IN THE SUPREME COURT OF NEW ZEALAND

SC 62/2010
[2011] NZSC 95

BETWEEN	IAN DAVID PENNY AND GARY JOHN HOOPER Appellants
AND	COMMISSIONER OF INLAND REVENUE Respondent

Hearing: 27-29 June 2011

Court: Elias CJ, Blanchard, Tipping, McGrath and William Young JJ

Counsel: G J Harley and C E Bibbey for Appellants
D J Goddard QC, H W Ebersohn and D Lemmon for Respondent

Judgment: 24 August 2011

JUDGMENT OF THE COURT

A The appeal is dismissed.

B **The appellants must pay the respondent's costs in the** sum of $25,000 together with his reasonable disbursements in connection with the appeal, as fixed by the Registrar if necessary.

REASONS

(Given by Blanchard J)

Introduction

[1] The issue before the Court is whether the way in which the appellant taxpayers used certain corporate and family structures constituted tax avoidance arrangements for the purposes of s BG 1 of the Income Tax Act 1994. The taxpayers are orthopaedic surgeons. Each quite separately and in different circumstances established structures with common features, namely a company registered under the

Companies Act 1993 of which the taxpayer was the sole director and in which the shares were held by family trusts. Each then sold his practice, from which he had been deriving a substantial income, to his company for a consideration which included an amount of goodwill and became an employee of the company. To all outward intents and purposes the orthopaedic practice continued as before, but with staff previously employed by the taxpayer now employed by the company, patients billed by it rather than by the taxpayer, and equipment and other assets owned (or leased from an associated entity) by the company.

[2] As from the point at which the maximum personal tax rate was increased from 33 cents in the dollar to 39 cents in the dollar (1 April 2000), each taxpayer received from his company remuneration well below the level he had earned when he conducted the practice in his own name. The balance of the annual net practice income was distributed to the family trust as a dividend, taxed at the 33 cent rate for trustee income (or the rate for individual beneficiaries). The effect of this arrangement was to relieve each taxpayer and his family from payment of the additional six cents in the dollar. The savings for each taxpayer were in the vicinity of $20,000–$30,000 per annum for the years with which this case is concerned.[1]

[3] There are additional features in the case of Mr Penny. He established a company/trust structure several years before the increase in the maximum individual tax rate and at a time when he would have obtained no tax advantage from use of the structure. After the tax rate change took effect, however, he limited the level of his salary and arranged for his family trust to lend back to him (interest free and with no repayment terms) a large part of the distributions of company profits that it received by way of dividend. Procedurally what occurred in his case was that he wrote cheques to himself drawn on the company's bank account, but at the end of each year in the accounts of the company and the trust these payments were treated as dividends to the trust and loans by the trust to Mr Penny.

[4] There is a subsidiary procedural issue in Mr Penny's case concerning the extent, if any, to which the Commissioner is prevented from relying on or referring

[1] The period covered by each case are the tax years ending 2002 , 2003 and 2004, but the taxpayers preserved their positions for subsequent years were they to be successful.

to the loans from his family trust by s 138G(1) of the Tax Administration Act 1994 because, it is said for Mr Penny, the loans were not referred to in the Commissioner's statement of position (SOP).

[5] The Commissioner made assessments increasing the taxable incomes of Mr Penny and Mr Hooper for the tax years ending 31 March 2002, 2003, and 2004 by an amount equal to the difference between the salaries actually paid and what the Commissioner assessed as commercially realistic salaries for their services.

[6] In the High Court MacKenzie J found that what each taxpayer did was not an arrangement which had the purpose or effect of tax avoidance. He cancelled the relevant assessments and directed the Commissioner to make an assessment in accordance with the amounts returned by the taxpayers in each case, and in one year in accordance with the notice of proposed adjustment (NOPA) of each taxpayer.[2] By majority, the Court of Appeal reversed his decision and declared the arrangements void against the Commissioner for income tax purposes.[3]

Statutory provisions

[7] The statutory provisions relevant to the appeals are the general anti-avoidance provision:

> **BG 1 Avoidance**
>
> **Arrangement void**
>
> (1) A tax avoidance arrangement is void as against the Commissioner for income tax purposes.
>
> **Enforcement**
>
> (2) The Commissioner, in accordance with Part G (Avoidance and Non-Market Transactions), may counteract a tax advantage obtained by a person from or under a tax avoidance arrangement.

and certain definitions found in s OB 1:

> **Arrangement** means any contract, agreement, plan, or understanding (whether enforceable or unenforceable), including all steps and transactions by which it is carried into effect:

---

2 *Penny v Commissioner of Inland Revenue* [2009] 3 NZLR 523 (HC).

3 *Commissioner of Inland Revenue v Penny* [2010] NZCA 231, [2010] 3 NZLR 360 per Hammond and Randerson JJ; Ellen France J dissenting.

> **Tax avoidance**, in sections BG 1, EH 1, EH 42, GB 1, and GC 12, 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:
>
> **Tax avoidance arrangement** means an arrangement, whether entered into by the person affected by the arrangement or by another person, that directly or indirectly–
>
> (a) Has tax avoidance as its purpose or effect; or
>
> (b) Has tax avoidance as one of its purposes or effects, whether or not any other purpose or effect is referable to ordinary business or family dealings, if the purpose or effect is not merely incidental.

Section GB 1(1) of the 1994 Act states the consequence if s BG 1 is successfully invoked by the Commissioner:

> **GB 1 Agreements purporting to alter incidence of tax to be void**
>
> (1) Where an arrangement is void in accordance with section BG 1, the amounts of gross income, allowable deductions and available net losses included in calculating the taxable income of any person affected by that arrangement may be adjusted by the Commissioner in the manner the Commissioner thinks appropriate, so as to counteract any tax advantage obtained by that person from or under that arrangement, and, without limiting the generality of this subsection, the Commissioner may have regard to—
>
> (a) Such amounts of gross income, allowable deductions and available net losses as, in the Commissioner’s opinion, that person would have, or might be expected to have, or would in all likelihood have, had if that arrangement had not been made or entered into; or
>
> (b) Such amounts of gross income and allowable deductions as, in the Commissioner’s opinion, that person would have had if that person had been allowed the benefit of all amounts of gross income, or of such part of the gross income as the Commissioner considers proper, derived by any other person or persons as a result of that arrangement.

Facts

[8] Mr Hooper restructured his practice in 2000. He and his wife already had “mirror” family trusts. The trustees were their solicitor and accountant. The

beneficiaries in each case were the other spouse and the Hoopers' children and grandchildren. So Mr Hooper was a beneficiary of the trust established by his wife, but not of his own trust. The trusts held practically all of the share capital of the new company, Hooper Orthopaedic Ltd. Mr Hooper was the sole director. He sold his practice to the company for $332,473, of which $330,000 was for goodwill. MacKenzie J recorded:[4]

> ... Mr Hooper's evidence is that after the transfer of the practice to the company his work day remained essentially the same. He continued to practise as an orthopaedic surgeon with the same expertise and skill as before, he saw the same number of patients, he continued to operate on his set operating sessions at the two private hospitals in Christchurch, and patients continued to look to him for their well-being. While the practice has been conducted by the company, the referral of patients has almost invariably been to Mr Hooper personally, not to the company. Letters are addressed to him personally. ...

[9] The personal tax increase occurred from 1 April 2000. Whereas in the financial years ending 31 March 1999 and 2000, Mr Hooper had net earnings from his practice before interest and tax of $659,000 and $651,000 respectively, after the tax increase and in the 2001–2004 years, while the net revenues of the practice went as high as $712,000 and never reduced below $556,000, Mr Hooper drew in each year a salary of $120,000 and the balance was earned by the company. As Randerson J observed in the Court of Appeal,[5] despite the fact that Mr Hooper continued to work exactly as before, his personal earnings from the practice dropped to around 18 per cent of his income before the restructuring.

[10] During the years in question the Hooper trusts received fully imputed dividends ranging from $228,000 to $392,000. A part of this was distributed to Mr Hooper's three daughters and taxed as their income. The rest was retained as trustee income and taxed at 33 cents in the dollar.

[11] The retained earnings of the Hooper trusts were invested in the family home and a holiday home and in bank deposits. No distribution or loans have been made to Mr or Mrs Hooper, although obviously they and their family enjoy the benefit of the two homes owned by their trusts.

---

4 At [5].
5 At [13].

[12] After investigations by the Commissioner began, from the 2004 year Mr Hooper returned a larger salary than that which had been attributed to him in the books of the company but, by filing a NOPA, sought an adjustment reflecting the actual salary. Both of the taxpayers did this from 2004 onwards so as to avoid any penalty relating to those years if the Commissioner's view prevailed.

[13] In 1997 Mr Penny formed Penny Orthopaedic Services Ltd (POS). He held all the shares in that company. In that year he also formed Orthopaedic Surgical Consultancy Ltd (OSCL). Mr Penny was the sole director of OSCL. All the shares in OSCL were held by his family trust. The trustees were his solicitors and accountant. The beneficiaries were himself, his wife and their children and grandchildren. The trust became the owner of the premises from which the practice was conducted, subject to a lease to POS. The practice was sold to POS for $144,310, including goodwill of $100,000. But two months later, in April 1997, POS on-sold the practice and all its assets to OSCL at a price which increased the goodwill to $1 million. MacKenzie J recorded:[6]

> ... This two-stage process for the transfer of the business to OSCL was part of a single restructuring plan. After the restructuring Mr Penny's day-to-day work arrangements remained essentially the same. Patients looked to him personally for their well-being. His letterhead was not changed, but invoices were issued in the name of the company. Each year a salary was fixed, essentially by Mr Penny, and Mr Penny returned that amount as his income from private practice. The fees paid by patients formed the income of OSCL and that income was, after deduction of expenses (including Mr Penny's salary), returned as taxable income by the company. The trust, as sole shareholder in OSCL, received fully imputed dividends from OSCL in each year and the dividends were substantially all retained as trustee income, and returned as such to the Commissioner. ...

[14] In the 1999 and 2000 years OSCL's net earnings before interest, tax and remuneration were $825,000 and $633,000, of which Mr Penny drew for himself $302,000 and $125,000[7] respectively. After the personal tax increase came into effect the net earnings ranged over the 2001–2004 years from $655,000 to $832,000 but in each year Mr Penny took only a salary of $100,000. In the 2004 year the

---

[6] At [7].

[7] The lower salary in this year was related to matrimonial problems. Mr Penny said that "there was no point in paying myself large amounts that would be matrimonial income". It has understandably not been argued that this factor could justify salary levels in respect of later years.

salary was about 14 per cent of the company's net earnings and it was an even lower percentage in 2002 and 2003.

[15] Mr Penny's trust advanced him $1.236 million by the end of the 2004 financial year. He used the advances to meet obligations to his wife arising out of the breakup of the marriage and for tuition expenses for their children.

[16] Both taxpayers accepted under cross-examination that they would not have entered into these arrangements with an unrelated party and that the salaries for the years in question were commercially unrealistic. Both said that they had carried out the restructuring of their practices because of a concern about exposure to medical negligence claims which might not be covered by the accident compensation scheme. MacKenzie J accepted that these concerns were genuine.[8]

The High Court judgment

[17] MacKenzie J found, uncontroversially, that the formation of a company, and the conduct of the medical practice through it, was a valid choice of business structure.[9] The transfer of the practice to the company altered the incidence of tax because the tax was payable by a different taxpayer and because the rates were different.[10] But that effect was not one to which s BG 1 was directed "unless there is some other principle, expressed in or to be implied from the scheme and purpose of the Income Tax Act, which renders the use of the corporate form inappropriate for the achievement of the purposes of the Act".[11] The Act, he said, does not in general terms prescribe that some items of income may be derived only by some categories of taxpayer.[12] He rejected an argument for the Commissioner that *Hadlee*[13] had established that there was a general intention in the Act to distinguish business income which was the product of personal exertion so far as its derivation was

---

[8] At [46].
[9] At [27].
[10] At [24].
[11] At [29].
[12] At [30].
[13] *Hadlee v Commissioner of Inland Revenue* [1991] 3 NZLR 517 (CA), affirmed [1993] 2 NZLR 385 (PC).

concerned.[14] As was common ground, the case was not one where the personal services attribution (PSA) rules, introduced in ss GC 14B–14E as from the time of the personal tax increase in 2000 as a specific anti-avoidance provision, applied to require the income of the company to be attributed to the person who provided services. The enactment of the PSA rules to deal with a particular, but quite different, potential for tax erosion did not indicate a legislative purpose with regard to income derived by a person conducting an independent business.[15]

[18] The Judge moved on to consider the fixing of the salaries. He noted the admission that the salaries were not commercially realistic, but he found nothing in the scheme and purpose of the Act supporting the proposition that payment of a commercially realistic salary in non-arm's-length transactions was a general and overriding requirement. He did not consider that it had been demonstrated that the fixing of the salary was part of a tax avoidance arrangement.[16]

[19] In relation to Mr Penny's borrowings from his trust, MacKenzie J said that circularity of money flows can be an important indicator of artificiality in an arrangement, and so an indicator of tax avoidance.[17] He approached the question on the basis that the legal form by which the economic consequence of access to the funds by the taxpayer was effected must be respected, except to the extent that the scheme and purpose of the Act requires that another legal form for achieving that economic substance must be adopted, so that the use of the chosen legal form is a device to avoid the adoption of the correct legal form.[18] The ability of Mr Penny to access, through the trust, funds which had been paid by OCSL as dividends arose from his status as a discretionary beneficiary. The Judge said that his conclusion that the earlier steps (formation of company and fixing of salary) were not tax avoidance was not altered by the fact that, in another capacity, Mr Penny was able to obtain the use of the funds derived from the income of the practice. The fact that he had the ultimate benefit could be an indicator of tax avoidance only if it was permissible for

[14] At [40].
[15] At [42].
[16] At [67]
[17] At [70].
[18] At [71].

him to do so only by deriving the funds as personal income, which the scheme and purpose of the Act did not require.[19]

[20] The same reasoning led the Judge to conclude that overall there was no tax avoidance in the arrangements as a whole.[20]

The Court of Appeal judgment

[21] In his reasons Randerson J said that the focus of the Commissioner's case had been on the manner in which the company and family trust structures had been used by the taxpayers, including, most importantly, the decisions made to allocate to themselves a salary from their respective companies at levels substantially below those that would be appropriate in an arm's-length commercial context.[21] The structures provided the platform or opportunity for the taxpayers to take advantage of changes in personal taxation rates and the lower company tax rate in the years in question.[22] The Judge considered that each decision on salary levels amounted to an "arrangement" under s BG 1, which he said was not limited to a specific transaction or agreement but might embrace a series of decisions and steps taken which together evidenced and constituted an agreement, plan or understanding: "[a]ny such arrangement may be continued in each of the income years in question or may be varied from year to year".[23] There was no question that one of the effects of the arrangement was to "alter the incidence of the taxpayers' personal income in the income years at issue".[24]

[22] Material to which Randerson J referred[25] made it clear to him that Parliament did not intend the PSA rules to be a comprehensive attempt to define all the activities that would constitute tax avoidance in the wake of the increase in the top personal tax rates. It was not proper to infer from the fact that Parliament had addressed the prospect of tax avoidance in one set of circumstances that it did not contemplate that

19 At [71]–[72].
20 At [81].
21 At [72].
22 At [76].
23 At [78].
24 At [86].
25 At [91].

the general tax avoidance provision might apply in other situations. The fact that the PSA rules were not engaged did not preclude reliance by the Commissioner on s BG 1.[26]

[23] Randerson J then considered a submission made by Mr Harley, for the taxpayers, that the Act permitted taxpayers to choose the manner in which they did business and that, as a general rule, a company is at liberty to remunerate its employees at such levels as it sees fit. In this context Randerson J discussed the significance of the *Hadlee* case. He acknowledged that *Hadlee* could not be applied directly to the present case since the practice income was derived by the companies, but issues discussed by Richardson J in *Hadlee* suggested that, when considering whether particular arrangements constituted tax avoidance, the adoption of business structures and other means which had the effect of diverting or splitting income generated by the personal exertion of individuals in a way which undermined the graduated personal tax regime was a relevant consideration in assessing whether the arrangements were within parliamentary contemplation.[27]

[24] The Judge concluded that the identified arrangements in this case not only had the effect of altering the incidence of income tax but that this was also at least one of its purposes and not merely an incidental purpose or effect.[28] There were two striking features. The first was that each taxpayer had been conducting his respective practice as an orthopaedic surgeon on his own account and then chose to incorporate. There could be no valid criticism of the adoption of the corporate vehicle as such. But it was the combination of that fact with the second striking feature which was significant. This was that in each case the net income before tax each man was receiving was dramatically reduced from the year 2000 onwards. Both taxpayers had accepted without hesitation that these salaries were at levels substantially below what could have been expected if they had been employed independently at arm's length. It was no coincidence that the marked drop in salaries paid coincided with the increase in the top personal tax rate. The only realistic inference to draw was that at least one of the purposes of the arrangements was to

---

[26] At [92]–[95].
[27] At [106].
[28] At [112].

alter the incidence of income tax.[29] There was no diminution of hours of work or degree of effort on the part of the taxpayers, nor was there any material reduction in gross income before expenses or any identified need for increased capital or other expenditure which might have justified a reduced salary. It was not suggested that there were charitable or other reasons that might have afforded legitimate reasons for the salary reductions.[30] In each case the surplus profits were transferred by way of dividend to the respective family trusts. The effect of that was to benefit the taxpayers and their families. While there could be no valid suggestion that the mere adoption of the company/trusts structure was improper, this structure was nevertheless the vehicle by which they were able to obtain the advantage of the lower company tax rate while still enjoying the full benefit of the income of the companies for themselves personally and their families.[31]

[25] Randerson J accepted that there may have been a secondary purpose or effect referable to ordinary business or family dealings, namely to benefit the taxpayers' family trusts. But the benefits flowing to the trusts could equally have been achieved by the taxpayers being paid salaries at levels which were commercially realistic.[32] The Judge did not attach any weight to the suggestion that the company structure was necessary to protect them from negligence claims given the existence of the ACC legislation and the fact that a company structure would not avoid personal responsibility in respect of any such claims in any event.[33] The avoidance of tax was more than a merely incidental purpose or effect of the arrangement. The salaries adopted were so far removed from commercial reality as to be contrived and artificial. They could not be regarded in any sense as within the acceptable limits of commercial practice.[34]

[26] In a concurring judgment, Hammond J said that the intertwined economic and commercial effects of what was done, in their proper legislative context, were that income derived from personal exertion should belong in its appropriate taxation band and should not be inappropriately diverted away. When Parliament had

---

29 At [115].
30 At [117].
31 At [118].
32 At [120].
33 At [121].
34 At [122].

increased the top tax rate to 39 per cent, the taxpayers deliberately took themselves out of that category by interposing a company/trust structure but, significantly, they retained control over the whole of the income generated which they then applied for the benefit of themselves and their families. Their salaries were fixed at artificially low levels.[35] The case was incontrovertibly one of tax avoidance – "a rather obvious, indeed blatant, stratagem".[36]

[27] In dissent, Ellen France J said that essentially she agreed with MacKenzie J, for the reasons he gave, that neither the formation of the companies with the resultant change in the incidence of tax nor the salary arrangements were inconsistent with the scheme and purpose of the Income Tax Act.[37] She agreed with Randerson J that the fact that the arrangements did not fall foul of the PSA rules was not determinative, but considered that the rules were relevant when considering notions of artifice or contrivance.[38] The obvious point was that what the taxpayers had done had not required any particular "ingenuity" such that Parliament could not have contemplated the use of company structures in this way.[39] Ellen France J did not agree that *Hadlee* supported a general proposition to the effect that the adoption of structures having the effect of diverting or splitting income generated by the personal exertions of individuals was relevant to the consideration of whether the arrangements were within parliamentary contemplation. This was not a case of income splitting. *Hadlee* was discussing the personal exertions of the taxpayer, which in this case had to be the exertions of the company, absent any suggestion that the company was a sham.[40]

[28] Nor did Ellen France J see the quantum of the salaries and the taxpayers' control over them as amounting to artifice or contrivance. The evidence of the accountancy expert, Mr Shewan, called for the taxpayers, suggested that what occurred here was consistent with acceptable commercial practice.[41] He had said that it was often the case that the principal family person working for a family-

---

35 At [157].
36 At [161].
37 At [165].
38 At [167].
39 At [168].
40 At [170]–[172].
41 At [173]–[174].

owned company did not derive close to what the Commissioner would treat as being a commercially realistic salary. Mr Shewan had mentioned situations in which there was a desire not to accumulate further assets in a person's own name due to asset protection concerns, such as exposure to negligence claims, creditors or matrimonial property disputes. Both taxpayers had given that reason as one of their reasons for adopting a corporate structure. While their reasoning in this respect was "somewhat slight", MacKenzie J had accepted their evidence that this was a genuine motive, along with others, for the choice made.[42] In terms of artifice or contrivance, it was also relevant that Mr Penny was operating his business in this way prior to the change to the company tax rate. There was an element of assessment "with the benefit of hindsight" by the Commissioner by reference to subsequent conduct and, Ellen France J thought, there was something a little odd about the position in terms of s BG 1 altering on an annual basis depending on the decision made about the salary to be paid and the related company resolution to that effect.[43]

Preliminary matters

[29] The parties have further pursued objections raised below about evidence called for the other side.

[30] Mr Penny objected to the Commissioner's evidence about the loans made to him by his trust. He says this is precluded by s 138G of the Tax Administration Act:

> **138G Effect of disclosure notice: exclusion of evidence–**
>
> (1) Unless subsection (2) applies, if the Commissioner issues a disclosure notice to a disputant, and the disputant challenges the disputable decision, the Commissioner and the disputant may raise in the challenge only—
>
> (a) The facts and evidence, and the issues arising from them; and
>
> (b) The propositions of law,—
>
> that are disclosed in the Commissioner's statement of position and in the disputant's statement of position.

42 At [176]–[178].
43 At [182]–[183].

> (2) A hearing authority may, on application by a party to a challenge to a disputable decision, allow the applicant to raise in the challenge new facts and evidence, and new propositions of law, and new issues, if satisfied that—
>
> > (a) The applicant could not, at the time of delivery of the applicant's statement of position, have, with due diligence, discovered those facts or evidence; or discerned those propositions of law or issues; and
> >
> > (b) Having regard to the provisions of section 89A and the conduct of the parties, the hearing authority considers that the admission of those facts or evidence or the raising of those propositions of law or issues is necessary to avoid manifest injustice to the Commissioner or the disputant.
>
> (3) For the purposes of subsection (1), a statement of position includes any additional information that the Commissioner and the disputant agree (under section 89M(13)) to add to the statement of position.

The taxpayer says that the evidence concerning the loans, and thus the issues arising from the existence of the loans, were not disclosed in the Commissioner's SOP, nor in his supplementary SOP. In particular, the Commissioner did not say therein that the loans were part of the alleged tax avoidance arrangement. It is said that no reliance was placed upon them as forming part of the arrangement until after the discovery process.

[31] It seems to us, however, that this last point fatally undermines the argument for Mr Penny since it is undisputed that until discovery was made the Commissioner did not learn that the loans were an accounting reconstruction of what actually occurred, namely that Mr Penny had drawn on company funds by signing its cheques made payable to himself. Furthermore, even if that had not been so, the Commissioner would have been entitled to refer to the loans in response to the statement in Mr Penny's SOP that he had been advised that a restructure of his assets would provide a greater degree of asset protection for his family. To the extent that the money immediately found its way back to Mr Penny, that protection could be at risk of his bankruptcy if he were ever to be faced with an uninsured negligence claim not covered by ACC. The Commissioner was therefore able to rely upon the making of the loans. It really is of little or no moment whether they were part of the arrangement, for the Commissioner's argument was that the purpose or effect of the company structure and the setting of the salary levels within that structure was to

enable earnings to be diverted to the trust and thereby be available to Mr Penny and his family without payment of the highest personal tax rate. That availability was plainly demonstrated by the use the trust made of the dividends.

[32] For his part, the Commissioner objects to portions of Mr Shewan's evidence in which Mr Shewan expressed his views on some of the legal issues in the case. It seems to us that the Court of Appeal dealt correctly with this objection. Randerson J said that this material had no place in the evidence of an expert witness and should more properly have come from counsel.[44] To that extent, the Court of Appeal put Mr Shewan's evidence to one side. So do we. But of course this Court did hear the same arguments canvassed by Mr Harley in his submissions. So there is no practical consequence of the upholding of the objection. It should, however, be observed that it is undesirable and wasteful of time and effort of both parties when such material appears in expert briefs of evidence. The practice of including it should stop. If it persists, courts should require amended briefs to be filed.

Analysis

[33] This case differs from *Ben Nevis*,[45] in which this Court explained the proper approach to questions of tax avoidance. Here there can be no question of the taxpayers failing to comply with specific taxation provisions. The structure both taxpayers adopted when they transferred their businesses (orthopaedic practices) to companies owned by their family trusts was, as a structure, entirely lawful and unremarkable. The adoption of such a familiar trading structure cannot per se be said to involve tax avoidance. It was a choice the taxpayers were entitled to make.[46] Nor is there anything unusual or artificial in a taxpayer then causing the company under his control to employ him on a salaried basis. What is said by the Commissioner to constitute tax avoidance is the fixing of the salaries at artificially low levels whereby the incidence of tax at the highest personal rate was avoided. It can hardly be a coincidence that this was done as soon as that personal tax rate was increased to 39 cents in the dollar, and not before that change was made by

---

44 At [97].

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

46 See *Ben Nevis* at [111] and [193].

Parliament.[47] But, again, there was no failure to comply with any express requirement of the Act in the setting of the salaries, since there is none. This is therefore a case in which, compliance in other respects being accepted,[48] it is possible to move straight to s BG 1 and to ask whether the use of the structure which was adopted when the salaries were fixed was beyond parliamentary contemplation and resulted in a tax avoidance arrangement. The Commissioner's case is that the avoidance resulted from a single step taken by each taxpayer which took advantage of an otherwise unobjectionable business structure. That step was the taxpayer's actions on each side of the employment contract relationship (as controlling director of the employer and as employee) in setting an artificially low level of salary which had the effect of altering the incidence of taxation. Once that artificial step was taken, matters proceeded in an orthodox manner with the payment of the bulk of the company's profits on a fully imputed basis to the shareholding trusts. That step made possible the distributions of dividends and the benefits which followed.

[34] Tax avoidance can be found in an individual step in a wider arrangement.[49] That step, when taken, can make the wider arrangement a tax avoidance arrangement. Where a particular step is done repetitively, such as in this case in the annual setting of the salary levels, the step may or may not amount to a tax avoidance depending on its purpose or effect on each occasion. If, for example, in one year the salary was set so as to absorb all the company profits, it could hardly be said that any avoidance was involved.[50] Similarly, the salary might be set at a relatively low level because the company had a commercial need to retain funds in order to make a capital expenditure. Again, no question of avoidance could arise. That would also be the position if the company was experiencing financial difficulties or reasonably considered that it might do so in the future, and could not afford to pay the family member employee the equivalent of a commercial rate for the time being, or reasonably took the view that it was not in the meantime financially prudent to do so. On the other hand, if the setting of the annual salary is influenced in more than an incidental way by a consideration of the impact of

---

47 See, however, fn 7 above concerning Mr Penny's position.

48 It was not argued that the decision in *Hadlee* (CA) precluded the diversion of income effected by the business structure adopted by the appellants.

49 *Ben Nevis* at [105].

50 In this and in the following examples, a company with only one business, in which it employs the taxpayer, is assumed.

taxation, the use of the structure in that way will be tax avoidance. The question to be asked is therefore why the salary was fixed as it was on a particular occasion. Whether that involved tax avoidance can be answered by looking at the effect produced by the fixing of the level of the salary in combination with the operation of the other features of the structure.

[35] The fixing of the low salary enabled most of the profits of the company from the professional practice to be transferred by way of dividends straight through to the trust, avoiding payment of the highest personal tax rate, and then use by the trust for the taxpayer's family purposes, including benefiting him by loans (Mr Penny) or funding the family home and holiday home (Mr Hooper). Although neither taxpayer was a trustee, each could naturally expect that the trustees whom they had chosen would act as they in fact did, and that the benefits of the use of the funds would thereby be secured without the impost of the highest personal tax rate.

[36] While another purpose was evident from the arrangements in the years in question, namely the protection of assets from professional negligence claims, it cannot have been the sole or a dominant purpose because of the protection already in place through the combination of the accident compensation scheme and insurance cover. This was demonstrated by Mr Penny's preparedness immediately to borrow money back (indeed it never actually left his hands) regardless of the supposed risk to him of claims by patients. One can also infer a genuine desire to build up assets for the benefit of the family in both cases. But plainly the tax advantage was, objectively, at the very least one of the principal purposes and effects of each arrangement. Indeed, the taxation advantage produced by the fixing of the salaries at low levels can fairly be seen as the predominant purpose, although the Commissioner does not need to establish that.

[37] If all this is now thought to be revolutionary by tax planners, as indeed was implicit in the submissions of Mr Harley for the taxpayers, our response is that nearly 50 years ago, in a similar case involving incorporation and the use of family trusts by medical practitioners, neither the High Court of Australia nor the Privy

Council had any hesitation in finding that there was tax avoidance. That case is *Peate v Commissioner of Taxation of Commonwealth of Australia*.[51]

[38] We understand that this case was referred to in submissions in the lower courts, but it was not mentioned in the judgments. It received only passing mention by reference to the Privy Council judgment in the written submissions in this Court, where attention was drawn from the Bench to what had been said by the High Court of Australia. It should be recorded that the Bench had in turn been directed to the case by a note on the Court of Appeal decision in this case by Michael Littlewood of the University of Auckland.[52]

[39] *Peate's* case involved eight doctors who had been practicing in partnership. The structure which replaced the partnership was necessarily rather more complicated than what occurred in the present case, but the essential details are strikingly similar. The eight doctors together formed one company (Westbank) of which they all were the directors, and each formed his own company. Those companies became the shareholders of Westbank. The company formed by the appellant, Dr Peate, was called Raleigh. The shareholders in Raleigh were the Peate family trusts and Dr Peate was its governing director. Raleigh purchased Dr Peate's practice assets. Dr Peate entered into an agreement with Raleigh to serve it on a salaried basis. Raleigh agreed with Westbank that, for a fee, it would make Dr Peate's services available to Westbank. All income from patient fees went to Westbank, which distributed to Raleigh a proportion of its net profits corresponding to his share in the previous partnership.[53] Dr Peate's salary was fixed well below the level of the fee received from Raleigh. For example, in one year Raleigh's share of Westbank's net income, by way of service fee, was, as adjusted by the Commissioner to reflect Dr Peate's earnings, £4,298, whereas the salary paid to Dr Peate had been £1,560. There was a tax advantage relating to superannuation but the major benefit of the scheme for the Peate family related to the tax avoided by the fixing of the salary. As in this case, the structure was being used to take advantage of different tax rates applying to individuals and trusts.

---

51 *Peate v Commissioner of Taxation of Commonwealth of Australia* (1962–1964) 111 CLR 443, affirmed [1967] 1 AC 308 (PC).

52 Michael Littlewood "*Penny and Hooper* and stare decisis" [2010] NZLJ 404.

53 Adjusted to allow for the fact that a ninth doctor had withdrawn.

[40] The Privy Council was almost peremptory in its unanimous conclusion that what was done had "the purpose and effect of avoiding [tax] liability imposed on each doctor".[54] Indeed, the Board announced during the course of argument that they were agreed that the general anti-avoidance provision applied in the circumstances of the case. The greater part of the Board's opinion, and the only basis for the dissent of Lord Donovan, was concerned with the Commissioner's powers of reconstruction, which were not then spelt out as they are in s GB1. In the present case there is no argument directed to the reconstruction. The question is the prior one of whether there has been tax avoidance. It was that question which was a focus of the High Court of Australia in *Peate*.

[41] The principal judgment on appeal from Menzies J, who sat at first instance in the High Court,[55] was that of Kitto J,[56] with whom McTiernan and Owen JJ concurred. He considered that the plan in which all the doctors participated plainly constituted an arrangement in the sense of s 260 of the Income Tax and Social Services Contribution Assessment Act 1936–1960 (Cth). He expressed his conclusion as follows:[57]

> The arrangement in the present case, considered objectively as is thus required, may well seem to be characterized by several purposes and effects, some of them unconnected with taxation, including the protection of individual members of the group against liability for negligence; the making of superannuation provision for employees, including doctors employed to assist the group; the better organization of the group's activities and particularly its methods of accounting; and the making of provision for the doctors' families. (All of these purposes, indeed, the appellant swore were actually contemplated in the formation of the plan.) But the question remains, whether the overt acts that were done under the plan are fairly explicable without an inference being drawn that tax-avoidance is a purpose of the arrangement as a whole. Menzies J thought they were not, and with respect I agree. The arrangement bears ex facie the stamp of tax-avoidance. An understandable purpose of providing for the doctors' families, and doing so quite honestly, is perfectly evident; but what is equally evident is a purpose of doing so by a method which will divert income away from the participating doctors to or for the benefit of their families, to the end that a substantial part of the tax might be avoided which would have been incurred if the income had first been derived by the doctors and then applied by them for the benefit of their families.

---

54 At 330.
55 At 445.
56 At 466.
57 At 469.

> The case therefore falls, plainly as I venture to think, within the application of s 260.

[42] Likewise, Taylor J said that it was:[58]

> ... clear enough that here there was an arrangement constituted by a predetermined and concerted series of transactions which had the effect, and were calculated to have the effect, of avoiding the liability of the appellant to tax on a specified share of profits earned by him in co-operation with a number of other medical practitioners and yet leaving him free, to all intents and purposes, to make such dispositions of that share for his own benefit and for the benefit of his wife and children.

He added:[59]

> Indeed, in its final analysis, the picture is little different from that which would have appeared if the appellant had assigned his future gross income upon condition that the assignee, after paying the appellant's share of working expenses, should then pay to the appellant such part of the net amount as he should direct and, thereafter, expend the balance in a specified manner for the benefit of the appellant's wife and children.

Later Taylor J expressly recognised that, although there were ends in view other than tax avoidance, such as the making of provision for Dr Peate's wife and children:[60]

> ... avoidance of tax was the means to those ends and a diminution in the appellant's tax was not merely an incident of what might be regarded as an ordinary family settlement; as I have already indicated avoidance of tax on income produced by the professional activities of the eight medical practitioners in question was at the very heart of the arrangement which was about as far removed as possible from any concept of ordinary business or family dealing. Further, it possessed no other feature to deny its true character, that is an arrangement having the purpose or effect of defeating, evading or avoiding income tax.

[43] Windeyer J addressed the same point:[61]

> It was argued that the arrangement that the taxpayer and his associates made was outside the operation of s 260. Doubtless several elements of the total scheme could, for the participants in it, have other advantages than the avoidance of a liability for income tax. And when, with the advice of their advisers, they concerted and entered into the scheme they had some of those advantages in mind. But that does not redeem their arrangement and what was done under it from the provisions of s 260. Moreover, in so far as those ulterior advantages do not themselves depend upon the avoidance of taxation

---

[58] At 475.
[59] At 475.
[60] At 476.
[61] At 477–478.

> they can be enjoyed. Section 260 makes the arrangement void as against the Commissioner of Taxation only: it does not impair whatever be the validity and effect of it and of its subordinate transactions as between the parties.

He also made a comment which serves as an answer to one of the arguments made for the present taxpayers about the need to respect corporate personality:[62]

> Whatever philosophical theory, if any, one entertains of the nature of corporate personality, not much assistance for questions such as arise in this case is got by emphasizing that in law a company is an entity distinct from its members. What is important is the function that the company in fact performs and which it was created to perform. It is not necessary for the application of s 260 to find that the case is one for "lifting the veil".

And he too considered, like Taylor J, that Dr Peate's company was:[63]

> ... like an assignee to whom the appellant had assigned the future income which Westbank Pty Limited was to collect as the fruits of his practice of his profession, such assignment to Raleigh being upon condition that it would deal with the moneys it got as he, the appellant, directed.

[44] Mr Harley submitted to us that *Peate*'s case was distinguishable because, as he put it, it was an annihilation case – where under s 260 the Commissioner had to annihilate everything and, as a result of scorched earth, "have ... the money in the hands of the taxpayer". In the present case the Commissioner was not attacking the corporate/trust structure as such and was not seeking to set it aside. We confess that we found this attempt at distinction unpersuasive. As the quotations from *Peate* in the High Court of Australia which we have set out amply demonstrate, the judgments were directed to whether there was tax avoidance in what Dr Peate and his colleagues had done. It was only if there was tax avoidance that any annihilation could occur.

[45] Mr Harley also submitted that *Peate*'s case was not in point today because the scheme of the Income Tax Act is now markedly different from the legislation both in Australia and in this country at the time it was decided. He spoke of the way in which the graduated scale of personal income tax has been altered, with a much lower maximum tax rate during the period with which this case is concerned. He described the Income Tax Act as having been lauded for its reflection of the

---

[62] At 480.
[63] At 480–481.

economic principle of tax neutrality, saying that the basis for a large number of tax avoidance arrangements had been swept away. He also submitted that what constitutes normal business planning, for example the use of corporate entities by doctors, is vastly different from what was professionally acceptable 50 years ago. Counsel also submitted that the prescription in the Act of the categories of taxpayers as individuals, companies, trusts and so forth, with some special anti-avoidance rules for related-party transactions including the PSA rules and rules about cross-border services, left no room for the operation of s BG 1 in a case such as the present.

[46] We do not accept these arguments. It was not the novelty of doctors trading through corporate structures in the 1950s which caused what they did in *Peate* to be regarded as tax avoidance but, rather, the way in which they used those structures to obtain tax advantages, in particular by the fixing of salary levels. As Kitto J put it, there was a "purpose of ... divert[ing] income away from the participating doctors to or for the benefit of their families, to the end that a substantial part of the tax might be avoided which would have been incurred if the income had first been derived by the doctors and then applied by them for the benefit of their families".[64] That purpose would not have been achieved if the salaries had not been fixed at artificially low levels.

[47] Although the New Zealand tax statute and some business practices have changed considerably in the intervening period, Parliament has deliberately preserved, and in fact enlarged, the New Zealand general anti-avoidance provision which corresponded to s 260 in *Peate*.[65] It continues to have work to do whenever a taxpayer uses specific provisions of the Act and otherwise legitimate structures in a manner which cannot have been within the contemplation of Parliament. The policy underlying the general anti-avoidance provision is to negate any structuring of a taxpayer's affairs whether or not done as a matter of "ordinary business or family dealings"[66] unless any tax advantage is just an incidental feature. That must include using a company structure to fix the taxpayer's salary in an artificial manner. The fact that many of the differences in rates which previously attracted the interest of

---

[64] At 469.

[65] See Land and Income Tax Amendment Act (No 2) 1974, s 9.

[66] The definition of "tax avoidance arrangement" in s OB 1.

tax planners have been removed is no basis for saying that s BG 1 cannot be resorted to by the Commissioner in the remaining situations where there are rate differentials and a taxpayer seeks to take advantage of them by artificial means. Woodhouse P said in *Challenge Corporation Ltd v Commissioner of Inland Revenue* that there must be a weapon able to thwart technically correct but contrived transactions set up as a means of exploiting the Act for tax advantages.[67] That is what the artificially low salary settings did in this case. They reduced each taxpayer's earnings but at the same time enabled the company's earnings (derived only because of the setting of the salary levels) to be made available to him through the family trusts. In reality, the taxpayers suffered no actual loss of income but obtained a reduction in liability to tax as if they had, to adapt Lord Templeman's dictum in *Challenge*.[68]

[48] Nor, as the *Challenge* case shows, does the existence in the PSA rules and the cross-border services rules of some specific anti-avoidance provisions have the consequence that s BG 1 cannot operate where the tax avoidance arrangement employed by a taxpayer does not fall within those specific rules. The Select Committee Report on the Taxation (Annual Rates, GST and Miscellaneous Provisions) Bill commented that the PSA rules (which it called the attribution rule) "supports the general anti-avoidance provisions of the Income Tax Act 1994."[69] The legislators thus recognised that the latter would continue to do their residual work, but no doubt with the hope that the delay and cost involved in using them could be obviated in specifically targeted situations. Unless the specific rules plainly are intended to cover the field in relation to the use of particular provisions by taxpayers or plainly exclude the use of the general anti-avoidance provision in a certain situation – which is not so here – then the Commissioner can rely upon s BG 1 to counter avoidance where that has occurred.

[49] It was submitted for the taxpayers that there is no concept of a commercially realistic salary to be found in the Income Tax Act – that it does not require that any employee be remunerated on such a basis. Mr Harley pointed out that commonly

---

67 *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (CA) at 532.

68 *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 555 (PC) at 561. See also *Ben Nevis* at [95].

69 Taxation (Annual Rates, GST and Miscellaneous Provisions) Bill (27-2) (select committee report) at 11.

family transactions are not based on market valuations. Both of those propositions can be readily accepted. But what the Act does require of taxpayers is that they should not structure their transactions with a more than merely incidental purpose of obtaining a tax advantage unless that advantage was in the contemplation of Parliament – as it is, for example, in the provisions enabling the setting up of Portfolio Investment Entities (PIEs), through which there can be investment in shares.[70] Parliament must have contemplated and been content that people may structure their transactions for commercial reasons or for family reasons in which any tax advantage is merely incidental, but that they will not be permitted to do so when tax avoidance is more than a merely incidental purpose or effect of the steps they have taken. It is thus appropriate for the Commissioner to examine whether a salary has been set at a certain level on a commercial basis or for family reasons in which the tax consequences played no more than an incidental role – whether, to use the words of Kitto J in *Peate*,[71] the fixing of the salary was "fairly explicable without an inference being drawn that tax-avoidance is a purpose of the arrangement as a whole" or, we would add, has become such a purpose. If the salary is not commercially realistic or, objectively, is not motivated by a legitimate (that is, non-tax driven) reason, it will be open to the Commissioner to assert that it was, or was part of, a tax avoidance arrangement.

[50] Mr Harley was critical of the way in which the Court of Appeal majority placed reliance for their finding of tax avoidance in this case on the decision in *Hadlee*. It was submitted that the remarks of Richardson J in that case about the taxability of earnings from personal exertion were made in a different context and cannot be transposed into the situation in this case. *Hadlee* concerned an assignment of a share of income of a continuing professional partnership. In contrast, in this case there was a genuine outright sale of the professional practice which afterwards was conducted by a different entity, the company, which at the same time had taken on the staff of the practice and the ownership or leasing obligations of the equipment used in the practice. It may be that this criticism has some force, and that in *Peate's* case Taylor and Windeyer JJ went too far if they really intended to say that what occurred truly amounted to an assignment of Dr Peate's earnings from his practice.

---

70 See subpart HM of the Income Tax Act 2007.
71 See [41] above.

Whether or not that is so, *Hadlee's* case has application, at least by way of analogy, when the artificiality of the fixing of the salaries comes to be examined under s BG 1 because, as the two Judges in *Peate* were aware, it would be strange if someone were not for tax purposes permitted to assign income of this kind but could still construct artificially a means of obtaining the same effect for a purpose of altering the incidence of taxation. Whether Richardson J's judgment has wider application must be left to a case in which that question is raised.

[51] Finally, we were referred by counsel to the decision of Cooke J, sitting at first instance, in *Loader v Commissioner of Inland Revenue*.[72] There the taxpayer had been in business as an earthmoving contractor. He formed a company in which his family trust held most of the shares. He was one of the trustees. The majority of his machinery was sold to the trust which bailed it to the company. The rest was sold to the company. The company then conducted the earthmoving business. The taxpayer was employed by the company. His salary and director's fees were fixed at a level which left the company with substantial profits, even after payment of bailment charges to the trust.

[52] The Commissioner invoked s 108 of the Land and Income Tax Act 1954 and sought to attribute the income earned by both the company and the trust to the taxpayer. The Commissioner failed. In an oral judgment Cooke J held that the arrangement was capable of explanation by reference to ordinary business or family dealing and was not tax avoidance. Evidence had been given that several considerations were in mind: the protection of limited liability in a hazardous business; the ability to raise bank finance by means of a debenture (not possible for a sole trader); stabilising the taxpayer's estate for estate duty purposes; transferring assets to the trust in a way which removed them from the risk of the earthmoving business; and tax saving.[73]

[53] It can readily be seen that there were some very solid non-tax related reasons for the restructuring. Cooke J did find that tax saving was one of the motives but, objectively, he found that it was not the principal purpose or one of a number of

---

72 *Loader v Commissioner of Inland Revenue* [1974] 2 NZLR 472 (SC).
73 At 476.

equally important principal purposes. He found that it was an incidental or subsidiary purpose.[74] The case turned on this finding. It also had features not present in this case. The Judge, for example, noted that the taxpayer had no beneficial interest in the trust property.[75] The Commissioner's attack in *Loader* seems to have been concentrated on the incorporation of a company, the establishment of the family trust and the bailment between the trust and the company, which Cooke J said were familiar types of transactions which it would be natural to adopt to achieve the objectives of the advantages of incorporation, preservation of valuable assets for the family and minimisation of estate duty (which was never proscribed by any anti-avoidance provision).[76] There was really no focus at all in *Loader* on the setting of the salary level in the consideration of the extent to which the taxpayer was motivated by tax advantage. Consequently, the case provides little support for the argument of the present appellants.

[54] We have reached the conclusion that the appellants have failed to show that the Commissioner acted incorrectly in treating the arrangements made by the taxpayers as void against him for income tax purposes under s BG 1.

Result

[55] The appeal is dismissed, with costs of $25,000 to the Commissioner. The taxpayers must pay the Commissioner's reasonable disbursements in connection with this appeal, as fixed by the Registrar if necessary.

Solicitors:
Alexander & Paull, Christchurch for Appellants
Crown Law Office, Wellington

---

[74] At 477.
[75] At 477.
[76] At 478.