IN THE HIGH COURT OF THE COOK ISLANDS
HELD AT RAROTONGA
(CIVIL DIVISION)

OA NO. 3/2007

BETWEEN	**TATUROANUI GRAHAM CROCOMBE** of Rarotonga, Company Director Appellant
AND	**GEOFFREY COLIN STODDART** Collector of Revenue Management Respondent

Dates of Hearing: 25 and 26 June 2012

Counsel: Messrs P W David & I F Hikaka for Appellant
Mr M J Ruffin & Ms M Henry for Respondent

Date of Judgment: 3 August 2012

JUDGMENT OF HUGH WILLIAMS J

RESULT

A. In the result the question for determination in the Case Stated is answered as follows:

1. **The respondent was correct in assessing the appellant the amounts credited to the appellant by The Rarotongan in the sums of $250,000 in each of 2000 and 2001.**

2. **The respondent was correct in assessing the appellant an amount credited to the appellant by The Rarotongan in 2002, but the amount so credited to the appellant varies on the evidence between $187,500 and $200,000. The actual amount is to be resolved by counsel or, failing agreement, to be resolved by the**

Court on submissions from counsel to be filed within 28 days of delivery of this judgment.

B. None of the matters raised by the appellant in his Response to the Case Stated and his additional ground of Improper Conduct have been made out.

C. Costs are to be dealt with in accordance with para [137].

D. As a matter of caution, all other outstanding matters between the parties are reserved.

CASE STATED

[1] On 17 November 2005 the appellant, Mr Crocombe, filed his personal tax returns for each of the years ended 31 December 1999, 2000, 2001, 2002, 2003 and 2004. They were all signed on 10 November 2005. They all showed income received from Mr Crocombe's employment by his company, The Rarotongan Beach Resort & Spa Limited ('The Rarotongan'), and interest from the same source in the following amounts:

Year	Income	Interest
1999	$ 25,000.00	$ 13,775.00
2000	$ 47,350.00	$ 12,255.00
2001	$ 52,083.33	$ 22,431.33
2002	$ 54,166.67	$ 22,264.42
2003	$ 50,000.00	$ 5,049.25
2004	$ 50,000.00	Nil

[2] Each of the returns was on a standard RM.5 form and each included statements detailing the income and interest received and the tax payable. But the return for 1999 also included a sheet which became pivotal during the hearing of this case. It read:

The Rarotongan Beach Resort Limited
Notes to the Financial Statements
For the Year Ended 31 March 2003

14. Fundamental Error

Retained earnings at 1 April 2002 have been restated to correct a fundamental error in the calculation of the shareholders salary and interest on the shareholders current account.

The impact of this error relates to the following years:

	Shareholder Salary	Interest	Total
9 Months 31 March 2002	(150,000)	(62,368)	(212,368)
(FILED) Year ended – 30 June 2001	(200,000)	(12,929)	(212,969)
(FILED) Year ended – 30 June 2000	(200,000)	5,401	(194,599)
	(550,000)	(69,936)	(619,936)

[3] The "Fundamental Error" page arose - in the circumstances later detailed - from the crediting of money to Mr Crocombe's current account in the books of The Rarotongan.

[4] The defendant, the then Collector (or Treasurer) of the Revenue Management Division ('RMD') of the Ministry of Finance and Economic Management ('MFEM') declined to accept the figures in Mr Crocombe's personal tax returns and, on 31 March 2006, reassessed his taxable income for each of the years for which the returns were received and substantially increased the amount of tax said to be payable by Mr Crocombe. On each of the Notices of Assessment for the 2000 and 2001 years Mr Haigh, now the Treasurer of the RMD of the MFEM but then the officer charged with the management of Mr Crocombe's tax affairs, wrote in the "As assessed" column "includes Director's fees of $250K".

[5] Through the accountants then acting for The Rarotongan and Mr Crocombe, Ernst & Young, Mr Crocombe objected to the notices of assessment for each of the tax years 1999-2004.

[6] Ernst & Young's initial letter dated 17 May 2006 said the assessments were "based on the notional salary amounts included in the Financial Statements of The

Rarotongan... which is not correct." The letter continued that Mr Crocombe received no salary from The Rarotongan until 2003 but that,

> Prior to 2003, the auditors of RBRS at the time, PricewaterhouseCoopers, suggested that a notional salary of $250,000 per annum be put through the financial statements in order for the financial statements to show more realistic net profits. Accordingly, notional salaries were included in the financial statements of RBRS as follows even though Mr Crocombe was not in receipt of the same:
>
> | | **$** |
> |---|---|
> | Year ended 30 June 2000 | 250,000 |
> | Year ended 30 June 2001 | 250,000 |
> | Period ended 31 March 2002 (9 months only) | 200,000 |
> | | 700,000 |
>
> However, PricewaterhouseCoopers later decided that the above was fundamentally wrong and adjusted the opening retained earnings in the financial statements of RBRS for the year ended 31 March 2003 in respect of the notional salary included in prior years financial statements (refer enclosed copy of Note 14 to the financial statements) as follows:
>
> | | **$** |
> |---|---|
> | Total notional salary included in the financial statements to 31 March 2002 | 700,000 |
> | Less: Adjustment to retained earnings | (550,000) |
> | | 150,000 |
>
> Even though RBRS had claimed deductions for $700,000 in their respective tax returns for the years ended 30 June 2000 and 2001 and period ended 31 March 2002, the adjustment of $550,000 together with adjustments in respect of interest were offered for tax in the tax returns of RBRS and were in fact taxed as ordinary income.
>
> Accordingly, total deductions claimed by RBRS in respect of employment salary payable to Mr Crocombe for 2000 to 2002 taking into account the above adjustment amounted to a total of only $150,000.
>
> **2000 to 2002 Assessments**
>
> The total amount claimed by RBRS by way of salary for Mr Crocombe was returned by Mr Crocombe in his personal tax returns as follows:

Tax Return for the Year:	**$**
2000	43,750.00
2001	52,083.33
2002	54,166.67
	150,000.00

> From the above it will be apparent that the total amount returned for tax by Mr Crocombe balances with the total amount ($150,000) claimed by RBRS over the years 2000 to 2002.
>
> On the contrary, where Mr Crocombe is to be assessed for $500,000 as per your 2000 to 2002 assessments, RBRS is in fact being deprived of $350,000 (being $500,000 less $150,000) in deductions.
>
> Additionally Mr Crocombe is also being taxed on amounts that he did not and will not receive.
>
> In view of the above, we would be grateful if you would reconsider the assessments raised for 2000 to 2002 and issue amended assessments in due course to properly take up the correct amount of salary paid/payable to the taxpayer as reflected in the tax returns lodged.

[7] After making comments on later assessments of tax paid, Ernst & Young sought waiver of any penalties.

[8] By letter dated 26 July 2006 the Collector disallowed Mr Crocombe's objection "insofar as the 2000 and 2001 assessments are concerned" and continued:

> Briefly, some of the factors taken into consideration when reaching this decision were:
>
> 1. The original accounts in question were audited and signed off by the company director.
>
> 2. Signed tax returns were filed for the company reflecting the original allocations.
>
> 3. The "fundamental" error does not appear to be a genuine error but more an attempt by tax advisors and/or the director concerned to minimise Mr Crocombe's immediate tax liability.

> 4. Existing case law and established practice in this area does not suggest that retrospective reductions in director's fees in these circumstances should be entertained.
>
> Please note that the company was assessed as per the original tax returns filed, ie. a deduction for director's fees as originally claimed has been allowed to the company.
>
> Enclosed is your client's 2002 Notice of Assessment for income tax which includes $200,000 of director's fees also originally declared and paid to your client.

[9] Ernst & Young wrote to the Collector on 5 September 2006 objecting to a Notice of Assessment dated 20 July 2006 in respect of the year ended 31 December 2002 and largely repeating the submissions in their earlier letter.

[10] After further correspondence, Ernst & Young, on 23 October 2006, asked for Mr Crocombe's disallowed objection to be heard by this Court in accordance with the Income Tax Act 1997 (the 'Act').

[11] Section 35(3) of the Act requires the Collector to "state and sign a case setting forth the facts as alleged by the Collector, the nature of the assessment made, the ground of objection thereto and the question for the determination of the Court."

[12] On 25 September 2007 the Collector filed a Case Stated in this Court saying:

> For each of the years ended 30 June 2000 and 20 June 2001 [The Rarotongan] paid to the Appellant a Director's fee of $250,000 and for the nine months ended 31 March 2002 the Company paid to the Appellant a Director's fee of $200,000 by crediting the amounts to the Appellant's current account with the Company.

[13] The Case Stated went on to record the objection of 17 May 2006 on the basis that:

> ...the original financial statements submitted to the Respondent for assessment by the Company contained "notional salary" figures for the Appellant that were "fundamentally wrong" and the amounts attributed as paid by the Company to the Appellant should be reduced to the following:

Year	Amended amount
2000	43,750.00
2001	52,083.33
2002	54,166.67
	$150,000.00

[14] The Case Stated posed the question for determination as:

> Whether the Respondent was correct in assessing the Appellant the following amounts credited to the Appellant by the Company:
>
> $250,000 in 2000
> $250,000 in 2001
> $200,000 in 2002
>
> or whether the Respondent should have permitted the retrospective reduction of these amounts.

[15] Mr Crocombe's response to the Case Stated, dated 19 March 2009, said:

> 1. The crediting of the amounts set out in the Case Stated was the result of an error in the accounts of The Rarotongan.
>
> 2. The error was corrected by the auditors for the Resort and the erroneously credited amounts were reversed and the correct amounts (as set out in the Case Stated) were entered into the accounts.
>
> 3. The Collector erred in assessing the income of the Appellant as including the erroneously credited amounts.
>
> 4. The Collector's assessments are incorrect or should be amended to exclude the erroneously credited amounts.

[16] A further ground of alleged Improper Conduct on the part of the Collector was added to the Case Stated at the hearing. It is detailed later in this judgment.

FACTS

[17] Mr Crocombe is the sole director of The Rarotongan, a resort complex bought by him and his interests in late 1997. They bought it from the Cook Islands

Government which had been running it unsuccessfully up to that date incurring large and continuing losses.

[18] When Mr Crocombe bought the complex it was in a parlous state, both in terms of infrastructure and financially. The buildings had become decrepit, the staff were poorly trained, the administrative and IT systems were antiquated and, almost inevitably in those circumstances, patronage had been declining and the Cook Islands tourism industry was suffering as a result.

[19] Mr Crocombe and his interests bought The Rarotongan for $3,250,000, settled by way of a promissory note payable in a decade. The hotel was then valued at $6million – but only on the basis that $3million was spent in refurbishment.

[20] Repairing the complex, upgrading the administrative systems, training the staff and generally getting the resort back onto a sound financial footing with corresponding increases in patronage absorbed many hours and much input from Mr Crocombe. He said he was working 80 hours a week at times to get the resort to the point where it could reopen and then cater to the public with a reasonable chance of financial success.

[21] It appears this process took a number of years with all profits in the meantime reinvested in the company and with Mr Crocombe taking no more than a nominal salary for the time and effort he was contributing.

[22] Mr Crocombe engaged PriceWaterhouseCoopers (‘PWC’) to assist on the financial side. They acted for Mr Crocombe and his other interests. The day to day liaison was with the financial controller and onsite manager of the PWC team when they were on Rarotonga and that person was responsible for all major decisions relating to the accounting systems for the resort complex.

[23] After a number of years input in this fashion and with the resort now reopen to the public after its considerable refurbishment, infrastructure upgrade, staff training and the like, Mr Crocombe said that when he and PWC were preparing the

30 June 2000 financial statements, it appeared a successful turnaround of the business in the future could be accomplished but the PWC partner made an:

> "observation that a common mistake made by owner-operated businesses is that they do not pay themselves either at all or a commercially realistic remuneration, thereby overstating the true underlying sustainable profitability of the company. .... He suggested it would cost at a minimum $250,000 to pay for [my] services, which were necessary for the company's progression.
>
> We both agreed that given the parlous financial state of the company and the need for heavy reinvestment to keep the company afloat that paying such a sum to either myself or any other person/persons simply was not an option and that his point, while valid, was simply theoretical and a useful tool to be used in the evaluation of the true performance of the company due to the fact that this notional $250,000 simply did not exist in the company's finances and therefore could not be paid in reality.
>
> This was my clear understanding of the situation at the time – that I was not, and would not be, getting a salary. This was simply impossible. Further, I knew I was owed around $1million by the company."

[24] As a result of that discussion sums were credited to Mr Crocombe's shareholder's current account in The Rarotongan's books. It had shown a company liability to Mr Crocombe of $100,000.00 as at 30 June 1998 but this fell to $46,694 the following year. But, after that, the sums in the suggested "Fundamental Error" were credited to Mr Crocombe's current account and the balance owing to him rose to $295,507 in the accounts to 30 June 2000, to $561,736 for the year ended 30 June 2001 and to $806,744 in the 9 months to 31 March 2002. Thereafter, in the accounts to 31 March 2003, the amount shown in Mr Crocombe's current account fell to $38,377 because of the "fundamental error" adjustment earlier set out.

[25] In addition it should be noted that, in addition to the phrasing of the fundamental error in the accounts earlier recounted, a statement attached to the company's tax return to 31 March 2002 (not filed until 17 November 2005) said, under the heading "Fundamental Error":

> "The auditors have agreed that there has been a fundamental error in the accounts for the years ended 30 June 2000, 30 June 2001 and for the nine months ended 31 March 2002 as reflected in Note 14 to the audited Financial

> Statements for the year ended 31 March 2003. This relates to director's fees. The auditors corrected these amounts including the corresponding interest calculation in relation to the shareholder's current account. The effect of these corrections is to reduce the expense of the company in the relevant years."

[26] The first increase in Mr Crocombe's current account occurred in conjunction with an exchange of emails which assumed significant importance in the hearing of this case. It took place between 27 February 2001 – three days after Mr Crocombe signed the company accounts for the year to 30 June 2001 – and concluded on 13 March 2001.

[27] In the earliest email The Rarotongan's financial controller asked Mr Crocombe about the "final adjustment for your remuneration" and asked "would you like me to show this as management fees or would you prefer it to be shown as salary?" Mr Crocombe replied the same day saying that "I guess that if it is salary I need to pay PAYE and management fees it would be dealt with via the company" and asking whether there were other implications. That produced a response on 28 February 2001 saying that "any income whether classified as salary or 'fees' ultimately has to be declared for tax purposes", but with the financial controller caveating his comment by saying he was no expert on Cook Islands tax laws and suggesting he could "run it past whoever does your personal tax returns".

[28] On 1 March 2001, Mr Crocombe replied, but this time copying it to the PWC representatives with whom he worked, saying to them that "I have put through $250,000 as management fees or salary through the accounts but have not drawn this amount" and asking whether the most tax effective way to handle the payment was as salary or management fees. He said "if I do not draw the $250,000 will I have to pay tax on it? Would it be better to draw it and advance it to the company?"

[29] That produced a response from a PWC partner - though not until 13 March 2001 through some error - speaking generally of Mr Crocombe being taxable in the Cook Islands as a resident but also commenting on Crocombe & Company Limited's tax in New Zealand. The email said "we have not researched the Cook Islands tax regime in any detail" but went on to make some general comment.

[30] That position and the practice of crediting sums to Mr Crocombe's current account annually continued until some time after 27 August 2003 when Mr Crocombe was advised by RMD that his tax returns for the years from 1997 had not been filed. He said he thought PWC was attending to this and immediately contacted them. A slight delay occurred until he was able to discuss the situation with PWC. That occurred around October 2003 at which point he said "PWC examined the situation and realised that they had made a fundamental error in relation to the notional salaries", something they endeavoured to correct with the annotation to the company's 31 March 2003 accounts.

[31] He also complained to PWC at about the same time saying in an email:

> "I have been further appalled that no-one at PWC, with full access to my NZ and Cook Islands accounts never thought to say that it was pretty dumb to be crediting salary and interest, both of which would not be drawn, as this would create a tax liability which would have to be paid in cash. It would appear to me that this is the downside of having only young graduates working on our audit. The first time that one of the accountants at Dorchester Finance reviewed the accounts they said "this is pretty dumb, who advised you to do that??" And that was free advice, which, as luck would have it, was followed shortly thereafter by a letter from the Cook Islands IRD. As it stands your advice is that now I am going to have to pay the Cook Islands Inland Revenue hundreds of thousands of dollars when in reality I have not been paying myself other than living costs and every cent has been reinvested back into the business."

[32] PWC then resigned as the accountants to Mr Crocombe and The Rarotongan and KPMG were instructed. A partner of that firm and Mr Crocombe met Mr Haigh on 19 January 2004 to discuss, amongst other things, the "reasons for reclassifying some of the director's fees credited to the shareholder's account", a meeting which resulted in a letter to RMD from KPMG on 7 May 2004 saying that the "figure of $250,000 was inserted by his previous advisers for economic analysis and financing purposes only" and that it was "never intended that this figure would be in the final statutory accounts".

[33] That request was declined but was renewed by KPMG on 9 May 2005. The letter attached a copy of the "Fundamental Error" Note 14 to The Rarotongan's accounts to 31 March 2003.

[34] Mr Crocombe filed his tax returns for the years 1999-2002 together with another copy of the "Fundamental Error" Note, around 10 November 2005 but the Collector issued Notices of Assessment to him that declined to allow restatement of the company's accounts for the "fundamental error".

[35] Mr Crocombe and The Rarotongan then instructed Ernst & Young as their accountants and the chain of correspondence from 17 May 2006, earlier set out, occurred.

[36] In cross-examination Mr Crocombe was taken through the various sets of company accounts in evidence, his execution of them, the notes to the accounts and, of course, the increasing balance shown in the shareholder's current account but said that his "focus was on the fundamentals" and that he was not "really focussed on that sort of matter". He acknowledged it was "an oversight which obviously as the owner I have primary responsibility for".

[37] Of the February/March 2001 email chain Mr Crocombe, in cross-examination, said he was asking for advice of the PWC tax experts when he sent the email. He acknowledged the email discussions occurred after the company's accounts were signed. Asked how, in light of the emails, he could assert that a mistake or error had been made when he was asking advice about the most tax effective way to handle the credit, he said:

> "Well it's an error because when you look at it on its face, it's commercially stupid to declare income which you don't receive and then incur a tax liability for it, that's just insane, no-one in their right mind would do it if they were aware of it."

[38] He suggested he did not understand the full implication of his request and he was only asking for advice when he asked "Will I have to pay tax on it?" To the renewed suggestion it could not in the circumstances be an error or mistake, Mr Crocombe said:

> "Well in business we have what's called a '12 year old test'. If you ask a 12 year old if this made any sense, they would say this doesn't make any sense, so obviously, somewhere along the line, I've missed, they had not provided the implications otherwise all of us would've said this is brainless, let's not do it, because otherwise all I'm doing is paying tax on money I don't receive

> which has to be insane. You're looking at something without looking at the full context. This is not a matter that they have provided considered advice and I've taken under consideration and come to a considered decision. This is something where pieces of the puzzle were being put together, and the fundamental piece of the puzzle had not yet arrived. When it did arrive, everybody went 'oh my goodness'."

[39] When it was put to him that he had signed The Rarotongan's accounts containing the credit before seeking tax advice on the implications he said "it was a fundamental error which we made [and] corrected once we realised the implications". He did not take advice before signing the accounts "because the same accountant was doing the taxes, PWC, and I thought they had dealt with all those matters".

[40] It was put to him that he signed the audited Financial Statements as at 30 June 2000 on 23 February 2001 and the accounts attached to the company's tax return the following day but, when it was suggested he must have been aware the additional $250,000 was showing up as a credit to his current account, he disagreed and said neither he nor PWC considered the position and that "we made a mistake collectively".

[41] He said that the mistake was repeated for the following years and again for the 9 months ended 31 March 2002. The focus, he said, was on the company's struggle for survival.

[42] On 19 October 2003, just before Mr Crocombe wrote the email to PWC earlier set out, one of PWC's accountants emailed another fellow employee to say that she had sent Mr Crocombe an email on 15 October "asking if he wanted to change the accounts to reverse the 2003 management fee" but had had no answer, and that "it is not practicable to reverse the fees for prior years". Mr Crocombe said that his discussion with the PWC partner would have been shortly after that email and his own.

[43] Asked whether there were signed company minutes relating to the $250,000 credits, Mr Crocombe said The Rarotongan had no meetings other than on land

matters because he was the sole director and effectively the sole shareholder. Accordingly there were no signed director's resolutions on the topic.

[44] When denying that either $250,000 credit represented the intention between The Rarotongan and himself, Mr Crocombe again applied his "12 year old test". He said that the situation which he, his staff and PWC found themselves in was "professionally embarrassing" and resulted from the fact their focus was on possible commercial total loss on the investment.

[45] Mr Haigh's evidence-in-chief largely dealt with the details of the relative documents and, as they have elsewhere been described, no recounting is necessary. The cross-examination of Mr Haig centred on the suggested 'improper conduct' ground later discussed.

[46] By consent a brief of evidence was adduced from a Mr Pickering, a partner in Ernst & Young. It attached Fundamental Reporting Standard No.7 ('FRS7') of the NZ Institute of Chartered Accountants dealing with "fundamental errors". Mr Pickering's brief did not link FRS7 or his evidence to The Rarotongan's accounts or Mr Crocombe's tax returns.

<u>GROUND 1: SECTION 48 INCOME TAX ACT 1997 and FUNDAMENTAL ERROR</u>

Law and Submissions

[47] Consideration of what may be termed the "Fundamental Error" aspect of this case begins by focussing on s 48 of the Act which reads:

> 48. <u>Income credited in account or otherwise dealt with</u> - For the purposes of this Act every person shall be deemed to have derived income although it has not been actually paid to or received by that person, or has already become due or receivable, but has been credited in account or reinvested, or accumulated or capitalised or carried to any reserve, sinking or insurance fund or otherwise dealt with in the interest or on the [sic] behalf of that person.

[48] Mr Ruffin, leading counsel for the Collector, submitted s 48 precisely fitted Mr Crocombe's position. Whether described as salary or as director's or management fees was immaterial: they were sums credited to his current account with The Rarotongan. Even though they were not "actually paid to or received" by him they were "credited in account" to him or, as an alternative, 'dealt with in the interest or on the behalf' of Mr Crocombe. Section 48 therefore deemed him to have derived the income represented by those credits, income which was taxable.

[49] Mr Ruffin submitted that the real essence of Mr Crocombe's appeal was that he sought to reopen The Rarotongan's accounts for the years ending 30 June 2000 and 2001 and the 9 months ending 31 March 2002 claiming they were incorrect because of "fundamental error".

[50] He submitted that, in default of case law in the Cook Islands, the Court should rely on New Zealand authority as to when accounts may be reopened. The Court did not understand Mr David, leading counsel for Mr Crocombe, to differ from this approach.

[51] The major case cited by Mr Ruffin was *Heywood v Parfitt* (M406/90 HC CHCH 12 July 1991 Tipping J). That case concerned partnership accounts and a central point was whether they could be reopened. The Judge, after citing partnership authority, held (at pp16-17):

> The primary grounds upon which a settled account may be impeached, either wholly or in part, are for fraud and mistake: see Lindley at page 640; Halsbury volume 35 paragraph 144 and Webb & Webb; Principles of the Law of Partnership 4th edition (1987) at page 201. In Webb & Webb the matter is put this way:
>
>> "A final account will start from the last settled account, ie. in ordinary cases, on the footing that the last periodical balance sheet is correct, for the Court will never (unless for some proved fraud or error) disturb a settled account."
>
> There is rightly no suggestion of fraud in the present case and it really comes down to whether the accounts should be re-opened for manifest error. I consider that the Court should approach a point such as this along similar lines to a rectification issue. The onus is on the party seeking to disturb the

> account to demonstrate that the written account does not accurately reflect the antecedent common intention of the parties. As in a rectification case the proof must be clear and cogent. In addition of course the party seeking to re-open must not have acquiesced in the accounts.

[52] Then, after citing authority for reopening accounts prepared after an accountant had "made a manifest error which was likely to have led to another error', the Judge held (at 19):

> "It is in my judgment extremely important that Courts do not too easily upset settled accounts upon which parties have acted."

going on to state that, even if accounts before him were wrong, the party seeking reopening (at 19):

> "... had acquiesced in the accounts in circumstances where it would now be quite unfair and unreasonable for the accounts to be reopened."

Tipping J went on to note that (at 19):

> "Acquiescence is a species of estoppel and has a strong relationship with Laches."

[53] *Heywood v Parfitt* was followed in the New Zealand High Court in *Moir v Moir* (CIV 2004-409-002501 HC CHCH 22 May 2006, at paras [41]-[51]) where Fogarty J, (at [45]) stated:

> "It is not the signing of accounts that will make it a stated account but the person to whom it is sent keeping it without making any objection so that that person shall be bound by the same",

noting Mrs Parfitt would have been prevented from disputing the accuracy of the accounts because Mr Heywood "had quite reasonably proceeded on the basis that the accounts represented the correct position and worked long hours in the Hotel in reliance upon that" (at [46]). After finding contributions by both parties of the same amount the Judge said (at [47]):

> "...the necessary elements of settled accounts described by Romer J in *Anglo-American Asphalt Co v Crowley Russell and Co* [1945] 2 All ER 324 at 331 apply. He said:
>
>> Where A owes, or may owe, B money, and B owes, or may owe, A money, and in their accounts they strike a balance and agree that balance, that truly represents the financial result of their transactions. There is mutuality in it, and whereas A may be giving up something or B may be giving up something for the purpose of settling the matter between them, they expressly or by implication agree to a conventional position which is established by striking a balance, and that results in what is called a settled account."

Fogarty J then went on to hold that (at [51]):

> Is axiomatic that mere delay, of itself, is not enough to constitute either laches or acquiescence... but what I find here is delay, with prejudice to plaintiff, on the part of the second defendant, acting for himself and where appropriate for the first defendant trustees." [1]

[54] *Heywood v Parfitt* was also followed by Asher J in *Malcolm v Mulcock & McCready* (CIV 2008-404-2295 HC AKL 4 November 2008 at paras [21]-[25]) and by Wylie J in *Commissioner of Inland Revenue v Allen & Palmer* (CIV 2007-404-1944 HC AKL 16 December 2009 at [74]-[77]).

[55] With specific reference to s 48 Mr Ruffin relied on a line of New Zealand precedent dealing with the former ss 92 of the Land and Income Tax Act 1954 and 75 of the Income Tax Act 1976 which were identical to s 48.

[56] The earliest Taxation Review Authority case on which Mr Ruffin relied was *Case Q49* (TRA No's 93/67 and 93/68, decision 36/93, 28 June 1993, Judge Willy). The objectors in that case were shareholders in a company which was sold to an associated company at a capital gain, on paper, which was credited to a capital reserve in the balance sheet and distributed to shareholders. The transaction was recorded in company minutes. It resulted in current account credits equivalent to the distribution.

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[1] (An appeal was dismissed without reference to the authorities; *Moir v Moir* CA 119/06 [2007] NZCA 228, 7 June 2007.)

[57] The Judge said had he accepted the minutes and the contents of the accounts at face value then the objections must fail as being caught by, amongst other sections, s 75. But then, by reference to a number of precedent cases, the Judge held (at p4):

> "I am satisfied that the evidence discloses that the transaction involving the debiting of the capital account and crediting of the shareholders current account and loan accounts does give rise to a deemed dividend."

citing from _Campbell v Commissioner of Inland Revenue_ [1968] NZLR 1, 3, to the effect that (at p5):

> "Although there has been no payment of a sum of money to the donees there is in effect a distribution of a sum of money by debit of the sum to the profit and loss account of the company and corresponding credit to the loan account of the debtors."

and then, from _Case F40_ (1983) 6 NZTC 59, 762, 59, 764:

> "...The money credited to the account would be of an earnings nature from the company to its shareholders and the debits to the account were private expenses of that shareholder... Any credit therein which comprise salary or director's fees or payments of that type must be taxed to the third objector as an individual in the ordinary way."

[58] The Judge then continued (at 6-7):

> "Mr Collins for the Commissioner relies on some observations made by me in _Case Q6_ (1993) 15 NZTC 5047 as to the nature of a current account. I there said:
>
>> "[A shareholders current account] represents no more than monies advanced to the company or borrowed from it by that shareholder pursuant to whatever arrangements are in force between them at any given time. The account may comprise monies which are otherwise payable to the shareholder in the form of undistributed profits that the shareholder chooses not to take out, it may be in the form of wages or directors' fees or it may be in the form of advances to the company. How so ever, current accounts arise, they result in contractual relations between company and shareholder which relationship will be governed by expressed or implied terms as to payment and repayment."

> I remain of that view.
>
> It is clear, taking the minutes and accounts at face value that what occurred in this case was that the company resolved to remove monies from the capital reserve and credit to the current account and loan account respectively of the two shareholders of the company. The debit side of the transaction viewed from the point of the view of the company is evidenced in the balance sheet under the heading "Term Liabilities". It there shows that the advances made to the shareholders are treated as debts owing by the company to them, and are included along with the debt owed by the company to its mortgagee.
>
> If the matter ended there the payments to the shareholders would clearly in my view amount to a distribution which is within the definition of a dividend in s 4 of the Act."

[59] The Judge then turned to other issues raised on behalf of the objectors, particularly the evidence from their accountant, that (at 8):

> "He had no authority to make the book entries which he did and that if he had realised the taxation consequences of what he was doing he would never have done it."

quoting from the accountant's evidence that what had happened was (at 9):

> "A journal entry made in error which was subsequently reversed when this matter was first raised."

That evidence led the Judge to hold (at 16):

> <u>THE TRANSFER OF FUNDS MADE IN ERROR</u>
> Counsel next submits that on the evidence of the accountant it is clear that the transaction effected by him by entries in the accounts of the company was done in error, and that if he had realised the taxation consequences he would not have done what he did. I have no doubt that with the benefit of hindsight and perhaps a more accurate appreciation of the consequences of the transfer of the funds from the company to the shareholders all parties wish that the money had been left where it was in the capital account of the company. The fact is that as at the date for the filing of the 1989 return the money had been credited to the shareholders' accounts and became their property. It may be that it is open to the shareholders to later disavow that transaction, as they have purported to do, evidence [sic] by the 1992 accounts, but that cannot operate retrospectively. The accounts clearly show for the years relevant to these objections that the money was held to the

> account of the shareholders with the consequence for the reasons I have previously given, that it became as at that time a dividend in their hands, and taxable as such. They may now reverse that process, but cannot thereby escape liability for the tax which was in my view rightly assessed as at the relevant dates.

[60] In *Case U27* (TRA 97/119 and 97/120, decision 25/99, 17 November 1999) resolutions in a company's minute book prepared by its accountant recorded remuneration paid to shareholders by credit to their current account where the accountant was ignorant of an ongoing dispute between the company and the IRD. The resolutions were accepted by the accountant as having been prepared in error, in that the company was not profitable at the time, and its policy was that in those circumstances shareholder's salaries would not be paid. The accountant later corrected the resolutions. Relying on *Dunn v Commissioner of Inland Revenue* (1974) 1 NZTC 61, 245, the Judge in *Case U27* held the rectification of the error was effectual and allowed the objection.

[61] In *Dunn*, a taxpayer was required to pay maintenance plus outgoings on a former matrimonial home. He set up a trust, the income of which was to be used toward his obligations but was insufficient to meet the liability in full. The Commissioner added the trust income to the taxpayer's income as being deemed to be derived from the taxpayer by virtue of the then s 92 of the Land and Income Tax 1954. The Commissioner's decision was upheld.

[62] After citing s 92 and other authority, Cooke J held:

> "As for sec. 92(1), the subsection must be read as a whole. It is concerned with when a person is deemed to derive income. What the section is aimed at, I think, is the kind of situation where income which in the ordinary course would reach the taxpayer's hands is in some way diverted to other uses of benefit to him. The section postulates that income has not been actually paid to or received by him, not already become due or receivable. Hence he could say that he has not derived it. So a rule is laid down that he shall be deemed to have derived it when it has been dealt with in his interest or on his behalf in any of various ways, some of which are specified. All the ways specified involve diversion of income which would otherwise have flowed to the taxpayer."

[63] Mr Ruffin submitted, with extensive reference to the facts, that the money credited in the various tax years to Mr Crocombe's current account was clearly deemed income within the meaning of s 48 and was accordingly taxable in the years to which it related. He submitted the facts disclosed no fundamental error or mistake in The Rarotongan's accounts and that, in any event, Mr Crocombe had acquiesced in those accounts with the accounts subsequently being signed, audited and filed with the company's tax returns. He submitted that, at best for the appellant, The Rarotongan's accounts for the 9 months ended 31 March 2003 were the only accounts open to the reversal of the current account balance.

[64] For Mr Crocombe, Mr David submitted the assessments the subject of the appeal were incorrect because they assessed the appellant's liability for tax by reference to company accounts which contained a fundamental error concerning the credits in the current account. Once discovered, the fundamental error was correctly reversed by applying appropriate standards. Thus the Collector's assessments were wrong and based on the appellant's receipt of money never actually received by him.

[65] He submitted that if audited company accounts show salary or fees as having been credited to a taxpayer's current account but auditors subsequently adjust the accounts by retrospectively reversing the amounts and the adjustment is made because no amount should have been credited because of a fundamental error, any assessment by the Collector should be reversed as the "individual taxpayer was never entitled to the amounts so credited and could never receive any benefit from it."

[66] Referring extensively to the facts of the case and also relying on the authorities cited by Mr Ruffin, Mr David submitted *Case C20* could be distinguished as none of the amounts credited were ever reversed and withdrawals were made. There was accordingly no error in crediting the accounts. *Case Q49* was also distinguishable in that there was no suggestion the correction of the error was made from the company's perspective. He said the mistake in this case was in crediting Mr Crocombe's nominal salary to an account when there was no intention of making that credit, still less payment. This was a mistake from The Rarotongan's perspective, he submitted, and emails concerning the journal entries were inconclusive and ambiguous. Mr David submitted the real mistake was that when

the accounts were prepared they wrongly stated an obligation of the company to pay Mr Crocombe money. That was a fundamental error on the part of the accountant satisfying FRS7 and other relevant standards and, he submitted, that if the Collector was going to assess Mr Crocombe's position by reference to the company accounts he must use accounts that properly reflected the company's position.

[67] With reference to FRS7 and New Zealand Standard Practice Statements, Mr David submitted the assessments for Mr Crocombe's tax were incorrect as they were made after the accounts had been corrected. He submitted PWC must have considered FRS7 in giving the company's accounts an untagged audit certificate that a fundamental error had occurred with the fundamental error being perpetuated by the Commissioner who assessed the appellant "as having received income he did not receive and was not entitled to receive". In any event, he submitted The Rarotongan's accounts were prepared for it, not for Mr Crocombe.

[68] Mr David further submitted that when accepted accounting practice was considered the notional salaries were not "credited in account" to Mr Crocombe within the meaning of s 48 because of the restatement following the suggested fundamental error. The appellant "did not have any entitlement to those monies because of the recognition of a fundament error... [and] he also had no entitlement to receive such money given the restatement of the company accounts".

<u>Discussion and decision on s 48 and "Fundamental Error"</u>

[69] According to Mr Crocombe's unchallenged evidence, when he and his interests bought The Rarotongan Resort, it was seriously rundown in every way. Years of mounting losses meant buildings and infrastructure were decrepit, systems were outdated, staff lacked training and, as a consequence, patronage was declining. The Cook Islands Government was only able to obtain a sale by deferring payment of the purchase price for a decade, and although the purchase price was only about half the complex's valuation at $6million at the time, that valuation was predicated on $3million being spent to upgrade the premises and facilities.

[70] Mr Crocombe's evidence was that very considerable effort on his part was required to turn the business around, repair the buildings and infrastructure, train the staff, revamp the systems and enable the business to survive and its patronage to improve. The effort required many hours of Mr Crocombe's personal involvement for years after the purchase.

[71] The Collector did not challenge Mr Crocombe's description of any of that.

[72] One of the terms on which The Rarotongan was bought, improved and managed was that the company accounts should be audited. This was a sound requirement given the sale involved $3,250,000 of public money and survival of the complex and thus payment of the money could not, at least in the early years, have been assured.

[73] Mr Crocombe said his accountants at the time PWC, advised him to include a salary, however nominal, in the company accounts for his personal efforts even if the salary could not be paid. This, too, would seem to have been standard, prudent, advice. The Rarotongan's audited accounts would not, in terms of the auditor's reports forming part of them, be "free from material mis-statements" and give a "true and fair view of the financial position of the company" unless they contained a quantified allowance for the amount of time and effort required of management to produce the financial result the accounts showed.

[74] It was immaterial whether the sum credited to Mr Crocombe's current account was shown as management fees, director's fees or drawings. What the accounts were required to show, in order to provide a true and fair picture of the financial position of the company, was a realistic assessment and quantification of the management time and input required to achieve the financial position the accounts reflected. That was so even if actual payment could not have been made or payment might have adversely affected the company's bank or other financial positions.

[75] Quantifying the director's efforts was also important and appropriate for a number of other reasons. They included:

a) the Cook Islands government was entitled to audited accounts for The Rarotongan which were accurate in their depiction of the company's overall financial position.

b) had another buyer emerged for The Rarotongan or a takeover offer been made and due diligence insisted on, Mr Crocombe would have wanted to ensure both that the accounts were accurate and showed his entitlement to be recompensed for his effort. The accounts would otherwise have been misleading or be understated.

c) Mr Crocombe's evidence made clear that the very difficult financial circumstances surrounding the resort and the company, particularly in the first few years, must have made The Rarotongan's survival at times a matter of doubt. The company may therefore have chosen to go into liquidation or a creditor might have placed it in liquidation during that period. (There was a suggestion the appointment of a receiver by a creditor had been attempted.) Had any of that occurred, as Mr David was constrained to acknowledge in argument, Mr Crocombe would have wanted to be entitled to prove for the debt the company owed him, and would have been naturally concerned to ensure the debt owing to him, as reflected in his current account, adequately recompensed him for the very considerable time, effort and money he had contributed to the company.

[76] It may be the case that the question of shareholder's correct remuneration was not addressed in the first year or two after purchase with so many other matters calling for attention, but by the time of the first company accounts put in evidence, those as at 30 June 1998, the shareholder's current account was then at $100,000 and generally increased annually thereafter until 2003. The amounts were a reduction of $533,306 to $46,694 as at 30 June 1999, an increase of $248,813 to $295,507 (30 June 2000), an increase of $266,229 to $561,736 (30 June 2001), an increase of $245,008 to $806,744 (9 months to 31 March 2002), and then the reductions for the suggested "fundamental error" in the year to 31 March 2003 by the adjustments of shareholder's salaries, $200,000 (30 June 2000) $200,000 (30 June 2001) and

$150,000 (9 months to 31 March 2002) (and consequential reductions for interest) which is at the heart of this part of this case.

[77] Alongside that evidence of the shifting balance in Mr Crocombe's current account are the fact that he signed the 30 June 1998 accounts on 1 June 1999, the 30 June 1999 accounts on 11 October 1999, the 30 June 2000 accounts on 24 February 2001, the 30 June 2001 accounts on 24 September 2001, the 31 March 2002 accounts on 12 June 2003, and the 31 March 2003 accounts on 28 January 2004.

[78] Though it appeared the company accounts put in evidence were incomplete for some years, no doubt they all followed the standard format for such documents and were in accordance with relative statutory and regulatory requirements. The audit reports which were in evidence made clear it was the director's responsibility to ensure the preparation and presentation of the accounts gave a "true and fair view of the financial position of the company" as at balance date and Mr Crocombe's execution of the accounts and, ultimately, their submission to the Collector as part of the company's tax returns amounted to an assurance of the accounts' correctness in showing the financial position of the company. In addition the accounts would have been sent, following audit, to the Cook Islands Government and, because of the company's indebtedness, presumably also been copied to The Rarotongan's creditors and bankers. The recipients of the company's accounts year on year would have been entitled to rely on them and Mr Crocombe's execution of them to show the true position of the company's finances.

[79] Of pivotal importance to this aspect of the case is the email chain earlier recounted running between 27 February 2001, three days after the 30 June 2000 accounts were signed, and 13 March 2001.

[80] What that email exchange shows is:

a) that although the 30 June 2000 accounts had been signed a few days beforehand Mr Crocombe, his internal accountants and PWC were still discussing the appropriate amount to be included in the accounts for Mr Crocombe's remuneration.

b) that possible taxation implications were uppermost in the minds of those involved in the exchange. That particularly applies to Mr Crocombe's email of 27 February 2001 at 6.56 pm when he discussed whether the tax on those payments would be for him personally or to be "dealt with via the company".

c) that he was advised on 28 February 2001 at 7.16 am by his internal accountant that any income had to be declared for declared for tax purposes but the sender was not a tax expert.

d) that it was Mr Crocobome who said, probably on 1 March 2001 at 5.38 pm, that "I had put through $250,000 as management fees or salary". That email shows it was Mr Crocombe who made that decision as director and he who took the necessary action and that he did so without fully knowing the tax implications of his move because he asked to be advised of the "most tax effective way to handle this". The credit to his current account and the consequent journal debit in the company's accounts had already taken place by that time; it had been "put through".

e) Mr Crocombe received some taxation advice from PWC on 13 March 2001, but it was clearly tentative and not definitive as to the tax consequences of Mr Crocombe's action.

f) for completeness, it needs to be noted that Mr Crocombe's action in relation to credits to his current account as at 30 June 2000 was repeated for the 2001 and 2002 accounts, again without evidence he sought advice as to the taxation consequences before taking the action.

g) there can be little doubt that when Mr Crocombe said on 1 March 2001 that he had "put through $250,000 as management fees or salary through the accounts" that must mean that his actions were already reflected in the company's accounts to 30 June 2000. The almost exact correspondence between Mr Crocombe's mention of $250,000 and the $248,513 increase in his current account in the account makes that plain as does the $250,000 "increase in the shareholders current account" in the reconciliation statement and the description in Note 5 to the Financial Statements.

[81] Although Mr Crocombe may not have held formal board meetings or executed formal board minutes or resolutions for The Rarotongan – understandable enough in circumstances where he was the sole director – his execution of the company's accounts coupled with the statement of his director's responsibilities and the reliance placed by the auditors on him as director in reporting to the Cook Islands Government makes clear that the company's accounts should be regarded as a settled account as that matter is discussed in the cases earlier traversed. That conclusion is also supported by The Rarotongan, though some years late, filing the salient parts of its annual accounts as part of its Tax Returns.

[82] It was submitted on Mr Crocombe's behalf that the company accounts reflected the position from its perspective, not the perspective of Mr Crocombe and that because he did not, and could not, draw the sums shown in his current account, s 48 was inapplicable to his circumstances.

[83] In the Court's view, that cannot be the case. The entries Mr Crocombe caused to be made in his shareholder's current account with The Rarotongan were an acknowledgement, which he arranged and the implementation of which he directed, that the company owed him the sum of money shown in the accounts. They were also an acknowledgement by him as shareholder that he was owed that sum. While the company accounts were, of course, prepared from the company's perspective, Mr Crocombe's sole directorship and, being, effectively, the company's sole shareholder, means the accounts were evidence, irrefutable once signed unless

meeting the criteria for re-opening, of the respective indebtedness and entitlement of the company and Mr Crocombe respectively.

[84] To this point, therefore, the only conclusion open is that, even though Mr Crocombe was not actually paid or did not actually receive the sums shown as owing to him by the company in his shareholder's current account, the sums were receivable – even if only capable of being paid by the company with some difficulty – and, having been credited to the account, meant Mr Crocombe was deemed to have derived those sums as income in the terms of s 48.

[85] In terms of *Heywood* the three sets of the The Rarotongan accounts in contention in this case were all settled or stated accounts as defined by the authorities. Until around October 2003 at the earliest, neither The Rarotongan or Mr Crocombe made any objection to the way in which the accounts were cast (*Moir*) because they showed an agreed balance (*Anglo Amercian Asphalt Co*). The observation made by NZ judges concerning current accounts in company financial statements are directly relevant to positions of The Rarotongan and Mr Crocombe and the credits must therefore be taxable (*Case F40*). Alternatively, rather than being paid to Mr Crocombe, the sums were "diverted to other uses of benefit to him" by being shown as debts payable to him from the company's books (*Dunn*).

[86] Section 48 accordingly applies to the amounts credited to Mr Crocombe's current account, unless The Rarotongan accounts can, as a matter of law, be reopened for the "fundamental error".

[87] The account as between Mr Crocombe and the company having been settled by his execution of the company's audited accounts (and by outside agencies no doubt relying on their accuracy) and there being no question of fraud, in accordance with *Heywood* and the other cases earlier discussed, the question is whether it was possible as a matter of law, for the settled accounts to be reopened for mistake.

[88] In that regard, both the cases and s 31 of the Act make clear the onus is on Mr Crocombe to demonstrate by cogent proof that the written accounts do not accurately reflect the antecedent intention of the parties.

[89] As noted in <u>*Dunn*</u>, the crediting of the funds in the company's accounts to Mr Crocombe's current account involved diversion of the income of the company which would otherwise have flowed to it, and which he was entitled to have flow to him in due course.

[90] Although the sums credited to the current account were created by journal entry, there was an effect on the general company position which would have been important in any of the scenarios discussed in paragraph [75]. Given that (part at least) of the company's accounts were filed with The Rarotongan's Tax Returns, though not until 2005, the company's taxation position would also have been affected by the putting through of the sums credited the current account.

[91] The necessity for Mr Crocombe to prove that the company accounts did not reflect the mutual intention of the parties also brings FRS7 into consideration.

[92] The first point to be noted is that Mr Ruffin accepted the New Zealand standards applied in the Cook Islands as they are apparently the standards local accountants apply.

[93] Mr Ruffin took the point first that Mr Crocombe had failed to demonstrate that the amounts shown in the shareholder's current accounts of The Rarotongan were in error.

[94] In the Court's view, there is considerable force in Mr Ruffin's submission in that regard. The evidenced reviewed shows Mr Crocombe's decision to "put through" the sums was a deliberate one taken by him when he was alive to the possibility there may have been taxation consequences for him personally but which he decided to effect without awaiting tax advice from PWC or his internal accountants. The practice was continued in subsequent years until the 2003 accounts were prepared which purported to restate what had occurred in 2000-2002, but not until October 2003 at the earliest.

[95] A deliberate decision, effected without awaiting advice and repeated in subsequent years, cannot amount to a fundamental error. The crediting of the various

sums to Mr Crocombe's current acc was a standard, prudent action to ensure the financial position between them was correctly stated. The making of the credits were accordingly not an error; what was an error was that the credits were made without fully understanding that, as a matter of law, the making of the credits would trigger s 48's operation. That is not an error in the accounts but a failure to gain a full understanding of the consequences of deliberate action before taking it.

[96] The Court's finding is, therefore, that there was no error in the way in which Mr Crocombe's current account with The Rarotongan was dealt with in the years in question.

[97] True, had Mr Crocombe known of the impact of s 48 which flowed from his actions on his own and the company's behalf, he would not have done what he did. His test given in evidence was whether a 12 year old would have done what he did, the answer to which was obviously "no".

[98] But the answers to that are first, that Mr Crocombe's ignorance of the law provides him with no excuse and, secondly, that the evidence shows he took certain deliberate actions when alive to their possibly having taxation consequences but did not await advice on them.

[99] The Court accordingly finds that there was no error, fundamental or otherwise, in the way in which Mr Crocombe managed the company's and his own affairs in relation to the credits in his shareholder's current account for the years in question.

[100] In light of that, there is, strictly, no need to consider FRS7 but, in case this matter comes for reconsideration, the Court deals with the point as briefly as possible.

[101] FRS7 covers both "extraordinary items" and "fundamental errors" and says (paragraph 3.1) that the standard's purpose is:

> "To establish criteria for the identification and disclosure of extraordinary items and fundamental errors so that users of the financial report are

> provided with information which is necessary for an understanding of the results of the entity for a period."

[102] Paragraph 4.2 of FRS7 defines "fundamental error" by saying:

> "An error is considered to be fundamental where it is so significant that it destroys the fair presentation of the financial report taken as a whole"

and goes on to suggest that (paragraph 4.3) errors in financial reports result from:

> "Mathematical mistakes, mistakes in the application of generally accepted accounting practice, or oversight or misuse of facts that existed at the time the financial statements were prepared."

[103] Paragraph 5.16 says:

> "The after-tax effects of fundamental errors shall be accounted for by adjusting the opening balance of equity and, where practicable, restating the comparative figures for the previous period. In a historical summary, the amounts relating to prior periods shall be restated where practicable and the fact of their restatement disclosed."

[104] Corrections of fundamental errors are dealt with in paragraph 5.20 which reads:

> "In exceptional circumstances a financial report may have been issued containing an error which is of such significance as to destroy its fair presentation. That financial report would have been withdrawn had the error been recognised at the time. The correction of such a fundamental error is to be accounted for, not by inclusion in the statement of financial performance of the current period, but by restating the prior period(s) with the result that the opening balance of retained earnings would be adjusted accordingly."

[105] In this case, there are at least two versions of the fundamental error in evidence. One said it related to director's fees, which was corrected by including it and interest in relation to the shareholder's current account as set out in the quoted table. The other said it resulted from a fundamental error in the calculation of the shareholder's salary and interest on the current account. There was also the suggestion it was "... inserted for economic analysis and financing purposes only".

[106] The first thing to be noted is that Mr Crocombe called no expert evidence which suggested that any error in relation to his current account with the company was “so significant that it destroys the fair presentation of the financial report taken as a whole”. Although Mr Pickering attached FRS7 to his brief of evidence, he nowhere dealt with The Rarotongan’s accounts and nowhere said the suggested error was of such significance that it met the test for “fundamental error”.

[107] The onus being on Mr Crocombe, the conclusion must therefore be that he has not proved that The Rarotongan’s accounts for the 2000-2002 periods were affected by a fundamental error such that their fair presentation of the company’s position was destroyed in terms FRS7.

[108] Indeed, if anything, the contrary has been proved because the crediting of the sums to Mr Crocombe’s current account provided users of the report with “information which is necessary for an understanding of the results of the entity for a period”.

[109] Secondly, even had Mr Pickering offered that opinion, counsel agreed that whether or not The Rarotongan’s accounts for the years in question was affected by what amounted to a “fundamental error” could not be definitively stated by an accountant offering an opinion in relation to FRS7. It was agreed the question was a matter for the Court.

[110] Thirdly, applying that test, the conclusion must be that a journal entry within the general ledger resulting in a restatement of the one line in the company’s accounts affecting the amount it acknowledges it owes its shareholder is not shown to be of such significance to the company’s financial report taken as a whole that it destroys the fair presentation of the report.

[111] It certainly affected the company’s financial position overall and, plainly, affected Mr Crocombe’s position, but in an enterprise of the scale of The Rarotongan and given that the additional sums shown in the current account were shown to be payable but were not meant to be paid, it could not be said that, even if there was an

error in the preparation of the company accounts as it related to the current account, it destroyed the "fair presentation of the financial report taken as a whole".

[112] A further point in that regard is to repeat that there was no error in the "putting through" of the additional amounts credited to Mr Crocombe as far as the company was concerned. The error was that Mr Crocombe was unaware, when he "put through" the sums mentioned, that his actions would result in additional taxation being payable by him personally under s 48. That may affect him personally but, as far as The Rarotongan's accounts are concerned, that is not an error under FRS7 which destroys the fair presentation of the company's accounts seen as a whole.

[113] Then it is to be noted is that it appears that it was only about late October 2003 when PWC was auditing The Rarotongan's accounts for the 9 months ending 31 March 2003 that Mr Crocombe became aware of the impact of s 48 on the sums he had arranged to be credited to his current accounts in the 2000-20002 accounting periods. It was only then that the readjustment was endeavoured to be undertaken by a Note to the company's 31 March 2003 accounts, signed by Mr Crocombe on 28 January 2004, which contained details of the suggested "fundamental error" and reduced his current account.

[114] While it may have been open, as between The Rarotongan and Mr Crocombe, to reverse the previous practice of crediting amounts to the latter's current account for the period ending 31 March 2003, the PWC accountants were correct in saying that it was not "practicable" to apply that readjustment to the 2000-2002 financial periods as these were the subject of a settled account. As they said - and FRS7 says - it was simply not open to The Rarotongan and Mr Crocombe to attempt, in around October 2003–January 2004, to recast accounts signed on 24 February 2001, 24 September 2001, and 12 June 2003.

[115] For completeness, the Court notes that the New Zealand Commissioner of Inland Revenue issued a standard practice statement – Mr David submitted in response to *Case U27* – on 5 May 2005 dealing with "retrospective adjustments to salaries paid to shareholder/employees". That statement required requests for

reconsideration of incorrect treatment of receipts or omissions of expenditure to be made in a timely fashion “when in the course of events and in the circumstances of the taxpayer company, one would have expected [the mistake] to have been discovered.” The New Zealand IRD said that demonstration of the “genuine error” was crucial to accepting an application for readjustment and that “shareholder-employee salaries are generally irrevocable, unless a genuine error has been made”.

[116] In this case, for the reasons already set out, the Court’s conclusion is that, irrespective of the categorisation of the credits of Mr Crocombe’s current account, no genuine error was made in the entries in The Rarotongan’s accounts, and, when the taxation impact of the credits became known, the attempted rectification was too late.

Acquiescence

[117] Because the Collector relied on it, it is necessary to deal with the suggestion that Mr Crocombe cannot succeed on this ground of the Case Stated because of his acquiescence. The point can be dealt with briefly.

[118] The authorities cited show the onus is on Mr Crocombe to show that it would be unfair and unreasonable for The Rarotongan’s accounts not to be reopened. Prejudice to persons relying on the accounts must be shown.

[119] Here, as has already been observed, the credit to Mr Crocombe’s current account in The Rarotongan accounts for the year to 30 June 2001 and its repetition in the two succeeding years went unchallenged – even unremarked – until October 2003 at the earliest, a period of up to 32 months. During that time, as the Court has observed, it is likely the Cook Islands Government and others relied on the audit accounts for the years in question. Further, had The Rarotongan filed its tax returns in accordance with the statutory timetable, the Collector would also have relied on the accounts being correct. All would be prejudiced by a reopening of the accounts at this juncture, around 10 years in the past. The Rarotongan itself may be prejudiced, given that any readjustment of the Annual Accounts in question may affect its own taxation and other affairs. Finally, when the crediting of the sums to

Mr Crocombe's current accounts has been held to be, at its highest in his favour, an error in his not awaiting taxation advice, it would be, in the Courts view, both unfair and unreasonable for the company's accounts to be reopened.

[120] Therefore, had it been necessary to reach a conclusion on this point, the Court would have held Mr Crocombe was debarred by acquiescence from having The Rarotongan's accounts for the 2000-2003 years reopened.

GROUND 2 : IMPROPER CONDUCT BY COLLECTOR?

[121] As a result of further discovery in the days leading up to the hearing, Mr Crocombe found that the Collector's file relating to this case disclosed it had been referred by the Collector at some stage to a Mr Clarke, a Cook Islands tax lawyer, for advice. Mr Crocombe became extremely concerned at this because, he said, Mr Clarke, whilst a lawyer, had not been in public practice for many years and was a business competitor of Mr Crocombe and The Rarotongan, not always on a fraternal basis.

[122] As a result, at the hearing, Mr Crocombe added a ground to his Case Stated to the effect that the Collector's actions concerning Mr Crocombe's tax position had been improperly conducted.

[123] Although the new ground was raised only in the last few days before the hearing and was not articulated by Mr Crocombe in any clear way, Mr Ruffin did not object to the suggestion of improper conduct being added to the Case Stated, but refuted that any improper conduct by the Collector had occurred.

[124] The material on which Mr Crocombe relied was:

(a) a memorandum by Mr Stoddart dated 29 July 2006 discussing Mr Crocombe's current account balances and the "fundamental error" as asserted by the accountants which has a handwritten note in the corner - partly cut off - which appears as though it may read "Files are with T Clarke".

(b) a file note of Mr Stoddart dated 15 December 2006 recording a meeting with Messrs Crocombe, David and Hikaka concerning Mr Crocombe's tax position which bears the note "??? Trevor Clarke – answer please?" and the handwritten addition - author unknown - "Yes".

(c) a draft letter from Mr Stoddart to Mr David dated 19 December 2006 with a handwritten note "Don't send this - per TC".

(d) a chronology relating to this matter prepared by the Collector which contains an entry dated 29 February 2008 relating to a letter to Mr Clarke "asking him to draft submissions; enquiring as to his availability to represent the Collector" and enclosing a number of financial documents relating to this dispute. A copy of the letter was produced at the hearing which largely confirmed the accuracy of the file note.

(e) a letter to Mr Clarke from MFEM dated 4 April 2008 enclosing, amongst other things, Mr Crocombe's file and asking Mr Clarke to discuss matters with Auckland counsel to secure representation for the Collector.

[125] Mr Crocombe had also obtained a copy of a Cook Islands Audit Office report dated 29 July 2011 concerning an arrangement apparently reached between Cook Islands Customs and Mr Clarke's company, Cook Islands Trading Corporation, concerning customs duty paid over a number of years on imported soft drinks. The report was, on its face, critical of Mr Stoddart, as former treasurer and manager of Customs, and Cook Islands Trading Corporation.

[126] When Mr Crocombe raised his concerns with the Collector, the response was that Mr Clarke's legal advice concerning this matter was privileged. Mr Crocombe continued to express concerns and said in evidence at this hearing that:

> "I am extremely concerned that the Collector has been providing my commercially sensitive financial and tax information to a direct competitor

> and supplier. I am even more concerned that the Collector has been seeking advice from a direct competitor and supplier on how to deal with my tax situation. This seems to me to be completely improper."

[127] Neither Mr Stoddart nor Mr Clarke gave evidence at this hearing. Indeed, there was no suggestion the issues raised by the appellant had been referred to either in the time available.

[128] In relation to the availability to Mr Crocombe of the ground of abuse of power, both counsel referred to the decision of the New Zealand Supreme Court in Tannadyce Investments Ltd v Commissioner of Inland Revenue [2012] 2 NZLR 153. In that case one of the issues was whether judicial review was available to challenge the correctness of tax assessments when the taxpayer had not invoked the statutory objection procedure. Elias CJ and McGrath J (dissenting) held (at 162-3 paras [11]-[12], [14]):

> **[11]** In a series of judgments, the meaning of the provisions limiting the availability of judicial review under the 1976 Act, in favour of the statutory objection and appeal process, came under close examination from the Court of Appeal. In Commissioner of Inland Revenue v Canterbury Frozen Meat Co Ltd [1994] 2 NZLR 681 (CA), the Court of Appeal, in applying ss 26 and 27, drew a distinction between challenging the correctness of an assessment of tax and challenging the process of the Commissioner in making it, along with the character of the resulting assessment decision. The exclusionary provisions applied to the former and precluded judicial review, but on their true meaning they did not apply to the latter. The Court held that the legitimacy of the process, and whether or not the character of the decision was in the nature of an assessment as envisaged by the legislation, could be attacked in judicial review proceedings on administrative law grounds provided that there was a sufficient evidential foundation (at 688). The Court also held that whether the particular "assessment" decision under challenge was so tentative and provisional that it was not an assessment for the purposes of the Act could be addressed in judicial review. The Court accordingly refused to strike out the judicial review proceedings brought against the Commissioner by the taxpayer.
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> **[12]** Subsequently, in Golden Bay Cement Co Ltd v Commissioner of Inland Revenue [1996] 2 NZLR 665 (CA), the Court of Appeal held that the Court's powers, on hearing an objection, to "confirm or cancel or vary" (under s 33(11)(a) of the 1976 Act) the assessment covered every situation in which an assessment was challenged. It

> followed that challenges to the *validity* of an assessment of tax, as well as to its correctness, could be determined under the statutory procedure (at 671-672, applying *Harley Development Inc v Commissioner of Inland Revenue* [1996] 1 WLR 727 (PC)). Importantly, the Court added that it would only be in exceptional cases, typically involving an abuse of power, that the Court would entertain an application by a taxpayer who had chosen not to appeal under the statutory procedure for judicial review of a decision (at 672). The Court of Appeal has also recognised that in objection proceedings the Taxation Review Authority's examination of the correctness of an assessment in objection proceedings could correct defects in the Commissioner's process in making an assessment; *Dandelion Investments Ltd v Commissioner of Inland Revenue* [2003] 1 NZLR 600 (CA) at [50]-[64].
>
> ...
>
> **[14]** To similar effect, in *Miller v Commissioner of Inland Revenue* [2001] 3 NZLR 316 (PC), the Privy Council said that despite the broad language of the exclusionary section, judicial review was not precluded if proper grounds were made out relating to the legitimacy of the process adopted by the Commissioner and the validity of the outcome. As well, in some circumstances the making of an assessment, whether correct or not, might be an abuse of power (at [14]). The Privy Council also said that:
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>> It will only be in exceptional cases that judicial review should be granted where the challenges can be addressed in the statutory objection procedure. Such exceptional circumstances may arise most typically where there is abuse of power; *Harley Developments Inc v Commissioner of Inland Revenue* at 736. But they have also been held to arise where the error of law claimed is fatal to the exercise of statutory power and where it would be wasteful to require recourse to the objection procedure: *Golden Bay Cement Co Ltd v Commissioner of Inland Revenue* at 671.

[129] The judgment of the majority of Blanchard Tipping and Gault JJ held (at 175-6 paras [58]-[59]):

> **[58]** But despite the comprehensive scope of the challenge procedure and the powers of hearing authorities, it is necessary to recognise the possibility that there may be rare cases in which it is not practically possible for a taxpayer to challenge an assessment under Part 8A. Indeed Tannandyce claims that the present is such a case. If that is so, proceedings for judicial review cannot be regarded as precluded

> by s 109 because the premise on which that section is framed, namely the ability of hearing authorities to consider any challenge, on whatever ground, is not present.
>
> **[59]** We should add, for completeness, that judicial review will also be available when what is in issue is not the legality, correctness or validity of an assessment but some suggested flaw in the statutory process that needs to be addressed outside the statutory regime, because it is not provided for within it. An example might be the case of a well-founded concern that a particular Taxation Review Authority should, for whatever reason, be restrained from considering a challenge; for example because of alleged bias on the part of the Authority. In such a case it would not be the disputable decision that was being disputed in a court but rather the legality of the process by which the challenge to that decision is to be determined under Part 8A. This is a different matter from a challenge to the legality of the process which led up to the making of the disputable decision. That process and any challenge to it directly puts in issue the disputable decision. Hence the challenge to that decision or its antecedents must follow the statutory procedure.

[130] Mr David submitted an inference was available that Mr Clarke had been given information and advice concerning the tax position of Mr Crocombe and The Rarotongan in circumstances where it was improper of the Collector to seek that advice and improper of Mr Clarke to accept the instructions and act on them.

[131] Mr Ruffin's response was that there was no evidence of Mr Clarke's involvement in the tax affairs of The Rarotongan or Mr Crocombe, before 31 March 2006 the date of the assessments at the heart of the case and the basis for the Case Stated nor before the objection was first notified on 17 May 2006.

[132] This point requires no extensive discussion. In early-mid 2006, were Mr Clarke's business interests in such competition with Mr Crocombe and his business interests that Mr Clarke could not have been regarded as giving the Collector impartial taxation advice – as to which there is little proof – and were Mr Stoddart aware of the suggested rivalry and commercial competition between Messrs Crocombe and Clarke at the time – as to which there is also little proof – then an argument may have been open that Mr Stoddart should not have offered Mr Clarke the brief and Mr Clarke should arguably have declined it. But, as mentioned, there is scant evidence and little proof of any of that.

[133] On the other hand, there was said to be nothing unusual in the Collector seeking taxation advice from Mr Clarke – Mr Haigh said he was the only tax lawyer in the Cook Islands and was frequently consulted by the Collector – and both Messrs Stoddart and Clarke would have been aware of the secrecy and confidentiality provisions of s 7 of the Act. In addition, as a lawyer of lengthy experience, Mr Clarke would have been similarly aware of the confidentiality requirements of solicitor-client communications and the privilege that attaches to them.

[134] Seen in that light, there is no proved basis for Mr Crocombe's inference that he or his commercial interests were likely to be damaged by the referral of the assessments and file in this case to Mr Clarke. Indeed, Mr Crocombe's objection to the Collector's position relating to his tax had been known from settlement discussions between the parties for a number of years but it was only when the formal assessments on which this case is based were issued on 31 March 2006 and the formal objections were received on 17 May 2006 that it became obvious the dispute would not settle. It was only then that the likelihood of a Case Stated crystallised (even though a formal request for the same was not sent until 23 October 2006). It follows that the possibility of ultimate Court action only became probable once the objection of 17 May 2006 had been formally disallowed on 26 July 2006. It was only then the Collector needed to take legal advice - he had been content to handle the matter internally until then - and make arrangements for representation in Court. The evidence shows that, too, occurred after the objection was disallowed.

[135] In those circumstances, Mr Ruffin is correct and there is no proof the Collector acted improperly in referring this matter to somebody who was said to be Mr Crocombe's commercial competitor at any time prior to any necessity for the Collector to seek outside assistance, still less to the point where the battle lines between these parties were drawn.

[136] The ground of improper conduct of the part of the Collector is accordingly dismissed.

<u>RESULT</u>

[137] In the result the questions posed for determination in the Case Stated are answered as follows:

(a) The respondent was correct in assessing the appellant the amounts credited to the appellant by The Rarotongan in the sums of $250,000 in each of 2000 and 2001.

(b) The respondent was correct in assessing the appellant an amount credited to the appellant by The Rarotongan in 2002, but the amount initially so credited to the appellant before the attempted reversal varies on the evidence between $187,500 and $200,000. The former appears the more intended as it amounts to three-quarters of $250,000 but the actual amount is to be resolved by counsel or, failing agreement, to be resolved by the Court on submissions from counsel to be filed within 28 days of delivery of this judgment.

[138] For the avoidance of doubt, the Court finds that none of the matters raised by the appellant in his Response to the Case Stated or in his additional ground of Improper Conduct have been made out.

[139] Counsel are to endeavour to agree issues of costs but if agreement eludes them, submissions on that topic (maximum 5 pages) are to be filed and served by the Respondent within 21 days of delivery of this judgment and by the Appellant within 35 days of delivery with each party certifying, if they consider it appropriate so to do, that the Court may determine all outstanding issues between them without a further hearing.

[140] Although this is an appeal brought by way of the Case Stated procedure, s 32 of the Act gives the Court power, as part of determining costs, to make orders concerning interest on the tax payable. In addition, as a result of this judgment, there may be issues of penalties which require further determination. Counsel did not address those points. It may prove to be over cautious but, in light of that, it is better to reserve any outstanding issues, including penalties and interest for a counsel's submissions.

[141] As a postscript – though it may only bear on the question of interest and penalties – Mr Crocombe's view that this claim "seeks to take opportunistic advantage of a technical mistake" is incorrect.. Amongst the reasons for taking that view, the Court observes:

(a) Both he and his company were several years late in filing their tax returns despite reminders from the Collector. This contributed to the delay in having this matter finalised, as did the time taken up in discussions with a view to settling the matter.

(b) It cannot be opportunistic for the Collector, whose duty it is to administer the tax laws of the Cook Islands, to take steps to recover tax properly payable.

(c) As shown at the outset, nearly five and three years elapsed between the filing of the Case Stated, and the filing of Mr Crocombe's response respectively and the case coming to a hearing. There was similarly no explanation for that delay – though Mr Crocombe has a claim against PWC which might have played a part. Even so, the file does not suggest that Mr Crocombe, as appellant, was pushing to have the matter heard at an earlier date.

Hugh Williams J