Privy Council Appeal No. 13 of 1975

Europa Oil (N.Z.) Limited – – – – – – *Appellant*

v.

The Commissioner of Inland Revenue – – – – *Respondent*

and Cross-Appeal

FROM

THE COURT OF APPEAL OF NEW ZEALAND

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 13TH JANUARY 1976

Present at the Hearing:
LORD WILBERFORCE
VISCOUNT DILHORNE
LORD DIPLOCK
LORD EDMUND-DAVIES
SIR GARFIELD BARWICK

[*Majority Judgment delivered by* LORD DIPLOCK]

This is the second time within the last five years that the Judicial Committee of the Privy Council has been called upon to examine the fiscal consequences of a complex set of contracts connected with the purchase by Europa Oil (N.Z.) Ltd. (" the Taxpayer Company ") of its stock in trade.

There have been two different sets of contracts. The first set (" the 1956 Contracts ") covered the period from 1956 to 1964; the second (" the 1964 Contracts ") covers the period from 1964 to 1971. The economic effect of the two sets of contracts and the business reasons for entering into them are similar and can be stated briefly.

The Taxpayer Company is one of a group of associated companies which it is convenient to refer to as " the Todd Group ". The effective management of all the companies in the group is exercised by Mr. Bryan Todd. The principal business of the Taxpayer Company is the marketing in New Zealand of petroleum products from the " light end " of refining—predominantly motor gasoline but including some gas oil. Its principal competitors in New Zealand are companies controlled by or associated with one or other of the major international oil companies which have interests in oilfields and refineries in the Middle East or elsewhere east of Suez from which their requirements of light end products can be obtained. In contrast to its competitors the Todd Group has no interests in any oilfield and during the period covered by the first set of contracts it had no interest in any refinery. It had to purchase its stock in trade in bulk from one or other of the major international oil companies in the fully refined form in which it was marketed in New Zealand.

Gulf Oil Corporation (" Gulf "), an American Company, is one of the major international oil companies. By itself or through its subsidiary companies (hereafter referred to as " the Gulf Group ") it had interests in oilfields in the Middle East and access to refinery capacity there.

The Group had ample outlets east of Suez for the heavy end products of refining crude oil from its oilfields, but an inadequate market for the light end products, and no outlet for these products in New Zealand. So the petroleum products of which it had a surplus to dispose of were those of which the Todd Group needed an assured source of supply. In this respect the business interests of the two groups were complementary.

The prices at which bulk supplies of crude oil and refined products were bought and sold on the world market were, at the relevant periods, tightly controlled by the major international oil companies. Sales were at " posted prices ", the posted price for a refined product being greater than the posted price for crude oil by an amount equivalent to the cost of refining with the addition of a refiner's profit.

In order to secure an assured outlet for the surplus light ends of the crude oil that it refined in the Middle East it was in the business interests of the Gulf Group to forgo some part of the refiner's profit included in the posted prices applicable to those refined products which it supplied to the Todd Group. The amount to be forgone was the subject of hard bargaining between the two Groups in 1956. It was ultimately fixed at 2·5 cents per gallon of gasoline or gas oil supplied to the Taxpayer Company. The Gulf Group, however, was for business reasons unwilling to depart from the established system of posted prices by making this concession in the form of a reduction in the price at which it sold the refined products to the Taxpayer Company. So the benefit of the concession of 2·5 cents per gallon had to be given by the Gulf Group to the Todd Group in some other form. For the period from 1956 to 1964 this was done under the 1956 Contracts.

In 1964 a refinery at Whangarei, the first to be constructed in New Zealand, came on full stream. It was, in effect, a co-operative venture in which the Todd Group and its principal competitors in the New Zealand market for refined products each had an interest. Since there is a relatively small demand in New Zealand for the heavy end products of refining crude oil, the refinery was designed to deal not only with crude oil but also, and mainly, with feedstocks in the form of semi-refined products from which the heavy ends had already been extracted by previous refining. When the facilities of the Whangarei refinery became available to the Taxpayer Company there was no longer any need for it to purchase its stock in trade in the form of fully-refined products; and it was the policy of the New Zealand Government to discourage this. What was now required by the Taxpayer Company was feedstocks for the Whangarei refinery in the form of semi-refined products. The business reasons for which it was in the mutual interests of the Todd Group and the Gulf Group that the latter should be the source of supply of the Taxpayer Company's requirements for fully-refined light end products applied with equal force to its requirements for semi-refined light end products as feedstocks for the Whangarei refinery. So the Gulf Group continued to forgo in favour of the Todd Group part of the refiner's profit included in the posted prices of those semi-refined products which were supplied to the Todd Group and to give the benefit of this concession to the Todd Group indirectly and not in the form of a reduction in the purchase price. This change in the nature of the petroleum products supplied by the Gulf Group to the Todd Group would in any event have necessitated some alteration in the contractual relations between the two groups. This took place in 1964 when the 1964 Contracts were substituted for the 1956 Contracts. The economic effect of the two sets of contracts is similar, but there are major differences in their terms and in the parties to them.

In particular under the 1956 Contracts the Taxpayer Company bought its requirements of fully-refined products directly from the Gulf Group under a long term contract (" the Products Contract ") expiring on

31st December 1966 whereby it undertook to purchase at posted prices the whole of its requirements of motor gasoline and was granted the option to purchase at posted prices gas oil up to certain limits in quantity. Under the 1964 Contracts the Taxpayer Company did not itself purchase any feedstocks directly from the Gulf Group. It purchased them from another company in the Todd Group, Europa Refining Company Ltd. (" Europa Refining ") which in turn purchased them from the Gulf Group under a long term contract (" the Supply Contract ") expiring on 31st December 1973 whereby it undertook to purchase at posted prices all the feedstocks charged by it to the refinery at Whangarei for the purpose of producing the fully-refined products needed to meet the requirements of Europa Refining or of the Taxpayer Company for marketing in New Zealand. Europa Refining is not a subsidiary of the Taxpayer Company nor are both companies subsidiaries or sub-sub-sidiaries of the same parent company in the Todd Group. The Taxpayer Company was under no contractual obligation to anyone to purchase any of its own requirements of feedstocks from Europa Refining. In practice it did so but under separate contracts entered into with Europa Refining for cargo lots of feedstocks as they were required.

Common to both sets of contracts, however, was the form in which the Todd Group obtained the benefit of that part of the refiner's profit included in the posted prices that the Gulf Group was willing to forgo in order to obtain an outlet for its light end products, as under. For this purpose the two groups in 1956 caused to be incorporated in the Bahamas a company, Pan Eastern Refining Co. Ltd. (" Pan Eastern "), of which one half of the share capital was held by a wholly-owned subsidiary of the Taxpayer Company, Associated Motorists Petrol Company Ltd. (" A.M.P."), and the other half by a company in the Gulf Group. The 1956 Contracts included a contract between Gulf and Pan Eastern (" the Processing Contract ") under which it was agreed that Pan Eastern should purchase from Gulf and Gulf should sell to Pan Eastern at posted prices the quantity of crude oil needed to provide the finished products to be purchased by the Taxpayer Company under the Products Contract. Gulf undertook to refine the crude oil on behalf of Pan Eastern for a processing fee and to purchase from Pan Eastern the resulting finished products at prices fixed in such a way as to ensure that Pan Eastern should make a profit out of the Processing Contract equivalent to approximately 5 cents per gallon on the finished products purchased by the Taxpayer Company from the Gulf Group under the Products Contract of which A.M.P.'s share by way of dividend would be 2·5 cents per gallon. In 1964 a contract in similar terms (" the New Processing Contract ") was entered into between Gulf and Pan Eastern relating to the feedstocks to be purchased by Europa Refining under the Supply Contract and the crude oil needed to provide those feedstocks.

Pan Eastern itself did no refining. Under the Processing Contract and the New Processing Contract this was done exclusively by the Gulf Group. What the contracts did was to provide the means by which a share of the refiner's profit on finished products and feedstocks sold by the Gulf Group to the Todd Group would be obtained by the Todd Group in the form of dividends on the shares in Pan Eastern held by A.M.P.

In the instant appeal as in the previous appeal their Lordships are concerned only with the liability of the Taxpayer Company for New Zealand income tax—not with the liability of any other members of the Todd Group of Companies. It is common ground that the dividends receivable by A.M.P. from Pan Eastern or by the Taxpayer Company from A.M.P. do not, as such, form part of the assessable income of the Taxpayer Company. Although he relies also on s.108 of the Land and Income Tax Act 1954, the main ground on which the Commissioner of

Inland Revenue has sought to recover tax upon them indirectly is by attacking the claim of the Taxpayer Company under s.111 to deduct as expenditure incurred in the production of its assessable income from its business of marketing petroleum products in New Zealand, so much of the price paid by the Taxpayer Company for the motor gasoline and gas oil under the 1956 Contracts or for the feedstocks under the 1964 Contracts as is equivalent to A.M.P.'s share of the profits made by Pan Eastern under the Processing Agreement or the New Processing Agreement. He contends that upon a true analysis of the legal nature of both sets of contracts the sums which were described in the relevant contracts as being the price of the product sold to the Taxpayer Company, were paid for a compound consideration consisting partly of goods sold and delivered and partly of other advantages to be received, *i.e.* profits to be derived by the Taxpayer Company through Pan Eastern and A.M.P.

The previous appeal was in respect of assessments to income tax made on the Taxpayer Company for the years ended 31st March 1960 to 31st March 1965 inclusive. In the first five of these years of assessment all the purchases by the Taxpayer Company were of motor gasoline and gas oil under the 1956 Contracts; but in the last year there were also some purchases of feedstocks under the 1964 Contracts. The evidence at the hearing in the Supreme Court was directed mainly to the 1956 Contracts and the arguments of the parties there, in the Court of Appeal and before this Board, were confined to the legal effect of these contracts. No point was taken in relation to the last year of assessment that the 1964 Contracts in connection with the purchases of feedstocks by the Taxpayer Company might have different legal characteristics.

The consequence of this was that it was the 1956 Contracts that were the subject of detailed examination and analysis in both the majority and the minority judgments of this Board. That the case under those contracts was a borderline one is apparent from the conflict of judicial opinion that it caused. The majority of this Board, in agreement with McGregor J. in the Supreme Court, upheld the Commissioner's contention under s.111. The minority, in agreement with the Court of Appeal, would have rejected it. The majority, however, while recording that it was not disputed that the 1964 Contracts bore the same legal character as the 1956 Contracts, did go on to consider the 1964 Contracts upon such material relating to them as was to be found in the evidence given at the hearing in the Supreme Court. That evidence did not, in the view of the majority of the Board, disclose any difference in legal character between the Taxpayer Company's expenditure on feedstocks under the 1964 Contracts and its expenditure on motor gasoline and gas oil under the 1956 Contracts. As stated in the judgment no point had been taken in the appeal that the purchases of feedstocks under the 1964 Supply Contract were made in the name of Europa Refining instead of that of the Taxpayer Company. Consequently no evidence at the hearing in the Supreme Court had been specifically directed to the corporate or, what is more important, the contractual relationship between Europa Refining and the Taxpayer Company in respect of feedstocks purchased by the latter. The Board, in the majority judgment, dealt with the matter on the footing that the Taxpayer Company was to be treated as the undisclosed principal on whose behalf Europa Refining had entered into the 1964 Contracts.

These lacunae in the evidence relating to the 1964 Contracts have now been filled by evidence adduced in the instant appeal which is concerned with the assessments to income tax made on the Taxpayer Company for the years ended 31st March 1966 to 31st March 1971 inclusive. During each of these years of assessment the expenditure of the Taxpayer

Company which is in dispute was in respect of feedstocks purchased by it from Europa Refining under the 1964 Contracts. The Taxpayer Company contends that the additional evidence now before the Board makes it manifest that the legal character of this expenditure is different from its former expenditure upon motor gasoline and gas oil under the 1956 Contracts and that the whole of the price paid by it to Europa Refining for feedstocks supplied under the 1964 Contracts is deductible under s.111.

During the six years of assessment that were the subject of the previous appeal s.111 of the Land and Income Tax Act 1954 was in the following terms: —

> 111. *Expenditure or loss exclusively incurred in production of assessable income*—(1) In calculating the assessable income of any person deriving assessable income from one source only, any expenditure or loss exclusively incurred in the production of the assessable income for any income year may, except as otherwise provided in this Act, be deducted from the total income derived for that year.
>
> (2) In calculating the assessable income of any person deriving assessable income from two or more sources, any expenditure or loss exclusively incurred in the production of assessable income for any income year may, except as otherwise provided in this Act, be deducted from the total income derived by the taxpayer for that year from all such sources as aforesaid.

It remained in the same form for the first two years of assessment that are the subject of the instant appeal; but in 1968 it was amended to read: —

> 111. *Expenditure or loss incurred in production of assessable income*—In calculating the assessable income of any taxpayer, any expenditure or loss to the extent to which it—
>
> (*a*) Is incurred in gaining or producing the assessable income for any income year; or
>
> (*b*) Is necessarily incurred in carrying on a business for the purpose of gaining or producing the assessable income for any income year—
>
> may, except as otherwise provided in this Act, be deducted from the total income derived by the taxpayer in the income year in which the expenditure or loss is incurred.

In the last four years of assessment the Taypayer Company's claim to the deduction is made under paragraph (*a*) of the amended section. In their Lordships' view the amendment to the section in 1968 makes no difference for the purposes of the instant appeal.

The actual language of s.111, both before and after the 1968 amendment, is simple enough. It does not, in their Lordships' view, need any detailed exegesis. The general principles of construction of a taxing statute are well-established. Those of particular relevance to s.111 are referred to in the majority judgment of this Board in the previous appeal where there are cited with approval two leading decisions of the High Court of Australia on the corresponding section in the Australian taxing statute (*Ronpibon Tin v. Federal Commissioner of Taxation* (1949) 78 C.L.R. 47 and *Cecil Bros. Pty. Ltd. v. Federal Commissioner of Taxation* (1964) 111 C.L.R. 430). Their Lordships do not find it necessary to repeat them here; they content themselves with emphasising that it is not the economic results sought to be obtained by making the expenditure that is determinative of whether the expenditure is deductible or not; it is the legal rights enforceable by the taxpayer that he acquires in return for making it.

The difficulty to which the section gives rise is not one of interpretation of the words it uses, but of the application of those words to particular transactions which may be entered into in the course of business where those contractual arrangements are complicated and involve a multiplicity of parties.

In the majority judgment in the previous appeal, however, one thing was said in connection with the need to analyse the legal character of the contractual arrangements, that would appear to have given rise to some misunderstanding in the instant appeal, *i.e.* the passage ([1971] A.C.760 at p. 772) where it is stated:

> " . . . the Crown is not bound by the taxpayer's statement of account, or by the heading under which expenditure is placed. It is entitled to ascertain for what the expenditure was in reality incurred."

Taken in isolation this might be thought to suggest that the Court was entitled to look behind the legal character of a payment made pursuant to the provisions of a contract and to take into account economic benefits which would in fact accrue to the taxpayer otherwise than as a matter of contractual right. Any such suggestion had, however, already been emphatically repudiated in a preceding paragraph in which *Commissioners of Inland Revenue v. Duke of Westminster* ([1936] A.C.1) had been referred to as authority; and the repudiation was repeated in the same paragraph as that in which the passage which their Lordships have just cited appears. Its concluding sentence is:

> " Taxation by end result, or by economic equivalence, is not what the section achieves."

Read in this context it becomes clear that the reference to " reality " was directed only to the legal character of the payment and not to its economic consequences. All that was meant was that the court was not bound by the description, such as " price of goods ", attached to it in the taxpayer's own accounts or in a particular contract, if upon an analysis of the contractual arrangements taken as a whole under which the payment was made it appeared that its true legal character did not accord with that description.

In this appeal, as in the previous appeal, the particular expenditure claimed to be deductible under the section consists of monies paid by the Taxpayer Company under contracts for the sale of goods whereby the property in the goods was transferred by the seller to the Taxpayer Company. The monies so paid were stated in those contracts to be the price at which the goods were sold; and since the goods were acquired by the Taxpayer Company as stock in trade for its business of marketing petroleum products in New Zealand, there is no question that, if those contracts had stood alone, the whole of the monies payable under them would be expenditure by the Taxpayer Company that was deductible under s.111. Those contracts, however, did not stand alone. They formed part of a complex of interrelated contracts entered into by various companies that were members of the Todd Group or the Gulf Group in connection with the same goods. The question in both appeals can accordingly be stated thus: Is the legal effect—as distinct from the economic consequences—of the provisions of the relevant interrelated contracts such that when the Taxpayer Company orders goods under the contract of sale and accepts the obligation to pay the sum stipulated in that contract as the purchase price, the Taxpayer Company by the performance of that obligation acquires a legally enforceable right not only to delivery of the goods but also to have some other act performed which confers a benefit in money or in money's worth upon the Taxpayer Company or some other beneficiary?

If the answer is " No ", the full amount of the sum stipulated as the purchase price is deductible under s.111. If the answer is " Yes ", the sum stipulated as the purchase price falls to be apportioned as to part to expenditure incurred in purchasing the goods and as to the remainder to expenditure incurred in obtaining performance of the other act, which in the instant case would not be deductible.

In their Lordships' view there is a difference that is crucial to the answer to this question in the legal character of payments made by the Taxpayer Company when it purchased motor gasoline and gas oil under the 1956 Contracts and those made when it purchased feedstocks under the 1964 Contracts.

The provisions of the 1956 Contracts are summarised and analysed in the majority judgment of this Board in the previous appeal. For present purposes it is only necessary to draw attention to two respects in which the legally enforceable rights of the Taxpayer Company under them differed from its legally enforceable rights under the 1964 Contracts.

(1) All purchases by the Taxpayer Company of motor gasoline and gas oil were made under a single contract of sale, the Products Contract, providing for the delivery by periodic instalments of the Taxpayer Company's requirements for those products over a period of ten years. The parties were the Taxpayer Company as buyer and Gulf Iran Company (" Gulfiran "), a subsidiary of Gulf.

(2) The nature of the Processing Contract has already been described. It imposed upon the parties to it, Gulf and Pan Eastern, mutual rights and obligations with respect to the purchasing by Pan Eastern from Gulf of the crude oil necessary to provide the requirements of the Taxpayer Company for motor gasoline and gas oil under the Products Contract, the processing of the crude oil and the resale of the refined products by Pan Eastern to Gulf at such prices as would ensure to Pan Eastern a profit of approximately 5 cents per gallon of motor gasoline or gas oil supplied to the Taxpayer Company under the Products Contract. Although the parties to the Processing Contract itself were Gulf and Pan Eastern, a separate Organisation Contract to which the parties were Gulf and the Taxpayer Company incorporated a covenant by Gulf that it would perform its obligations to Pan Eastern under the Processing Contract and promptly pay to Pan Eastern any monies due to it thereunder.

The majority of the Board in the previous appeal concluded that the combined effect of these three contracts was that whenever the Taxpayer Company placed an order with Gulfiran for delivery of an instalment of goods under the Products Contract and accepted an obligation to pay the sum stipulated in that contract as the purchase price, it acquired by virtue of the placing of that order an enforceable right to have payments made by Gulf to Pan Eastern under the Processing Contract in such amount as would ensure to Pan Eastern a profit of 5 cents per gallon of goods ordered.

In contrast to the position under the 1956 Contracts the Taxpayer Company was not a party to any of the 1964 Contracts entered into with companies that were members of the Gulf Group. All its purchases of feedstocks during the years of assessment with which the instant appeal is concerned were made from European Refining under contracts of sale for one or more cargo lots of feedstocks entered into from time to time during the years of assessment. These contracts of sale were not in writing.

Their terms are a matter of inference from the voluminous evidence as to what was done; and, given the identity of management of the two companies, this has presented the courts below with a difficult task. It has not been rendered easier by the fact that it was apparently the original intention that the sales by Europa Refining to the Taxpayer Company should be of refined products into which the feedstocks had been converted by treatment in the refinery at Whangarei; but government regulations in New Zealand created obstacles to this; and a careful analysis of the evidence by both the Supreme Court and the Court of Appeal has resulted in concurrent findings that the Taxpayer Company purchased feedstocks and not refined products from Europa Refining.

The Taxpayer Company was under no pre-existing or continuing contractual obligation to purchase its requirements of feedstocks from Europa Refining. Contractually it was free to buy them wherever it chose. Its liability to pay to Europa Refining the sums stipulated as the purchase price arose only as and when the individual contracts for the sale of particular cargo lots were entered into.

All the feedstocks sold on by Europa Refining to the Taxpayer Company had in fact been purchased by Europa Refining from Gulf Exploration Company ("Gulfex", a member of the Gulf Group) under the 1964 Supply Contract to which the only parties were Europa Refining and Gulfex. As already mentioned, apart from the difference in parties this was in similar terms to the 1956 Products Contract except that the mutual obligations of the parties as to the quantities of feedstocks to be purchased and delivered were so defined as to be limited, as events turned out, to the quantities actually sold on by Europa Refining to the Taxpayer Company. Any feedstocks that the Taxpayer Company might buy from other sources were not within the Supply Contract.

The 1964 New Processing Contract relating to feedstocks was also in similar terms to the 1954 Processing Contract relating to motor gasoline and gas oil which it replaced. The parties were the same, Gulf, and Pan Eastern; but whereas in the 1956 Organisation Contract Gulf had covenanted with the Taxpayer Company that it would perform its obligations to Pan Eastern under the 1956 Processing Agreement, it entered into no corresponding covenant with the Taxpayer Company with respect to its obligations to Pan Eastern under the 1964 New Processing Agreement. A covenant by Gulf to perform its obligations to Pan Eastern under the New Processing Agreement was contained in a 1964 Re-organisation Contract but the only parties to this contract were Gulf and Todd Participants Ltd.—the parent company of Europa Refining but not of the Taxpayer Company.

It follows that whenever the Taxpayer Company entered into a contract with Europa Refining for the sale and delivery of one or more cargo lots of feedstocks and thereby accepted an obligation to pay the sum stipulated in that contract as the purchase price, the only right that it thereby acquired which was legally enforceable against anyone was the right to delivery of the feedstocks by Europa Refining.

In their Lordships' view the result upon the Commissioner's claim under s.111 is that it must fail. The true legal character of the whole of the expenditure claimed to be deductible is that of the purchase price of stock in trade for the Taxpayer Company's business of marketing petroleum products and nothing else. As such it is deductible in full in calculating the Taxpayer Company's assessable income from that business.

Their Lordships must accordingly now turn to the alternative claim by the Commissioner under s.108 of the Land and Income Tax Act 1954.

During the years of assessment that are in issue in the instant appeal it was substantially in the following terms, which, however, incorporate a minor amendment made in 1968 that does not affect the issue in the instant appeal:—

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

There are several things to be noted in connection with the application of this section.

First, it is not a charging section; all it does is to entitle the Commissioner when assessing the liability of the taxpayer to income tax to treat any contract, agreement or arrangement which falls within the description in the section as if it had never been made. Any liability of the taxpayer to pay income tax must be found elsewhere in the Act. There must be some identifiable income of the taxpayer which would have been liable to be taxed if none of the contracts, agreements or arrangements avoided by the section had been made.

Secondly, the description of the contracts, agreements and arrangements which are liable to avoidance presupposes the continued receipt by the taxpayer of income from an existing source in respect of which his liability to pay tax would be altered or relieved if legal effect were given to the contract, agreement or arrangement sought to be avoided as against the Commissioner. The section does not strike at new sources of income or restrict the right of the taxpayer to arrange his affairs in relation to income from a new source in such a way as to attract the least possible liability to tax. Nor does it prevent the taxpayer from parting with a source of income.

Thirdly, the references in the section to "the incidence of income tax" and "liability to pay income tax" are references to New Zealand income tax. The section is not concerned with the fiscal consequences of the impugned contracts, agreements or arrangements in any other jurisdiction. In the instant case it would have made no difference if Pan Eastern, instead of being established in a tax haven, had been established in the United Kingdom and incurred liability to pay corporation tax there upon its profits under the New Processing Agreement.

Fourthly, the section in any case does not strike down transactions which do not have as their main purpose or one of their main purposes tax avoidance. It does not strike down ordinary business or commercial transactions which incidentally result in some saving of tax. There may be different ways of carrying out such transactions. They will not be struck down if the method chosen for carrying them out involves the payment of less tax than would be payable if another method was followed. In such cases the avoidance of tax will be incidental to and not the main purpose of the transaction or transactions which will be the achievement of some business or commercial object (*Newton v. Commissioner of Taxation* [1958] A.C. 450 at p. 465: *Mangin v. Commissioner of Inland Revenue* [1971] A.C. 739: *Ashton v. Commissioner of Inland Revenue* [1975] 3 All E.R. 225).

Their Lordships' finding that the monies paid by the Taxpayer Company to Europa Refining is deductible under s.111 as being the actual price paid by the Taxpayer Company for its stock in trade under contracts for the sale of goods entered into with Europa Refining, is incompatible with those contracts being liable to avoidance under s.108.

In order to carry on its business of marketing refined petroleum products in New Zealand the Taxpayer Company had to purchase feedstocks from someone. In respect of these contracts the case is on all fours with *Cecil Bros. Pty. Ltd. v. Federal Commissioner of Taxation* (*ubi sup.*) in which it was said by the High Court of Australia at p. 434:

> "It is not for the Court or the Commissioner to say how much a taxpayer ought to spend in obtaining his income";

to which their Lordships would add: It is not for the Court or Commissioner to say from whom the taxpayer should purchase the stock in trade acquired by him for the purpose of obtaining his income.

The Commissioner must therefore be able to point to some other of the 1964 Contracts the avoidance of which would have the legal effect of making the profits earned by Pan Eastern under the New Processing Agreements, or the dividends payable out of these profits to A.M.P., part of the assessable income of the Taxpayer Company.

He seeks first to avoid the original 1956 Organisation Contract pursuant to which Pan Eastern was incorporated in the Bahamas. As was held by the Court of Appeal in the previous appeal, there were good commercial reasons, unconnected with the liability of the Taxpayer Company to New Zealand income tax, for incorporating Pan Eastern and for selecting the Bahamas as its seat. Furthermore the 1956 Organisation Contract created a new source of income for the Taxpayer Company which did not exist before the 1956 Processing Contract came into force. The Taxpayer Company was perfectly entitled to make arrangements whereby the income from that source was received by it in the form of dividends upon the shares of its wholly-owned subsidiary A.M.P. paid out of A.M.P.'s share of profits earned by Pan Eastern. In their Lordships' view there is no ground upon which the original 1956 Organisation Contract could be treated as void under s.108.

The Commissioner next seeks to avoid the 1964 Supply Contract and the 1964 New Processing Contract. To neither of these was the Taxpayer Company a party. Whatever effect the avoidance of the Supply Contract might have upon the mutual liabilities of Europa Refining and Gulfex it could not have any effect upon the income of the Taxpayer Company. The effect of avoidance of the 1964 Processing Contract is easier to discern. The property in the feedstocks supplied by Gulfex to Europa Refining under the Supply Contract would never have passed to Pan Eastern but would have remained vested in the Gulf Group until sold to Europa Refining; and the payments made by Gulf to Pan Eastern could accordingly have been treated by the Commissioner as having been made without consideration. But this would have been of no avail to him. Pan Eastern did in fact receive the payments; it did in fact pay dividends out of the proceeds; what it paid out to its own shareholders does not lose the legal character of a dividend because the profits out of which the dividend was paid must be deemed to have been derived from gratuitous payments. *A fortiori* this cannot affect the legal character of the dividends upon its own shares payable by Europa Refining to the Taxpayer Company.

So even if s.108 does entitle the Commissioner to treat as void for income tax purposes contracts to which the taxpayer himself is not a party and which do not give rise to any beneficial interest in him—(a question which it is not necessary to decide for the purposes of the instant appeal)—there is, in their Lordships' view, no ground upon which the Commissioner's claim can be justified under that section.

Their Lordships will humbly advise Her Majesty that the appeal should be allowed, the Orders of the Court of Appeal and the Supreme Court set aside and the matter remitted to the Supreme Court with a direction that it answer in the affirmative the question posed in the Case stated by the Commissioner of Inland Revenue on 24th October 1972 and amend the assessments accordingly.

A cross-appeal by the Commissioner of Inland Revenue concerned questions which do not arise in view of their Lordships' advice on the appeal and they will humbly advise Her Majesty that it be dismissed.

The Commissioner of Inland Revenue must pay the costs of the appeal and the cross-appeal to their Lordships' Board.

[*Dissenting Judgment by* LORD WILBERFORCE]

There are three main points for consideration in this appeal, each of which may involve subsidiary questions:

1. Whether s.111 of the Land and Income Tax Act 1954, as it stood in 1968, applied so as to permit the appellant company, Europa Oil (N.Z.) Ltd. ("Europa Oil"), to make certain deductions for the purpose of calculating its assessable income in the years of assessment 1966, 1967 and 1968; and correspondingly whether s.111 as amended in 1968 applied so as to permit similar deductions to be made as regards the years of assessment 1969, 1970 and 1971.

2. Whether, if the whole of the claimed expenditure in any year was not deductible, an apportionment should be made as between deductible and non-deductible expenditure, and if so what the basis of such deduction should be.

3. Whether s.108 of the Act applies so as to avoid all or some of the contracts, agreements or arrangements entered into by the appellant, or otherwise relevant in the case, and if so with what consequences as regards the liability of the appellant company for income tax.

The previous appeal to this Board, decided in 1971, involved consideration of an elaborate series of contracts entered into in 1956. The effect of these contracts, very summarily, was to provide Europa Oil with a supply of petroleum products by the Gulf Organisation ("Gulf") at Middle East "posted prices". At the same time, by virtue of the establishment in the Bahamas of Pan Eastern Refining Co. Ltd. ("Pan Eastern"), a company owned as to 50% by Gulf and as to 50% by a wholly owned subsidiary of Europa Oil, a benefit, intended to be the equivalent of 2·5 cents (U.S.) per gallon supplied to Europa Oil by Gulf, became available to Europa Oil. It was held by this Board that the consideration paid by Europa Oil under its supply contract with Gulf was not expenditure exclusively incurred in the production of the assessable income but was in part incurred in order to obtain the benefit through Pan Eastern, and that to that extent it was not deductible.

The 1971 appeal was concerned mainly with the assessments made in years to which the 1956 contracts applied, but there was also a short period covered by fresh contracts of a similar but not identical character made in 1964. These are the contracts involved in the present appeal.

Their Lordships, on the materials then available, made some examination of the 1964 contracts, and concluded that for income tax purposes they had no different effect from the contracts of 1956. In the present proceedings, which are wholly concerned with the 1964 contracts (including in that expression certain documents later than 1964), the

appellant has contended, as it has every right to do, that there are important and indeed vital differences between the 1956 contracts and the 1964 contracts, so that a different taxation result should follow. This question, as the learned trial Judge and the Court of Appeal found, is not an easy one to answer, so complicated are the arrangements and transactions relevant in the period.

Although the 1956 contracts and the judgment of this Board in 1971 have been fully analysed both in the Courts of New Zealand and in the majority judgment in this appeal I think it necessary to explain shortly what, as I understand it, was the basis of the 1971 judgment.

That judgment took as its starting point the terms of s.111 in its pre-1968 form. For convenience, I repeat it—

> " 111. *Expenditure or loss exclusively incurred in production of assessable income*—(1) In calculating the assessable income of any person deriving assessable income from one source only, any expenditure or loss exclusively incurred in the production of the assessable income for any income year may, except as otherwise provided in this Act, be deducted from the total income derived for that year."

It is seen that the critical words are " expenditure . . . exclusively incurred in the production of the assessable income ".

It was in the course of examining these words that the judgment used the words " [the Crown] is entitled to ascertain for what the expenditure was in reality incurred ". As is explained in the majority judgment in this appeal, the context makes plain that this was not an endorsement of taxation by economic equivalence or end result: indeed any suggestion to that effect was repudiated by the Board's judgment. What the passage was saying, and there is nothing new in this, is that it is not sufficient, or decisive, for the taxpayer to call or label his expenditure the purchase price for his trading stock, if in fact the transaction was something different, *e.g.* if the money was in part paid as the price of his trading stock, in part paid in order to obtain some other benefit. Concretely in relation to the facts of the case, it was not sufficient for the taxpayer to point to the products contract (see [1971] A.C. p. 772H) under which Europa Oil agreed to buy gasoline from Gulf at " posted prices " and to say that the posted price automatically became deductible expenditure. That was the view of the minority in that appeal: they considered that the relevant payments made by Europa Oil to Gulf under the products contract were simply made as payment for trading stock—as in the Australian case of *Cecil Bros. Pty. Ltd. v. Federal Commissioner of Taxation* (1964) 111 C.L.R. 430—and that the Pan Eastern benefit was something " collateral " or was simply an inducement to pay posted prices. But that was not the view of the majority, which held that the expenditure was made in part in order to obtain the Pan Eastern benefit—and for that benefit. The decision of the majority thus involved an interpretation of s.111 and in particular of the words " incurred in the production of the assessable income " which required the Court to examine and analyse the benefit or benefits gained by the expenditure. If what was gained was trading stock and nothing else, the expendture is wholly deductible. If what is intended to be gained, and what is in fact gained, is some other advantage, the expenditure is not wholly deductible and a problem of apportionment arises. The minority judgment took a narrower view, holding, as I understand it, that it is not legitimate to look beyond the contract between

the buyer and the seller, and that if the contract is nothing but a contract of sale, then (following the *Cecil Bros.* case) the expenditure is wholly deductible.

In my respectful opinion the present case ought to be decided on the basis of the interpretation adopted by the Board in the 1971 appeal, as the Courts in New Zealand have considered.

This brings me to the question of legal enforceability which perhaps lies at or near the centre of this appeal. The appellant's argument is that if some other benefit (in this case the Pan Eastern benefit) is to be considered as something for which the expenditure was partly incurred, that other benefit must be contractually enforceable by the person making the expenditure. They then continue by pointing out that, whereas in 1956 Gulf was under a direct contractual obligation to Europa to secure to Pan Eastern the Pan Eastern benefit, there was no such direct obligation in 1966. Therefore, they say, the vital element of contractual obligation is missing. I understand this argument to be accepted by the majority opinion.

Before I attempt to deal with it, I must mention the other important difference between the facts in this appeal and those considered in 1971. This is that the contracting party with "Gulf" is not Europa Oil but Europa Refining Co. Ltd. (Europa Refining).

The existence of Europa Refining was made known in the 1971 appeal but, as the judgment states, ([1971] A.C. p. 776A) no point had been made by the taxpayer concerning the use of this company instead of Europa Oil; it was understood, moreover, that Europa Refining was a wholly owned subsidiary of Europa Oil.

Evidence in the present case now establishes that the latter understanding was incorrect. Europa Refining is not a subsidiary of Europa Oil, nor are both companies subsidiaries of the same parent. Each is wholly owned by a distinct company in the Todd group, each of which companies is controlled by the same shareholder. No doubt if one is having regard to economic reality there is no substance in the use of one company or the other. Europa Refining was a paper company with no staff and a minimum organisation: it took no risks and made no profits. The reasons for its creation had mainly to do with requirements of New Zealand law. They are set out fully in the judgment of McCarthy P. (4 A.T.R. 477). But the appellant company is perfectly entitled to point to the distinct corporate entities, and in a taxation case to rely upon the distinction. It still remains to see what part Europa Refining played.

In the present case it was Europa Refining which on 10th March 1964 entered into the supply contract with Gulf. On the same day Gulf entered into a processing agreement with Pan Eastern, which, as in 1956, would ensure for Pan Eastern a "profit" related to the gallonage of oil and products supplied by Gulf. Europa Oil had no supply contract with Gulf, and had no long term contract with Europa Refining. It simply placed a series of individual orders with Europa Refining for its requirements, as needed, these orders being informal, as between closely associated companies. Each order was then automatically followed by a corresponding order by Europa Refining from Gulf. It appears indeed from the terms of the Feed Stock Supply Contract of 10th March 1964 (Record pp. 3112, 3113, 3114) that Europa Refining was under an obligation to Gulf to do this and this was so held by the Court of Appeal (see 4 A.T.R. p. 480). These orders in turn automatically produced, in due course, as the result of contractual

obligations, the Pan Eastern benefit. It is right to point out that this benefit was very large: according to a table appearing in the judgment of McMullin J. it amounted to about 25% of Europa Refining's (in fact Europa Oil's) f.o.b. payments, or $U.S. 9·5 million over the six years.

It is difficult to believe that Europa Oil, which was going to receive this benefit, did not frame its purchasing arrangements, and accept to to pay a price, which would enable it to do so. As the Court of Appeal found, Europa Refining (and so also Europa Oil) would not have agreed to pay posted prices for crude oil but for the fact that the processing agreement (between Gulf and Pan Eastern) gave Pan Eastern a profit of 15% on the posted prices of crude oil so long as no discounts were arranged under the supply contract (4 A.T.R. p. 491). And as and when prices under the supply contract were altered, so automatically were the prices under the processing contract. Europa Oil's interest in the matter is underlined by letter agreements, contemporaneous with the 1964 contracts, by which Gulf undertook with Europa Oil not to require the winding up of Pan Eastern because of the termination of the 1956 processing contract.

There are a number of other differences, real or alleged, between the 1956 situation and that of 1964 which have been painstakingly examined by the Court of Appeal, and which have been covered by unanimous findings. I accept these findings, but since they reinforce rather than weaken the Court's ultimate conclusions I need not repeat them.

The question can now be faced whether the differences above mentioned should lead to a different result in this appeal from that reached in 1971. Such difficulty as there is in answering this question arises because it is first necessary to decide which of the elements relied upon, or referred to, in 1971 in support of the conclusion then reached were necessary to it. Facts which may be relevant to a given conclusion and which may support it, are not *ipso facto* necessary for that conclusion. The case relating to the 1956 contracts was, in the view of the 1971 majority, a strong one, particularly because of the explicit undertaking by Gulf to Europa Oil to perform the processing contract and to secure for Pan Eastern the benefit provided for by that contract. But, in my opinion, it would be to take too narrow a view of the majority judgment, and of s.111, to confine the decision to a case where the benefit obtained by the expenditure is contractually secured in the sense that as part of the purchasing contract, or even as a part of a separate but integrated contract, the seller agreed with the buyer to pay it. The words of the section " expenditure exclusively incurred in the production of the assessable income " by contrast point to the disallowance of expenditure not so exclusively incurred, and it is this wording which gave rise to the test of " reality ". What was the expenditure for? What was it intended to gain? What did it gain? What elements entered into the fixing and acceptance of it? These are the questions to be asked. To rephrase this so as to ask, " What did the other party legally bind himself to pay or do ", is to confine the cases where no deduction is allowed to one special case: to substitute a legalistic test for a commercial test. I think in this context of the often quoted words of Dixon J. where he said in a different but analogous context that what is an outgoing of capital and what is an outgoing on account of revenue depends on

> " what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured . . . in the process " (*Hallstroms Pty. Ltd. v. F.C.T.* (1946) 72 C.L.R. 634, 648).

The words " in the production of the assessable income " are wide words—wider than " in order to obtain trading stock ", wider than " in consideration of something which the other party agrees to provide." This was recognised by the 1971 judgment and reflected in its wording.

If then the test is reality (in the sense described)—what was the expenditure really for?; how does it fit the facts? The simple approach, for which the appellant contends, is to say that Europa Oil only entered into one contract, or series of contracts from time to time, with Europa Refining and this was simply to buy products. But I find this far too simple. There was Europa Refining with a supply contract with Gulfex under which (see above) Europa Refining was obliged to buy from Gulfex all products needed to meet Europa Oil's New Zealand marketing requirements; there was Gulf with a simultaneous contract with Pan Eastern—a contract in which it was recited that Gulf had agreed to guarantee the performance of Gulfex's obligations, and had agreed to enter into a contract with Pan Eastern in order to obtain the benefits of the contract with Europa. Under this contract a substantial benefit was contractually secured for Europa Oil through its subsidiary A.M.P.

Europa Oil knew all about this (in the words of the Court of Appeal it was " privy " to these arrangements): it knew and contemplated that the moment it placed an order with Europa Refining, Europa Refining would order from Gulfex and that in due course a benefit—very large—would arise for Pan Eastern and so ultimately for itself. If, at the time when Europa Oil placed orders with Europa Refining, it was not possible to quantify exactly what the amount of this benefit would be because of possible movements in posted prices, the amount could be calculated with reasonable accuracy. I agree with the conclusion of McCarthy P. that it is the circumstance, that Europa Oil was in a position to expect a substantial profit (*viz.* through Pan Eastern) when incurring the obligation to pay, which is of importance, and the fact that the quantum of that profit was not always determinable in advance is relatively unimportant (4 A.T.R. 481). Europa Oil would never have agreed to pay " posted prices " for the products had it not known that, related to these prices, for every gallon ordered, a benefit would arise for Pan Eastern. In my opinion it cannot be said, in these circumstances, that Europa Oil's payments were for products and nothing else.

This was the view of the learned judges in the Court of Appeal.

McCarthy P. considered that if he was to follow the route which he believed was directed by the Privy Council the inquiry should be whether at the time when the stock, whatever it was, was ordered, the appellant knew as a result of the process which it thus put in train that it was to receive, pursuant to the existing machinery, an identifiable advantage—(4 A.T.R. 482). Richmond J. summed up his conclusions in the following illuminating passage which I quote in full because I respectfully agree wholly with it.

> " When Europa Oil in subsequent years, in the closest possible co-operation with Europa Refining, initiated the ordering of feedstocks, it was not just initiating orders by Europa Refining for feedstocks from any source. The orders were for feedstocks from Gulfex under the 1964 supply contract and a portion of the moneys advanced by Europa to Europa Refining was for the specific purpose of meeting payments under invoices rendered under that contract. There was no profit in these transactions from the point of view of Europa Refining, apart from the opportunity to invest funds held in London and possibly, the right to retain the alternate freight differential. When one reverts to the basic question—for what was this expenditure in reality incurred—the answer can only be that it was to obtain both the feedstocks and the Pan Eastern benefit.

> Put in a slightly different way, the consideration for Europa Oil's expenditure was not just the feedstocks but also the ordering of those feedstocks from Gulfex. The arrangements between Europa Oil and Europa Refining under which Europa Oil acquired feedstocks cannot therefore be isolated from the 1964 series of contracts and were sufficiently integrated with those contracts to satisfy their Lordships' test." (p. 493).

His Honour there refers to the fact that as orders were placed by Europa Oil with Europa Refining, Europa Oil made its money available to Europa Refining so as to meet invoices when due. He also refers to the fact that Europa Refining made no profit on orders. These, and other factual details, carefully found by the Court, fully support his argument: the contract between Europa Oil and Europa Refining was not a normal contract of purchase and sale at all: the interested party was Europa Oil; the benefit to be gained was Europa Oil's; part of the benefit was the Pan Eastern benefit. Beattie J., after stating his initial inclination to follow, in effect, the path taken by the majority in this appeal, continued:

> " However, I am now persuaded by what the President has said in his judgment when discussing their Lordships' expression, ' as part of the contractual relationship ' that the contractual arrangement here was not simply the agreement between Europa and Europa Refining. By isolating that agreement and ignoring the inter-relationship of Europa Oil with the Europa Refining-Gulf-Pan Eastern arrangements, means discarding the ' in reality ' approach adopted by the majority of the Judicial Committee. Clearly, Europa Oil benefited from the arrangement with Pan Eastern when it made payments or advances to Europa Refining. I say this because, in my opinion, when the appellant arranged its orders with Europa Refining, that company had no alternative because of the terms of the 1964 feedstock supply contract, but to pass on those orders to Gulf. At the same time the appellant must have anticipated the benefit that ultimately would accrue to it through Pan Eastern." (pp. 497/8)

For these reasons, which the judgments in the Court of Appeal amplify through a number of factual findings, I would support their conclusions and hold that the deduction was not allowable under the former s.111. I agree further with their conclusions—as I think does the majority—that the revision of s.111 in removing " exclusively " does not lead to a different result.

As regards the new limb (*b*) of s.111 introduced in 1968, which introduces the words " necessarily incurred ", there was some difference of view expressed in the Court of Appeal. As this is a comparatively recent section in New Zealand, though the subject of judicial interpretation in Australia, I prefer to express no opinion upon it.

2. As to the question of apportionment I do not think that there is any doubt that, if total deduction is prohibited by s.111, some apportionment of expenditure is required. That this may be a difficult matter in individual cases does not, in my respectful opinion, indicate that the case is not one for apportionment at all: the Courts must do their best as on an issue of fact. In the 1971 case it was assumed that if (as was held) expenditure was to be disallowed, it must be on a pound for pound basis—*i.e.* for every £1 of benefit secured, £1 of expenditure should be disallowed.

This assumption has been questioned in the present case, in my opinion with some force. It may well be that some more scientific attempt should be made to ascertain how much of the expenditure was incurred in obtaining the benefit, and this has been attempted by the Courts in New Zealand. Neither side is satisfied with the result and each side appeals. Since my view as to the necessity for apportionment does not prevail it would be unhelpful to enter into this difficult matter.

3. As to s.108. On my view of the case this does not arise and I express no view whether it could be applied to the present facts.

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In the Privy Council

EUROPA OIL (N.Z.) LIMITED

v.

THE COMMISSIONER OF INLAND REVENUE

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