THE EFFECT OF SECTION 108 OF THE LAND AND INCOME TAX ACT 1954

Elmiger v. **C.I.R.** [1967] N.Z.L.R. 161

With due acknowledgment to Stephen Potter's "Gamesmanship" language Professor G. S. A. Wheatcroft has defined tax avoidance as "The art of dodging tax without actually breaking the law."[1] In more conventional terms tax avoidance and tax evasion are commonly distinguished as follows. Tax avoidance means reducing the burden of taxation by legal means; tax evasion means doing so by illegal means.

Apart from legislating against tax evasion, legislatures have found it necessary to bar recognition for tax purposes of some tax avoidance arrangements. They have done this through provisions striking at specific types of tax avoidance and, in some cases, through general provisions. The recent decision of the Court of Appeal in *Elmiger* v. *Commissioner of Inland Revenue* [1967] N.Z.L.R. 161, makes it obvious that section 108 of the Land and Income Tax Act 1954 is a potent general anti-avoidance provision. No attempt is made in this note to consider fully the implications of the decision in *Elmiger's* case for solicitors who have advised, or will be advising, clients on the formation of trusts aimed at reducing income tax by spreading the income between members of a family instead of concentrating it in the hands of the number one breadwinner. Suffice it to say that many such family trusts will warrant reappraisal and that section 108 and *Elmiger's* case are both matters with which general practitioners will want to make themselves very familiar. The significance of *Elmiger's* case is highlighted by the fact that the learned editor of the New Zealand Law Reports has seen fit to devote fifteen pages of the report of the case to counsel's submissions.

Section 108 of the Land and Income Tax Act 1954 provides:

> Every contract, agreement, or arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void in so far as, directly or indirectly, it has or purports to have the purpose or effect of in any way altering the incidence of income tax, or relieving any person from his liability to pay income tax.

Statutory precursors of this section initially provided that the agreements in question were void and of no effect "as between the parties thereto". A radical change occurred when these words were omitted from section 82 of the Land and Income Assessment Act 1900, and replaced with " . . . shall be absolutely void . . . " To the same effect was section 103 of the Land and Income Assessment Act 1908. With

1. (1955) 18 M.L.R. 209.

the passing of section 162 of the Land and Income Tax Act 1916 the section was reduced to its present form, with the exception that at that stage the prohibition applied to land tax as well as to income tax.

When one considers the width of the wording of section 108 and its statutory predecessors it is surprising that the sections lay relatively dormant for over half a century as a means to counter tax avoidance schemes. Investigation shows that successive Commissioners must have had their enthusiasm dampened by unsuccessful attempts on the part of the Crown to rely on the sections. The application of section 108 to income tax avoidance had been considered by the Supreme Court on only four occasions prior to *Elmiger* and in three of these cases the decision went in favour of the taxpayer.[2] In the fourth case[3] Hardie Boys J. held that an objector to an assessment was not able to set up the voiding effect of section 108 against the Commissioner and decided the case independently of the section. This decision is the subject of further comment later in this note. Two pre *Elmiger* attempts by the Commissioner to invoke section 108 before the Taxation Board of Review were also unsuccessful.[4]

Against this background the Commissioner's successful reliance on section 108 before Woodhouse J.[5] and in the Court of Appeal[6] in *Elmiger* can be fully appreciated as a milestone in anti tax avoidance litigation in New Zealand. A certain consequence will be an increased airing of section 108 in the courts in future.

In *Elmiger* the appellants, two brothers, were contractors in the Taupo area engaged in earth moving work and the like for which heavy and expensive power machinery was required. Their annual takings were substantial. In 1962 they entered into an arrangement involving the setting up of a trust by their father of which they were the trustees, the sale of two of their earth moving machines to that trust on terms which allowed the purchase price to remain owing as an interest free loan payable on demand, and, contemporaneously, an agreement to hire the two machines back from the trust at hourly rates subject to a minimum monthly charge. The income beneficiaries under the trust were the wives and children of the appellants and the trust deed contained the curious provision that on the date for distribution (31 March, 1968) the capital remaining should go to the trustees, i.e. in the ordinary course to the appellants personally.

2. *Timaru Herald* v. *Cmr of Taxes* [1938] N.Z.L.R. 978; *Purdie* v. *C.I.R.* [1965] A.I.T.R. 603; *Lewis* v. *C.I.R.* [1965] N.Z.L.R. 634. The predecessor of section 108 applied to land tax as well as income tax; the leading land tax avoidance case is *Charles* v. *Lysons* [1922] N.Z.L.R. 902 in which the Court of Appeal held an agreement to be void inter partes as purporting to alter the incidence of land tax. Observations by the court that the section applied only inter partes and had no fiscal effect were distinguished in *Elmiger* on the grounds that the comments applied to land tax and were in any event entirely obiter. (For other cases dealing with avoidance of land tax see Abridgement of New Zealand Case Law Vol. 8 p.553.)
3. *C.I.R.* v. *Brown* [1962] N.Z.L.R. 1091.
4. (1963) 2 N.Z.T.B.R. Case 8 and (1965) 3 N.Z.T.B.R. Case 8.
5. [1966] N.Z.L.R. 683.
6. [1967] N.Z.L.R. 161.

The two brothers continued their business to all intents and purposes as before, they continued to use the machines, and the total earnings produced by the combination of their labours and the use of the machines, continued to come into their hands as income in their business. In the Court of Appeal North P., Turner and McCarthy JJ. held, as had Woodhouse J. in the Supreme Court, that section 108 applied with the consequence that the appellants were taxable on the income they derived from the business with no deductions for the charges for hire of the plant in question.

The learned judges of the Court of Appeal carefully limited their consideration of the effect of section 108 to the facts before them but even so certain general conclusions can be drawn from their judgments.[7]

(1) Section 108 does not strike at sham transactions having no basis whatever other than the avoidance of tax.[8]

(2) It is immaterial that the avoidance of tax was not the sole purpose or effect of the arrangement. Section 108 can still work if one of the purposes or effects was to avoid liability for tax.

(3) Section 108 is not concerned with the motives of individuals. In applying the section you look at the arrangement itself to see what its purpose and effect is, irrespective of the motives of the person who made it.[9]

(4) A submission that section 108 only strikes at contracts or arrangements made by the taxpayer with third parties and has no fiscal effect is not tenable.[10]

(5) The words of section 108—" . . . shall be absolutely void in so far as, . . . it has or purports to have the purpose or effect of . . . relieving any person from his liability to pay income tax."—apply at the stage of earning assessable income. The word "relieving" does not limit the application of the section to a contract, agreement or arrangement striking only at a liability to pay income tax which has already accrued.[11]

(6) For an arrangement to be caught by section 108 you must be able to predicate that it was implemented in a particular way so as to alter the incidence of tax between parties or to relieve the taxpayer from liability to pay income tax. In *Elmiger's* case the court was concerned only with the second of these two limbs; the principles applying to the first limb have still to be enunciated by the courts. Dealing with the second or relieving limb Turner J. said:[12]

> If this cannot be predicated, but it must be acknowledged that the transactions are capable of explana-

7. [1967] N.Z.L.R. 161.
8. Dictum of Hardie Boys J. in *Lewis* v. *Commissioner of Inland Revenue* [1965] N.Z.L.R. 634 disapproved per North P. at 179 and per Turner J. at 187.
9. Conclusions (2) and (3) are principles from the judgment of the Privy Council in *Newton* v. *F.C.T.* [1958] A.C. 450, applied by North P. at 179.
10. Per North P. at 181 after distinguishing *Charles* v. *Lysons* [1922] N.Z.L.R. 902 C.A.
11. Per North P. at 182.
12. At 187.

> tion by reference to ordinary business or family dealing, without necessarily being labelled as a means of relieving the taxpayer from liability for tax, then the arrangements will not come within the section.

(7) It should be stressed that after the arrangement in question the Elmiger brothers derived the same income as before. Accordingly the case does not decide whether section 108 can ever apply to a case where a taxpayer has deprived himself of a source of income, so that he no longer derives, after the arrangement, the income which he derived before.

Many lawyers have doubtless advised their clients to enter into tax avoidance schemes similar to the arrangement drawn up for the Elmiger brothers. Any feelings of regret that the opportunities for tax avoidance have obviously been further limited by the Court of Appeal's decision should be tempered by the sober realisation that large scale tax avoidance is an evil. "Tax avoidance on a significant scale necessarily involves some loss of revenue to the Treasury and its practical effect is to shift the burden of that taxation on to the shoulders of other taxpayers."[13]

Much of the time of counsel and the court in *Elmiger* was taken up with a consideration of Australian authorities. In particular North P. considered in some detail the advice of the Privy Council delivered by Lord Denning in *Newton's*[14] case. In that case the Australian general anti-avoidance provision analogous to our section 108 was fully considered by the Board. The section—section 260 of the Income Tax and Social Services Contribution Assessment Act 1936-1960—provides:

> Every contract, agreement, or arrangement made or entered, into orally or in writing, . . . shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly—
> (a) Altering the incidence of any income tax;
> (b) Relieving any person from liability to pay any income tax or make any return;
> (c) Defeating, evading, or avoiding any duty or liability imposed on any person by this Act; or
> (d) Preventing the operation of this Act in any respect be absolutely void [as against the Commissioner or in regard to any proceeding under this Act][15], but without prejudice to such validity as it may have in any other respect or for any other purpose.

I propose to consider the significant differences between, and the relative effectiveness of, the Australian and New Zealand provisions. It should perhaps be mentioned that the New Zealand Land and Income

13. "Attitudes to Income Tax Avoidance"—an inaugural address given by Professor I.L.M. Richardson at Victoria University of Wellington on 18 April 1967, now published in (1967) 30 N.Z.J.P.A. 1.
14. [1958] A.C. 450.
15. Words in brackets were not in the original Act but were added in 1936.

Assessment Act 1900 was used as a precedent for the Australian provision.

The most obvious distinction between the two provisions is that limbs (c) and (d) of the Australian provision do not appear in its New Zealand counterpart. In *Elmiger's* case counsel for the Commissioner submitted that limbs (c) and (d) had been omitted from the New Zealand provision in 1916 because they were redundant so long as the 'relieving' limb was retained. This submission was apparently accepted by the Court of Appeal.

The next significant difference is that section 108 provides that the contract etc. shall be 'absolutely void' while section 260 enacts that the contract etc. shall be 'absolutely void *as against the Commissioner*' without prejudice to its validity inter partes. The consequences of this distinction have yet to be spelt out in the Courts but they could be disastrous for some ill advised New Zealand taxpayer in the future.

The position in Australia prior to the insertion of the words 'as against the Commissioner' can be illustrated by the case of *De Romero* v. *Read* (1932) 48 C.L.R. 649. By a supplemental indenture to a deed of separation a husband covenanted in 1924 to pay his former wife during her lifetime an annual sum of £10,000 free from all income tax payable by her in respect of the annuity. The husband died in 1928, and in that and two subsequent years, the wife paid certain sums in respect of State income tax on the annuity. On a case stated for the determination of the question whether the executors and trustees of the deceased husband were liable to pay to the wife the tax paid by her, the High Court of Australia held:

(1) that the covenant by the husband, if it operated, would have the effect, within the meaning of the precursor of section 260 of "altering the incidence" of tax;
(2) to the extent to which it purported so to operate it was therefore void, and the executors were not liable for the amounts paid by the wife in income tax.

Lord Denning has described the harsh consequence of the decision in *De Romero* v. *Read* as an "unexpected effect" of section 260 in that the section was held to avoid a transaction between subjects.[16] The report does not spell out the detailed consequences of the decision for Mrs de Romero but presumably in addition to failing to recover the tax paid she would have also forfeited her entitlement to the annuity for the balance of her lifetime. These severe results of a provision which voided the husband's covenant inter partes even where there was no attempt to impede the collection of tax obviously contributed to the insertion of the words "as against the Commissioner" in 1936.

As section 108 of our legislation provides that the contract etc. "shall be absolutely void" the harshness of the decision in *De Romero* v. *Read* would persist in New Zealand in similar circumstances. It follows that the Elmiger brothers' arrangement having been declared void it would be unenforceable by one of them against the other. In addition both brothers would be precluded from recovering at law, from the beneficiaries of the trust, any contribution towards the addi-

16. *Newton* v. *F.C.T.* [1958] A.C. 450 at 464.

tional tax payable by them following the application of section 108. If one turns from the facts of *Elmiger* to examine hypothetical circumstances some complex situations can be foreseen.

Say A transfers a freehold property to trustees of the A Family Trust and then leases it back for business purposes so that the rental becomes income of the trustees. It is possible that such a transaction could be rendered void in terms of section 108 as having been made for the purpose of relieving A from his liability to pay income tax. Providing the transfer to the trustees was entered on the Register before the transaction was queried by the Commissioner of Inland Revenue, they would appear to have gained an indefeasible title notwithstanding any subsequent declaration by the courts that the transfer was voided by section 108. The indefeasibility of the title of registered proprietors derived from void instruments was established in *Boyd* v. *Mayor of Wellington* [1924] N.Z.L.R. 1174 and accepted by the Privy Council in *Frazer* v. *Walker* [1967] 1 A.C. 569. It would seem that the impasse envisaged could not be resolved by any of the existing statutory exceptions[17] to indefeasibility of title under the Land Transfer Act 1952. The power of the court to cancel or correct certificates of title or entries in the register does not extend beyond those cases in which adverse claims against the registered proprietors are admitted by the Act: *Assets Co. Ltd.* v. *Mere Roihi* [1905]A .C. 176, 195, P.C.

If A wanted to regain title to the property against the wishes of the trustees he would have to rely on the transaction having been voided by the court. In addition to the obstacles provided by the Land Transfer Act A would, on the authority of *C.I.R.* v. *Brown* [1962] N.Z.L.R. 1091, be unable to treat the agreement falling within the provisions of section 108 as non-existent. In *Brown's* case Hardie Boys J. held that on the basis of the maxim *ex turpi causa non oritur actio* an objector was in the position of a plaintiff claiming relief and therefore not able to set up his own wrongful act and illegal transaction against the Commissioner. If that case was correctly decided[18] it would follow that A could not set up the voided transaction in proceedings against the trustees. It follows too that A's rights to remain in possession of the land under the lease would depend on whether or not the lease had been registered.

A second hypothetical situation which could give rise to similar difficulties is a transfer of shares in a company being declared void under section 108 after the legal title has passed to a transferee on registration. Section 124 of the Companies Act 1955 governs the powers of the courts to rectify the register but it does not appear to cover the problem raised.

It has been shown that the insertion of the words "as against the Comissioner' in section 260 has given the Australian provision advantages over our section 108 in its operation inter partes. However it does not follow that the Australian Amendment of 1936 should be copied in New Zealand for section 260 is not without its defects. An astute

17. Adams, *Land Transfer Act* (1958) 9.
18. The judgment in *Brown's* case is the subject of criticism later in this note.

Australian observer has commented[19] that section 260 gives scope for the Commissioner to inflict double taxation—even to the extent where the aggregate tax could well exceed 100C in the $.[20] This comment is based on the decision of the High Court of Australia in *Rowdell Pty Ltd* v. *Federal Commissioner of Taxation* (1962-1963) 111 C.L.R. 106.

Rowdell Pty, a company dealing in shares, purchased the shares of other companies having accumulated profits which, if distributed by way of dividend, would attract tax in shareholders' hands. Rowdell Pty acquired the shares at a price approximating the value of the companies' assets less 10%. The companies were then stripped of the whole or a great part of their accumulated profits by means of declarations of dividends or distributions in liquidation or both, and the shares were resold if the company was not in liquidation or, if it was, Rowdell Pty participated in a liquidator's distribution of capital. The High Court held that section 260, though avoiding the arrangements for the sale and purchase of the shares for the purpose of assessing the vendor shareholders to tax, did not render void the transfers of shares to Rowdell Pty for the purpose of assessing its liability to tax.

On this interpretation of section 260 the insertion in 1936 of the words "as against the Commissioner" has had the result that the Commissioner may treat transactions as void but no one else is enabled to do so;

> . . . i.e. so that the Commissioner may treat transactions as void for the purposes of levying tax on the party who did not in fact or in law derive the said item of income, but not void for the purpose of taxing the other party who actually derived the said item of income.[21]

In fact in its appeal to the High Court, Rowdell Pty was successful in having the assessments in question set aside on grounds not connected with section 260. Even so, the prospect of double taxation in Australia as a result of section 260 is far from fantasy. In *Rowdell's* case Kitto J. dismissed the fundamental proposition against double taxation as being simply a notion with superficial attractiveness.[22]

Returning to the New Zealand scene we can conclude that the absence of the words "as against the Commissioner" in section 108 is a mixed blessing. In Australia in 1966 a person in the position of Mrs De Romero could succeed in recovering tax paid by her against her husband's executors. In New Zealand she would be debarred by virtue of the provision of section 108 that the arrangement "shall be absolutely void".

19. Australian Current Taxation, Vol. 17, p.71.
20. Such a prospect may well seem abhorrent to the average taxpayer but it is salutary to recall an observation of Lord Greene M.R. in *Howard De Walden* v. *I.R.C.* [1942] 1 K.B. 389 at 387—"It scarcely lies in the mouth of the taxpayer who plays with fire to complain of burnt fingers."
21. Australian Current Taxation, Vol. 17, page 72.
22. (1962-1963) 111 C.L.R. 106 at 122.

On the other hand the bogey of double taxation that looms in Australia is less likely to eventuate in New Zealand. Here the words "absolutely void" without the proviso "as against the Commissioner" should suffice to defeat the possibility of the Commissioner's relying on section 108 in order to treat a transaction as void so as to tax a person who did not, apart from the section, derive an item of income, but not as void for the purpose of taxing another party who actually derived the said item of income. This optimistic forecast is subject to the qualification that if the decision of Hardie Boys J. in *C.I.R.* v. *Brown* [1962] N.Z.L.R. 1092 is correct the possibility of double taxation does exist in New Zealand. His Honour held that an objector to an assessment of income tax is, on the basis of the maxim *ex turpi causa non oritur actio,* not able to set up the voiding effect of section 108 against the Commissioner. It follows that circumstances could arise whereby two parties were assessed for tax on the same amount[23] and the one who had had the sum in question in his hands would be precluded from setting up the voiding effect of section 108 against the Commissioner. A query is raised as to the correctness of Hardie Boys J.'s decision because, with respect, it is submitted that he applied a maxim pertaining to illegal contracts to an arrangement which was merely voided by statute.[24]

What facts emerge from the foregoing comparison of the Australian and New Zealand general anti-avoidance provisions? It has been illustrated that both section 108 and section 260 have their weaknesses in so far as their voiding effect is concerned. As a final comment it is interesting to note that in the recently published Report on Taxation in New Zealand the Taxation Review Committee has adopted the Australian approach in recommending the amendment of section 108 so that—

> Contracts, agreements, or arrangements caught thereby are absolutely void only as against the Commissioner of Inland Revenue or in regard to proceedings under the Land and Income Tax Act 1954.

In doing so the Committee discussed the defects in section 108 but did not refer to weaknesses in the Australian section.

J.P.G.

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23. "If in any case a doubt arises as to whether tax is payable by A or B, a convenient course would be for the Commissioner to assess both of them, leaving both of them to appeal in accordance with the Act"—per Salmond J. in *Hawke's Bay Farmers' Co-operative Association* v. *Gower* [1925] N.Z.L.R. 189 at 190. So far as is known the Commissioner has never accepted Salmond J.'s invitation; to do so would undoubtedly leave the Commissioner wide open to criticism for having acted arbitrarily.

24. Void covenants " . . . are not 'illegal' in the sense that a contract to do a prohibited or immoral act is illegal . . . The law does not punish them. It simply takes no notice of them."—per Denning L.J. in *Bennett* v. *Bennett* [1952] 1 K.B. 249 at 260.