IN THE COURT OF APPEAL OF NEW ZEALAND

CA327/2016
[2017] NZCA 54

BETWEEN	HONK LAND TRUSTEES LIMITED Appellant
AND	COMMISSIONER OF INLAND REVENUE Respondent

Hearing:	2 March 2017
Court:	Randerson, Cooper and Winkelmann JJ
Counsel:	M T Lennard for Appellant A B Goosen and K J Walton for Respondent
Judgment:	10 March 2017 at 11:30 am

JUDGMENT OF THE COURT

A The appeal is dismissed.

B The appellant must pay the respondent costs for a standard appeal on a band A basis and usual disbursements.

REASONS OF THE COURT

(Given by Randerson J)

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Introduction

[1] This appeal is concerned with the deductibility in the 2005 income year of management fees paid by the appellant trustee (HLT) to a related entity, Honk Land Limited (HLL).

[2] The respondent Commissioner disallowed the deduction. This decision was upheld by Judge Allison Sinclair in the Taxation Review Authority (the TRA).[1] A subsequent appeal by HLT to the High Court was dismissed by Ellis J.[2]

[3] The essence of the decision in the TRA, endorsed by the High Court, was:

(a) The management fees were not deductible because there was insufficient proof they related to any relevant services actually provided by HLL.

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1 *XXX v Commissioner of Inland Revenue* [2015] NZTRA 10, (2015) 27 NZTC 3-009 [TRA judgment].

2 *Honk Land Trustees Ltd v Commissioner of Inland Revenue* [2016] NZHC 1316, (2016) 27 NZTC 22-055 [High Court judgment].

(b) Alternatively, the charging of the fees was a contrivance designed to enable the Honk Land Trust (the Trust) to avoid paying tax.

(c) The imposition by the Commissioner of a 50 per cent shortfall penalty was appropriate on the ground that HLT had taken an abusive tax position.

Background

[4] In 2002 Mr David Andrew Tauber settled the Honk Land Trust (the Trust). Initially, HLL was the Trust's corporate trustee but it was replaced on 9 July 2004 by HLT.[3] Mr Tauber is a discretionary beneficiary of the Trust. In 2005 he was the controlling mind of a number of companies and other entities beneficially owned by the Trust. These entities comprised a wider business enterprise (the Honk Group). HLT directly owned Honk Group Limited which, in turn, directly and indirectly, owned various other companies undertaking different business activities. HLL was one of these subsidiary companies.

[5] In the 2005 income year the Trust earned income from commercial rentals, dividends and interest from associated entities. During that year, it sold two of the three commercial properties it owned. HLL owned a commercial building in Takapuna worth some $20 million and earning substantial rental income.

[6] The financial statements for the Trust in the relevant year recorded management fees totalling $1,152,824 as an expense of the Trust. This sum comprised $1,116,000 charged by HLL and $36,824 charged by Basin Ridge Management Limited (Basin Ridge), Mr Tauber's management company. There is no dispute that the income tax effect of the management fee expenses of $1,116,000 was that the Trust had no tax to pay. In its turn, HLL offset the payment it received from HLT against existing losses with the result that HLL paid no tax on the management fee income.

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[3] One of the reasons this occurred was that HLL was to be sold. Its shares were sold by an agreement of 12 July 2005.

Issues

[7] Ellis J described the relevant issues in these terms:[4]

> (a) whether the $1,116,000 management fee deduction claimed by the Trust in the 2005 income year was deductible under s BD 2(1)(b)(i) or (ii) of the Income Tax Act 1994 (the ITA);
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> (b) if the management fee was deductible, whether it was part of a tax avoidance arrangement under s BG 1 of the ITA;
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> (c) if there was a tax avoidance arrangement, whether the voiding of the arrangement counteracted the tax advantage obtained by the HLT under the arrangement, or whether the Commissioner was obliged to reconstruct under s GB 1 in accordance with what HLT says would have happened, had the arrangement not been entered into; and
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> (d) whether the Trust is liable for an "abusive tax position" shortfall penalty or, alternatively, an "unacceptable tax position" shortfall penalty, under ss 141D and 141B respectively of the Tax Administration Act 1994 (TAA).

[8] The TRA and the High Court found against HLT on each of these issues for substantially the same reasons. Ellis J said the first and most fundamental question raised was whether any management services were actually provided by HLL to the Trust.[5] If they were not, then all other grounds of appeal necessarily failed. On this key question, both the TRA and the High Court found on the evidence that HLT had not satisfied the onus of showing that management services were provided by HLL.

[9] On appeal, HLT submits that the TRA and the High Court were wrong to find against it in respect of all of the identified issues.

Were management services provided by HLL to HLT?

[10] For HLT, Mr Lennard submitted that the High Court was wrong to find that HLT had not satisfied the onus of establishing that management services were in fact supplied by HLL to HLT. Since the High Court Judge agreed with the TRA's findings on this point, we begin by setting out the essence of the reasoning in both the TRA and the High Court judgments.

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4 High Court judgment, above n 2, at [9].
5 At [10].

The findings in the Taxation Review Authority

[11] The TRA received a substantial body of documentary evidence along with oral evidence from Mr Tauber, the Commissioner's investigator Mr Nixon, and Mr Macalister, a chartered accountant and tax adviser. All three witnesses were cross-examined at some length.

[12] In finding that the evidence did not show that management services were provided by HLL to HLT, the TRA noted the absence of any documentary evidence other than the recording of the expense in the end-of-year financial statements for both entities, and the absence of any detailed evidence of particular services for which the management fees were charged or for which entity particular work was done.[6]

[13] As well, the TRA took into account the facts that: as well as the management fees of $1,116,000, HLT paid additional management fees directly to Basin Ridge of $36,824; during the second half of the year in question, two of HLT's buildings were sold which would have resulted in a reduction in any management services required; Mr Tauber had admitted in cross-examination that the management fees charged in 2005 also included charges for work undertaken for HLT in 2004; and the fees charged were not fixed by reference to costs incurred but simply by reference to the amount required to offset HLT's income for tax purposes.

The High Court judgment

[14] Addressing the Trust's proposition that the TRA had failed to weigh or evaluate Mr Tauber's oral evidence, Ellis J concluded the TRA had inferred that no management services were provided by HLL to the Trust, taking into account all the other evidence before her, and the absence of any supporting documentation.[7] Noting the absence of any written management agreement between the two entities or any other supporting documentation, Ellis J referred to a number of undisputed facts which, together, persuaded her that the TRA was correct to find there was

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6 TRA judgment, above n 1, at [62].

7 High Court judgment, above n 2, at [18].

insufficient evidence to establish that the management services were provided. These were:[8]

> (a) the undisputed absence of any actual payment by the Trust to HLL for the management fees (journal entries recorded the transactions at the end of the financial year);
>
> (b) the undisputed fact that HLL had never charged either the Trust or any other entity management fees in any year other than 2005, which also happened to be the first year the Trust made a profit;
>
> (c) the undisputed fact that in the 2004 income year, the Trust paid management fees of $378,393 directly to the management companies of Mr Tauber and Mr Webb;
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> (d) the undisputed fact that HLL had no employees but, instead, was itself charged for management services it received from [Basin Ridge] and Mt Richmond Investments Ltd (both being Mr Tauber's management companies), and the Chester Family Trust (an entity connected with Paul Webb who was Mr Tauber's business associate);
>
> (e) the undisputed fact that the total management fee expense incurred by HLL in the 2005 year of $497,970 was less than half of the fee it charge[d] the Trust ($1,116,000). Some of those management fees were incurred by HLL in managing its own commercial building at Takapuna; and
>
> (f) the undisputed fact that the management fee that was charged by HLL to the Trust was for managing all of the companies in the group and the "related trusts", which included HLL itself.

[15] The Judge then recorded the following additional undisputed facts:[9]

> (a) without the management fee expense the Trust would have recorded income of $1,685,529.21 for the 2005 year;
>
> (b) the Trust could not offset its profit against the losses of related companies because the ITA does not permit a trust to offset income to a company. Losses may be transferred only between two or more companies from the same group;
>
> (c) in a resolution dated 30 June 2005 HLT (as trustee of the Trust) resolved to distribute the entire dividend income it had received to Mr Tauber;
>
> (d) after the distribution of this dividend income, the Trust would have had income of $1,116,000 with tax to pay of $368,280;

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8 High Court judgment, above n 2, at [18] (footnotes omitted).
9 At [19].

(e) the management fee expense of $1,116,000 therefore precisely matched the Trust's income with the effect that the Trust would pay no tax;

(f) the management fee was set at the end of the financial year by reference to the profit that the Trust would have made had the management fee not been charged;

(g) HLL was the only company in the group with available losses;

(h) without the management fee income in 2005 HLL would have had a taxable loss of $966,788;

(i) HLL would shortly have lost the advantage of those losses because the company was about to be sold; and

(j) there were no other companies in the group in a profit position that could have set off HLL's loss in 2005.

[16] Ellis J's view was that these matters collectively formed a more than adequate basis for the TRA to draw the conclusion it did. Having reviewed the transcript of the evidence given before the TRA, she also concluded that Mr Tauber's evidence was "implausible, contradictory, vague and equivocal" in a number of important ways.[10] By way of example, she noted that during cross-examination as to whether he could produce relevant documentary evidence to support the provision of management services to the Trust, Mr Tauber had said he had not come prepared to produce evidence. The Judge regarded this as a remarkable statement given Mr Tauber's substantial experience and understanding of taxation matters and the disputes process.[11]

[17] Second, the Judge found there was a lack of clarity in Mr Tauber's evidence about the extent to which the fee charged included a charge for services allegedly provided in the preceding (2004) year. His response on this topic was:

> Yeah, well there's a bit of catch up but when you say specifically in terms of what proportion related to provision of services in earlier years and that year, most of it would relate to 2005 but some of it would've related to a bit of catch up, yeah, in terms of whether it's one third, two thirds, I'd have to reapply my mind to that.

[18] Third, the Judge referred to a surprising and contradictory shift in Mr Tauber's evidence. In his written brief, he said it was the Trust that undertook

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10 High Court judgment, above n 2, at [20].
11 At [22].

management services for related companies and trusts in the Honk Group, including HLL. As the Judge noted, on its face, this appeared to be quite contrary to the whole thrust of the Trust case and other parts of Mr Tauber's evidence to the effect that it was HLL that had undertaken management services for the Trust, not the other way around.[12]

[19] Judge Sinclair had raised this issue with Mr Tauber during the course of his evidence in the TRA. Ellis J recorded the relevant parts of the exchange between Judge Sinclair and Mr Tauber:

> Q. Can I just enquire then why 79 [the relevant paragraph in his brief] is worded like that? I come back to the same issue that Mr Goosen has, it says, "Honk Land Trust undertook management services for related companies and trusts." As you just described the activities Mr Tauber they seem to be performed anyway by Honk Land Limited?
>
> A. Yeah, well maybe Honk Land Limited is, should be – because it had the management structure there but in respect of the other entities and other interests –
>
> Q. Well you talk about it being management of numerous contracting advisors and employees, all group enterprises, funding obligations et cetera, when you look at that paragraph you pretty much describe what you say Honk Land Limited was doing?
>
> A. Well, it was, ah, Honk Land Limited was providing those services for the trust but it was the trust's responsibility to deliver all those services.
>
> Q. So what do you mean by "undertook management services"?
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> A. Well, it [HLT] took management services because it had secured the services from Honk Land Limited, Honk Land Trust had secured the services of myself and the resources, I mean we could've parked the costs structure in the top entity but that wouldn't have been prudent and is not the commercial norm, the commercial norm is to isolate the management function in a subsidiary entity and that provides the services to the parent that then recharges, the parent being Honk Land Trust.
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> Q. Right, well I understand what you're saying but it doesn't seem to me to reflect in that paragraph which perhaps you might have a read of over lunchtime.
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> A. I can maybe see if I want to alter it or refine it.

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12 At [26].

[20] As Ellis J noted, although Mr Tauber offered to alter or refine his evidence in response to Judge Sinclair's questions, he did not in fact do so, leaving his evidence confused and equivocal at best.

[21] Summarising her views on this aspect of the case, Ellis J stated:[13]

> [29] As the TRA accepted, it may well be that HLT required some management and, in the absence of its own employees, might reasonably have paid some other person or entity for that. But the onus was on HLT to establish that management services were provided to it by HLL, satisfaction of which would logically entail both the identification of the relevant services and proof that they were performed by HLL. Putting to one side his failure to identify any specific services that were provided to the Trust at all, my general sense of Mr Tauber's evidence was that he was suggesting either that:
>
> (a) HLL provided services by acting as some form of conduit for services that were in fact performed by other entities within the Honk Group (such as Mr Tauber's own management company) the charge for which was simply passed on with a hefty premium added (which meant that the total charge happened to equal the Trust's total income) for so doing; or
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> (b) all the entities in the Honk Group were so intertwined that he could effectively choose which entities should charge and pay for the cost of managing the entire group by reference to their respective financial positions.
>
> [30] In my view both positions are facile. Although at trial evidence was called from a tax accountant, Mr Macalister, as to the apparent prevalence of this type of arrangement at the time for the reasons I later give I do not find it compelling.
>
> [31] In the end, it is difficult not to agree with the Commissioner that, in reality, the management fee was a rather unsophisticated ex post facto contrivance designed solely to effect the transfer of the precise amount of taxable income upon which the Trust would otherwise have had to pay tax.
>
> [32] Accordingly, in my assessment the TRA was not only not wrong, but was right, to find that no management services were provided by HLL to the Trust. There is, therefore, no need to consider the legal aspects of the appeal. I merely note that if management services were in fact provided, notwithstanding the view that both Judge Sinclair and I have taken that they were not, I would also agree with her (for the reasons she gave) that:
>
> (a) the requisite nexus with the earning of the Trust's assessable income is absent; or (if that is wrong) –

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13 High Court judgment, above n 2.

(b) the payment of the fee formed part of or constituted a void tax avoidance arrangement that was appropriately reconstructed by the Commissioner.

The case for HLT

[22] Mr Lennard accepted that although the appeal to this Court is by way of rehearing, HLT still bears the onus of satisfying the Court that it should differ from the decision under appeal. The appellate court is only justified in interfering if it considers that the decision under appeal is wrong.[14]

[23] Mr Lennard submitted that HLT had substantial real estate assets in its own right.[15] HLL had its own interests including the substantial property in Takapuna already mentioned. As well, the Honk Group had a number of subsidiaries with significant assets and borrowings all of which required management.

[24] Mr Lennard submitted, and we accept, that HLT necessarily required some management. It is common ground that HLT had no employees of its own. Counsel submitted Mr Tauber's evidence was clear that HLL provided the management services to HLT. HLL had previously been the trustee for the Trust and in that capacity HLL had provided management services to HLT. After the change in trustee in July 2004, HLL continued to provide management services to the Trust at a level counsel submitted was commercially realistic and appropriate having regard to the scale of HLT's activities. In the light of Mr Tauber's evidence, which counsel described as strong and compelling, it was unrealistic to expect that closely held entities would have recorded management fee arrangements in the way expected for arm's-length entities or public companies.

[25] Mr Lennard pointed out that other companies in the Group had charged HLT for management services in the previous tax year, and these had not been challenged by the Commissioner. He submitted that in the 2005 tax year, HLT was undergoing a significant expansion in scale and profitability. Companies such as Basin Ridge had

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[14] *Austin, Nichols & Co Inc v Stichting Lodestar* [2007] NZSC 103, [2008] 2 NZLR 141 and, in relation to factual findings, *Rangatira Ltd v Commissioner of Inland Revenue* [1997] 1 NZLR 129 (PC) and *Rae v International Insurance Brokers (Nelson Marlborough) Ltd* [1998] 3 NZLR 190 (CA) at 197.

[15] One in Karangahape Road, Auckland worth $10 million and the other in Newmarket, Auckland worth $8 million.

charged HLL for services rendered to the Honk Group and, especially in relation to HLT's assets and business, it was appropriate for HLL to pass these costs on to HLT. Similarly with costs HLL incurred in paying most of the office and sundry administration costs at the relevant time. Viewed overall, the management fee was part of a chain of management fees going down to those who provided the management. The Commissioner had assessed the income and expenditure side of every other management fee and had assessed the management fee in dispute as income in the hands of HLL.

[26] Counsel identified particular transactions which, it was submitted, showed HLL was undertaking work in relation to HLT's assets and business. These included a re-financing application on behalf of HLL but also involving HLT assets, and HLL acting as trustee in the sale of HLT's Karangahape Road and Newmarket properties. Reference was also made to HLL being responsible in the 2005 year for the payment of the majority of office costs totalling $120,000. In comparison, very little of these expenses were paid by HLT. In referring to this work, no account was taken of the personal exertion of time and effort by Mr Tauber and his business partner Mr Webb undertaking work on HLT's behalf.

Analysis

[27] We accept Mr Goosen's submission for the Commissioner that HLT has not satisfied the onus of demonstrating that the High Court was wrong on the key issue of whether and, if so, to what extent, management services were provided by HLL to the Trust.

[28] While it is not in dispute that the Trust required some management in respect of its own assets and business, HLT simply failed to meet the threshold of identifying what management services were provided to the Trust and did not prove they were performed by HLL.

[29] In our view the key points that stand out are:

(a) In the 2004 tax year HLT paid a total of $378,393 in management fees directly to Basin Ridge and the Chester Family No. 2 Trust.[16] HLL did not receive any income from management fees that year but was charged management fees of $424,282 by Basin Ridge.

(b) Matters were said to have changed in the 2005 tax year. According to Mr Tauber, HLL undertook the management work for all entities in the Honk Group including HLT. HLL's financial statements for 2005 show it was charged management fees totalling $497,970 by Basin Ridge and three other providers. That was necessary because HLL had no employees of its own.[17]

(c) For the first and only time, HLL charged the Trust the disputed management fees of $1,116,000 in the 2005 year. This expense happened to be claimed in the first year the Trust made a profit.

(d) The amount of the payment matched the surplus profit in the Trust and had the effect of eliminating the tax otherwise payable by HLT .

(e) The payment also enabled HLL to offset the amount received against its losses. This meant it had no tax to pay on the management fee income and no losses to carry forward.

(f) Without the payment, HLT would have been liable to pay tax of $368,280 and HLL would have had a loss of $966,788 for the year.[18]

[30] The amount ultimately settled upon for the disputed management fees was decided at or after the end of the financial year and was allocated retrospectively by journal entry at the fixed rate of $93,000 per month.[19] This and the lack of documentary evidence is not necessarily fatal but the problem for HLT is that

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16 An entity associated with Mr Tauber's business associate Mr Webb.

17 Mr Lennard's submission that Mr Tauber received a salary from HLL in the 2005 year is not supported by HLL's financial statements or his personal tax return.

18 Once the shares in HLL were sold, this loss could not be used by HLL to its benefit in future years.

19 There was some evidence to suggest that consideration was given in early February 2015 to fees of $150,000 per annum but this was not pursued.

Mr Tauber failed to provide any detailed or convincing explanation as to what management services were provided to HLT or how the sum charged was calculated.

[31] In the end, he conceded to Judge Sinclair in the TRA that HLT had effectively been recharged for management services HLL had provided to all the entities in the Honk Group. This was said to be on the footing that the Trust was the parent of the Group. Mr Tauber also accepted that the amount charged had included "a bit of a catch up" for management fees not charged in the 2004 year, but he did not provide any information which might have enabled an appropriate allocation of the management fees between the 2004 and 2005 years.

[32] The amount charged to HLT alone was more than double the amount HLL was charged by Basin Ridge and others for management fees for the entire Group. Mr Tauber did not provide any satisfactory explanation for this nor explain why HLT did not pay management fees directly to Basin Ridge and others as it had in 2004. Finally, a comparison of the financial statements for HLT for the 2004 and 2005 years does not support the submission that HLT's assets or business activities were substantially expanded in 2005. In that year HLT sold two of its three commercial buildings; its net assets of about $4 million increased only marginally from 2004; and its gross income decreased from $2.8 million to $1.77 million.[20] There is nothing to justify the threefold increase in management fees over those paid the year before.

[33] We agree with the judgments below that the proper inference to draw is that the management fees for 2005 were fixed by reference to HLT's taxable income and for the purpose of eliminating its liability for tax in that year. There was no satisfactory evidence to support the claim that management services were provided by HLL to HLT or in what amount. It follows that HLT's challenge to the findings in the lower court on this issue must fail.

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[20] Mr Lennard pointed to an increase in net profit by over $4 million but this was almost wholly attributable to a gain on the sale of HLT's properties.

Was the High Court correct to find there was no sufficient nexus shown between the management fees and the earning of HLT's assessable income and/or in the course of carrying on its business?

[34] The key provision governing the deductibility of expenses for income tax purposes is s BD 2 of the Income Tax Act 1994 (the ITA). This relevantly provides:

> **BD 2 Allowable deductions**
>
> *Definition*
>
> (1) An amount is an allowable deduction of a taxpayer
>
> (a) …
>
> (b) to the extent that it is an expenditure or loss
>
> (i) incurred by the taxpayer in deriving the taxpayer's gross income, or
>
> (ii) necessarily incurred by the taxpayer in the course of carrying on a business for the purpose of deriving the taxpayer's gross income, ….

[35] The authorities relating to deductibility of expenses are well known and not in dispute.[21] A deduction is available only where the expenditure at issue is incurred by the taxpayer in order to gain or produce its assessable income, or is incurred in order to carry on a business for that purpose. It is necessary first to establish the true character of the payment. It then becomes a matter of fact and degree to determine whether the necessary relationship is established.[22]

[36] Mr Lennard submitted it was difficult to differentiate between management services provided or required for individual entities in the Honk Group. Counsel argued that in such circumstances, with tightly held companies and other entities, it was permissible to take a global approach to the allocation of management fees. We are unable to accept that submission for two main reasons. First, s BD 2 is focussed on expenditure by the tax-paying entity concerned and which has the required nexus with the derivation of that taxpayer's income. Second, the section permits deductions for expenditure only to the extent that it is incurred for any of the

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21 *Commissioner of Inland Revenue v Banks* [1978] 2 NZLR 472 (CA); *Buckley & Young Ltd v Commissioner of Inland Revenue* [1978] 2 NZLR 485 (CA).

22 *Buckley & Young Ltd v Commissioner of Inland Revenue*, above n 21, at 487.

purposes identified in s BD 2(1)(b). It is well established that the words "to the extent that" contemplate an apportionment between expenditure that is properly attributable to the identified purposes and that which is not.[23] We are satisfied that s BD 2 does not permit a global approach to the deduction of expenditure without regard to the extent to which it is incurred for the identified statutory purposes in respect of the individual tax-paying entity claiming the deduction.

[37] The TRA found there was insufficient proof of the required nexus, and that finding was upheld by Ellis J.[24] Those findings were inevitable in the light of their conclusion that there was insufficient proof that management services were provided by HLL to HLT and, if so, to what extent. Since we have upheld these findings, it follows that we agree that the necessary nexus for the purposes of s BD 2 was absent.

[38] Mr Lennard referred us to the decision of Williams J in *Lockwood Buildings Ltd v Commissioner of Inland Revenue*.[25] We are satisfied that any reliance on that case is misplaced. Whether the taxpayer had demonstrated the necessary nexus between itself and the expenditure was not in issue. Nor was there any question that the parent company provided management services to the taxpayer or as to the value of those services. Rather, the question was whether the amount paid by Lockwood to its parent company was properly categorised as capital or revenue.

[39] Mr Lennard also argued that the nexus for deductibility was present because management services were provided by HLL to HLT's subsidiaries to enable them to pay dividends to the Trust. We accept Mr Goosen's submission that HLT's argument is precluded by ss BD 2(2)(b) and CB 10(2) of the ITA. HLT was only able to receive a dividend from Honk Group Ltd because that was the only entity it owned directly. However, under s CB 10(2) dividends between wholly-owned companies are exempt income. This means that dividends were not part of HLT's gross income by virtue of s BD 1(2)(a).

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23 *Commissioner of Inland Revenue v Banks*, above n 21, at 176 and *Buckley & Young Ltd v Commissioner of Inland Revenue*, above n 21, at 487.

24 TRA judgment, above n 1, at [69] and High Court judgment, above n 2, at [32].

25 *Lockwood Buildings Ltd v Commissioner of Inland Revenue* [1996] 2 NZLR 58 (HC).

[40] Mr Lennard submitted finally that it was a matter of commercial reality that management services to a group would usually be for the benefit of the group as a whole but it will often be impossible to say which particular group members are the main or principal beneficiaries of any particular activity. He submitted a tolerant approach to the allocation of management charges is adopted by practitioners and accepted by the Commissioner. In this respect, counsel relied on the evidence of Mr Macalister. While we accept that complete precision may not always be possible with regard to the division of management services between the members of a group of companies or other entities, the evidence in the present case fell well short of even a modest degree of precision. In this case, there was no division of management services at all.

Was the High Court correct to hold that if the management fee was deductible, it was part of a tax avoidance arrangement under s BG 1 of the ITA?

[41] In the TRA, Judge Sinclair considered the Commissioner's alternative submission that if the management fees were deductible under s BD 2 of the ITA, then the transaction was part of a tax avoidance arrangement under s BG 1. She concluded in accordance with the established authorities that the whole transaction was contrived, artificial and made no commercial sense.[26] She was satisfied the transaction was outside the purpose and contemplation of Parliament when it enacted s BD 2. She further found that the tax avoidance purpose or effect of the arrangement was not merely incidental. Rather, the entire purpose of the arrangement was to avoid the incidence of tax. The findings in the TRA on this point were upheld by Ellis J.

[42] A general tax avoidance mechanism has long been a feature of income tax legislation in New Zealand. The current provision is s BG 1 of the Income Tax Act 2007, and it is in substantially similar form to its predecessors. Mr Lennard correctly summarised the key features of the legislation as follows:

(a) An arrangement is a contract, agreement, plan or understanding, whether or not enforceable, including all steps and transactions by which it is carried into effect.

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[26] TRA judgment, above n 1, at [94].

(b) A tax avoidance arrangement must have a "more than merely incidental" purpose or effect of tax avoidance.

(c) Tax avoidance includes:

(i) directly or indirectly altering the incidence of any income tax;

(ii) directly or indirectly relieving a person from liability to pay income tax or from a potential or prospective liability to future income tax;

(iii) directly or indirectly avoiding, postponing, or reducing any liability to income tax or any potential or prospective liability to future income tax.

(d) A tax avoidance arrangement is void against the Commissioner for income tax purposes.

[43] If a tax avoidance arrangement is found to exist then the Commissioner has the power to reconstruct the arrangement in order to counteract the tax advantage under the arrangement.

[44] The Supreme Court has confirmed the principles applicable to the general anti-avoidance provision in two decisions: *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* and *Penny v Commissioner of Inland Revenue*.[27] The principles are not in dispute. For present purposes it is only necessary to refer to the key points:

(a) The majority in *Ben Nevis* explained that s BG 1 and other provisions in the tax legislation (the specific provisions) are to work in tandem; neither is to override the other.[28]

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[27] *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289; *Penny v Commissioner of Inland Revenue* [2011] NZSC 95, [2012] 1 NZLR 433.

[28] *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 27, at [103].

(b) The policy underlying the general anti-avoidance provision is to negate any structuring of a taxpayer's affairs for the purpose of avoiding tax, whether or not undertaken in the course of ordinary business or family dealings, unless any tax advantage is merely an incidental feature.[29]

(c) The legislation requires that taxpayers 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.[30]

[45] In *Ben Nevis* the majority adopted a two-step approach.[31] The first step considers whether the taxpayer has met the requirements of the specific provisions relied upon in order to achieve the tax result sought. Generally, a specific provision is designed to give a taxpayer the tax result if its use falls within its ordinary meaning.[32] If the specific provisions are not complied with, then the taxpayer is not entitled to the tax outcome for which it contends and the issue of tax avoidance does not arise. In the present case, this was the conclusion reached in both the TRA and the High Court.

[46] If the requirements of the specific provisions are satisfied, the second step is engaged. This requires consideration of the use of the specific provisions 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 or purpose of Parliament when it enacted the specific provision, the transaction will be a tax avoidance arrangement.[33]

[47] As the majority of the Supreme Court found in considering these issues, the Court is not limited to purely legal considerations.[34] The ultimate question is

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29 *Penny v Commissioner of Inland Revenue*, above n 27, at [47].
30 At [49].
31 *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 27, at [107].
32 At [106].
33 At [107].
34 At [109].

whether the arrangement, viewed in a commercially and economically realistic way, makes use of the specific provision in a manner consistent with Parliament's purpose. If not, there will be a tax avoidance arrangement.

[48] The majority of the Supreme Court in *Ben Nevis* said that a classic indicator that specific provisions have been used in a manner outside Parliament's contemplation is the gaining of the benefit of the specific provision in an artificial or contrived way.[35] For example, in *Penny*, it was the adoption of artificially low salaries for the principals of two companies that was found to constitute a tax avoidance arrangement.[36]

[49] If, contrary to our view, HLT had established it was entitled to deduct the management fees under the specific provisions of s BD 2 of the ITA, we would have had no difficulty in agreeing with the High Court that there was a tax avoidance arrangement in terms of s BG 1. For the reasons we have already set out,[37] we are satisfied that the circumstances in which the management fees were fixed and charged were contrived and artificial. They were clearly made for the purpose of eliminating the income tax otherwise payable. Indeed that was the entire purpose and effect of the arrangement. We accept the Commissioner's submission that another purpose and effect of the arrangement was not only to eliminate any tax obligation in HLT but also to transfer taxable profits out of the Trust to HLL. This enabled HLL to take advantage of its losses before its shares were sold, which would have meant the capacity to use such losses was no longer available. Put another way, the arrangement effectively amounted to a loss offset between a company and a trust, which is not permitted.[38]

[50] It follows that we also agree that the tax avoidance purpose or effect of the arrangement was more than merely incidental. We conclude that no basis has been shown to interfere with the findings made in the TRA and the High Court on this issue.

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35 At [108].

36 *Penny v Commissioner of Inland Revenue*, above n 27, at [33]–[36].

37 See above at [27]–[33].

38 The Income Tax Act 1994 only provides for the grouping of losses amongst companies, and only if all of the rules for grouping of losses are satisfied: subpart IG.

[51] We are also satisfied that if it had been necessary for the Commissioner to rely on the general anti-avoidance provision, it was unnecessary for the Commissioner to exercise the reconstruction powers available under the Act. The voiding of the arrangement would have the effect of removing the management fee, thereby disallowing the deduction claimed by the Trust under the arrangement. This also had the consequential effect of removing the income returned by HLL.

[52] We agree with the submission made by Mr Goosen on behalf of the Commissioner that it is no answer for HLT to say that instead of using the management fee to transfer the Trust profits to HLL, it could have distributed its profit to HLL as beneficiary income. As this Court held in *Alesco New Zealand Ltd v Commissioner of Inland Revenue*, the question is whether the particular arrangement had the effect of avoiding or reducing any liability to income tax.[39] It is not whether the taxpayer would have been equally able to avoid or reduce its liability by implementing a different and permissible arrangement.

Was the High Court correct to hold that HLT was liable for an abusive tax position penalty under s 141D of the Tax Administration Act 1994?

[53] The TRA found that HLT was liable to pay a shortfall penalty of 50 per cent for taking an abusive tax position in terms of s 141D of the Tax Administration Act 1994 (the TAA).[40] In reaching that conclusion, the TRA held that the transaction was undertaken for the dominant purpose of avoiding tax and that the imposition of a shortfall penalty was appropriate. This finding was upheld in the High Court.[41]

[54] The approach to shortfall penalties under the TAA has the following main steps:

(a) There must be a tax shortfall.[42]

(b) The taxpayer must have taken an "unacceptable tax position" under s 141B of the TAA. That is so if the position taken, viewed

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39 *Alesco New Zealand Ltd v Commissioner of Inland Revenue* [2013] NZCA 40, [2013] 2 NZLR 175 at [39] and [40].

40 TRA judgment, above n 1, at [120].

41 High Court judgment, above n 2, at [63].

42 As defined in s 3(1) of the Tax Administration Act 1994 (TAA).

objectively, fails to meet the standard of being about as likely or not to be correct at the time it is taken.[43] Matters that must be considered are the actual or potential application of all relevant tax laws and relevant judicial decisions.[44]

(c) If the Commissioner contends that the taxpayer has taken an abusive tax position, s 141D applies.

[55] Section 141D requires proof the taxpayer has taken an unacceptable tax position but also requires further elements. It relevantly provides:

> (1) The purpose of this section is to penalise those taxpayers who, having taken an unacceptable tax position, have entered into or acted in respect of arrangements or interpreted or applied tax laws with a dominant purpose of taking, or of supporting the taking of, tax positions that reduce or remove tax liabilities or give tax benefits.
>
> (2) A taxpayer is liable to pay a shortfall penalty if the taxpayer takes an abusive tax position (referred to as an **abusive tax position**).
>
> …
>
> (4) This section applies to a taxpayer if the taxpayer has taken an unacceptable tax position.
>
> …
>
> (6) A taxpayer's tax position may be an abusive tax position if the tax position is an incorrect tax position under, or as a result of, either or both of—
>
> (a) a general tax law; or
>
> (b) a specific or general anti-avoidance tax law.
>
> (7) For the purposes of this Part … an **abusive tax position** means a tax position that,—
>
> (a) is an unacceptable tax position at the time at which the tax position is taken; and
>
> (b) viewed objectively, the taxpayer takes—
>
> (i) in respect, or as a consequence, of an arrangement that is entered into with a dominant purpose of avoiding tax, whether directly or indirectly; or

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43 TAA, s 141B(1), (5) and (6).

44 Section 141B(7).

(ii) where the tax position does not relate to an arrangement described in subparagraph (i), with a dominant purpose of avoiding tax, whether directly or indirectly.

[56] As Ellis J stated, s 141D contemplates two situations where a taxpayer may be found to have taken an abusive tax position:

(a) the Commissioner or the court has found that there is a void tax avoidance arrangement entered into with the dominant purpose of avoiding tax; or

(b) there is no such arrangement but the relevant position was nonetheless taken with a dominant purpose of avoiding tax.

[57] The penalty for taking an abusive tax position is 100 per cent of the tax shortfall[45] but this may be reduced by 50 per cent if it is the first occasion.[46]

[58] We agree that the Commissioner was entitled to impose a shortfall penalty under s 141D of the TAA for these reasons:

(a) Despite Mr Lennard's argument to the contrary, there clearly was a tax shortfall for the 2005 year. The definition of "tax shortfall" in terms of s 3(1) of the TAA contemplates two distinct situations. The first is where the taxpayer's tax position results in too little tax being paid or payable by the taxpayer or another person. The second is where the taxpayer's tax position overstates a tax benefit, credit or advantage to the taxpayer or another person. Here, the Commissioner was at least entitled to rely on the first of these alternatives since HLT was clearly paying too little tax.

(b) We have concluded that, even if HLL provided some management services to HLT, there was a tax avoidance arrangement. This leads to the inevitable conclusion that HLT took an unacceptable tax position in terms of s 141D by entering into or acting in respect of

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45 TAA, s 141D(3).

46 Section 141FB.

arrangements with the dominant purpose of reducing or removing its tax liability.

(c) Although the Supreme Court's decisions in *Ben Nevis* and *Penny* had not been delivered at the time the arrangements were entered into, HLT could not reasonably have concluded it was appropriate to deduct management fees for services not actually provided. As the Supreme Court said in *Ben Nevis*, the merits of the arguments supporting the taxpayer's interpretation must be strong, although it is not necessary to show a 50 per cent prospect of success.[47] The general avoidance provisions have been well known for many years and the courts have consistently disallowed deductions that were not incurred for genuine commercial purposes.[48] As the Commissioner also submitted, by 2001 the Privy Council had disallowed "administration charges" under a general anti-avoidance provision in *O'Neil v Commissioner of Inland Revenue*.[49]

(d) Ellis J was right to be sceptical about any reliance on Mr Macalister's evidence for the reasons she sets out in her judgment.[50]

(e) We also record Ellis J's conclusion that while a distribution from the Trust to HLL might have had the same or similar tax consequences for HLT it would not have had the same tax consequences (and would have been disadvantageous) either to HLL or to Mr Tauber personally.[51]

Result

[59] For the reasons given:

(a) The appeal is dismissed.

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47 *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 27, at [184].

48 *Erris Promotions Ltd v Commissioner of Inland Revenue* (2003) 21 NZTC 18,330 (HC); *Halliwell v Commissioner of Inland Revenue* [1978] 1 NZLR 363 (SC) at 375; *Wisheart, Macnab and Kidd v Commissioner of Inland Revenue* [1972] NZLR 319 (CA); and *Elmiger v Commissioner of Inland Revenue* [1967] NZLR 161 (CA).

49 *O'Neil v Commissioner of Inland Revenue* [2001] UKPC 17, [2001] 3 NZLR 316 at [7] and [9].

50 High Court judgment, above n 2, at [50].

51 At [60].

(b) The appellant must pay the respondent costs for a standard appeal on a band A basis and usual disbursements.

Solicitors:
Carmine Law, Auckland for Appellant
Crown Law Office, Wellington for Respondent