Inland Revenue
Te Tari Taake

25OIA2140

9 May 2025

[redacted]

Dear [redacted]

Thank you for your request made under the Official Information Act 1982 (OIA), received on 13 April 2025. You requested the following:

> *"I am requesting access to the legislative files relating to section 108 of the Land and Income Tax Act 1954 substituted by section 9(1) of the Land and Income Tax Amendment Act (No. 2) 1974."*

Information being released

The legislative files relating to section 108 of the Land and Income Tax Act 1954 that I have located are released to you, attached as **Appendix A.**

Some information is withheld in the Appendix as it is considered sensitive revenue information under section 18(1) of the Tax Administration Act 1994 (TAA) because it is reasonably capable of being used to identify entities. Sensitive revenue information can only be released in certain circumstances, as set out in section 18D to 18J and schedule 7 of the TAA.

In this case, there are no grounds that permit me to release this information to you. I have therefore decided to withhold this information under section 18(c)(i) of the OIA, as making the information available would be contrary to Inland Revenue's confidentiality obligations in section 18(1) of the TAA.

Where information is not considered in scope of your request, it is withheld as "not in scope" in the Appendix.

Right of review

If you disagree with my decision on your OIA request, you have the right to ask the Ombudsman to investigate and review my decision under section 28(3) of the OIA. You can contact the office of the Ombudsman by email at: info@ombudsman.parliament.nz.

25OIA2140

Publishing of OIA response

We intend to publish our response to your request on Inland Revenue's website (ird.govt.nz) as this information may be of interest to other members of the public. This letter, with your personal details removed, may be published in its entirety. Publishing responses increases the availability of information to the public and is consistent with the OIA's purpose of enabling more effective participation in the making and administration of laws and policies and promoting the accountability of officials.

Thank you again for your request.

Yours sincerely

Peter Frawley
Policy Lead - Legislative Drafting and Business

Appendix A

File No. 118

Volume No. 2

SUBJECT (or NAME): LEGISLATION - 1974
LAND & INCOME TAX AMENDMENT ACT NO.2 1974.
ANNUAL ACT - CORRESPONDENCE RE S.O.P.

File Opened SECTIONS 3-9 File Closed:
Previous File: Subsequent File:

OTHER RELEVANT FILES

Subject: File No.

Folio	Referred to	Date	Cleared, Initials	Folio	Referred to	Date	Cleared, Initials

DISPOSAL CATEGORY

Item 101

83512C—250 000/6/82DK

SECTION 8

SALE OF TRADING STOCK FOR INADEQUATE CONSIDERATION

(2) Value of land to be adopted when a scheme of subdivision or development has commenced within 10 years of acquisition of the land

You will recall that it was considered that, when a scheme of subdivision or development (other than a scheme involving work of a minor nature) is undertaken within 10 years of acquisition, it was a reasonable assumption that the scheme was in mind when the property was acquired. Accordingly, it was considered that the full profit calculated as the difference between the ultimate selling price and the original cost of the land plus any cost of development should be assessed. However, my legal advisers now feel that the Courts could well hold that, as the section refers to the profit arising from the "scheme", this means only the profit over and above the value at the time the scheme is commenced.

As indicated, this was not the intention when the particular provision was drafted. You may feel that it should be clarified in this year's legislation.

Other matters of a more minor nature involved in the legislation of last year affecting land deals are -

(3) Land transferred at less than full consideration in circumstances where the profits would otherwise be assessed for tax.

Such transfers are usually between "associated persons".

In general terms section 102 of the Tax Act provides that when trading stock is transferred at less than its full market value that value can be used for the purpose of arriving at the assessable income of the transferor. For this purpose, the term "trading stock" is deemed to include land and any personal property in which the person is dealing. However, in last year's legislation, while it was intended to use the provision of section 102 for all the new situations in which sales or transfers of land at full value would otherwise be assessed, the actual legislation as drafted has left some uncertainty and the matter should be clarified accordingly.

(4) Transfer of land by a company to its shareholders at less than market value.

Somewhat similar provisions as set out in (3) above apply in these circumstances. Again there is some doubt as to the legal effect of last year's legislation and this should also be clarified.

SECTION 9

AGREEMENTS PURPORTING TO ALTER INCIDENCE OF TAXATION TO BE VOID

DIVIDEND STRIPPING

The question has been raised as to the amount to be assessed to a taxpayer pursuant to sub-section (4) of the new section 108 when he sells shares in a company for a consideration based on his fully paid-up capital plus, say, 90% of his share of the accumulated profits.

e.g. A owns all the shares in X Ltd which has a paid-up capital of $1,000 and accumulated profits of, say, $2,000. He is paid $2,800 for his shares. The question is, should he be treated as having received 2,000 dividends or 1,800?

The position has been discussed with the Office Solicitor and we consider that in the above case the taxpayer should be assessed on $2,000 pursuant to sub-section (4). This is on the basis that of the considerations he receives for his shares, $2,000 and not merely $1,800 represents or is equivalent to the amount which he was likely to have received as dividends if the arrangement to sell the shares had not been entered into.

Another point, if the full $2,000 is not assesse is that if another company has purchased the shares from the taxpayer and then winds up the company first mentioned in this memorandum, the Department would be in difficulty in treating the $200 profit that it makes as assessable income. The Department could not claim that the shares have been purchased with a view to resale as the shares are not, in fact, reso and the company is entitled to claim that the amour paid to it on winding up is expressly deemed to be a dividend under the Tax Act and is therefore to be treated as non assessable income in its hands.

For these reasons, the full amount of $2,00 in the above example should be treated as assessabl to the vendor of the shares provided, of course, the circumstances are such to bring the case within sub-section (4) of the new section 108.

(D. A. Stevens)
Commissioner.
8.11.74.

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Commissioner.
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FEDERATED FARMERS OF NEW ZEALAND (INC.)
HEAD OFFICE: 4TH FLOOR, WOOL HOUSE, 139-141 FEATHERSTON STREET, WELLINGTON, C.1, N.Z.
P.O. BOX 715 TELEGRAMS: "FARMLANDS TELEPHONE 46-889

23 October 1974

The Hon. R. J. Tizard,
Minister of Finance,
Parliament House,
WELLINGTON.

see RJY. Hold for the file on this amendment

Dear Mr. Tizard,

Re: Amendment to Land and Income Tax Amendment No.2

The Federation wishes to advise you that after examining the Amendment to clause 8 of the Land and Income Tax Amendment Bill (No.2), it has come to the opinion that the amendment does not materially alter the original clause 8 of the Bill.

When the Federation first presented its submissions it drew attention to the desirability of retaining the test under Section 108 as the principal purpose of the taxpayer in making the arrangements, and of preserving the defence of an ordinary family dealing.

Even although the new amendment has changed the wording of the original clause 8, and a transitional period for taxpayers to arrange their affairs in order to comply with the proposed law is now provided, the Federation believes that its initial objections have not been reflected in the amendment, and accordingly respectfully asks that further consideration be given to the Federation's original proposals;

"Under the proposed Section 108 the test of principal purpose which the Courts have construed from the existing Section 108(1) has been explicitly removed. Under the existing legislation tax avoidance had to be a principal purpose of any agreement or arrangement before it could be upset by the Commissioner of Inland Revenue.

The Federation strongly urges that the principal purpose test should be continued as an integral part of the legislation on agreements purporting to alter the incidence of taxation. If family trusts can be upset, even when tax avoidance are not their principal purpose, then the way is clear to upset many bona fide family trusts.

As so often happens in these cases a subsidiary effect is that a taxpayer's affairs are so ordered that there is a lessening of the burden of taxation. The Federation does not support those artificial schemes whereby taxation avoidance is a principal purpose. We do, however, support the right of the taxpayer to enter into family arrangements and set up trusts in order to dispose of property to the best advantage among members of his family.

....

The proposed Section 108 in Subsection (2) removes a defence which has been long recognised by the Courts and that is the defence of "ordinary family dealing". On the basis of "ordinary family dealing" many farmers throughout New Zealand have established trusts and entered into arrangements for the protection of their properties. These arrangements are often an integral part of the settling of farmers' sons upon the land. Indeed because a farmer has been able to resort in confidence to these measures younger persons have been able, in an orderly way, to take over family properties, often with beneficial results in productivity. The removal of this defence, together with the removal of the principal purpose test referred to earlier will create a grave situation in the farming industry with regard to "ordinary family dealings". Transactions and arrangements, which up until now could be undertaken in confidence, will no longer be able to be undertaken with any degree of certainty as to their outcome. There will no longer be the encouragement for the older farmer to transfer his farming assets to sons, with consequent influx of new ideas, new methods and renewed drive. Productivity will undoubtedly suffer."

Yours sincerely,

A.F. Wright,
Senior Vice-President.

H.O.45

16 October 1974

The Minister of Finance,
Parliament Buildings,
WELLINGTON.

CLAUSE 8 OF NO. 2 TAX BILL - ANTI-TAX AVOIDANCE PROVISION
PROPOSED ALTERATION BY THE OPPOSITION

You have asked for a report on the attached draft of an amendment which the Opposition proposes to move at the Committee stages of the Bill.

As you know, the clause rewrites entirely section 108 of the Tax Act and you have already circulated a new version in a Supplementary Order Paper. Before commenting on the Opposition's own version, I give the following background.

The reasons for the proposed changes to section 108 this year are:-

(a) To get over criticism from the Courts that the section in its present form was "unfinished", in other words, that it did not state to whom the income was to be assessed in any arrangement which was struck down by the section.

(b) The Department considered that dicta from the Courts since Justice Woodhouse gave his judgment in the Elmiger case in 1966 had tended to erode the position of the Revenue and destroy what was generally regarded as the proper balance struck by the Woodhouse decision.

In addition to the criticism of the Courts about the unfinished nature of the section as referred to in (a) above, the Courts also suggested that the section should attempt to spell out all the types of situations and cases in which the section should apply. This particular point has some relevance as regards the version proposed by the Opposition.

For various reasons, it was decided not to attempt to spell out the types of situation in which the section was to apply, viz.

i) that, for one thing, there were numerous circumstances or methods adopted by taxpayers in transferring income to members of their family or family trusts and to cover all such circumstances and situations would be difficult;

ii) if circumstances were spelt out, it could conceivably play into the hands of the taxpayers and their professional advisers in suggesting ways to circumvent the new provisions. I might add that the Attorney-General, in response to a letter from the President of the Court of Appeal, made much the same comment as this.

Turning now to the version suggested by the Opposition, the main points are:-

(a) It is very much in line with legislation which has been prepared by Dr I.L.M. Richardson of Wellington for Mauritius and Western Samoa. He is a leading tax expert in New Zealand and attended with the representatives of the Law Society when they called on you.

(b) It does not attempt to spell out circumstances or types of cases in which the section is to be applied. Rather, what it does do is to list a number of <u>criteria</u> which should be taken into account in deciding whether or not tax avoidance is present in a particular arrangement.

(c) It does not have any specific provision to cover dividend stripping as is contained in the version in the Supplementary Order Paper which you have circulated.

(d) It apparently is to apply to all arrangements including past arrangements. This could well be an oversight by the Opposition.

Dealing with each of these aspects, I advise:

As regards (a) and (b), Inland Revenue considers that listing criteria to be taken into account in considering whether tax avoidance is present

does not add any greater certainty as to which types of cases or circumstances the section is to apply. If anything, it would tend to confuse the position.

On the other hand, while the version in the Supplementary Order Paper neither lists the types of cases to be considered nor the criteria to be followed in relation to the section, it nevertheless preserves wherever possible the language of the old section. In this way, it also preserves the dicta and decisions from previous cases.

It also uses language very similar to what Justice Woodhouse used in the Elmiger case. For instance, sub-clause (1) of Clause 8 in the Supplementary Order Paper states, in effect, that the section is to apply if one of the purposes or effects is tax avoidance, so long as it is something more than merely an incidental feature of the arrangement, notwithstanding that there is some other purpose which may have been induced through ordinary business or family considerations. As stated, this is very much in line with the quote from Justice Woodhouse's judgment, viz.

> "Accordingly it is my opinion that family or business dealings will be caught by s.108 despite their characterization as such, if there is associated with them the additional purpose or effect of tax relief (in the sense contemplated by the section) pursued as a goal in itself and not arising as a natural incident of some other purpose".

- As regards (c) above, it is considered that some specific provision is necessary to cover dividend stripping. This is for the reason that a person may sell his shares in, say, a moribund company for the express purpose of avoiding the dividend tax which would have been payable if he would up the company but, in the absence of a specific provision, the Revenue may need to wait until the company in which the shares were previously held had itself declared a dividend notwithstanding that the person has already benefitted by an amount equivalent to the dividend in the consideration he has received for the sale of his shares.

- As regards (d) above, as stated, the fact that the Opposition's version does not exclude old arrangements from the new provisions could well be an oversight. In the version in the

Supplementary Order Paper, it is now stated that the old section 108 will continue to apply in relation to "old arrangements" when and so long as they remain binding on the particular taxpayer.

Summary

Inland Revenue would not recommend the adoption of the Opposition's version and I would suggest you make the following points in debate:

- The Opposition's version only spells out criteria and not circumstances or cases in which the section should or should not apply and therefore does not take the section any further than the version in the Supplementary Order Paper. Spelling out a number of criteria always leaves some uncertainty as to what weight is to be given to any particular criterion.

- By contrast, the version in the Supplementary Order Paper has adopted the language, as far as practicable, of the old section subject to some strengthening to get over some adverse comments in the Courts since Justice Woodhouse gave his judgment in the Elmiger case. The new section is considered to do no more than restore what was regarded as the proper balance achieved by that Judgment between the protection of the Revenue and the rights of the taxpayer to dispose of his assets to his family or trusts for them. In short, the position was generally accepted for tax purposes following the Elmiger case if a taxpayer was prepared to transfer his permanent assets to his family permanently. On the other hand, if he merely attempted to divert income without the transfer of his permanent assets, it would be struck down by the section.

  As stated, the new version of the Supplementary Order Paper is considered to restore this proper balance.

- The Opposition version is silent as to its application and therefore would presumably apply the new version to old transactions. It could therefore be more harsh than the amended version in the Supplementary Order Paper which preserves the old law in respect of old arrangements when and so long as they remain binding on the taxpayer.

Out now

A version similar to that suggested by the Opposition was considered as it is very similar to the legislation in Mauritius and Western Samoa but, while it may be suitable for those countries, it could well be that the old section 108 with its past history, dicta and interpretations, when suitably amended, is better for New Zealand conditions. In this connexion, I would add that the practical operation of the Opposition version has not, so far as I am aware, been tested in Mauritius and Western Samoa where similar legislation has been adopted.

(D. A. Stevens)
Commissioner.

[illegible] business or activity, had all the commercial transactions

transactions and relations been wholly at arm's length.

WESTERN SAMOA (draft)

43. Tax avoidance arrangements void: (1) Every arrangement shall be absolutely void as against the Commissioner for income tax purposes if and to the extent that its purpose or one of its main purposes is tax avoidance.

(2) In determining whether the purpose or one of the main purposes of an arrangement is tax avoidance the following considerations shall be taken into account:

(i) Where the arrangement might reasonably be expected to have been entered into and implemented in that particular way if tax avoidance had not been its purpose or one of its main purposes;

(ii) Whether the rights and obligations arising under the arrangement might reasonably be expected to have been created under an arrangement not having tax avoidance as its purpose or one of its main purposes;

(iii) The extent to which the emphasis in the arrangement is substantially on income factors,

(iv) The overall effect of the arrangement on the practical carrying on of any existing business or other activity to which it relates;

(v) The dependence on the taxpayer for the earning or accruing of income under the arrangement;

(vi) The extent of the control over the earning and disposition of income under the arrangement in practice achieved by the taxpayer;

(vii), Any disadvantage accruing to the taxpayer from the arrangement:

(viii) The tax advantage obtained through the arrangement:

(ix) The income tax and other implications of other courses of action open to the taxpayer at the time he entered into the arrangement:

(x) Any other relevant consideration.

(3) Where an arrangement is void under this section the residual assessable income of a taxpayer party to the arrangement shall be adjusted as the Commissioner considers appropriate so as to counteract the tax advantage obtained by the taxpayer under the arrangement and without limiting the generality of the foregoing the Commissioner shall have regard to the income that in his opinion would in all likelihood have been derived by the taxpayer (including deductions that in the opinion of the Commissioner would in all likelihood have been incurred by the taxpayer) had the arrangement not been entered into.

(4) Where by reason of the operation of this section an amount is included in or not deducted in arriving at the residual assessable income of any taxpayer which in the opinion of the Commissioner is directly or indirectly included or reflected in the residual assessable income of any other taxpayer the residual assessable income of the other taxpayer shall be reduced by that amount.

(5) For the purposes of this section:

"Arrangement" means any agreement plan or understanding whether enforceable or unenforceable including all steps any transactions by which it is carried into effect.

"Liability" includes a potential or prospective liability in respect of future income.

"Purpose" means the end in view or object of the arrangement and does not include the motive or intention of the taxpayer except insofar as evidenced in the arrangement.

"Tax avoidance" includes directly or indirectly (a) altering the incidence of any income tax, (b) relieving any person from liability to pay income tax, (c) avoiding reducing or postponing any liability to pay income tax.

(6) This section shall apply and prevail notwithstanding any other provision in this Act except only where it is expressly and specifically otherwise provided.

Division 13 : Country of Derivation of Income

44. Liability of income for assessment: (1) Subject to the provisions of this Act, all income derived by any person who is resident in Western Samoa at the time when he derived that income shall be assessable for income tax whether it is derived from Western Samoa or from elsewhere.

(2) Subject to the provisions of this Act, all income derived from Western Samoa shall be assessable for income tax, whether the person deriving that income is resident in Western Samoa or elsewhere.

(3) Subject to the provisions of this Act, no income which is neither derived from Western Samoa nor derived by a person then resident in Western Samoa shall be assessable for income tax.

(See page 258/9)

MAURITIUS

D—ANTI-AVOIDANCE PROVISIONS

Interest on debentures issued by reference to shares.

36. Where a company has issued debentures to its shareholders any class of shareholders, and the amount of the debentures ued to each shareholder has been determined by reference to the mber, the nominal value or the paid-up value of the shares in that mpany or in any other company, whether or not that other mpany is being or has been wound up, that were held by or on half of the shareholder at the time the debentures were issued or any earlier time, the interest paid by the company on the bentures so issued shall not be an allowable deduction and shall deemed to be a dividend received from the company by the areholders or class of shareholders of the company.

Excess of remuneration or share of profits.

37. (1) Subject to subsection (3), where—

(a) (i) a taxpayer carries on any business or other income earning activity and employs a relative, or, being a company, employs a relative of a director or shareholder of the company, to perform services in connection with the business or activity; or

(ii) a taxpayer carries on business or other income earning activity as an associate with any person, whether or not any other person is a member of the *société*, and—

(A) a relative of the taxpayer is employed by the *société* to perform services in connection with the business or activity; or

(B) where one of the associates is a company, a relative of a director or shareholder of the company is employed by the *société* to perform services in connection with the business or activity; or

(iii) a taxpayer carries on business or other income earning activity in association with a relative or with a company of which a director or shareholder is a relative of the taxpayer or, being a company, carries on business or other income earning activity in asssociation with a relative of a director or shareholder of the company, whether or not any other person is a member of the *société;* and

(b) the Commissioner is of opinion that the remuneration, salary, share of profits or other income payable to or for the benefit of that relative or company under the contract of employment or on the terms of the *société* exceeds the amount which is reasonable having regard to the nature and extent of the services rendered, the value of the contributions made by the respective associates by way of services or capital or otherwise, and any other relevant matters,

e Commissioner may apportion the net income of the business or her income earning activity, without deducting any amount yable to that relative or company, between the parties to the

contract of employment or the associates or any of them in such shares and proportions as he considers reasonable, and the amounts so apportioned shall be deemed to be income derived by the persons to whom those amounts are so apportioned and by no other person.

(2) Subject to subsection (3), where any sum paid or credited by a company, being or purporting to be remuneration for services rendered by a person who is a relative of a director or shareholder of the company, is apportioned to that company in accordance with subsection (1), the amount so apportioned to the company shall be deemed to be a dividend received by that person as a shareholder of the company.

(3) This section shall not apply to a contract of employment or an agreement to form a *société* where—

(a) the contract or agreement is in writing signed by all the parties ;

(b) no associate and no person employed under the contract or agreement was a minor at the date on which the contract was signed ;

(c) the contract or agreement is binding on the parties for a term of not less than three years and cannot be terminated by any party before the expiry of that term;

(d) each party to the contract has a real and effective control of the remuneration, salary, share of profit, or other income to which he is entitled under the contract; and

(e) the remuneration, salary, share of profit or other income payable to a relative or to a company of which a director or shareholder is a relative is not of such an amount that the transaction constitutes a gift or other disposition of property without adequate consideration in money or money's worth.

Excessive remuneration to shareholder or director.

38. Where any sum paid or credited by a company, being or purporting to be remuneration for services rendered by a person who is a shareholder or director of the company, exceeds the amount which in the opinion of the Commissioner is reasonable, the amount of the excess shall not be an allowable deduction and shall be deemed to be a dividend received by that person as a shareholder of the company.

Excessive management expenses.

39. (1) Subject to subsection (2), where a person carries on any business or other income earning activity and the Commissioner is of the opinion that any management expenses incurred by him exceed the amount which is reasonable having regard to the nature and extent of the management services rendered, the amount of the excess shall not be an allowable deduction.

(2) This section shall not apply to the extent that the income of the taxpayers concerned is adjusted under sections 36, 37 or 38.

Excessive undistributed profits of companies.

40. (1) Subject to the other provisions of this section, where the Commissioner is of opinion that a company has not distributed to its shareholders by way of dividend during an income year a reasonable part of the distributable income of the company for that income year, he may determine that the amount of the insufficient distribution shall be deemed to have been distributed as a dividend amongst the shareholders in that income year and they shall be assessable accordingly.

(2) An investment company shall be deemed to have made an insufficient distribution in every case where it has not so distributed eighty per cent of its distributable income amongst the shareholders and the undistributed portion of the eighty per cent of its distributable income shall be deemed to have been distributed as a dividend amongst the shareholders in the income year and they shall be assessable accordingly.

(3) In determining whether a company other than an investment company has distributed a reasonable part of its distributable income the Commissioner shall consider any sum expended or applied, or intended to be expended or applied, out of the income of the company for any of the following purposes to have been available for distribution amongst the shareholders—

(a) in or towards payment for the business, undertaking or property which the company was formed to acquire or which was the first business, undertaking or property of a substantial character in fact acquired by the company; or

(b) in redemption or repayment of any share or loan capital or debt, including any premium on such share or loan capital or debt, issued or incurred in or towards payment for any such business, undertaking or property, or issued or incurred for the purpose of raising money applied in or towards payment therefor; or

(c) in meeting any obligation of the company in respect of the acquisition of any such business, undertaking or property; or

(d) in redemption or repayment of any share or loan capital or debt, including any premium on such share or loan capital or debt, issued or incurred otherwise than for adequate consideration.

(4) *(a)* For the purposes of subsection (3), any share or loan capital or debt shall be deemed to be issued or incurred otherwise than for adequate consideration if it is issued or incurred—

(i) for consideration the value of which to the company is substantially less than the amount of the capital or debt, including any premium thereon; or

(ii) in or towards or for the purpose of raising money applied or to be applied in or towards the redemption or repayment of any share or loan capital or debt which itself was issued or incurred for a consideration specified in sub-paragraph (i) or which represents, directly or indirectly, any share or loan capital or debt which itself was issued or incurred for such consideration;

(b) For the purposes of this subsection and subsection (5) money applied or to be applied for any purpose shall be deemed to include money applied or to be applied in or towards the replacement of that money.

(5) Where a company is a shareholder who under this section is deemed to have received a dividend, the amount of that dividend shall, for the purposes of the application of subsections (1) and (2) to distributions of income by that company, be deemed to be part of its net income.

(6) *(a)* Where the proportionate share of a shareholder of a company in the distributable income of the company has under this section been included in his net income for any income year, the income tax payable in respect of the proportionate share may, if the shareholder so elects by giving written notice to the Commissioner at any time before the due date for payment of the income tax, be recovered from the company.

(b) Where notice has been given by a shareholder under paragraph *(a)*, the Commissioner may serve a notice on the company requiring the company to pay the sum stated in the notice, and, in default of payment, the income tax may be recovered from the company in the manner provided by this Act.

(c) Income tax paid by a company on behalf of a shareholder under paragraph *(b)* shall, on the subsequent distribution in whatever form of the undistributed income to the shareholder, be recovered by deduction from that distribution.

(7) Any undistributed income which has been assessed to income tax under this section shall, when subsequently distributed, be deemed not to form part of the income of any individual entitled to that income.

(8) Subject to subsection (9), for the purposes of this section "distributable income" means the difference between—

(a) the sum of—

(i) the net income derived by the company in the income year; and

(ii) any dividends deductible by the company under section 55 in that income year;

and

(b) the sum of—

(i) the amount of the income tax in respect of the chargeable income derived by the company in that income year; and

(ii) any sum which in that income year the company—

(A) subscribes for share capital of a developing or a development company or an export enterprise ;

(B) places on deposit with the Development Bank of Mauritius for at least one year; or

(C) advances on loan to the Government of Mauritius for at least one year.

(9) Any sum which is received by a company on—

(a) the sale of shares or repayment of share capital referred to in subsection (8) *(b)* (ii) (A) to the extent of the amount subscribed; or

(b) the withdrawal or repayment of the deposit or loan referred to in subsection (8) *(b)* (ii) (B) and (C),

shall be deemed to be distributable income and taken into account under this section either in the income year in which it is received or in the income year in which it was subscribed, placed on deposit or advanced on loan as the Commissioner considers reasonable.

Leases for other than an adequate rent

41. Where property owned by a person, by two or more persons whether jointly or in undivided ownership or by a *société* is leased to a relative of any of those persons or any associate of the *société* or to a related company, or where property owned by a company is leased to a shareholder or a relative of a shareholder or to any other person, and the rent is not an adequate rent for the property or the lease makes no provision for the payment of rent—

(a) there shall be deemed to be payable under the lease a rent that is equal to an adequate rent for the property, and that rent shall be deemed to be income derived by the lessor—

(i) if a rent is payable under the lease, in respect of the periods for which the rent is so payable ; or

(ii) if no rent is payable under the lease, in respect of such periods as the Commissioner determines ; and

(b) the rent deemed to be payable under paragraph *(a)* shall be deemed to accrue from day to day during the period in respect of which it is payable, and shall be apportioned accordingly.

Rights over income retained.

42. Where a person sells property or any right to income to a relative and retains or obtains the power to enjoy income arising from that property or from that right or retains or obtains the right to dispose of or direct or control the disposition of that income or of that property or right, the income shall be deemed to be income derived by the transferor and by no other person as if the sale had not taken place.

Application of arm's length test.

43. (1) This section shall apply to any case where—

(a) any business or other income earning activity carried on in Mauritius—

(i) is controlled by a non-resident ; or

(ii) is carried on by a non-resident company or by a company in which more than one half of the shares are held by or on behalf of a non-resident ; or

(b) in the carrying on of any business or other income earning activity in Mauritius, any person controlling that business or activity, by reason of his relationship or otherwise with any other person, is not in the opinion of the Commissioner at arm's length with that person with respect to any commercial or financial transaction ; and

(c) it appears to the Commissioner that the business or other income earning activity in Mauritius produces no net income or less than the amount of net income which in the opinion of the Commissioner might be expected to be derived from that business or activity.

(2) Where the conditions specified in subsection (1) are satisfied, the net income of any person carrying on a business or other income earning activity in Mauritius shall be the amount which the Commissioner determines would have been derived from that business or activity had all its commercial and financial transactions and relations been wholly at arm's length.

Tax avoidance arrangements avoid.

44. (1) Every arrangement shall be void for income tax purposes if and to the extent that its purpose or one of its purposes is tax avoidance, having regard to—

(a) whether the arrangement might reasonably be expected to have been entered into and implemented in that particular way if tax avoidance had not been its purpose or one of its purposes ;

(b) whether the rights and obligations arising under the arrangement might reasonably be expected to have been created under an arrangement not having tax avoidance as its purpose or one of its purposes ;

(c) the extent to which the emphasis in the arrangement is substantially on income factors ;

(d) the overall effect of the arrangement on the practical carrying on of any existing business or other income earning activity to which it relates ;

(e) the dependence on the taxpayer for the earning or accruing of income under the arrangement ;

(f) the extent of the control over the earning and disposition of income under the arrangement in practice exercised by the taxpayer ;

(g) any advantage or disadvantage accruing to the taxpayer from the arrangement ;

(h) the income tax and other implications of other courses of action open to the taxpayer at the time he entered the arrangement ; and

(i) any other relevant considerations.

(2) Where an arrangement is void the net income of a taxpayer party to the arrangement shall be adjusted as the Commissioner considers appropriate so as to counteract the tax advantage obtained by the taxpayer under the arrangement, having regard *inter alia* to the income that in his opinion would in all likelihood have been derived by the taxpayer, and including allowable deductions that in the opinion of the Commissioner would in all likelihood have been incurred by the taxpayer, had the arrangement not been entered into.

(3) Where an amount which, by virtue of this section, is included in or not deducted in arriving at the net income of a taxpayer is in the opinion of the Commissioner directly or indirectly included or reflected in the net income of any other taxpayer, the net income of the other taxpayer shall be reduced by that amount.

(4) In this section—

(a) " arrangement " means any agreement, plan or understanding, whether enforceable or unenforceable, and includes any step or transaction by which it is carried into effect ;

(b) " purposes " in relation to an arrangement, means the end in view or object of the arrangement, but does not include the motive or intention of the taxpayer except in so far as evidenced in the arrangement.

PART V—PERSONAL RELIEFS AND DEDUCTIONS FROM INCOME TAX

A—DEDUCTIONS FROM NET INCOME

Reliefs limited to individuals in Mauritius

45. Subject to section 46, no relief shall be allowable under this Part unless the taxpayer is a resident and is not a company.

HEB/CMP

CROWN LAW OFFICE

P.O. Box 5012
Telephone 71765

Law Society Building
26 Waring Taylor Street
WELLINGTON C.1.

30 September 1974

The Commissioner of
Inland Revenue,
WELLINGTON.

PROPOSED AMENDMENT TO S.108 BY WAY OF
SUPPLEMENTARY ORDER PAPER NO PCO 42A/2

Miss Hand of your department saw me this afternoon and showed me the proposed amendment to the Land and Income Tax Amendment Bill presently before Parliament, and informed me that the paper had to be printed in final form this evening for submission to the Minister of Finance tomorrow. The proposed new section does approach the matter from a somewhat different angle and in the time available it would be quite impossible for me to express any opinion on its efficacy.

(H. E. Blank)
Crown Counsel

GL

H.O.22

25 September 1974

The Minister of Finance,
Parliament Buildings,
WELLINGTON.

MAIN POINTS ARISING IN DISCUSSIONS WITH CHAMBER OF COMMERCE AND FEDERATED FARMERS ON ANTI TAX AVOIDANCE PROVISIONS

As requested Mr O'Donnell and I have reviewed the points made at the two meetings with you in relation to the new version of Clause 8 of the No.2 Tax Bill. I report as follows:

1. Scope of new Provisions

Sub-clause (1) of the new version of section 108 of the Tax Act states, inter alia:

> "Every contract (etc.) ..... shall be absolutely void ..... for income tax purposes if ..... it has .....
>
> (a) as its purpose or effect or as one of its purposes or effects (not being a merely incidental purpose or effect) ..... the avoidance of tax (etc.) .....
>
> (b) Whether or not that contract (etc.) is an ordinary business or family dealing."

Previously the old section 108 -

- So far as (a) above is concerned referred to "the purpose or effect" and
- as regards (b) did not have any reference to business or family dealing.

The Chamber of Commerce and Federated Farmers submitted that the widening from the previous "the purpose or effect" test and the exclusion of reliance on ordinary business or family dealing as justifying the tax avoidance has taken the scope of the section too far.

Comment

A short and effective answer - and one which you could probably use in debate - is that the new version endorses in more or less the same terms dicta from Justice Woodhouse in the Elmiger case. He stated:

> "Accordingly it is my opinion that family or business dealings will be caught by s.108 despite their characterization as such, if there is associated with them the additional purpose or effect of tax relief (in the sense contemplated by the section) pursued as a goal in itself and not arising as a natural incident of some other purpose. If this were not so, I suppose an appropriate legal window dressing could still be devised to defeat the general objects of the section."

The Elmiger dicta gave what was considered a balanced line between the Revenue and the rights of the taxpayer to deal with his assets without adverse tax effects. The guidelines issued by the Department following the Elmiger case showing the "Whites" and the "Blacks" (i.e., the acceptable and unacceptable) gave what is considered this proper balance.

Since the Elmiger decision, dicta from New Zealand cases (and not an Australian case as you may have been lead to believe) and from the Privy Council in relation to a New Zealand case has tended to erode the position of the Revenue as stated in Elmiger. For instance:

- It has been suggested that tax avoidance had to be the "sole or principal purpose".
- Also that the taxpayer needed to be a direct party to the arrangement.
- Undue weight was being given to "ordinary business" or family dealing" as justifying the arrangement compared with the dicta as above of Justice Woodhouse on this point.

It is also considered that not only is the new version of section 108 in line with what Justice Woodhouse said but also gives the same effect as pronounced in the Australian case of Hollyock in which the Judge:

- Disagreed with dicta from New Zealand cases that tax avoidance had to be the "sole or principal" purpose;

- Nevertheless stated that tax avoidance needs to be something more than an "incidental" feature;

- Implied that an arrangement, etc. could be acceptable for tax purposes if the "income producing substance" (e.g. permanent assets) were effectively transferred.

2. The question of whether the section should state that it does not apply to permanent transfers of permanent assets

You will recall that the Federated Farmers representatives were apprehensive that the new section would discourage farmers from making over their farms to their families in their lifetime because of the threat of having the arrangements nullified as tax avoidance devices under the new section.

We in Inland Revenue are convinced that the dicta from the Courts, even though based on the old section, when applied to the new version of section 108, would preclude this from happening.

There are really two reasons for this:

(i) The taxpayer could argue that if he has made over his permanent assets permanently the income arising from those assets belongs to the new owner of the assets and, therefore, the tax liability is that of the new owner of the assets and not of the old - the latter therefore could not be relieved of this liability.

(ii) In any case any avoidance of tax by the original owner would be merely incidental to the transfer of the assets and, therefore, expressly excluded from the new version of the section.

As indicated the specific reference to "incidental" in the new version gives the same effect in this context as that placed on the old section by Justice Woodhouse.

As mentioned to you after the representatives had left the two meetings, Inland Revenue did consider making specific reference to the effect that the section was not to apply to permanent transfers of permanent assets but discarded this approach on the grounds that there are so many different ways in which businesses and sections of businesses can be transferred that it would be difficult to adequately cover the position by specific reference.

3. Conclusion

While there must always be a degree of uncertainty in this area Inland Revenue considers that the new version of section 108 does no more than give the proper balance between the Revenue and the taxpayer.

To sum up:

- Amendments were needed to the section to give effect to the criticism by the Courts that the old section was "unfinished", that is it did not state to whom the income involved was to be assessed when the arrangement etc. was voided for tax purposes.

- Opportunity was taken in the amendments to remove the adverse effects of dicta from New Zealand cases in the period subsequent to Elmiger.

- The amendments do no more than restate what Justice Woodhouse said in Elmiger in fact the language of the section and the quote (above) from his judgment, are very similar.

- The amendments give the same effect as the Australian decisions.

- The language of the old section is otherwise preserved as far as possible - so as to obtain the interpretations already given - rather than completely rewording the section. To do so would probably have meant a new series of cases.

In all circumstances no further amendments seem necessary.

(D. A. Stevens)
Commissioner of Inland Revenue

GL

H.O. 17

23 September 1974

The Minister of Finance,
Parliament Buildings,
WELLINGTON.

SUBMISSIONS FROM FEDERATED FARMERS ON
CLAUSE 8 NO.2 TAX BILL - ANTI TAX AVOIDANCE PROVISION

You are to see representatives from Federated Farmers on Tuesday morning.

To assist you in considering their likely representations I enclose copies of the following:

(i) A letter of 12 September I received from Federated Farmers on Clause 8

(ii) My reply to them

(iii) The guidelines which are referred to in that reply and which were issued to seminars by this Department in 1971.

These guidelines were considered to give a reasonable balance between the Revenue and the taxpayer at the time and the main purpose of the new section is to restore the position given therein. You may be interested in the types of situations which were regarded as acceptable and unacceptable respectively.

(D. A. Stevens)
Commissioner of Inland Revenue

Encls.

GL

H.O.17

23 September 1974

The Minister of Finance,
Parliament Buildings,
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(D. A. Stevens)
Commissioner of Inland Revenue

Encls.

LTK

174

23.9.74

Mr R. B. McLuskie,
Assistant General Secretary,
Federated Farmers of New Zealand (Inc.),
P. O. Box 715,
WELLINGTON

Dear Mr McLuskie,

I refer to your recent submissions on the Land and Income Tax Amendment (No.2) Bill now before the House.

On the question of Clause 8 which introduces the new anti-tax avoidance measures, I understand the Commissioner of Inland Revenue has already sent you a copy of the new version which it is proposed to introduce in a Supplementary Order Paper. The Commissioner will have also explained the main changes in the new draft.

One further point is that the retrospective effect of the clause has been reconsidered. It is now proposed to further amend the clause in respect of arrangements which were entered into prior to the date of introduction of this year's income tax legislation. To the extent that income is applicable to rights and obligations which arise from arrangements made prior to that date the income will be subject to the old law as represented in the existing section so long as those rights and obligations remain binding on all parties to the arrangements.

I trust that these now largely allay the fears and doubts you expressed about the clause as originally drafted but I would be pleased to consider any further submissions you may care to make on the proposed new version of the clause.

Yours faithfully,

Hon. R. J. T.

Minister of Finance

LTK

174.

23 SEP 1974

Mr R. B. McLuskie,
Assistant General Secretary,
Federated Farmers of New Zealand (Inc.),
P. O. Box 715,
WELLINGTON

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I trust that these now largely allay the fears and doubts you expressed about the clause as originally drafted but I would be pleased to consider any further submissions you may care to make on the proposed new version of the clause.

Yours faithfully,

(Sgd.) R. J. TIZARD

Minister of Finance

Hon. Minister of Finance

Original submitted herewith for your signature.

Commissioner

91 9T 7x

LTK

23 SEP 1974

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Assistant General Secretary,
Federated Farmers of New Zealand (Inc.),
P. O. Box 715,
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I trust that these now largely allay the fears and doubts you expressed about the clause as originally drafted but I would be pleased to consider any further submissions you may care to make on the proposed new version of the clause.

Yours faithfully,

(Sgd.) R. J. TIZARD

Minister of Finance

Commissioner of Inland Revenue
Referred for draft reply

FEDERATED FARMERS OF NEW ZEALAND (INC.)
HEAD OFFICE: 7TH FLOOR, C.U. WOOL HOUSE, 140-144 FEATHERSTON STREET, WELLINGTON, C.1, N.Z.
P.O. BOX 715 TELEGRAMS: "FARMLANDS" TELEPHONE 46-889

27 August 1974

174

Hon. W. E. Rowling,
Minister of Finance,
Parliament House,
WELLINGTON.

Dear Mr. Rowling,

Enclosed please find a submission to you on the Land and Income Tax Amendment Bill (No.2). In this submission the Federation expresses its deep concern about some clauses in the Bill, and suggests amendments. A deputation from the Federation would like to meet you to discuss this submission. Would you please let us know a time that would be suitable for you.

OK?
I guess so.
Ow.
10.15.
Tuesday 3 Sept.

Yours sincerely,

R. B. McLuskie,
Assist. Gen.Secretary.

SUBMISSION TO THE HON. W. E. ROWLING, MINISTER OF FINANCE, ON THE LAND AND INCOME TAX AMENDMENT BILL NO.2, 1974.

1. Federated Farmers wish to express concern to you about several clauses in the Land and Income Tax Amendment Bill(No.2),and respectfully ask that serious consideration be given by you to the amendments we suggest.

2. Clause 8 of the Bill which repeals and replaces with another provision Section 108 of the Land and Income Tax Act 1954, later amended by Section 16 (1) of the Land and Income Tax Act No.2, 1968, in our opinion goes to extreme lengths to correct a number of difficulties which the Courts have pointed out in the present legislation.

3. Over the years the New Zealand Courts have given a number of decisions which have spelt out the framework for the application of the present Section 108 of the Act. However, it has become apparent that there are some area which have posed difficulties for the Courts and which it has been suggested should be the subject of some further legislative provision. It has no where been suggested by the New Zealand Courts or the Privy Council, to which some New Zealand cases have gone on appeal, that Section 108 be widened to the extent it has been under the proposed amendment whereby virtually every arrangement, including what would be regarded at present as bona fide family trusts, can be upset by the Commissioner of Inland Revenue.

4. The existing Section 108 was designed to strike down taxation arrangements which have tax avoidance as their principal purpose, and in this the Section has the support of many. At the same time it has long been accepted in this country, and indeed in most democratic countries, that a taxpayer has the right to so order his affairs that he can make reasonable provisions for his family. This is a situation which has been recognised and made use of by many in the farming community. The Courts have also spelt out the exemption of ordinary business and family dealings from the provisions of the existing Section 108.

5. The proposed legislation will, however, have the effect

....

of allowing the Commissioner to strike down those ordinary business and family arrangements. Under the proposed Section 108 the test of principal purpose which the Courts have construed from the existing Section 108(1) has been explicitly removed. Under the existing legislation tax avoidance had to be a principal purpose of any agreement or arrangement before it could be upset by the Commissioner of Inland Revenue.

The Federation strongly urges that the principal purpose test should be continued as an integral part of the legislation on agreements purporting to alter the incidence of taxation. If family trusts can be upset, even when tax avoidance are not their principal purpose, then the way is clear to upset many bona fide family trusts.

As so often happens in these cases a subsidiary effect is that a taxpayer's affairs are so ordered that there is a lessening of the burden of taxation. The Federation does not support those artificial schemes whereby taxation avoidance is a principal purpose. We do, however, support the right of the taxpayer to enter into family arrangements and set up trusts in order to dispose of property to the best advantage among members of his family. The Federation accordingly asks that the proposed Section 108 be deleted to be replaced with the present Section 108 with the specific inclusion of the principal purpose test by adding the word 'principal' before the word 'purpose' in the fifth line of the existing Section 108 so that it will now read:

> "Agreements purporting to alter incidence of taxation to be void - Every contract, agreement, or arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the Commissioner for income tax purposes in so far as, directly or indirectly, it has or purports to have the principal purpose or effect of in any way altering the incidence of income tax, or relieving any person from is liability to pay income tax."

....

6. The proposed Section 108(1) also contains "reconstruction" machinery whereby the Commissioner after striking down an agreement is enabled to reconstruct the arrangement in order to allow full assessment of the tax avoider. The Federation is of the opinion that reconstruction machinery should be incorporated into the New Zealand legislation. This is in line with suggestions by both the Privy Council and the Court of Appeal. In other words if a transaction is annihilated under the Section there should be machinery which would permit the Commissioner to assess taxation. However, the machinery proposed in the Bill would have the effect of assessing tax against persons who have already disposed of the income. We consider that the person in receipt of the income arising from the arrangement should be the person to pay the tax under any reconstruction.

7. The proposed Section 108 in Subsection (2) removes a defence which has been long recognised by the Courts and that is the defence of "ordinary family dealing". On the basis of "ordinary family dealing" many farmers throughout New Zealand have established trusts and entered into arrangements for the protection of their properties. These arrangements are often an integral part in the settling of farmers' sons upon the land. Indeed because a farmer has been able to resort in confidence to these measures younger persons have been able, in an orderly way, to take over family properties, often with beneficial results in productivity. The removal of this defence, together with the removal of the principal purpose test referred to earlier will create a grave situation in the farming industry with regard to "ordinary family dealings". Transactions and arrangements, which up until now could be undertaken in confidence, will no longer be able to be undertaken with any degree of certainty as to their outcome. There will no longer be the encouragement for the older farmer to transfer his farming assets to sons, with consequent influx of new ideas, new methods and renewed drive. Productivity will undoubtedly suffer. The Federation strongly urges, therefore, that the proposed Section 108(2) be deleted from the Bill.

....

8. The proposed Section 108(3) is described by the Inland Revenue Department as a subsection to cover a form of tax avoidance called dividend stripping. In our opinion the subclause as worded goes far beyond dividend stripping in its scope, and indeed would bring within its scope many ordinary business transactions. In the Federation's opinion the clause should be redrafted in order to catch those techniques which can clearly be described as dividend stripping. The Federation has no redraft of the clause to submit. However, we are concerned at the wide scope of the proposed subclause.

9. The retrospective effect of the proposed legislation is also a matter of great concern to the Federation. The proposed Section 108 states that the Section shall apply with respect to the tax on income derived in the income year commencing on the first day of April 1975 (whether the contract, agreement or arrangement was made or entered into on, before or after that date) and in every subsequent year.

If our submissions with respect to the proposed Section 108(1), together with our request that the proposed Section 108(2) is deleted, are heeded, then the retrospective clause will not necessarily be of concern. However, if the Bill is proceded with in substantially its present form, then the retrospective clause could cause a great deal of harm, as the Section would then apply to any contract, agreement or arrangement made before the 1st April 1975.

As we have indicated above the proposed legislation is so wide that many transactions which at present would be considered valid transactions entered into as "normal family dealings" could be upset. We ask, therefore, that the Section apply only to income which is subject to an arrangement entered into after the Bill has become law.

10. As you are aware the Federation has long supported the establishment of adverse event bonds, and welcomes the introduction of legislation to cover the taxation aspects of these bonds. We are, however, concerned at the treatment under the proposed legislation in clause 24 of adverse event bonds on the retirement of a taxpayer from farming or on the death of the taxpayer. As subclause 6 and 7 of clause 24 are presently drafted, any bond held

....

by a taxpayer on his death or retirement is redeemed and the amount received will be treated as assessable income derived from the taxpayer immediately before his death or retirement.

The Federation considers these subclauses, unless they have appropriate provisos, will hamper the optimum utilisation of the bonds by farmers and will discourage investment in them, particularly by older farmers.

The Bill, as at present drafted, also causes inequities between those farmers operating on an individual, completely self-employed basis and those farmers operating in a company structure or trust.

11. The Federation urges that provision should be included in clause 24 to allow spreading of income received by the redemption of adverse event bonds on the death or retirement of the taxpayer. Spreading provisions are available for amounts held in the income equalisation reserve account for the taxpayer at the time of his death or retirement. While recognising that the five-year limits on deposits somewhat simplify the spreading of equalising reserves, we believe similar provisions, properly qualified, should be included in clause 24. We, therefore, suggest that following subclause 6 of clause 24 the following be inserted:

> "Provided that to the extend that the amount so refunded consists of a bond or bonds purchased in any accounting year earlier than the year of retirement, the taxpayer shall, if he so elects, be entitled to allocate to that earlier year, or any year up to ten years prior to the retirement of the taxpayer whichever is the later, an amount not exceeding the amount of those bonds, or as the case may be of that bond. Any amount so allocated to any such earlier year shall be deemed to be assessable income derived by the taxpayer in that year".

12. The Federation respectfully suggests that following subclause 7 of clause 24 the following be inserted:

.....

"Provided that to the extent that the amount so refunded consists of a bond or bonds made in respect of any accounting year earlier than the year of death, the trustee shall be entitled to allocate to that earlier year, or any year up to ten years prior to the death of the taxpayer, whichever is the later, an amount not exceeding the amount of those bonds, or as the case may be of that bond. Any amount so allocated to any such earlier year shall be deemed to be assessable income derived by the taxpayer in that year."

"Provided also that, if the trustee does not make an election in accordance with the first proviso to this subsection, he shall, if he so elects be entitled to allocate, in such amounts as he specifies, the whole or part of any bonds or any bond included in the amount remaining held by the taxpayer at the date of his death to any time or times subsequent to the death of the taxpayer, being a time or times not later than -

(a) The expiration of 5 years after the end of the accounting year in respect of which the bonds or, as the case may be, the bond, was purchased; or

(b) The end of 3 years immediately after the death of the taxpayer, -

whichever is the earlier. Any amount allocated by the trustee under this proviso shall continue to be held as bonds until the time allocated as aforesaid in respect of that amount, and shall be redeemed and the amount so received be deemed to be assessable income derived by the trustee at the time so allocated."

SUMMARY

1. Federated Farmers of New Zealand considers that clause 8 of the Bill dealing with agreements purporting to alter the incidence of taxation is so wide that it gives power to the Commissioner of Inland Revenue to strike down most normal family trust arrangements.

....

2. The Federation urges that an amendment to the existing Section 108 be confined to the addition of the words 'principal' before the word 'purpose' in the fifth line of the existing section, and that a reconstruction clause be added which would give power to the Commissioner to assess income resulting from the transaction as income in the hands of the recipient of that income.

3. The Federation urges that the proposed Section 108(2) be deleted and that the proposed retrospective application of Section 108 be amended, so that if the clause goes forward in substantially its present form, then it only applies to arrangements made or entered into after the Bill becomes law.

4. The Federation submits that clause 24 be amended to enable spreading provisions at the time of the death or retirement of the taxpayer.

GL

Mr W.M. Rogers,
Secretary,
New Zealand Law Society,
P.O. Box 5041,
WELLINGTON.

Dear Mr Rogers,

Since I wrote to you on 23 September I have, of course, had the very helpful discussions with you and other representatives of your Society on the wording of Clause 8 of the No.2 Tax Amendment Bill.

I think it is true to say that your Society and I are in general agreement as to what should be the objective of a clause of this nature, namely, to achieve the right balance between the Revenue and the rights of the taxpayer to transfer assets to members of his family.

I think we would also be in general agreement that it would be in line with this objective that if a taxpayer transferred permanently his permanent assets such as freehold land or an interest therein, or his shares in a company to members of his family, such a transfer in itself should not be regarded as a form of tax avoidance. On the other hand I think we would agree that if the taxpayer attempted to divert the income from such assets to members of his family without transferring the assets themselves that the matter should be at least considered in relation to the anti avoidance provisions. This, of course, is a broad generalisation and could be affected by other factors in a particular case.

It brings me to the point, of course, that there can be differences of opinion as to what is the appropriate way to express such an objective in a clause of this nature. As you know, several methods were considered, as for instance, whether the clause should attempt to specify the particular situations which are to be struck down or specify the type of situation which would be free of any challenge. A third alternative would be to spell out in some detail the criteria which should be taken into account in considering whether tax avoidance is present in a particular arrangement.

I could say that all these approaches have their own inherent difficulties bearing in mind the great variety of circumstances in which taxpayers transfer their assets or their rights to income to members of their families.

In the final analysis I have decided that the best approach in relation to section 108 is:

- firstly, of course to get over the difficulty which the Courts have often referred to about the "unfinished" nature of the section;

- secondly in respect of other amendments which were considered necessary to follow very closely the dicta of Justice Woodhouse in the Elmiger Case which at the time was considered to have drawn the correct dividing line between the acceptable and the unacceptable;

- and finally to otherwise follow the language of the old section 108 rather than attempting a host of new terms and definitions which could have caused their own difficulties.

I am confident that the new Clause 8 will place the tax avoidance provisions in their proper perspective and I would again thank your Society for its real help in the matter.

Yours faithfully,

Minister of Finance

LTK

173A.

23 SEP 1974

The Secretary,
New Zealand Chambers of Commerce,
P. O. Box 1071,
WELLINGTON

Dear Sir,

I refer to your recent submissions on the Land and Income Tax Amendment (No.2) Bill now before the House.

On the question of Clause 8 which introduces the new anti-tax avoidance measures, I understand the Commissioner of Inland Revenue has already sent you a copy of the new version which it is proposed to introduce in a Supplementary Order Paper. The Commissioner will have also explained the main changes in the new draft.

One further point is that the retrospective effect of the clause has been reconsidered. It is now proposed to further amend the clause in respect of arrangements which were entered into prior to the date of introduction of this year's income tax legislation. To the extent that income is applicable to rights and obligations which arise from arrangements made prior to that date the income will be subject to the old law as represented in the existing section so long as those rights and obligations remain binding on all parties to the arrangements.

I trust that these now largely allay the fears and doubts you expressed about the clause as originally drafted but I would be pleased to consider any further submissions you may care to make on the proposed new version of the clause.

Yours faithfully,

(Sgd.) R.J. TIZARD

Minister of Finance

Hon. Minister of Finance

Original submitted herewith for your signature.

Commissioner

9191 74

LTK

173A.

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New Zealand Chambers of Commerce,
P. O. Box 1071,
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I trust that these now largely allay the fears and doubts you expressed about the clause as originally drafted but I would be pleased to consider any further submissions you may care to make on the proposed new version of the clause.

Yours faithfully,

Minister of Finance

NZ Society of Accts

LTK

167

23 SEP 1974

Mr W. A. Clark,
Secretary,
National Taxation and Legislation
Committee,
New Zealand Society of Accountants,
P. O. Box 10046,
WELLINGTON

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(Sgd.) R. J. TIZARD

Minister of Finance

Copy of original correspondence enclosed

28/11

167

LTK

23 9. 74

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Yours faithfully,

(Sgd.) R. J. TIZARD

Minister of Finance

Hon. Minister of Finance

Original submitted herewith for your signature.

Commissioner

9/9/74

LTK

Commissioner of Inland Revenue
Referred ~~for draft reply~~
14/10/75
23 SEP 1974

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National Taxation and Legislation
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New Zealand Society of Accountants,
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Yours faithfully,

(Sgd.) R. J. TIZARD

Minister of Finance

SUBMISSION TO: Honourable W.E. Rowling, Minister of Finance.

FROM: National Taxation and Legislation Committee, New Zealand Society of Accountants.

SUBJECT: Land and Income Tax Amendment Bill (No.2)

We have examined the clauses of the Bill and wish to make the following submissions:

Clause 8: Agreements Purporting to Alter Incidence of Taxation to be Void

(1) General Comments

Clause 8 of the Bill contemplates wide changes to the Act. It now appears that any transaction which in any way alters a taxpayer's liability to pay income tax could be covered by the new section 108. This is a substantial change from the existing legislation and in view of the uncertainties as to the extent of the proposed amendment and the apprehension felt by many members of our profession who have studied the clause, we submit that the clause should be deleted from the No.2 Bill and re-introduced in a later Bill after further examination and study by Government and interested parties.

If the clause cannot be deleted from the Bill, however, we submit that it should be amended in such a way as to make the new section much more specific as to the classes of transaction which it is, or is not, designed to strike down or annihilate.

Clause 8 has given rise to much concern among our members in public practice and these submissions reflect the views of members and branch taxation committees throughout the country. If the reasoning behind some of our submissions is not acceptable we would suggest that the fact that a considerable number of our members have read into clause 8 interpretations which we understand are not intended is itself sufficient to justify postponement of the clause and the introduction of a more specific section 108.

Before enlarging on our submissions we emphasise that the Government has the full support of the Society to the extent that this clause is designed to prevent arrangements whereby any person deliberately sets out, by artificial methods, to evade or avoid the payment of his proper liability for income tax. Our concern is, however, that in attempting to catch the offender the legislation has been drawn so wide as to be capable of destroying many legitimate and desirable transactions. Whereas the present section 108 has generally been a successful and practical anti-avoidance measure the Society does recognise, nevertheless, that the time is now appropriate for Government to remedy a number of well known defects in its present wording. In suggesting that the clause proposes making changes beyond those defects commented upon from time to time by the Courts we particularly have in mind those proposed changes relating to the "principal purpose" test, "ordinary family dealings" and "dividend stripping" arrangements.

(2) Subclause (1), Subsection (1) of proposed section 108

(a) Date of Application

We submit that in subsection (1) of the proposed section 108 the words "whether before or" should be deleted from the second line. We consider that existing arrangements should only be challenged under the present legislation. There has been a precedent for this type of arrangement under the sections relating to specified trusts and to property syndicates.

(b)/

(b) Purpose and Effect

Undoubtedly the main causes of our concern are the following underlined words in subsection (1) of the proposed section 108:

> "... it has or purports to have the purpose or effect, or purposes or effects which include the purpose or effect (whether or not the principal purpose or effect) of in any way altering the incidence of income tax ....."

When the other provisions of the proposed section are added to the above it is our opinion that the section taken as a whole is undesirable because:

I. The classes of transaction covered by the section would be very extensive and the Commissioner of Inland Revenue would have an unnecessarily wide discretion as to when the section is to apply. In Gerards case the Court of Appeal asked that the section be made more precise and state the classes of transaction to be struck down. We submit that the proposed section increases rather than diminishes the uncertainty of the existing section.

not discretion.

II. Interpreted literally, the section could make void the natural and desirable disposition of assets to other members of a family group. This is particularly important to our farming and secondary industries.

III. Pending the availability of new case law the taxpayer and his advisers will be placed in an uncertain position. It could possibly be held that a perfectly legitimate commercial or family arrangement is void against the Commissioner because, apart from its main purposes and effects, it has the purely incidental effect of altering to a relatively minor extent the incidence of taxation.

The point has been made to us by the Commissioner that the "purpose or effect" provisions had to be amended to ensure that obvious tax avoidance schemes did not escape section 108 merely because the tax avoidance was not the sole or at least the principal purpose or effect. We accept this as partially valid. On the grounds of equity we consider the proposed change would be fairer if the "purpose or effect" provision applied where one of the principal purposes or effects is the alteration of the incidence of taxation.

We are also aware that the Commissioner considers that, based on decisions of the Australian Courts, the proposed new section 108 would not act to void those contracts, agreements or arrangements where tax avoidance is a purely incidental feature. However as the wording in the proposed subsection (1) is different and goes beyond the equivalent Australian section it is dangerous to assume that New Zealand courts will place the same interpretation on the subsection. We can find little support for the Commissioner's interpretation that the Courts would not apply subsection (1) where the alteration in the incidence of taxation is incidental.

A further point made by the Commmssioner is that where a person makes over permanent and outright an asset to members of his family or a family trust, then that transaction of itself will not be caught by the section.

While we are extremely grateful to the Commissioner for his comments, we must emphasise that our concern and attention at this point is directed towards the literal meaning of the proposed section and not the Commissioner's proposed application thereof. In this respect we make the following points:

I. The "purpose or effect" provisions have changed from being too narrow to being far too wide.

II./

II. With respect we cannot see that the Australian attitude regarding "incidental" tax avoidance, being based on legislation which differs significantly from the proposed section 108, can be held out as a precedent for New Zealand taxpayers.

III. If it is not intended to upset arrangements where any tax avoidance is purely incidental to a legitimate and desirable principal purpose, then we suggest it would be reasonable to specifically exclude such arrangements from the section. We cannot support the view that suggests that the correct interpretation of the proposed legislation means that where tax avoidance is an incidental feature of a contract, agreement, or arrangement, the contract agreement, or arrangement will not come within the new subsection (1).

IV. We suggest that if the relevant part of subsection (1) were reworded along the following lines then the legislation would be more specific in its application but still sufficiently strong to achieve its objectives:

"... it has or purports to have the purpose or effect or purposes or effects which include the purpose or effect, (not being incidental purposes or effects), of in any way altering the incidence of income tax ...."

V. We would further suggest that permanent and outright dispositionsof property and other common transactions which are not intended to be upset by section 108, should be specifically excluded.

It is regarded as fundamental that on an issue as important and controversial as the incidence of taxation, the rules should, as far as reasonably possible, be clearly laid down by Government through its legislation. The proposed enactment will deny the taxpayer this fundamental right to know what the law is.

(c) Reconstruction Provision

With reference to the Commissioner's power to deem that income was derived by certain persons, we consider that the meaning of the words "would have, or might be expected to have, or would in all likelihood have ...." are obscure and we submit that the more normal test of reasonableness would better serve the purposes of the section. The wording could be along the following lines:

"... would have or might reasonably have been expected to have ...."

While we appreciate the Court's concern at the present defect in section 108 in that the Commissioner does not have specific power to make assessments to counter tax avoidance and that even under the proposed legislation the Commissioner's powers are subject to review by the Taxation Board of Review or the Courts on objection by the taxpayer, we feel the wording we have suggested is more definitive.

As the proposed change could still have the effect of assessing tax against a taxpayer who has disposed or surrendered the right to income from which the tax would in the usual course be paid, we suggest that the uncertainty would be removed if the taxpayer receiving the income as a result of the arrangement etc. is assessed with the tax at the rate the other taxpayer would have paid. The party being taxed would then be entitled to claim legitimate deductions and exemptions instead of the notional deductions necessary under the proposed subsection.

(3)/

(3) Subclause (1), Subsection 2 of proposed section 108

(a) Family Dealings

Read in conjunction with subsection (1) of the proposed section 108, subsection (2) could be used to void many socially and economically desirable arrangements within the category of "ordinary family dealings" despite any contention that for the subsection to apply it would still be necessary in "family dealings" for there to be a purpose of tax avoidance.

Our concern can best be expressed by way of example. It is generally acknowledged that one of the ways in which a farmer can transfer his property to his son is to sell the farm to the son and accept a mortgage back for the unpaid purchase money. Interest would probably not be charged by the father. We submit that legitimate and reasonable family transactions involving an outright and permanent disposition of property and a valid and genuine alienation of income should be specifically excluded from the subsection. If this and other similar "family dealings" are to be upset then it will not only impede the desirable transfer of farm land to the younger generation but will dissipate the equity of our farming units.

Over the years the Courts, both in New Zealand and abroad, have accepted the principle that tax avoidance legislation did not, and should not, apply to transactions that are capable of explanation by reference to ordinary business or family dealings. Such transactions have not been annihilated unless they were artificial. Should the proposed subsection be enacted we foresee the Courts having considerable difficulty interpreting the proposed subsection. Considering all aspects, therefore, the Society recommends that this subsection be deleted from the Bill. Should this recommendation not be acceptable then we further submit that the purpose and effect of this subsection would be better understood if the word "solely" were inserted as follows in the sixth line of the subsection:

> "... shall be excluded from the operation of that subsection solely by reason of the fact ...."
>
> and that the definition "any members of any family" be qualified in such a way as to exclude small or minor interests or shareholdings.

(4) Subclause (1), subsection 3 of the proposed section 108

"Dividend Stripping" Provision

The Commissioner has advised that subsection (3) of the new section is intended to be limited in its application to the device commonly known as "dividend stripping". We submit that there is a good case for legislation dealing with this type of transaction. However, if such transactionsare not already covered by section 108 or the proposed subclause (1) we suggest that any such new legislation should be drafted so as to specifically describe what is in fact "dividend stripping".

We consider that, read in conjunction with subsection (1), this subsection could cover a wide range of legitimate normal business transactions involving the sale and purchase of shares in companies with undistributed profits. As with subsection (1) we are of the opinion that this subsection has been drawn far wider than is necessary and adds further to the difficulties of the taxpayer.

We/

We submit that the "dividend stripping" type of transaction should be capable of much finer definition and that the subsection should be drafted so as to leave no doubt that normal business dealings involving shares will not be upset. We also make the point that the factor which gives rise to the "dividend stripping" activity is the "double taxation" on company and dividend income and some easing of this situation could itself make "dividend stripping" less prevalent.

(5) Subclause (3)

Retroactive Effect

Sub-clause (3) provides that the new section will apply as from 1 April 1975 to all contracts, agreements or arrangements made on or before that date. Many of these contracts etc. now in existence have been made on the basis of Court decisions, and we submit that it is inequitable to include in this amending legislation a provision which in effect reverses Court decisions applying to established contracts. We submit that the new section should apply only to all contracts etc. made after the introduction of the Bill or to renewals or extensions of existing contracts after that same date. The loss of revenue would probably only be minor and individuals who had acted on advice given in good faith, would be protected.

Clause 16: Revised Assessments where Assets Sold after Deduction of Depreciation Allowances

Subclause (1) empowers the Commissioner to treat as assessable income the excess of the selling price of an asset over its book value. As the excess of the selling price over book value could well include an excess over original cost the effect would be to empower the Commissioner to tax the excess as a capital profit. To avoid this we submit that the following words should be added to the subclause:

> "Provided that the amount of the excess so assessable shall not in any case exceed the aggregate of the deduction allowed by way of depreciation in respect of that asset".

Subclause (1) also empowers the Commissioner to tax recovered depreciation notwithstanding that some part of that depreciation may never have been allowed as a deduction. Accordingly we submit that the following proviso should be added to the subclause:

> "Provided that where the deduction allowed in respect of depreciation has in any preceding year been less than the total depreciation on that asset, the excess so assessable shall not exceed an amount calculated in accordance with the following formula:
>
> $\frac{a}{b} \times c$
>
> Where 'a' is the amount of depreciation allowed as a deduction
>
> 'b' is the total depreciation on that asset, and,
>
> 'c' is the excess otherwise assessable under this section".

In subclause (4) which proposes to amend section 117 of the principal Act by adding to subsection (5) subsections (5A) and (5B), it is stated in (5B) (a) that the part of any insurance claim received for repairable damage to an asset that exceeds the amount spent on repairs shall be deducted from the depreciated value of the asset. It is submitted that it would be preferable if taxpayers were given a choice either to deduct the excess from the depreciated value of the asset or to treat the excess as taxable income.

Clause 19/

Clause 19: Transitional Provisions in Respect of Certain Assets

Subclause (1)(b) requires that for a taxpayer to be entitled to the right of election the plant or machinery must not be "acquired or installed" until after 31 March 1975 whereas in previous clauses of this Bill dealing with the repeal of existing depreciation allowances the expression "first used in the production of assessable income" is used. Apart from the fact that the legislation should be consistent in this regard the present wording of the clause would be unfair to a taxpayer who enters a binding contract before say 30 May 1974 and wishes to claim an investment allowance but is precluded from doing so because, while the asset was installed on 31 March 1975, it was not first brought into use until 1 April 1975. We submit, therefore, that the following should be substituted for the present subclause (1)(b):

"1.(b) That plant or machinery was not first used in the production of assessable income until after the 31st day of March 1975, and"

Clause 27: Special Provisions for Income Equalisation Reserve Deposits for the Accounting Year 1973-74

The third paragraph of subsection (1) of section 136C of the principal Act provides that once a voluntary refund has been made to a taxpayer in respect of an accounting year in accordance with section 136E of the Act, no further deposits may be made for the same accounting year unless the Commissioner is satisfied that, before the subsequent deposit is made, the refund had been wholly applied for the purposes of the development or expansion of the business.

While this restriction was removed for the 1973 year it could be applied to future years. In the present situation farmers making withdrawals from the scheme on 1 July 1974 and nominating such withdrawals as 1975 income could be precluded from making further deposits relating to the 1975 tax year if they so desired. The present uncertainty is most unsatisfactory to farmers who find it difficult to plan ahead while market realisations are so unpredictable and it is recommended that the relative subsection of the Act should be withdrawn, or, alternatively, that provision be made in the Act that the restrictions which were lifted for the 1973 year also be extended for the 1974 and 1975 years and that the position be reviewed annually so that farmers will know that the restriction will not apply for at least two years in advance.

Woodward House,
99 The Terrace,
WELLINGTON.

26 August 1974

1974 Reign file for Bill.

IR 217

Commissioner of Inland Revenue

Referred for ~~draft reply~~ MIN. 201

14/10/74

INLAND REVENUE DEPARTMENT

HEAD OFFICE
DOMINION LIFE ARCADE
WELLINGTON, N.Z

P.O. BOX 2198

TELEPHONE: 40-070

Please address all correspondence to – The Commissioner of Inland Revenue

20 September 1974

Minister of Finance,
Parliament Buildings,
WELLINGTON.

LAW SOCIETY'S SUBMISSIONS OF CLAUSE 8
NO. 2 TAX BILL - ANTI TAX AVOIDANCE

1. You have asked for a report on the attached submissions from the New Zealand Law Society. Representatives of the Society are to see you at ~~9 a.m. on Tuesday, 24 September~~. 9am Thurs 26 ✓ You may wish to have the Department's Office Solicitor, Mr O'Donnell and me present at the interview.

General Comments:

(i) Possibly the main point in the criticism is that the clause is still drawn in general terms and does not attempt to define all the particular circumstances which are acceptable or which alternatively are unacceptable for tax purposes. It is true that the two main criticisms of the old section made by the Courts have been:

✓ (a) That the section failed to define these circumstances, and

✓ (b) The section was "unfinished" in the sense that it did not say to whom the income involved in the arrangement is to be assessed once the arrangement has been voided for tax purposes. This particular point is now covered in the new section.

The Department did consider whether an attempt should be made to list the circumstances which should be attacked or alternatively, those which should be excluded from the operations of the section. However, it was considered this would be difficult to do because there would be a wide variety of circumstances to cover and there is always a risk that listing specific types of arrangements would facilitate the work of the legal advisers in advising their clients how to circumvent the new provisions. The Attorney General in a reply to the President of the Court of Appeal made the same point namely that he considered the section should be left in general terms and no attempt made to spell out the circumstances to which it was to apply.

Seen RJY 23-9-74

..2..

(ii) The submissions from the Society do point up the difficulty which must necessarily arise in any provision, whether in New Zealand or any other country, which attempts to draw a dividing line between arrangements which are, and those which are not, acceptable for tax purposes. It would be true to say that in whatever way the section was framed, it would have its own difficulties.

(iii) It is noted at the foot of the submissions that one of the representatives for the Society will be Dr I.L.M. Richardson who is widely regarded as one of the leading taxation experts in New Zealand, particularly in relation to the old section 108. Dr Richardson at one time worked in the Solicitor-General's office and after a period in the law faculty at Victoria University has now gone into private practice. It is of some interest to note that in a number of tax cases involving section 108 he has represented the Solicitor-General and in other section 108 cases he has represented the taxpayer against the Solicitor-General. He has been retained by at least two overseas developing countries to write tax legislation and has written his own version of an anti-tax avoidance provision. The Department considered this provision but felt that the particular approach used should not be adopted in New Zealand for the following reasons :-

(a) The provision is also in general terms in the sense that it does not spell out the classes of arrangements that are to be caught. It does, however, spell out certain criteria (although these are not exhaustive) to be taken into account in deciding whether any particular arrangement is to be treated as void for tax purposes. This, however, would still leave the whole matter to the judgment of whoever is deciding the case, namely the Department in the first instance and, in the event of appeal the Board of Review or the Court which may substitute its own judgment for that of the Department.

(b) The new section 108 as appearing in the Bill itself and in the new version that is proposed for a Supplementary Order Paper has adopted the language of the old section as far as possible. It was thought that this was the best approach as the benefit of that dicta of the Courts could be taken into account and thus avoid a whole new series of cases to decide what particular wording meant.

(iv) The representations must, of course be given due weight. However, I assume that you will still prefer to push ahead and get the clause passed now that it has been introduced rather than

..3..

take the clause from the Bill and make it the subject of further study both within and outside the Department.

(v) There is some criticism in the submissions that the new section 108 as was the position with the old section, does not state whether or not it takes precedence over other provisions of the Tax Act which may authorise a deduction or an exemption. In other words, the submissions pose the question whether there is still tax avoidance if a taxpayer avails himself of these other provisions. On this point, the Department has had no difficulty in the past and it is not expected that the situation will change under the new provision. By way of example, there is a provision in the Tax Act giving exemption up to $500 in respect of interest derived in any year on Post Office National Development Bonds. By itself the fact that a person invests in such bonds instead of other securities, and thereby gains the exemption, would not render him open to attack under section 108.

Specific Points:

It is somewhat difficult to pinpoint the specific points in the Law Society's representations but the following comments are offered.

(i) Under the heading "3. Sub-section 1" as it appears on page 3 the submissions stated that there should be a fair balance preserved in the section between the State and the citizen.

Comment: The Department feels that this has been achieved in the new version. What has been done is to try and write into the new section no more than what was considered to be the position in New Zealand following the Elmiger decision in 1966. To do this it was necessary to remove alleged weaknesses which have been disclosed by dicta from the Courts, particularly in New Zealand since the Elmiger decision.

The Department considers that the new version gives the approximate effect that the Australian Courts have been giving right up to the present time to section 260 of the Australian Act which is the counterpart of section 108 of the New Zealand Tax Act. On this point the constructions placed on the section by the Australian Courts are considered to be better law and more in keeping with the intentions of the legislature than some of the recent decisions handed down in relation to some of our own cases.

In a case in Australia in 1971 of Hollyock v C.I.R., the following were relevant points made :-

- For the anti-tax avoidance provisions to apply the element of tax avoidance need not be the "sole or principal purpose" but had to be something more than an "incidental purpose" - this is the effect given in sub-clause 1 of the new version of section 108.
- Notwithstanding what has just been said, it was implied in the Hollyock decision that an arrangement would not be struck down if the "income producing substance" was made over permanently to the member of the taxpayer's family etc. The Department considers that this is the effect given in the new section 108 and if permanent assets such as an interest in land or blocks of shares etc are made over permanently to members of a taxpayer's family, the arrangement would not be voided by the new section 108.

In this same context the rules in relation to an anti-tax avoidance provision should be drawn in a way that gives the effect intended by Parliament and it should not be left to a contest giving the taxpayer a change of winning no matter how blatant his avoidance device is. Nevertheless, it is considered the new section does give the proper balance between the acceptable and the unacceptable.

(ii) There is mention that if an arrangement can be explained by ordinary "family or business dealing" it should be acceptable for tax purposes.

Comment: In the new version of section 108 there is mention to the effect that ordinary family or business dealing will not by itself be regarded as a reason for the section not applying. The danger if this is not done is if a type of tax avoidance became prevalent such as paddock trusts the Courts may accept this as ordinary family dealing no matter what element of tax avoidance was present. However, it is important to note that this provision must be read subject to the general provision that if tax avoidance is merely an incidental feature of the arrangement it will not be caught under the section.

Submissions on Sub-section 4 - Dividend Stripping:

The point here is that sub-section 4 is inserted to cover a device which was growing in New Zealand and which is known as "dividend stripping." What was happening is that a company which may have ceased business and had large accumulated profits was owned by individuals. If the profits were distributed by way of dividends the individuals would pay dividend tax on them. However, under the device as practised, the individuals would arrange to sell their shares to a finance company which was prepared to pay them an amount equal to the capital plus

accumulated profits less a "commission." The point here is that if the finance company then caused a dividend to be declared to it by the first mentioned company, the dividends would be treated as non-assessable income under general provisions of the Tax Act that inter-company dividends are not directly assessable for tax. Further, any profit derived by the individual selling the shares would, unless he is in the business of dealing in shares, be treated as a capital receipt in his hands and, therefore, not subject to tax.

Comment: The submissions from the Law Society claim that this particular sub-section goes too far and could catch genuine share transfers in cases where ordinary shares are sold "cum dividend" on the open market just prior to a dividend declaration. The submissions, however, do not appear to take into account the fact that the sub-section will apply only where the shares are sold or otherwise disposed of under "a contract, agreement, or arrangement if the kind referred to in sub-section (1) of this section." The words quoted would exclude the case where tax avoidance is only an incidental feature of the transaction.

Alleged Retrospective Effect:

As agreed by you this has now been removed in the proposed Supplementary Order Paper by a provision to the effect that the old section 108 will apply in relation to arrangements entered into prior to the introduction of the Bill to the extent and so long as any commitments entered into prior to that date remain binding on the taxpayer concerned.

(D.A. Stevens)
Commissioner

appl.
9 an Tues. 24/9

Commissioner of Inland Revenue
Referred for ~~draft reply~~ report.
17/9/74.

New Zealand Law Society

THE LAW SOCIETY BUILDING
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WELLINGTON, 1, NEW ZEALAND

TELEPHONE 58-764
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SECRETARY: W M RODGERS

SUBMISSIONS OF THE NEW ZEALAND LAW SOCIETY

LAND & INCOME TAX AMENDMENT BILL (No. 2)

1. Introductory

The Society recognises that the interpretation and application of the existing section 108 of the Land and Income Tax Act 1954 has given rise to very great difficulties. There have been many decisions of the Courts and Board of Review and literally hundreds of other cases where its application has been considered by the Commissioner and/or by taxpayers and their advisers. There have been numerous seminars throughout New Zealand devoted to discussion of its application. Few sections of the laws have created more problems in practice than s. 108, both in New Zealand and in Australia, where s.260 of the Income Tax Assessment Act 1936-73 is similar.

However, the Society considers that the provisions embodied in Clause 8 of the Land and Income Tax Amendment Bill (No. 2) are not an improvement on the existing section; that they will not solve the problems highlighted by the Courts but rather will make existing problems more acute; and that, if enacted in their present form, they will operate unfairly to taxpayers and create serious problems for the Courts and for lawyers called on to advise in relation to their application.

2. General Comments

The Society has five general criticisms of Clause 8:

(i) It is prolix and difficult to understand and apply. The new subsection occupies 21 lines. The long involved subsections make it difficult to determine the interpretation and application of the provision. A taxpayer would certainly not understand it and even a lawyer with experience in the field would find it difficult to advise on its application with any confidence.

(ii) The Courts criticised the old s.108 for its lack of clarity and its arbitrariness. In Gerard - (1974) 4 ATR 369 - it was stigmatised as "fiscal fantasy". But all that has been done in the new subsection (1) is to add additional phrases designed to eliminate some of the problems the Commissioner has met in the Courts by adding sufficient words to cover every possibility.

(iii) Kitto J. in Newton's case [1958] AC 450 - (and his statement was said by Lord Wilberforce in the New Zealand Privy Council decision in Mangin - [1971] NZLR 591 - to be "the last word ... on the Australian section") said:

> "Section 260 is a difficult provision, inherited from earlier legislation and long overdue for reform by someone who will take the trouble to analyse his ideas and define his intentions with precision before putting pen to paper."

Regrettably the new legislation does not take that opportunity.

(iv) It would still be necessary for advisers to know the case law under the old s.108 and the Australian s.260 - running to at least 30 cases - with all the inconsistencies which have resulted from developments and changes in judicial thinking over the years as the Courts have themselves acknowledged.

This difficulty would have been avoided at least to a large extent by defining various terms in the section, such as "relieve", "liability" and "arrangement".

(v) The new draft by no means resolves the key interpretation problems under the old s.108. Two references to recent cases illustrate this.

First, in his recent judgment in Gerard (in which the Crown was unsuccessful) McCarthy P. noted that the taxpayer proposed to raise again in the Privy Council certain questions including questions as to the meaning of "altering the incidence of income tax" and "relieving any person from his liability to pay income tax". These expressions remain in the new legislation and thus if in another tax case the Privy Council upholds the challenge, the provisions would presumably require further modification by the Legislature. In Gerard McCarthy P. also said:

> "The section is notoriously difficult. It cannot be given a literal application, for that would, the Commissioner has always agreed, result in the avoidance of transactions which were obviously not aimed at by the section. So the Courts have had to place glosses on the statutory language in order that the bounds might be held reasonably fairly between the Inland Revenue authorities and taxpayers. But no one suggests that this is satisfactory, especially as one result has been that the Privy Council has been forced in a number of cases to assume the task, rightly one for the Legislature, of providing the tests according to which our people are to be taxed."

McCarthy P.'s basic criticism has not been met in the new draft.

Second, in the Privy Council decision in Mangin, Lord Wilberforce noted that there were four areas of uncertainty. He said:

> "If one compares it with more recent examples of legislation, it can be seen, and the decisions show, that it is deficient in a number of respects:
>
> (a) It fails to define the nature of the liability to tax, avoidance of which is attached. Is this an accrued liability, a future, but probable liability, or a future hypothetical liability? Is it one which must have arisen but for the arrangement, or which might have arisen but for the arrangement, and if "might", probably might or ordinarily might or conceivably might?
>
> (b) It fails to specify any circumstances in which arrangements, etc. which in fact have fiscal consequences may be outside the section, and, if such exist, to specify on whom the onus lies, and to the satisfaction of whom, to establish the existence of such circumstances. The tax-payer is left to work his way through a jungle of words, "purpose", "or", "effect", "purported purpose", "purported effect" which existing decisions have glossed but only dimly illuminated.
>
> (c) It fails to specify the relation between the section and other provisions in the Income Tax legislation under which tax reliefs, or exemptions, may be obtained. Is it legitimate to take advantage of these so as to avoid or reduce tax? What if the only purpose is to use them? Is there a distinction between

"proper" tax avoidance and "improper" tax avoidance? By what sense is this distinction to be perceived?

(d) It gives rise to a number of extremely difficult problems as to what hypothetical state of affairs is to be assumed to exist after the section has annihilated the tax avoidance element in the arrangement."

All four of these uncertainties remain to a greater or lesser extent under the new provision.

3. Subsection (1)

It is submitted that in redrafting s.108 the observations of Kitto J. and Lord Wilberforce should be kept in mind. It is suggested:

(i) That the section should hold a fair balance between the State and the citizen by adopting a middle course and avoiding the two extremes of taxing on the premise that every citizen is under an obligation to conduct his affairs so as to pay the maximum tax on the one hand and of taxing only if an existing tax liability is deliberately shifted or changed on the other.

(ii) The middle course should recognise that tax is an important and proper factor in the making of business decisions. What should be struck at are arrangements which are outside the range of acceptable business and family practices. In its latest decision in Ashton and Wheelans - (1974) 4 ATR 381 - the Court of Appeal per McCarthy P. referred to the category of cases "where it can be said that the taxpayer exercised his right to choose, within the range of ordinary family or business dealings, a method of carrying out the arrangement which was the most favourable to him from a taxation point of view". The Court noted that in that situation the Commissioner failed and it is suggested the legislation should accept that position.

(iii) The provision should be self-contained in the sense of being capable of being understood by accountants, lawyers and taxpayers without reference to the mass of earlier case law. Thus:

(a) It should be formulated using terms which have a single, settled meaning, or which are defined for the purposes of the section; and

(b) At least the more significant guidelines in determining the application of the provision should be spelled out.

(iv) The new subsection (1) in the revised draft may apply whether or not the arrangement is an ordinary business or family dealing.

In the past the Courts have had regard to business and to family purposes served by any arrangement. Many transactions have a solid base in family reality being designed to assist the orderly passing of property from one generation to another, to minimise the impact of estate duties and to promote loyalty within the family to the family business by giving younger members shares in the assets and income. Other transactions may be commercially realistic and at the same time provide tax savings. The Courts should be entitled to give such weight as they regard as appropriate to these factors in the particular circumstances and should not be subject in this respect to the awkwardly expressed prohibition under the new subsection (1).

4. Subsection (4)

On its face the revised subsection (4) allows the Commissioner to apportion the sale price of shares whenever there are accumulated profits in the Company at the time of the sale. This is because sooner or later those profits might

be expected to be paid out as dividends. It would also appear to apply to sales of shares in public companies where the shares are cum div.

It is assumed that the object of subsection (4) is to deal with dividend stripping including cases where shares are sold to a loss company. But as drafted the subsection goes much further and would impede ordinary business transactions in which escape from tax is not a goal. It is in effect a retained profits tax imposed at the moment of sale and if desired on policy grounds should be included in modified form in Part VIA of the Act dealing with excess retention tax.

5. Clause 8(3)

The subclause is retrospective in the sense that it applies to income derived under an arrangement after 1 April 1975 whether the arrangement was entered into before or after that date. It follows that a legally binding arrangement for a term of years which satisfied s.108 at the time it was made may be struck down for tax purposes and because the arrangement would still remain in force as between the parties the taxpayer would be taxable on sums which the other parties to the arrangement are legally entitled to retain. This element of retrospectiveness in the provision should be deleted by providing for the new section to apply to arrangements entered into either after 1 April 1975 or after the date of introduction of the Bill whichever is preferred.

6. Commissioner's Memorandum

The Society has had the opportunity of considering the Memorandum by the Commissioner of Inland Revenue relating to the proposed changes under the new Section 108. It is unable to agree that the proposed provision has the limited effect attributed to it by the Commissioner.

Furthermore there are two reasons why it would not be satisfactory to rely on the interpretation which the Commissioner proposes to accord the provision even assuming that interpretation would itself produce a fair result. The first is that taxpayers should not have to depend on the willingness of the Commissioner to interpret and imply a broad provision in a limited way particularly as the Commissioner cannot bind himself for the future. The second is that the Commissioner does not have a discretion in the matter and other parties to an arrangement may insist on the full application of the section. For example Trustees of a family trust would be entitled to contend that the Section applied to an arrangement with the result that it was void (but only for tax purposes) and the Commissioner was obliged to tax the settlor or other prime mover rather than the Trustees. In this respect the Commissioner's Memorandum at page 8 fails to recognise that because arrangements continue to have effect inter partes there may be no means available to a taxpayer to escape the impact of the new section from 1 April 1975.

DATED the 9th day of September 1974

For the Society

C.I. Patterson
I.L.M. Richardson

L.H. Southwick Q.C.
Vice-President

W.M. Rodgers
Secretary

IR 217

INLAND REVENUE DEPARTMENT

HEAD OFFICE
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Please address all correspondence to – The Commissioner of Inland Revenue

31 May 1974

The Minister of Finance,
Parliament Buildings,
WELLINGTON.

CRITICISM OF SECTION 108 OF THE TAX ACT -
ANTI-TAX AVOIDANCE PROVISIONS

You have asked for my comments on the attached:

- correspondence between the President of the Court of Appeal and the Attorney-General (No.912)
- newspaper clippings (No.905).

At the outset I mention that you have already approved some time ago that section 108 be amended in this year's tax legislation.

The background to the defects in the section has been given before but is as follows. The section is a brief one, viz.

> "108 Agreements purporting to alter incidence of taxation to be void - Every contract, agreement, or arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the Commissioner for income tax purposes 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."

The main criticism of the section voiced in the Courts and the Privy Council is that it is silent on how or to whom is to be assessed the income involved when a particular arrangement is voided.

The obvious remedy is for the section to deem for tax purposes the income to have been derived by the particular taxpayer who would have derived it if the contract or arrangement voided by the section had not in fact been made. This is the point which you have agreed should be covered in this year's amending legislation.

However, there is also another point involved. That is, whether the section should spell out either in general terms or in specific detail the types of transactions which are to be regarded as void for tax purposes. On the question of whether specific detail should be written into the section, I refer here to a passage from the judgment of Sir Thaddeus McCarthy, President of the Court of Appeal, when considering the Gerard case -

> "One can only hope that the legislation will now listen to what has been said by the Judiciary and by legal interpreters and will state in precise language not only what classes of transactions are to be struck down but what are to be the results of that action."

As to the passage I have underlined, it will be seen that the Attorney General in his reply to Sir Thaddeus suggests that he would not be in favour of too much precision in the section, no doubt on the basis that it would show to would-be tax avoiders how to step outside such precise provisions. There is considerable force in this view.

However, Inland Revenue considers that if no specific detail is written into the section, there should be some general provision so as to get over another difficulty the Courts have thrown up in their dicta on the section. It is this. The Courts have stated that the section is so widely drawn that they are bound to restrict it in some way so as to give a realistic application. The Courts have accordingly said that the section is not to be applied if the particular arrangement can be explained by "ordinary business or family dealing". The reference to ordinary family dealing could be explained as follows. A father may transfer a block of shares permanently to, say, a family trust of his children. This would be accepted as ordinary family dealing, i.e. to give a permanent source of income to the trust even though the tax on the resultant dividends may be less than if they had been assessed to the father. However, if it were a contrived situation in which the "income producing substance" was not transferred permanently to the trust or the assets transferred were short-term or wasting ones, the inference adopted by the Department and originally supported by the Courts was that the particular arrangement was not so much a desire to give a family trust a permanent source of income but rather to relieve the father of part of his tax liability. In this context, three examples of relevant cases are as follows:

- In the Elmiger case which was regarded in legal circles with a lot of importance, a contracting partnership sold on favourable terms earthmoving equipment to family trusts of the two partners. The partnership then leased the equipment back and paid hire charges to the trusts.

- In the Mangin case which finally went to the Privy Council, the father was a farmer and leased on a temporary basis certain paddocks to a family trust which took the receipts from the paddocks.

- In the Marx and Carlsen cases, the farmer leased his farm and bailed his livestock in each case to the family trust but carried on more or less as before in managing the whole farming operations.

The Department won all the above cases.

However, in the recent Loader case, Justice Cook has accepted that the particular arrangements were not void under section 108. One of these arrangements concerned plant and machinery which were transferred by the father on an interest free loan basis to a family trust which hired it out to a family company which then carried on the activity with the plant and machinery. The Department considered that the circumstances were very similar to the Elmiger case but Justice Cook held that the arrangement could be acceptable as being ordinary family dealing.

It will be appreciated that to remove this weakness without carrying the section too far may involve some difficulty in drafting.

Question of Appeal in the Gerard case

The Department was successful in the Privy Council in the Mangin case which was a "paddock trust" situation. As stated, a paddock trust is one in which the trust leases paddocks from the farmer (usually the father) and then becomes entitled to all the proceeds from the particular paddocks. Generally, the operations are carried on in the same way as formerly with the father continuing to do all the work on the paddocks involved. The Department considered that this was a proper case to apply section 108 as it did not involve a permanent transfer of the "income producing substance".

A detail in the Mangin case was that the proceeds were first paid by the produce merchants to the father who was bound as between the trust and himself to pay the proceeds to the trust.

In the Gerard case, which is another paddock trust case but which has now been decided against the Department in the Court of Appeal, the proceeds were paid direct to the family trust.

It is true that dicta in the Mangin case gives some weight to a distinction being required to be made in the context of section 108 between the two sets of circumstances.

However, the Department considers that this dicta was merely "obiter". Further that it would be illogical to make any real distinction for tax purposes between the two sets of circumstances, and that the Privy Council may well be prepared to say that, looking at the realities of the situation, the section should be applied in the Gerard case.

Gerard is regarded as somewhat of a test case and there are approximately 80 cases depending on its ultimate decision. The back years' revenue involved in all these cases is at present being estimated.

It is now necessary to decide whether to appeal to the Privy Council against the recent Court of Appeal decision in the Gerard case. The matter has been discussed with the Solicitor-General who says there would be uncertainty as to what would be the final outcome if the Gerard case were taken to the Privy Council. I am to discuss this matter further with him when the estimate of Revenue involved is available. Perhaps in the meantime, the Attorney General may care to express a view and I attach a copy of this memorandum for your reference to him if you desire.

Newspaper Comments

I refer in this context to the attached newspaper cuttings that you referred for my comments. The newspapers, of course, enjoy any criticism by a Judge of any statutory provision. It will be seen that the Christchurch Star, while acknowledging that Inland Revenue has won many plaudits for a more enlightened approach in its dealings with the public, considers the Department has a blind spot so far as section 108 is concerned meaning that the Department has been over-enthusiastic in applying the section.

On this particular point, the Department has in recent years set out guidelines and general principles which it considers should be adopted in relation to section 108. In doing this, the Department has followed what in its view the Courts would hold to be the position and not necessarily what the Department itself considered was the proper approach under the section. In point of fact since and including the Elmiger case the Department has won 17 cases outright and 1 partly out of a total of 24 cases which have been heard by the Board of Review or the Courts on Section 108.

The Department has also sponsored seminars with the accountancy and legal professions so that the guidelines we are following would be at least understood. It is somewhat ironical that the comments in the Christchurch Star are in the context of a paddock trust case as the Department has won the only paddock trust case which so far has gone to the Privy Council. One judge in the Gerard case referred to the "fiscal fantasy" in which the Department was indulging. However, as stated the

Department has largely followed previous dicta from the Courts in applying the section and if there is any fiscal fantasy involved it would seem to be in the faculty of the Courts to distinguish for tax purposes two cases in which the only differences are that in one case receipts were paid direct to the family trust and in the other the receipts were first paid to the father who paid them as he was bound to the family trust.

Summary

To summarise:

(a) It seems to me that there is general agreement that Section 108 should be amended - in the way already approved by you - so as to state what is to be the result of voiding an arrangement in terms of the section.

(b) Careful consideration will need to be given as to whether the section at least in some general terms refers to the types of transactions which should be covered by the section and to get over the difficulty that the Courts have thrown up as regards "ordinary family dealing".

I would be pleased to discuss the whole matter regarding section 108 with you again.

(D. A. Stevens)
Commissioner of Inland Revenue

H.O 1082

Mr Buckton advises that recommendation approved. J.R. 27/8/74.

22 August 1974

The Minister of Finance,
Parliament Buildings,
WELLINGTON.

NEW ANTI-TAX AVOIDANCE PROVISIONS IN CLAUSE 8 OF THE LAND AND INCOME TAX AMENDMENT (NO. 2) BILL

You have already received a number of representations, and it seems others will follow, from legal and other circles that the new provisions at least have the appearance of going too far against the taxpayer.

Inland Revenue considers it has a counter to this line of argument as set out in the background notes which were given to you. On your authority, these have been given to the accountancy and legal societies and other interested people. However, following discussions with the Solicitor-General whose office is well acquainted with the old section 108, we now suggest that the section could be improved as a matter of drafting and in presentation to taxpayers and their advisers without lessening the effect of the clause as it appears in the Bill.

I accordingly attach a proposed new draft of section 108 to replace that in the present Clause 8 in the Bill. The main changes are -

(a) There is now a direct reference in the new section to the effect that it will not apply if the purpose or effect of tax avoidance is merely an incidental one in the particular contract, agreement, or arrangement. It is considered that this would have been the effect of the version in Clause 8 as at present drafted particularly having regard to dicta from Australian Courts but for appearance sake it would be better to state this in specific terms.

(b) There is also added in the first sub-clause of the new version that, if there is present something more than an incidental degree of tax avoidance, the fact that it can be explained by "ordinary business dealing" will not be taken

as a valid reason for not applying the section. Previously in this context the reference was only to "family dealing". However, as stated, the provision stating that a contract, agreement or arrangement which has only an "incidental" purpose of tax avoidance would still not be caught gives the appropriate effect in this regard.

(c) Another change of any substance is a more detailed reference as to what is to happen when the section applies. As indicated in past reports, the main criticism of the Courts of the existing section is that it did not say what was to happen when a contract, agreement or arrangement was voided for tax purposes. The version in the Bill as drafted states that the Commissioner is to determine how much income would have been assessed to the main taxpayer involved if the contract, agreement or arrangement had not been entered into. However, it is possible that, because of the contract, agreement or arrangement actually entered into, the overall income in a particular situation has been increased. For instance, a farmer who has only been engaged in sheep farming may arrange a trust for his family. He gives the trust the use of a particular paddock on which it is decided for the first time to grow, say, potatoes or some other crop giving a more lucrative return than what was derived from that particular paddock from sheep farming. The Solicitor-General in particular thinks that this should be covered and this is done in paragraph (b) of sub-clause (2).

(d) The only other change of any significance is the regrouping of the sub-clauses in a way which is easier to follow than in the previous draft.

Finally, I would ask your permission to give copies of the suggested amended draft to the Law and Accountants' Societies and other representative bodies prior to it being formally introduced into the House as a Supplementary Order Paper. It would be preferable to do it this way so as to reduce the chances of any further changes being considered desirable after a Supplementary Order Paper had been introduced.

You may also consider that in these circumstances a copy of the new draft should be given to the Leader of the Opposition. There has been a precedent for this course.

Referred for your consideration.

(D.A. Stevens)
Commissioner.

Encl.

22 August 1974

The Minister of Finance,
Parliament Buildings,
WELLINGTON.

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Referred for your consideration.

(D.A. Stevens)
Commissioner.

Encl.

HO 1030

IR 217

Commissioner of Inland Revenue

Referred ~~for draft reply~~

17/7/74

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Please address all correspondence to – The Commissioner of Inland Revenue

17 July 1974

The Minister of Finance,
Parliament Buildings,
WELLINGTON.

LAND AND INCOME TAX AMENDMENT BILL

ANTI-AVOIDANCE PROVISIONS IN SECTION 108 AS THEY RELATE TO "DIVIDEND STRIPPING" OPERATIONS

As you know, the anti-avoidance provisions in section 108 have been strengthened in the above Bill following comments from the Courts. In the attached correspondence you have received from Mr Michael Moore, M.P., reference is made to an alleged form of tax avoidance. This is commonly referred to as "dividend stripping" and operates as follows. A company may have ceased to trade but has large accumulated profits which, if distributed by way of dividends, would be liable for tax in the hands of any shareholders who are individuals.

In an attempt to circumvent the dividend tax liability on the existing shareholders, at least one financial organization operating as a company has in a number of cases offered to buy the shares for a consideration equal to the full amount of the paid-up capital plus 90% of the accumulated profits. The financial company then draws off the dividends but these are merely treated as non-assessable income in its hands for tax purposes. This is under the general provisions of the Tax Act whereby inter company dividends are treated as non-assessable income. The real effect is that the former shareholders would hope to avoid the dividend tax on the selling price of the shares which, as stated, is largely inflated by reason of accumulated profits.

Based on some recent Australian Court decisions, Inland Revenue has been seeking to apply section 108 even in its present form and will continue to do so under the strengthened section 108 in the above Bill.

However, there is one point of uncertainty. This is that, while the Department has been given power to deem income to have been derived by the taxpayer who would have derived it if the arrangement (which is voided for tax purposes) had not in fact been entered into, there is some difficulty in the absence of an express provision to say in what year he would have derived the income in the circumstances quoted above as this would be dependent on the company in fact declaring the dividend.

We now consider that this should be spelt out in these particular circumstances in the Amendment Bill. A further provision is accordingly being inserted today in the Bill deeming that, when a person sells shares in the circumstances quoted, he shall be deemed to have received the relevant dividend in the year of sale as distinct from when the company may ultimately declare a dividend to the financial company which has purchased the shares.

Referred for your information and approval of the added provision being included in the Bill.

I attach a suggested draft reply to Mr Michael Moore, M.P.

RECOMMENDATION APPROVED

(D. A. Stevens)
Commissioner.

Encl.

18 JUL 1974

IR 217

H O 1082

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Please address all correspondence to – The Commissioner of Inland Revenue

22 August 1974

The Minister of Finance,
Parliament Buildings,
WELLINGTON.

NEW ANTI-TAX AVOIDANCE PROVISIONS IN CLAUSE 8 OF THE LAND AND INCOME TAX AMENDMENT (NO. 2) BILL

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Inland Revenue considers it has a counter to this line of argument as set out in the background notes which were given to you. On your authority, these have been given to the accountancy and legal societies and other interested people. However, following discussions with the Solicitor-General whose office is well acquainted with the old section 108, we now suggest that the section could be improved, as a matter of drafting, and in presentation to taxpayers and their advisers without lessening the effect of the clause as it appears in the Bill.

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as a valid reason for not applying the section. Previously in this context the reference was only to "family dealing". However, as stated, the provision stating that a contract, agreement or arrangement which has only an "incidental" purpose of tax avoidance would still not be caught gives the appropriate effect in this regard.

(c) Another change of any substance is a more detailed reference as to what is to happen when the section applies. As indicated in past reports, the main criticism of the Courts of the existing section is that it did not say what was to happen when a contract, agreement or arrangement was voided for tax purposes. The version in the Bill as drafted states that the Commissioner is to determine how much income would have been assessed to the main taxpayer involved if the contract, agreement or arrangement had not been entered into. However, it is possible that, because of the contract, agreement or arrangement actually entered into, the overall income in a particular situation has been increased. For instance, a farmer who has only been engaged in sheep farming may arrange a trust for his family. He gives the trust the use of a particular paddock on which it is decided for the first time to grow, say, potatoes or some other crop giving a more lucrative return than what was derived from that particular paddock from sheep farming. The Solicitor-General in particular thinks that this should be covered and this is done in paragraph (b) of sub-clause (2).

(d) The only other change of any significance is the regrouping of the sub-clauses in a way which is easier to follow than in the previous draft.

Finally, I would ask your permission to give copies of the suggested amended draft to the Law and Accountants' Societies and other representative bodies prior to it being formally introduced into the House as a Supplementary Order Paper. It would be preferable to do it this way so as to reduce the chances of any further changes being considered desirable after a Supplementary Order Paper had been introduced.

You may also consider that in these circumstances a copy of the new draft should be given to the Leader of the Opposition. There has been a precedent for this course.

Referred for your consideration.

Approved

27 AUG 1974

Encl.

(D.A. Stevens)
Commissioner.

H.O. 1063

12 August 1974

The Minister of Finance,
Parliament Buildings,
WELLINGTON.

NEW SECTION 108 OF TAX ACT
ANTI-TAX AVOIDANCE PROVISIONS

You are to discuss this matter with our Office Solicitor and me on Tuesday, 13 August at 9 a.m. The new section 108 is contained in Clause 8 of the Amendment Bill at present before the House.

We have prepared the attached memorandum dealing with the background and effect of the changes made in the new section. You may care to read it before we have the discussions. If you agree, the memorandum could be used in dealing with any representations you may receive from legal and other professional sources.

(D. A. Stevens)
Commissioner.

Encl.

PROPOSED LEGISLATION CHANGES IN SECTION 108 OF THE TAX ACT WHICH CONTAINS ANTI-TAX AVOIDANCE PROVISIONS

There have been some comments from legal and other circles about the effect of the new section 108 which is to be substituted for the present section. The new section has three subsections and an explanation is now given of the changes which have been brought about by each of these subsections whether by themselves or in relation to other provisions of the new section. Firstly, a brief indication is given of the nature of the changes and later some explanatory comments thereon are given.

(1) In the new subsection (1) there are three changes of some consequence, viz.

i) Whereas the present section uses the words "the purpose or effect", the new subsection (1) uses the words "the purpose or effect, or purposes or effects which include the purpose or effect (whether or not the principal purpose or effect)".

ii) Since attempts have been made in the past to escape the section on the ground that the person against whom the assessment was made was not himself a party to the contract, agreement, or arrangement, the new subsection (1) specifically provides that the section will apply whether or not that person is a party to the contract, agreement, or arrangement.

iii) The present section in its terms merely voids certain contracts, agreements, or arrangements without giving the Commissioner specific powers to make assessments to counteract the tax avoidance. This matter has been referred to by the Courts

(including the Privy Council) as a defect which requires the attention of the legislature. The new subsection (1) cures this defect and at the same time precludes double taxation. The exercise of the Commissioner's powers (including the exercise of his discretions) under the new provision is, of course, subject to review by the Board of Review or the Courts on objection by the taxpayer.

(2) Subsection (2) of the new section states in effect that the fact that a particular contract, agreement or arrangement may have been induced by the desire of a taxpayer to benefit the members of his family or, as the section says, "was influenced by considerations of ordinary family dealing" will not <u>of itself</u> be taken as grounds for accepting the tax avoidance scheme. However, as is mentioned in more detail below, this subsection must be read in conjunction with subsection (1) and if in fact there is no tax avoidance in the contract, agreement, or arrangement it will not be caught under the operations of the whole section even if made with relatives.

(3) Subsection (3) of the new section deals with a particular device called "dividend stripping" and is limited in its application to this type of transaction. Again, as is explained in more detail below, it will not cover normal sales of shares or indeed outright permanent transfers of shares in a continuing company to a member of a taxpayer's family.

The above points are now dealt with in detail.

(a) So far as paragraph (1)(i) is concerned, this is considered to merely restore the interpretation which was placed on the present section 108 until comparatively recent times and which, it is understood, is still the interpretation placed by the Australian Courts on the corresponding Australian provision which, on the particular point under consideration under paragraph (1)(ii), does not differ from our present section 108. In recent times, however, certain dicta in the judgments of our New Zealand Courts would suggest a more restrictive interpretation of the present section 108, namely, that, in order to bring a contract, agreement, or arrangement within the section, it must be shown that its sole purpose or effect or at least its principal purpose or effect is tax avoidance.

The new subsection (1) provides that where a contract, agreement, or arrangement has a plurality of of purposes or effects one of which is tax avoidance, the latter purpose or effect need not be the principal purpose or effect. That, as indicated above, is the interpretation which, it is understood, is placed by the Australian Courts on the corresponding Australian provision. That does not mean, however, that, where tax avoidance is a purely incidental feature of a contract, agreement or arrangement, the contract, agreement, or arrangement will come within the new subsection (1). This again is considered to be in line with the attitude taken by the Australian Courts on the corresponding Australian provision. Perhaps it should also be made clear at this point that, if a person wishes to make over permanently a permanent

asset such as land or shares in a company outright to members of his family or family trust, this transaction will not of itself be caught under the new section.

So far as paragraph (1)(ii) above is concerned, this is merely to get over a difficulty that a taxpayer could avoid having what was obviously a tax avoidance scheme nullified by not being a direct party to the particular contract, agreement, or arrangement notwithstanding that he may have been the prime instigator in it. By itself, it does not call for any detailed comment.

Turning now to paragraph (1)(iii), this particular passage is to meet the widespread criticism that was made of the old section that, while it may have voided a particular contract, agreement, or arrangement for income tax purposes, it was silent as to what was to happen or how the income involved was to be assessed when the particular contract, agreement, or arrangement had been set aside. This particular part of subsection (1) now states that it will be left to the Commissioner to determine how much income has been diverted away from the person concerned and to this extent it will be assessed to him.

It is, of course, important to remember that any determination made by the Commissioner will be subject to the usual rights of objection. Leaving the determination to the Commissioner in these circumstances can also get over the difficulty against the taxpayer which is inherent in the present section. Dicta from the Courts seem to suggest that, if, for

instance, a taxpayer artifically created a deduction for tax purposes and the whole contract, agreement, or arrangement was voided, all that was to be done was to disallow that deduction without necessarily substituting another deduction in its place. For instance, if a taxpayer had diverted plant and machinery to a trust and was paying higher rentals on a lease back arrangement, the present section in a strict sense would merely have disallowed the rental as a deduction but may not have allowed him depreciation in lieu thereof. This part of the provision will enable the Commissioner to make an appropriate adjustment in his favour.

(b) So far as subsection (2) of the new section is concerned, as indicated above, the point here is that, if there is a purpose or effect of tax avoidance present in a contract, agreement, or arrangement, the fact that it was induced by considerations of ordinary family dealing will not be able to be advanced as a reason for having the contract, agreement, or arrangement accepted for tax purposes. However, it is stressed that it would still be necessary in a situation of "family dealing" for there to be a purpose of tax avoidance for the section to apply. Perhaps the following illustration will amplify this point.

If a farmer transfers permanently his freehold land or part thereof to a member of his family or to his family trust, this would in broad terms be acceptable for tax purposes as not being labelled as tax avoidance.

However, if a farmer merely leased a paddock to a family trust to enable the trust to take the proceeds, this would be regarded under the new section as a tax avoidance scheme and the fact that it was induced by ordinary family dealing could not be invoked to take it out of subsection (1).

(c) Turning now to subsection (3) of the new section which, as indicated above, is a subsection to cover a form of tax avoidance called "dividend stripping". A number of instances have arisen in New Zealand where what were formerly operating companies have ceased to trade but have large accumulated profits and the shares are owned by individuals. In the ordinary case, if the company is wound up, any amounts paid to the individual shareholders in excess of their paid up capital would be treated as dividends and liable for dividend tax accordingly. However, what has been done in a number of cases is for a financial company to acquire the shares and then declare a dividend in its favour which would be merely treated as non-assessable income under a general provision of the Tax Act which states that inter-company dividends shall not be treated as taxable income for tax purposes.

It is probable that this type of dividend stripping is caught under the present section 108 and the Department has in fact applied the section in a number of cases. One part of the new subsection (3) deems the consideration to be a dividend derived in the year in which the shares are sold and therefore assessable in that year rather than at some future date when the company in which the accumulated profits were held declares a dividend.

General Comments

As indicated above, the new section 108 is largely to restore the interpretation which was given some years ago to the present section 108 with the added provision to overcome the difficulty referred to by the Courts that the old section was silent as to what was to happen to the relevant income when a particular contract, agreement, or arrangement was voided under the section.

The Commissioner has received his own legal advice both within and outside the Department on the new provisions and he is assured that, having regard to this advice and the dicta from some Australian cases, the practical effect of the new section 108 could be summarized as follows -

i) If the "income producing substance" or, in other words, permanent assets such as freehold land, blocks of shares, etc, is made over permanently to a member of the taxpayer's family or family trust or family company, this would generally be regarded as outside the scope of the new section.

ii) If, on the other hand, what is done is to retain ownership or control of the income producing substance as, for instance, if part of a business or part of freehold land is given on a temporary basis to a member of the family or family trust or if what could be referred to as short term assets are made over and leased back, etc, this would be regarded as caught within the section.

It is considered that the new section does give a reasonable result and that, while combatting what are clearly tax avoidance schemes, still leaves room for genuine permanent transfers of assets to be made between members of a family.

One final point is that there has been some comment as to the amended section applying as from the 1 April 1975 to all contracts, agreements, or arrangements made on or before that date. It is considered that this is the best approach and it will enable taxpayers and their advisers between now and that date to look at their existing arrangements.

As the types of contracts, agreements, or arrangements which will be set aside by the new section will be largely those of a temporary nature, it is considered that this particular aspect of the new provisions will give a proper measure of justice.

Min 201

20 September 1974

Minister of Finance,
Parliament Buildings,
WELLINGTON.

LAW SOCIETY'S SUBMISSIONS OF CLAUSE 8
NO. 2 TAX BILL - ANTI TAX AVOIDANCE

1. You have asked for a report on the attached submissions from the New Zealand Law Society. Representatives of the Society are to see you at 9 a.m. on Tuesday, 24 September. You may wish to have the Department's Office Solicitor, Mr O'Donnell and me present at the interview.

General Comments:

(i) Possibly the main point in the criticism is that the clause is still drawn in general terms and does not attempt to define all the particular circumstances which are acceptable or which alternatively are unacceptable for tax purposes. It is true that the two main criticisms of the old section made by the Courts have been:

(a) That the section failed to define these circumstances, and

(b) The section was "unfinished" in the sense that it did not say to whom the income involved in the arrangement is to be assessed once the arrangement has been voided for tax purposes. This particular point is now covered in the new section.

The Department did consider whether an attempt should be made to list the circumstances which should be attacked or alternatively, those which should be excluded from the operations of the section. However, it was considered this would be difficult to do because there would be a wide variety of circumstances to cover and there is always a risk that listing specific types of arrangements would facilitate the work of the legal advisers in advising their clients how to circumvent the new provisions. The Attorney General in a reply to the President of the Court of Appeal made the same point namely that he considered the section should be left in general terms and no attempt made to spell out the circumstances to which it was to apply.

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(ii) The submissions from the Society do point up the difficulty which must necessarily arise in any provision, whether in New Zealand or any other country, which attempts to draw a dividing line between arrangements which are, and those which are not, acceptable for tax purposes. It would be true to say that in whatever way the section was framed, it would have its own difficulties.

(iii) It is noted at the foot of the submissions that one of the representatives for the Society will be Dr I.L.M. Richardson who is widely regarded as one of the leading taxation experts in New Zealand, particularly in relation to the old section 108. Dr Richardson at one time worked in the Solicitor-General's office and after a period in the law faculty at Victoria University has now gone into private practice. It is of some interest to note that in a number of tax cases involving section 108 he has represented the Solicitor-General and in other section 108 cases he has represented the taxpayer against the Solicitor-General. He has been retained by at least two overseas developing countries to write tax legislation and has written his own version of an anti-tax avoidance provision. The Department considered this provision but felt that the particular approach used should not be adopted in New Zealand for the following reasons :-

(a) The provision is also in general terms in the sense that it does not spell out the classes of arrangements that are to be caught. It does, however, spell out certain criteria (although these are not exhaustive) to be taken into account in deciding whether any particular arrangement is to be treated as void for tax purposes. This, however, would still leave the whole matter to the judgment of whoever is deciding the case, namely the Department in the first instance and, in the event of appeal the Board of Review or the Court which may substitute its own judgment for that of the Department.

(b) The new section 108 as appearing in the Bill itself and in the new version that is proposed for a Supplementary Order Pape has adopted the language of the old secti as far as possible. It was thought that this was the best approach as the benefi of that dicta of the Courts could be tak into account and thus avoid a whole new series of cases to decide what particul wording meant.

(iv) The representations must, of course be given weight. However, I assume that you will s prefer to push ahead and get the clause pa now that it has been introduced rather th

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take the clause from the Bill and make it the subject of further study both within and outside the Department.

(v) There is some criticism in the submissions that the new section 108 as was the position with the old section, does not state whether or not it takes precedence over other provisions of the Tax Act which may authorise a deduction or an exemption. In other words, the submissions pose the question whether there is still tax avoidance if a taxpayer avails himself of these other provisions. On this point, the Department has had no difficulty in the past and it is not expected that the situation will change under the new provision. By way of example, there is a provision in the Tax Act giving exemption up to $500 in respect of interest derived in any year on Post Office National Development Bonds. By itself the fact that a person invests in such bonds instead of other securities, and thereby gains the exemption, would not render him open to attack under section 108.

Specific Points:

It is somewhat difficult to pinpoint the specific points in the Law Society's representations but the following comments are offered.

(i) Under the heading "3. Sub-section 1" as it appears on page 3 the submissions stated that there should be a fair balance preserved in the section between the State and the citizen.

Comment: The Department feels that this has been achieved in the new version. What has been done is to try and write into the new section no more than what was considered to be the position in New Zealand following the Elmiger decision in 1966. To do this it was necessary to remove alleged weaknesses which have been disclosed by dicta from the Courts, particularly in New Zealand since the Elmiger decision.

The Department considers that the new version gives the approximate effect that the Australian Courts have been giving right up to the present time to section 260 of the Australian Act which is the counterpart of section 108 of the New Zealand Tax Act. On this point the constructions placed on the section by the Australian Courts are considered to be better law and more in keeping with the intentions of the legislature than some of the recent decisions handed down in relation to some of our own cases.

In a case in Australia in 1971 of Hollyock v C.I.R., the following were relevant points made :-

- For the anti-tax avoidance provisions to apply the element of tax avoidance need not be the "sole or principal purpose" but had to be something more than an "incidental purpose" - this is the effect given in sub-clause 1 of the new version of section 108.
- Notwithstanding what has just been said, it was implied in the Hollyock decision that an arrangement would not be struck down if the "income producing substance" was made over permanently to the member of the taxpayer's family etc. The Department considers that this is the effect given in the new section 108 and if permanent assets such as an interest in land or blocks of shares etc are made over permanently to members of a taxpayer's family, the arrangement would not be voided by the new section 108.

In this same context the rules in relation to an anti-tax avoidance provision should be drawn in a way that gives the effect intended by Parliament and it should not be left to a contest giving the taxpayer a change of winning no matter how blatant his avoidance device is. Nevertheless, it is considered the new section does give the proper balance between the acceptable and the unacceptable.

(ii) There is mention that if an arrangement can be explained by ordinary "family or business dealing" it should be acceptable for tax purposes.

Comment: In the new version of section 108 there is mention to the effect that ordinary family or business dealing will not by itself be regarded as a reason for the section not applying. The danger if this is not done is if a type of tax avoidance became prevalent such as paddock trusts the Courts may accept this as ordinary family dealing no matter what element of tax avoidance was present. However, it is important to note that this provision must be read subject to the general provision that if tax avoidance is merely an incidental feature of the arrangement it will not be caught under the section.

Submissions on Sub-section 4 - Dividend Stripping:

The point here is that sub-section 4 is inserted to cover a device which was growing in New Zealand and which is known as "dividend stripping." What was happening is that a company which may have ceased business and had large accumulated profits was owned by individuals. If the profits were distributed by way of dividends the individuals would pay dividend tax on them. However, under the device as practised, the individuals would arrange to sell their shares to a finance company which was prepared to pay them an amount equal to the capital plus

accumulated profits less a "commission." The point here is that if the finance company then caused a dividend to be declared to it by the first mentioned company, the dividends would be treated as non-assessable income under general provisions of the Tax Act that inter-company dividends are not directly assessable for tax. Further, any profit derived by the individual selling the shares would, unless he is in the business of dealing in shares, be treated as a capital receipt in his hands and, therefore, not subject to tax.

Comment: The submissions from the Law Society claim that this particular sub-section goes too far and could catch genuine share transfers in cases where ordinary shares are sold "cum dividend" on the open market just prior to a dividend declaration. The submissions, however, do not appear to take into account the fact that the sub-section will apply only where the shares are sold or otherwise disposed of under "a contract, agreement, or arrangement if the kind referred to in sub-section (1) of this section." The words quoted would exclude the case where tax avoidance is only an incidental feature of the transaction.

Alleged Retrospective Effect:

As agreed by you this has now been removed in the proposed Supplementary Order Paper by a provision to the effect that the old section 108 will apply in relation to arrangements entered into prior to the introduction of the Bill to the extent and so long as any commitments entered into prior to that date remain binding on the taxpayer concerned.

(D.A. Stevens)
Commissioner

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23 SEP 1974

Mr W.M. Rogers,
Secretary,
N.Z. Law Society,
P.O. Box 5041,
WELLINGTON.

Dear Mr Rogers,

I have delayed writing in answer to your letter of 16 August until now as I wanted to consider, without haste, the points made in your own letter and in others I have received. In the result I have had a new version of section 108 drafted which I propose to substitute for that in the Bill. This change will be made in due course by Supplementary Order Paper. However, I am sure you will be interested in the revised section and I am enclosing two copies of the draft for your consideration.

It is considered that the new version is an improvement as a matter of drafting and in presentation to taxpayers without lessening the effect of the clause as it appears in the Bill.

The main changes are :

(a) There is now a direct reference in the new section to the effect that it will not apply if the purpose or effect of tax avoidance is merely an incidental one in the particular contract, agreement or arrangement. It is considered that this would have been the effect of the version in clause 8 of the Bill particularly having regard to dicta from Australian Courts, but for appearance sake it is considered better to state this in specific terms.

(b) There is also added in the first sub-clause of the new version that, if there is present something more than an incidental degree of tax avoidance, the fact that it can be explained by "ordinary business dealing" will not be taken as reason for not applying the section. Previously in this context the reference was only

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to family dealing. However, as stated the provision stating that a contract, agreement or arrangement which has only an incidental purpose of tax avoidance would still not be caught gives the appropriate effect in this regard.

(c) Another change of substance is a more detailed reference as to what is to happen when the section applies. The main criticism of the Courts in relation to the existing section 108 is that it does not say what is to happen when a contract, agreement or arrangement is voided for tax purposes. The version in the Bill states that the Commissioner is to determine how much income would have been assessed to the main taxpayer involved if the contract, agreement or arrangement had not been entered into. However, it is possible that because of the contract, agreement or arrangement actually entered into the overall income in a particular situation may be increased. This situation is now covered in paragraph (b) of sub-clause (2) in the new version.

(d) The only other significant change is the regrouping of the sub-clauses in a way which is considered to be easier to follow than the version in the Bill.

You already have, I understand, a copy of some notes sent to you by the Commissioner on the Bill version of the new section 108. I want now to add a few comments on the particular point raised by you in paragraph 3 of your letter about the judicially derived rule as to "principal" purpose.

As I understand the position the dicta from New Zealand Courts until quite recently did not state that the old section referred only to cases in which tax avoidance was the sole or principal purpose. However, the dicta did make it clear that tax avoidance had to be something more than an incidental feature. It seems that the Australian Courts still adopt the former view under the comparable section 260 and the new section 108 is merely intended to restore that position in New Zealand. The Australian approach is amplified in the High Court of Australia decision in Hollyock v Federal Commissioner of Taxation in 1971. The Judge in referring to some comments of Turner J. in the Mangin case in New Zealand said :

> "...to say that the section applies only to arrangements whose sole purpose is tax avoidance would be contrary to the decisions in Newton's and Hancock's cases."

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Other quotations from the same judgment are :

"...to hold that tax avoidance should be the principal purpose of the arrangement would seem to me to be opposed to the reasoning on which those decisions rest, and would introduce into section 260 a refinement which is not suggested by the words of the section itself..."

"...on the other hand, if tax avoidance is an inessential or incidental feature of the arrangement, that may well serve to show that the arrangement cannot necessarily be labelled as a means to avoid tax."

I expect that the Committee stages of the Land and Income Tax Amendment Bill (No. 2) will commence some time next week. It is at that stage that the proposed new version of section 108 will be substituted for that in the Bill. I would ask you therefore to bear these time constraints in mind in any consideration you give to the new version.

Yours sincerely,

(Sgd.) R. J. TIZARD

(R.J. Tizard)
Minister of Finance

MIN 201

20 September 1974

Minister of Finance,
Parliament Buildings,
WELLINGTON.

LAW SOCIETY'S SUBMISSIONS OF CLAUSE 8
NO. 2 TAX BILL - ANTI TAX AVOIDANCE

1. You have asked for a report on the attached submissions from the New Zealand Law Society. Representatives of the Society are to see you at 9 a.m. on Tuesday, 24 September. You may wish to have the Department's Office Solicitor, Mr O'Donnell and me present at the interview.

General Comments:

(i) Possibly the main point in the criticism is that the clause is still drawn in general terms and does not attempt to define all the particular circumstances which are acceptable or which alternatively are unacceptable for tax purposes. It is true that the two main criticisms of the old section made by the Courts have been:

(a) That the section failed to define these circumstances, and

(b) The section was "unfinished" in the sense that it did not say to whom the income involved in the arrangement is to be assessed once the arrangement has been voided for tax purposes. This particular point is now covered in the new section.

The Department did consider whether an attempt should be made to list the circumstances which should be attacked or alternatively, those which should be excluded from the operations of the section. However, it was considered this would be difficult to do because there would be a wide variety of circumstances to cover and there is always a risk that listing specific types of arrangements would facilitate the work of the legal advisers in advising their clients how to circumvent the new provisions. The Attorney General in a reply to the President of the Court of Appeal made the same point namely that he considered the section should be left in general terms and no attempt made to spell out the circumstances to which it was to apply.

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(ii) The submissions from the Society do point up the difficulty which must necessarily arise in any provision, whether in New Zealand or any other country, which attempts to draw a dividing line between arrangements which are, and those which are not, acceptable for tax purposes. It would be true to say that in whatever way the section was framed, it would have its own difficulties.

(iii) It is noted at the foot of the submissions that one of the representatives for the Society will be Dr I.L.M. Richardson who is widely regarded as one of the leading taxation experts in New Zealand, particularly in relation to the old section 108. Dr Richardson at one time worked in the Solicitor-General's office and after a period in the law faculty at Victoria University has now gone into private practice. It is of some interest to note that in a number of tax cases involving section 108 he has represented the Solicitor-General and in other section 108 cases he has represented the taxpayer against the Solicitor-General. He has been retained by at least two overseas developing countries to write tax legislation and has written his own version of an anti-tax avoidance provision. The Department considered this provision but felt that the particular approach used should not be adopted in New Zealand for the following reasons :-

(a) The provision is also in general terms in the sense that it does not spell out the classes of arrangements that are to be caught. It does, however, spell out certain criteria (although these are not exhaustive) to be taken into account in deciding whether any particular arrangement is to be treated as void for tax purposes. This, however, would still leave the whole matter to the judgment of whoever is deciding the case, namely the Department in the first instance and, in the event of appeal the Board of Review or the Court which may substitute its own judgment for that of the Department.

(b) The new section 108 as appearing in the Bill itself and in the new version that is proposed for a Supplementary Order Paper has adopted the language of the old section as far as possible. It was thought that this was the best approach as the benefit of that dicta of the Courts could be taken into account and thus avoid a whole new series of cases to decide what particular wording meant.

(iv) The representations must,of course be given due weight. However, I assume that you will still prefer to push ahead and get the clause passed now that it has been introduced rather than

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take the clause from the Bill and make it the subject of further study both within and outside the Department.

(v) There is some criticism in the submissions that the new section 108 as was the position with the old section, does not state whether or not it takes precedence over other provisions of the Tax Act which may authorise a deduction or an exemption. In other words, the submissions pose the question whether there is still tax avoidance if a taxpayer avails himself of these other provisions. On this point, the Department has had no difficulty in the past and it is not expected that the situation will change under the new provision. By way of example, there is a provision in the Tax Act giving exemption up to $500 in respect of interest derived in any year on Post Office National Development Bonds. By itself the fact that a person invests in such bonds instead of other securities, and thereby gains the exemption, would not render him open to attack under section 108.

Specific Points:

It is somewhat difficult to pinpoint the specific points in the Law Society's representations but the following comments are offered.

(i) Under the heading "3. Sub-section 1" as it appears on page 3 the submissions stated that there should be a fair balance preserved in the section between the State and the citizen.

Comment: The Department feels that this has been achieved in the new version. What has been done is to try and write into the new section no more than what was considered to be the position in New Zealand following the Elmiger decision in 1966. To do this it was necessary to remove alleged weaknesses which have been disclosed by dicta from the Courts, particularly in New Zealand since the Elmiger decision.

The Department considers that the new version gives the approximate effect that the Australian Courts have been giving right up to the present time to section 260 of the Australian Act which is the counterpart of section 108 of the New Zealand Tax Act. On this point the constructions placed on the section by the Australian Courts are considered to be better law and more in keeping with the intentions of the legislature than some of the recent decisions handed down in relation to some of our own cases.

In a case in Australia in 1971 of Hollyock v C.I.R., the following were relevant points made :-

- For the anti-tax avoidance provisions to apply the element of tax avoidance need not be the "sole or principal purpose" but had to be something more than an "incidental purpose" - this is the effect given in sub-clause 1 of the new version of section 108.
- Notwithstanding what has just been said, it was implied in the Hollyock decision that an arrangement would not be struck down if the "income producing substance" was made over permanently to the member of the taxpayer's family etc. The Department considers that this is the effect given in the new section 108 and if permanent assets such as an interest in land or blocks of shares etc are made over permanently to members of a taxpayer's family, the arrangement would not be voided by the new section 108.

In this same context the rules in relation to an anti-tax avoidance provision should be drawn in a way that gives the effect intended by Parliament and it should not be left to a contest giving the taxpayer a change of winning no matter how blatant his avoidance device is. Nevertheless, it is considered the new section does give the proper balance between the acceptable and the unacceptable.

(ii) There is mention that if an arrangement can be explained by ordinary "family or business dealing" it should be acceptable for tax purposes.

Comment: In the new version of section 108 there is mention to the effect that ordinary family or business dealing will not by itself be regarded as a reason for the section not applying. The danger if this is not done is if a type of tax avoidance became prevalent such as paddock trusts the Courts may accept this as ordinary family dealing no matter what element of tax avoidance was present. However, it is important to note that this provision must be read subject to the general provision that if tax avoidance is merely an incidental feature of the arrangement it will not be caught under the section.

Submissions on Sub-section 4 - Dividend Stripping:

The point here is that sub-section 4 is inserted to cover a device which was growing in New Zealand and which is known as "dividend stripping." What was happening is that a company which may have ceased business and had large accumulated profits was owned by individuals. If the profits were distributed by way of dividends the individuals would pay dividend tax on them. However, under the device as practised, the individuals would arrange to sell their shares to a finance company which was prepared to pay them an amount equal to the capital plus

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accumulated profits less a "commission." The point here is that if the finance company then caused a dividend to be declared to it by the first mentioned company, the dividends would be treated as non-assessable income under general provisions of the Tax Act that inter-company dividends are not directly assessable for tax. Further, any profit derived by the individual selling the shares would, unless he is in the business of dealing in shares, be treated as a capital receipt in his hands and, therefore, not subject to tax.

Comment: The submissions from the Law Society claim that this particular sub-section goes too far and could catch genuine share transfers in cases where ordinary shares are sold "cum dividend" on the open market just prior to a dividend declaration. The submissions, however, do not appear to take into account the fact that the sub-section will apply only where the shares are sold or otherwise disposed of under "a contract, agreement, or arrangement if the kind referred to in sub-section (1) of this section." The words quoted would exclude the case where tax avoidance is only an incidental feature of the transaction.

Alleged Retrospective Effect:

As agreed by you this has now been removed in the proposed Supplementary Order Paper by a provision to the effect that the old section 108 will apply in relation to arrangements entered into prior to the introduction of the Bill to the extent and so long as any commitments entered into prior to that date remain binding on the taxpayer concerned.

(D.A. Stevens)
Commissioner

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SUBMISSIONS OF THE NEW ZEALAND LAW SOCIETY

LAND & INCOME TAX AMENDMENT BILL (No. 2)

1. Introductory

The Society recognises that the interpretation and application of the existing section 108 of the Land and Income Tax Act 1954 has given rise to very great difficulties. There have been many decisions of the Courts and Board of Review and literally hundreds of other cases where its application has been considered by the Commissioner and/or by taxpayers and their advisers. There have been numerous seminars throughout New Zealand devoted to discussion of its application. Few sections of the laws have created more problems in practice than s. 108, both in New Zealand and in Australia, where s.260 of the Income Tax Assessment Act 1936-73 is similar.

However, the Society considers that the provisions embodied in Clause 8 of the Land and Income Tax Amendment Bill (No. 2) are not an improvement on the existing section; that they will not solve the problems highlighted by the Courts but rather will make existing problems more acute; and that, if enacted in their present form, they will operate unfairly to taxpayers and create serious problems for the Courts and for lawyers called on to advise in relation to their application.

2. General Comments

The Society has five general criticisms of Clause 8:

(i) It is prolix and difficult to understand and apply. The new subsection occupies 21 lines. The long involved subsections make it difficult to determine the interpretation and application of the provision. A taxpayer would certainly not understand it and even a lawyer with experience in the field would find it difficult to advise on its application with any confidence.

(ii) The Courts criticised the old s.108 for its lack of clarity and its arbitrariness. In Gerard - (1974) 4 ATR 369 - it was stigmatised as "fiscal fantasy". But all that has been done in the new subsection (1) is to add additional phrases designed to eliminate some of the problems the Commissioner has met in the Courts by adding sufficient words to cover every possibility.

(iii) Kitto J. in Newton's case [1958] AC 450 - (and his statement was said by Lord Wilberforce in the New Zealand Privy Council decision in Mangin - [1971] NZLR 591 - to be "the last word . . . on the Australian section") said:

> "Section 260 is a difficult provision, inherited from earlier legislation and long overdue for reform by someone who will take the trouble to analyse his ideas and define his intentions with precision before putting pen to paper."

Regrettably the new legislation does not take that opportunity.

(iv) It would still be necessary for advisers to know the case law under the old s.108 and the Australian s.260 - running to at least 30 cases - with all the inconsistencies which have resulted from developments and changes in judicial thinking over the years as the Courts have themselves acknowledged.

This difficulty would have been avoided at least to a large extent by defining various terms in the section, such as "relieve", "liability" and "arrangement".

(v) The new draft by no means resolves the key interpretation problems under the old s.108. Two references to recent cases illustrate this.

First, in his recent judgment in Gerard (in which the Crown was unsuccessful) McCarthy P. noted that the taxpayer proposed to raise again in the Privy Council certain questions including questions as to the meaning of "altering the incidence of income tax" and "relieving any person from his liability to pay income tax". These expressions remain in the new legislation and thus if in another tax case the Privy Council upholds the challenge, the provisions would presumably require further modification by the Legislature. In Gerard McCarthy P. also said:

> "The section is notoriously difficult. It cannot be given a literal application, for that would, the Commissioner has always agreed, result in the avoidance of transactions which were obviously not aimed at by the section. So the Courts have had to place glosses on the statutory language in order that the bounds might be held reasonably fairly between the Inland Revenue authorities and taxpayers. But no one suggests that this is satisfactory, especially as one result has been that the Privy Council has been forced in a number of cases to assume the task, rightly one for the Legislature, of providing the tests according to which our people are to be taxed."

McCarthy P.'s basic criticism has not been met in the new draft.

Second, in the Privy Council decision in Mangin, Lord Wilberforce noted that there were four areas of uncertainty. He said:

> "If one compares it with more recent examples of legislation, it can be seen, and the decisions show, that it is deficient in a number of respects:
>
> (a) It fails to define the nature of the liability to tax, avoidance of which is attached. Is this an accrued liability, a future, but probable liability, or a future hypothetical liability? Is it one which must have arisen but for the arrangement, or which might have arisen but for the arrangement, and if "might", probably might or ordinarily might or conceivably might?
>
> (b) It fails to specify any circumstances in which arrangements, etc. which in fact have fiscal consequences may be outside the section, and, if such exist, to specify on whom the onus lies, and to the satisfaction of whom, to establish the existence of such circumstances. The tax-payer is left to work his way through a jungle of words, "purpose", "or", "effect", "purported purpose", "purported effect" which existing decisions have glossed but only dimly illuminated.
>
> (c) It fails to specify the relation between the section and other provisions in the Income Tax legislation under which tax reliefs, or exemptions, may be obtained. Is it legitimate to take advantage of these so as to avoid or reduce tax? What if the only purpose is to use them? Is there a distinction between

"proper" tax avoidance and "improper" tax avoidance? By what sense is this distinction to be perceived?

(d) It gives rise to a number of extremely difficult problems as to what hypothetical state of affairs is to be assumed to exist after the section has annihilated the tax avoidance element in the arrangement."

All four of these uncertainties remain to a greater or lesser extent under the new provision.

3. Subsection (1)

It is submitted that in redrafting s.108 the observations of Kitto J. and Lord Wilberforce should be kept in mind. It is suggested:

(i) That the section should hold a fair balance between the State and the citizen by adopting a middle course and avoiding the two extremes of taxing on the premise that every citizen is under an obligation to conduct his affairs so as to pay the maximum tax on the one hand and of taxing only if an existing tax liability is deliberately shifted or changed on the other.

(ii) The middle course should recognise that tax is an important and proper factor in the making of business decisions. What should be struck at are arrangements which are outside the range of acceptable business and family practices. In its latest decision in Ashton and Wheelans - (1974) 4 ATR 381 - the Court of Appeal per McCarthy P. referred to the category of cases "where it can be said that the taxpayer exercised his right to choose, within the range of ordinary family or business dealings, a method of carrying out the arrangement which was the most favourable to him from a taxation point of view". The Court noted that in that situation the Commissioner failed and it is suggested the legislation should accept that position.

(iii) The provision should be self-contained in the sense of being capable of being understood by accountants, lawyers and taxpayers without reference to the mass of earlier case law. Thus:

(a) It should be formulated using terms which have a single, settled meaning, or which are defined for the purposes of the section; and

(b) At least the more significant guidelines in determining the application of the provision should be spelled out.

(iv) The new subsection (1) in the revised draft may apply whether or not the arrangement is an ordinary business or family dealing.

In the past the Courts have had regard to business and to family purposes served by any arrangement. Many transactions have a solid base in family reality being designed to assist the orderly passing of property from one generation to another, to minimise the impact of estate duties and to promote loyalty within the family to the family business by giving younger members shares in the assets and income. Other transactions may be commercially realistic and at the same time provide tax savings. The Courts should be entitled to give such weight as they regard as appropriate to these factors in the particular circumstances and should not be subject in this respect to the awkwardly expressed prohibition under the new subsection (1).

Justice Woodhouse
Mr Ellwood

4. Subsection (4)

On its face the revised subsection (4) allows the Commissioner to apportion the sale price of shares whenever there are accumulated profits in the Company at the time of the sale. This is because sooner or later those profits might

be expected to be paid out as dividends. It would also appear to apply to sales of shares in public companies where the shares are cum div.

It is assumed that the object of subsection (4) is to deal with dividend stripping including cases where shares are sold to a loss company. But as drafted the subsection goes much further and would impede ordinary business transactions in which escape from tax is not a goal. It is in effect a retained profits tax imposed at the moment of sale and if desired on policy grounds should be included in modified form in Part VIA of the Act dealing with excess retention tax.

5. Clause 8(3)

The subclause is retrospective in the sense that it applies to income derived under an arrangement after 1 April 1975 whether the arrangement was entered into before or after that date. It follows that a legally binding arrangement for a term of years which satisfied s.108 at the time it was made may be struck down for tax purposes and because the arrangement would still remain in force as between the parties the taxpayer would be taxable on sums which the other parties to the arrangement are legally entitled to retain. This element of retrospectiveness in the provision should be deleted by providing for the new section to apply to arrangements entered into either after 1 April 1975 or after the date of introduction of the Bill whichever is preferred.

6. Commissioner's Memorandum

The Society has had the opportunity of considering the Memorandum by the Commissioner of Inland Revenue relating to the proposed changes under the new Section 108. It is unable to agree that the proposed provision has the limited effect attributed to it by the Commissioner.

Furthermore there are two reasons why it would not be satisfactory to rely on the interpretation which the Commissioner proposes to accord the provision even assuming that interpretation would itself produce a fair result. The first is that taxpayers should not have to depend on the willingness of the Commissioner to interpret and imply a broad provision in a limited way particularly as the Commissioner cannot bind himself for the future. The second is that the Commissioner does not have a discretion in the matter and other parties to an arrangement may insist on the full application of the section. For example Trustees of a family trust would be entitled to contend that the Section applied to an arrangement with the result that it was void (but only for tax purposes) and the Commissioner was obliged to tax the settlor or other prime mover rather than the Trustees. In this respect the Commissioner's Memorandum at page 8 fails to recognise that because arrangements continue to have effect inter partes there may be no means available to a taxpayer to escape the impact of the new section from 1 April 1975.

DATED the 9th day of September 1974

For the Society

C.I. Patterson
I.L.M. Richardson

L.H. Southwick Q.C.
Vice-President

W.M. Rodgers
Secretary

SUPREME COURT OF NEW ZEALAND

INLAND REVENUE COMMISSIONER (NZ) v GERARD

McCarthy P

Richmond and Speight JJ

20 May 1974

Avoidance of tax — Assessable income — Trust created for benefit of taxpayer's issue — Taxpayer leased parts of his farm to trustees — Taxpayer employed by trustees to cultivate land leased — Net annual income of trust paid to taxpayer's wife — Whether transactions void — Land and Income Tax Act 1954 (NZ), s 108.

The taxpayer carried on business as a farmer By deed dated 29 June 1964, a Mr Murchison created a trust with an initial settlement of £5 for the benefit of the taxpayer's issue The trustees were the taxpayer's wife and Pyne Gould Guinness Ltd, stock and station agents By successive agreements to lease dated respectively 15 July 1966, 26 June 1967, 28 November 1968 and 18 July 1969, the taxpayer leased part of his farm to the trustees at a nominated rent or such rents as might be determined by the Stamp Office In any case, no rents different to those stated in the leases were determined The trustees employed the taxpayer to cultivate the lands the subject of the lease at the usual rates charged by agricultural contractors and engaged a contractor to harvest the crops The trustees arranged for the sale of the crops, received the proceeds from the sales and met all expenditure in connexion with the crops Each year, the net income of the trust was paid to the taxpayer's wife for the benefit of the infant children

For the years of income ended 31 May 1967 to 1970 inclusive the Commissioner assessed the taxpayer on not only the income returned by himself but also on the income returned by the trust and the commission paid to the trustees The taxpayer appealed to the Supreme Court of New Zealand

For the Commissioner, it was submitted that the transactions creating and relating to the trust were absolutely void or void as against the Commissioner for income tax purposes

On behalf of the taxpayer, it was submitted that the transactions creating the trust had neither the purpose nor effect of altering the incidence of income tax, that the taxpayer was not in any case a party to the transaction and that even if the transactions creating and relating to the trust were void as against the Commissioner, which was not admitted, this would not result in a liability to income tax on the part of the taxpayer

The Supreme Court held, allowing the appeal (i) that the income neither reached nor passed through the taxpayer's hands, (ii) that no trust could be implied in favour of the taxpayer which was binding on either the trustees or the taxpayer's wife, and (iii) that it was for Parliament, and not the Court, to fill the legislative vacuum and make expressed provision for an implied trust in the statute

The Commissioner appealed to the Court of Appeal of New Zealand

It was agreed for the respondent that certain agreements, but not the deed of trust, fell within s 108, but counsel for the taxpayer argued that the purely annihilating effect of s 108 would not result in a situation in which the income was derived by the taxpayer For the Commissioner it was argued that money received by the taxpayer's wife as trustee for the infant beneficiaries was held by her on behalf of the taxpayer under a constructive trust.

Held, dismissing the appeal that (i) the Commissioner was not entitled to include the income arising from the sale of the crop by the trustee, (ii) it could not be said that the taxpayer derived income in the notional state of affairs revealed after the annihilation of certain steps, (iii) it is not possible to imply a trust in favour of the taxpayer in respect of income received by his wife as trustee for his children, and (iv) it was not necessary to consider whether the family trust should properly be regarded as an essential part of the tax avoiding arrangement and therefore itself avoided

Appeal

This was an appeal to the Court of Appeal of New Zealand from a judgment of Wilson J in the Supreme Court of New Zealand on 11 October 1972 (3 ATR 271).

The facts appear sufficiently from the judgment.

H E Blank and *H R Sorenson,* for the appellant.

E J Somers QC and *A J Forbes,* for the respondent.

McCarthy P: This appeal is from a judgment of Wilson J in the Supreme Court in which he raises his voice against the failure of the Legislature to take heed of the many criticisms of s 108, not only by judges of this Court and the Supreme Court in New Zealand, but also by members of the Privy Council, Lords Donovan and Wilberforce in particular, and against the Commissioner's extension of the operation of this extraordinarily difficult section into what he, Wilson J, called a world of fiscal phantasy. I think it proper that I should say that I think that strong words by the judge were justified. The section is notoriously difficult. It cannot be given a literal application, for that would, the Commissioner has always agreed, result in the avoidance of transactions which were obviously not aimed at by the section. So the Courts have had to place glosses on the statutory language in order that the bounds might be held reasonably fairly between the Inland Revenue authorities and taxpayers. But no one suggests that this is satisfactory especially as one result has been that the Privy Council has been forced in a number of cases to assume the task, rightly one for the Legislature, of providing the tests according to which our people are to be taxed As Wilson J points out, arguments on the application of s 108 are now rarely, if ever, based on the text of the section itself; they are mainly, if not wholly, centred on the glosses placed by the courts on the text.

There is moreover another consequence to which it is proper to draw attention. Since the Commissioner has over more recent years invoked this section with increasing regularity, the time of this Court is correspondingly occupied in endeavouring to tread its way through the uncertain swampland, which has been thus created by the courts in their attempts to do justice in the face of an unworkable section. Too much of the time of this heavily pressed Court is occupied by this section. One can only hope that the Legislature will now listen to what has been said by the Judiciary and by legal commentators, and will state in precise language not only what classes of transactions are to be struck down, but what are to be the results of that action.

This present case is another of what have come to be called in this country "paddock trusts" The respondent is a farmer of Mayfield in Canterbury, and the case before us concerns his tax liability for the years ended 31 May 1967, 1968, 1969 and 1970. In each of these years the Commissioner assessed the respondent to income tax on income which included not only that returned by him but also that returned by his family trust plus the commission paid to the trustees thereof. The respondent objected to these assessments. The Commissioner stated a case, and that came before Wilson J.

It is agreed that Wilson J assembled the facts accurately from the Case Stated. No oral evidence was given. I take up Wilson J's statement at this point. By deed dated 29 June 1964 a Mr Murchison created a trust, known as the Thornycroft Family Trust, for the benefit of the objector's issue, with an initial capital of £5 contributed by the Settlor. The trustees were the objector's wife and Pyne Gould Guinness Ltd, a company carrying on business as stock and station agents and as trustee. By successive agreements to lease dated respectively 15 July 1966, 26 June 1967, 28

November 1968 and 18 July 1969 the Objector agreed to lease various parts of the farm to the trustees at rents which were expressed to be at a stipulated figure or such higher figure as might be assessed by the Stamp Office so that there would be no element of gift in the several transactions, but in the event no higher rent was assessed in any case In each farming season during the currency of these agreements to lease the objector was employed by the trustees to cultivate the lands agreed to be leased, to sow them in wheat and linseed and to manage the areas so sown, at the usual rates charged by agricultural contractors. The trustees paid a contractor to harvest the crops (and, I infer, engaged him for the purpose), arranged the sale of the crops and received the proceeds of such sales. They also met all expenditure necessary for manure, top-dressing, seeds, freight, and the like, in connexion with the crops. Each year the full amount of the net income of the trust was distributed amongst the infant beneficiaries and paid to Mrs Gerard for their benefit.

Counsel for the respondent Mr Somers, both in the Supreme Court and this Court, has acknowledged his inability to argue that the arrangement was an ordinary business or family dealing. He accepts that having regard to the now widely-known test stated by Lord Denning in *Newton v Commissioner of Taxation of the Commonwealth of Australia* [1958] 2 All ER 759, [1958] AC 450, the arrangement must be seen as a device for avoiding tax, and therefore in terms of s 108, as absolutely void as against the Commissioner for income tax purposes. Doubtless, as Wilson J observed, Mr Somers felt compelled to make this concession by virtue of the similarity between the facts here and those of such cases as *Marx v Commissioner of Inland Revenue* [1970] NZLR 182 and *Mangin v Commissioner of Inland Revenue* [1971] NZLR 591 PC But Mr Somers wishes to keep open for argument before the Privy Council, if that be necessary, three submissions which up till now have been concluded against him by previous decisions of the Privy Council or of this Court, which decisions he hopes to have reconsidered. They are: 1. That s 108 is limited to cases where the incidence of or liability to income tax has already accrued when the transaction is entered into; 2. That s 108 applies only to income derived and not to income which a taxpayer might have, but did not derive. By this submission he hopes to over-ride certain conclusions in both *Marx's Case* and *Mangin's Case* that income becomes taxable if at any time it is in the hands of the taxpayer, albeit that he is responsible to account to another for it; and 3. That the transactions in a case such as the present, whether viewed singularly, together, or in any combination, do not constitute contracts, agreements or arrangements of the type referred to in s 108. Here, presumably, he hopes to re-argue the test stated in *Newton's Case*. The reservation of these matters is part of a pattern which we have seen emerging recently, because of the feeling at the Bar — whether it be merited or not I do not say — that the different opinions expressed by the members of the Privy Council concerning the constructions to be put on the section and, more especially, the results which flow from holding arrangements void, justify the hope that a Board of different membership might feel themselves able to depart from what has been said earlier. This is but another illustration of the unsatisfactory state of affairs surrounding s 108, and emphasises again the desirability of legislative attention to it.

In view of the concession that the arrangement must be regarded as being in breach of s 108, two questions are left: 1. What steps in the total scheme or arrangement are rendered void; and 2. What are the consequences of that avoidance?

As to the first. It is accepted by the respondent taxpayer that the four agreements to lease and the contracts between the trustees of the trust and the taxpayer for the cultivation, sowing, and management of the land and the crops, are to be considered void The Commissioner would include the deed of trust. This is resisted by the respondent. The Commissioner does not now contend, though he did in the Supreme Court, that the harvesting contracts and the contracts for sale of the crops, both arranged by the trustees, are to be avoided.

So far as the deed of trust is concerned, it is not difficult to suspect that the trust was set up as an important and necessary step in the whole scheme, and that it should fall along with the lease and the contract of employment. However, there is no satisfactory evidence to support a conclusion to that effect and it could be that the deed was, in truth, prepared entirely separately and has been used, as well, for matters unconnected with those we are considering. So Mr Somers maintains that there is no factual basis for the annihilation of the trust deed. It may be that s 20 of the Inland Revenue Department Amendment Act 1960 answers this submission, but this section was not seriously invoked by Mr Blank.

In any event, says Mr Somers in his second-line defence of the deed of trust, the objector was not a party to the document. In *Wisheart, Macnab and Kidd v Commissioner of Inland Revenue* [1972] NZLR 319, Turner J said in this Court that the only arrangements which can be set aside under s 108 are arrangements to which the objecting taxpayer is a party. Because of that view, he refused to declare void one of the series of dealings which the Commissioner attacked in that case The Chief Justice in *Udy v Commissioner of Inland Revenue* [1972] NZLR 714 later refused to follow this particular observation of Turner J, saying that it was unsupported by authority and had been arrived at without the precise point being argued He felt free to hold that where the taxpayer procures the making of the transaction, s 108 can be applied even though the taxpayer was not a party to the particular document attacked. Wilson J in the lower court in this present case took the same view Mr Blank, however, contends that both the Chief Justice and Wilson J misinterpreted what Turner J said, and overlooked that his remarks were applied to a particular arrangement about which it could not be said affirmatively that the taxpayer had procured the document. This may be correct. However, if Turner J meant that a transaction even though procured by a taxpayer, cannot be attacked unless the taxpayer is a party to the formal documents effecting it, I would like to reserve my opinion on that for another case.

In any event, I think it unnecessary to take up a definite posture concerning the elimination of the trust deed, because I am quite firmly of the view that here it does not matter whether the deed itself is eliminated. From the point of view of the Commissioner what must be removed are the transactions between the taxpayer and the trustees. Once they are out of the way, then the continued existence of the trust deed itself seems to me to be unimportant. If the factual situation exposed by annihilation reveals a gift on trusts detailed in a particular deed, the continued existence of the terms of that deed may be of importance in ascertaining whether the gift on trust failed. But as I shall later say, I do not believe that we would be justified in notionally constructing a gift here.

I now come to the complicated question of the results of annihilation, about which the statute says nothing. Section 108 certainly avoids, but it does not say that income which has not come into the hands of the taxpayer, or which he has not derived in some other way, can be attributed to him for

the purposes of taxation. That s 108 is purely an annihilating section and nothing more had long been held by the Australian Courts before it was confirmed by the Privy Council in *Newton's Case*, which, as is well known, is the foundation of all our case law in New Zealand in relation to s 108. The like Australian section to s 108 is s 240. Lord Denning said in *Newton's Case:*— "This question then arises: What is the effect of s 260 on that arrangement? It is quite clear that nothing is avoided as between the parties but only as against the commissioner. As against him the arrangement is 'absolutely void' so far as it has the purpose or effect of avoiding tax. This is not a very precise use of the words 'absolutely void'. Ordinarily, if a transaction is absolutely void, it is void as against all the world. In this case what is meant is that the commissioner is entitled completely to disregard the arrangement — and the ensuing transactions — so far as they have the purpose or effect of avoiding tax. In the words of the courts of Australia, it is an 'annihilating' provision — the commissioner can use the section so as to ignore the transactions which are caught by it. *But the ignoring of the transactions — or the annihilation of them — does not itself create a liability to tax.* In order to make the taxpayers liable, the commissioner *must show that moneys have come into the hands of the taxpayers which the commissioner is entitled to treat as income derived by them.* Their Lordships agree with the way in which Fullagar J put it in his judgment: 'Section 260 alters nothing that was done as between the parties. But, for the purposes of income tax, it entitles the commissioner to look at the end result and to ignore all the steps which were taken in pursuance of the avoided arrangement.' (The italics in this and other quotations in this judgment are mine.) Lord Denning repeated more than once in the course of this opinion that the Commissioner must be able to trace the income into the hands of the taxpayer and he applied that requirement to all the income under examination, including sums which an agent of the taxpayer received for expenses.

The importance of seeing correctly the annihilating effect of s 240 (and hence our s 108) was raised before the Privy Council again in *Peate v Federal Commissioner of Taxation* [1967] 1 AC 308; 10 AITR 65. The majority of the Board there justified their inclusion in the taxable income of the appellants certain moneys which in fact had not passed through the appellants' hands, because they had earned those moneys and once the offending transactions were annihilated then the exposed situation would make the appellants entitled to receive them. At p 331 (AC) and p 69 (AITR) their Lordships said· "Section 260 has to be construed with ss 17 and 19. It can only have practical effect in preventing tax avoidance if the commissioner is entitled to make an assessment on the basis that the contracts, agreements and arrangements rendered void by it had never been made This necessarily involves treating the taxpayer as having derived income in excess of that derived by him pursuant to the arrangements. In their Lordships' opinion, reading these three sections together, the commissioner was entitled to assess the appellant on the income he would have received in each of the three years if the arrangements coming within s 260 had not been made in 1956." It is plain that their Lordships relied on s 19 which is the equivalent of our s 92(1). It may be asked then whether our s 92(1) could be invoked in this case. Section 92(1) reads:

> "92 **Income credited in account or otherwise dealt with** (1) For the purposes of this Act every person shall be deemed to have derived income although it has not been actually paid to or received by him, or

already become due or receivable, but has been credited in account or reinvested, or accumulated, or capitalised, or carried to any reserve, sinking, or insurance fund, or otherwise dealt with in his interest or on his behalf "

But this question is answered by Mr Blank's express disclaimer of any reliance upon that section. He says that it was not designed for use in the present class of case, and at first sight I would agree. What he says, instead, is that when the leases, the employment of the taxpayer and the trust itself are annihilated, then the wife of the taxpayer and the stock company are seen to have received money from the harvesting and selling of grain sown and cultivated by the taxpayer on his own land, and that being the situation they must be held to to have received that money pursuant to a constructive trust which required them to account to the respondent. By this route the Commissioner claims that the respondent, as the beneficiary of that trust, is to be treated for taxation purposes as having derived the money

But Mr Somers says that this notional attribution to the taxpayer of income which he did not receive and of which he was unable to compel payment is not permissible, for two principal reasons which I will discuss

The first reason is that if we were to erect a constructive trust we would be doing exactly what the Privy Council has said should not be done — that is legislating to fill a lacuna existing in what Lord Donovan called a "half-finished" section. Lord Donovan first drew attention to *Peate's Case* to this gap, especially at p 347 (AC) and p 79 (AITR), when he pointed out that it was not enough to destroy: "The old order is not revived by thus annihilating the new. What is needed is authority for the commissioner to make such assessments to tax as in his view are required to prevent the avoidance of tax which would otherwise occur. Section 260 contains no such authority; and without it, the attempt to impose liability in accordance with 'the facts that remain' leads to difficulty and frustration. The section is obeyed at one time and disobeyed at another." Lord Donovan's judgment was a dissenting one because he could not see that on any basis the taxpayer could be said to have derived the disputed income. The majority, as I have said earlier, seem to have called in aid the equivalent of our s 92 In *Mangin's Case, supra* on appeal from this Court, Lord Donovan delivered the opinion of the majority (Lord Donovan, Viscount Dilhorne, Lord Pearson and Sir Frank Kitto) and he returned to the same point. It is necessary to quote a somewhat lengthy passage from his opinion (p 596): "The third contention of the appellant is that s 108 can have no application to any income which the taxpayer did not derive. The 1954 Act provides — see s 77(2) — that income tax is to be payable on all income derived by the taxpayer; and in this case the appellant did not derive that portion of the income of the farm which went, under the 'paddock trusts' to the trustees

"This contention throws into relief the difficulties caused by leaving a section such as s 108 completely silent as to what is to happen once the contract, agreement or arrangement has been declared absolutely void so far as its tax relieving purpose or effect is concerned Is a vacuum left or is the taxpayer to be deemed to go on deriving the income? What is to happen if, simply in order to avoid tax, he has parted with the source of the income? Or receives money which is capital and not income? Section 108 gives no guidance at all on these points whether regarded alone or in conjunction with s 77 of the 1954 Act or s 78. In consequence, and in consequence also of some of the absurdities to which a strictly literal interpretation of s 108 would lead, Judges have been compelled to search for an interpretation which would make the section both workable and just. In doing so they

inevitably approach the line where interpretation ceases and legislation begins — *a line which they may not cross* It is not that the problem confronting the legislator is insoluble. What is needed is simply a provision to the effect that where s 108 applies the taxpayer shall be deemed to have derived the income which he would have derived but for the contract, agreement or arrangement avoided by the section: and that the Commissioner might make assessments upon him accordingly.

"But if future cases may reveal la cunae in s 108 which (if that section be left in its present half-finished state) Judges must refuse to fill, the present case does not." Now it is true that some of this could be said to be obiter, for Lord Donovan's opinion finds that the income had actually passed through the hands of the taxpayer and so the taxpayer had derived it. Lord Wilberforce differed on this point, taking the view that the Commissioner could not avail himself of that circumstance for it had only so passed on its way to trustees who were entitled to it.

In another judgment delivered in the Privy Council on the same day, *Commissioner of Inland Revenue v Europa Oil (NZ) Ltd* [1971] NZLR 641, Lord Donovan delivered a dissenting opinion on behalf of himself and Viscount Dilhorne and reinforced his statement in *Mangin* in these words: "These absurdities convince us that if the Board acceded to the invitation to apply it to a case like the present, it would certainly not be correctly interpreting the will of the New Zealand Legislature. We think the true interpretation of s 108 to be adopted is that set out by the majority of the Board in the current case of *Mangin v Commissioner of Inland Revenue* " The majority in the *Europa Case* did not find it necessary to consider s 108.

In *Wisheart, Macnab and Kidd v Commissioner of Inland Revenue, supra,* North P said. "I think it must now be accepted that in the view of all their Lordships who sat in *Mangin's Case* what was said in *Peate's Case* really amounted to legislating rather than interpreting the section. I draw this inference because the suggested amendment to s 108 proposed by Lord Donovan in *Mangin's Case* closely follows the way the majority of their Lordships expressed themselves in *Peate's Case.*" Haslam J at p 337, after citing from the observations of Lord Donovan said: "Unless and until such a change appears in the text of the section, judges cannot cross 'the line where interpretation ceases and legislation begins', but must attribute a meaning to the section that is 'both workable and just'.

"In effect therefore, s 108 annihilates but cannot create; it nullifies but does not revest. *Unless the income can be left in the taxpayer's hands by the avoiding process and his accounting to another in pursuance of the 'arrangement' be rendered void ab initio at that point,* so as to strip away retrospectively his fiduciary functions, s 108 *cannot bring the income back into his hands to be eligible for tax purposes."*

So even though some of what was said in *Mangin* may be obiter, this Court plainly has accepted that it cannot disregard even if it wanted to, such repeated warnings from the Privy Council in relation to this particular section against moving into the field of the Legislature by filling the vacancy which it left deliberately

It is in the light of these statements that Mr Somers claims that to imply a trust here would be doing just what the Privy Council warned against, for a constructive trust would be nothing more than an equitable remedy to enable something to be done for which the statute has not provided. That the real function of such a trust is the provision of an equitable remedy was stated by Lord Denning in *Hussey v Palmer* [1972] 3 All ER 744 at 747. That was a case where the plaintiff built, at her own cost, an extra room on a

house belonging to her son-in-law. She was to live in it. Later she sought to recover the cost from the son-in-law as money lent to him. Lord Denning, after holding that there was no loan, said: "If there was no loan, was there a resulting trust? and, if so, what were the terms of the trust? Although the plaintiff alleged that there was a resulting trust, I should have thought that the trust in this case, if there was one, was more in the nature of a constructive trust; but this is more a matter of words than anything else. The two run together. By whatever name it is described, it is a trust imposed by law whenever justice and good conscience require it. It is a liberal process, founded on large principles of equity, to be applied in cases where the defendant cannot conscientiously keep the property for himself alone, but ought to allow another to have the property or a share in it. The trust may arise at the outset when the property is acquired, or later on, as the circumstances may require. *It is an equitable remedy by which the court can enable an aggrieved party to obtain restitution.* It is comparable to the legal remedy of money had and received which, as Lord Mansfield said, is very beneficial and, therefore, much encouraged."

This view of Lord Denning of a constructive trust is much closer to that prevailing in the United States than had generally been accepted in England. In the United States the device of a constructive trust is seen as part of the law of restitution required by unjust enrichment, and is therefore dealt with in the Restatement of Restitution rather than in the Restatement of Trusts I would have thought that there was much to be said for this view of its essential character, but until *Hussey v Palmer, supra* that received little support in England. In *Reading v Attorney-General* [1951] AC 507 at 513, Lord Porter rejected it rather decisively and, indeed, it has generally been accepted that constructive trusts, in which rather general term I include resulting trusts, are substantive in nature and not purely remedial; as the authors of *Goff and Jones's Law of Restitution* point out (p 37).

Be this as it may, it is not possible to imply a trust here. The least objectionable form of trust would be a resulting trust, one supported by the argument that the taxpayer must be seen, once the lease and employment contract are annihilated, as having made a *gift* to the trustees of the crop, that to be held on the terms of the Deed of Trust. If that were the position, then it would be possible to take the argument further and say that the gift, having been made in breach of the statute, a resulting trust in favour of the donor arose because of failure of the trust on which the gift was made. That is a well recognized foundation for a resulting trust. But all this demands a gift, and there is no factual basis for one here, even a gift of the crop. The annihilation of the transactions of lease and employment does not eliminate the facts disclosed by the case stated that possession of the crop was given by the taxpayer to the trustees pursuant to a contractual arrangement, which the parties thought binding, and which required the taxpayer to give a lease of the land and to sow the crop, in exchange for certain payments to him. Even if those facts are shut out from our vision, there is no gift. All that is left then is that the trustees took the crop, presumably without any legal authority, and sold it If that be the true approach then, possibly, the taxpayer should be regarded as having a right of action for restitution in one of its different forms, or for conversion, or for trespass. But whatever form that right of action were to take it must be something very different from a trust Clearly, to my mind, it would be wrong on a claim by the Commissioner for tax by invoking s 108 to convert a right of action in tort into a trust. To do that and thereby fill in the gap in the legislation would be

go far beyond what the Privy Council for this Court has done up to date and far beyond what I think we are entitled to do.

I would uphold the judgment of Wilson J that the Commissioner was not entitled to include the income arising from the sale of the crop by the trustees, and would dismiss the appeal.

The Court being unanimous the appeal is dismissed

The appellant will pay the respondent's costs in the sum of $450 and approved disbursements

Richmond J: I concur in the observations of the President concerning the difficulties created by s 108 and the need for legislative clarification.

The principle is now well established that s 108 of the Land and Income Tax Act 1954 is of no assistance to the Commissioner unless the avoidance of an arrangement and of steps taken to carry it out reveals a notional situation in which it can properly be said that the taxpayer has derived income. It also seems clear, particularly since the decision of the Privy Council in *Mangin v Commissioner of Inland Revenue* [1971] NZLR 591, that the section does not entitle the Court to construct some relationship between the taxpayer and other parties involved It can only deal with the matter on what remains of the factual situation after avoidance of all transactions having the purpose or effect of avoiding tax.

In the present case the transactions by which the initial plan was carried into effect and which had the effect of avoiding taxation were in particular the leases from the taxpayer to the trustees of the Murchison Family Trust and the contract between those trustees and the taxpayer whereby the taxpayer cultivated the land and planted and managed the crop as an employee of the trustees. Under these arrangements the taxpayer had no proprietary interest in the crop which at all times belonged to the trustees. What then is the notional position revealed when the lease and contract just referred to are rendered absolutely void by s 108? One must deal with the matter simply on the facts remaining, namely that the taxpayer planted and produced a crop on his own land. It was therefore his crop. But by growing a crop he did not derive income. He could only derive income if the crop was sold and he himself either received the proceeds of sale or, at least, became entitled to those proceeds. In the latter case, it might be possible to apply the provisions of s 92(1) of the Act whereby it is provided:—

> "92 **Income credited in account or otherwise dealt with** (1) For the purposes of this Act every person shall be deemed to have derived income although it has not been actually paid to or received by him, or already become due or receivable, but has been credited in account, or reinvested, or accumulated, or capitalised, or carried to any reserve, sinking, or insurance fund, or otherwise dealt with in his interest or on his behalf."

In the leading cases dealing with the effect of s 108 and its Australian equivalent the Courts have found that after avoidance of certain transactions the legal and factual situation remaining has disclosed either the actual receipt by the taxpayer of moneys owing to him or something tantamount to an application of moneys owing to the taxpayer in a manner which could be described as a crediting in account or as a dealing in his interest or on his behalf. Thus in *Newton v Commissioner of Taxation of the Commonwealth of Australia* [1958] 2 All ER 759; [1958] AC 450 the situation revealed after avoidance was one in which the taxpayers were entitled to receive certain dividends declared by a company. Their Lordships were able to say that the money by which those dividends were

paid actually came into the hands of the shareholders with the excep[illegible] of a comparatively small amount which remained in the pocket of a company called Pactolus Ltd. As to that particular sum of money, Lord Denning said (at p 468): "But when the transfer is ignored, that profit is seen to be nothing more or less than remuneration which the original shareholders allowed Pactolus to retain for services rendered. The position is the same as if the shareholders had received it as part of the special dividend and then returned it to Pactolus as remuneration. The Commissioner can therefore treat this £102,414 also as income derived by the shareholders." Although his Lordship did not expand further on this particular point I assume that the money in question was regarded as money to which the shareholders were entitled but which was retained by Pactolus and thereby dealt with on behalf of the shareholders.

The next important case was *Peate v Federal Commissioner of Taxation* [1967] 1 AC 308; 10 AITR 65. As I understand the decision in that case, the majority of their Lordships found that after avoidance of a number of complicated transactions the notional situation which remained was one of a number of doctors actually carrying on their profession and earning fees as a partnership either within the ordinary meaning of the word "partnership" or within a special definition contained in the Australian Act. The bulk of the income earned found its way in the first instance into the hands of the doctors concerned The remaining fees earned by the doctors were received by a company called Westbank, the formation and existence of which was avoided by s 260 of the Australian Act. At p 333 their Lordships said: "In so far as patients did in fact contract to pay Westbank for the treatment they received, treating the income of Westbank as that of the doctors does not in their Lordships' opinion require any substitution of any contract for that made by the patient. The sums received by Westbank from such patients were, as were the fees earned by the doctors employed by Westbank at a salary, part of the income of the doctors who were, if the existence of Westbank is disregarded, in receipt of income jointly." Earlier in the judgment express reference had been made to s 19 of the Australian Act which is the equivalent of our s 92(1). I confess to having some difficulty in understanding with confidence the steps in their Lordships' reasoning but it may be that the passage which I have just cited means that as the doctors had earned the fees they and they alone became entitled to them and that once the existence of Westbank was disregarded, the fact remained that those fees had been received and dealt with in a way directed by the doctors. If I am wrong in that interpretation of the judgment, then I agree with what was said in this Court by North P in *Wisheart, Macnab and Kidd v Commissioner of Inland Revenue* [1972] NZLR 319 at 326, when he said: "I think it must now be accepted that in the view of all their Lordships who sat in *Mangin's Case*, what was said in *Peate's Case* really amounted to legislating rather than interpreting the section."

Finally in *Mangin's Case* itself the basis of the decision was clearly an actual receipt by the taxpayer of the proceeds of sale of the crop.

In the present case the proceeds of sale of the crop were not in fact at any time received by the taxpayer. Mr Blank did not rely on s 92(1) but submitted that the trustees of the Murchison Trust, in the notional state of affairs revealed by avoidance of the lease and the cultivation contract, are found to be acting as constructive trustees *for the taxpayer* in relation to the crop and its proceeds with the result, as I understand it, that the net proceeds of the sale after allowing for the actual expenses incurred by the

trustees in relation to the crop amount to income derived by them as trustees for a beneficiary (the taxpayer) absolutely entitled in possession He placed particular reliance on the old case of *Brown v Litton* (1711) 1 *Peere Williams* 140; 24 ER 329. That, however, was a case in which the defendant had constituted himself a trustee *de son tort* by using money belonging to a deceased estate for the purposes of trade. As such he was accountable to the executrix for the profits of trading. It seems to me that the decision in that case and in other cases referred to by Mr Blank arose from the fundamental circumstance that the property used for the purposes of trade was trust property. In the present case I find it impossible to apply the same principle to the facts revealed after avoidance. The crop and the land on which it was grown were the absolute legal and beneficial property of the taxpayer and were not affected by any trust at all. I can see no basis on which it can be said that the crop was grown or harvested or sold by the trustees of the Murchison Trust as trustees for the taxpayer. In this context I have given thought to the possibility of a resulting trust of the kind which arises when a settlor transfers property to a trustee on trusts which fail, as would the Murchison Trust in the present case if it too is caught by s 108 But it would be necessary at least to show that in the notional state of affairs revealed after avoidance the trustees of that trust acquired the legal ownership of the crop. I see no justification for so holding, for their title to the crop disappears with the avoidance of the arrangement. In any event I did not understand Mr Blank to argue the case on this basis.

I would add that in my opinion the effect of s 108 is merely to deprive the transactions which it avoids of all legal effect and operation as between the taxpayer and the Commissioner. It does not go to the extent of requiring the Court to disregard for all purposes the acts of the parties in entering into those transactions In particular, the Court can take cognizance of the transactions for the purpose of arriving at the actual intentions of the parties when they acted in the manner in which they did. In the present case the trustees intended to sell the crop in their own right. It is therefore impossible for the Court to impute to them some notional relationship with the taxpayer into which they never entered as, for example, a notional appointment of the trustees as agents of the taxpayer to sell the crop, or a notional gift of the crop by the taxpayer to the trustees The true position revealed after avoidance is that the taxpayer and the trustees were acting under a common mistake as to the ownership of the crop. In such a situation there may well be a remedy in equity whereby restitution could be achieved by ordering payment to the taxpayer of a sum equivalent to the price obtained on the sale of the crop less the costs of harvesting and cultivation and rental payments paid by the trustees. That, however, is a very different thing from saying that the trustees of the Murchison Trust derived income as trustees for the taxpayer. In my opinion, the present case is of a kind envisaged by the majority of their Lordships in *Mangin's Case*. The Court is unable to say that in the notional state of affairs revealed after avoidance the taxpayer did derive income as contended for by the Commissioner.

I would add that on the view which I have taken of this case it makes no difference whether or not the Murchison Family Trust be regarded as an essential part of the tax avoiding arrangement and therefore itself avoided by the provisions of s 108. I have accordingly not found it necessary to express any opinion on that point.

I would dismiss the appeal.

Speight J: I agree that the appeal should fail Emphasis has already been laid on the fact the Commissioner did not challenge the sale of the crops and receipt of the proceeds by the trustees The crux of the matter is that no sure conclusion can be drawn as to the true situation whereby this money was in their hands. Was it a gift? A conversion? The subject of a resulting trust? There are a number of possibilities which come to mind — it is not the function of this Court to fill the vacuum These matters have been fully canvassed and nothing useful could be achieved by repeating the observations already made by the other members of the Court of the difficulties in the way of construing the funds as derived income.

At no stage was the money in the hands of Mr Gerard, not even in the capacity as an agent. We then arrive at a situation to adopt words of Lord Wilberforce, that the limits of judicial interpretation, however liberal or commonsense the process may be claimed to be, would be passed if one attempted to apply s 108 to the present facts.

The appeal should be dismissed.

Solicitor for the appellant: *Crown Law Office*, Wellington.

Solicitors for the respondent: *Duncan Cotterill & Co*, Christchurch.

E F MANNIX
BARRISTER-AT-LAW

Mr R.B. McLuskie,
Assistant General Secretary
and Legal Adviser,
Federated Farmers of N.Z. (Inc.),
P.O. Box 715,
WELLINGTON.

Dear Mr McLuskie,

I have carefully considered your letter of 12 September. It is a little difficult for me to comment freely on it as I see that you will be discussing clause 8 of the No. 2 Tax Bill with the Minister of Finance. What I say below are my own personal views but I trust they may be of assistance to you in any further study you make of the clause.

Let me say at the outset that I personally consider that the guidelines the Inland Revenue Department issued in 1967 (following the Elmiger case) and again in 1971 (as part of its paper to a series of seminars) struck the proper balance between the Revenue and the rights of a taxpayer to transfer his assets without adverse tax effects.

These guidelines were based on what was considered to be the effect of the Elmiger decision and dicta in other cases both in New Zealand and Australia up to that time. I attach a copy of these guidelines. So far as the farming community is concerned, it will be seen that while each case would need to be considered on its own particular facts the guidelines would in general terms accept permanent transfers of the farming property itself or an interest therein as not caught under section 108, but would seek to apply the section in all paddock trust situations and the other type of farming arrangements referred to in paragraph 2 under the heading The "Blacks" in the guidelines.

Perhaps your Association may care to express a view whether in broad terms that this is the proper dividing line that the section should seek to establish.

Since 1971 there have been a number of cases which have eroded the position of the Revenue in New Zealand and destroyed what was considered the proper balance between the taxpayer and the revenue up to that time. Dicta from these later cases tended to hold :

* That tax avoidance had to be the sole or principal purpose (which was contrary to what was said in Australian cases - I refer to this below).

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- That an arrangement could be acceptable if it could be explained by family or business dealing, no matter that tax avoidance was quite a significant element in the whole arrangement.
- That the fact that the taxpayer was not a direct party to an arrangement could prejudice the position of the Revenue despite the fact that he was the principal instigator of the whole arrangement.

In addition there was some criticism from the Courts that the old section 108 was "unfinished" in the sense that it failed to say what was to happen to the income when a particular arrangement was struck down by the section.

The main considerations in redrafting the section were to specifically correct this unfinished aspect to which I have just referred and what is important in the present context to also restore the position to what it was considered to be following the Elmiger decision in 1966 but to do no more than that. However, it was considered necessary in achieving this end to specifically deal with the dicta from the Courts since 1971 which had, as stated, destroyed the balance previously obtained.

With this background I turn now to the specific points in your letter. You suggest the word "principal" should be inserted before the word "purpose". However, for the reasons as stated above it is considered that the test of principal purpose was not the interpretation given to the section in the immediately post Elmiger period. It is relevant to point out here that the Australian Courts have refused to follow the later dicta from the New Zealand Courts and some apparent dicta from the Privy Council on New Zealand cases and they have maintained that the Australian section 260, which is the counterpart of the old section 108, has the following effect:

- It is not necessary for taxing authority to show that tax avoidance is the <u>sole or principal purpose</u> of the particular arrangement.
- However, tax avoidance has to be something more than merely an incidental feature.
- It is contemplated that an outright transfer of "the income producing substance" would be acceptable for tax purposes.

I refer in particular in this respect to the case of Hollyock v C.I.R.

I deal now with the reference to "ordinary family dealing". Again this is to get over the difficulty which could arise from recent dicta from the Courts. This dicta has tended to accept that if a taxpayer could point to a common practice

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(e.g. the fact that the creation of paddock trusts was common in a particular area may have been accepted as ordinary "family dealing") this would take the arrangement outside the section no matter how strong was the element of tax avoidance. As already indicated to you it is considered the provision in sub-clause (1) of the new clause that the element of tax avoidance must be something more than an incidental purpose protects the position of the taxpayer while getting over the difficulty to which I have just referred.

I trust this has set my views out in proper perspective for you.

Yours faithfully,

(D.A. Stevens)
Commissioner

FEDERATED FARMERS OF NEW ZEALAND (INC.)

7TH FLOOR, C.U. COMMERCIAL UNION HOUSE, 140-144 FEATHERSTON ST., WELLINGTON, 1, N.Z.
P.O. BOX 715 TELEGRAMS: "FARMLANDS" TELEPHONE 46-869

12 September 1974

Mr D. A. Stevens,
Commissioner,
Inland Revenue Department,
WELLINGTON.

Dear Mr Stevens,

Thank you for your letter of 30 August, together with the proposed substitution for clause 8 of the Land and Income Tax Amendment Bill (No. 2).

The Federation has given close consideration to the substituting clause, but it is our firm opinion that the reworded clause does not meet the objections we made in our submissions to the Minister of Finance.

In our original submissions we asked that the existing Section 108 should be clarified by inserting the word 'principal' before the word 'purpose' in the fifth line. It would thus be made clear that agreements and arrangements referred to would be void only if they had the principal purpose or effect of altering the incidence of income tax or relieving any person from his liability to pay income tax.

Under the proposed further amendment the arrangement would be void whenever the arrangement has, or purports to have, as its purpose or effect the altering in any way of the incidence of income tax, etc., on all occasions where the altering of income tax is more than a mere incidental purpose or effect.

The proposed further amendment also continues the provision whereby the defence of "ordinary family dealing" is removed, even in those cases where the minimising of tax is just something a little more than a mere incidental purpose or effect. The Federation in its previous submissions had urged strongly the deletion of the provision whereby it is proposed to remove the defence of ordinary family dealings. We again urge strongly the removal of the bar to this defence.

As you may be aware we had earlier arranged for a deputation from Federated Farmers to see Mr Rowling on this Bill. Because of circumstances it was not possible to see him. We will now be renewing our request to see the new Minister of Finance, Mr Tizard, and will be approaching his private secretary to see if an interview can be arranged.

It is our very firm opinion that case law was giving Section 108 defined limits within which normal estate

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planning could take place. The one exception was a reconstruction clause. The introduction of new legislation if proceeded with will, in our opinion, create a grave situation in the farming industry. As we have stated previously, transactions and arrangements which up until now could be undertaken in confidence will no longer be able to be undertaken with any degree of certainty as to their outcome.

Yours sincerely,

R. B. McLUSKIE,
Assist. General Secretary
and Legal Adviser.

NEW ZEALAND SOCIETY OF ACCOUNTANTS

Woodward House, 99 The Terrace. P.O. Box 10046, Wellington, New Zealand
Telephones: 71-572, 70-029. Telegraphic Address: "Fidelis", Wellington.
Secretary: K. R. Macdonald

D.2/20/1003/04

3 September 1974

Mr. D.A. Stevens,
Commissioner of Inland Revenue,
Inland Revenue Department,
P.O. Box 2198,
WELLINGTON.

Dear Mr. Stevens,

Thank you for your letter of 28 August concerning the redrafting of section 108 of the Act as contained in Clause 8 of the Land and Income Tax Amendment Bill (No. 2).

I have passed copies of your letter and the proposed amendment on to all Wellington members of the Society's National Taxation and Legislation Committee for any action they consider necessary.

Thanks again for supplying particulars of the proposed change.

Kind regards,

Yours sincerely,

W.A. Clark,
Secretary,
National Taxation and Legislation Committee

WAC:OW

H.O. 1093

29 August 1974

The Minister of Finance,
Parliament Buildings,
WELLINGTON.

SECTION 108 - ANTI-TAX PROVISIONS IN CLAUSE 8, NO. 2 TAX BILL

Arising from an interjection by the Leader of the Opposition during your Second Reading speech on the Tax Amendment Bill last night, I attach comments which may assist you and possibly some of your colleagues in answering any likely questions which may be raised.

(D. A. Stevens)
Commissioner.

Encl.

SECTION 108 - ANTI-TAX AVOIDANCE CLAUSE IN (NO.2) TAX BILL

POSSIBLE COMMENTS BY OPPOSITION IN SECOND READING DEBATE

i) Based on an interjection by the Leader of the Opposition during the Minister's Second Reading speech on the No. 2 Tax Amendment Bill last night, it is likely that he will ask why Clause 8 of the Bill introducing a new version of section 108 was not included as a Budget item and

ii) he may also claim that the Department is too enthusiastic in promoting the amendment and that the changes go too far against the taxpayer.

The following comments may assist in subsequent debate.

Three answers could be given in respect of (i) above, viz.

(a) The Judgment in the Court of Appeal in the Gerard case was handed down on 20 May 1974 i.e. only 10 days before Budget date of 30 May. In this Judgment there was criticism of the existing section and a suggestion that the legislature should do something about it. However, there was insufficient time for an appraisal of the position before Budget date.

(b) The decision in Gerard gave an illogical result as between two taxpayers in more or less the same real circumstances - again, as stated, there was no time before Budget to consider the whole situation - but clearly when this was examined some action was needed.

(c) In any case, as explained below in relation to (ii) above, the new version of section 108 in the Bill is intended to merely restore what was considered to be the effect of the old section 108 following the decision and dicta in the well known Elmiger case in New Zealand in 1966. This was generally considered to have given a reasonable result at the time. However, subsequent dicta from the New Zealand Courts and Privy Council have tended to restrict the application of the section to greatly reduced areas and in doing so to produce illogical results between two taxpayers in similar circumstances.

So far as (ii) above is concerned, as already stated the Department considers the new version will merely restore what was considered to be the effect of the old section following the Elmiger case in 1966.

Based on dicta from Elmiger and other cases, the Inland Revenue Department published in its Public Information Bulletin in September 1967 the guidelines and interpretations it would follow in considering transactions between taxpayers and members of their families and family trusts.

Later on in 1971, the Department combined with the New Zealand Society of Accountants to conduct seminars throughout New Zealand again explaining the guidelines and interpretations of the section it was following.

Basically, the Department's attitude based on dicta from the Courts was that, where the "income producing substance" was permanently transferred to members of a taxpayer's family or family trust, it was acceptable for tax purposes. In other words, if permanent assets such as freehold land or shares in a company were transferred - no matter how favourable were the terms of transfer - the transfer would be accepted. However, if the use of such assets was merely transferred for a short period or, alternatively, if "short term" assets such as plant and machinery were sold to a family trust and hired back (this was the situation in the Elmiger case), these types of cases would run the risk of being declared void for tax purposes.

Incidentally, the Department was commended in professional circles for coming out with its guidelines so taxpayers and their advisers could at least know of the Department's approach. The guidelines given by the Department in 1967 and 1971 are still considered valid in relation to the mainspring of the new section 108 i.e. subsection (1).

However, since the Elmiger case and the issue of the Public Information Bulletin in 1967 and the seminars of 1971, the Courts in New Zealand with apparent support from the Privy Council, have tended, as stated, to take a narrower view of the circumstances in which the section could be applied with illogical results as between taxpayers. In the Mangin case which was a "paddock trust" situation, the farmer received the proceeds from the paddock he had leased to the trust and then paid the receipts to the trustees. This case was decided by the Privy Council in favour of the Department. In the Gerard case, the receipts were paid direct to the trustees and the Court of Appeal found against the Revenue.

It would be relevant to point out here that the Australian Courts have refused to follow the later dicta from the New Zealand Courts and some apparent dicta from the Privy Council on New Zealand cases and they have maintained that the Australian section 260, which is the counterpart of the old section 108, has the following effect:

- It is not necessary for the taxing authority to show that tax avoidance is the "sole or principal purpose" of the particular arrangement

- Nevertheless, tax avoidance has to be something more than merely an incidental feature

- It is contemplated that an outright transfer of the "income producing substance" would be acceptable for tax purposes. This was confirmed, in particular, by the case of Hollyock (not Holyoake).

To summarize, it is considered that the new version of section 108 does no more than restore the position to what was considered to be the position in New Zealand following the Elmiger case in 1966 and what in general terms is still considered to be the position adopted by the Australian Courts under the counterpart of the old section 108 in Australia. No doubt the Leader of the Opposition, when Minister of Finance, would have had occasion to look at the guidelines and dicta the Department was following and would have satisfied himself that the dividing line between the acceptable and unacceptable was correctly drawn.

Some Philosophical Arguments on Tax Avoidance Generally

Over the years, there has been comment on just how far a person should be able to avoid or reduce his tax and what action the legislature should take to combat the various types of tax avoidance. In its papers for the 1971 seminars, these opposing points of view were dealt with and I attach as Appendix A the relevant comments.

I also attach Appendix B, the guidelines issued by the Deoartment in 1971 at the seminars referred to above.

Some Reflections on Tax Avoidance

A paper on tax avoidance should perhaps make at least passing reference to the divergence of opinion relating to -

(2) The ethics of avoiding or reducing the liability for income tax by arrangements which are within the law.

It is interesting to note that in the decade before the Second World War the following much quoted dicta emerged from the Courts -

Ayshire Pullman Motor Services and Ritchie v. I.R. Commissioners (1929) 14 T.C. 754 -

"No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores."

Duke of Westminster v. I.R. Commissioners (1936) A.C.1 -

"Every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then however unappreciative the Commissioner of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax."

Since Lord Clyde and Lord Tomlin made these pronouncements the Courts have expressed the view that untrammelled freedom on the part of a taxpayer "to order his affairs" so as to pay as little tax as possible is not necessarily in the best interests of the community -

Latilla v. I.R. Commissioners (1943) A.C. 377

"Judicial dicta may be cited which point out that however elaborate and artificial such methods may be, those who adopt them are 'entitled' to do so. There is, of course, no doubt that they are within their legal rights, but that is no reason why their efforts or those of the professional gentlemen who assist them in the matter should be regarded as a commendable exercise of ingenuity or as a discharge of the duties of good citizenship. On the contrary, one result of such methods, if they succeed, is, of course, to increase pro tanto the load of tax on the shoulders of the great body of good citizens who do not desire or do not know how to adopt these manoeuvres."

More recently in Elmiger v. C.I.R. (1966) N.Z.L.R. 683 Woodhouse J. commented at page 686 -

"...since the House of Lords was obliged to consider the highly beneficial arrangements which were able to be made in 1930 on behalf of the Duke of Westminster there has been a growing awareness by the Legislature and the Courts alike that ingenious legal devices contrived to enable individual taxpayers to minimise or avoid their tax liabilities are often not merely sterile or unproductive in themselves (except perhaps in respect of their tax advantages for the taxpayer concerned), but that they have social consequences which are contrary to the general public interest."

B.

To consider the application of these principles in specific situations, it is convenient to divide cases into two categories -

* those where it is considered section 108 clearly does not apply - the "WHITES"

* those where it is considered that section 108 clearly applies - the "BLACKS".

The "WHITES"

Cases where the Department would generally regard section 108 as not having any application include -

(1) Transfers of land and buildings, blocks of flats, commercial and farm properties where these assets play a major part in the derivation of the income involved.

(2) The sale and lease back of a taxpayer's freehold business premises or farm property.

(3) The transfer of income yielding investments such as shares in public companies, debentures, Government and local body stock, mortgages and interests in real estate syndicates. Generally, the Department will not differentiate between shares in public companies and those in private companies but where small parcels of shares in a private company controlled by a taxpayer are transferred to a relative (or a family trust) and all subsequent dividends are paid on the relative's shares only, section 108 would be generally regarded as applying.

The assets mentioned above are often referred to as "permanent" assets. Where such assets are transferred, the Department generally accepts that the transaction gives effect to a plan to provide a permanent income producing and capital appreciating asset for the benefit of the transferee and that any income tax savings are merely incidental. The Department does not cavil at favourable terms of transfer provided there is a permanent transfer without reservations or reversions.

Circumstances where section 108 is regarded as applying include

(1) Where only part of a business is transferred and the taxpayer retains management and/or control of the business which continues to be operated as a single entity. Here the Department looks particularly closely at the facts before deciding whether a separate and distinct business has come into existence or whether the arrangement is tantamount to a "business within a business". Examples of situations in this category where section 108 would be applied are -

(a) "paddock trust" arrangements - Mangin v. C.I.R. 70 A.T.C. 6001

(b) arrangements where there has been an artificial division of the one business - 10 C.T.B.R.(N.S.) Case 113.

(c) arrangements where family companies, family trusts or family partnerships are established to "service" a professional practice or other business and the provision of services such as nursing and receptionist staff, clerical and office staff, cleaning services and so on is an integral part of the professional practice or business - 3 N.Z.T.B.R. Case 32, 4 N.Z.T.B.R. Case 19.

(d) the transfer of insurance and similar collecting agencies to a relative, family company or family trust where the work involved in earning the

commission continues to be performed by the taxpayer and/or his staff <Wisheart and Others v. Inland Revenue Commissioner (N.Z.) 1 A.T.R. 434 >

(2) Where the taxpayer retains full ownership of the assets which play a substantial part in the derivation of the income and merely gives the relative, family trust or family company the right to use such assets. Lease and bailment arrangements such as those encountered in the Marx and Carlson cases are examples of schemes which are clearly in this category.

(3) Where the income-earning structure of the business is such that it depends for its income on the professional knowledge, skills or expertise of the taxpayer - Peate case and 15 C.T.B.R. (N.S.) Case 36.

(4) Where "wasting assets" such as plant and machinery, motor cars, office equipment and other assets which diminish in value over a relatively short economic life, are transferred to a relative or other family entity and then leased back. Arrangements in this category are not regarded as being capable of explanation as a means of creating a permanent income producing fund for the benefit of the taxpayer's family and, in the Department's view, have the "goal" of tax avoidance through the rent deduction to the high income bracket taxpayer and the shift of income to the low income relative or other family entity - Elminger case and 3 N.Z.T.B.R. Case 38.

(5) Where a taxpayer makes an interest-free advance repayable on demand to a relative or family entity and then borrows the money back as an unsecured loan bearing interest at (say) 10% the arrangement would be regarded as having the object of reducing the liability for income tax by the creation of an artificial deduction.

(6) The Department would also generally invoke section 108 where a taxpayer advances to a relative or family entity by way of an interest free loan repayable on demand the funds required to purchase a short-life or "wasting asset" - this type of arrangement is little different from those described in (4) and (5) above.

Evening Post
Sat 31.4.76

Mr Muldoon Condemns 'Worst Possible' Clause In Tax Bill

Parliamentary Reporter

"RETROSPECTIVE legislation of the worst possible kind," was how the Leader of the Opposition (Mr Muldoon) described a clause in the Land and Income Tax Amendment Bill (No 2) in Parliament yesterday.

Clause 8 of the Bill was "bad in principle," he said, and expressed surprise that the Minister of Justice (Dr Finlay) supported it.

"It makes it impossible for any citizen who tries to minimise his tax to win a case against the Commissioner of Inland Revenue."

The clause was just one step away from having tax avoidance — as distinct from tax evasion —made illegal.

"This Government is going to greater and greater extremes in limiting the liberty of the subject."

He accused Dr Finlay of not knowing the difference between tax avoidance, tax minimisation, and tax evasion.

"Tax evasion is illegal and subject to stiff penalties. Tax avoidances and minimisation are the arranging of one's affairs so as to pay the smallest amount of tax possible. There's a world of difference between them and tax evasion."

Not Illegal

Tax avoidance and minimisation were not illegal or immoral anywhere — but they would be if this clause was passed unchanged.

Any arrangment, no matter how innocent, which had the effect of a reduction in the income tax of a person would be hit by this clause.

"The taxpayer will lose before he even goes to Court," he said.

Earlier, Dr Finlay said tax evasion was practised with varying degrees of skill and efficiency around the world, and there were virtual "national championships" in France and Italy.

However, this meant that some people were not paying their share of the nation's administration and development costs.

It was not as easy for the ordinary man in the street to avoid his tax, said Dr Finlay, as the businessman and the self-employed Clause 8 would plug a gap that existed in the tax provisions.

Mr P I Wilkinson (Nat, Rodney) said clause 8 allowed the Commissioner of Inland Revenue to void for tax purposes any contract, trust or other arrangement for the avoidance of taxation, whether or not tax avoidance was the main intention and whether or not it was made in the course of ordinary family dealings.

The Opposition refused to accept that it was impossible to draft a law that would exempt genuine deals while catching dodgers, and it would be tabling such a draft at a later stage as an amendment to the Bill.

Jail For Man Who Upset Guide Meeting

PALMERSTON N, Today (PA). — A 24-year-old Australian, Robert Smith, who last week broke up a Girl Guide meeting at Levin when he threatened the Guide captain with a knife, was sentenced to six months' imprisonment when he appeared in the Palmerston North Magistrate's Court yesterday.

Mr A A Coates, SM, said he would also recommend to the Minister of Internal Affairs that Smith be deported on the completion of his prison sentence.

Smith appeared on charges of assault, possessing an offensive weapon, and frequenting a public place with felonious intent. At an earlier Court sitting, he had pleaded guilty to all three charges.

Flying high above the Porirua Mall yesterday is 14-year-old Ian Matthews, of Porirua. Ian was one of many children who took advantage of a trampoline provided by the YMCA as part of their holiday programme. Next week the YMCA activities will include a day camp, a creative workshop and a variety of indoor sports at the Ngatitoa Domain Hall.

Mr P.J.H. Jenkin,
Messrs Chapman, Trip & Co.,
Barristers and Solicitors,
P.O. Box 993,
WELLINGTON.

Dear Mr Jenkin,

I enclose for your information a copy of a proposed new version of section 108 which the Minister of Finance proposes to substitute for that in clause 8 of the Land and Income Tax Amendment Bill (No. 2) now before Parliament. I also enclose a copy of a letter, the original of which was addressed to another body. This letter explains the significant changes in the proposed new draft.

The amendment will be made at the Committee stages.

Yours faithfully,

(D.A. Stevens)
Commissioner

Encl.

30 August 1974

Mr R.B. McLuskie,
Assistant General Secretary,
Federated Farmers of N.Z. (Inc),
P.O. Box 715,
WELLINGTON.

Dear Mr McLuskie,

I enclose for your information a copy of a proposed new version of section 108 which the Minister of Finance proposes to substitute for that in clause 8 of the Land and Income Tax Amendment Bill (No. 2) now before Parliament. I also enclose a copy of a letter, the original of which was addressed to another body. This letter explains the significant changes in the proposed new draft.

The amendment will be made at the Committee stages.

Yours faithfully,

(D.A. Stevens)
Commissioner

Encl.

30 August 1974

Mr G.H. Gould,
Messrs Lane, Neave & Co.,
P.O. Box 201,
CHRISTCHURCH.

Dear Mr Gould,

I enclose for your information a copy of a proposed new version of section 108 which the Minister of Finance proposes to substitute for that in clause 8 of the Land and Income Tax Amendment Bill (No. 2) now before Parliament. I also enclose a copy of a letter, the original of which was addressed to another body. This letter explains the significant changes in the proposed new draft.

The amendment will be made at the Committee stages.

Yours faithfully,

for (D.A. Stevens)
Commissioner

Encl.

30 August 1974

Dear Mr

Since the Land and Income Tax Amendment Bill (No. 2) was introduced further consideration has been given to the drafting and presentation of the new section 108 contained in clause 8 of the Bill.

The Minister of Finance has authorised me to give you a copy of the new version which it is proposed to substitute by Supplementary Order Paper for that in the Bill.

This amendment will be made at the Committee stages which I expect will begin some time next week. There is, therefore, some degree of urgency in any consideration that your wishes to give to the proposed new version.

It may help you if I outline the main changes. These are :-

(a) There is now a direct reference in the section to the effect that it will not apply if the purpose or effect of tax avoidance is merely an incidental one in the particular contract, agreement or arrangement. It is considered that this would have been the effect of the version in clause 8 particularly having regard to dicta from Australian Courts, but for an appearance sake it seems better to state this in specific terms.

(b) There is also added in the first sub-clause of the new version that if there is present something more than an incidental degree of tax avoidance, the fact that it can be explained by "ordinary business dealing" will not be taken as a reason for not applying the reason. Previously in this context the reference was only to "family dealing." However, the provisions stating that a contract, agreement or arrangement which has only an <u>incidental</u> purpose of tax avoidance would still not be caught gives the appropriate effect in this regard.

..2..

(c) Another change of some substance is a more detailed reference as to what is to happen when the section applies. The main criticism of the Courts in relation to the existing section 108 is that it does not say what is to happen when a contract, agreement or arrangement is voided for tax purposes. The version in clause 8 of the Bill states that the Commissioner is to determine how much income would have been assessed to the main taxpayer involved if the contract, agreement or arrangement had not been entered into. However, it is possible that because of the contract, agreement or arrangement actually entered into the overall income in a particular situation has been increased. This situation is now covered in paragraph (b) of sub-clause (2).

(d) The only other significant change is the regrouping of the sub-clauses in a way which is considered to be easier to follow than in the version in clause 8.

Kind regards,

Yours sincerely,

(D.A. Stevens)
Commissioner

28 August 1974

8. Agreements purporting to alter incidence of taxation to be void - (1) The principal Act is hereby amended by repealing section 108 (as amended by section 16(1) of the Land and Income Tax Amendment Act (No.2) 1968), and substituting the following section:

"108 (1) Every contract, agreement, or arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the Commissioner for income tax purposes if and to the extent that, directly or indirectly, it has or purports to have as its purpose or effect or as one of its purposes or effects (not being a merely incidental purpose or effect) the altering in any way of the incidence of income tax or the relieving in any way of any person from his liability to pay income tax, whether or not that person or any other person affected by that contract, agreement, or arrangement is a party to that contract, agreement, or arrangement, and whether or not that contract, agreement, or arrangement is an ordinary business or family dealing.

"(2) Where any contract, agreement, or arrangement is void in accordance with the provisions of subsection (1) of this section, any person (being a person who, in the opinion of the Commissioner, would have, or might be expected to have, or would in all likelihood have, derived any income but for that contract, agreement, or arrangement) shall be deemed to have derived such income as, in the opinion of the Commissioner, either -

"(a) He would have, or might be expected to have, or would in all likelihood have, derived but for that contract, agreement, or arrangement; or

"(b) He would have derived if he had been entitled to the benefit of all the income, or of such part thereof as the Commissioner thinks proper, derived by any other person or persons as a result of that contract, agreement, or arrangement -

and shall be assessable and liable for income tax accordingly.

"(3) Where any income is deemed to have been derived by any person pursuant to the provisions of subsection (2) of this section, that income shall be deemed not to have been derived by any other person.

"(4) Without limiting the generality of subsections (1) and (2) of this section, it is hereby declared that where, in any income year, any person sells or otherwise disposes of any shares in any company under a contract, agreement, or arrangement (being a contract, agreement, or arrangement of the kind referred to in subsection (1) of this section) under which that person receives, or is credited with, or there is dealt with on his behalf, any consideration (whether in money or money's worth) for that sale or other disposal, being consideration the whole or, as the case may be, a part of which, in the opinion of the Commissioner, represents or is equivalent to, or is in substitution for, any amount which, if that contract, agreement or arrangement had not been made or entered into, that person would have derived or would derive, or might be expected to have derived or to derive, or in all likelihood would have derived or would derive as income by way of dividends in that income year, or in any subsequent income year or years, whether in one sum in any of those years or otherwise howsoever, an amount equal to the value of that consideration or, as the case may be, of that part of that consideration shall be deemed to be a dividend derived by that person in that first-mentioned income year."

(2) The Land and Income Tax Amendment Act (No.2) 1968 is hereby consequentially amended by repealing section 16.

(3) This section shall apply with respect to the tax on income derived in the income year commencing on the 1st day of April 1975 (whether the contract, agreement, or arrangement was made or entered into on, before, or after that date) and in every subsequent year.

The Secretary,
National Taxation Committee,
N.Z. Society of Accountants,
P.O. Box 10046,
WELLINGTON.

Dear Mr Clark,

Since the Land and Income Tax Amendment Bill (No. 2) was introduced further consideration has been given to the drafting and presentation of the new section 108 contained in clause 8 of the Bill.

The Minister of Finance has authorised me to give you a copy of the new version which it is proposed to substitute by Supplementary Order Paper for that in the Bill.

This amendment will be made at the Committee stages which I expect will begin some time next week. There is, therefore, some degree of urgency in any consideration that your Committee wishes to give to the proposed new version.

It may help you if I outline the main changes. These are :-

(a) There is now a direct reference in the section to the effect that it will not apply if the purpose or effect of tax avoidance is merely an incidental one in the particular contract, agreement or arrangement. It is considered that this would have been the effect of the version in clause 8 particularly having regard to dicta from Australian Courts, but for an appearance sake it seems better to state this in specific terms.

(b) There is also added in the first sub-clause of the new version that if there is present something more than an incidental degree of tax avoidance, the fact that it can be explained by "ordinary business dealing" will not be taken as a reason for not applying the reason. Previously in this context the reference was only to "family dealing." However, the provisions stating that a contract, agreement or arrangement which has only an <u>incidental</u> purpose of tax avoidance would still not be caught gives the appropriate effect in this regard.

..2..

(c) Another change of some substance is a more detailed reference as to what is to happen when the section applies. The main criticism of the Courts in relation to the existing section 108 is that it does not say what is to happen when a contract, agreement or arrangement is voided for tax purposes. The version in clause 8 of the Bill states that the Commissioner is to determine how much income would have been assessed to the main taxpayer involved if the contract, agreement or arrangement had not been entered into. However, it is possible that because of the contract, agreement or arrangement actually entered into the overall income in a particular situation has been increased. This situation is now covered in paragraph (b) of sub-clause (2).

(d) The only other significant change is the regrouping of the sub-clauses in a way which is considered to be easier to follow than in the version in clause 8.

Kind regards,

Yours sincerely,

(D.A. Stevens)
Commissioner

28 August 1974

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Ref: 7/28 Commissioner of Inland Revenue

Refer ... reply

19/11/74

New Zealand Law Society

TELEPHONE 58-764
P O BOX 5041
Secretary W M Rodgers

THE LAW SOCIETY BUILDING
26 WARING TAYLOR STREET
WELLINGTON, C1 NEW ZEALAND

16 August, 1974.

Hon. W.E. Rowling,
Minister of Finance,
Parliament Buildings,
WELLINGTON.

Dear Mr. Rowling,

Further to my letter of 5 August regarding the proposed amendment to Section 108 of the Land and Income Tax Act 1954 and your subsequent reply, I have been instructed to advise you that the Society views the proposed amendment in its present form with concern.

It is accepted that the presently existing section is far from satisfactory, and as has been noted in the highest Courts, is in need of legislative review.

In the Society's view, however, the proposed amendment in its present form will create more difficulties than it will resolve. Without attempting any exhaustive list at this stage, the Society notes the following as problems obviously inherent in the proposed new section:-

1. Uncertainty in its application;

2. Retrospective effect. Particularly when the provisions of sub-clause (2) removing the judicially derived exemption for ordinary family dealing are borne in mind, the section will retrospectively affect a very considerable number of family trusts set up in bygone years, introducing much confusion.

3. Displacement of the judicially derived rule that to be caught by the section a transaction must have a "principal" purpose of tax avoidance by a rule which brings within the scope of the section a transaction having any purpose of tax avoidance, 'whether or not the principal purpose or effect". A multitude of transactions entered into primarily for business and family reasons and having only a relatively minor and incidental tax avoidance purpose will be prejudiced.

4. Assessment following application of the section. The section had adopted the 'fictional income" test as the means of assessment of the taxpayer

following application of the section. This test has been widely criticised and is considered by many to be unworkable.

The Society is in the course of preparation of a detailed submission in relation to the proposed amendment and in this particular case requests the opportunity of waiting upon you to present the submission and review the position further.

Yours sincerely,

W. M. Rodgers
Secretary

The Secretary,
New Zealand Law Society,
P.O. Box 5041,
WELLINGTON.

Dear Sir,

CLAUSE 8 OF THE LAND AND INCOME TAX AMENDMENT BILL (NO. 2) 1974

I understand that you have received a number of representations from your members on this Clause which rewrites anti-tax avoidance provisions in section 108 of the Tax Act.

The Minister of Finance has authorized me to supply you with a copy of the attached paper which sets out the changes in the new provisions which are considered to have any significant effect.

I trust this will be useful in the Society's deliberations.

Yours faithfully,

(D. A. Stevens)
Commissioner.

Encl.

John

Copy for your information

LAND AND INCOME TAX AMENDMENT BILL (NO.2)

8. Agreements purporting to alter incidence of taxation to be void - (1) The principal Act is hereby amended by repealing section 108 (as amended by section 16(1) of the Land and Income Tax Amendment Act (No.2) 1968), and substituting the following section:

"108 (1) Every contract, agreement, or arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the Commissioner for income tax purposes if and to the extent that, directly or indirectly, it has or purports to have as its purpose or effect or as one of its purposes or effects (not being a merely incidental purpose or effect) the altering in any way of the incidence of income tax or the relieving in any way of any person from his liability to pay income tax, whether or not that person or any other person affected by that contract, agreement, or arrangement is a party to that contract, agreement, or arrangement, and whether or not that contract, agreement, or arrangement is an ordinary business or family dealing.

"(2) Where any contract, agreement, or arrangement is void in accordance with the provisions of subsection (1) of this section, any person (being a person who, in the opinion of the Commissioner, would have, or might be expected to have, or would in all likelihood have, derived any income but for that contract, agreement, or arrangement) shall be deemed to have derived such income as, in the opinion of the Commissioner, either -

"(a) He would have, or might be expected to have, or would in all likelihood have, derived but for that contract, agreement, or arrangement; or

"(b) He would have derived if he had been entitled to the benefit of all the income, or of such part thereof as the Commissioner thinks proper, derived by any other person or persons as a result of that contract, agreement, or arrangement -

and shall be assessable and liable for income tax accordingly.

"(3) Where any income is deemed to have been derived by any person pursuant to the provisions of subsection (2) of this section, that income shall be deemed not to have been derived by any other person.

"(4) Without limiting the generality of subsections (1) and (2) of this section, it is hereby declared that where, in any income year, any person sells or otherwise disposes of any shares in any company under a contract, agreement, or arrangement (being a contract, agreement, or arrangement of the kind referred to in subsection (1) of this section) under which that person receives, or is credited with, or there is dealt with on his behalf, any consideration (whether in money or money's worth) for that sale or other disposal, being consideration the whole or, as the case may be, a part of which, in the opinion of the Commissioner, represents or is equivalent to, or is in substitution for, any amount which, if that contract, agreement or arrangement had not been made or entered into, that person would have derived or would derive, or might be expected to have derived or to derive, or in all likelihood would have derived or would derive as income by way of dividends in that income year, or in any subsequent income year or years, whether in one sum in any of those years or otherwise howsoever, an amount equal to the value of that consideration or, as the case may be, of that part of that consideration shall be deemed to be a dividend derived by that person in that first-mentioned income year."

(2) The Land and Income Tax Amendment Act (No.2) 1968 is hereby consequentially amended by repealing section 16.

(3) This section shall apply with respect to the tax on income derived in the income year commencing on the 1st day of April 1975 (whether the contract, agreement, or arrangement was made or entered into on, before, or after that date) and in every subsequent year.

AMENDMENT TO CLAUSE 8(1) of L. & I.T. AMENDMENT (No. 2)

00. Agreements purporting to alter incidence of taxation to be void - subclause (1) of clause 8 of the Land and Income Tax Amendment (No. 2) is hereby amended by repealing subsection (1) of section 108 of the principal Act, and substituting the following subsection:

"(1) For the purposes of income tax -

(a) Every contract, agreement, or arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the Commissioner if and to the extent that, directly or indirectly, it has or purports to have the purpose or effect, or purposes or effects which include 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 (whether or not that person or any other person affected by that contract, agreement, or arrangement is a party to that contract, agreement or arrangement); and

(b) Where any contract, agreement, or arrangement is void in accordance with the provisions of paragraph (a) of this subsection, any person (being a person who, in the opinion of the Commissioner, would have or might have been expected to have, or would in all likelihood have, derived any income but for that contract, agreement, or arrangement) shall be deemed to have derived such income and shall be assessable and liable accordingly; and

(c) Where any income is deemed to have been derived by any person pursuant to the provisions of paragraph (b) of this subsection, that income shall be deemed not to have been derived by any other person."

00. Agreements purporting to alter incidence of taxation to be void - clause 8 of the Land and Income Tax Amendment (No. 2) is hereby amended by repealing subclause (1) and substituting the following subclause:

(1) The principal Act is hereby amended by repealing section 108 (as amended by section 16(1) of the Land and Income Tax Amendment Act (No. 2) 1968), and substituting the following section:

"108 (1) Every arrangement shall be absolutely void as against the Commissioner for income tax purposes if and to the extent that, 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, whether or not that person or any other person affected by that arrangement is a party to that arrangement.

"(2) Where any arrangement is void in accordance with the provisions of subsection (1) of this section, any person (being a person who, in the opinion of the Commissioner, would have, or might be expected to have, or would in all likelihood have, derived any income but for that arrangement) shall be deemed to have derived such income and shall be assessable and liable for income tax accordingly.

"(3) Where any income is deemed to have been derived by any person pursuant to subsection (2) of this section, that income shall be deemed not to have been derived by any other person.

"(4) Without limiting the generality of the foregoing subsections of this section, it is hereby declared that no arrangement, being an arrangement made or entered into among, or affecting, any members of any family shall be excluded from the operation of those subsections by reason of the fact that the making or entering into of that arrangement was in any way influenced by considerations of ordinary family dealing.

The reference in this subsection to any members of any family shall be deemed to include a reference to -

"(a) Any relative of any such member; and

"(b) The trustee of any trust in which any such member or relative has an interest (including a contingent interest); and

"(c) Any partnership or other association of persons in which any such member, relative, or trustee has an interest; and

"(d) Any company of which any such member, relative, trustee, partnership or association is a shareholder.

"(5) Without limiting the generality of subsection (1) or subsection (2) of this section, it is hereby declared that where, in any income year, any person sells or otherwise disposes of any shares in any company under an arrangement (being an arrangement that, directly or indirectly, 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)

under which that person receives, or is credited with, or there is dealt with on his behalf any consideration (whether in money or money's worth) for that sale or other disposal, being consideration, the whole or, as the case may be, a part of which, in the opinion of the Commissioner, represents or is equivalent to, or is in substitution for, any amount which, if that arrangement had not been made or entered into, that person would have derived or would derive, or might be expected to have derived or to derive, or in all likelihood would have derived or would derive as income by way of dividends in that income year, or in any subsequent

year or years, whether in one sum in any of those years or otherwise howsoever, an amount equal to the value of that consideration, or, as the case may be, of that part of that consideration shall be deemed to be a dividend derived by that person in that first-mentioned income year.

"(6) For the purposes of this section -

"'Arrangement' means any contract, agreement, or arrangement made or entered into, whether before or after the commencement of this Act:

"'Purpose or effect' includes purposes or effects which include the purpose or effect, whether or not the principal purpose or effect."

AMENDMENT TO CLAUSE 8(1) of L. & I.T. AMENDMENT (No. 2)

00. Agreements purporting to alter incidence of taxation to be void - subclause (1) of clause 8 of the Land and Income Tax Amendment (No. 2) is hereby amended by repealing subsection (1) of section 108 of the principal Act, and substituting the following subsection:

"(1) For the purposes of income tax -

(a) Every contract, agreement, or arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the Commissioner if and to the extent that, directly or indirectly, it has or purports to have the purpose or effect, or purposes or effects which include 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 (whether or not that person or any other person affected by that contract, agreement, or arrangement is a party to that contract, agreement or arrangement); and

(b) Where any contract, agreement, or arrangement is void in accordance with the provisions of paragraph (a) of this subsection, any person (being a person who, in the opinion of the Commissioner, would have or might have been expected to have, or would in all likelihood have, derived any income but for that contract, agreement, or arrangement) shall be deemed to have derived such income and shall be assessable and liable accordingly; and

(c) Where any income is deemed to have been derived by any person pursuant to the provisions of paragraph (b) of this subsection, that income shall be deemed not to have been derived by any other person."

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(1) The principal Act is hereby amended by repealing section 108 (as amended by section 16(1) of the Land and Income Tax Amendment Act (No. 2) 1968), and substituting the following section:

"108 (1) Every arrangement shall be absolutely void as against the Commissioner for income tax purposes if and to the extent that, 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, whether or not that person or any other person affected by that arrangement is a party to that arrangement.

"(2) Where any arrangement is void in accordance with the provisions of subsection (1) of this section, any person (being a person who, in the opinion of the Commissioner, would have, or might be expected to have, or would in all likelihood have, derived any income but for that arrangement) shall be deemed to have derived such income and shall be assessable and liable for income tax accordingly.

"(3) Where any income is deemed to have been derived by any person pursuant to subsection (2) of this section, that income shall be deemed not to have been derived by any other person.

"(4) Without limiting the generality of the foregoing subsections of this section, it is hereby declared that no arrangement, being an arrangement made or entered into among, or affecting, any members of any family shall be excluded from the operation of those subsections by reason of the fact that the making or entering into of that arrangement was in any way influenced by considerations of ordinary family dealing.

The reference in this subsection to any members of any family shall be deemed to include a reference to -

"(a) Any relative of any such member; and

"(b) The trustee of any trust in which any such member or relative has an interest (including a contingent interest); and

"(c) Any partnership or other association of persons in which any such member, relative, or trustee has an interest; and

"(d) Any company of which any such member, relative, trustee, partnership or association is a shareholder.

"(5) Without limiting the generality of subsection (1) or subsection (2) of this section, it is hereby declared that where, in any income year, any person sells or otherwise disposes of any shares in any company under an arrangement (being an arrangement that, directly or indirectly, 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)

under which that person receives, or is credited with, or there is dealt with on his behalf any consideration (whether in money or money's worth) for that sale or other disposal, being consideration, the whole or, as the case may be, a part of which, in the opinion of the Commissioner, represents or is equivalent to, or is in substitution for, any amount which, if that arrangement had not been made or entered into, that person would have derived or would derive, or might be expected to have derived or to derive, or in all likelihood would have derived or would derive as income by way of dividends in that income year, or in any subsequent

year or years, whether in one sum in any of those years or otherwise howsoever, an amount equal to the value of that consideration, or, as the case may be, of that part of that consideration shall be deemed to be a dividend derived by that person in that first-mentioned income year.

"(6) *For the purposes of this section* -

"'Arrangement' means any contract, agreement, or arrangement made or entered into, whether before or after the commencement of this Act:

"'Purpose or effect' includes purposes or effects which include the purpose or effect, whether or not the principal purpose or effect."

Mr David C. Gould,
Pyne, Gould, Guinness Ltd,
Box 112,
CHRISTCHURCH.

Dear David,

I have your letter of 19 August. I was interested in your comments about the new anti-tax avoidance provision and I think you may be unduly apprehensive.

Enclosed are some notes on the new provision which my colleague, Hon. W.E. Rowling, has had produced for the information of various people and bodies who are interested in the new measure. You will possibly find them valuable in any detailed consideration you give to the clause.

The new section 108 has been drafted using as far as possible the language of the old provision in order to preserve the relevance and value of the large body of case law that has been built up in relation to it. At the same time, some of the language has been expanded to clarify the intention of the existing legislation in the light of recent interpretations placed on it. It has also been expanded to meet a particular criticism relating to "substitution" or, in other words, what is to happen to income once an arrangement is put aside by the section.

Until quite recently, it was always the view that a tax avoidance purpose need not be the sole or dominant feature of a scheme for that scheme to come within the ambit of section 108. In 1970, some words of Mr Justice Turner in Mangin's case were taken up later by the Privy Council and adopted as an interpretation of the section. In brief, it would have meant that, before the section applied, tax avoidance would have to be the sole or principal purpose.

You know, of course, that the comparable Australian provision, section 260, is virtually identical with our own section 108. I mention this because of some interesting comment in a later Australian case on the interpretation adopted in the Mangin case. The case I refer to is

Hollyock v F.C. of T. 2 A.T.R. 1971 at page 606.

The Judge in referring to some comments of Turner J. in the Mangin case in New Zealand said :-

> "...to say that the section applies only to arrangements whose sole purpose is tax avoidance would be contrary to the decisions in Newton's and Hancock's cases."

Other quotations from the same judgment are :-

> '"...to hold that tax avoidance should be the principal purpose of the arrangement would seem to me to be opposed to the reasoning on which those decisions rest, and would introduce into section 260 a refinement which is not suggested by the words of the section itself..."
>
> '"...on the other hand, if tax avoidance is an inessential or incidental feature of the arrangement, that may well service to show that the arrangement cannot necessarily be labelled as a means to avoid tax."

These extracts highlight what is considered to be the true intention of section 108 as it relates to 'purpose or effect' and the wording in the new provision has been adopted to give a clear indication of this intention.

I trust you will find my comments reassuring.

Kind regards,

Yours sincerely,

Encl.

Associate Minister of Finance

Mr David C. Gould,
Pyne, Gould, Guinness Ltd,
Box 112,
CHRISTCHURCH.

Dear David,

I have your letter of 19 August. I was interested in your comments about the new anti-tax avoidance provision and I think you may be unduly apprehensive.

Enclosed are some notes on the new provision which my colleague, Hon. W.E. Rowling, has had produced for the information of various people and bodies who are interested in the new measure. You will possibly find them valuable in any detailed consideration you give to the clause.

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Associate Minister of Finance

DOMINION OF NEW ZEALAND

Solicitor-General's Office,

WELLINGTON.

13 August 1974

The Commissioner of Inland Revenue,
WELLINGTON.

PROPOSED AMENDMENT TO S.108

1. Following our meeting last week I discussed this matter at some length with Messrs Blank and Sorensen. We had almost finalised our conclusions, when the copy of your memorandum to the Minister of Finance dated 12 August 1974 arrived yesterday afternoon. I feel that it is better at this stage merely to give you my own comments rather than attempt to consider and comment upon the notes attached to your memorandum to the Minister. I do note, however, that on p.7 of the notes the statement is made that you have received legal advice from both within and outside the Department and that you are assured that the new proposals are effective for the purposes mentioned. I should confirm, what I understand Mr Blank has already told you, that insofar as advice from outside the Department is concerned, this Office is not fully in agreement with your views and indeed I think I made this clear to you and your officers last week, particularly with regard to subs.(2) of the Bill. I understand from Mr Blank that it was your intention to advise the Minister of Finance accordingly.

2. I have redrafted subss.(1) and (2) of the Bill and enclose a copy of the draft for your consideration. You will see that I have divided subs.(1) into three subsections and subs.(2) of the Bill has become subs.(4) of my draft. The division of subs.(1) has been done for the purposes of clarity. In my opinion the amendments suggested wouldhelp to give the new section full efficacy and in particular to enable it to be more easily interpreted by the Courts.

3. The amendments I have made may be summarised as follows:

(i) I have rephrased that portion of subs.(1) of the Bill dealing with the position where there is more than one purpose or effect in the arrangement, by saying that where the arrangement has the purpose or effect or one of the purposes or effects mentioned it will be void. This overcomes the use of the phrase in the Bill "or purposes or effects which include the purpose or effect" which I find confusing. It also eliminates the need to distinguish between principal and other purposes or effects.

(ii) There are two points in connection with the derivation of income where transactions have been avoided, which, I suggest, might be improved:

(a) The words "such income" in line 45 of the Bill (p.5) are apparently intended to relate back to income which the taxpayer would have or might be expected to have or would in all likelihood have derived (i.e. the wording within the preceding brackets). I think that it would be clearer and leave less room for argument if the same wording were repeated again outside the brackets, thus "as in the opinion of the Commissioner he would have or might be expected to have or would in all likelihood have derived but for the contract, agreement or arrangement and shall be assessable and liable for income tax accordingly".

(b) Such amendment, and indeed the subsection as it stands in the Bill, would "catch" only income which by reason of the taxpayer's previous activities he might have or be expected to receive had the contract, agreement or arrangement not been made. It would not, in my view, "catch" any new source of income which was created for the first time by the contract, agreement or arrangement itself. For example, suppose a taxpayer had the sum of $10,000 invested in Government stock at an interest rate of 5% p.a. His income from this would be $500. Suppose he then transferred this capital sum to a trust for his children or sold the stock and lent the $10,000 cash to the trust, interest free, and that the trustees invested the $10,000 in a finance company which paid an interest rate of 10% p.a. An income of $1000 p.a. would be produced. Under subs.(1) of the Bill and under the wording I have set out above, I do not think it could be said, that the arrangement under which the $1000 was earned, produced a quantum of income equivalent to that which the taxpayer would have been likely to have earned but for the arrangement. It is more logical to say that he would have only received $500 had the arrangement not been entered into. I think, therefore, that under the section as it stands it would be proper to bring $500 only into the taxpayer's income. To get over this difficulty I have, in my draft, given the Commissioner the option of assessing the taxpayer either on the basis of what he would have derived had the arrangement not been entered into or what he would have derived if he had been entitled to all the benefit from the arrangement. This would allow the Commissioner in the example I have given to say that if the taxpayer had been entitled to any benefit from the arrangement it would have been to the extent of $1000 not $500. Whether you wish to "catch" the full $1000 in my example or only the $500 is a matter of policy for decision by you in consultation with the Minister.

4. As indicated at my meeting with you, I felt that there was a possibility that subs.(2) of the Bill would either fail to apply to any "ordinary family dealing" or would apply to all ordinary family dealings whether or not they were intended to avoid tax. I also felt that reference to family dealings alone and not also to business dealings might lead to difficulties in applying the Judge made law, beginning with Lord Denning's pronouncement in Newton, which has tended to treat the two types of dealing as being in the same category. I have accordingly redrafted subs.(2) of the Bill as my subs.(4) with a view to having the section apply to both types of dealing and also making it clear that where a transaction is an ordinary family or business dealing it is not thereby excluded from the operation of the section. This latter point is important, because I think that Lord Denning's classic statement (on p.466 of the Appeal Case reports) can at least on one view be open to the construction that once it can be shown that an arrangement is an ordinary business or family dealing the section no longer applies. I think it is also desirable that the meaning of these terms should not be precisely defined as this may create more problems of interpretation and limitation than it solves.

5. I have not thought it necessary to consider the provisions of subs.(3) of the Bill but you may think it is desirable if my other amendments are to be adopted to ensure that they do not conflict with nor materially affect the application of this latter subsection.

Solicitor-General

Encl.

Section 108

(1) Every contract agreement or arrangement made or entered into whether before or after the commencement of this Act shall be absolutely void as against the Commissioner for income tax purposes if and to the extent that directly or indirectly it has or purports to have

(a) 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, or

(b) as one of its purposes or effects the altering in any way of the incidence of income tax or the relieving of any person from his liability to pay income tax

(whether or not that person or any other person affected by that contract, agreement or arrangement is a party to that contract, agreement or arrangement).

(2) Where any contract, agreement or arrangement is void in accordance with the foregoing provisions of subs.(1) any person (being a person who in the opinion of the Commissioner would have or might be expected to have or would in all likelihood have derived any income but for that contract, agreement or arrangement) shall be deemed to have derived such income as in the opinion of the Commissioner either

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(b) he would have derived if he had been entitled to all the benefit of the contract, agreement or arrangement

and shall be assessable and liable for income tax accordingly.

(3) Where income is deemed to have been derived by any person pursuant to the foregoing provisions of subsection (2) hereof that income shall be deemed not to have been derived by any other person.

(4) It is declared that because a contract, agreement or arrangement is an ordinary business or family dealing it shall not for that reason be excluded from the application of subsection (1) hereof which shall nevertheless apply to such contract, agreement or arrangement if it has or purports to have the purpose or effect or one of the purposes or effects referred to in subsection (1) hereof.

(5) Same as (3) of Bill.

DOMINION OF NEW ZEALAND

Solicitor-General's Office,

WELLINGTON,

13 August 1974

The Commissioner of Inland Revenue,
WELLINGTON.

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2. I have redrafted subss.(1) and (2) of the Bill and enclose a copy of the draft for your consideration. You will see that I have divided subs.(1) into three subsections and subs.(2) of the Bill has become subs.(4) of my draft. The division of subs.(1) has been done for the purposes of clarity. In my opinion the amendments suggested wouldhelp to give the new section full efficacy and in particular to enable it to be more easily interpreted by the Courts.

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4. As indicated at my meeting with you, I felt that there was a possibility that subs.(2) of the Bill would either fail to apply to any "ordinary family dealing" or would apply to all ordinary family dealings whether or not they were intended to avoid tax. I also felt that reference to family dealings alone and not also to business dealings might lead to difficulties in applying the Judge made law, beginning with Lord Denning's pronouncement in Newton, which has tended to treat the two types of dealing as being in the same category. I have accordingly redrafted subs.(2) of the Bill as my subs.(4) with a view to having the section apply to both types of dealing and also making it clear that where a transaction is an ordinary family or business dealing it is not thereby excluded from the operation of the section. This latter point is important, because I think that Lord Denning's classic statement (on p.466 of the Appeal Case reports) can at least on one view be open to the construction that once it can be shown that an arrangement is an ordinary business or family dealing the section no longer applies. I think it is also desirable that the meaning of these terms should not be precisely defined as this may create more problems of interpretation and limitation than it solves.

5. I have not thought it necessary to consider the provisions of subs.(3) of the Bill but you may think it is desirable if my other amendments are to be adopted to ensure that they do not conflict with nor materially affect the application of this latter subsection.

Barnes

Solicitor-General

Encl.

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(whether or not that person or any other person affected by that contract, agreement or arrangement is a party to that contract, agreement or arrangement).

(2) Where any contract, agreement or arrangement is void in accordance with the foregoing provisions of subs.(1) any person (being a person who in the opinion of the Commissioner would have or might be expected to have or would in all likelihood have derived any income but for that contract, agreement or arrangement) shall be deemed to have derived such income as in the opinion of the Commissioner either

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and shall be assessable and liable for income tax accordingly.

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(4) It is declared that because a contract, agreement or arrangement is an ordinary business or family dealing it shall not for that reason be excluded from the application of subsection (1) hereof which shall nevertheless apply to such contract, agreement or arrangement if it has or purports to have the purpose or effect or one of the purposes or effects referred to in subsection (1) hereof.

(5) Same as (3) of Bill.

Sunday Herald Wellington Bureau.

An unannounced change in the tax law which would have the effect of voiding practically every family or business arrangement made to avoid tax could well provoke one of the longest and most bitter tax debates in Parliament since the payrol tax was introduced.

An amendment to section 108 of the Land and Income Tax Act, under which most trusts or family arrangements are made , tightens the law existing and , if passed in its present form, would declare invalid any arrangement which avoids or reduces taxation,

The explanatory notes to the proposed change in the law, which is contained in clause 8 of the Land and Income Tax amendment bill (no 2) state that the change is in line line with suggestions made by the courts.

But tax lawyers and accountants do not see it that way. They see the change as a tightening of the law. The courts, in recent privy council and court of appeal decisions, have simply sought a clarification of the law.

It is because the proposed changes emboied in the bill, which has yet to have its second reading before Parliament, would void existing arrangements and tighten the law to prevent similar arrangements in the future that the measuring is drawing fire from the New Zeland Society of Accountants, the Law Society , the Associated Chambers of Commerce and Federated Farmers.

The latter organisation sees the proposed change as a means of breaking up the laege paddock trusts which have become part and parcel of New Zealand farming. They see it too as an adjunct to the legislation which placed a capital gains-type tax on farm land sold for development.

The explanatory notes provided by the Parliamentary Counsel state that the proposed change to Clause 108 "strengthen the provisions...in relation to contracts agreements or arrangements having the purpose of or effect of altering the incidence of taxation"

A new subsection to the clause would "void such arrangements, whether their principal purpose of effect is the alteration of income tax or the relief of any person from his liability to pay tax." To the extent that such an arrangement is voided, the notes state, any person who in the opinion of the commission , would in all likelihood have derived an income shall be deemed to have derived that income, and that income shall accordingly be deemed not to have been derived by any other person.

A further provision would also rule out arrangements , agreements or contracts , among members of a family (trusts) that were previously allowable because they were classified as "ordinary family dealings."

Yet a further provision covers dealings in shares. Finally, the bill provides that the new provision shall apply only from April 1, 1975 , but it says that the changes will apply "whether the contract , agreement or arrangement was made or entered into on, before, or after that date ".

There can be no doubt that Clause 108 of the Land and Income tax act has been confusing and unclear for some time.

It has been the subject of much litigation and some interesting comments in the judgements delivered.

For example, in 1971, in the Privy Council, on Mangin v Commissioner of Inland Revenue, Lord Wilberforce said clause 108 was a "misty instrument which breaks in our hands and is no longer capable of repair "- ie by the courts.

Only this year, on May 20, in the court of Appeal case, Gerard v the Commissioner of Inland Revenue, Mr Justice McCarthy referred to "the uncertain swampland of the judicial dicta (comments) which have placed glosses on the section ".

There have been many references by the courts to the need for clarification, but not to a tightening of the law.

One tax authority predicted this week that whatever the intention of the Commissioner of Inland Revenue, the cluase could be construed in such a way as to through doubt on the thousands of genuine family trusts.

There is nothing in the wording of the clauses as they are written in the bill that prevents the commissioner, in his discretion, from cracking down on ever genuine trust --- as well as those of doubtful credibility.

"Even the incidental effect of avoiding tax is enough to catch a trust under the clause as it is written in the bill," one tax consultant said.

Estate and tax planning really came into its own in New Zealand following the Nordmeyer budget of 1958, although its origins were in the middle ages.

The proposed 1974 amendment, in the words of one consultant : "Places in jeopardy thousands of family arrangements which up to now have been perfectly legal, valid and proper. I can forsee a spate of defensive litigation."

ends Hancox.

Memo Bill Stuart - I have asked Bill rowling for his comments to run with this story.

ends Hancox.

11.7.74

The Commissioner.

DIVIDEND STRIPPING - SECTION 108

(1) i) Assume a company with $500 in capital and $500 accumulated profits, with its sole asset $1000 in cash.

Assume the sole shareholder, "A", sells his shares to "B Ltd" for $90.

Assume "B Ltd" winds up the company and collects $100 comprising $50 return of capital and $50 dividend.

ii) In Tech. Ruling Supplement No. 13, on the strength of a number of recent Australian cases, we have indicated that section 108 should be applied to assess the original shareholder, "A", on the dividend he avoided receiving as such by selling his shares at an apparent capital profit.

iii) The question is what is the amount of the dividend to be assessed to "A"? Is it -

(a) $40 - being the excess of the $90 received over the paid up capital of the shares, or

(b) $50 - being the amount of the dividend actually received by the new shareholders?

(2) i) In earlier discussions I have contended for - and you provisionally supported my view - that the "realities" of the deal are that the original shareholder received $90 instead of the $100 he would have received if he had wound up himself, made a capital profit of $40 in lieu of a dividend of $50, and that we should treat the "capital profit" as the quantum of the taxable dividend.

ii) In contrast, Mr Manning suggested that if section 108 applies the annihilation principle, in the absence of a substitution provision, necessarily means we must have regard to the dividend actually declared viz. $50 in the example quoted, and relate this back to the original shareholder, "A".

(3) i) You will recall that in commenting on my discussions with the Australian tax officers on this point, I said that they felt, in the light of the Newton and Hancock cases, that the assessable dividend to the vendors would have to be regarded as the actual dividend subsequently paid to the strippers, as against the New Zealand view that it would be the excess of the sale price of the shares over the paid up capital, but that the Australians conceded they could be in some difficulty if the declaring of the dividend by the new shareholders was delayed for some reason.

ii) Mr Sorensen has now given a Legal Opinion, at the request of Mr Manning, which supports the Australian and Mr Manning's view that the profit to be assessed to the original shareholders is to be related to the subsequent dividend paid to the new shareholders, whether the subsequent distribution is more or less than the amount paid for the shares.

(4) I do not like the conclusion reached by Mr Sorensen for the following reasons -

i) In my view, it does not reflect the "reality" of the situation. The old shareholder, "A", in the case quoted received $90, not $100, and it seems unduly harsh to argue that this should be regarded as a dividend of $50 and a return of capital of $40, involving a revenue receipt of $50 and a capital loss of $40. To me, he artificially made a capital profit of $40 which it is reasonable to treat as a dividend representing the amount received on account of the undistributed profits of the company.

ii) As acknowledged by the Australian tax authorities, this interpretation would leave us out on a limb in the event of a subsequent distribution being delayed or not taking place at all. I do not accept Mr Sorensen's view that this is unlikely to occur. The new shareholders may prefer to obtain the use of the company's funds by way of inter company loans, as has been done on occasions in the Brierly group, or revive the trading activities of the company and employ its capital therein.

iii) I am not convinced that the Australian cases are in fact decisive on this point as many of those quoted really involved transactions where virtually the <u>whole</u> of the subsequent distributions found their way back to the original shareholders and there was no outsider taking a cut as in most of the N.Z. cases - certainly all those involved with the Comsec group.

iv) Even if Mr Sorensen's view of the legal position is felt to be probably correct, I would still prefer to assess only the "profit" of $40 in the example quoted. This is because -

(a) of the factors mentioned in (i) and (ii) above

(b) of the fact that the amount I would prefer to assess would in most cases be less than that arising from a full subsequent distribution where an arm's length third party is involved - this is the Comsec position.

(c) I do not think the legal position is beyond doubt.

(d) It is better to apply s.108 to achieve a reasonable result than an unreasonable one.

(5) i) I commented above that while not seriously contesting the legal conclusions reached by Mr Sorensen, I was not entirely convinced that they necessarily applied in all cases. This is because, as in all Court decisions, the decisions on which his conclusions are

based must be considered in the light of their own facts. This is of special significance when, as I believe, applying such an interpretation to cases with rather different facts could result in an illogical result.

ii) In the first case quoted - Bell v. F.C. of T. - some $77,000 was paid to the old shareholders in the guise of the sale of shares. The Commissioner applied s.260 and assessed the whole of this amount as a dividend but it is important to note that there were existing undistributed profits in excess of this sum. This point was mentioned by the Full Court and their Judgment includes the words - "On 3.2.48 $77,000, consisting entirely of profits, was withdrawn from the company's bank account, and $11,000 of it passed, indirectly but by steps that are clearly traceable on the face of the bank's ledgers, into Bell's bank account".

iii) In Newton's case once again it was undistributed profits that were paid out and which found their way, through an intervening company, to the original shareholders who in this case were the continuing shareholders. As quoted by Mr Sorensen "the special dividends were derived in their entirety by the original shareholders". In essence, there is no true sale of the ordinary shares to an arm's length party at all, as the shares apparently retained by the purchasing company retained only limited future dividend rights.

iv) In Hancock's case, the essential facts seem much the same in that no true third party was involved and what occurred was a distribution of accrued profits to an existing shareholder. In the portion of the Judgment quoted by Mr Sorensen, the following comments occur - "The effect was exactly that which, in the absence of an arrangement, could have been produced only by the Hancocks retaining their shares, receiving the dividend moneys in respect of them free of income tax, and applying all but $2500 in purchasing the Lefroy shares after the dividends thereon had been paid."

v) In Myfield No. 1 the Australian Judge decided that a subsequent dividend received by a third party (presumed) was assessable in full to the original shareholders even though they had in fact sold out for $5000 less than the value of the shareholders' funds. This decision would seem to be against my contention and in favour of Mr Sorensen's conclusions. It is not, however, clear just how much paid up capital was included in the shareholders' funds.

vi) In Ellers Motor Sales, the shares were apparently sold to a third party but in this case the dividend assessed to the original shareholders was the amount they actually received which was somewhat less than the dividend subsequently declared. Once again, it is not clear what amount of paid up capital was involved although it may not be without significance that the dividend subsequently declared was in itself somewhat greater than the amount received by the original shareholders.

vii) In Bailes case, there was a series of subsequent dividends which were all assessed back to the original shareholders but it is not clear whether or not there was any connexion between the new holding company and the original shareholders. In addition the subsequent dividends were all in respect of accumulated profits at the date of the transfer, and it would seem that the sale price of the shares was related to such undistributed profits. It may be of some significance that in the course of this Judgment it was remarked that "In the cases to which we were referred, the fact that the money paid to the taxpayer could be identified as undistributed profits appears to have been relevant in determining the purpose or effect of the arrangement and I do not wish to express any view on how that determination might be affected if, for instance, only a small part of the "real money" was undistributed profits. It is sufficient to say that these appeals are not concerned with cases of that sort".

viii) In 18 C.T.B.R.(NS)No. 71 the amount assessed to the original shareholders was what they received for the sale of the shares to a stranger which had been calculated as the asset backing less 1%. Once again, the amount of paid up capital is not stated but would appear to have been Nil as the total subsequent distribution was regarded as a dividend.

ix) In the course of the decision in 18 C.T.B.R. a Board Member in explaining the decision to assess the original shareholders with what they actually received rather than the amount of the subsequent distribution stated in relation to Bell's case "The Court seems to have been concerned with the amount Bell received under the guise of capital". Mr Sorensen is not impressed with the Company's reasoning but to me it expresses the nub of the matter, and is precisely the position with which we are concerned.

(6) i) I have commented in some detail on the cases referred to by Mr Sorensen. My purpose in so doing has been to suggest that when they are considered in the light of -

- in some cases the lack of a true third party
- the subsequent distribution being in many cases confined to accumulated profits
- the doubts as to the amounts of prior paid up capital -

the dicta quoted in 18 C.T.B.R. that what we should be concerned with is "the amount (of undistributed profits) received in the guise of capital" remains a valid guide. I believe the individual circumstances of individual cases vary so much in vital respects of the kind already referred to that it is dangerous to take what was regarded as the proper amount of the dividend related back in one case as being the yardstick to apply in all dividend stripping cases.

ii) I prefer to stick to what seems to me the essential feature of a dividend stripping case. What is the amount of the "dividend" avoided by the former shareholders by selling their shares in the particular circumstances being queried. I remain of the opinion that the only reasonable figure to assess is the amount received for the shares reduced by the amount of paid up capital in respect thereof.

(C. P. Berg)
Director (Policy and Research)

DIRECTOR (POLICY & RESEARCH)

DIVIDEND STRIPPING

ASSESSMENT FOLLOWING AN ANNIHILATION UNDER SECTION 108 LAND AND INCOME TAX ACT 1954

1. Mr Manning, Regional Controller (Northern), has asked for my opinion as to the determination of the assessable income of a taxpayer on the invoking of s.108 in a dividend stripping case. (Refer my Opinion dated 19 December 1973 (L.O. 1973/142) on the application of s.108 in dividend stripping cases).

In order to answer the question posed, I propose to review several of the more recent dividend stripping cases in which s.260, the Australian equivalent to s.108, was invoked and examine the method of assessment adopted in those cases.

2. Bell v. F.C. of T. (1953) 87 CLR 548; 5 AITR 462. The seven taxpayers, shareholders in a Papuan company, each proposed to sell his single share in that company. W., a solicitor, was appointed a director of the company. W. drew his own cheques for £11,000 each to six clients as a loan; W. and each of the six then drew their own cheques for £11,000 which were exchanged for a share transfer executed by one of the seven shareholders. The next day the company registered the share transfers and authorised a loan of £77,000 to W. The company's cheque for £77,000 to W. and the cheques drawn the day before were then cleared simultaneously; thereafter each of the seven old shareholders obtained a bank draft for his £11,000. On the third day the Papuan company paid a dividend of £11,000 on each share and cheques were paid into the bank accounts of the new shareholders, who thereupon repaid the loans made them by W., and he in turn repaid his loan from the company. The result of these transactions was that the Papuan company had, at the end of three succeeding days, disposed of £77,000, being nearly the whole of its distributable profits, and the seven old shareholders between them had received £77,000, each having received £11,000 as the price of his one share in the company, and those shares were legally and beneficially owned by the new shareholders.

The Commissioner assessed the taxpayers on the basis that in consequence of the application of s.260 each received £11,000 as part of a distribution by the company to its shareholders out of profits, so that each amount was assessable as a dividend.

In confirming the assessment on appeal the Full Court said, at p.477,

> "Then if this arrangement be treated as void, what remains? Simply this, that on 3 February 1948 £77,000, consisting entirely of profits, was withdrawn from the company's bank account, and £11,000 of it passed, indirectly but by steps which are clearly traceable on the face of the bank's ledgers, into Bell's bank account; and Bell is to be considered as remaining at that time a shareholder in the company, his transfer to Corlett being ex hypothesi void as against the Commissioner as an integral part of the arrangement. This means that the application of s.260 in this case is to eliminate those features of the case upon which the exclusion of the £11,000 from assessable income depends, and by that means to establish the correctness of the assessment appealed against."

3. Newton v. F.C. of T. (1958) AC 450; (1958) 2 All ER 759; 7 AITR 289 (PC). The facts of the dividend stripping transactions which involved three private motor companies is set out in the judgment, at p.302,

> "For simplicity, their Lordships will consider what happened in the case of one of the private motor companies only; but all three carried out similar transactions. The company amended its articles of association so as to give special dividend rights to eighty thousand ordinary £1 shares, which entitled the holders of the shares to a dividend of £5.15.10 on every £1 share. That comes to a total of nearly £460,000 as special dividend. After the payment of that dividend, those shares were to carry only a five per cent fixed dividend. The original shareholders then sold these shares to a company called Pactolus, Ltd (which was a private company controlled by a consulting accountant) at a price of nearly £460,000 - roughly equal to the anticipated dividend. The Pactolus company paid to the original shareholders the price by cheque and, at about the same time, received from the motor company a cheque for the special dividend. The two cheques were for about the same amount - £460,000. The Pactolus company was only able to pay for the shares because of the special dividend it received on them.
>
> .....
>
> So much for the one company. Taking the transactions of all three companies together, the result at the end of it all was that the motor companies distributed £1,764,136 as special dividends. Most of this found its way back to the original shareholders, who received £1,661,722 in cash. .....The Pactolus company had received 161,213 shares..... The Pactolus company had also retained £102,414 in cash."

The judgment, at p.306, gives the Court's view on what is to be assessed following the invoking of s.260.

> "In this case, the Commissioner must accept the arrangement in so far as it had the effect of creating special dividend rights in the original shareholders - for that did nothing to avoid tax; but he can ignore the arrangements in so far as the original shareholders transferred those dividend rights (with the shares) to the Pactolus company for money - for it was that transaction which gave the character of capital to the money received by the shareholders. When that transaction is ignored, it becomes apparent that special dividends were declared on shares which are to be deemed for this purpose to be still held by the original shareholders. Those dividends amount to £1,764,136 paid out by the company. If and so far as the Commissioner can show that those special dividends reached the hands of the original shareholders, he is entitled to treat it as income derived by them from the shares. Now the Commissioner can trace the sum of £1,661,722 in cash actually into the hands of the original shareholders. He is entitled, therefore, to treat it as income derived by them. He cannot trace the balance of £102,414 actually into their hands. It remained in the pocket of Pactolus Ltd. It was ostensibly the profit of the Pactolus company on buying the shares. But when the transfer is ignored, that profit is seen to be nothing more nor less than remuneration which the original

shareholders allowed the Pactolus company to retain for services rendered. The position is the same as if the shareholders had received it as part of the special dividend and then returned it to the Pactolus company as remuneration. The Commissioner can, therefore, treat this £102,414 also as income derived by the shareholders."

The Commissioner assessed the taxpayers (the original shareholders) upon their relative proportions of the sums totalling £1,764,136 as being property income. The Commissioner contended that "the amended assessments should be sustained on the footing that the special dividends were derived in their entirety by the original shareholders, a portion of each such dividend having been actually received by them, and the remainder having been paid to Pactolus at their instance and retained by Pactolus with their consent and for its own benefit as something in the nature of a remuneration or a reward for its co-operation in the transactions": refer High Court judgment in 7 AITR at p.16.

4. Hancock v. C. of T. (1961) 108 CLR 258; 8 AITR 328. The issued capital of Mulga Downs Pty Ltd consisted of 18,945 shares of £1 each fully paid, of which 11,210 were held by the Lefroy family, 6730 by taxpayer, 1,000 by his son, and 5 by his wife (the case concerned only taxpayer and his son). Taxpayer had long entertained a hope that his family should own the whole of the shares, or at least a controlling interest, in Mulga Downs. Rowdell Ltd purchased the Lefroy's shares for £40,000 and those of the taxpayer and his son for £23,500. The shares were transferred to Rowdell on 30 April 1949. Subsequent to the sale to Rowdell two dividends totalling £50,000 were declared the first immediately after registration of the transfers, the second three weeks later. At the end of these transactions Rowdell had received dividends of £50,000 out of which it retained £7,500 for itself after paying £40,000 to the Lefroys, and £2,500 to taxpayer and his son as deposit on the sale of their shares. Rowdell then sold all its shares in Mulga Downs to taxpayer and his son for £21,000. This was done on 3 June 1949, when Rowdell paid the balance of the purchase money, £21,000, to taxpayer and his son, and then delivered transfers of the Mulga Downs shares in exchange for the transferees' cheques totalling £21,000.

By majority the Full Court held that the effect of the application of s.260 was that taxpayer and his son were assessable in respect of so much of the dividends paid by Mulga Downs as they would have received if they had not sold their shares i.e. £17,759 and £2,637 respectively.

"Indeed the point of the whole arrangement that has been considered void as against the Commissioner was to effect a liberation of the fund of profits without incurring tax and at the same time by means of the fund liberated to acquire the shares of the Lefroys. That was what was done. The Hancocks received £2,500 in addition..... In the distribution of the fund the proportion referable to the shares held at the beginning by the present appellant George Hancock would be as 6,730 is to 18,945; for of the issued capital of 18,945 shares, George Hancock held 6,730. For myself, I do not see why he should not be assessed on the basis of this fraction of the distributable profit forming part of his assessable income." : per Dixon, C.J. at p.333.

"But while the examination that has been made of the steps taken to carry out the arrangement shows, as I think, that the Commissioner cannot succeed in an endeavour to support the impugned

assessment wholly by means of a process of tracing, it also puts beyond all question that the transfers which enabled Rowdell to receive so much of the £50,000 as was distributed by Mulga Downs in respect of the 7728 Hancock shares formed part of an arrangement which was a means for producing to the Hancocks, first, a portion (£2500) of the distributions, in cash but as capital instead of as income, and, secondly, the Lefroy shares. As regards the £2500 the case is indistinguishable from Bell's Case (1953), 87 C.L.R. 548, 5 A.I.T.R. 462: the money followed a course of the first kind mentioned in proposition (5)* above. As regards the rest of the distributions on the 7728 shares, the money followed a course of the second kind: the Hancocks have never received the moneys, but they have received the Lefroy shares instead. I say instead, because the practical result which the carrying out of the arrangement achieved was an exchange by the Hancocks of the right to participate in the planned distributions of Mulga Downs for the Lefroy shares in the "milked" company. The effect was exactly that which, in the absence of an arrangement, could have been produced only by the Hancocks retaining their shares, receiving the dividend moneys in respect of them free of income tax, and applying all but £2500 in purchasing the Lefroy shares after the dividends thereon had been paid. The arrangement was, therefore, a means for avoiding the income tax which the Hancocks would have been liable to pay if they had achieved the same results without an arrangement. One may accept without hesitation their stoutly-maintained assertion that in their minds the arrangement was predominantly a means for getting in the Lefroy shares. That was, no doubt, their long-standing ambition. It was that which drew them into the arrangement when it was proposed to them. But the stubborn fact remains that, for whatever else the arrangement was a means, it was a means for the avoidance of tax. The consequence which s.260 produces is that the transfers of the 7728 shares to Rowdell are to be treated as void, and Rowdell's receipt of the dividend moneys in respect of those shares is to be considered a receipt of the Hancocks' moneys by arrangement with them, and therefore as a derivation of those moneys by the Hancocks, with the character of company distributions still upon them.

In my opinion, the amended assessment was correct, and the appeal from the order of Fullagar, J., should be dismissed.": per Kitto, J. at pp.340-1.

*Proposition (5) stated by Kitto, J. at p.335 was that the acts done will enable an arrangement to be characterized as a means for the avoidance of tax "if they have included a transfer of property from the taxpayer in consequence of which income from the property, instead of being received as such by the taxpayer, has followed either of two courses: (i) a course which has carried it through the hands of other persons to the taxpayer, but so as to reach him with the character of capital; or (ii) a course which has amounted in effect to an application of the moneys by the taxpayer, and so has been a practical equivalent of a receipt by him followed by an expenditure by him".

5. Mayfield v. F.C. of T. (No.1) (1961) 108 CLR 303; 8 AITR 354. In this case the Mayfield family sold their shares in Mayfield Investments Ltd. The sale price of £40,975 was approximately £2250 less than the value of the net assets of Mayfield Investments Ltd. This amount of £2250 had been agreed upon as the purchasers' profit under the plan. After the registration of the transfers of its shares, Mayfield Investments Ltd declared a dividend of £11,600 on 30 November 1950 and in January 1951 the company went into voluntary liquidation. The distribution by the liquidator of £32,196 comprised, return of capital, £14,500; capital profit on sale of shares, £17,398; undistributed income, £298.

It was held that s.260 applied with the effect that the transfers of shares in Mayfield Investments Ltd were void, so that the Mayfield family must be treated as remaining the shareholders of that company at all relevant times. Menzies, J. held that whatever the family received out of any distribution of profits by the company was taxable. Of the £11,600 distributed to the purchasers as the new shareholders, £1475 and then £7500 was paid by them to the family (as deposit and an instalment on the purchase of the family's shares); the family was therefore liable to tax on £8925 in proportions according to shareholdings. Of the £11,600 dividend, the family did not actually receive £2625 (being £1600 used to pay up unpaid shares and £1025 retained by the purchasers from the dividends paid to them); but as the family, being entitled to dividends, disposed of them by an arrangement to avoid taxation which the Commissioner was bound to disregard, and because the dividends were paid by reason of what the family did, the £2625 also was to be regarded as income derived by them. Likewise, the £298 paid by the liquidator out of ordinary profits, although not actually received by the family, was also treated as income derived by the family and therefore taxable.

The Commissioner also assessed the family in respect of the £17,398 capital profit distributed on liquidation. Menzies, J. allowed the objection against this assessment saying, at p.320: p.364, "Had the members of the Mayfield family, as shareholders, received the payments from the Capital Profit Reserve, they would have not been taxable under s.47 of the Act and I do not think that s.260 turns them into taxable dividends."

6. In Mayfield v. F.C. of T. (No.2) (1961) 108 CLR 323; 8 AITR 366 the Mayfield family sold their shares in Mayfield Holdings Ltd for £56,900, which amount was approximately £5000 less than the shareholders' funds of that company. Subsequently, on 27 April 1954, the company declared a dividend of £48,000 and a further dividend of £1200 was declared on 10 June 1954. In October 1954, the company went into voluntary liquidation. "I decide, therefore, that the dividends of £48,000 and £1200 distributed by Mayfield Holdings Ltd on 28 April and 8 June 1954.respectively are, so far as the Commissioner is concerned, the income of the taxpayers proportionally to their shareholding immediately before the transfers of 21 April 1954.": per Menzies, J. at p.334: p.372.

7. F.C. of T. v. Ellers Motor Sales Pty Ltd (1972) 3 ATR 45. The four taxpayers Ellers Motor Sales Ltd, Junelle Ltd, and Mr and Mrs Ellers, sold their shares in Harcourt Ltd to Holdings Ltd for £356,900.6.8d., that is, £1766.16.8d. per share. Harcourt then declared a dividend of £358,923 which was paid to Holdings.

"As regards the two sums of £1766.16.8 each received by John and June Ellers, s.260 in my opinion avoids, as against the Commissioner, the transfer of their two shares in Harcourt to Holdings. Those sums must therefore be considered a distribution of funds by Harcourt to them as shareholders and as such assessable income in their hands.....As regards the sum of £176,683.6.8 each received by Motor Sales and Junelle, s.260 has a similar operation and avoids the transfer of Motor Sales' 100 shares and Junelle's 100 shares in Harcourt to Holdings. These sums also therefore fall within the category of a distribution to shareholders and so assessable income....": per McTiernan, J. at p.48.

"I have stated the conclusion that the appellant was entitled to assess the respondents on the footing that the sums which they received from the sale of the shares in Harcourt were received by them as dividends, by means of which the profits of Harcourt were distributed to them.": per Walsh, J. at p.57.

Each taxpayer was assessed on the sum actually received by them (in aggregate, £356,900.6.8), however, in the individual assessments the Commissioner described the sum assessed as the the taxpayer's proportion of the distribution of £358,923 by Harcourt! (refer p.46). "The difference in the two sums is basically accounted for by the cost of the operation.": McTiernan, J. at p.47.

8. Chief Collector of Taxes v. Bailes (1973) 3 ATR 717. This was an appeal from the Income Tax Tribunal decision in 17 C.T.B.R. (NS) P.N.G. Case 10 to the Supreme Court of Papua New Guinea.

On 10 April 1967 Mr Bailes sold shares in G. G. Bailes Ltd to R.M.I. Holdings Ltd for $335,299.80. On the same date Mrs Bailes sold her shares in G. G. Bailes Ltd to the same purchaser for $248,934.70. On 25 April 1967 Bailes declared a dividend of $39,995 to Holdings; up to 30 June 1971 Holdings had received by way of dividends from Bailes $325,995, and in addition, the taxpayers together received approximately $319,000 in reduction of their loans to Holdings (used to purchase the taxpayers' shares in Bailes): refer p.719. Applying s.361 (the equivalent to s.260) the Chief Collector assessed the taxpayers on the basis that the dividends derived by Holdings from Bailes during the years of income ended 30 June 1967, 1968 and 1969 constituted assessable income during those years in their hands. The Court confirmed the assessments.

"Counsel for the respondents argued that the present cases were distinguishable from such cases as Bell (1953) 87 C.L.R. 548; 5 A.I.T.R. 462; Newton (1958), 98 C.L.R. 1; 7 A.I.T.R. 298; Hancock '1963), 108 C.L.R. 258; 8 A.I.T.R. 328; Mayfield (1961), 108 C.L.R. 323; 8 A.I.T.R. 366, and Ellers Motor Sales Pty Ltd (1972), 46 A.L.J.R. 181; 3 A.T.R. 45, in all of which the distribution attacked was made from undistributed profits already accumulated at the time of distribution. In the present cases, it was argued, the payments were to be made from future profits but this is true of only about one-sixth of the total payable. The purchase price or loan - whichever it be - was something in excess of $580,000. The sale occurred in April 1967 when the accumulated profits of the group at the end of that financial year could no doubt have been estimated with some degree of accuracy and the total of the accumulated undistributed profits of the group at 30 June 1967 had in fact grown to approximately $480,000 compared with approximately $356,000 at the end of the previous year. We were not told of the precise terms of payment to the respondents on this subject the minutes of the holding are silent, but as at 30 June 1971 $319,000 had been paid and as at 30 June 1972 $478,000. It is only payments after 30 June 1972, on account of the balance of approximately $102,000, which will bring the total paid to the respondents to a figure in excess of the group's accumulated profits at 30 June 1967.

In the cases to which we were referred, the fact that the money paid to the taxpayer could be identified as undistributed profits appears to have been relevant in determining the purpose or effect of the arrangement and I do not wish to express any

view on how that determination might be affected if, for instance, only a small part of the "real money" - to adapt an expression of Fullagar, J., in Newton (1958) 98 C.L.R. 1; 7 A.I.T.R. 298 - was undistributed profits. It is sufficient to say that these appeals are not concerned with cases of that sort.": per Clarkson, J. at pp.724-5.

9. 18 C.T.B.R. (N.S.) Case 71 (1973). The taxpayer, his wife and daughter sold their shares in their family company to a stranger for $360,156.30 on 26 November 1969. After the transfer of the shares the company on 28 November 1969 declared a dividend of $363,336 to the new shareholders. The Commissioner avoided the transfer of the shares under s.260 and assessed the taxpayers on the $363,336 in appropriate proportions. The individual assessments described the sum assessed as "your proportion of the distribution made by W. Pty Ltd on 28 November 1969" (refer p.553). By majority the Board held that the total amount included in the taxpayers' assessable income should be reduced to $360,156 being the amount received by them. (The Chairman (Mr Dubout) dissenting, considered that the merely annihilating effect of s.260 did not expose the taxpayers to liability).

The purchase price for the shares was agreed to be an amount equal to the worth of the asset backing less one percent. In terms of the final balance sheet, and as incorporated into the purchase agreement, this meant that the purchaser had to pay $360,156.30, calculated as follows:

Assets of W. (in fact cash)	$363,794.24
One percent thereof	$ 3,637.94
	$360,156.30

It was said that the purchaser sought this amount of one percent to cover outgoings for stamp duty and other matters incidental to the acquisition of the shares: refer p.556.

10. I think the raison d'être of any dividend stripping operation is to effect the release of distributable profits, which would in the normal course be income, in the guise of capital payments. In all the cases considered a dividend was declared to the new shareholders; these dividends formed an integral part of the whole sale and purchase arrangement. When the transfer of shares is avoided the taxpayer is left in the position of remaining the shareholder and is to be assessed accordingly. This approach is explained by Walsh, J. in the Ellers Motor Sales Case (supra) at p.54:

> "Subject to certain arguments to the contrary which have yet to be considered, this appears to me to be an arrangement of the kind to which s.260 should be applied, so as to enable the Commissioner to assess tax on the former shareholders in Harcourt as if they had remained its shareholders, in accordance with the principles as to the operation of s.260 established in such cases as Bell v. Federal Commissioner of Taxation (1953), 87 C.L.R. 548; 5 A.I.T.R. 462, Federal Commissioner of Taxation v. Newton (1957), 96 C.L.R., 577; 7 A.I.T.R. 1, and on appeal to the Privy Council 98 C.L.R. 1; 7 A.I.T.R. 298, and Hancock v. Federal Commissioner of Taxation (1961), 108 C.L.R. 258; 7 A.I.T.R. 328. According to those authorities it is appropriate to look at the end result of the transaction from the point of view of Harcourt and from the point of view of those who were its shareholders before the transfer of the shares to Holdings. The end result was that the

profits had gone out from Harcourt and that an equivalent amount had come into the hands of its shareholders. To adopt the phrase used by Fullagar, J., in Newton's Case (1957), 96 C.L.R., at p.656; 7 A.I.T.R., at p.57, it may be said in my opinion that "the only real money" which figured in the transactions was Harcourt's money. The loan from the bank to Ellers, the loan from Ellers to Holdings, the use by Holdings of the credit so obtained to pay for the shares, the use of the dividend received by Holdings to pay back the loan obtained from Ellers and the use by him of that money to repay the bank were all steps in the transaction which, although they were "genuine" and although on the face of them they effected transfers of assets (the Harcourt shares) in exchange for a price, did not prevent the end result from being, as it was intended to be, that the Harcourt profits found their way into the hands of those who had been its shareholders. It does not matter that the payment for the shares was made (by means of borrowed money) before the dividend was actually received by Holdings. As was said by Menzies, J., in Mayfield v. Federal Commissioner of Taxation (No.2) (1961), 108 C.L.R. 323, at p.334; 8 A.I.T.R. 366, at p.373: "a substantial identity between what the company distributed and what the assumed members received is sufficient"."

11. In any given case where s.108 is invoked, it is my view that the assessment should be made on the basis, not of the amount actually received for the shares but of the proportion of the distribution to which the taxpayer qua shareholder would have been entitled to receive as dividends. This becomes apparent, I think, having regard to cases such as Hancock, Mayfield (No.1) and Bailes where the taxpayers received sums in excess of what their share in the distribution would have been, and the converse situation in Newton and Mayfield (No.2) where the share of the distribution exceeded the sum actually received by the taxpayer; in all these cases the assessment was based on the portion of the distribution attributable to the taxpayer's shares. Although the sum in fact assessed in Ellers Motor Sales was the amount actually received by the taxpayer, the Commissioner nevertheless described this sum in his assessment as the taxpayer's proportion of the distribution by Harcourt. The small difference (amounting to 1% of the distribution) between these two figures was explained as being the cost of the operation. The Court upheld the Commissioner's basis of assessment.

The Court in Rowdell Pty Ltd v. F.C. of T. (1963) 111 CLR 106, a case concerning the purchaser-shareholder in dividend stripping arrangements, appears to have accepted, having regard to the decided cases, that the vendor-shareholder in such arrangements as were avoided by s.260 was assessed on the basis of an appropriate proportion of the distribution.

12. The only case that will require further explanation in the light of my conclusion is the Board of Review decision in Case 71. (para. 9 supra). There the taxpayer received a sum equal to the amount of the distribution less 1%, the 1% going towards costs. The Commissioner assessed using the amount of distribution; the Board reduced this to the sum actually received.

At pp.578-579, Mr Dempsey, Member, says:

"46. As I consider that the case of this taxpayer and his co-shareholders cannot in any material aspect be distinguished

from the case of Bell, supra, I uphold the decision of the Commissioner that s.260 applies to the transaction. This then leads me to decide what is the correct amount to be included in the assessment when this section is applied.

47. The Commissioner has assessed each taxpayer on their respective share of the dividend of $363,336 which was declared by the new directors on 28 November 1969 and after these taxpayers had ceased to be shareholders in the company. In point of fact the amount they collectively received and which was paid to them on 26 November 1969 was $360,156.

48. My understanding of the decision in the case of Bell, supra, is that the decision of the court was that Bell was assessable on the sum paid to him on 3 February 1948 in consideration for the transfer of his share in the Papuan company, viz., £11,000. I do not consider that in arriving at this decision the court was influenced by the fact that on the next day a dividend was declared and the amount of such dividend attributable to the share previously held by Bell was also £11,000. The court seems to have been concerned with the amount Bell received under the guise of capital.

49. If I be correct in this view then the amount this taxpayer and his co-shareholders received as a distribution of the company's funds was the amount of $360,156 paid to them on 26 November 1969.

50. I would accordingly hold that the assessments should in principle be confirmed but that they should be reduced in each case to assess each shareholder on their share of this sum of $360,156 in lieu of their share of $363,336."

I am not convinced that Mr Dempsey's interpretation of Bell is correct. In that case the Commissioner's assessment described the £11,000 as "Amount received in respect of your share in Simmonds, Harper & Larkin Ltd" (5 AITR at p.463). McTiernan, J. at first instance opined (5 AITR at p.471) that the £11,000 "was correctly described as an amount which the taxpayer received in respect of his share."

In all the cases subsequent to Bell the Commissioner described the sum assessed as being the taxpayer's proportion of the distributions: for example, Newton (refer 7 AITR at p.5). With regard to the Bell Case, Lord Denning in Newton said, "In the opinion of their Lordships, it (Bell's Case) was rightly decided". It would seem then that the Privy Council did not consider their decision in Newton to be at variance with that of the High Court in Bell.

I think Bell can be reconciled with Newton and the other subsequent cases if the description of the assessed sum, namely, "received in respect of your share" is interpreted as being synonymous with "attributable to your share" rather than "consideration for your share". In the context of Bell the word "received" is apt to the facts of that case; there it was found possible to trace dividend moneys from a company to Bell, and show that although they had in fact reached Bell as capital they were the produce of shares formerly held by him and transferred under an arrangement which ensured that he would receive them, but receive them transformed into capital and so made free of income tax: see Hancock's Case 8 AITR at p.335 per Kitto, J.

13. The weight of judicial opinion commencing with Newton at least, if not Bell, in my view supports assessment in terms of the distribution actually made. In Mayfield (No.2), Hancock, and Bailes, which involved more than one distribution following sale of the shares (in Mayfield (No.1) there was a second distribution as part of a winding up), the taxpayers were assessed on what would have been their entitlement under all the distributions had they remained shareholders; this was the result of annihilating the share transactions.

14. A question that might arise is how to assess where there is no distribution. I do not consider that such a situation would ever arise in cases to which s.108 would apply; it is of the essence of these schemes that there be a release of distributable profits. Although it would be more likely that a distribution be made almost immediately after the transfer of shares as in Bell, distribution can occur months later, as in Hancock, or even over a period of years as in Bailes. What is essential to the application of s.108 is to be able to identify the transactions as a release of profits to the taxpayer. On this particular point (identifying the transaction as a release of profits) the following passage from the judgment of Menzies, J. in Mayfield (No.2) is noteworthy. (108 CLR at p.334):

> ".... I consider that notwithstanding the overdraft arranged by Argo as an interim financial measure for the provision of funds to pay for the shares, the payments made by Argo and Kentish on 21 April 1954 for the purchase of the taxpayers' shares in Mayfield Holdings Ltd, which totalled £56,900, came to the extent of £49,200 from the profits of the company which were distributed shortly afterwards. This conclusion, I consider, follows from what was said by all the members of the Court in Hancock v. F.C. of T. negativing the need for the tracing of what the taxpayers received back to the bank account of the distributing company. A substantial identity between what the company distributed and what the assumed members received is sufficient. As an affirmative statement of the position, I cite the following words from the judgment of the Chief Justice in Hancock's Case: "It does not seem to me to matter at all what interim financial expedients were resorted to or which moneys or whose credit was used in the course of carrying out the transaction. It is the result that exposes the taxpayer to liability: a result necessarily involving the employment by the taxpayer of a distribution of the profit fund". (108 CLR at p.282)"

15. When assessing a taxpayer by reference to dividend distributed in respect of his shares no adjustment should be made for "return of capital"; such an adjustment is not supported by the cases, furthermore, it is, in my opinion, wrong in principle. A return of capital occurs on the winding up of a company. To the extent that the dividend comprises a capital distribution, it should not be assessed to the taxpayer.

In Mayfield (No.1),(para. 5 supra), the company went into voluntary liquidation two months after the share transfers had been registered and a dividend distributed. The sums distributed by the liquidator comprised, return of capital, undistributed capital profit, and undistributed income. With reference to the liquidator's distribution, the Court held that the taxpayer was assessable only in respect of the appropriate proportion of the income portion of that distribution.

16. "It is necessary now to refer to some submissions on behalf of the respondents. One was that s.260 is not applicable, for the reason that the profit did not get out to the pockets of the shareholders, but remained in the company group; and will be liable when distributed by Holdings to taxation as dividends received by the shareholders therein. In relation to that submission, there has been a contest upon the question whether or not it is inevitable that a tax liability of that kind will be incurred in the future. In my opinion, this is not inevitable, but I do not think that the result of these appeals depends in any way upon deciding what tax, if any, will be imposed in the future in consequence of an assumed distribution of profits by Holdings, whether by way of dividends or by way of a distribution in a winding-up. There is no doubt that "the real money" came to the hands of the respondents. It came in such a form that it is not taxable unless s.260 operates. The question whether s.260 operates or does not operate to enable the appellant for the purposes of the assessment of tax upon the recipients to treat the money as if it had been received by them as income cannot depend, in my opinion, upon what will ultimately happen to the profits shown in the balance sheet of Holdings as at 30 June 1965 as "unappropriated profits"." (Ellers Motor Sales Case 3 ATR at p.56 per Walsh, J.).

It has been suggested to me that the final sentence (commencing, "The question whether s.260 operates or not....") of the above passage might be read as being in conflict with my conclusion that assessments in dividend stripping cases are to be made by reference to distributions (para. 11 supra). However, in my view, this is far from the true tenor of that sentence.

The taxpayers submitted in Ellers Motor Sales that the profit did not escape tax; the profit had remained within the company group and would be liable and assessable as dividends at a future date when distributed to the shareholders. For this reason it was contended that s.260 was not applicable. His Honour considered that the consequence of eventual liability was not inevitable as contended. In the last sentence Walsh, J. is saying that the invoking of s.260 to enable the Commissioner to make the assessment could not, in his opinion, be dictated by whether or not the profit would eventually be assessed when distributed to the persons who happened to be the shareholders at the time.

17. As well as the taxpayer being assessable under s.108, it would seem that the new shareholder is also assessable:

> "Of course, Rowdell may be liable to be assessed to income tax on the footing that the dividend moneys it received from Mulga Downs formed part of its assessable income. If s.260 applies in relation to the Hancocks so as to include in their assessable incomes a part of the same dividends, the result may seem odd since it would mean that dividend moneys from Mulga Downs are to be treated as if they had been derived as income twice, and by different taxpayers. But that would be because, by the terms of the section, the avoidance which it produces is only as against the Commissioner, so that the Commissioner may treat transactions as void, but no-one else is enabled to do so." (Hancock's Case 8 AITR at p.338 per Kitto, J.).

Note, in Rowdell Pty Ltd v. F.C. of T. (1963) 111 CLR 106; 9 AITR 177 the Full Court accepted that even though a distribution is assessed to the vendor-shareholder under s.260, the

purchaser-shareholder is still entitled to the dividends in fact received as assessable income in the form of dividends: see, e.g. 9 AITR at pp.194-5 per Kitto, J. (Refer also Investment & Merchant Finance Corporation Ltd v. F.C. of T. (1971) 2 ATR 361.)

18. My views can be summarised as follows:

(i) the vendor-shareholder is to be assessed on the proportion of dividend distribution referrable to his shares;

(ii) in calculating the assessable income no adjustment should be made for a notional return of capital;

(iii) to the extent that a dividend comprises a capital distribution, that distribution (so far as it relates to the taxpayer's shares) should not be treated as assessable income of the vendor-shareholder (taxpayer).

Holger R Sorensen

(Holger R. Sorensen)
Solicitor
26.6.74

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27 May 1974

Rt. Hon. Sir Thaddeus McCarthy,
President,
Court of Appeal,
Judge's Chambers,
Box 1606,
WELLINGTON

My dear Mr President,

Thank you for forwarding me the judgements in Gerard's case which I have read with interest. I agree that Section 108 could do with a bit of early attention with a view to having it "finished" (to adopt Lord Donovan's terminology) but I would not favour too much precision. I hardly need to say that the ingenuity of the would-be tax avoider is almost boundless and the Commissioner (and the Courts) must, I think, have some flexibility of action to counter his devious manoeuvring.

Yours sincerely,

[redacted]
Attorney-General

The Minister of Finance

The attached letter refers to the decision of the Court of Appeal in Commissioner of Inland Revenue v. Gerard. No doubt the Commissioner has a copy and while I think McCarthy P. let himself be carried away a little into an extravagance of language I still think there is considerable substance in the recommendation attributed to Lord Donovan in Mangin's case in the last six lines of page 10. This would still leave the Commissioner with all the flexibility he needs and strengthen the backing up he may expect from the Courts.

[redacted]
Attorney-General

Court of Appeal of New Zealand

Judges' Chambers,
Box 1606,
Wellington, N.Z.

23 May 1974

The Hon. A.M. Finlay, Q.C., M.P.,
Attorney-General,
Parliament Buildings,
WELLINGTON

Dear Mr Attorney,

You may have seen in the newspapers some comments of mine in a judgment Commissioner of Inland Revenue v. Gerard. Their purpose was to draw the attention of the Legislature, once again, to the unsatisfactory state of s.108 of the Land and Income Tax Act. You will know of what the Privy Council and numerous legal commentators, as well as the New Zealand Judiciary, have said about this section.

I well understand that the responsibility for taxation legislation is strictly the province of the Minister of Finance, but the impact which this section is having on the work of the courts is a matter which would interest you, so I am sending you a copy of the judgments in this case.

Yours faithfully,

Thomas Gresson

President

24/5/74

NEW ZEALAND SECTION 108 CASES

Name	Review Authority	Dept. Won	Dept. Lost	Partly Lost	Details
[redacted]N Sydney B.) WHEELANS John W.)	CA	X	-	-	Hiring off of part of accountancy practice work to family trusts and appointment of accountancy partnership to do the actual work.
CARLSON Lawrence W.	CA	X	-	-	Lease of farm to family trust and employment of taxpayer as share milker.
ELMIGER Brothers	CA	X	-	-	Sale of equipment to family trusts and hire back to taxpayers.
GRIERSON Ralph M.	SC	-	X	-	Sale to and hire back from family trust of equipment.
GOVAN, Lawrence	SC	-	X	-	Annual transfer of shares to charitable trust and transfer back to taxpayer.
HOLLIS, STRATTON AND LAWSON	BOR	X			Accountancy partnership employed family trusts partnership to carry out machine accounting services.
HOLMES, Barrie T.	BOR	X			Sale to and lease back from family trust of dentist's equipment.
LAWLER, MANNING AND THEILMAN	SC	X			Sale to and hire back from company whose shareholders were family trusts, of anaesthetic equipment. Premises and staff supplied to partnership.
LESLIE, James D.	BOR	X			Appeal pending. Lease of farm to family trust. Trust employed share milker.
LOADER, Ian D.	SC	-	X	-	Sale of equipment to trust, lease by trust to company and hire back by taxpayer from company.
MANGIN, O.T.	SC	X	-	-	Paddock trust.
MARTIN, G.R.	SC	X	-	-	Assignment of partnership interest to loss company.
MARX, S.	CA	X	-	-	Lease of farm to family trust and employment of taxpayer as share milker.
MACKAY, K.V.	CA	X	-	-	Solicitors partnership dissolved. Partners made interest free loans to family trusts. Trusts made loans at interest to new partnership.

Name	Review Authority	Dept. Won	Dept. Lost	Partly Lost	Details
O'KANE CONSTRUCTION CO. LTD	SC	-	X	-	Sale of assets of to major shareholders family trust and lease back to company.
PEDLOW, T.T.	BOR	X	-	-	Services provided by family trust to dentist.
REID, L.R.W. & SON	BOR	-	X	-	Lease of farm property to wives' partnership. Taxpayers employed by wives' partnership.
RIDLEY MOTORS LTD	SC	X	-	-	Hiring off of used car part of business to family trust.
UDY, H.A.F.	SC	X	-	-	Sale of equipment to family trust. Trust carried on business as contractor and employed taxpayer.
UXORUM (Lewis & Jeeks)	SC	-	X	-	Loans to partners' wives to buy bookkeeping machine and hire of machine by partnership.
WELLS, Peter D.	SC	X	-	-	Sale of chiropractor's equipment car and tenancy of premises to company. Employment of taxpayer by company.
WISHEART McNAB & CO.	CA	-	-	X	Transfer of insurance agencies to company (shareholders family trust)- Department lost. Hire of office machines by company and subsequent hire to partnership for increased rental.- Department Won.
		16	6	1	

Australian Cases - Section 260, Income Tax Assessment Act 1936

Cases since 1965: Total 12 (4 Board of Review)
Won 6
Lost 5
Partly allowed 1

1. Mobil Oil Australia Ltd v F.C.T. 9 A.I.T.R 630 (1965, Privy Council) Lost.

Facts: Appellant Company entered into agreements with a number of service station proprietors whereby the latter agreed to sell exclusively the products of the Appellant Company. In return the appellant made cash payments to the proprietors and performed repairs and alterations on the service stations. The cash payments were made either annually or by way of lump sum in advance. The advance payments were treated as loans to the proprietors repayable with interest by monthly instalments but if trading agreements continued the appellant company undertook to pay the proprietors monthly amounts equalling the amounts of the instalments.

Held: The transactions were capable of explanation by reference to ordinary business arrangements and were not void under s.260 of the Act.

2. Peate v F.C.T. 10 A.I.T.R. 65 (1966 Privy Council) Won

Facts: Goodwill and assets of medical practice sold by doctors to family companies. Doctors agreeing to serve those companies as employees.

Held: Arrangements had the purpose and effect of avoiding tax and were void under s.260 and what remained was an association of doctors in receipt of income jointly.

3. Case A55 - No.2 B of R 69 A.T.C. 319 (1969) - Won

Facts: Coy (P. Ltd) owned medical practice and doctor claimed he carried on practice in his capacity as governing director of P. Ltd not on his own account, nor in partnership with other doctors.

Held: Not an ordinary business or family arrangement. S.260 applied (Question of whether the income was within the ordinary concepts of income, really the income of the Doctor was not considered.)

4. Case B45 - No.3 B of R 70 A.T.C. 223 (1970) Lost

Facts: Private company surrendered lease shortly after completion of factory improvements on leased land paid for by lessee. Lessor controlled lessee company. Commissioner argued that if taxpayer company surrendered the lease, the arrangements between it and the lessor had the purpose or effect of avoiding a liability imposed on taxpayer by the Act.

Held: Transactions were not such as necessarily to be labelled as a means to avoid tax. Course of action was one open to the taxpayer, resembling the 'choice' in Keighery's Case (1958) 11 A.T.D. 359.

5. F.C.T. v Casuarina Pty Ltd 2 A.T.R. 161 (1970) Lost

Facts: Taxpayer acquired the status of a public company and by certain transactions received a dividend sufficient to avoid undistributed profits tax.

Held: Section 260 did not apply. Taxpayer had merely taken advantage of an advantage provided in the Act for public as opposed to private companies. Conversion to public status was therefore acceptable.

6. Franklin's Selfserve Pty Ltd v F.C.T. 1 A.T.R. 673 (1970) Won

Facts: Acquisition of shares in a loss company by means of a number of transactions.

Held: Section 260 voided the issue of shares in the loss company as that issue was part of an elaborate arrangement to re-open a past transaction and re-organise the shareholding in the taxpayer.

7. Hooker-Rex Pty Ltd v F.C.T. 1 A.T.R. 641 (1970) Lost

Facts: Options to purchase land held by appellant but allowed to expire so that subsidiary could exercise fresh options with appellant guaranteeing all payments. That subsidiary had substantial losses from previous years, which losses were deducted from the ultimate sale of the property.

Held: Ordinary business dealing and section 260 not applicable. Act did not place any restriction on the use as deductions of losses incurred by public companies, so open to such a public company to take advantage of the provision allowing a deduction for past year loss.

8. Ellers Motor Sales Pty Ltd v F.C.T. 3 A.T.R. 45 (1971) Won

Facts: Shareholders in private company sold their interests in that company to a newly formed public company. Public company then declared dividends. Act provided full rebates on public company dividends but only 50 percent rebates on private company dividends.

Held: Section 260 avoided the transaction whereby the interests were sold to the public company and dividend deemed to have been derived from the private company in proportion to the shareholding therein.

9. Hollyock v F.C.T. 2 A.T.R. 601 (1971) Lost

Facts: Half pharmacy business sold to wife. Purchase price payable on demand without interest. Business carried on by taxpayer in same way as before the sale. Deed provided that taxpayer held the business, assets and income on trust absolutely for himself and the purchaser in equal shares.

Held: Section 260 applied as tax avoidance one of the purposes and not an ordinary business or family dealing nor a mere disposition of income producing property.

10. Williams v F.C.T. 3 A.T.R. 236 (1972) Lost

Facts: Taxpayer realised he would have large taxable income much of which represented profit from purchase and sale of speculative mining shares. To avoid this he applied for mining shares costing more than his profit in order to get a deduction under the Act. Eleven days after allotment he sold some of those shares for their cost.

Held: Taxpayer was entitled to the deduction and section 260 had no application.

11. Case E18, No. 38 of R 73 A.T.C. 134 (1973) Partly Allowed

Facts: Sale of shares with accumulated profits, company then declared dividend greater than purchase price paid to taxpayer and his family.

Held: Section 260 left taxpayer and his family liable to tax not on their notional respective shares of the (greater) dividend subsequently declared by the company, but on their (lesser) respective shares of so much of that notional dividend as actually found its way into their hands in purported capital form, i.e. the sale price received.

12. 18 C.T.B.R. (N.S.) Case 71 (1973) Won

Facts: All shares in family company sold cum div. Only asset in the company was cash. Dividend declared after transfer of shares.

Held: Section 260 avoided the transfer of shares and taxpayers assessable on a proportion of the dividend declared to the amount received by them as the sale price.

APPENDIX G

SUGGESTION THAT THE ANTI-TAX AVOIDANCE PROVISIONS IN SECTION 108 BE STRENGTHENED

You will recall the comments made by Mr Lloyd Martin, Chairman of the Board of Review in his recent letter to you and supported by Inland Revenue Department. Section 108 in general terms provides in effect that any arrangements made for the purpose of relieving any taxpayer from his obligations to pay tax will be void for tax purposes.

The provision is used to counter attempts made by, say, parents or spouses to reduce the overall tax on their income by artificial diversions of income to members of their family.

The Privy Council in a New Zealand case heard before them drew attention to the fact that, while the section went so far as to void an arrangement, it did not proceed to say to whom the income affected by the voiding of the arrangement was to be assessed. Mr Lloyd Martin and the Department consider that the section should be strengthened to permit the Commissioner to do this.

Recommendation:

That section 108 be amended to give effect to this dicta from the Privy Council.

Kellaway

(29)

Section 108 - to be noted for amendment next year to say what is to happen to the income when section 108 applies i.e. if section 108 applies the T/P is deemed to have derived the income

Verbal direction from Commissioner arising from a brief discussion on margin Decision - accepted that taxpayer (explanation) licenses not available during ordinary family business dealings + found that T/P in fact sold the coat + received proceeds

Mem 9 Jun
Wellington.

Section 108 - Anti-avoidance provision

1. Section 108 of the Tax Act is a brief general provision which sets aside ~~so~~ for income tax purposes arrangements which purport to alter the incidence of income tax or relieve any person from his liability to pay income tax.

2.1 An equivalent provision is included in the Property Speculation Tax Bill in relation to the limited area to which that Bill is to apply i.e. profits from land speculation. This latter provision has been drafted to take regard of comment made by the Courts from time to time in relation to the existing S. 108 in the Tax Act. A significant feature of S108 is that it omits to say what situation remains after arrangements are set aside - who derives what income etc ~~and what tax~~ Up to the present the Department has adopted the practice of allocating the income concerned to the person it considers would have derived the income in the absence of the arrangement. Tax has been assessed accordingly. However there is no specific authority in the section to do this.

2.2 The new equivalent ~~provision~~ measure ~~code~~ in the Property Speculation Tax Bill ~~does~~ includes a provision enabling the Commissioner to

make an assessment of property speculation tax the person by whom he considers the tax would have been payable but for the arrangement.

3.1 It is considered desirable to make a similar provision in Section 108 and that this should be introduced this year so that the amended section parallels that in the Property Speculation Tax Bill. There are other differences in the draft measure in the P.S.T. Bill and some further consideration of whether these drafting changes should also be adopted in an amended section 108 is still required.

~~In the~~

3.2 Your approval is sought to a review of section 108 with a view to incorporating in it the provision referred to in paragraph 2.2 above ~~together with other~~ and any other changes considered necessary in the light of the review.

D.A.S.
Comm.

Comms

I asked Mr. Lincoln to note this for possible legislation. The Property Spec. Tax decision overcomes substitution. This in itself may weaken our position in cases going to Courts & Privy Council under S. 108 in its present form. At some stage we will probably have to amend S. 108. The question is should it be this year or later. Perhaps we ought to wait ~~until~~ until Gerard has been heard by the Privy Council.

L.H. 27/6/72

For All Government Members

LAND AND INCOME TAX AMENDMENT (NO. 2) BILL
BACKGROUND TO CLAUSE 8 - ANTI-TAX AVOIDANCE PROVISION

This clause replaces section 108 of the Tax Act. The previous section was an important one and was the subject of many tax cases. Nevertheless, it was a short section as follows -

> "108. Agreements purporting to alter incidence of taxation to be void - Every contract, agreement, or arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the Commissioner for income tax purposes 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."

As stated, the Courts have had to consider this section many times and a section with very similar wording in the Australian Tax Act. In recent times, the Courts have tended to criticise it

i) Firstly, that it was in too general terms, and

ii) Secondly, while the section could apply to void arrangements, it was silent on just what was to happen after the arrangements had been voided for income tax purposes.

Tax Avoidance

Tax avoidance has always occupied the attention of some taxpayers and their advisers and the increases in monetary incomes in recent years coupled with the structure of the income tax rate scale which reaches relatively high marginal rates at a fairly early point in the scale have tended to increase the numbers of taxpayers giving attention to ways and means of defeating the tax legislation.

A favoured device was the use of a family trust, say, for the wife and/or children (usually infant children) of the taxpayer. It will be readily apparent that if a person had an income from a business of, say, $20,000, there would be considerable tax savings if he could so arrange his affairs that the income was split, say, five ways as to $4,000 each between himself, his wife and, say, three children, without effectively losing control of the income.

A real problem is to arrive at a formula which, while countering the more blatant type of tax avoidance cases, nevertheless recognises that a parent should be able to transfer income producing assets permanently either to his wife or to his children without the transfer being set aside for tax purposes.

Following dicta from the Courts over a considerable period, the Department was prepared to accept the proposition that, if the "income producing substance" was made over outright to the members of the taxpayer's family or to his family trust, it would be acceptable for tax purposes. On the other hand, if the taxpayer kept full control of the assets and only diverted the income from them on a temporary basis, it would be unacceptable.

Cases which the Department has accepted as genuine are -

(a) Shares in a company made over outright to members of a taxpayer's family or a family trust for them.

(b) A share in freehold land or livestock or in a business being transferred permanently to the taxpayer's family so that they could then enter into partnership with him on a proper basis.

On the other hand, examples of cases which the Department sought to set aside were

(c) Paddock trust situations in which a farmer merely leased a paddock to a family trust and, after doing all the work thereon, allowed the family trust to take the proceeds.

(d) A taxpayer who, having previously owned "wasting assets" such as plant and motor vehicles, sold them to a family trust and then hired them back, say, at a high rental.

(e) Professional firms, in particular doctors, where the professional fees were made over to a family company rather than being treated as the personal income of the taxpayer.

However, the Department has not always been successful in applying the existing section 108 to the circumstances referred to in (c) to (e) inclusive and the following uncertainties have arisen -

(1) As indicated, the Courts have criticised that the section in its present form is silent as to who is to be assessed with the income when an arrangement is voided. For instance, the Department lost a case in the Court of Appeal where, in a paddock trust, the proceeds from the paddock were paid to the trustees, the Court holding that, notwithstanding that the arrangement made ran foul of section 108, there was nothing in it to say that the income involved was to be assessed to the parent.

(2) When the section refers to the purpose or effect, does this imply that the Department must prove that it was the sole or principal purpose? A number of cases have been lost where the Court has held that, while tax avoidance was in the mind of the taxpayer, the arrangement could be explained by "ordinary family dealing" (namely, the desire to benefit the taxpayer's family).

Amending Provisions

The new section 108 differs from the old to get over the difficulties referred to above in the following ways -

. Sub-clause (1) extends the test of tax avoidance from being simply "the purpose or effect" to any arrangement which has the "purposes or effects which include the purpose or effect (whether or not the principal purpose or effect)".

. Sub-clause (1) also makes it clear that the taxpayer himself need not be a direct party to the arrangement - the Department lost a case where the taxpayer, while being the instigator of the arrangement, was not a direct party to the arrangement between the trustees of his family trust and the third party.

. Sub-clause (1) now gives the Commissioner power to assess to the taxpayer the income which could be expected to have been derived by that taxpayer if the arrangement now voided had not, in fact, been entered into. This meets the principal criticism of the Courts.

. Sub-clause 3. This deals with a particular device called "dividend stripping" which has become prevalent in New Zealand and Australia in recent years. It concerns a situation in which a company which may have ceased to trade has large accumulated profits which, if distributed, would bear dividend tax in the hands of any shareholders who are individuals. What happens is that a company engaged in financial transactions offers to buy the shares from the individual shareholders at a price which may be equivalent to the full capital of the first mentioned company plus 90% of the accumulated profits. The purchasing company then has a dividend declared in its favour but it does not pay tax thereon under a general provision in the tax Act that inter company dividends are not directly assessed for tax. It is hoped that in this way the previous individual shareholders would escape dividend tax. This sub-clause is designed to meet these particular circumstances by deeming the relevant part of the consideration for the sale of the shares in these particular circumstances to be a dividend.

General Comment

It may be claimed that the new provisions are still in general terms and that they do not spell out the specific circumstances which are to be struck down. However, the circumstances in which financial arrangements between a taxpayer and members of his family are made vary considerably and it is considered that for this reason the provisions must remain in general terms.

It may also be claimed that the new provisions will go too far. However, the Department considers that before an arrangement is voided under sub-clause (1) of the new clause, it must have for at least one of its purposes or effects the avoidance of tax. Accordingly, the Department would consider that any arrangement which made over outright financial assets such as shares in a company or a share in freehold land preparatory to a partnership as in (a) and (b) above would not be caught by the new provisions.

The new clause is not to take effect until 1.4.75. This will give taxpayers and their advisers an opportunity to look at existing arrangements.

(W. E. Rowling)
Minister of Finance.

SECTION 108 - "PURPOSE OR EFFECT"

1. Newton v C.I.R. (1958) A.C. 450 & 467 - "It is clear from this analysis that the avoidance of tax was not the sole purpose or effect of the arrangement. The raising of new capital was an associated purpose. But the section can still work if one of the purposes or effects was to avoid liability for tax.
   In that case avoidance of tax was regarded as an "essential feature" of the arrangement there under consideration.

2. Peate v F.C.T. (1964) III C.L.R.443 - Taylor J said that the arrangements had other ends in view, "but avoidance of tax was the means to those ends and a diminution in the appellants tax was not merely an incident of what might be regarded as an ordinary family settlement."

3. Mangin v C.I.R. (1970) 1 A.T.R.835 & 841 adopted the language of Turner J in the lower Court, saying the section applied to "a ~~share~~ scheme ..... devised for the sole purpose or at least the principal purpose of" escaping liability on tax.

4. Hollyock v F.C.T. 2A.T.R. 601 & 606-7, per Gibbs J.
   "To say that the section applies only to arrangements whose sole purpose is tax avoidance would be contrary to the decisions in Newton's Case and in Hancock's Case. To hold that tax avoidance should be the principal purpose of the arrangement .... would introduce into s.260 a refinement which is not suggested by the words of the section itself, and which would tend to increase, rather than remove, the difficulties to which the section

gives rise, by requiring the courts to weigh one purpose against another and to decide which was predominant. An arrangement ..... does not in my opinion escape from s.260 simply because it cannot be held that the avoidance of tax is the principal purpose of the scheme. On the other hand, if tax avoidance is an inessential or incidental feature of the arrangement, that may well serve to show that the arrangement cannot necessarily be labelled as a means to avoid tax." (Underlining is mine).

5. Udy v C.I.R. (1972) N.Z.L.R. 714 & 717, per Wild C.J. "The purpose and effect is ascertained by examining the overt acts by which the arrangement was implemented. If on that examination it can be predicated that the scheme was devised for the sole purpose, or at least the principal purpose, (of tax avoidance) ..... it is within the section. If it cannot be so predicated then the scheme is not caught".

6. O'Kane Construction Co. Ltd v C.I.R. (1974), N.Z.L.R. 707 "Principal purpose" test applied.

7. Martin v C.I.R. (1973) N.Z.L.R. (C.A.)

Richmond J. left open for future consideration "whether s.108 may not apply in circumstances where tax avoidance is an essential purpose of the scheme, albiet neither the sole nor the principal purpose". (Underlining is mine) White J. also left that question open for future consideration.

8. Ashton and Wheelans v C.I.R. - C. of A. 1974. - "Principal purpose" test applied.

9. McKay v C.I.R. 3 A.T.R.63 - "Principal purpose" test applied.

10. Grierson v C.I.R. 3 A.T.R.3 - Tax avoidance not the "principal purpose" of the scheme.

11. Loader v C.I.R. 4 A.T.R.341 - Cooke J. said and 345-6 "I see nothing in the documents or the arrangement as a whole or the manner in which it has operated to warrant an inference that tax saving was either the principal purpose or one of a number of equally important principal purposes. On the overt acts test, the more obvious conclusion is that it was an incidental or subsidiary purpose." (Underlining is mine).

PROPOSED LEGISLATION CHANGES IN SECTION 108 OF THE TAX ACT WHICH CONTAINS ANTI-TAX AVOIDANCE PROVISIONS

There have been some comments from legal and other circles about the effect of the new section 108 which is to be substituted for the present section. The new section has three subsections and an explanation is now given of the changes which have been brought about by each of these subsections whether by themselves or in relation to other provisions of the new section. Firstly, a brief indication is given of the nature of the changes and later some explanatory comments thereon are given.

(1) In the new subsection (1) there are three changes of some consequence, viz.

i) Whereas the present section uses the words "the purpose or effect", the new subsection (1) uses the words "the purpose or effect, or purposes or effects which include the purpose or effect (whether or not the principal purpose or effect)".

ii) Since attempts have been made in the past to escape the section on the ground that the person against whom the assessment was made was not himself a party to the contract, agreement, or arrangement, the new subsection (1) specifically provides that the section will apply whether or not that person is a party to the contract, agreement, or arrangement.

iii) The present section in its terms merely voids certain contracts, agreements, or arrangements without giving the Commissioner specific powers to make assessments to counteract the tax avoidance. This matter has been referred to by the Courts

(including the Privy Council) as a defect which requires the attention of the legislature. The new subsection (1) cures this defect and at the same time precludes double taxation. The exercise of the Commissioner's powers (including the exercise of his discretions) under the new provision is, of course, subject to review by the Board of Review or the Courts on objection by the taxpayer.

(2) Subsection (2) of the new section states in effect that the fact that a particular contract, agreement or arrangement may have been induced by the desire of a taxpayer to benefit the members of his family or, as the section says, "was influenced by considerations of ordinary family dealing" will not of itself be taken as grounds for accepting the tax avoidance scheme. However, as is mentioned in more detail below, this subsection must be read in conjunction with subsection (1) and if in fact there is no tax avoidance in the contract, agreement, or arrangement it will not be caught under the operations of the whole section even if made with relatives.

(3) Subsection (3) of the new section deals with a particular device called "dividend stripping" and is limited in its application to this type of transaction. Again, as is explained in more detail below, it will not cover normal sales of shares or indeed outright permanent transfers of shares in a continuing company to a member of a taxpayer's family.

The above points are now dealt with in detail.

(a) So far as paragraph (1)(i) is concerned, this is considered to merely restore the interpretation which was placed on the present section 108 until comparatively recent times and which, it is understood, is still the interpretation placed by the Australian Courts on the corresponding Australian provision which, on the particular point under consideration under paragraph (1)(ii), does not differ from our present section 108. In recent times, however, certain dicta in the judgments of our New Zealand Courts would suggest a more restrictive interpretation of the present section 108, namely, that, in order to bring a contract, agreement, or arrangement within the section, it must be shown that its sole purpose or effect or at least its principal purpose or effect is tax avoidance.

The new subsection (1) provides that where a contract, agreement, or arrangement has a plurality of of purposes or effects one of which is tax avoidance, the latter purpose or effect need not be the principal purpose or effect. That, as indicated above, is the interpretation which, it is understood, is placed by the Australian Courts on the corresponding Australian provision. That does not mean, however, that, where tax avoidance is a purely incidental feature of a contract, agreement or arrangement, the contract, agreement, or arrangement will come within the new subsection (1). This again is considered to be in line with the attitude taken by the Australian Courts on the corresponding Australian provision. Perhaps it should also be made clear at this point that, if a person wishes to make over permanently a permanent

asset such as land or shares in a company outright to members of his family or family trust, this transaction will not of itself be caught under the new section.

So far as paragraph (1)(ii) above is concerned, this is merely to get over a difficulty that a taxpayer could avoid having what was obviously a tax avoidance scheme nullified by not being a direct party to the particular contract, agreement, or arrangement notwithstanding that he may have been the prime instigator in it. By itself, it does not call for any detailed comment.

Turning now to paragraph (1)(iii), this particular passage is to meet the widespread criticism that was made of the old section that, while it may have voided a particular contract, agreement, or arrangement for income tax purposes, it was silent as to what was to happen or how the income involved was to be assessed when the particular contract, agreement, or arrangement had been set aside. This particular part of subsection (1) now states that it will be left to the Commissioner to determine how much income has been diverted away from the person concerned and to this extent it will be assessed to him.

It is, of course, important to remember that any determination made by the Commissioner will be subject to the usual rights of objection. Leaving the determination to the Commissioner in these circumstances can also get over the difficulty against the taxpayer which is inherent in the present section. Dicta from the Courts seem to suggest that, if, for

instance, a taxpayer artifically created a deduction for tax purposes and the whole contract, agreement, or arrangement was voided, all that was to be done was to disallow that deduction without necessarily substituting another deduction in its place. For instance, if a taxpayer had diverted plant and machinery to a trust and was paying higher rentals on a lease back arrangement, the present section in a strict sense would merely have disallowed the rental as a deduction but may not have allowed him depreciation in lieu thereof. This part of the provision will enable the Commissioner to make an appropriate adjustment in his favour.

(b) So far as subsection (2) of the new section is concerned, as indicated above, the point here is that, if there is a purpose or effect of tax avoidance present in a contract, agreement, or arrangement, the fact that it was induced by considerations of ordinary family dealing will not be able to be advanced as a reason for having the contract, agreement, or arrangement accepted for tax purposes. However, it is stressed that it would still be necessary in a situation of "family dealing" for there to be a purpose of tax avoidance for the section to apply. Perhaps the following illustration will amplify this point.

If a farmer transfers permanently his freehold land or part thereof to a member of his family or to his family trust, this would in broad terms be acceptable for tax purposes as not being labelled as tax avoidance.

However, if a farmer merely leased a paddock to a family trust to enable the trust to take the proceeds, this would be regarded under the new section as a tax avoidance scheme and the fact that it was induced by ordinary family dealing could not be invoked to take it out of subsection (1).

(c) Turning now to subsection (3) of the new section which, as indicated above, is a subsection to cover a form of tax avoidance called "dividend stripping". A number of instances have arisen in New Zealand where what were formerly operating companies have ceased to trade but have large accumulated profits and the shares are owned by individuals. In the ordinary case, if the company is wound up, any amounts paid to the individual shareholders in excess of their paid up capital would be treated as dividends and liable for dividend tax accordingly. However, what has been done in a number of cases is for a financial company to acquire the shares and then declare a dividend in its favour which would be merely treated as non-assessable income under a general provision of the Tax Act which states that inter-company dividends shall not be treated as taxable income for tax purposes.

It is probable that this type of dividend stripping is caught under the present section 108 and the Department has in fact applied the section in a number of cases. One part of the new subsection (3) deems the consideration to be a dividend derived in the year in which the shares are sold and therefore assessable in that year rather than at some future date when the company in which the accumulated profits were held declares a dividend.

General Comments

As indicated above, the new section 108 is largely to restore the interpretation which was given some years ago to the present section 108 with the added provision to overcome the difficulty referred to by the Courts that the old section was silent as to what was to happen to the relevant income when a particular contract, agreement, or arrangement was voided under the section.

The Commissioner has received his own legal advice and he is assured that, having regard to this advice and the dicta from some Australian cases, the practical effect of the new section 108 could be summarized as follows -

i) If the "income producing substance" or, in other words, permanent assets such as freehold land, blocks of shares, etc, is made over permanently to a member of the taxpayer's family or family trust or family company, this would generally be regarded as outside the scope of the new section.

ii) If, on the other hand, what is done is to retain ownership or control of the income producing substance as, for instance, if part of a business or part of freehold land is given on a temporary basis to a member of the family or family trust or if what could be referred to as short term assets are made over and leased back, etc, this would be regarded as caught within the section.

It is considered that the new section does give a reasonable result and that, while combatting what are clearly tax avoidance schemes, still leaves room for genuine permanent transfers of assets to be made between members of a family.

One final point is that there has been some comment as to the amended section applying as from the 1 April 1975 to all contracts, agreements, or arrangements made on or before that date. It is considered that this is the best approach and it will enable taxpayers and their advisers between now and that date to look at their existing arrangements.

As the types of contracts, agreements, or arrangements which will be set aside by the new section will be largely those of a temporary nature, it is considered that this particular aspect of the new provisions will give a proper measure of justice.

Not in scope

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Commission
FOR YOUR CONSIDERATION
K. W. KERSLEY
PARLIAMENTARY COUNSEL
4/10/74

No.

P.C.O. 42A/3
Drafted by Mr Kersley
CONFIDENTIAL

HOUSE OF REPRESENTATIVES

Supplementary Order Paper

Tuesday, the 1st Day of October 1974

LAND AND INCOME TAX AMENDMENT (NO. 2)

Proposed Amendments

Hon. Mr TIZARD, in Committee, to move the following amendments:

Clause 8: To omit this clause on pages 5 to 7, and substitute the following clause:

8. Agreements purporting to alter incidence of taxation to be void—(1) The principal Act is hereby amended by repealing section 108 (as amended by section 16 (1) of the Land and Income Tax Act (No. 2) 1968), and substituting the following section:

"108. (1) Every arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the Commissioner for income tax purposes if and to the extent that, directly or indirectly,—

"(a) Its purpose or effect is tax avoidance; or

"(b) Where it has 2 or more purposes or effects, one of its purposes or effects (not being a merely incidental purpose or effect) is tax avoidance, whether or not any other or others of its purposes or effects relate to, or are referable to, ordinary business or family dealings,—

whether or not any person affected by that arrangement is a party thereto.

"(2) Where an arrangement is void in accordance with subsection (1) of this section, the assessable income and the non-assessable income of any person affected by that arrangement shall be adjusted in such manner as the Commissioner considers appropriate so as to counteract any tax advantage obtained by that person from or under that arrangement, and, without limiting the generality of the foregoing provisions of this subsection, the Commissioner may have regard to such income as, in his opinion, either—

"(a) That person would have, or might be expected to have, or would in all likelihood have, derived if that arrangement had not been made or entered into; or

"(b) That person would have derived if he had been entitled to the benefit of all income, or of such part thereof as the Commissioner considers proper, derived by any other person or persons as a result of that arrangement.

"(3) Where any income is included in the assessable income or, as the case may be, in the non-assessable income of any person pursuant to subsection (2) of this section, then, for the purposes of this Act, that income shall be deemed to have been derived by that person and shall be deemed not to have been derived by any other person.

"(4) Without limiting the generality of the foregoing provisions of this section, it is hereby declared that where, in any income year, any person sells or otherwise disposes of any shares in any company under an arrangement (being an arrangement of the kind referred to in subsection (1) of this section) under which that person receives, or is credited with, or there is dealt with on his behalf, any consideration (whether in money or money's worth) for that sale or other disposal, being consideration the whole or, as the case may be, a part of which, in the opinion of the Commissioner, represents, or is equivalent to, or is in substitution for, any amount which, if that arrangement had not been made or entered into, that person would have derived or would derive, or might be expected to have derived or to derive, or in all likelihood would have derived or would derive, as income by way of dividends in that income year, or in any subsequent income year or years, whether in one sum in any of those years or otherwise howsoever, an amount equal to the value of that consideration or, as the case may be, of that part of that consideration shall be deemed to be a dividend derived by that person in that first-mentioned income year.

"(5) Where any arrangement has been made or entered into before the 1st day of October 1974 and the Commissioner is satisfied, in respect of that arrangement or, as the case may be, in respect of a part of that arrangement, that the terms or conditions of that arrangement or, as the case may be, of that part (being legally binding terms or conditions which were agreed upon before that date) prevent the discontinuance of that arrangement or, as the case may be, of that part, the following provisions shall apply—

"(a) Subsections (1) to (4) of this section shall not be applied with respect to that arrangement or, as the case may be, with respect to that part so long as that arrangement or, as the case may be, that part is so prevented from being discontinued and is continued strictly in accordance with the requirements of the aforementioned terms or conditions thereof; and

"(b) So long as the said subsections (1) to (4) of this section are not applied with respect to that arrangement or, as the case may be, with respect to that part in accordance with paragraph (a) of this subsection, the section for which this section was substituted by section 8 of the Land and Income Tax Amendment Act (No. 2) 1974 shall, notwithstanding the repeal thereof by the said section 8, be deemed to remain in full force and effect in relation to that arrangement or, as the case may be, in relation to that part.

"(6) For the purposes of this section—

"'Arrangement' means any agreement, plan, or understanding (whether enforceable or unenforceable) including all steps and transactions by which it is carried into effect:

"'Liability' includes a potential or prospective liability in respect of future income:

"'Tax avoidance' includes—

"(a) Directly or indirectly altering the incidence of any income tax:

"(b) Directly or indirectly relieving any person from liability to pay income tax:

"(c) Directly or indirectly avoiding, reducing, or postponing any liability to income tax."

(2) The Land and Income Tax Amendment Act (No. 2) 1968 is hereby consequentially amended by repealing section 16.

(3) This section—

(a) In the case of an arrangement (as defined in subsection (6) of section 108 of the principal Act as substituted by subsection (1) of this section) made or entered into on or after the 1st day of October 1974, shall be deemed to come into force on the 1st day of October 1974, and shall apply with respect to the tax on income derived during the income year that commenced on the 1st day of April 1974 and in every subsequent year:

(b) In the case of an arrangement (as so defined) made or entered into before the 1st day of October 1974, shall, subject to subsection 5 of section 108 of the principal Act (as substituted by subsection (1) of this section) apply with respect to the tax on income derived in the income year commencing on the 1st day of April 1975 and in every subsequent year.

Clause 15: To insert in subparagraph (ii) of paragraph (b) of the definition of the term "specified area" in subsection (1) of the proposed new section 114F, as inserted by subclause (1), after the word "Eastbourne", in line 17 on page 12, the word "Kapiti,".

To add to subsection (4) of the proposed new section 114F of the principal Act, as inserted by subclause (1) on page 15, the following proviso:

"Provided that where that asset is an asset of a kind in respect of which the deduction allowed by the Commissioner under section 113 of this Act is customarily calculated at a

rate which is not less than 20 percent of the diminishing value of that asset, the deduction allowed under this section shall be increased by an amount not exceeding an amount equal to 10 percent of that capital expenditure so incurred in respect of that asset.

Clause 16: To omit from subclause (1) lines 30 to 33 on page 18, and substitute the following lines:

reduced by that allowance, an amount (hereinafter referred to as the specified amount) equal to the smaller of—

"(a) The amount of that excess:

"(b) The amount equal to the sum of all such deductions so allowed in respect of that asset,—

shall, subject to this section, be included in the assessable income derived by the taxpayer in the income year in which the asset was sold or disposed of:

To omit from subclause (1) the words "the total of any such excess amounts" in the proposed proviso to subsection (1) of the said section 117 in lines 34 and 35 on page 18, and substitute the words "any specified amount or, if in any income year there is more than one specified amount to be included in the assessable income of the taxpayer, the total of all such specified amounts".

To omit from subclause (1) the words "total amount" in the proposed proviso to subsection (1) of the said section 117 in line 41 on page 18, and substitute the words "specified amount or, as the case may be, that total of all such specified amounts".

To insert in subclause (1), after the words "made in writing by" in the proposed proviso to subsection (1) of the said section 117 in line 36 on page 18, the word "him".

To add to subclause (4) the following proviso to the proposed new subsection (5B) of the said section 117 on page 21:

"Provided that the taxpayer may, upon application made in writing by him or on his behalf within the time within which he is required to furnish a return of his income for the income year in which that payment was received, or within such further time as the Commissioner in his discretion may allow in any case or class of cases, elect that the amount of that excess shall be included in his assessable income in the income year in which that damage occurred."

Clause 18: To insert in subclause (1), after the words "The taxpayer" in the proposed subparagraph (ii) of paragraph (b) of subsection (4A) of section 117A of the principal Act in line 24 on page 22, the words ", on or before the terminating date,".

Clause 19: To omit from paragraph (b) of subclause (1) the words "not acquired or installed until" in lines 16 and 17 on page 23, and substitute the words "first used in the production of assessable income".

Clause 22: To omit from subclause (3) the proposed paragraph (a) of subsection (3) of section 126A of the principal Act in line 21 on page 26.

To omit from subclause (3) the words "or an employee of" in the proposed paragraph (c) to subsection (3) of the said section 126A in line 23 on page 26.

Clause 24: To omit subsection (4) of the proposed new section 129CI of the principal Act, as inserted by subclause (1) on page 31, and substitute the following subsection:

"(4) Where in any accounting year the aggregate purchase price of all bonds purchased in that year and within the specified period in relation to that year exceeds the amount of the deduction allowed under subsection (2) of this section, the amount of that excess shall for the purposes of this section be apportioned among those bonds, rateably in accordance with their purchase price, and subsections (5), (6), (7), (8), and (9) of this section shall apply to the amount received, or the amount that would have been received, on the redemption of any of those bonds, reduced by the amount of that excess so apportioned to it.

To omit subsections (6) and (7) of the proposed new section 129CI of the principal Act, as inserted by subclause (1) on pages 31 and 32, and substitute the following subsections:

"(6) Where any taxpayer (not being a company or a trustee) has during any accounting year retired from carrying on his farming business, the amount that would have been received on redemption of any bond held by him if it had been redeemed immediately after his retirement shall be assessable income derived by him in that accounting year:

"Provided that where any bond has been purchased or deemed to have been purchased in any accounting year earlier than the year of retirement, the taxpayer shall, if he so elects by notice in accordance with subsection (6A) of this section be entitled to allocate to that earlier year the amount that would have been received on the redemption of the bond, and any amount so allocated to any such earlier year shall be deemed to be assessable income derived by the taxpayer in that year.

"(6A) Every notice under subsection (6) of this section shall be in writing, and shall be given to the Commissioner within the time within which the taxpayer is required to furnish a return of his income for the year of retirement, or within such further time as the Commissioner, in his discretion, may allow in any case or class of cases.

"(7) Where any taxpayer (not being a taxpayer to whom subsection (6) of this section applies) dies during any accounting year, the amount that would have been received on the redemption of any bond held by him if it had been redeemed immediately after his death shall be assessable income derived by the taxpayer immediately before his death:

"Provided that where any bond has been purchased or deemed to have been purchased in any accounting year earlier than the year of death, the trustee of the taxpayer's estate shall, if he so elects by notice in accordance with subsection (7A) of this section, be entitled to allocate to that earlier year an amount not exceeding the amount that would have been received on the redemption of the bond and any amount so allocated to any such earlier year shall be deemed to be assessable income derived by the taxpayer in that year;

"Provided also that, if the trustee does not make an election in accordance with the first proviso to this subsection, and he carries on the farming business of the taxpayer and so elects by notice in accordance with subsection (7A) of this section, the amount that would have been received on the redemption of the bond shall not be assessable income derived by the taxpayer but the amount actually received on the redemption of the bond shall be assessable income derived by the trustee in the accounting year in which the bond is redeemed.

"(7A) Every notice under subsection (7) of this section shall be in writing, and shall be given to the Commissioner within the time within which the trustee of the taxpayer's estate is required to furnish a return of the taxpayer's income for the period to the date of his death, or within such further time as the Commissioner, in his discretion, may allow in any case or class of cases.

"(7B) For the purposes of subsections (6) and (7) of this section, where any bond is purchased by any taxpayer earlier than the commencement of the accounting year which commenced 5 years before the commencement of the accounting year in which the taxpayer retired or, as the case may be, died, the bond shall be deemed to have been purchased in that first-mentioned accounting year.

To add to the proposed new section 129CI of the principal Act as inserted by subclause (1) on page 32, the following subsection:

"(10) Notwithstanding anything in section 24 of this Act, the Commissioner may, for the purpose of giving effect to this section, amend any assessment or assessments of the taxpayer at any time."

Clause 27: To omit this clause and substitute the following clause:

27. Special provisions for income equalisation reserve deposits for the accounting years 1973–74 and 1974–75—Section 25 of the Land and Income Tax Amendment Act 1973 shall apply to deposits made in respect of the accounting year (as defined in section 136B of the principal Act) corresponding to the income year that commenced on the 1st day of April 1973, and to deposits made in respect of the accounting year (as so defined) corresponding to the income year that commenced on the 1st day of April 1974 in the same manner, with any necessary modifications, as it applies to deposits made in respect of the accounting year (as so defined) corresponding to the income year that commenced on the 1st day of April 1972.

Clause 30A: To insert, after clause 30 on page 36, the following clause:

30A Payment of land tax and income tax—(1) Section 204 of the principal Act (as substituted by section 36 (1) of the Land and Income Tax Amendment Act 1972 and amended by section 42 (2) of the Land and Income Tax Amendment Act 1973) is hereby further amended by adding the following subsection:

"(2) Income tax payable on income derived in any income year and not previously due and payable by any company which does not have a fixed establishment in New Zealand and which is not deemed to be resident in New Zealand within the meaning of Part VI of this Act shall be due and payable on the 7th day of February in the year next succeeding the income year."

(2) This section shall be deemed to have come into force on the 5th day of November 1973 (being the date of the passing of the Land and Income Tax Amendment Act 1973), and shall apply with respect to the tax on income derived in the income year that commenced on the 1st day of April 1972 and in every subsequent year.

Clause 32: To omit this clause on page 37, and substitute the following clause:

32. Provisional taxpayers—(1) Section 41 of the Income Tax Assessment Act 1957 is hereby amended by omitting the words "every person who in any income year derives assessable income otherwise than from source deduction payments", and substituting the words "every person (not being a person who derives assessable income solely from source deduction payments or a company which does not have a fixed establishment in New Zealand and which is not deemed to be resident in New Zealand within the meaning of Part VI of the principal Act) who in any income year derives assessable income".

(2) This section shall be deemed to have come into force on the 5th day of November 1973 (being the date of the passing of the Land and Income Tax Amendment Act 1973), and shall apply with respect to the tax on income derived in the income year that commenced on the 1st day of April 1972 and in every subsequent year.

Clause 33: To omit this clause on page 37, and substitute the following clause:

33. Transitional arrangements for the payment of income tax and provisional tax by subsisting companies and certain other taxpayers—(1) Section 45 of the Land and Income Tax Amendment Act 1973 is hereby amended as from its commencement by inserting in subsection (2), after the words "expressly provided for in the principal Act", the words "other than a company which does not have a fixed establishment in New Zealand and which is not deemed to be resident in New Zealand within the meaning of Part VI of the principal Act".

(2) Notwithstanding anything in subsection (1) of this section or in any provision of the principal Act or the Income Tax Assessment Act 1957, income tax (being income tax not previously due and payable) payable by any taxpayer, being a company which does not have a fixed establishment in New Zealand and which is not deemed to be resident in New Zealand within the meaning of Part VI of the principal Act, on income derived in the income year that commenced on the 1st day of April 1972 shall be due and payable on the date 30 days after the date of the passing of this Act.

EXPLANATORY NOTE

Clause 8: This amendment substitutes a new clause 8.

Subclause (1) rewrites the proposed section 108 of the principal Act.

Subsection (1) of the section provides that every arrangement (as defined in subsection (6)) made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the Commissioner for income tax purposes if and to the extent that, directly or indirectly,—

(a) Its purpose or effect is tax avoidance, as defined in subsection (6)); or

(b) One of its purposes or effects (not being a merely incidental purpose or effect) is tax avoidance, and notwithstanding that any other purpose or effect relates to ordinary business or family dealings.

Subsection (2) provides that where such an arrangement is void, the assessable and non-assessable income of any person affected by the arrangement is to be adjusted by the Commissioner in such manner as he thinks appropriate so as to counter any tax advantage obtained by that person under the arrangement.

Subsection (3) provides that where any income is included in the assessable or the non-assessable income of any person under subsection (2), it shall be deemed not to have been derived by any other person

Subsection (4) is basically the same as subsection (3) of section 108 in the Bill.

Subsection (5) provides that where any arrangement has been made or entered into before 1 October 1974 and the Commissioner is satisfied that the terms and conditions of the arrangement legally prevent the discontinuance of the arrangement, the provisions of the present section 108 shall be deemed to remain in full force and effect in respect of that arrangement to the extent that the arrangement is strictly continued in accordance with those terms and conditions.

Subsection (6) provides the definitions.

The new *subclause (2)* is the same as subclause (2) in the Bill.

The new *subclause (3)* provides a new application date for the proposed section 108 as follows—

(a) In the case of an arrangement made or entered into on or after 1 October 1974, the section is to apply to the tax on income derived in the 1974–75 income year and in subsequent years.

(b) In the case of an arrangement made or entered into before that date, (and subject to the new subsection (5) of section 108) the section is to apply to the tax on income derived in the 1975–76 income year and in subsequent years

Clause 15: The first amendment includes the new Borough of Kapiti in the definition of the term "specified area" as part of the Wellington regional area.

The second amendment provides that where an asset is of the kind that is entitled to an ordinary depreciation allowance on a diminishing value basis of 20 percent or more, the first year depreciation allowance otherwise allowable may be increased by up to 10 percent of the capital expenditure on that asset.

Clause 16: The first three amendments make it clear that the amount to be included in the assessable income of any taxpayer following the sale or other disposal of any asset in respect of which depreciation has been allowed is not to exceed the amount of the depreciation so allowed

The fourth amendment corrects a drafting omission.

The fifth amendment provides that, where the taxpayer elects, the amount of any payment made to him in respect of any damage, not being irreparable damage, to any asset in excess of the amount expended on repairs may be treated as assessable income in the year in which the payment is received, and not as a reduction in the value of that asset for depreciation purposes.

Clause 19. This amendment provides that subclause (1) is to apply where the plant or machinery was first used in the production of assessable income after 31 March 1975.

Clause 22: These 2 amendments provide that a donation made as a scholarship or fellowship by any company (not being a public company) to an employee (not being a shareholder) of that company or any associated company is not excluded from the deduction under section 126A of the principal Act.

Clause 24. These amendments rewrite part of the proposed new section 129CI of the principal Act which deals with the treatment for tax purposes of the purchase and redemption of Adverse Event Bonds.

The first amendment redrafts subsection (4) of the new section consequentially on the changes set out in the next amendment.

The second amendment replaces subsections (6) and (7) of the new section by subsections (6), (6A), (7), (7A), and (7B).

The new subsection (6) provides that, where the taxpayer so elects by notice, the amount to be received on the redemption of any bond may be treated as assessable income in the year of purchase instead of the year that the taxpayer retired from his farming business.

The new subsection (6A) provides for the procedure for giving notice of election under subsection (6).

The new subsection (7) provides that instead of being assessable income immediately before the death of the taxpayer, the amount to be received on the redemption of any bond may, if the trustee of the taxpayer's estate so elects by notice, be treated—

(a) As assessable income in the year of purchase of the bond, to the extent that it is so allocated; or

(b) If the trustee continues the farming business of the taxpayer and so elects by notice, as assessable income of the trustee in the year the trustee actually redeems the bond.

The new subsection (7A) provides for the procedure for giving notice of election under subsection (7).

The new subsection (7B) provides that for the purposes of subsections (6) and (7), any bonds purchased more than 5 years before the commencement of the year in which the taxpayer retired or, as the case may be, died are to be deemed to have been purchased in the year commencing 5 years before the year of retirement or, as the case may be, death of the taxpayer.

The third amendment adds a new subsection (10) to the section to enable the Commissioner to reopen and amend assessments for earlier years to carry out the provisions of subsections (6) and (7).

Clause 27: The present clause 27 has been redrafted to extend its provisions to include deposits made in the income equalisation reserve for the 1974–75 accounting year as well as the 1973–74 accounting year.

Clause 30A. The new clause provides for the date of payment of income tax by taxpayers who are companies which do not have a fixed establishment in New Zealand and which are not deemed to be resident in New Zealand

Clause 32 This new clause amends section 41 of the Income Tax Assessment Act 1957 to provide that provisional taxpayers do not include a non-resident company which does not have a fixed establishment in New Zealand as well as a person who derives income solely from source deduction payments.

Clause 33 redrafts the present clause 33 to exclude all non-resident companies which do not have a fixed establishment in New Zealand from the transitional arrangements for the payment by 14 instalments of the income tax on income derived in the income year that commenced on 1 April 1972.

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