Interpretation Guideline: IG 12/01

GOODS AND SERVICES TAX; INCOME TAX – "SHAM"

Contents

Introduction 1
Analysis 2
Summary 2
Meaning of sham 4
When sham can be alleged 9
Courts' approach to determining sham 11
Consequences of a finding of sham 17
Case summaries 18
Examples 21

Introduction

1. Interpretation guidelines discuss the Commissioner's approach to the interpretation of a general area of law where there are also taxation implications. They are intended to clarify general points of interpretation that may cause difficulty for practitioners, taxpayers and Inland Revenue.

2. This interpretation guideline reviews the New Zealand, Australian and English case law on sham. In doing so, it clarifies the Commissioner's understanding of:

   - the meaning of sham;
   - when sham can be alleged;
   - how the courts determine whether there is a sham; and
   - the consequences of a finding of sham.

   To illustrate the practical application of the sham doctrine, the guideline summarises two significant sham cases and discusses two factual examples.

3. The conclusions reached in this interpretation guideline are set out in paragraphs 5 – 13 below. The main conclusions can be summarised as follows:

   - An allegation of sham is serious – it is akin to an allegation of fraud. The courts have stated that an allegation of sham should not be made lightly, and that a high standard of evidence is required to prove it.

   - A sham exists where the parties to the transaction documents did not intend to create the legal rights and obligations created by those documents, and intended to mislead third parties into considering they had created those legal rights and obligations. The parties intended either to create different rights and obligations to those recorded in the documents, or to create no legal rights or obligations at all.

   - In considering whether the transaction documents are shams, the courts are concerned with the parties' subjective intentions, and not

with the economic substance or commercial reality of the transaction.

- A sham can exist at the time the documents are created. Documents that were bona fide when created can later become shams. This will occur when the parties agree to change the terms of their transaction, but leave the original documents standing so as to give the impression that those documents continue to accurately record the terms of their transaction.

- If the court is satisfied that the allegation of sham is proven, the documents are disregarded to the extent they are shams. A document may be a sham in part and, in such cases, only that part of the document will be disregarded. The true arrangement between the parties (ie, the legal rights and obligations (if any) they created) is then given effect and the parties taxed accordingly. By contrast, if the court is satisfied that the documents are not shams, the parties are taxed in accordance with the legal rights and obligations created in those documents (except where s BG 1 or another anti-avoidance provision applies).

4. This interpretation guideline replaces the earlier interpretation guideline "Sham – meaning of the term", *Tax Information Bulletin,* Vol 9, No 11 (November 1997). This guideline does not signal a change of approach by the Commissioner towards sham. The main differences between this guideline and the earlier guideline can be summarised as follows:

   - The earlier guideline has been reorganised and revised so as to improve its readability.
   - The earlier guideline's analysis has been updated to take account of subsequent court decisions, in particular the Supreme Court's decision in *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115, [2009] 2 NZLR 289.
   - New discussion has been inserted on the onus and standard of proof where sham is alleged in the tax law context.

Analysis

Summary

5. As a general rule, the tax treatment of transactions between taxpayers depends on the legal rights and obligations created by the transaction documents. However, if satisfied that the documents are "shams", the courts disregard them to the extent they are shams. The court then gives effect to the true legal arrangement between the parties and the parties are taxed accordingly.

6. The essential characteristic of a sham is pretence. A sham exists where the parties intend the transaction documents to mislead third parties as to the true nature of the relationship between the parties. The parties intend either to create different rights and obligations to those recorded in the documents, or to create no legal rights or obligations at all.

7. The leading New Zealand authority on sham is *Ben Nevis.* In this decision, the Supreme Court reiterated the requirements for sham as set out in Diplock LJ's judgment in *Snook v London and West Riding Investments Ltd* [1967] 2 QB 786 (CA). It also described the effect of a sham in the tax law context (at [33]):

> A sham in the taxation context is designed to lead the taxation authorities to view the documentation as representing what the parties have agreed when it does not record their true agreement. The purpose is to obtain a more favourable taxation outcome than that which would have eventuated if documents reflecting the true nature of the parties' transaction had been submitted to the Revenue authorities.

8. To establish sham, it must be shown that the parties did not intend to create the legal rights and obligations recorded in the transaction documents; and that they intended that third parties would be misled by those documents into considering that the parties had created those legal rights and obligations. In considering whether there is a sham, the courts are concerned with the parties' subjective intentions and not with the economic substance and commercial reality of the transaction.

9. A sham can exist from the time when a document is created. A document that was bona fide when created can later become a sham. This will happen where the parties agree to change the terms of their transaction, but leave the original transaction documents standing so as to give the impression that those documents continue to accurately record the terms of their transaction.

10. The courts' approach to determining whether there is a sham can be outlined in three stages.

11. First, the courts determine the legal rights and obligations recorded in the documents. The courts interpret the documents objectively to arrive at the meaning a reasonable person would give them. They may consider evidence of surrounding circumstances at the time the documents were created to ascertain the meaning of the words used, but this evidence cannot be used to contradict or vary the terms of the documents. Evidence of the parties' subjective intentions is not considered at this stage.

12. Second, the courts then consider whether there is evidence that the documents are shams. The courts are concerned with the parties' subjective intentions at this stage. To show there is a sham, the courts must be satisfied on the balance of probabilities that:

    - the parties did not intend to create the legal rights or obligations recorded in the documents, and
    - it was intended that third parties would be misled by those documents into thinking the parties had created those rights and obligations.

    An allegation of sham is serious – it is akin to an allegation of fraud. Consequently, the courts have made clear that an allegation of sham is not to be made lightly and that a high standard of evidence is required to prove it.

13. Third, if the court is satisfied the documents are shams, the documents are disregarded to the extent they are shams. A document may be a sham in part and, in such cases, only that part of the document will be disregarded. The true arrangement between the parties (ie, the legal rights and obligations (if any) they created) is then given effect and the parties taxed accordingly. By contrast, if the court is satisfied that the documents are not shams, the parties are taxed in accordance with the legal rights and obligations created in those documents (except where s BG 1 or another anti-avoidance provision applies).

Meaning of sham

14. The doctrine of sham is a long-standing doctrine developed by the courts. In his article "Sham, trusts and mutual intention" [2008] NZLJ 227, Matthew Conaglen observes:

> For well over two hundred years, the courts have refused to permit sham transactions – transactions which were created as "a mere cloak or screen for another transaction" (*Yorkshire Railway Wagon Co v Maclure* (1882) 21 ChD 309 at 318) – to conceal the truth. They have asserted a jurisdiction to "see through" (ibid) such transactions to get at "the real truth of the matter" (*Re Watson* (1890) 25 QBD 27 at 33).
>
> …
>
> The jurisdiction to ignore sham transactions is a jurisdiction of general application.

English case law

15. The classic definition of sham is contained in *Snook v London and West Riding Investments Ltd.* In this English Court of Appeal decision, Diplock LJ stated (at 802):

> I apprehend that, if it has any meaning in law, it means acts done or documents executed by the parties to the 'sham' which are intended by them to give to third parties or to the Court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create. But one thing, I think, is clear in legal principle, morality and the authorities … that for acts or documents to be a 'sham,' with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations which they give the appearance of creating.

16. Diplock LJ's definition was discussed in *Hitch v Stone* [2001] EWCA Civ 63, [2001] BTC 78. In this English Court of Appeal decision, Arden LJ stated (at [63], [66] and [69]):

> 63. The particular type of sham transaction with which we are concerned is that described by Diplock LJ in *Snook*, above. It is of the essence of this type of sham transaction that the parties to a transaction intend to create one set of rights and obligations but do acts or enter into documents which they intend should give third parties, in this case the Revenue, or the court, the appearance of creating different rights and obligations. The passage from Diplock LJ's judgment set out above has been applied in many subsequent decisions and treated as encapsulating the legal concept of this type of sham.
>
> …
>
> 66. Second, as the passage from *Snook* makes clear, the test of intention is subjective. The parties must have intended to create different rights and obligations from those appearing from (say) the relevant document, and in addition they must have intended to give a false impression of those rights and obligations to third parties.
>
> …
>
> 69. Fifth, the intention must be a common intention: see *Snook*'s case, above.

17. Diplock LJ's judgment in *Snook* is authority for the proposition that a sham will exist where:

- the parties intended that the transaction documents (or the acts they have done) would not create the legal rights or obligations they appear to create; and
- it was intended that the documents (or acts) would mislead a third party into believing the parties had created those rights and obligations.

New Zealand case law

18. New Zealand courts have defined sham consistently with Diplock LJ's judgment in *Snook*. As defined by the New Zealand courts, a sham exists where the parties execute documents, or do acts, so as to mislead third parties as to the true nature of the legal arrangement between the parties. The parties either intended to create different rights and obligations to those recorded in the documents, or to create no legal rights or obligations at all.

19. For example, in *Bateman Television Ltd v Coleridge Finance Co Ltd* [1969] NZLR 794 (CA), Turner J held (at 813):

> I think that the occasions on which Courts have set aside the form of a transaction as a "sham" are confined to cases in which, really doing one thing, the parties have resorted to a form which does not fit the facts in order to deceive some third person, often the revenue authorities, into the belief that they were doing something else. Thus where in a lease both parties prescribe a rent in excess of what is really to be paid, so as to deceive those who collect taxes as to the quantum of a deduction to be allowed, this is a sham … .

To similar effect, in the same decision McCarthy J reiterated Diplock LJ's judgment in *Snook* by stating (at 821):

> … whatever else is accepted as being involved in the concept of a sham, one thing is clear in legal principle, morality and authority, namely that for acts or documents to be a sham all the parties thereto must have a common intention that the acts or documents are not to create legal rights and obligations which they give the appearance of creating.

20. By contrast, there is no sham if the parties intended the document to be legally effective. In *Paintin and Nottingham Ltd v Miller Gale and Winter* [1971] NZLR 164 (CA), Turner J held (at 175):

> The word "sham" is well on the way to becoming a legal shibboleth; on its mere utterance it seems to be expected that contracts will wither like one who encounters the gaze of a basilisk. But by a "sham" is meant, in my opinion, no more and no less than an appearance lent by documents or other evidentiary material, concealing the true nature of a transaction, and making it seem something other than what it really is. The word "sham" has no applicability to transactions which are intended to take effect, and do take effect, between the parties thereto according to their tenor … .

21. In *Marac Finance Ltd v Virtue* [1981] 1 NZLR 586 (CA), Richardson J stated (at 588) that a sham could exist at the outset when the documents are created. Alternatively, the documents might be bona fide when created but could later become shams. This would happen when the parties agree to change the terms and conditions of their transaction, but decide to leave the original documents unchanged so as to mislead third parties:

> Where the essential genuineness of the documentation is challenged a document may be brushed aside if and to the extent that it is a sham. There are two such situations: (1) where the document does not reflect the true agreement between the parties in which case the cloak is removed and recognition given to their common intentions; and (2) where the document was bona fide in inception but the parties have departed from their initial agreement and yet have allowed its shadow to mask their new arrangement.

See similar statements in *Mills v Dowdall* [1983] NZLR 154 (CA), at 160.

22. In the trust law context, the Court of Appeal in *Official Assignee v Wilson* [2007] NZCA 122, [2008] 3 NZLR 45 clarified that whether there is a sham depends on the **subjective** intention of the parties. Robertson and O'Regan JJ held (at [50]):

> An important prior question is whether common intention must be ascertained objectively, as is usual in the construction of commercial documents, or subjectively, in the departure from orthodox norms of construction. Where a sham is alleged, should a Court look behind the objective trust appearance of an alleged sham so as to ascertain

> the true nature of the transaction? The answer must be "Yes". Otherwise, the most insidious kinds of shams are those most able to work their mischief. To answer "No" would be to give exaggerated weight to the objective appearance of a transaction. While the objective appearance is the default determinant of a transaction's effect and substance, sham transactions are by definition transactional aberrations, and therefore require departure from the default principles of analysis.

Glazebrook J concurred with Robertson and O'Regan JJ (at [108]):

> In my view, where a sham is alleged, the search is for subjective intent that the transaction is a sham. After all, the whole point of a sham is that it is intended to have an effect other than the effect it would have if looked at objectively. See Conaglen at p 186, *Hitch v Stone* [2001] STC 214 at para [56] per Arden LJ (for the Court) and *Sharrment v Official Trustee* (1988) 18 FCR 449 at p 456, where Lockhart J said:
>
> It is not clear from Diplock LJ's formulation [in *Snook*] whether it is the subjective intention of the parties that is determinative, although logically this seems to be the correct result. In *Coppleston's* case Hunt J (at 98; 4022) took the view that the authorities established that it is the intention of the parties to the transaction which determines the question whether the act or document was never intended to be operative according to its tenor at all but rather was meant to cloak another and different transaction.

23. In *Official Assignee v Wilson* the Court of Appeal accepted that the sham doctrine can apply to express trusts. Some overseas courts have also accepted that express trusts can be shams: *Midland Bank Plc v Wyatt* [1995] 1 FLR 697 (Ch); *Shalson v Russo* [2003] EWHC 1637 (Ch), [2005] Ch 281; *Sharrment Pty Ltd v Official Trustee in Bankruptcy* (1988) 18 FCR 449 (FCAFC). The law is not entirely settled as there are some issues concerning how the sham doctrine applies to trusts, for example, as to whether a validly created trust can subsequently become a sham trust and vice-versa.

24. The New Zealand and English case law on sham was summarised by the Supreme Court in *Ben Nevis.* This decision is the latest and leading authority on sham in New Zealand. In *Ben Nevis* the Supreme Court stated (at [33], footnote omitted):

> There is no need for us to engage in any extended discussion of what constitutes a sham for present purposes. In essence, a sham is a pretence. It is possible to derive the following propositions from the leading authorities. A document will be a sham when it does not evidence the true common intention of the parties. They either intend to create different rights and obligations from those evidenced by the document or they do not intend to create any rights or obligations, whether of the kind evidenced by the document or at all. A document which originally records the true common intention of the parties may become a sham if the parties later agree to change their arrangement but leave the original document standing and continue to represent it as an accurate reflection of their arrangement.

The "leading authorities" referred to by the Supreme Court were (at footnote 34) *Snook v London & West Riding Investments Ltd*; *Paintin and Nottingham Ltd v Miller Gale and Winter*; and *NZI Bank Ltd v Euro-National Corporation Ltd* [1992] 3 NZLR 528 (CA).

25. The English and New Zealand decisions refer to the need to show the parties to the alleged sham had a "common intention". The courts have not provided much guidance on this common intention requirement. It is clear it must be shown that the parties did not intend to create the legal rights and obligations recorded in the transaction documents. It is also clear it must be shown that it was intended that the documents would mislead third parties into thinking that those legal rights and obligations had been created. What is less clear is whether both parties must share in this intention to mislead.

26. Some United Kingdom decisions have suggested that a sham may exist where only one party intends to deceive, and the other party "merely went

along with the 'shammer' not either knowing or caring about what he or she was signing": *Midland Bank Plc v Wyatt* [1995] 1 FLR 697, at 699 – 700; *Minwalla v Minwalla* [2004] EWHC 2823 (Fam), [2005] 1 FLR 771. Other United Kingdom decisions have rejected this approach: *Shalson v Russo*; *Al-Sabah & Abacus Ltd v Grupo Torras SA* [2004] WTLR 1 (Royal Court (Jersey)).

27. It is unclear which approach will be taken in New Zealand. In *Official Assignee v Wilson*, Robertson and O'Regan JJ noted (at [36] – [39]) that *Wyatt* could be seen to support the proposition that it is sufficient that one party intends to mislead, while the other party is "reckless or ignorant" about what he or she was signing and goes along with the "shammer". However, their Honours stopped short of endorsing this approach, and instead noted that an "alternative view" was that *Wyatt* did not support this proposition. In her separate concurring judgment, Glazebrook J noted (at [114]) that the "weight of overseas authority suggests … complicity or at least … ignorance and recklessness" by one party might be sufficient. Her Honour also stopped short of endorsing this approach.

Australian case law

28. Australian courts have defined sham consistently with *Snook* and the New Zealand case law: *Cranstoun v FCT* 84 ATC 4,876 (QSC); *Faucilles Pty Ltd v FCT* 90 ATC 4,003 (FCAFC); *Case W48* 89 ATC 460; and *Sonenco (No. 87) Pty Ltd v Commissioner of Taxation* (1992) 111 ALR 131 (FCAFC).

29. For example, in *Equuscorp Pty Ltd v Glengallan Investments Pty Ltd* [2004] HCA 55, 211 ALR 101, the High Court of Australia held (at [46]):

> "Sham" is an expression which has a well-understood legal meaning. It refers to steps which take the form of a legally effective transaction but which the parties intend should not have the apparent, or any, legal consequences.

The High Court of Australia cited the Full Federal Court of Australia's decision in *Sharrment v Official Trustee*. In this decision, the Full Federal Court cited Diplock LJ's judgment in *Snook* and held (at 454):

> A "sham" is therefore, for the purposes of Australia law, something that is intended to be mistaken for something else or that is not really what it purports to be. It is a spurious imitation, a counterfeit, a disguise or a false front. It is not genuine or true, but something made in imitation of something else or made to appear to be something which it is not. It is something which is false or deceptive.

30. Again, in the Full Federal Court of Australia decision in *Richard Walter Pty Ltd v FCT* 96 ATC 4,550, Hill J defined (at 4,562):

> … a transaction as being a sham transaction where it involves:
>
> > A common intention between the parties to the apparent transaction that it be a disguise for some other and real transaction or for no transaction at all.
>
> In so doing I give effect to the words emphasised in the passage from Diplock LJ [in *Snook*].
>
> For example, parties might bring into existence a document described as a mortgage which records an advance by a lender to a borrower of a sum of money and the obligation of the borrower to repay it. The document may be a disguise in the sense that while on its face it appears to be a mortgage securing an obligation to repay, there is no real transaction at all behind it for which the document will be a disguise. Such would commonly be the case where the so called mortgage is brought into existence as part of a "money-laundering" exercise to enable a fraudulent explanation to be given as to how certain funds came into the hands of the person described as the mortgagor.
>
> However, in a case such as the present where there have been real payments made by bills of exchange in the form of cheques cleared through the banking accounts of the parties and recorded as loans in relevant books of account, the transactions involving the bills of exchange can clearly not be a disguise for something which is not a transaction at all. Rather, for there to be a sham there will need, in such a case, to be a

> common intention of both the apparent lender and the apparent borrower, that the transaction which they have purported to have entered into disguises some real transaction.

In his separate concurring judgment, Lockhart J also defined (at 4,552) sham consistently with *Snook*.

31. These Australian cases may therefore assist in understanding and applying the sham doctrine in New Zealand. However, the High Court of Australia's decision in *Raftland Pty Ltd v FCT* 2008 ATC ¶20-029 (HCA) suggests a broader approach to sham might be taken by the Australian courts in the future.

32. In *Raftland*, the majority of the High Court (Gleeson CJ, and Gummow and Crennan JJ) suggested transaction documents can be shams even if there was no evidence that the parties intended to mislead third parties. Their Honours stated (at [35] – [36]) that the term "sham" could be used in a "less pejorative" sense to cover cases where there is an "apparent discrepancy between the entitlements appearing on the face of the documents and the way in which the funds were applied … [that could give] rise to a question whether the documents were to be taken at face value".

33. In their separate judgments, Kirby J (at [145] – [146]) and Heydon J (at [173]) defined sham consistently with Diplock LJ's judgment in *Snook.* Kirby J stated that traditionally Australian courts had adopted this narrow approach to sham. His Honour outlined the requirements of sham as follows (at [145] – [146] and [148], footnotes omitted):

> [145] The key to a finding of sham is the demonstration, by evidence or available inference, of a disparity between the transaction evidenced in the documentation (and related conduct of the parties) and the reality disclosed elsewhere in the evidence. Where, for example, the evidence shows a discordance between the parties' legal rights or obligations as described in the documents and the actual intentions which those parties are shown to have had as to their legal rights and obligations, a conclusion of sham will be warranted.
>
> [146] The test as to the parties' intentions is subjective. In essence, the parties must have intended to create rights and obligations different from those described in their documents. Such documents must have been intended to mislead third parties in respect of such rights and obligations.
>
> …
>
> [148] To justify a conclusion that documents constitute a sham, the requisite intention to mislead must be a common intention of the parties. An exception may exist where the acts and documents reflect a transaction divisible into separate parts, such that a transaction is a sham as to part only of the transaction.

34. However, Kirby J left open the possibility that Australian courts might adopt a broader approach to sham (at [159]):

> There is an orthodox approach to sham, accepted and expressed in Australian legal doctrine, as in the law of other, similar jurisdictions. There have also been suggestions of the emergence of a broader approach to the notion of sham, particularly in revenue cases. I accept that the "narrower" approach to sham, explained by this Court in *Equuscorp*, is applicable to this case. It was correctly applied by the primary judge. However, in my view, the idea of sham could be broadened somewhat. Doing so would not cut across the language and purpose of the explicit tax avoidance provisions enacted as Pt IVA of the Act. On the contrary, such an approach would be compatible with that contained in Pt IVA and the purposes that led to the enactment of that Part. It would demonstrate, once again, that in the present age, the doctrines of the common law evolve in the orbit of statute.

35. The majority of the High Court, and Kirby J, did not discuss the boundaries of any broader conception of sham. Kirby J reviewed (at [105] – [136]) Commonwealth case law, and noted that in Canadian and some English cases "the judges have indicated some degree of willingness to consider

the development of a broader and more robust approach to the identification of a sham" (at [113]). In doing so, the Canadian and English courts had sought to "ameliorate the strictness" of Diplock LJ's definition of sham in *Snook* by considering the economic substance and commercial reality of the transactions concerned.

36. In *Raftland,* Kirby J observed that in New Zealand, by contrast, the courts had adhered to a "narrow operation of the sham doctrine" that is consistent with *Snook* (at [128]). This is the Commissioner's view as well. New Zealand case law is clear that, when considering allegations of sham, the courts are concerned only with the parties' common intention (ie, whether the parties intended to mislead third parties as to the true nature of their relationship.) The courts are not concerned with the economic substance or commercial reality of the transaction. In *Ben Nevis*, the Supreme Court reiterated (at [33]) that a sham will exist when the transaction documentation "does not evidence the true common intention of the parties". It also stated (at [39]):

> Those engaging in a sham are in reality seeking to deceive others as to the true nature of what they have agreed and are intending to achieve.

37. In *R v Connolly* (2004) 21 NZTC 18,884 (HC), the High Court rejected a broader approach to sham. In this decision, the Crown submitted that the term "sham" should be given a broader meaning "when examining schemes pursuing tax advantage". Under this broader meaning, circular transactions involving no real money were shams as they were "fictional" (at [72] and [74]). Fogarty J rejected this submission. His Honour held (at [99] – [100]) that the New Zealand courts had adhered to the "classic definition of sham in *Snook*". Consequently, there was no authority for "a broader meaning of sham, broader than the narrow definition in *Snook*".

Summary

38. A sham exists where the transaction documents created by the parties are intended to mislead third parties. The parties intend either to create different rights and obligations to those recorded in the documents, or to create no legal rights or obligations at all.

39. To establish sham it must be shown that the parties did not intend to create the legal rights and obligations recorded in the documents; and that they intended that third parties would be misled by the documents into considering that the parties had created those legal rights and obligations. In considering whether transaction documents are shams, the courts are concerned with the parties' subjective intentions and not with the economic substance and commercial reality of the transaction.

40. A sham can exist at the time the documents are created. A document that was bona fide when created can later become a sham. This will happen where the parties agree to change the terms of their transaction, but leave the original documents standing so as to give the impression that those documents continue to accurately record the terms of their transaction.

When sham can be alleged

Sham cannot be alleged by a party to the transaction

41. Parties are bound by the legal documents they execute. They cannot argue that they are not bound by them (except where they were induced to execute the documents by fraud, mistake or misrepresentation). Consequently, the parties to a transaction cannot allege that the

documents they have executed are shams. In *Official Assignee v Wilson*, Glazebrook J stated (at [109]):

> This does not mean that a settlor is entitled to give later oral evidence of his or her subjective intentions, particularly where this is with a view of depriving the beneficiaries of their rights under the trust or … defrauding a third party … . [I]n *Snook*, Diplock LJ made it clear at p 802 … that no unexpressed intentions of a "shammer" should affect the rights of a party whom he or she deceived.

No halfway house between sham and a genuine arrangement

42. The courts have stated that there is no "halfway house" between a sham and a legally effective transaction. In *Marac Life Assurance Ltd v CIR* [1986] 1 NZLR 694 (CA), Richardson J said (at 706):

> … at common law there is no halfway house between sham and characterisation of the transaction according to the true nature of the legal arrangements actually entered into and carried out.

His Honour explained this position more fully in *Mills v Dowdall,* at 159:

> 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 a 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. A document may be brushed aside if and to the extent that it is a sham in two situations: (a) where the document does not reflect the true agreement between the parties, in which case the cloak is removed and recognition given to their common intentions …; and (b) where the document was bona fide in inception but the parties have departed from their initial agreement while leaving the original documentation to stand unaltered.

43. No legal principle allows the courts to disregard documents that correctly record the parties' intentions on the basis that the substance of the transaction could be interpreted in such a way that it would produce some different legal result. Consequently, the courts cannot disregard the legal arrangements that are in place and consider the economic substance when determining the tax treatment of an transaction: *Re Securitibank Ltd (No 2)* [1978] 2 NZLR 136 (CA), at 168; *NZI Bank Ltd v Euro-National Corporation Ltd*, at 539; *Australia and New Zealand Savings Bank Ltd v FCT* [1993] 25 ATR 369 (FCAFC).

Onus and standard of proof

44. This section discusses the onus and standard of proof where sham is alleged in the tax law context.

45. When the Commissioner considers that the transaction documents are shams, the Commissioner will disregard the documents (to the extent they are shams) for the purposes of calculating the taxpayer's tax liability. The Commissioner may then assess or reassess the taxpayer according to what the Commissioner considers is the true legal arrangement between the parties disguised by the documents. [The consequences of a finding of a sham are discussed further in paragraphs 76 – 81 below.]

46. For the Commissioner's assessment to be valid, it cannot be made "arbitrarily in disregard of the law or facts as known to him" the Commissioner or be based on "an arbitrary conjecture or [be] demonstrably unfair": *Lowe v CIR* (1981) 5 NZTC 61,006 (CA), at 61,015 and 61,026. The Commissioner must make an honest judgement as to the tax liability on the information in the Commissioner's possession: *CIR v Canterbury Frozen Meat Company Ltd* (1994) 16 NZTC 11,150 (CA), at 11,160. This obligation cannot be elevated into a requirement that the

Commissioner not assess unless and until fully informed of the taxpayer's affairs: *CIR v NZ Wool Board* (1999) 19 NZTC 15,476 (CA), at 15,489. Nor is it a requirement for a valid assessment that the Commissioner must believe the assessment "will ultimately prove to be correct": *Canterbury Frozen Meat,* at 11,160. The courts have noted that the taxpayer is likely to be in the best position to provide the evidence required to determine the allegation: *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA), at 61,283; *Case N39* (1991) 13 NZTC 3,333.

47. Therefore, the Commissioner when making an assessment must act in good faith. The assessment must be based on the available facts and so represent the Commissioner's honest opinion. This means that, before disregarding a document on the basis of sham, the Commissioner must honestly consider that the available information supports the document being a sham. The Commissioner is not required to be completely confident that a court would uphold the sham allegation.

48. However, the Commissioner must give due regard to the fact that an allegation of sham is akin to an allegation of fraud. As the Supreme Court in *Ben Nevis* stated (at [39]):

> An allegation of sham, being akin to an allegation of fraud, should not be lightly made. Those engaging in a sham are in reality seeking to deceive others as to the true nature of what they have agreed and are intending to achieve.

Similarly, in *Case U6* (1999) 19 NZTC 9,038 the Taxation Review Authority stated that the allegation of sham is "a very serious allegation" and that (at [86]):

> The facts must be measured against the gravity of the allegation and such a serious charge must always be responsibly made.

49. If the taxpayer disagrees with the Commissioner's view that the document is a sham, the taxpayer may challenge the assessment through the disputes process. If this occurs, the Commissioner has the "evidentiary onus" of pointing to evidence supporting the sham allegation. The standard of proof on the Commissioner is commensurate with the gravity of the allegation of sham: *Case X10* (2005) 22 NZTC 12,155, at [121].

50. Under s 149A(2) of the Tax Administration Act 1994, the onus of proof is on the taxpayer to show why the assessment is wrong and by how far it is wrong: *Buckley & Young*; *Beckham v CIR* (2008) 23 NZTC 22,066 (CA). The standard of proof required is the balance of probabilities: *Yew v CIR* (1984) 6 NZTC 61,710 (CA). This means that the taxpayer must establish on the balance of probabilities that the evidence or inferences pointed to by the Commissioner do not support the allegation of sham: *Case X10*, at [123].

Courts' approach to determining sham

51. This section discusses the New Zealand courts' approach to determining whether there is a sham.

Courts' general approach to analysing transaction documents

52. Before considering whether there is evidence supporting an allegation of sham, the courts determine what legal rights and obligations are created by the transaction documents.

53. The following principles were set out by Richardson J in *Re Securitibank (No. 2)* and *Marac Finance Ltd v Virtue*:

- The true nature of the transaction must first be determined in a careful, systematic and objective way.
- The legal character of the transaction is decisive of its true nature and not the overall economic consequences to the party.
- The legal character of the transaction cannot be determined conclusively by the nomenclature or labelling that is used by the parties. It is the inevitable effect of the terms of the contract that matters, not simply the form or language in which the parties chose to express it.
- In order to determine the true nature of the legal relationship the whole of the contract must be considered.
- Where the transaction is embodied in several interrelated documents, all the documents must be considered together and one may be read to explain the others.
- The documents are interpreted objectively so as to arrive at the meaning they would reasonably convey to a reasonable person.
- When interpreting the transaction documents, the courts are not concerned with ascertaining the parties' subjective intentions. The courts may consider the circumstances surrounding the entering into the transaction, and oral evidence may be admitted for the purposes of ascertaining the surrounding circumstances. Such evidence allows the courts to understand the setting in which the documents were executed. It cannot be given for the purposes of varying or contradicting the documents.

54. More recently, the Supreme Court in *Ben Nevis v CIR* at [48] emphasised that the character of the transaction is determined by the "true meaning of all provisions" of the documents, not the labels adopted in those documents:

> … it is the true meaning of all provisions in a contract that will determine the character of a transaction rather than the label given to it. The label "licence premium" is accordingly not what is important in the present case, but rather the true contractual nature of the legal rights for which payment is to be made and the effect of applying the tax legislation to a payment of that character.

55. For further discussion on the interpretation of contractual documents, see: *Vector Gas Ltd v Bay of Plenty Energy Ltd* [2010] NZSC 5, [2010] 2 NZLR 444,; *Yoshimoto v Canterbury Golf International Ltd* [2001] 1 NZLR 523 (CA); *Boat Park Ltd v Hutchinson* [1999] 2 NZLR 74 (CA).

Matters the courts examine when determining if there is a sham

56. After ascertaining the legal rights and obligations recorded in the transaction documents, the courts consider whether any evidence shows that:
    - the parties intended to create different legal rights and obligations to those created by the transaction documents; and
    - it was intended that third parties would be misled by the documents into considering that they had created the legal rights and obligations created by the documents.

57. When considering an allegation of sham, the courts are concerned to ascertain the parties' subjective intentions: *Official Assignee v Wilson*, at [50] and [108]. As a result, the courts consider evidence that would normally be excluded when determining the objective meaning of the

documents: *Buckley & Young*, at 61,277. In *Hitch v Stone*, the English Court of Appeal stated (at [65]):

> First, in the case of a document, the court is not restricted to examining the four corners of the document. It may examine external evidence. This will include the parties' explanations and circumstantial evidence, such as evidence of the subsequent conduct of the parties.

In *Raftland* Kirby J stated (at [147] footnote excluded):

> Where a court is considering a suggestion of sham that has a reasonably arguable evidential foundation, the court will not be confined to examining the propounded documentation alone. It may examine (and draw inferences from) other evidence, including the parties' explanations (if any) as to their dealings, and evidence describing their subsequent conduct.

58. The courts are reluctant to find sham and require clear evidence to justifying doing so. Mere circumstances of suspicion do not by themselves establish a transaction as a sham; it must be shown that the outward and visible form does not coincide with the inward and substantial truth: *Miles v Bull* [1969] 1 QB 258, at 264. An allegation of sham may be proven even in the absence of direct evidence, and on the basis of inferences drawn from the surrounding circumstances: *Sharrment v Official Trustee*, at 539. However, where there is no direct evidence, the courts require "compelling material". A finding of sham cannot be made if another inference is at least equally open on the facts: *Official Assignee v Wilson*, at [93]; *Sharrment v Official Trustee*, at 544.

59. The courts' reluctance to find sham is attributable to them recognising the need for "commercial certainty". In *Official Assignee v Wilson*, the Court of Appeal stated (at [52] and [111]):

> [52] … that courts will not wantonly interfere in ostensibly valid commercial transactions. … A Court will only look behind a transaction's ostensible validity if there is good reason to do so, and "good reason" is a high threshold, since a premium is placed on commercial certainty.
>
> …
>
> [111] … The party asserting the existence of the sham bears the onus of proving this on the balance of probabilities. Further, the ordinary approach to proof in civil cases should apply, where the more serious the allegation, the less likely it is that the event occurred and, therefore the stronger the evidence must be before the allegation will be established on the balance of probabilities … .

In *Raftland* Kirby J stated to similar effect (at [144]):

> Although, therefore, courts will ordinarily give legal effect to documents according to their language, sham analysis is an exception to that conventional approach. That is why it requires exceptional circumstances to enliven a conclusion that documents and acts amount to a sham, with the legal results that such a conclusion justifies.

Tax avoidance

60. Sham is not the same as tax avoidance. In *Ben Nevis* the Supreme Court emphasised (at [34]) that sham and tax avoidance are different:

> It is important to keep firmly in mind the difference between sham and avoidance. A sham exists when documents do not reflect the true nature of what the parties have agreed. Avoidance occurs, even though the documents may accurately reflect the transaction which the parties intend to implement, when, for reasons to be discussed more fully below, the arrangement entered into gives a tax advantage which Parliament regards as unacceptable.

The Supreme Court held (at [38]) that the fact the transactions concerned involved or facilitated tax avoidance did not mean they were shams. Similarly in *Accent Management Ltd v CIR* [2007] NZCA 230, (2007) 23 NZTC 21,323, the Court of Appeal held (at [59]) that the concepts of sham and tax avoidance are not correlatives.

61. Consequently, a transaction can be a "tax avoidance arrangement" under s BG 1 without being a sham. Similarly, a transaction can be a sham without being a "tax avoidance arrangement". If a transaction involves tax avoidance, but the documents reflect the true nature of what the parties have agreed, the Commissioner can only challenge it under s BG 1 (or any other anti-avoidance provision).

62. That sham and tax avoidance are different does not preclude the Commissioner from alleging that a transaction is a sham and, in the alternative, a tax avoidance arrangement.

Legally discouraged or prohibited arrangements

63. A transaction is not a sham only because it is discouraged or prohibited by legislation: *Sharrment Pty Ltd v Official Trustee*, at 455. Transaction documents that take effect between the parties as they are intended cannot be shams even if, for example, they are deliberately planned so as to fraudulently prefer one creditor over others. Other statutes and rules of law may "thwart the intentions" of those who enter into particular transactions, but the fact that the law does so does not mean such transactions are shams: *Paintin and Nottingham Ltd v Miller Gale and Winter*, at 175.

Ulterior purpose or motive

64. A transaction is not a sham merely because the parties entered it with an ulterior purpose or motive. "If what is done is genuinely done, it does not remain undone merely because there was an ulterior purpose in doing it": *Miles v Bull (No 1)*, at 264. For example, in *Official Assignee v Wilson*, at [123] the settlor created a trust for the ostensible purpose of providing for his children. The evidence showed that the settlor had set up the trust for the ulterior purpose of keeping his assets secure from creditors. The Court of Appeal held that this evidence did not show that the trust was a sham. However, this does not mean that evidence of an ulterior purpose is irrelevant. The existence of an ulterior purpose by one or both parties, together with other factors, may be considered relevant evidence of the parties' real intentions: *Re La Rosa; Ex p Norgard v Rocom Pty Ltd* (1990) 93 ALR 571 (FCA), at 581.

Parties' subsequent conduct

65. When considering allegations of sham, the courts are not restricted to considering the parties' conduct before or at the time the transaction documents were created. The courts are entitled to consider the parties' subsequent conduct: *AG Securities Ltd v Vaughan* [1990] 1 AC 417 (HL), at 475.

66. The case law shows that the courts have been frequently asked to find sham on the basis of that the parties acted inconsistently with the terms of the transaction documents. The courts have held that such evidence does not necessarily show the parties did not intend the documents to be effective and binding. In *Hitch v Stone* the English Court of Appeal stated (at [68]):

> … the fact that parties subsequently depart from an agreement does not necessarily mean that they never intended the agreement to be effective and binding. The proper conclusion to draw may be that they agreed to vary their agreement and that they have become bound by the agreement as varied … .

Similarly, in *Sonenco (No 87) Pty Ltd*, the Full Federal Court of Australia stated (at [82]):

> As was pointed out in *Snook* … one must first determine what were the genuine common intentions of the parties. If the acts and documents in question reflect those intentions, there will be no "sham". Haphazard conduct or departures from the provisions of the documentation may, or may not, indicate that the documents do not truly reflect what was intended. What is crucial … is the ascertainment of the parties' real intentions.

For similar comments, see *Australian Guarantee Corporation (NZ Ltd) v Broadlands Finance Ltd; General Motors Acceptance Corporation (NZ) Ltd v Australian Guarantee Corporation (NZ) Ltd and Broadlands Finance Ltd* (HC Auckland, A 256/80, 11 October 1983), at 22.

67. It is noted that part performance of the terms of the document does not preclude a finding of sham. In *Hitch v Stone* the English Court of Appeal stated (at [76]):

> However I would not agree with the judge that performance of the 1984 agreement in part was sufficient to remove the possibility of its being a sham. Part performance of the 1984 agreement does not in my judgment mean that it cannot be a sham. The terms actually performed may be terms of the true arrangement between the parties and they may accordingly have somewhat different consequences from the same terms appearing in the sham transaction. The correspondence of the terms in this respect is then coincidental and partial.

Mislabelled or carelessly prepared documents

68. On occasions, parties may use incorrect terms in their transaction documents. For example, the parties may use the term "lease" in the documents when the legal effect of the documents is that they have created a licence; or one party may be described as an "independent contractor" when the legal effect of the documents is that this party is an "employee". Mislabelling does not, by itself, mean the documents are shams. In *Accent Management Ltd*, the Court of Appeal stated (at [54]):

> At trial the argument against the taxpayers other than those associated with Dr Muir and Mr Bradbury was that the arrangements were shams because they were not true insurance arrangements. The conclusion does not follow logically from the asserted premise. A contract can be mislabelled without being ineffective. If the relevant arrangements were mislabelled as "insurance" but were nonetheless intended to create real legal obligations which were to be honoured, they would necessarily not be shams.

As the Court of Appeal held, a mislabelled transaction document cannot be disregarded if the parties intended the legal rights and obligations created by the document to be legally effective.

69. Similarly, carelessness, or haste, in the preparation of the documents does not, by itself, provide evidence of sham: *Bateman Television v Coleridge Finance Co Ltd*; *Coppleson v Commissioner of Taxation* (1981) 52 FLR 95 NSWSC), at 104.

Lack of commerciality or artificiality

70. "Artificiality and lack of a commercial point … are not indicia of sham": *Accent Management Ltd v CIR* (CA), at [59]. An artificial arrangement is not a sham if the transaction document "had the effect that it purported to have", and did not purport "to do something different from what the parties had agreed to do": *IRC v Littlewoods Mail Order Stores Ltd* [1963] AC 135 (HL), at 155; *Sharrment Pty Ltd v Official Trustee*, at 454-455; *Sonenco (No 87) Pty Ltd v Commissioner of Taxation*, at [82] – [84]. In *Hitch v Stone*, the English Court of Appeal stated (at [67]):

> … the fact that the act or document is uncommercial, or even artificial, does not mean that it is a sham. A distinction is to be drawn between the situation where parties make

> an agreement which is unfavourable to one of them, or artificial, and a situation where they intend some other arrangement to bind them. In the former situation, they intend the agreement to take effect according to its tenor. In the latter situation, the agreement is not to bind their relationship.

71. That the transaction between the parties is circular will not, by itself, show it is a sham. In *Re Barnett (Deceased) Perpetual Trustee Co Ltd v Barnett* (1969) 2 NSWR 720 (NSWSC), at 730-731, the Supreme Court of New South Wales held that a transaction was not a sham only because it involved a "round robin of cheques" (ie, the cheques exchanged by the parties were not cashed and instead cancelled each other out). Similarly, in *Equuscorp Pty Ltd v Glengallan Investments Pty Ltd*, the High Court of Australia rejected (at [46] – [48]) the submission that the transactions were shams as no "real money" was lent or brought into the venture. The evidence showed that the parties intended the transactions to be legally effective – debts were created and satisfied by the debiting and crediting of the parties' accounts.

72. This does not mean that artificiality or lack of commerciality is irrelevant when deciding whether there is a sham: *Case X10*, at [116]. The courts have taken into account (along with other factors) elements of artificiality and lack of commerciality when deciding whether the documents reflect the legal rights and obligations the parties intended to create: *Erris Promotions Ltd v CIR* (2003) 21 NZTC 18,330 (HC), at [106]; *Raftland Pty Ltd,* at [149]; *Hitch v Stone*, at [75] – [80]. In *National Westminster Bank Plc v Jones* [2001] 1 BCLC 98 (Ch), the English High Court (Chancery Division) stated (at 109):

> Accordingly, while the palpable, and freely admitted artificiality of the agreements in the present case cannot be doubted, it certainly does not follow that, as a result, the agreements must be shams. However, in my judgment, the fact that a particular transaction is palpably artificial is a factor which can properly be taken into account when deciding whether it is a sham. Indeed, it would seem to me to require very unsual circumstances before the court held that a transaction which was not artificial was in fact a sham.

73. The courts have emphasised that the complexity of a transaction does not, by itself, establish that the arrangement is a sham: *Sharrment Pty Ltd v Official Trustee*, at 455. In *Coppleson v Commissioner of Taxation* the Supreme Court of New South Wales stated (at 100):

> The fact that, in order to obtain those advantages, the transaction became complex and elaborate rather than simple and straightforward does not seem to me to affect its true nature if in legal form it is a gift and if the parties thereto intended it to be operative according to its tenor … .

Parties adopt one legal form over another

74. A transaction is not a sham just because the parties could have structured it in another way. In *Bateman Television v Coleridge Finance Co Ltd*, the appellants entered into arrangements for the hire-purchase of television sets. The respondent submitted that the arrangements were "shams" in that the "reality" was that the arrangements were "moneylending transactions requiring the formalities prescribed by the Moneylenders Act [1908]". Under the Moneylenders Act, moneylending arrangements were illegal and void if they did not conform to the formalities prescribed in the legislation. The Court of Appeal rejected this submission. Turner J stated (at 813):

> I think that the occasions on which Courts have set aside the form of a transaction as a "sham" are confined to cases in which, really doing one thing, the parties have resorted to a form which does not fit the facts in order to deceive some third person, … into the belief that they were doing something else … but I cannot agree that the term is applicable to the form of a transaction into which the parties are legally at liberty to

> enter, and into which they do in fact enter, if what they do is simply to prefer this form of transaction to some other into which they might have entered, but did not.

Part shams

75. In some cases the parties intended to create some, but not all, the legal rights and obligations recorded in the transaction documents. For example the parties may genuinely intend to create a sale and purchase agreement, yet also intend to deceive third parties by falsifying the pricing or payment terms in the agreement. In *Hitch v Stone* the English Court of Appeal held that a finding of sham is not excluded by the fact that parts of the document are genuine. Arden LJ stated (at [85]):

> **…** the effect of Mr Price's submission is that the court will be precluded from finding that a document is a sham because it includes an additional provision which is intended to be effective. This might deprive the doctrine of sham of any operation in a situation which is logically indistinguishable from the situation where the doctrine of sham already applies. **In my judgment, the law does not require that in every situation every party to the act or document should be a party to the sham.** I accordingly reject Mr Price's submission save that I accept that the case where a document is properly held to be only in part a sham will be the exception rather than the rule, and will occur only where the document reflects a transaction divisible into separate parts.
>
> [emphasis added]

Similarly in *Raftland* stated (at [148]) Kirby J stated:

> [148] To justify a conclusion that documents constitute a sham, the requisite intention to mislead must be a common intention of the parties. An exception may exist where the acts and documents reflect a transaction divisible into separate parts, such that a transaction is a sham as to part only of the transaction.

Consequences of a finding of sham

Transaction documents void and unenforceable "to the extent" that they are shams

76. When the courts find that the transaction documents are shams, the documents are disregarded "to the extent" they are shams: *Buckley & Young*, at 61,276. In *Henwood v CIR* (1995) 17 NZTC 12,271 (CA), Richardson J stated (at 12,276) that "[d]ocuments and clauses in documents may be brushed aside if they are sham." Where the **entire** document is a sham, the document is "void and unenforceable" and "wholly invalid and of no effect": *Midland Bank plc v Wyatt*; *Minwalla v Minwalla*. By contrast where **part** of the document is a sham and this part is severable, the document is void and unenforceable only in respect of that part: *Raftland*, at [148]; *Case W48* 89 ATC 460, at [26].

77. It is noted that an innocent third party might be able to enforce rights arising under a sham arrangement: *Hitch v Stone*, at [87]; *Official Assignee v Wilson*, at [120] – [122], per Glazebrook J.

78. By contrast, if the court is satisfied that the documents are not shams, the documents contain the legal rights and obligations the parties intended to create. The Commissioner therefore cannot disregard the documents (unless there is statutory authorisation to do so, for example, under ss BG 1 and GA 1). Consequently, the parties are taxed in accordance with the legal rights and obligations created by the documents (except where s BG 1 or another anti-avoidance provision applies).

True legal arrangement given effect

79. When the courts brush aside a sham document, they then ascertain the true legal arrangement between the parties. This does not involve

considering the economic substance of the arrangement. Instead the courts determine the legal rights and obligations (if any) that the parties intended to create. In *Buckley & Young* Richardson J stated (at 495):

> As a cloak or façade to conceal the true nature of the payment, the qualifying reference to the $6,000 per year must be brushed aside as not reflecting the true intentions of the parties. That step does not leave a vacuum. It becomes necessary to determine for what the payments were to be made. Just as oral evidence is always admissible in support of an argument that a transaction is in whole or in part a sham, so, too, that evidence may at the same time assist in determining what was the positive common intention of the parties in that regard.

80. In the tax context, this means that the parties to the sham are taxed on the basis of the true legal arrangement between them. As already discussed (see paragraphs 44 – 48 above), when the Commissioner considers the transaction document is a sham, the Commissioner will disregard that document (to the extent it is a sham) for the purposes of calculating the taxpayer's tax liability. The Commissioner may then amend the taxpayers' assessments to reflect the true legal arrangement between the parties.

81. The current approach of ascertaining the true arrangement between the parties can be contrasted with the approach taken in some earlier decisions concerning transactions involving the refinancing of existing liabilities. This earlier approach was explained in by Thorp J in *Australian Guarantee Corporation (NZ Ltd) v Broadlands Finance Ltd*, at 22 – 23:

> The significance of a finding of sham has changed. In the earlier cases, certainly when the transaction was in the nature of the refinancing of existing liability rather than the creation of a new obligation for the purpose of acquiring a new asset, a finding of sham almost inevitably led the court to infer that the true nature of the transaction was one of loan. That apparent dichotomy has been disavowed in a series of cases.

His Honour identified (inter alia) *Paintin* and *Re Securitibank Ltd (No 2)* as decisions where the courts had "disavowed" this earlier approach, and stated (at 24):

> From these decisions it now follows, as I read the authorities, that a mere finding of sham, that is to say that the documentation amounts to a facade, will not aid the party who proves that fact unless, in addition, he can point to positive evidence that the underlying intention was one of loan.

Case summaries

82. In New Zealand few reported tax cases have upheld a finding of sham. This is largely due to the courts' reluctance to entertain sham allegations. The following tax law cases on sham will now be summarised:

- *Erris Promotions Ltd v CIR* – where the High Court held that three software purchases were shams.
- *Accent Management Ltd* and *Ben Nevis* – where the Court of Appeal and the Supreme Court held that an insurance arrangement was not a sham.

When reading these summaries, and also other decisions considering sham, it is important to keep in mind that a finding of sham in a particular case is inherently fact-dependent.

Erris Promotions Ltd

83. In *Erris Promotions Ltd,* the High Court considered whether three software purchases were shams. Ronald Young J cited Diplock LJ's definition of sham in *Snook* as "conveniently set[ting] out what constitutes a sham" (at

[91]). Applying Lord Diplock LJ's definition, his Honour held that the three software purchases were shams.

84. With respect to the first software purchase, the parties had purported to buy and sell software. However, the facts showed that nothing was transferred "other than [an] idea which is in itself not depreciable". There were no specifications, no source code and no software. Ronald Young J inferred from the lack of due diligence that the parties knew there was no software being bought and sold (at [106]):

> Any credible sale of software for $144m would require as a minimum extensive due diligence involving technical analysis of the software and what it could do, an in-depth analysis of the market, due diligence of legal issues which would include ensuring that the vendor owned the software. Enquiries would be made as to the cost of replicating this software and whether there were any other similar products available overseas. There was none of this because both parties knew the purchase was a sham. … I find the agreement … was a sham and that both parties knew there was nothing beyond an idea unable to be protected in a property sense, bought or sold.

85. Ronald Young J held that these facts showed the first purchase was a sham. His Honour did not consider it relevant that the $144 million price was "self-evidently an absurd purchase price" but observed, as an aside, that "[t]he purchase of an idea, not especially original, for $144m says it all" (at [106]).

86. With respect to the second software purchase, Ronald Young J held that the purported purchase was a sham because the vendor did not own the software. His Honour was satisfied that both parties knew the vendor did not own what he purported to sell (at [119]). The third software purchase was also a sham because the vendor did not own the software he purported to sell and, in addition, part of that software did not exist at the time of sale. Ronald Young J was satisfied that both parties knew that the vendor did not own the software and that it was not fully developed (at [128]).

Accent Management Ltd and Ben Nevis

87. In *Accent Management Ltd* and *Ben Nevis* the Court of Appeal and Supreme Court considered whether insurance arrangements were shams. Under the insurance arrangements, the insured parties were insured for a "loss of surplus" expected to be derived from a forestry venture. In return, the insured parties were required to pay an initial premium of $1,307 per hectare each and, on or before 31 December 2047, another premium of $32,791 per hectare (with respect to one party) and $410,104 per hectare (with respect to the other party). The documentation provided that the last figure was to be adjusted so that the total amount required to be paid would not exceed the amount of the cover the insurer was obliged to provide.

88. The evidence showed the insurer was not expected to accumulate the premium income and had not entered into any reinsurance arrangements. On the structure of the insurance arrangements, there was no need for accumulations of premiums or reinsurance. This was because the net effect of the arrangements was that either one of the insured parties would default in its obligations (thereby releasing the insurer from its liability to make payment), or the 2047–2048 wash up would occur in a way that was self-funding for the insurer. In addition, the parent company of the insured parties gave the insurer a letter of comfort, and this created an additional element of circularity to the insurance arrangements. Under the letter of comfort, the parent company undertook to provide funds to the insurer to meet any claim under the

policy, provided the insurer had exhausted its resources and its ability to call on "contributors and/or insurers or reinsurers" in meeting claims.

89. The Court of Appeal examined the correspondence between the parties concerning the setting up of the insurance arrangements. One letter showed the parties considered that there was "no real risk in the whole thing". Another letter showed the parties considered that the entering of the insurance arrangement was a necessary condition to obtain tax relief, and that the actual outcome of the arrangement in 2047–2048 was "not considered material".

90. The Court of Appeal examined how the initial premium of $1,307 per plantable hectare paid to the insurer was used. The initial premium was first applied to cover the costs of establishing the insurer and to provide a US $200,000 bond required by the inspector of insurance in the British Virgin Islands. A substantial part of the remainder of the premium was paid as a "finder's fee" to another entity, and was then made available to the family trusts of the arrangement's architects. The net result was that the insurer retained only $157 per plantable hectare for possible accumulation, and the family trusts of the architects of the arrangement had the benefit of the "vast bulk" of the initial premiums.

91. The Court of Appeal held that the insurance arrangements by a "narrow margin" were not shams.

92. With respect to the requirement to pay the initial premium, the Court of Appeal stated that the arrangements were clearly "highly artificial and indeed contrived" (at [58]). However, artificiality and lack of commercial point (other than tax avoidance) are not indicia of sham, and the concepts of sham and tax avoidance were not correlatives. While there were "elements of pretence (and certainly concealment)" associated with the insurer's arrangements with respect to the initial premiums it was paid, these were explicable on bases other than sham, in particular the possibility of disallowance by the Commissioner for tax avoidance (at [59]). Accordingly, the Court of Appeal declined to find that the insurance arrangement provisions as to the payment of the initial premiums were shams.

93. The Court of Appeal then considered whether the contractual provisions governing the 2047-2048 wash up were shams. It held that the evidence showed that the parties did not have any settled intention that the 2047 premiums would be paid. At the time of entering the arrangements, the parties regarded what would happen in 2047 as immaterial and to be addressed at that time. Their state of mind was "perhaps best categorised as involving indifference" as to whether the wash-up transactions occurred. This was presumably because, given the circular nature of insurance arrangements, the parties thought they could avoid the possibility of suffering any appreciable adverse consequences associated with the 2047 obligations (at [62]).

94. However, these factors did not persuade the Court of Appeal that the provisions for the 2047 wash-up were shams. It held (at [63]):

> By a narrow margin, however, we have reached the view that we cannot classify the transactions as shams. An obligation can be genuinely entered into even though subject to legal or practical defeasance or entered into on the basis that it might be replaced by another amended obligation. In a strange way, the very circularity which is involved in the transactions might be thought to be consistent with a desire that they be at least capable of achievement (or legally agreed variation) during or prior to the wash up. Whether these transactions are shams depends primarily on the states of mind of Dr Muir and Mr Bradbury as to their genuineness. Given that it is not to their advantage

> that the transactions be shams, it might be thought a little perverse to attribute to them states of mind which are inconsistent with their best interests.

95. On appeal, the Court of Appeal's conclusion on sham was upheld in *Ben Nevis*. However, the Supreme Court appeared to more firmly hold that the insurance arrangements were not shams:

> [38] The Courts below correctly applied the law and arrived at concurrent findings with which we agree. In short, we consider it has not been shown that the parties to the relevant documents were intending to deceive the Commissioner as to the nature of their arrangement in respect of insurance or as to their intention to implement the insurance arrangements according to their tenor. The fact that the insurance arrangements were constructed in a way that, as will later be demonstrated, materially contributed to the whole Trinity scheme being characterised as a tax avoidance arrangement does not, according to proper principles of law, mean that the insurance aspect of the whole scheme was a sham. The fact that the insurance arrangements were put in place with the purpose or effect of obtaining a tax advantage does not mean they were a sham.
>
> [39] The shifting nature of the Commissioner's allegations of sham as this litigation proceeded, and the contradiction which derives from the Commissioner's acceptance that the initial premium was prima facie deductible, makes it difficult for the Commissioner to sustain the proposition that the insurance arrangement was a sham. An allegation of sham, being akin to an allegation of fraud, should not be lightly made. Those engaging in a sham are in reality seeking to deceive others as to the true nature of what they have agreed and are intending to achieve. That is not shown here.

96. The Court of Appeal and Supreme Court's decisions emphasise that an allegation of sham should not be lightly made as it is akin the fraud, and that clear evidence is required to support such an allegation. The decisions also emphasise that sham and tax avoidance are different. In this respect, it is observed that the Court of Appeal and the Supreme Court held that the arrangements were not shams, even though they also held that s BG 1 applied to the same arrangements.

Examples

97. These two examples illustrate how the sham doctrine might operate in practice.

Example 1

98. C owns a shop that sells building materials. D owns and operates a house building company that is registered for GST purposes. D is currently building his own house using labour and materials provided by himself (and not his company). D wants to purchase building materials from C in order to complete his house. D visits C's shop and purchases the materials using his own money. D informs C that he is purchasing the materials for his company, and asks C to prepare an agreement for sale and purchase of the materials that identifies D's company as the purchaser. C and D sign the sale and purchase agreement. D then uses the building materials in the construction of his house. D claims input tax deductions for the GST paid on the building materials and, in support of his claims, produces the agreement for sale and purchase.

99. On the facts of this example, the agreement for sale and purchase is not a sham. In order to establish that the agreement is a sham, **both** parties must be shown to have the common intention not to create the legal rights and obligations contained in the agreement, and that it was intended that a third party (ie, Inland Revenue) would be misled into believing they had created these rights and obligations.

100. The common intention requirement is not satisfied on the facts. D did not intend that his company would take ownership of the building materials. Instead, D intended that he himself would take ownership of the materials, thereby enabling him to use them for building his house. D also intended to mislead Inland Revenue into believing that his company had purchased the materials, as shown by him presenting the agreement in support of his input tax deduction claims. However, the evidence does not suggest that C shared D's intention. C was unaware of D's intention to use the materials personally and, from his perspective, considered that he was contracting to sell the building materials to D's company.

101. While the requirements of sham are not satisfied, it may be necessary to consider (as a separate matter) whether D's claims amount to evasion or avoidance.

Example 2

102. M works for P and is paid fortnightly wages that are subject to PAYE. M and P consider that they could both attain a tax advantage by opting out of their PAYE obligations, because P could stop deducting PAYE and M could take deductions not available to employees. Accordingly, M and P enter into a new contract that expressly states that the nature of the employment relationship is one "for service" rather than "of service". The contract states that M is a self-employed independent contractor of P. Under the contract's terms, P is not responsible for holiday pay or sick leave and M is responsible for supplying to P all the equipment, plant, and so on for the contract work.

103. After the new contract is signed, the only noticeable difference in the employment relationship is the contract. All other facets of the relationship between M and P remain the same. M and P do not implement the terms of the new contract and have no intention of doing so. The "employment relationship" maintains the same entitlements and obligations as before. Although the new contract stipulates that M is not entitled to holiday pay or sick leave, M continues to take paid holidays and sick leave. P continues to provide all the assets and make all the decisions regarding how the business and M's services are to be managed. In reality, M and P are continuing to operate in a "master–servant" relationship. However, for tax purposes, P ceases to deduct PAYE from M's fortnightly "contractual payments". When queried about this lack of deduction, P produces the new contract for services as evidence of the new relationship.

104. The new employment relationship is clearly a sham. M and P intend to deceive the Commissioner by holding out that an independent contractual arrangement exists when clearly there is no change in the employment relationship. Once a sham is established, the new arrangement is ignored and legal effect is given to the real employment status. Also, it is likely that M's failure to deduct PAYE from the "wages" mean M is subject to shortfall penalties. However, if M and P genuinely began to operate in accordance with the express terms in the new agreement for services then no sham would exist. Alternatively, if M and P entered into the new contract, did not implement its terms in practice, but continued to meet their legal and taxation obligations on the basis that an employment relationship still existed, there would not be a sham. For a sham to exist, the parties' common intention must be to mislead someone else (such as the Commissioner) in respect of the true legal or factual position.

References

Related rulings/statements

Interpretation guideline, "Sham – meaning of the term", *Tax information Bulletin,* Vol 9, No 11 (November 1997)

Subject references

Sham

Legislative references

Income Tax Act 2007, s BG 1

Tax Administration Act 1994, s 113 and s 149A

Case references

Accent Management Ltd v CIR [2007] NZCA 230, (2007) 23 NZTC 21,323

AG Securities Ltd v Vaughan [1990] 1 AC 417 (HL)

Al-Sabah & Abacus Ltd v Grupo Torras SA [2004] WTLR 1 (Royal Court (Jersey))

Australia and New Zealand Savings Bank Ltd v Commissioner of Taxation [1993] 25 ATR 369 (FCAFC)

Australian Guarantee Corporation (NZ Ltd) v Broadlands Finance Ltd; General Motors Acceptance Corporation (NZ) Ltd v Australian Guarantee Corporation (NZ) Ltd and Broadlands Finance Ltd (HC Auckland, A 256/80, 11 October 1983)

Bateman Television Ltd v Coleridge Finance Co Ltd [1969] NZLR 794 (CA)

Beckham v CIR (2008) 23 NZTC 22,066 (CA)

Ben Nevis Forestry Ventures Ltd v CIR [2008] NZSC 115, [2009] 2 NZLR 289

Boat Park Ltd v Hutchinson [1999] 2 NZLR 74 (CA)

Buckley & Young Ltd v CIR (1978) 3 NZTC 61,271 (CA)

Case N39 (1991) 13 NZTC 3,333

Case U6 (1999) 19 NZTC 9,038

Case W48 89 ATC 460

Case X10 (2005) 22 NZTC 12,155

CIR v Canterbury Frozen Meat Company Ltd (1994) 16 NZTC 11,150 (CA)

CIR v New Zealand Wool Board (1999) 19 NZTC 15,476 (CA)

Coppleson v Commissioner of Taxation (1981) 52 FLR 95 (NSWSC)

Cranstoun v FCT 84 ATC 4,876 (QSC)

Equuscorp Pty Ltd v Glengallan Investments Pty Ltd [2004] HCA 55

Erris Promotions Ltd v CIR (2003) 21 NZTC 18,330 (HC)

Faucilles Pty Ltd v FCT 90 ATC 4,003 (FCAFC)

Henwood v CIR (1995) 17 NZTC 12,271 (CA)

Hitch v Stone [2001] EWCA Civ 63, [2001] BTC 78

IRC v Littlewoods Mail Order Stores Ltd [1963] AC 135 (HL)

Lowe v CIR (1981) 5 NZTC 61,026 (CA)

Marac Finance Ltd v Virtue [1981] 1 NZLR 586 (CA)

Marac Life Assurance Ltd v CIR [1986] 1 NZLR 694 (CA)

Midland Bank Plc v Wyatt [1995] 1 FLR 697 (Ch)

Miles v Bull (No 1) [1969] 1 QB 258

Mills v Dowdall [1983] NZLR 154 (CA)

Minwalla v Minwalla [2004] EWHC 2823 (Fam), [2005] 1 FLR 771

National Westminster Bank Plc v Jones [2001] 1 BCLC 98 (Ch)

NZI Bank Ltd v Euro-National Corporation Ltd [1992] 3 NZLR 528 (CA)

Official Assignee v Wilson [2008] NZCA 122, [2008] 3 NZLR 45

Paintin and Nottingham Ltd v Miller Gale and Winter [1971] NZLR 164 (CA)

R v Connolly (2004) 21 NZTC 18,884 (HC)

Raftland Pty Ltd v FCT 2008 ATC ¶ 20-029 (HCA)

Re Barnett (Deceased) Perpetual Trustee Co Ltd v Barnett (1969) 2 NSWR 720 (NSWSC)

Re La Rosa; Ex p Norgard v Rocom Pty Ltd (1990) 93 ALR 571 (FCA)

Re Securitibank Ltd (No 2) [1978] 2 NZLR 136 (CA)

Richard Walter Pty Ltd v FCT 96 ATC 4,550 (FCAFC)

Shalson v Russo [2003] EWHC 1637 (Ch), [2005] Ch 281

Sharrment v Official Trustee (1988) 18 FCR 449 (FCAFC)

Snook v London and West Riding Investment Ltd [1967] 2 QB 786 (CA)

Sonenco (No. 87) Pty Ltd v Commissioner of Taxation (1992) 111 ALR 131 (FCAFC)

Vector Gas Ltd v Bay of Plenty Energy Ltd [2010] NZSC 5, [2010] 2 NZLR 444

Yew v CIR (1984) 6 NZTC 61,710 (CA)

Yoshimoto v Canterbury Golf International Ltd [2001] 1 NZLR 523 (CA)