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TAX INFORMATION Bulletin

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Inland Revenue
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YOUR OPPORTUNITY TO COMMENT

Inland Revenue regularly produces a number of statements and rulings aimed at explaining how taxation law affects taxpayers and their agents. Because we are keen to produce items that accurately and fairly reflect taxation legislation and are useful in practical situations, your input into the process, as a user of that legislation, is highly valued.

You can find a list of the items we are currently inviting submissions on as well as a list of expired items at **taxtechnical.ird.govt.nz** (search keywords: public consultation).

Email your submissions to us at **public.consultation@ird.govt.nz** or post them to:

Public Consultation
Tax Counsel Office
Inland Revenue PO Box 2198 Wellington 6140

You can also subscribe at **ird.govt.nz/subscription-service/subscription-form** to receive regular email updates when we publish new draft items for comment.

Your opportunity to comment

Ref	Draft type	Title	Comment deadline
ED0246	Determination	Tax treatment of reimbursing payments made to employees	17 March 2023

IN SUMMARY

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NEW LEGISLATION

This section of the *TIB* covers new legislation, changes to legislation including general and remedial amendments, and Orders in Council.

Order in Council – Tax Administration (January Cyclone Event) Order 2023

Remission of use-of-money interest for taxpayers affected by Cyclone Hale

Order

The Tax Administration (January Cyclone Event) Order 2023 was made on 25 January 2023 and came into force on 26 January 2023. The Order declares the January Cyclone Event to be an emergency event for the purpose of section 183ABA of the Tax Administration Act 1994. This section allows the Commissioner to remit use-of-money interest payable on late tax payments following emergency events.

Background

The floods, landslides and other damage that occurred because of Cyclone Hale from 8 January to 12 January 2023 has been declared to be an emergency event applying to the Coromandel, Gisborne, Northland, Wairarapa, and Wairoa areas.

The Order applies to taxpayers whose ability to pay their tax on time, or accurately estimate their provisional tax, was significantly adversely affected by the disruption caused by the weather fronts in the specified regions and who were unable to pay their tax on time as a consequence. This includes tax payments such as GST (due 16 January) and PAYE (due 20 January).

Taxpayers may apply for interest remission once their tax returns and payments are up to date. Different rules apply in cases of financial hardship.

Effective date

The declaration commenced 26 January 2023 and expires 31 March 2023.

Further information

Find out more about Inland Revenue's tax relief measures at **www.ird.govt.nz**

The new regulations can be found at: **www.legislation.govt.nz/regulation/public/2023/0001/11.0/whole.html**

Order in Council – Tax Administration (January Flood Events) Order 2023

Remission of use-of-money interest for the North Island Flood Events (January 2023)

Order

The Tax Administration (January Flood Events) Order 2023 was made on 8 February 2023 and came into force that day. The Order declares the January flood events to be emergency events for the purpose of section 183ABA of the Tax Administration Act 1994. This section allows the Commissioner to remit use-of-money interest payable on late tax payments following emergency events.

Background

The floods, landslides and other damage that occurred because of the heavy rainfall from 26 January to 3 February 2023 has been declared to be an emergency event applying to the Northland, Auckland, Waikato, and the Bay of Plenty regions.

The Order applies to taxpayers whose ability to pay their tax on time, or accurately estimate their provisional tax, was significantly adversely affected by the disruption caused by the weather fronts in the specified regions and who were unable to pay their tax on time as a consequence. This includes tax payments such as GST, which was due on 30 January 2023, as well as income tax which was due on 7 February 2023.

Taxpayers may apply for interest remission once their tax returns and payments are up to date. Different rules apply in cases of financial hardship.

Effective date

The declaration commenced 8 February 2023 and expires 30 April 2023.

Further information

Find out more about Inland Revenue's tax relief measures at **www.ird.govt.nz**

The new regulations can be found at **https://www.legislation.govt.nz/regulation/public/2023/0003/11.0/whole.html**

Order in Council – Tax Administration (February Cyclone Event) Order 2023

Remission of use-of-money interest for Taxpayers affected by Cyclone Gabrielle

Order

The Tax Administration (February Cyclone Event) Order 2023 was made, and came into force, on 20 February 2023. The Order declares the February Cyclone Event (Cyclone Gabrielle) to be an emergency event for the purpose of section 183ABA of the Tax Administration Act 1994. This section allows the Commissioner to remit use-of-money interest payable on late tax payments following emergency events.

Background

The flooding, landslides and other damage that occurred because of Cyclone Gabrielle from 12 to 16 February 2023 has been declared to be an emergency event applying to the Auckland, Bay of Plenty, Gisborne, Hawke's Bay, Northland, and Waikato regions, and the Tararua district.

The Order applies to taxpayers whose ability to pay their tax on time, or accurately estimate their provisional tax, was significantly adversely affected by the disruption caused by the weather fronts in the specified regions and who were unable to pay their tax on time as a consequence. This includes tax payments for PAYE (due 20 February), GST and provisional tax (due 28 February).

Taxpayers may apply for interest remission once their tax returns and payments are up to date.

Effective date

The declaration commenced 20 February 2023 and expires 30 June 2023.

Further information

Different rules apply in cases of financial hardship. Find out more about Inland Revenue's tax relief measures at **ird.govt.nz**.

The new regulations can be found at

https://www.legislation.govt.nz/regulation/public/2023/0010/9.0/whole.html

LEGISLATION AND DETERMINATIONS

This section of the *TIB* covers items such as recent tax legislation and depreciation determinations, livestock values and changes in FBT and GST interest rates.

FDR 2023/01 – A type of attributing interest in a foreign investment fund for which a person may use the fair dividend rate method (Units in the Plato Global Macro Equity Fund– Class Z)

Any investment by a New Zealand resident investor in units in the Plato Global Macro Equity Fund– Class Z, (previously Two Trees Global Equity Macro Fund -Class Z) to which none of the exemptions in section EX 29 to 43 of the Income Tax Act 2007 apply, is a type of attributing interest for which the investor may use the Fair Dividend Rate method to calculate Foreign Investment Fund income for the interest.

This Determination is a variation of Determination number 2022/01 previously issued to "Two Trees Global Equity Macro Fund". There are no material changes to the Discussion and Scope previously published, other than the name change.

Reference

This determination is made under section 91AAO(1)(a) of the Tax Administration Act 1994. This power has been delegated by the Commissioner of Inland Revenue to the position of Technical Specialist under section 7 of the Tax Administration Act 1994.

Discussion (which does not form part of the determination)

Units in the Plato Global Macro Equity Fund– Class Z ("Plato Global Fund"), to which this determination applies, are attributing interests in a foreign investment fund ("FIF") for New Zealand resident investors when none of the exemptions in section EX 29 to EX 43 of the Income Tax Act 2007 apply.

Under EX 32 of the Income Tax Act 2007 an exemption may arise for an Australian Unit Trust and a New Zealand resident investor so that a person's rights in the unit trust in an income year are not an attributing interest. The determination will only apply when an attributing interest arises.

New Zealand resident investors are required to apply the FIF rules to determine their tax liability in respect of their Plato Global Fund investments each income year.

The investments held by the Plato Global Fund may consist predominantly of financial arrangements providing funds to a person. In addition, some New Zealand resident investors may hedge their attributing interests in the Plato Global Fund back to New Zealand dollars. Therefore, section EX 46(10)(cb) of the Income Tax Act 2007 could apply to prevent those investors from using the fair dividend rate method in the absence of a determination under section 91AAO of the Tax Administration Act 1994.

The policy intention is that the FDR method of calculating FIF income should not be applied to investments that provide a New Zealand resident investor with a return similar to a New Zealand dollar denominated debt investment. It is appropriate for the Commissioner to take into account the whole of the arrangement in ascertaining whether an investment in a FIF provides the New Zealand-resident investor with a return akin to a New Zealand dollar denominated debt investment.

Notwithstanding that the Plato Global Fund may have assets predominantly comprising financial arrangements and New Zealand resident investors may enter into related New Zealand dollar hedging arrangements, the overall arrangement contains sufficient risk so that it is not akin to a New Zealand dollar-denominated debt instrument. Accordingly, I consider it is appropriate for New Zealand resident investors to use the fair dividend rate method to calculate FIF income from their attributing interest in the Plato Global Fund.

Scope of determination

This determination is issued on the basis of information provided to the Commissioner before the date of this determination and applies to an attributing interest in a FIF held by New Zealand resident investors in a non-resident issuer where:

1. The non-resident issuer:
    - Is known at the date of this determination as the Plato Global Macro Equity Fund;
    - Invests in long and short positions in equity, bond, currency and commodity markets, as well as making other investments;
    - Is operated with separate classes of units.
2. The attributing interest consists of class Z units issued in the Plato Global Fund, a class of units that provides an interest in the underlying assets of the Plato Global Fund that predominantly (by notional exposure) invests in long and short positions in equity, bond, currency and commodity markets, as well as making other investments. Exposure to these markets is primarily achieved through the use of exchange traded futures or over the counter derivatives such as currency forward contracts. For the purposes of covering the derivative positions, the Plato Global Fund also holds cash and cash equivalents which may mean that the underlying assets of the fund predominantly (i.e. 80% or more by value at a time in the income year) consist of financial arrangements; and
3. The investment interest attributable to the class Z units are subject to currency hedging arrangements undertaken by the New Zealand resident investors for the purposes of eliminating exchange rate risk on a highly effective basis.

This determination is made subject to the following conditions:

1. The investment in the Plato Global Fund is not part of an overall arrangement that seeks to provide the New Zealand resident investor with a return that is equivalent to an effective New Zealand dollar denominated interest exposure.
2. The absolute value of the Plato Global Fund's notional derivative exposure must not fall to 20% or less of its Net Asset Value for a continuous period of 45 days. Should this occur, the determination ceases to apply from the first day of the following quarter.

Interpretation

In this determination unless the context otherwise requires:

"Fair dividend rate method" means the fair dividend rate method under section YA 1 of the Income Tax Act 2007;

"Financial arrangement" means financial arrangement under section EW 3 of the Income Tax Act 2007;

"Foreign investment fund" means foreign investment fund under section YA 1 of the Income Tax Act 2007;

"Plato Global Fund" means an Australian Unit Trust known at the date of this determination as the Plato Global Macro Equity Fund – Class Z.

Determination

This determination applies to an attributing interest in a FIF, being a direct income interest in the Plato Global Fund. This is a type of attributing interest for which the investor may use the fair dividend rate method to calculate FIF income from the interest.

Application Date

This determination applies for the 2023 and subsequent income years.

However, under section 91AAO(3B) of the Tax Administration Act 1994, this determination does not apply for a person and an income year beginning before the date of the determination unless the person chooses that the determination apply for the income year.

Dated this 25th day of January 2023.

Iain McConville

Technical Specialist

INTERPRETATION STATEMENTS

This section of the *TIB* contains interpretation statements issued by the Commissioner of Inland Revenue.

These statements set out the Commissioner's view on how the law applies to a particular set of circumstances when it is either not possible or not appropriate to issue a binding public ruling.

In most cases Inland Revenue will assess taxpayers in line with the following interpretation statements. However, our statutory duty is to make correct assessments, so we may not necessarily assess taxpayers on the basis of earlier advice if at the time of the assessment we consider that the earlier advice is not consistent with the law.

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

Part | Wāhanga 1 Introduction

This statement explains the Commissioner's view of the law on tax avoidance

1.1 This statement explains the Commissioner's view of the law on tax avoidance in Aotearoa New Zealand. It sets out the approach the Commissioner will take to the general anti-avoidance provisions in the Income Tax Act 2007 – ss BG 1 and s GA 1. Where s BG 1 applies, s GA 1 enables the Commissioner to make an adjustment to counteract a tax advantage obtained from or under a tax avoidance arrangement. It is accompanied by a fact sheet: IS 23/01 FS.

1.2 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.[1] This approach is referred to as the Parliamentary contemplation test. The Parliamentary contemplation test was confirmed as the proper and authoritative approach to applying s BG 1 by the Supreme Court in *Penny* and *Frucor*.[2] This statement is based on and reflects the view of the Supreme Court as set out in *Ben Nevis*, and applied in *Penny* and *Frucor*.

1.3 This statement is also relevant to s 76 of the Goods and Services Tax Act 1985 (the GST general anti-avoidance provision). This is because s 76 was aligned with s BG 1 in 2000.

1.4 This statement is in 10 parts. Part 1 contains this introduction, a brief history of the general anti-avoidance provision and a summary of Parts 2 to 10. Part 2 considers the purpose of s BG 1 in the light of the Supreme Court decision in *Ben Nevis*. In Part 3, the relevance of the interpretation and application of provisions specific to the arrangement is considered. Parts 4 and 5 respectively consider the meanings of "arrangement" and "tax avoidance arrangement".

1.5 Part 6 considers the Parliamentary contemplation test adopted by the Supreme Court in *Ben Nevis* (SC) – the test of whether an arrangement has a tax avoidance purpose or effect. A key aspect of the test is considered in Part 7. This is the need to view an arrangement in a commercially and economically realistic way to determine its commercial reality and economic effects.[3] The application of s BG 1 is considered in Part 8.

1.6 Part 9 considers counteracting a tax advantage obtained under a tax avoidance arrangement (s GA 1). Part 10 concludes the statement by considering a collection of issues (some of which are now historical) which arise from time to time in the context of tax avoidance.

1.7 The appendix sets out the relevant legislation.

[1] *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115, [2009] 2 NZLR 289 at [100]. References in this statement to the decision in *Ben Nevis* (SC) refer to the majority decision delivered by the Court, unless otherwise stated.

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

[3] Referred to in this statement as determining an arrangement's "commercial and economic reality".

This statement replaces previous statements

1.8 In February 1990, the Commissioner issued a policy statement on s 99 of the Income Tax Act 1976 (the general anti-avoidance provision).[4] The Commissioner issued a replacement statement (IS 13/01) on 13 June 2013. [5]

1.9 This statement replaces IS 13/01. From the date of this statement, IS 13/01 no longer represents the Commissioner's view on ss BG 1 and GA 1.

History of the general anti-avoidance provisions

1.10 The Supreme Court in *Ben Nevis* briefly referred to the history of the general anti-avoidance provision in New Zealand.[6] The Court noted that a general anti-avoidance provision has been in New Zealand tax legislation since 1878. The provision became s 108 of the Land and Income Tax Act 1954. Judicial criticisms of s 108 led to changes being made in 1974.[7] The changes:

- confirmed that s 108 had effect for tax purposes by stating the arrangement was absolutely void as against the Commissioner for income tax purposes;
- confirmed that s 108 applied whether or not the taxpayer was a party to the arrangement;
- recast the provision's wording so that a tax avoidance arrangement included an arrangement where one of its purposes was tax avoidance provided that purpose was not a "merely incidental" purpose;
- provided that an arrangement could be tax avoidance whether or not other purposes or effects of the arrangement were referable to ordinary business or family dealings;
- empowered the Commissioner to adjust the assessable income of any person affected by the arrangement to counteract any tax advantage obtained by that person under the arrangement; and
- inserted definitions of "tax avoidance" and "liability" which expanded the range of tax advantages that could constitute tax avoidance.[8]

1.11 Section 108 of the Land and Income Tax Act 1954, as amended in 1974, successively became:

- s 99 of the Income Tax Act 1976;
- ss BG 1 and GB 1 of the Income Tax Act 1994;
- ss BG 1 and GB 1 of the Income Tax Act 2004; and
- ss BG 1 and GA 1 of the Income Tax Act 2007.

1.12 Many cases on tax avoidance refer to these predecessors of ss BG 1 and GA 1. Cases that have considered them remain authoritative to the extent they are consistent with *Ben Nevis* (SC) or support a principle or illustrate a point concerning elements of the tax avoidance inquiry. However, to the extent that earlier decisions are inconsistent with the approach to applying s BG 1 set out in *Ben Nevis* (SC), they are no longer relevant. Whether some of the judicial approaches arising before *Ben Nevis* (SC) remain relevant is discussed in Part 10.

Summary

1.13 This summary outlines the Commissioner's view of the law on tax avoidance in Aotearoa New Zealand explained in this statement.

Part 2: The purpose of s BG 1 and Ben Nevis (SC)

1.14 Section BG 1 is the principal vehicle in the Act to address tax avoidance. Section BG 1 provides that a tax avoidance arrangement is void as against the Commissioner for income tax purposes and where it applies the Commissioner may counteract any tax advantage that a person obtains from or under the arrangement.

[4] See Appendix C to *Tax Information Bulletin*, Vol 1, No 8 (February 1990).

[5] IS 13/01: "Tax avoidance and the interpretation of ss BG 1 and GA 1 of the Income Tax Act 2007", *Tax Information Bulletin* Vol 25, No 7 (August 2013): 4.

[6] At [71]–[83].

[7] By s 9 of the *Land and Income Tax Amendment* (No 2) Act 1974.

[8] The phrase "ordinary business or family dealings" is used in the definition of "tax avoidance arrangement" in s YA 1 of the Act. This statement generally uses "commercial or private purposes" to refer to non-tax avoidance purposes of an arrangement, which would include ordinary business or family dealings.

1.15 The courts have described the purpose of s BG 1 in a variety of ways, including to:

- avoid the fiscal effect for tax purposes of arrangements having a more than merely incidental purpose or effect of tax avoidance (*Ben Nevis* (SC));
- prevent uses of the specific provisions that fall outside their intended scope in the overall scheme of the Act (*Ben Nevis* (SC));
- prevent uses of the specific provisions that cannot have been within the contemplation and purpose of Parliament when it enacted the provisions (*Ben Nevis* (SC));
- prevent uses of specific provisions and otherwise legitimate structures in a manner that cannot have been within the contemplation of Parliament (*Penny* (SC));
- negate any structuring of a taxpayer's affairs in an artificial manner where the tax advantage is more than merely incidental (*Penny* (SC)); and
- thwart technically correct but contrived transactions set up as a means of exploiting the Act for tax advantages (*Challenge* (CA)). [9]

1.16 The Supreme Court in *Ben Nevis* considered it desirable to settle the approach to applying s BG 1. This approach is referred to as the Parliamentary contemplation test. It reconciles specific provisions with s BG 1 on the basis that:

- Parliament's overall purpose is best served by interpreting specific provisions and s BG 1 so as to give appropriate effect to the purposes of each. Neither the specific provisions nor s BG 1 is overriding, and they work together in tandem. Each provides a context that determines the meaning and, in particular, the scope of the other.
- The purposes of specific provisions must be distinguished from the purpose of s BG 1.
- Specific provisions have a focus determined primarily through their text and in light of their specific purpose.
- Section BG 1 is designed to address tax avoidance.

1.17 The Court considered that "threshold" arguments (ie, that there is no tax avoidance where the ordinary meaning of a specific provision is satisfied) cannot be correct. Satisfying the ordinary meaning of a specific provision is not sufficient to negate the potential application of s BG 1.

1.18 The Court explained that, in a case involving reliance by the taxpayer on specific provisions, applying s BG 1 would be preceded by an inquiry into whether the application of the specific provisions is within their ordinary meaning and intended scope (see Part 3). If that is shown, a second inquiry is undertaken into whether the arrangement has a more than merely incidental purpose or effect of tax avoidance under s BG 1. This is the tax avoidance inquiry (see Parts 4 to 8).

1.19 The tax avoidance inquiry can involve two tests:

- the Parliamentary contemplation test; and
- the merely incidental test.

1.20 The Parliamentary contemplation test requires deciding whether the arrangement, when viewed in a commercially and economically realistic way, makes use of the specific provisions in a manner consistent with Parliament's purpose when it enacted the provision.

1.21 If an arrangement has two or more purposes or effects and at least one is a tax avoidance purpose or effect, it will be a tax avoidance arrangement if the tax avoidance purpose or effect is more than merely incidental to the other purposes or effects.

1.22 The Commissioner considers that s BG 1 not only applies to arrangements that involve the positive utilisation (or "use") of specific provisions, but it can also apply to arrangements that have the effect that provisions of the Act do not apply (ie, they "circumvent" a provision).

Part 3: Interpretation and application of specific provisions

1.23 The meaning of a specific provision is "ascertained from its text and in the light of its purpose and its context"[10] (a purposive approach).

1.24 Under a purposive approach, the actual words of a specific provision are the most important factor in interpreting the

[9] Challenge Corporation Ltd v CIR [1986] 2 NZLR 513 (CA) at 532, as cited in Penny (SC) at [47] and, in turn, cited in Frucor (SC) at [55].

[10] Section 10(1) of the Legislation Act 2019.

provision. However, the proper meaning of a provision is not necessarily its purely literal or grammatical meaning. A provision's meaning is ascertained from the ordinary meaning of its words (having regard to any statutory definitions) and taking into consideration the purpose of the provision and its context.

1.25 Generally, a purposive interpretation will be the same as the literal meaning as the purpose and the wording will align. If words have two or more meanings, they should be given the one that best accords with the purpose of the legislation. Sometimes, however, to give effect to a clear statutory purpose a strained interpretation (that is one that extends or restricts the literal meaning) may be appropriate – provided the strained interpretation is one the words can legitimately bear.

1.26 Parliament's purpose for a specific provision is what Parliament intended the provision to achieve. Broadly, in the context of tax legislation this is directed toward:

- providing an advantage;
- preventing an advantage; or
- providing a particular treatment for an amount or thing.[11]

1.27 Parliament may have multiple levels of purpose for a specific provision and its purpose may be stated broadly or narrowly. Each provision will have its own particular purpose. It may also have a purpose in a regime, subpart or part of the Act as well as in the Act as a whole.

1.28 Extrinsic materials may be considered to understand the background of a specific provision and what Parliament was trying to achieve. Generally, extrinsic materials are documents produced in the course of enacting legislation. Courts have referred to extrinsic materials to provide background to or confirm a decision on the meaning of a specific provision. However, the courts have generally not shown any willingness to rely on extrinsic materials for an interpretation inconsistent with the words.

1.29 In the context of applying specific provisions, the true nature of an arrangement is determined by the legal rights and obligations (ie, the legal form)[12] of the transactions entered into and the legal steps that are followed.

1.30 Generally, tax outcomes under specific provisions do not depend on the economic consequences of transactions. In contrast, an economic substance approach is permitted and required when applying s BG 1.

1.31 The requirements of a specific provision will generally be satisfied by part of an arrangement (ie, a step or transaction). In contrast, s BG 1 applies to an arrangement as a whole. An arrangement may include additional steps or transactions not directly relevant to the satisfaction of the specific provision.

1.32 Specific provisions that are anti-avoidance provisions (ie, specific anti-avoidance provisions) do not prevent s BG 1 applying unless it is clear Parliament intended this. Section BG 1 may apply to an arrangement that is the same, similar or close to an arrangement covered by a specific anti-avoidance provision.

1.33 In a dispute, the Commissioner can argue that a specific provision applies or not and, in the alternative, that s BG 1 applies.

Part 4: Meaning of "arrangement"

1.34 Parts 4 to 8 of the statement consider the tax avoidance inquiry commencing in Part 4 with the consideration of the meaning of an "arrangement".

1.35 The key statutory concept in s BG 1 is the definition of a "tax avoidance arrangement". The definition uses terms that are further defined, including the term "arrangement".

1.36 An "arrangement" means an "agreement, contract, plan, or understanding, whether enforceable or unenforceable". An arrangement embraces all kinds of concerted action by which persons may arrange their affairs for a particular purpose or to produce a particular effect.

[11] Generally referred to in this statement collectively as "tax advantages".

[12] Various terms have been used at times to describe similar concepts relating to the legal rights and obligations created that are relevant to the application of specific provisions, such as "legal form", the "true legal character", the "legal substance", or, simply, the "form" of a transaction. In this statement "legal form" is used to contrast with the "economic substance" approach used when applying s BG 1.

1.37 An arrangement may involve more than one transaction or document. Whether two or more transactions or documents together constitute an "arrangement" is a matter of fact. The courts will ask whether the transactions or documents are sufficiently interrelated or interdependent or both. An arrangement requires an overall plan, or some prior planned linking or sequencing, or both, of transactions or documents. A mere sequence of unplanned events does not constitute an "arrangement".

1.38 An arrangement includes "all steps and transactions by which it is carried into effect". This means an arrangement includes the various actions undertaken to carry the arrangement into effect even if the actions are not themselves an "agreement, contract, plan, or understanding".

1.39 An arrangement can be carried out by one person because an "arrangement" can be a plan undertaken by one person.

1.40 An arrangement does not require a consensus or a meeting of minds of two or more persons. A taxpayer could be party to an "arrangement" even if they are not aware of its details.

1.41 Part of an arrangement can be an arrangement under s BG 1 in its own right, provided that the part also satisfies the definition of an "arrangement".

1.42 The definition of "arrangement" (and "tax avoidance arrangement" and s BG 1 itself) contains no limitation as to the location of where parts of, or steps and transactions in, an arrangement arise. An "arrangement" includes steps and transactions that are entered into, or carried out, outside New Zealand.

Part 5: Meaning of "tax avoidance arrangement"

1.43 A "tax avoidance arrangement" is an arrangement that has a "purpose or effect" of "tax avoidance" that is "more than merely incidental".

Meaning of "tax avoidance"

1.44 The definition of "tax avoidance" is inclusive. This means the meaning of the term in the Act is not determined solely with reference to the definition. It is also necessary to consider the term's ordinary meaning and the approach taken by the courts to tax avoidance.

1.45 Some phrases in the definition of "tax avoidance" extend the ordinary meaning of tax avoidance. For example, the definition refers to a "potential or prospective liability to future income tax". This phrase removes any doubt over whether tax avoidance is limited to situations where the taxpayer has already derived income.

1.46 The courts typically decide whether there is tax avoidance without any detailed analysis of the statutory definition of "tax avoidance".

1.47 The taxpayer must actually or potentially avoid some income tax for s BG 1 to apply. Section BG 1 is about the avoidance of income tax. The amount and timing of the tax avoided does not need to be certain for s BG 1 to apply.

1.48 Establishing tax avoidance does not require identifying some hypothetical alternative arrangement the taxpayer might have entered into (sometimes referred to as a "counterfactual"). New Zealand courts have not relied on counterfactuals to reach a view on whether an arrangement has a tax avoidance purpose or effect. Following *Ben Nevis* (SC), the Parliamentary contemplation test determines whether an arrangement has a tax avoidance purpose or effect. That test does not require considering a hypothetical arrangement.

Meaning of "purpose or effect"

1.49 An arrangement must have a "purpose or effect" of tax avoidance to be a tax avoidance arrangement. It is settled law that the purpose or effect of an arrangement is determined objectively. The subjective motive, intentions or purposes of the parties are not relevant.

1.50 An arrangement's objective purpose is determined by working backwards from the arrangement's effect. If an arrangement has a particular effect, that will be its purpose. The effect of an arrangement must be ascertained from the terms of the arrangement.

1.51 Oral evidence is admissible as evidence if it establishes the terms of the arrangement. However, oral evidence that is inconsistent with the objectively determined purpose or effect of the arrangement is not relevant.

1.52 Courts do not take subjective evidence into account when assessing the purpose or effect of an arrangement.

Meaning of a purpose or effect that is "more than merely incidental"

1.53 The merely incidental test is relevant only where an arrangement has two or more purposes or effects and at least one purpose or effect is tax avoidance. A tax avoidance purpose is merely incidental if it is not pursued as an end in itself and naturally follows from, attaches to, or is subordinate or subsidiary to, a non-tax avoidance purpose.

1.54 The Supreme Court in *Ben Nevis* said that it would rarely be the case that the use made of a specific provision which is outside Parliamentary contemplation could result in the tax avoidance purpose being merely incidental.

1.55 If a tax avoidance purpose is achieved as a result of artificiality or contrivance, the tax avoidance purpose is likely to be an end in itself and unlikely to be merely incidental to another purpose.

1.56 The significance or size of a tax benefit achieved under an arrangement will not, of itself, establish whether a tax avoidance purpose is merely incidental. Nevertheless, in the Commissioner's view, the size of a tax benefit may, in some cases, be a strong evidential factor in deciding whether a tax avoidance purpose follows naturally from a non-tax avoidance purpose.

1.57 Sometimes taxpayers may put forward as non-tax avoidance purposes of an arrangement the following:

- a tax purpose that is integral to a tax avoidance purpose;
- a non-tax avoidance purpose that is underpinned by tax avoidance; and
- a very general non-tax avoidance purpose that does not explain the adoption of the specific structure of the arrangement.

1.58 The Commissioner considers the above examples of non-tax avoidance purposes that may be put forward are either tax avoidance purposes or are so general in nature they will not lead to a finding that an arrangement's tax avoidance purpose or effect is merely incidental to them.

1.59 The Court of Appeal in *Russell* (CA) observed that the Parliamentary contemplation test and the merely incidental test require consideration of many of the same matters.[13]

Part 6: Parliamentary contemplation test

1.60 The Parliamentary contemplation test sets out the question to be answered when determining whether an arrangement has a tax avoidance purpose or effect. That question is whether the arrangement, viewed in a commercially and economically realistic way, makes use of, or circumvents, the specific provision in a manner consistent with Parliament's purpose (often referred to as the "ultimate question").

1.61 If, having regard to the commercial and economic reality of the arrangement, the use or circumvention of the specific provision is consistent with Parliament's purpose, the arrangement will not have a tax avoidance purpose or effect. The tax advantage gained from such a use or circumvention remains a permissible tax advantage. If, having regard to the commercial and economic reality of the arrangement, the use or circumvention of the specific provision is outside Parliament's purpose, the arrangement will have a tax avoidance purpose or effect. The tax advantage gained from such a use or circumvention will be an impermissible tax advantage unless the tax avoidance purpose or effect is merely incidental to some other purpose or effect of the arrangement.

1.62 The Parliamentary contemplation test requires that the use or circumvention of the specific provision is viewed in light of the arrangement as a whole. Furthermore, the matters that may be considered are not limited to the legal rights and obligations created by the arrangement. It is necessary to view the arrangement's use or circumvention of the specific provisions in a commercially and economically realistic way.

1.63 The courts have referred to a number of factors that can assist in considering tax avoidance and viewing an arrangement in a commercially and economically realistic way when applying the Parliamentary contemplation test. These 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;

[13] *Russell v CIR* [2012] NZCA 128, (2012) 25 NZTC 20–120 at [42].

- 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.

The factors are discussed in detail in Part 7.

1.64 Of these factors, the presence of artificiality or contrivance is significant. This is because the courts have consistently stated that obtaining tax advantages by artificial or contrived means is a use or circumvention of specific provisions outside Parliament's contemplation.

Penny (SC) illustrates the application of the Parliamentary contemplation test

1.65 The Supreme Court's decision in *Penny* is important because it illustrates the Court's approach that tax advantages gained through artificial or contrived means will be outside Parliament's contemplation. The Supreme Court in *Penny* focused on the commercial or private purposes for the setting of each taxpayer's salary paid by their companies each year. These purposes were not considered the sole or dominant purposes of the arrangement. Instead, the Court considered that each arrangement had a predominant purpose of avoiding the highest personal tax rate (although it acknowledged that it was not essential to the application of s BG 1 for the Commissioner to establish a predominant purpose).

Parliament's purpose and the Parliamentary contemplation test

1.66 Parliament's purpose for the specific provisions is distinct from its purpose for s BG 1. The Parliamentary contemplation test requires consideration of both these purposes in order for Parliament's overall purpose to be achieved.

1.67 The inquiry into Parliament's purpose under the Parliamentary contemplation test is a hypothetical one. That is, if Parliament had foreseen the particular arrangement when it enacted the specific provision, would it have viewed the use or circumvention of the specific provision as within the provision's purpose.

1.68 An arrangement may use a combination of unrelated provisions enacted at different times. If so, it is unlikely Parliament will have explicitly considered the interaction of the provisions in the way used by an arrangement. Their individual purposes must still be ascertained, and these may indicate something about their combination. For example, in some cases Parliament may have contemplated that one provision should prevail over others. Separate parts of an arrangement may use or circumvent unrelated specific provisions. If so, the purpose of each provision needs to be considered separately, and the inquiry into Parliament's purpose undertaken for each.

1.69 It may be possible, on reading an Act as a whole, to discern a theme running through the legislation that may be relevant to determining Parliament's purpose for a specific provision. This approach has been applied in several GST tax avoidance cases. However, the income tax legislation is much more extensive in its scope and may not necessarily have a discernible or helpful overall theme.

1.70 The Commissioner considers that Parliament's purpose for a specific provision can be translated into facts Parliament would expect to see present or absent to give effect to that purpose. In addition to particular facts, Parliament's purpose might translate to legal, commercial, economic or other concepts (features or attributes). Facts, features or attributes may in some cases be a practical technique to help with the complex task of applying the Parliamentary contemplation test.

Part 7: Commercial and economic reality of an arrangement

1.71 Viewing the arrangement in a commercially and economically realistic way involves considering how the whole arrangement works over its lifetime in commercial and economic, and not legal, terms.

Factors identified by the courts

1.72 Viewing an arrangement as a whole and in a commercially and economically realistic way can be assisted by considering the factors that the courts have referred to as listed in [1.63].

1.73 Some of the factors are closely connected and may overlap. The relevance and significance of the factors will depend on the particular facts of the arrangement entered into and no one factor will usually be determinative. A combination of factors will often be significant.

Artificiality, contrivance, and pretence

1.74 Artificiality in a tax avoidance context includes 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.

1.75 A contrivance is a planned course of action that is devised, created or planned to attain a specific end. The specific end:

- does not arise naturally, spontaneously or in an unplanned way; and
- is not an incident of some other end or aim.

1.76 An arrangement or steps in an arrangement may involve both artificiality and contrivance. However, the two concepts do not encompass uses of specific provisions that involve nothing more than explicitly legislated options or actions that have a purpose or effect only for tax.

1.77 The structuring of an arrangement so that a taxpayer gains the benefit of specific provisions in an artificial or contrived way is outside Parliamentary contemplation.

1.78 Like artificiality and contrivance, a pretence can arise where the commercial or economic reality of the arrangement is different to its legal form. A pretence, like artificiality and contrivance, is a taxpayer created distortion that affects how a specific provision applies. In the Commissioner's view, if pretence is present in an arrangement, then artificiality or contrivance is likely to also be present.

1.79 Pretence in the context of tax avoidance is different to a sham. A sham in a tax context is designed to mislead the Commissioner into viewing documents as representing what the parties have agreed when, in fact, the documents do not record their true common intention. Pretence and tax avoidance can occur, even though the documents may accurately reflect what the parties intend to implement.

1.80 Pretence will often be highly relevant to whether there is a tax avoidance arrangement.

Manner in which the arrangement is carried out

1.81 The manner in which the arrangement is carried out may indicate that:

- an arrangement has no commercial or private purpose;
- a feature or step in the arrangement has no objectively identifiable commercial or private purpose and is a means to obtain a tax advantage;
- there is no underlying prospect of commercial profit and no commercial justification or rationale for the arrangement; or
- the legal structure of an arrangement is complex in contrast to its economic substance, which may, in turn, indicate that the purpose for such complexity is the gaining of a tax advantage and not a commercial or private purpose.

Role of all relevant parties and their relationships

1.82 The roles of and relationship between the parties may:

- indicate that orthodox arm's-length or market forces are absent;
- introduce or enable a distortion in the arrangement, such as non-arm's length or non-market pricing or payment on non-market terms; or
- enable an arrangement to be structured in a particular way to obtain a tax advantage that would not otherwise be possible.

Economic and commercial effect of documents and transactions

1.83 The examination of the economic and commercial effects of documents and transactions may indicate that:

- the arrangement's commercial or private purpose is obscure, in contrast to the clarity of its tax advantages;
- the arrangement has no commercial or private purpose;
- the arrangement's commercial or private purpose has no commercial or private rationale, justification or logic, independent of the tax advantages;
- the arrangement's commercial or private purpose cannot be achieved independently of its tax advantages;
- a timing mismatch exists between payment in legal terms and payment in commercial and economic terms;
- the taxpayer, in economic terms, has not incurred any real expenditure and is unlikely to, or will not, incur any real expenditure;
- a payment has not, in commercial terms, been paid; or
- the tax advantage the taxpayer gained is totally disproportionate to the economic burden the taxpayer suffered.

Nature and extent of the financial consequences

1.84 The nature and extent of the financial consequences of the arrangement may indicate that:

- the taxpayer has claimed a deduction for expenditure where, in reality, the taxpayer does not suffer the economic cost of the expenditure; or
- the amount of the taxpayer's assessable income has been reduced but the taxpayer, in reality, suffers no proportionate loss of income because they, in fact, retain the use and benefit of the income.

Duration of the arrangement

1.85 Timing features of the arrangement may indicate or identify that:

- the arrangement has been structured to create or take advantage of a timing mismatch to obtain a tax advantage;
- the arrangement has an artificial element; or
- the duration of the arrangement is such that its commercial purpose is unlikely to, or cannot, be achieved – meaning the arrangement has, in reality, no commercial purposes.

Circularity in the arrangement

1.86 The presence of circularity in an arrangement or in a part of it may indicate that, in reality, the arrangement or one of its steps has:

- no commercial or private purpose; and
- the purpose of obtaining a tax advantage.

Inflated expenditure or reduced levels of income in the arrangement

1.87 The presence in an arrangement of inflated expenditure or reduced levels of income may indicate that the amount of the expenditure or income has been artificially set for the purpose of obtaining a tax advantage and not for a commercial or private purpose.

The parties to the arrangement undertaking limited or no real commercial or economic risks

1.88 The absence, or limited nature and extent of, commercial or economic risks may indicate that:

- the tax advantages obtained under the arrangement are disproportionate to the risks undertaken by the parties; or
- the obtaining of the tax advantage is a purpose, or the sole purpose, of the arrangement.

Arrangement being pre tax negative

1.89 An arrangement that is financially unprofitable before tax is said to be "pre-tax negative and post-tax positive" and this may indicate that:

- the arrangement has no commercial purpose; or
- the arrangement's commercial purpose has no commercial rationale, justification or logic, independent of the tax advantages;

- the clarity of the tax advantages is in marked contrast to the obscurity of the prospect of any ultimate commercial profit; or
- obtaining the arrangement's tax advantages is a purpose of the arrangement.

Economic equivalence and counterfactuals

1.90 The principle of economic equivalence is a principle that concerns the proper approach to the application of specific provisions, not the application of s BG 1. It provides that it is not permissible to consider the economic substance of a transaction when applying a specific provision to the transaction. The application of the specific provision is determined by the true legal nature of a transaction and the legal rights and obligations created.

1.91 In contrast, an economic substance approach is permitted and required when applying s BG 1. This is because, under the Parliamentary contemplation test, s BG 1 requires an arrangement to be viewed in an economically realistic way.

1.92 Viewing an arrangement in an economically and commercially realistic way does not require a comparative analysis with a hypothetical alternative (sometimes referred to as a "counterfactual") arrangement. However, that does not prevent considering whether the commercial or private purposes of the arrangement, as put forward by a taxpayer, explains the arrangement's structure or the way it has been carried out.

Part 8: Applying s BG 1

1.93 Whether s BG 1 applies to an arrangement turns on the specific facts of the arrangement actually entered into. As the application of s BG 1 is an intensely fact-based inquiry it is not possible to approach the application of s BG 1 in an inflexible or overly prescriptive way. The Supreme Court decisions in *Ben Nevis*, *Penny* and *Frucor* demonstrate that the answer to applying s BG 1 involves drawing a conclusion from:

- the established facts;
- the arrangement's effects; and
- Parliament's purposes for the specific provisions and s BG 1.

1.94 The inference or conclusion that s BG 1 applies must be reasonable. That is, the inference must be one 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.

1.95 The Commissioner's approach to applying s BG 1 to an arrangement involves:

- Understanding the legal form of the arrangement by identifying and understanding:
  - All of the steps and transactions that make up the arrangement.
  - The commercial or private purposes of the arrangement.
  - The arrangement's tax effects and how they have been achieved by the arrangement. This requires identifying and understanding:
    - the specific provisions that apply to the arrangement, and why they apply; and
    - any potentially relevant provisions that do not apply and why they do not apply.
- Identifying and understanding Parliament's purpose for the specific provisions that are used or circumvented by the arrangement from their text, the statutory context, case law and relevant extrinsic material.
  - Having identified Parliament's purpose for the specific provisions, it may be helpful to then identify any facts, features or attributes Parliament would contemplate being present (or absent) when permissible tax advantages arise under the specific provisions.
- Understanding the commercial and economic reality of the arrangement as a whole. Factors to consider in this context 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 roles 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.

- Considering the implications of the preceding analysis of Parliament's purpose for the specific provisions and the arrangement's purposes, tax effects and commercial and economic reality as a whole. Bearing in mind Parliament's purpose for s BG 1, this is likely to highlight a number of interrelated matters, including:
  - The presence (or absence) of artificiality, contrivance or pretence. The presence of 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 veracity of the arrangement's commercial or private purposes (in contrast to the clarity or otherwise of the arrangement's tax advantages). The analysis may show the arrangement's apparent commercial or private purposes as previously analysed may not be consistent with the arrangement's commercial or economic reality.
  - Whether or not the use or circumvention of the relevant specific provisions is consistent with Parliament's purposes for the provisions. It may be helpful, in some cases, to consider whether any facts, features or attributes previously translated from Parliament's purpose for the specific provisions 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.
- 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?

1.96 Parliament's purpose for a specific provision under the Parliamentary contemplation test may be the same as the purpose identified under the inquiry into whether the application of the specific provisions is within their ordinary meaning and intended scope. Therefore, the purpose of the specific provisions may have already been comprehensively identified under the initial inquiry into the application of the specific provisions. However, under the tax avoidance inquiry, the whole of the arrangement is considered, and some aspects of Parliament's purpose may need to be considered in that light. When a detailed consideration of Parliament's purpose for the specific provision has not occurred under the initial inquiry, Parliament's purpose for the specific provision must be considered as part of the Parliamentary contemplation test.

1.97 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. The merely incidental test involves the consideration of many of the same matters 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.

Part 9: Counteracting the tax advantage

1.98 The Commissioner is not required to apply s GA 1 where the voiding of an arrangement under s BG 1 appropriately counteracts the impermissible tax advantage or tax advantages. However, if the voiding does not do this, then the Commissioner is under a duty to apply s GA 1 to counteract any impermissible tax advantage.

1.99 Section GA 1(2) gives the Commissioner a broad and flexible discretion about how to make adjustments to counteract a tax advantage. The Commissioner considers s GA 1(2) empowers the Commissioner to make adjustments to:

- negate any tax advantage arising from a tax avoidance purpose or effect that has not been counteracted by voiding the arrangement, including making appropriate consequential adjustments; and
- reinstate permissible tax outcomes voided by the arrangement.

1.100 Permissible tax outcomes do not include the parts of an arrangement so interdependent and interconnected with the tax avoidance parts as to be integral to them.

1.101 The Commissioner is not under a duty to precisely describe the basis for an adjustment. The Commissioner may have different options available when counteracting a tax advantage. The Commissioner may:

- adjust the taxable income of any person affected by an arrangement, regardless of whether they are a party to the arrangement or were unaware they have benefited from the arrangement;
- adjust tax advantages that arise at a time after the arrangement is put in place;
- adjust tax credits;
- consider hypothetical alternative situations when deciding on an adjustment; and
- adjust ancillary taxes, such as, non-resident withholding tax, resident withholding tax, fringe benefit tax and PAYE.

1.102 The Commissioner cannot ultimately include an amount of income or deduction in the taxable income of more than one person under the adjustment power in s GA 1.

1.103 If a taxpayer wishes to dispute an adjustment the Commissioner has made, the onus is on the taxpayer to show that the adjustment is wrong and by how much it is wrong.

Part 10: Other issues

1.104 The Commissioner's position on certain other issues is as follows:

- Generally, the judicial approaches applied before *Ben Nevis* (SC) are not relevant to the extent that those approaches are inconsistent with *Ben Nevis* (SC).
- To some degree, the predication test remains relevant but only in the sense that under the Parliamentary contemplation test it is still necessary to objectively determine or "predicate" that tax avoidance is a purpose or effect of the arrangement.
- Cases decided before *Ben Nevis* (SC) remain relevant to the extent that they support a principle or illustrate a point concerning elements of the tax avoidance inquiry.
- The application of the Parliamentary contemplation test does not involve the Commissioner dictating how taxpayers do business. An arrangement is a tax avoidance arrangement due to its facts, and these are outside the Commissioner's control. The operation of s BG 1 does not change the facts of an arrangement nor the parties' legal rights and obligations to one another. Section BG 1 simply affects the taxation outcomes of an arrangement.
- Complex arrangements are not tax avoidance arrangements merely because they are complex. However, if the complexity is not objectively explicable in terms of commercial or private purposes and is to achieve a tax advantage as an end in itself, the arrangement will be a tax avoidance arrangement.
- Section BG 1 cannot be used by the Commissioner to fill a legislative gap.
- An arrangement that results in the payment of tax, or in the payment of more tax when all affected parties are considered, can be a tax avoidance arrangement.
- Where an arrangement has a purpose or effect of obtaining a tax advantage in another country that purpose or effect is not a tax avoidance purpose or effect for the purposes of s BG 1. It is possible that the New Zealand tax avoidance purpose or effect of the arrangement may be merely incidental to the arrangement's purpose or effect of avoiding foreign tax.
- A double tax agreement (DTA) does not override s BG 1.
- The application of s BG 1 and a DTA to an arrangement depends on the specific provisions used or circumvented:
  - Where a DTA applies and an arrangement uses or circumvents specific provisions of the Act (other than the DTA articles) in a manner outside Parliament's purpose, s BG 1 is applied first to establish the domestic tax position and the DTA is then applied.
  - Articles of DTAs are (effectively) treated as specific provisions of the Act. Hence, under the tax avoidance inquiry where the arrangement uses (or circumvents) the DTA articles in a manner outside Parliament's purpose, s BG 1 can be applied to the application of the DTA articles.
- There will inherently be uncertainty whenever a taxing statute contains a general anti-avoidance provision. However, the Commissioner in this statement has sought to provide a framework and an approach to ss BG 1 and GA 1 that will

guide taxpayers and their advisers. If taxpayers and advisers require certainty for a particular arrangement, they can apply to the Commissioner for a binding ruling.

Flow Charts

1.105 A flow chart summarising the approach taken in this statement to whether s BG 1 applies to an arrangement is included at the end of Part 8 (Flow Chart 1 at p 70). A flow chart showing the steps to applying s GA 1 is included at the end of Part 9 (Flow Chart 2 at p 78).

Part | Wāhanga 2 The purpose of s BG 1 and Ben Nevis (SC)

Introduction

2.1 Section BG 1 is a general anti-avoidance provision. It states that:

- a tax avoidance arrangement is void as against the Commissioner for income tax purposes; and
- the Commissioner may, under Part G, counteract a tax advantage that a person has obtained from or under a tax avoidance arrangement.

2.2 A tax avoidance arrangement is an arrangement that has tax avoidance as:

- its sole purpose or effect; or
- one of its purposes or effects and that purpose is more than merely incidental to any other purpose or effect.

2.3 Section BG 1 applies to void a tax avoidance arrangement. This means the income tax outcomes that apply to the arrangement under specific provisions have no effect. Specific provisions are provisions in the Act other than s BG 1.

2.4 Section BG 1 is self-activating, so its application is not dependent on any action by the Commissioner. Whether s BG 1 applies to an arrangement is determined by its facts.

Section BG 1 is the principal vehicle to address tax avoidance

2.5 Section BG 1 is the principal vehicle in the Act to address tax avoidance whether it involves the use of a specific provision or its circumvention.[14] The Supreme Court in *Ben Nevis* stated:

> [103] … The presence in the New Zealand legislation of a general anti-avoidance provision suggests that our **Parliament meant it to be the principal vehicle by means of which tax avoidance is addressed.** The general anti avoidance regime is designed for that purpose, whereas individual specific provisions have a focus which is determined primarily by their ordinary meaning, as established through their text in the light of their specific purpose. In short, the purpose of specific provisions must be distinguished from that of the general anti avoidance provision.
>
> …
>
> [106] … **The general provision is designed to avoid the fiscal effect of tax avoidance arrangements having a more than merely incidental purpose or effect of tax avoidance. Its function is to prevent uses of the specific provisions which fall outside their intended scope in the overall scheme of the Act.** …
>
> [107] … The taxpayer must satisfy the Court that the use made of the specific provision is within its intended scope. If that is shown, a further question arises based on the taxpayer's use of the specific provision viewed in the light of the arrangement as a whole. **If, when viewed in that light, it is apparent that the taxpayer has used the specific provision, and thereby altered the incidence of income tax, in a way which cannot have been within the contemplation and purpose of Parliament when it enacted the provision, the arrangement is a tax avoidance arrangement.** … [Emphasis added]

2.6 The Supreme Court in *Penny* referred to the purpose of s BG 1 and the policy underlying it:

> [47] … [Section BG 1] continues to have work to do whenever a taxpayer uses specific provisions of the Act and otherwise legitimate structures in a manner which cannot have been within the contemplation of Parliament. The policy underlying the general anti avoidance provision is to negate any structuring of a taxpayer's affairs whether or not done as a matter of "ordinary business or family dealings" unless any tax advantage is just an incidental feature. That must include using a company structure to fix the taxpayer's salary in an artificial manner. … Woodhouse P said in *Challenge Corporation Ltd v Commissioner of Inland Revenue* that there must be a weapon able to thwart technically correct but contrived transactions set up as a means of exploiting the Act for tax advantages. That is what the artificially low salary settings did in this case.

[14] See discussion from [2.27] below, regarding the Commissioner's view that s BG 1 applies both where a specific provision is used and when it is circumvented.

2.7 Section BG 1 has its own purpose. The courts have described this purpose in a variety of ways, including to:

- avoid the fiscal effect for tax purposes of arrangements having a more than merely incidental purpose or effect of tax avoidance (*Ben Nevis* (SC));
- prevent uses of the specific provisions that fall outside their intended scope in the overall scheme of the Act (*Ben Nevis* (SC));
- prevent uses of the specific provisions that cannot have been within the contemplation and purpose of Parliament when it enacted the provisions (*Ben Nevis* (SC));
- prevent uses of specific provisions and otherwise legitimate structures in a manner that cannot have been within the contemplation of Parliament (*Penny* (SC));
- negate any structuring of a taxpayer's affairs in an artificial manner where the tax advantage is more than merely incidental (*Penny* (SC)); and
- thwart technically correct but contrived transactions set up as a means of exploiting the Act for tax advantages (*Challenge* (CA)).[15]

Supreme Court in Ben Nevis considered it desirable to settle the approach to s BG 1

2.8 Determining the correct approach to deciding whether s BG 1 applies, or specific provisions operate, has been difficult. Before *Ben Nevis* (SC), the courts had noted the difficulties in reconciling s BG 1 and specific provisions.

2.9 For example, in 1971 Lord Wilberforce in *Mangin* outlined deficiencies he saw with the general anti-avoidance provision: [16]

> It fails to specify the relation between the section and other provisions in the Income Tax legislation under which tax reliefs, or exemptions, may be obtained. Is it legitimate to take advantage of these so as to avoid or reduce tax? What if the only purpose is to use them? Is there a distinction between "proper" tax avoidance and "improper" tax avoidance? By what sense is this distinction to be perceived?

2.10 In 1986, Woodhouse P in *Challenge* (CA) referred to a criticism of the general anti-avoidance provision based on a literal reading of the provision: [17]

> A criticism levelled at s 99 [of the Income Tax Act 1976], as it has been levelled at the earlier s 108 [of the Land and Income Tax Act 1954], is that on its face the language is so encompassing when read literally that major qualifications must be read into it if various deduction and other provisions of the Act are to be left effective. It cannot have been the purpose of the legislature, so it is said, to import into the Income Tax Act a general provision so spacious in operation that other sections would be virtually impotent. …

2.11 A central issue for the Supreme Court in *Ben Nevis* was the relationship between the specific provisions and s BG 1. The Court described the problem:

> [12] The expanded provision, and its successors, did not, however, explicitly resolve a central issue that had arisen with s 108 of the [Land and Income Tax Act 1954]. That was the relationship between the general anti avoidance provision and the many "specific provisions" that allow tax concessions, principally through authorising deductions and depreciation allowances. Taxpayers enter into many transactions which have been structured with the purpose of taking advantage of specific provisions in order to reduce tax. **While the general anti avoidance provision is expressed broadly, its purpose cannot be to strike down arrangements which involve no more than appropriate use of specific provisions. On the other hand, strict compliance with the requirements of specific provisions cannot have been intended to immunise all arrangements involving their use against being categorised as tax avoidance arrangements, which it was the purpose of the general provision to avoid.**
>
> [13] The present appeals are the first occasion this Court has had to consider when use of specific provisions will amount to proscribed tax avoidance. There is little explicit guidance in the legislation and the current case law has become complex, through being encumbered by considerations and tests that the legislation does not specify. **Through a process of interpretation of all the relevant statutory provisions, we must identify a means for determining where permissible use of specific provisions ends and tax avoidance begins.** [Emphasis added]

2.12 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. [18] The Supreme Court has subsequently confirmed that approach in *Penny* and *Frucor*.[19]

[15] Cited in *Penny* (SC) at [47] and cited in turn in *Frucor* (SC) at [55].

[16] *Mangin v CIR* [1971] NZLR 591 (PC) at 602.

[17] At 535. See also *Elmiger v CIR* [1966] NZLR 683 (SC) at 687–688; *Challenge* (CA) per Cooke J at 541 and Richardson J at 548; *CIR v BNZ Investments Ltd* [2002] 1 NZLR 450 (CA) (*BNZ Investments No 1* (CA)).

[18] At [100].

[19] *Penny* at [33], *Frucor* at [53].

Approach to reconciling the specific provisions and s BG 1

2.13 The Supreme Court in *Ben Nevis* set out its approach to reconciling specific provisions and s BG 1 by first explaining the principles underlying its approach:

> [102] It is accordingly the task of the Courts to apply a principled approach which gives proper overall effect to statutory language that expresses different legislative policies. It has long been recognised those policies require reconciliation. The approach must ensure that the particular case before the court is examined by reference to the respective legislative policies. It must enable decisions to be made on individual cases through the application of a process of statutory construction focusing objectively on features of the arrangements involved, without being distracted by intuitive subjective impressions of the morality of what taxation advisers have set up.

2.14 The Court explained that the approach to reconciling the specific provisions and s BG 1 must:

- Ensure an arrangement is examined by reference to the different legislative policies that are expressed in the specific provisions and in s BG 1.
- Enable decisions to be made on individual cases through a process of statutory construction. That process must focus objectively on the specific facts of the arrangement. The process must not be distracted by intuitive subjective impressions of the morality of the tax outcomes.

Specific provisions and s BG 1 work together in tandem

2.15 The Court explained how Parliament's overall purpose for a taxing statute that contains a general anti-avoidance provision is best served:

> [103] We consider Parliament's overall purpose is best served by construing specific tax provisions and the general anti-avoidance provision so as to give appropriate effect to each. They are meant to work in tandem. Each provides a context which assists in determining the meaning and, in particular, the scope of the other. Neither should be regarded as overriding. Rather they work together. …

2.16 The Court set out the conceptual framework and principles for how specific provisions and s BG 1 are reconciled:

- In a taxing statute that includes a general anti-avoidance provision, Parliament's overall purpose is best served by interpreting specific provisions and s BG 1 so as to give appropriate effect to the purpose of each. Neither the specific provisions nor s BG 1 is overriding, and they work together in tandem. Each provides a context that determines the meaning and, in particular, the scope of the other.
- The purpose of specific provisions must be distinguished from the purpose of s BG 1.
- Specific provisions have a focus determined primarily through their text and in light of their specific purpose and context.
- Section BG 1 is designed to address tax avoidance.

2.17 The Court continued to explain aspects of this framework:

> [104] Parliament must have envisaged that the way a specific provision was deployed would, in some stances, cross the line and turn what might otherwise have been a permissible arrangement into a tax avoidance arrangement. Ascertaining when that will be so should be firmly grounded in the statutory language of the provisions themselves. Judicial attempts to articulate how the line is to be drawn have in the past too often been seized on as if they were equivalent to statutory language. Judicial glosses and elaborations on the statutory language should be kept to a minimum.
>
> [105] The key statutory concept in the general anti-avoidance provision is of a tax avoidance arrangement, as Parliament has defined it. By means of the definition of tax avoidance, a tax avoidance arrangement includes an arrangement which directly or indirectly alters the incidence of any income tax. It is arrangements of that and allied kinds which are void against the Commissioner under s BG 1(1). An arrangement includes all steps and transactions by which it is carried out. Thus, tax avoidance can be found in individual steps or, more often, in a combination of steps. Indeed, even if all the steps in an arrangement are unobjectionable in themselves, their combination may give rise to a tax avoidance arrangement.

2.18 In the above, the Court explained:

- Parliament must have envisaged that the way a specific provision was used would, in some circumstances, cross the line and turn what might otherwise have been a permissible arrangement into a tax avoidance arrangement.
- Ascertaining whether the line has been crossed should be firmly grounded in the statutory language of the provisions.
- Tax avoidance can be found in individual steps or in a combination of steps.
- All steps in an arrangement may, in isolation from one another, be unobjectionable. However, their combination may give rise to a tax avoidance arrangement.

2.19 The Court considered that the approach it had set out still allowed taxpayers the freedom to structure transactions to their best tax advantage. The Court stated:

> [111] The appellants made a sustained plea that the courts should not deprive commercial and other parties of tax beneficial choices. On the approach we have set out, taxpayers have the freedom to structure transactions to their best tax advantage. They may utilise available tax incentives in whatever way the applicable legislative text, read in the light of its context and purpose, permits. They cannot, however, do so in a way that is proscribed by the general anti avoidance provision.

Satisfying the ordinary meaning of a specific provision does not prevent s BG 1 applying

2.20 The Court observed that simply satisfying the ordinary meaning of a specific provision does not negate a claim of tax avoidance:

> The appellants' "threshold" argument accordingly cannot be correct. That argument was to the effect that once the ordinary meaning of a specific provision was satisfied there could be no tax avoidance.[20]

2.21 The "threshold" argument is commonly associated with Richardson J's "scheme and purpose" approach in the Court of Appeal in *Challenge* (although, in the Commissioner's view, the threshold argument misunderstands Richardson J's approach). This approach was rejected by the Privy Council in *Challenge*. The "scheme and purpose" approach and the "threshold" argument have no relevance to the proper approach to s BG 1. The "scheme and purpose" approach is considered in this statement at [10.4] to [10.16] as part of this statement's discussion of other issues.

Parliamentary contemplation test

2.22 The Court explained that, in a case involving "reliance by the taxpayer on specific provisions", applying s BG 1 would be preceded by an inquiry into whether the use made of the specific provision is within its ordinary meaning and intended scope. If that is shown, a second inquiry is undertaken into whether the arrangement has a more than merely incidental purpose or effect of tax avoidance under s BG 1. This is the tax avoidance inquiry.[21]

2.23 The tax avoidance inquiry can involve two tests:

- the Parliamentary contemplation test; and
- the merely incidental test.

2.24 The initial inquiry into the application of the specific provisions is discussed in Part 3 and the tax avoidance inquiry is discussed in Parts 4 to 8. The Parliamentary contemplation test is discussed in Part 6. In short, that test requires:

- identifying the specific provisions used by an arrangement;
- viewing the arrangement as a whole and in a commercially and economically realistic way; and
- deciding whether the arrangement, when viewed in this way, makes use of the specific provisions in a manner consistent with Parliament's purpose when it enacted the provision.

2.25 The Court considered that, if the arrangement makes use of the specific provision in a manner that is consistent with Parliament's purpose, then the arrangement will not have a tax avoidance purpose or effect.[22] If the use made of the specific provision is outside Parliament's purpose, then the arrangement will have a tax avoidance purpose or effect.

2.26 If an arrangement has two or more purposes or effects, and at least one is a tax avoidance purpose or effect, it will be a tax avoidance arrangement if the tax avoidance purpose or effect is more than merely incidental to the other purposes or effects. The merely incidental test is discussed in Part 5.

Section BG 1 applies to arrangements that use or circumvent specific provisions

2.27 Section BG 1 can only apply if an arrangement is first subject to the specific provisions of the Act. In deciding whether the specific provisions apply as claimed or s BG 1 applies, a view may be required to be reached not only as to how particular provisions apply, but also as to which provisions an arrangement ensures do not apply. This is because, under the tax avoidance inquiry, a decision must be reached not only on whether certain provisions apply in a way Parliament contemplated, but also on whether certain other provisions do not apply in a way Parliament contemplated. It follows that some tax avoidance arrangements involve the positive utilisation (or "use") of specific provisions while other arrangements may have the effect that specific provisions of the Act do not apply (ie, they "circumvent" a provision).

[20] Footnote 113 at [104].

[21] At [107].

[22] At [109].

2.28 The arrangement in *Ben Nevis* (SC) involved the "use" of specific (deduction) provisions.[23] In *Ben Nevis*, the Supreme Court referred throughout to the "use" of provisions. Because of the facts, the Court did not have to consider an arrangement that involved the circumvention of provisions. However, as explained above, the Commissioner considers that s BG 1 can also apply to an arrangement that "circumvents" a specific provision.[24] The Commissioner considers this is a logical extension from the Supreme Court in *Ben Nevis* referring to the application of specific provisions.

2.29 Circumvention can be seen in *Penny*, where the *Ben Nevis* approach was applied by the Supreme Court. The Supreme Court in *Penny* stated:

> [33] **This case differs from *Ben Nevis***, in which this Court explained the proper approach to questions of tax avoidance. Here there can be no question of the taxpayers failing to comply with specific taxation provisions.
>
> ...
>
> [35] **The fixing of the low salary enabled most of the profits of the company from the professional practice to be transferred by way of dividends straight through to the trust, avoiding payment of the highest personal tax rate**, and then use by the trust for the taxpayer's family purposes, including benefiting him by loans (Mr ***Penny***) or funding the family home and holiday home (Mr Hooper). [Emphasis added]

2.30 The Supreme Court concluded that fixing the taxpayer's salary in an artificial and contrived manner, along with other features of the arrangement, meant the arrangement was a tax avoidance arrangement. The fixing of the taxpayer's salary can be seen as circumventing the highest marginal tax rate (in Sch 1 of the Income Tax Act 1994).

2.31 However, the fixing of the taxpayer's salary can equally be viewed as the taxpayer using (and thereby gaining the benefit of) the lower tax rates (also in Sch 1) in an artificial and contrived way. That is, the taxpayer's use of a lower marginal rate was outside Parliament's contemplation because, in reality, the taxpayer had suffered no reduction in income. Accordingly, it is possible that a single arrangement has the effect of both using and circumventing provisions in a way Parliament did not contemplate.

2.32 An arrangement could be seen as potentially circumventing numerous specific provisions. Therefore, there has to be some logical link between the tax advantages arising under the arrangement and the provisions being circumvented.

Part | Wāhanga 3 Interpretation and application of specific provisions

Introduction

3.1 The Supreme Court in *Ben Nevis* explained that in a case involving reliance by the taxpayer on specific provisions, applying s BG 1 is preceded by an inquiry concerning the application of the specific provisions (the initial or specific provision inquiry). The initial inquiry is whether the use made of the specific provision is within its ordinary meaning and intended scope.

3.2 If that is shown, a second inquiry is undertaken into whether the arrangement has a sole or more than merely incidental purpose or effect of tax avoidance under s BG 1 (the tax avoidance inquiry). These are separate inquiries, and both are important in their own right.

3.3 Under the initial inquiry, a taxpayer must be able to show that the use or circumvention of the specific provision is within its ordinary meaning and intended scope. The tax avoidance inquiry cannot be undertaken without the initial inquiry because the initial inquiry helps inform and guide the tax avoidance inquiry.

3.4 This Part of the statement sets out the approach to interpreting and applying specific provisions under the initial inquiry. While the general principles of statutory interpretation discussed in this Part also apply to interpreting and applying s BG 1 under the tax avoidance inquiry, Parts 4 to 8 of this statement consider the different aspects of that inquiry.

3.5 As mentioned at [2.27], the Commissioner considers that s BG 1 can apply to an arrangement that circumvents a specific provision, therefore, the following discussion is also relevant where a specific provision is alleged not to apply.

[23] The taxpayers in *Ben Nevis* (SC) argued that certain provisions of the Income Tax Act 1994 applied: s EG 1, which allowed a deduction for depreciation, and s DL 1(3), which provided for a deduction for insurance premiums.

[24] "Circumvent", or its variants, are used in neutral terms as meaning the "non-application" of a specific provision.

Meaning is ascertained from text, purpose and context

3.6 Section 5(1) of the Interpretation Act 1999[25] provided that the meaning of an enactment must be "ascertained from its text and in the light of its purpose". The Supreme Court in *Fonterra* stated:[26]

> [22] It is necessary to bear in mind that s 5 of the Interpretation Act 1999 makes text and purpose the key drivers of statutory interpretation. The meaning of an enactment must be ascertained from its text and in the light of its purpose. **Even if the meaning of the text may appear plain in isolation of purpose, that meaning should always be cross checked against purpose in order to observe the dual requirements of s 5**. In determining purpose the Court must obviously have regard to both the immediate and the general legislative context. Of relevance too may be the social, commercial or other objective of the enactment.
>
> ...
>
> [24] Where, as here, the meaning is not clear on the face of the legislation, the Court will regard context and purpose as essential guides to meaning. [Emphasis added]

3.7 Although *Fonterra* was not a tax case, the Supreme Court's purposive approach in *Fonterra* is the same as the approach taken in tax cases. For example, the Supreme Court in *Stiassny* affirmed that tax Acts are interpreted like any other Act.[27] The Court stated:

> [23] **In this country, the general approach to the interpretation of a revenue statute is much the same as for other statutes. The purpose of a taxing provision may be a guide to its meaning and intended application.** But, as Burrows and Carter point out, in most cases the only evidence of that purpose is the detailed wording of the provision and the safest method is to read the words in their most natural sense. In construing and applying a taxing provision, a court leans neither for nor against the taxpayer, but should require that before the provision is effectual to make the taxpayer amenable to the tax, it uses words which, on a fair construction, must be taken to impose that tax in the circumstances of the case. [Emphasis added]

3.8 The Supreme Court in *Ben Nevis* stated that "individual specific provisions have a focus which is determined primarily by their ordinary meaning, as established through their text in the light of their specific purpose".[28] The Court made clear in the accompanying footnote that it was referring to s 5 of the Interpretation Act 1999.

3.9 The Supreme Court in *Stiassny* noted that generally the only evidence of purpose will be the detailed wording of the provision. The Court said that the safest method is to read the words of the provision in their most natural sense. As discussed below, extrinsic materials may also be relevant.

3.10 *Statute Law in New Zealand* states that words are to be given a liberal interpretation to make sure the legislation's purpose is achieved.[29] Hand in hand with the need to give effect to purpose, is the need to examine the text of the Act in context:[30]

> A section should be read in the context of the Act as a whole (the "scheme of the Act" as it is often called), and it is permissible to consult a much wider range of extrinsic materials than was once the case to understand the background to the Act and what its framers were trying to achieve by it.

3.11 *Statute Law in New Zealand* notes that the actual words of the Act remain the most important factor in interpreting statutory provisions. However, the meaning of a provision is not necessarily its purely literal or grammatical meaning. The meaning of a provision is the most natural and ordinary meaning of the words in their context and taking into account the purpose of the provision. [31]

3.12 Generally, a purposive interpretation will also be the literal or grammatical meaning because the purpose and wording will align with one another.[32]

3.13 *Statute Law in New Zealand* goes on to explain how the purposive approach to interpreting legislation works. The following principles can be taken from that explanation:[33]

[25] From 28 October 2021, s 5(1) of the Interpretation Act 1999 was replaced by s 10(1) of the Legislation Act 2019. Section 10(1) refers to the meaning of legislation being "ascertained from its text and in the light of its purpose **and its context**" [Emphasis added].

[26] *Commerce Commission v Fonterra Co operative Group Ltd* [2007] NZSC 36, [2007] 3 NZLR 767.

[27] *Stiassny v CIR* [2012] NZSC 106, [2013] 1 NZLR 453. See also *Terminals (NZ) Ltd v Comptroller of Customs* [2013] NZCS 139, [2014] 1 NZLR 121 at [39].

[28] At [103].

[29] JF Burrows and RI Carter, *Statute Law in New Zealand* (6th ed, LexisNexis, Wellington, 2021) at 287.

[30] At 227-228.

[31] At 288.

[32] *Statute Law in New Zealand* at 294 and D Bailey and L Norbury, *Bennion on Statutory Interpretation* (7th ed, LexisNexis, London, 2017) at 343.

[33] At 295–297.

- If words have two or more possible meanings, they should be given the one that best accords with the purpose of the legislation.
- A strained interpretation may be put on the words if the purpose of the provision requires it, but the strained interpretation must be one the words can bear.
- General words should be given a meaning that conforms with the purpose of the Act in question.
- Legislation that is obscurely or badly drafted should be interpreted to give effect to the underlying purpose of the legislation.

3.14 Parliament's purpose for a specific provision can be understood as what Parliament intended the provision to achieve. This can be expressed as the:

- end or object Parliament had in mind for the provision;
- mischief or defect in the law that the provision is directed at remedying; or
- reasons why the provision was enacted.

3.15 Parliament's purpose in the context of tax legislation can also be expressed broadly in terms of being directed toward:

- providing an advantage (eg, allowing a deduction for expenditure incurred in deriving assessable income);
- preventing an advantage (eg, prohibiting a deduction for expenditure of a private or domestic nature); or
- providing a particular treatment for an amount or thing (eg, deeming a market value or treating a unit trust as a company).[34]

Parliament may have multiple levels of purpose for a specific provision

3.16 Parliament may have multiple levels of purpose for a specific provision and its purpose may be stated broadly or narrowly.[35] Parliament's purpose may relate to a provision's role in:

- particular;
- a regime;
- a subpart of the Act;
- part of the Act; or
- the Act as a whole.

3.17 For example, the imputation regime has specific provisions with several levels of purpose. At the most specific level, s OB 4 provides rules for when an imputation credit arises in a company's imputation credit account.

3.18 At a broader level, the purpose of s OB 4 can be seen in the context of the scheme of subpart OB. That scheme is to provide rules for a system that:

- levies tax at the company and shareholder levels; and
- gives credits to shareholders for company tax paid.[36]

3.19 At an even broader level, the policy of the imputation regime is to ensure, as far as possible, that income earned through a company is taxed at the marginal tax rates of the shareholders. This accords with the objective of taxing income from capital at the tax rates of the owners of the capital.[37]

[34] Generally referred to collectively in this statement as "tax advantages".

[35] *Statute Law in New Zealand* at 309–316 and *Bennion on Statutory Interpretation* (7th ed) at 349–350.

[36] See also *The Taxation of Distributions from Companies* (Consultative Committee on the Taxation of Income from Capital, November 1990).

[37] See *Full Imputation: Report of the Consultative Committee* (Consultative Committee on Full Imputation and International Tax Reform, April 1988) at 1.4.1.

3.20 Specific provisions often give effect to a particular policy in the Act.[38] It is also possible for the purpose of a specific provision to be discerned from its role in the Act as a whole. *Statute Law in New Zealand* states it "is often possible, on reading an Act as a whole, to discern a theme running through its main provisions".[39] The courts sometimes refer to this concept in terms of looking for the "scheme" of the Act.[40]

3.21 However, sometimes specific provisions may not be part of a wider regime. In that case, the purpose of the provision can be derived only from the provision itself and any relevant extrinsic material. For example:

- Section DA 2(4) denies a deduction for expenditure or loss incurred in deriving income from employment.
- Section DB 2 provides rules for the treatment of GST for income tax purposes.

Extrinsic materials can provide background or confirm a specific provision's meaning

3.22 Extrinsic materials may be considered to understand the background of a specific provision and what Parliament was trying to achieve.[41] Extrinsic materials are documents produced in the course of enacting legislation. Examples include:

- law reform reports;
- discussion documents;
- officials' reports and discussion documents (eg, Inland Revenue and Treasury publications on taxation bills);
- select committee reports; and
- parliamentary debates (Hansard).

3.23 New Zealand courts have frequently taken a pragmatic approach to the use of extrinsic materials. They mostly concern themselves with the emphasis to give to the material rather than whether it is admissible as evidence. They have referred to extrinsic materials:

- as part of the background to a decision; or
- to confirm a decision that has been reached by other means.[42]

3.24 However, extrinsic materials should be used with care. They do not take the place of a careful analysis of the words of a provision. The courts have generally not shown any willingness to rely on extrinsic materials for an interpretation inconsistent with the words, when purposively interpreted.[43]

Tax outcomes under specific provisions turn on the legal rights and obligations created

3.25 It is necessary to work out the true nature of the legal arrangements actually entered into and carried out before determining how the tax outcomes arising under specific provisions apply. The Court of Appeal in *Finnigan* described this principle:[44]

> The legal principles governing the characterisation of transactions and payments made under transactions are well settled. **Parties are free to choose whatever lawful arrangements will suit their purpose. The true nature of their transaction can only be ascertained by careful consideration of the legal arrangements actually entered into and carried out. That does not turn on an assessment of the broad substance of the transaction or of the overall economic consequences to the parties or of legal consequences which would follow from an alternative course which they could have adopted but chose not to do. It is the legal character of the transactions that are actually entered into and the legal steps which are followed which are decisive.** The only exceptions to those principles are where the essential genuineness of the transaction is challenged and sham is established and where there is a statutory provision such as s 99 of the Income Tax Act 1976 [s BG 1] mandating a broader or different approach which applies in the circumstances of the particular case. [Emphasis added]

[38] See, for example, *Westpac Banking Corporation v CIR* (2009) 24 NZTC 23,834 (HC) at [612] where the High Court identified the legislative policy behind the foreign tax credit regime.

[39] At 309, when discussing the purpose of an Act.

[40] See *Ben Nevis* (SC) at [106]; *BNZ Investments No 1* (CA) at [61]; *Challenge* (CA) at 549.

[41] *Statute Law in New Zealand* at 287–288.

[42] See *R v Aylwin* [2008] NZCA 154 at [58] and *Statute Law in New Zealand* at 362-363.

[43] See *CIR v Roberts* [2019] NZCA 654 at [62].

[44] *Finnigan v CIR* (1995) 17 NZTC 12,170 (CA) at 12,173–12,174. The cited passage repeats and incorporates a number of the principles earlier stated by the Court of Appeal in *Buckley & Young v CIR* [1978] 2 NZLR 485; *Mills v Dowdall* [1983] NZLR 154 (CA); and *Marac Life Assurance Ltd v CIR* [1986] 1 NZLR 694 (CA).

3.26 And Tipping J in *A Taxpayer* (CA) expressed the principle in this way:[45]

> Except in cases involving sham or avoidance, taxation issues should be decided on the basis of the legal and equitable rights and obligations deriving from the transaction to which the taxpayer is a party, or the circumstances in which the taxpayer is involved. Taxation issues should not be decided on the basis of the so called economic substance or reality of the transaction, or of the circumstances in which the taxpayer is involved.

3.27 The legal rights and obligations created by the arrangement are determined by ordinary legal principles and will generally require a contractual analysis of the arrangement. The Supreme Court in *Ben Nevis* stated:

> [47] In proceeding in this way, the Court must also respect the fact that frequently in commerce there are different means of producing the same economic outcome which have different tax consequences. **When considering the application of a specific tax provision, before reaching any question of avoidance, the Court is concerned primarily with the legal structures and obligations the parties have created** and not with conducting an analysis in terms of their economic substance and consequences, or of alternative means that were available for achieving the substantive result.
>
> [48] On the other hand, it is the true meaning of all provisions in a contract that will determine the character of a transaction rather than the label given to it. The label "licence premium" is accordingly not what is important in the present case, but rather the true contractual nature of the legal rights for which payment is to be made and the effect of applying the tax legislation to a payment of that character. Once the nature of the contractual rights and obligations has been determined in this way, the specific provision can be applied. [Emphasis added]

3.28 Generally, tax outcomes under specific provisions do not depend on the economic or other consequences of an arrangement. However, Parliament may indicate in the specific provision itself or in the relevant regime that an economic substance approach is required.[46]

3.29 As discussed in Part 7, the approach under s BG 1 is not limited to the legal rights and obligations created by an arrangement.

English cases on economic substance are of limited assistance

3.30 The Supreme Court in *Ben Nevis* referred to an approach in certain English cases to interpreting specific provisions.[47] These cases were decided before the United Kingdom enacted a general anti-avoidance provision. The approach allowed courts to take into account the economic substance of an arrangement.

3.31 The minority in *Ben Nevis* (SC) considered this approach applied in New Zealand. They wrote separately to express their reservations on the approach of the majority to interpreting specific provisions.[48]

3.32 However, the majority in *Ben Nevis* (SC) concluded the English cases were of limited assistance and care must be taken when applying English cases in a different New Zealand context. The court stated:

> [110] English decisions provide limited direct assistance. To the extent that they have, over recent decades, adopted a more purposive approach to interpretation of tax legislation, they provide helpful insights. They are not, however, concerned with the reconciliation of potentially conflicting provisions. United Kingdom tax legislation has never had a general anti-avoidance provision. As a result of this difference it has been suggested that the English purposive approach involves considerations that are somewhat removed from the wording of the New Zealand statute. A purposive approach is, in any event, limited in the extent to which it can avoid arrangements on its own. Such an approach is, however, reinforced in New Zealand by the presence in our legislation of the general anti-avoidance provision. Care must, therefore, be taken when applying English cases in the different New Zealand context in which the meaning and scope of the general anti-avoidance provision, as well as that of specific provisions, must be addressed and applied.

3.33 Accordingly, the English cases were not concerned with how to reconcile the potential conflict between a general anti-avoidance provision and specific provisions. The position of the majority on the limited assistance of the English cases is the current law in New Zealand.[49]

[45] *A Taxpayer v CIR* (1997) 18 NZTC 13,350 at 13,366 (CA).

[46] *Sovereign Assurance Company Ltd v CIR* [2012] NZHC 1760, (2012) 25 NZTC 20–138 at [88].

[47] *W T Ramsay Ltd v Inland Revenue Commissioners* [1982] AC 300 (HL), *Furniss (Inspector of Taxes) v Dawson* [1984] AC 474 (HL), *MacNiven (HM Inspector of Taxes) v Westmoreland Investments Ltd* [2001] UKHL 6, [2003] 1 AC 311 and subsequent cases.

[48] At [5].

[49] See *Cullen Group Ltd v CIR* [2019] NZHC 404 at [57].

Interpreting specific provisions in the context of tax avoidance

Specific anti-avoidance provisions do not prevent s BG 1 applying

3.34 Specific anti-avoidance provisions are provisions that relate to particular specific provisions and arrangements. It has been argued that there is no scope for s BG 1 to apply if there is a specific anti-avoidance provision. For example, the taxpayer in *Challenge* (PC) argued that s BG 1 could apply only to arrangements not dealt with by the specific anti-avoidance provision.[50]

3.35 However, the Privy Council in *Challenge* disagreed and stated: [51]

> A likely explanation is that Parliament was indifferent to or unmindful of any overlap between the general provisions of s 99 and the particular provisions of s 191(1)(c)(i) or that, in view of the well-known difficulties encountered in the formulation and enforcement of effective anti-tax avoidance provisions, Parliament thought that an overlap might be useful and could not be harmful. Parliament may have had in mind two different tax avoidance positions.

3.36 Section BG 1 may apply to an arrangement that is the same, similar or close to an arrangement covered by a specific anti-avoidance provision. For example, where an arrangement is structured to circumvent the scope of a specific anti-avoidance provision.

3.37 Section BG 1 might also apply to arrangements that avoid tax in a different way than that covered by a specific anti-avoidance provision. The Privy Council in *Challenge* also said that a specific anti-avoidance provision could not be interpreted to effectively "silently repeal" the general anti-avoidance provision.[52]

3.38 The Supreme Court in *Penny* (SC) took a similar view. The taxpayer argued that the specific anti-avoidance provisions for some related party transactions left no room for s BG 1 to apply. The Court rejected the taxpayer's argument:

> [48] **Nor, as the *Challenge* case shows, does the existence in the PSA rules and the cross-border services rules of some specific anti avoidance provisions have the consequence that s BG 1 cannot operate where the tax avoidance arrangement employed by a taxpayer does not fall within those specific rules.** The Select Committee Report on the Taxation (Annual Rates, GST and Miscellaneous Provisions) Bill commented that the PSA rules (which it called the attribution rule) "supports the general anti avoidance provisions of the Income Tax Act 1994". The legislators thus recognised that the latter would continue to do their residual work, but no doubt with the hope that the delay and cost involved in using them could be obviated in specifically targeted situations. **Unless the specific rules plainly are intended to cover the field in relation to the use of particular provisions by taxpayers or plainly exclude the use of the general anti avoidance provision in a certain situation — which is not so here — then the Commissioner can rely upon s BG 1 to counter avoidance where that has occurred.** [Emphasis added]

3.39 The Supreme Court said there may be instances where a specific anti-avoidance provision is plainly intended to:

- cover the field; or
- exclude the use of the general anti-avoidance provision.

3.40 Whether this is the case depends on the meaning and intended scope of the specific anti-avoidance provision. A taxpayer arguing that a specific anti-avoidance provision excludes s BG 1 from applying is unlikely to succeed unless it is clear Parliament intended this. For example, where a specific anti-avoidance provision states that it overrides s BG 1.

Specific provisions and s BG 1 can be argued in the alternative

3.41 The Commissioner can argue in a dispute that the use made of a specific provision is not within its ordinary meaning and intended scope and that, in the alternative, s BG 1 applies. For example, the Commissioner might argue:

- an expense is not deductible under a specific provision; and
- if the expense is deductible, then s BG 1 applies.

3.42 Some may consider that the Commissioner, in arguing in the alternative, is in effect, holding contrary and inconsistent views of the facts and law at the same time. However, this is not the case. The Commissioner can argue in a dispute that a specific provision or s BG 1, alternatively, applies or does not apply based on certain facts.

[50] *Challenge Corporation Ltd v CIR* [1986] 2 NZLR 513 (PC).

[51] At 559.

[52] At 560.

3.43 This is consistent with the High Court's view in *Westpac*:

> [314] **Accordingly, I am satisfied that the Commissioner has correctly disallowed Westpac's deductions for the GPFs [guarantee procurement fees]. They were not paid according to a "financial arrangement" or in deriving gross income. In my judgment Westpac's use of the deductibility provisions was not within their ordinary meaning and scope in the light of their specific purposes.**
>
> [315] That finding is not, however, determinative of the proceeding. I must still consider Westpac's claim that, regardless of the lawfulness of its GPF deductions, the transactions are not tax avoidance arrangements and, even if they are, that the Commissioner has wrongfully reconstructed them. In fiscal terms, the consequences are potentially much greater than disallowing the bank's total deductions for GPF expenditure. On the Commissioner's case, they extend to the lawfulness of all the bank's deductions claimed for the cost of funds. [Emphasis added]

3.44 The court in *Westpac* (HC) went on to consider tax avoidance and found that the guarantee procurement fees (GPFs) were also an integral element of the tax advantage subject to s BG 1:

> [614] Westpac's tax advantage combined two principal elements of deductibility falling within the composite label of the cost of funds – funding cost and the GPF. There was no hierarchy or ranking between them. While only the GPF was unlawfully deducted and the separate source of a finding of avoidance, none, of the deductions would have been generated without completion of the transaction as a whole. All of its elements were integral.

3.45 There is no need to consider whether s BG 1 applies to the use or the circumvention of a specific provision if a taxpayer's arguments about the application or non-application of the specific provisions fail.[53] However, even if this is the case, s BG 1 may still apply to the arrangement as a whole in relation to some other use or circumvention of the Act. [54]

3.46 This was confirmed by the High Court in *Westpac*:

> [187] However, taking [107] as a whole and in context, I do not read *Ben Nevis* as mandating that the avoidance inquiry will not proceed unless the taxpayer shows that the use made of a specific provision is within its intended scope. I construe the first three sentences in [107] as reinforcing the court's point made in [106] that proof of a taxpayer's compliance with a specific provision does not exclude the scope for a wider inquiry into the arrangement as a whole. Wild J, when postulating a distinctive two step inquiry, was apparently of the same opinion: *BNZ Investments* (No 2) at [122] and [123].
>
> [188] An anomaly would arise otherwise; for example, a court might disallow a claim for a relatively minor deduction, thus barring it from proceeding to an avoidance inquiry into the transaction as a whole. That result would be contrary to the way the Commissioner has argued his case and to *Miller v C of IR; Managed Fashions Ltd v C of IR* (1998) 18 NZTC 13,961; [1999] 1 NZLR 275 (CA) at NZTC 13,977; NZLR 298–299.
>
> [189] There may be cases where the taxpayer's misuse of a specific provision is so extreme or clear cut that a finding of tax avoidance will inevitably follow. **But a wider inquiry will necessarily be appropriate where the arrangement involves a number of composite or interdependent steps, including the step which is the subject of a disputed deductibility claim.** Its resolution will not normally be decisive of the avoidance inquiry. [Emphasis added]

Requirements of a specific provision may be met by part of an arrangement

3.47 A specific provision applies if the requirements stated in the provision are met. Where the requirements are met by a part of an arrangement, it is not necessary to consider the other parts of the arrangement.

3.48 By contrast, s BG 1 applies to the arrangement as a whole and is concerned with the purpose or effect of the arrangement. An arrangement may include steps and transactions that are not relevant to the requirements of the specific provision. This will be particularly so where an arrangement involves the use of multiple specific provisions.

Part | Wāhanga 4 Meaning of "arrangement"

Introduction

4.1 This and following parts of the statement concern the tax avoidance inquiry and look at the essential elements of that inquiry. This includes:

- the meanings of an "arrangement" (this Part) and a "tax avoidance arrangement" (Part 5);
- the Parliamentary contemplation test (Part 6);
- the commercial and economic reality of an arrangement (Part 7); and
- applying s BG 1 (Part 8).

[53] See for example, *Inland Revenue Commissioner v Europa Oil (NZ) Ltd* [1971] NZLR 641 (PC) [*Europa (No 1)*].

[54] See for example, *Westpac* (HC) at [187]-[189].

4.2 Section BG 1 applies to a "tax avoidance arrangement" as defined in s YA 1. The Supreme Court in *Ben Nevis* considered the definition was the key statutory concept in s BG 1.[55] The definition uses the terms "arrangement" and "tax avoidance". These terms are also defined in s YA 1.

4.3 The definitions of "tax avoidance arrangement" and "tax avoidance" are considered in Part 5. This Part of the statement considers the definition of "arrangement" in s YA 1:

> **arrangement** means an agreement, contract, plan, or understanding, whether enforceable or unenforceable, including all steps and transactions by which it is carried into effect.

Key features of an "arrangement"

An arrangement is an agreement, contract, plan or understanding

4.4 The definition of "arrangement" provides for varying degrees of formality and enforceability. For example, an arrangement may be:

- a legally binding contract;
- an agreement or plan that may or may not be legally binding;
- an understanding that may or may not be legally binding; or
- a contract that is not enforceable at law due to public policy, contractual incapacity, or illegality.

4.5 The courts have considered definitions of "arrangement" in earlier Income Tax Acts. They described an arrangement as embracing all kinds of concerted action by which persons may arrange their affairs:

- for a particular purpose; or
- to produce a particular effect.

4.6 For example, Richardson P in *BNZ Investments No 1* (CA) stated:

> [45] **The words contract, agreement, plan and understanding appear to be in descending order of formality.** A contract is more formal than an agreement, and in ordinary usage is usually written while an agreement is generally more formal than a plan, and a plan more formal or more structured that an understanding. **And it is accepted in the definition of arrangement that the contract, agreement, plan or understanding need not be enforceable.** Section 99 thus contemplates arrangements which are binding only in honour.
>
> [46] In *Jaques v Federal Commissioner of Taxation* (1924) 34 CLR 328 at p 359 Isaacs J said that arrangement in s 260 meant an arrangement which was in the nature of a bargain but which might not legally or formally amount to a contract or an agreement. **And in *Bell v Federal Commissioner of Taxation* (1953) 87 CLR 548 at p 573, the High Court of Australia described arrangement as extending beyond contracts and agreements "so as to embrace all kinds of concerted action by which persons may arrange their affairs for a particular purpose or so as to produce a particular effect".** *Newton* [[1958] AC 450 at p 465] is to similar effect. Their Lordships considered arrangement apt to describe something less than a binding contract or agreement, something in the nature of an understanding between two or more persons – a plan arranged between them which may not be enforceable at law. Lord Denning went on in the same paragraph to say that the whole set of words in the section denoted concerted action to an end; (at p 455) that the "the whole complicated series of transactions must have been the result of a concerted plan"; (at p 467) that looking at the whole of the arrangement, "the whole of the transactions show that there was concerted action to an end"; and at p 468 that the exposition of the law given by the High Court of Australia in ***Bell*** was a valuable guide to the true understanding of the section. Similarly, in *Rowdell Pty Ltd v Federal Commissioner of Taxation* [1963] 9 AITR 177 at p 194, Kitto J said: "The operation of s 260 extends, of course, beyond the arrangement (in the limited sense of the consensus between the parties) to everything done as part of the concerted means adopted for the avoidance of a liability to tax". [Emphasis added]

4.7 Richardson P was considering a previous definition of "arrangement". The previous definition listed the types of arrangement in descending order of formality. The current definition lists the same types of arrangement alphabetically, so that "agreement" comes before "contract". Despite this slight difference, Richardson P's point that the definition provides for varying degrees of formality and enforceability remains relevant.

An arrangement may involve more than one transaction or document

4.8 The words "an agreement, contract, plan, or understanding" are singular. However, this does not mean that an arrangement is confined to a single transaction or document.

[55] At [105].

4.9 Whether two or more transactions or documents together constitute an "arrangement" is a matter of fact. [56] As discussed below, the courts ask whether:

- the transactions or documents are sufficiently interrelated or interdependent;
- there is an overall plan; or
- there is prior planned linking or sequencing or both.

4.10 This analysis requires consideration of the nature and extent of the relationship between the transactions or documents. For example, McMullin J in *Tayles* (CA) examined various individual transactions and documents to determine the scope of the arrangement.[57] The taxpayer in *Tayles* (CA) executed three documents:

- a deed of trust;
- a deed of partnership; and
- an agreement for the bailment of stock.

4.11 McMullin J decided that the three documents combined to form the arrangement. McMullin J stated:[58]

> It follows that before that section can be said to have application to a particular case there must be an inquiry as to whether there has been an arrangement at all and, if so, what is its nature or purpose. It has never been the case for the taxpayers that the three documents executed by each did not amount to an arrangement.

4.12 Also, the Privy Council in *Europa No 1* considered whether six agreements constituted a single agreement. Although this was in the context of the application of specific provisions, the Commissioner considers the same considerations and conclusions would apply in the context of the meaning of "arrangement".

4.13 The Privy Council held that the agreements were "far too close, and far too carefully worked out" to isolate and treat as "a series of independent bargains".[59]

4.14 The objective evidence in *Europa No 1* (PC) showed an interdependence between the agreements because:

- they were made on the same date and some of them contained references to the other agreements;
- they indicated that one party never intended to bind itself without entering into the other agreements; and
- the effect of one of the agreements was to enable one party to sue for any breach of the other agreements.

4.15 Their Lordships concluded:[60]

> The documents therefore, in their Lordships' opinion, point unequivocally towards an interdependence of obligations and benefits under a complex of contracts which, though embodied in separate documents represents one contractual whole … — that the contractual arrangements were interdependent, one on the other.

4.16 The High Court in *AMP Life* had to decide whether there was an "arrangement" comprised of the following events involving AMP and AFS (a subsidiary):[61]

- AMP and its various subsidiaries (including AFS) grouping losses and claiming deductions for these in the 1988 income year.
- AMP subscribing for capital in AFS in December 1989.
- AMP selling its shares in AFS to AMP Discount Corporation in October 1992.
- AMP claiming a deduction for the loss on the disposal of the AFS shares.

4.17 In *AMP Life*, the High Court said that a "mere sequence of events, each with knock on causative consequences" did not constitute an arrangement.[62] The High Court decided there was no prior planned linking or sequencing (or both) between the four transactions. The High Court stated:

> [126] … There were trading losses by the subsidiaries. They are not of course alleged to be part of the arrangement, but set the scene. AMP then procured the deduction for its own benefit of those trading losses. … There is no direct evidence AMP

[56] *Peterson v CIR* [2005] UKPC 5, [2006] 3 NZLR 433 (PC) at [33].

[57] *Tayles v CIR* [1982] 2 NZLR 726 (CA).

[58] At 734.

[59] At 651.

[60] At 651-652.

[61] *AMP Life Ltd v CIR* (2000) 19 NZTC 15,940 (HC).

[62] At [125].

> planned, at the time it took the s 191 deductions, to capitalise the loss making subsidiaries and to procure repayment of debt in the way which eventually occurred. … **Much more importantly however, there is no direct evidence or room for inference on [the] balance of probabilities that at the time AMP took the benefit of s 191 deductions AMP planned not only capitalisation and debt repayment, but also dissolution of AFS, or sale followed by dissolution of AFS.** Indeed, the evidence is to the contrary. AMP did not need to have such plans at the time of the s 191 deductions. Its plans, if any, for AFS and the other subsidiaries were a further and distinct issue which could await developments. …. On the evidence, not contested by the Commissioner, AMP did take its time. On 15 December 1989 AFS subsidiaries were transferred to AMP, and AFS became moribund. Considerably later, "at some stage during 1992" (in or before April 1992) it was decided AMP no longer needed to retain AFS. **This was a new decision.** The timing was not challenged by the Commissioner in evidence. **It was not, for example, suggested that all this involved carefully staged waiting so as to give the appearance of staged and separate decisions.** AFS then resolved to dissolve on 9 April 1992. Then, at some stage in April 1992 after the resolution for winding up, AMP became aware of a possible technical issue as to deductibility under s 204C in event of liquidation; and commencing 4 August 1992 the decision was made to interpose a sale within the group, eventually effected 14 October 1992. **This is a sequence of events. It is the way things eventuated. It cannot be strained to fit within concepts involving overall planning such as contracts, agreements, plans or understanding. The legislation is not aimed at simple sequences of events of this character without prior overall planning.** These happen, and are allowed for on the basis of experience, within the tax base. **The legislation is concerned with planned measures, not allowed for, which degrade the tax base.** [Emphasis added]

4.18 The High Court in *Krukziener* agreed with the approach in *AMP Life* (HC).[63] The Court stated:

> [6] In *AMP Life v CIR*, McGechan J held that the discrete steps relied on by the Commissioner in that case, as amounting to an arrangement, were not sufficient because:
>
> They are a mere sequence of events, each with knock on causative consequences, but that situation does not suffice. **The concepts of contract, agreement, plan or understanding predicate some prior planned linking or sequencing or both**, and that element is missing.
>
> [7] In the present case, referring to *AMP Life*, the TRA correctly identified the need for an arrangement to be more than merely discrete steps, observing that:
>
> These transactions must apply in a concerted way as part of a predetermined end. [Emphasis added]

An arrangement includes "all steps and transactions by which it is carried into effect"

4.19 Section YA 1 defines the term "arrangement" as "including all steps and transactions by which it is carried into effect".[64] The meaning of these words can be informed by their relationship with the first part of the definition of arrangement.

4.20 The first part of the definition says that an arrangement "means an agreement, contract, plan, or understanding". In particular, it is helpful to look at the effect of the words:

- "means" in the first part of the definition; and
- "including" in the second part of the definition.

4.21 The use of "means" and "including" in the two parts of the definition indicates that Parliament intended to distinguish between the parts.[65] The definition of arrangement is exhaustive because it states that an arrangement "means" an agreement, contract, plan or understanding.[66] Also, the drafting style of the Act is to use "means" to introduce an exhaustive definition. [67] Therefore, an "arrangement" must be "an agreement, contract, plan, or understanding".

4.22 The word "including" indicates that an arrangement also consists of "all steps and transactions by which it is carried into effect". This means a step or transaction:

- by itself is not an arrangement because it is not an agreement, contract, plan or understanding; and
- will be part of an arrangement only if it is a step or transaction by which the agreement, contract, plan or understanding "is carried into effect".

4.23 This interpretation is supported by the majority's decision in *BNZ Investments No 1* (CA). Richardson P, for the majority, rejected a submission that transactions that were not an agreement, contract, plan, or understanding were still an arrangement. He held that the words "including all steps and transactions by which it is carried into effect" were concerned

63 *Krukziener v CIR (No 3)* (2010) 24 NZTC 24,563 (HC).

64 The Supreme Court in *Ben Nevis* at [105] observed that tax avoidance can be found in individual, or a combination of, steps. See also, Part 6.

65 *Statute Law in New Zealand* at 569.

66 *BNZ Investments No 1* (CA) at [121] per Thomas J.

67 New Legislation – Income Tax Act 2007, *Tax Information Bulletin* Vol 20, No 2 (March 2008): 27.

with implementing a "contract, agreement, plan or understanding". He stated:

> [48] … The word "it" in "by which it is carried into effect" refers back to the applicable "arrangement" and does not extend it.

4.24 The words "including all steps and transactions by which it is carried into effect" reflect that "agreement, contract, plan, or understanding" may not describe all of the practical steps and transactions needed to carry out an arrangement. Therefore, the definition makes clear that an arrangement includes the various actions undertaken to carry the arrangement into effect even if the actions are not themselves an "agreement, contract, plan, or understanding".

4.25 This interpretation is consistent with *Penny* (CA) where Randerson J stated:[68]

> [78] I am satisfied that an "arrangement" is not limited to a specific transaction or agreement but may embrace a series of decisions and steps taken which together evidence and constitute an agreement, plan or understanding. Any such arrangement may be continued in each of the income years in question or may be varied from year to year.

4.26 The practical effect of the words "including the steps and transactions by which it is carried into effect" was illustrated in *Alesco* (CA):[69]

> [31] While it was not in dispute before us, it is important to identify the nature and extent of the impugned arrangement within the meaning of s OB 1. **It was common ground in the High Court that the notes themselves constituted the arrangement. However, as both counsel accepted in this Court, the arrangement is of wider ambit. In summary the arrangement includes all steps taken for the purpose of implementing Alesco's investment in the notes** including the relevant funding instruments – the subscription agreement and the notes – and, as Mr McKay submits, the cash flows themselves. Additionally, as Mr Brown submits, the arrangement included all incidental steps taken by Alesco NZ to claim the tax advantages such as completing the income tax returns. We emphasise that the statutory arrangement is distinct from the underlying commercial transactions constituted by Alesco NZ's acquisition of the two other New Zealand companies. [Emphasis added]

4.27 An arrangement may comprise a large number of interdependent steps and transactions. For example, in *Westpac* (HC) the arrangement: [70]

- comprised 24 separate detailed steps; and
- included all discussions, decisions and correspondence, both internal to the Westpac Banking Corporation and certain subsidiaries and the counterparty, as to the transaction structure and the implementation steps.

Other features of an "arrangement"

An arrangement may be carried out by one person

4.28 Another issue is whether an arrangement may involve only one person.

4.29 Parts of the definition of "arrangement" are arguably more consistent with the situation where two or more persons are involved. However, arrangement is defined to include a "plan", which could apply to a single person.

4.30 Wylie J in *Russell* (HC) stated that one person could devise and carry out a plan.[71] The Court of Appeal in *Russell* agreed that a one-person plan could be an arrangement:

> [54] We agree with the Judge [Wylie J] that if consensus is needed, the appellant provided any necessary consensus for the purposes of the overall plan. The appellant orchestrated the whole arrangement. **However, we note that the statutory definition of "arrangement" does not require such consensus: a plan will suffice**. Here the overall plan was that created, designed and executed by the appellant. We note also that an arrangement includes "all steps and transactions by which it is carried into effect". Again, no consensus is needed. [Emphasis added]

4.31 Therefore, the definition of arrangement and the *Russell* (CA) case indicate that a plan undertaken by one person could amount to an arrangement.

An arrangement does not require consensus or a meeting of minds

4.32 A person may not agree with, or even be aware of, a transaction carried out by a second person. In such cases, the first person might argue that they are not a party to an arrangement that includes the transaction. The Court in *BNZ Investments No 1* (CA) considered this type of argument.

68 *CIR v Penny* [2010] NZCA 231, [2010] 3 NZLR 360.

69 *Alesco New Zealand Ltd v CIR* [2013] NZCA 40, [2013] 2 NZLR 175.

70 At [36] and [121]–[146].

71 *Russell v CIR (No 2)* (2010) 24 NZTC 24,463 (HC) at footnote 33 at [101].

4.33 The taxpayer argued it was a party to an arrangement with another party involving certain transactions. However, the taxpayer argued that this arrangement did not include other transactions undertaken by the other party. The taxpayer argued this was because it was unaware of what the other party intended to do in carrying out those other transactions.

4.34 In *BNZ Investments No 1*, the majority of the Court of Appeal accepted this argument. The majority held that the taxpayer was not party to an arrangement that included those other transactions. However, Thomas J rejected this argument in his dissenting judgment. He considered the taxpayer could be party to an arrangement even if it was not consciously involved in or aware of the tax avoidance transaction or steps.[72]

4.35 The majority of the Privy Council in *Peterson* endorsed Thomas J's approach. Lord Millett, writing for the majority, said:

> [34] … Their Lordships do not consider that the "arrangement" requires a consensus or meeting of minds; the taxpayer need not be a party to "the arrangement" and in their view he need not be privy to its details either. On this point they respectfully prefer the dissenting judgment of Thomas J in *Commissioner of Inland Revenue v BNZ Investments Ltd* [[2002] 1 NZLR 450 (CA)].

4.36 The Supreme Court in *Ben Nevis* noted the different approaches taken in *Peterson* (PC) and *BNZ Investments No 1* (CA).[73] The Supreme Court stated that "it is unnecessary for us to decide whether to depart from that aspect of the Privy Council's judgment in *Peterson* in this case".[74]

4.37 Therefore, the Commissioner considers the legal position remains as stated by the Privy Council in *Peterson*. That is, the term "arrangement" in s BG 1 does not require consensus or a meeting of minds.[75] This conclusion is consistent with the conclusion above that an arrangement includes a plan undertaken by one person.

Parts of an arrangement can be an arrangement in their own right

4.38 An arrangement may consist of more than one agreement, contract, plan or understanding. However, the definition of "arrangement" does not address whether an arrangement could also be part of another wider arrangement. Taking a wider or narrower view of the arrangement may affect whether the arrangement is a tax avoidance arrangement.

4.39 The Commissioner considers an agreement, contract, plan or understanding that is itself an arrangement, may also be part of a wider arrangement under s BG 1. The majority in *Peterson* (PC) recognised this view:

> [33] Their Lordships consider that the Commissioner is entitled at his option to identify the whole or any part or parts of a single composite scheme as the "contract, agreement, plan or understanding" which constitutes the "arrangement" for the purpose of s 99.

4.40 However, a part of an arrangement that is not itself an agreement, contract, plan or understanding cannot constitute a separate arrangement.[76]

An arrangement includes anything entered into, or carried out, outside New Zealand

4.41 Sometimes arrangements involve steps or transactions carried out or brought into effect wholly or partly outside New Zealand. The definition of "arrangement" (and "tax avoidance arrangement" or s BG 1 itself) contains no limitation as to the location of where parts of, or steps and transactions in, an arrangement arise. Therefore, any arrangement that has a more than merely incidental purpose or effect of avoiding New Zealand income tax is void under s BG 1, even if it is entered into or carried out wholly or partly outside New Zealand.

4.42 The High Court in *BNZ Investments No 1* agreed with this view, stating:[77]

> [123] … While he [the Commissioner] must respect the building blocks of a transaction, foreign made, for what they are, that does not preclude his coming to a view that what has occurred abroad could have a purpose or effect of avoidance of income tax in New Zealand. **What is done abroad is done abroad, but can still be part of an 'arrangement' with the purpose or effect of tax avoidance in New Zealand**, with s 99 applicable to elements or consequences in New Zealand accordingly. [Emphasis added]

72 At [127] and [131].

73 At [160].

74 At [161].

75 A taxpayer "affected" by a tax avoidance arrangement could still be liable to an income tax adjustment under s GA 1 even under the majority's approach in *BNZ Investments No 1* (CA).

76 As discussed in Part 6, tax avoidance can be found in an individual step that is not itself an agreement, contract, plan, or understanding. See also, *Ben Nevis* (SC) at [105].

77 *BNZ Investments Ltd v CIR* (2000) 19 NZTC 15,732 (HC) (*BNZ Investments No 1* (HC)).

Part | Wāhanga 5 Meaning of "tax avoidance arrangement"

Introduction

5.1 Section BG 1 applies to a "tax avoidance arrangement" as defined in s YA 1:

> **tax avoidance arrangement** means an arrangement, whether entered into by the person affected by the arrangement or by another person, that directly or indirectly—
>
> (a) has tax avoidance as its purpose or effect; or
>
> (b) has tax avoidance as 1 of its purposes or effects, whether or not any other purpose or effect is referable to ordinary business or family dealings, if the tax avoidance purpose or effect is not merely incidental.

5.2 In addition to the concept of an "arrangement", the definition contains three key concepts:

- "tax avoidance" as defined;
- a "purpose or effect" of an arrangement; and
- a purpose or effect that is "more than merely incidental".

Meaning of "tax avoidance"

Definition of "tax avoidance" includes and extends the ordinary meaning

5.3 "Tax avoidance" is defined in s YA 1 as:

> **tax avoidance** includes—
>
> (a) directly or indirectly altering the incidence of any income tax:
>
> (b) directly or indirectly relieving a person from liability to pay income tax or from a potential or prospective liability to future income tax:
>
> (c) directly or indirectly avoiding, postponing, or reducing any liability to income tax or any potential or prospective liability to future income tax.

5.4 The definition of "tax avoidance" contains three paragraphs. Each paragraph lists matters that are included in the definition. Some phrases used in the paragraphs do not add anything to an ordinary understanding of tax avoidance. For example, "avoiding … tax" or "relieving a person from a liability to pay income tax".

5.5 Other phrases in the paragraphs, however, extend the ordinary meaning of tax avoidance. For example, the inclusion of a "potential or prospective liability to future income tax".

5.6 Before 1974, there was no statutory definition of "tax avoidance" in the Act, and the general anti-avoidance provision was itself an exhaustive definition of "tax avoidance".[78] The general anti-avoidance provision was amended in 1974 and introduced an inclusive definition of "tax avoidance".[79] This means that the meaning of the term in the Act is not determined solely with reference to the definition. [80] It is also necessary to consider the term's ordinary meaning and the approach taken by the courts to tax avoidance.

5.7 The courts typically decide whether tax avoidance exists without any detailed analysis of the statutory definition of "tax avoidance", including the term's ordinary meaning.[81] At times, the courts have not referred to the definition at all.

5.8 The Supreme Court in *Ben Nevis* did not analyse the statutory definition of "tax avoidance" when setting out the Parliamentary contemplation test. The Court briefly referred to the definition but did not discuss it in its decision. [82] The Court also briefly referred to the definition in its conclusion on the Parliamentary contemplation test:

> [156] Having regard to the various features of the arrangement we have discussed, our conclusion is that the appellants' use of the specific provisions was not within Parliament's purpose and contemplation when it authorised deductions of the kinds in question. The appellants **altered the incidence of income tax** by means of a tax avoidance arrangement which the Commissioner correctly treated as void against him. [Emphasis added]

78 Section 108 of the Land and Income Tax Act 1954.

79 See *Miller v CIR (No 1)* (1997) 18 NZTC 13,001 (HC) at 13,029 and *Challenge* (CA) at 541.

80 The amendments in 1974 meant that the term included what North P had said earlier in Marx v CIR [1970] NZLR 182 (CA) that the "obvious and popular meaning" of "tax avoidance" "should be preferred" (at 194). The amendments are also consistent with Parliament's intention to give the section full effect and prevent it from being read down.

81 For example, *Miller v CIR* [2001] 3 NZLR 316 (PC); *Peterson* (PC); *Dandelion Investments Ltd v CIR* [2003] 1 NZLR 600 (CA); *Westpac* (HC) at [619]; *BNZ Investments Ltd v CIR* (2009) 24 NZTC 23,582 (*BNZ Investments No 2* (HC)) at [526]; *Russell* (HC) at [115]–[116]; *Krukziener* (HC) at [58]; *Penny* (CA) at [112]; *Penny* (SC) at [50].

82 At [105].

5.9 The Supreme Court in *Ben Nevis* noted that, when reframing the legislation in 1974, Parliament chose not to specify with greater particularity the kind of arrangements to which it would apply. Parliament left it to the courts to work out if s BG 1 applies, and in doing so, what is "tax avoidance":

> [101] In doing so we keep in mind that the present form of the general anti avoidance provision remains largely the same as that adopted in 1974, when Parliament chose, in reframing the then s 108, not to specify with any particularity the kind of arrangements to which it would apply. This was left to the courts to work out. **Parliament did not regard it as inconsistent with the judicial function for the courts to decide which arrangements, having a purpose or effect of saving tax, would be caught by the amended general anti avoidance provision.** Of greater legislative concern was that however carefully the general provision might be drafted, the results of taxpayers' ingenuity in adapting the forms in which they did business could not be predicted. [Emphasis added]

Some income tax must be actually or potentially avoided

5.10 A taxpayer must actually or potentially avoid some income tax for s BG 1 to apply. Section BG 1 is about the avoidance of income tax. The ordinary meaning of the word "avoidance" indicates an alteration of the tax liability of at least one taxpayer is needed.

5.11 Also, the amount and timing of the tax avoided does not need to be certain for s BG 1 to apply. This is clear from the "tax avoidance" definition referring to a potential or prospective liability to future income tax.

5.12 The courts accept an alteration in an actual or prospective tax liability is needed for s BG 1 to apply. For example, the Supreme Court in *Ben Nevis* referred to arrangements "saving tax" without qualification (see [101] of the decision at [5.9] above).

Establishing "tax avoidance" does not require identifying a counterfactual

5.13 It is sometimes argued that "tax avoidance" requires a comparison between the tax outcomes of the alleged tax avoidance arrangement and some other alternative fact situation. This other fact situation might be:

- a hypothetical alternative arrangement the taxpayer might have entered into (sometimes referred to as a "counterfactual"); or
- what might have otherwise arisen had the arrangement not occurred.

5.14 Section BG 1 does not require a specific counterfactual to be identified. This contrasts with s GA 1(4) (discussed in Part 9) which explicitly provides the Commissioner with the discretion to identify a counterfactual when determining whether to adjust a person's taxable income to counteract a tax advantage obtained by the person from or under a tax avoidance arrangement.

5.15 It is also sometimes argued that the words "potential or prospective liability to future income tax" in the statutory definition of "tax avoidance" implicitly require a comparison with hypothetical tax outcomes.

5.16 However, the Commissioner considers the potential or prospective tax liability relates to the tax outcomes that are yet to arise for the arrangement actually entered into. It is not about looking to the tax outcomes of some alternative arrangement.

5.17 The Court of Appeal in *Alesco* held that the application of s BG 1 does not require a comparative or counterfactual analysis to establish tax avoidance. In *Alesco*, the taxpayer advanced a counterfactual argument as to why the arrangement did not constitute tax avoidance. The Commissioner's position was that counterfactuals were irrelevant as a matter of law and, if that position were wrong, the taxpayer failed on the facts. The Court agreed with both grounds the Commissioner advanced.[83]

5.18 New Zealand courts have not relied on counterfactuals to reach a view on whether an arrangement has a tax avoidance purpose or effect. Following the Supreme Court decision in *Ben Nevis*, the courts must apply the Parliamentary contemplation test to determine whether an arrangement has a tax avoidance purpose or effect, and that test does not require considering a hypothetical arrangement.

5.19 As discussed in Part 6, reaching a view on the Parliamentary contemplation test is an intensely fact-based inquiry regarding the arrangement actually entered into. That inquiry does not require identifying an alternative fact situation.

[83] At [35]-[41].

Meaning of "purpose or effect"

"Purpose or effect" is determined objectively

5.20 An arrangement must have a "purpose or effect" of tax avoidance to be a tax avoidance arrangement.

5.21 It is settled law that the purpose or effect of an arrangement is determined objectively. The subjective motives, intentions or purposes of the parties are not relevant. The Privy Council confirmed this in *Newton* and *Ashton*.[84]

5.22 The Privy Council in *Ashton* stated:[85]

> In *Newton v Commissioner of Taxation* [1958] AC 450; [1958] 2 All ER 759 the Privy Council had to consider s 260 of the Commonwealth of Australia Income Tax and Social Services Contribution Assessment Act 1936–1951, a section very similar to s 108. In that case Lord Denning delivering the judgment of the Board said:
>
> > "**The word 'purpose' means, not motive but the effect which it is sought to achieve — the end in view. The word 'effect' means the end accomplished or achieved.** The whole set of words denotes concerted action to an end — the end of avoiding tax" (ibid, 465; 763).
>
> And:
>
> > "**... the section is not concerned with the motives of individuals.** It is not concerned with their desire to avoid tax, but only with the means which they employ to do it. It affects every 'contract, agreement or arrangement' (which their Lordships will henceforward refer to compendiously as 'arrangement') which has the purpose or effect of avoiding tax. **In applying the section you must, by the very words of it, look at the arrangement itself and see which is its effect — which it does — irrespective of the motives of the persons who made it.** Williams J put it well when he said: '**The purpose of a contract, agreement or arrangement must be what it is intended to effect and that intention must be ascertained from its terms.** Those terms may be oral or written or may have to be inferred from the circumstances but, when they have been ascertained, their purpose must be what they effect'" ([1958] AC 450, 465). [Emphasis added]

Purpose of an arrangement determined by working backwards from the effect

5.23 The Supreme Court in *Glenharrow* emphasised that the "purpose or effect" of an arrangement is determined objectively.[86] *Glenharrow* was a decision concerning the application of the general anti-avoidance provision, s 76, of the Goods and Services Tax Act 1985 (the GST Act). The Court held that the same objective test applied to GST avoidance as to income tax avoidance under s BG 1. The Court relied on income tax avoidance cases to support its view. Significantly, the Supreme Court delivered its decision in *Glenharrow* on the same day as its income tax avoidance decision in *Ben Nevis*. Four of the five justices who made up the Supreme Court bench in *Ben Nevis* were also on the bench in *Glenharrow*.[87]

5.24 The Supreme Court in *Glenharrow* explained how to determine the objective purpose of an arrangement. This is done by considering the effect the arrangement has had and by working backwards from the effect to determine the purpose of the arrangement. Referencing *Newton* and *Ashton*, the Court stated:

> [38] What Lord Denning was emphasising was that the general anti-avoidance provision was concerned not with the purpose of the parties but with the purpose of the arrangement. That is a crucial distinction. Once you put the purpose of the parties to one side and **seek by objective examination to find the purpose of the arrangement, you must necessarily do that by considering the effect which the arrangement has had — what it has achieved — and then, by working backwards as it were from the effect, you are able to determine what objectively the arrangement must be taken to have had as its purpose.** That approach is inevitable once any subjective purpose or motive is ruled out of contention, as the authorities say it must be. The position is summed up in a passage from the advice of the *Privy Council in Ashton v Commissioner of Inland Revenue* where Viscount Dilhorne said:
>
> > "If an arrangement has a particular purpose, then that will be its intended effect. If it has a particular effect, then that will be its purpose and oral evidence to show that it has a different purpose or different effect to that which is shown by the arrangement itself is irrelevant to the determination of the question whether the arrangement has or purports to have the purpose or effect of in any way altering the incidence of income tax or relieving any person from his liability [to] pay income tax."
>
> This passage may at first sight appear somewhat circular but must be read as a whole. Viscount Dilhorne was clearly ruling out evidence of subjective purpose or motive and requiring the objective purpose to be determined from the effect of the arrangement. He went on immediately to approve what Lord Denning had also said in *Newton*:

[84] *Newton v Commissioner of Taxation* [1958] AC 450 (PC), *Ashton v CIR* [1975] 2 NZLR 717 (PC).

[85] At 721–722.

[86] *Glenharrow Holdings Ltd v CIR* [2008] NZSC 116, [2009] 2 NZLR 359 at [36].

[87] Elias CJ and Tipping, McGrath and Anderson JJ.

> "In order to bring the arrangement within the section you must be able to predicate — by looking at the overt acts by which it was implemented — that it was implemented in that particular way so as to avoid tax."
>
> It is because the objective purpose is deduced from the effect that the phrase "purpose or effect" in general anti-avoidance provisions has been said to be a composite term. [Emphasis added]

5.25 The Supreme Court in *Glenharrow*, like the Privy Council in *Ashton*, said it is not relevant whether a taxpayer had an intention of avoiding tax.[88] The Court also said the arrangement must not be judged, impermissibly, on the basis of what happened afterwards:

> [51] … There was no prospect of the payment being made by any other means. The only person who made any legal commitment to the $45m was *Glenharrow*, which had a [total] capital of $100 only. Mr Fahey [the shareholder of *Glenharrow*] had found the $80,000 deposit but, according to the evidence, was not to be looked to as a guarantor, nor did he ever undertake to introduce further capital into his company. **It should be emphasised that this analysis does not depend upon hindsight. It looks at the matter as it would have appeared to an objective observer at the time when the arrangement was entered into. The arrangement is not being judged, impermissibly, on the basis of what actually happened afterwards.** [Emphasis added]

5.26 The approach reaffirmed by *Glenharrow* (SC) has subsequently been applied in both GST and income tax cases.[89] Section 76 of the GST Act was also amended to resemble the income tax general anti-avoidance provision more closely than it did when it was considered in *Glenharrow* (SC). Therefore, the approaches to both provisions are similar.

If an arrangement has a particular effect, then that will be its purpose

5.27 The courts have commented on the meaning of the words "purpose" and "effect" in the definition of "tax avoidance arrangement". For instance, the Privy Council in *Ashton* stated that "if an arrangement has a particular purpose, then that will be its intended effect" and "if it has a particular effect, then that will be its purpose".[90]

5.28 In *Tayles*, the Court of Appeal said the words "purpose" and "effect" are looked on as a composite term and that:[91]

> "The word 'purpose' means, not motive but the effect which it is sought to achieve – the end in view. The word 'effect' means the end accomplished or achieved. The whole set of words denotes concerted action to an end – the end of avoiding tax" (*Newton v Commissioner of Taxation* at p 465).

5.29 Generally, the courts have considered the purpose of the arrangement as the:

- "intended effect"; [92] or
- "effect which [the arrangement] sought to achieve".[93]

5.30 Therefore, if an arrangement has a particular effect, that will be its purpose. The effect of an arrangement must be ascertained from the terms of the arrangement bearing in mind those matters discussed in Part 4.

Oral evidence inconsistent with objective purpose or effect is inadmissible

5.31 The terms of an arrangement may be written, oral, or inferred from the circumstances.

5.32 The Privy Council in *Ashton* said that if part of an arrangement is oral, then oral evidence to establish the arrangement's terms is admissible as evidence. The Privy Council stated: [94]

> **A contract, agreement or arrangement to which s 108 applies may be wholly in writing, partly in writing and partly oral or wholly oral. When it appears that any part of it was oral, evidence is properly admissible to determine its terms**, and when such evidence is given, it may not be easy to separate evidence relating to the terms of the contract, agreement or arrangement from evidence as to the purpose of the parties to it but it does not follow that their evidence as to their purpose is relevant to the question whether s 108 does or does not apply. [Emphasis added]

5.33 However, the Privy Council also stated that oral evidence inconsistent with the purpose or effect of an arrangement is not relevant:[95]

> If an arrangement has a particular purpose, then that will be its intended effect. If it has a particular effect, then that will be its purpose and **oral evidence to show that it has a different purpose or different effect to that which is shown by the arrangement**

88 At [39].

89 For example, *Penny* (CA) at [66]–[68]; *Westpac* (HC) at [198]–[200]; *Krukziener* (HC) at [32].

90 At 722.

91 At 734.

92 *Newton* (PC) at 464; *Ashton* (PC) at 721–722.

93 *Tayles* (CA) at 734; *Glenharrow* (SC) at [38]; *Westpac* (HC) at [200].

94 At 721.

95 At 722.

> **itself is irrelevant** to the determination of the question whether the arrangement has or purports to have the purpose or effect of in any way altering the incidence of income tax or relieving any person from his liability to pay income tax. [Emphasis added]

5.34 Similarly, the High Court in *Westpac* said the following about oral evidence:

> [44] … Their accounts provided a linking narrative, supplementing and explaining the picture available from the primary documents, and were relevant to an assessment of the commercial or economic realities of aspects of the transactions. **Subject to certain limited qualifications to be discussed later, oral evidence is otherwise inadmissible to establish that a transaction has a purpose or effect different from that disclosed by the documents themselves**: *Tayles v Commissioner of Inland Revenue* [1982] 2 NZLR 726 (CA) at 733. [Emphasis added]

5.35 The qualifications to be discussed later by the High Court were not about the purpose or effect of an arrangement. They were about the admissibility and relevance of subjective opinions of experts on an aspect of an arrangement. For example, whether a valuation or pricing is at a market rate.

Subjective evidence of purpose not relevant

5.36 It has sometimes been argued that the courts should and do take subjective evidence into account when assessing the purpose or effect of an arrangement. However, as first established in *Newton* and applied in all subsequent general anti-avoidance cases in Australia and New Zealand, the test is objective. The Supreme Court in *Glenharrow* reaffirmed this long-settled position. The Court of Appeal in *Alesco* repeated that the test is objective.[96]

5.37 Judges on occasions may refer to subjective evidence in the course of their judgments, but this is not used to establish the purpose or effect of an arrangement. Judicial reference to subjective evidence is often made simply as a matter of observation as to the taxpayer's stated purpose for the arrangement and to record the nature of a taxpayer's evidence.[97] Courts have also referred to subjective evidence to confirm a finding they have taken on an objective analysis of the arrangement,[98] or as a way of leading into possible non-tax avoidance purposes or effects of an arrangement.[99]

Meaning of a purpose or effect that is "more than merely incidental"

5.38 A "tax avoidance arrangement" is an arrangement that has tax avoidance as:

- its sole purpose or effect; or
- one of its purposes or effects and that purpose is more than merely incidental to any other purpose or effect.

5.39 Accordingly, the merely incidental test is relevant only where an arrangement has two or more purposes or effects and at least one purpose or effect is tax avoidance.

5.40 Generally, the word "purpose" is used in the following discussion to refer to both "purpose" and "effect".

Meaning of "merely incidental" in the merely incidental test

Two possible ordinary meanings of "merely incidental"

5.41 The term "merely incidental" is not defined in the Act. Therefore, it is necessary to consider its ordinary meaning. "Incidental" is defined in the *Shorter Oxford English Dictionary*[100] as:

> **incidental** … 1 liable to happen ***to***: naturally attaching *to*. … **2** Occurring as something casual or of secondary importance; not directly relevant ***to***; following (*up*)*on* as a subordinate circumstance

5.42 The meaning of "merely incidental" was considered by Woodhouse P in *Challenge* (CA): [101]

> But the bracketed words enable a "merely incidental" tax avoidance purpose to be disregarded. So the meaning of that qualifying phrase is all important. Does it have the rather exiguous meaning and effect of excusing only the "the casual" or "the minor" or "the inconsequential" tax avoidance purposes?

5.43 The above suggests two possible meanings of merely incidental in the definition of "tax avoidance arrangement". A purpose could be merely incidental if it:

- is relatively minor, small or inconsequential compared with other purposes; or
- naturally attaches to or follows on as a consequence of other purposes.

96 At [27] and [94].

97 See, for example, *Ashton* (PC) at 721.

98 See, for example, *Westpac* (HC) at [613].

99 See, for example, *Ben Nevis* (SC) at [138] or [148].

100 *Shorter Oxford English Dictionary* (6th ed, Oxford University Press, New York, 2007).

101 At 533.

Legislative history indicates "follows as a consequence of other purposes" meaning of merely incidental was intended

5.44 The merely incidental wording was introduced in 1974. It restored the approach to s 108 of the Land and Income Tax Act 1954, a predecessor of s BG 1, taken by Woodhouse J in *Elmiger* (HC). In cases following *Elmiger* (HC), some courts had departed from Woodhouse J's "natural incident" approach and applied a "sole or principal purpose" approach (eg, *Mangin* (PC)).

5.45 Woodhouse J in *Elmiger* (HC) stated: [102]

> Accordingly it is my opinion that family or business dealings will be caught by s. 108 despite their characterisation as such, if there is associated with them the additional purpose or effect of tax relief … **pursued as a goal in itself and not arising as a natural incident of some other purpose.** [Emphasis added]

5.46 In 1974, when Parliament considered the Bill that introduced the merely incidental wording, the then Minister of Justice, the Hon Dr Finlay, stated:[103]

> That [*Elmiger*] is a decision which I, for my part, regard as a landmark in our legal and social history, and typical of the enlightened approach one has come to expect from Mr Justice Woodhouse. …
>
> The *Elmiger* case unfortunately represented something of a high point, and since that time the courts have tended to retire from the position that was taken up. At any rate this is what has been happening in New Zealand; not so in Australia, where there is a difference of opinion and where the *Elmiger* approach still prevails – they are satisfied that if one of the purposes of a device or scheme that is adopted, and that is of an unusual character, is for the purpose of evading taxation, then it may be struck down, and they need not be satisfied that that is the sole purpose of the arrangement.

5.47 The Minister of Justice continued by citing the decision of *Hollyock* (HCA). [104] The High Court of Australia in *Hollyock* rejected the *Mangin* (SC) "sole or principal purpose" test. The Minister also stated:[105]

> The courts ought to be armed, as they have been on the example of *Elmiger*, to strike it [tax avoidance] down, and I am very much in favour of restoring the authority of *Elmiger* …

5.48 Therefore, of the dictionary definitions, the legislative history indicates that a purpose would be "merely incidental" if it follows on as a consequence of other purposes.

Merely incidental purpose is one that is not pursued as an end in itself and naturally follows from some other purpose

5.49 The Court of Appeal had its first opportunity to consider the merely incidental test in *Challenge*. Woodhouse P dismissed the first possible meaning of merely incidental and settled on the second as the meaning of "merely incidental" in s 99 of the Income Tax Act 1976, the predecessor to s BG 1. [106] He stated:[107]

> As a matter of construction **I think the phrase "merely incidental purpose or effect" in the context of s 99 points to something which is necessarily linked and without contrivance to some other purpose or effect so that it can be regarded as a natural concomitant.** … Already I have mentioned the example put forward in this case of goods manufactured in New Zealand and sold overseas in the knowledge that surrounding costs were likely to be assisted by a tax saving which would not be applicable in the case of internal sales. **But it could hardly be said in such a case that the trading had been pursued to gain the tax advantage as an end in itself.** … So regarded, the tax saving purpose intended as a support to the operation could in the ordinary course no more be labelled an end in itself than the purpose of avoiding or minimising any other cost likely to affect the operation. … [Emphasis added]

5.50 Woodhouse P considered that a "merely incidental" tax avoidance purpose is one that naturally follows from some other purpose. He described such a purpose as one that is "necessarily linked and without contrivance to some other purpose" and "not pursued to gain the tax advantage as an end in itself".

5.51 The High Court in *Westpac* made the similar point that a purpose that is pursued as a goal in itself will not be a "merely incidental" purpose:

> [618] The tax avoidance purpose here could never be regarded "as a natural concomitant" of a dominant commercial purpose. Deployment of the deductibility provisions to reduce the bank's liability to income forecast in the following year in accordance with its tax shelter or capacity calculation became a discrete and real end or objective on its own. … **Westpac's use of its tax shelter**

[102] At 694.

[103] New Zealand Parliamentary Debates (30 August 1974) 393 NZPD at 4,192–4,193.

[104] *Hollyock v FCT* (1971) 125 CLR 647 (HCA).

[105] At 4,194.

[106] On appeal, the Privy Council overturned the majority's decision in the Court of Appeal.

[107] At 533-534.

> **was a significant or actuating purpose which was pursued as a goal in itself in each transaction. As a matter of fact and degree, Westpac's tax avoidance purpose was more than merely incidental to any legitimate commercial purpose.** [Emphasis added]

5.52 The Court of Appeal in *Alesco* also adopted the second possible meaning as the meaning of "merely incidental". The Court referred to a merely incidental purpose as follows:

> [30] In our judgment the use of the phrase "not merely" reinforces a conclusion that a tax avoidance purpose, if found, will offend s BG 1 unless it **naturally attaches to or is subordinate or subsidiary to a concurrent legitimate purpose or effect.** Identification of a business purpose will not necessarily protect a transaction from scrutiny where tax avoidance is viewed as "a significant or actuating purpose which had been pursued as a goal in itself". … [Emphasis added]

5.53 The High Court in *Westpac* also observed that arrangements to which the more than merely incidental test might apply lie within a spectrum.[108] At one end are obvious examples where tax avoidance is a clear purpose. At the other end are arrangements that have a clear and definable commercial purpose where the alteration in tax liability naturally follows from the commercial purpose.

5.54 Arrangements that fall in between – where obtaining a tax advantage is a real or appreciable purpose and there is a concurrent commercial purpose – present the difficulties. The High Court stated that drawing a line between such cases "requires an evaluative judgement, to be exercised according to the facts and degree of the particular circumstances".[109]

5.55 The above approach to the meaning of "merely incidental" has been adopted in several decisions. [110]

Size of a tax benefit may be a strong evidential factor

5.56 As concluded above, a merely incidental purpose describes a purpose that follows naturally from some other purpose. The test is not whether a purpose just happens to be minor or small compared with other purposes. Therefore, the size of a tax benefit achieved under an arrangement will not, of itself, establish whether a tax avoidance purpose is more than merely incidental.

5.57 Nevertheless, in the Commissioner's view, the size of a tax benefit may, in some cases, be a strong evidential factor that a court will consider in deciding whether a tax avoidance purpose follows naturally from a non-tax avoidance purpose. If the tax benefits are very large, in absolute or relative terms, it may be difficult to establish that the tax benefits merely follow naturally from some other purpose.[111]

Certain purposes put forward by taxpayers are not relevant non-tax avoidance purposes

5.58 Sometimes taxpayers may put forward as non-tax avoidance purposes of an arrangement the following:

- a tax purpose that is integral to a tax avoidance purpose;
- a non-tax avoidance purpose that is underpinned by tax avoidance; and
- a very general non-tax avoidance purpose that does not explain the adoption of the specific structure of the arrangement.

5.59 The Commissioner considers the above examples of non-tax avoidance purposes that may be put forward are either tax avoidance purposes or will not lead to a finding that an arrangement's tax avoidance purpose or effect is merely incidental to them.

A tax purpose integral to a tax avoidance purpose

5.60 Non-tax avoidance purposes include purposes giving rise to legitimate tax advantages. The Commissioner considers a legitimate tax purpose does not include a tax purpose that is integral to a tax avoidance purpose. This will be the case even though the tax purpose, when viewed in isolation, appears consistent with Parliament's purpose.

5.61 An example of where this might arise is where an arrangement involves borrowing from a third party at market rates to fund the arrangement, resulting in interest deductions. Such an arrangement was seen in *Westpac* (HC). The High Court found that the borrowing was part of the arrangement and integral to the arrangement's tax avoidance purpose or effect:

> [573] Westpac's initiating step was to source or locate sufficient funds to meet its contractual obligation to Koch. There is a plethora of internal correspondence dealing with the arrangements to borrow on the international money markets for this purpose.

[108] At [211]–[212].

[109] At [212].

[110] For example, *Case M72* (1990) 12 NZTC 2,419 at 2,424; Case S95 (1996) 17 NZTC 7,593 at 7,602; *Case X1* (2005) 22 NZTC 12,001 at [359]–[362] and [392]; *Accent Management Ltd v CIR* (2005) 22 NZTC 19,027 (HC) at [300]; and *Ben Nevis* (SC) at [8]–[9].

[111] See, for example, *Hadlee v CIR* [1989] 2 NZLR 447 (HC) at 470 and *Accent Management* (HC) at [309]-[310].

> Without or but for that step, the transaction would never have gone ahead. The bank's borrowing was "an indispensable part of that which produced the tax benefit": *FCT v Hart* 2004 ATC 4599; (2004) 217 CLR 216, ATC 4603; CLR 225 per Gleeson CJ and McHugh J. **And, I repeat again, its cost of finds (sic) fixed at the current swap rate was an integral component of the dividend rate formula through which its taxation benefits were shared.** [Emphasis added]

5.62 The Court also stated:

> [641] … Westpac's tax advantage combined two principal elements of deductibility falling within the composite label of the cost of funds — funding cost and the GPF [guarantee procurement fee]. There was no hierarchy or ranking between them. While only the GPF was unlawfully deducted and the separate source of a finding of avoidance, none of the deductions would have been generated without completion of the transaction as a whole. **All of its elements were integral.** … [Emphasis added]

5.63 Although these passages of the decision relate to the scope of the arrangement and reconstruction respectively, the cost of funds viewed in isolation may have been legitimate (ie, the borrowing was a non-tax avoidance purpose of the arrangement). However, this would not have meant the taxpayer could have argued that the tax avoidance purposes of the arrangement were merely incidental to the borrowing. This is because the borrowing was an integral part of the tax avoidance purposes of the arrangement.

Non-tax avoidance purposes underpinned by tax avoidance

5.64 A non-tax avoidance purpose may be underpinned by (ie, dependent on) tax avoidance. For example, a taxpayer might argue that an arrangement's non-tax avoidance purpose is to achieve a better rate of return on an investment. However, that return might be achieved as a result of a purpose of tax avoidance (such as an amount not being subject to tax). If so, the tax avoidance purpose will not be merely incidental to the non-tax avoidance purpose. This is because the non-tax avoidance purpose is dependent on or underpinned by tax avoidance.

Very general non-tax avoidance purposes

5.65 Section BG 1, including the merely incidental test, is applied to the actual arrangement entered into. Woodhouse P in *Challenge* (CA) said that whether a tax avoidance purpose is merely incidental is considered "by reference to the arrangement itself".[112]

5.66 In some cases, taxpayers put forward non-tax avoidance purposes that are very general in nature and could be achieved in different ways. For example, it is sometimes argued that a purpose of an arrangement is to "raise finance".

5.67 Because these very general non-tax avoidance purposes could potentially be achieved in many different ways, they may not fully explain why a specific arrangement was entered into. More detailed information about the requirements that led to the actual arrangement entered into may be needed.

5.68 When presented with such general non-tax avoidance purposes, the courts have commonly held that more was needed. This was because the focus was on the specific arrangement entered into.

5.69 The High Court in *BNZ Investments No 1* noted that there was an ordinary business purpose – the intention to make profits. The Court considered this purpose in light of the specific way in which the arrangement was structured. McGechan J stated:

> [103] I am quite unable to accept submission (a). Clearly, and at the very least, one of the purposes or effects of the downstream transactions was tax avoidance, and that was not a merely incidental purpose or effect. One need not look very far. **There was, of course, an ordinary business purpose or a degree of ordinary business purpose in what was done. Fay Richwhite and CML intended to make profits.** That is true in all business, including business carried forward in a tax effective way: it is not done for amusement or to tantalise the tax man. **They went about it, however, in a way which — tax factors apart — was extraordinarily and unnecessarily complicated. There was no reason — tax factors apart — for the elaborate downstream chain and auxiliary activities being included in something which in essence was a lending of money raised by the [redeemable preference share] transactions on secure investments earning interest.** To say otherwise is like travelling from Wellington to Auckland through Stewart Island, the Chathams and Kermadecs (if not Easter Island), then claiming that is just another available route. [Emphasis added]

5.70 The Court of Appeal in *Alesco* also considered the purpose and the specific way an arrangement was structured. The taxpayer highlighted that the arrangement had an underlying commercial rationale to fund acquisitions. The taxpayer said that the arrangement was unlike other tax avoidance cases where transactions would not have been entered into but for the tax benefits. The Court stated:

[112] At 533.

> [112] However, this distinctive factor does not protect Alesco NZ. The question is whether the particular arrangement, regardless of whether it was the originating or intermediate step, had the purpose or effect of tax avoidance. A structure whereby the parent provided funding to its subsidiary of $78 million for years on an interest free basis, in exchange for the subsidiary issuing to it optional convertible notes, cannot possibly have been chosen for a predominantly commercial purpose. Mr McKay has not identified one, and nor could he.

Tax avoidance will rarely be merely incidental

5.71 The Parliamentary contemplation test as set out by the Supreme Court in *Ben Nevis* is discussed in Part 6. The test asks if an arrangement makes use of a specific provision in a manner that is outside Parliament's purpose. In setting out the test, the Court recognised the requirement under the legislation to have regard to merely incidental purposes or effects. However, the Court said that it will rarely be the case that the use made of a specific provision which is outside Parliamentary contemplation could result in the tax avoidance purpose being merely incidental. [113]

5.72 The Court was observing that if an arrangement makes use of a specific provision in a manner that is outside Parliament's purpose, it is then likely that the tax avoidance purposes or effects of the arrangement have been pursued as an end in themselves and will not be merely incidental to a non-tax avoidance purpose or effect.

5.73 This will be particularly so where an arrangement has been structured so that a taxpayer gains the benefit of a specific provision in an artificial or contrived way.[114] This is because there are similar factors considered under the merely incidental test and the Parliamentary contemplation test. Where tax advantages have been obtained by artificiality or contrivance, the tax avoidance purpose is likely to be an end in itself and the tax avoidance purpose is then unlikely to be merely incidental to another purpose.

5.74 Woodhouse P in *Challenge* (CA) commented on the relevance of contrivance or artificiality to the merely incidental test: [115]

> **When construing s 99 and the qualifying implications of the reference in subs (2)(b) to "incidental purpose" I think the questions which arise need to be framed in terms of the degree of economic reality associated with a given transaction in contrast to artificiality or contrivance or what may be described as the extent to which it appears to involve exploitation of the statute while in direct pursuit of tax benefits.** To put the matter in another way, there is all the difference in the world, I think, between the prudent attention on the one hand that can always be given sensibly and quite properly to the tax implications likely to arise from a course of action when deciding whether or not to pursue it and its pursuit on the other hand simply to achieve a manufactured tax advantage. [Emphasis added]

5.75 It may be thought that the Supreme Court's comments in *Ben Nevis* diminish the role of the merely incidental test. However, *Penny* (SC) demonstrates that the Supreme Court considers the merely incidental test has a continuing role in the s BG 1 inquiry. The Supreme Court in *Penny* said it had explained the proper approach to tax avoidance in *Ben Nevis* (SC). It also said that other purposes of the arrangements were evident (eg, asset protection and accumulating assets for the benefit of family). It is implicit in its conclusion that the tax advantage was a principal or predominant purpose, and that the tax advantage purpose was not merely incidental to the other purposes.[116]

5.76 However, the Court discussed possible non-tax avoidance purposes that, had they been present, would have been relevant. These purposes included the company:[117]

- paying a relatively low level of salary because it had a commercial need to retain funds to make a capital expenditure; or
- experiencing financial difficulties and, for the time being, not being able to afford to pay the equivalent of a commercial rate.

5.77 The Court of Appeal in *Russell* (CA) observed that if an arrangement makes use of a specific provision in a manner that is outside Parliament's purpose, it will usually be difficult to establish that the tax avoidance purpose is merely incidental to a non-tax avoidance purpose. It also observed that the Parliamentary contemplation test and the merely incidental test require consideration of many of the same factors. The Court of Appeal stated:

> [42] The determination of whether a tax avoidance purpose is merely incidental to another purpose or effect is a separate enquiry from the Parliamentary contemplation step. **Yet both steps will require consideration of many of the same factors**

[113] At [114].
[114] At [108].
[115] At 535.
[116] At [36].
[117] At [34].

> including whether the arrangement is commercially realistic and whether the arrangement has secured the benefit of the specific provisions in an artificial or contrived way. **If an arrangement has been found to be contrived under the Parliamentary contemplation test, it will usually be difficult for a taxpayer to establish that the tax purpose is a natural concomitant of a non-tax purpose.** [Emphasis added]

Part | Wāhanga 6 Parliamentary contemplation test

Introduction

6.1 The Supreme Court in *Ben Nevis* considered it desirable for it to settle the approach to applying s BG 1. This approach is referred to as the Parliamentary contemplation test. In the later decision of *Penny*, the Supreme Court reiterated that it had explained the "proper approach to questions of tax avoidance" in *Ben Nevis* (SC).[118] And the Supreme Court in *Frucor* referred to the "approach expressly and authoritatively adopted" in *Ben Nevis*.[119]

6.2 The Supreme Court is New Zealand's highest senior court. Therefore, the approach the majority of the Court set out in *Ben Nevis*, which was unanimously endorsed in *Penny* (SC) and *Frucor* (SC), is binding on all other courts.[120] The Commissioner must interpret and apply s BG 1 in accordance with the Supreme Court's approach as set out in *Ben Nevis*, and applied in *Penny* and *Frucor*.

6.3 This Part of the statement focusses on the Parliamentary contemplation test. However, an important aspect of the test concerning the factors considered when applying the test, is discussed in more detail in Part 7.

Parliamentary contemplation test determines if a tax avoidance purpose or effect exists

6.4 The Supreme Court in *Ben Nevis* set out the question that must be answered when determining whether an arrangement has a tax avoidance purpose or effect under the Parliamentary contemplation test:

> [109] ... **The ultimate question is whether the impugned arrangement, viewed in a commercially and economically realistic way, makes use of the specific provision in a manner that is consistent with Parliament's purpose.** If that is so, the arrangement will not, by reason of that use, be a tax avoidance arrangement. If the use of the specific provision is beyond Parliamentary contemplation, its use in that way will result in the arrangement being a tax avoidance arrangement. [Emphasis added]

6.5 The Parliamentary contemplation test requires asking whether the arrangement, viewed in a commercially and economically realistic way, makes use of the specific provision in a manner consistent with Parliament's purpose (referred to as the "ultimate question").

6.6 The Parliamentary contemplation test is an intensely fact-based inquiry. This can be seen in the detailed way the Supreme Court appraised the arrangement in *Ben Nevis* for tax avoidance purposes.[121] The Court of Appeal has also referred to this in *Russell*.[122] And, in *Alesco* the Court of Appeal stated:

> [94] This country's tax avoidance jurisprudence is characterised by its authoritative and constant emphasis on the centrality of findings of fact made according to the relevant statutory principles. In *Elmiger v Commissioner of Inland Revenue* [[1966] NZLR 683 (SC)], North P stated what may then have seemed trite that whether a transaction is a tax avoidance arrangement is "... ultimately a question of fact". The same fundamental point has since been made time and again and is true for all disputed claims of tax avoidance. **The intensely factual focus of the inquiry reflects the need to identify the elements of the impugned arrangement and, objectively, its purposes and effect while taking into account its economic substance rather than being limited to an assessment of its legal form.** [Emphasis added]

Two inquiries arise – specific provisions then s BG 1

6.7 In *Ben Nevis* the Supreme Court explained that in a case concerning the application of s BG 1 two inquiries arise.[123] The initial inquiry is the specific provision inquiry. It is the inquiry into the application of a specific provision and whether the taxpayer's use is within its intended scope. As discussed in Part 3, this inquiry involves assessing whether the relevant legal

[118] At [33].

[119] At [53].

[120] The decisions of higher courts are binding on lower courts in the judicial hierarchy under the doctrine of stare decisis (a Latin term meaning "to stand for things decided").

[121] At [115]-[148].

[122] At [39].

[123] At [107].

structures, rights and obligations the parties created are within the provision's ordinary meaning. The matters considered in the specific provision inquiry will generally not involve consideration of the arrangement as a whole. Instead, the inquiry considers only that part of the arrangement directly relevant to determining whether the elements specified in the specific provision are satisfied by the legal form of the relevant parts of the arrangement.

6.8 If the initial inquiry is satisfied, then the tax avoidance inquiry is carried out involving the Parliamentary contemplation test and, if necessary, the merely incidental test.[124] In contrast to the specific provision inquiry, the Parliamentary contemplation test requires that the use or circumvention of the specific provision is viewed in the light of the arrangement as a whole. The inquiry focuses on the factual reality of the arrangement actually entered into and its use or circumvention of specific provisions. If the arrangement uses or circumvents the specific provision in a way not within the contemplation and purpose of Parliament, then:

- the tax advantage gained from such use or circumvention of the specific provision is impermissible; and
- the arrangement will have a purpose or effect of tax avoidance.

6.9 Certain comments of the majority in *Frucor* (SC) (at [58]) may appear at face value as suggesting a different interpretative approach applies to each of these two inquiries. The majority refers to specific provisions being interpreted on a "largely textual basis" with "scheme and purpose considerations" largely coming into play under the tax avoidance inquiry.

6.10 However, in the Commissioner's view the majority's comments at [58] need to be read in the light of the preceding discussion starting from [51]. That discussion traverses the Courts' attempts to resolve the "apparent awkwardness" of applying a generally expressed rule such as s BG 1 in the highly prescriptive legislative context of income tax legislation. The majority's view was that when tax avoidance is in issue, the question of whether s BG 1 or the specific provision should prevail "is not susceptible to resolution on the basis of the usual interpretative techniques" applied to the meaning of a single specific provision.[125]

6.11 Seen in this light, in the Commissioner's view, the majority was noting in [58] that, in practical terms when s BG 1 is being considered, the tax avoidance inquiry is of paramount importance. Practically then, the interpretative techniques employed in applying a purposive approach (referred to by the majority as "scheme and purpose considerations") can come to the fore more in the tax avoidance inquiry.

Factors considered under the Parliamentary contemplation test

6.12 The Supreme Court also explained in *Ben Nevis* that s BG 1 does not confine the matters that may be considered as to whether a tax avoidance arrangement exists. The Court identified some non-exhaustive factors that may be relevant:

> [108] The general anti avoidance provision does not confine the Court as to the matters which may be taken into account when considering whether a tax avoidance arrangement exists. Hence the Commissioner and the courts may address a number of relevant factors, the significance of which will depend on the particular facts. **The manner in which the arrangement is carried out will often be an important consideration. So will the role of all relevant parties and any relationship they may have with the taxpayer. The economic and commercial effect of documents and transactions may also be significant. Other features that may be relevant include the duration of the arrangement and the nature and extent of the financial consequences that it will have for the taxpayer.** As indicated, it will often be the combination of various elements in the arrangement which is significant. **A classic indicator of a use that is outside Parliamentary contemplation is the structuring of an arrangement so that the taxpayer gains the benefit of the specific provision in an artificial or contrived way. It is not within Parliament's purpose for specific provisions to be used in that manner**. [Emphasis added]

6.13 One of the factors referred to by the Supreme Court in *Ben Nevis* was artificiality or contrivance. The Supreme Court stated that it is not within Parliament's purpose for an arrangement to be structured so that a taxpayer gains the benefit of specific provisions in an artificial or contrived way.

6.14 In cases other than *Ben Nevis* (SC), the courts have found other factors to be significant, including circularity, inflated expenditure or reduced levels of income, the limitation or lack of real commercial or economic risks and the arrangement being pre tax negative. All the factors the courts mention are discussed in Part 7.

[124] As discussed in Part 5, it will rarely be the case that the use made of a specific provision which is outside Parliamentary contemplation could result in the tax avoidance purpose being merely incidental.

[125] At [51].

Penny (SC) illustrates the application of the Parliamentary contemplation test

6.15 The decision in *Penny* (SC) is important because it is a Supreme Court judgment that applied the approach to tax avoidance as set out in *Ben Nevis* (SC).[126] It is important in understanding the Parliamentary contemplation test and its application to an arrangement not focussed on deductions as was the case in *Ben Nevis* (SC) and *Frucor* (SC). And it illustrates the point made above that it is not within Parliament's contemplation for tax advantages to arise through artificial or contrived means.

6.16 The Supreme Court in *Penny* said the case differed from *Ben Nevis* (SC) in that there was no question of the taxpayers in *Penny* failing to comply with specific taxation provisions. The structure adopted when the taxpayers transferred their businesses to companies owned by their family trusts was, as a structure, "entirely lawful and unremarkable".[127]

6.17 When applying the Parliamentary contemplation test in *Penny*, the Supreme Court focused on the commercial or private purposes for the setting of each taxpayer's salary paid by their companies. This was a step the companies repeated annually. The Court stated:

> [34] ... if the setting of the annual salary is influenced in more than an incidental way by a consideration of the impact of taxation, the use of the structure in that way will be tax avoidance. The question to be asked is therefore why the salary was fixed as it was on a particular occasion. Whether that involved tax avoidance can be answered by looking at the effect produced by the fixing of the level of the salary in combination with the operation of other features of the structure.

6.18 The Court said the question was "why the salary was fixed as it was on a particular occasion". To answer this question, the Court looked at the:

- effect produced by the setting of the salary; and
- operation of the other features of the arrangement.

6.19 The Court stated that the effect produced by the setting of the salary at a low level on each occasion together with the operation of the other features of each arrangement was as follows:

> [35] The fixing of the low salary enabled most of the profits of the company from the professional practice to be transferred by way of dividends straight through to the trust, **avoiding payment of the highest personal tax rate**, and then use by the trust for the taxpayer's family purposes, including benefiting him by loans (Mr Penny) or funding the family home and holiday home (Mr Hooper). [Emphasis added]

6.20 In relation to the commercial or private purposes for the arrangements, the Court continued, stating:

> [36] While another purpose was evident from the arrangements in the years in question, namely the protection of assets from professional negligence claims, it cannot have been the sole or a dominant purpose because of the protection already in place through the combination of the accident compensation scheme and insurance cover. This was demonstrated by Mr Penny's preparedness immediately to borrow money back (indeed it never actually left his hands) regardless of the supposed risk to him of claims by patients. One can also infer a genuine desire to build up assets for the benefit of the family in both cases. But plainly the tax advantage was, objectively, at the very least one of the principal purposes and effects of each arrangement. Indeed, the taxation advantage produced by the fixing of the salaries at low levels can fairly be seen as the predominant purpose, although the Commissioner does not need to establish that.

6.21 Accordingly, on the facts before it, the Court concluded that each arrangement had a predominant purpose of obtaining a tax advantage of avoiding the highest personal tax rate (although the Court acknowledged the Commissioner does not need to establish a predominant purpose).

6.22 In the Commissioner's view, the following commercial or private aspects of the arrangements were influential in the Court's conclusion that the tax advantages were not merely incidental to other purposes of the arrangements:[128]

- The salary level was not set for commercial or private purposes.
- The protection of assets from professional negligence claims could not have been the sole or a dominant purpose. This was because of the protection provided from the accident compensation scheme and insurance cover.

6.23 The Court's approach in *Penny* (SC) confirms that it is relevant when applying the Parliamentary contemplation test to consider and examine the non-tax avoidance purposes or effects of an arrangement. As expressed by the Supreme Court

[126] Elias CJ and Tipping and McGrath JJ were members of both the Supreme Court bench in *Ben Nevis* and the bench in *Penny*. Tipping and McGrath JJ were part of the majority in *Ben Nevis* that considered it desirable to settle the approach to s BG 1 (the Parliamentary contemplation test). Elias CJ (jointly with Anderson J) was in the minority in *Ben Nevis*. They wrote separately to the majority to express reservations on aspects of the majority's reasoning on the application of s BG 1. The reservations were not essential to the conclusion.

[127] At [33].

[128] At [34]-[36].

in *Penny*, it is open to the Commissioner to assert a tax avoidance arrangement if the structuring of a taxpayer's affairs "objectively, is not motivated by a legitimate (that is, non-tax driven) reason".[129]

6.24 As mentioned at [2.30] and [2.31], *Penny* (SC) can be seen as a case where the taxpayer used or circumvented the specific provisions concerned with tax rates through the setting of the salary levels. The Supreme Court considered that the setting of the salary was artificial when viewed in the light of the arrangement as a whole and in a commercially and economically realistic way. The taxpayer's use or circumvention of the provisions of the Act was outside Parliamentary contemplation because the taxpayer gained tax advantages in an artificial way. The arrangement had a purpose or effect of tax avoidance because it was not within Parliament's purpose for s BG 1 for provisions of the Act to be used or circumvented, and tax advantages gained, in that way.

6.25 The Supreme Court's application of the Parliamentary contemplation test in *Penny* is consistent with their description of the purpose of s BG 1, as discussed in Part 2, which includes preventing uses of otherwise legitimate structures in a manner that cannot be within the contemplation of Parliament.[130] It is also consistent with the discussion in Part 7 about artificiality or contrivance.

Parliament's purpose and the Parliamentary contemplation test

6.26 Finally, when it comes to the Parliamentary contemplation test there are some particular aspects of the inquiry into Parliament's purposes that are useful to consider. These are discussed in the remainder of this Part of the statement.

Purpose of specific provisions is distinct from purpose of s BG 1

6.27 The Supreme Court in *Ben Nevis* explained that to give appropriate effect to specific provisions and to s BG 1, it is necessary to distinguish the purpose of specific provisions from the purpose of s BG 1.[131] The Court then explained the nature of the distinction:

> [106] Put at the highest level of generality, a specific provision is designed to give the taxpayer a tax advantage if its use falls within its ordinary meaning. That will be a permissible tax advantage. The general provision is designed to avoid the fiscal effect of tax avoidance arrangements having a more than merely incidental purpose or effect of tax avoidance. Its function is to prevent uses of the specific provisions which fall outside their intended scope in the overall scheme of the Act. Such uses give rise to an impermissible tax advantage which the Commissioner may counteract. The general anti avoidance provision and its associated reconstruction power provide explicit authority for the Commissioner and New Zealand courts to avoid what has been done and to reconstruct tax avoidance arrangements.

6.28 The purpose of a specific provision is to give a taxpayer a tax advantage if the use of the specific provision is within its ordinary meaning. The ordinary meaning is determined primarily from the text, purpose and context of the specific provision. The use of a specific provision within its ordinary meaning is a permissible tax advantage.

6.29 The purpose of s BG 1, as the Supreme Court described it in *Ben Nevis*, is to avoid the fiscal effect for tax purposes of arrangements having a more than merely incidental purpose or effect of tax avoidance.[132] Its purpose is to prevent tax advantages gained from the use of specific provisions in a way that falls outside their intended scope in the overall scheme of the Act. Such tax advantages are impermissible and are to have no effect for tax purposes.

6.30 Also as mentioned from [2.15], the purposes of the specific provision and s BG 1 are to be achieved 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.

Inquiry into Parliament's purpose is a hypothetical one

6.31 The inquiry into Parliament's purpose under the Parliamentary contemplation test does not ask whether Parliament contemplated the actual arrangement entered into, with all of its steps and transactions and its use or circumvention of the specific provisions. The test is a hypothetical inquiry. That is, if Parliament had foreseen the actual arrangement when it enacted the specific provision, would it have viewed the use made (or circumvention) of the specific provision within the provision's purpose.

[129] At [49]. The Supreme Court referred to objective "motivation". It is settled law that in this context the taxpayer's subjective motivation is not relevant – see discussion in Part 5 concerning how an arrangement's "purpose or effect" is determined objectively.

[130] At [47].

[131] At [103].

[132] The Supreme Court in *Penny* (SC) at [47] similarly explained that the legislative policy underlying s BG 1 is to negate any structuring of a taxpayer's affairs unless any tax advantage is just an incidental feature. See also Part 2.

6.32 The hypothetical nature of the inquiry was referred to by Wild J in *BNZ Investments No 2* (HC):

> [134] In [101] in *Ben Nevis* the Supreme Court again makes the point — it had earlier been made in the submissions of counsel for the Commissioner referred to by Cooke J at NZTC 5,013; NZLR 541 in *Challenge* — that **no [general anti-avoidance rule] can anticipate all the results of taxpayers' ingenuity in crafting arrangements. Thus Parliament could not, and will not, have contemplated the particular arrangement in issue.** That arrangement is likely to deploy a number of statutory regimes or provisions. I agree with Mr Brown's submission for the Commissioner that it is unreal to suggest that Parliament, when it enacted the deductibility and subvention provisions and the FTC and conduit regimes, might actually have contemplated transactions structured as are those in issue in these proceedings.
>
> [135] It follows that I agree with the Commissioner's submission that the question for the court at step 2 is necessarily an *(sic)* hypothetical one. Guided by the considerations and the approach set out by the Supreme Court in [108] and [109] in *Ben Nevis*, the court is essentially asking itself: had Parliament foreseen transactions of this type when enacting the specific provisions deployed in the transactions, would it have viewed them as within the scheme and purpose of those specific provisions? [Emphasis added]

6.33 Similarly, the Court of Appeal in *Russell* (CA) stated:

> [39] The Parliamentary contemplation test is an intensely fact-based inquiry. It is not simply a matter of seeking to divine what members of Parliament actually intended or had in mind when enacting the relevant provisions. Rather, the determination of whether a particular arrangement would be within Parliament's contemplation is a hypothetical inquiry.

Purposes of each unrelated specific provision used in combination by an arrangement

6.34 An arrangement may use a combination of unrelated provisions enacted at different times. If so, it is unlikely Parliament will have explicitly considered the interaction of the provisions in the way used by an arrangement.

6.35 The High Court in *Westpac* found that the arrangement used a combination of provisions in a way that would not have been contemplated by Parliament when it enacted the various provisions used by the arrangement:

> [606] Self evidently, such a deployment would not have been within Parliament's contemplation when the ITA was enacted. The legislature would not have contemplated that a taxpayer might lawfully use the deductibility provisions, in conjunction with a pre existing right to exempt income, to provide funding to a party at a price considerably below market by returning a share of the domestic taxation benefit derived from claiming a deduction for a non existent expense.

6.36 Therefore, the relevant inquiry is whether the use or circumvention of the specific provisions is within Parliament's purpose for the specific provisions combined in the particular manner by the arrangement. The Parliamentary contemplation test is not concerned with identifying a purpose for that particular combination of specific provisions. This is because it is unlikely that such a purpose exists.

6.37 This does not mean that Parliament's purpose for the unrelated provisions is not ascertained in these circumstances. This is still necessary. While there may not be a combined purpose discernible, the unrelated provisions' individual purposes may indicate something about their combination. For example, Parliament may contemplate that in some cases one provision should prevail over others.

Purpose of each specific provision where arrangement avoids tax in more than one way

6.38 Separate parts of an arrangement might use or circumvent unrelated specific provisions. If so, the purpose of each provision needs to be considered separately. For example, in *Ben Nevis* the Supreme Court had to consider Parliament's purpose for two separate and unrelated specific provisions used by two separate aspects of the arrangement. The licence premium aspect used a specific provision allowing a deduction for depreciation for depreciable property. The insurance premium aspect used a specific provision that provided a person carrying on a forestry business a deduction for expenditure on insurance premiums.

Purpose discerned from a theme running through the legislation

6.39 As mentioned at [3.20], it may be possible, on reading an Act as a whole, to discern a theme running through the legislation. This theme may be relevant to determining Parliament's purpose for a specific provision. This approach has been applied in several GST tax avoidance cases. For example, the courts have held that Parliament intends that GST inputs and outputs balance.[133] It also intends that inputs and outputs have a certain degree of temporal connection.[134] The courts identified these principles from the scheme of the GST Act.

[133] *Ch'elle Properties (NZ) Ltd v CIR* [2007] NZCA 256, [2008] 2 NZLR 342 at [38], and *Education Administration* at [43].

[134] *Ch'elle* at [41] and *Education Administration* at [43].

6.40 The Supreme Court outlined Parliament's purpose for the GST Act as a whole in *Glenharrow*:

> [47] … **The whole premise of the Act generally and of the secondhand goods provisions in particular is that transactions will be driven by market forces:** that their commercial and fiscal effects will be produced by those forces and will not contain distortions which affect (that is, defeat) the contemplated application of the GST Act. It is when market forces do not prevail that s 76 is available to the Commissioner. Take an obvious example (which on the High Court's finding of fact is not the present case). An unregistered vendor and a registered purchaser, not being associated persons, inflate the price of goods in return for a non recourse loan to the purchaser by the vendor. The purchaser obtains the advantage of a higher input tax deduction/refund. This would plainly defeat the intent and application of the Act, namely that the purchaser's deduction would be no more than the tax fraction of the market value of the goods. If the price were influenced by the tax advantage, the purchaser would be achieving something not contemplated by the Act – an artificially enhanced deduction. It is the same if the structure of the transaction enables the purchaser to obtain an artificially early deduction, that is, one which is unrelated to the market realities of the transaction. [Emphasis added]

6.41 In *Frucor* (SC) the majority cited passages from its decision in *Ben Nevis*[135] and then stated:

> [54] In these passages [from *Ben Nevis* (SC)], the expression "specific provision" is used in contradistinction to the GAAR, rather than as indicating a tax provision which is expressed with great particularity. **Indeed, it can cover general features of the tax system, such as income tax being a tax on income, as in *Penny v Commissioner of Inland Revenue (Penny and Hooper)*, or the general right to deduct expenses incurred in generating income, as in many other cases.** [Emphasis added]

6.42 However, unlike the GST Act, the income tax legislation is much more extensive and diverse in its scope. It may not necessarily have a discernible or helpful overall theme. As Richardson J stated in *Challenge* (CA): [136]

> Tax legislation reflects historical compromises and it bears the hands of many draftsmen in the numerous amendments made over the years. It is obviously fallacious to assume that revenue legislation has a totally coherent scheme, that it follows a completely consistent pattern, and that all its objectives are readily discernible.

Purpose translated into facts, features or attributes

6.43 When it comes to the complex task of deciding whether Parliament's purpose for the specific provision is met under the Parliamentary contemplation test, 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 Parliament would expect to see 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 circumstances.

6.44 Sometimes the circumstances will be certain facts Parliament would expect to be present (or absent) and these will be readily ascertainable. For example, in the depreciation rules, it may be concluded that Parliament's purpose includes allowing deductions against income for owners of assets used to derive income. Therefore, Parliament would expect there must be an asset, the asset must be used in deriving income and the asset must be owned by a taxpayer.

6.45 In addition to particular facts, the Commissioner considers that Parliament's purpose might translate into legal, commercial, economic, or other concepts (referred to here as "features or attributes"). For example, a legal concept could arise if a deduction was available for a lease payment, but not for a licence payment. If so, the features or attributes relevant to Parliament's purpose would be those relating to the distinction between the legal concepts of leases and licences (involving, for example, looking at whether the relevant party has exclusive possession).

6.46 A commercial concept could relate, for example, to the concept of contracts of insurance, as was considered in *Ben Nevis* (SC). The Court had to decide whether certain amounts paid were "insurance premiums" and identified the commercial features of a contract of insurance. These included, risk management, reinsurance and being open to the public, rather than secret.

6.47 An example of an economic concept can also be found in *Ben Nevis* (SC) where the Court took the view that a feature of an expense is that it needed to be incurred in an economic sense.[137]

6.48 Parliament also sometimes uses a term relying on the fact that it has been given a meaning by the courts, and those judicial decisions will need to be considered to understand Parliament's purpose. An example is where the courts have identified a number of attributes of the concept of income according to ordinary concepts.

[135] *Ben Nevis* (SC) at [107] and [109].

[136] At 549.

[137] See also, *Frucor* (SC) at [10](c).

6.49 As explained in Part 8, translating Parliament's purposes for specific provisions into facts, features or attributes that Parliament would expect to be present (or absent) when permissible tax advantages arise under the specific provisions may be helpful in some instances when applying the Parliamentary contemplation test.

Part | Wāhanga 7 Commercial and economic reality of an arrangement

Introduction

7.1 The Parliamentary contemplation test involves answering the "ultimate question". That is, whether the arrangement, viewed in a commercially and economically realistic way, uses or circumvents the specific provision in a manner that is consistent with Parliament's purpose.

7.2 The Parliamentary contemplation test applies to the arrangement viewed as a whole. This includes looking at a transaction in the context of the wider arrangement despite the specific provision taxing the transaction on a separate entity basis.[138]

7.3 The Supreme Court in *Ben Nevis* used the following phrases in its judgment:[139]

- the "commercial reality and economic effect" of a use made of the specific provision; and
- an arrangement "viewed in a commercially and economically realistic way".

7.4 In *Frucor* (SC) the majority referred to "economic substance" and "economic effect".[140]

7.5 The Commissioner considers these phrases have the same meaning. The result of viewing an arrangement in a commercially and economically realistic way to determine its commercial and economic effect is referred to in this statement as the arrangement's "commercial and economic reality".

7.6 This Part of the statement considers:

- the factors referred to by the courts when determining whether the arrangement, when viewed in a commercially and economically realistic way, makes use of or circumvents the specific provisions in a manner that is consistent with Parliament's purpose;
- the principle of economic equivalence and its relationship and relevance to viewing an arrangement in a commercially and economically realistic way; and
- hypothetical alternative arrangements that are economically equivalent to the arrangement entered into (sometimes referred to as "counterfactuals").

Factors identified by the courts

7.7 The Supreme Court in *Ben Nevis* identified a number of factors that may be helpful to consider when determining whether a tax avoidance arrangement exists.[141] These factors included:

- 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; and
- the duration of the arrangement.

7.8 In addition, the Court stated that a classic indicator of a use that is outside Parliamentary contemplation is the structuring of an arrangement so that the taxpayer gains the benefit of the specific provision in an artificial or contrived way.[142] The courts have also used the term "pretence". For instance, the Supreme Court in *Ben Nevis* observed that pretence will often be highly relevant to whether there is a tax avoidance arrangement.[143]

[138] See *Frucor* (SC) at [79].

[139] At [109].

[140] At [10]-[11], [19], [72], [75]-[76], [85]-[86] and [93] ("economic substance") and [93] ("economic effect").

[141] At [108].

[142] At [108], where the Supreme Court referred to artificiality or contrivance (in the alternative) but then found the insurance aspect of the arrangement in the case was both artificial and contrived (at [148]). While different, because they often appear together in this way, in this statement "artificiality or contrivance" is treated as a single factor.

[143] At [97].

7.9 Artificiality and 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 cases discussed from [7.31] show how the presence of artificiality and contrivance contributed to the courts' finding of tax avoidance.

7.10 In discussing these factors, the Court stated:[144]

- the significance of each factor in an individual case will depend on the particular facts of the case; and
- it will often be a combination of factors that will be significant.

7.11 Accordingly, no one factor (or any matters mentioned in the discussion below about what the consideration of each factor may indicate) will usually determine the application of s BG 1.

7.12 Significantly, the factors the Court identified relate to matters of fact and not matters of law. The Court said that determining whether a tax avoidance arrangement exists is not limited to purely legal considerations. [145]

7.13 Some of the *Ben Nevis* (SC) factors are closely connected and, depending on the facts of an arrangement, may overlap. For example, factors that may be particularly closely related are the economic and commercial effect of documents and transactions, and the nature and extent of the financial consequences the arrangement will have for the taxpayer.

7.14 As mentioned, in other cases, the courts have found the following factors to be significant:

- 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.

7.15 The factors are discussed further below with examples of each factor from tax avoidance case law.

Artificiality, contrivance and pretence

Meaning of "artificiality" in the tax avoidance context

7.16 The *Shorter Oxford English Dictionary* defines "artificiality" and "artificial" as:

> **artificiality ... 2** The quality or state of being artificial ...
>
> **artificial 1** Made by or resulting from art or artifice; constructed, contrived; not natural (though real). **2** Not real; imitation, substitute ...

7.17 In the Commissioner's view, artificiality in the tax avoidance context includes 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.

7.18 Where, in reality, an arrangement or some part of it is artificial, the artificiality can distort the application or non-application of specific provisions. The tax advantage gained from that distorted application or non-application will be impermissible. The use of specific provisions in an artificial or contrived manner is outside Parliamentary contemplation.[146]

7.19 Artificiality is not to be confused or conflated with commercial innovation and novelty. An arrangement may involve commercial innovation or novelty, but these features alone would not mean the arrangement involves tax avoidance. The mere fact a transaction has unusual aspects will not necessarily be suggestive of tax avoidance. Innovation, novelty, uniqueness and new products may be unassociated with tax avoidance.

[144] At [108].

[145] At [109].

[146] *Ben Nevis* (SC) at [108].

7.20 On the other hand, unusual commercial practice may be indicative of a tax avoidance arrangement. Also, a structure in common usage can still be a tax avoidance arrangement. Just because a tax avoidance arrangement may have become widely used, for instance, where a scheme is used by several taxpayers in an industry, will not make it any less a tax avoidance arrangement.

Meaning of "contrivance" in the tax avoidance context

7.21 The *Shorter Oxford English Dictionary* defines "contrivance" and "contrive" as:

> **contrivance 1** A thing contrived as a means to an end; an expedient, a stratagem, a trick. **b** A device, an arrangement, an invention. **2** The action of contriving or ingeniously bringing about; machination (in a bad sense), trickery … **b** Arrangement of parts according to a plan; design …
>
> **contrive 1** Plan or design with ingenuity and skill; devise, invent (in a bad sense) plot … **3** Find a means of effecting; find a way to do; manage …

7.22 A contrivance is a course of action that is devised, created or planned to attain a specific end (in this context, a tax advantage). The specific end:

- does not arise naturally, spontaneously or in an unplanned way; and
- is not an incident of some other end or aim.

Use of legislated options or actions existing only for tax is not artificiality or contrivance if no additional features exist

7.23 Artificiality or contrivance in this context are not being used to describe uses of specific provisions that involve nothing more than explicitly legislated options or actions that have a purpose or effect only for tax and have no existence outside the Act in the real world of commercial or private dealings.

7.24 Examples include arrangements that, when viewed in a commercially and economically realistic way, comprise nothing more than the use of the provisions enabling:

- the setting up of portfolio investment entities; or
- a company with a tax loss to share its loss with a profit company through a loss offset election or subvention payment.

7.25 These options and actions have only a tax purpose or effect. However, the use of such options and actions will not, in and of themselves, be artificial or contrived. Without additional features, arrangements involving such options or actions will not be tax avoidance arrangements because their use of these options has been contemplated by Parliament.

Meaning and relevance of "pretence" in the tax avoidance context

7.26 As mentioned, the courts have used the term "pretence" in the context of tax avoidance. The *Shorter Oxford English Dictionary* relevantly defines "pretence" and "pretend" as:

> **pretence … 4** The action or an act of pretending: (and instance of) make-believe, (a) fiction.
>
> **pretend … 3 a** Profess to have (a quality etc): profess *to do*. **… b** Lay claim to (a thing, esp. a right, title, etc). … **4** Make oneself appear *to be, to do*, or make it appear *that* something is the case, in order to deceive others or in play;

7.27 It may be evident when an arrangement is viewed in a commercially and economically realistic way that a mismatch exists between the arrangement's legal form and its commercial and economic reality. That is, the legal form makes it appear (ie, it pretends) that something is the case when in reality it is not. It follows that, like artificiality and contrivance, a pretence is a taxpayer created distortion that affects how a specific provision applies. In the Commissioner's view, if pretence is present in an arrangement, then artificiality or contrivance is likely to also be present in an arrangement.

7.28 However, the concept of "pretence" in the tax avoidance context is not to be confused with the concept of "sham". A sham in a tax context is designed to mislead the Commissioner into viewing documents as representing what the parties have agreed when, in fact, the documents do not record their true common intention.[147] That is because the parties do not intend to create any rights and obligations or intend different ones to those created in the documents.

7.29 However, in tax avoidance cases, taxpayers usually:

- intend that the legal rights and obligations created by the documents are to be given legal effect; and
- want to obtain the tax outcomes under the specific provisions, and this requires the legal rights and obligations created to have legal effect.

[147] *Ben Nevis* (SC) at [33].

7.30 A sham is legally ineffective and it is, therefore, very unlikely that "tax avoidance" could arise where there is a sham. This is because the legal rights and obligations required for the specific provisions to apply (or not apply) will not be present. Consequently, it is very unlikely that the Parliamentary contemplation test will arise for consideration. However, sham is sometimes raised as an alternative argument in a tax avoidance context.

Case examples of artificiality, contrivance or pretence

Ben Nevis (SC)

7.31 The Supreme Court in *Ben Nevis* considered that the licence premium promissory notes and insurance features were artificial elements in the arrangement. While the promissory note potentially meant expenditure had been incurred under the specific provision, in commercial terms it was not incurred because the note was an "artificial element" and "gratuitous mechanism" from a business point of view.[148] The Supreme Court also held that the payment of the second insurance premium by promissory note was an artificial payment implemented for tax purposes. The Court also held that the insurance feature of the arrangement was both artificial and contrived. [149]

7.32 The Court considered that because of the tax avoidance context the commercial aspects of the note needed to be considered. The Court also commented on the clarity of the tax advantages being in marked contrast to the prospect of any ultimate commercial profit. [150] The lack of commerciality (ie, non-tax avoidance purposes) concerning the use of the promissory notes meant that they were an artificial element in the arrangement.

7.33 The Court held that the primary, if not sole, purpose of the promissory notes was to generate a tax deduction. For these reasons, the taxpayer's use of the relevant specific provisions was not within the contemplation of Parliament.

Glenharrow (SC)

7.34 The Supreme Court in *Glenharrow* held that the payment of the price for the mining licence in the arrangement was a very artificial element. [151] The price was paid in legal terms by an exchange of cheques and vendor finance. But, at the time the arrangement was entered into, as objectively determined, the payment in commercial and economic terms was an impossibility. The artificial payment created a distorting effect and the Court held that this distorting effect defeated the intent and application of the GST Act.[152]

Penny (SC)

7.35 As mentioned at [6.24], the Supreme Court in *Penny* held that the use of the otherwise legitimate company structure to fix the taxpayer's salary in an artificial manner to obtain a tax advantage was within the policy underlying s BG 1.[153] That policy is to negate any structuring of a taxpayer's affairs, whether done as a matter of "ordinary business or family dealings", unless any tax advantage is just an incidental feature.

7.36 Each arrangement sought to take advantage of the specific provisions of the Act by artificial means. The setting of the salary at an artificially low level took advantage of the differential income tax rates for personal and trustee income.

White (HC)

7.37 The High Court in *White* found on the facts of the case that, among other things, the inability of a company to pay a salary due to unforeseen circumstances did not turn an otherwise acceptable business arrangement into one characterised as artificial or a contrivance.[154] On this point it disagreed with the finding of the Taxation Review Authority that the lack of a salary was artificial and contrived.[155]

Challenge (PC)

7.38 In *Challenge* (PC) the taxpayer company entered into an arrangement to acquire an unrelated loss company to offset the losses against its assessable income. The Privy Council majority observed that the taxpayer was purchasing the tax benefit of a loss sustained by another taxpayer.[156]

148 At [119].
149 At [147].
150 At [122].
151 At [51].
152 At [47].
153 At [47].
154 *White v CIR* (2010) 24 NZTC 24,600 at [75].
155 At [68].
156 At 588.

7.39 The Privy Council majority held that the taxpayer and its subsidiaries pretended they had suffered a loss. In reality, however, the loss was sustained by a company outside the taxpayer's group of companies. The sole purpose of the arrangement was tax avoidance.[157]

Dandelion (CA)

7.40 In *Dandelion* (CA), the taxpayer entered into a "financing" transaction for the sole purpose of obtaining an interest deduction. Interest was deductible under a provision that permitted interest deductions on money borrowed to acquire shares in another group company. The taxpayer derived exempt dividend income of approximately the same amount.

7.41 The Court of Appeal held that the arrangement was a tax avoidance arrangement. The Court described the arrangement as an "artifice involving a pretence and not a real group investment transaction at all".[158]

Frucor (SC)

7.42 The majority in *Frucor* (SC) concluded that an arrangement that included the taxpayer issuing a 5-year optional convertible note for about $204m to the New Zealand branch of an overseas bank (DAP) was a tax avoidance arrangement. The majority concluded that the taxpayer had used the specific provisions to claim deductions for interest in an artificial and contrived manner that cannot have been within Parliament's contemplation.[159]

7.43 The Commissioner argued that, as a matter of commercial and economic reality, DAP only advanced a portion of the face value of the note ($55m). Accordingly, the Commissioner disallowed interest deductions claimed for the balance ($149m). In its assessment, the majority of the Supreme Court considered there were many elements of artificiality about the funding arrangement that were functions of the fundamental artificiality of the convertible note. [160]

Education Administration (HC)

7.44 The High Court in *Education Administration* concluded that s 76, the general anti-avoidance provision of the GST Act, applied to the arrangement. The arrangement involved a timing mismatch between the invoice and payments bases for accounting for GST.

7.45 The Court held that the arrangement had been structured in a way that cannot have been contemplated by Parliament. A number of factors in combination indicated that the arrangement was artificial and contrived:

- the taxpayer had no capital;
- two companies were created by parties that, in reality, were engaged in a joint venture;
- the companies were registered for GST with different accounting bases;
- an artificially inflated hourly rate was set; and
- invoices were issued for the full amount, but required immediate payment of only 10% with the remaining 90% being a contingent liability.

7.46 The Court observed that the GST Act permits a degree of mismatch between the invoice and payments basis for accounting for GST, and not every mismatch or timing advantage will be within the scope of s 76 of the GST Act.

7.47 However, the Court said that the particular mismatch crossed the line and had a tax avoidance purpose. This was because the mismatch was part of an arrangement that had been structured to gain a tax advantage in an artificial and contrived way.[161]

BNZ Investments No 2 (HC)

7.48 The High Court in *BNZ Investments No 2* considered the factual issue of whether a guarantee procurement fee (GPF) was a contrivance.[162] BNZ paid the GPF to the parent of the counterparty in consideration of the parent guaranteeing the payment obligations of its subsidiary. The Court concluded that it was a contrivance.[163]

[157] At 562–563.
[158] At [85].
[159] At [10].
[160] At [81]–[85].
[161] At [84].
[162] At [306]-[330].
[163] At [327].

7.49 The Court also concluded that the setting of the swap rate was contrived to increase the tax benefits flowing from the transactions.[164] The Court held that s BG 1 applied to all the arrangements in issue for six principal reasons, including that each arrangement generated deductible expenses in a contrived or artificial way.[165]

Westpac (HC)

7.50 The High Court in *Westpac* concluded that the guarantee procurement fee was a contrivance in the arrangements in issue.[166]

Manner in which the arrangement is carried out

7.51 The manner in which the arrangement is carried out refers to the particular way in which the arrangement has been structured. As discussed in Part 4, an arrangement involves overall planning and the planned linking or sequencing of the steps and transactions that comprise the arrangement.

7.52 Therefore, when considering the manner in which an arrangement has been carried out, it may be relevant to consider whether the structure of the arrangement:

- differs from usual commercial or private structures and practice (which is not to be confused with the impermissible consideration of hypothetical alternative arrangements (counterfactuals) the taxpayer could have entered into but did not);
- has any unusual features;
- is explicable from a commercial or private point of view; and
- has the effect that specific provisions apply or do not apply.

7.53 Case examples of where the manner in which the arrangement has been carried out was relevant include:

- *Ben Nevis* (SC): Where the Court referred to the manner in which the specific provision had been used, particularly, in relation to the promissory notes. The Court held that from a business point of view the promissory notes were a gratuitous mechanism in the structure. [167]
  The structure of the arrangement also included the incorporation of a single purpose company (CSI) in a tax haven to provide insurance and the payment of an insurance premium by promissory note. The Supreme Court concluded that:[168]
  - CSI, contrary to the usual activities of an insurer, undertook no real risk;
  - CSI's inclusion in the structure was simply as a pro forma vehicle to achieve the deductibility of the second insurance premium;
  - the inclusion in the arrangement of the insurance aspect was both artificial and contrived; and
  - the payment of the second premium by means of the promissory note was, in commercial terms, no payment at all.
- *BNZ Investments No 2* (HC): Where the Court commented on various unusual features of the arrangements and how they were structured and carried out:[169]
  - Each of the six arrangements was a standard form transaction replicated for different businesses which can indicate a tax avoidance purpose or effect.
  - The arrangements were complex given that in economic substance they were straightforward loans.
  - The inclusion of the guarantee procurement fee was:
    - commercially unusual;
    - not commercially justifiable;
    - a contrivance; and
    - even if commercially justifiable, at a rate that was grossly inflated above any market rate.

[164] At [388].
[165] At [526].
[166] At [595] and [597].
[167] At [119].
[168] At [148]-[149].
[169] At [284]-[285], [359], [404] and [516].

- The structure of each arrangement enabled the New Zealand tax benefits to be shared between the BNZ and the counterparty.
- The interest rate swap was included in the structure for the primary purpose of fixing the tax benefits.
- The manner in which the interest rate swaps were transacted was not in accordance with market practice.

- *Westpac* (HC): Where the Court found the structure of the arrangement did not make commercial sense and contained commercially unusual features, such as:[170]
  - *Westpac*, a lower-rated entity in market credit ratings, providing funds to a higher-rated entity, contrary to usual market theory and practice.
  - The higher-rated entity agreed to pay a price for the funds from *Westpac* well in excess of the market price payable by an entity with such a higher credit rating.
  - *Westpac* and the higher-rated entity agreed to exchange equivalent amounts.
- The Court also held that: [171]
  - The inclusion of the guarantee procurement fee (GPF) in the arrangement did not serve an objectively ascertainable business purpose. Although the amount of the GPF was substantial, it was never the subject of careful evaluation or negotiation. The usual element of commercial tension was absent in setting its amount. Even if the GPF was commercially justifiable, its amount substantially exceeded a notional market rate.
  - The GPF's function in the structure of the arrangement was to generate a deduction for an expense that appeared genuine but was a contrivance, both in concept and amount.
- *Education Administration* (HC): Where the Court described aspects of the arrangement relating to the agreement between two companies, including the requirement to only pay 10% of the invoice immediately, as unusual.[172]
- *Penny* (SC): Where the Supreme Court said that the structure each taxpayer adopted was entirely lawful and unremarkable. However, the Court went on to hold that each arrangement was a tax avoidance arrangement. This was because the structure adopted enabled:
  - The salary of each taxpayer to be set at an artificially low level, which avoided the highest personal tax rate on the income derived from the taxpayer's professional services.
  - Most of the company's profits derived from the professional services of one of the taxpayers to be transferred by way of dividends to his family trust and used by the trust to benefit the taxpayer.
  - Each taxpayer to obtain a reduction in liability to tax but, in reality, suffer no actual loss of income.

7.54 The cases show the manner in which the arrangement is carried out may indicate that:

- an arrangement has no commercial or private purpose;
- a feature or step in the arrangement has no objectively identifiable commercial or private purpose and is an artificial and contrived means to obtain a tax advantage;
- there is no underlying prospect of commercial profit and no commercial justification or rationale for the arrangement; or
- the legal structure of an arrangement is complex in contrast to its commercial and economic reality which may, in turn, indicate that the purpose for such complexity is the gaining of a tax advantage and not a commercial or private purpose.

[170] At [586].

[171] At [594], [601], [603] and [595].

[172] At [57].

Role of all relevant parties and their relationships

7.55 Considering the roles and relationships of the relevant parties includes considering whether:

- the parties are associated or closely related;
- the parties are part of the same corporate group;
- a party controls some or all of the other parties, including the taxpayer; and
- the parties have a common interest or unity of purpose in using or circumventing a specific provision in a particular way to obtain a tax advantage.

7.56 Case examples of where the role and relationships of the parties was relevant include:

- *Ben Nevis* (SC): Where the role and relationship of the scheme's architect with the insurer (CSI) was significant because tax advantages were achieved by the deduction of an insurance premium, without investors suffering any actual economic outlay. CSI was incorporated on the instructions of the scheme's architect and he was instrumental in the formulation of CSI's business plan.
- *Penny* (SC): Where the role and relationship of the company and family trust enabled each taxpayer to use funds without the impost of the highest personal tax rate.[173]
- *Russell* (HC): Where the Court noted a very significant factor was that the taxpayer retained control of the whole of the income generated and could direct how it was to be applied. [174]
- *Cullen Group* (HC): Where the Court considered that Parliament would not have contemplated such transactions between highly-related parties that meant, in effect, the former shareholder retained a determining level, or a very high level, of control over various parties and, in reality, was on both sides of the loan transactions.[175]
- *BNZ Investments No 2* (HC) and *Westpac* (HC): Where unrelated parties nevertheless had a "unity of purpose in obtaining and dividing the maximum possible tax benefits".[176]

7.57 The cases indicate that examining the roles of the relevant parties and any relationship that they may have with the taxpayer is a relevant factor because it may:

- indicate that orthodox arm's-length or market forces are absent;
- introduce or enable a distortion in the arrangement, such as non-arm's length or non-market pricing or payment on non-market terms; or
- enable an arrangement to be structured in a particular way to obtain a tax advantage that would not otherwise be possible.

Economic and commercial effect of documents and transactions

7.58 The documents and transactions of an arrangement can be examined to see whether they are consistent with real outcomes under the arrangement. This factor overlaps with the following factor concerning the nature and extent of the financial consequences.

7.59 Case examples of where the economic and commercial effects of documents and transactions was relevant include:

- *Ben Nevis* (SC) where:
  - The obscurity of there being any ultimate commercial profit, in contrast to the clarity of the tax advantages, was a relevant matter the Court considered. There appeared to be no commercial purpose for the syndicate of investors to pay a licence to use the land when the syndicate had already funded its purchase. This raised a serious question over whether the arrangement had a true commercial purpose as distinct from a tax-saving purpose.
  - The Court considered it was permitted to examine the commercial nature of costs incurred and any factors that might indicate the expenditure will never truly be incurred.[177] The Court identified various matters that

[173] At [35].

[174] At [131].

[175] At [65].

[176] *Westpac* (HC) at [597]. See also, *BNZ Investments No 2* (HC) at [506].

[177] At [128].

indicated that the expenditure on the licence would never be truly incurred and it was, in reality, illusory.[178] A second insurance premium paid by way of a promissory note was also considered, in reality, not a payment at all.[179]

- *Glenharrow* (SC): Where the Court held that the exchanging of cheques produced an artificial effect. While it was payment in legal terms, in economic terms, the taxpayer did not provide consideration in money. This was because it was commercially impossible for the taxpayer to make payment. Viewed in a commercially and economically realistic way, the payment was artificial.[180]
- *Frucor* (SC): Where the majority of the Court held that the arrangement was a tax avoidance arrangement because the taxpayer had not suffered the economic burden Parliament contemplated when providing tax relief by way of allowing deductions for interest incurred.[181]
- *BNZ Investments No 2* (HC): Where the Court considered that putting aside the tax advantages, the arrangement had no commercial rationale or logic because it involved lending or investing at a substantial loss.[182]
- *Westpac* (HC): Where the Court's view of the arrangement focussed on the absence of underlying commercial profitability, the commercial and economic effect of the guarantee procurement fee and whether the taxpayer incurred the real economic consequences envisaged for the deductibility provisions and the foreign tax regime used by the arrangement. The Court accepted that each arrangement had a commercial purpose, but this had to be distinguished from their underlying commercial or business viability.[183] The Court concluded that:[184]
  - Due to the self-cancelling effect of the exchanges inherent in the pricing structure, the guarantee procurement fee expense was illusory.
  - There was no underlying prospect of profitability and thus no commercial justification for the transaction.
  - The legal structures superimposed a legal form contrary to the economic substance of the arrangements as loans to obtain a tax advantage.
  - The arrangement that used the foreign tax credit regime did not involve the economic burden of foreign tax being paid or suffered by the taxpayer or the foreign counterparty.
  - Although the arrangements had commercial purposes, the taxpayer loaned funds to save taxes, not to achieve profits, hence those commercial purposes could not be achieved independently of the tax advantages arising under the arrangement.
- *Education Administration* (HC): Where the Court said that a core value underlying a GST input tax deduction is that a taxpayer claiming a deduction is subject to, and incurs, a real and genuine economic burden.[185] The Court held that the taxpayer, in reality, did not suffer a real and genuine economic burden. The taxpayer claimed an input tax deduction for 100% of the amount of each invoice but had paid only 10% of the invoiced amount with the balance being a contingent liability.
- *Alesco* (CA): Where the Court observed that the underlying premise of deductibility provisions is that they apply only when real economic consequences have been incurred and that the taxpayer had not, in fact, incurred a real economic cost.[186] The taxpayer did not actually pay interest or suffer an analogous liability, but it had obtained a reduction in liability to tax as if it had. The Court went on to conclude that the structuring of the arrangement had no commercial purpose. The only available inference was that the taxpayer had adopted the structure to obtain a taxation benefit whereby the advantage gained of interest deductions was totally disproportionate to the economic burden the taxpayer suffered.[187]

[178] At [130].
[179] At [148].
[180] At [53].
[181] At [10].
[182] At [512].
[183] At [590].
[184] At [597], [599], [603], [612] and [617].
[185] At [61].
[186] At [83].
[187] At [112]-[113].

- *Penny* (SC): Where the Court concluded that the tax advantage obtained by the contrived setting of artificially low salaries was, objectively, the predominant purpose of each arrangement.[188]

7.60 The cases illustrate that examination of the economic and commercial effects of documents and transactions may indicate:

- the arrangement's commercial or private purpose is obscure, in contrast to the clarity of its tax advantages;
- the arrangement has no commercial or private purpose;
- the arrangement's commercial or private purpose has no justifiable commercial or private rationale, justification or logic, independent of the tax advantages;
- the arrangement's commercial or private purpose cannot be achieved independently of its tax advantages;
- a timing mismatch between payment in legal terms and payment in commercial and economic terms;
- the taxpayer, in economic terms, has not incurred any real expenditure and is unlikely to, or will not, incur any real expenditure;
- a payment has not, in commercial terms, been paid; or
- the tax advantage the taxpayer gained is totally disproportionate to the economic burden the taxpayer suffered.

Nature and extent of the financial consequences

7.61 The nature and extent of the financial consequences that an arrangement has for the taxpayer will frequently be closely connected, and may overlap, with the economic and commercial effect of documents and transactions factor. This is because the nature and extent of the financial consequences will frequently be determined by the economic and commercial effects of documents and transactions.

7.62 Case examples of where the nature and extent of the financial consequences of the arrangement include those discussed in the preceding factor. In particular:

- *Ben Nevis* (SC): Where, in commercial terms, the payment of the insurance premium by means of the promissory note was not payment at all.[189]
- *Glenharrow* (SC): Where the Supreme Court observed that the financial consequence of the structure adopted was a GST refund that was totally disproportionate to the real economic burden and benefits the taxpayer had undertaken or obtained. [190]
- *Westpac* (HC): Where the financial returns enjoyed by the parties were the result of a formula designed to share deductions but in substance the economic burden and benefit were non-existent.[191]
- *Education Administration* (HC): Where the taxpayer claimed a GST refund for the full amount of each invoice but only paid 10% of the invoiced amount.
- *Penny* (SC): Where the taxpayers suffered no actual loss of income but obtained a reduction in liability as if they had.[192]
- *Challenge* (PC): Where the taxpayer company and its subsidiaries offset its profits against the losses of another company without, in reality, having suffered the loss that would entitle it to do so.[193]

7.63 The cases show the nature and extent of the financial consequences of the arrangement may indicate that tax advantages are being obtained by pretence, such as where:

- the taxpayer has claimed a deduction for expenditure where, in reality, the taxpayer does not suffer the economic cost of the expenditure; or
- the amount of the taxpayer's assessable income has been reduced but the taxpayer, in reality, suffers no proportionate loss of income because they, in fact, retain the use and benefit of the income.

188 At [36].
189 At [148].
190 At [54].
191 At [596].
192 At [47].
193 At 562-563.

Duration of the arrangement

7.64 The duration of the arrangement relates to timing features that include:

- the duration of the entire arrangement (eg, whether it is of a short or long duration);
- the intervals between particular events occurring in the arrangement;
- whether the arrangement is for a specific period; and
- whether the arrangement is perpetual.

7.65 Case examples of where the duration of the arrangement has been relevant include:

- *Ben Nevis* (SC): Where the use of the specific provisions was distorted by the duration of the entire arrangement, including the 50 year timing mismatch between the legal payment and the economic payment of the licence fee.
- *Ch'elle* (CA): Where a timing mismatch created by the arrangement between the invoice and payment bases of accounting for GST distorted the application of the GST Act. The timing mismatch was created by the use of 114 companies that had no commercial purposes other than to act as a mechanism to obtain a tax advantage.[194]
- *Glenharrow* (SC): Where the short duration of the arrangement was a significant factor making it impossible for the taxpayer to commence mining operations and extract sufficient stone to repay the vendor finance. The arrangement had a very artificial element in that the purchase price was not, and could not, be paid in economic terms.[195]

7.66 The cases show the timing features of an arrangement may indicate or identify that:

- the arrangement has been structured to create or take advantage of a timing mismatch to obtain a tax advantage;
- the arrangement has an artificial element; or
- the duration of the arrangement is such that its commercial purpose is unlikely to, or cannot, be achieved – meaning the arrangement has, in reality, no commercial purposes.

Circularity in the arrangement

7.67 Circularity may arise where:

- An arrangement involves circular movements of money which have the economic effect of being self-cancelling and, in reality, not suffered. For example, a circular flow of funds may arise from:
  - an exchange of cheques; or
  - funds flowing through a series of steps, with consequential tax advantages, and returning to their originating source.
- An arrangement, or a part of it, involves steps that have the commercial effect of being self-cancelling. For example, where a commercial risk at one step is cancelled by another step with the effect that, in reality, there is no risk at all.

7.68 Case examples of where circularity has been relevant include:

- *Ben Nevis* (SC): Where circularity was relevant to understanding the commercial reality of the insurance aspect of the arrangement, and led to the view the parties undertook no real risk with the inference that this aspect of the arrangement was simply a method where substantial tax benefits could be obtained.[196]
- *Frucor* (SC): Where the Supreme Court considered that in economic substance there was complete circularity of various amounts of the funding arrangement.[197]
- *Peterson* (PC): Where the Privy Council considered that circular movements of money sometimes conceal the fact that there is no underlying activity.[198]
- *Dandelion* (CA): Where the arrangement involved a series of steps by which the same funds were passed on one day through companies in various countries and then unwound a year later. This lead the Court to conclude that the arrangement was circular and had no financial effects.[199]

[194] At [52].
[195] At [51].
[196] At [146] and [148].
[197] At [85].
[198] At [45].
[199] At [85].

7.69 The cases suggest the presence of circularity in an arrangement or in a part of it may indicate that, in reality, the arrangement or one of its steps has:

- no commercial or private purpose; and
- the purpose of obtaining a tax advantage.

7.70 An arrangement, however, may demonstrate elements of circularity that have a commercial basis and do not cross the line and turn an otherwise permissible arrangement into a tax avoidance arrangement (see *Westpac* (HC)[200]).

Inflated expenditure or reduced levels of income in the arrangement

7.71 Inflated expenditure and reduced levels of income arise where an amount of expenditure or income has been set at an amount above or below a commercial or market rate. Case examples of where inflated expenditure or reduced levels of income have been relevant include:

- *Glenharrow* (SC): where the Court considered inflated expenditure introduced a distortion affecting (and defeating) the contemplated application of the GST Act.[201]
- *BNZ Investments No 2* (HC) and *Westpac* (HC): Where guarantee procurement fees were substantially overpriced.[202]
- *Education Administration* (HC): Where the hourly rates aspect of the arrangement was not set at a market rate with the effect of artificially increasing the amount of the GST refund that could be claimed.[203]
- *Erris Promotions* (HC): Where tax was avoided by creating inflated depreciation losses through the purchasing of software at prices that were grossly inflated. [204]
- *Penny* (SC): Where the setting of artificially low salaries and resulting reduction in the taxpayers' incomes was a significant factor in combination with the taxpayers suffering no actual loss of income.
- *Russell* (SC): Where the low salary of the taxpayer bore no relationship to the work he undertook or salaries payable in the marketplace but he retained control of his employer's income derived from his work.

7.72 The presence in an arrangement of inflated expenditure or reduced levels of income may indicate that the amount of the expenditure or income has been artificially set for the purpose of obtaining a tax advantage and not for a commercial or private purpose.

The parties to the arrangement undertaking limited or no real commercial or economic risks

7.73 Consideration of whether the parties to the arrangement have, in reality, undertaken commercial or economic risks may indicate that the parties have not undertaken any actual risks.[205]

7.74 The cases suggest the absence, or limited nature and extent, of commercial or economic risks may indicate that:

- the tax advantages obtained under the arrangement are disproportionate to the risks undertaken by the parties; or
- the obtaining of a tax advantage is a purpose, or the sole purpose, of the arrangement.

Arrangement being pre-tax negative

7.75 An arrangement is pre-tax negative where it is financially unprofitable before tax. It is the tax effects (ie, the tax advantages that are obtained) that make the arrangement financially profitable. After tax, the arrangement can be described as "post-tax positive".

7.76 An arrangement that is pre-tax negative and post-tax positive may indicate that:

- the arrangement has no commercial purpose;[206]
- the arrangement's commercial purpose has no commercial rationale, justification, or logic, independent of the tax advantages;[207]

200 At [580].

201 At [47].

202 At [511] and [439] respectively.

203 At [66]-[67].

204 *Erris Promotions Ltd v CIR* (2003) 21 NZTC 18,330 (HC) at [335].

205 See *Ben Nevis* (SC) at [148], *BNZ Investments No 2* (HC) at [523], *Erris Promotions* (HC) at [339] and *Dandelion* (CA) at [85]. See also, *Glenharrow* (SC), where the facts show there was no commercial or economic risk to the taxpayer or its sole shareholder.

206 See *BNZ Investments No 2* (HC) at [526] and *Westpac* (HC) at [599].

207 See *BNZ Investments No 2* (HC) at [512].

- the clarity of the tax advantages is in marked contrast to the obscurity of the prospect of any ultimate commercial profit;[208] or
- obtaining the arrangement's tax advantages is a purpose of the arrangement.[209]

Economic equivalence and counterfactuals

7.77 The Commissioner considers that, in the context of discussing the commercial and economic reality of an arrangement, it is necessary to understand the principle of "economic equivalence" and the subject of counterfactuals.

Economic equivalence concerns the inquiry into specific provisions

7.78 The principle of economic equivalence is a well-settled principle of tax law. However, it concerns the proper approach to the application of specific provisions, not the application of s BG 1. The principle provides that it is not permissible to consider the economic substance of a transaction when applying a specific provision to the transaction.

7.79 The principle of economic equivalence is derived from the judgment of Lord Tomlin in the *Duke of Westminster* (HL). [210] The principle was referred to by Lord Wilberforce in *Europa No 1* (PC).[211] The principle is also reflected in the passages cited in this statement from *Finnigan* (CA) (at [3.25]), *A Taxpayer* (CA) (at [3.26]), and *Ben Nevis* (SC) (at [3.27]).

7.80 Lord Tomlin in the *Duke of Westminster* (HL) said:[212]

> **... it is said that in revenue cases there is a doctrine that the Court may ignore the legal position and regard what is called "the substance of the matter",** and that here the substance of the matter is that the annuitant was serving the Duke for something equal to his former salary or wages, and that therefore, while he is so serving, the annuity must be treated as salary or wages. This supposed doctrine (upon which the Commissioners apparently acted) seems to rest for its support upon a misunderstanding of language used in some earlier cases. **The sooner this misunderstanding is dispelled, and the supposed doctrine given its quietus, the better it will be for all concerned** ... [Emphasis added]

7.81 In *Europa No 1* (PC), the Commissioner had issued assessments disallowing the taxpayer's claim to deduct expenditure under:

- s 111 of the Land and Income Tax Act 1954; or
- s 108, the general anti-avoidance provision of the Land and Income Tax Act 1954.

7.82 The majority of the Privy Council in *Europa No 1* held that the Commissioner's assessments disallowing the expenditure under s 111 were correct. It was, therefore, unnecessary for them to consider whether s 108 applied. When delivering the judgment of the majority, Lord Wilberforce referred to the economic equivalence principle: [213]

> The question for decision is not to be answered by describing the benefit derived by Europa through Pan Eastern as in substance a discount or, more ambiguously, as a price concession. No doubt it was a concession obtained from Gulf, in the course of a discussion about prices, but, in a matter of taxation it is necessary to consider and respect the legal form in which the concession was embodied. Their Lordships have no need to restate the principle laid down in such cases as *Commissioners of Inland Revenue v Duke of Westminster* [1936] AC 1 a decision cited in the judgments appealed from and fully accepted as applicable. **It is not legitimate in this branch of the case, as distinct from that involving s 108, to disregard the separate corporate entities or the nature of the contracts made and to tax Europa on the substantial or economic or business character of what was done. The use of the word "concession" does not resolve the dispute, whether what was done was in law, or merely the economic equivalent of, a reduction in price. The one may have quite different taxation results from the other.**
>
> ...
>
> For a claim to disallow a portion of expenditure incurred in purchasing trading stock to succeed, the Crown, in their Lordships' judgment, must show that, as part of the contractual arrangement under which the stock was acquired some advantage, not identifiable as, or related to the production of, assessable income, was gained, so that a part of the expenditure, which can be segregated and quantified, ought to be considered as consideration given for the advantage. **Taxation by end result, or by economic equivalence, is not what [s 111 of the Land and Income Tax Act 1954] achieves.**
>
> This test, the strictness of which their Lordships consider should be emphasised, can only be satisfied after a rigorous and objective examination of the contractual arrangements under which the expenditure is made. [Emphasis added]

[208] See *Westpac* (HC) at [604].

[209] See *Westpac* (HC) at [598].

[210] *Inland Revenue Commissioners v Duke of Westminster* [1936] AC 1 (HL).

[211] At 648.

[212] At 19.

[213] At 648–649.

7.83 Lord Wilberforce in the above passage reiterated and reaffirmed the principle of economic equivalence. That is, in applying specific provisions to a transaction, as distinct from the general anti-avoidance provision, it is not legitimate to:

- disregard the legal rights and obligations created and the true legal nature of the transaction; and
- apply the specific provision to the economic substance of the transaction.

7.84 As discussed in Part 3, the inquiry into the application of the specific provision is determined by the true legal nature of a transaction and the legal rights and obligations created. The application of the specific provision is not determined on the economic substance or the commercial reality of the transaction.

Economic substance, but not counterfactuals or economic equivalence, is relevant

7.85 As Lord Wilberforce explicitly recognised in *Europa No 1* by his use of the phrase "as distinct from that involving s 108", considerations of commercial and economic reality or economic substance are relevant to the application of the general anti-avoidance provision. An economic substance approach is permitted and required when applying s BG 1.

7.86 This is because the tax avoidance inquiry includes determining whether the arrangement has a "tax avoidance" purpose or effect. That is determined by asking under the Parliamentary contemplation test whether the arrangement, viewed in a commercially and economically realistic way, uses or circumvents the specific provision in a manner that is consistent with Parliament's purpose.

7.87 And, as discussed in Part 5:

- s BG 1 is concerned with the purpose or effect of the arrangement actually entered into;
- s BG 1 is not concerned with the purpose or effect of counterfactuals; and
- the Court of Appeal in *Alesco* confirmed that the application of s BG 1 does not require a comparative or counterfactual analysis to establish tax avoidance.[214]

7.88 While an economic substance approach is permitted under s BG 1, it is incorrect to contend an arrangement has a tax avoidance purpose or effect by:

- comparing the arrangement entered into with a hypothetical alternative arrangement such as an alternative arrangement that:
  - is economically equivalent to the arrangement entered into; or
  - could have possibly been entered into; and
- contending that the differences between the arrangement entered into and the hypothetical alternative arrangement establish that the arrangement entered into:
  - has a purpose or effect of tax avoidance; or
  - does not have such a purpose or effect.

7.89 The requirement under the Parliamentary contemplation test to view an arrangement in a commercially and economically realistic way does not require identifying a hypothetical alternative arrangement (sometimes referred to as a "counterfactual"). Such an approach would involve consideration of counterfactuals rather than the required analysis of the arrangement actually entered into.

7.90 Despite this, the economic substance approach may, however, at times involve drawing a conclusion that an arrangement (or a transaction in it) is in economic substance different to its legal form. For example, in *Westpac* the High Court considered the arrangements were, in economic substance, loans.[215]

7.91 As stated, viewing an arrangement in a commercially and economically realistic way does not require a comparative analysis with a hypothetical alternative arrangement. However, that does not prevent considering whether the commercial or private purposes of the arrangement as put forward by a taxpayer explains the arrangement's structure or the way it has been carried out.

7.92 For example, in *Frucor* the Court of Appeal held that the taxpayer's evidence as to the arrangement's commercial purposes did not explain why the arrangement used a convertible note structure involving a branch of an offshore bank.

[214] At [35]-[41].

[215] At [330]. See also *Frucor* (CA) at [85] where the Court considered the purpose of the arrangement was to "dress up a subscription for equity as an interest only loan". In *Frucor* (SC), the majority of the Supreme Court upheld the Court of Appeal's view of the facts and decision on the tax avoidance issue.

The asserted commercial purposes could have been readily achieved by borrowing the same amount from a bank in New Zealand at the same interest rate. The taxpayer's evidence did not explain why the arrangement used the convertible note structure if it was not for the purpose of obtaining an impermissible tax advantage.[216]

Part | Wāhanga 8 Applying s BG 1

Introduction

8.1 Applying s BG 1 includes answering the "ultimate question". That is, whether the arrangement, viewed in a commercially and economically realistic way, makes use of the specific provision in a manner consistent with Parliament's purpose for it.[217] As mentioned at [2.16], in a taxing statute that includes a general anti-avoidance provision such as s BG 1, Parliament's overall purpose is best served by interpreting specific provisions and s BG 1 as working in tandem with neither overriding. Each provides a context that determines the meaning and scope of the other.

8.2 Section BG 1 applies where an arrangement's sole purpose or effect is tax avoidance. Where an arrangement has two or more purposes or effects and one purpose or effect is tax avoidance, applying s BG 1 requires determining whether the tax avoidance purpose or effect is merely incidental to another purpose or effect. This is because s BG 1 is designed to avoid the fiscal effect of tax avoidance arrangements having a more than merely incidental purpose or effect of tax avoidance.[218] Many of the same factors considered under the Parliamentary contemplation test are relevant to the merely incidental test.[219] The Supreme Court has stated that it will be rare for a tax avoidance purpose or effect to be merely incidental to another purpose or effect.[220]

8.3 Building on the explanations and analysis set out in earlier Parts of this statement, in this Part the Commissioner sets out a general approach to applying s BG 1. At the end of this Part there is a flow chart that summarises the approach taken in this statement to whether s BG 1 applies to an arrangement.

8.4 Whether s BG 1 applies to an arrangement turns on the specific facts of the arrangement actually entered into. As the application of s BG 1 is an intensely fact-based inquiry it is not possible to approach the application of s BG 1 in an inflexible or overly prescriptive way.

A reasonable inference or conclusion is required

8.5 Applying s BG 1 requires drawing an inference or reaching a conclusion on the "ultimate question" to determine whether the arrangement has a tax avoidance purpose or effect, and, if required, whether the tax avoidance is merely incidental.

8.6 The Supreme Court in *Glenharrow* said the application to an arrangement of a general anti-avoidance provision such as s 76 of the GST Act is to be objectively assessed and "the assessment will principally be a matter of inference from the arrangement and its effect".[221]

8.7 *Ben Nevis* (SC), *Penny* (SC) and *Frucor* (SC) demonstrate that the answer to applying s BG 1 involves drawing a conclusion from:

- the established facts;
- the arrangement's effects; and
- Parliament's purposes for the specific provision and s BG 1.

8.8 The inference or conclusion must be reasonable. That is, the inference must be one that is:

- open on the evidence and on the facts established from the evidence;[222]
- logical and convincing;
- not mere speculation; and

[216] At [81].

[217] *Ben Nevis* (SC) at [109].

[218] *Ben Nevis* (SC) at [106].

[219] *Russell* (CA) at [42].

[220] *Ben Nevis* (SC) at [114].

[221] At [40].

[222] In complex commercial transactions an opinion from a suitably qualified and independent expert may assist in ascertaining if a fact in an arrangement is of consequence to whether the arrangement has a tax avoidance purpose or effect.

- not an intuitive subjective impression (that is, a subjective view that an arrangement has a tax avoidance purpose or effect that is not derived from an objective analysis of the specific facts of the arrangement, its effects, and Parliament's purpose for the specific provision).

Considering whether there is a tax avoidance purpose or effect

8.9 The Commissioner's approach to applying s BG 1 to an arrangement involves undertaking several steps as described next.

The Commissioner's approach to applying s BG 1

Understand the legal form of the arrangement

8.10 Understand the legal form of the arrangement by identifying and understanding:

- All of the steps and transactions that make up the arrangement (see Part 4 as to what is an "arrangement").
- The commercial or private purposes of the arrangement.
- The arrangement's tax effects and how they have been achieved by the arrangement based on the legal rights and obligations created (see Part 3). This requires identifying and understanding:
  - the specific provisions that apply to the arrangement, and why they apply; and
  - any relevant provisions that do not apply and why they do not apply (see discussion of circumvention from [2.27]).

Ascertain Parliament's purpose

8.11 Identify and understand Parliament's purpose for the specific provisions that are used or circumvented by the arrangement from their text, the statutory context (including the statutory scheme relevant to the provision), case law and any relevant extrinsic material.

8.12 See Part 3 for the general interpretative approach to ascertaining Parliament's purpose for specific provisions, and also Part 6 (from [6.26]) for particular aspects of the inquiry into Parliament's purposes that are useful to consider in the context of the Parliamentary contemplation test.

8.13 Having identified Parliament's purpose for the specific provisions, as mentioned at [6.43], it may be helpful to then identify any facts, features or attributes that Parliament would contemplate being present (or absent) when permissible tax advantages arise under the specific provisions.

Understand the commercial and economic reality of the arrangement as a whole

8.14 Understand the commercial and economic reality of the arrangement as a whole. Factors (as detailed in Part 7) that may be helpful to consider in this context 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.

Consider whether the arrangement makes use of, or circumvents, the specific provisions in a manner consistent with Parliament's purpose

8.15 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 Parliament's purpose for s BG 1 explained in Part 2, 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.

8.16 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, as stated at [7.9], 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.

8.17 Artificiality, contrivance or pretence must be considered in the context of the arrangement as a whole. In Part 7, artificiality is 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.

8.18 The preceding analysis may show the arrangement's apparent commercial or private purposes as previously analysed may not be consistent with its commercial or economic reality. Part 7 refers to this matter variously in terms of different factors showing 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.

8.19 Understanding the commercial and economic reality of the arrangement as a whole may indicate the arrangement uses or circumvents a specific provision in a manner that is not consistent with Parliament's purpose. This is because such understanding may raise doubts as to whether Parliament would have contemplated permissible tax advantages arising under the specific provision in those circumstances.

8.20 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.

8.21 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, as mentioned at [6.30], 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, as mentioned from [8.5] above.

8.22 Also, some types of arrangements do not lend themselves as readily as others to the use of the facts, features or attributes technique, particularly where it is more difficult to isolate specific provisions being used or circumvented. For example, the Supreme Court in *Penny* considered that s BG 1 could apply due to the setting of artificially low salaries, even though there was "no failure to comply with any express requirement of the Act in the setting of salaries, since there is none".[223]

Decide if there is a tax avoidance purpose or effect

8.23 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?

8.24 As mentioned from [8.5], the answer must be a reasonable inference that is open on the evidence, able to be drawn from the facts and is logical and convincing. It cannot be the result of mere speculation or subjective intuitive impression.

Other matters relevant to this approach

8.25 As illustrated in the order of analysis set out above, the Commissioner considers that it is sensible to identify Parliament's purpose for the specific provisions before viewing the arrangement in a commercially and economically realistic way. This order of analysis is suggested because understanding Parliament's purpose for the specific provisions used or circumvented guides and informs the tax avoidance inquiry by:

- guiding the analysis of whether the arrangement, when viewed as a whole and in a commercially and economically realistic way, makes use of or circumvents the relevant provisions in a manner consistent with Parliament's purpose; and
- providing guidance on the aspects of the arrangement that may need to be focused on when viewing the arrangement in a commercially and economically realistic way.

8.26 When the arrangement is viewed as a whole in a commercially and economically realistic way, further relevant provisions may be identified (particularly those that have been circumvented) or raise further questions as to Parliament's purposes for the provisions already identified. This will then require circling back to consider Parliament's purposes for those provisions.

8.27 Parliament's purpose for any specific provision under the Parliamentary contemplation test may be the same as the purpose identified under the initial inquiry. That is, the inquiry into whether the application or non-application of the specific provision is within its ordinary meaning and intended scope.

8.28 Frequently, Parliament's purpose will already have been comprehensively considered under the initial inquiry. Therefore, for practical purposes when applying the Parliamentary contemplation test, identifying Parliament's purpose for the specific provision may not need to be repeated as a separate exercise, if this has been fully analysed already.

8.29 However, under the tax avoidance inquiry the whole of the arrangement is considered, and some particular aspects of Parliament's purpose may need to be considered in that light, as explained in Part 6. Therefore, where a comprehensive inquiry into Parliament's purpose for the specific provision has not occurred under the initial inquiry, Parliament's purpose must be considered as part of the Parliamentary contemplation test.

Considering whether the tax avoidance purpose or effect is merely incidental

8.30 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.

[223] At [33].

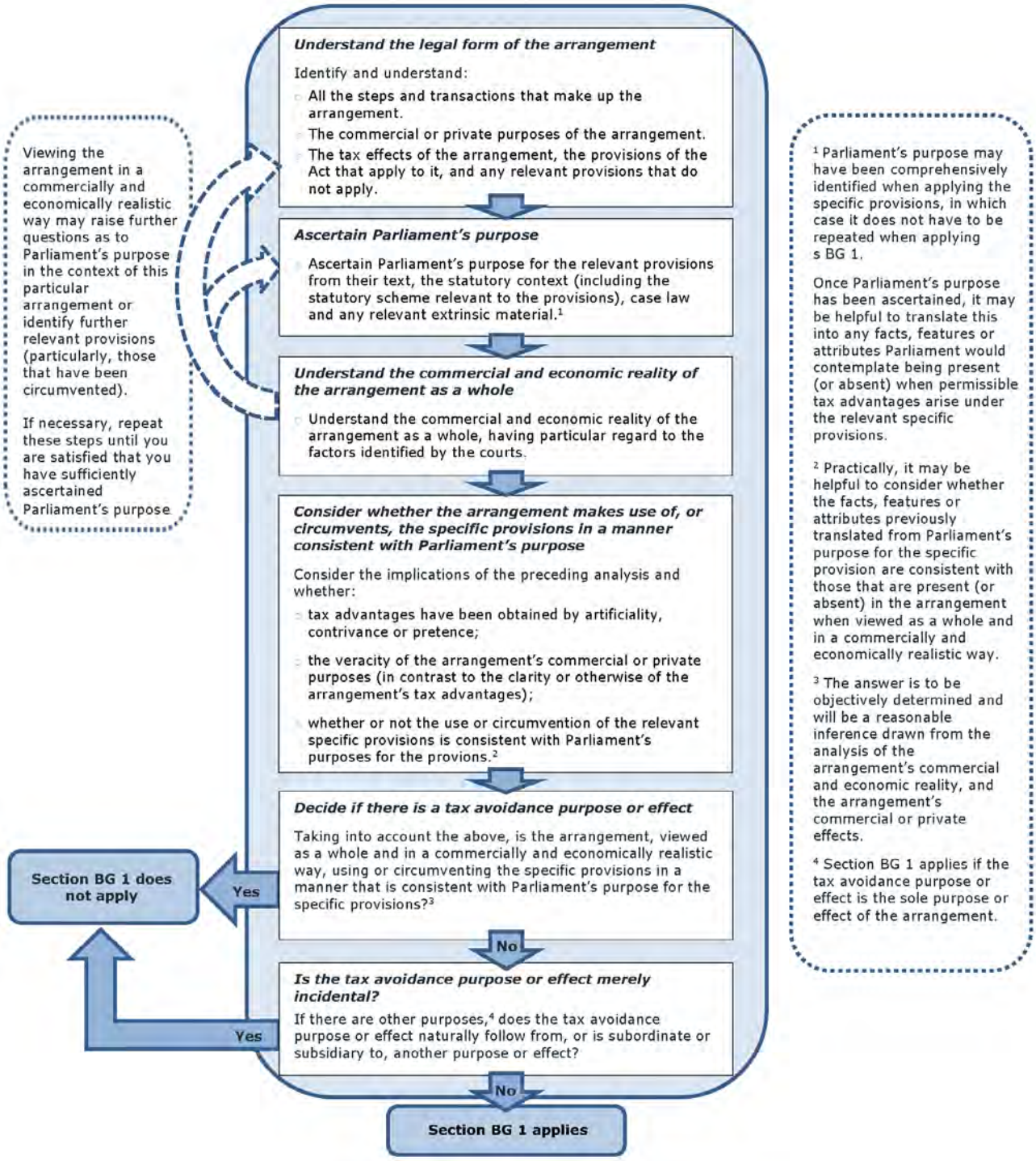
8.31 Therefore, the non-tax avoidance purposes of the arrangement identified when considering the arrangement under the Parliamentary contemplation test, are also relevant to the merely incidental test. Non-tax avoidance purposes include:

- 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).[224]

8.32 Part 5 discusses the merely incidental test in more detail. In Part 5 it was noted that the merely incidental test involves the consideration of many of the same matters that are considered under the Parliamentary contemplation test. A conclusion under the Parliamentary contemplation test that an arrangement has a tax avoidance purpose or effect means it is unlikely that the arrangement's tax avoidance purpose will be merely incidental.

[224] See *Ben Nevis* (SC) at [106].

Flow chart 1: An approach to the tax avoidance inquiry



Part | Wāhanga 9 Counteracting the tax advantage

Introduction

9.1 Section BG 1 states that:

- a tax avoidance arrangement is void as against the Commissioner for income tax purposes; and
- the Commissioner may, under Part G, counteract a tax advantage that a person has obtained from or under a tax avoidance arrangement.

9.2 Section BG 1 is an annihilating provision. It does not of itself create a tax liability.[225] It voids the whole arrangement for tax purposes from the beginning of the arrangement. There are no words of apportionment in s BG 1. This means there is no scope to leave in place part of a tax avoidance arrangement.

9.3 Therefore, all tax outcomes of the arrangement, including permissible tax outcomes, are void. After an arrangement is voided under s BG 1, the Commissioner applies s 113 of the Tax Administration Act 1994 to amend the assessment.

9.4 Section GA 1 applies if an arrangement is void under s BG 1.[226] The Commissioner is not required to apply s GA 1 if the voiding of an arrangement under s BG 1 appropriately counteracts a tax advantage obtained by a person from or under the arrangement and no more.

9.5 Under s GA 1(2), the Commissioner "may" adjust a person's taxable income to counteract a tax advantage obtained from or under a tax avoidance arrangement:

> *Commissioner's general power*
>
> (2) The Commissioner may adjust the taxable income of a person affected by the arrangement in a way the Commissioner thinks appropriate, in order to counteract a tax advantage obtained by the person from or under the arrangement.

9.6 The word "may" in s GA 1(2) does not mean that the Commissioner has complete choice whether to apply s GA 1. The word "may" recognises that there are circumstances where it is not necessary to exercise the power in s GA 1.[227] In other circumstances, the Commissioner is under a duty to apply s GA 1. When the voiding appropriately counteracts the tax advantage and does no more than that, then the Commissioner will not be required to apply s GA 1. The Privy Council in *Miller* stated:

> [23] … It is relevant to observe that the question of whether an arrangement is void against the Commissioner under s 99(2) is not a matter for his discretion or policy. The Act says that an arrangement falling within the terms of the section "shall be absolutely void". **Likewise, the Commissioner is under a statutory duty to reassess the taxpayer's assessable income to counteract any tax advantage.** Discretion enters into the matter only as to the method of calculation by which the Commissioner discharges that duty. [Emphasis added]

9.7 At the end of this Part there is a flow chart of the steps to applying s GA 1.

Nature of the adjustment power in s GA 1

The Commissioner has broad discretion about the types of adjustments to make

9.8 Section GA 1(2) empowers the Commissioner to adjust the "taxable income of a person affected by the arrangement in a way the Commissioner thinks appropriate". Section GA 1(2) provides that the Commissioner exercises this power "to counteract a tax advantage obtained … from or under the arrangement".

9.9 The term "tax advantage" is not defined in the Act for the purposes of s GA 1. However, it includes the tax outcomes achieved under a tax avoidance arrangement that are outside the contemplation of Parliament. The Supreme Court in *Ben Nevis* describes these types of tax outcomes as "impermissible" tax advantages.[228]

[225] *Challenge* (CA) at 548; *Wisheart, Macnab and Kidd v CIR* [1972] NZLR 319 (CA) at 337.

[226] Section GA 1(1).

[227] This also applies to the use of "may" in s BG 1(2) which also refers to the Commissioner adjusting the taxable income of a person affected by a tax avoidance arrangement.

[228] At [106].

9.10 Section GA 1(2) gives the Commissioner a broad and flexible discretion about how to make adjustments to counteract a tax advantage. Blanchard J in *Miller* (CA) referred to s 99(3) of the Income Tax Act 1976, a predecessor of s GA 1, as providing a wide power which does not inhibit the Commissioner from looking at the matter broadly.[229] However, the Commissioner must exercise s GA 1(2) with the object in mind of counteracting the tax advantage.

9.11 This requirement follows from the purpose of ss BG 1 and GA 1 of counteracting tax avoidance. It would be outside this purpose for the Commissioner to apply ss BG 1 or GA 1 in a way that did more than counteract the tax advantage.

9.12 The Commissioner considers that the broad nature of the power under s GA 1(2) empowers the Commissioner to make adjustments to:

- negate any tax advantage arising from a tax avoidance purpose that has not been counteracted by voiding the arrangement, including making appropriate consequential adjustments; and
- reinstate permissible tax outcomes voided by s BG 1.

9.13 The courts have not expressly considered the scope of the types of adjustments that the Commissioner may make. However, as discussed next, there is some judicial authority supporting the above adjustments.

Negate any tax advantage arising from a tax avoidance purpose not counteracted by voiding the arrangement

9.14 The adjustments made in *Miller* (PC) and *Miller* (CA) are examples of where voiding the arrangement did not sufficiently negate the tax advantages. That litigation involved an arrangement that produced tax advantages for different people at different points.

9.15 The tax advantages under the arrangement may not have been counteracted by simply voiding the arrangement. Lord Hoffmann in *Miller* (PC) explained:

> [11] The complication of the scheme affected the forms of reconstruction available to the Commissioner under s 99(3) [of the Income Tax Act 1976 – a predecessor of s GA 1]. It produced tax advantages for different people at a number of different points. The artificial grouping of the trading company with Mr Russell's tax loss companies made the scheme viable because it enabled his companies to receive the profits without themselves becoming liable to tax. The artificial arrangements for payment by the trading company of administration and consultancy fees enabled the trading companies to eliminate their own liability to tax by claiming deductions under s 104 of the [Income Tax Act 1976]. And of course the primary objective of the scheme was to give the appellants the tax advantage of receiving part of the company's profits without paying income tax.

9.16 Other taxpayers' taxable income may be affected as a consequence of the voiding of an arrangement or by the adjustments to negate the tax advantages made to the taxable income of persons directly affected. In these cases, consequential adjustments may be necessary. Consequential adjustments may be needed to ensure that the overall tax advantages are correctly negated.

9.17 For example, the Court of Appeal in *Miller* accepted that the Commissioner had the power to make necessary consequential adjustments as a consequence of other adjustments made to counteract a tax advantage.[230] In *Miller* (CA), the Commissioner had adjusted the taxable income of a company but later assessed the company's former shareholders without withdrawing the company assessment. The Court recognised the need for a consequential adjustment to ensure income reconstructed to the former shareholders was not also included in the company's assessment. The Court did not overtly link this power to the specific section that prevents double counting.[231] However, the Court's earlier discussion of concurrent assessments and consequential adjustments suggests this link.[232]

9.18 It has long been the Commissioner's practice to make consequential adjustments. The courts have not adversely commented on this approach.

Reinstate permissible tax outcomes voided by the arrangement

9.19 The courts in some cases have appeared to accept the Commissioner's approach of reinstating some tax outcomes from the arrangement.[233]

9.20 The Commissioner's adjustments in *Ben Nevis* (SC) reinstated some of the deductions claimed by the taxpayers. These deductions were for the planting and tending costs related to the trees. The Supreme Court stated:

[229] *Miller v CIR* [1999] 1 NZLR 275 (CA) at 302.

[230] At 304.

[231] The section that prevents double counting is now s GA 1(6).

[232] At 292.

[233] For example, *Ben Nevis* (SC) at [31]; *Glenharrow* (SC) at [55]; *Peterson v CIR* (No 2) (2002) 20 NZTC 17,761 (HC) at [70].

> [31] None of the expenses claimed related to the costs to the syndicate of planting and tending trees. No issue has arisen concerning the tax treatment of those costs.

9.21 The arrangement in *Glenharrow* (SC) involved the application of s 76 of the GST Act which contains a similar adjustment power as s GA 1. The Commissioner's adjustments focused only on the part of the consideration where no actual payments had been made. The Supreme Court stated:

> [55] Since, as we have concluded, the Commissioner could properly be satisfied that the arrangement was entered into between the parties to defeat the intent and application of the Act, s 76 [of the GST Act] requires him to treat it as void for the purposes of the Act. The Commissioner must then adjust the amount of the tax which is refundable "in such a manner as the Commissioner considers appropriate so as to counteract any tax advantage obtained ... from or under that arrangement". **The Commissioner has a discretion in this respect. He chose to exercise it by treating the deposit as the only payment made by Glenharrow in the taxable period in respect of which the refund was claimed and allowed a refund of the tax fraction of that payment. That, it seems to us, was an entirely proper exercise of the discretion.** It was in accordance with the reality of what had occurred during that period. The Court of Appeal decided that the Commissioner should also treat the instalments made during later periods as payments and should allow further refunds. That too reflects the reality of what occurred in the periods in question. The Commissioner has not challenged the Court of Appeal's decision. We can see no basis upon which either the Commissioner's original decision or the adjustment ordered by the Court of Appeal can be impugned by the taxpayer. [Emphasis added]

9.22 The arrangement in *Peterson* (HC) involved what the High Court described as "an inflated deduction".[234] The Commissioner's assessment adjusted only for the inflated amounts. The Court endorsed this approach:

> [70] The remaining issue then is whether the Commissioner's reconstruction or adjustment pursuant to s 99(3) [of the Income Tax Act 1976 – a predecessor of s GA 1] was permissible. **The technique utilised by the Commissioner of disallowing Mr Peterson's share of the partnerships loss which is attributable to the inflated cost was the very kind of adjustment approved by the Privy Council in *Miller v C*** of IR [2001] 3 NZLR 316 (PC) [also reported as *O'Neil v CIR* (2001) 20 NZTC 17,051]. And it must be particularly difficult to interfere with the Commissioner's exercise of his discretion under s 99(3), for what is involved is the exercise of a discretion. In my view the Commissioner was entitled to impugn this transaction under the statutory provision he relied upon, and in the manner he in fact did.
> [Emphasis added]

9.23 The Commissioner's power under s GA 1 does not extend beyond making adjustments to counteract impermissible tax advantages arising from or under a tax avoidance arrangement. The Commissioner considers that Parliament would not have intended that permissible tax outcomes would be nullified.

9.24 The High Court in *BNZ Investments No 1* considered only a tax advantage obtained out of tax avoidance may be counteracted:

> [200] While the law does not allow a taxpayer to contend that if there had been no such tax advantage he would never have entered the transaction, and accordingly there can be nothing to reconstruct, I have no doubt s 99(3) [of the Income Tax Act 1976 – a predecessor of s GA 1] is intended to counteract tax advantages obtained out of avoidance, but not otherwise. **Where tax advantages are increased through avoidance over a base level which would have existed in any event, it is that increment above base level which is to be counteracted, not the legitimate base level itself.** That is all preservation of the tax base – the purpose of the section – requires. [Emphasis added]

9.25 However, adjustments to reinstate permissible tax outcomes are ones the Commissioner thinks are appropriate. Permissible tax outcomes do not include the tax outcome from parts of an arrangement so interdependent and interconnected with the tax avoidance parts as to be integral to them. This will be so even if the parts of the arrangement could be argued to be permissible when:

- viewed in isolation; or
- in a different arrangement.

9.26 This point is illustrated in *Westpac* (HC). The High Court found that the funding costs for the arrangement could not be distinguished from the guarantee procurement fee (GPF). The Court said:

> [641] Third, the Commissioner is not bound to isolate out and counteract only particular elements giving rise to a tax advantage. Westpac's tax advantage combined two principal elements of deductibility falling within the composite label of the cost of funds — funding costs and the GPF. There was no hierarchy or ranking between them. **While only the GPF was unlawfully deducted and the separate source of a finding of avoidance, none of the deductions would have been generated without completion of the transaction as a whole. All its elements were integral.** The bank was able to set off or deduct all expenses against its other New Zealand income as a result. [Emphasis added]

[234] At [64].

The Commissioner may choose from different options to counteract a tax advantage

9.27 The Commissioner has a broad discretion as to how to make adjustments to counteract a tax advantage. An issue that arises in this context is the degree of specificity the Commissioner must reach in applying s GA 1. The Commissioner is not under a duty to precisely describe the basis for an adjustment. The taxpayer in *Westpac* (HC) submitted that the Commissioner must determine precisely what constitutes tax avoidance. The High Court disagreed and said:

> [639] I do not accept [the taxpayer's] submission as a matter of principle for a number of reasons. First, the Commissioner's statutory obligation to reconstruct is simply to counteract a tax advantage obtained from and under a transaction. He is not under any further duty to determine precisely what constitutes the tax avoidance or identify a particular aspect giving rise to a tax advantage.

9.28 *Westpac* (HC) confirms that the Commissioner may have different options available when counteracting a tax advantage. The High Court upheld the Commissioner's adjustment and went on to confirm that an alternative adjustment may also have been appropriate.[235]

9.29 Similarly, the High Court in *Miller* said:[236]

> Where the legal construct of a company is used there is likely to be more than one way of defining and counteracting the tax advantage. … In this sphere there is not inexorably any single right answer …

9.30 The Court of Appeal in *Dandelion* confirmed the breadth of the discretion. McGrath J made the following observations about the adjustment the Commissioner made:

> [86] But in any event the Commissioner was entitled in the exercise of the discretion under s 99(3) [of the Income Tax Act 1976 – a predecessor of s GA 1] to disallow the appellant's claim for deduction and as long as the Commissioner was of the opinion it was a proper adjustment to make under s 99(3) it cannot be attacked on the basis that the Commissioner has not simultaneously amended an inconsistent assessment of another taxpayer: *Miller v Commissioner of Inland Revenue* [1999] 1 NZLR 275, 289, 292 (CA).

9.31 The High Court in *Westpac* also observed that the "traditional principles of judicial restraint" apply to the Commissioner's discretion:

> [622] … First, once the Commissioner avoids an arrangement he "may" adjust the amounts of gross income, allowable deductions and available net losses including calculating taxable income "in the manner [he] thinks appropriate". **The traditional principles of judicial restraint in determining a challenge to a discretionary power apply; the question is whether the Commissioner "adopted a reconstruction which was outside the scope of his powers":** *Ben Nevis* at [170]. [Emphasis added]

9.32 While the Commissioner's discretion is broad, the adjustment must be part of counteracting an impermissible tax advantage. The references in various cases to the Commissioner's discretion are to be read subject to that requirement.

The Commissioner may consider hypothetical situations

9.33 Section GA 1(4) and (5) supplements the Commissioner's general power in s GA 1(2). These subsections expressly allow the Commissioner to consider hypothetical alternative situations (that is, counterfactuals) in deciding on an adjustment:

> *Commissioner's identification of hypothetical situation*
>
> (4) When applying subsections (2) and (3), the Commissioner may have regard to 1 or more of the amounts listed in subsection (5) which, in the Commissioner's opinion, had the arrangement not occurred, the person —
>
> (a) would have had; or
>
> (b) would in all likelihood have had; or
>
> (c) might be expected to have had.
>
> *Reconstructed amounts*
>
> (5) The amounts referred to in subsection (4) are—
>
> (a) an amount of income of the person:
>
> (b) an amount of deduction of the person:
>
> (c) an amount of tax loss of the person:
>
> (d) an amount of tax credit of the person.

[235] At [624] and [668].

[236] At 13,036.

9.34 Section GA 1(4) provides that the Commissioner may have regard to various amounts in determining the most appropriate adjustment. These are amounts of income, deduction, tax loss, or tax credit that, had the arrangement not occurred, a person:

- would have had; or
- would in all likelihood have had; or
- might be expected to have had.

9.35 However, the Commissioner does not have to base the adjustment on an analysis of these amounts. The Supreme Court in *Ben Nevis* said that the "general power" of adjustment is supplemented by the "specific powers" under which the Commissioner "could have regard to" the amounts listed.[237]

9.36 The Court of Appeal in *Alesco* rejected an argument that the Commissioner is required to identify a hypothetical alternative arrangement:

> [123] [The taxpayer's] argument fails for two reasons which we can articulate briefly. First, his submission is wrong in law. The terms of s GB 1 are plain. **In exercising her discretion the Commissioner "may have regard to" an alternative funding arrangement. But she is not bound to take that step, and nor should she be where the tax advantage can be counteracted simply by disallowing the impermissible deductions.** It is immaterial that Alesco NZ required the funding for a new acquisition. That is because the appropriate comparison was available within the available taxation treatments of the [optional convertible notes]: that was precisely how she adjusted Alesco NZ's liability. [Emphasis added]

9.37 Similarly, the High Court in *Westpac* stated that the Commissioner "is entitled" to have regard to such amounts[238].

9.38 Blanchard J also noted in *Miller* (CA) that the Commissioner:[239]

> ... **"may"** have regard to the income which the person he is assessing would have or might be expected to have or would in all likelihood have received but for the scheme, **but the Commissioner is not inhibited from looking at the matter broadly and making an assessment on the basis of the benefit directly or indirectly received by the taxpayer in question.** [Emphasis added]

9.39 On appeal, the Privy Council in *Miller* appears to suggest that when reconstructing the Commissioner is required to have regard to what is likely to have happened if there was no arrangement:

> [22] Their Lordships consider that this argument is based upon a misapprehension about the effect of a reconstruction. **The Commissioner's duty is to make an assessment with regard to what in his opinion was likely to have happened if there had been no scheme. But that does not mean that he is actually rewriting history. The reconstruction is purely hypothetical and provides a yardstick for the assessment.** Although the income is deemed to have been derived by the person assessed (see s 99(4)) [of the Income Tax Act 1976], **the nature and source of the income remains what it was,** namely the company's net profits routed to the shareholders through Mr Russell's company. None of this was disclosed. [Emphasis added]

9.40 However, the Privy Council's comment was made in a situation where the Commissioner had put forward an alternative arrangement. Also, the comment was part of a discussion on the application of the time bar provisions rather than the general anti-avoidance provision.

9.41 The Commissioner's view is that the Privy Council was not considering whether the Commissioner is required to have regard to a likely alternative. Rather, the Privy Council was setting out the effect of an adjustment. An adjustment is:

- purely hypothetical;
- intended to provide a yardstick for assessment; and
- does not change the actual nature or source of the amounts adjusted.

9.42 The Commissioner's view is consistent with the decision in *Alesco* (CA). The Court of Appeal considered that the Privy Council in *Miller* was not saying the Commissioner is under an affirmative duty to adjust by having regard to what is said to be the most likely counterfactual transaction. The Court said:

> [126] In *Miller* Lord Hoffmann did no more than affirm the Commissioner's statutory power to have regard to an alternative or counterfactual in circumstances where the taxpayer challenged it on appeal. **But he certainly did not say, as [the taxpayer] suggests, that the Commissioner is under an affirmative duty to adjust by having regard to the tax effect of what is said to be the most likely counterfactual transaction.** [Emphasis added]

9.43 The Commissioner can choose to have regard to one or more amounts of income, deduction, tax loss or tax credit when applying s GA 1(4) and (5). The Commissioner does not have to compare the arrangement entered into with

[237] At [169].

[238] At 623.

[239] At 302.

a hypothetical alternative arrangement. As stated by the Privy Council in *Miller* cited above, the reconstruction is hypothetical and does not constitute rewriting history. This means that not all the parties to an arrangement necessarily have to be treated as if the hypothetical reconstruction had, in reality, occurred.

9.44 Further, where the Commissioner applies s GA 1(4) and (5), the Commissioner:

- must counteract any tax advantage obtained;[240] and
- does not need to determine an alternative beneficial transaction that the taxpayer might have entered into but did not.[241]

9.45 The Commissioner can consider what was done in determining what is likely to have happened if there had been no arrangement. The taxpayers in *Miller* (CA) argued that they would likely have retained the profit within the company rather than the profits being distributed to the shareholders. Blanchard J disagreed:[242]

> **We consider that the likelihood of receipt of moneys by the former shareholders must be judged by what they have actually done. They caused all the profits to be removed from the company.** It must therefore be taken that these sums would have been distributed in the form of additional salaries, management bonuses, dividends or in some other manner in the years in which they were earned by Fiorucci and would not have been left in the company. **The desire of the shareholders to extract them is demonstrated by what they actually did.** They were unlikely to have waited 10 years to get their hands on each instalment of earnings. [Emphasis added]

Onus is on taxpayer to show adjustment is wrong and by how much

9.46 The Supreme Court in *Ben Nevis* said that the onus is on a taxpayer to show that the Commissioner's adjustment is wrong and by how much it is wrong. The Court stated:

> [171] **Furthermore, when taxpayers challenge an assessment based on a reconstruction adopted by the Commissioner, the onus is on them to demonstrate, not only that the reconstruction was wrong, but also by how much it was wrong.** Unless the taxpayer can demonstrate with reasonable clarity what the correct reconstruction ought to be, the Commissioner's assessment based on his reconstruction must stand. This is settled law. In this case we are of the view that the appellants have not shown that the Commissioner's assessment based on his reconstruction was wrong. Even if they had shown that to be so, they have not shown on any reasonably clear basis to what extent it should be varied. **The appellants did not submit any specific proposed reconstruction of their own, the validity of which the Court could then have evaluated. The Commissioner's assessment must therefore stand.** [Emphasis added]

9.47 This is a long-established proposition and similar comments were made in *Westpac* (HC).[243]

Scope of the adjustment power in s GA 1

Taxable income of a "person affected" by the arrangement may be adjusted

9.48 The Commissioner may adjust the taxable income of a person affected by a tax avoidance arrangement to counteract a tax advantage obtained by that person from or under the arrangement (s GA 1(2)). The person need not be a party to the arrangement but must be affected by the arrangement in the sense of receiving a tax advantage from or under the arrangement.

9.49 Lord Millett in *Peterson* (PC) considered a person could be affected by an arrangement whether or not they were a party to it, privy to its details or both:

> [34] Their Lordships are satisfied that the "arrangement" which the [C]ommissioner has identified had the purpose or effect of reducing the investors' liability to tax and that, **whether or not they were parties to the arrangement or the relevant part or parts of it, they were affected by it.** Their Lordships do not consider that the "arrangement" requires a consensus or meeting of minds; **the taxpayer need not be a party to "the arrangement" and in their view he need not be privy to its details either.** [Emphasis added]

9.50 Further, the Supreme Court in *Ben Nevis* stated:

> [164] On the ordinary meaning of the emphasised language in s GB 1 [a predecessor to s GA 1], once the existence of a tax avoidance arrangement has been established, all those taxpayers who have benefited from it may be subject to corrective adjustments by the Commissioner in the exercise of the reconstruction power. **No question of mutuality or even awareness by a benefiting taxpayer is a necessary element.** [Emphasis added]

[240] *Westpac* (HC) at [623]; *Ben Nevis* (SC) at [169].

[241] *Westpac* (HC) at [623]; *Accent* (CA) at [155].

[242] At 301.

[243] At 631.

9.51 Therefore, "a person affected" by a tax avoidance arrangement may include a person:

- whether or not they were a party to the arrangement;[244] or
- unaware they have benefited from the arrangement.[245]

9.52 For example, the beneficiaries of a trust could be persons affected by a tax avoidance arrangement. They may not be parties to the arrangement or even be aware of the arrangement. However, their income may be adjusted under s GA 1 if that is required to counteract tax advantages they have received as beneficiaries.

9.53 Also, more than one person may be affected by an arrangement. Therefore, the Commissioner may need to adjust the taxable income of multiple persons affected to counteract the tax advantages.

Timing of when taxable income may be adjusted

9.54 As discussed in Part 5, an arrangement may be a tax avoidance arrangement where the tax advantage is a prospective or potential future liability to income tax. This follows from the definition of "tax avoidance" including future tax liabilities. For example, a tax avoidance arrangement that involves accumulating tax losses may mean the tax advantage from or under the arrangement relates to future tax liabilities.

9.55 It follows that a tax advantage may eventuate after the arrangement is put in place. If so, the s GA 1(2) adjustment will relate to an arrangement put in place in a previous year.

Tax credits may be adjusted

9.56 Section GA 1(3) confirms that the Commissioner can adjust tax credits when using s GA 1 to counteract a tax advantage:

> *Commissioner's specific power over tax credits*
>
> (3) The Commissioner may—
>
> (a) disallow some or all of a tax credit of a person affected by the arrangement; or
>
> (b) allow another person to benefit from some or all of the tax credit.

No double counting of income or deduction

9.57 A further limit on the Commissioner's power of adjustment is set out in s GA 1(6):

> *No double counting*
>
> (6) When applying subsection (2), if the Commissioner includes an amount of income or deduction in calculating the taxable income of the person, it must not be included in calculating the taxable income of another person.

9.58 A predecessor to s GA 1(6) was considered in *Miller* (CA) Blanchard J stated:[246]

> It is not necessary on each occasion when the Commissioner makes an assessment of one taxpayer which is inconsistent with his earlier assessment of a different taxpayer that he simultaneously should amend that earlier assessment. **That must ultimately be done or the Commissioner would, in effect, be collecting the same tax twice over, but he is to be allowed some flexibility in the timing of the adjustment to meet administrative demands** and to enable him to await the outcome of objection proceedings in relation to the assessments. [Emphasis added]

9.59 Accordingly, while the Commissioner has some flexibility as to timing, the Commissioner cannot ultimately include an amount of income or deduction in the taxable income of more than one person.

Ancillary taxes may be adjusted

9.60 Section GA 1 is modified by s YA 2(4) when it is applied to an "ancillary tax". The reference in s GA 1(2) to a person's "taxable income" is read as a reference to their "liability to the ancillary tax".

9.61 Also, s GA 1(5) is modified by s YA 2(4) with the addition of para (e). Paragraph (e) refers to "an amount subject to the ancillary tax".

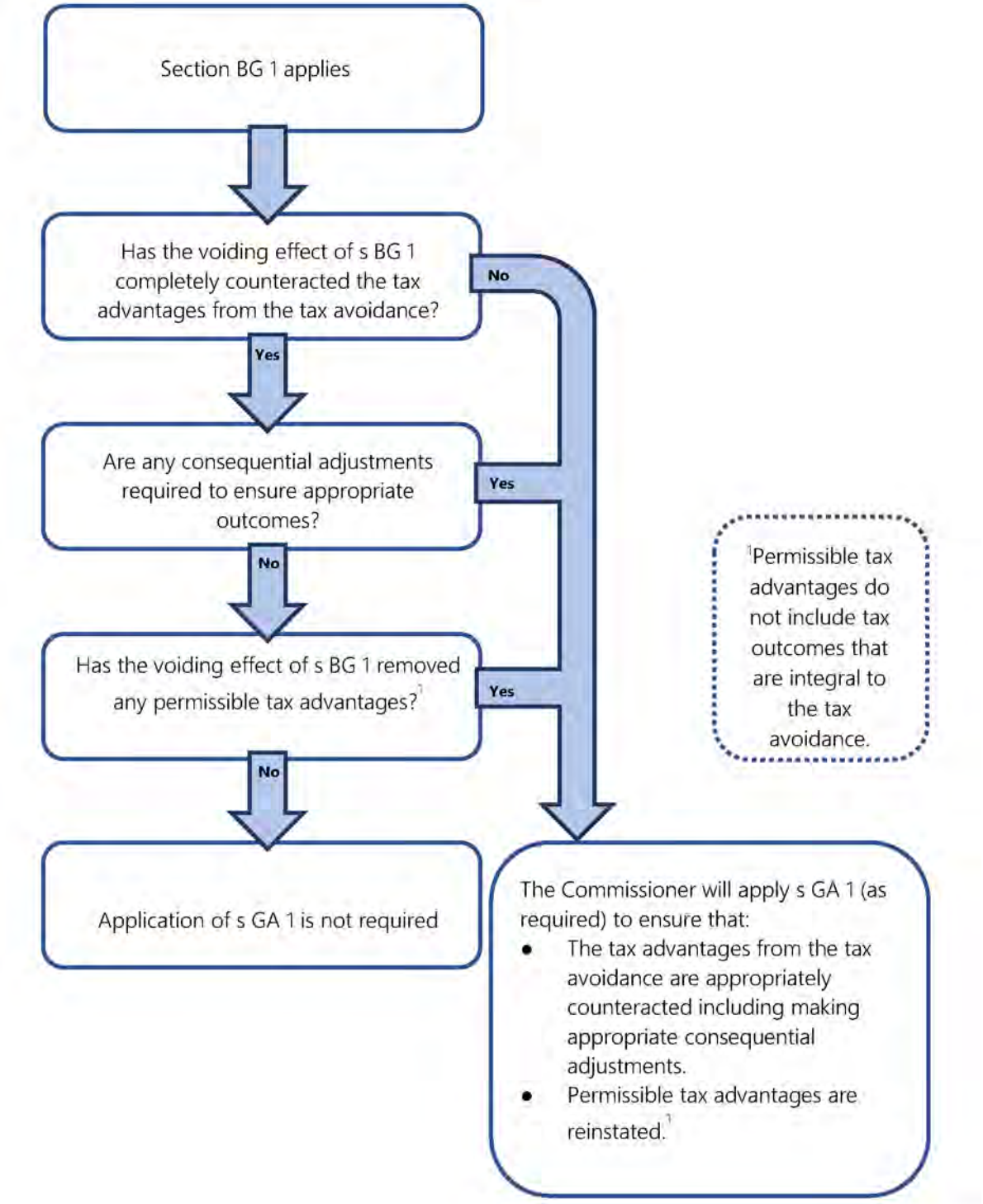
9.62 The term "ancillary tax" is defined in s YA 1. Ancillary taxes include taxes such as non-resident withholding tax, resident withholding tax, fringe benefit tax and PAYE. Accordingly, s GA 1 can apply to these ancillary taxes.

[244] *Peterson* (PC) at [33]–[34]; BNZ Investments No 1 (CA) at [175].

[245] *Ben Nevis* (SC) at [164]–[168].

[246] At 292.

Flow chart 2: An approach to s GA 1



Part | Wāhanga 10 Other issues

Introduction

10.1 This Part of the statement considers issues that have been raised about s BG 1 from time to time. The issues are:

- whether the following judicial approaches from before *Ben Nevis* (SC) remain relevant:
  - the "scheme and purpose" approach;
  - the choice principle;
  - the predication test;
  - the new source doctrine; and
  - the *Duke of Westminster* principle;
- whether the principle that the Commissioner cannot dictate how taxpayers do business prevents s BG 1 from applying;
- whether complex arrangements are necessarily tax avoidance arrangements;
- whether s BG 1 can be applied to fill in a legislative gap;
- whether an arrangement that results in the payment of tax can be a tax avoidance arrangement;
- whether a tax advantage in another country is a tax avoidance purpose or effect;
- whether double tax agreements affect how s BG 1 applies; and
- whether s BG 1 creates an unacceptable level of uncertainty.

Whether judicial approaches before Ben Nevis (SC) remain relevant

10.2 The following discussion must be read bearing in mind that the Supreme Court in *Ben Nevis* considered it desirable for it to settle the overall approach to s BG 1 (an approach confirmed by the Supreme Court in *Penny* and *Frucor*). However, that does not mean cases decided before *Ben Nevis* (SC) are not relevant to the extent that they support a principle or illustrate a point concerning elements of the tax avoidance inquiry.

10.3 Despite this, questions sometimes arise as to whether the following judicial approaches from before *Ben Nevis* have any relevance:

- the "scheme and purpose" approach;
- the choice principle;
- the predication test;
- the new source doctrine; and
- the *Duke of Westminster* principle.

"Scheme and purpose" approach has no relevance

10.4 The "scheme and purpose" approach to applying s BG 1 is commonly used to refer to the approach Richardson J took in *Challenge* (CA) and referred to by him, or other judges, in many subsequent cases.

10.5 Richardson J said that the scheme and relevant objectives of the legislation need to be examined to determine whether there is any room in the statutory scheme for the general anti-avoidance provision to apply to a particular arrangement:[247]

> In the end the legal answer must turn on an overall assessment of the respective roles of the particular provision and s 99 [of the Income Tax Act 1976] under the statute and of the relation between them. That is a matter of statutory construction and the twin pillars on which the approach to statutes mandated by s 5(j) of the Acts Interpretation Act 1924 rests are the scheme of the legislation and the relevant objectives of the legislation. Consideration of the scheme of the legislation requires a careful reading in its historical context of the whole statute, analysing its structure and examining the relationships between the various provisions and recognising any discernible themes and patterns and underlying policy considerations.
>
> ...
>
> For the inquiry is as to whether there is room in the statutory scheme for the application of s 99 in the particular case. If not, that is because the state of affairs achieved in compliance with the particular provision relied on by the taxpayer is not tax avoidance in the statutory sense. Reading s 99 in this way is to give it its true purpose and effect in the statutory scheme and so to allow it to

[247] At 549.

> serve the purposes of the Act itself. It is not the function of s 99 to defeat other provisions of the Act or to achieve a result which is inconsistent with them.

10.6 Over time it has been clear that Richardson J's "scheme and purpose" formulation has been cited as authority for some different views:

- The first view is that compliance with the specific provisions will be sufficient to establish that Parliament's purpose for those provisions is satisfied. This interpretation is referred to as "the threshold argument".
- The second view is that a careful analysis of the Act is required to understand Parliament's purpose for the provision – including consideration of the scheme of the legislation and its objectives – and whether applying s BG 1 would be outside that purpose.

10.7 The Commissioner considers that the second view more accurately reflects Richardson J's view. However, if the first view is the practical effect of Richardson J's approach, then such an approach was rejected by the Supreme Court in *Ben Nevis*.[248]

10.8 Richardson J in *Challenge* (CA) decided that technical (literal) compliance with the specific provision providing for the offsetting of losses within a group of companies by means of a subvention payment was consistent with the specific scheme and purpose of the specific provisions. He considered that to treat the arrangement as a tax avoidance arrangement under the general anti-avoidance provision would defeat, not promote, the legislative purpose of the specific provisions. He also considered that the arrangement did not alter the incidence of income tax contemplated by the Income Tax Act 1976.

10.9 Richardson J's approach was not followed by the majority of the Privy Council on appeal in *Challenge* (PC). This was because his approach did not take account of the economic reality of the arrangement. The majority said the following:

- The specific provision was intended to give effect to the reality of group profits and losses. The taxpayer's group, in reality, did not suffer a loss since the loss had been suffered by the loss company before joining the group.[249]
- Most tax avoidance involves a pretence. The taxpayer group pretended to suffer a loss when in truth (reality) the loss had not been suffered by the group. The loss had been suffered by the loss company before joining the group.[250]

10.10 The Supreme Court in *Ben Nevis* mentioned "scheme and purpose" in the context of its discussion of the *Challenge* decisions. The Court said the following:

- Richardson J held, in effect, that literal compliance satisfied the statutory purposes. He did not, therefore, consider it necessary to consider the economic reality of the arrangement.[251]
- The effect of Richardson J's approach was to reconcile the specific provisions and the general anti-avoidance provision by reading down the scope of the general anti-avoidance provision. His approach to the scheme and purpose of the legislation required the general anti-avoidance provision to be read in the context of the specific provisions that were dominant.[252]

10.11 The Court observed that the Privy Council in *Challenge* accepted the importance of the scheme and purpose of the specific provision but that it had differed from Richardson J on its application.[253] The Privy Council did not accept that on a purposive approach the application of the general anti-avoidance provision could be limited in a way that ignored the economic reality of the transaction as contemplated by Parliament. The Court then went on to state:

> [95] Subsequent case law generally has proceeded, sometimes implicitly, on the basis of this scheme and purpose approach, but consistently with the underlying reasoning of the Privy Council by paying attention to whether the commercial reality of a transaction is consistent with its legal form … Whatever terminology is used, the important aspect of *Challenge Corporation*, however, is the underlying approach.

10.12 The Commissioner considers that it is clear from *Ben Nevis* (SC) and subsequent tax avoidance case law that the Parliamentary contemplation test differs significantly to Richardson J's "scheme and purpose" approach:

- The requirement under the Parliamentary contemplation test to consider the commercial and economic reality of the taxpayer's use or circumvention of a specific provision is a significant point of distinction between the Parliamentary contemplation test and the "scheme and purpose" approach of Richardson J.

248 At footnote 113.
249 At 558.
250 At 562–563.
251 At [88].
252 At [89].
253 At [94].

- The Parliamentary contemplation test is an intensely fact-based and specific inquiry. This contrasts with Richardson J's approach, which focused, in a formalistic or legalistic way, on the scheme and purpose of specific provisions and placed significantly less, if any, emphasis on an arrangement's commercial and economic reality.

10.13 The Commissioner considers that case law after *Ben Nevis* (SC) supports the Commissioner's view of Richardson J's "scheme and purpose" approach. The difference following *Ben Nevis* (SC) is that it is clearer that the approach to s BG 1 must take into account the commercial and economic reality of the arrangement when understanding whether the use of the specific provisions is within Parliament's contemplation. This increased emphasis on commercial and economic reality means it is possible that not all previously decided cases would be decided the same way following the Supreme Court decision in *Ben Nevis*.

10.14 Harrison J in *Westpac* (HC) said:

> [194] In summary, *Ben Nevis* represents, I think, a significant shift in identifying the principles to be applied when construing s BG 1, mandating a broader inquiry than was previously required — a "wider perspective" — consistent with settled principles of statutory interpretation: at [99]. [The Commissioner's counsel] observes that the phrase "scheme and purpose" is conspicuously absent from the ratio. I doubt that the court was rejecting the scheme and purpose approach of itself but was instead expanding its scope. The previous constraints imposed by a legalistic focus, to the exclusion of economic realism, have gone.

10.15 And Randerson J in the Court of Appeal in *Penny* (CA) said:

> [62] … The scheme and purpose approach adopted in earlier decisions has been endorsed in general terms but with some important clarifications. A key concept clarified by the [Supreme] Court is the relationship between specific tax provisions and a general anti avoidance provision. While it has long been accepted that compliance with specific tax provisions does not oust the application of the general anti avoidance provision, the Supreme Court has rejected the approach adopted by Richardson J in the *Challenge Corporation* case which effectively reconciled conflicting provisions by reading down the scope of the general avoidance provision.

10.16 The above passages make clear that the legalistic focus of Richardson J's scheme and purpose approach, to the exclusion of commercial and economic realism:

- has no relevance under the Parliamentary contemplation test; and
- was rejected by the Supreme Court in *Ben Nevis*.

Choice principle does not provide immunity from s BG 1

10.17 The choice principle refers to the proposition that where a person chooses between two or more courses of action explicitly recognised in the Act, s BG 1 should not apply to negate the course of action chosen (and the resulting tax advantage) since Parliament expressly made that choice available.

10.18 The choice principle was originally developed in the High Court of Australia in such cases as *Keighery*.[254] The Court held that the Australian general anti-avoidance provision was not intended to deny a taxpayer the choice between two or more options expressly provided by the Income Tax and Social Services Contribution Act 1936–52 (Australia). Dixon CJ, Kitto and Taylor JJ in their joint judgment said:[255]

> Whatever difficulties there may be in interpreting s. 260 [of the Income Tax and Social Services Contribution Act 1936-52 (Australia)], one thing is at least clear: the section intends only to protect the general provisions of the Act from frustration, and not to deny to taxpayers any right of choice between alternatives which the Act itself lays open to them. It is therefore important to consider whether the result of treating the section as applying in a case such as the present would be to render an attempt to defeat etc a liability imposed by the Act or to render ineffectual an attempt to give a company an advantage which the Act intended it might be given.

[254] *WP Keighery Pty Ltd v FCT* (1957) 100 CLR 66 (HCA).

[255] At 92.

10.19 The principle was expanded in later cases to situations where the Act offers tax benefits to taxpayers who adopt a particular course of conduct. For example, Stephen J in *Mullens* said:[256]

> The principle in *W. P. Keighery Pty. Ltd. v. Federal Commissioner of Taxation* is not to be confined to cases where the Act offers to the taxpayer a choice of alternative tax consequences either of which he is free to choose … **So, too, if … the Act offers certain tax benefits to taxpayers who adopt a particular course of conduct; the adoption of that course does not establish any purpose or effect such as is described in s. 260** [of the Income Tax and Social Services Contribution Act 1936-52 (Australia)]. Instead, an assessment which reflects the tax consequences of the course of conduct which the taxpayer has in fact adopted will then represent a due and proper incidence of tax, there will be no relief from, or defeating of, liability to tax and the Act will have the very operation which the legislature intended. [Emphasis added]

10.20 The choice principle was discussed in New Zealand in *Challenge* (CA):

- Woodhouse P described the choice principle as a "legal rights test". He considered that the principle was not in accord with the purpose intended by Parliament for s 99 of the Income Tax Act 1976 (now s BG 1) in its general statutory setting in the Act and that it should not be adopted in New Zealand.[257]
- Richardson J, on the other hand, considered that *Keighery* (HCA) provided powerful support for the proposition that for a taxpayer to do no more than adopt a course of action that the Act specifically contemplates does not result in an alteration to the incidence of income tax contemplated by the Act.[258]

10.21 In *Ben Nevis* (SC), the taxpayers argued that the courts should not apply s BG 1 where that would deprive taxpayers of tax beneficial choices provided in the Act. In response, the Supreme Court said taxpayers have the freedom to structure transactions to their best tax advantage, but they cannot do so in a way that is prohibited by s BG 1:

> [111] The appellants made a sustained plea that the courts should not deprive commercial and other parties of tax beneficial choices. On the approach we have set out, taxpayers have the freedom to structure transactions to their best tax advantage. They may utilise available tax incentives in whatever way the applicable legislative text, read in the light of its context and purpose, permits. They cannot, however, do so in a way that is proscribed by the general anti avoidance provision.

10.22 Similarly, the Supreme Court in *Penny* (SC) said that the structure each taxpayer adopted was, as a structure, entirely lawful, unremarkable, and a choice that each taxpayer was entitled to make.[259] The structure was the transfer of an orthopaedic practice to a company owned by the taxpayer's family trust and the employment by the company of the taxpayer on a salary.

10.23 However, because of the way each structure was used, the Supreme Court held that each arrangement was a tax avoidance arrangement. Each structure was used to set the salary for each taxpayer at a low level for the principal purpose of obtaining a tax advantage.

10.24 The Commissioner's view is that the choice principle does not provide immunity from s BG 1.[260] The relevant question in New Zealand is whether the use made of, or the circumvention of, the specific provision is within Parliament's contemplation, when the arrangement is viewed as a whole and in a commercially and economically realistic way.

Predication test remains relevant to some extent

10.25 The predication test refers to the test set out by Lord Denning in the Privy Council decision in *Newton*. *Newton* concerned s 260 of the Commonwealth Income Tax and Social Services Contribution Assessment Act 1936–1951 (Australia). Lord Denning said:[261]

> In order to bring the arrangement within the section you must be able to predicate – by looking at the overt acts by which it was implemented – that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section.

10.26 The predication test as formulated by Lord Denning did not limit the application of the general anti-avoidance provision to arrangements that had a sole or principal purpose of tax avoidance. Lord Denning in *Newton* said: [262]

[256] *Mullens v FCT* (1976) 135 CLR 290 (HCA) at 318.

[257] At 538–539.

[258] At 552.

[259] At [33].

[260] The Commissioner's view is guided by the comments made by the Supreme Court in *Ben Nevis* at [111] and the comments and approach of the Court in *Penny*.

[261] At 466.

[262] At 467.

> It is clear from this analysis that the avoidance of tax was not the *sole* purpose or effect of the arrangement. The raising of new capital was an associated purpose. But, nevertheless, the section can still work if one of the purposes or effects was to avoid liability for tax. The section distinctly says "*so far* as it has" the purpose or effect. This seems to their Lordships to import that it need not be the sole purpose. Looking at the whole of this arrangement, their Lordships have no doubt that it was an arrangement which is caught by s 260 [of the Commonwealth Income Tax and Social Services Contribution Assessment Act 1936–1951 (Australia)]. The whole of the transactions show that there was concerted action to an end – and that one of the ends sought to be achieved was the avoidance of liability for tax.

10.27 In New Zealand, one of the first instances of the application of the predication test was by Woodhouse J in *Elmiger* (SC). He considered the general anti-avoidance provision in the Land and Income Tax Act 1954 and said:[263]

> On the principles laid down by the Privy Council [in *Newton*], therefore, and taking into account the Australian decisions, it seems that the application of s. 108 [of the Land and Income Tax Act 1954] will depend first upon a decision as to whether an income tax advantage was one of the actuating purposes of the transaction under review; or whether it is "capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means" for obtaining such a tax advantage. (See *Newton's* case [1958] A.C. 450, 466). And this decision is to be made objectively by looking at the overt acts done in pursuance of the whole arrangement (ibid., 465) … it is my opinion that family or business dealings will be caught by s. 108 despite their characterisation as such, if there is associated with them the additional purpose or effect of tax relief (in the sense contemplated by the section) pursued as a goal in itself and not arising as a natural incident of some other purpose. If this were not so I suppose an appropriate legal window dressing could still be devised to defeat the general objects of the section.

10.28 Lord Donovan, in delivering the majority judgment of the Privy Council in *Mangin*, said that:[264]

- the clue to the meaning of Lord Denning's test lay in the words "without necessarily being labelled as a means to avoid tax"; and
- this phrase referred to arrangements "devised for the sole purpose, or at least the principal purpose, of" tax avoidance.

10.29 On one view, the majority's approach involved a possible departure from the approach in *Newton* (PC). This is due to the majority's apparent view that the general anti-avoidance provision applied to an arrangement only if tax avoidance was the sole or principal purpose of the arrangement.

10.30 However, five years after *Mangin*, the Privy Council in *Ashton* referred to Lord Denning's predication test. The Privy Council said that if one purpose or effect of an arrangement is tax avoidance, then the general anti-avoidance provision will apply:[265]

> Lord Denning in Newton said that it seemed to their Lordships that the inclusion of the words "so far as" showed that tax avoidance need not be the sole purpose … Section 108 [or the Land and Income Tax Act 1954] also contains the words "so far as" and [the taxpayer] in opening this appeal said that he would not dispute that one of the purposes and effects of the arrangement made by the appellants was to avoid the incidence of tax. If that was, as in their Lordships' view it clearly was, one purpose and one effect of the arrangement, it matters not what other purposes or effects it might have; s 108 applies … An arrangement which can properly be regarded as an ordinary business or family dealing is not to be regarded as entered into for the purpose or to have the effect of tax avoidance even though that ordinary dealing may result in less tax being paid than would otherwise be exigible. Tax avoidance is not the purpose of such a transaction.

10.31 McMullin J in *Tayles* (CA) said:[266]

- The Privy Council in *Ashton* had reiterated that an arrangement must necessarily be labelled as a means to avoid tax and not be explicable as an ordinary business or family dealing for the arrangement to be a tax avoidance arrangement.
- *Ashton* (PC) reaffirmed the exemption of ordinary business and family dealings from the scope of s 108 of the Land and Income Tax Act 1954 conferred by *Newton* (PC).
- Based on *Mangin* (PC) and *Ashton* (PC), s 108 of the Land and Income Tax Act 1954 would apply to an arrangement if the sole or principal purpose of the arrangement was to avoid tax or if one of the purposes of the arrangement was to avoid tax – whatever any other purpose it might have.

[263] At 694.

[264] At 598.

[265] At 723.

[266] At 735.

10.32 In the Court of Appeal in *Challenge*:

- Woodhouse P said that the questions that arise in applying the general anti-avoidance provision need to be framed in terms of the degree of economic reality associated with an arrangement in contrast to artificiality or contrivance or the extent to which the arrangement involves exploitation of the Act in direct pursuit of tax benefits.[267]
- Woodhouse P went on to say, that the predication test continued to have application in New Zealand to the general anti-avoidance provision following the provision's amendment in 1974 (which introduced the current form of the general anti-avoidance provision).[268] In other words, an arrangement's economic reality was to be considered when applying the prediction test.
- Richardson J referred to the predication test but expressed no view on whether it continued to have application. He considered that literal compliance with the specific provision was consistent with the specific scheme and purpose of the specific provision. He said to treat the arrangement as a tax avoidance arrangement would defeat, and not promote, the purpose of the provision.[269]

10.33 In the Privy Council in *Challenge*, neither the majority nor minority, referred to the predication test.

10.34 The Supreme Court in *Ben Nevis* referred to the predication test when discussing the 1974 legislative changes to the general anti-avoidance provision. The Court said:

> [81] The changes to s 108 [of the Land and Income Tax Act 1954] went some way towards clarifying the types of transactions that the section was intended to cover. The tax avoidance definition was extended to cover a wider range of tax advantages that could amount to tax avoidance, … The section also expressly included future income and potential liability, … The new definition of "tax avoidance arrangement" included an arrangement where one of its purposes was tax avoidance, that not being a "merely incidental purpose". **At the same time the legislation dispensed with Lord Denning's predication test in Newton by stating that an arrangement could amount to tax avoidance whether or not other purposes or effects of the arrangement were referable to ordinary business or family dealings.** [Emphasis added]

10.35 However, Harrison J in *Westpac* expressed reservations about the Supreme Court's comment above. The Court said:

> [198] *Glenharrow* is also directly material even though it was decided in a slightly different statutory context. The Supreme Court considered the extent to which the taxpayer's subjective purpose was relevant to whether a transaction was designed to defeat the Goods and Services Tax Act 1985. The court unanimously approved Lord Denning's test propounded for the Privy Council in *Newton* at ATD 445; AC 465, holding that the phrase "purpose or effect" (replicated in s OB 1) referred not to the taxpayer's motive but to the objective which the arrangement sought to achieve; that is, "the end in view". **(I agree with [the Commissioner's counsel] that, with respect, the Supreme Court's statement in *Ben Nevis* at [81] that the statutory changes made to the anti-avoidance provisions in 1974 "dispensed with Lord Denning's predication test in Newton" is expressed too widely; a key component remains, as *Glenharrow* confirms.)** [Emphasis added]

10.36 The Commissioner considers that:

- the Supreme Court's statement in *Ben Nevis* that the legislative changes in 1974 dispensed with Lord Denning's predication test referred to the test as it had been interpreted in *Mangin* (PC);
- the predication test remains relevant to some degree but only in the sense that it is still necessary under the Parliamentary contemplation test to objectively determine or "predicate" that tax avoidance is a purpose or effect of the arrangement;[270] and
- predicating that tax avoidance is a purpose or effect of the arrangement will principally be a matter of inference from the arrangement (viewed as a whole and in a commercially and economically realistic way) and its effect.

Section BG 1 can apply to a "new source" of income

10.37 The "new source" doctrine is the proposition that tax avoidance cannot exist where an arrangement involves a new source of income. The Privy Council referred to the doctrine in *Europa No 2*.[271] Lord Diplock stated:[272]

> Secondly, the description of the contracts, agreements and arrangements which are liable to avoidance presupposes the continued receipt by the taxpayer of income from an existing source in respect of which his liability to pay tax would be altered or relieved if

[267] At 535.

[268] At 539.

[269] At 551.

[270] See, for example, *Frucor* (SC) at [87].

[271] *Europa Oil (NZ) Ltd v CIR* [1976] 1 NZLR 546 (PC) (*Europa No 2* (PC)).

[272] At 556.

> legal effect were given to the contract, agreement, or arrangement sought to be avoided as against the Commissioner. **The section does not strike at new sources of income or restrict the right of the taxpayer to arrange his affairs in relation to income from a new source in such a way as to attract the least possible liability to tax.** Nor does it prevent the taxpayer from parting with a source of income. [Emphasis added]

10.38 The doctrine was considered in *Gulland* (HCA) and *Bunting* (FCAFC).[273] The doctrine was developed in the case law on the general anti-avoidance provision in Australia at a time when the Australian legislation did not contain a power to adjust amounts to counteract a tax advantage obtained from a tax avoidance arrangement. As explained in *Bunting* (FCAFC), the doctrine provided that for the general anti-avoidance provision to apply the following must be the case:

- An arrangement must not involve a new source of income. This was on the ground that the operation of the general anti-avoidance provision depended on an alteration of the existing incidence of tax or an existing liability to pay tax.
- An antecedent situation or transaction must exist, such that when the arrangement is annihilated (voided) a situation or transaction is left that gives rise to assessable income. This was on the ground that absent an antecedent situation or transaction, the voiding would annihilate the new source of income and nothing would be left.

10.39 The High Court in *BNZ Investments No 1* rejected the new source doctrine as being obsolete. This was due to the legislative changes made to the general anti-avoidance provision in 1974. The changes expanded the definition of "tax avoidance" beyond "altering the incidence of income tax" to include "directly or indirectly avoiding" any liability to income tax. The Court said:

> [122] … I regard the "new source" doctrine as obsolete. Observations made in *Europa Oil (NZ) Limited v C of IR* [1976] 1 NZLR 546 (PC) [also reported as *Europa Oil (NZ) Ltd v CIR (No 2)*; *CIR v Europa Oil (No 2)* (1976) 2 NZTC 61,661] were based on former s 108 [of the Land and Income Tax Act 1954] which pivoted on "alteration of incidence". Section 99 [of the Income Tax Act 1976], in the expanded definition of "tax avoidance" contained in s 99(1), now extends beyond "alteration of incidence" to include even "directly or indirectly avoiding" liability. While there were obvious logical difficulties in regarding creation of a new source of income as "altering incidence", that does not apply in relation to "avoiding", and even less so in relation to "indirectly avoiding".

10.40 The Commissioner's view is that s BG 1 can apply to an arrangement that involves a "new source" of income.

Duke of Westminster principle not relevant when applying s BG 1

10.41 The *Duke of Westminster* principle is the proposition that taxpayers are entitled to order their affairs so that tax is less than it otherwise would be. It originates from Lord Tomlin's statement in *Duke of Westminster*:[274]

> Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.

10.42 At the time of *Duke of Westminster*, United Kingdom legislation did not contain a general anti-avoidance provision. A long line of authority says that this case is not relevant when considering the application of an anti-avoidance provision.

10.43 For instance, Woodhouse J in *Elmiger* (SC) said:[275]

> … I was referred to the well-known dictum of Lord Tomlin in *Duke of Westminster v Commissioners of Inland Revenue* [1936] A.C. 1; [1935] All ER Rep. 259 …
>
> Nevertheless, since the House of Lords was obliged to consider the highly beneficial arrangements which were able to be made in 1930 on behalf of the Duke of Westminster, there has been a growing awareness by the Legislature and the Courts alike that ingenious legal devices contrived to enable individual taxpayers to minimise or avoid their tax liabilities are often not merely sterile or unproductive in themselves (except perhaps in respect of their tax advantages for the taxpayer concerned), but that they have social consequences which are contrary to the general public interest. There is the problem, too, that the Legislature usually is lagging several steps behind the ever-developing arrangements worked out by experts in this field on behalf of their taxpayer clients.

10.44 And, Baragwanath J in *Miller* (HC) said:[276]

> Section 99 [of the Income Tax Act 1976] is not to be construed according to the *Duke of Westminster's* case or Rowlatt J's dictum [that there is no equity to tax].

10.45 The Supreme Court in *Ben Nevis*, *Glenharrow*, *Penny* and *Frucor* did not mention the *Duke of Westminster* principle.

[273] *FCT v Gulland* (1985) 160 CLR 55 (HCA) and *Bunting v FCT* 89 ATC 5,245 (FCAFC).

[274] At 19.

[275] At 686–687.

[276] At 13,032.

10.46 The Commissioner considers that it is settled law that the *Duke of Westminster* principle is not relevant when applying s BG 1.

The Commissioner's inability to dictate how taxpayers do business is not relevant

10.47 It is a settled principle of tax law that the Commissioner cannot dictate to taxpayers how they operate their businesses or transact their commercial dealings.[277]

10.48 It is sometimes argued that this principle prevents the Commissioner:

- when considering whether an arrangement is a tax avoidance arrangement, from examining the pricing of transactions in, or amounts paid or received under the arrangement; and
- adjusting under s GA 1 the taxable income of a person to counteract a tax advantage obtained by that person from or under a tax avoidance arrangement.

10.49 This argument is frequently based on the High Court of Australia decision in *Cecil Bros* where the Court said that "it is not for the Court or the Commissioner to say how much a taxpayer ought to spend in obtaining his income".[278] The Privy Council cited that statement with approval in *Europa No 1*, *Europa No 2*, and *Peterson*.

10.50 As discussed in Part 3, the application of a specific provision to a taxpayer is to be determined on:

- the basis of the legal rights and obligations of the transaction to which the taxpayer is a party; or
- the circumstances in which the taxpayer is involved.

10.51 The pricing in the transaction is accepted at face value as the price legally paid or received. However, as discussed in Part 7, *Ben Nevis* (SC) makes clear that when considering the application of s BG 1 to an arrangement, the arrangement is to be viewed as a whole and in a commercially and economically realistic way.

10.52 Viewing an arrangement as a whole and in a commercially and economically realistic way may identify pricing that has been set above or below commercially realistic rates for a tax purpose and not for a commercial or private purpose.

10.53 For example, the Supreme Court in *Penny* readily accepted that the Act contains no concept of a commercially realistic salary and that family transactions are commonly not based on market rates. The Court, however, also said that:[279]

> The Act does, however, require that taxpayers not structure their transactions with a more than merely incidental purpose of obtaining a tax advantage, unless that (more than merely incidental) tax advantage was in the contemplation of Parliament.

10.54 It was, therefore, appropriate for the Commissioner to examine whether:

- a salary has been set at a certain level on a commercial basis or for private purposes (that is, non-tax purposes); and
- tax consequences (objectively) played an incidental role.

10.55 If the level of a salary was not commercially realistic or, objectively, the setting of its level was not explicable by a non-tax purpose, it will be open to the Commissioner to assert the salary was, or was part of, a tax avoidance arrangement.

10.56 The Supreme Court in *Glenharrow* commented about not respecting bargains that have artificial features with advantageous tax consequences and the application of the general anti-avoidance provision (in the GST Act) to such bargains:

> [47] … The whole premise of the Act generally and of the secondhand goods provisions in particular is that transactions will be driven by market forces: that their commercial and fiscal effects will be produced by those forces and will not contain distortions which affect (ie defeat) the contemplated application of the [GST Act]. It is when market forces do not prevail that s 76 [of the GST Act] is available to the Commissioner. …
>
> [48] **It may be said, and indeed the appellant does say, that to approach the question of the intent and application of the Act in this way is not to respect the bargain struck by the parties and would allow the Commissioner to restructure their bargain for them, with different GST consequences, and would thus be productive of uncertainty. But that uncertainty is inherent where transactions have artificial features combined with advantageous tax consequences not contemplated by the scheme and purpose of the Act. There will also inevitably be uncertainty whenever a taxing statute contains a general anti avoidance provision intended to deal with and counteract such artificially favourable transactions.** It is simply not possible to meet the objectives of a general anti avoidance provision by the use, for example, of precise definitions, as may be able to be done where an anti avoidance provision is directed at a specified type of transaction.
>
> [49] Transactions which are driven only by commercial imperatives are unlikely to produce tax consequences outside the

[277] *Cecil Bros Pty Ltd v FCT* (1964) 111 CLR 430 (HCA); *Europa No 1* (PC); *Europa No 2* (PC).

[278] At 434.

[279] At [49].

> purpose of the legislation and, in any isolated case in which the commercial drivers do have unusual consequences, the existence of those consequences will surely alert the parties to the possibility that the Commissioner may consider invoking the general anti-avoidance provision and may have to be persuaded that the intent of the legislation is not actually being offended. An advance ruling can be sought. [Emphasis added]

10.57 The Commissioner accepts that matters for taxpayers, and not the Commissioner, to determine include such things as:

- how they should operate their businesses;
- how they should price their transactions;
- what amounts they should pay or receive in operating their businesses; or
- how they should transact their commercial dealings.

10.58 The Commissioner, however, does not accept that the principle expressed at [10.47] has any application when considering whether an arrangement is a tax avoidance arrangement. Therefore, the principle does not prevent the Commissioner from:

- examining the commercial and economic reality of the pricing of transactions in, or amounts paid or received under, an arrangement; or
- exercising the statutory power under s GA 1 of adjusting the taxable income of a person to counteract a tax advantage obtained by that person from or under a tax avoidance arrangement.

10.59 Otherwise expressed, the application of the Parliamentary contemplation test does not involve the Commissioner dictating how taxpayers do business. An arrangement is a tax avoidance arrangement due to its facts, and these are outside the Commissioner's control. The operation of s BG 1 does not change the facts of an arrangement nor the parties' legal rights and obligations to one another. Section BG 1 simply affects the taxation outcomes of an arrangement.

Complex arrangements are not necessarily tax avoidance arrangements

10.60 Section BG 1 will not apply to an arrangement simply because the arrangement is complex. An arrangement may be complex, for example, due to:

- the commercial purpose that is sought to be achieved and the complex nature of the commercial transactions that are required to achieve such a purpose;
- the complexity of (non-tax) regulatory regimes; or
- the involvement of multiple parties located in different countries (possibly with materially different regulatory regimes).

10.61 However, if the complexity of an arrangement is not objectively explicable in terms of commercial or private purposes and is to achieve a tax advantage as an end in itself, the arrangement will be a tax avoidance arrangement.

10.62 For example, the High Court in both *BNZ Investments No 2* and *Westpac* considered the complex transactions in each case were tax avoidance arrangements, but not by reason of that complexity. In both cases, the High Court held that the transactions were in economic substance straightforward loans and had no independent commercial rationale or logic because they were loss making. The Court said that the only, or primary purpose, of the transactions was to obtain tax advantages.

10.63 The Supreme Court in *Ben Nevis* observed that taxpayers have the freedom to structure transactions to their best tax advantage.[280] However, they cannot do so in a way proscribed by s BG 1.

Section BG 1 cannot be used by the Commissioner to fill in a legislative gap

10.64 The expression "legislative gap" refers to the situation where legislation does not cover a particular circumstance. Such a gap may not be deliberate and can arise because:

- of an omission or oversight by Parliament; or
- the particular circumstance may not have been foreseen by Parliament.

10.65 However, such a gap may also be deliberate in that Parliament's purpose in enacting the legislation was that the legislation did not cover the gap.

[280] At [111].

10.66 It is a settled principle of statutory interpretation that a court may, in limited circumstances, fill a legislative gap. However, this is only to make the Act work as Parliament must have intended. The court, however, in filling a gap cannot cross the line and change or make policy. Changing or making policy is a function that belongs to Parliament.

10.67 The leading case in New Zealand on "gap filling" is the decision of the Court of Appeal in *Northland Milk Vendors.*[281] That case concerned new legislation, the Milk Act 1988. There was a problem that had not been expressly provided for in the legislation and that Parliament had possibly not even foreseen. The problem was that the Milk Act 1988 did not provide for home delivery of milk in the interim period from the Act coming into force and the establishment of the new Milk Authority.

10.68 The Court of Appeal identified contextual indications in the Act relevant to the problem, in particular in its Long Title. The Long Title indicated the Act was to provide for "continued home delivery". This enabled the Court to conclude that Parliament must have intended that home delivery of milk continue in the interim period. The Court filled in the gap to make it work as Parliament must have intended.

10.69 An issue that is raised from time to time is whether the Commissioner can use ss BG 1 and GA 1 to fill in a gap in the Act where a specific provision (or combination of provisions) does not cover a particular circumstance in an arrangement. That is, no Parliamentary purpose is reasonably discernible and the resulting tax outcomes are viewed as undesirable from a tax policy point of view.

10.70 The Commissioner's position is that ss BG 1 and GA 1 cannot apply in such a circumstance to fill a gap. This is for two reasons:

- The principle that a court, in appropriate circumstances, can gap fill is a principle of statutory interpretation that applies to the interpretation and application of specific provisions. It is not a principle applicable to the application of the Parliamentary contemplation test.
- Using ss BG 1 and GA 1 to fill a gap would involve the Commissioner making policy, which is a function solely for Parliament.

An arrangement resulting in tax being paid can involve tax avoidance

10.71 It may be argued that if an arrangement results in the payment of tax it cannot be a tax avoidance arrangement. It may also be argued that an arrangement that results in the payment of more tax when all affected parties are considered, cannot be a tax avoidance arrangement for the parties who might be considered to have, despite this overall effect, paid less tax.

10.72 The Commissioner does not accept these arguments for the following reasons:

- Under s GA 1, the Commissioner can adjust the taxable income of individual taxpayers if they are persons affected by the arrangement.
- The Parliamentary contemplation test is applied to the arrangement entered into and the focus is on the use (or circumvention) of specific provisions, not simply on how much tax is paid overall.
- Even though, in some situations, some tax may have been paid under a tax avoidance arrangement, Parliament may have contemplated more tax being paid.
- Some tax avoidance arrangements may require the payment of tax to achieve the result that is outside Parliament's contemplation. For example, the tax avoidance aspect of an arrangement may require the payment of tax to generate imputation credits that are then applied in a manner that is not within Parliament's contemplation.

A tax advantage in another country is not a tax avoidance purpose or effect

10.73 Some arrangements might have the effect of gaining a tax advantage in a country other than New Zealand. If so, an issue might arise as to the relevance of this purpose or effect of the arrangement when considering whether s BG 1 applies.

[281] *Northland Milk Vendors Association v Northern Milk Ltd* [1988] 1 NZLR 530 (CA).

10.74 Where an arrangement has a purpose or effect of obtaining a tax advantage in another country, that purpose or effect is not a tax avoidance purpose or effect under s BG 1. This is for two reasons:

- A "tax avoidance arrangement" is an arrangement that has a purpose or effect in relation to "income tax" imposed by the Act.[282] Foreign income tax is not "income tax" imposed by the Act. Therefore, the avoidance of foreign tax is not tax avoidance for the purposes of s BG 1.
- The Parliamentary contemplation test examines whether an arrangement, viewed as a whole and in a commercially and realistic way, uses or circumvents the specific provision in a manner consistent with Parliament's purpose. The specific provision is a provision in the New Zealand Act. It is not a specific provision contained in the income tax legislation of another country.

10.75 However, the avoidance of foreign tax may be relevant to the application of the merely incidental test in s BG 1. An arrangement may avoid not only foreign income tax but also income tax imposed by the Act. Where an arrangement has two or more purposes or effects and one purpose or effect is tax avoidance, the merely incidental test must be applied.

10.76 The merely incidental test provides that an arrangement will not be a tax avoidance arrangement if the tax avoidance purpose or effect of the arrangement is merely incidental to a non-tax avoidance purpose or effect of the arrangement. The avoidance of foreign income tax is a non-tax avoidance purpose or effect of the arrangement.

10.77 Accordingly, it is possible that the tax avoidance purpose or effect of the arrangement may be merely incidental to the arrangement's non-tax avoidance purpose or effect of avoiding foreign tax. The consequence will be that the arrangement is not a tax avoidance arrangement. However, if the New Zealand tax avoidance purpose is pursued as an end in itself and does not naturally follow from, attaches to, or is subordinate or subsidiary to, a non-tax avoidance purpose, the tax avoidance purpose will not be merely incidental.

10.78 And, the New Zealand government, through the Commissioner, has responsibilities under various legal instruments, including tax treaties, to exchange information with other tax authorities. If an arrangement has the effect of gaining a tax advantage from another country's tax system, the Commissioner may provide details and documentation to that other country.

Double tax agreements do not prevent s BG 1 from applying

10.79 Double tax agreements (DTAs) are international treaties that are entered into primarily to prevent double taxation on cross-border income. To achieve this, DTAs may limit the tax that can be imposed by the country of source or residence or require a tax credit to be provided for foreign tax paid.

10.80 Section BH 1(4) provides that DTAs generally have overriding effect. However, this does not extend to s BG 1 (as clarified in a 2017 amendment). This means that a DTA will not prevent s BG 1 from applying.

10.81 The Commissioner's view on the interaction of s BG 1 and a DTA is explained in a *Tax Information Bulletin* item:[283]

> … OECD Commentary [to the Model Tax Convention on Income and on Capital] states that, as a general rule, there will be no conflict between GAARs [general anti-avoidance rules] and the properly constructed provisions of DTAs [double tax agreements]. It also confirms that States are not obliged to grant the benefits of a DTA if the DTA has been abused (noting that it should not be lightly assumed that the DTA has been abused). … In almost all cases, no conflict should arise between a DTA and the GAAR. While a conflict could theoretically result in a treaty override, this issue is largely academic and arises for all countries that have the same law regarding their GAAR, not just New Zealand. These countries include Australia, the United Kingdom and Canada, which have also provided clarification in their domestic legislation that their GAAR overrides DTAs. …

10.82 If an arrangement uses or circumvents specific provisions of the Act and a DTA also applies, then, under a tax avoidance inquiry, the specific provisions are applied to the facts of the arrangement viewed as a whole and in a commercially and economically realistic way. Having so determined the application or non-application of the specific provisions, the articles of the relevant DTA are then applied. In other words, s BG 1 is applied to establish the domestic tax position of a person regarding the arrangement, and this may change how a DTA subsequently applies.

10.83 For example, if s BG 1 applies and the proceeds of a share sale are, in commercial and economic reality, a dividend and the Commissioner under s GA 1 adjusts a taxpayer's income on that basis, the dividend article of the relevant DTA would then apply.

[282] Under the definitions in s YA 1 of "income tax", "tax avoidance arrangement" and "tax avoidance".

[283] New legislation: Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Act 2017, *Tax Information Bulletin* Vol 29, No 5 (June 2017): 133.

10.84 In addition, the articles of a DTA are effectively incorporated into New Zealand domestic law, although are interpreted differently.[284] As such, in a s BG 1 inquiry the articles of a DTA are treated as if they were specific provisions of the Act. It follows that, if an arrangement uses or circumvents an article of a DTA, then under s BG 1 the DTA applies to the specific facts of the arrangement viewed as a whole and in a commercially and economically realistic way, rather than to the legal form of the arrangement. This may mean the DTA articles apply differently than would otherwise be the case. This may also mean any tax advantage arising under, or as a result of, the DTA is counteracted. If not, the Commissioner can reconstruct the arrangement to ensure the tax advantage arising through the DTA is appropriately counteracted.

10.85 Finally, the Commissioner notes that many of New Zealand's DTAs have an article creating a mutual agreement procedure. Under a mutual agreement procedure, the contracting states to a DTA engage with each other to resolve any dispute that may arise from the way the DTA is being interpreted and applied (and this can be initiated by the taxpayer). The mutual agreement procedure may be available where s BG 1 applies to a cross-border arrangement and involves the use of a DTA.

Section BG 1 inherently produces uncertainty

10.86 An argument is sometimes made that:

- taxpayers should have certainty about how the tax laws apply so they can enter into transactions knowing the financial consequences; and
- s BG 1, and its interpretation, produces uncertainty.

10.87 In the Commissioner's view, the argument that s BG 1 produces uncertainty does not have sufficient regard to the need for, and nature of, a general anti-avoidance provision. The Supreme Court made it clear in *Ben Nevis* that Parliament chose not to specify the kind of arrangements to which s BG 1 would apply and left it to the courts to draw the relevant conclusion on a case-by-case basis:

> [112] **The appellants also argued that tax avoidance legislation should be interpreted in a way which gives taxpayers reasonable certainty in tax planning.** But Parliament has left the general anti avoidance provision deliberately general. That approach has been retained despite the introduction of a civil penalties regime in relation to taxpayers who take certain types of incorrect tax position. **The courts should not strive to create greater certainty than Parliament has chosen to provide**. We consider that the approach we have outlined gives as much conceptual clarity as can reasonably be achieved. As in many areas of the law, there are bound to be difficult cases at the margins. But in most cases we consider it will be possible, without undue difficulty, to decide on which side of the line a particular arrangement falls. [Emphasis added]

10.88 The Supreme Court in *Glenharrow* said that there will inherently be uncertainly whenever a taxing statute contains a general anti-avoidance provision:

> [48] It may be said, and indeed the appellant does say, that to approach the question of the intent and application of the Act in this way is not to respect the bargain struck by the parties and would allow the Commissioner to restructure their bargain for them, with different GST consequences, and would thus be productive of uncertainty. **But that uncertainty is inherent where transactions have artificial features combined with advantageous tax consequences not contemplated by the scheme and purpose of the Act. There will also inevitably be uncertainty whenever a taxing statute contains a general anti avoidance provision intended to deal with and counteract such artificially favourable transactions. It is simply not possible to meet the objectives of a general anti avoidance provision by the use, for example, of precise definitions, as may be able to be done where an anti avoidance provision is directed at a specified type of transaction.** [Emphasis added]

10.89 Hammond J in *Penny* (CA) observed that in taxation law the function of the courts is to see that the legislative purposes of Parliament are not frustrated by clever manipulation. And, that it is undesirable and impractical to ask courts to provide all-encompassing templates and bright-line rules:

> [162] Finally, courts exist to resolve particular controversies. Much as professional advisers may yearn for all encompassing templates, to ask courts to attempt to anticipate other possible situations and produce clear, bright line rules is undesirable and impracticable in taxation law. The function of the court is to see that the legislative purpose of Parliament is not overtaken by "merely clever" manipulation of particular rules, as happened in this case. And the court can only determine one case at a time.

[284] See from [63] of IS 16/05: "Income Tax – foreign tax credits – how to claim a foreign tax credit where the foreign tax paid is covered by a double tax agreement", *Tax Information Bulletin* Vol 28, No 12 (December 2016):41.

10.90 The courts have been clear when dealing with the argument that s BG 1 produces uncertainty:

- Parliament has deliberately chosen not to provide the level of certainty sometimes desired by taxpayers and their advisers. The courts should not strive to create greater certainty than Parliament has chosen to provide.
- Of greater legislative concern to Parliament than providing absolute legislative certainty, is the concern that the general anti-avoidance provision must be capable of responding to the ingenuity of taxpayers in adapting the forms in which they do business to obtain tax advantages. Section BG 1 is general, and not specific, for this reason.
- Uncertainty is inherent in transactions with artificial features combined with tax advantages not contemplated by Parliament.
- Uncertainty is inherent in a general anti-avoidance provision designed to address and counteract transactions set up as a means of exploiting the Act for tax advantages.
- Arrangements that, objectively determined, have been structured with nothing more than the purpose or effect of achieving a commercial or private purpose are unlikely to use or circumvent specific provisions and produce tax advantages that are outside Parliament's purpose for specific provisions.

10.91 When the purpose of specific provisions and the purpose of s BG 1 are distinguished and understood, the courts consider that the tax avoidance law in New Zealand, including the Parliamentary contemplation test, provides a reasonable level of certainty for taxpayers.

10.92 If taxpayers and advisers require certainty on whether s BG 1 applies to their arrangements, they may apply to the Commissioner for a binding ruling. If the Commissioner rules that s BG 1 does not apply to the arrangement, that ruling will be legally binding on the Commissioner for the period of the ruling.

10.93 The Commissioner in this statement has sought to provide a framework and an approach to ss BG 1 and GA 1 that will guide taxpayers and their advisers in their consideration of whether the tax avoidance provisions apply to their arrangements.

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Appendix – Legislation | Āpititanga – Whakature

Income Tax Act 2007

BB 3 Overriding effect of certain matters

Tax avoidance arrangements: subpart BG

(1) Under Part G (Avoidance and non-market transactions), the Commissioner may counteract a tax advantage from a tax avoidance arrangement.

...

BG 1 Tax avoidance

Avoidance arrangement void

(1) A tax avoidance arrangement is void as against the Commissioner for income tax purposes.

Reconstruction

(2) Under Part G (Avoidance and non-market transactions), the Commissioner may counteract a tax advantage that a person has obtained from or under a tax avoidance arrangement.

GA 1 Commissioner's power to adjust

When this section applies

(1) This section applies if an arrangement is void under section BG 1 (Tax avoidance).

Commissioner's general power

(2) The Commissioner may adjust the taxable income of a person affected by the arrangement in a way the Commissioner thinks appropriate, in order to counteract a tax advantage obtained by the person from or under the arrangement.

Commissioner's specific power over tax credits

(3) The Commissioner may—

(a) disallow some or all of a tax credit of a person affected by the arrangement; or

(b) allow another person to benefit from some or all of the tax credit.

Commissioner's identification of hypothetical situation

(4) When applying subsections (2) and (3), the Commissioner may have regard to 1 or more of the amounts listed in subsection (5) which, in the Commissioner's opinion, had the arrangement not occurred, the person—

(a) would have had; or

(b) would in all likelihood have had; or

(c) might be expected to have had.

Reconstructed amounts

(5) The amounts referred to in subsection (4) are—

(a) an amount of income of the person:

(b) an amount of deduction of the person:

(c) an amount of tax loss of the person:

(d) an amount of tax credit of the person.

No double counting

(6) When applying subsection (2), if the Commissioner includes an amount of income or deduction in calculating the taxable income of the person, it must not be included in calculating the taxable income of another person.

Meaning of tax credit

(7) In this section, tax credit means a reduction in the tax a person must pay because of—

(a) a credit allowed for a payment by the person of an amount of tax or of another item; or

(b) another type of benefit.

YA 1 Definitions

arrangement means an agreement, contract, plan, or understanding, whether enforceable or unenforceable, including all steps and transactions by which it is carried into effect

tax avoidance includes—

(a) directly or indirectly altering the incidence of any income tax:

(b) directly or indirectly relieving a person from liability to pay income tax or from a potential or prospective liability to future income tax:

(c) directly or indirectly avoiding, postponing, or reducing any liability to income tax or any potential or prospective liability to future income tax

tax avoidance arrangement means an arrangement, whether entered into by the person affected by the arrangement or by another person, that directly or indirectly—

(a) has tax avoidance as its purpose or effect; or

(b) has tax avoidance as 1 of its purposes or effects, whether or not any other purpose or effect is referable to ordinary business or family dealings, if the tax avoidance purpose or effect is not merely incidental.

Goods and Services Tax Act 1985

76 Avoidance

(1) A tax avoidance arrangement entered into by a person is void against the Commissioner for tax purposes.

(2) A tax avoidance arrangement is one that directly or indirectly—

(a) has tax avoidance as its purpose or effect; or

(b) has tax avoidance as one of its purposes or effects, whether or not another purpose or effect relates to ordinary business or family dealings, if the purpose or effect is not merely incidental.

(3) If a tax avoidance arrangement is void against the Commissioner, the Commissioner may adjust the amount of tax payable by, or the amount of tax refundable to, a registered person affected by the arrangement, whether or not the registered person is a party to the arrangement, in the manner the Commissioner considers appropriate to counteract any tax advantage obtained by the registered person from or under the arrangement.

(4) For the purpose of subsection (3), the Commissioner may, in addition to any other treatment the Commissioner considers appropriate, treat—

(a) a person who is not a registered person and who is a party to or has participated in an arrangement as being a registered person:

(b) a supply of goods and services, whether or not a taxable supply, that is affected by or is part of an arrangement as being made to or by a registered person:

(c) a supply of goods and services as occurring in a taxable period that, but for an arrangement affected by this section, would have occurred in the taxable period in which the supply was made:

(d) a supply of goods and services as having been made, or consideration for the supply as having been given, at open market value.

(5) Subsection (6) applies if—

(a) a person (person A) enters into an arrangement on or after 22 August 1985 whereby a taxable activity formerly carried on by person A is carried on, in whole or in part, by another person (person B) or other persons; and

(b) either—

(i) person A and person B are associated persons; or

(ii) person A and the other persons are associated persons.

(6) For the purpose of sections 15(3), 15(4), 19A(1) and 51(1), the value of the supplies made in the course of carrying on all taxable activities in a 12-month period starting on the first day of any month by person A and person B or person A and the other persons is, to the extent that the value relates to supplies arising from the taxable activity formerly carried on by person A, each to be treated as being equal to the aggregate of the value of the taxable supplies made by all persons for that period.

(7) The Commissioner may, having regard to the circumstances of the case and if the Commissioner considers it equitable to do so, determine that subsection (6) does not apply to person A, person B or the other persons.

(8) For the purpose of this section—

arrangement means a contract, agreement, plan or understanding, whether enforceable or unenforceable, including all steps and transactions by which it is carried into effect

tax avoidance includes—

(a) a reduction in the liability of a registered person to pay tax:

(b) a postponement in the liability of a registered person to pay tax:

(c) an increase in the entitlement of a registered person to a refund of tax:

(d) an earlier entitlement of a registered person to a refund of tax:

(e) a reduction in the total consideration payable by a person for a supply of goods and services.

QUESTIONS WE'VE BEEN ASKED

This section of the *TIB* sets out the answers to some day-to-day questions people have asked. They are published here as they may be of general interest to readers.

QB 23/01: Income tax: scenarios on tax avoidance – 2023 No 1

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:[1]
   - 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.[2] 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.[3]
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 with the Parliamentary contemplation test.[4] The Supreme Court confirmed the Parliamentary contemplation test as the proper and authoritative approach to applying s BG 1 in *Penny* and *Frucor*.[5]
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.

[1] 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).

[2] 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.

[3] 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.

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

[5] *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].

- 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?[6]
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.
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.[7]
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.
    - 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.

[6] *Ben Nevis* (SC) at [109].

[7] *Ben Nevis* (SC) at [114].

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".[8]
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:
    - commercial purposes;
    - private purposes; and

[8] At [33].

- 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)[9]).
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),[10] and BR Pub 15/08[11]).
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:

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

[10] *FCT v Roberts; FCT v Smith* 92 ATC 4380 (FCAFC).

[11] 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*).

- 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.
- 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:[12]

- 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.
- 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:

[12] 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.

- 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.[13]

[13] 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.

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.
    - 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%.[14] 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 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.

[14] The post-tax positive return is calculated as follows: (4.9% x (1–0.28)) – (5.0% x (1–0.39)) = 0.478%.

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:[15]
    - 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.

[15] This scenario has been adapted from example 2 of IS 13/01.

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.

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.

References | Tohutoro

Legislative References | Tohutoro whakatureture

Income Tax Act 2007: ss AA 1, BC 4, BD 1, BG 1, CB 32C, CP 1, CX 55, CX 56, DA 2, DB 6, DB 7, EW 46C, FA 2; GA 1, subpart HM, HM 2, HM 6, HM 56, HM 71, sch 6

Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014: s 102 Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Act 2017: 14, 75

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Ben Nevis Forestry Ventures Ltd v CIR [2008] NZSC 115, [2009] 2 NZLR 289

Frucor Suntory New Zealand Ltd v CIR [2022] NZSC 113

Pacific Rendezvous Ltd v CIR [1986] 2 NZLR 567 (CA)

FCT v Roberts; FCT v Smith 92 ATC 4380 (FCAFC)

Penny v CIR [2011] NZSC 95, [2012] 1 NZLR 433 (also known as *Penny & Hooper*)

Other References | Tohutoro anō

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, Tax Information Bulletin* Vol 27, No 5 (June 2015): 3

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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"

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QB 14/11: *Income tax – scenarios on tax avoidance, Tax Information Bulletin,* Vol 26, No 11 (December 2014): 3

QB 15/01: *Income tax – tax avoidance and dept capitalisation, Tax Information Bulletin,* Vol 27, No 3 (April 2015): 25

QB 15/11: *Income tax – scenarios on tax avoidance – 2015, Tax Information Bulletin,* Vol 27, No 10 (November 2015): 27

QB 23/02: "Income tax: scenarios on tax avoidance – 2023 No 2"

Related parties debt remission, An officials' issues paper (Policy and Strategy, Inland Revenue and the Treasury, February 2015)

Taxation of investment income (A Government discussion document, Policy Advice Division of Inland Revenue, June 2005)

QB 23/02: Income tax: scenarios on tax avoidance – 2023 No 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 QWBA:
   - 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.[1]
2. The withdrawn QWBAs were based on the Commissioner's statement on tax avoidance IS 13/01.[2] 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. The answers as to whether or not s BG 1 applies in each of the scenarios have not changed. Due to subsequent legislative changes, some of the scenarios in the withdrawn QWBAs have not been updated.[3]
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 with the Parliamentary contemplation test.[4] The Supreme Court confirmed the Parliamentary contemplation test as the proper and authoritative approach to applying s BG 1 in *Penny* and *Frucor*.[5]
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?[6]
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.

[1] 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).

[2] 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.

[3] This QWBA comprises scenarios 1 and 3 from QB 15/11. Scenario 2 has been updated separately in QB 23/01 "Income tax: scenarios on tax avoidance – 2023 No 1".

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

[5] *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].

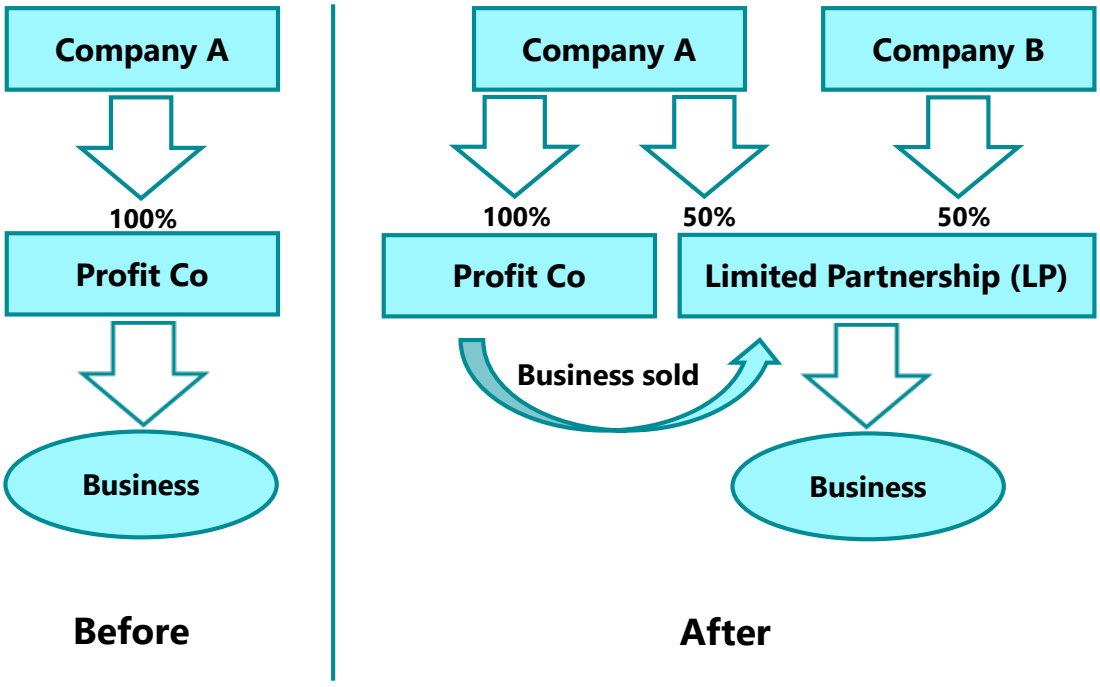
[6] *Ben Nevis* (SC) at [109].

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.[7]
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 — Use of a limited partnership

Question | Pātai

11. Does s BG 1 apply in the following circumstances:
    - There are 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;
    - Companies A and B establish a limited partnership registered under the Limited Partnerships Act 2008 (the LP);
    - 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; and
    - Profit Co sells its business operations to the LP at the open market value of those operations.
12. The following diagram shows the situation before and after the above events:



Answer | Whakautu

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

[7] *Ben Nevis* (SC) at [114].

Explanation | Whakamāramatanga

Introduction

14. 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.
15. Then, ascertain Parliament's purpose for the specific provisions the arrangement uses or circumvents.
16. 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 maybe 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.
17. 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.
18. 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 specific provisions.
19. 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.
20. 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.

21. 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.
22. 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.
23. 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.
24. A lack of consistency under the facts, features or attributes technique may indicate that Parliament's purpose for the specific provisions 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.
25. 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".[8]
26. 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.
27. 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.
28. 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:
    - 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).

[8] At [33].

The arrangement's scope, purposes and tax effects

29. The steps and transactions that make up the arrangement described at [11] are:
    - Companies A and B establish a limited partnership registered under the Limited Partnerships Act 2008 (the LP);
    - Companies A and B make equal contributions to the capital of the partnership and agree to each receiving 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;
    - Company A and Profit Co apply the group company rules of subpart IC to their respective tax positions taken for income tax purposes; and
    - Company A and Company B return for income tax purposes a 50% share each of the LP's profits.
30. On the face of it, the arrangement serves the commercial purposes of Company B taking a financial interest in the business of Profit Co.
31. 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; and
    - Company A's ability to group tax losses with Profit Co under subpart IC is unaffected.
32. These tax effects arise under the following specific provisions:
    - s CB 1 (Amounts derived from business)
    - subpart HG (Joint venturers, partners, and partnerships)
    - subpart IA (General rules for tax losses)
    - subpart IC (Grouping tax losses).
33. 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 specific provisions

Business income

34. Parliament contemplates 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* (CA), "[a] gain made in the ordinary course of carrying on the business is thus stamped with an income character".[9]

Losses

35. 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 being dealt with in certain ways. A net loss is dealt with under Part I (Treatment of tax losses) and it may be offset against future income, made available to certain other persons 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).
36. 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). Temporary rules also permit some losses to be carried back to prior years (s IZ 8).[10]

[9] *AA Finance v CIR* (1994) 16 NZTC 11,383 (CA) at 11,391.

[10] The *COVID-19 Response (Taxation and Other Regulatory Urgent Measures) Act* 2020 introduced a temporary loss carry back regime applicable to the 2018-19 and 2019-20 income years.

37. However, Parliament has also provided specific restrictions for companies (s IA 5).[11] 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.
38. 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

39. 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.[12]
40. 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").
41. 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 or attributes

42. 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:
    - 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 (or failing that, the business continuity provisions of subpart IB are met).
    - 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.

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

43. In the Commissioner's opinion, when the arrangement is viewed as a whole and in a commercially and economically realistic way using the factors mentioned at [17], it can be seen that there are real economic consequences to the parties that reflect the arrangement's legal form and there are no indications of tax advantages arising as a result of artificiality or contrivance.

[11] With effect on 1 April 2020, subpart IB provides that in certain situations a tax loss may be carried forward despite a breach of s IA 5 if there is no major change in the nature of the business. For the purposes of this scenario, it is assumed the parties could not rely on the rules in subpart IB.

[12] *New legislation – Taxation (Limited Partnerships) Act 2008*, *Tax Information Bulletin* Vol 20, No 8 (September/October 2008): 4.

44. That is, the reality of the arrangement accords with:
    - Companies A and B contributing equally to the formation of a registered limited partnership from which they return equal shares of income and losses for tax purposes;
    - an arm's-length sale of Profit Co's business to the LP;
    - the LP, and not Profit Co, conducting the business and deriving business income; and
    - no change in the composition of the group of persons holding voting interests in Company A or Profit Co.
45. 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.
46. 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.

Answering the ultimate question

47. 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.
48. As mentioned, viewing the arrangement in this scenario as a whole in a commercially and economically realistic way does not highlight that tax advantages have been obtained by artificiality, contrivance or pretence.
49. The arrangement serves the commercial purposes of Company B taking a financial interest in the business of Profit Co.
50. There is a partnership between Companies A and B registered under the Limited Partnerships Act 2008 which the partners are contributing to and benefiting from equally. Accordingly, Company B's investment through a limited partnership is consistent with Parliament's purposes that limited partnerships are used as investment vehicles.
51. There has been no change in who holds shares in Company A or Profit Co affecting the commonality or continuity of shareholding requirements of the Act. This means 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.
52. 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 [[16], [[23] and [42] above).
53. All the facts, features or attributes mentioned earlier are present in the arrangement as matters of commercial and economic reality, further reinforcing the view that the arrangement does not appear to use or circumvent specific provisions of the Act in a manner outside Parliament's contemplation.
54. 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.
55. However, applying the Parliamentary contemplation test requires determining the commercial and economic reality of the arrangement actually entered into. Establishing tax avoidance does not require identifying some hypothetical alternative arrangement the taxpayer may have entered into (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.

56. In addition, the Supreme Court in *Ben Nevis* 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 contemplated by Parliament, they have freedom to choose how they structure their arrangements.[13] Accordingly, there is no general requirement for the parties in this scenario to adopt an alternative, less tax-favourable, arrangement.
57. 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 a tax avoidance purpose or effect and, without more, s BG 1 would not apply.

Scenario 2 — Use of a discretionary trust

Question | Pātai

58. Does s BG 1 apply in the following circumstances:
    - trustees of a trust pay or vest income in an income year to beneficiaries that are 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;
    - the trust was validly established and the trustees have fully complied with the Trusts Act 2019, 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; and
    - for tax purposes, the trust is classified as a complying trust under s HC 10.

Answer | Whakautu

59. 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 [92] below.

Explanation | Whakamāramatanga

Introduction

60. The Commissioner's approach to applying s BG 1 is set out in scenario 1 at [14] to [28] above.

The arrangement's scope, purposes and tax effects

61. The steps and transactions that make up the arrangement are:
    - The trustees of the trust appointing the beneficiaries.
    - The trustees deriving income and paying or vesting that income to the beneficiaries.
62. On the face of it, the arrangement serves the commercial or private purposes of vesting income in, or paying income to, a beneficiary taking into account the beneficiary's tax position.
63. 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%.
64. 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; and

[13] *Ben Nevis* (SC) at [111] and *Penny* (SC) at [49].

- 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.

65. 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 specific provisions

Beneficiary income

66. 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 (s HC 5). Beneficiary income is taxed at the beneficiary's marginal tax rate. An amount derived by a person is income under s CV 13(a) if it is beneficiary income under s HC 6.

67. In order to be a valid distribution, an amount must be vested or paid in accordance with the terms of the trust. The terms of some trusts may limit the amount of the gross income the trustees can distribute to an amount equal to the net income of the trust. Otherwise, if it is permitted, a trustee could distribute all the gross income meaning any expenditure incurred has to be paid out of other sources (previous income, capital or corpus) and possibly lead to the trustee incurring a tax loss.

68. Also, if an amount of income derived by a trustee is of a particular character (eg, interest income), the income will retain this character in the hands of the beneficiary when the amount becomes beneficiary income. Similarly, if an amount of income has a source in New Zealand it will have the same source in the hands of the beneficiary when the amount becomes beneficiary income.

69. Under s HC 6, for income to be treated 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).

70. 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).

71. Beneficiary income is discussed in Part 5 of the Commissioner's Interpretation Statement IS 18/01.[14] IS 18/01 makes the following additional points concerning beneficiary income:
    - the amount vested or paid can take the form of money or money's worth;
    - the exact amount vested or paid need not be specified at the time as long as the amount can be calculated when the assessment of income is made for the income year;
    - where an amount is future property or an expectancy, the vesting or payment will not be effective until the amount is received or receivable;
    - an amount may vest in a beneficiary as a result of a clause in a trust deed or as a result of the exercise of a discretion given to a trustee to allocate an amount to a beneficiary;
    - an amount will vest in a beneficiary only if the beneficiary is given an indefeasible right to the amount (ie, the trustee cannot later change their mind and decide not to give the amount to the beneficiary);
    - on vesting, a beneficiary obtains an absolute interest in the amount vested. The interest can be a right to present or future possession of the amount;
    - even if there is a right to present possession, the trustee may hold the amount until the beneficiary demands it;[15]
    - the vesting cannot be subject to a condition being met or an event occurring;
    - beneficiary income will be paid to a beneficiary either when it is distributed to the beneficiary; credited to the beneficiary or is dealt with in their interest or on their behalf in some other way;

[14] IS 18/01: *Taxation of trusts – Income tax*, *Tax Information Bulletin* Vol 30, No 7 (August 2018): 17.

[15] Note, that since IS 18/01 was published it has been accepted that the income tax law around whether a beneficiary who leaves distributions in a trust is considered a settlor of the trust has been unclear (see *Commissioner's Operational Position – New section HC 27(6) – treatment of beneficiary as a settlor in certain circumstances*, *Tax Information Bulletin* Vol 31, No 8 (September 2019): 113. From 1 April 2020, s HC 27(6) provides that a beneficiary is not a settlor of the trust solely as a result of being owed money by a trustee if the amount owing is not more than $25,000 or the trustee pays market rate interest on the amount.

- making a loan to a beneficiary will not constitute payment of beneficiary income because of the obligation to repay the loan amount; and
- where a beneficiary has a discretionary interest in income, it is necessary for the trustee to pass a resolution that initiates the making of a payment to that beneficiary.

72. Section GB 22 is a specific anti-avoidance provision applying to situations where a trustee enters into an arrangement to defeat the intent and application of the rules relating to beneficiary income and taxable distributions. However, the existence of a specific anti-avoidance provision does not preclude the application of s BG 1.[16]

73. The phrase used in the legislation for beneficiary income that "vests absolutely in interest" is discussed in more detail in the Commissioner's Interpretation Statement IS 12/02.[17]

Discretionary trusts and allocating beneficiary income

74. 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 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 trustees in terms of amounts allocated to beneficiaries.

75. For example, where beneficiary income includes imputation 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 deterred 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.

76. 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* made it clear that the beneficiaries of a discretionary trust have no proprietary interest in the trust property or its income.[18] 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.

77. *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 Trusts Act 2019, the trust deed and general trust law.

78. Parliament's purposes for trustee income and beneficiary income can be found in a combination of the Trusts Act 2019, general trust law, Part B and subpart HC of the Act. From this, it can be concluded that neither the Trusts Act 2019, 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.

79. 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.

[16] *Penny* (SC) at [48].

[17] 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.

[18] *Gartside v IRC* [1968] 1 All ER 121 (HL).

Facts, features or attributes

80. 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 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.

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

81. In the Commissioner's opinion, when the arrangement is viewed as a whole and in a commercially and economically realistic way using the factors mentioned at [17], it can be seen that the arrangement's commercial and economic reality is consistent with its legal form and tax advantages do not arise as a result of artificiality or contrivance.
82. That is, in reality, there is in this scenario a validly established trust. The distributions of beneficiary income have been undertaken in compliance with the Trusts Act 2019, the trust deed, general trust law requirements and subpart HC of the Act. 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.

Answering the ultimate question

83. 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.
84. As mentioned, viewing the arrangement in this scenario as a whole, in a commercially and economically realistic way does not indicate tax advantages have been obtained by artificiality, contrivance or pretence.
85. As stated, in the arrangement for 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. 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.
86. The arrangement serves the commercial or private purposes of vesting income in, or paying income to, a beneficiary taking into account the beneficiary's tax position. In short, the arrangement achieves the usual purposes of a discretionary trust.
87. 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 [16], [23] and [80] above).
88. All these facts, features or attributes are present in the arrangement as matters of commercial and economic reality, further reinforcing the view that the arrangement does not appear to use or circumvent specific provisions of the Act in a manner outside Parliament's contemplation.
89. 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.

90. The Commissioner considers this is the correct conclusion despite the 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 consistent with what Parliament would have contemplated.[19] Where the use of the provisions is outside what Parliament would have contemplated for them it is appropriate for s BG 1 to apply.

91. 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 has a tax avoidance purpose or effect in the first instance. Note that, prior to *Ben Nevis* (SC), Richardson J recognised this for trusts in *Challenge Corporation* (CA):[20]

> … 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.

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 to. 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 and this may be because of artificial or contrived elements or steps in the arrangement or the use of pretence.

94. That is, where it is arguable whether, in commercial or economic reality:
    - the beneficiary is a beneficiary of the trust, or
    - a distribution of income was made to the beneficiary.

95. 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; and
    - 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.

96. However, 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 to.[21]

97. Although argued under provisions other than the trust rules, *Krukziener (No 3)* is an example of where, in the context of s BG 1, a court clearly considered that the use and benefit of income distributed by trustees was enjoyed by a person other than the beneficiaries nominated to receive the distributions.[22]

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

99. 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.

[19] At [111].

[20] *CIR v Challenge Corporation Ltd* [1986] 2 NZLR 513 (CA) at 548–549.

[21] However, see footnote 16 regarding s HC 27 and the potential for a beneficiary to be treated as a settlor of the trust.

[22] *Krukziener v CIR (No 3)* (2010) 24 NZTC 24,563 (HC).

References | Tohutoro

Legislative References | Tohutoro whakatureture

COVID-19 Response (Taxation and Other Regulatory Urgent Measures) Act 2020

Income Tax Act 2007: ss BC 4, BC 5, BG 1, CB 1, CV 13(a), CW 9, GA 1, GB 22, HC 6, HC 10, HG 2 to HG 11, subparts IA, IB and IC, IA 2, IA 4, IA 5, IB 3, IZ 8, LE 5, YA 1

Limited Partnerships Act 2008

Trusts Act 2019

Case References | Tohutoro kēhi

AA Finance v CIR (1994) 16 NZTC 11,383 (CA)

Ben Nevis Forestry Ventures Ltd v CIR [2008] NZSC 115, [2009] 2 NZLR 289

CIR v Challenge Corporation Ltd [1986] 2 NZLR 513 (CA)

Frucor Suntory New Zealand Ltd v CIR [2022] NZSC 113

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TECHNICAL DECISION SUMMARIES

Technical decision summaries (TDS) are summaries of technical decisions made by the Tax Counsel Office. As this is a summary of the original technical decision, it may not contain all the facts or assumptions relevant to that decision. A TDS is made available for information only and is not advice, guidance or a "Commissioner's official opinion" (as defined in s 3(1) of the Tax Administration Act 1994). **You cannot rely on this document as setting out the Commissioner's position more generally or in relation to your own circumstances or tax affairs**. It is not binding and provides you with no protection (including from underpaid tax, penalty or interest).

TDS 22/22: Income tax: Is the Taxpayer entitled to a partial write-off of their final tax liability?

Technical decision summary – Adjudication

Decision date | Te Rā o te Whakatau: 21 July 2022

Issue date | Te Rā Tuku: 6 December 2022

Subjects | Ngā kaupapa

Is the Taxpayer entitled to a partial write-off of their final tax liability?

Abbreviations | Whakapotonga kupu

The abbreviations used in this document include:

CCS	Customer & Compliance Services, Inland Revenue
Commissioner	Commissioner of Inland Revenue
RIT	Residual income tax
SOP	Statement of Position
TAA	Tax Administration Act 1994

Taxation laws | Ngā ture tāke

All legislative references are to the Tax Administration Act 1994 (**TAA**) unless stated otherwise.

Facts | Ngā meka

1. The Taxpayer was an individual and was paid fortnightly. During the year in dispute there were 27 fortnightly paydays.
2. The PAYE tables for fortnightly pay periods calculate PAYE on the basis that there are 26 paydays during a tax year. On the odd occasion when there are 27 fortnightly paydays during a tax year, the (correct) use of the PAYE tables causes insufficient PAYE to be deducted for that year. In this summary the Taxpayer's 27th fortnightly pay is referred to as the extra pay or the extra pay period, as the context requires.
3. Section 22J provides for a write-off of the tax that relates to an extra pay under certain circumstances. The requirements for an amount of tax arising from an extra pay period to be written off under s 22J are contained in cl 1(c) of schedule 8, part B.[1]

[1] See [12] below.

4. The Taxpayer was assessed with residual income tax (**RIT**) of $450 for the year in dispute. The parties agreed that, of the RIT amount:
   - $350 was attributable to the extra pay, and
   - $100 related to a lump sum received by the Taxpayer during the year.
5. In addition, the Taxpayer:
   - was not entitled to working for families tax credits during the year in dispute, and
   - did not change tax code during the year or use a tailored tax code.
6. The Taxpayer claimed that $350 of the income tax assessment should be written off under s 22J because it solely related to the extra pay. CCS argued that the Taxpayer was not entitled to a write-off at all because:
   - s 22J only applies to a person's entire final tax liability, not a part of their final tax liability, and
   - the parties agreed that the Taxpayer's final tax liability was a composite amount caused by the extra pay and the lump sum.
7. In addition, the Commissioner has adopted a write-off threshold amount for fortnightly extra pays. If the final tax liability amount is more than the threshold then CCS will not write the tax off. The Taxpayer's RIT was more than the threshold amount. The Taxpayer argued that this was an extra-statutory threshold which was not stipulated in s 22J (or schedule 8).

Issues | Ngā take

8. In deciding whether the Taxpayer was entitled to a partial write-off of their final tax liability, the Tax Counsel Office considered the following issues:
   - Interpretation of the words "amount of tax":
     - How should the words "amount of tax" in clause 1(c) of schedule 8, part B, be interpreted?
     - If the "amount of tax" referred to in clause 1(c) is the taxpayer's final tax, is it correct to write off the part of the "amount of tax" that arises solely because of an extra pay period, even though part of the "amount of tax" arises for some other reason?
   - Is the Commissioner's use of a monetary threshold permissible in the circumstances?

Decisions | Ngā whakatau

9. The Tax Counsel Office decided that none of the Taxpayer's final tax liability could be written off under s 22J and clause 1(c) of schedule 8, part B.

Reasons for decisions | Ngā take mō ngā whakatau

Issue 1 | Take tuatahi: Interpretation of the words "amount of tax"

10. The TAA makes provision for an "amount of tax" that arises solely because of an extra pay period to be written off. The relevant provisions are s 22J(1) and clause 1(c) of schedule 8, part B.
11. Section 22J(1) provides as follows:

    When amounts written off

    (1) For the purposes of this subpart, the Commissioner may write off **an amount of tax payable by a qualifying individual** for a tax year if the requirements of schedule 8, part B are met. [Emphasis added]

12. Clause 1(c) of schedule 8, part B sets out the requirements for an amount of tax arising from an extra pay period to be written off under s 22J:

    Writing off certain amounts of tax payable

    Subject to clause 2, the Commissioner must write off the following amounts under section 22J:

    ....

    (c) an **amount of tax relating to the income of an individual for a tax year that arises solely because the individual has an extra pay period** in the corresponding income year, ... [Emphasis added]

13. The parties accepted that the provisions were ambiguous and that it was possible to interpret the "amount of tax" as meaning either:
    - Taxpayer argument: An *identifiable portion* of an overall final tax liability where that portion arises solely because of an extra pay period (ie, a partial write-off was permissible).
    - CCS argument: The *full amount* of an overall final tax liability where the full amount arises solely because of the extra pay period (ie, a partial write-off was not possible).
14. To establish the correct interpretation the Tax Counsel Office analysed (among other things) the following subjects:
    - Principles of statutory interpretation.
    - Plain and ordinary meaning of "amount of tax" in s 22J and clause 1(c) of schedule 8, part B.
    - Purpose of s 22J and clause 1(c) of schedule 8, part B.

Principles of statutory interpretation

15. Section 10 of the Legislation Act 2019 (previously s 5 of the Interpretation Act 1999) is the starting point for all statutory interpretation.[2] The requirements of s 5(1) of the Interpretation Act 1999 were examined by the Supreme Court in *Fonterra*.[3]
16. The Tax Counsel Office noted that *Fonterra* makes it clear that legislation is to be interpreted in the following way:
    - the statutory text be considered in isolation of purpose to determine its plain and ordinary meaning or meanings
    - the meaning, or possible meanings, of the text must then be crossed-checked against the purpose of the legislation
    - in determining purpose, regard must be had to both the immediate and general legislative context; it may also be relevant to consider the social, commercial or other objectives of the legislation.
17. The Tax Counsel Office also noted that s 10(4) of the Legislation Act 2019 states that the text of the legislation includes preambles, a table of contents, headings, diagrams, graphics, examples and explanatory material, and the organisation and format of the legislation.

Plain and ordinary meaning of "amount of tax" in s 22J and clause 1(c) of schedule 8, part B

18. The first step taken by the Tax Counsel Office was to consider the statutory text in isolation of purpose to determine its plain and ordinary meaning or meanings.
19. Following analysis of *Fonterra*, s 22J and clause 1(c), the Tax Counsel Office considered the plain and ordinary meaning was unclear. This was because:
    - the word "an" amount of tax was used instead of "the" amount of tax
    - as accepted by the parties, it was possible to interpret the "amount of tax" as meaning either:
        - any part of the individual's final tax that arises solely because of the extra pay, or
        - the individual's final tax, where the full amount of the final tax arises solely because of the extra pay period, and
    - the wording of s 22J and clause 1(c) did not mirror each other.

Purpose of s 22J and clause 1(c) of schedule 8, part B

20. The next step was for the meaning, or possible meanings, of the text to be crossed-checked in the light of any discernible purpose of the legislation.
21. The Tax Counsel Office considers the following factors inform the purpose of s 22J:
    - The Taxation (Annual Rates for 2018–19, Modernising Tax Administration, and Remedial Matters) Act 2019 contains a statement to the effect that most people would pay what they needed to and get what they are entitled to during the year without having to do anything.
    - Subpart 3B provides the administrative settings that underpin an individual's obligations to calculate and satisfy their income tax liability for a tax year.
    - The purpose of s 22J is to mandate the write-off of an amount of tax payable by a qualifying individual for a tax year. In the context of automatically finalising a taxpayer's account after the end of an income year without the taxpayer

[2] It was noted that s 10 of the Legislation Act 2019 is substantially the same as s 5 of the Interpretation Act 1999.

[3] *Commerce Commission v Fonterra Co-operative Group Ltd* [2007] NZSC 36; [2007] 3 NZLR 767 (SC).

having to do anything, the Tax Counsel Office considers the amount of tax in question must be the whole of a person's final tax liability.

- Further, viewing s 22J in its context, the following matters were relevant:
  - *The timing of when s 22J applies* – The write-off provisions apply when an amount is owing after the Commissioner has finalised a person's account and an assessment has been made. The Commissioner finalises an account and makes an assessment on the basis of the information in the Commissioner's possession.
  - *Consistency with s 22I* - Section 22I provides that when the Commissioner finalises a person's account they are treated as having filed a tax return and having made a self-assessment. The flowchart for s 22I indicates that the person would either have tax to pay or a write-off. There is no middle ground (ie, the flowchart does not indicate that a write-off of part of the tax to pay could occur, and a remainder still be payable).
  - *Section 22J does not contemplate a refund* - The write-off provisions do not contemplate that a person who qualifies for a write-off will become entitled to a refund as a result of the write-off being made. The flowchart for s 22J does not contemplate that any taxpayer will be entitled to a refund after a write-off has occurred. There are only two possible outcomes that can arise as a result of working through the flowchart. That is, there is either a write-off of the individual's balance, or the individual has tax to pay.
  - *Tax payable for a tax year* - Section 22J gives the Commissioner a mandate to write off "tax payable by a qualifying individual for a tax year". The Tax Counsel Office considers that the words "tax payable … for a tax year", more correctly refer to a taxpayer's final tax for a tax year rather than tax that relates to a portion of the income that the taxpayer earned during the tax year.
  - *No clear language of apportionment* - Clause 1(c) does not contain any clear language of apportionment. For instance, clause 1(c) does not say that an amount of tax must be written off "to the extent" it arises solely because of an extra pay period. If the legislature intended to make provision for partial write-offs, clear language to that effect could have been used.

22. In the context of automatically finalising a taxpayer's account after the end of an income year without the taxpayer having to do anything, the Tax Counsel Office concluded that the amount of tax in dispute must be the whole of a person's final tax liability and not a part of the liability. Accordingly, in order to qualify for a write-off under s 22J and clause 1(c), the full amount of a person's final tax liability must arise solely because of an extra pay period.

Conclusion

23. In accordance with the decision in *Fonterra*, it was considered by the Tax Counsel Office that the correct interpretation of the words "amount of tax" in s 22J and clause 1(c) was that they described the full amount of a person's final tax liability for a tax year and not a part of the liability. Therefore, since the Taxpayer's final tax liability for the year was a composite amount (ie, not all of the Taxpayer's final tax liability arose solely because of an extra pay period), the Tax Counsel Office concluded that none of the Taxpayer's final tax liability for the year could be automatically written off under s 22J and clause 1(c).[4]

Issue 2 | Take tuarua: The Commissioner's use of a monetary threshold

24. The issue was whether the Commissioner's use of monetary thresholds was permissible in the circumstances.

25. CCS raised the application of ss 6 and 6A in support of its view that the extra pay period thresholds were administrative in nature and were adopted to assist the Commissioner in administering s 22J.

Section 6

26. Section 6(1) obliges the Commissioner, along with all other officers of Inland Revenue, to use "best endeavours" to protect the "integrity of the tax system". This obligation must be discharged "at all times". The words "in relation to the collection of the taxes and other functions under the Inland Revenue Acts" indicate that this obligation must be discharged by the Commissioner in all aspects of the operation of the tax system.

[4] While not authoritive in relation to the interpretation of the relevant legislation, the Tax Counsel Office noted the analysis and overall conclusions were consistent with the commentary and guidance published by the Commissioner shortly after the Taxation (Annual Rates for 2018–19, Modernising Tax Administration, and Remedial Matters) Act 2019 was enacted - see *Tax Information Bulletin* Vol 31 No 4 May 2019.

27. Section 6(2) lists the factors that comprise the term "integrity of the tax system". The factors listed in s 6(2) are fundamental principles in tax law.[5] In providing that it applies "without limiting its meaning", s 6(2) indicates that the list of factors is not exhaustive. The listed factors indicate that the term "integrity of the tax system" is a multifaceted concept. Some factors may be more important or relevant than others, whether generally or in particular circumstances. There may be potential for conflict between particular factors (see *Westpac & ANZ National Bank*).
28. The Tax Counsel Office noted that s 6 refers to the rights of taxpayers to have their liability determined fairly, impartially and according to law. It also refers to the responsibilities of those administering the law to do so fairly, impartially and according to law.

Section 6A

29. Section 6A was enacted to provide legislative recognition of the Commissioner's need to manage and allocate resources according to their best use. Section 6A provides the framework within which the Commissioner administers the tax system, by providing guidance on how to manage and allocate resources while ensuring that the integrity of the tax system is protected.
30. The Commissioner is responsible for the "care and management of the taxes covered by the Inland Revenue Acts". The phrase "care and management" is not defined in the TAA and has not been given any detailed consideration by the courts.
31. The Tax Counsel Office considered that the words "care and management of the taxes covered by the Inland Revenue Acts" meant that the Commissioner was responsible for administering the tax system by carrying out the functions with which they were charged. The phrase "care and management" indicated that the Commissioner was to carry out those functions in a manner that fostered the integrity and effective functioning of the tax system.
32. The practical implications of the Commissioner's "care and management" responsibility were discussed in *Fairbrother v CIR*.[6] In *Fairbrother*, the Commissioner submitted that outside the relief and remission provisions, they could not agree to accept less tax from taxpayers than they considered due. Justice Young noted the similarity between s 6A(3) and the obligation imposed by the United Kingdom's "care and management" provision. Justice Young considered that s 6A amounted to "statutory ratification" of the House of Lords' approach in the *Fleet Street Casuals* case.[7] Justice Young stated that s 6A authorised the Commissioner to act outside the "four corners" of the relief and remission provisions. Justice Young held that the Commissioner was not under "an absolute obligation to collect the right amount of tax" in the absence of explicit contrary statutory direction. Consequently, the Commissioner can lawfully decide to collect *less tax* than otherwise required by the Inland Revenue Acts.
33. The Tax Counsel Office concluded that the courts have interpreted ss 6 and 6A as meaning the Commissioner is not under "an absolute obligation to collect the right amount of tax" in the absence of explicit contrary statutory direction. The Commissioner can lawfully decide to collect *less tax* than otherwise required by the Inland Revenue Acts (*Fairbrother v CIR*, *Fleet Street Casuals*).

Summary of ss 6 and 6A

34. The main principles from ss 6 and 6A are:
    - Section 6(1) obliges the Commissioner to use "best endeavours" to protect the "integrity of the tax system". The words "in relation to the collection of the taxes and other functions under the Inland Revenue Acts" indicate that this obligation must be discharged by the Commissioner in all aspects of the operation of the tax system.
    - The Commissioner is responsible for the "care and management of the taxes covered by the Inland Revenue Acts" under s 6A. The phrase "care and management" recognises that the Commissioner must operate the tax system within the limited resources provided by Parliament.
35. The courts have interpreted ss 6 and 6A as meaning the Commissioner is not under "an absolute obligation to collect the right amount of tax" in the absence of explicit contrary statutory direction. The Commissioner can lawfully decide to collect *less tax* than otherwise required by the Inland Revenue Acts (*Fairbrother v CIR*, *Fleet Street Casuals*).

[5] *Westpac Banking Corporation Limited v CIR & Ors; ANZ National Bank Limited & Ors v CIR* (2008) 23 NZTC 21.

[6] *Fairbrother v CIR* (2000) 19 NZTC 15,548.

[7] *IRC v National Federation of Self-Employed and Small Businesses Ltd* [1982] AC 617 (also known as the *Fleet Street Casuals* case). The Tax Counsel Office noted that in *Fleet Street Casuals*, the House of Lords held that the United Kingdom "care and management" provision authorised the Revenue to agree not to investigate past years' tax of Fleet Street casual workers in return for those workers registering with the Revenue and complying with their future obligations.

Application to the facts

36. The issue was whether the Commissioner's use of monetary thresholds was permissible in the circumstances.

37. The Tax Counsel Office noted that the parties were in general agreement about how the thresholds had been calculated. That is, the thresholds represented the maximum amount that could be attributable to having an extra pay period during the relevant tax year plus a small margin "to account for rounding errors".

38. The purpose of subpart 3B as it relates to individuals is to ensure that most people pay what they need to and get what they are entitled to during the year without having to do anything. Consistent with that purpose, the Commissioner has:
    - Automated the end of year process for the vast majority of individual taxpayers (ie, administrative actions take place without human interaction).
    - Removed the need for individual consideration of any particular taxpayer's circumstances in most cases, and dramatically reduced that need overall.
    - This includes write-off of the following under schedule 8 of part B:
        - final tax amounts of $50 or less in certain circumstances for qualifying individuals under cls 1(a), (ab) and (ac)
        - final tax amounts relating to reportable income that is derived for a tax year by an individual solely from certain benefits under cl 1(b), and
        - relevantly, in this case, final tax amounts relating to the income of an individual for a tax year where that final tax amount arises solely because the individual has an extra pay period in the corresponding income year under cl 1(c).

39. In the case of thresholds and extra pay periods, and in keeping with the purposes of subpart 3B (ie, automation):
    - the Commissioner adopts administrative thresholds for taxpayers who have an extra pay period,
    - the Commissioner is aware that some taxpayers who have a composite amount would benefit because their tax would be written off when they would not be entitled to a write off under the correct statutory interpretation of s 22J and cl 1(c),[8] but
    - only a relatively small number of such taxpayers are likely to be affected, and
    - importantly, all taxpayers who only have an extra pay period (and nothing else that causes the PAYE tables to deduct too little tax) will have their tax written off automatically as part of the "end-of-year refunds or bills to pay" process.

40. In accordance with *Fairbrother and Fleet Street Casuals*, the Commissioner can lawfully decide to adopt an administrative threshold so long as it results in the Commissioner collecting *less tax* than would otherwise be required under the correct statutory interpretation. For completeness, the Tax Counsel Office noted that writing off too much tax is collecting *less tax* than would otherwise be required.

41. The Tax Counsel Office considered that having a threshold (which incorporates a small margin) to facilitate:
    - the automation of the process, and
    - the efficient management of the tax assessment and collection process

    was permissible. But it was an administrative action and did not alter the correct interpretation of the provisions (as concluded in issue 1 above).

42. Individuals, like the Taxpayer, who had two or more amounts of income that cause the PAYE tables to deduct too little tax (ie, extra pay and lump sum), would not get an automatic write off if their final tax amount was more than the threshold. This was an example of the lawful inconsistency that was permitted under ss 6 and 6A. In other words, it was not that the law was being incorrectly applied to the Taxpayer, rather it was that the Commissioner could lawfully choose not to enforce the law against the concessionary class of taxpayers:
    - whose final tax liability for a tax year was less than the threshold
    - who had an extra pay period, and
    - who also received another source of income tax that caused the PAYE tables to deduct too little tax.

Conclusion

43. The Tax Counsel Office concluded that none of the Taxpayer's final tax liability could be written off under s 22J and cl 1(c) for the year in dispute.

[8] See the conclusion to Issue 1 above.