CASE NOTES

Tasman Insulation New Zealand Ltd v Knauf Insulation Ltd

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I INTRODUCTION

It might seem obvious that trademarks should not be registered for generic or descriptive terms. The function of a mark is to identify that a certain product comes from an identifiable source.[1] Generic marks do not render products more easily identifiable. While they may be advantageous for the owner of the mark, they result in confusion in the market, as consumers struggle to identify products from other sources that can no longer be freely and accurately described. It would be ridiculous, for example, to allow Kleenex to register a mark for the word "tissues", because it would impede other tissue manufacturers' ability to accurately label their products. Such marks would provide an unfair advantage for the owner, at the expense not only of its competitors, but also its consumers, and by extension, the market as a whole. As a consequence, generic marks are not registrable. Where the mark becomes generic after registration, it may be revoked. Such revocation is known colloquially as genericide. The issue becomes more complex, however, where the mark has existed for a long time; where the word has become a generic descriptor by virtue of the owner's own success; or where the word alone is generic but becomes distinctive in certain contexts. *Tasman Insulation New Zealand Ltd v Knauf Insulation Ltd* is the first New Zealand case to explore the law on this point.[2]

II FACTS

Outside of New Zealand, the word "batt" (or "batting") has always been considered a generic description of matted fibres, including insulation.[3] Consequently, in other jurisdictions, it has not been registrable as a trademark.[4] However, since 1973, Tasman Insulation has owned the mark BATTS in New Zealand in class 17 insulating materials.[5] The mark has always been used along with another word that renders it much more distinctive: PINK BATTS.[6]

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1 Paul Sumpter *Trade Marks in Practice* (2nd ed, LexisNexis, Wellington, 2011) at 54; and Trade Marks Act 2002, s 5, definition of "trade mark". See also ss 18 and 89(2).
2 *Tasman Insulation New Zealand Ltd v Knauf Insulation Ltd* [2014] NZHC 960.
3 At [1] and [16]–[20].
4 At [1].
5 At [1].
6 At [76].

Starting in December 2010, Knauf Insulation, a competitor, began importing various EARTHWOOL insulation products. Some of these were labelled as "batts".[7] Tasman sent Knauf cease and desist letters in respect of the labelling. Knauf responded that it was using "batts" in a descriptive, non-infringing manner and, furthermore, that the term had become generic in any case.[8] Following further correspondence, Knauf undertook to stop using the allegedly infringing labelling.[9] In reality, it did not. In 2011 a shipment of insulation, which used the word "batt" in its packaging labels, was held at the border under a Customs notice Tasman had filed.[10]

Knauf applied for revocation of the trademark on the grounds that the mark had become a common name in general public use. That is, it was now generic and descriptive, rather than indicating origin. It also claimed that the mark was invalid for lack of genuine use.[11] Tasman filed trademark infringement proceedings based on Knauf's packaging and website. The mark was used on the website both in text and in the underlying code, so that it would appear in searches for the word "batts".[12] Alongside this, there were various additional cross-claims under the Fair Trading Act 1986.

III LAW ON GENERICIDE

In New Zealand, s 18 of the Trade Marks Act 2002 sets out the law on registration of generic trademarks. It protects against the registration of descriptive marks and demonstrates that marks are aimed at identifying not the type of product, but the particular source:

> **18 Non-distinctive trade mark not registrable**
>
> (1) The Commissioner must not register—
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> ...
>
> (b) a trade mark that has no distinctive character:
>
> (c) a trade mark that consists only of signs or indications that may serve, in trade, to designate the kind, quality, quantity, intended purpose, value, geographical origin, time of production of goods or of rendering of services, or other characteristics of goods or services:
>
> (d) a trade mark that consists only of signs or indications that have become customary in the current language or in the bona fide and established practices of trade.
>
> (2) The Commissioner must not refuse to register a trade mark under subsection (1)(b), (c), or (d) if, before the date of

7 At [22]–[23].
8 At [24]–[25].
9 At [26]–[27].
10 At [33]–[34].
11 At [67]–[69].
12 At [54], [56] and [65].

> application for registration, as a result of either the use made of it or of any other circumstances, the trade mark has acquired a distinctive character.

Section 66(1)(c) sets out the law on revocation of pre-existing generic trademarks:

> **66 Grounds for revoking registration of trade mark**
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> (1) The registration of a trade mark may be revoked on any of the following grounds:
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> ...
>
> (c) that, in consequence of acts or inactivity of the owner, the trade mark has become a common name in general public use for a product or service in respect of which it is registered...

It is crucial that the mere fact that a trademark has become generic is not enough to justify revocation. The genericisation of the mark must be attributable to its owner. Additionally, the relevant use is general public use, as opposed to use in trade or industry.13

Also relevant to the case, and of some general interest, was s 66(1)(a), which allows for revocation of a mark where it is not genuinely used over a period of three years or more:

> (1) The registration of a trade mark may be revoked on any of the following grounds:
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> (a) that at no time during a continuous period of 3 years or more was the trade mark put to genuine use in the course of trade in New Zealand, by the owner for the time being, in relation to goods or services in respect of which it is registered

IV THE DECISION

Lack of Genuine Use

The issue of genuine use essentially amounted to an assertion that a trademark that is never used on its own, but only in combination with a more distinctive mark (a "limping mark"), is not genuinely used.[14] So since the mark BATTS had not been used alone, but only as part of the compound mark PINK BATTS, there was no genuine use.

The Court rejected this argument. Brown J concluded that the case law established that second-level and third-level marks could legitimately be registered as marks and that, therefore, use of a limping mark must logically

13 See also at [85]–[90].

14 At [77]. The term "limping mark" comes from *Philips Electronics BV v Remington Consumer Products* [1998] RPC 283 (Pat) at 296.

be genuine use, provided it was used as a mark and not as a description.[15] Tasman had so used BATTS, so this cause of action failed.[16]

Genericide

Neither the issue of genericism, nor the assertion that any genericism, could be proven. The difficulty with genericism was that the onus was on the applicant to prove that the mark had become common in the general public, which the judge considered to be a heavy burden of proof.[17] There must be widespread use. Proof of synecdoche or use as a result of widespread recognition of the mark was not sufficient.[18]

Knauf argued that "batts" had always been a generic word and that the mark had been in danger since at least 1977, when oppositions were lodged against various marks containing the word BATTS. By this time, however, the registration had already been in place for four years. Brown J therefore concluded that this argument amounted to a contention that the mark should never have been registered in the first place because it was never capable of being used as a trademark. This assertion fell outside of the scope of s 66(1)(c), which did not involve looking at the merits of the original registration, and therefore this argument could not justify revocation.[19]

Next, the Court examined whether the mark had become generic. Brown J was forced to address the jurisdictional issue of whether actions prior to the enactment of the Trade Marks Act 2002 could be taken into account for the purposes of s 66. Taking into account the fact that the Act was passed in part to "more clearly define the scope of rights protected by registered trade marks",[20] he concluded that retrospectivity should only be assumed where it was clearly authorised.[21] That was not the case in s 66. Therefore, Knauf had to show that the mark had become generic due to acts or inactions that had occurred since 20 August 2003.[22]

Knauf led evidence including market research and surveys of Trade Me insulation listings, which, it contended, showed that "batts" was a generic term.[23] However, this evidence was not considered sufficiently conclusive. It did not show that the mark had become *sufficiently* generic to justify revocation. Therefore, although Brown J accepted that the reality might be that "batts" was a generic word, Knauf had not discharged its burden of proof.[24]

15 At [80]–[81].
16 At [82]–[84].
17 At [90]–[91].
18 At [92] and [126].
19 At [98]–[104].
20 Section 3(a).
21 At [105]–[111].
22 At [111].
23 At [112]–[148].
24 At [126], [135] and [145]–[147].

Additionally, Brown J concluded that even if he were wrong and the mark *had* been shown to have become generic, Knauf had also failed to show causation. Following the only other New Zealand case to deal with genericism in any context, *DB Breweries Ltd v Society of Beer Advocats Inc*, where "Radler" was found not to be a generic term, he clarified what he considered eligible "acts" and "inactions" to be.[25] An example of an act causing genericism might be use of the mark in a non-trademark fashion, for example as a noun. An example of inaction might be a failure to prevent others using the mark in a non-trademark fashion. Tasman had not acted as an ideal trademark owner would on either count but, overall, its record was a good one.

Other Defences

Knauf defended Tasman's trademark infringement claim using s 89(2), which allows non-trademark use. It contended that it had used "batts" as a synonym for "slabs", not in an adjectival, trademark-like fashion to indicate source.[26] Since a trademark was essentially a badge of origin, Knauf argued such use was non-infringing.[27] The labelling on the packets, for example, said "Knauf batts"; "Knauf" was the badge of origin, while "batts" merely referred to the format of the product. On the facts, Brown J concluded that the installation instructions and packaging were non-trademark use.[28] Only the use of the word "batts" in the website source code constituted an infringement.[29] That was despite the fact that the use was invisible to website users unless they specifically sought out the source code — an issue which had been controversial in the past.[30] Brown J considered that the fact that the code could be viewed by an "informed internet user" rendered it visible and, therefore, "use" in the context of infringement.[31]

Knauf's defence that "batt" was too dissimilar to "BATTS" to constitute infringement also failed, for obvious reasons.[32] Additional defences under ss 95 ("honest practices") and 105 ("unjustified proceedings") also failed regarding the website, the sole remaining instance of infringement.[33] Knauf's contention that the mark should be revoked under s 66(1)(c) as not being a valid registration failed for the same reasons as the original claim for revocation.[34]

25 *DB Breweries Ltd v Society of Beer Advocats Inc* IPO T19/2011, 13 July 2011; and *Tasman*, above n 2, at [151]–[159].
26 *Tasman*, at [202]–[205].
27 At [208]–[209].
28 At [211]–[221].
29 At [222]–[223].
30 At [224]–[235]. See also *Complete Technology Integrations Pty Ltd v Green Energy Management Solutions Pty Ltd* [2011] FCA 1319; *Reed Executive Plc v Reed Business Information Ltd* [2003] RPC 12 (Ch); and Joined Cases C-236/08, C-237/08 and C-238/08 *Google France SARL v Louis Vuitton Malletier SA* [2010] RPC 19 (CJEU).
31 *Tasman*, at [236].
32 At [237]–[242]. Infringement would have been under s 89(1).
33 At [243]–[260] and [262]–[271].
34 At [261].

Analysis

As a practical matter, it seems that it will be very difficult to show genericism as opposed to name recognition. Knauf adduced evidence from Trade Me showing use of "batts" in five different categories. It argued that at least one category (use of "batts" on its own to refer to the products of a manufacturer other than Tasman) showed clear generic use.[35] Brown J accepted that the public domain was the correct place to seek information about public use and that even when Trade Me users referred to Pink Batts, they could nonetheless be using the mark in a descriptive, non-trademark fashion.[36] Nonetheless, it was easy to confuse the success or dominance of the trademark with its use as a generic descriptor, and use by way of synecdoche would not amount to genericism. The quantitative data alone was insufficient; Knauf had not shown enough evidence to meet the high burden of proof that there had been widespread generic use.[37] Moreover, Brown J considered that careless use by members of the public should not sway the final decision.[38]

Similarly, analysing Knauf's collected evidence of Internet search results, dictionaries and so on, the Judge concluded that there was some evidence of generic use but not enough to justify revocation. Finally, he considered a Colmar Brunton market survey, which showed a series of images along with the question "which of these insulation products, if any, are 'batts'?" to show brand recognition, not genericism.[39] People would assume that at least one product shown was "batts", realise that one was pink, recall the existence of Pink Batts and therefore choose the pink product. The failure of all this evidence demonstrates that it will be difficult and labour-intensive for applicants to show genericism. Evidence of qualitative use is critical but since generic use must be widespread, as a practical matter, quantitative evidence must also be led.[40] Particularly in the context of a word like "batts", which, although allegedly generic, is not in everyday use by most parts of the population, it will be difficult to show evidence of genericism without crossing over into issues of market dominance. The same difficulty arose in *DB Breweries*, although the evidence in that case was of a much lower standard, consisting mainly of pro forma declarations from members of the Society of Beer Advocats.[41]

Proving causation will also be difficult, following Brown J's finding that s 66 is not retrospective, meaning that genericism must be attributable to the mark owner's actions since 2003.[42]

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35 At [112]–[121].
36 At [121]–[125].
37 At [126].
38 At [132]–[133]. See also the source of this argument: *Wineworths Group Ltd v Comite Interprofessionel du Vin de Champagne* [1992] 2 NZLR 327 (CA) at 337 per Gault J.
39 *Tasman*, above n 2, at [137]–[148].
40 At [92]–[93]. See also the discussion of the Trade Me evidence at [113]–[126].
41 *DB Breweries*, above n 25.
42 *Tasman*, at [105]–[111].

In the case of older marks, such as the Batts one, that will be very difficult to establish. Indeed, Knauf was unable to show any significant evidence, relying on use by a single firm and on Tasman's failure to respond when the mark was used descriptively, such as on Trade Me listings. That was because it was alleging that the mark had been generic since the 1970s. If the genericism predated the Act, then as a matter of logic it would be impossible to show causation after the Act came into force. Moreover, Brown J acknowledged the evidence of a linguist that, as a matter of fact, it is almost impossible to prevent an organic change in the usage of a mark.[43] This would seem to weigh significantly in favour of mark owners. On that basis, and considering the steps Tasman had taken, such as the use of brand style guides, Tasman could have done more to safeguard the mark but it was not their fault if it had become generic.[44]

On one hand, this approach is logical. The wording in the statute did not explicitly allow for retrospective evidence and certainty for trademark owners is an important consideration. The whole point of a trademark, after all, is to allow mark owners to protect their brand. On the other hand, the question must be asked whether the law, as interpreted in this case, truly upholds the aims of the trademark regime. While each individual choice may seem sound in isolation, this case involved a confluence of factors, which together had a potentially worrying effect: a limping mark, evidential difficulties in proving genericism (as opposed to evidence that suggested distinctiveness) and a tough approach to jurisdiction.

The effect of the ruling on retrospectivity would seem completely to exclude the ability to revoke a mark that became generic prior to 2003. Surely this cannot have been the intended effect of the Act. While it no doubt clarifies the law from registered owners' perspective, from the point of view of an applicant for revocation or a consumer, it seems to draw an arbitrary line in the sand. If a mark has become so generic that it no longer indicates source, then the matter of timing appears a relatively minor point, which should logically be subordinate to the question of whether the mark is fit for purpose. This view is reinforced by the existence of s 73, which allows for invalidation of marks that were not registrable at the time of their registration, provided they have not since acquired a distinctive character.

Section 73 demonstrates that the Act does look at the present reality, regardless of past mistakes. While it is true that there might be situations where applicants could argue non-use under s 66(1)(a), this decision also establishes that that will be difficult to prove. The acceptance of limping marks and the high evidential standard required of both genericism and fault are entirely justifiable on their own for reasons Brown J clearly outlined in his decision. However, in context, they seem to heighten the effect of a tough ruling, at the expense of other stakeholders in trademark law.

43 At [171].
44 At [173].

Vinelight Nominees Ltd v Commissioner of Inland Revenue

SHIV NARAYAN*

I BACKGROUND

Vinelight was an appeal by the taxpayers against the decision of the High Court upholding the Commissioner's assessments,[1] which was an appeal of a decision of the Taxation Review Authority (TRA).[2] As the Supreme Court has denied leave to appeal, the Court of Appeal's decision is final.[3]

The dispute centred on the restructuring of a family's investments. The family concerned carried out business in New Zealand through Vinelight Investments Ltd (VIL), which, through subsidiaries, engaged in money-lending and invested in real property and shares. It was not in dispute that VIL was a New Zealand resident for tax purposes.

The family also owned Weyand Investments Ltd (Weyand), an investment company incorporated in Hong Kong. Weyand financed VIL's business activities with interest-free loans, which totalled more than $3 million. The key, however, was that Weyand was not required to pay tax in Hong Kong because Hong Kong generally only taxes income derived from within its jurisdiction. In other words, Hong Kong residents are not taxed on income derived from outside the territory.[4]

The family's dealings were reorganised in 1998. The main consequences of the restructure, as summarised by the Court of Appeal, were:[5]

- The Vinelight Trust and its corporate trustee, Vinelight Nominees Limited (VNL), were created. Weyand was a beneficiary of the trust.
- VIL arranged to pay management fees to VNL. These fees were set at $12,500.00 per month, a sum deliberately chosen to offset VIL's taxable income.
- VNL assumed responsibility for debt owed by VIL to Weyand and, for the first time, interest was charged. The rate was 16.5 per cent per annum, which was well above commercial interest rates at the time. This rate was purposefully set to ensure that the interest would offset

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1 *Vinelight Nominees Ltd v Commissioner of Inland Revenue* [2012] NZHC 3306, (2012) 25 NZTC ¶20-155.

2 *Case 11/2011* [2011] NZTRA 07, (2011) 25 NZTC ¶1-011.

3 *Vinelight Nominees Ltd v Commissioner of Inland Revenue* [2014] NZSC 74, (2014) 26 NZTC ¶21-076.

4 Inland Revenue Ordinance 1947 (HK), s 14. See *Encyclopaedia of Hong Kong Taxation* (looseleaf ed, LexisNexis, 1993) vol 3 Taxation of Income at II-[4953].

5 *Vinelight Nominees Ltd v Commissioner of Inland Revenue* [2013] NZCA 655, (2013) 26 NZTC ¶21-055, at [3] [*Vinelight (CA)*].

taxable income — the "management fees" — VNL received from VIL.

- VNL, in turn, registered for the approved issuer levy (AIL) regime and recorded its loan from Weyand under that regime. The regime would enable VNL to pay the levy at two per cent on interest payments rather than non-resident withholding tax (NRWT), which would otherwise be imposed at 15 per cent.

The intended tax outcome of the arrangement was that the family's tax burden in New Zealand would be greatly reduced by shifting all profit up to the Vinelight Trust and paying it out of New Zealand subject only to AIL. This outcome, however, depended on Weyand being a non-resident for New Zealand tax purposes. If Weyand was a resident, VNL would be required to deduct resident withholding tax (RWT) at the rate of 30 per cent on the interest paid to Weyand and Weyand would be required to pay income tax in New Zealand.

II RESIDENCE

A foreign-incorporated company is a tax resident when its centre of management is in New Zealand or its directors, acting in that capacity, exercise control of the company in New Zealand.[6] The Court emphasised that the centre of management test for tax residence should not be conflated with the alternative test based on directorial control, and that the centre of management test is a question of fact and substance.

The Commissioner contended that, until March 2003, Weyand was a tax resident because it had its centre of management in New Zealand. The Commissioner, in particular, relied on multiple facts to support this position. First, that Weyand's directors consulted tax advisers in New Zealand about the restructuring and its implementation. Secondly, that Weyand's directors demanded interest on the Vinelight Trust's debt to Weyand by addressing the demand to their residential address in Auckland. Finally, that Weyand's directors attended to the preparation of financial statements in New Zealand.

The taxpayer, on the other hand, argued that mere administrative acts do not constitute a centre of management. The Court, however, was not convinced that there should be a distinction between acts of superior and administrative management. In the Court's view, a distinguishing approach would result in some dimensions of management being irrelevant. Furthermore, it would conflate the centre of management test with the acts of directors test. That being so, the Court agreed with the earlier decisions of the TRA and the High Court, holding that Weyand's centre of management lay in New Zealand and, therefore, it was a tax resident in New Zealand.

6 Income Tax Act 1994, s OE 2(1) (s YD 2(1)). For authoritative reference, the equivalent provision of the Income Tax Act 2007 follows the Income Tax Act 1994 provision in parenthesis throughout the article.

This analysis may seem controversial. For example, if repeated in practice, this analysis may mean that minor tasks often given to employees or accountants may be sufficient for a company to have its centre of management in New Zealand. For some, that will be a difficult pill to swallow. Nevertheless, it is correct. New Zealand tax residency should not be escaped by merely attending to formalities offshore. If the test is a question of fact and substance, then a company resides where the centre of management actually abides. In this case, there is little doubt that place was New Zealand.

III RESIDENT WITHHOLDING TAX

The second issue was whether, supposing Weyand's residency, VNL was obliged to account for RWT or, at least, whether it *now* had to account for it. VNL opposed the imposition of RWT on three grounds.

First, VNL challenged that, as it did not pay the interest to Weyand "wholly or partly in the course of or furtherance of a taxable activity", it did not attract liability to withhold RWT.[7] However, the Court declined to address the merits of the argument. As the question of taxable activity was not outlined in the appellant's statement of position, the taxpayer was not permitted to raise such arguments. This aspect of *Vinelight* is a poignant reminder that the pre-litigation process can prove fatal for the taxpayer if procedures are not followed correctly.

Secondly, VNL argued that it had reasonably concluded that it need not deduct RWT. Under the Income Tax Act, a person is not liable to deduct and pay any amount to the Commissioner under the RWT rules where, in relation to any given payment, that person:[8]

> a) On reasonable grounds and having made all reasonable inquiries, concluded that that payment or receipt constituted non-resident withholding income as being an amount derived by a person not resident in New Zealand and was for that reason not resident withholding income; and
>
> b) Complied with all the obligations on the part of that person which would have been applicable under this Act or the Tax Administration Act 1994 had that payment or receipt constituted non-resident withholding income.

Section NF 5 envisages that a taxpayer may not know much about a third party lender that is resident offshore. For that reason, it permits a taxpayer to escape liability for RWT by demonstrating that it was incorrect on reasonable grounds about the lender's residency. Therefore, the question was: did VNL make reasonable inquiries and have reasonable grounds for concluding that it need not deduct RWT?

7 Income Tax Act 1994, s NF 2(4)(b)(ii) (s RE 4(3)(b)).
8 Section NF 5(1) (s RE 22(2)).

The Court noted that the reasonable inquiries test was not restricted to inquiries as to facts, as there was no reason to restrict the ordinary meaning of s NF 5 in that way. In fact, it may well be reasonable to expect some taxpayers to make inquiries of a professional advisor and the reasonableness obligation extends to the content of the taxpayer's inquiries. For example, once a taxpayer is advised about the eligibility for NRWT it must satisfy itself that, as a matter of fact, those eligibility requirements are actually met.

In the view of the Court, the taxpayer's claim that it was not liable to deduct RWT could not succeed. VNL's conclusion that Weyand was non-resident was not founded on reasonable grounds. VNL, in fact, had not actually made any inquiries about Weyand's residency. Furthermore, VNL did not reach any conclusion about Weyand's status. As a result, s NF 5 was not available to VNL.

This, of course, is unsurprising. Weyand and VNL, though strictly not associated, could hardly be more closely connected. Both were family entities; both shared the same management. But that relationship did not pre-empt the need to make inquiries. The lesson, therefore, is that taxpayers must make all inquiries to ensure that offshore lenders are, in fact, resident offshore. Failure to do so may result in an adverse RWT finding at a later date, which may be costly.

Thirdly, VNL argued that the statutory time bar prevented the Commissioner from reassessing certain income years for RWT. VNL argued that, because it had filed AIL returns for the relevant period, it had completed the obligation in the time bar provisions that the taxpayer filed the relevant tax return. The Court rejected this argument. In order to meet the requirement, VNL would have needed to file an RWT return, which was the relevant return. The AIL returns were not the relevant forms required and thus, the time bar did not apply.

IV TAX AVOIDANCE

The next question was whether the arrangement amounted to a tax avoidance arrangement. A "tax avoidance arrangement" is void against the Commissioner and the Commissioner can assess those affected by the arrangement as if it never existed.[9] A "tax avoidance arrangement" is defined as an arrangement that has tax avoidance as a purpose or effect, as long as that purpose or effect is not "merely incidental" to ordinary business dealings.[10]

Evidently, the statutory test is not instructive. Consequently, the courts have attempted to demarcate between acceptable and unacceptable tax

9 Income Tax Act 2007, s BG 1.

10 Section YA 1, definition of "tax avoidance arrangement".

planning. The Supreme Court, for example, has noted that tax avoidance occurs when:[11]

> … the taxpayer has used [a] specific provision [of the Act], and thereby altered the incidence of income tax, in a way which cannot have been within the contemplation and purpose of Parliament when it enacted the provision …

The Court, agreeing with both the TRA and the High Court, found that the arrangement was a tax avoidance arrangement. Furthermore, the Court determined that the tax avoidance was not merely incidental. Rather, tax avoidance was the dominant purpose of the arrangement. In reaching this conclusion, the Court accepted that the arrangement's purpose was set out in documents prepared by tax advisers, which explained the arrangement's potential tax savings.

The weight the Court gave to the tax advisor's advice was unsurprising in light of their comprehensive discussion of statements made by tax advisors in earlier GAAR cases. It was, nevertheless, contentious. When determining whether an arrangement has a more than incidental purpose or effect of tax avoidance, the purpose or effect ought to be established objectively from what the arrangement accomplishes. The fact that an arrangement asserts tax savings does not necessarily mean that arrangement has tax avoidance as a purpose.

In spite of that, the weight the Court placed on the tax advisor's statements ought to be understood in light of the facts of the case. For example, the interest rate and management fees were carefully set at a level to offset taxable income. These levels reflected a dogged pursuit to minimise tax, rather than achieve any commercial aims. If anything, the arrangement was deliberately structured to ensure that tax benefits could be obtained. For instance, the Vinelight Trust was only included in the structure to prevent VNL and Weyand being associated persons for the purposes of the NRWT regime. If Weyand was a non-resident but associated, that would have meant that NRWT would be deducted at 15 per cent. The Court's conclusion of tax avoidance, then, seems correct. This was a situation where the taxpayers took advantage of tax provisions in a manner not contemplated by Parliament in order to minimise their tax liabilities, divorced from any commercial need. It was, one might say, textbook tax avoidance.

As a last stand, the taxpayer raised a question of reconstruction. If a tax avoidance arrangement is void, the Commissioner is empowered to counteract a tax advantage obtained by a person from such an arrangement.[12] But this reconstruction may only be used to adjust gross income, allowable deductions and available net losses in calculating taxable income.[13] In the taxpayer's view, by adjusting the rate of tax payable, the Commissioner

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11 *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 at [107].

12 Income Tax Act 2007, s BG 1(2).

13 *Vinelight (CA)*, above n 5, at [74]; Income Tax Act 1994, Section GB 1(1).

exercised a power of reconstruction unavailable in the statute. The Court disagreed. All the Commissioner did was assess VNL for NRWT on its reported non-resident withholding income. There was no need for adjustments. As a result, the Commissioner did not exercise her power of reconstruction and the taxpayer's argument failed.

V PENALTIES

The Commissioner also imposed penalties having decided that the taxpayers' position was abusive when taken. An "abusive tax position" is a "tax position that was unacceptable when taken and which, viewed objectively, was taken regarding an arrangement having a dominant purpose of avoiding tax".[14] A tax position is deemed unacceptable if "viewed objectively, the tax position fails to meet the standard of being about as likely as not to be correct."[15]

The taxpayer argued that the positions it had taken were not unacceptable. In particular, the taxpayer submitted its positions were not obviously wrong according to the law as it stood at the time the restructuring occurred. The Court, however, was not convinced that the arrangement would have survived full disclosure to the Commissioner when it was established. The arrangement, viewed as a whole, strictly complied with specific tax laws but served the dominant purpose of avoiding tax. This was reinforced, in the Court's view, by the advice received by the taxpayer regarding the potential tax savings from the restructure. Thus, the test for an abusive tax position was met.

The Court's short conclusion that a penalty applied is consistent with recent decisions. Yet, the ease with which a penalty of up to 100 per cent can be imposed is disconcerting. In this case, the finding of tax avoidance arose from aspects of the arrangement's execution — Weyand's centre of management not being in Hong Kong and interest rates not being set at commercial levels — as opposed to anything particularly aggressive about the arrangement itself. Had the arrangement been implemented differently, a conclusion of tax avoidance would not have been a certain result. Furthermore, given the taxpayer's reliance on what it would have considered to be sound tax advice, the penalties seem harsh. But the policy direction is loud and clear: if you avoid tax, be prepared to be penalised to the full extent of the law.

14 *Vinelight (CA)* at [84]; Tax Administration Act 1994, s 141D(7).
15 Section 141B(1).

VI CONCLUSION

The *Vinelight* decision will be concerning for taxpayers attempting to siphon their New Zealand income through companies and trusts offshore to avoid the imposition of New Zealand's maximum tax rate. Such arrangements are not uncommon. *Vinelight*, then, may usher in a new era of conservative tax planning for these individuals. But taxpayers should also be cautious. In particular, taxpayers should be mindful to ensure that their actions do not inadvertently make a company, incorporated elsewhere, a New Zealand resident for tax purposes. Additionally, taxpayers should inquire as to lenders' claims that they are non-resident. As *Vinelight* shows, relying on the advice of tax advisors is unlikely to find favour with the judiciary. Taxpayers should, therefore, carefully consider the risk of inventive tax planning arrangements, which may go horribly wrong.

Carr v Gallaway Cook Allan

NUPUR UPADHYAY*

> *"The first and foremost principle of law in commercial arbitration is that it is founded on the autonomy of the parties' will."*[1]

I INTRODUCTION

In June 2014, the New Zealand Supreme Court in *Carr v Gallaway Cook Allan* set aside an arbitral award, following a successful arbitration, due to a procedural error in the arbitration agreement.[2] Although two key principles behind commercial arbitration are party autonomy and limited judicial intervention, the Supreme Court was willing to set aside the arbitral award due to a drafting error in the arbitration agreement, which both parties had contributed to. This decision has the potential to adversely affect New Zealand's reputation as an arbitration-friendly nation. The decision also emphasises the need for care in drafting an arbitration agreement.

II BACKGROUND

This dispute began with Messrs Carr and Humphries, who entered into a settlement agreement for a commercial transaction where the latter agreed to transfer properties to the former for a certain sum of money. The settlement was scheduled for 4 pm on 31 May 2007. However, it did not go ahead. Mr Humphries subsequently cancelled the agreement. After taking legal action to oppose the cancellation, which was ultimately unsuccessful, Mr Carr then attempted to hold the firm of solicitors acting for him, Gallaway Cook Allan (GCA), liable for the failure to settle. Mr Carr claimed that his solicitors had been negligent and that their negligence resulted in the failure to settle with Mr Humphries, allegedly causing him losses of $12,500,000.

Mr Carr and GCA agreed to resolve the dispute over GCA's alleged negligence through arbitration. The parties entered into an arbitration agreement in September 2010 that was intended to be a full and final determination of the issue. However, cl 1.2 of the arbitration agreement allowed the parties a right of appeal from the arbitrator's award to the High Court on "*questions of law and fact*". These words were italicised in the agreement and followed by the phrase "emphasis added".

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* BCom/LLB(Hons).

1 Clive M Schmitthoff "Defective Arbitration Clauses" [1975] JBL 9 at 9.

2 *Carr v Gallaway Cook Allan* [2014] NZSC 75 [*Carr* (SC)].

Importantly, the Arbitration Act 1996 only allows for the right of appeal on questions of law.[3] It does not allow a right of appeal on questions of fact. The Act itself defines questions of law very specifically and expressly states that issues relating to evidence or factual inferences do not constitute questions of law.[4] Neither party seemed to be aware that this was an inappropriate extension of the statutory right of appeal contained in the Act.

The dispute was arbitrated before the Hon Robert Fisher QC over ten days in November 2010. The arbitrator found against Mr Carr's claim on the basis that although GCA had been negligent, its negligence did not cause the failure to settle. Questions about the validity of the extended appeal right in the arbitration agreement did not feature in the arbitration.

Mr Carr then appealed to the High Court to set aside the award under art 34(2) of sch 1 of the Act on the basis that it was invalid due to the extended appeal right, which allowed for an appeal on questions of fact, contrary to the Act.[5] In the alternative, if the award was valid, he sought to appeal both on questions of law and fact.

GCA's argument was that, once the words "*and fact*" were severed from cl 1.2, the remainder of the arbitration agreement could be enforced. In the alternative, GCA argued that the Court's discretionary power to set aside the award should not be exercised in this case.

III PROCEDURAL HISTORY

In the High Court, both parties agreed that cl 1.2 extended the jurisdiction of the courts to intervene in an arbitral award beyond that permitted by the Act. The central issue was over the severability of the words "*and fact*" from the rest of the arbitration agreement. Ellis J set aside the arbitral award under art 34(2)(a)(i) of sch 1 of the Act, which allows the court to set aside an award if it is invalid under New Zealand law. Her Honour did so on the basis that the words "*and fact*" were so fundamental to the agreement that they could not be severed. Her Honour stated that the right of appeal on questions of fact was crucial to the arbitral agreement as a whole because without its inclusion Mr Carr would not have agreed to arbitrate.

The Court of Appeal overturned the High Court decision.[6] It held that the words "*and fact*" could indeed be severed from the rest of the arbitration agreement, as doing so did not change the substance of the agreement.[7] Furthermore, the Court of Appeal did not set aside the award. The Court's analysis relied on the purpose and policy behind the Act, which included providing parties with autonomy, efficiency and a procedure with limited judicial intervention.[8] Having entered into an arbitral agreement and

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3 Arbitration Act 1996, sch 2, cl 5.
4 Schedule 2, cl 5(10).
5 *Carr v Gallaway Cook Allan* [2012] NZHC 1537, [2012] 3 NZLR 97.
6 *Gallaway Cook Allan v Carr* [2013] NZCA 11, [2013] 1 NZLR 826 [*Carr* (CA)].
7 At [42] and [48].
8 At [66]; and see also Arbitration Act, above n 3, s 5.

having had the dispute determined by an arbitral award, the Court of Appeal thought it would be contrary to the Act's legislative purpose to allow a party to benefit from setting aside the award due to a procedural error that both of the parties were responsible for.[9]

IV SUPREME COURT DECISION

In June 2014, the Supreme Court held that the arbitral award should be set aside because the words "*and fact*" rendered the entire arbitration agreement invalid. The Court considered three issues on appeal.[10] The first was what the Act meant by the words "arbitration agreement". This issue related to a new argument raised by GCA, which it had not raised in either of the two previous proceedings. The second was whether the words "*and fact*" could be severed from the rest of the otherwise valid arbitration agreement. The third was, in the event that the words could not be severed and the entire agreement was invalid, whether the High Court should have exercised its jurisdiction to set aside the arbitral award.

What is an "arbitration agreement"?

GCA argued that the Act's definition of "arbitration agreement" — "an agreement ... to submit to arbitration"[11] — only referred to the provision that actually submitted the dispute to the arbitration process.[12] Any other provisions relating to the procedural aspects of the arbitration were separate from, and ancillary to, the actual agreement to arbitrate.

On this issue, the Supreme Court was unanimous in rejecting GCA's argument. The Court distinguished between two situations. First, a situation where parties include an arbitration clause in their contract, which, according to the doctrine of separability (provided for in art 16(1) of sch 1 of the Act), forms a separate arbitration agreement. Secondly, a situation where the entire contract between the parties is about the decision to arbitrate a dispute and sets out the process for doing so.[13] The Court held that the facts of this case fell into the second situation and the entire agreement was the arbitration agreement. The Court rejected the submission that cl 16 supported the proposition that the definition of "arbitration agreement" was confined merely to the particular contractual term submitting a dispute to arbitration. The agreement to arbitrate came with certain conditions as to the procedure of the arbitration, including the extended appeal right. Therefore, if the appeal right was not available, the entire agreement was invalid.[14]

9 *Carr* (CA), above n 6, at [67].
10 *Carr* (SC), above n 2, at [28].
11 See the definition of "arbitration agreement": Arbitration Act, above n 3, s 2.
12 *Carr* (SC), at [35].
13 See Amokura Kawharu "Arbitral Jurisdiction" (2008) 23 NZULR 238 at 240 and 242.
14 *Carr* (SC), at [44].

Can the Words "*and fact*" be Severed from the Agreement to Arbitrate as a Whole?

The Supreme Court was again unanimous on this issue. The Court rejected GCA's argument that cl 1.2 was severable from the rest of the agreement. The Court found that the severability of a contractual term is a matter of construction and words could not be severed where doing so would change the contract's substance or object.[15] The Court found that the words could not be severed in this case for two key reasons. First, the fact that the words in cl 1.2 were italicised and followed by the phrase "emphasis added" indicated their importance to the agreement.[16] Secondly, the Court held that if cl 1.2 was read objectively, the ability to appeal on a wider (factual) basis was central to the agreement to arbitrate due to the fact-specific nature of the question of GCA's liability in negligence. On that basis the Court held that the words "*and fact*" were not severable and, therefore, the arbitration agreement as a whole was invalid.[17]

If the Words "*and fact*" are not Severable and the Arbitration Agreement is Invalid, Should the Award be Set Aside on Policy Grounds under art 34(2)(a)(i) of sch 1 of the Act?

The Supreme Court was divided on this issue. The majority, consisting of Elias CJ and McGrath, William Young and Glazebrook JJ, reinstated the High Court's decision to set aside the award. The majority said that where an arbitration agreement has been compromised by a defect, that defect goes to the legitimacy of the award.[18] Although the power to set aside an award was discretionary, the majority found that the absence of a valid arbitration agreement was such a fundamental problem that it was appropriate to exercise the discretion to set aside the arbitral award.[19]

However, Arnold J, dissenting, believed that the ground for setting aside an award in art 34(2)(a)(iv) was relevant when considering the discretion to set aside an award under art 34(2)(a)(i). Article 34(2)(a)(iv) states that a court can refuse to set aside an arbitration agreement when the parties' agreement was contrary to a non-derogable provision of the relevant part of the Act.

Arnold J carefully considered art 34(2)(a)(iv) and the principle behind it: that an arbitral award should not be set aside merely because the parties failed to follow an agreed provision, no matter how important that provision was to the agreement, if that provision was contrary to a non-derogable provision in sch 1 of the Act.[20] Arnold J suggested the majority of the Court had undermined art 34(2)(a)(iv) by finding that it could not apply to an invalid agreement to arbitrate. That finding allowed the Court to set

15 At [62].
16 At [70].
17 At [71].
18 At [78].
19 At [86].
20 At [117].

aside the arbitral award where the only problem with it was that it followed a procedure contrary to a non-derogable provision in the Act. His Honour thought that this was a wrongful exercise of the Court's discretion and one that undermined the principle behind art 34(2)(a)(iv).[21]

Consequences of the Decision

On a basic level, the decision of the Supreme Court demonstrates that those drafting arbitration agreements should be very careful to avoid errors, even ones relating to a point of procedure. Parties who fail to do so risk wasting time and money if their arbitration award is set aside, despite having concluded a proper arbitration.

More importantly, the Supreme Court's decision has the potential to create the perception that New Zealand is an unfriendly arbitration destination. As the Court of Appeal in this proceeding acknowledged, underlying arbitration legislation are principles of party autonomy, limited intervention of courts and finality of an arbitral award.[22] These principles derive from the United Nations Commission on International Trade Law Model Law on International Commercial Arbitration.[23] The majority of the Supreme Court's finding that "it will rarely be appropriate for the Court to refuse to set aside such an award" indicates, contrary to the principles noted above, a readiness by courts to intervene and render arbitral awards unenforceable.[24] Since the Arbitration Act was formulated so as to replicate the principles of the Model Law, it follows that for the Supreme Court to contradict the principles may create this negative perception of New Zealand.

V CONCLUSION

The majority of the Supreme Court allowed an unsuccessful party to an arbitral award to set aside that award due to a procedural error in the drafting of the arbitration agreement, which it was partly responsible for. This decision seems to undermine concepts of party autonomy, limited court intervention and finality — key principles of commercial arbitration. It is possible that the finding in this case will be confined to its particular facts given that the erroneous words were italicised and specifically emphasised in the agreement. Perhaps if they had not been, the Court would have been willing to sever them and retain the validity of the remainder of the agreement, thereby allowing the results of a properly conducted arbitration to prevail.

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21 At [117].

22 *Carr* (CA), above n 6, at [66].

23 *Report of the United Nations Commission on International Trade Law on the work of its eighteenth session* A/40/17 (1985) at 81.

24 *Carr* (SC), above n 2, at [80].