

# Income tax: scenarios on tax avoidance – 2023 No 1

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QB 23/01

This Question We've Been Asked (QWBA) updates tax avoidance scenarios from earlier publications that have become outdated. The earlier publications include QWBAs that were based on the Commissioner's statement on tax avoidance published in 2013 (IS 13/01). IS 13/01 has been replaced by IS 23/01: "Tax avoidance and the interpretation of the general anti-avoidance provisions sections BG 1 and GA 1 of the Income Tax Act 2007".

## Key provisions | Whakaratonga tāpua

Income Tax Act 2007 – ss BG 1, GA 1

**REPLACES | WHAKAKAPIA: QB 14/11 (scenario 1) and QB 15/11 (scenario 2)**

## Background | Horopaki

1. This Question we've been asked (QWBA) is one of two QWBAs that replaces some of the scenarios on tax avoidance that appeared in the following QWBAs that are withdrawn from the date of this publication:<sup>1</sup>
  - QB 14/11: Income tax – scenarios on tax avoidance
  - QB 15/01: Income tax – tax avoidance and debt capitalisation
  - QB 15/11: Income tax – scenarios on tax avoidance – 2015.
2. The withdrawn QWBAs were based on the Commissioner's statement on tax avoidance IS 13/01.<sup>2</sup> IS 13/01 has been replaced by IS 23/01: "Tax avoidance and the interpretation of the general anti-avoidance provisions sections BG 1 and GA 1 of the Income Tax Act 2007". This QWBA updates some of the earlier scenarios to reflect the new statement. Scenario 3 (use of a portfolio investment entity (PIE)) is adapted from example 2 of IS 13/01. The answer as to whether or not s BG 1 applies in each of the scenarios has not changed. Due to subsequent legislative changes, some of the scenarios in the withdrawn QWBAs have not been updated.<sup>3</sup>
3. Section BG 1 is the principal vehicle to address tax avoidance in the Income Tax Act 2007. The Supreme Court in *Ben Nevis* considered it desirable to settle the approach to the relationship between s BG 1 and the specific provisions in the rest of the Act

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<sup>1</sup> Published in: *Tax Information Bulletin* Vol 26, No 11 (December 2014): 3 (QB 14/11), *Tax Information Bulletin* Vol 27, No 3 (April 2015): 25 (QB 15/01) and *Tax Information Bulletin* Vol 27, No 10 (November 2015): 27 (QB 15/11).

<sup>2</sup> IS 13/01: *Tax avoidance and the interpretation of ss BG 1 and GA 1 of the Income Tax Act 2007* published in *Tax Information Bulletin* Vol 25, No 7 (August 2013): 4.

<sup>3</sup> This QWBA comprises updated versions of scenario 1 from QB 14/11 and scenario 2 from QB 15/11. The remaining scenarios from QB 15/11 (scenarios 1 and 3) have been updated in a separate QWBA (QB 23/02: "Income tax: scenarios on tax avoidance – 2023 No 2").

The following QWBA or scenarios have not been updated:

- QB 14/11, scenario 2 (Look-through company election). Scenario 2 concerned s CB 32C (Dividend income for first year of look-through company) prior to its replacement by s 14(1) of the *Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Act 2017*.
- QB 14/11, scenario 3 (Substituting debentures). Scenario 3 concerned substituting debentures under s FA 2(5), repealed from 1 April 2015 by s 102(3) of the *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014*.
- QB 15/01: Legislative changes were made to reverse the conclusion in QB 15/01 at the time of its publication, see: *Related parties debt remission, An officials' issues paper* (Policy and Strategy, Inland Revenue and the Treasury, February 2015). See also: s EW 46C inserted by s 75 of the *Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Act 2017* with effect from 1 April 2008.

with the Parliamentary contemplation test.<sup>4</sup> The Supreme Court confirmed the Parliamentary contemplation test as the proper and authoritative approach to applying s BG 1 in *Penny and Frucor*.<sup>5</sup>

4. The test involves ensuring Parliament's purpose for the specific provision and its purpose for s BG 1, as the principal vehicle in the Act to address tax avoidance, are achieved. This occurs by the specific provision and s BG 1 working in tandem with each providing the context that defines the meaning and scope of the other. Hence, the Parliamentary contemplation test requires consideration of Parliament's purpose for the specific provision and its purpose for s BG 1. Parliament's overall purpose comprises both of these purposes.
5. The Commissioner's view as to whether s BG 1 applies in these scenarios must be understood in the following terms:
  - The arrangements are framed broadly.
  - The conclusions reached are limited to the arrangements as set out.
  - 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.
  - Because the objective is to consider the application of s BG 1, the analysis proceeds on the basis that the tax effects under the applicable specific provisions of the Act are achieved as stated.
  - The implications of any relevant specific anti-avoidance provisions are not considered.
6. Applying s BG 1 requires answering the "ultimate question" under the Parliamentary contemplation test: does the arrangement, when viewed in a commercially and economically realistic way, make use of, or circumvent, the specific provisions in a manner consistent with Parliament's purpose?<sup>6</sup>
7. If the arrangement uses or circumvents a specific provision in a manner that is outside Parliament's purpose, it has a tax avoidance purpose or effect. Where an arrangement has two or more purposes or effects and one purpose or effect is tax avoidance, s BG 1 will apply only if the tax avoidance purpose or effect is more than merely incidental to another purpose or effect of the arrangement.

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<sup>4</sup> *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115, [2009] 2 NZLR 289 at [100].

<sup>5</sup> *Penny v CIR* [2011] NZSC 95, [2012] 1 NZLR 433 (also known as *Penny & Hooper*) at [33] and *Frucor Suntory New Zealand Ltd v CIR* [2022] NZSC 113 at [53].

<sup>6</sup> *Ben Nevis (SC)* at [109].

8. The merely incidental test involves the consideration of many of the same factors that are considered under the Parliamentary contemplation test. A conclusion under the Parliamentary contemplation test that an arrangement uses or circumvents a specific provision in a manner that is outside Parliament's purpose (ie, it has a tax avoidance purpose or effect) means it is unlikely that the arrangement's tax avoidance purpose will be merely incidental.<sup>7</sup>
9. 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 the voiding of the arrangement does not appropriately counteract the tax advantages, the Commissioner is under a duty to apply s GA 1 to ensure this outcome is achieved.
10. For a comprehensive explanation of the Commissioner's view of the law concerning applying ss BG 1 and GA 1, see IS 23/01: "Tax avoidance and the interpretation of the general anti-avoidance provisions sections BG 1 and GA 1 of the Income Tax Act 2007".

## Scenario 1 — Interest deductions where shareholder loans replaced

### Question | Pātai

11. Does s BG 1 apply in the following circumstances:
  - Mr and Mrs B are the settlors of a family trust of which they and their children are discretionary beneficiaries. They are also trustees of the family trust along with an independent trustee.
  - Company A is wholly owned by the family trust. Mr and Mrs B are the sole directors of the company. Company A is not a qualifying company.
  - Over a period of years, the trust has advanced from its cash reserves \$1m to the company. The shareholder loans were made on interest-free and on-demand terms.
  - Company A has used the shareholder loans to finance its business operations for the purpose of deriving assessable income.

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<sup>7</sup> *Ben Nevis* (SC) at [114].

- The trustees of the family trust demand repayment of the full amount of the loans outstanding.
- Company A borrows \$1m from a third-party lender at market interest rates.
- The third-party borrowing by Company A is secured over the assets of the trust.
- Company A uses the third-party borrowing to repay to the trust the \$1m in shareholder loans.
- The trust subsequently uses the repaid funds to acquire a holiday home for use by the trust's beneficiaries.
- Company A incurs interest on the third-party borrowing and deducts the cost of the interest from its assessable income for the purposes of calculating its income tax liabilities.

## Answer | Whakautu

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

## Explanation | Whakamāramatanga

### Introduction

13. The Commissioner's approach to applying s BG 1 is as follows. First, understand the legal form of the arrangement in terms of its scope, commercial or private purposes and tax effects.
14. Then, ascertain Parliament's purpose for the specific provisions the arrangement uses or circumvents.
15. The Commissioner considers that, in some cases, a helpful practical technique may be to consider "facts, features or attributes" for a specific provision. Once Parliament's purpose for a specific provision has been ascertained, that purpose may be translated into facts, features or attributes that Parliament would contemplate being present (or absent) to give effect to that purpose. This is because a specific provision sets out a legal rule that will be activated or satisfied by the existence (or non-existence) of certain explicit and implicit facts, features or attributes. These might include legal, commercial, economic, or other concepts.

16. Next, understand the commercial and economic reality of the arrangement as a whole. Factors the courts have referred to that may be helpful to consider include:
- whether the taxpayer has gained the benefit of the specific provision in an artificial or contrived way, or by pretence;
  - the manner in which the arrangement is carried out;
  - the role of all relevant parties and their relationships;
  - the economic and commercial effect of documents and transactions;
  - the nature and extent of the financial consequences;
  - the duration of the arrangement;
  - whether there is circularity in the arrangement;
  - whether there is inflated expenditure or reduced levels of income in the arrangement;
  - whether the parties to the arrangement have undertaken limited or no real commercial or economic risks; and
  - whether the arrangement is pre-tax negative.
17. Then consider the implications of the preceding analysis of Parliament's purposes for the specific provisions and the arrangement's purposes, tax effects and commercial and economic reality as a whole. Bearing in mind s BG 1's purpose as the principal vehicle in the Act to address tax avoidance, the analysis is likely to highlight a number of interrelated matters, including those concerning:
- The presence (or absence) of artificiality, contrivance or pretence.
  - The veracity of the arrangement's commercial or private purposes (in contrast to the clarity or otherwise of the arrangement's tax advantages).
  - Whether or not the use or circumvention of the relevant specific provisions is consistent with Parliament's purposes for the provisions.
18. The preceding analysis of the arrangement may highlight that tax advantages have been obtained by artificiality or contrivance. Artificiality or contrivance is a significant factor because the courts have confirmed that using or circumventing specific provisions to obtain tax advantages in artificial or contrived ways is outside Parliament's contemplation for those specific provisions. The related concept of pretence will also be highly relevant.

19. Artificiality, contrivance or pretence must be considered in the context of the arrangement as a whole and can be described as including something that in commercial and economic reality (as objectively determined):
- is not commercially realistic;
  - would not happen in that particular way or would not happen at all in commercial or private dealings, independent of the tax advantages;
  - has no commercial or private purpose;
  - has a commercial or private purpose, but that purpose has no commercial or private rationale or logic, independent of the tax advantages; or
  - distorts the application or non-application of specific provisions.
20. The analysis of the arrangement's commercial and economic reality may show the arrangement's apparent commercial or private purposes as previously analysed may not be consistent with its commercial and economic reality. The analysis may show that the arrangement may not, in reality, have any commercial or private purposes or that aspects of the arrangement suggest those purposes lack a rationale or justification once shorn of the tax advantages. Arrangements are likely to be outside Parliament's purpose for the specific provision where:
- the arrangement has no commercial or private purpose;
  - a step in the arrangement has no commercial or private purpose and the step uses or circumvents the specific provision;
  - the arrangement (or a step) has a commercial purpose, but that purpose has no commercial rationale or viability independent of the tax advantage; or
  - the arrangement (or a step) is structured in a manner where the commercial or private purposes are dependent on a tax advantage being achieved.
21. Understanding the commercial and economic reality of the arrangement as a whole may indicate the arrangement uses (or circumvents) specific provisions in a manner that is not consistent with Parliament's purposes.
22. Practically, the technique of using facts, features, or attributes may be helpful in some cases with ascertaining whether an arrangement has crossed the line into tax avoidance. This involves considering whether the facts, features or attributes previously translated from Parliament's purpose for the specific provision are consistent with those that are present (or absent) in the arrangement when viewed as a whole and in a commercially and economically realistic way.

23. A lack of consistency under the facts, features or attributes technique may indicate that Parliament's purpose for the specific provision is not being met. On the other hand, consistency under the facts, features or attributes technique does not prevent the application of s BG 1. The technique can only assist in assessing whether Parliament's overall purpose for the specific provisions and s BG 1 is being met. It is not a bright-line test nor a substitute for considering all the relevant facts and reaching a reasonable inference or conclusion.
24. Also, some types of arrangements do not lend themselves as readily as others to the use of the facts, features or attributes technique. See, for example, *Penny* (SC) where there was "no failure to comply with any express requirement of the Act in the setting of salaries, since there is none".<sup>8</sup>
25. Finally, taking into account all of the matters considered above, answer the ultimate question: does the arrangement, viewed in a commercially and economically realistic way, use or circumvent the specific provisions in a manner that is consistent with Parliament's purpose? The answer must be a reasonable inference that is:
- open on the evidence and on the facts established from the evidence;
  - logical and convincing;
  - not mere speculation; and
  - not an intuitive subjective impression.
26. If tax avoidance is not the sole purpose or effect of the arrangement, consideration will need to be given to whether the tax avoidance purpose or effect is merely incidental. Applying the merely incidental test involves considering:
- the relationship between the tax avoidance purpose or effect of the arrangement and other purposes or effects of the arrangement (non-tax avoidance purposes); and
  - whether the tax avoidance purpose or effect follows as a natural incident of another purpose.
27. Therefore, the non-tax avoidance purposes of the arrangement (which generally are identified when considering the arrangement under the Parliamentary contemplation test) are also relevant to the merely incidental test. Non-tax avoidance purposes include:

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<sup>8</sup> At [33].



- commercial purposes;
- private purposes; and
- purposes giving rise to legitimate tax advantages (ie, where the use or the circumvention of specific provisions is within Parliament's contemplation).

### **The arrangement's scope, purposes and tax effects**

28. The steps and transactions that make up the arrangement are:
- the trustees of the family trust demanding repayment in full of the \$1m in shareholder loans;
  - Company A borrowing \$1m from a third party on an arm's-length basis;
  - Company A repaying \$1m to the family trust;
  - the trustees purchasing a residential property for \$1m and settling the acquisition with the funds received from Company A; and
  - Company A deducting the cost of the interest incurred on the third-party borrowing from its assessable income for the purposes of calculating its income tax liabilities.
29. On the face of it, the arrangement serves the commercial purposes of maintaining sufficient working capital in the company in order to continue its business operations while freeing up funds for the trust to apply to other assets (the residential property).
30. The tax effect for Company A is that an interest deduction will be available under ss DA 1, DB 6 or DB 7 and the private limitation in s DA 2(2) does not apply.

### **Parliament's purposes for the specific provisions**

31. 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).
32. Parliament's purpose for the general deductibility provisions is to allow expenditure incurred in carrying on a business or deriving assessable income to be deductible from the income – as long as the expenditure is not capital or private or domestic in nature (s DA 2).
33. Very broadly, capital expenditure is "one-off" expenditure on acquiring fixed assets, such as land and buildings, that provide a benefit over a period of years. Private or domestic expenditure is expenditure referable to living as an individual member of

society or to a household or family unit. Private or domestic expenditure is not usually referable to carrying on a business or deriving assessable income.

34. Interest deductions are treated differently to other deductions, including not being subject to the limitation on deducting capital expenditure (s DB 6). The limitation on deducting private or domestic expenditure still applies.
35. Generally, for interest deductions Parliament contemplates interest to be deductible where the loan capital relating to that interest is used in a business or in some other way in the production of assessable income (s DB 6, *Pacific Rendezvous Ltd (CA)*<sup>9</sup>).
36. Parliament has also distinguished between some companies and other taxpayers for interest deductions. Significantly, interest incurred by some companies is deductible under s DB 7 without the need to establish a connection between the borrowing and carrying on a business or deriving assessable income. Section DB 7 does not apply to qualifying companies, nor does it apply to interest that is related to tax. Section DB 7 contains other rules relating to non-resident companies, wholly-owned groups of companies and consolidated groups.
37. By making this distinction for some companies, Parliament intended to clarify the interest deductibility rules applying to companies and to reduce compliance costs by simplifying those rules.
38. Also, the Commissioner's view is that Parliament's purpose for allowing deductions for interest is satisfied where borrowed funds are used to replace amounts invested in income-earning activities by repaying those amounts to the persons who invested them (*Roberts and Smith (FCAFC)*,<sup>10</sup> and BR Pub 15/08<sup>11</sup>).
39. Having identified Parliament's purposes for the specific provisions in this scenario, it is possible to translate Parliament's purposes into the following facts, features or attributes that Parliament would contemplate being present:
  - A borrower has received money from a lender.
  - The borrower has assumed a liability to repay the money to the lender.
  - The borrower has assumed a liability to pay the lender interest for the money lent.

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<sup>9</sup> *Pacific Rendezvous Ltd v CIR* [1986] 2 NZLR 567 (CA).

<sup>10</sup> *FCT v Roberts; FCT v Smith* 92 ATC 4380 (FCAFC).

<sup>11</sup> BR Pub 15/04 – BR Pub 15/09 *Interest Deductibility — Roberts and Smith — Borrowing to replace and repay amounts invested in an income earning activity or business*.

- The interest deductions do not confer a private or domestic benefit on an individual (ie, a shareholder or employee).
- The borrower is a company.
- The borrowed funds are applied to a purpose that has a connection or nexus with the borrower's income-earning activity.
- The circumstances comply with s DB 7 (ie, the company is not a qualifying company, the interest is not related to tax, and the rules relating to non-resident companies, wholly-owned group or consolidated groups are satisfied).

### **Viewing the arrangement as a whole and in a commercially and economically realistic way**

40. Viewing the arrangement as a whole and in a commercially and economically realistic way is assisted by considering the factors listed in [16] above. The factors that are significant in this scenario are:

- *The role of all relevant parties and their relationships* – Almost all the parties to the arrangement are associated or closely related. Usual arm's-length or market forces are absent, particularly in the shareholder lending which is on interest-free terms. However, there is nothing in how the arrangement obtains a tax advantage that particularly hinges on the association or relatedness of the parties, given that the advantage arises from interest payments made to an unrelated third party.
- *Circularity in the arrangement* – There are circular flows of money in this arrangement, however, these are consistent with the commercial reality of borrowing and repaying funds.
- *The parties to the arrangement undertaking limited or no real commercial or economic risk* – To the contrary, in this arrangement the third-party borrowing and security given in respect of that borrowing represents that real risk has been taken on by the parties.
- *Artificiality and contrivance* – There is nothing in the arrangement to show that Company A has obtained a tax advantage in an artificial or contrived way. The interest expense has been incurred as a matter of commercial and economic reality.

## Answering the ultimate question

41. Applying s BG 1 requires answering the “ultimate question” of whether the arrangement, viewed in a commercially and economically realistic way, uses or circumvents the specific provisions in a manner that is consistent with Parliament’s purpose.
42. Analysing the arrangement in this scenario as a whole and in a commercially and economically realistic way does not highlight any issues with the arrangement’s commercial purposes nor does it suggest that tax advantages have been obtained by artificiality, contrivance or pretence.
43. The arrangement has a private purpose as it allows the family trust to reinvest its funds in a holiday home. The arrangement has a commercial purpose in that Company A is refinancing borrowings it has made in order to carry on its business activities.
44. Company A has assumed a real liability in favour of the third-party lender and incurred interest as a matter of commercial and economic reality. Company A either satisfies s DB 7 or the circumstances are such that the interest deductibility test is satisfied as the borrowed funds are used to replace amounts invested in the company’s business.
45. This conclusion is not negated by the fact that the lending is secured over the assets of the trust. The deductibility of the interest paid on the money lent in this scenario turns on the question of the use of the funds borrowed, not the nature of any security given. Similarly, how the trust then uses the funds repaid does not have a bearing on this question. The Commissioner does not consider the circumstances are such that the interest could be characterised as private or domestic expenditure subject to the private limitation. As stated, the borrowed funds are replacing funds previously invested in the company’s business operations. The commercial and economic reality is that the borrowed funds are used in the business and there is no private use of those funds.
46. Nor does the conclusion alter if it is considered that the tax advantage would not have arisen had the trust borrowed directly to acquire the holiday home. Viewing an arrangement in a commercially and economically realistic way does not involve a comparative analysis with a hypothetical alternative arrangement (sometimes referred to as a “counterfactual”). New Zealand’s courts have not relied on counterfactuals to reach a view on whether an arrangement has a tax avoidance purpose or effect. Applying s BG 1 requires considering the arrangement actually entered into.
47. In short, the relevant factors, when applied to the arrangement in this scenario, indicate that the arrangement involves, as a matter of commercial and economic reality, the

borrowing of funds by a company with the company incurring the attendant interest liabilities.

48. Accordingly, the arrangement does not appear to use or circumvent specific provisions of the Act in a manner outside Parliament's contemplation. This can also be (optionally) analysed in terms of the facts, features or attributes Parliament would expect to be present or absent (see [15], [22] and [39] above).
49. In this scenario, the facts, features or attributes that Parliament would contemplate being present (or absent) in an arrangement making use of the provisions dealing with interest deductions are present as matters of commercial and economic reality in this arrangement. That is, there is borrowing by a company with attendant interest liabilities in circumstances that comply with s DB 7 or that have sufficient nexus or connection with a business or income-earning activity. Also, the interest deductions are not private or domestic expenditure. This further reinforces the view that the arrangement does not appear to use or circumvent specific provisions of the Act in a manner outside Parliament's contemplation.
50. In the Commissioner's opinion, taking into account all of the above matters, this arrangement does not use or circumvent the specific provisions in a manner that is outside Parliament's purposes for those provisions. As such, it is not a tax avoidance arrangement as it does not have tax avoidance as a purpose or effect and, without more, s BG 1 would not apply.

## Scenario 2 — Interest deductions and use of a portfolio investment entity

### Question | Pātai

51. Does s BG 1 apply in the following circumstances:<sup>12</sup>
  - An individual taxpayer, with income that places them on a marginal tax rate of 39%, borrows funds for a fixed term of 2 years from Bank A and incurs interest at a fixed rate of 5% per annum.

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<sup>12</sup> As originally stated in QB 15/11, 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.

- 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.

## Answer | Whakautu

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

## Explanation | Whakamāramatanga

### Introduction

53. The Commissioner's approach to applying s BG 1 is set out in scenario 1 at [13] to [27] above.

### The arrangement's scope, purposes and tax effects

54. The steps and transactions that make up the arrangement are:
- the taxpayer borrowing funds for a fixed term of 2 years from Bank A at a fixed interest rate of 5% per annum;
  - the taxpayer applying the borrowed funds to acquire an investor interest in a multi-rate PIE sponsored by Bank A;
  - the taxpayer notifying the PIE to apply an investor rate of 28%;
  - the PIE investing all funds in New Zealand dollar interest-bearing 2-year deposits with Bank A at a fixed pre-tax return of 4.9% per annum;

- the taxpayer's PIE income being retained by Bank A in satisfaction of the interest obligations under the loan by Bank A to the taxpayer;
  - the PIE attributes income to the taxpayer; and
  - the taxpayer filing tax returns in which they deduct the interest expenditure incurred on the borrowed funds (as calculated under the financial arrangements rules) against their other income.
55. On the face of it, the arrangement serves the commercial or private purpose of providing an investment to enhance the taxpayer's savings and investment activities.
56. 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 other income taxed at a marginal tax rate of 39%.

### **Parliament's purpose for the specific provisions**

57. The relevant provisions of the Act are the PIE rules in subpart HM, ss BD 1, CP 1, CX 55, CX 56 and sch 6 and the provisions governing the deductibility of interest (ie, the general permission in s DA 1 and s DB 6).

### **The PIE rules**

58. 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).
59. 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.

60. 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)(c)). 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 for a natural person investor is 28%, which is less than the top personal tax rate.
61. 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 prescribed investor rate). 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 prescribed investor rate is a final tax on the PIE income.
62. 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 where such vehicles were disadvantaged. It was considered important that investors' decisions were not distorted by different tax treatments for income from investments that were similar in nature.
63. Also, the timing of the introduction of the PIE rules was linked to the introduction of the KiwiSaver scheme and Parliament's wider purpose 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.<sup>13</sup>
64. Having identified Parliament's purposes for the specific provisions in this scenario it is possible to translate Parliament's purposes into the following facts, features or attributes Parliament would contemplate being present:
- 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.
  - A natural person who is a New Zealand resident.

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<sup>13</sup> 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.



- An investment by the natural person in the PIE as part of the investors' savings and investment activities.
- The notification to the PIE by the investor of their prescribed investor rate and IRD number.
- Income is earned by the PIE and 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.

### **Interest deductibility**

65. Parliament's purpose for interest deductibility provisions (including the translation of that purpose into facts, features or attributes) is discussed as part of the answer to scenario 1 of this QWBA (see [31] to [39] above).

### **Viewing the arrangement as a whole and in a commercially and economically realistic way**

66. Viewing the arrangement as a whole and in a commercially and economically realistic way is assisted by considering the relevant factors out of those listed in [16] above. The factors that are significant in this scenario are:
- *The manner in which the arrangement is carried out* – The arrangement is unusual from a commercial or private point of view because the taxpayer is borrowing funds to reinvest them at a return less than the cost of borrowing. Another unusual feature includes the narrow restriction placed on what the borrowed funds can be used for. From a commercial perspective the arrangement is artificial in the sense that it is not commercially realistic given there is no prospect of a profit independent from the tax advantages.
  - *The role of all relevant parties and their relationships* – This is a prominent feature of this arrangement, with Bank A acting as lender, sponsor of the PIE and the sole investment option for the PIE's funds. Usual arm's-length or market forces are absent, particularly in the rates set for interest on the loan and the return on the PIE's investments contributing to what are commercially artificial returns.

- *Economic and commercial effect of documents and transactions* – As mentioned, the commercial or private purposes cannot be achieved independent of the tax advantages.
- *Nature and extent of the financial consequences* – This factor overlaps with the preceding factors and, again, the financial consequences of the arrangement are that the tax advantages are essential to the arrangement achieving its purposes.
- *Duration of the arrangement* – The duration of the arrangement is notable in that the terms of the loan by Bank A to the taxpayer and the investment of the PIE's funds with Bank A are identical.
- *Circularity of the arrangement* – There are circular flows of money in this arrangement, with loan funds flowing from Bank A to the taxpayer and on to the PIE and then back to Bank A. Similar circular flows occur in reverse with the investment returns on the PIE's funds, flowing from Bank A to the PIE to the taxpayer and back to Bank A.
- *Inflated expenditure or reduced levels of income* – There is a lack of commerciality in the rates applied to the loan and PIE investments. Effectively, Bank A is lending to the taxpayer in circumstances where the borrower, on the face of it, is guaranteed to make a loss. That is, the taxpayer is borrowing money at 5% so they can invest it at 4.9%.
- *The parties to the arrangement undertaking little or no real commercial or economic risk* – In this arrangement Bank A is not undertaking any real risk in lending to the taxpayer as they are assured that the borrowed funds are returned to it.
- *Arrangement is pre-tax negative* – The arrangement is pre-tax negative. 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 0.478%. 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 39%.<sup>14</sup> Also, the fixed nature of the terms and interest rates applying to the borrowing and to the PIE investment precludes any other economic gains arising from the arrangement.
- *Artificiality or contrivance* – A number of the above factors suggest that the arrangement has been designed (ie, structured) so that a tax advantage is

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<sup>14</sup> The post-tax positive return is calculated as follows:  $(4.9\% \times (1-0.28)) - (5.0\% \times (1-0.39)) = 0.478\%$ .

obtained by artificiality or contrivance. In particular, the pre-tax negative/post-tax positive nature of the arrangement, the lack of real commercial or economic risk to the parties, the interest rate and terms of the loan set by Bank A and the circular flow of funds mentioned.

### Answering the ultimate question

67. Applying s BG 1 requires answering the “ultimate question” of whether the arrangement, viewed in a commercially and economically realistic way, uses or circumvents the specific provisions in a manner that is consistent with Parliament’s purpose.
68. The Commissioner accepts that Parliament contemplated taxpayers could invest through a PIE to secure the tax advantage of the maximum prescribed investor rate of 28%. For instance, the current arrangement can be contrasted with a situation where a taxpayer on the highest marginal tax rate withdrew existing investment funds from a non-PIE investment to invest in a PIE. 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 (see scenario 3 below).
69. However, it is evident when viewing the arrangement as a whole and in a commercially and economically realistic way, the form of the arrangement, as an investment in a PIE, is not consistent with its commercial and economic reality and the apparent commercial or private purposes of the arrangement are undermined.
70. There is a direct and unambiguous connection between the tax advantages arising under the arrangement and the artificial or contrived elements of the arrangement. Any commercial or private purposes of the arrangement have no rationale independent of the tax advantages – their achievement is dependent on the tax advantages being achieved. In particular, the lending, borrowing and investment elements of the arrangement are artificial or contrived. The tax advantages are achieved under the specific provisions as a result of the pretence that there has been borrowing of funds to apply to an income earning activity and that the PIE is part of the taxpayer’s savings and investment activities.
71. As mentioned, the borrowing is being invested at less than the cost of borrowing and the bank is not undertaking any real risk in lending. Together, this suggests there is, in commercial and economic reality, 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 in the arrangement is not part of the taxpayer’s savings and investment activities.

72. On this basis, it appears that the arrangement's use of the specific provisions of the Act (particularly the PIE regime) is not consistent with Parliament's purpose for the provision. The artificial or contrived elements of the arrangement appear to be contrary to Parliament's purpose for s BG 1.
73. The scenario can also be (optionally) analysed in terms of the facts, features or attributes Parliament would expect to be present or absent (see [15], [22] and [64] above). In this scenario a number of relevant facts, features or attributes are considered to be present in this arrangement as far as the operation of the PIE. There is a multi-rate PIE deriving income. Tax is paid at the investors' notified investor rates so that the PIE's tax liability resembles the total tax liability the group of investors would have had if they had invested 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.
74. However, the Commissioner considers that the following facts, features or attributes that Parliament would expect to be present in the arrangement as matters of commercial and economic reality, are absent:
- Borrowed funds on which interest accrues have been applied in connection with an income-earning activity.
  - The PIE investment is part of the investors' savings and investment activities.
75. Viewing the arrangement in terms of facts, features or attributes further reinforces the view that the arrangement uses or circumvents specific provisions of the Act in a manner outside Parliament's contemplation.
76. In the Commissioner's opinion, taking into account all of the above, this arrangement uses or circumvents the specific provisions in a manner that is outside of Parliament's purposes for those provisions. As such, the arrangement has tax avoidance as one of its purposes or effects.

### **The merely incidental test**

77. Because the arrangement has a tax avoidance purpose or effect, it is necessary to consider whether the tax avoidance purpose or effect is merely incidental to a non-tax avoidance purpose or effect. If so, s BG 1 will not apply. 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.

78. 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.
79. 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 of the arrangement.

### **Conclusion on tax avoidance**

80. The Commissioner considers that the arrangement involves a more than merely incidental purpose or effect of tax avoidance and the arrangement is a tax avoidance arrangement that would be subject to s BG 1.

### **Reconstruction**

81. Where s BG 1 applies, the arrangement is void as against the Commissioner. The next matter to consider is whether voiding the arrangement adequately counteracts the tax advantage gained by the taxpayer from the arrangement. If not, the Commissioner is under a duty to apply s GA 1 to reconstruct the arrangement to ensure this occurs. The Commissioner has a broad discretion as to how to reconstruct an arrangement. In some scenarios there may be more than one approach possible.
82. In this scenario, voiding the arrangement would mean both the PIE income and interest deductions would be disregarded for tax purposes. However, while there are tax effects from the arrangement for both the PIE and the taxpayer, the arrangement creates an overall tax advantage for the taxpayer. This means reconstructing the arrangement for the taxpayer may be appropriate provided it restores 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 39% marginal tax rate matches the tax already paid by the PIE at the 28% prescribed investor rate. This approach would adequately counteract the tax advantage by making tax a neutral factor in the arrangement.

## Scenario 3 — Reinvestment and use of a portfolio investment entity

### Question | Pātai

83. Does s BG 1 apply in the following circumstances:<sup>15</sup>
- The taxpayer, a salary and wage earner on the top marginal tax rate of 39%, has a term deposit with their local bank (Bank A) that has just matured. The taxpayer wants to reinvest the amount with their bank for a year.
  - Bank A offers the taxpayer the option of investing in:
    - another term deposit earning 5% interest and taxed at 39%; or
    - a multi-rate portfolio investment entity (PIE) earning a 5% return, but the taxpayer's prescribed investor rate means they are taxed on the PIE income at 28%.
  - The taxpayer chooses to invest the amount in the PIE as it will generate a higher after-tax return than that generated by the term deposit and there seems to be no significantly greater risk.

### Answer | Whakautu

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

### Explanation | Whakamāramatanga

#### Introduction

85. The Commissioner's approach to applying s BG 1 is set out in scenario 1 at [13] to [27] above.

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<sup>15</sup> This scenario has been adapted from example 2 of IS 13/01.

## The arrangement's scope, purposes and tax effects

86. The steps and transactions that make up the arrangement are:
- the taxpayer directing their bank to reinvest the funds from the maturing term deposit into the bank's PIE investment product;
  - the PIE meeting all the requirements for being a multi-rate PIE as set out in the Act;
  - the taxpayer notifying the PIE to apply their prescribed investor rate of 28%;
  - the PIE investing all funds in New Zealand dollar interest-bearing 2-year deposits with Bank A at a fixed pre-tax return of 5% per annum;
  - the PIE attributes income to the taxpayer and pays the tax on the income at their prescribed investor rate of 28%;
  - the taxpayer correctly treats the PIE income as excluded income for tax purposes meaning that it is not assessable income; and
  - the distribution of the net after-tax return on their investment is also correctly treated as excluded income being a distribution to an investor in a multi-rate PIE.
87. On the face of it, the arrangement serves the commercial or private purposes of providing an investment as part of the taxpayer's savings and investment activities.
88. The tax effects of the arrangement are that the taxpayer derives excluded income from the PIE, on which a final tax has been levied at their notified investor rate of 28%.

## Parliament's purpose for the specific provisions

89. The relevant provisions (the PIE rules) and purpose for them (including the translation of that purpose into facts, features or attributes) are set out above in Scenario 2 at [58] to [64].

## Viewing the arrangement as a whole and in a commercially and economically realistic way

90. Unlike the arrangement in scenario 2 above, under this arrangement there is a real investment by the taxpayer in a PIE. There is no borrowing of funds to make the investment in the PIE at a return less than the cost of borrowing.

91. The PIE is in commercial and economic terms a collective investment vehicle as envisioned by the PIE provisions and is similar to other collective investment vehicles offered by other banks. Unlike the arrangement in scenario 2, the taxpayer is not required to invest in the PIE nor is the PIE obliged under its investment policy to invest in Bank A's deposits (although it has done so). Although the PIE and Bank A are related, the investment is made at the same rate available to Bank A's term deposit customers.
92. The PIE investment will provide a positive return and is, unlike scenario 2, not reliant on the tax advantages to do so. Also, there are a number of features of the arrangement that can be seen to arise as matters of commercial and economic reality:
- The taxpayer is a natural person and is a New Zealand resident.
  - The PIE has been notified of the taxpayer's correct prescribed investor rate.
  - The taxpayer derives income from their investment in the PIE.
  - The PIE pays tax on any income it attributes to the taxpayer at the taxpayer's prescribed investor rate.
  - The taxpayer's prescribed investor rate is the rate set by Parliament.
  - The income the PIE attributes to the investor in a tax year is the investor's excluded income and is not returned by the taxpayer as assessable income.
  - The income attributed to the investor from their PIE investment is taxed at the rate Parliament intended for that type of investment.

### Answering the ultimate question

93. Applying s BG 1 requires answering the "ultimate question" of whether the arrangement, viewed in a commercially and economically realistic way, uses or circumvents the specific provisions in a manner that is consistent with Parliament's purpose.
94. The Commissioner accepts that Parliament contemplated taxpayers could invest through a PIE to secure the tax advantage of the maximum prescribed investor rate of 28%. In this scenario, viewing the arrangement as a whole and in a commercially and economically realistic way does not indicate tax advantages have been obtained by artificiality or contrivance. The arrangement serves the commercial or private purposes of providing an investment as part of the taxpayer's savings and investment activities.



95. As noted above at [92], the investment will provide a positive return absent the tax advantages and there are a number of features of the arrangement that arise as matters of commercial and economic reality. These suggest that the arrangement is not using or circumventing provisions of the Act in a manner outside Parliament's purposes. Those features could also be described in terms of the facts, features or attributes Parliament would expect as discussed above at [15], [22] and [64].
96. In the Commissioner's opinion, taking into account all of the above matters, this arrangement does not use or circumvent the specific provisions in a manner that is outside of Parliament's purposes for those provisions. As such, it is not a tax avoidance arrangement as it does not have tax avoidance as a purpose or effect and, without more, s BG 1 would not apply.

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## About this document | Mō tēnei tuhinga

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