Tax update

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examines the tax position of victims of fraud

Tax avoidance litigation tends to reveal the basics of a legal system because at its core the methodology used is different from the ordinary methodology used in our legal system. A good example of this is the case of *HC Services Ltd v Commissioner of Inland Revenue* [2014] NZHC 1169, (2014) 26 NZTC 21,071. This judgment exposes a conceptual error in the legal logic of the taxpayer's case and sets out clearly the relationship fraud has to the creation of legal rights and obligations generally and the application of the general anti-avoidance provision in particular.

This article will look at the misunderstanding in the *HC Services* case with respect to the consequences of fraud and will then look at the remedies available to a taxpayer who is a victim of fraud. To expose the misunderstanding in the *HC Services* case it is necessary first to explain the facts and then the basic legal concepts at play.

The taxpayer was an accounting firm. The firm participated in what it thought was an employee indemnity fund for the benefit of the employees of the firm. The costs of such funds were, in the tax years in question, deductible under s DF 2 of the Income Tax Act 1994 (ITA 1994) and DC 5 of the ITA 2004. Deductible payments were those made to an employee welfare fund, as long as the fund fully secured rights for the employees.

The scheme in question was cooked up in Wyoming and was licenced to an Australian company which rather sloppily redrafted the documents to suit a New Zealand employer. The actual developer of the scheme was convicted of corruption in 2008 relating to offences committed in Australia.

The New Zealand accounting firm, however, was very taken with the scheme and marketed it in this country and encouraged a number of accountants and tax agents to sign up to it. The package was marketed on the basis that it enabled employers to borrow funds to make the payments into what they thought were properly constructed benefit funds for their employees, which complied in all respects with New Zealand law.

The package of contracts required the New Zealand employer to execute a power of attorney and to pay a fee to a promoter. The entity that held the power of attorney then created a promissory note in favour of a fund manager which covered the employer contribution and a fee to the fund manager. Under the scheme the promissory note was treated as a payment, made on behalf of the employer and a deduction was claimed.

The obligation represented by the promissory note was satisfied by a loan that was made from a company to the employer and then transferred to the entity which had issued the power of attorney, which then used it to meet the obligation to the fund manager. There were various conditions surrounding the "investment" with the fund manager. A fee was charged

for the establishment of the scheme, the professional fees associated with it, and interest associated with the loan.

Inland Revenue assessed the accounting firm by disallowing all the deductions associated with the scheme, and imposed an abusive tax position shortfall penalty that was reduced by 50 per cent for previous compliant behaviour. The matter first went before the Taxation Review Authority on a threshold question of whether fraud on the taxpayer precluded the operation of the general anti-avoidance provision. The taxpayer lost the legal argument but there were findings in its favour to the effect that the firm had been the victim of fraud in some limited respects, namely that the promoter could be said not to have delivered what was legally contracted for. The matter was appealed to the High Court and came before Fogarty J who was content to proceed on the assumption that the TRA Judge had been correct to find that the taxpayer had been a victim of fraud (at [20]).

Turning to the legal arguments, the taxpayer advanced the argument that because of the "fraud" there was "as a matter of fact no obligations or arrangements entered into in the history of this matter…" and therefore nothing on which the taxing provisions could bite.

The law is that in the absence of a sham or of a particular statutory provision like s BG 1 of the Income Tax Act 2007, the legal consequences of a transaction are determined by the legal rights and obligations created by the contracts in question. The majority in *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115; [2009] 2 NZLR 289 accepted this orthodoxy saying:

> When considering the application of a specific tax provision, before reaching any question of avoidance, the Court is concerned primarily with the legal structures and obligations that the parties have created and not with conducting an analysis in terms of their economic substance and consequences, or of alternative means that were available for achieving the same substantive result.

There are two exceptions to this principle: where the documents or acts of the parties to the transaction are a sham, or where there is a statutory provision that directs a departure from the principle approach. The support from authority here is exceptionally strong (see *Mills v Dowdall* [1983] NZLR 154 (CA) at p 159, line 50 per Richardson J, *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA) at p 13,360 per Tipping J, *Re Securitibank Ltd (No 2)* [1978] 2 NZLR 136 (CA) at p 168, lines 25–35, *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 at p 61,276; [1978] 2 NZLR 485 (CA) at p 490, lines 8–14, C*IR v Europa Oil (NZ) Ltd* 70 ATC 6012 at p 6,018; [1971] NZLR 641 (PC) at pp 647 and 648, *Finnigan v CIR* (1995) 17 NZTC 12,170 at pp 12,173–12,174).

IMPACT OF FRAUD

What went wrong in the *HC Services* case was the assumption that fraud was coextensive with sham accompanied by the assumption that if a transaction was a fraud there are no legal rights and obligations created (see [28] and [30]).

Sham is a technical concept and while it might often involve fraud on a third party it will not typically involve fraud inter-partes so to speak. This is because a sham only arises in limited situations. The seminal statement of what constitutes a sham is a statement by Diplock LJ in *Snook v London & West Riding Investments Ltd* [1967] 2 QB 786 at p 802:

> I apprehend that, if it [sham] has any meaning in law, it means acts done or documents executed by the parties to the "sham" which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create. One thing I think, however, is clear in legal principle, morality and the authorities … that for acts or documents to be a 'sham', with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations which they give the appearance of creating.

The *Snook* conceptualisation of a sham has been adopted into New Zealand jurisprudence: see *Paintin and Nottingham Ltd v Miller Gale and Winter* [1971] NZLR 164 at pp 168 and 175, *Bateman Television Ltd v Coleridge Finance Co Ltd* [1969] NZLR 794, *NZI Bank Ltd v Euro-National Corp Ltd* (1992) 6 NZCLC 67,913 at pp 67,925–67,296; [1992] 3 NZLR 528 at p 539, *Ben Nevis Forestry Ventures Ltd v CIR; Accent Management Ltd v CIR* (2009) 24 NZTC 23,188 (SC) at para [33].

The High Court Judge noted that in *Yorkshire Railway Wagon Co v Maclure* (1882) 21 Ch D 309, to which Diplock LJ was referring in *Snook*, the "Judge had found that the Railway Company's advisers had convinced themselves this was a valid sale of stock, not a loan. Ironically, the Wagon Company understood it as a loan. But the essential point is the need for a common intention that the contract is a sham, otherwise it is real."

On these facts there was no common intention that the documents comprising the scheme did not accurately describe what the parties really agreed. Rather, the third party promoter had simply defrauded the accounting firm by leading them to believe that the scheme worked, when it did not work even on a black letter basis.

Fogarty J articulates very clearly the consequences of fraud on legal rights and obligations at [35], where he says:

> a fraud can nonetheless transfer property rights or create obligations or benefits. The presence of fraud by a party to a transaction enables the innocent counterparty to apply to have the transaction declared void. But until that happens, the transaction is valid.

The Judge's analysis, is with respect, entirely correct. Fraud does not vitiate the rights and obligations created by contracts prior to a court declaring the transaction to be void.

What then ought the victim of fraud do in a tax context?

TAX REMEDIES

The correct procedure for a victim of fraud in a situation analogous to this is for the victim to sue in the civil courts for orders to have the contract declared void: see the Contractual Remedies Act 1979, s 7(3). Part of that action will be to recover the fees and other expenses actually paid away and for declarations that any liabilities created by the fraudulent transactions and still unmet by the victim are no longer binding.

At the same time a voluntary disclosure ought to be filed. This alerts Inland Revenue to the fact that the returned position is incorrect. Inland Revenue should also be told of the application to have the transaction declared void. This information is important because, depending on the particular facts, the outcome of the civil litigation may affect the timing and amount of any deduction.

As to the ability to claim a deduction for the expenditure made but not recovered, a deduction in this circumstances could probably be sustained under s DA 1(1)(b) and arguably under s DB 42 of the ITA 2007.

Section DB 42 provides a deduction for misappropriated property. This section obviously applies where the employer has been the victim of straight out thief from the till or pilfering of stock but it is less clear whether it applies to situations like this where the fraud is more in the nature of dishonest misrepresentations. Nonetheless there is a strong argument that the actions of the third party fraudster indirectly amounted to the fraudster misappropriating to themselves funds paid over on the mistaken belief that the scheme worked.

Under s DB 42 the loss to the victim sets the limit of the deduction. It is for that reason that the amount of the deductions which will be permitted will be impacted on by the civil proceeding including recovery action. Further, the Commissioner has discretion under s DB 42 to allow the deduction to be taken in earlier years. Hence, depending on the facts, it may be possible to get the deduction under s DB 42 to coincide with the tax years to which the voluntary disclosure relates.

Ironically, despite the taxpayer in this case having misfired with its argument that the fraud meant that the avoidance provision did not apply there, is nothing in principle to stop it now executing the correct mitigation strategy and seeking deductions for its losses.

In simple cases of employee fraud, tax law not only allows for deductions to the employer for their losses but there are also provisions dealing with the making good of the losses: see s DB 43 and DB 44. Thus there are tax remedies for victims of fraud. They lie however in the Act itself rather than in the suggestion that fraud completely vitiates contractual obligations for tax purposes.