Privy Council Appeal No. 20 of 1970

The Commissioner of Inland Revenue – – – *Appellant*

v.

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

FROM

THE COURT OF APPEAL OF NEW ZEALAND

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 21ST OCTOBER 1970

Present at the Hearing:

LORD DONOVAN
VISCOUNT DILHORNE
LORD WILBERFORCE
LORD PEARSON
SIR FRANK KITTO

(*Majority Judgment delivered by* LORD WILBERFORCE)

This appeal concerns assessments to income tax for the years ending 31 March 1960 to 31 March 1965 inclusive made upon the respondent company ("Europa"). Objections having been made by Europa, a case was stated by The Commissioner of Inland Revenue under section 32 of the Land and Income Tax Act 1954. This came before the Supreme Court, and, after receiving evidence, oral and written, McGregor J. gave judgment in favour of the Commissioner. Europa appealed, and the Court of Appeal unanimously decided in its favour. The Commissioner now appeals to the Board.

The main question is whether the respondent is entitled, in calculating its assessable income, to deductions for the years in question totalling (as quantified by the Commissioner) £3,062,962 claimed by it to represent part of the cost of purchasing its trading stock *viz.* certain oil products, or whether these deductions ought to be disallowed on the ground that the amounts in question do not represent expenditure for trading stock or otherwise in the production of assessable income. In order to establish its right to these deductions, the respondent must satisfy the requirement laid down in s.111(1) of the Land and Income Tax Act 1954. This, with the preceding s.110, is in the following terms.

> "110. Except as expressly provided in this Act, no deduction shall be made in respect of any expenditure or loss of any kind for the purpose of calculating the assessable income of any taxpayer.
>
> 111. (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."

If the respondent succeeds in its claim to deduct the sums in question under s.111, the Commissioner nevertheless seeks to bring them back into the assessments by virtue of s.108 of the Act. This is a section which renders void any contract or arrangement having the purpose or effect of altering the incidence of income tax or relieving a taxpayer from his liability to pay income tax. There was a third contention based upon estoppel, but this was abandoned by the respondent.

The evidence which the courts have had to consider is voluminous. It has been comprehensively assembled and analysed in the judgment of McGregor J. and again in the three judgments in the Court of Appeal. Having the benefit of this analysis, and of the findings of fact which were made, their Lordships can state with comparative brevity those matters which appear to be of significance in the case, on the basis that if amplification is desired on any point, reference may be made to the judgments in the New Zealand Courts.

The respondent company, Europa, at the material time, was a company marketing petroleum products in New Zealand. It was independent, in the sense that it was not controlled by, or allied to, any of the major international oil companies. It was necessary for it to obtain its supply of products from one of the major producers, and desirable, if not essential, to do so under a long-term contract. It appears that before the events which are material in the present case it had a supply agreement through a subsidiary with Caltex, due to expire on 31 December 1956. In 1954–55 there were negotiations between Mr. Todd, the Chairman of Europa, and Caltex on the terms on which the contract might be renewed. Mr. Todd was determined to secure concessions, either directly as to price or in some indirect manner, but these were not forthcoming from Caltex. So Mr. Todd turned to another source and sought to obtain supplies from Gulf Oil Corporation (" Gulf ").

Gulf is a major international Oil Company with access to very large supplies of Middle East crude oil. It had a large market for the heavy-end products of refining (such as fuel oil) but no market East of Suez for the light ends (such as gasoline), and no outlet in New Zealand. Europa's requirement was mainly for gasoline and only to a small extent for heavy-end products, so the interests of the two companies were complementary.

At the time when negotiations were taking place between Europa and Gulf (1955–56), the price structure as regards Middle East Oils which was adopted by the major oil producers was based on what is known as " posted prices ". These are prices published by McGraw-Hill of New York in a daily price service known as Platt's Oilgram and are taken to represent market prices for bulk supplies. It appears that in 1955–56, suppliers did not grant discounts on posted prices, but did offer various kinds of indirect inducements to purchasers in order to obtain sales. Gulf, in particular, would have found it difficult to grant any discount off posted prices to Europa because it had a pooling arrangement with another major company, Shell, which itself had a market in New Zealand, which arrangement would have been adversely affected by discounts granted to a competitor. Mr. Todd was insistent on obtaining if not a direct discount off the price, at least some indirect concession which would have a comparable economic effect. Gulf was anxious to obtain Europa's custom, so a basis existed for an arrangement. Mr. Todd, evidently an adroit and effective negotiator, succeeded in gaining

concessions which, in economic terms, were of great value to Europa. The present appeal turns upon the legal character of these concessions and their relation to the expenditure incurred by Europa in acquiring its supplies from Gulf.

The initial contracts between Europa and Gulf were made in April 1956. They will have to be examined in some detail, but a summary resumé may be made of them at this stage. There were three main contracts, all dated 3 April 1956.

I. "The products contract." This was made between Europa and a subsidiary of Gulf called Gulf Iran Company (Gulfiran). The contract was for a period of ten years, to 31 December 1966; it obliged Gulfiran to sell and Europa to buy all Europa's requirements for gasoline in New Zealand and such gas oil as Europa might require. The price was, in effect, the posted price. Delivery was to be F.O.B. tanker to be provided by Europa.

II. "The affreightment contract". This was made between Gulf and Europa. Gulf agreed to transport by tanker Europa's New Zealand requirements.

Under it Europa obtained the benefit of the lower of two specified freight rates. No reliance is placed by either side upon the details, or effect, of this agreement.

III. "The Organisation Contract." This was made between Gulf and Europa. It provided for the incorporation in the Bahama Islands of a company to be called "Pan Eastern Refining Co. Ltd." ("Pan Eastern") with a capital of £100,000 to be subscribed by the parties in equal shares. Gulf agreed to enter into a contract, ("The Processing Contract") with Pan Eastern in a form scheduled to the Organisation contract.

The Processing Contract (which was in fact entered into between Gulf and Pan Eastern) provided for the purchase by Pan Eastern from Gulf at posted prices of sufficient crude oil to produce the gasoline required by Europa under the Products Contract. This crude oil was to be processed for Pan Eastern by Gulf at a fee payable by Pan Eastern. The gasoline, after refining, was to be repurchased by Gulf at posted prices. Other products were to be purchased by Gulf at prices sufficient to ensure net earnings for Pan Eastern in terms of a formula.

Pan Eastern was not intended to, and did not, itself do any refining. The refining and sale process was notional: what actually happened (and was intended) was that by means of invoicing and book entries Pan Eastern was credited with, and in due course paid by Gulf, sums which, for every gallon of gasoline ordered by Europa from Gulf under the Products Contract, produced for Pan Eastern a profit in accordance with the formula. The formula was such that, as prices stood in 1956 Pan Eastern would earn approximately 5c. per gallon of gasoline purchased by Europa, but this figure could vary upwards or downwards with any move in the prices of crude oil or gasoline, and, theoretically (though this did not happen) might produce no profit or even a loss for Pan Eastern. As Europa was intended to have a half interest in Pan Eastern, Europa's interest would amount to about 2·5c. profit per gallon if the formula worked according to plan.

Europa did not itself take up any shareholding in Pan Eastern. Instead this was taken by a wholly owned subsidiary of Europa, a New Zealand Company called Associated Motorists Petrol Company Limited ("A.M.P.") Gulf's 50% interest was taken up by a subsidiary of Gulf called Propet Company Ltd. ("Propet").

In order to ensure that each partner's share in Pan Eastern's profits should reach it, there was a clause (54) in Pan Eastern's Articles of Association under which at the request of either shareholder, the profits of Pan Eastern had to be distributed as dividend. In fact, in the earlier years of operation, a proportion of Pan Eastern's earnings was retained by it and not distributed, but since Europa, through A.M.P., could have procured a full distribution, this circumstance can not be material in the assessment of Europa to tax.

After 1956, there occurred changes in the relative prices of crude oil and gasoline such as to affect adversely the amount of Pan Eastern's " earnings ". Although each side placed considerable reliance on these variations and on the negotiations which followed in order to restore the level of Pan Eastern's profits, their Lordships do not consider that a reference to them has more than narrative interest. It is sufficient to state that, after some hard bargaining between Mr. Todd, for Europa, and Gulf, an arrangement was made in 1959, by which although the basic formula was retained, Gulf would grant a voluntary discount off the price of crude oil " sold " to Pan Eastern of such an amount as would restore the " earnings " of Pan Eastern to a minimum of 5c. per gallon of gasoline. This adjustment was made retrospective to 1956.

In 1959 it became apparent that the Government of New Zealand was interested in the setting up of a refinery in New Zealand; approval for its construction was given in 1962. Gulf and Europa therefore became interested in arranging a supply of feedstocks to Europa so that it could participate in the refinery. There was a series of contracts entered into in 1962 but these were not acted on, being superseded by a fresh series executed in 1964. These agreements followed a similar pattern to the contracts of 1956: it is not necessary at this stage to particularise their effect. A full analysis of them is given in the judgment of McGregor J. It has been assumed that they involve the same consequences as regards taxation as the earlier contracts. Their Lordships will examine this assumption at a later stage.

It should finally be mentioned that in 1961 there was an agreement between Europa and B.P. (New Zealand) Limited for the supply of gas oil and lighting Kerosene which involved the granting by another member of the B.P. group, B. P. Trading Ltd., of a commission to a subsidiary of Europa established in England called Pacific Trading Transport Ltd. (" P.T.T.").

By agreement between the revenue authorities in New Zealand and those in the United Kingdom, the income of P.T.T. was eventually charged with income tax in New Zealand. The Commissioner has sought to increase Europa's assessments by disallowing deductions equivalent to the amounts of commission paid to P.T.T. on the same basis as he has sought to increase Europa's assessments by reference to the latter's payments to Gulf. The Solicitor-General however conceded at the bar that if the Crown were to succeed in its claim, a refund would fall to be made to P.T.T. of income tax paid by it on the equivalent amount; otherwise there would appear to be double taxation on what is, effectively, the same income. Their Lordships will not, in these circumstances, give any separate consideration to the claim in so far as it relates to Europa's expenditure with B.P.

Very large sums were earned by and paid to Pan Eastern under the contracts above stated. It is common ground that neither in the hands of Pan Eastern, nor as received by Europa as dividend, are these sums as such assessable to New Zealand income tax. The Commissioner however aims, in the first branch of the case, at achieving substantially the same fiscal result by disallowing, out of the expenditure made by

Europa in each relevant year in purchasing its products under the Products Contract of 1956, and the similar contract of 1964, a sum equivalent to the profit of Pan Eastern for the same year. It is this claim, one of an unusual character, which must now be examined. If the Commissioner establishes his right in principle to disallow a portion of the expenditure, no question has been raised regarding the actual amount involved.

The Commissioner's case has been put in the course of the proceedings in various ways.

First, it has been said that the amounts paid to Pan Eastern, which for simplification may be referred to as 2·5c per gallon of gasoline (though as has been shown there were variations in this figure and there were other products involved), were in effect discounts off the purchase price. Although Europa was unable to secure a discount *eo nomine,* it is clear that in 1956 Mr. Todd was determined to secure some concession, as to the price of products, equivalent to a discount. And this, it is claimed, is what the 2·5c per gallon really was. It bore a direct relation to each order for products placed by Europa with Gulf: as each order was placed Europa knew exactly what it had to pay and what Pan Eastern would receive. It could enter in its books of account, on the expenditure side the "posted price" for the quantity ordered, and on the credit side the 2·5c per gallon which it knew would at once be credited to Pan Eastern and which it knew it could obtain in due course from Pan Eastern; or it could simply enter a net price, arrived at by deducting the one from the other as the "real" price of the product. Either way, the "real" price per gallon of gasoline paid by Europa was not the "posted price" but the posted price less 2·5c, and only this lesser amount ought to be deducted from Europa's trading receipts in order to arrive at its assessable income.

Secondly, and the major emphasis was placed on this in argument, it was contended that the expenditure incurred by Europa under the Products Contracts was not exclusively incurred in order to produce assessable income, through the resale of petroleum products, but was incurred in part for the purpose of producing a return to Europa through Pan Eastern and that such part of the expenditure is not deductible. The part so non-deductible is to be quantified by reference to the amount receivable through Pan Eastern.

The respondent, in answer to these contentions, points to the nature of the relevant contract under which the expenditure was incurred. This, it claims, was simply a contract for the purchase of petroleum products at a price, namely the posted price. The respondent never received nor was entitled to any discount: such money as it received was by way of dividend distributed by Pan Eastern to Europa's subsidiary A.M.P. Europa was never in a position to obtain its products at less than posted prices and it was precisely because a discount was not obtainable that Europa sought and obtained concessions of a different character. Such benefit as Europa obtained by way of dividend through Pan Eastern, was a purely collateral benefit, or by-product of the main agreement which attracts its own tax incidence according to its character. There exists, it is said, no ground for denying to Europa the trader's normal right to deduct from his revenue the whole expenditure he incurs in purchasing his trading stock.

These contentions raise difficult issues, as may be seen from the fully reasoned judgments given either way by the New Zealand Courts. Their Lordships consider it necessary first to dispose of some portions of the argument, on each side, which they regard as unsustainable or fallacious.

1. It has not been contended nor was it found, that the complicated arrangements involving Pan Eastern, which were made in 1956 and 1964, or any part of them, were a sham. It is true that the learned Solicitor-General emphasised the point that there was no real joint refining venture between Europa and Gulf, that Pan Eastern's operations were notional, and that the transactions which resulted in Pan Eastern earning a " profit " were paper transactions. Their Lordships would not differ from this as description, but they regard it as largely irrelevant, or at least as leaving the real question still to be argued. For even though there was no actual refining venture this does not mean that the arrangements can be disregarded. These were perfectly consistent with an intention that Europa, placing large orders for refined oil products with Gulf, a producer of crude with refining capacity, should obtain a share in the profits of refining the crude. They would so represent a genuine commercial operation: whether Europa obtained a profit through an actual refining operation jointly undertaken, or through a calculated formula, on the footing that the refining was done in some other way, makes no relevant difference. The essential problem is to relate the " refining profit ", however obtained or calculated, to the expenditure of Europa in buying gasoline etc., from Gulf.

2. The question for decision is not to be answered by describing the benefit derived by Europa through Pan Eastern as in substance a discount or, more ambiguously, as a price concession. No doubt it was a concession obtained from Gulf, in the course of a discussion about prices, but, in a matter of taxation it is necessary to consider and respect the legal form in which the concession was embodied. Their Lordships have no need to restate the principle laid down in such cases as *The Commissioners of Inland Revenue v. Duke of Westminster* [*1936*] A.C. p.1 a decision cited in the judgments appealed from and fully accepted as applicable. It is not legitimate in this branch of the case, as distinct from that involving s. 108, to disregard the separate corporate entities or the nature of the contracts made and to tax Europa on the substantial or economic or business character of what was done. The use of the word " concession " does not resolve the dispute, whether what was done was in law, or merely the economic equivalent of, a reduction in price. The one may have quite different taxation results from the other.

3. The argument that this was a discount or price concession is not made any stronger by pointing out (correctly in fact) that the receipts by Europa were directly related to and calculated by reference to the gallonage of products ordered by Europa. There might be many methods of obtaining a profit based on the gallonage bought, without it being possible to say that the profit truly represented a reduction in the price paid, or that the purchase price should be treated as reduced by it. For example, if Europa and Gulf had actually owned a pre-existing joint refinery, the effect of placing an order for gasoline with Gulf might produce a refining profit for Europa directly based on the quantity ordered, but this itself would be no reason for treating the price paid as reduced by the profit. And similarly if Europa and Gulf jointly owned a tanker fleet, or a pipeline, or if Europa owned shares in Gulf's refining company.

4. A similar argument on the other side was that Europa's benefit through Pan Eastern was merely a by-product or collateral. So to describe it may be intelligible. But the words by themselves are too imprecise to solve the problem. The profit may have been a by-product in the sense that the main objective was to obtain gasoline and resell it at a profit: but merely so to describe it does not prevent it representing part of that for which Europa's expenditure was made.

In the opinion of their Lordships, the use of all these words and phrases, " discount "—" two purposes "—" collateral "—" by-product "— and they may add the phrase that Pan Eastern was " a mere repository " for Europa's money, shed only a partial light. They are no substitute for a close consideration of the terms of s. 111 and an analysis of the contracts. s. 111 requires the taxpayer to show, as a condition of any deduction in respect of expenditure, that the expenditure was exclusively incurred in the production of the assessable income. In any question as to the legitimacy of a reduction claimed, two points must be borne in mind. First 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. This is clearly the basis upon which the Board dealt with the two New Zealand cases of *Ward & Co. v. Commissioner of Taxes* [1923] A.C. 145 and *Aspro Ltd. v. Commissioner of Taxes* [1932] A.C. 683. The High Court of Australia took a similar approach in *Ronpibon Tin v. The Federal Commissioner of Taxation* (1948–49) 78 C.L.R. 47. It is moreover clear that the form of the New Zealand s. 111 entitles the Commissioner to apportion expenditure between what is exclusively incurred in the production of assessable income and what is not. But secondly, a trader is entitled to conduct his business and to acquire his trading stock in his own way. It is not for the Crown to say that he might have acquired his stock at a lesser price and to deny him any deduction above what it considers he should have paid. This was the basis, as their Lordships understand it of the decision of the High Court of Australia in *Cecil Bros. Pty Ltd. v. Federal Commissioner of Taxation* 111 C.L.R. 430. The proposition that " it is not for the Court or the Commissioner to say how much a taxpayer ought to spend in obtaining his income, but only how much he has spent " was one which the High Court considered to be soundly based on authority and with which their Lordships fully agree. Although s. 111 differs from the relevant Australian section, this makes no difference to the application of the principle. In their Lordships' opinion, s. 111 does not enable the Crown to disallow expenditure genuinely made whenever it can be found that some economic advantage accrues to the trader as a result of making the expenditure: after all, the trader is taxed on his profits and if he succeeds in obtaining what are effectively profits in such a way as not to pay tax on them, the Crown has other weapons. For a claim to disallow a portion of expenditure incurred in purchasing trading stock to succeed, the Crown, in their Lordships' judgment, must show that, as part of the contractual arrangement under which the stock was acquired some advantage, not identifiable as, or related to the production of, assessable income, was gained, so that a part of the expenditure, which can be segregated and quantified, ought to be considered as consideration given for the advantage. Taxation by end result, or by economic equivalence, is not what the section achieves.

This test, the strictness of which their Lordships consider should be emphasised, can only be satisfied after a rigorous and objective examination of the contractual arrangements under which the expenditure is made.

Their Lordships proceed to consider the effect of the contractual arrangements. They take first those made between Europa and Gulf in 1956. They are lengthy and, in certain respects, technical but only a few key provisions are relevant to the issue now considered.

I. The *Products Contract* between Gulfiran and Europa, dated 3 April 1956 provided for the purchase by Europa of Europa's requirements for gasoline in New Zealand at " posted prices ".

[Gulfiran was a wholly owned subsidiary of Gulf, and Gulf itself was directly involved under IV below]

II. The *Organisation Contract* between Gulf and Europa was entered into on the same date. It contained the following recitals:

> " WHEREAS, contemporaneously herewith GULF IRAN COMPANY and EUROPA have entered into a Petroleum Products Sales Contract and GULF and EUROPA have entered into a Contract of Affreightment;
>
> WHEREAS, GULF and EUROPA have mutually agreed to procure the incorporation in and under the laws of the Bahama Islands of PAN EASTERN REFINING COMPANY, LIMITED, a company to be registered under the Companies Act (Revised Edition 1929, Chapter 83), and hereinafter referred to as " PAN EASTERN," in which EUROPA shall beneficially be interested as to moiety of the shares therein, either directly or through its subsidiaries and in which GULF or its nominee shall beneficially be interested as to a moiety of the shares therein;
>
> WHEREAS, GULF and EUROPA have further agreed that GULF shall enter into a contract with PAN EASTERN, within a reasonable time after its incorporation, for a supply of crude oil and the processing thereof and disposal of the products therefrom which contract is hereinafter referred to as the " Processing Contract;"
>
> WHEREAS, the benefits to be secured and enjoyed by EUROPA by reason of its beneficial interest in the company so to be incorporated and the execution and carrying out by GULF and PAN EASTERN of the Processing Contract is a major inducement to EUROPA to enter into the Petroleum Products Sales Contract and the Contract of Affreightment; and
>
> WHEREAS, the parties hereto accordingly are desirous of securing such benefits to EUROPA and for that purpose have agreed to enter into this present Contract;"

Under the *Organisation Contract* (*a*) (Cl. V.) Gulf agreed to enter into the *Processing Contract* with Pan Eastern in the form scheduled to the *Organisation Contract* (*b*) (Clause IX) Gulf covenanted and agreed with Europa that Gulf would faithfully perform and discharge all Gulf's obligations under the *Processing Contract* and would promptly pay to Pan Eastern all money payable by Gulf under the *Processing Contract*, and (sub-Clause (*b*)) that Pan Eastern's earnings for each quarter and throughout the term of the *Processing Contract* would be as provided for in the Processing Contract.

III. The *Processing Contract*, (scheduled to the *Organisation Contract*), and in fact entered into in 1956, recited the *Products Contract*, recited that Gulf had agreed to supply Gulfiran with petroleum products necessary to fulfil the latter's obligations under the *Products Contract;* recited that " in order to obtain the benefit of said contract with Europa [Gulf] has agreed to enter into [the Processing Contract] with Pan Eastern ", then provided for the sale by Gulf to Pan Eastern and for the purchase by Pan Eastern from Gulf of a quantity of crude oil sufficient to produce such quantities and quality of such gasoline as Gulfiran was required to deliver to Europa under the Products Contract. The contract then contained provisions as to prices to be paid by Gulf to Pan Eastern for products to be such as should ensure that the net earnings of Pan Eastern should be as determined according to a formula (cl. 6.04 and 7.01). [This formula was varied in 1959 in the light of movements in prices so as to preserve Pan Eastern's earnings at a minimum of 5c. per gallon of gasoline.]

IV. A guarantee dated 3rd April, 1956 between Gulf and Europa by which Gulf guaranteed Gulfiran's performance of the *Products Contract*.

V. An agreement made the 3rd April, 1956 between Gulfiran and Europa (Exh. A. 18). This recites the making of the *Processing Contract*, and the *Products Contract* and then provided that if due performance of the *Processing Contract* or any part of it should be excused by reason of *force majeure*, Europa should be at liberty on 90 days' notice to rescind the *Products Contract* without prejudice to accrued rights.

VI. And finally mention may be made of an arrangement made in September-December 1960 (Exh.W. Record p. 4181) by which it was agreed by Gulfiran that Europa might defer payment of invoices for petroleum products so long as Pan Eastern retained undistributed profits of equivalent amount.

On this summary it is now possible to decide between the rival contentions: whether, as Europa asserts, there was a contract for the purchase of gasoline at a price representing nothing but expenditure on gasoline accompanied it may be by some collateral, incidental, uncovenanted advantage, which did not form part of the consideration for Europa's expenditure; or whether, as the Commissioner contends, there was a single interrelated complex of agreements under which Europa should be considered as incurring expenditure for a compound consideration consisting partly of gasoline to be supplied and partly of advantages, *i.e.*, profits, to be derived through Pan Eastern.

To their Lordships it appears that the conclusion can only be in favour of the Commissioner. The integration of Europa's agreement to buy gasoline, at posted prices, with Gulf's agreement to provide earnings for Pan Eastern, is far too close, and far too carefully worked out, to permit the isolation of the agreement for sale (Products Contract) and the treatment of the expenditure incurred under it as incurred exclusively for the purchase of trading stock. The contemporaneous date of all the agreements (it is not significant that formally the processing contract cannot have taken effect until Pan Eastern was incorporated in June 1956), the recital of the Products Contract in the Organisation Contract, the Processing Contract, and the agreement numbered (V) above, point to a single complex agreement, rather than a series of independent bargains. The reference in the Organisation Contract to the Processing Contract as a major inducement to Europa to enter into the Products Contract and the similar reference in the Processing Contract itself, taken by themselves might be ambiguous and open to the contention that the Processing Contract and the benefits to be derived from it were merely some collateral advantage and not part of the consideration for the Products Contract. Their Lordships do not think that such a contention, in the whole context, has much force, but any plausibility it might seem to possess is destroyed by the agreement numbered (V). This shows beyond doubt that Europa never intended to bind itself to buy gasoline from Gulf without the benefit of the advantage to be gained, through Pan Eastern, from the Processing Contract. Moreover, under Clause IX of the Organisation Contract (summarised above) Gulf undertook a direct obligation with Europa to carry out the Processing Contract, to pay Pan Eastern all money due under it and that Pan Eastern's earnings should be as provided in the Processing Contract. The effect of this is that Europa could directly sue Gulf for any breach of the Processing Contract and for any failure to maintain Pan Eastern's earnings. The arrangement made in 1960, though not part of the original contract series, underlines the intimate connection between money due by Europa under the Products Contract and money due to Europa, through Pan Eastern under the

Processing Contract: the one could be deferred so long as the other was not withdrawn.

The documents therefore, in their Lordships' opinion, point unequivocally towards an interdependence of obligations and benefits under a complex of contracts which, though embodied in separate documents represents one contractual whole. In addition, there was extensive oral evidence in particular from Mr. Todd, Europa's Chairman who negotiated them on Europa's behalf. McGregor J. heard this evidence, and upon the basis of it as well as upon the documentary evidence, came substantially to the same conclusion as that of their Lordships—that the contractual arrangements were interdependent, one on the other. He did, it is true, place more weight on a finding that there was no true joint refining venture between Europa and Gulf than their Lordships are disposed to do but the kernel of his findings is contained in the passages where he said "I do not think these contracts can be considered individually. They are all allied and form parts of one complete and related arrangement between the two companies [*i.e.*, Gulf and Europa] and their respective subsidiaries, all under the control of the two principal contracting parties. The recitals in the various contracts show clearly that they are interlinked. The whole basis of the arrangements was that Europa should obtain what might be described as a refund through Pan Eastern." . . . "I am satisfied that the whole basis of the arrangement was a return guaranteed to Europa by Gulf of 2·5 cents or thereabouts per gallon on gasoline purchased by Europa." Read with his analysis of the contractual documents, this amounts to a finding that Europa would not have entered into an agreement to buy at posted prices but for Gulf's agreement to provide a concession, and, given the contemporaneity and interlinkage of the contracts, leads only to the conclusion that the "processing" benefits formed part of the consideration for Europa's expenditure.

It has already been stated that it was not disputed that the 1964 series of contracts bears the same legal character as those of 1956. But their Lordships have given careful and independent consideration to these agreements in order to determine whether, in respect of them, the Commissioner is able to satisfy the strict requirements which their Lordships consider must be satisfied before expenditure can be disallowed under s. 111.

The essential agreements are as follows:

I. A "Supply Contract" for feed stock dated 10 March, 1964 between Gulf Exploration Company (Gulfex—a subsidiary of Gulf) and Europa Refining Co. Ltd., a wholly owned subsidiary of Europa ("Europa Refining"). [No point has been made by the respondent concerning the use of this company instead of Europa.] Under this contract Europa Refining agreed to purchase (*inter alia*) crude oil at posted prices and naphtha at the posted price of Kuwait crude oil plus an additional charge in respect of the excess of naptha gravity over the gravity of Kuwait crude oil.

II. A "Processing Contract" between Gulf and Pan Eastern [therein called "Paneast"] made "as of" 10 March, 1964. This recited the supply contract and continued—

> "Whereas Gulf . . . has agreed to guarantee the performance by Gulfex of its obligations to Europa (sc. Europa Refining) under the aforesaid contract, and *in order to obtain the benefits of said contract with Europa has further agreed to enter into this contract* with Paneast whereunder Paneast will process crude oil." . . .

The operative portion of the contract was similar in structure to the Processing Contract of 3 April, 1956. Gulf agreed to supply to Pan Eastern crude oil sufficient to meet Europa's requirements of crude oil feed stocks and finished products under the Supply Contract: Gulf agreed to process crude oil for Pan Eastern and to buy back equivalent quantities to the quantities supplied by Gulfex to Europa. The price arrangements were such as to ensure for Pan Eastern a profit related to the gallonage of oil and products supplied by Gulfex for Europa.

III. An agreement of guarantee made "as of 10 March, 1964" between Gulf and Europa Refining by which Gulf guaranteed the performance by Gulfex of the Supply Agreement.

In addition to the above, it was shown that, at the time these contracts were negotiated, substantial discounts on Middle East crude oils were available. In the opinion of an expert called by the Commissioner, it was "inconceivable that Europa should have entered into a crude oil supply arrangement without a discount on the posted price at least in an indirect form." Moreover, in March 1965, Gulfex granted a direct discount to Europa Refining on the price of Kuwait-Iranian crude oil supplied under the Supply Contract, with effect from 1 April, 1964; a reduction was also made in the price of naphtha. But contemporaneously (in March 1965) Gulf applied a corresponding reduction in the prices paid by Gulf to Pan Eastern under the Processing Contract. This illustrates vividly the intimate connection between the price paid by Europa Refining under the Supply Contract with that paid by Gulf under the Processing Contract and shows that Europa would not have agreed to the former unless, as part of the bargain, Gulf had agreed to the latter.

This summary shows, in their Lordships' opinion that precisely the same character has to be attributed to Europa's expenditure under the 1964 series of contracts as to the expenditure under the 1956 series. The Supply Contract cannot be isolated: as part of the consideration for it ("in order to obtain the benefits") Gulf accepted the obligations of the Processing Contract.

The only other relevant contracts were those between B.P. (New Zealand) Ltd. and Europa and between British Petroleum Trading Ltd. U.K. and Pacific Trading and Transport Co. Ltd. The position as regards these matters has already been explained.

Their Lordships are of opinion, that as regards the application of s. 111 of the Land and Income Tax Act 1954 the Commissioner's case is made out and that the assessments are correct. They agree with the judgment of McGregor J. and substantially with his reasons.

It is therefore unnecessary to deal with the Commissioner's alternative contention based on s. 108 of the Act: their Lordships express no opinion whether, had the claim under s. 111 failed, the claim under s. 108 could have succeeded.

Their Lordships will humbly advise Her Majesty that the appeal should be allowed and the judgment of McGregor J. restored. The respondent must pay the costs of the appeal.

[*Dissenting Judgment by* LORD DONOVAN *and* VISCOUNT DILHORNE]

If it were right to regard the series of contracts concluded in this case in 1956 and again in 1964 as effecting no more than a purchase of oil, there would be no problem. The initial outlay at posted prices would be purely provisional; and all the intervening transactions up to and including the receipt of a dividend by Europa from Associated Motorists Corporation ("A.M.P.") would be nothing but the operation and result of a formula by which the purchase price for oil was finally fixed.

Such a view contradicts the evidence. Mr. Todd for Europa realised that he could not get a discount off posted prices. He had therefore tried to get from Europa's previous suppliers of oil—Caltex—a share of refining profits instead. Negotiations to this end broke down. But he succeeded in getting a share of refining profits from Gulf—again *instead* of the discount he was unable to secure.

This being the evidence, and it being conceded that the contract producing the share of refining profits to Europa (via of course Pan Eastern and A.M.P.) is a genuine contract taking effect according to its terms, how is it to be ignored, and treated as a mere device for providing a discount off posted prices? If the Board is to pay more than lip service to the salutary doctrines laid down in the *Duke of Westminster's* case and again in the *Wesleyan and General Assurance Society's* case it must give all the contracts their legal effect. And doing that it finds that what Europa contracted to pay and did pay for its oil was the posted price; and that what it received from A.M.P. as a dividend was at source a share of Gulf's refining profits.

When the arrangements made in this case including the formation of Pan Eastern and A.M.P. are described, as on behalf of the Commissioner they were described, as "mere machinery" for the quantification of a discount or a price concession, we think it is worth while recalling how Lord Sumner dealt with a somewhat similar argument in *Gas Lighting Improvement Co. v. Inland Revenue Commissioners* [1923] A.C. 723 at pp. 740–741.

> "It is said that all this was 'machinery', but that is true of all participations in limited liability companies. They and their operations are simply the machinery, in an economic sense, by which natural persons, who desire to limit their liability, participate in undertakings which they cannot manage to carry on themselves, either alone or in partnership, but, legally speaking, this machinery is not impersonal though it is inanimate. Between the investor, who participates as a shareholder, and the undertaking carried on, the law interposes another person, real though artificial, the company itself, and the business carried on is the business of that company, and the capital employed is its capital and not in either case the business or the capital of the shareholders. Assuming, of course, that the company is duly formed and is not a sham (of which there is no suggestion here), the idea that it is mere machinery for effecting the purposes of the shareholders is a layman's fallacy. It is a figure of speech, which cannot alter the legal aspect of the facts."

Again, if the parties to a bargain agree upon what they want from each other and execute contracts the legal effect of which is to carry out their wishes, those contracts not being mere shams, then we know of no doctrine which enables a taxing authority to refuse to recognise the contracts and their legal effects when assessing the parties to tax. There may, of course, be a Statute which confers such a power, but

in its absence the taxing authority has no right to proceed upon the basis that the bargain embodied in the contracts is non-existent or is some different bargain altogether. If the contracts yield the Revenue some unintended increase of tax, there is never any challenge: and any plea for mitigation by the taxpayer is usually met by the answer that unfortunately the contracts must be given their legal effect. The Revenue must take the rough with the smooth, and the Commissioner in the present case is not entitled to brush aside the contracts which produced a share of the refining profits of Gulf to Europa, and to say that what the parties bargained for and what Europa got was something quite different.

It is inconclusive that the appropriate share of Gulf's refining profits to be paid to Pan Eastern varied according to the quantity of oil bought by Europa. This is what one would expect, and it does not establish that such share is a discount, anymore than the dividend received from a co-operative society which is related to purchases establishes that the price of goods bought from it is so much less. "There is no relation between the measure which is used for the purpose of calculating a particular result and the quality of the figure that is arrived at by means of the test". (Per Lord Buckmaster in *Glenboig Union Fireclay Co. v. Inland Revenue* [1922] S.C. (H.L.) 112 at p. 115.

This brings us to the "dual purpose" argument adduced by the Commissioner to justify, under the terms of section 111 (1) of the Land and Income Tax Act 1954, an abatement of the deduction for the purchase price of the oil which was Europa's stock-in-trade. In our opinion this argument is fallacious; and the fallacy consists in confusing inducement with purpose.

Section 111 (1) which is to be read with section 110 of the same Act provides that in calculating assessable income, only that expenditure "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 from that year".

In more than one of the judgments in this case the adverb is at times transposed and the section considered as if it read "incurred exclusively in the production etc. etc.". This improves the grammar and clarifies the meaning.

In order to discover whether the posted prices represent expenditure so incurred by Europa the test of purpose is employed. For what purpose or purposes did Europa pay posted prices for its oil is the question which is posed as being the one the answer to which will solve the problem. We agree with this approach and adopt it.

In the majority judgment the test is also propounded "Did the processing benefits form part of the consideration for Europa's initial expenditure?" We prefer not to adopt this. In terms of section 111 one is seeking to find the reason why expenditure was incurred, and the right answer is more likely to be found by adopting the test of purpose. The majority judgment recognises that not every economic advantage accruing to the trader as the result of his expenditure justifies an abated deduction under section 111 (1): and some of these advantages could reasonably be called part of the consideration given to the trader for his outlay. Trading stamps are an obvious example.

For what purpose or purposes then did Europa incur the expenditure represented by the payment of posted prices? The answer is to be gathered partly from the relevant contracts and partly from the admissible oral evidence.

It is important at the outset however to emphasise that under section 111 (1) the strict question is not why did Europa enter into any of the relevant contracts, but for what purpose did it thereafter pay out the money the full deduction of which as an expense is challenged. The two questions are not the same. It goes very little distance towards answering the right one to emphasise what is clearly true that here we are dealing with a complex of inter-related contracts. For present purposes that means no more than this: that when seeking to discover the purpose or purposes of Europa in paying out particular sums one should have regard to all the contracts, since the answer may have to be deduced from more than one of them. But the fact that these contracts are contemporaneous, and interlinked, while being the justification for taking them all into account, by itself does not solve the problem.

The Products Contract obliged Europa to pay posted prices for the oil it bought.

By the Organisation Contract Gulf agreed to enter into the Processing Contract with Pan Eastern; and both Gulf and Europa declared that the prospective benefits to Europa under the Processing Contract were a major inducement to Europa to enter into, among other things, the Products Contract. The Processing Contract provided for monies to be paid to Pan Eastern by Gulf in respect of refining and according to a formula. And Gulf acknowledged that it entered into the Processing Contract in order to obtain the benefit of the Products Contract with Europa. Nothing in these contracts (which are the principal ones bearing upon the present question) nor in the others, contains anything to contradict or even qualify the conclusion clearly to be drawn from the documents that the prospect of sharing in the refining profits was an inducement to Europa to pay posted prices for the oil it bought. The agreement of 3rd April 1956 between Gulfiran and Europa which provided that if certain events prevented the performance of the Processing Contract, then Europa could upon notice rescind the Products Contract is clearly neutral upon the point whether the prospect of a share in refining profits was simply an inducement to pay posted prices or was something more. So also is Gulf's under-writing of the Processing Contract.

Turning to the relevant and admissible evidence which is that of Mr. Todd, the Managing Director who negotiated the contracts, again there is nothing in it which contradicts or casts any doubt upon the accuracy of the declaration in the Organisation Contract above referred to. It would indeed be strange if there were: for the truth of that declaration is almost self-evident.

On this basis of fact the contention of the Commissioner in terms of section 111 (1) could be accurately framed thus: because Europa was induced to bind itself to pay posted prices for its oil the value of the inducement must be deducted to arrive at the price it paid for oil. The *non sequitur* in this proposition is obvious, and understandably the Commissioner puts it differently. Using the test of purpose he claims that the posted prices were paid for two purposes: (1) to obtain oil, (2) to obtain a share of the refining profits.

This is really no better. It involves saying that each time the Secretary of Europa wrote out a cheque in payment of an invoice for oil he was also paying for the right to receive a prospective amount of refining profits. But Europa already had this right. It had bought it by agreeing to pay posted prices for oil, and by subscribing for one half of the share capital of A.M.P. Let it be supposed, for the sake of the argument, that Europa had the single purpose of buying oil. The consequence would

still have followed that it remained entitled to a share of the refining profits. Of course this right was contingent upon its paying posted prices, but paying posted prices *for oil.*

Putting the matter in another way—Gulf says to Europa "If you will pay £*x* to us for your oil, we will see that you get £*y* as a share of refining profits." In terms of section 111 (1) it is, in our view, perfectly correct to assert that under such an arrangement £*x* is paid exclusively for oil; that £*y* is the inducement to pay it exclusively for oil; and that £*y* when received is a collateral advantage.

It is instructive to see where the Commissioner's argument would lead if it were right. There are numerous instances where a trader is induced to pay prices asked for by his supplier because of some inducement held out to him to do so. Extended credit: a promise to hold the prices steady for a stipulated period: the prospect of a dividend based on purchases if the supplier is a Co-operative Wholesale Society: and so on. Moreover, a parent company may place its orders for stock with a subsidiary company induced by the prospect of an enhanced dividend from the latter. In all such cases the logic of the Commissioner's argument would compel him to abate the deduction allowable under section 111 (1).

Any rational apportionment of the purchase price paid by the trader in such cases would however be almost impossible. It is so in the present case, and the Commissioner makes no attempt at it. Instead he simply takes the figure of refining profit received or receivable and deducts it from the posted price. This is not apportionment. It is instead an operation which credits Europa with the totally fictitious "purpose" of paying £1 for every £1 of refining profit. And in the case of P.T.T. the position is reached where the Commissioner first gets tax on the commission received by that company and then requires tax on the same amount as a result of the abated deduction under section 111 (1). The Solicitor-General was in the end constrained to agree that if he were held right on section 111 (1) tax on the commission would have to be refunded. Yet the Act taxes that commission. The comparable situation with regard to Europa is that in its hand the dividend from A.M.P. is expressly exempt from tax but *de facto* the exemption is withheld.

All this, as we have said, flows from confusing inducement with purpose: by mistakenly equating the thing promised with the method of earning it. The argument for the taxing authority in the Australian case of *Cecil Bros. Pty. Ltd. v. Federal Commissioner of Taxation* (1962) 111 C.L.R. 430 exhibited a similar flaw and the High Court of Australia rightly made short work of it. The taxpayer had paid more for its stock-in-trade than it need have done, being induced to do so by a desire to prosper the supplier. The dual purpose argument was advanced by the taxing authority and rejected. Despite ingenious arguments to the contrary suggested by the Solicitor-General in the present case, there is no difference of principle between the two.

In the Court of Appeal in New Zealand *North P.* said:—

> "Therefore, I must start with the premise that it paid no more for its supplies of gasoline than the current market price. The fact that Europa received a collateral benefit by reason of its shareholding in Pan Eastern, in my opinion, is irrelevant. In my opinion, what happened was that by adroit negotiations conducted by Mr. Todd, Europa won a share in a refiner's profit which otherwise would have gone exclusively to Gulf. The revenue authorities in New Zealand

were deprived of nothing. Europa had bound itself to pay current posted prices and, in my opinion, once that is made clear the amounts so paid, supported as no doubt they were by vouchers, were deductible as items of expenditure. It had no option in the matter. It had bound itself to pay the current posted prices whether or not Pan Eastern for some reason or another ceased to earn profits. I see no reason why the new arrangement made in 1964 should be treated any differently for it is closely linked with the earlier agreement and in any case there is insufficient evidence to show that the contract price for feedstocks was other than the market price in New Zealand. In reaching this conclusion, I have not overlooked the fact that the New Zealand section imposes a narrower test than that applied in the United Kingdom and Australia, but for present purposes the fact that the New Zealand section requires that the expenditure should be 'exclusively' incurred in the production of the assessable income of the taxpayer can make no difference when the Court is concerned with the purchase of trading stock which undoubtedly was exclusively required for the purpose of the taxpaying company's business."

Turner J.'s view was this:—

"But if the Commissioner is entitled to examine the payments made for purchases in the present case, can he establish satisfactorily that more was paid than would have had to be paid on the open market? Where a deduction is claimed, and the taxpayer can establish (as was established in the case before us) that the moneys paid out were paid out in the production of the assessable income, the Commissioner may, while conceding this, question whether the payments were *exclusively* so incurred. It seems to me that while the onus of proving that they were must finally rest upon the taxpayer, yet the evidentiary burden which lies upon him may be discharged at an early stage in the inquiry if he is able to demonstrate —as in the case before us—that the moneys were paid out in discharge of a contractual liability binding upon the taxpayer. Where this is shown there can be no doubt *ex hypothesi* but that the taxpayer was bound to pay; and bound to pay every penny of what was paid. The only question is as to the purposes which actuated him in incurring the liability to make the payment. And when this stage is reached, if it then appears that in paying the amount which the taxpayer was in law bound to pay, he paid no more than he would have had to pay on the available market for the supplies, even if he had never entered into the contract at all, then it cannot matter what other purposes of the taxpayer were collaterally served by the payment. Nothing more has in such a case been paid, over and above what would have had to be paid for the goods had the collateral purposes never entered the mind of the taxpayer. Now I think that this is where matters were left by the evidence in the case before us."

McCarthy J. said:—

"But if, as I prefer, purpose is the test, and if when there are two purposes established the Commissioner may apportion, then the question here is whether such a second purpose has been established in the present case. My view is that it has not; this for the reasons which I have given generally in relation to the matter of discount, especially that it seems to me not sufficiently established that at material times Europa was in a position to secure supplies to New Zealand at lower prices to itself; on the contrary I

think it was virtually forced to accept bills at posted prices. The mere fact that it secured for another company in which it holds a substantial interest contemporaneous benefits of a very substantial nature seems to me more an incidental consequence than a direct purpose of its expenditure. I think that the situation in this case may be likened to that in *I.R.C. v. Korner (supra)* and, as was said then, I say now, that the benefit to Pan Eastern was immaterial, unless that was a purpose of the expenditure. Doubtless that benefit was keenly desired and fought for but as Europa, as it seems to me, had really no option in the matter but was obliged in any event to pay posted prices, the obtaining of the additional advantages for Pan Eastern was 'simply a by-product of this outlay not its purpose'. For these reasons I am not in favour of supporting the Commissioner's disallowance of these particular sums."

We agree with these conclusions.

In these circumstances we must deal with the alternative argument for the Commissioner based on section 108 of the Act of 1954. With all due respect it seems to us to be hopeless. When the Statute confers freedom of tax in respect of a dividend received from a foreign subsidiary how is liability created by receiving that very thing? In *Keighery Proprietary Ltd. v. Federal Commissioner of Taxation* 100 C.L.R. 66 the High Court of Australia faced with a cognate question arising in connection with the comparable s.260 in the Income Tax Act of Australia answered it by saying that the section did not apply and we respectfully agree.

Again if that which relieved from tax is an arrangement part of which produces tax-free income, how does one annihilate that part by declaring it void and still preserve the income?

The Solicitor-General went so far as to declare that a gift of income-producing property to a charity made for the express purpose of giving a tax-exempted income to the charity would be void under section 108 and the income would be assessable on the donor. If true, this should soon dry up many of the wells of charity in New Zealand.

Again a citizen subscribing for Government Securities issued on terms that the income would be tax-free in his hands, and doing so for the express purpose of having the advantage, would, so the Solicitor-General asserted, also fall foul of s.108. Its terms would be applied to him and he would be liable to tax on the income notwithstanding the inducement held out by the Government.

These absurdities convince us that if the Board acceded to the invitation to apply it to a case like the present, it would certainly not be correctly interpreting the will of the New Zealand Legislature. We think the true interpretation of section 108 to be adopted is that set out by the majority of the Board in the current case of *Mangin v. Commissioner of Inland Revenue.*

On all the issues raised in the present case we respectfully agree with the conclusions of the Court of Appeal in New Zealand and would therefore humbly advise Her Majesty that this appeal should be dismissed.

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In the Privy Council

THE COMMISSIONER OF
INLAND REVENUE

v.

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