Replaced by QB 23/01 and QB 23/02

QUESTION WE'VE BEEN ASKED QB 15/11

INCOME TAX – SCENARIOS ON TAX AVOIDANCE – 2015

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Question We've Been Asked is about s BG 1.

Introduction

1. At a tax conference in 2014, a panel discussed whether s BG 1 would apply to certain scenarios. Inland Revenue was invited to provide comment on the scenarios and did so as part of that panel discussion. Given that discussion, and the view that the scenarios would be of interest to a wider audience, the scenarios have been used as the basis of this Question We've Been Asked (QWBA). This QWBA follows the publication of two QWBAs concerning s BG 1 and different scenarios discussed at an earlier tax conference in 2013: QB 14/11: "Income tax – scenarios on tax avoidance" *Tax Information Bulletin* Vol 26, No 11 (December 2014): 3 and QB 15/01: "Income tax – tax avoidance and debt capitalisation" *Tax Information Bulletin* Vol 27, No 3 (April 2015): 25.

2. The Commissioner's view as to whether s BG 1 applies in these scenarios must be understood in the following terms. First, the conclusions reached are limited to the arrangements set out below. Additional relevant facts or variations to the stated facts might materially affect how the arrangements operate and different outcomes under s BG 1 could arise. Next, as the objective is to consider the application of s BG 1, the analysis proceeds on the basis that the tax effects under the specific provisions of the Act are achieved as stated. Finally, the implications of any relevant specific anti-avoidance provisions are not considered.

3. Section BG 1 is only considered after determining whether other provisions of the Act apply or do not apply. Where it applies, s BG 1 voids a tax avoidance arrangement. Voiding an arrangement may or may not appropriately counteract the tax advantages arising under the arrangement. If it does not appropriately counteract the tax advantages, the Commissioner is required to apply s GA 1 to ensure this outcome is achieved.

4. The explanations in this QWBA apply the approach to s BG 1 set out in the Commissioner's Interpretation Statement IS 13/01: "Tax avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007" *Tax Information Bulletin* Vol 25, No 7 (August 2013): 4.

SCENARIO 1 – USE OF A LIMITED PARTNERSHIP **Scenario 1 replaced by QB 23/02**

Arrangement

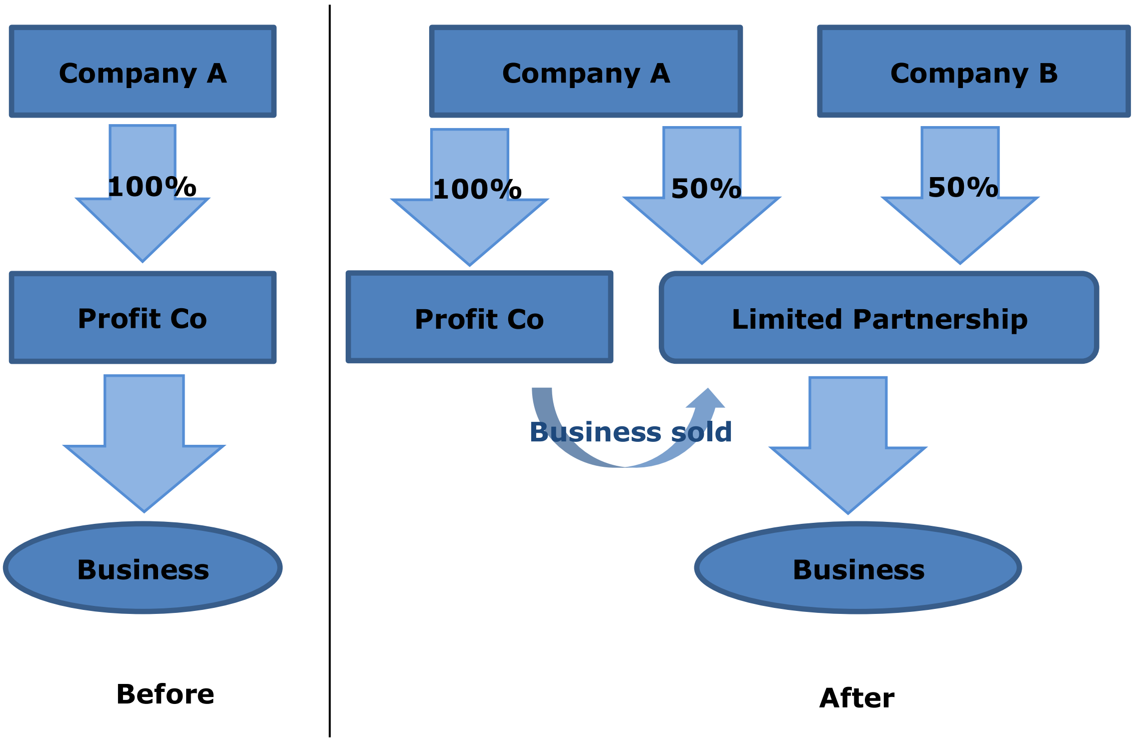
5. This scenario concerns an arrangement involving three New Zealand resident companies:

   - Company A, a tax loss company;
   - Profit Co, a wholly-owned subsidiary company of Company A that is operating a profitable business; and
   - Company B, a company that is unassociated with Company A and Profit Co.

6. The arrangement:

- Companies A and B establish a limited partnership (LP), registered under the Limited Partnerships Act 2008.
- Companies A and B make equal contributions to the capital of the partnership and agree to each receive a 50% share of partnership profits and losses.
- Profit Co sells its business operations to the LP at the open market value of those operations.

7. The following diagram shows the situation before and after the arrangement:



Question

8. Does s BG 1 apply to this arrangement?

Answer

9. No. The Commissioner's view is that, without more, s BG 1 would not apply to this arrangement.

Explanation

The arrangement's objectives and tax effects

10. The objective of the arrangement is for Company B to take a financial interest in the business of Profit Co.

11. The tax effects of the arrangement are:

- Profit Co no longer derives business income.
- The LP derives business income.
- The LP is transparent for tax purposes with Companies A and B each deriving 50% of the LP's income.
- Company A can offset its share of LP income against its tax losses.

- Company A's ability to group tax losses with Profit Co under subpart IC is unaffected.

12. These tax effects arise under the following specific provisions:

    - s CB 1 (Amounts derived from business)
    - core provisions: s BC 4 (Net income and net loss); s BC 5 (Taxable income)
    - subpart IA (General rules for tax losses)
    - subpart IC (Grouping tax losses)
    - subpart HG (Joint venturers, partners, and partnerships).

13. There may also be tax effects arising from the sale of the business (eg, depreciation recovered), although these are not of significance to the subsequent s BG 1 analysis.

Parliament's purposes for the provisions at issue

Business income

14. Parliament intends that amounts a person derives from a business are treated as income and taxed. This is made clear by Parliament explicitly legislating s CB 1 to ensure this is the case. As stated by Richardson J of a predecessor of s CB 1 in *AA Finance Ltd v CIR* (1994) 16 NZTC 11,383 (CA), "[a] gain made in the ordinary course of carrying on the business is thus stamped with an income character" (at 11,391).

Losses

15. Parliament contemplates taxpayers incurring losses where their annual total deduction is more than their annual gross income (s BC 4(3)). It contemplates the net loss is dealt with in certain ways. A net loss is dealt with under Part I (Treatment of tax losses) and it may be offset from future income, made available to another person or dealt with in certain other ways (s BC 4(4)). A person's taxable income for a tax year is determined after subtracting any available tax losses under Part I (s BC 5).

16. Generally, Part I provides that a person's tax loss for a tax year is the sum of their loss balance brought forward, current year net loss and certain other amounts (eg, unused imputation credits) (s IA 2). Any tax losses not able to be offset against current income can be carried forward to subsequent income years and offset (s IA 4).

17. However, Parliament has also provided specific restrictions for companies (s IA 5). These restrictions require a minimum of 49% continuity of voting interests to be held by the same group of people from when the losses are incurred to when they are ultimately offset against income. That is, within some limits, Parliament generally expects the same group of people with a financial interest in the company when the losses are incurred get to enjoy the benefit of those losses being offset against income in the future.

18. Similarly, where a tax loss is to be made available to another person and the parties are companies, Parliament expects a 66% commonality of shareholding to exist between the profit and loss companies from the start of the period when the loss was incurred to the end of the year of offset (subpart IC).

Limited partnerships

19. The primary objective of the limited partnership rules is to facilitate sustainable growth in New Zealand's investment capital sectors, such as venture capital, by providing a legal and tax structure recognised and accepted by investors (see "New legislation – Taxation (Limited Partnerships) Act 2008" *Tax Information Bulletin* Vol 20, No 8 (September/October 2008): 4).

20. A limited partnership under the Act means a limited partnership registered under the Limited Partnerships Act 2008. It includes an overseas limited partnership, but does not include a "listed limited partnership" or a "foreign corporate limited partnership" (s YA 1 definition of "limited partnership").

21. Generally, limited partnerships are treated as transparent for tax purposes (s HG 2). For the purposes of calculating partners' obligations and liabilities, the partners are treated as carrying on the partnership's activities and having the status, intention and purpose of the partnership (s HG 2(1)). Any income, expenses, tax credits, rebates, gains and losses arising for the partnership flow through to the partners in proportion to their interest in the partnership (s HG 2(2)). There are rules concerning the entry and exit of partners (ss HG 3 to HG 10). There are also rules placed on limited partners that ensure the partners' tax losses are restricted if the amount of the loss exceeds the tax book value of their investment (s HG 11).

Facts, features and attributes

22. To give effect to its purposes for these provisions, Parliament would expect to see the following facts, features or attributes, as matters of commercial and economic reality:

- The formation of a partnership relationship between Companies A and B.
- The registration of the partnership as a limited partnership under the Limited Partnerships Act 2008.
- Companies A and B contributing equally to the capital of the LP as agreed between them.
- The disposal of Profit Co's business to the LP, with the consequences that Profit Co no longer conducts the business and ceases to derive business income.
- The LP acquiring the business of Profit Co at its open market value, with the consequences that the LP conducts the business and commences deriving business income.
- Companies A and B sharing equally in the profits or losses of the LP, returning these as income or losses in their respective tax returns each year the arrangement remains operative.
- A minimum of 49% continuity of shareholding in the group of persons holding voting interests in Company A from the beginning of the year in which the company's tax losses were incurred until the end of any year in which they are offset against LP income.
- A minimum of 66% commonality of shareholding between the group of persons holding voting interests in Company A and Profit Co from the time Company A incurred the tax losses until the end of any year in which they are offset against any future income of Profit Co.

The commercial reality and economic effects of the arrangement

23. The next step is to consider the commercial reality and economic effects of the arrangement. This is undertaken to determine whether the required facts, features and attributes are present in the arrangement. If so, Parliament's purposes for the relevant provisions are being upheld.

24. The commercial and economic reality of the current arrangement is that:

- Companies A and B contribute equally to the formation of a registered limited partnership from which they return equal shares of income and losses for tax purposes.
- There is an arm's-length sale of Profit Co's business to the LP.
- The LP, and not Profit Co, conducts the business and derives business income.
- There is no change in the composition of the group of persons holding voting interests in Company A or Profit Co.

Applying the Parliamentary contemplation test

25. In the Commissioner's opinion, the commercial and economic reality of the arrangement accords with its legal form. There are real economic consequences to the parties that reflect that form and there are no indications of artificiality or contrivance or other factors that might suggest this was not the case. In reality, a limited partnership has been formed through which a third-party investor, Company B, has contributed capital to take an interest in an actual and existing profitable business. The nature and extent of the financial consequences for the parties is consistent with this arm's-length investment by Company B. Accordingly, Company B's investment through a limited partnership is consistent with Parliament's purposes that limited partnerships are used as investment vehicles.

26. For its part, Company A divests itself of half of its interests in the business and suffers the economic burden of no longer having full access to the profits of the business. It does, however, continue to have the ability to offset losses against half of those profits when those profits are received in the form of LP income. This is because there has been no change in shareholding in Company A that could have meant the company was not able to offset its losses against its share of the LP income or any future income of Profit Co. Therefore, the arrangement does not defeat Parliament's general expectation that the group of people with a financial interest in a company when losses are incurred should also enjoy the benefit of those losses being offset against income in the future.

27. In short, all of the facts, features or attributes Parliament would expect to see present in an arrangement to give effect to its purposes for the specific provisions are present in the current arrangement. Also, there are no facts, features or attributes present in, or absent from, the arrangement that are inconsistent with those expectations.

28. It may be thought that the step of selling the business to the LP was included in the arrangement for tax reasons. That is, to invest in the business activity of Profit Co, Company B could have bought shares in that company. Had this been the arrangement instead, one of the tax effects of this alternative arrangement would have been to breach the loss grouping provisions of the Act. Company A would then have been unable to offset its losses against any of the profits generated by the business activity.

29. However, applying the Parliamentary contemplation test requires determining the commercial and economic reality of the arrangement actually entered into. It does not involve identifying an arrangement, or one of several arrangements, that is economically equivalent to the arrangement entered into. The latter approach is sometimes referred to as using economic equivalence. It is not the correct approach for determining the economic and commercial reality of an arrangement (see the Commissioner's comments in IS 13/01 at [377]).

30. In addition, the Supreme Court in *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115 (at [111]) considered that taxpayers have the freedom to structure transactions to their best tax advantage. They cannot, however, do so in a way that is proscribed by the general anti-avoidance provision. That is, provided taxpayers make use of the provisions of the Act in a way intended by Parliament, they have freedom to choose how they structure their arrangements (see also *Penny v CIR* [2011] NZSC 95 at [49]). Accordingly, there is no general requirement for the parties in this scenario to adopt an alternative, less tax-favourable, arrangement.

31. As determined above, the arrangement in this scenario is not considered to contravene Parliament's purposes for the specific provisions in question.

Conclusion on tax avoidance

32. In the Commissioner's opinion, without more, the factual situation in this scenario is not one to which s BG 1 would apply. That is, the arrangement does not have a tax avoidance purpose or effect.

SCENARIO 2 – INTEREST DEDUCTIONS AND USE OF A PORTFOLIO INVESTMENT ENTITY

Scenario 2 replaced by QB 23/01

Arrangement

33. This scenario concerns the following arrangement:

- An individual taxpayer, with income that places them on the top marginal tax rate of 33%, borrows funds for a fixed term of 2 years from Bank A and incurs interest at a fixed rate of 5% per annum.
- Under the conditions of the loan, the taxpayer must apply the borrowed funds to acquire an investor interest in a multi-rate portfolio investment entity (PIE) sponsored by Bank A with any PIE income retained by the bank in satisfaction of the taxpayer's interest obligations under the loan.
- Bank A's lending is secured over the taxpayer's investor interest in the PIE.
- The taxpayer notifies the PIE to apply an investor rate of 28%.
- Under its investment policy, the multi-rate PIE must invest all funds in New Zealand dollar interest-bearing 2-year deposits with Bank A. It derives a fixed pre-tax return of 4.9% per annum.
- In their annual tax return, the taxpayer deducts the interest expense incurred on the borrowed funds (as calculated under the financial arrangements rules) against their other income.

34. The interest rates and their margin in this arrangement are those provided to the Commissioner at the tax conference. Other facts implicit in the scenario presented at the conference concerning the rates being fixed, the duration of the arrangement and the terms of the loan have been explicitly added.

35. The Commissioner understands that the arrangement as presented may not be realistic or reflect what might occur in practice. Despite this, the arrangement does provide an opportunity to examine how s BG 1 may apply in this context.

Question

36. Does s BG 1 apply to this arrangement?

Answer

37. Yes. The Commissioner's view is that s BG 1 would apply to this arrangement.

Explanation

The arrangement's objectives and tax effects

38. The objective of the arrangement is to provide the taxpayer with investment income.

39. The tax effects of the arrangement for the taxpayer are that they:

- derive excluded income from the PIE, on which a final tax has been levied at their notified investor rate of 28%, and
- obtain a deduction for interest expenditure, which is offset against income taxed at a marginal tax rate of 33%.

40. The relevant provisions of the Act are the PIE rules in subpart HM, ss CP 1 and CX 56 and the provisions governing the deductibility of interest (ie, the general permission in s DA 1 and s DB 6).

Parliament's purpose for the provisions at issue

The PIE rules

41. A PIE is an entity that makes investments on behalf of one or more investors where the entity has chosen to become a PIE (ss HM 2(1) and HM 71). An aim of the rules is for PIEs to be taxed on collective investment income on a similar basis to individual investors. For instance, PIEs are not taxed on realised gains on shares in New Zealand resident companies, similar to the treatment of most individual investors (s CX 55).

42. Upon becoming a PIE, entities must choose to become a particular type of PIE (s HM 2(2)). The PIE featured in the arrangement has chosen to become a "multi-rate PIE". A multi-rate PIE is liable for tax on the proceeds of investments attributed to natural person investors calculated at different tax rates, being those rates applicable for each investor (s HM 6(1)). In this way, a multi-rate PIE's total tax liability is intended to resemble the total tax liability the group of investors would have had if the investors had made the investments separately.

43. It is also intended that investors receive an after-tax economic return that they would receive if they personally made similar investments to those made by the PIE (s HM 6(2)). However, Parliament also contemplates that some investors could pay less tax if they invested through a PIE than if they invested personally because the maximum prescribed investor rate (PIR) for a natural person investor is 28%, which is less than the top personal tax rate. Therefore, investors' returns may only resemble what they would receive if investing personally.

44. Generally, natural person investors in multi-rate PIEs have no further tax liability on income for which the PIE has a tax liability (s HM 6(1)). This is provided the investor has notified the PIE of the correct rate at which tax is to be paid on their

investment proceeds (the PIR). The rate is usually based on the investor's income in previous years (s HM 56, sch 6). The investor's income attributed from a multi-rate PIE is excluded income of the investor (ss CP 1 and CX 56). Excluded income is not included in the investor's assessable income (s BD 1). In most cases, this means that the tax paid by the PIE at the investor's PIR is a final tax on the PIE income.

45. One of the purposes of the rules was to remove inconsistencies between the tax treatment of investments made personally by investors and those made as part of a collective investment vehicle that disadvantaged the latter. It was considered important that investors' decisions were not distorted by different tax treatments for income from investments that were similar in nature.

46. Also, the timing of the introduction of the PIE rules was linked to the introduction of the KiwiSaver scheme and Parliament's wider purposes of encouraging a long-term retirement savings habit amongst New Zealanders. These measures were expected to result in a rise in taxpayer participation in collective investment vehicles (see *Taxation of investment income* (A Government discussion document, Policy Advice Division of Inland Revenue, June 2005) at [1.13] and the First Reading of the KiwiSaver Bill, Hon Dr Michael Cullen, Minister of Finance (2 March 2006) 626 NZPD 1673.

Interest deductibility

47. The purpose of the Act is to impose tax on net income (s AA 1), which is the amount remaining after deducting from income all deductions allowed under the Act (s BC 4). Generally, deductions are available because Parliament is concerned with taxing a gain, being the balance of proceeds over the costs of generating income.

48. Accordingly, a taxpayer is allowed a deduction for interest expenditure provided it is incurred in deriving their assessable or excluded income or in the course of carrying on a business for the purpose of deriving assessable or excluded income (s DA 1). Deductions for interest are not precluded merely because the interest might be regarded as being of a capital nature (s DB 6). By allowing interest deductions, Parliament clearly contemplates borrowed capital being applied to a purpose that has a connection or nexus with an income-earning activity. In allowing losses to be carried forward, Parliament also contemplates that a return will not always arise from a taxpayer's activities in a particular income year and that in some cases deductions, such as for interest expenditure, will exceed income.

Facts, features and attributes

49. To give effect to its purposes for these provisions, Parliament would expect to see the following facts, features or attributes, as matters of commercial and economic reality:

- An entity acting as a collective investment vehicle for one or more investors.
- The entity has chosen to become a PIE and meets all the requirements of being a multi-rate PIE under the Act.
- Income earned by the PIE is attributed to investors based on their investor interests, on which tax is paid by the PIE at the investors' notified investor rates.
- The PIE's tax liability resembles the total tax liability the group of investors would have if the investors were to make the investments separately.

- The investors’ after-tax economic return from their interest in the PIE resembles the return that would arise if the investors had invested personally in similar investments to those made by the PIE.
- Borrowed funds on which interest accrues have been applied in connection with an income-earning activity.
- The PIE is part of the investors’ savings and investment activities.

The commercial reality and economic effects of the arrangement

50. The next step is to consider the commercial reality and economic effects of the current arrangement. This is undertaken to determine whether the required facts, features and attributes are present in the arrangement. If so, Parliament’s purposes for the relevant provisions are being upheld.

51. It is accepted that in this arrangement there exists, as matters of commercial and economic reality, the following facts, features and attributes:

- An entity is acting as a collective investment vehicle for one or more investors, including the taxpayer.
- The entity has chosen to be a multi-rate PIE and meets all the requirements of being a multi-rate PIE under the Act.
- Income earned by the PIE is attributed to the taxpayer based on their investor interest and on which tax is paid by the PIE at the taxpayer’s notified investor rate.
- The PIE’s tax liability resembles the total tax liability the group of investors would have if the investors were to make the investments separately.
- The taxpayer’s after-tax economic return from the interest in the PIE resembles the return that would arise if they had invested personally in similar investments to those made by the PIE.

52. However, Parliament would also expect to see present, as matters of commercial and economic reality, the following facts, features and attributes:

- The borrowed funds on which the interest accrued and claimed by the taxpayer as a deduction have been applied in connection with an income-earning activity.
- The PIE is part of the taxpayer’s savings and investment activities.

53. Ascertaining whether these facts, features or attributes are present as matters of commercial and economic reality must take into account the whole of the arrangement. Viewed as a whole, the arrangement involves circular movements of funds. Amounts lent by the bank to the investor must be re-invested with the bank via the PIE. Similarly, interest income paid by the bank must be applied in satisfaction of the investor’s interest obligation to the bank. The circular movement of money in an arrangement is often an indicator of tax avoidance, as it can lead to the effective neutralisation or distortion of economic outcomes. This, in turn, may mean that the expected facts, features or attributes are not, in reality, present.

54. The economic consequences that arise as a result of the circularity in the present arrangement are that the taxpayer’s interest income on the PIE investment is wholly applied in satisfaction of their interest obligation to the bank, with the remainder being funded by the tax system (see para 56 below). In reality, borrowing usually requires undertaking risk. The commercial and economic reality of the current arrangement, however, is that the usual risks associated

with borrowing are absent. Also, the circular nature of the arrangement means that typical commercial constraints do not apply and the arrangement could be scaled-up to any level of borrowing and investing.

55. The result is that the financial consequences of the arrangement are neutralised or distorted and unlike those expected of an arrangement involving borrowing and investing. It follows that, as a matter of commercial and economic reality, there is no real borrowing or application of funds to an income-earning activity. It also follows that, as a matter of commercial and economic reality, the involvement of the PIE is not part of the taxpayer's savings and investment activities.

56. Furthermore, as mentioned, the taxpayer's interest obligations under the loan not satisfied by the PIE income are funded by the tax system. This is the result of the arrangement as a whole being pre-tax negative and post-tax positive. That is, the arrangement makes a gross loss of 0.1% because the interest rate on the loan of 5.0% is greater than the PIE income of 4.9%. In comparison, the arrangement is post-tax positive and produces a net return of 0.178%. This is because the PIE income is subject to tax at 28% with the interest expense able to be offset against non-PIE income that would have been subject to tax at the higher rate of 33%[1]. This aspect of the arrangement means that, even if it is accepted that the arrangement involves borrowing and investing as matters of commercial and economic reality (which it is not), any net investment return arises from the tax system and not the investment itself. This also leads to a conclusion that there is no real savings or investment activity as contemplated by Parliament.

57. While the fact that an arrangement may be pre-tax negative and post-tax positive is not decisive of itself, it is relevant here as this aspect of the arrangement is fixed for the duration of the arrangement. This is because of the fixed nature of the terms and interest rates applying to the borrowing and to the PIE investment. It is also because the nature of the PIE's investment in fixed interest deposits precludes any other economic gains arising from the arrangement. This can be contrasted with other arrangements where either the pre-tax negative investment return is the result of unforeseen events or there is the prospect of other economic gains arising.

58. In summary, there is on the face of it, borrowing with a connection with an income-earning activity of savings and investment. In commercial and economic reality, however, there is no real borrowing or application of funds to an income-earning activity. It follows there can, in reality, be no savings and investment activity. The pre-tax negative, post-tax positive aspect of the arrangement also leads to this latter conclusion.

Applying the Parliamentary contemplation test

59. Applying the Parliamentary contemplation test requires reaching a view on whether the arrangement, when viewed in a commercially and economically realistic way, makes use of the Act in a manner that is consistent with Parliament's purpose. This is done in light of the relevant Parliamentary purposes and the facts, features and attributes that have been identified.

60. The Commissioner accepts that Parliament contemplated taxpayers investing through a PIE to secure the tax advantage of the maximum PIR of 28%. For instance, the current arrangement can be contrasted with a situation where a

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[1] The post-tax positive return is calculated as follows:

$$(4.9\% \times (1-0.28)) - (5.0\% \times (1-0.33)) = 0.178\%.$$

taxpayer on the highest marginal tax rate withdrew existing investment funds from a non-PIE investment to invest in a PIE (see Example 2, IS 13/01 at 98-101). In that situation the involvement of a PIE is still part of the taxpayer's savings and investment activities because there is an actual investment being made. Therefore, arrangements strongly influenced by tax outcomes are not necessarily tax avoidance arrangements subject to s BG 1.

61. When the current arrangement is viewed in a commercially and economically realistic way, it was accepted that certain facts, features and attributes are present (see para 51). However, as the previous discussion shows, key facts, features or attributes that Parliament would expect to be present are absent from the current arrangement. These are the borrowing's connection to an income-earning activity in a real sense and the involvement of the PIE as part of the taxpayer's savings and investment activities.

62. Overall, the arrangement lacks key facts, features and attributes Parliament would expect to see present to give effect to its purposes for the interest deductibility and PIE rules. This means the arrangement is outside Parliament's purposes for those rules and has a tax avoidance purpose or effect.

The merely incidental test

63. Because the arrangement has a tax avoidance purpose or effect, the next step is to test whether the tax avoidance purpose or effect is merely incidental to a non-tax avoidance purpose or effect. In that case, s BG 1 will not apply even though the arrangement has a tax avoidance purpose or effect. A "merely incidental" tax avoidance purpose or effect is something that follows from, or is necessarily and concomitantly linked to, without contrivance, some other purpose or effect.

64. The purposes or effects of the arrangement could be seen as being concerned with the generation of investment income, which, in turn, relates to the savings and investment activities of the taxpayer. However, this is too general a purpose or effect to explain why the arrangement was structured in the manner it was, particularly using borrowing and a multi-rate PIE. General purposes that can potentially be achieved in several different ways will not explain the particular structure of the arrangement. Consequently, the existence of such a purpose will not be sufficient to establish that a tax avoidance purpose or effect is merely incidental to it.

65. Also, it appears that the only purpose or effect of the arrangement is to generate a return from the tax system, which is a tax avoidance purpose or effect. Therefore the tax avoidance purpose or effect cannot be merely incidental to any other purpose or effect.

Conclusion on tax avoidance

66. Accordingly, the Commissioner considers that the merely incidental test does not prevent the arrangement being considered a tax avoidance arrangement and subject to s BG 1.

Reconstruction

67. Where s BG 1 applies, the arrangement is void as against the Commissioner. The next question to consider is whether this adequately counteracts the tax advantage gained by the taxpayer from the arrangement. If not, the Commissioner must consider using the powers provided by s GA 1 to reconstruct the arrangement to ensure this occurs. The Commissioner has a broad discretion

as to how to reconstruct an arrangement and in some scenarios there may be more than one approach possible.

68. In this scenario, voiding the arrangement would mean both the PIE income and interest deductions would be disregarded for tax purposes. However, the tax effects of these two aspects of the arrangement, while creating an overall tax advantage for the taxpayer, are, in practice, spread between the taxpayer and the PIE. This means reconstructing the arrangement may be appropriate provided it restored the arrangement's pre-tax economic outcome, so that it results in a negative return. One straightforward approach to achieving this would be to limit the taxpayer's interest deductions so that the tax benefit arising from them at the 33% marginal tax rate matches the tax already paid by the PIE at the 28% PIR. This approach would adequately counteract the tax advantage by making tax a neutral factor in the arrangement.

SCENARIO 3 – USE OF A DISCRETIONARY TRUST **Scenario 3 replaced by QB 23/02**

Arrangement

69. This scenario concerns an arrangement where trustees of a trust pay or vest income in an income year to a single beneficiary and the beneficiary is either:

- an individual adult beneficiary who is taxed on the beneficiary income at the lowest marginal tax rate, or
- a corporate beneficiary (that may or may not be solvent) with total tax losses available in that year equal to, or greater than, the beneficiary income, or
- a corporate beneficiary, where the beneficiary income is a dividend from a foreign company and exempt income of the beneficiary under s CW 9.

70. The only additional facts present are as follows. The trust was validly established and, in undertaking the arrangement, the trustees have fully complied with the terms of the trust deed and with their obligations under general trust law to distribute income to the beneficiaries. The terms of the trust deed do not require the trustees to distribute any or all of the income derived each year. The trustees also have the discretion to choose the beneficiaries or class of beneficiaries that are to receive trust property. All beneficiaries of the trust are existing beneficiaries of the trust and New Zealand tax residents. For tax purposes, the trust is classified as a complying trust under s HC 9. That is, the trust is an ordinary New Zealand domestic trust with New Zealand resident settlors and trustees.

Question

71. Does s BG 1 apply to this arrangement?

Answer

72. No. The Commissioner's view is that, without more, s BG 1 would not apply to the arrangement. Variations to the facts that may lead the Commissioner to reach a different view are discussed from para 92.

Explanation

The arrangement's objectives and tax effects

73. The objective of the arrangement is to vest income in, or pay income to a beneficiary taking into account the beneficiary's tax position.

74. The tax effect of the arrangement is that the income derived by the trustees and vested in or paid to the beneficiary is not trustee income and not subject to tax at the trustee tax rate of 33%.

75. Instead, the tax effect is that the income is beneficiary income and:

- in the case of the individual, is taxed at a rate of tax that is less than the trustee tax rate;
- in the case of the loss company, is not taxed because of the availability to the beneficiary of sufficient tax losses to offset against the income;
- in the case of the dividend from a foreign company paid or vested to a corporate beneficiary, is not taxed because the income retains its identity as foreign dividends and is exempt income of the beneficiary under s CW 9.

76. The relevant provisions of the Act are the trust rules in subpart HC relating to beneficiary income and the core provisions in Part B.

Parliament's purposes for the provisions at issue

Beneficiary income

77. Subpart HC provides rules for the taxation of trusts, including the taxation of beneficiary income. Income derived by a trustee is treated as trustee income and taxed at the rate of 33% unless it is distributed as beneficiary income. Beneficiary income is taxed at the beneficiary's marginal tax rate (s HC 5). An amount derived by a person is income if it is beneficiary income under s HC 6 (s CV 13(a)).

78. Under s HC 6, for income to be distributed as beneficiary income it must be income derived by a trustee that:

- "vests absolutely in interest" in a beneficiary in the income year, or
- is "paid" to a beneficiary either in the income year or within a certain period after the end of the income year (ie, within six months of the end of the income year or the earlier of when the trust tax return is filed or is due).

79. Accordingly, beneficiary income can arise in two ways—where it vests absolutely in interest in the beneficiary or where it is paid to the beneficiary (although there is some overlap between the two).

80. Beneficiary income is discussed in the Commissioner's Interpretation Statement IS 12/02: "Income Tax – Whether income deemed to arise under tax law, but not trust law, can give rise to beneficiary income" *Tax Information Bulletin* Vol 24, No 7 (August 2012): 49. In summary, the discussion concludes that, in relation to beneficiary income:

- The phrase "vests absolutely in interest" is a trust law concept and is not defined in the Act.
- "Vested" means indefeasibly vested, in the sense of finally and absolutely vested, so that the beneficiary obtains an immediate right of present or future possession of the income.
- The income must exist at the time of vesting. While the amount vested need not be received by the beneficiary until some time in the future, the income must exist rather than be future income or merely an expectancy.

- The mechanisms by which an amount can vest absolutely in interest in a beneficiary include:
  - a provision of the trust deed that vests the income in the beneficiary, without the need for a trustee resolution;
  - a resolution of the trustees vesting the income in the beneficiary;
  - a payment to, or a credit to an account of, the beneficiary in the income year (or within a certain period after the end of the year).
- An amount will be "paid" if it is actually paid, distributed, credited or dealt with in the beneficiary's interest or on their behalf. A declaration or resolution by a trustee allocating income to a beneficiary will be sufficient for an amount to be "paid".

81. Accordingly, income need not be physically paid to a beneficiary (such as with a physical transfer of funds to an account) for a beneficiary to derive beneficiary income. It is sufficient for an amount to be credited to a beneficiary, or dealt with in the beneficiary's interest or on their behalf in some other way.

Discretionary trusts and allocating beneficiary income

82. Subpart HC is silent on how trustees of discretionary trusts that are classified as complying trusts should determine who receives beneficiary income or the amount of that income. Parliament has generally left it to general trust law to determine this aspect of trust taxation. However, once trustees make decisions within the constraints of the general trust law, Parliament has indicated its expectations as to the tax consequences that arise. It can be seen that in some areas Parliament has placed practical limitations on the trustees in terms of amounts allocated to beneficiaries. For example, where beneficiary income includes imputation tax credits trustees are effectively prevented by s LE 5 from streaming the credits to one beneficiary. Section LE 5 limits the imputation credit available to a beneficiary by pro-rating the credits over all distributions made to all beneficiaries in the relevant income year. Similarly, in certain circumstances trustees are effectively prevented by s HC 35 from distributing beneficiary income of more than $1,000 in an income year to a beneficiary that is a minor as amounts in excess of that are taxed at the trustee tax rate.

83. Under trust law, where a trust instrument provides trustees with a discretion to choose which beneficiaries should receive trust property, the trustees are entitled to prefer some beneficiaries over others. The House of Lords' decision in *Gartside v IRC* [1968] 1 All ER 121 made it clear the objects of a discretionary trust have no proprietary interest in the trust property or its income. Their rights are restricted to a right to be considered for nomination as a beneficiary by the trustees and a right to compel proper administration of the trust. *Gartside* also confirmed that the trustees of a discretionary trust owe fiduciary duties to discretionary beneficiaries. The beneficiaries have a right that would attract the protection of a court of equity to ensure the trustees carry out their duties fairly, reasonably or properly. This means trustees of a trust must not exercise their discretion without properly considering all relevant matters as directed by the trust deed and general trust law.

84. Parliament's purposes for trustee and beneficiary income can be found in a combination of general trust law, Part B and subpart HC of the Act. From this, it can be concluded that neither the general trust law nor the Act prevents trustees of a discretionary trust taking into account the tax consequences arising for a beneficiary if they were to receive beneficiary income. These tax consequences arise in the context of the core provisions of the Act from which income tax obligations and entitlements are determined, taking into account such things as

tax rates, credits and deductions. Parliament contemplated that tax rates, credits and deductions apply to the income actually derived by the taxpayer. Income derived by a taxpayer could include beneficiary income. In other circumstances, the Act provides for tax losses to arise and for these to be offset against income actually derived by taxpayers. Also, s HC 22 shows that Parliament contemplates that, in some contexts in relation to non-complying trusts, taxpayers deriving beneficiary income may also have tax losses.

Facts, features and attributes

85. Given the above aspects of the trust rules, Parliament would contemplate that the facts, features and attributes present in an arrangement involving beneficiary income would include:

- A valid trust exists, where the trustees act in accordance with the trust deed and general trust law:
  - The necessary prerequisites to the formation of a trust are met, including the certainty of:
    - an intention to establish a trust,
    - the trust assets being unambiguously defined, and
    - the beneficiaries being able to be ascertained.
  - The trustees are holding and dealing with trust property, including deriving income from the trust property, on behalf of beneficiaries in accordance with the trust deed and general trust law.
- Income derived by the trustees is paid or vested as beneficiary income to beneficiaries.
- The beneficiaries receiving distributions of income are eligible to benefit under the trust. That is, they are, in reality, beneficiaries of the trust.
- The beneficiaries receive the distributions of income. That is, they benefit in some way, either immediately or from future possession of the income so that, in reality, there is a distribution of income to them.
- The core provisions of the Act, including the rules concerning income, exempt income, basic tax rates and tax losses, apply according to the individual circumstances of the beneficiary.

The commercial reality and economic effects of the arrangement

86. The next step is to consider the commercial reality and economic effects of the arrangement. This is undertaken to determine whether the required facts, features and attributes are present in the arrangement. If so, Parliament's purposes for the relevant provisions are being upheld.

87. In this scenario there is a validly established trust. The distributions of beneficiary income have been undertaken in compliance with the trust deed, general trust law requirements and subpart HC of the Act. The facts, features and attributes Parliament would expect are present as matters of commercial and economic reality. There is no suggestion the beneficiaries are not, in reality, entitled under the trust, or that they will not benefit from the distribution of income to them. Further, on the simple facts of this arrangement, there are no facts, features and attributes present in, or absent from, the arrangement that mean the arrangement is outside Parliament's purposes for the provisions of the Act other than subpart HC.

88. In effect, the commercial and economic reality of the arrangement is the same as its legal form – a distribution of income to beneficiaries as beneficiary income.

Applying the Parliamentary contemplation test

89. The relevant facts, features and attributes contemplated by Parliament to be present in an arrangement involving beneficiary income are present in this arrangement as matters of commercial and economic reality. In these circumstances, the conclusion reached from applying the Parliamentary contemplation test is that the arrangement in this scenario is not a tax avoidance arrangement. This means that s BG 1 would not apply to the scenario.

90. The Commissioner considers this is the correct conclusion despite the clear implication that the trustees' choices in this scenario were significantly influenced by tax considerations. The Supreme Court in *Ben Nevis* considered that taxpayers could structure their arrangements to their best tax advantage, provided the use of the provisions is within what Parliament would have contemplated (at [111]). Where the use of the provisions is outside what Parliament would have contemplated for them it is appropriate for s BG 1 to apply. Accordingly, arrangements strongly influenced by tax outcomes are not necessarily tax avoidance arrangements subject to s BG 1. Such influences on arrangements would be relevant to whether tax outcomes were merely incidental, but this only becomes important if the arrangement is a tax avoidance arrangement in the first instance. Note that, prior to *Ben Nevis*, Richardson J recognised this for trusts in *CIR v Challenge Corporation Ltd* [1986] 2 NZLR 513 (CA) at 548-549:

> ... but it was obviously never intended that the use of trusts, which in New Zealand practice in the vast majority of cases is substantially influenced by tax considerations, should be automatically voided under its provisions.

Conclusion on tax avoidance

91. From a commercial and economic reality perspective, the arrangement in this scenario results in the relevant trust provisions and other provisions of the Act applying as Parliament would expect. In those circumstances, it is appropriate that s BG 1 should not apply to the arrangement.

Factual variations

92. While the Commissioner considers s BG 1 does not apply on the simple facts of the arrangement in this scenario, there may be arrangements involving distributions of beneficiary income where the Commissioner may reach a different conclusion.

Factual variations in relation to Parliament's purposes for the trust rules

93. Different facts may call into question whether Parliament's purposes for the trust rules are being given effect. As mentioned above, the facts, features and attributes that need to be present to give effect to Parliament's purposes for the taxation of beneficiary income include the existence of a beneficiary of the trust and of a distribution to that beneficiary. On some facts, it will be arguable that no distribution of income to a beneficiary of the trust was made from a commercial or economic perspective. That is, where it is arguable that, in commercial and economic reality, either:

- the beneficiary was not a beneficiary of the trust, or
- no distribution of income was made to the beneficiary.

94. Consideration would need to be given to various facts, including (but not limited to):

- the timing and pattern of the addition or removal of beneficiaries;
- how and when the income was distributed (eg, whether authorised distributions are paid in cash or credited to beneficiaries' current accounts);
- any facts indicating that, in commercial and economic reality, parties other than the trustees or the beneficiaries nominated to receive distributions obtain the use and benefit of the income;
- any facts indicating that, in commercial and economic reality, there is no realistic prospect of the beneficiaries ever benefiting from the income allocated to them.

95. On their own there may be nothing inherently wrong with any one of these factors. For instance, the fact that in any income year the trustees have resolved to pay beneficiary distributions by credit to account and retain the funds for use within the trust would not, on its own, indicate Parliament's purposes for the distribution of beneficiary income were not being given effect. However, in some cases, a combination of the above facts may raise doubts as to whether, in commercial and economic reality, the trustees have made a distribution of income to a beneficiary.

96. Although argued under provisions other than the trust rules, *Krukziener v CIR* (No 3) (2010) 24 NZTC 24,563 (HC) is an example of where, in the context of s BG 1, a court clearly considered that the commercial and economic reality of an arrangement was that the use and benefit of income distributed by trustees was enjoyed by a person other than the beneficiaries nominated to receive the distributions.

Factual variations in relation to Parliament's purposes for other provisions

97. Another situation where the Commissioner may reach a different conclusion is where an arrangement is contrary to Parliament's purposes for provisions of the Act, other than the trust rules. It is not possible to be specific about such arrangements due to the range of arrangements and other provisions of the Act that could arise. It is likely that, unlike the current scenario, such arrangements would involve additional entities and steps that contribute to the potential for these arrangements to be regarded as tax avoidance arrangements.

98. Regardless, the same approach to applying s BG 1 outlined above would apply. This approach commences with discerning Parliament's purposes for the relevant provision or provisions of the Act. It then requires determining the facts, features and attributes Parliament would expect to be present (or absent). Finally, the arrangement is examined and a decision is reached on whether the requisite facts, features and attributes are present as matters of commercial and economic reality. If not, the arrangement is likely to be a tax avoidance arrangement unless the tax avoidance purpose or effect is merely incidental to a non-tax avoidance purpose or effect of the arrangement.

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Beneficiary income
Interest deductions
Limited partnerships
Merely incidental
Portfolio Investment Entity
Reconstruction
Tax avoidance
Tax avoidance arrangement
Trustee income

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