Practitioner’s viewpoint: Supreme Court lays down tax avoidance law for first time, 01 February 2009

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The Supreme Court’s long-awaited judgments in *Accent Management Ltd* v *C of IR*; *Ben Nevis Forestry Ventures Ltd* v *C of IR* [2008] NZSC 115 and *Glenharrow Holdings Ltd* v *C of IR* [2008] NZSC 116 have given a clear warning to taxpayers who engage in aggressive tax planning. In strongly worded, unanimous decisions the Supreme Court rejected both taxpayers’ appeals and ruled in favour of the Commissioner of Inland Revenue that the “artificial and uncommercial” arrangements constituted tax avoidance under s BG 1 of the *Income Tax Act 1994* and s 76 of the *Goods and Services Tax Act 1985*. In this article **Mark Keating**, senior lecturer in taxation at the University of Auckland, examines both Supreme Court decisions and considers whether they are consistent with each other and with previous tax avoidance case law. In particular, the article examines whether the decisions extend the reach of the general anti-avoidance provisions. The writer concludes that our highest Court has completed the swing in favour of Inland Revenue shown in recent tax avoidance cases by the Court of Appeal.

Background

The judgments in *Accent Management Ltd* v *C of IR*; *Ben Nevis Forestry Ventures Ltd* v *C of IR* [2008] NZSC 115 (the Trinity case) and *Glenharrow Holdings Ltd* v *C of IR* [2008] NZSC 116 (the Glenharrow case) were the first decisions by the new Supreme Court on the vexed question of when proper tax planning crosses the line into impermissible tax avoidance. Although the Court found the taxpayers correctly applied the black letter law in each case, their arrangements were void for tax purposes on the grounds the taxpayers had not truly suffered the economic burden required under the particular provisions to warrant the considerable tax benefits obtained.

The Trinity scheme

The Trinity arrangement, “the brainchild” of Auckland tax lawyer Dr Garry Muir, is New Zealand’s biggest tax scheme (to date) concerning possibly $3 billion of tax deductions. It involved taxpayers planting Douglas fir trees on forestry land owned by subsidiaries of the Trinity Foundation Limited, a non-trading charitable entity. The taxpayers licensed the land (valued at only $700 per hectare) from Trinity for a fee of $2m. The taxpayers insured their ability to pay the license fee under an “extremely unorthodox” insurance arrangement involving a number of “captive” insurance companies and trusts established in various tax havens by Dr Muir.

Although both the license fee and the insurance premium were not payable until 2048 and 2047 respectively, the taxpayers claimed immediate tax deductions for these non-forestry expenses. This was on the basis that they had purportedly paid these costs up front by issuing to Trinity and the insurer (CSI) promissory notes that matured in 50 years time and were to be paid from the proceeds of the trees. By deducting these fees, and offsetting them against their other income, the taxpayers drastically reduce their tax liability for 50 years. Therefore at its simplest level the Trinity arrangement involved a “clever” exploitation of timing advantages inherent in the forestry regime (see the comments by William Young P at (2007) 23 NZTC 21,323 at para [140]).

Both the High Court and Court of Appeal found that Trinity was a “highly artificial” and “entirely tax-driven scheme”, and therefore constituted a tax avoidance arrangement in breach of s BG 1, *Income Tax Act 1994*.

The Trinity case: approach of the Supreme Court

In the first part of its judgment the Supreme Court justices disagreed over whether the taxpayers were properly entitled to claim the license fee and insurance premium deductions under the black letter law.

The minority (Ellias CJ and Tipping J) adopted an unorthodox approach that appeared to elevate the economic substance of the arrangement over its legal form. Relying upon principles of interpretation arising from the English cases generally referred to as “fiscal nullity”, the minority found the taxpayers were not properly entitled to the deductions under the specific provisions, and therefore the Commissioner did not have to rely upon the general anti-avoidance provision.

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> "[2]… recourse to the general anti-avoidance provision is not necessary … If the use of the specific provision falls outside its intended scope of the scheme of the Act, the use is not authorised within the meaning of the specific provision. …
>
> [3] The first question is whether the claimed allowance or deduction falls within the meaning of the specific provision, purposively construed. If it does not, the Commissioner can disallow the claim. …
>
> [6] We think it doubtful that the claim fell within the scope of the relevant statutory provisions, properly construed."

Such an approach has not previously been applied in New Zealand. Traditionally the economic substance of the arrangement is only considered during the application of the general anti-avoidance provision, not when interpreting the scope and application of the black letter law, as explained by the Court of Appeal in the leading case of *Mills* v *Dowdall* [1983] NZLR 154. Had this unusual judgment come from the majority, it would have thrown doubt on the established approach to the interpretation of revenue statutes.

By contrast, the majority (Tipping, McGrath and Gault JJ) found that (para [35]) : "despite what can be said about the ... arrangements for avoidance purposes," the deductions would have been permitted. Adopting a traditional form-over-substance analysis, the majority determined the deductions would have been allowed under the black letter law (which largely confirmed the reasoning of the High Court and Court of Appeal):

- the license fee was paid for the right to use land and was therefore fixed life intangible property that was depreciable on a straight line basis over the 50 years of the arrangement, under then Pt EG (now Pt EE, *Income Tax Act 2007*), and
- the insurance premium was not a sham and therefore was deductible, although it also arguably had to be spread over the 50 years as part of a financial arrangement, under Pt EH (now Pt EW).

In reaching this decision the majority expressly questioned the application of the English case law to the interpretation of New Zealand's general anti-avoidance provision:

> "[110] English decisions provide limited direct assistance. To the extent that they have, over recent decades, adopted a more purposive approach to interpretation of tax legislation, they provide helpful insights. They are not, however, concerned with the reconciliation of potentially conflicting provisions. United Kingdom tax legislation has never had a general anti-avoidance provision. …. Care must, therefore, be taken when applying English cases in the different New Zealand context."

The Trinity case: tax avoidance

The Trinity scheme contained a number of artificial or uncommercial features which the Supreme Court concluded could not be explained by reference to business or family dealings. These included:

- the lack of any realistic expectation of profit from the arrangement
- the discrepancy between the underlying value of the forestry land and the license fees payable to Trinity
- the calculation of the license fee by Dr Muir based on tax considerations, thereby ensuring the only benefits from the scheme were the ongoing tax deductions
- the "artificial and contrived" insurance structure
- the "payment" of both license fee and insurance premium using a promissory note from each taxpayer, to be satisfied in 50 years time, and
- the length of the arrangement itself, which made any future payment obligation so remote as to lack reality.

All these features combined to give taxpayers a significant timing advantage by permitting immediate deductions greatly in excess of their actual economic costs, while the scheme itself offered little prospect of a commercial return. Accordingly the Court was unanimous that the Trinity arrangement was "both artificial and contrived" (para [148]) and therefore was "clearly a tax avoidance arrangement" (para [182]).

At para [202] the majority justices noted that, on general principles concerning the application of s BG 1:

"… the highly contrived nature of the whole arrangement, in conjunction with the mismatch of timing between when deductions were claimed and payments were to be made, always meant this arrangement was highly likely to be set aside".

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The minority agreed that the scheme, including the licence fee and insurance premium, constituted tax avoidance. This conclusion was supported by a document obtained by the Serious Fraud Office, apparently co-written by Dr Muir, stating the "real benefits of the deal are the tax concessions" and "the actual outcome of the deal in fifty years time is not considered material".

As a result, the majority concluded that "The appellants altered the incidence of income tax by means of a tax avoidance arrangement which the Commissioner correctly treated as void. …" (para [156]). The minority agreed with this conclusion, noting:

> "[8] In application of the general anti-avoidance provision contained in s BG 1 we agree with the reasons why Tipping, McGrath, and Gault JJ conclude that the scheme, including the licence fee component and the insurance premium, constituted tax avoidance. We consider it plainly established that fiscal advantage was the purpose or effect of the arrangement. Nor was this object merely incidental to a business purpose. It was a principal object in itself."

The Trinity case: shortfall penalties

The Supreme Court confirmed the 100% shortfall penalties imposed on the taxpayers for adopting an abusive tax position under s 141D of the *Tax Administration Act 1994*.

First, claiming deductions under the Trinity arrangement involved an unacceptable interpretation of s BG 1. While a taxpayer's interpretation need not have been correct, the majority held that to avoid a shortfall penalty, the merits of the arguments supporting the taxpayer's interpretation must be substantial. This reasoning followed the interpretation of the similar Australian penalty provisions used by the Federal Court in *Walstern Pty Ltd* v *FC of T* 2003 ATC 5076; 138 FCR 1. Adopting an objective test meant that the taxpayer's belief that the position taken was correct, or not unacceptable, was irrelevant. (para [184]).

While application of the anti-avoidance provision is notoriously difficult, the Court felt "There were features in the arrangement which led us to conclude that the arrangement was clearly a tax avoidance arrangement. The effect of this conclusion … is that the appellants in their returns took an incorrect tax position under a general anti-avoidance law." (para [182])

Second, the Court ruled the penalty involved an objective test as to the purpose of the arrangement itself and not the subjective intention of the taxpayer. Contrary to the taxpayers' arguments, the penalty may be imposed "irrespective of what may be known or inferred concerning the motives of individual investors". (para [207])

This ruling on the application of s 141B(1)(b) finally resolves any dispute as to whether the penalties for unacceptable interpretation/unacceptable tax position or abusive tax position must be determined entirely on objective criteria. While this result may seem a harsh result for taxpayers who have little or no knowledge of the offending tax aspects of the arrangement, it means both the anti-avoidance provision and the relevant shortfall penalty apply the same objective test. A taxpayer's ignorance or innocence as to the tax avoidance aspect is no defence.

The Glenharrow case

The *Glenharrow* case dealt with an arguably less clear-cut arrangement. It involved a GST second-hand goods input tax credit on the purchase of a 10-year mining license that had been issued for $100 in 1990 and later on sold for $10,000. In 1997 Glenharrow Holdings Ltd, a $100 shelf company, purchased the license for $45m. The purchase price was satisfied in two ways:

- $80,000 paid in cash, and
- $44,920,000 provided as vendor finance.

Repayment of the vendor's loan was to be funded from profitable exploitation of the mining license, and the taxpayer made several payments totalling $210,000 towards this debt over the next three years, before the license expired.

Glenharrow claimed a second-hand input tax credit for the full $45m. Although the $45m purchase price was found to be grossly inflated the High Court found (and the Court of Appeal accepted) the parties had negotiated honestly and their agreement was genuine. Nevertheless, both courts ruled the arrangement

defeated the intent and application of the Goods and Services Tax Act 1985 (the GST Act) and was therefore void against the Commissioner under s 76 *GST Act 1985*.

Supreme Court decision: Glenharrow

The *Glenharrow* case was decided under former s 76 of the GST Act, which applied to arrangements that "defeat the intent and application" of the GST Act. The section was rewritten in 2000 to catch arrangements that "have a purpose or effect of tax avoidance", to bring it into line with the wording in s BG 1.

Given the difference in wording, there was uncertainty over the application of former s 76, particularly whether it involved an objective test of the arrangement or a subjective test of the taxpayer's purpose. This was crucial given the High Court findings in *Glenharrow* that the taxpayers had acted honestly, if over-optimistically, in reaching their bargain.

Firstly, the Supreme Court ruled that the unusual wording of former s 76 did not alter its scope and application as a general anti-avoidance provision. The current version of the section merely stated expressly what was implicit in the former version.

As in the Trinity case, the Supreme Court concluded that:

> "[40]… The intention of the Act will be defeated if an arrangement has been structured to enable the avoidance of output tax, or the obtaining of an input deduction in circumstances where that consequence is outside the purpose and contemplation of the relevant statutory provisions."

After reviewing the history and role of GST in New Zealand, the Court concluded:

- there will usually be, over time, some balancing of inputs and outputs by a supplier
- taxpayers should not obtain unacceptable windfalls in their dealings with unregistered persons
- parties should generally be dealing with each other at approximately market value, and
- timing differences between input and output tax ought not to be exploited.

GST, the Court noted at para [42], was intended to be broad-based, efficient and neutral. Despite that, tax avoidance opportunities notably remained at the boundaries between taxable and non-taxable transactions and between registered and unregistered persons. Accordingly, the general anti-avoidance provision was considered necessary.

Considering the facts in *Glenharrow*, the Court stated:

> "[46]… There is … potential for registered taxpayers knowingly or otherwise to create distortions at the boundary between themselves and unregistered persons. The same can occur where transactions are between those registered on a payments basis and those registered on an invoice basis (as in *Ch'elle Properties (NZ) Ltd* v *C of IR* (2004) 21 NZTC 18,618 and *Nicholls* v *C of IR* (1999) 19 NZTC 15,233. The general anti-avoidance provision is available to stop or counteract both these distortions."

The Court also decided that, as with the general anti-avoidance provisions directed to income tax, s 76 must involve an objective test of the purpose of the arrangement and not a difficult subjective review of the state of mind of the participants.

> "[35]… whether or not a particular arrangement constitutes tax avoidance should not depend on difficult judgments about what the taxpayer had in mind. If it did, a scheme which was void if devised and implemented by one taxpayer could be immune from s 76 if developed by another. …
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> [36] A natural and sensible reading of s 76, as it stood prior to 2000, … requires the Commissioner and the Court to ask what objectively was the purpose of the arrangement, which in turn requires examination of the effect of the arrangement."

The Court therefore ruled that a taxpayer can honestly but mistakenly commit tax avoidance. If two persons who knowingly inflate the purchase price of second-hand goods are guilty of tax avoidance (because their arrangement gives rise to a tax advantage outside the contemplation of the Act), then so too must innocent persons who have mistakenly agreed on an inflate price for the same goods.

This conclusion follows the long line of cases, starting with *Newton* v *FC of T* [1958] AC 450, stipulating that the purpose or effect of the arrangement must be determined objectively and not by reference to the motives

of the taxpayers. Nevertheless the finding of tax avoidance against an apparently honest taxpayer is the most contentious aspect of the *Glenharrow* decision, with many commentators suggesting the taxpayer's genuine business purpose should preclude application of the general anti-avoidance provision.

Taxpayers' arguments against tax avoidance

In both the *Trinity* and *Glenharrow* cases, the taxpayers raised a number of legal arguments as to why the relevant general anti-avoidance provision should not apply. In particular, they argued the section should not be applied literally or otherwise all tax advantages might be vulnerable to attack as tax avoidance. Particularly for income tax there are incentives and concessionary provisions that Parliament has intended be available to taxpayers and s BG 1 should not be used to prevent access to those legitimate tax benefits. For GST purposes the taxpayer was concerned s 76 was being used to second-guess the price agreed between parties at arms' length to deny an input tax credit by reading into all transactions a market value requirement not expressly provided for in the Act.

In both cases the Supreme Court adopted the same reasoning and recognised that two competing interests must be balanced in the application of anti-avoidance provisions:

- the Court must recognise the operation of specific provisions, many of which provide a legitimate incentive for taxpayers, and
- even strict compliance with specific provisions will not abrogate the application of s BG 1.

In the *Trinity* case, the taxpayers argued they were entitled to make tax-beneficial commercial choices, and that the general anti-avoidance provision should be interpreted as narrowly as possible to give taxpayers reasonable certainty in tax planning.

After reviewing the legislative history of s BG 1 in detail, the Court dismissed both arguments:

- a strong role for s BG 1 does not deprive taxpayers of the freedom to structure their transactions to their best tax advantage, provided they utilise the statutory concession in the manner permitted by the legislation and not in a manner proscribed by the general anti-avoidance provision,
- the general anti-avoidance provision is deliberately imprecise and the courts should not create greater certainty than Parliament has chosen to provide. The section must remain deliberately vague because, no matter how carefully such a provision is drafted, the ingenuity of taxpayers cannot be predicted, and s BG 1 must retain the flexibility to be applied to novel arrangements.

The majority stated:

> "[104] Parliament must have envisaged that the way a specific provision was deployed would, in some circumstances, cross the line and turn what might otherwise be a permissible arrangement into a tax avoidance arrangement. [At this point, the court rejected the argument that satisfaction of a specific tax provision meant the general anti-avoidance provision could not apply]…
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> [105]… Thus, tax avoidance can be found in individual steps or, more often, in a combination of steps. Indeed, even if all the steps in an arrangement are unobjectionable in themselves, their combination may give rise to a tax avoidance arrangement. …
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> [106]… [s BG 1's] function is to prevent uses of the specific provisions which fall outside their intended scope in the overall scheme of the Act. Such uses give rise to an impermissible tax advantage which the Commissioner may counteract."

The Court acknowledged that, while there may be difficult cases on the margins, generally an examination of the facts and the economic substance of each arrangement (see para [109]) will make it possible to decide on which side of the line a particular arrangement falls.

When determining if a particular arrangement is tax avoidance, the Court proposed a two-stage test:

> "[107] When, as here, a case involves reliance by the taxpayer on specific provisions, the first inquiry concerns the application of those provisions. The taxpayer must satisfy the Court that the use made of the specific provision is within its intended scope. If that is shown, a further question arises based on the taxpayer's use of the specific provision viewed in the light of the arrangement as a whole. If, when viewed in that light, it is apparent that the taxpayer has used the specific provision, and thereby altered

> the incidence of income tax, in a way which cannot have been within the contemplation and purpose of Parliament when it enacted the provision, the arrangement will be a tax avoidance arrangement."

The Supreme Court specifically referred to the majority Privy Council judgment in *Peterson* v *CIR*(2005) 22 NZTC 19,098 which the taxpayers had relied upon as supporting their approach. The Court, concluded that decision was based solely on the concessions given by the Commissioner in that case and did not require a narrow interpretation of the general anti-avoidance provision.

In *Glenharrow* the taxpayer argued s 76 ought not be permitted to interfere with a bargain honestly reached by non-associated taxpayers, as to do so would create unwelcome uncertainty for taxpayers. Again, the Court rejected this claim:

> "[48]… uncertainty is inherent where transactions have artificial features combined with advantageous tax consequences not contemplated by the scheme and purpose of the Act. There will also inevitably be uncertainty whenever a taxing statute contains a general anti-avoidance provision intended to deal with and counteract such artificially favourable transactions. It is simply not possible to meet the objectives of a general anti-avoidance provision by the use, for example, of precise definitions, …"

For taxpayers seeking certainty, the Court recommended a binding ruling be obtained from the Commissioner. That may be unwelcome advice to taxpayers who have experienced the binding ruling regime, with its associated cost and potential delays.

Emphasis on facts in tax avoidance

Perhaps more than any other area, tax avoidance will depend upon the facts determined in each case. The Supreme Court noted at para [97] that whether an arrangement is an artifice or involves a pretence will often be highly relevant to whether there is an arrangement that has a purpose of tax avoidance.

Facts demonstrating a lack of commerciality, circularity, or pretence will be just as relevant as the actual arrangement entered into by taxpayers. The Court therefore considered all relevant factors regarding the structure and implementation of the arrangement by the taxpayers.

These include:

- the way in which the arrangement is carried out
- the role of the relevant parties and any association they may have
- the economic and commercial effects of the various steps
- the duration of the arrangement, and
- the nature and extent of the fiscal consequences.

In the *Trinity* case, the Court advised "A classic indicator of a use that is outside Parliamentary contemplation is the structuring of an arrangement so that the taxpayer gains the benefit of the specific provision in an artificial or contrived way. It is not within Parliament's purpose for specific provisions to be used in that manner".(para [108])

Likewise, in *Glenharrow* the Court warned against transactions that have artificial features combined with advantageous tax consequences not contemplated by the scheme and purpose of the GST Act.

The Court has effectively put taxpayers on notice that their tax structures may be subjected to detailed scrutiny, with all aspects being examined to determine if they can be justified on commercial grounds. If the arrangement contains unusual aspects or uncommercial features, particularly regarding the means of payment, the general anti-avoidance provisions will be likely to apply.

Reconstruction by Commissioner

Both Supreme Court decisions involved a consideration of the breadth of the Commissioner's power of reconstruction.

In the *Trinity* case the Supreme Court confirmed the reasoning of the *Privy Council in Peterson* v *C of IR* (2005) 22 NZTC 19,098 that persons affected by a tax avoidance arrangement are susceptible to reassessment under s GB 1 regardless of whether they actually participated in, or even know about, the tax avoidance aspects of the arrangement.

The Court reasoned:

> "[164]… once the existence of a tax avoidance arrangement has been established, all those taxpayers who have benefited from it may be subject to corrective adjustments by the Commissioner in the exercise of the reconstruction power. No question of mutuality or even awareness by a benefiting taxpayer is a necessary element.
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> ...
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> [168] It follows that the argument based on BNZ Investments does not assist the appellants … Parliament did not confine the reach of what is now s GB 1 [of the *Income Tax Act 1994*] to those who were *involved* in the arrangement without being parties. Rather coverage extends to *any person affected* by the arrangement. A taxpayer who claims a deduction in terms of a tax avoidance arrangement can hardly claim not to be affected by the arrangement."

This reasoning effectively limits the Court of Appeal's decision in *C of IR* v *BNZ Investments Ltd* (2001) 20 NZTC 17,103 to its narrow facts. Henceforth, there will be no scope for taxpayers to plead ignorance of an arrangement under which they obtain a tax benefit. The very receipt of a tax benefit will be sufficient to permit the Commissioner to void the arrangement and reconstruct their tax affairs as "a person affected by that arrangement" under s GA 1 of the *Income Tax Act 2007*.

Second, in both the *Trinity* and *Glenharrow* cases, the Court appears to have given substantial backing to the Commissioner's wide discretionary power of reconstruction. In *Trinity*, the Commissioner had denied any deduction for the license fee and insurance premium, and the taxpayers complained this reconstruction was overly harsh. However, the Court emphasised the Commissioner may reconstruct the taxpayers' returns in the manner he thinks appropriate to counteract the tax advantage obtained:

> "[170]… the appellants have not established that the Commissioner adopted a reconstruction which was outside the scope of his powers.
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> [171]… when taxpayers challenge an assessment based on a reconstruction adopted by the Commissioner, the onus is on them to demonstrate, not only that the reconstruction is wrong, but also by how much it is wrong. Unless the taxpayer can demonstrate with reasonable clarity what the correct reconstruction ought to be, the Commissioner's assessment based on his reconstruction must stand."

In the *Glenharrow* case the Commissioner allowed an input tax credit only for the $80,000 cash deposit, along with the additional $210,000 cash payments. While the taxpayers had claimed an input tax credit on the full $45m, the High Court had reduced that to approximately $9m based on its own valuation of the mining license. The Supreme Court rejected that compromise reconstruction and upheld the Commissioner's reassessment that allowed an input tax credit only for the cash payments.

> "[55]...The Commissioner has a discretion in [respect of reconstruction]. He chose to exercise it by treating the deposit as the only payment made by Glenharrow … That, it seems to us, was an entirely proper exercise of the discretion. It was in accordance with the reality of what had occurred during that period. … we can see no basis upon which … the Commissioner's original decision … can be impugned by the taxpayer."

This approach significantly reduces a taxpayer's chances of contesting any reconstruction on the grounds that the Commissioner acted unreasonably or exceeded his very wide statutory powers. There is therefore only a slim chance that a taxpayer will get to keep even the less egregious tax benefits obtained under an arrangement. The Commissioner's preferred reconstruction will be hard to over-turn. The approach in the "dentist trust" case Case W33 (2004) 21 NZTC 11,321, where the TRA took it upon itself to determine the appropriate reconstruction, is almost certainly incorrect.

A new test for Tax Avoidance?

Although the *Trinity* and *Glenharrow* cases involved very different factual scenarios under different Acts, they represent the Supreme Court's first consideration of tax avoidance. The *Glenharrow* judgment repeatedly refers to the reasoning in the Trinity case to support its conclusions. As such, the decisions obviously contain a number of consistent principles and clear sign-posts regarding the treatment of tax avoidance.

The Supreme Court in the *Trinity* case explained that tax avoidance involved a three-step process (see para [160]). These were:

- there is an arrangement, although whether there must be a consensual meeting of minds between all parties to that arrangement was not determined
- that arrangement had a purpose or effect of tax avoidance by reducing or altering the incidence of tax
- if those requirements are met, the arrangement is then void against the Commissioner who may exercise the reconstruction power in what is now s GA 1 of the Income Tax Act 2007 to reassess any person affected so as to counteract the tax benefits obtained (whether or not that person was a party to the arrangement or knew about its tax avoidance aspects).

The most difficult aspect of applying these steps is to determine whether tax has actually been avoided or whether any avoidance is merely incidental. But in both the *Trinity* and the *Glenharrow* cases, the Supreme Court emphasised that taxpayers must bear the true economic cost of any tax benefit they claim if that benefit obtained is not to be struck down as tax avoidance. In both cases the Court freely permitted itself to analyse the economic substance of the arrangement to determine whether it fell properly within the black letter law or was caught as tax avoidance.

In the *Trinity* case the minority undertook that analysis to determine whether the taxpayer met the requirements for deductibility under the black letter law, while the majority undertook a similar analysis using the authority of s BG 1.

The starting point of this economic analysis was the Privy Council's decision in *Challenge Corp Ltd* v *C of IR* (1986) 8 NZTC 5,219, which the Supreme Court cited (para [91]) for the principle that "a tax avoidance arrangement was one where a taxpayer derived a tax advantage from a transaction without suffering the reduction in income, loss or expenditure which Parliament intended those qualifying for a reduction in tax liability to suffer".

The Supreme Court concluded the underlying reasoning of both the *Challenge* and *Peterson* decisions was whether the commercial reality of the transaction was consistent with its legal form:

> "[109]… the Courts are not limited to purely legal considerations. They should also consider the use made of the specific provision in the light of commercial reality and economic effect of that use. The ultimate question is whether the impugned arrangement, viewed in a commercially and economically realistic way, makes use of the specific provision in a manner that is consistent with Parliament's purpose."

In the *Trinity* case, the Court considered the use of promissory notes payable in 50 years time meant neither the license fee nor the insurance premium had really been paid by the taxpayers. This was on the basis that while technically correct in law, in substance, the debt remained unpaid. It therefore concluded:

> "(para [147])... the purported payment did not give rise to any economic consequences on either side. [148] ... the payment of the second premium by means of the promissory note was, in commercial terms, no payment at all."

Deduction of the premium gave the investors substantial tax advantages without them suffering any corresponding economic outlay:

> "[127]… it is the fact that under the arrangement the appellants will receive the benefits of tax deductions but probably never incur the real expenditure."
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> ...
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> [128]… the Court is permitted, when considering the question of tax avoidance, to examine the commercial nature of the incurred cost and any factors that might indicate that the expenditure will never be truly incurred."

In the *Glenharrow*case, the Court considered the use of vendor finance did not amount to actual payment for the mining license. In reality, the only part of the price which in economic terms would ever be paid was the $80,000 deposit and the further $210,000.

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The Court concluded that the vendor finance amounted to a "pay as you go" transaction which produced an artificial effect with consequent tax advantage, contrary to all economic reality. In economic terms, Glenharrow gave no consideration in money because of the commercial impossibility of payment by it in the circumstances where it was virtually uncapitalised and not supported by its shareholder. "[The terms of the arrangement] had no such reality as a 'cash' transaction, despite being structured as if it were." (see para [53]).

In reaching this conclusion, the Court made it clear the normal use of vendor finance will not generally constitute tax avoidance. Rather it was only the particular facts in *Glenharrow* (a $100 shelf company with no guarantee from its owners and no realistic possibility of repaying the loan from exploiting the mining license) that meant in economic reality payment was not made.

It is important to note that in neither *Trinity* nor *Glenharrow* did the Court focus upon the inflated amounts the taxpayers agreed to pay as being crucial to the tax avoidance analysis — rather, it was the lack of actual payment of the agreed amount that was decisive. In *Glenharrow* the Court expressly stated "it is not the price but the 'payment' that created the distorting effect".

Accordingly, these cases expressly did not over-turn the long-standing rule in *Cecil Bros Pty Ltd* v *FC of T* (1964) 111 CLR 430 and *Europa Oil (NZ) Ltd* v *C of IR* [1976] 1 NZLR 546 (PC) that it is not for the Commissioner or the Court to tell a taxpayer how much to spend in obtaining its income. Those cases remain good law. Rather, the new test appears to be whether the taxpayer has actually paid the amount it has agreed to spend. The taxpayer must have truly suffered the economic cost of the tax benefit that it has claimed. Anything less may not be sufficient.

Conclusion

Both the *Trinity* and *Glenharrow* judgments are strong and unanimous decisions in favour of a broad interpretation and application of the general anti-avoidance provisions. They determine that deductions for "payments" that have not really been made in any economic sense will not be permitted. Payments that are deferred for an extended period (as in *Trinity*) or which are funded by money-go-rounds (as in *Glenharrow*) will not be allowed for tax purposes.

These unanimous decisions clearly put taxpayers on notice that only if they actually suffered the true economic cost expected to be paid under the black letter law can they keep the resulting tax benefit. In its newsletter to clients in December 2008 PricewaterhouseCoopers explained "the Supreme Court's decisions raise the bar for all taxpayers". The pendulum on tax avoidance seems to have swung in favour of Inland Revenue.

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