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PENNY AND HOOPER AND *STARE DECISIS*

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The aim of this note is to examine a particular aspect of *Commissioner of Inland Revenue v Penny and Hooper* [2010] NZCA 231 – the well known case about the two surgeons who conducted their practices through a company owned by a trust and thus reduced the tax on the profits from 39 percent to 33 percent. The case raises in an unusually stark form the most difficult and important question in tax law – namely, how is the line to be drawn between permissible tax planning and impermissible tax avoidance? An appeal to the Supreme Court is pending, but in the meantime this note aims to draw attention to an aspect of the case that seems to have gone unremarked – namely, that both the High Court and the Court of Appeal decided the case without mentioning *Peate v Commissioner of Taxation* [1967] 1 AC 308, a Privy Council decision that seems directly on point and that, according to the conventional approach to doctrinal analysis, would have been regarded as of at least persuasive authority.

Penny and Hooper

The cases of the two surgeons – Penny and Hooper – were unrelated but similar and so were heard together. But since the differences between them were treated by the High Court and the Court of Appeal as inconsequential, the facts of one can stand for both.

In 1991, Penny commenced practice on his own account. In 1997, he arranged for the incorporation of a company, owned by a trust. The trustees were Penny's accountant and two of his solicitors and the beneficiaries were Penny and his family. He then sold his practice to the company. The company employed him to provide surgical services. Penny continued to treat patients, as before. The patients paid fees to the company (rather than to Penny personally); and the company paid Penny a salary. The fees came to about $1,100,000 a year; the salary came to about $100,000 a year; and the company also incurred other deductible expenditure of about $500,000 a year. The company thus operated at a profit of about $500,000 per year, which it distributed to its shareholder (the trust). The salary of $100,000 paid to Penny by the company was taxable at the personal rates, the highest of which was then 39 percent. But the company's profits ($500,000 or so) were taxable at only 33 percent, and no further tax was payable by the trust or the beneficiaries. Arranging his practice in this way thus saved Penny six percent on the $500,000 – or so he claimed. It is worth noting – though presumably irrelevant, as a matter of law, and not mentioned in any of the judgments – that most New Zealand medical practices, outside the public sector, are apparently organised along more or less the same lines.

The Commissioner invoked section BG 1 of the Income Tax Act 1994, which contained what is colloquially referred to as the General Anti-Avoidance Rule or GAAR (now section BG 1 of the Income Tax Act 2007). Section BG 1(1) provided

(and still provides), "A tax avoidance arrangement is void as against the Commissioner for income tax purposes." This was supported by section BG 1(2) of the 1994 Act, which provided that "the Commissioner...may counteract a tax advantage obtained by a person from or under a tax avoidance arrangement." Section BG 1(2) of the 2007 Act is worded very slightly differently; it provides that "the Commissioner may counteract a tax advantage that a person has obtained from or under a tax avoidance arrangement." But presumably this refining of the wording makes no difference. In any event, the question – at once both very simple and extraordinarily difficult – was whether what Penny had done was *tax avoidance* (and therefore void, because of the GAAR) or *permissible tax planning* (and therefore beyond the scope of the GAAR).

As one would expect, both Mackenzie J in the High Court (19 March 2009) and all three judges in the Court of Appeal (Randerson, Hammond and Ellen France JJ) followed the landmark Supreme Court decision *Ben Nevis Ltd v Commissioner of Inland Revenue* [2009] 2 NZLR 289. There, both the majority (Tipping, McGrath and Gault JJ) and the minority (Elias CJ and Anderson J) confirmed that the GAAR applies only to tax avoidance and not to the obtaining of permissible tax advantages. In the High Court, Mackenzie J held that what Penny had done was not tax avoidance. The Act, he explained, provided for individuals to be taxed at rates of up to 39 percent and companies and trusts to be taxed at 33 percent; it thus gave the proprietor of a business the choice of either (a) carrying it on in his own name (and paying tax at 39 percent) or (b) using a company or a trust or both (and paying tax at 33 percent). If the use of the corporate structure had been contrived or artificial, said Mackenzie J, it might have constituted avoidance; but that was not the case. Therefore, he concluded, the GAAR did not apply. In other words, what Penny had done was permissible tax planning, not tax avoidance.

The Court of Appeal, by a majority of two to one, came to the opposite conclusion. According to Randerson and Hammond JJ, what Penny had done went beyond what Parliament had mind when it enacted the legislation. It was therefore not permissible tax planning but tax avoidance. The GAAR applied, so that the arrangement was void (under subsection 1); and the Commissioner was entitled (under subsection 2) to do what was necessary to "counteract" the "tax advantage" that Penny had obtained by using the company and the trust. France J disagreed with Randerson and Hammond JJ, for reasons much the same as Mackenzie J's.

Who was right – Randerson and Hammond JJ, or Mackenzie and France JJ – is a difficult question which the Supreme Court may be expected to answer in due course. This note does not attempt to predict the outcome, or to suggest what it should be. Rather, its very limited aim is to point out that none of the four judgments mentions the decision of the Privy Council in *Peate's* case, the facts of which were practically identical to those of *Penny*.

Peate's Case

The taxpayer in *Peate* was a doctor. He and seven other doctors carried on a medical practice in partnership in Australia. In 1956, each of the eight doctors established a company owned by or on trust for himself and his family. The company established by the taxpayer was owned by trustees for the benefit of his wife and children. The eight doctors also established a ninth company, called Westbank, which was owned by the eight family companies. The partnership was then dissolved and the medical

practice which it had carried on was instead carried on by Westbank. Each of the eight doctors was employed by his family company. The family companies in turn supplied the doctors' services to Westbank. The doctors treated patients in the same way as before, except that the patients paid Westbank rather than the doctors. Westbank paid the family companies more than the family companies paid the doctors. What would have been the doctors' income was thus converted in part into the income of the family companies, in whose hands it was taxed at a lower rate. The Commissioner assessed the taxpayer to tax as if he were still practising in partnership with his fellows and defended the assessments on the basis of the Australian GAAR (section 260 of the Income Tax and Social Services Contribution Assessment Act 1936 (Australia)). The Judicial Committee split four to one. The majority (Viscount Dilhorne, Lord Morris, Lord Pearce and Lord Pearson) upheld the assessments. Lord Donovan dissented.

The majority judgment was delivered by Viscount Dilhorne. His Lordship seems to have regarded it as obvious that the arrangements adopted by the eight doctors constituted tax avoidance, for he reached this conclusion without giving any reasons: at 330. He thus held that section 260 applied and that the assessments were sound.

Although Lord Donovan dissented, he agreed with the majority that what the taxpayer had done amounted to tax avoidance and that this was too obvious to require any discussion: at 339. The reason for his dissent was that he thought that, whilst what the doctors had done was plainly tax avoidance, section 260 suffered from a technical deficiency as a result of which it failed to provide a remedy. The problem – known as the "annihilation" problem – was that the Australian GAAR (like the New Zealand GAAR at that time) merely rendered the offending scheme void; it did not confer on the Commissioner a power of reconstruction, such as is now provided for by section BG 1(2) of the New Zealand Act (see above). The majority dealt with this problem on the basis that, once the tax avoidance arrangements were disregarded, what remained was the eight doctors practising in partnership, as before – and assessable to tax on their respective shares of the partnership's income, as before: at 331-333. According to Lord Donovan, however, what remained, once the tax avoidance arrangements were disregarded, was the eight doctors *not* practising in partnership. "The old order is not revived by thus annihilating the new", he said at 347.

Peate's case would thus seem to be directly relevant to *Penny's*, for the facts seem not to be distinguishable in any material particular – in each, a doctor channelled the income from his medical practice to a company owned by a trust, in whose hands, but for the GAAR, it was taxable at a lower rate than it would have been in his. Nor would it seem correct to disregard the case on the grounds of the differences in the wording between the Australian statute and the New Zealand equivalent. It is true that there were differences, but they seem irrelevant. The Australian GAAR expressed itself to apply to any arrangement having "the purpose or effect...of...avoiding any...liability" to income tax; the New Zealand equivalent, recited above, applies to every "tax avoidance arrangement". But to attach any significance to this difference in the statutory language would seem difficult to justify. It seems self evident that the two provisions carry essentially the same meaning, a view supported by the authorities. See for instance *Mangin v Inland Revenue Commissioner* [1971] AC 739, in which the Privy Council regarded its own earlier decisions on the Australian GAAR as applicable to the New Zealand equivalent, and Michael Littlewood, "The Privy Council and the Australasian Anti-Avoidance Rules" [2007] British Tax

Review 175. The point is that the basic issue in *Penny* is the same as in *Peate*: was what the doctors did permissible tax planning or was it tax avoidance?

Why Was *Peate* Not Mentioned in *Penny*?

Whether counsel in *Penny* directed the attention of the High Court and the Court of Appeal to *Peate's* case is unclear. But as Mackenzie J observed in *Penny*, the Supreme Court in *Ben Nevis* had "reviewed the relevant authorities in detail" and "restated the principles to be applied and the approach to be adopted" when applying the GAAR. It would "not therefore be helpful", he said, for him to review the authorities again (at [18]). One sympathises with this, because merely answering the question is difficult enough, without examining the differences between the new approach (represented by *Ben Nevis*) and the old (represented by the earlier decisions). Even so, we are left, with respect, with an unusual outcome in that the High Court and the Court of Appeal have decided a case without mentioning a decision of the Privy Council apparently directly on point. Perhaps it can be inferred that, in the view of all four judges – Mackenzie, Randerson, Hammond, and France JJ – the Supreme Court in *Ben Nevis* has impliedly overruled the Privy Council in *Peate*, even though in *Ben Nevis* neither the majority nor the minority mentioned *Peate* and Randerson and Hammond JJ came to the same conclusion in *Penny* as the Privy Council in *Peate*. But it is only an inference, for none of the four judges in *Penny* either mentioned *Peate* or explained why the Privy Council's approach should no longer be regarded as sound.

Moreover, the High Court's and the Court of Appeal's disregarding of the pre-*Ben Nevis* cases was selective, for some of them they discussed. Thus it appears that some pre-*Ben Nevis* cases are still authoritative and some are not, but it is unclear which are which. The scope for argument would seem to be considerable.

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