with the consequence that the return which his work produced, instead of being his own income and taxable as such, would be divisible between him – as salary – and his wife and family as his employers and that his holiday pay, superannuation payments and other benefits would be tax deductions ... how much more would be left in the hands of the family group after each of them had paid tax on what came to his or her hands! To achieve such a result where a man has been working in partnership with others in the same way and wishes to continue [doing so] in much the same way except fiscally would,

however, necessitate the exercise of some ingenuity, not to say boldness, particularly in the case of men subject to both professional and statutory controls, eg lawyers and doctors." His Honour then considers the facts of the case and concludes that the arrangement in *Peate v FCT* was tax avoidance, but there was then an appeal to the full Court of the High Court, and the judgment of the full Court begins at 466.

Justice McTiernan agreed with Justice Kitto, that Justice Kitto notes the appeals before the Court, and I'm just – just make sure I have the paragraphs because I had another version as well. After describing the plan that was adopted at the foot of page 468, his Honour says, "In accordance with the plan, the appellant and the other doctors who participated from time to time conducted as employees of Westbank the work of the practices that formerly they had carried on in partnership. The plan and all that was done under it plainly constituted an 'arrangement' in the sense of 260." And so then the question became, in terms of *Newton* in part, 10 lines down, "whether, upon consideration of the overt acts which have been done in carrying out the plan, the arrangement is to be recognised as a means for the avoidance of a tax liability, whether or not it be a means to other ends also. The arrangement in the present case, considered objectively ... may well seem to be characterised by several purposes and effects, some of them unconnected with taxation, including the protection of individual members of the group against liability for negligence; the making of superannuation provision for employees ... the better organisation of the group's activities and particularly its methods of accounting; and the making of provision for the doctors' families. (All of these purposes, indeed, the appellant swore were actually contemplated in the formation of the plan.)"

Very similar to this case. But the question remains whether the overt acts that were done under the plan are fairly explicable without an inference being drawn that tax avoidance is a purpose of the arrangement as a whole. Justice Menzies thought they were not, and with respect, I agree. The agreement bears ex facie the stamp of tax avoidance. n understandable purpose of providing for the doctors' families and doing so quite honestly is perfectly evident but, and this I think picks up questions from your Honour Justice Tipping and your Honour Justice Young yesterday, what is equally evident is a purpose of doing so by a method which will divert income away from the participating doctors, to or for the benefit of their families, to the end that a substantial part of the tax might be avoided which would have been incurred if the income had first been derived by the doctors and then applied by them for the benefit of their families. The case therefore falls plainly, as I venture to think, within the

application of 260. And then his Honour turns to the consequences of that conclusion.

Justice Taylor's judgment begins at 472 and without going through it in detail, I'll perhaps just draw the Court's attention to the passage that begins at the foot of page 474, "The interrelated and concerted transactions by which these results were brought about," with reference to the difficulties of s 260, and down through the rest of 475.

BLANCHARD J:

Well, halfway down the first paragraph there is an interesting observation: "Indeed, in its final analysis, the picture is little different from that which would have appeared if the appellant had assigned his future gross income," etc

MR GODDARD QC:

Yes, "upon condition that the assignee, after paying the appellant's share of working expenses, should then pay to the appellant such part of the net amount as he should direct and, thereafter, expend the balance in a specified manner for the benefit of the appellant's wife and children." It's just the same in substance as if you attempted to do that by assignment, and there's no reason for applying anti-avoidance rules which look at substance, not form, to reach a different conclusion simply because a different tool is used to bring about the same result. So it's about 12 lines down on page 475, and then his Honour goes through the alternative explanations, reference – capable of explanation by what happens to ordinary business or family dealing and the emphasis that, and the rejection of that, and over on 476, the last paragraph I was going to draw attention to. Actually the next two. So 476 it's, "it is, I think, not open to doubt that the purpose and effect of the arrangement which is now attacked was to avoid tax. It is true, no doubt, that it had other ends in view such as the making of provision for the appellant's wife and children. But avoidance of tax was the means to those ends and a diminution in the appellants' tax was not merely an incident of what might be regarded as an ordinary family settlement; as I have already indicated avoidance of tax on income produced by the professional activities of the eight medical practitioners in question was at the very heart of the arrangement which is about as far removed as possible from any concept of ordinary business or family dealing ... it possessed no other feature to deny its true character, that is an arrangement having the purpose or effect of defeating, evading or avoiding income tax."

A further point was made that even if the various dealings did constitute an arrangement of that character, its avoidance did not enable it to be said the appellant had derived the income. That's to say that no part of the profits earned by the professional activity of the appellant could be said to found its way into his hands. There was then a discussion of the way in which fees were paid and the retention of control by the directors, but doctors – "But", at the foot of the page, fourth to the bottom line, "it is unnecessary to rely upon these matters in rejecting the appellant's submission on this point. I have no doubt that the avoidance of the agreements ... produces a situation in which the Commissioner is entitled to say that what Westbank received it received in part on behalf of the appellant." It really starts to turn to reconstruction.

And then there's a characteristically elegant and historically informed judgment of Justice Windeyer, a thing of great beauty, if I may respectfully say so. After introducing the facts, his Honour, at the top of 478, explains that, "s 260 is a new form of response to the attempts of taxpayers to escape by lawful means from the tax-gatherer's net. It is not altogether fanciful to see the section as a parallel with the Statute of Uses and its reference to 'divers and sundry imaginations, subtle inventions and practices'. For, just as in Tudor times men sought to separate the enjoyment of the profits of land from the legal title to it and so to avoid the burdens of the old feudal dues, so in modern times men have sought to have the enjoyment or the disposition of the produce of their labour or their capital without the burden of the levy which the state imposes. In each case the legislature intervened to frustrate their designs."

"A taxpayer may legitimately regard it as a business-like action so to arrange his affairs in the interest of himself and his family as to reduce his liability for taxes. But that does not mean that whatever method he adopts to that end can itself be said to be explicable as an ordinary business or family dealing putting it outside s 260. It was argued that the arrangement in this case did not in one of its aspects differ essentially from the mere carrying on by a company of a trading business formerly carried on in partnership and in another aspect from the management and investment of capital assets by a private company and the distribution among shareholders of the income periodically arising. The resemblances seemed to me remote. Whatever may be said of the company ... separately regarded, the

combined and inter-related activities and purposes of it and its companion Raleigh Pty Ltd are certainly remarkable and out of the ordinary."

"A proprietary company, controlled by one man, has today taken the place of John Doe, William Roe and others who at an earlier time came out of ink-wells in attorneys' offices to do acts in the law of which law-abiding citizens might have the benefit while avoiding disadvantageous consequences. By incantations by typewriter, the obtaining of two signatures, payment of fees and compliance with formalities for registration, a company emerges. It is a new legal entity, a person in the eye of the law. Perhaps it were better in some cases to say a legal persona, for the Latin word in one of its senses means a mask ..."

TIPPING J:

Why on earth didn't you read the last four words, Mr Goddard? Spare us.

MR GODDARD QC:

For fear that I might be asked to do a translation on the spot, which –

ELIAS CJ:

Well, you're probably the only counsel who could read it accurately, so…

MR GODDARD QC:

I could read it accurately but to give a really nice translation would require – there's something about the mask departing, the thing remains, *manet res*, so yes, all right, I'll do it. "*Eripitur persona, manet res*." The persona –

TIPPING J:

If you take away the –

MR GODDARD QC:

– the mask being taken away –

TIPPING J:

If you take away the mask –

MR GODDARD QC:
– the thing remains.

TIPPING J:
– the reality emerges –

MR GODDARD QC:
Yes.

TIPPING J:
– or remains.

MR GODDARD QC:
"Res" which is the word for "thing", which is where we get reality from, of course. Yes, quite so, sir. Your Honour made me do that.

And then over the page, "Raleigh Pty Ltd was upon its creation at once obedient in its mind and its actions to the bidding of its governing director. He was a solicitor," so on and so forth, the objects were to run the medical practice. The company acquired the instruments it needed, and then, middle of the page, being in – the surgeon then no longer having the instruments he needed, covenanted "'to serve the company as medical practitioner in the business carried on by the company'", and became, at the direction of Raleigh, his family company, a servant of Westbank, the company carrying on the practice, the two companies begotten and born at the same time.

Now, it was suggested that a medical practitioner becoming the paid servant of a company is not an ordinary business dealing, and my learned friend suggested yesterday that that may no longer be true today, and one might ask what the chicken is and what the egg is in relation to tax and structures of that kind, but it's certainly not a matter that in and of itself would command the same surprise today.

There is, however, going on from that, the question of looking further and seeing what was really intended and what occurred, and a statement of Lord Atkin's was, his Honour said, "apposite at this point". "'I had fancied,' his Lordship said, 'that ingrained in the personal status of a citizen under our laws was the right to choose for himself whom he would serve: and that this right of choice constituted the main difference between a servant and a serf,'" and that I think is part of

my learned friend's submissions, that the doctors were free to serve companies. "But, of course," his Honour went on, "the appellant was in no danger from his subjection to the dictates of Raleigh Pty Ltd, because no sooner had he become its servant on those terms than he became in substance and effect its master." And the way in which that occurred is explained.

The next paragraph, "It is not in legal theory impossible or incompatible for a person to be both governing director in sole control of a company and servant of that company or its agent to contract on its behalf," *Lee v Lee's Air Farming Limited*. "If a company is duly incorporated and registered ... and the proper records are kept in due form, prescribed returns are made, it continues to exist as a legal entity. In that sense it is a reality not a sham. But I thought that in the argument for the appellant too much was made of this. The cat that the monkey employed to pull the chestnuts from the fire was a real cat. And other cats' paws have been real too. Straw bail were real men. Whatever philosophical theory, if any, one entertains of the nature of corporate personality, not much assistance for questions such as arise in this case is got by emphasising that in law a company is an entity distinct from its members. What is important is the function that the company in fact performs and which it was created to perform. It is not necessary for the application of s 260 to find that the case is one for 'lifting the veil'."

Reference to Gower, and another Court of Appeal decision, and reference to façades, but, "Whether that description," his Honour went on to say, "could be used of Raleigh Pty Ltd," the family company, "I do no consider; for I prefer to regard that company not as a façade or screen but as one of the instruments by which the appellant and others sought to carry their plan into effect," and that's very much the submission here. "I agree with my brother Taylor that it, Raleigh, was like an assignee to whom the appellant had assigned the future income which Westbank Pty Ltd was to collect as the fruits of his practice of his profession, such assignment to Raleigh being upon condition that it would deal with the moneys it got as he, the appellant, directed. That seems to be substantially the only part Raleigh had to play", and then there's reference to the salary paid to the doctor's wife.

"I have made these remarks about Raleigh because it sheds a light upon the purpose and effect of the whole arrangement in which it was created to play and did play a part. But I agree with Menzies J that it is not the interposition of Raleigh that brings the arrangement within s 260. That comes about not because of some particular

element in the arrangement or of any of its subordinate transactions but from a consideration of it as a whole," from the *res*, once one removes the *persona*.

And then his Honour agrees with Justice Kitto and Justice Taylor, and Justice Owen agrees with Justice Kitto.

That's the High Court of Australia. The Privy Council, the s 260 issue, was live. It was one of the grounds of appeal necessarily –

WILLIAM YOUNG J:
It's dealt with in a paragraph though.

MR GODDARD QC:
But it's just dispatched very briefly, and all I really wanted to say was that this was not seen as difficult by their Lordships. They looked at it. They read the High Court of Australia decision. They said yes, obviously. So that's really that decision in the Privy Council. But it's the ease with which their Lordships, and brevity with which their Lordships, reached the conclusion which in my submission provides the strongest support for the Commissioner's submission in this case. And so I say, and this is my 5.3, *Peate* is on all fours with the present case.
The PSA Rules do not provide a relevant point of distinction, for the reasons I touched on when discussing *Challenge*, that I'll come to in a moment in my 6.1, and, although my learned friend talked about a paradigm shift I think he eventually resorted to, in relation to taxation since the mid-1980s in New Zealand and the emphasis on tax neutrality, of course the only reason we're here is that that pursuit of tax neutrality was not complete. There remained a graduated scale for individuals, and there continued to be taxation of individuals, of natural persons, at rates different from those applicable to companies and trusts, and so at that boundary, just like the GST secondhand goods boundary, opportunities for tax avoidance remain, and exactly the same analysis is applicable. The avoidance of a graduated rate scale applicable to individuals was still an act of business, as we can see from these cases and the advice of accountants to adopt such structures in the New Zealand of the early 2000s, just as it was last century, though admittedly in response to a much steeper and graduated scale.

5.4, if one imagined going to an objective observer and showing that objective observer the diagrams that form the last two pages of my submissions, the structure

of the arrangements adopted and then the table underneath it, even if one were to drop out the two columns headed "Annual CRS" and "Midpoint CRS" that result from the analysis of Mr Lyne, and simply look at the diagram and look at what actually happened in effect, the earnings of the company, the earnings of Mr Hooper and the tax saving in each year, I think that that objective observer, shown that single page and asked what the purpose and effect of the arrangements, by which Mr Hooper was employed and paid that salary, were, the observer would unhesitatingly identify tax reduction as one of the purposes and effects of the arrangements. Nor do I understand my learned friend to suggest that that was merely incidental.

So, as I say at 5.5, other purposes might be identified, but to echo the Chief Justice in *Hadlee* in a passage expressly adopted by the President in his judgment, "The potential tax benefits are obvious and significant. It would require a considerable degree of naivety to conclude that they played merely an incidental part in the scheme."

I then turn to some specific arguments made by my learned friend. First, the heavy emphasis put on the PSA Rules and I took the Court earlier to his paragraph 66 and the suggestion that when adopting the PSA Rules, at the time when the top personal rate was increased to 39%, Parliament has exercised its powers prescriptively and completely, and that it's important not to undermine Parliament's emphasis on the asset threshold and the 80% fee threshold. This is the same argument that was unsuccessfully run, eventually unsuccessfully run, in *Challenge*, and that this Court discussed in *Ben Nevis.* But we have also here some additional assistance from the legislative history, which suggests that not only is that conceptually wrong, it's also ahistorical.

If I could take the Court to the Court of Appeal's judgment in the present case and the judgment of Justice Randerson, at paragraph [91]. His Honour sets out here the commentary on the Bill, which introduced the PSA Rules, and the summary of proposed amendment, "The Bill introduces an anti-avoidance rule broadly aimed at employees who circumvent the top personal tax rate of 39% by interposing a company trust or partnership between themselves and their employer, in order to have their income tested at a lower rate. The rule will attribute what generally is in substance employment income to the employee. It supports the general anti-avoidance provisions of the Income Tax Act 1994, applies for income tax purposes only". Application date. Background, "the attribution rule addresses the need to

protect the PAYE tax base following the increase in the top personal tax rate, from 1 April 2000, to 39%. Anecdotal evidence suggests that simple avoidance schemes are being targeted at employees. Income tax legislation already contains general anti-avoidance rules that can be used to counter such avoidance activity. Experience has shown, however, that they are time-consuming and costly to apply", and our presence here is perhaps some evidence of that. "Relying on these rules to counter the expected rise in cases of alienation of income by employees would mean that the results would most likely not become public through the courts for several years. Such delays could seriously erode the additional tax revenue intended, by raising the top personal tax rate to 39 percent. The proposed legislation addresses this problem by providing explicit rules ..."

And so, as his Honour said in paragraph [92], and it's really impossible, I think, to improve on this paragraph, "This material makes it clear that Parliament did not intend the PSA Rules to be a comprehensive attempt to define all the activities that would constitute tax avoidance in the wake of the increase in the top personal tax rates. Rather, the PSA Rules were intended as a mechanism to restrain tax avoidance in a defined situation more rapidly than would be possible using the general anti-avoidance provision."

BLANCHARD J:
What exactly was the document that Justice Randerson is quoting?

MR GODDARD QC:
It's the explanatory note to the Bill.

WILLIAM YOUNG J:
It's on the front of the Bill presumably, is it?

MR GODDARD QC:
Yes, on the front of the Bill.

BLANCHARD J:
So it's definitely admissible?

MR GODDARD QC:
Yes, I'm all right on this one, Sir, unlike other recent sins.

BLANCHARD J:

Well, I've learned to watch you carefully, Mr Goddard. If I may say so.

MCGRATH J:

Mr Goddard, I see that in the judgment of Justice MacKenzie at [41] he suggests it's part of the report of the Finance and Expenditure Committee, it seems to be the same process.

BLANCHARD J:

Well, it would still be admissible.

MCGRATH J:

It's still admissible on that basis.

MR GODDARD QC:

I'm sorry, your Honour, I thought that was the –

ELIAS CJ:

Do we have –

MCGRATH J:

We don't have the material itself, I don't think.

ELIAS CJ:

We can get it.

MR GODDARD QC:

Yes, that must be right, it must be the commentary provided on the Bill as reported back, not the Bill as produced –

MCGRATH J:

Thank you.

MR GODDARD QC:

The coincidence of language is too great otherwise, I'm grateful to your Honour, and I'm sorry for getting that wrong, I read them all and blurred them in my mind. So, that's my 6.1. I don't know that I need to spend much time on the 6.2, that there's no commercially realistic salary concept in the Act. The concepts in the Act on which the Commissioner relies are the concepts underpinning section BG 1, concepts of commercial and economic reality, concepts of artifice and pretence. Asking what salary would be commercially realistic is intended to be no more than trying to understand whether those concepts are engaged. So there's no magical concept of a commercially realistic salary present in the Act that we have to find somewhere, rather in attempting to respond to the question posed by the courts: are these arrangements realistic as a matter of commerce, as a matter of economics or do they involve artifice or pretence. What Mr Lyne has done is answer the question asked by the Commissioner: what would be commercially realistic? And the conclusion that was reached is that whatever would be commercially realistic we're a million miles from it here, and that was not in dispute. The taxpayers accepted in the High Court and at every stage of this matter that what they were paid was not within a commercially realistic range.

Turning to *Loader*, I think the point I'm making really emerged from questions from the Court to my learned friend yesterday, or it might be Monday, there was no allegation in that case of any artifice or any uncommerciality. The decision confirms the use of a family company and family trust is not in of itself, without more, tax avoidance, but that tells us nothing here because that's not what the Commissioner is arguing, and this is very similar to the point made in *Glenharrow* at [53] about a sale of an asset with vendor finance and a cheque swap, it's one thing to say that normally that would be inoffensive, but another to say it's never, therefore, a context within which –

TIPPING J:

It's not an offensive method.

MR GODDARD QC:

Yes.

TIPPING J:

But it can be put to offensive use.

MR GODDARD QC:

Yes, you can use a knife for a range of things, good or ill, it's just a tool. The other points I would just note about *Loader* are that the test applied by Justice Cooke at first instance as his Honour understood at the time was whether tax avoidance was the sole or at least principle purpose of the arrangement, and, of course, that's very different from the test now and the "merely incidental" test, and also although I am conscious of the eminence of the Judge delivering the decision, it was an oral decision in which *Elmiger* is not referred to, although his Honour does say in one, "I have considered all the reported cases on the matter", but it then goes on to say, "they didn't help me very much," but there's no explanation of why it was distinguishable from *Elmiger*, a case to which superficially one might think it had some resemblance, but the key point is that there was no allegation of artifice or uncommerciality, and so it really provides no guidance at all in the present case, where that is very much at the forefront of the Commissioner's case. Mr Shewan's examples, which are set out in my learned friend's paragraph 14, and this is where I think the distinction lies between a market salary and what is commercially realistic. It may be important and it ties into what your Honour Justice Tipping said the other day about the presence of an objective reason for paying something less than a market salary. The Commissioner accepts that there may be, in certain circumstances, good objective reasons for a family company to pay a working director something less than or different from a market salary for the services performed, and it's whether what is paid is commercially realistic, having regard to those objective factors.

So, it's a question of what's commercially realistic which is needed, to be no more than the flip side of the enquiry into artifice, pretence, commercial economic reality is broader than just asking, so what's the market rate for these services? And, of course, if we look at the example of a start-up which in its early years makes losses and cannot pay any salary, if the company has no more money to pay a salary, then that's a relevant objective factor, which sheds light on what's commercially realistic. To take the second example of a serious illness suffered by the employee so they can't work but remain an employee, again, if no profits are generated, if the company has no money, that's inevitably going to inform what it's commercially realistic to do.

BLANCHARD J:

Well, you don't expect to pay for lengthy periods for people who can't work because they ill.

MR GODDARD QC:

Also, so one looks for objective factors and asks, is there a perfectly sensible objective reason for the way in which this salary has been set, and in all the examples given by Mr Shewan there are such reasons, and the inability to pay is a real inability, and it's not the case that the rest of a substantial profit is finding its way to be used for the same purposes that an individual income at that level would otherwise be used for.

TIPPING J:

Mr Goddard, if we go your client's way, are we going to find ourselves with lots of arguments around the margins? I hear you say this is a clear and obvious case, but there may be some cases that are debatable?

MR GODDARD QC:

Yes.

TIPPING J:

Now, does that mean we're going to have a whole heap of litigation arguing about people's salary, which should've been a bit more or –

MR GODDARD QC:

The test of what's commercially realistic, necessarily it seems to me, is going to involve a range. There's generally going to be wide range of outcomes in any given case which would be, or at least a range that would be commercially realistic and fine differences of a few thousand dollars here or there do not enable one to say, "Well, this is not commercially realistic," so it's not a matter of second-guessing precise decisions, it's a matter of being able to say, "This is outside the range of what can be considered commercially realistic". I would've thought that would reduce the number of cases in which the issue arose but, yes, inevitably there will be boundary cases, and that these issues involve matters of judgment and that people can differ on matters of judgement is no new discovery in the context of s 99, s 108, s BG1 – I can't say to your Honour, no problem at all.

TIPPING J:

No, you mean this is just inherent in the necessary inquiry?

MR GODDARD QC:

Yes.

TIPPING J:

And it doesn't cease to be a necessary inquiry because there will be some cases that are difficult?

MR GODDARD QC:

Yes, that puts it better than I did, thank you, and the courts have made that point in other tax avoidance cases, that many cases will be clear, there will be some harder ones, such is life. In particular, such is life when Parliament deliberately adopts the sort of technique of general proscription that is used in section BG 1 and its predecessors. So what I say at 6.4(b) is, so, there will be cases where not paying a market salary is commercially realistic, where paying no or very little salary may be commercially realistic, but when substantial profits are generated from the taxpayer's personal skill and efforts and those profits are controlled by the taxpayer and made available for the benefit of the taxpayer and his family, it's artificial and a pretence to say that he's earning only 20% of those profits.

And the lengths to which my learned friend's argument would take matters are really, I think, illustrated by the concession made in argument below and before this Court, that if the taxpayers' arguments are accepted then a zero salary would not be tax avoidance, even if the whole of the practice profits are controlled by and used for the benefit of the taxpayer and his family, via a family trust. And, indeed, one would not be able to say that cases such as *Y1* and *Y5*, which are in the bundle, were tax avoidance, even though salary is reduced to a level where the taxpayer qualifies for Working for Families and doesn't merely reduce their liability to tax but qualifies for tax credits and is paid money – that's a surprisingly suggestion.

The hindsight issue at 6.5, I don't think I need to spend any more time on. I've already mentioned the importance of the manner in which an arrangement is carried out in *Ben Nevis* and the definition of arrangement. 6.6, similarly, I think I've dealt with – although the Penny structure was set up in 1997, the issue's not the structure, it's how it was used and a key element of that use, a key element of the arrangement, was the decision in each year on salary and bonuses and so forth. You can't understand the purpose and effect of the arrangement until you know its terms, you don't know its terms until the year in question, it's as simple as that.

Some emphasis is put in paragraph 65(f) of my learned friend's submissions on there being an outright and permanent sale of property here. That may sometimes be a relevant factor, it's certainly not the only factor, but where it is relevant, to the extent that it's relevant, it's a little difficult to describe this as an outright and permanent sale of property in terms of the income-earning capacity of the doctors, because each doctor was left in control each year of how much of the practice profits to treat as salary and how much to channel to the company or trust and of course was free, sitting on both sides of the transaction, to agree to terminate the arrangement at any time and practice on their own account. If one of them had been offered a full-time position by the medical school teaching, had been attracted by that for personal reasons, one can hardly imagine that any major difficulty would have arisen in securing a release from the service of the company in order to be able to pursue that. The negotiation with himself would, I suspect, eventually have come to a successful conclusion.

Goodwill, I said I would come back to. The Commissioner's argument on goodwill is presented in the alternative and for the reasons touched on in the submissions it seems very difficult to believe that an asset of value was being transferred here; that it wasn't of particular importance I think is illustrated by the absence of any employment contract or expressed restraint of trade for Mr Hooper, and the fact that although an employment agreement was signed between Mr Penny and the first company incorporated, Penny Orthopaedics Limited, everyone forgot to bother to assign it to the new company before POL was liquidated, or to enter into a new one many years on.

There is the point Justice Blanchard raised about insurance the other day, there was some evidence of income protection insurance on the part of Mr Hooper for a much smaller amount, but none that I could see on a quick look yesterday in respect of Mr Penny, but, of course, more importantly, there were many risks that couldn't be insured against, that the company necessarily assumed, such as a decision to work longer hours in the public sector, again a decision to give medical practice and raise rare sheep or whatever other lifestyle changes people in their 40s sometimes inexplicably embark on, I'm almost through that danger phase. So, a range of risks that couldn't be protected against, for which payment was made, but also the point in *Hadlee* that actually even if some real goodwill was being purchased here, there's just an extraordinary disproportion between the return to the company and what was paid. Most striking for Mr Hooper, a payment of some $300,000-odd, more than a

100% return in every year. But even for Mr Penny, what he received was merely $100,000. The next company then on-sold the right to exploit him for $1 million, but, even there, the return was spectacular and, across the three years in question here, never mind the whole 10 years, was more than recouped.

Admissibility of the Shewan brief, the Court expressed some frustration yesterday at being troubled with these matters. Let me say briefly, why the objection was taken is that briefs of this kind are becoming reasonably common in tax avoidance cases and that means that not only do the arguments have to be addressed by counsel in submission, but then in addition one faces the dilemma of whether to cross-examine on these issues of not.

ELIAS CJ:

But it's not a dilemma, really, because if you had the courage of your convictions, you'd simply say to the court, "I'm not proposing to cross-examine on any of this material, I should be making submissions in due course on it."

MR GODDARD QC:

And indeed, that's largely what experienced counsel do, but one shouldn't, in my submission, be put in the position of having to take that punt and then find that, as Justice MacKenzie did, it was treated as admissible and helpful and –

ELIAS CJ:

It might've been helpful submission.

MR GODDARD QC:

The question of s 92, the old rule in *Brown v Dunne* and to cross-examine, and I don't think you're going to invite the Court to depart from, arises and so, your Honour is right, but it's possible to have the courage of one's convictions and do this, but why should counsel, why should parties be expected to have to deal with submissions from both witnesses and counsel which, inevitably to the extent they duplicate matters, take extra time, inconsistent, I might say, with one of the policies of the Evidence Act, which is the efficient disposal of proceedings. These are properly matters of submission. In my submission, it is appropriate to discourage this practice and the cumulative risk and uncertainty it causes, especially if people were to respond in kind, as the Commissioner is supposed to, you know, call evidence from Sir Ivor Richardson on what the scheme and purpose of the Act really is.

BLANCHARD J:
Then we'd know.

MR GODDARD QC:
I wish your Honour hadn't said that, it's a rhetorical question.

ELIAS CJ:
It is, of course, regrettably the practice that's ubiquitous in the resource management field, and perhaps a little bit more debatably in trade practices.

WILLIAM YOUNG J:
Or valuation cases.

ELIAS CJ:
Sorry?

WILLIAM YOUNG J:
In valuation cases.

ELIAS CJ:
Yes, yes, yes.

MR GODDARD QC:
The fact that something which is wrong in principle is also rampant is not a reason to tolerate it, your Honour.

ELIAS CJ:
I'm just really wondering what you want from us on this?

WILLIAM YOUNG J:
A big growl.

MR GODDARD QC:
Yes, something, a growl, would be helpful because it might discourage people from embarking on this in the future and it might, for example, provide a platform for a

costs order directed to the evidence of a particular witness and the need to deal with it in the future. While we're on the wish list, can I also beg the Court to refer to *Peate* somewhere in the judgment because that's not, despite being referred to in the High Court and the Court of Appeal, it's not referred to in the judgments and the result is that one, if not two, critical articles have already been written wondering what counsel for the Commissioner could be thinking not to have referred to *Peate* in this case, not to mention a barrage of telephone calls and emails asking me if I've done any research on this at all, so whatever the result is in this case, my life would be immeasurably improved if the Court were to at least footnote *Peate*, it's the wish list.

TIPPING J:

"Referred to by Mr Goddard."

MR GODDARD QC:

I'd be so grateful, perhaps if your Honour could say I dwelt on it for some time. Coming back to my submissions, that it is inadmissible is in my submission, very clear and it's unhelpful, and it would be helpful if you addressed it. That leaves, with 10 minutes to go to lunch, which I think is probably about plenty of time if not more than enough time, the evidence exclusion issue which passed – unless the Court has any questions for me before I sit down?

ELIAS CJ:

No thank you.

MR GODDARD QC:

Thank you, your Honour.

ELIAS CJ:

Yes, Mr Ebersohn.

MR EBERSOHN:

May it please the Court.

ELIAS CJ:

You've heard, of course, the exchanges and we have, of course, read your helpful submissions, so perhaps you can bear that in mind in addressing us.

MR EBERSOHN:

Thank you, Ma'am, I'll be brief, my impression was, from yesterday, that there wasn't a need to cover this in any great detail. I think, just on a point of clarity, that we need to make it clear that the Commissioner's position, that what he's relying on, is essentially what the Court of Appeal found, that we're not in fact seeking to say it's part of the, that the loan's part of the arrangement. We're quite content to rely on the loans as being evidence of contrivance or artifice. What I think we should look at very quickly is the Commissioner's submissions in this regard, and just go to paragraph 12.7, which is at page 27 of the submissions, and that first sentence there says, "First, the arguments that these cash flows formed part of the relevant arrangements was raised in the Commissioner's SOPs." I think that sentence can simply be changed to say, "First, these cash flows were raised in the Commissioner's SOPs", and the rest of the submissions will effectively remain the same if you, if that's done, and that would then clarify the approach which the Commissioner's adopting.

TIPPING J:

These cash flows were raised in the Commissioner's SOPs?

MR EBERSOHN:

Really, as simple as that. Now, my learned colleague, Ms Bibby, stated yesterday that Justice Randerson, when he actually gave his decision, departed from that and she took the Court to paragraph, I think it was [113], and I'd like to return to paragraph [113] of the Court of Appeal's decision very briefly, and that's the paragraph which starts off with, "There are two striking features of the arrangement adopted by both respondents." And it's quite clear what the first striking feature is. The first is that each had been conducted, had conducted in respect of practices as orthopaedic surgeons on their own account and then chose to incorporate their practices.

Now, my learned colleague went on to say that the second feature was the cash flows, the loans, but, in fact, it's the second feature quite clearly set down on the second half of that paragraph. It starts, "But is the combination of that fact with the second striking feature which I consider significant. In each case, the net income before tax each respondent was receiving was dramatically reduced from the year 2000 onwards." So in fact, all that the second dramatic feature which his Honour was

relying on was merely the reduction of the income and not the cash flows, which were simply evidence of the contrivance or artifice.

Now, my learned colleague also acknowledged that the statement of position only requires an outline, and that's expressed, it's in the Act. The, I can take the Court, if anybody, if required to, but it is in section 89 of the Tax Administration Act. It's also common cause, and as a matter of logic, it really has to be in that form. Laws of Anime process and it's not possible at the stage of statement of position to articulate with absolute precision how the case will eventually be argued, several years later, in the Supreme Court, given the fact that there are judgments being received in the meantime and that the law is evolving.

Now, taking, in footnote 76, I set out the authorities which show that this has generally been accepted by the Courts, that it is an outline, the Act says it is an outline, I'm not going to go through those. I think that's common cause of the parties, but what I would like to do is just go through the actual statements of position briefly, which are in the case in appeal, volume 3, and the Commissioner's statement of position in respect of Mr Penny is at tab 25 and starting at page 381 –

ELIAS CJ:
Sorry, page?

MR EBERSOHN:
381. We have set out the company's net dividends to the company shareholder, being the trust, sets out for the four years what those dividends were, and I think at this point it's just worth noting that the way Mr Penny took his drawings and the way that it was recorded, in fact he used the company cheque book as if it was his own and then that was recorded later, after the event, as a dividend from the company to the family trust and as a loan from the family trust to Mr Penny. So incorporated in these dividends is in fact, in these cash flows, is in fact the amounts loaned and I think that that's worth keeping in mind when the remaining features of the statement of position are looked at.

Then if we turn to page 401, we have the paragraph 920, which was referred to yesterday and that's quite clear, the second sentence of that, "Although an artificially low salary was paid to the taxpayer, having control of the income of the company, he's still got the use of the income of the company from other avenues, dividends to

the family trust." All that this evidence is, is an illustration of how Mr Penny got those, got that use and, in fact, the dividends to the family trust is exactly the same cash flow, which is the loan to Mr Penny from that family trust and sits very clearly within the outline. This issue was responded to in the, there was no ambush here, this issue was responded to by the taxpayer in his SOP at tab 26. So he's well aware of it at paragraph, at page 415, paragraph 58, and that the second half of that paragraph, "It is not acceptable to use as a basis of the application of taxation through the avoidance provision that the disputants still got the use of the income from an avenue, dividends from the family trust. To do so disregards the legal nature of the relationship between the shareholder and the company." Well, that first of all illustrates one of the themes of the appellants' argument in this case, which has been consistent throughout, and then that is that you've got to stick with the legal form of actually entered into, in trying to minimise the role of contrivance or artifice.

The Commissioner then responded again to this in the additions to the statement of position, which is at tab 27, "It also forms part, in terms of Tax Administration Act, it forms part of the statement of position." At page 427, at 2.5, where he writes, "Mr Penny also states it's not acceptable for the Commissioner to use, as a basis of the application of the anti-avoidance provision that Mr Penny has still got the use of the income of the company from another avenues, dividends from a family trust. To do so disregards the legal nature of the relationship between the shareholder and the company." The point that the Commissioner, the point of the Commissioner's argument, is that each one allows them to look at the arrangement as a whole, including each entry that formed part of the arrangement, and so this issue was very, very clearly before, within the statement of position, it was responded to by the appellants, it was responded again to by the Commissioner. Yes, it could have been, there could have been more particulars provided, but it's clearly within the outline contained in the statement of position.

The next point to note, and this is dealing with Mr Penny's statement of position, tab 27, sorry, tab 26, is at page 409, paragraph 17, and there Mr Penny notes that the purpose of the trust, or that the concern that they had when it was up, was asset protection, and I think the point should be made that section 138G allows parties to rely on issues, propositions which are to advance either parties' statement of position, and in the case, which is in the bundle, I won't take you to it, *Delphi Fishing Company,* the High Court felt that that meant you should be able to respond to propositions raised by the other party.

Now, it's clearly highly relevant to whether a trust is for the protection of assets that, in fact, the primary assets of the trust are being loaned to Mr Penny. If Mr Penny is bankrupted, those assets are then lost, a point made in the Commissioner's SOPs, so it's on this basis as well, it can come in as a response to an issue raised by the appellant.

And then the last, second-to-last, issue is just to note that each party in issue covered yesterday, each party reserved their position in respect of discovery. Both parties' statements of position mirrored each other. If I can take the Court to Mr Penny's statement of position at 25, page 388, this is the end of the list of evidence, the first half of the page and the third-to-last item, all other evidence –

BLANCHARD J:
I'm sorry, which page is it?

MR EBERSOHN:
388.

BLANCHARD J:
Thank you.

MR EBERSOHN:
The first half of the page is the list of evidence. The third-to-last item, "All other evidence held by the taxpayers, or any third party, that is disclosed in the discovery process." I think it's important to keep in mind that the statements of position in the evidence exclusion rule is to promote open communication and freer communication, but at the same time it does not provide an incentive for the party to disclose something which is prejudicial to their case, something which may harm their case, and so it's not uncommon for parties to insert into the statement of position, as Mr Penny has done and as the Commissioner has done, something which essentially says, evidence from discovery.

Now, it is correct that my learned friend made the point that the accounts were, the Commissioner had the accounts, it's listed in the evidence, prior to the assessment, but what was discovered in the discovery process, were the cheques, the account, the cheque slips –

WILLIAM YOUNG J:

The way it was done.

MR EBERSOHN:

The way it was done, the manner in which it was carried out. The fact that the two were, the loans and the dividends, for example, were in fact the same cash flow, that Mr Penny used the account as if it was his own, and that component of it, should still be admissible under that, on that basis.

And lastly, just in passing, it's worth noting that there's no artifice or pretence, is pleaded by, in terms of the cash flows, pleaded by Mr Penny at paragraph 34(b) and (d) and, sorry, my apologies, it's paragraph 43(c), and if you're going to plead that there's no contrivance or artifice, the Commissioner should be able to respond to that and say why there is in fact artifice or contrivance.

Unless there's anything further the Court wants me to address, then that's pretty much it.

ELIAS CJ:

No, thank you very much, all right, we'll take the lunch adjournment now, resume at 2.15 pm.

COURT ADJOURNS: 1.03 PM

COURT RESUMES: 2.20 PM

ELIAS CJ:

Yes, Mr Harley.

MR HARLEY:

Your Honours will be relieved to know that, in terms of the reply that I've prepared, I'm very confident that we'll be finished before six this evening.

ELIAS CJ:

Oh, yes, thank you.

MR HARLEY:

And if your Honours restrain yourselves, I'm very confident that it will be considerably before six and I'm absolutely certain that if I was still going at half past four, your Honours would be very confident about telling me to sit down.

BLANCHARD J:

Or you might be speaking to an empty room.

ELIAS CJ:

Not at all.

MR HARLEY:

There are a couple of small points, just to clear the decks. Having reflected on the exchange between your Honours and my friend, in terms of the parliamentary materials, I am sure that they are two separate documents. If you wish, I can locate them and identify them for what they are, but they are correctly described by the Judge, in respect of the document he drew on, and by Justice Randerson in the document that he drew on.

The Judge's is the FEC report. The explanatory note goes with the Bill on introduction.

ELIAS CJ:

So Justice Randerson was referring to the introductory –

MR HARLEY:

Explanatory note.

ELIAS CJ:

Explanatory note, I see, thank you. Well, we can extract those.

MR HARLEY:

The second point I wanted to make, and hopefully not in an overly cheeky way, was that if my friend is able to persuade the Court that you should, in essence, spank me, for the content of Mr Shewan's brief, you should be fair and have a look at the Commissioner's briefs from Mr Lyne, in respect of his opinion about the law relating to matrimonial property and the law relating to goodwill for family companies, and because Mr Goddard is responsible for starting it –

ELIAS CJ:

I don't think Mr Goddard was, in the end, interested really in attributing blame, he'd just like some sort of, as he put it, "growl," so –

MR HARLEY:

And your Honours you should growl at him because he started it.

ELIAS CJ:

I would hope that we can avoid growling at anyone, but we might say something about that unless it is unnecessary.

BLANCHARD J:

Some undifferentiated growling.

ELIAS CJ:

Yes.

MR HARLEY:

I've got some far more serious points. The third matter that I wanted to address is really one of information, and to respond to a question yesterday from Justice Blanchard which I had overlooked replying to. The question he asked was whether there were insurance arrangements in respect of these companies for the two surgeons. The answer is yes. Mr Hooper gave direct evidence, which is in the pink volume at page 110, about income insurance for loss of earnings at $300,000. In addition, the High Court had before it, in evidence, the accounts of each company. Each set of accounts shows the making by each company of substantial insurance premium payments.

Mr Penny did not give direct evidence on the subject. The accounts, in respect of both companies, do not describe in detail the nature of the insurance payments, nor do they record whose life was covered in respect of either the earnings or life cover.

BLANCHARD J:

We would know from those accounts that they were life insurance or whatever they're called, income protection insurance.

MR HARLEY:

Your Honour, you'd only know that by looking at the amounts paid and because Hooper said that that was his understanding of the nature of the premiums. The first point of substantive reply to my friend really starts at his note 2.1, which misstates what's said in submission for the taxpayers and the response is not to the point. It's never been suggested that anyone working for either of these companies has independently generated fee income for them which was separately recorded or itemised or charged by the relevant company. That's even in the case of Mr Hooper's company and its employment of Dr Lee Hooper as a medical practitioner, nor in the case of Mr Penny's company, the expert surgeon assistance that he had employed.

The point that I was trying to make is that everyone involved in these enterprises contributes to the business income earned by the company and indeed every asset of all types from goodwill to the substantial business assets to the premises, to the motor vehicles, indivisibly is part of the company's income-earning process. I don't, for one moment, doubt that Messrs Penny and Hooper are highly talented and specialised orthopaedic surgeons and that the practices of the companies depend on what I would describe as their force of attraction to patients and other medical practitioners referring patients to them in recognition of their skill and expertise but, having said that, there just isn't any doubt from a practical level that neither of them could conduct the businesses of these companies to the extent they do without the support of every asset, including the people.

As I have noted in submission, Mr Penny was seeing 90 patients a week, he was also performing up to six surgical lists per week. As a matter of commonsense, it is simply impossible for a person, no matter how enormously skilled and talented he or she might be, to do that without the assistance of others, any more than it's possible to attribute to Mr Gates, because of his genius, all of Microsoft's earnings, it's a preposterous position and it's not a claim that even Mr Gates makes.

It's for that reason that the constant reference by the Commissioner to the assignment of the business income of the company, to the personal services assignment doctrine that's recognised in *Hadley*, is misconceived. Moreover, properly understood, *Peate's* case is clearly distinguishable in terms of that very proposition for the reasons that I explained yesterday, but to summarise, and I'll come back to it in a little bit more detail going through *Peate*, *Peate* starts with an

annihilation of the company, it's voided and all transactions effected with the company are voided. That is not what's happening here, the company and its ownership of the business assets and of the business itself is respected. The focus is on the commercially realistic salary.

My next point is to go to the Commissioner's note at paragraph 6.3 and his attempt to distinguish *Loader* on the asserted basis that the Commissioner did not there assert that the arrangements in that case were artificial. He most certainly did, it was the core of the basis of assessment and argument addressed by Justice Cooke. If your Honours look at the case, what you'll see is that the arrangement that's voided in the *Loader* case is the transfer of the business and its business assets to the company and to the plant trust. The Judge identifies the basis of assessment at page 474, from lines 33 to 45. He then correctly identifies from the *Mangin* case, but he doesn't say that's where it's coming from, but he's referred to *Mangin* earlier, that the argument is based on what we know is the *Newton* predication test, and he identifies the *Newton* predication test by reference to the ordinary business or family dealing yardstick at page 475, lines 1 to 10. He then goes on and identifies that the Commissioner does not seek to void the trust, but that the focus of the attack was his words, "particularly the joint effect or operation of the trust and company", which you'll see at page 477 over to 478. And then whether or not the *Newton* predication test could be satisfied on the facts by reference to the three objects claimed by the taxpayers.

He identifies those three objects as being incorporation for the protection of valuable assets, estate duty, and tax savings, and his Honour then concludes that the steps taken were, in his words, "familiar types of transactions, which it would be natural to adopt to achieve the three objects." That's at page 478, lines 47 to 50.

He then deals with the Commissioner's asserted artificiality expressly. That is identified on page 478 at the last line, and then he goes on to explain the basis of the argument for the Commissioner, being the one-man control of the company and that it very largely, the one man, "very largely controls the administration of both trust and company and yet carries on the business much on the same lines, in fact ... as before incorporation." You'll find that at page 479, lines 1 to 4.

The Judge then rules, at page 479, line 7, "The situation does not appear abnormally artificial." The Judge then goes on to discuss the *Udy v Commissioner of Inland*

Revenue [1972] NZLR 714 (SC) case as being the closest in point. He describes the case by reference to its facts, making clear his understanding that in the *Udy* case there was no clear, outright alienation of the business, nor was there the suggestion of a wholesale reorganisation of the taxpayer's affairs in *Udy* such as *Marx*, the present case. He makes those comments at 479, lines 24 to 27.

Finally Justice Cooke then likens the *Udy* case to what he refers to as a "paddock trust case", which can only be a reference to the Court of Appeal's decisions earlier in what are *Marx and Carlson v Commissioner of Inland Revenue* and to the *Mangin* case. *Mangin* is in the materials, *Marx and Carlson* is the subject of much discussion in the *Mangin* case and I don't need to take you to either of them.

In that context it is inconceivable that Justice Cooke didn't consider the cases such as *Elmiger* because he had the *Mangin* case explicitly before him, and it's inconceivable too that the Judge didn't know of the *Peate* case. By 1974 I would surmise that Justice Cooke was possibly well on the way to recognising the difference that was arising from the mid-1950s, with the incorporation of family businesses, because that's the foundation of his recognition of the legitimacy of what Mr Loader and his family had done.

The next point I want to address is my friend's repeated reference to the so-called asserted 80% reduction in income by Messrs Penny and Hopper, which in fact they have not asserted at any point in any part of the evidence. But it's as emotive as it is wrong in fact, when the matrix is understood correctly. Both Penny and Hooper had continued throughout to derive their Canterbury District Health Board income as surgeons. Each set at the outset of incorporation a salary level, on advice, of 1.4 times what they had expected from the Canterbury District Health Board income and they saw that as a reasonable proxy to reward themselves from the company for what they were doing. They confirm in evidence that they were doing the same work in their public and private practices. As Hooper's income was just over $200,000 per annum, you'll see that in the pink volume at page 103, and Penny's income was between $180 and $200,000, leaving the bonus payments to the side for the moment, you'll see that in the pink volume at 162 and in Mr Lyne's table at page 224. Both gave evidence that each was able, comfortably, to live on those income levels. You'll see that from Mr Hooper, at the pink volume 116, and indeed his reply to counsel in cross-examination as to his income levels when he said that he worked for other than money. You will see that in the pink volume at 182.

The next point I want to address is the Commissioner's assertion as to the scope or reach of this argument and whether or not, in principle, a commercially realistic salary level must be paid, regardless of the circumstances of the company. With all due respect to my friend's submission in respect of that, it is irreconcilable with the Commissioner's stance in *White's* case.

TIPPING J:

I don't think he argues regardless of the circumstances of the company, Mr Harley.

MR HARLEY:

No, he's saying that it's appropriate to take into account the circumstances of the company.

TIPPING J:

Yes.

MR HARLEY:

And I'm saying to you that, property understood, that is not what the Commissioner is doing at all.

TIPPING J:

Sorry, I must've misunderstood you.

BLANCHARD J:

You'll have to expand on that because I don't understand what you're saying either.

MR HARLEY:

I am saying that the Commissioner's stance is that, as a matter of principle, the Act requires the company to pay what the Commissioner assesses as a commercially realistic salary level, regardless of any other aspect of the business of the company, it is focussed on the medical services revenue, that's what –

BLANCHARD J:

I didn't think that was what was being submitted to us at all.

MR HARLEY:

That's not what he said was his stance, I'm saying to you that, properly understood, that is actually what the Commissioner's stance is. And let me explain why that is his stance: in cross-examination of Mr Lyne, he accepted that his sole focus was on the medical services revenue and that he would have no regard to any other circumstance of the company.

BLANCHARD J:

That may have been what that witness was saying, and it may have been what the Commissioner was aiming at, at that time, but we surely need to consider the submissions as they're put to this Court, and it was put on a different basis.

MR HARLEY:

Yes, it was put on a different basis, Sir, and I accept that, but it isn't –

BLANCHARD J:

If you'd like us to say that we don't agree with the Commissioner's original proposition that he's now not putting up, maybe, but it seems a bit pointless.

MR HARLEY:

If you just let me finish for a moment by reference to the stance that he has adopted: as illustrated in *White's* case, the basis of assessment in *White's* case is a reflection of the principle that the Act requires the medical practitioner to derive the medical services revenue, and that is where he started and that is where his witness started in these cases.

BLANCHARD J:

We're not arguing or hearing argument on *White's* case at the moment, and we can't be drawn in to commenting on *White's* case because it's still coming up through the court system.

MR HARLEY:

Your Honour, I'm not asking you to do that. What I'm asking you to do is to focus on the nature of the grounds of assessment that's being made here, which is to attribute to the surgeons what is a hindsight reflection of the actual medical services revenue from the company to them.

TIPPING J:

Is that on the reconstruction?

MR HARLEY:

No it's the basis of assessment.

TIPPING J:

Well it must follow voiding, mustn't it?

MR HARLEY:

Well, one's the mirror –

TIPPING J:

Yes.

MR HARLEY:

– image of the other but the proposition that's being argued here is that the commercially realistic salary principle is a derivative, he says, of the personal services doctrine reflected in the Act. That's the principle he's trying to establish. And if that is the principle then it can't matter what the circumstances of the company are.

BLANCHARD J:

Well if we say it can matter, that'll solve your problem.

MR HARLEY:

To some extent.

BLANCHARD J:

I thought that Mr Goddard's submission in accepting that was realistic. He addressed Mr Shewan's examples.

TIPPING J:

The question is whether what is paid is commercially realistic in the light of all the circumstances facing the company. That's what I wrote down.

MR HARLEY:

Yes, that's what he said, and I'm inviting your Honours to –

ELIAS CJ:

It's not what he means.

MR HARLEY:

I'm inviting your Honours to reflect on what it actually means when we get to the asserted personal services doctrine. I want to deal with this in quite a lot of detail because it's fundamental to what the Commissioner is actually asking the Court to approve here.

TIPPING J:

He's not asking us to void the company.

MR HARLEY:

No, he's not.

TIPPING J:

But are you saying that is effectively what's going to happen? I don't understand the proposition if that's what it is. But if it's something else I need to be enlightened.

WILLIAM YOUNG J:

So you're not facing full-blown *Hadlee*, that's not an argument?

MR HARLEY:

Well, we'll see about –

WILLIAM YOUNG J:

Rather it's the spirit of *Hadlee* being invoked I think.

BLANCHARD J:

It's a vibe.

MR HARLEY:

And it brings to mind the wonderful rejoinder in Lord Hoffmann's speech in *Norglen* where he identifies spooky jurisprudence by reference to the penumbrant spirit. Your Honours are all familiar with the passage but let me –

WILLIAM YOUNG J:

It's "suspected practitioners of the art", I think, or "accused practitioners of the art of spooky jurisprudence" perhaps.

MR HARLEY:

Let me focus on what I say is the principled response to the Commissioner's asserted position in terms of the spirit of *Hadlee*, if we can put it that way. In doing so I would like first to summarise a number of the propositions that I understood to have been put both to me and to my friend in the exchanges by Justice McGrath. The proposition is said to be that the Act reflects that personal exertion income from employment or self-employment has a special character. For the purposes of the scheme of the Act, by which I mean the identification of the quality or source of the income, and secondly that this proposition is reflected in the personal rate graduated structure. So as to reflect the appropriateness for s BG 1 purposes, that approach, in terms of articulating the scheme of the Act for present purposes, the architecture in the language of her Honour the Chief Justice is underpinned by those elements in terms of the proposition and in dealing or responding to it firstly let me recognise that Sir Ivor Richardson explained those very ideas in *Hadlee* and that, at the time he wrote that judgment, he was dealing with the 1980 model of the Act when we had a 60% personal rate and a very different company rate and we had a steep graduated personal rate structure. The Judge clearly wasn't dealing with the circumstances in which a business is acquired by a company which had a different rate of tax, and an entirely different regime of taxation then in force, the classical system. But the submission that I've made is that it is a misconception in principle to translate the assignment doctrine to what is a wholly different scheme of taxation for company income, and I would have made that submission then and I certainly make it in the context of these facts now, because neither of them can be said to be within the scheme of the Act by the time we get to the 1990s.

I've attempted to list what was a transformation of our Act to a model that was regarded as being almost perfect in terms of economic neutrality for taxation. We won the prize from the OECD and from tax economists around the world for what we

did. I've spoken already, and don't need to go over again, the regime for the taxation of trusts and the changes that were made to that in terms of infant beneficiaries having to be taxed at the marginal rate of 33% instead of zero. I have also spoken of the fundamental effect of the change to the classical system of company taxation to full imputation and hopefully, with respect, I can say that that change was probably something beyond the wildest dreams of Viscount Dilhorne when he wrote the Board's judgment in *Peate*, or of the High Court of Australia, equally, when it dealt with *Newton's* case or with *Peate*. The point is carefully and significantly made in the extract that I read to you yesterday in the forward to the book from the Honourable Murray Gleeson in terms of the difference between now and then and the doctor's bill.

But it's important against that background to reflect just how far we went with the purity of economic neutrality for tax purposes in our Act. This probably is not a complete list of the purifying process, but it'll be a pretty good one. We removed all kinds of personal exemption. We removed the deductions for life insurance and for superannuation personal contributions. We brought to tax the contributions by employers when making contributions to superannuation and other schemes for employees as a proxy at 33 cents. We introduced fringe benefit tax at 33 cents on the employer in respect of the benefits provided to the employee by the company or employee that were not otherwise treated as personal employment income. The dividend definition was extensively rewritten to provide for deemed dividend taxation at 33 cents in respect of the provision of any property by a company to its employees, as distinct from the dividend expectation of a shareholder in that role as a shareholder. More broadly, we removed generally all types of tax preference and tax subsidy, whether for individuals or for business entities, these were totally removed as we purified ourselves to this model.

The effect of these changes is profound. They removed the distortions as far as was possible between different types of income and different types of taxpayer. Justice Richardson would be the first to acknowledge that the model he was talking about in 1980, or when he wrote the judgment in *Hadlee* in the early 1990s, reflecting the facts of the circumstances in the 1980s, the profound effect of the pursuit of economic neutrality, both between different types of taxpayer in terms of horizontal equity, and different types of income, either earned by the same taxpayer or different taxpayers, in terms of vertical equity. By the late 1980s what the Judge had referred to at the beginning of his judgment as the 50% rate difference had been so

substantially reduced it was almost nothing and when the rate change was made in the 1st of April 2000, it was just six cents, not 50%.

ELIAS CJ:

Sorry, what is this submission directed at? What in the scheme or principles of the Act changes? Are you saying that equity doesn't need to be pursued because it's been achieved as far as is possible? I'm just a little lost as to the drift of the submission you're making here?

MR HARLEY:

I'm saying that the alignment of the rate structures, and the sweeping changes that I have made in – that I have referred to in respect of all kinds of income and taxpaying entities, is such that the basis on which *Hadlee* itself was decided is wholly different from the circumstances that we're now dealing with in the context of this case. And I am also saying in respect of that that at the time the rate change was made in April 2000, Parliament itself recognised the potential to alter from what was an alignment to the misaligned rate advantage at six cents. And in so doing it stamped its ground with the Personal Services Attribution Rules and it identified the personal services nature of the income that it wanted to protect in terms of the relationship among taxpayers and the neutrality to be accorded to them. And it's on that basis that I argued yesterday, and maintain today –

ELIAS CJ:

There's no room.

MR HARLEY:

As a matter of conclusion, it has defined the territory.

ELIAS CJ:

I see. Thank you.

TIPPING J:

Is not the essential point of *Hadlee* still with us? If you have a graduated tax scale for individuals and a flat rate for companies? And the top rate for individuals is higher than that for companies? I would have thought that was the key feature of *Hadlee* which, unless I'm mistaken, at least at the time with which this case is concerned, was still with us?

MR HARLEY:

Your Honour, we're talking about the difference between the night and the day, though, when the rate structure produces a difference of 50% –

TIPPING J:

That's a question of degree –

MR HARLEY:

Yes.

TIPPING J:

– but you're talking about principle.

MR HARLEY:

Yes. And I'm saying when you move from 50% difference to 6% difference, and Parliament has selected its Personal Services Attribution Rules, it has exercised with deliberate focus its concern with rate structure and personal services income. That's the submission.

McGRATH J:

Justice Richardson is speaking in the opening remarks of his judgment in *Hadlee*. He is expressing the position as at May 1991, is he not?

MR HARLEY:

No.

McGRATH J:

Well he's saying the graduated rate structure is a basic feature of the New Zealand income tax system.

MR HARLEY:

Well, at the time he is saying that, he is reflecting against his introductory paragraph of the facts and circumstances of *Hadlee* and the assignment in 1980 or '81, when that graduated rate structure was so steep. By 1991 there was a personal rate structure that was graduated, but it was nowhere near 50%.

McGRATH J:

That's the point I'm making, that it seems to me that his opening remarks refer to the structure as being, in current terms, a basic feature of the system. He then goes on to say by way of illustration and talks about what the position was in 1981 and 1982. But it just seems to me that what was happening a few years before May 1991, at a, in between, if you like, the events of *Hadlee* and his judgment, doesn't seem to have altered his position in relation to the currency of the graduated rate structure as being a basic feature of the system.

MR HARLEY:

Well, your Honour, my response to that is the Judge is speaking generally and without regard to any of the features that I have described in terms of trusts or companies or any of the economic neutrality that I have referred to in respect of all the other changes that were made which produce a far stronger economic neutrality base than he actually describes in that part of his judgment.

McGRATH J:

Does this mean that you really are taking issue with his observation that a graduated rate structure is a basic feature of the New Zealand income tax system?

MR HARLEY:

I am taking issue with that in the context of the facts of this case, at this time, because of the features that I've identified and my reliance on the Personal Services Attribution Rules being Parliament's focus in terms of that particular concern.

McGRATH J:

All right, I understand that.

MR HARLEY:

I am not saying the Judge was wrong at the time he was writing. I know better than that.

With reference to *Peate's* case, the important point in relation to *Peate* is that it is an annihilation case of the company, and where the description of Justices Taylor and Windeyer in terms of the assimilation to assignments is applicable in that context, but it isn't, in my submission, applicable to the present.

TIPPING J:

I would have thought, Mr Harley, that their Honours were referring to the question of assignment, or the analogy with assignment, before they got to the question of annihilation.

MR HARLEY:

Your Honour, I think that that is not a fair reading of the contextual dispute before the Court, which is *Newton* predication test, on the basis that the Commissioner, in order to succeed under s 260, has to annihilate everything and have, as a result of the scorched earth, the money in the hands of the taxpayer.

TIPPING J:

But you only get to annihilate if you've got avoidance.

MR HARLEY:

Yes, and what the Commissioner did was he voided everything.

TIPPING J:

Yes, I understand that –

BLANCHARD J:

I thought they were concerned with what tax avoidance was, not with annihilation. They are saying, and the Privy Council said, what happened here was tax avoidance.

MR HARLEY:

Yes, they did say that.

BLANCHARD J:

And then moved on to well, what do you do about it in terms of the relatively limited remedies that the Commissioner had in those days.

MR HARLEY:

There's no difference between us, your Honour. All I'm saying is that the context in which they are discussing the assimilation of the doctor's revenue, if I can use that neutrally, to an assignment is in the context of an annihilation of the company and its derivation by the company.

BLANCHARD J:

I still don't understand that.

McGRATH J:

They're looking at the income-splitting stage.

TIPPING J:

Yes, they haven't got to annihilation. Annihilation is the consequence of the analysis which they were making in which this assignment analogy was drawn.

MR HARLEY:

Yes, but it's the foundation of the Commissioner's assessment that's before the Court, is –

TIPPING J:

I don't think they were working backward.

MR HARLEY:

I don't say they were. I am saying that the foundation of the Commissioner's assessment in *Peate's* case, as it was in all of the old s 108 and 260 cases, starts with the voiding of the entire set of steps within the defined arrangement in this case.

TIPPING J:

But they've got to qualify for avoidance.

MR HARLEY:

And they are –

BLANCHARD J:

They didn't – they'd never started with annihilation. They had – what had to be demonstrated was that there was tax avoidance. If there was tax avoidance, then there was annihilation.

MR HARLEY:

Your Honours, the starting place in *Peate* is on the one hand the Commissioner's attack using s 260 against the contracts, the company and the trusts, and the answer

from the taxpayers that they were able to explain their way out of it or not using the *Newton* predication test, and the Court's response was no, you don't. This is an assimilation of income by way of assignment. That's their response.

BLANCHARD J:

Well, it's the response of two of the Judges. I don't know that it's the response of Justice Kitto.

MR HARLEY:

I accept that, Sir, yes. Yes, no, that's correct, and in that regard, and particularly in respect of some of the somewhat colourful language of Justice Windeyer, I would have been pleased to read to him, as he was thinking those thoughts, the following.

ELIAS CJ:

What is it?

MR HARLEY:

It's a passage from a speech of Lord Sumner's in a case called *Gas Lighting Improvement Co Ltd v Inland Revenue Commissioners* [1923] AC 723 (HL) in 1923 appeal cases. Your Honour Justice Tipping will be familiar with this passage.

TIPPING J:

Am I?

MR HARLEY:

Oh, yes. *Chen v Butterfield* (1996) 7 NZCLC 261,086, your Honour, you'll remember 1996 well.

TIPPING J:

That was lifting the corporate veil, was it?

MR HARLEY:

Yes.

TIPPING J:

Good gracious me. All right.

MR HARLEY:

"It is said that all this", that is the company, its incorporation and its acquisition of the business, "was 'machinery', but that is true of all participations in limited liability companies. They and their operations are simply the machinery, in an economic sense, by which natural persons who desire to limit their liability, participate in undertakings which they cannot manage to carry on themselves, either alone or in partnership, but legally speaking this machinery is not impersonal though it is inanimate. Between the investor, who participates as shareholder, and the undertaking carried on, the law imposes another person, real though artificial, the company itself ... and the capital employed is its capital and not in either case the business or the capital of the shareholders. Assuming, of course, that the company is duly formed and is not a sham (of which there is no suggestion here), the idea that it is mere machinery for effecting the purposes of the shareholders is a layman's fallacy. It's a figure of speech which cannot alter the legal aspect of the facts."

Well, Justice Windeyer's judgment in *Peate* goes a long way around really saying that he's not much impressed either with that conceptualisation or with *Salomon*, and he gives a gratuitous dig at *Lee v Lee's Air Farming* on the way past as well, whereas the submission I'm making is that in the context of the regime for taxation that we're dealing with, the company and its role in the derivation of the business income is fundamental.

McGRATH J:

My impression was that the Judge, after discussing *Salomon* and toying, if you like, with the possibility of a façade, a sham, turned his mind away from that and said – well, turned against that, and he said well, no, actually the reality here really is that the company is not a façade or screen, but it's one of the instruments by which the appellant and others sought to carry their plan into effect. So he, in the end, was saying that this company really did have a role and it was a crucial role in what he concluded was tax avoidance.

MR HARLEY:

Yes, he does come to express himself in exactly those terms on page 480.

McGRATH J:

So I don't think that the *Salomon* argument or the sham argument, as I would put it, really was part of his thinking at the end at all.

MR HARLEY:

And I'm simply taking the point in respect of the regime that I have described, to use her Honour the Chief Justice's description, the architecture of the Act, the result is prescribed for the reasons that I have submitted and the Personal Services Attribution Rules meet the very point that you were making in terms of the exchanges with my friend and with me in terms of where Parliament's focus was on the personal rate structure.

I have referred yesterday in submission to the passage in the judgment of Lord Hoffmann about the inappropriateness of courts or the Commissioner to step over the rules that Parliament actually does pass, particularly by reference to associated persons and related party dealings. It's not the function of s BG 1 to provide what are parliamentary remedies over what Parliament itself has specifically focused on, and where it has recognised and identified the very elements that underlie the Commissioner's approach in this case. That is not the role of the Courts, and it's not the place for s BG 1.

Your Honours, those are my submissions in reply.

ELIAS CJ:

Yes, thank you, Mr Harley. Thank you, counsel, for your considerable assistance in this matter. We'll reserve our decision.

COURT ADJOURNS: 3.07 PM