Fiscal Nullity

Chris Ohms *

Joint Winner of the Law Review Prize for 1989

Introduction

The role of motive[1] in deciding on the efficacy of a tax efficient transaction is an issue that has perplexed the judiciary in derivative common law countries such as New Zealand, Australia, Canada and the United Kingdom ever since the inception of income taxation in their respective legal systems.[2] Recently the House of Lords in *Craven v White*[3] examined this fundamental issue yet again and reaffirmed what had once been regarded as the correct response to the issue of motive in tax avoidance transactions.

In common law countries liability for taxation generally flows from the legal structures within which taxpayers choose to earn their income.[4] By way of example, the taxation system of a particular country may apply a different rate of tax to the earnings of a corporation than to that of an individual. If the corporate rate is lower than that for an individual (especially in the presence of a highly progressive rate structure), it may be desirable for a taxpayer to earn income through a company rather than personally. If the law of the particular legal system in question recognises the right of an individual to

* BCom, LLM (Hons)

1 A motive here is a reason which prompts or induces an action.
2 Income tax was first introduced in New Zealand by the Land and Income Tax Assessment Act 1891.
3 [1988] BTC 268.
4 Ward et al, "The Business Purpose Test and Abuse of Rights" [1985] BTR 68.

incorporate, should the court then recognise that separate corporate identity when assessing taxation liability - even though the incorporation has been undertaken solely for the purpose of reducing taxation liability?[5]

In a general sense the issue that was examined in *Craven v White*,[6] and which is the topic of this article, is whether the courts will recognise a transaction where taxpayers either:

(i) arrange or rearrange their affairs, as allowed by private and public law, with the object and intent of tax avoidance and substantially without any independent business purpose;[7] or

(ii) carry through a bona fide transaction with a business purpose in a manner that will attract the minimum amount of tax.[8]

Historically, both English and Commonwealth courts have adopted an approach giving full legal effect for tax purposes to transactions (or series thereof) which may have been undertaken to avoid tax or which are tax efficient.[9] However in a series of cases[10] the House of Lords has displayed a shift in attitude away from the principles enunciated in the older cases. These cases suggest that the presence of a tax saving motive will mean that for fiscal purposes the transaction will be disregarded and treated as a "fiscal nullity". Thus taxpayers would not be able to arrange their affairs solely to avoid tax or to carry through a transaction tax efficiently. A considerable debate ensued over this new approach. In the United Kingdom, the Chief Secretary to the Treasury made the following comment in the House of Commons:[11]

> I should also touch on the implications of the recent decision of the House of Lords in *Furniss v Dawson*. [It is no longer possible to assume] that the Courts will always look at the form rather than the substance of a transaction or various transactions.

Formulating the Issue

All forms of taxation are imposed by Parliament.[12] There is no rule of common law or equity which makes a person liable to tax:[13]

> In considering the application of [fiscal legislation] to particular transactions and documents the true legal rights of the parties are to be regarded irrespective of a mere name given to the transaction or document, but this rule does not authorise any a priori construction of a

5 Ibid.

6 Supra at note 3.

7 Supra at note 4, at 69.

8 Ibid.

9 *IRC v Duke of Westminster* [1936] AC 1; *IRC v Fisher's Executors* [1926] AC 395; *Ayrshire Pullman Motor Service v IRC* (1929) 14 TC 754; *Griffiths v Harrison* [1962] 1 All ER 909; *Floor v Davis* [1979] 2 WLR 830.

10 *WT Ramsay Ltd v IRC* [1982] AC 300; *IRC v Burmah Oil Co Ltd* (1981) 42 TR 535; *Furniss v Dawson* [1984] AC 474.

11 Reproduced in Pinson, *Pinson on Revenue Law* (17th ed) 696.

12 Ibid, 678.

13 23 *Halsbury's Laws of England* (4th ed) para 82.

legal situation for the purpose of attracting tax to it.

It follows that any question concerning the right of taxpayers to mitigate their taxation liability must be resolved within the statutory regime that imposes tax:[14]

> [T]he problem ... is usually ... first, what is the meaning of the relevant statute? Secondly, does the true effect of the acts or omissions of the taxpayer come within or without that meaning?

In the decision of the Supreme Court of Canada, in *Stubart Investments Ltd v The Queen*, Estey J saw the question as:[15]

> [A] determination of the proper role of the Court in construing the Income Tax Act in circumstances such as these where the Crown relies on the general pattern of the Act and not upon any specific taxing provision.

The issue then becomes how the court will interpret taxation legislation where a taxpayer has entered into a transaction solely to avoid tax, or where a transaction which has been entered into for other reasons is structured in a tax efficient manner.

The Rules of Statutory Interpretation

The "proper role" of the court in issues of tax mitigation must be ascertained within the established constitutional principle of parliamentary sovereignty. The court must apply the legislation and not function in a legislative capacity itself. In *Ransom v Higgs* Lord Simon of Glaisdale commented that:[16]

> It may seem hard that a [taxpayer may avoid his fair share of tax]. But for the Courts to try to stretch the law to meet hard cases (whether the hardship appears to bear on the individual taxpayer or on the general body of taxpayers as represented by the Inland Revenue) is not merely to make bad law but to run the risk of subverting the rule of law itself.

When construing a statute it is necessary to ascertain the intention of the Legislature. The contemporary approach[17] is to give effect to the grammatical and ordinary meaning of the words, in the context of the overall object or purpose which the statute as a whole is intended to achieve. If it is considered that the statutory words in their ordinary sense would produce a result contrary to the purpose of the statute, the judge may apply them in any secondary

14 Wheatcroft, "The Attitude of the Legislature and the Courts to Tax Avoidance" (1955) 18 MLR 209, 214.

15 10 DLR (4th) 1, 32.

16 [1974] 1 WLR 1594, 1616.

17 Cross, *Statutory Interpretation* (2nd ed) 47. Section 5(j) of the Acts Interpretation Act 1924 directs the court to accord to every Act and to every statutory provision such fair, large and liberal interpretation as will best ensure the attainment of the object of the legislation according to its true intent, meaning and spirit. Compare in Australia s 15AA of the Acts Interpretation Act 1901 (Cth).

meaning which they are capable of bearing. Writing extra-judicially, Richardson J has placed this approach in the context of fiscal legislation:[18]

> The twin pillars on which our approach to statutes rests are the scheme of the legislation and the purpose of the legislation.

The issue in tax mitigation is to identify those circumstances in which it is permissible for the court to rely on perceived underlying policies of the income tax legislation, in order to bar recognition of transactions which would otherwise have beneficial tax consequences for the taxpayer.[19] If the scheme and purpose of income tax legislation is the framework within which these issues are to be resolved then it is necessary to appreciate in a broad sense what that purpose is and how the scheme of the legislation implements that purpose.

Form or Substance

The second issue that faces a court in deciding whether a particular provision applies is to ascertain the true effect of the acts or omissions of the taxpayer. Determination of this issue will depend upon how the character of a transaction is to be analysed in law.[20] An arrangement made by a taxpayer may be considered by the court, for income tax purposes, in one of two ways. First, a transaction may be analysed according to its legal form. Second, a transaction may be analysed according to the substance of the transaction or the overall economic consequences which attend the transaction.[21]

It is of crucial importance to decide whether a formalistic approach or a substantive approach is appropriate in taxation matters. If a formalistic approach is adopted, taxpayers may mitigate taxation liability by structuring transactions which fall outside or inside the ambit of fiscal legislation, depending on the type of transaction under review. If a substantive approach is adopted the legal structures created by a taxpayer may be ignored and thus any tax saving element may fail.

Fiscal Nullity

The Traditional Approach

As noted, English courts have traditionally adopted an approach that gives full legal effect for tax purposes to transactions and series of transactions

18 Richardson, *Appellate Court Responsibilities and Tax Avoidance* (1986) ATF 3, 80. Consideration of the scheme of the legislation requires a careful reading in its historical context of the whole Act, including the Long Title; analysing its structure, examining the relationship between the various provisions, and recognising any discernible themes and underlying policy considerations.

19 Supra at note 18, at 9.

20 Ibid, 16.

21 *1989 New Zealand Master Tax Guide*, para 190.

which may have been carried out or arranged for the purpose of avoiding tax.[22] The leading case of *IRC v Duke of Westminster*[23] established that the form of a transaction or series of transactions was to be given full legal effect. In that case Lord Russell of Killowen summarised the English position:[24]

> I confess that I view with disfavour the doctrine that in taxation cases the subject is to be taxed if, in accordance with a Court's view of what it considers the substance of the transaction, the Court thinks that the case falls within the contemplation or spirit of the statute.

This approach was consistently adopted by the English courts[25] up until the time of the fiscal nullity cases.[26] Australian courts have traditionally displayed a strong preference for form rather than substance in their characterisation of tax cases.[27] Under the influence of the then Chief Justice, Sir Garfield Barwick, there were a series of decisions from the High Court in the previous decade affirming this basic principle.[28] For instance, in *Slutzkin v FCT* Barwick CJ stated that:[29]

> *Inland Revenue Commissioner v Duke of Westminster*, [1936] AC 1, too easily forgotten, is still basic in this area of the law. There is no room in that area for any doctrine of economic equivalence. To the legal form and consequence of the taxpayer's transaction, which has in fact taken place, effect must be given.

The approach of the Chief Justice has also been adopted in later decisions of the High Court.[30]

Until *Stubart Investments Ltd v The Queen*[31] the position in Canada was less clear. There had been indications that the Federal Court of Appeal was prepared to use a substantive test in some circumstances. In *MNR v Leon*,[32] a series of management companies were created by the owners of a profitable business as part of a tax avoidance plan. By routing their business profits through these management companies, the original owners were able to receive the profits with minimal taxation exposure. At first instance, Heald J concluded that none of the management companies had any employees (except the shareholders), nor fixed or working capital, and that the sole reason for interposing the management companies was to reduce future tax. He concluded:[33]

22 Supra at note 4, at 100.
23 [1936] AC 1.
24 Ibid, 24.
25 Supra at note 9.
26 Supra at note 10.
27 See Ward, supra at note 4, at 112.
28 *Cridland v FCT* [1976] ATC 4,095; *Mullens v FCT* [1976] ATC 4,288; *Phillips v FCT* [1977] ATC 4,169; *Slutzkin v FCT* [1977] ATC 4,076.
29 Ibid, 4,079.
30 Notably *FCT v Gulland* [1985] 2 ATC 4,765.
31 Supra at note 15.
32 (1976) 68 DLR (3d) 568. See also *Legace v MNR* [1968] CTC 98; *Richardson Terminals Ltd v MNR* [1971] CTC 42; *Dominion Bridge v The Queen* [1975] CTC 263.
33 Ibid, 576.

> Thus, the interposition of the management companies between the employer and employee was a sham, pure and simple, the sole purpose of which was to avoid payment of tax.

This statement was affirmed by the Court of Appeal:[34]

> It is the agreement or transaction in question to which the Court must look. If the agreement or transaction lacks a bona fide business purpose, it is a sham.

The Court of Appeal was prepared to go behind the formal structure created by the taxpayer and to look at the broad substance of the arrangement, by ignoring the separate management company personality, if it perceived that there was a tax inducing factor.

Following the English tradition, New Zealand courts have always preferred form to substance in matters of taxation. The Privy Council in *CIR v Europa Oil (NZ) Ltd* stated:[35]

> In a matter of taxation it is necessary to consider and respect the legal form in which the [transaction] was embodied. Their Lordships have no need to restate the principle laid down in such cases as *Inland Revenue Commissioners v Duke of Westminster*.

In *Mills v Dowdall*[36] the Court of Appeal held that the true nature of transactions could only be ascertained by careful consideration of the legal arrangements actually entered into and carried out. Prima facie, the Court was not entitled to make an assessment of the broad substance of the transaction measured by the results intended and achieved; nor of the overall economic consequences to the parties; nor of the legal consequences that would follow from an alternative course which they could have adopted had they chosen to do so.[37]

A Separate Doctrine

In *WT Ramsay Ltd v IRC*[38] the House of Lords were confronted with a tax avoidance scheme which sought to minimise the taxpayer's exposure to capital gains tax. The taxpayer had a realised taxable capital gain. To avoid the payment of capital gains tax the taxpayer then entered into a complex series of transactions which gave rise to an allowable capital loss and an equivalent non-taxable capital gain. The Inland Revenue urged their Lordships to treat the tax avoidance scheme as artificial and a fiscal nullity for tax purposes. On a substantive approach, when the transactions were viewed as a whole, it was evident that the gain and loss produced by the scheme were meant to be self-cancelling. Lord Wilberforce concluded that the scheme was to be treated as fiscal nullity and that no loss was available to be offset against the realised

34 Ibid, 574.
35 [1971] AC 760, 771.
36 [1983] NZLR 154.
37 Supra at note 18, at 17.
38 Supra at note 10.

capital gain. He stated:[39]

> The capital gains tax .... is a tax on gains (or I might have added gains less losses), it is not a tax on arithmetical differences. To say that a loss (or gain) which appears to arise at one stage in an indivisible process, and which is intended to be and is cancelled out by a later stage ... is not such a loss (or gain) as the legislation is dealing with, is in my opinion well and indeed essentially within the judicial function.

On the plain facts of the case, the result was not very dramatic. The scheme entered into by the taxpayer was wholly artificial and self-cancelling. A plain reading of the legislation involved could support the decision of the House of Lords. Lord Wilberforce felt that the scheme was nothing more than a tax avoidance mechanism which possessed no "independent commercial purpose"[40] sufficient to attract the beneficial statutory treatment sought by the taxpayer.

The House of Lords had another tax avoidance scheme to consider in *IRC v Burmah Oil Co Ltd*.[41] In that case the taxpayer had realised a loss which was not allowable under the capital gains legislation. It sought to convert this loss into an allowable loss by engaging in a complex series of intra-corporate loans and reorganizations. As a result, the taxpayer was of the opinion that it had incurred an allowable loss which it then sought to set off against other income. The Inland Revenue, on the authority of *WT Ramsay Ltd v IRC*, argued that the transaction should be disregarded as artificial. The House of Lords decided in favour of the Inland Revenue, applying *WT Ramsay Ltd v IRC*, and held that there was neither a real loss nor a loss in the statutory sense. Lord Diplock stated that:[42]

> It would be disingenuous to suggest, and dangerous on the part of those who advise on elaborate tax-avoidance schemes to assume, that *Ramsay's* case did not mark a significant change in the approach adopted by this House in its judicial role to a pre-ordained series of transactions (whether or not they include the achievement of a legitimate commercial end) into which there are inserted steps that have no commercial purpose apart from the avoidance of a liability to tax which in the absence of those particular steps would have been payable.

As with *WT Ramsay Ltd v IRC* however, *IRC v Burmah Oil Co Ltd* could still be explained simply on the basis that the loss was wholly artificial and did not comply with the legislation in question on this narrow basis.

The doctrine was considered again by the House of Lords in *Furniss v Dawson*.[43] In that case[44] the taxpayers were shareholders in a company. They received a cash offer for their shares from a interested purchaser. The problem with a simple sale from the vendor's point of view was that on the sale of the shares a chargeable gain would accrue, and there would be an

39 Ibid, 326.
40 A phrase used by Estey J in *Stubart Investments v The Queen* supra at note 15, at 16.
41 Supra at note 10.
42 Ibid, 536.
43 Supra at note 10.
44 Facts are taken from Pinson, supra at note 11, at 685.

immediate liability to capital gains tax. To defer any taxation liability the vendors exchanged their shares for shares in a holding company incorporated in the Isle of Man. On a literal reading of the capital gains legislation this was an "exchange" of shares and was exempt from capital gains tax. The provision relied on was known as a "roll-over" section and was premised on the policy basis that a mere exchange of shares by a shareholder for new shares in a new company, which then carried on the previous economic existence of the former company, could not be said to give rise to a real gain to the shareholders who in reality had not realised their capital in the corporate structure. The vendors then had the holding company sell the shares it had received from them (in exchange for its own shares) to the purchaser.

The Inland Revenue argued that a sale had taken place direct to the purchaser from the vendor and sought to have the holding company disregarded on the basis that it was a fiscal nullity. The House of Lords applied *WT Ramsay Ltd v IRC* and *IRC v Burmah Oil Co Ltd* and found that the vendors were liable to capital gains tax. Lord Brightman delivered the leading judgment and said of the doctrine:[45]

> First, there must be a pre-ordained series of transactions; or, if one likes, one single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial (i.e. business) end. ... Secondly, there must be steps inserted which have no commercial (business) purpose apart from the avoidance of a liability to tax-not 'no business effect'. If those two ingredients exist, the inserted steps are to be disregarded for fiscal purposes. The court must look at the end result.

The House of Lords appeared to widen the scope of the fiscal nullity doctrine by finding in favour of the Crown. Rather than simply being a question of whether an artificial loss might not be recognised for statutory reasons, the case appears to give a wider ground and to apply the fiscal nullity concept whenever the taxpayer had a tax avoidance motive. The decision in *Furniss v Dawson* therefore raised questions as to the exact nature of the fiscal nullity doctrine. On a plain reading of the judgment of Lord Brightman it appears that the House of Lords felt that any tax saving scheme that was (i) preconceived, and (ii) existed for tax saving reasons, would provide grounds for the court to adopt a substantive approach and to ascertain the economically equivalent transaction. The most controversial aspect of the decision is found in the statement that:[46]

> This composite transaction may or may not include the achievement of a legitimate commercial (i.e. business) end.

Prima facie, it appeared that not only would a transaction motivated solely by a tax saving factor be caught by the new doctrine but that an otherwise bona fide transaction would be caught as well.

The decision was a substantial departure from the traditional view that a

45 Supra at note 10, at 527.
46 Ibid.

taxpayer could act tax efficiently.[47] By way of illustration, it is instructive to return to the hypothetical situation posed earlier. If a sole proprietor were to incorporate in order to reduce taxation liability, the fiscal nullity doctrine could operate to in effect ignore the corporate entity and attribute the corporate earnings to the individual. This could occur if the incorporation was undertaken solely to reduce tax or even if it was entered into for supplementary commercial ends such as limited liability. The substance of the transaction (the shareholder earning via another legal form) would be used by the court rather than the form of the transaction (the company earning as a separate legal entity).

A central problem with this approach was stated by Richardson J:[48]

> [T]here is a particular need in commercial cases for certainty and for predictability of the legal result. ... Commercial men are entitled to order their affairs to achieve the legal and lawful results which they intend.

One of the fundamental criteria of good income tax legislation is that it be simple and certain. This involves ensuring that both those who must administer and those who must comply with the tax system can do so within the skills and resources open to them.[49]

The Aftermath

In *Craven v White*,[50] members of the White family were shareholders in a company (Q) which operated a number of supermarkets. Negotiations to sell the business to another company (O) reached an advanced stage but were broken off. At that point a previous proposal to merge the company with another chain of supermarkets was revived. An Isle of Man company (M) was formed to act as a holding company after the merger took place and the taxpayers exchanged their shares in Q for shares in M. At this stage, however, O expressed renewed interest in the sale and began negotiating again with the Whites and Q. Eventually a sale was made to O.

At issue was whether the sale by M to O could be attributed to the Whites under the fiscal nullity doctrine. The Inland Revenue sought to attack the transaction on two bases. First, it was argued that there was a wide general principle, grounded in the trilogy of fiscal nullity cases, that a transaction entered into with the motive of minimising the taxpayer's burden of tax could be ignored or struck down. In other words, the Inland Revenue sought a literal interpretation of the decision of Lord Brightman in *Furniss v Dawson*.[51] Second, the Inland Revenue argued that on the facts of the case there was a sufficiently prearranged transaction to support finding that in effect a sale had

47 See for example *Tayles v CIR* [1982] 2 NZLR 726, 735-36.
48 Supra at note 18, at 20.
49 Chetwin, "Personal Income Tax: An Economic Perspective" [1982] VUWLR 115, 117.
50 Supra at note 3.
51 Supra at note 10.

taken place directly between the Whites and O.

The House of Lords found for the taxpayer. In doing so they respected the arrangements actually entered into by the Whites and found that there was no direct sale to O. The leading judgment was delivered by Lord Oliver. He rejected any wide concept of fiscal nullity and was concerned to limit and explain the basis of Lord Brightman's decision in *Furniss v Dawson*. The crucial finding made by Lord Oliver was that motive is irrelevant when deciding on the efficacy of a tax efficient transaction. He stated:[52]

> A transaction entered into with the motive of minimising the subject's burden of tax [may not] for that reason ... be ignored or struck down.... [T]he fact that the motive for a transaction may be to avoid tax does not invalidate it unless a particular enactment so provides.

His Lordship went on to say:[53]

> The suggestion that there should be introduced a moral dimension into the equation is important, however, since it forms the basis of the suggestion implicit in the Crown's submission on the instant appeal.... Your Lordships are thus invited not simply to analyse the transaction, to construe the statute and then apply it to the analysis of what the taxpayer has really done, but to construct a general catch-all formula for rendering ineffective any step undertaken with a view to the avoidance or minimisation of tax on an anticipated transaction or disposition.

Lord Oliver then discussed the other fiscal nullity cases. His Lordship found that *WT Ramsay Ltd v IRC*[54] and *IRC v Burmah Oil Co Ltd*[55] were decided simply on the basis that in those cases the "paper loss" created by the transactions in question were not the type of loss recognised by the legislation under review.

The present case involved a direct agreement between vendor and purchaser, using a company agent to pass title to the shares being sold and to receive consideration. There was no agreement reached when the shares were exchanged by the Whites for shares in M and the subsequent sale to O was unrelated to the first transaction. This factor was seen by Lord Oliver as one of the more difficult aspects of the case. Just how far did negotiations have to proceed before the parties could be said to have realised a gain? On the last issue Lord Oliver required that there at least be agreement on the principal terms to the point at which it could be said that there would be no practical likelihood that the transaction which actually took place would not take place.[56]

Lord Templeman delivered the most lucid minority argument. Even he did not support the first proposition advanced by the Crown. He stated:[57]

> In these appeals the Revenue argued that *Furniss* decided that whenever a taxpayer carries

52 Supra at note 3, at 290.
53 Ibid, 293.
54 Supra at note 10.
55 Supra at note 10.
56 Supra at note 3, at 300.
57 Ibid, 278.

out a tax avoidance transaction, that must be ignored for the purpose of computing the liability of the taxpayer to tax.... The courts have neither the power nor the desire to interfere.

Lord Templeman found for the Crown on his view of the facts. His Lordship could see no relevant distinction between the facts in *Furniss v Dawson* and those in the present case.[58] It is significant that Lord Templeman found for the taxpayer in the accompanying cases *IRC v Bowater Property Developments Ltd*[59] and *Baylis v Gregory*[60] on the basis that the series of events in those cases were not sufficiently preordained to bring them within the narrower scope of *Furniss v Dawson*. Indeed, Lord Templeman said that:[61]

The taxpayers placed themselves in a position to escape tax in the future but there was no scheme [similar to that in *Furniss v Dawson*].

In Canada, the Supreme Court showed that it was not prepared to accept the fiscal nullity doctrine in its wide form in *Stubart Investments Ltd v The Queen*.[62] In that case a company with accumulated tax losses established an arrangement to undertake the business of an associated profitable company. The object of the structure was to utilise accumulated tax losses. The Department of National Revenue contended that the whole transaction was entered into solely to avoid tax and was a fiscal nullity.

In a decision which foreshadowed *Craven v White*, Estey J rejected any wide anti-avoidance notion based on the presence of a tax saving motive. He stated:[63]

I would therefore reject the proposition that a transaction may be disregarded for tax purposes solely on the basis that it was entered into by a taxpayer without an independent or bona fide business purpose.

He also affirmed that the earlier Federal Court of Appeal cases, which suggested a different approach, were distinguishable.[64]

The basis for the fiscal nullity doctrine was explained by Estey J in similar terms to those later used by Lord Oliver in *Craven v White*. Estey J considered that *WT Ramsay Ltd v IRC* and *IRC v Burmah Oil Co Ltd* were to be explained on the basis that, in each case, a scheme was undertaken in which the taxpayer took affirmative action to create the "loss" or "gain" by a transaction or series of transactions not otherwise required in the ordinary course of business.[65] *Furniss v Dawson* was really a situation where the taxpayer designed an artifice to postpone receipt of the proceeds of sale

58 Ibid, 284.
59 [1988] BTC 268.
60 Ibid.
61 Supra at note 10, at 284.
62 Supra at note 15.
63 Ibid, 30.
64 Supra at note 32.
65 Supra at note 15, at 21.

under an agreement reached directly between the parties to the transaction before the accounting scheme was established.[66] The interposition of a new entity into the sale added nothing to the legal relationship of the parties.

In Australia, the High Court recently had occasion to comment on the fiscal nullity doctrine. In *John v FCT*[67] the Court had to consider the effectiveness of a tax avoidance transaction. Of interest in the case is the fact that the High Court expressly rejected the application of the doctrine on the basis of an existing anti-avoidance provision in the Income Tax Assessment Act 1936-1977. The High Court felt that inclusion of s 260 in that Act indicated a statutory intent that the provision was to be the only source for the Court to draw from in deciding on avoidance issues. It was stated:[68]

> The Act, in sec. 260 and now in Pt IVA, makes specific provision on the topic of what may be called tax minimisation arrangements and thereby excludes any implication of a further limitation upon that which a taxpayer may or may not do for the purpose of obtaining a taxation advantage.

The Court did not feel that it was necessary to explain the rationale for the earlier fiscal nullity decisions.

In New Zealand there has been no pronouncement on the scope of the fiscal nullity doctrine to date by the Court of Appeal or the Privy Council. In *Mills v Dowdall*[69] Cooke J (as he was then) suggested that the doctrine could apply, but did not expand his analysis. The majority in that case however affirmed the basic principle that form takes precedence over substance. In *CIR v Challenge Corporation Ltd* it was noted by Cooke J (as he was then) that the Commissioner had expressly disclaimed reliance on the doctrine of fiscal nullity.[70] Strictly, the position is thus still open in New Zealand. However, it is unlikely that the Court would feel able to use the fiscal nullity concept, if at all, in the wide sense that it appeared in *Furniss v Dawson*, for the same reasons that it was rejected in *Craven v White*, *Stubart Investments Ltd v The Queen* and *John v FCT*.

Fiscal Nullity in New Zealand

It is submitted that the correct rationale to be placed on the fiscal nullity cases was that provided by Estey J in *Stubart Investments Ltd v The Queen*,[71] where he concluded that it seemed more appropriate to turn to an interpretation test that would provide a means of applying the Act so as to affect only the conduct of a taxpayer which has the designed effect of defeating the expressed intention of Parliament. Under this approach the tax statute is

66 Ibid.
67 89 ATC 4101.
68 Ibid, 4110.
69 Supra at note 36.
70 [1986] 2 NZLR 513, 572 (CA).
71 Supra at note 15, at 31.

extended to reach conduct of the taxpayer which clearly falls within 'the object and spirit' of the taxing provisions.

The same point has been made by Richardson J:[72]

> This brings me to the difficult question: under what circumstances if any does reliance on perceived basic underlying policies of the income tax legislation justify barring recognition of transactions which would otherwise have beneficial tax consequences for the taxpayer? The brief and inadequate answer is: where the scheme and policy of the legislation require the non-recognition of the transaction for income tax purposes.

This approach is of course an example of the contemporary purposive approach to statutory interpretation. Such an approach leads inexorably to the question: what is the scheme and purpose of modern income tax legislation and in what circumstances will there be a statutory mandate for the court to ignore the beneficial tax consequences of a taxpayer's transaction? The problem requires consideration of, first, the scheme and purpose of the Income Tax Act 1976 and, second, how the Act can be interpreted to deal with the various techniques of tax avoidance.

Scheme and Purpose[73]

In 1967 the Taxation Review Committee noted that fiscal legislation serves, inter alia, three important purposes:[74]

(i) It provides revenue to finance necessary government expenditure.
(ii) It acts as an instrument to achieve the economic aims of government.
(iii) It achieves the social aims of government.

It was recognised that the role of fiscal legislation had undergone an evolutionary process driven by the increasing role that government plays in society.[75] The wider purposes of fiscal legislation were also recognised by Richardson J in *Grieve v CIR*, where he said:[76]

> [There exist] incentive deductions and allowances and tax credits ... [which] have become such a feature of commercial life in recent years. There are numerous provisions in the statute which afford special tax treatment to special types of activities - usually to encourage increased production and exports.

The other important matter requiring consideration is how the purposes of fiscal legislation are structurally achieved. The Income Tax Act 1976 consists

72 Supra at note 18, at 9.
73 Cf supra at note 18, at 19.
74 *Report of the Taxation Review Committee* (1967) 13.
75 In *Stubart Investments Ltd v The Queen*, supra at note 15, at 30 Estey J made a similar comment in relation to the Income Tax Act (Canada): "The apparent legislative intent ... in the modern taxing statutes, may have a dual aspect. Income tax legislation ... is no longer a simple device to raise revenue to meet the cost of governing the community. Income taxation is also employed by government to attain selected economic policy objectives. Thus the statute is a mixture of fiscal and economic policy."
76 [1984] 1 NZLR 101, 112.

of three basic components: the tax base; the tax unit; and the rate schedule.

The tax base defines what is to be included as taxable income and what is to be deducted to obtain a proper measure of net income. Historically, New Zealand has had a narrowly defined income tax base, taxing items of a revenue rather than a capital nature. Under s 65, income that is included in the tax base falls within three categories:[77]

(i) Income from labour - s 65(2)(b);
(ii) Income from investments, such as rents - s 65(2)(g), royalties - s 65(2)(h), interest and dividends - s 65(2)(j); and
(iii) Income from business - s 65(2)(a).

The tax base does not include capital receipts.[78] As a general rule, the common law holds that a receipt of a capital nature, such as a profit made on the sale of a fixed asset, will not be income; while a profit made on a regular and organised basis, such as a business receipt, will be income.

The tax unit specifies the unit whose income is being measured, whether it be the individual or a larger family grouping, and the treatment of other legal entities such as trusts and companies. Under the Act individuals,[79] companies[80] and trusts[81] are treated as separate taxable entities. An exception to this basic rule occurs when distributions of income are made from companies and trusts to their members. Income distributed from a company to its shareholders and from a trust to its beneficiaries is taxed on a "conduit" basis, in that it is taxed only once, in the hands of the individual receiving the distribution.[82]

The rate schedule specifies the rate or schedule of rates to be applied to the net income of the tax unit. Previously, the Act had a highly progressive rate schedule for individuals and separate rates for trusts and companies. In light of the recent reform, the individual rate scale has been flattened[83] and the rate for companies and trusts made equal to the top individual rate.

An Overview of Tax Avoidance

Stiglitz suggests that there are three basic methods of tax avoidance.[84] First, taxes may be postponed. The present discounted value of a postponed tax can be much less than that of a tax currently payable. Tax avoidance schemes

77 Supra at note 21, at para 133.
78 With the exception of certain provisions in s 67.
79 Section 38; s 2.
80 Ibid.
81 Sections 226-233.
82 For companies this occurs under the new dividend imputation system contained in ss 394A-394ZZX; for trusts this occurs under the new trust taxation regime contained in ss 226-233.
83 For individuals the rate is currently 24% for income up to $30,875 and 33% for income over $30,875.
84 Stiglitz, "The General Theory of Tax Avoidance" 28 Nat Tax J 325.

often take advantage of accounting rules under the Act which permit income recognition to be deferred and expense recognition accelerated, resulting in an overall postponement of a tax liability until the next taxable period.

Second, the taxpayer may utilise arbitrage between legal entities facing different tax rates. When two entities face a rate difference, such as might occur between two individuals on different marginal rates, or between an individual and a company or trust on different rates, arbitrage may occur between the two entities. That is, an income stream may be transferred from the higher rate entity to the lower rate entity, where it will be subject to the lower rate of tax. This method is typically described as "income splitting". In *Marx v CIR* Turner J depicted instances of this form of tax arbitrage as:[85]

> Cases in which by virtue of the transactions the taxpayer derives less income than he would or might, but for the arrangement, have derived, others (generally relatives) emerging with larger incomes.

Third, the taxpayer may utilise tax arbitrage across income steams facing different tax rates. When a taxable entity has a choice of differing rates on income streams, there will be an advantage to convert a particular receipt into a form that attracts no or a lower rate of tax. Under current law, the Act does not make capital gains taxable. This provides an inducement to convert the returns of capital or labour into capital gains. Judicially, this form of arbitrage is known as "conversion". In *Marx v CIR* Wild CJ said of these schemes:[86]

> There are the cases in which the purpose and effect of the arrangement is or purports to be to convert taxable income into capital. They may be called the conversion cases.

A Rationale

I submit that the fiscal nullity doctrine is in fact an example of the court deciding whether the tax avoidance scheme of the taxpayer has fulfilled the necessary legal conditions required by the legislation to gain recognition. By looking at the basic scheme of the Act, including the tax base, tax unit, and rate schedule, the court has to decide whether the true nature of the transactions, as performed by the parties, do in fact fulfil the conditions desired by the taxpayer.

To illustrate my contention I consider the above approach in the context of the three basic tax avoidance methods discussed above.

When considering an instance of postponement, the court will ascertain whether the income sought to be deferred has not in fact already been derived under s 65 in the immediate taxable period. Similarly, it will decide whether an item of prepaid expenditure can be deducted by applying s 104, governing general deductibility, in accordance with normal principles.

85 [1970] NZLR 182, 203 (CA).
86 [1969] NZLR 464, 470.

Where there has been tax arbitrage between entities, the court will decide if the entity seeking to derive income at the lower rate does in fact derive the income stream under the Act. This will, in turn, depend on whether the income stream has successfully been transferred to the lower rate entity and whether that entity is legally able to derive the income.

Finally, in a case involving tax arbitrage across income streams, the court will examine the legal relations (and the effect thereof) created by the taxpayer, in order to decide whether the particular receipt can be said to be capital under the common law.

Dealing with Avoidance in New Zealand

Fiscal nullity is not the only weapon in the arsenal of the New Zealand Commissioner. In *Mills v Dowdall* the Court of Appeal noted that:[87]

> The only exceptions to the principle that the legal consequences of a transaction turn on the terms of the legal arrangements actually entered into and carried out are: (i) where the essential genuineness of the transaction is challenged and sham is established; and (ii) where there is statutory provision, such as s 99 of the Income Tax Act 1976, mandating a broader or different approach which applies in the circumstances of the particular case.

These exceptions will now be considered.

The Application of Section 99

Section 99 is a general provision aimed at tax avoidance schemes. Section 99(2) states, inter alia, that:

> Every arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the Commissioner for income tax purposes if and to the extent that, directly or indirectly, -
> (a) Its purpose or effect is tax avoidance; or
> (b) Where it has 2 or more purposes or effects, one of its purposes or effects (not being a merely incidental purpose or effect) is tax avoidance, whether or not any other or others of its purposes or effects relate to, or are referable to, ordinary business or family dealings, -
>
> whether or not any person affected by that arrangement is a party thereto.

An arrangement is defined in s 99(1) as:

> [A]ny contract, agreement, plan, or understanding (whether enforceable or unenforceable) including all steps and transactions by which it is carried into effect.

This definition is extremely wide in its ambit and will cover most tax-planning structures that a taxpayer may enter into. Generally a taxpayer will admit to the existence of an arrangement.[88]

The crucial issue in s 99 is when does an arrangement have a more than incidental purpose or effect of tax avoidance.

87 Supra at note 36, at 159-160.
88 See for example *Halliwell v CIR* [1978] 1 NZLR 363, 367.

As a preliminary matter, it has been held that purpose is to be found from effect. In accordance with *Newton v FCT*,[89] a court will look at the objective facts evidencing an arrangement. If the objective facts show that the effect of tax avoidance is present, then the purpose of that arrangement will be one of tax avoidance. The question of what motivated the arrangement, subjectively, is irrelevant. The Court of Appeal in *Tayles v CIR* summarised the position when McMullin J said:[90]

> [Section 99] is not concerned with the motives of individuals nor their desire to avoid tax but only with the means which they employed to do it; it is the arrangement itself and not the motives of those who make it from which its purpose and effect are to be deduced. ... The test is objective and the purpose of the arrangement must be determined by what the transaction effects.

However, the question remains as to what, objectively, is a purpose or effect of more than an incidental nature. Unfortunately, there has only been one major decision to date on s 99. In *CIR v Challenge Corporation Ltd*[91] the Commissioner contended that the taxpayer company was within the scope of s 99(2) when it purchased a company solely to offset that company's accumulated tax losses against its own assessable income. The Privy Council found that s 99(2) did apply in the circumstances of the case.

What is of importance is the general scope of s 99(2) as seen by the Board. In essence, the Privy Council decided that s 99 applied to arrangements which could be termed "tax avoidance" and not to those which could be classified as "tax mitigation":[92]

> 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 advantages is not derived from an "arrangement" but from the reduction of income which he accepts or

89 [1958] AC 759.

90 Supra at note 47, at 733.

91 Supra at note 70 (CA); [1986] 2 NZLR 556 (PC). Of the recent cases to consider s 99, only one has been at the High Court: *Hadlee & Anor v CIR*, High Court. 16 June 1989 (M 171/88). Interestingly the Taxation Review Authority in a trilogy of cases (*Case L3* (1989) 11 NZTC 1005; *Case L4* (1989) 11 NZTC 1020; *Case L6* (1989) 11 NZTC 1037) appears to confirm the view expressed by this article. In those cases the taxpayer instead of leasing a car for his business arranged for his family trust to purchase the car and on-lease it to the taxpayer. By doing this the taxpayer effectively split his income and had the trust derive it at a lower rate of tax. The arrangement was necessary to the taxpayer's on-going business and would have proceeded quite apart from the taxation advantages. Moore DCJ rejected the submission of the Commissioner that s 99 applied to deny deduction of the rental payments to the trust. He found that the arrangement only had the effect of tax minimisation (at 1019) and that by implication the arrangement only had an incidental purpose or effect of tax avoidance. His Honour quoted the decision of Woodhouse P in *CIR v Challenge Corporation Ltd* and found (at 1018): "[t]hat [decision] seems to ... express and reflect a theme consistently found in decisions under the predecessors of s 99 and to accord with the distinction between tax avoidance and the minimisation drawn by the majority in the Privy Council. Those expressions and that distinction appear intended to express and encapsulate long-standing concepts as to when s 99 can be invoked."

92 Ibid, 561 (PC).

the expenditure which he incurs.

Tax avoidance was clearly distinguished:[93]

> 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 entitled him to that reduction. The taxpayer engaged in tax avoidance does not reduce his income of suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had.

These passages prima facie indicate that an arrangement will only come within the scope of s 99(2) if it does not involve a taxpayer actually experiencing a reduction in income either by losing an item of income or by incurring a real expenditure. Such a test, which essentially depends upon an actual diminution in assessable income, is in itself too simplistic. The Board failed to refer to any jurisprudence on s 108 of the Land and Income Tax Act 1954, the forerunner to s 99. To this extent the decision of Woodhouse P[94] in the Court of Appeal appears to state, more conclusively, the correct bounds of s 99(2). The President felt that s 99(2) would not apply to an arrangement which had only an incidental tax avoidance purpose. A merely incidental purpose or effect was seen by Woodhouse P as:[95]

> [One] which is necessarily linked and without contrivance to some other purpose or effect so that it can be regarded as a natural concomitant.

Thus the President affirmed his own approach, to the earlier s 108, formulated in *Elmiger v CIR*:[96]

> [Arrangements where] one of the actuating purposes of the transaction under review [was a tax advantage.

Section 99 and Fiscal Nullity

The distinction between s 99 and fiscal nullity turns on the distinction between purpose and motive. Much confusion still surrounds these concepts. Purpose as used in income tax legislation normally refers to:[97]

> Those objects which . . . will probably be achieved by [one's] act.

Estey J in *Stubart Investments v The Queen* seems to display this confusion when he states:[98]

> I would therefore reject the proposition that a transaction may be disregarded for tax purposes solely on the basis that it was entered into by a taxpayer without an independent or bona fide business purpose. . . . The economic policy element of the Act sometimes takes the form of an inducement to the taxpayer to undertake or redirect a specific activity. . . . Thus,

93 Ibid.
94 Supra at note 70, at 533 (CA).
95 Ibid.
96 [1966] NZLR 683, 694. See also, in relation to s 108, *Tayles v CIR* supra at note 47, at 736 per McMullin J.
97 Avery-Jones [1983] BTR 9, 21.
98 Supra at note 15, at 30.

by imposing a positive requirement that there be such a bona fide business purpose, a taxpayer might be barred from undertaking the very activity Parliament wishes to encourage.

Estey J appears here to equate purpose (in the sense defined above) with motive. In this he is incorrect. With the exception of s 99, the scheme of the Act disregards motive, and is concerned instead with purpose. The dilemma facing Estey J dissolves on this analysis. The Act certainly provides *an inducement* or *motive* of tax avoidance in many of its incentive provisions, but this is not a requirement for the application of these provisions. What is required is that the activity undertaken by the taxpayer display the purposes (amongst others) required by the particular provision.

It is submitted that the dissent of Woodhouse P in *CIR v Challenge Corporation Ltd*[99] correctly states the position. In dealing with the question of whether the deliberate use of export incentive provisions to avoid tax was caught by s 99, Woodhouse P stated:[100]

> Conventional exporters do not trade to save tax but to achieve profits. To put this point in another way, among the cost factors to be taken into account, one of them, to a greater or lesser extent, would sensibly and properly be the tax factor. So regarded, the tax saving purpose intended as a support to the operation could in the ordinary course no more be labelled an end in itself than the purpose of avoiding or minimising any other cost likely to effect the operation.

In other words, s 99 is concerned with motive, objectively determined. I further submit that purposes which are, as ends in themselves, more than incidental are also motives. They are motivating purposes. Equivalently, the fact that a purpose is a motive makes it more than incidental. Thus those provisions which depend on purpose and disregard motive, such as those relating to tax expenditures, do not conflict with a provision in the same income tax system such as s 99 which depends on motive.

Woodhouse P's criteria for the application of s 99(2) therefore mean that an arrangement will be caught by s 99(2) if objectively it appears to have been actuated by a tax avoidance motive. It is to be noted that Woodhouse P explicitly recognised in his judgment that an arrangement could be actuated by reasons other than tax avoidance but nonetheless could be structured in a tax efficient manner. A similar approach had been adopted under s 108:[101]

> Tax savings which [occur] as no more than an incident of a scheme which could have been carried into effect in one of two ways, one taxable and the other not, do not result in the scheme being caught by the section.

In *CIR v Challenge Corporation Ltd* the President said:[102]

99 Supra at note 70 (CA).

100 Ibid, 534.

101 *Tayles v CIR*, supra at note 47.

102 Supra at note 70, at 533. Typically cases involving s 108 fell into defined categories. Two of these were: (i) where one taxpayer sought to divert an income to another taxpayer on a lower rate of income tax; and (ii) where one taxpayer incurred expenditure to reduce taxable income and the expenditure was paid to a taxpayer on a lower rate of income tax.

> Many taxpayers when considering a course of action are likely to appreciate and welcome an opportunity provided by the Act for achieving some tax benefit as an aspect of it. But this should not bring the transaction or transactions almost automatically within the avoidance provisions of section 99.

In essence, when a taxpayer diverts income or incurs expenditure and the income or expenditure is shifted to a lower rate taxpayer, s 99(2) will apply if it can be said objectively that the actuating reason for the arrangement was tax avoidance. If, on the other hand, the arrangement would have taken place regardless then s 99(2) will not apply.

If this interpretation of s 99 is accepted, the fiscal nullity doctrine is reconcilable with the presence of s 99 in the Income Tax Act 1976. The fiscal nullity doctrine, being concerned with the formal arrangements entered into by the taxpayer, seeks to ascertain exactly what those relationships are. Section 99, on the other hand, disregards the form of the arrangement and looks at the substance of the transaction. The reconciliation provided by the Court of Appeal in *Mills v Dowdall*,[103] between the function of the Court in ascertaining the formal arrangements entered into by the taxpayer and the role of s 99, is also an explanation of the relationship between the fiscal nullity doctrine and s 99.

Sham Transactions

The second exception to the rule that form will prevail over substance occurs where a transaction is found to be a sham. The doctrine of sham transactions has historically been used by the court as a justification for ignoring the formal arrangements constructed by the parties to the transaction. It is generally taken to apply to transactions conducted with an element of deceit that is designed to disguise their true nature. The essential point about the doctrine is that the parties never intend to create the legal relations that are formed. Its effect is that the transaction is to be disregarded at the outset simply because there is no valid transaction. The Court of Appeal in *Mills v Dowdall*[104] held that a sham would exist where either (i) the transaction does not reflect the true agreement between the parties, in which case recognition is given to the true common intentions; or (ii) where the transaction was bona fide in inception but has since been departed from while leaving the initial agreement unaltered. Sham and fiscal nullity are again reconcilable. The sham doctrine only operates where the intent of the parties does not reflect their arrangement. The fiscal nullity doctrine assumes that the arrangements are intended and seeks to ascertain exactly what that intention is.

103 Supra at note 36.
104 Ibid.

Conclusion

I have argued that fiscal nullity is not a separate doctrine. Rather, the process of ascertaining whether a transaction is a fiscal nullity is simply the process of (i) analysing the exact legal relationships created by the taxpayer, and (ii) deciding whether the particular fiscal legislation extends to cover those legal relationships. In doing so, the court is to adopt a formalistic approach, and will ignore a taxpayer's motivation. There are only two exceptions to these principles, which are contained in s 99 and in the doctrine of sham.

I suggest that this explanation of fiscal nullity, and of its possible application to potential tax avoidance schemes, is consistent with the approach of the Court of Appeal in New Zealand in recent years[105] and is that articulated by Richardson J in *Mills v Dowdall*:[106]

> The legal principles governing the ascertainment of the true legal character of a transaction are now well settled. . . . It frequently happens that the same result in a business sense can be attained by two different legal transactions. The parties are free to choose whatever lawful arrangements will suit their purposes. The true nature of their transactions can only be ascertained by careful consideration of the legal arrangements actually entered into and carried out. Not on an assessment of the broad substance of the transaction measured by the results intended and achieved; or of the overall economic consequences to the parties. . . .

In itself fiscal nullity is not a new concept. As the High Court in *John v FCT* observed:[107]

> If [fiscal nullity] is advanced as a matter [determined by the Act] there is no occasion to resort to any new principle of construction.

And as Estey J noted in *Stubart Investments Ltd v The Queen*:[108]

> Without any need for new principles of taxation, tax liability arose.

105 *Re Securitibank Ltd (No 2)* [1978] 2 NZLR 136; *Buckley & Young Ltd v CIR* [1978] NZLR 485; *CIR v Smythe* [1981] 1 NZLR 673; *Mills v Dowdall* supra at note 36.

106 Supra at note 36, at 159.

107 Supra at note 67, at 4110.

108 Supra at note 15, at 20.