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Our ref: BG 1 Draft – KPMG Submission

Inland Revenue
Public Consultation
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BG 1 Draft – KPMG Submission

Dear Sir/Madam

We welcome the opportunity to comment on the draft interpretation statement.

We understand the draft updates Inland Revenue's position from IS 13/01. It reflects its current approach to the interpretation and application of BG 1. It is however expected to be a consolidation of its position rather than a change. This is reflected in the draft QWBA's released with the draft statement.

We have approached the draft from that perspective – how readable and useful is it for advisors when considering the application of BG 1?

We have included in Appendix 1 comments on the interaction of BG 1 with DTAs. We have also included an annotated draft with further comments. The approach we have taken is to respond to the particular statements made. We have particularly focussed on apparent inconsistencies and contradictions. We are mindful of the Courts view that principles derived from the cases may be no more than "judicial glosses". In our view, although the draft does a valiant job of distilling principles, the contradictions and lack of coherence make that task difficult.

The issue of the draft has also caused us to reconsider what *Ben Nevis* means. This reconsideration is at Appendix 2. The Appendix includes commentary, analysis and a series of propositions which we consider are important for a finalised statement to address.

For us an important proposition is that any approach to the interpretation of BG 1 must be capable of explaining why most arrangements are not subject to it. It is not sufficient for the approach to explain why it applies to some arrangements.

Notably, the draft does not explain why the *Peterson* arrangements were not tax avoidance. This also leads to the question of did the Supreme Court inadvertently overrule the Privy Council in this and other decisions. (It appears to us that this is what the Supreme Court did but we consider the Commissioner should explain her view on that question.)

By contrast, there is little analysis of *Ben Nevis No 2*. Although it is a very short and, in many respects, unsatisfactory judgment, it is an application of *Ben Nevis.* Although some of our analysis can only be characterised as speculative, the Commissioner's view and analysis may assist taxpayers with the principles for interpreting BG 1.

Given that BG 1 is most often illuminated, or not, through litigation, we have copied Crown Law with our response. It should illustrate the difficulty that taxpayers and advisors have with the cases.

As always, we are happy to discuss our response. We can be contacted on 04 815 4518 or 09 367 5940.

Yours sincerely

John Cantin
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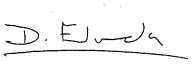

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APPENDIX 1

Interaction between section BG 1 and DTAs

The Commissioner's view is that the order of the application of s BG 1 and a DTA to an arrangement depends on the specific provisions used. She further states that DTA articles are effectively treated as specific provisions of the Act, referring to the Court of Appeal decision *CIR v Lin* [2018] NZCA 38.

This comment raises the question regarding how DTA provisions will be interpreted in a section BG 1 context. By referring to the *Lin* decision and stating that the DTA articles should be treated as "specific provisions of the Act", the implication is that the Commissioner's view is that a literal "textual" approach to DTA interpretation is appropriate.[1]

In *Lin*, the Court effectively stated that DTAs are to be interpreted according to the same principles as apply to private contractual instruments and that each DTA "must be construed discretely, in accordance with its own particular terms."

However, as has been pointed out by a number of commentators, the Court of Appeal's approach in *Lin* differs from that applied in earlier New Zealand decisions and by international courts when interpreting international instruments such as DTAs and other tax treaties. These earlier New Zealand decisions and international decisions have preferred a purposive approach to DTA interpretation, recognising that tax treaties are not akin to private contracts (the approach taken in *Lin*). Further, these cases have also recognised that the process for agreeing the text of a DTA differs from the process for statute law, meaning that the same approach to interpretation is not generally appropriate.

As you will also know, previously, the Court of Appeal (in a precedent applied by the High Court in the *Lin* case, but not referred to in the Court of Appeal judgment) has held that the interpretation of DTA's "should not be rigidly controlled by domestic precedents of an antecedent date, but rather that the language of the rules should be construed on broad principles of general acceptation" (see CIR *v JFP Energy* [1990] 3 NZLR 536 at 540). Given the equivalent status of the two decisions (both being made by the Court of Appeal), we consider there is some doubt as to whether the approach outlined in *Lin* is correct.

In addition, we note that a literal approach to applying DTA provisions per *Lin* would also seem to contradict the broader, more purposive approach, outlined for the application of section BG 1.

We consider the Commissioner's view on the interpretation of DTA provisions needs to be reconsidered, in light of the above uncertainties.

Further, and possibly as a result, the Commissioner's draft is unclear on how the interaction works. We consider there should be separate statements depending on what is the tax effect at issue. In other words, there are two questions:

1. Can a DTA prevent BG 1 applying when the Commissioner considers BG 1 applies?
2. Can the Commissioner apply BG 1 when she considers a DTA is being "misused"?

Answering those two questions separately should help with understanding the Commissioner's position. We note from the draft that the Commissioner's answers are No and Yes to these questions.

[1] The Commissioner has also referred to Lin in her recent draft issues paper on *Trusts and the Australian-New Zealand Double Tax Agreement (IRRUIP15*, 18 December 2020, para 8).

Responses to the draft

We have in the attached added comments and questions on the draft. Given the time available, we have not developed our own detailed summary of what *Ben Nevis* means. Further, we have not ensured that all the comments are consistent (and not contradictory) or that comments are made whenever a same or similar comment could be made.

The responses refer to Appendix 2 of our submission which follows. As with the other comments, Appendix 2 may also apply to other parts of the statement.

APPENDIX 2

This appendix summarises the results of our review. It does not generally provide a detailed analysis or references to cases and the draft. This is due to the limited time available for responding (compared to the three or so years for the development of this draft, we have limited time to respond.) We have also assumed that a reader of our response will be familiar with the cases referred to and their citations.

Introductory comments

As well as considering the draft and the decisions, we have also considered the transcript of the *Ben Nevis* Supreme Court hearing. Some of our comments and questions arise from a consideration of that transcript.

At the outset, we note, with respect, how little the judges seemed to understand the financial arrangements rules and the accrual expenditure rules. The concepts and their interaction are complex. However, in the context of a parliamentary contemplation test, understanding how these regimes work is critical.

The potential lack of understanding means that the judges struggle to explain the commercial and tax effects of the arrangement and steps taken. In our view, it is critical that Inland Revenue and Crown Law and the taxpayer are able to properly articulate the tax regimes for the benefit of the judges.

We consider this further in subsequent comments. However, when discussing alternatives as available arguments, we note the potential for taxpayers to put their position in "jeopardy". This provides a constraint on what taxpayers do argue.

What did the Supreme Court do in Ben Nevis?

The *Ben Nevis* decision was eagerly awaited for what it said about prior cases. Was the decision a continuation of those cases or a departure? The draft statement proceeds on the basis that the decision is **the** word on BG 1. This implies that the Supreme Court overruled Privy Council decisions.

We consider whether that is what was done and conclude this was not done explicitly.

Did the Supreme Court overrule the Privy Council in Peterson?

In *Susan Couch v The Attorney General* SC 49/2006 [2010] NZSC 27, McGrath J stated:

> *It follows that, in order for the Crown's application to succeed, this Court must reconsider and overrule the ratio of the Privy Council's judgment. This raises for the first time the issue of when the Court should reconsider judgments on New Zealand law of the Privy Council.* [Paragraph 205, p92, emphasis added]

For present purposes, the matter at issue in that case is not relevant. However, it is clear that the Supreme Court not only considered and overruled the Privy Council in this judgement, but went further, noting that it must overrule the Privy Council in order to rule in favour of the Crown.

There are other clear statements in *Couch*, from those supporting the majority decision and those dissenting, that the Supreme Court has the ability to overrule a Privy Council judgment and that it should be slow to do so. (See Blanchard J's decision for example.)

Couch was decided in July 2010 after a March 2009 hearing which followed the December 2008 judgement in *Ben Nevis*. There are two judges in common, Elias CJ and Tipping J. Elias CJ dissented from the Court's decision to overrule the Privy Council. Tipping J concurred.

Implications for Ben Nevis

There is no such explicit statement in *Ben Nevis* that the Supreme Court overruled the Privy Council. Indeed, that is consistent with McGrath J's statement that *Couch* was the first time overruling the Privy Council arose for decision by the Supreme Court.

Accordingly, *Ben Nevis* must be reconciled with *Peterson* and read consistent with the Privy Council's anti-avoidance cases.

We identify *Peterson,* in particular, because it raises similar questions regarding the incurring of expenditure within the Act's contemplation in the context of analogous funding – the deductible expenditure was funded through arrangements where the taxpayer was not at risk).

If the decisions cannot be reconciled, the Supreme Court has inadvertently overruled *Peterson*.

In our view that is it not a good position for the Supreme Court. For the reasons discussed in Blanchard J's decision in *Couch*, overruling a prior decision needs to be done with care and explicitly, and the Supreme Court notes it should be slow to do so. We therefore assume that any overrule is inadvertent rather than deliberate.

Implications for the draft (and original IS)

The draft takes as its starting point that the decision in *Ben Nevis* is new and that previous decisions are largely irrelevant (although previous decisions, except *Peterson*, are included in Appendix 2 to illustrate particular principles).

In our view that must mean the draft takes the view that the Supreme Court has overruled the Privy Council. The Supreme Court in *Couch* states that it has not done so (otherwise *Couch* could not have been the first decision for this to occur.).

Question to answer

We therefore consider that the draft must either reconcile *Ben Nevis* to prior Privy Council decisions or explain why Inland Revenue interprets *Ben Nevis* as overruling *Peterson* (without the Court saying that) and effectively ignoring it in the draft statement. (The reconciliation task should be Inland Revenue's, so we do not explicitly undertake that task. However, our further comments include an attempt an explanation of various decisions in *Ben Nevis* terms.)

Impact on our further analysis

We acknowledge the reality that *Ben Nevis* provides the Supreme Court's view of section BG 1, despite questions remaining about the status of *Peterson* and other Privy Council decisions. Until the Supreme Court further clarifies what it did in *Ben Nevis*, it remains the law in New Zealand (in other words an inadvertent overrule remains an overrule).

For the purposes of our remaining comments on the draft statement, we therefore proceed on the basis that *Ben Nevis* rules the application of section BG 1.

The threshold question

Status of BG 1 – it can always apply?

The status of BG 1 is critical to its application. The cases are in our view clear. Section BG 1 is not subservient to any other provision. It has, as a core provision, equal status and is ever present.

Section BG 1, in theory, must be considered for every arrangement. Accordingly, any principles of interpretation of BG 1 must be equally capable of explaining why section BG 1 does or does not apply to a particular arrangement.

In our view, this has been the law in New Zealand since the Privy Council's decision in *Challenge,* and no court has overturned it. That is, the effect of the *Challenge* decision (that the satisfaction of specific loss grouping anti-avoidance rules still allow BG 1 to apply), means that satisfaction of any other provision of the Act does not prevent BG 1 from applying.

Threshold arguments

Accordingly, "threshold arguments" can only be directed to ensuring that the interpretation of BG 1 must allow some (most) arrangements that are not tax avoidance arrangements within its meaning.

To step this out:

— BG 1 can always apply;

- However, it cannot apply to all arrangements;
- This limitation must be applied through the interpretation and application of BG 1.
- The interpretation of BG 1 must be capable of ensuring that not all arrangements are subject to BG 1.

A threshold argument could be that the answer is so plain that the detail of BG 1 can be ignored. That is an argument that has to rely on the facts and circumstances of the case and the application of BG 1 to those facts. It cannot succeed on the argument that BG 1 cannot apply. As *Penny and Hooper* illustrates, an argument that BG 1 obviously does not apply will always be subject to an actual consideration of whether BG 1 does apply.

Implications for the draft

Given *Challenge*:

- An argument that BG 1 cannot apply because a specific provision is satisfied, cannot succeed;
- The only "threshold" argument that can succeed is equivalent to saying that a proper interpretation and application of BG 1 is that it does not apply.

It would be helpful if the draft approached its interpretation accordingly.

It would also be helpful if a new term was used to describe the available argument as we consider "the threshold question" has been interpreted in different ways. It is therefore unhelpful to apply the term to two possible arguments.

Reconciling scheme and purpose and parliamentary contemplation

As noted in the draft, one interpretation of the "scheme and purpose" approach to applying BG 1 is that it does not apply if a specific anti-avoidance or other provision applies. We consider this narrow approach to applying BG 1 ended with the Privy Council's decision in *Challenge* (see above.) In *Ben Nevis* terms, the Privy Council considered the Court of Appeal did not properly analyse and apply parliamentary contemplation of what parliament expected to allow a loss offset when it focused only on the specific loss anti-avoidance rules.

A broader scheme and purpose approach, which considers the Act's application in the context of the arrangement, is consistent with the parliamentary contemplation test. The *Challenge* decision can be restated in this way:

- Viewed commercially and realistically, the way that the Challenge group incurred a tax loss was not a loss contemplated by parliament.
- The tax effects were not incidental to the way that Challenge incurred the loss, they could only be explained by the tax effects.
- BG 1 applied.

Although the Supreme Court does not explain *Challenge* in this way, as the Court did not in *Ben Nevis* explicitly overrule the Privy Council, the decision needs to be explained and reconciled in *Ben Nevis* terms. We consider the above analysis does that.

Implications for the draft

Whether or not Inland Revenue considers that *Ben Nevis* overrules Privy Council decisions, a reconciliation should be stated in the draft.

Counter-factual versus comparison

We consider that the very nature of BG 1 requires a comparison. A tax avoidance arrangement requires an alteration in tax. The essence of the test is that there must be a difference and

therefore a comparison of the effect of the arrangement to "something" must be done. The question is what is that "something"?

In our view, the Courts do not properly articulate their answer. Their focus is on comparisons they do not accept as relevant. In fact, in many avoidance cases, the relevant comparison is to the taxpayer doing nothing. In other words, the question is what would the tax have been if the taxpayer had not entered the arrangement?

For example, in *Ben Nevis*, the implicit comparison is to if they had not made the forestry investment. A comparison to that position is the taxpayer would have paid more tax (see also below). This is in our view a counter-factual but the Courts, and the draft, state a counter-factual cannot be used to defend the application of BG 1.

Our reading of what the Courts are actually saying

The available counter-factual must be grounded in what was actually done. In this sense, the unavailable counter-factuals are hypotheticals but remain a counter-factual.

For example, in *Ben Nevis*, especially from the transcripts, the Court was concerned with whether the taxpayer could explain why the promissory notes were used (see below for further comment on this). This may be seen as a more direct comparison than the one stated above. It is an alternative view of what comparison was required.

This view is similar to the question in *Alesco*, which was why were the convertible notes, in the form that they were, used? The option of using a plain vanilla loan to fund the acquisition did not explain the use of the convertible notes. They were therefore an unavailable comparison.

Implications for the draft

As with the threshold argument, the term used is important. We consider that BG 1 requires a comparison. That is also properly termed a counter-factual. However, the Court decisions confirm that the comparison must be one grounded in what was done.

We consider the draft should draw out the difference between a comparison and a hypothetical as the best way to give effect to this.

(Note we consider this further when considering reconstruction).

'In the alternative' arguments

Issue 1: failed black letter law arguments

The draft notes that the Commissioner is able to argue both a failure to satisfy a specific provision and that BG 1 applies if the specific provision is satisfied. The cited passages do not support this conclusion.

This is because the cited passages consider the wider effects of an arrangement and whether those effects are susceptible to BG 1 applying. Without BG 1, the cost of funds would have remained deductible. With BG 1, the Commissioner was able to reconstruct so that interest expenditure was non-deductible.

In short, a failure to satisfy a particular provision means that BG 1 can still apply to an arrangement and its wider effects. It is only those wider effects which are at issue under BG1 as the specific expenditure or income which does not satisfy a specific provision is already dealt with under the Act. If there are no wider effects of an arrangement, BG 1 has no work to do (as the arrangement cannot be a tax avoidance arrangement.)

The draft should be amended to correct and explain its conclusions.

Issue 2: alternative - that another specific provision applies

The *Redcliffe* argument that the financial arrangements rules applied to spread the expenditure is an example of another provision that might apply and therefore might provide a different result for BG 1.

It was unfortunately prevented from being advanced in the main *Ben Nevis* judgement and received cursory treatment in the recall *Ben Nevis No 2* judgement.

In brief, the *Redcliffe* argument was that the financial arrangements rules applied to spread the taxpayer's expenditure. Although this would not have allowed as much deductible expenditure in the year, the argument was that this meant that the arrangement was not a tax avoidance one.

The Supreme Court dealt with this argument in two ways:

- It concluded that the taxpayer was unable to raise this argument as it was too late in the disputes process. It was only raised in the Supreme Court.
  - This conclusion ignored the Court of Appeal's 2006 decision in *Zentrum* which was not, per the transcripts, raised either by the taxpayer or the Commissioner. In fact, per the transcripts, the Commissioner argued, despite the Court of Appeal success for the Commissioner's argument, that the taxpayer was not entitled to raise the further argument. We consider this further below.
- In *Ben Nevis No 2*, it said that it would have made no difference to its decision without further explanation. (This is perhaps the most unfortunate Supreme Court decision to date. Its offhanded dismissal of the Redcliffe argument led to many further court appearances for Ben Nevis taxpayers who argued, albeit unsuccessfully, that they still had an ability to dispute. Much court and, therefore taxpayer, money was wasted.) It is therefore difficult to state why the Court considered this was the case. We outline a possible analysis.

The financial arrangement argument is important because, in principle, the financial arrangements and accrual expenditure rules are designed to deal with expenditure which relates to a period of time. If those rules apply then the parliamentary contemplation of how the Act applies and therefore whether BG 1 applies is very much at issue.

As we noted at the outset, from the transcript the judges appeared to struggle with the financial arrangements rules and the accrual expenditure rules. Further, when considering the *Redcliffe* argument, the judges appeared to see the argument as one of fact – what did the taxpayers do?

That is in our view entirely the wrong question, the Redcliffe argument was one of how does the Act apply to the arrangements? This focus appears to be lacking in the oral argument of the taxpayer and the Commissioner (who we expect should have known better as the Commissioner considered and decided not to apply the financial arrangements rules).

The Court's dismissal of the argument may therefore have been because they saw it as a factual argument which the Court could not consider at that stage of the dispute.

However, *Ben Nevis No 2* goes further, it states that:

- If the financial arrangements rules did apply;
- The arrangement would still have failed the parliamentary contemplation test.

That requires some analysis.

The financial arrangements and accrual expenditure rules, if they applied, would likely:

- Have imputed interest on an agreement for sale and purchase of property or services which would be deductible under the interest deductibility tests over the life of the arrangement;
- Spread the insurance premium over the life of the insurance contract.

(We have not reanalysed the *Ben Nevis* arrangements to determine exactly how the *Redcliffe* argument would have applied but consider this outline is sufficient for present purposes. We

note that the Commissioner is in a better position to state exactly how the rules might have applied. The Commissioner considered those rules in detail before instead applying the arguments advanced by *Ben Nevis* in her BG 1 argument.)

This outcome appears consistent with the purpose of the financial arrangements and accrual expenditure rules. Expenditure is deducted in the period to which it relates.

However, the Court, assuming it got this far, stated that was not sufficient – BG 1 still applied.

In our view, the Court concluded that the taxpayers did not "really incur the expenditure" required for the amounts to be deductible. This applies the "commercially and realistic" lens required by the test.

Our reason for stating the conclusion in this way is:

- The arrangement was seen as "funding the premium" but
- as the payment was out of future income (and the taxpayers were protected from a failure of income to be produced), the taxpayers did not pay the expenditure.

The insurance and license payments can be seen to not be "really incurred".

If the Court did overrule the Privy Council in *Peterson,* we think this explains the difference.

- The Privy Council concluded that the *Peterson* expenditure was incurred in such a way as to meet the test for deduction.
- The Supreme Court concluded that the *Ben Nevis* expenditure, viewed in a commercial and realistic way, must be "really incurred" to prevent BG 1 from applying.

Implication for the draft

The draft ignores *Ben Nevis No 2*. The draft should explain *Ben Nevis No 2* as it is an example of the Supreme Court applying BG 1 when a different set of specific provisions apply.

Given the brevity of the decision we acknowledge this may not be easy. However, we consider that it can be explained and further, despite our comments that the Supreme Court itself says, in *Couch*, it has not overruled the Privy Council in its *Ben Nevis* decision, it shows that the Supreme Court has overruled at least the Privy Council's *Ben Nevis* decision.

Zentrum, Ben Nevis No 2 and unstated arguments

In Zentrum the Court of Appeal allowed the Commissioner to advance a sham argument which had not been, per the taxpayer, raised previously. *Zentrum* distinguished *Farnsworth*.

Ben Nevis implied an overrule of *Zentrum*. This is because, if the Commissioner is allowed to raise new arguments so too is the taxpayer. *Ben Nevis* prevented the taxpayer from advancing an argument.

Ben Nevis No 2 retreated from that implied overrule. It did so by concluding that BG 1 applied in any case (on the Redcliffe argument of how the specific provisions applied) and by stating that *Ben Nevis* should not be taken to be the Court's position on *Zentrum*.

Generally, and specifically in a BG 1 context, the Commissioner's position on *Zentrum* is important. This is especially the case as in Zentrum the Commissioner argued that new arguments could be made by her while in *Ben Nevis* she argued that taxpayers could not. This

suggests the Commissioner considers that *Zentrum* was wrongly decided but also that the Commissioner is prepared to argue opposite positions in her favour.

Taxpayers faced with a BG 1 NOPA should know whether the Commissioner will argue that *Zentrum* applies to prevent any future arguments being taken by the taxpayer.

We have not reanalysed *Zentrum* but we recall that, as with *Concepts 124 Ltd,* these decisions did not appear to be consistent with the disputes rules and in particular the evidence exclusion rule.

Implications for the draft

The Commissioner should state her view on *Zentrum*. It is important for taxpayers to know the bounds of the dispute they have with the Commissioner.

We expect the Commissioner to state that this is not a subject for a BG 1 IS. That may be the case.

However, a Commissioner's statement on whether she will follow *Zentrum* (and why) is long overdue. She should issue a draft as soon as possible.

Unstated arguments ("avoiding the battle to lose the war")

When reflecting on the BG 1 cases, there often appear to be unstated explanations.

In *Ben Nevis*, the promissory notes tax effect appears to be that the financial arrangements rules do not apply to the rest of the arrangement (as the relevant expenditure was immediately paid). Colloquially, the promissory notes "avoided" the application of the financial arrangements rules. (As it happens, the Supreme Court was of the view that BG 1 would still have applied).

For many cross-border arrangements, it is the foreign tax effects which are unstated. For example, that foreign transfer pricing rules do not apply. (We note that the hybrid rules are now specific rules which deal with other foreign tax effects.)

Taxpayers appear not to advance these explanations because they place their position at risk. In Ben Nevis, the risk is squarely on BG 1 applying (because the steps are explainable by their tax effect – the financial arrangement rules do not apply). In other situations, because a foreign tax position may be put at risk.

Implications for the draft

We accept that it is not for the Commissioner to advise taxpayers how the arrangement's effects should be described. However, given our comments on *Zentrum* and our comments to follow on reconstruction, we consider it worthwhile the Commissioner noting that a decision on BG 1 is made on the facts. Taxpayers need to put to her the full facts if they are seeking a favourable decision.

Westpac and reconstruction

In *Westpac*, the taxpayer sought to introduce evidence of its cost of funds to show that the Commissioner's reconstruction was incorrect. The court denied that argument apparently on the basis that the Commissioner's reconstruction, based on the facts available to her at the time of the assessment meant the Court was limited in what facts it could consider.

If that is the basis for the decision, it appears to be wrong. The TAA provision used by the Court applies generally, not just to GB 1. If the decision is correct, it has wider ramifications for the court process relating to tax disputes.

For example, it would mean that discovery of taxpayer information is not available. As that information was not available to the Commissioner when the assessment was made, it can be of

no assistance to the Court if the Court can only use the information available to the Commissioner when making the Court's decision.

Despite this apparent contradiction, the Commissioner sought discovery from taxpayers as well as arguing that the further facts could not be used by the taxpayer.

Implications for the draft

The *Westpac* reconstruction decision is not covered in the draft. The Commissioner's position on this important point should be.

Summary

We have covered a number of issues in this Appendix. In summary:

- Tax legislation has some complex regimes. Understanding how they work is critical to the application of BG 1. Inland Revenue and taxpayers need to be able to explain them well to the Courts.
- Either the Supreme Court has not overruled Privy Council decisions, in which case those decisions need to be explained in *Ben Nevis* terms, or it has, in which case, Inland Revenue should explain why it considers that is the case.
- The use of "counter-factual" and "threshold" to label arguments are unhelpful. They should be restated to better reflect what the Courts are actually doing.
- The parliamentary contemplation test is explainable in broad 'scheme and purpose' terms.
- For the Commissioner to argue both a specific provision is not satisfied and BG 1 applies, there must be a wider arrangement. If the only matter at issue is a specific provision, a failure to satisfy that provision means there is no tax avoided.
- The Supreme Court's decision in *Ben Nevis No 2* needs to be explained. Inland Revenue is in the best position to explain that decision.
- Taxpayers should be advised that BG 1 is a factual inquiry so the commercial and other effects of their arrangements and the steps taken are critical. They need to be clear on what they have done and why. Further, unstated explanations cannot be taken into account.
- The Commissioner's position on *Zentrum* and *Westpac* need to be publically stated. The Commissioner's position on both of these appear unprincipled.

Inland Revenue
Te Tari Taake

EXPOSURE DRAFT – FOR COMMENT AND DISCUSSION ONLY

Deadline for comment: 31 March 2021. Please quote reference: PUB00305

INTERPRETATION STATEMENT IS XX/XX

TAX AVOIDANCE AND THE INTERPRETATION OF THE GENERAL ANTI-AVOIDANCE PROVISIONS SECTIONS BG 1 AND GA 1 OF THE INCOME TAX ACT 2007

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

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Part 1 Introduction

About this statement

1.1 This statement explains the Commissioner's view of the law on tax avoidance in New Zealand. It sets out the approach the Commissioner will take to s BG 1, the general anti-avoidance provision in the Income Tax Act 2007, and to s GA 1. Section GA 1 enables the Commissioner to make an adjustment to counteract a tax advantage obtained from or under a tax avoidance arrangement.

1.2 The Supreme Court in *Ben Nevis* settled the approach to the relationship between s BG 1 and the specific provisions in the rest of the Act when the Court set out what is referred to as the Parliamentary contemplation test.[1] The Parliamentary contemplation test was confirmed as the proper approach to applying s BG 1 by the Supreme Court in *Penny.*[2] This statement is based on and reflects the view of the Supreme Court in *Ben Nevis* and *Penny*.

1.3 This statement is also relevant to s 76 of the Goods and Services Tax Act 1985 (the 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 history of the general anti-avoidance provision and a summary of Parts 2 to 10. At the end of Part 1 are two flowcharts. The flow charts summarise the approach taken in this statement to whether s BG 1 applies to an arrangement and the steps to applying s GA 1.

1.5 Part 2 considers the purpose of s BG 1 in light of the Supreme Court decision in *Ben Nevis*. In Part 3, the interpretation and application of the specific provisions is considered. Parts 4 and 5 respectively consider the meanings of "arrangement" and "tax avoidance arrangement".

1.6 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 (which in this statement is referred to as determining its "commercial and economic reality"). The application of s BG 1 is considered in Part 8.

1.7 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.

1.8 There are two appendices to this statement. Appendix 1 sets out the relevant legislation. Appendix 2 provides case law examples relating to the factors considered when viewing the arrangement in a commercially and economically realistic way as discussed in Part 7.

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[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].

Inland Revenue
Te Tari Taake

This statement replaces previous statements

1.9 In February 1990, the Commissioner issued a policy statement on s 99 of the Income Tax Act 1976 (the general anti-avoidance provision).[3] The Commissioner issued a replacement statement (IS 13/01) on 13 June 2013.[4]

1.10 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.

1.11 The following Questions we've been asked (QWBA) are now withdrawn:

- QB 14/11: Income tax – scenarios on tax avoidance[5]
- QB 15/01: Income tax – tax avoidance and debt capitalisation[6]
- QB 15/11: Income tax – scenarios on tax avoidance – 2015.[7]

1.12 The QWBA are withdrawn because legislative changes have made some of the scenarios in them outdated. To the extent the scenarios in the QWBAs continue to have relevance, they have been updated to be consistent with this statement and reissued in QB XX/XX "Income tax: scenarios on tax avoidance – reissue of QB 14/11 scenario 1 and QB 15/11 scenario 2" and QB XX/XX "Income tax: scenarios on tax avoidance – reissue of QB 15/11 – scenarios 1 and 3". Although the scenarios have been updated to reflect the approach set out in this statement, there has been no change in the conclusions reached on each scenario from when they were originally published.

History of the general anti-avoidance provision

1.13 The Supreme Court in *Ben Nevis* briefly referred to the history of the general anti-avoidance provision in New Zealand.[8] The Court noted that a general anti-avoidance provision has been in New Zealand tax legislation since 1878. The provision initially focussed on land tax and was extended to income tax in 1891. The provision was redrafted in 1900, 1908 and 1916 and, without significant change, became s 108 of the Land and Income Tax Act 1954:

> Every contract, agreement, or arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void in so far as, directly or indirectly, it 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.

1.14 Judicial criticisms of s 108 of the Land and Income Tax Act 1954 led to changes being made in 1974.[9] 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;

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

[4] 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.

[5] *Tax Information Bulletin* Vol 26, No 11 (December 2014): 3.

[6] *Tax Information Bulletin* Vol 27, No 3 (April 2015): 25.

[7] *Tax Information Bulletin* Vol 27, No 10 (November 2015): 27.

[8] At [71]–[83].

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

- recast the provision's wording so that a tax avoidance arrangement included an arrangement where one of its purposes was tax avoidance, other than 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.[10]

1.15 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.

1.16 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). However, to the extent that earlier decisions are inconsistent with *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

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

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

1.18 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.

1.19 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));

[10] 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.

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- prevent uses of 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)).[11]

1.20 The Supreme Court in *Ben Nevis* settled 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 purpose of each.
- Neither the specific provisions nor s BG 1 is overriding.
- Specific provisions and s BG 1 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 gives a taxpayer a tax advantage if its use is within its ordinary meaning.
- Section BG 1 is designed to address tax avoidance.

1.21 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.

1.22 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 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).

1.23 The tax avoidance inquiry can involve two tests:

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

1.24 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.

1.25 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.

[11] *Challenge Corporation Ltd v CIR* [1986] 2 NZLR 513 (CA) at 532, as cited in *Penny* (SC) at [47].

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1.26 The Commissioner considers that s BG 1 can also apply to an arrangement that "circumvents" a specific provision.

Part 3: Interpretation and application of specific provisions

1.27 The meaning of a specific provision is "ascertained from its text and in the light of its purpose"[12] (a purposive approach).

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

1.29 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.

1.30 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.[13]

1.31 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.

1.32 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.

1.33 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)[14] of the transactions entered into and the legal steps that are followed.

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[12] Section 5(1) Interpretation Act 1999.

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

[14] 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 the "economic substance" approach used when applying s BG 1.

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1.34 Generally, tax outcomes under specific provisions do not depend on the economic consequences of transactions. However, Parliament may indicate in the specific provision itself, or in the relevant regime, that economic consequences are relevant to the application of the specific provision. In contrast, an economic substance approach is permitted and required when applying s BG 1.

1.35 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.

1.36 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.

1.37 In a dispute, the Commissioner can argue that a specific provision applies or not and, in the alternative, that s BG 1 applies. The Commissioner can also argue that if the court makes certain findings of fact or law that a different specific provision applies (as well as s BG 1, in the alternative).

Part 4: Meaning of "arrangement"

1.38 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".

1.39 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".

1.40 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.

1.41 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".

1.42 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".

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

1.44 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.

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1.45 Parts of an arrangement can be an arrangement under s BG 1 in their own right. However, a part of an arrangement that is not itself an agreement, contract, plan or understanding cannot constitute a separate arrangement.

1.46 The definition of "arrangement" (and "tax avoidance arrangement and s BG 1 itself) contains no extraterritorial limitation. An "arrangement" includes steps and transactions that are entered into, or carried out, outside New Zealand.

Part 5: Meaning of "tax avoidance arrangement"

1.47 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"

1.48 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.

1.49 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.

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

1.51 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.

1.52 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"

1.53 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.

1.54 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.

1.55 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.

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1.56 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"

1.57 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.

1.58 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.

1.59 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 very unlikely to be merely incidental to another purpose.

1.60 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 be a strong evidential factor in deciding whether a tax avoidance purpose follows naturally from a non-tax avoidance purpose.

1.61 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.

1.62 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.

1.63 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 factors.[15]

Part 6: Parliamentary contemplation test

1.64 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").

1.65 If 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 is a permissible tax

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

advantage. If 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.

1.66 The inquiry 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.

1.67 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. 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 use.

1.68 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.

1.69 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.

1.70 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;
- 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 risks; and
- whether the arrangement is pre-tax negative.

The factors are discussed in detail in Part 7.

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

1.72 Whether or not artificiality or contrivance is present, the Commissioner also considers that in some cases it can be useful to consider whether there are any facts, features or attributes that Parliament would contemplate being present (or absent) when permissible tax advantages arise under the specific provisions. If such facts, features or attributes can be identified, their presence or absence in the particular arrangement, when viewed as a whole and in a commercially and economically realistic way, may assist and inform the answer to the "ultimate question". That is, whether the arrangement makes use of, or circumvents, the specific provisions in a manner consistent with Parliament's purpose.

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

1.73 The Supreme Court's decision in *Penny* is important because it illustrates the Court's approach that tax advantages gained through artificial or contrived elements of the arrangement will be outside Parliament's contemplation. In addition, *Penny* (SC) reinforces that applying s BG 1 involves focussing on asking whether the arrangement makes use of, or circumvents, the specific provision in a manner consistent with Parliament's purpose and drawing on the relevant factors, such as artificiality or contrivance, to arrive at an answer.

1.74 *Penny* (SC) also confirms that it is relevant when applying the Parliamentary contemplation test to consider and examine non-tax avoidance purposes or effects of an arrangement.

Part 7: Commercial and economic reality of an arrangement

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

Factors identified by the courts

1.76 Viewing an arrangement in a commercially and economically realistic way can be assisted by considering the factors that the courts have referred to as listed in [1.70].

1.77 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. A combination of factors will often be significant.

Artificiality, contrivance, and pretence

1.78 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
- involves a distortion with its legal effect.

1.79 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.

1.80 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.

1.81 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.

1.82 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.

1.83 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.

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

Manner in which the arrangement is carried out

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

- 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 due to its structure; or
- the legal structure of an arrangement is complex in light of 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

1.86 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.

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Economic and commercial effect of documents and transactions

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

- the arrangement has no commercial or private purpose;
- the arrangement's commercial or private purpose cannot be achieved independently of its tax advantages;
- the arrangement's commercial or private purpose is obscure, in contrast to the clarity of its tax advantages;
- the arrangement's commercial or private purpose has no commercial or private rationale, justification or logic, independent of the 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;
- the tax advantage the taxpayer gained is totally disproportionate to the economic burden the taxpayer suffered;
- the tax advantage is obtained from a deduction for expenditure when the commercial reality is that the expenditure is of a capital or private nature; or
- the taxpayer has had the benefit of a non-assessable receipt when the commercial reality is that they have received income.

Nature and extent of the financial consequences

1.88 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 incur 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 actual loss of income because they, in fact, retain the use and benefit of all of the income.

Duration of the arrangement

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

- the arrangement has been structured to create or take advantage of a timing mismatch between:
  - legal payment and economic payment; or
  - the invoice and accounting bases of accounting for GST; or
- the duration of the arrangement is such that its commercial purpose is unlikely to, or cannot, be achieved.

Circularity in the arrangement

1.90 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

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- the purpose of obtaining a tax advantage.

Inflated expenditure or reduced levels of income in the arrangement

1.91 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 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 risks

1.92 The absence, or limited nature and extent of commercial or economic risk may:

- mean the tax advantage obtained under the arrangement is disproportionate to the risk; and
- indicate that the obtaining of the tax advantage is a purpose of the arrangement.

Arrangement being pre-tax negative

1.93 An arrangement that is pre-tax negative and post-tax positive 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; and
- obtaining the arrangement's tax advantages is a purpose of the arrangement.

Economic equivalence and counterfactuals

1.94 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.

1.95 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.

1.96 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

1.97 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. *Ben Nevis* (SC) and *Penny* (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 purpose for the specific provisions.

1.98 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 cogent (that is, convincing);
- not mere speculation; and
- not an intuitive subjective impression (ie, a subjective view that an arrangement has a tax avoidance purpose or effect that is not derived from an objective analysis of the facts of the arrangement, its effects, and Parliament's purpose for the specific provision).

1.99 The Commissioner considers that a useful approach to applying s BG 1 to an arrangement involves:

- Understanding the legal form of the arrangement by:
  - Identifying all of the steps and transactions that make up the arrangement.
  - Understanding 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 Parliament's purpose for the specific provisions that are used or circumvented by the arrangement.
- Viewing the arrangement as a whole in a commercially and economically realistic way, including considering any non-tax avoidance purposes or effects. 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 taken limited or no real risks; and
  - whether the arrangement is pre-tax negative.

- Determining, by inference from the facts and objectively determined non-tax avoidance purposes of the arrangement when viewed in a commercially and economically realistic way, whether the arrangement makes use of, or circumvents, the specific provision in a manner consistent with Parliament's purpose.

1.100 Parliament's purpose for a specific provision under the Parliamentary contemplation test is 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 identified under the initial inquiry into the application of the specific provisions. 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.

1.101 Answering the question of whether the arrangement makes use of, or circumvents, the specific provision in a manner consistent with Parliament's purpose requires:

- viewing the arrangement as a whole and in a commercially and economically realistic way; and
- considering whether there is any elements of the arrangement from which it can be inferred that Parliament would not have contemplated the gaining of the tax advantages in the particular circumstances.

1.102 Considering the factors referred to by the courts assists in answering the question. This includes considering the particularly significant factor of whether the tax advantages have been obtained by way of artificiality or contrivance. The structuring of an arrangement so that a taxpayer gains the benefit of a specific provision in an artificial or contrived way is outside Parliamentary contemplation. Therefore, it can assist to specifically consider whether, objectively determined, the arrangement has been structured so that a tax advantage is obtained by artificiality or contrivance.

1.103 Whether or not artificiality or contrivance is present, the Commissioner also considers that in some cases it can be useful to consider whether there are any facts, features or attributes that Parliament would contemplate being present (or absent) when permissible tax advantages arise under the specific provision. If such facts, features or attributes can be identified, they could be compared with the facts, features or attributes that are present (or absent) in the arrangement when viewed as a whole and in a commercially and economically realistic way.

1.104 Arrangements are likely to be outside of Parliament's purpose for specific provisions 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 such that the commercial or private purposes are dependent on a tax advantage being achieved.

1.105 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 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 very unlikely that the arrangement's tax avoidance purpose will be merely incidental.

Part 9: Counteracting the tax advantage

1.106 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. However, if the voiding does not do this, then the Commissioner can apply s GA 1 to counteract the impermissible tax advantage.

1.107 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.

1.108 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.

1.109 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 arising 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.

1.110 The Commissioner cannot ultimately include an amount of income or deduction in the taxable income of more than one person when determining an appropriate adjustment.

1.111 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

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

- Except for the predication test, the judicial approaches applied before *Ben Nevis* (SC) are not relevant to the extent that those approaches are inconsistent with *Ben Nevis* (SC).
- The predication test remains relevant to the extent that under the Parliamentary contemplation test it is necessary to objectively determine or "predicate" that tax avoidance is a purpose or effect of the arrangement.
- 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 non-tax avoidance purpose or effect of avoiding foreign tax.
- A double tax agreement (DTA) does not override s BG 1.
- The order of application of s BG 1 and a DTA to an arrangement depends on the specific provisions used or circumvented. Articles of DTAs are (effectively) treated as specific provisions of the Act. Where an arrangement uses or circumvents specific provisions, other than DTA provisions, 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. If the arrangement uses (or circumvents) the DTA provisions in a manner outside Parliament's purpose, s BG 1 can be applied after the application of the DTA.
- 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, they can apply to the Commissioner for a binding ruling.

Flowcharts

1.113 The following flowcharts show the approach taken in this statement to whether s BG 1 applies to an arrangement (Flowchart 1) and the steps to applying s GA 1 (Flowchart 2).

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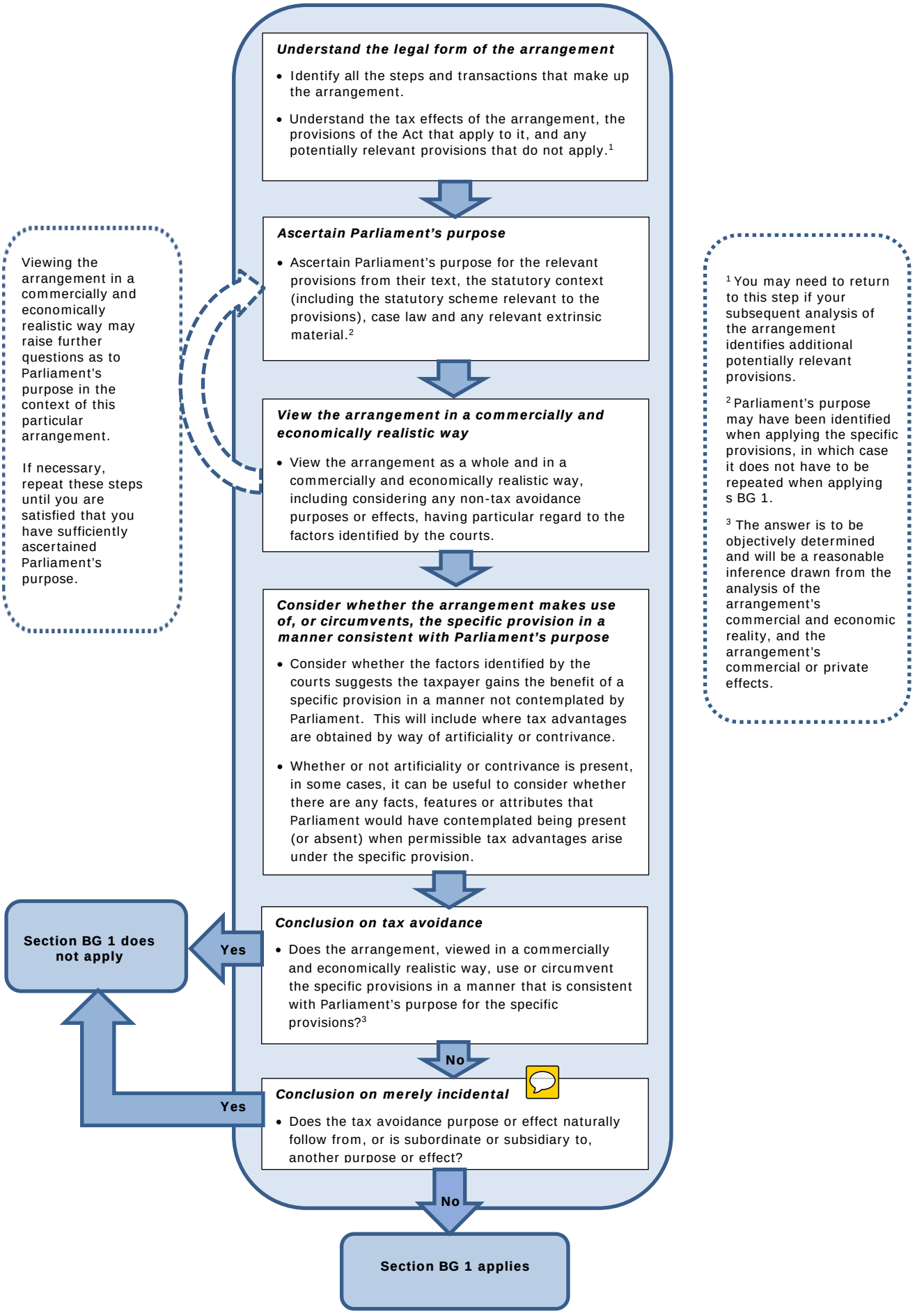
Flow chart 1: An approach to the tax avoidance inquiry



[1] You may need to return to this step if your subsequent analysis of the arrangement identifies additional potentially relevant provisions.

[2] Parliament's purpose may have been identified when applying the specific provisions, in which case it does not have to be repeated when applying s BG 1.

[3] The answer is to be objectively determined and will be a reasonable inference drawn from the analysis of the arrangement's commercial and economic reality, and the arrangement's commercial or private effects.

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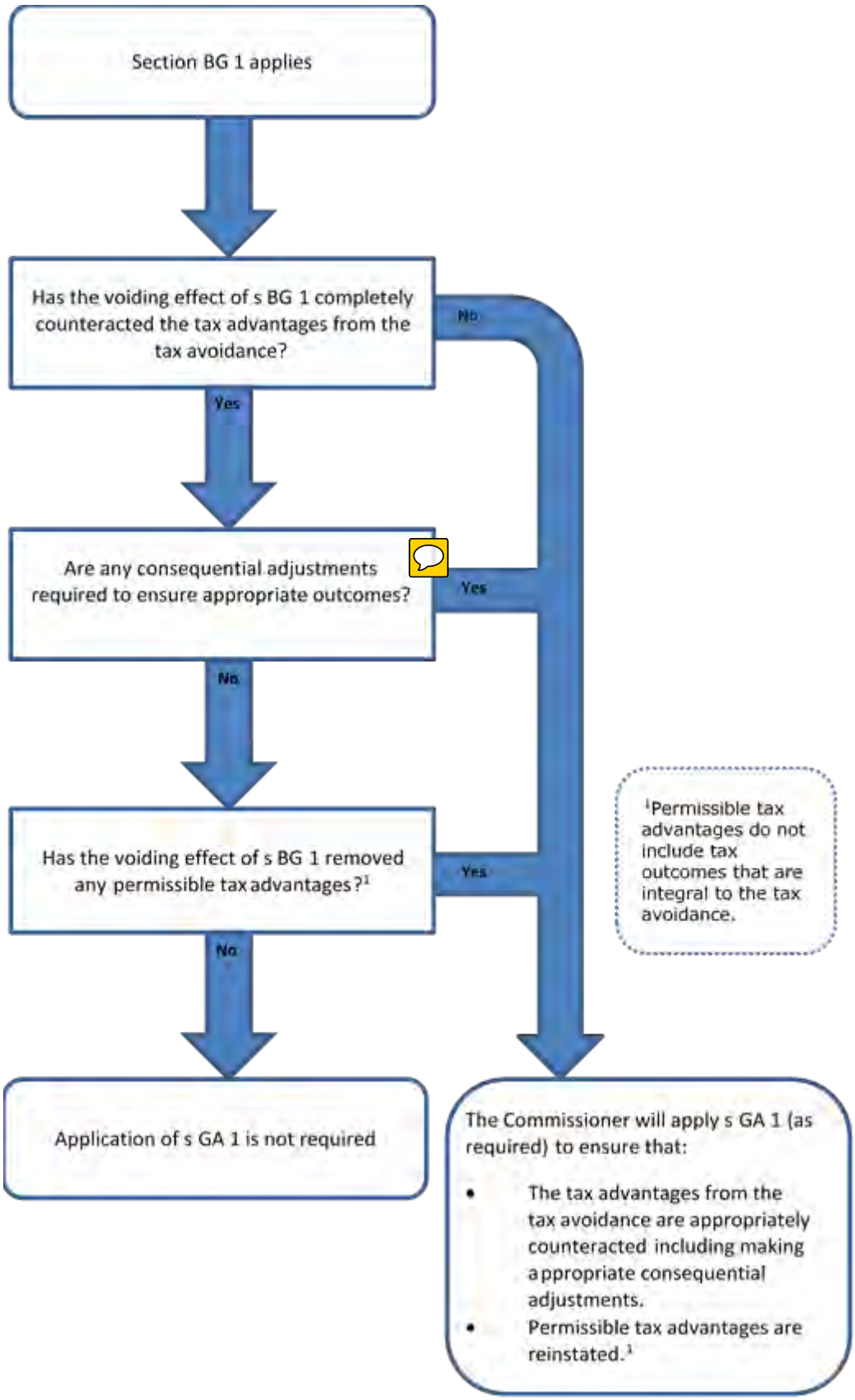
Flow chart 2: An approach to s GA 1



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

Introduction

2.1 Section BG 1 is known as the 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 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. It 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 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)).

2.6 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.

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...

> [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.** 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.
>
> [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]

2.7 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. [Emphasis added]

Supreme Court settled the approach to s BG 1 in *Ben Nevis*

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 Woodhouse P in *Challenge* (CA) in 1986 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 1999], as it has been levelled at the earlier s 108 [of the Land 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:

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[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)).

> [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]

The approach to reconciling the specific provisions and s BG 1

2.12 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.

2.13 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 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

2.14 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.** 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. [Emphasis added]

2.15 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.
- Specific provisions and s BG 1 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.
- Section BG 1 is designed to address tax avoidance.

2.16 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.

2.17 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.

Threshold argument

2.18 The Court observed that simply satisfying the ordinary meaning of a specific provision does not negate a claim of tax avoidance:[18]

> 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.

2.19 The "threshold" argument is commonly associated with Richardson J's "scheme and purpose" approach in the Court of Appeal in *Challenge* (although, in the

[18] Footnote 113 at [104].

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 [10.17] as part of this statement's discussion of other issues.

The Parliamentary contemplation test

2.20 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.[19]

2.21 The tax avoidance inquiry can involve two tests:

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

2.22 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 in a commercially and economically realistic way; and
- 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.

2.23 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.[20] If the use made of the specific provision is outside Parliament's purpose, then the arrangement will have a tax avoidance purpose or effect.

2.24 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.

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

2.25 The arrangement in *Ben Nevis* (SC) involved the "use" of specific (deduction) provisions.[21] The Supreme Court stated:

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[19] At [107].

[20] At [109].

[21] 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.

> [107] When, as here, a case involves reliance by the taxpayer on specific provisions, the first inquiry concerns the application of those provisions. …

2.26 Because of the facts in *Ben Nevis*, the Supreme Court referred throughout to the "use" of provisions. However, the Commissioner considers that s BG 1 can also apply to an arrangement that "circumvents" a specific provision. The Commissioner considers this is a logical extension from the Supreme Court in *Ben Nevis* referring to the application of specific provisions. An arrangement circumvents a specific provision when it has been structured so that the specific provision does not apply to the arrangement.

2.27 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**, 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]

2.28 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).

2.29 However, the fixing of the taxpayer's salary can equally be viewed as the structuring of an arrangement so that the taxpayer used (and thereby gained the benefit of) 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 of Parliament's contemplation because, in reality, the taxpayer had suffered no reduction in income.

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Part 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 and whether the use made of the specific provision is within its ordinary meaning and intended scope (the initial inquiry).

3.2 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 (the tax avoidance inquiry).

3.3 This part of the statement sets out the approach to interpreting and applying specific provisions under the initial inquiry into the application of the specific provisions. This approach differs to the approach to applying s BG 1 under the tax avoidance inquiry.[22]

3.4 As mentioned at [2.25], the Commissioner considers that s BG 1 can apply to an arrangement that circumvents a specific provision, therefore, the following discussion may be relevant where a specific provision is alleged not to apply.

Meaning is ascertained from text and purpose

3.5 Section 5(1) of the Interpretation Act 1999[23] provides 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:[24]

> [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]

3.6 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.[25] 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,

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[22] Parts 4-8 consider the tax avoidance inquiry.

[23] When it comes into force, s 5(1) of the Interpretation Act 1999 will be 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].

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

[25] *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].

> on a fair construction, must be taken to impose that tax in the circumstances of the case. [Emphasis added]

3.7 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".[26] The Court made clear in the accompanying footnote that it was referring to s 5 of the Interpretation Act 1999.

3.8 The Supreme Court later said that in a case involving reliance by the taxpayer on a specific provision, an initial inquiry is into whether the use made of a specific provision is within its intended scope:

> [107] When, as here, a case involves reliance by the taxpayer on specific provisions, the first inquiry concerns the application of those provisions. The taxpayer must satisfy the Court that the use made of the specific provision is within its intended scope.

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.[27] Hand in hand with the need to give effect to purpose, is the need to examine the text of the Act in context:[28]

> 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.

3.12 Generally, a purposive interpretation will also be the literal or grammatical meaning because the purpose and wording will align with one another.[29]

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:[30]

- 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.

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[26] At [103].

[27] JF Burrows and RI Carter, *Statute Law in New Zealand* (5th ed, LexisNexis, Wellington, 2015) at 221.

[28] At 221.

[29] *Statute Law in New Zealand* at 227 and D Bailey and L Norbury, *Bennion on Statutory Interpretation* (7th ed, LexisNexis, London, 2017) at 343.

[30] At 228–230.

- 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).[31]

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.[32] 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.[33]

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

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

[32] *Statute Law in New Zealand* at 237–244 and *Bennion on Statutory Interpretation* (7th ed) at 349–350.

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

rates of the shareholders. This accords with the objective of taxing capital income at the tax rates of the individual.[34]

3.20 Specific provisions often give effect to a particular policy in the Act (eg, the mining or foreign tax credit regimes). The High Court in *Westpac* identified the legislative policy behind the foreign tax credit regime:[35]

> [612] … As demonstrated by s LC 1(3A), the [foreign tax credit] regime was intended to provide New Zealand taxpayers with credits for tax paid in a foreign jurisdiction.

3.21 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".[36] The courts sometimes refer to this concept in terms of looking for the "scheme" of the Act.[37]

3.22 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

3.23 Extrinsic materials may be considered to understand the background of a specific provision and what Parliament was trying to achieve.[38] 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*).

3.24 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.

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

[35] *Westpac Banking Corporation v CIR* (2009) 24 NZTC 23,834 (HC).

[36] At 238, when discussing the purpose of an Act.

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

[38] *Statute Law in New Zealand* at 220–221.

3.25 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.

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

3.26 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:[39]

> 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]

3.27 And, Tipping J in *A Taxpayer* (CA) expressed the principle in this way:[40]

> 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.

3.28 The true nature of an arrangement in a s BG 1 context depends on the legal rights and obligations created by the arrangement. These 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]

3.29 Generally, tax outcomes under specific provisions do not depend on the economic or other consequences of an arrangement. However, Parliament may indicate in

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[39] *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).

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

the specific provision itself or in the relevant regime that an economic substance approach is required.[41]

3.30 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

3.31 The Supreme Court in *Ben Nevis* referred to an approach in certain English cases to interpreting specific provisions.[42] 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.

3.32 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:

> [5] We do not therefore accept that when considering the application of a specific tax provision, and before considering the question of avoidance, the Court is concerned primarily with the legal structures and obligations created by the parties, and not with the economic substance of what they do.

3.33 However, the majority in *Ben Nevis* (SC) concluded that the English cases were of limited assistance and that care must be taken when applying English cases in a different New Zealand context.[43] This was because the 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 relevance of the English cases is the current law in New Zealand.[44]

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.[45]

3.35 However, the Privy Council in *Challenge* disagreed and stated:[46]

> 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

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

[42] *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.

[43] At [110].

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

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

[46] At 559.

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.[47]

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. If a court makes different findings of facts or law, then the Commissioner can make alternative arguments that different specific provisions also apply.

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

[47] At 560.

> [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 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. However, even if this is the case, s BG 1 may still apply to the arrangement as a whole for other specific provisions.

3.45 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

3.46 A specific provision will apply 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.

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.

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Part 4 Meaning of "arrangement"

Introduction

4.1 This and following Parts of the statement concern the tax avoidance inquiry and look at the essential parts of that inquiry including 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).

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.[48] 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**

[48] At [105].

> **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.

4.9 Whether two or more transactions or documents together constitute an "arrangement" is a matter of fact.[49] 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 determination 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.[50] 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:[51]

> 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.

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

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

[51] At 734.

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4.12 Also, the Privy Council in *Europa No 1* considered whether six agreements constituted a single agreement.[52] 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".[53]

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:[54]

> 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 elements between AMP and AFS (a subsidiary):[55]

- 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.[56] 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 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 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

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[52] *CIR v Europa Oil (NZ) Ltd* [1971] NZLR 641 (PC) (*Europa No 1* (PC)).

[53] At 651.

[54] At 651 – 652.

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

[56] At [125].

> 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).[57] 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".[58] 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.[59] The definition of arrangement is exhaustive because it states that an arrangement "means" an agreement, contract, plan or understanding.[60] Also, the drafting style of the Act is to use "means" to introduce an exhaustive definition.[61] Therefore, an "arrangement" must be "an agreement, contract, plan, or understanding".

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[57] *Krukziener v CIR (No 3)* (2010) 24 NZTC 24,563 (HC).

[58] 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.

[59] *Statute Law in New Zealand* at 436.

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

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

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 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:[62]

> [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):[63]

> [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:[64]

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

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

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

[64] At [36] and [121]–[146].

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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.[65] 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* 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.

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.[66]

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)].

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

[66] At [127] and [131].

4.36 The Supreme Court in *Ben Nevis* noted the different approaches taken in *Peterson* (PC) and *BNZ Investments No 1* (CA).[67] 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".[68]

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.[69] This conclusion is consistent with the conclusion above that an arrangement includes a plan undertaken by one person.

Parts of an arrangement can be 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 may not only be an arrangement, it 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.[70]

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. However, the definition of "arrangement" (and "tax avoidance arrangement" or s BG 1 itself) contains no extraterritorial limitation.

4.42 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 outside New Zealand.

4.43 The High Court in *BNZ Investments No 1* agreed with this view, stating:[71]

> [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]

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[67] At [160].

[68] At [161].

[69] 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).

[70] 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].

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

Inland Revenue
Te Tari Taake

Part 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".[72] The general anti-avoidance provision was amended in 1974 and introduced an inclusive definition of "tax avoidance".[73] This means that the meaning of the term in the Act is not determined solely with reference to the definition.[74] It is also necessary to consider the term's ordinary meaning and the approach taken by the courts to tax avoidance.

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[72] Section 108 of the Land and Income Tax Act 1954.

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

[74] 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.

5.7 The courts typically decide whether tax avoidance exists without any detailed analysis of the statutory definition of "tax avoidance".[75] 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.[76] 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]

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

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[75] 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].

[76] At [105].

- 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) 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, Alesco failed on the facts. The Court agreed with both grounds the Commissioner advanced.[77]

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.

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 motive, intentions or purposes of the parties are not relevant. The Privy Council confirmed this in *Newton* and *Ashton*.[78]

5.22 The Privy Council in *Ashton* stated:[79]

> 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:

[77] At [35] to [41].

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

[79] At 721–722.

> **"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.[80] *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*.[81]

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 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*:

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

[81] 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.[82] 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 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.[83] 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". The Privy Council in *Ashton* stated (at 722):

> These observations of Lord Denning in relation to s 260 of the Australian Act are equally applicable to s 108. The passage he cited from the judgment of Williams J in *Newton* in the High Court of Australia ((1957) 96 CLR 578, 630) was preceded by the following:
>
> > "During the argument of the present appeals the meaning of the words 'purpose or effect' received considerable discussion. **These words are in the alternative but they do not appear to me to have any real difference in meaning**" (96 CLR 578, 630).
>
> **Their Lordships agree. 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** … [Emphasis added]

5.28 McMullin J in the Court of Appeal decision in *Tayles* said:[84]

> The issue before the Board of Review, the Supreme Court and this Court involved an inquiry into the purpose or effect of the arrangement admittedly made. **Whatever difference of meaning there may be in dictionary terms between the words "purpose" or "effect", posed as they seem to be as alternatives in s 108, they usually have been looked on in the cases as a composite term. "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). [Emphasis added]

5.29 The courts have considered the purpose of the arrangement as the:

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[82] At [39].

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

[84] At 734.

- "intended effect";[85] or
- "effect which [the arrangement] sought to achieve".[86]

5.30 Therefore, if an arrangement has a particular effect, then 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:[87]

> **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:[88]

> 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. [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

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[85] *Newton* (PC) at 464; *Ashton* (PC) at 721–722.

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

[87] At 721.

[88] At 722.

Supreme Court in *Glenharrow* reaffirmed this long settled position. More recently, the Court of Appeal in *Alesco* repeated that the test is objective.[89]

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.[90] Courts have also referred to subjective evidence to confirm a finding they have taken on an objective analysis of the arrangement,[91] or as a way of leading into possible non-tax avoidance purpose or effects of an arrangement.[92]

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

Introduction

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 is more than merely incidental to any other purpose or effect.

5.39 The second alternative of a tax avoidance arrangement or 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* 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):[93]

> 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:

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[89] At [27] and [94].

[90] See, for example, *Ashton* (PC) at 721.

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

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

[93] At 533.

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

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, 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:[94]

> 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:[95]

> 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).[96] The High Court of Australia in *Hollyock* rejected the *Mangin* (SC) "sole or principal purpose" test. The Minister also stated:[97]

> 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.[98] He stated:[99]

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[94] At 694.

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

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

[97] At 4,194.

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

[99] At 533 to 534.

> 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 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.[100] 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".[101]

5.55 The above approach to the meaning of "merely incidental" has been adopted in several decisions.[102]

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[100] At [211]–[212].

[101] At [212].

[102] 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].

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

5.56 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.

5.57 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

5.58 Non-tax avoidance purposes include purposes giving rise to permissible tax advantages. The Commissioner considers a permissible 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.

5.59 An example 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. 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 fixed at the current swap rate was an integral component of the dividend rate formula through which its taxation benefits were shared**. [Emphasis added]

5.60 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]

Non-tax avoidance purposes underpinned by tax avoidance

5.61 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 because the non-tax avoidance purpose is dependent on or underpinned by tax avoidance.

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Very general non-tax avoidance purposes

5.62 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".[103]

5.63 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".

5.64 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.

5.65 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.

5.66 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]

5.67 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] 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.

Size of a tax benefit may be a strong evidential factor

5.68 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

[103] At 533.

of a tax benefit achieved under an arrangement will not, of itself, establish whether a tax avoidance purpose is more than merely incidental.

5.69 Nevertheless, in the Commissioner's view, the size of a tax benefit may 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.

Tax avoidance will rarely be merely incidental

5.70 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 of 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 but 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.[105]

5.71 The Court was observing that if an arrangement makes use of a specific provision in a manner that is outside of Parliament's purpose, it is then very 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.

5.72 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.[106] 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 way of artificiality or contrivance, the tax avoidance purpose is likely to be an end in itself and the tax avoidance purpose is then very unlikely to be merely incidental to another purpose.

5.73 Woodhouse P in *Challenge* (CA) commented on the relevance of contrivance or artificiality to the merely incidental test:[107]

> **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]

5.74 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

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[104] See, for example, *Hadlee v CIR* [1989] 2 NZLR 447 (HC) at 470.

[105] At [114].

[106] At [108]

[107] At 535.

the benefit of family). It is implicit in its conclusion and that the tax advantage was a principal or predominant purpose that the tax advantage purpose was not merely incidental to the other purposes.[108]

5.75 However, the Court discussed possible non-tax avoidance purposes that, had they been present, would have been relevant. These purposes included the company:[109]

- 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 able to afford to pay the equivalent of a commercial rate.

5.76 The Court of Appeal in *Russell* (CA) also observed that if an arrangement makes use of a specific provision in a manner that is outside of Parliament's purpose, it is then very unlikely 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** 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]

[108] At [36].

[109] At [34].

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Part 6 Parliamentary contemplation test

Introduction

6.1 The Supreme Court in *Ben Nevis* settled 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).[110]

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* and as applied in *Penny* (SC) is binding on all other courts.[111] The Commissioner must interpret and apply s BG 1 in accordance with the Supreme Court's approach in *Ben Nevis* and *Penny*.

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 under the Parliamentary contemplation test that must be answered when determining whether an arrangement has a tax avoidance purpose or effect:

> [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 (often referred to as the "ultimate question").

6.6 If the use of the specific provision is consistent with Parliament's purpose, the arrangement will not have a tax avoidance purpose or effect. If the use of the specific provision is outside Parliament's purpose, the arrangement will have a purpose or effect of tax avoidance. The tax advantage gained from such a use 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.

Parliament's purpose and the Parliamentary contemplation test

Purpose of specific provisions must be distinguished from purpose of s BG 1

6.7 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.[112] The Court then explained the nature of the distinction:

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[110] At [33].
[111] The decisions of higher courts are binding on lower courts in the judicial hierarchy under the doctrine of *stare decisis.*
[112] At [103].

> [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.

6.8 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 and purpose of the specific provision. The use of a specific provision within its ordinary meaning is a permissible tax advantage.

6.9 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.[113] Its purpose is to prevent tax advantages gained from the use of specific provisions in a way that fall 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.

6.10 The Commissioner considers the distinction between the purpose of a specific provision and the purpose of s BG 1 and the need to give effect to them both lies at the core of understanding the Supreme Court's approach to s BG 1. The distinction is reflected in the different scope of the inquiries carried out to determine:

- whether the requirements for the application of a specific provision are satisfied; and
- whether the taxpayer's use of the specific provision is outside of its intended scope in the overall scheme of the Act.

The inquiry into Parliament's purpose is a hypothetical one

6.11 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 provisions' purpose.

6.12 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.
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> [135] It follows that I agree with the Commissioner's submission that the question for the court at step 2 is necessarily an hypothetical one. Guided by the considerations and the

[113] 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.

> 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]

6.13 Similarly, the Court of Appeal in *Russell* 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 unrelated specific provisions used by an arrangement

6.14 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.

6.15 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.

6.16 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.

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

6.17 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

6.18 As mentioned at [3.21], 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.[114] It also intends

[114] *Ch'elle Properties (NZ) Ltd v CIR* [2007] NZCA 256, [2008] 2 NZLR 342 at [38], and *Education Administration v CIR* (2010) 24 NZTC 24,238 (HC) at [43].

that inputs and outputs have a certain degree of temporal connection.[115] The courts identified these principles from the scheme of the GST Act.

6.19 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]

6.20 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):[116]

> Tax legislation reflects historical compromises and it bears the hands of many draftsmen in the numerous. 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.

The Supreme Court's approach to applying s BG 1

Two inquiries arise – specific provisions then s BG 1

6.21 The Court explained that in a case concerning the application of s BG 1 two inquiries arise.[117] 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 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 in terms of the legal form of the relevant parts of the arrangement.

6.22 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.[118] 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. If the arrangement uses or circumvents the specific provision in a way not within the contemplation and purpose of Parliament, then:

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

[116] At 549.

[117] At [107].

[118] 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.

- 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.

6.23 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.[119] The inquiry focuses on the factual reality of the arrangement actually entered into and its use or circumvention of specific provisions. The Court of Appeal has also referred to this in *Russell*[120]. 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]

Factors considered under the Parliamentary contemplation test

6.24 The Court explained 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]

6.25 The focus of the factors is on understanding how the arrangement as a whole works over its lifetime in commercial and economic reality, and not in legal terms, to answer the "ultimate question". That is, whether the arrangement, when viewed in a commercially and economically realistic way, uses or circumvents the specific provisions in a manner consistent with Parliament's purpose. As stated by the Court, it will often be the combination of various factors in an arrangement that will be significant.

6.26 The Court emphasised that the matters that may be considered under these factors are not limited to purely legal considerations (ie, the legal rights and obligations created by the arrangement or the arrangement's legal form).[121] It is necessary to consider the use of the specific provision in the light of viewing the arrangement in a commercially and economically realistic way (ie, the commercial

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[119] At [115] to [148].

[120] At [39].

[121] At [109].

and economic reality of the arrangement and the economic substance of its use of the specific provision).

6.27 In other cases, the courts have found other factors to be significant, including circularity, inflated expenditure or reduced levels of income, the limitation or lack of real risks and the arrangement being pre-tax negative. All the factors the courts mentioned are discussed in Part 7.

Tax advantages gained through artificial or contrived means is an instance of a use that is outside Parliament's contemplation

6.28 As noted above, one of the factors referred to by the Supreme Court in *Ben Nevis* was artificiality or contrivance. This factor is particularly significant because 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.

6.29 The Court referred to the artificial features of the payment of the licence premium by way of promissory note as an example of the artificial use of a specific provision outside of its intended scope.[122] The Court noted how the artificial features of the promissory note contributed to the tax advantages obtained by the arrangement. For instance, 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.[123]

6.30 Other examples of the courts referring to artificiality or contrivance when finding a tax avoidance arrangement exists can be found in appendix 2. They include *Penny* (SC), *Glenharrow* (SC), *BNZ Investments No 2* (HC), *Westpac* (HC), *Education Administration* (HC) and *Frucor* (CA)[124].

6.31 Whether or not artificiality or contrivance is present, the Commissioner also considers that in some cases it can be useful to consider whether there are any facts, features or attributes that Parliament would contemplate being present (or absent) when permissible tax advantages arise under the specific provisions. 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. If such facts, features or attributes can be identified, their presence or absence in the particular arrangement, when viewed as a whole and in a commercially and economically realistic way, may assist and inform the answer to the "ultimate question". That is, whether the arrangement makes use of, or circumvents, the specific provisions in a manner consistent with Parliament's purpose.[125]

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[122] At [107].

[123] At [119].

[124] *CIR v Frucor Suntory New Zealand Ltd* [2020] NZCA 383.

[125] The consideration of the presence (or absence) of facts, features or attributes suggested here is not to be confused with or mistaken for the view that the satisfaction of the ordinary meaning of a specific provision negates the application of s BG 1 (ie, "threshold" arguments, as discussed in Part 2).

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

6.32 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, 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.

6.33 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]

6.34 When applying the Parliamentary contemplation test in *Penny,* the Supreme Court focused on 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.

6.35 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.

6.36 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]

6.37 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.

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[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 settled 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].

6.38 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).

6.39 In the Commissioner's view, the following 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 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.

6.40 As mentioned at [2.28], *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 specific provision was outside Parliamentary contemplation because the taxpayer gained the benefit of specific provisions 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 specific provisions to be used or circumvented, and tax advantages gained, in that way.

6.41 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.[129] It is also consistent with the discussion from [6.28] above about artificiality or contrivance. The Court approved the statement of Woodhouse P in *Challenge* (CA) that s BG 1 is a weapon to thwart technically correct but contrived transactions set up as a means of exploiting the Act for tax advantages.[130]

6.42 *Penny* (SC) reinforces that applying s BG 1 involves:

- focussing on asking the question of whether the arrangement makes use of, or circumvents, the specific provision in a manner consistent with Parliament's purpose; and
- drawing on the relevant factors, such as artificiality or contrivance, to arrive at an answer.

6.43 The Court's approach in *Penny* (SC) also 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 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".[131]

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[128] At [34] to [36].

[129] At [47].

[130] At [47].

[131] 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.

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Part 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 Supreme Court in *Ben Nevis* used the following phrases in its judgment:[132]

- 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".

7.3 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".

7.4 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

Introduction

7.5 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.[133] 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.

7.6 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

[132] At [109].

[133] At [108].

way.[134] 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.[135]

7.7 Artificiality or contrivance is a particularly significant factor because one instance of a use or circumvention of specific provisions outside of Parliament's contemplation is where tax advantages are obtained in artificial or contrived ways.

7.8 In discussing these factors, the Court stated:[136]

- 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.

7.9 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.[137]

7.10 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.

7.11 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 undertaking limited or no real risks; and
- whether the arrangement is pre-tax negative.

7.12 The factors are discussed further below and appendix 2 provides examples of each factor from tax avoidance case law.

Artificiality, contrivance and pretence

Meaning of "artificiality" in the tax avoidance context

7.13 *The Shorter Oxford English Dictionary* defines "artificiality" and "artificial" as:[138]

> **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…

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[134] 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.

[135] At [97].

[136] At [108].

[137] At [109].

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

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7.14 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
- involves a distortion of its legal effect.

7.15 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.[139]

7.16 Artificiality is not to be confused or conflated with commercial innovation and novelty. An arrangement may involve commercial innovation or novelty that is not part of a plan or concerted course of action to attain an impermissible tax advantage. Any resulting tax advantage from such an arrangement is very unlikely to be tax avoidance.

Meaning of "contrivance" in the tax avoidance context

7.17 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…

7.18 A contrivance is a 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.

7.19 In the Commissioner's view, a contrivance in the tax avoidance context is a planned course of action to achieve an impermissible tax advantage.

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

7.20 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.

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

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

- 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.

7.22 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.

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

7.23 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;

7.24 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. Thus, 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.

7.25 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.[140] That is because the parties do not intend to create any rights and obligations or intend different ones to those created in the documents.

7.26 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.

7.27 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.

Manner in which the arrangement is carried out

7.28 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

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

arrangement involves overall planning and planned linking or sequencing of the elements, steps and transactions that comprise the arrangement.

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

- 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.

7.30 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);
- whether the structure of the arrangement has any unusual features;
- whether the structure of the arrangement is explicable from a commercial or private point of view; and
- whether the structure of the arrangement has the effect that specific provisions apply or do not apply.

Role of all relevant parties and their relationships

7.31 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.

7.32 Therefore, it may be relevant to consider 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 a specific provision in a particular way to obtain a tax advantage.

Economic and commercial effect of documents and transactions

7.33 The examination of the economic and commercial effects of documents and transactions is a relevant factor because it may indicate:

- the arrangement has no commercial or private purpose;
- the arrangement's commercial or private purpose cannot be achieved independently of its tax advantages;

- the arrangement's commercial or private purpose is obscure, in contrast to the clarity of its tax advantages;
- the arrangement's commercial or private purpose has no justifiable commercial or private rationale, justification or logic, independent of the 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;
- the tax advantage the taxpayer gained is totally disproportionate to the economic burden the taxpayer suffered;
- the tax advantage is obtained from a deduction for expenditure when the commercial reality is that the expenditure is of a capital or private nature; or
- the taxpayer has had the benefit of a non-assessable receipt when the commercial reality is that they have received income.

Nature and extent of the financial consequences

7.34 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.

7.35 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 incur (suffer) the economic cost of the expenditure;
- the amount of the taxpayer's assessable income has been reduced but the taxpayer, in reality, suffers no actual loss of income because they, in fact, retain the use and benefit of all of the income.

Duration of the arrangement

7.36 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 between:
  - legal payment and economic payment; or
  - the invoice and accounting bases of accounting for GST;
- the duration of the arrangement is such that its commercial purpose is unlikely to, or cannot, be achieved.

7.37 Timing features 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.

Circularity in the arrangement

7.38 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.

7.39 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.

7.40 An arrangement, however, may demonstrate elements of circularity that have a commercial basis and without crossing the line and turning an otherwise permissible arrangement into a tax avoidance arrangement.

Inflated expenditure or reduced levels of income in the arrangement

7.41 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.

7.42 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 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 risks

7.43 Consideration of whether the participants in the arrangement have, in reality, undertaken financial or commercial risks may indicate that:

- the participants have not undertaken any actual risks; or
- the nature and extent of the risks are limited or contingent.

7.44 The absence, or limited nature and extent of commercial or economic risk may:

- mean the tax advantage obtained under the arrangement is disproportionate to the risk; and
- indicate that the obtaining of a tax advantage is a purpose of the arrangement.

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Arrangement being pre-tax negative

7.45 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".

7.46 An arrangement that is pre-tax negative and post-tax positive 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; and
- obtaining the arrangement's tax advantages is a purpose of the arrangement.

Economic equivalence and counterfactuals

7.47 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

7.48 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.

7.49 The principle of economic equivalence is derived from the judgment of Lord Tomlin in the *Duke of Westminster* (HL)[141] and was referred to by Lord Wilberforce in *Europa No 1* (PC)[142]. The principle is also reflected in the passages cited in this statement from *Finnigan* (CA) (at [3.26]), *A Taxpayer* (CA) (at [3.27]), and *Ben Nevis*(SC) (at [3.28]).

7.50 Lord Tomlin in the *Duke of Westminster* (HL) said:[143]

> **... 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]

7.51 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.

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[141] *Inland Revenue Commissioners v The Duke of Westminster* [1936] AC 1 (HL).

[142] At 648.

[143] At 19.

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7.52 The majority of the Privy Council in *Europa No 1* held that the Commissioner's assessments disallowing the expenditure under s 111 of the Land and Income Tax Act 1954 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:[144]

> 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]

7.53 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.

7.54 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 to the s BG 1 inquiry

7.55 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.

7.56 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,

[144] At 648–649.

viewed in a commercially and economically realistic way, uses or circumvents the specific provision in a manner that is consistent with Parliament's purpose.

7.57 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 (at [35]–[41]) that the application of s BG 1 does not require a comparative or counterfactual analysis to establish tax avoidance.

7.58 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.

7.59 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.

7.60 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.[145]

7.61 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.

7.62 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 when 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

[145] 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".

note structure, if it was not for the purpose of obtaining an impermissible tax advantage.[146]

[146] At [81].

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Part 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.[147]

8.2 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.[148] Many of the same factors considered under the Parliamentary contemplation test are relevant to the merely incidental test.[149] Consequently it will be rare for a tax avoidance purpose or effect to be merely incidental to another purpose or effect.[150]

8.3 In this part of the statement the Commissioner sets out a general approach to applying s BG 1. At the end of this Part there is a flowchart 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.

8.5 Importantly, applying s BG 1 to an arrangement requires the exercise of judgement as to the reasonable inference or conclusion to be drawn from the facts, as discussed next.

A reasonable inference or conclusion is required

8.6 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.

8.7 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".[151]

8.8 *Ben Nevis* (SC) and *Penny* (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 purpose for the specific provision.

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[147] *Ben Nevis* (SC) at [109].

[148] *Ben Nevis* (SC) at [106].

[149] *Russell* (CA) at [42].

[150] *Ben Nevis* (SC) at [114].

[151] At [40].

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8.9 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;[152]
- logical and cogent (that is, convincing);
- not mere speculation; and
- 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 facts of the arrangement, its effects, and Parliament's purpose for the specific provision).

8.10 This approach of reaching a conclusion on the application of s BG 1 reflects the approach taken by the courts, as illustrated by the Supreme Court's approach in *Ben Nevis* and *Penny*.

Ben Nevis *(SC)*

8.11 In *Ben Nevis*, the Supreme Court concluded that the primary, if not sole, purpose of the promissory note to pay the licence premium was to generate a tax deduction. It was an artificial component included in the arrangement for the purpose of tax avoidance.

8.12 The Court's conclusion was drawn from three features of the arrangement relating to the promissory note and the objectively determined effects of those features:

- From a commercial point of view, the promissory note given in 1997 did not achieve payment of the premium until receiving the net stumpage from the harvesting of the forest in 2048.
- The real risk that the forestry scheme would never be profitable due to the way in which its funding had been structured and the lack of any apparent commercial rationale for the licence premium:
  - The investors had funded the purchase of the plantable land in 1997 by paying over three times its cost in return for an option to acquire ownership of the land at half its then value in 2048; and
  - The investors had also agreed to pay a licence premium of $2,050,018 per plantable hectare for a 50-year licence to use the plantable land, the purchase of which they had already funded.
- The 50-year timing difference between the legal payment (by means of the promissory note) and the commercial payment (from the net stumpage) of the licence premium.

8.13 The Court also noted that it was useful to point out that on the taxpayers' own approach to how the licence premium was calculated, it appeared that it was never intended that the forest would make a profit. It referred to a taxpayer document that set out the projected value of the forest and said that the compelling inference was that the $2,050,018 was the after-tax amount that the forest was expected to yield in 2048. It then observed that if the expected after-tax returns only equalled the licence premium to be paid out of the proceeds (which would not satisfy the insurance premium similarly payable in 2048), the apparent benefits to investors would only be the tax deductions.

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[152] 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.

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8.14 The Court similarly concluded that the promissory note to pay the insurance premium was an artificial payment implemented for the purpose of obtaining a tax advantage. The promissory note enabled the taxpayers to claim a deduction for their expenditure on the premium in one sum in the first year of the 50-year arrangement. The payment of the premium by means of the promissory note was, in commercial terms, no payment at all. It did not result in any economic consequences for the parties and deferred the economic impact of the payment for 50 years.

8.15 That finding, in combination with the following findings from the facts, lead to the inference that the insurance aspect of the arrangement was artificial and contrived. Due to being constructed in that way, the use of the specific provision could not have been within the contemplation of Parliament when it enacted the specific provision:

- The insurance involved a substantial amount of circularity as a result of a letter of comfort that indemnified in large part the insurer's risk.
- The premiums were not set on an independent basis.
- The insurer was not an arm's-length insurer because the designer of the arrangement controlled it.

Penny *(SC)*

8.16 The Supreme Court in *Penny* held that the arrangements were tax avoidance arrangements. Each arrangement involved the repetitive step of the annual setting of the taxpayers' salaries. The approach of the Supreme Court in reaching its conclusion was to examine why the salaries had been set at a certain level on each occasion. That involved a consideration of whether the salaries had been set on a commercial basis or for family purposes, or to obtain a more than merely incidental tax advantage.[153]

8.17 The Supreme Court observed that the setting of the low salary had the effect of increasing the amount of the company's professional practice income that was transferred to each taxpayer's family trust by way of dividend payment. The trust then used the dividend payment for the purposes of each taxpayer and his family. The dividend payment was taxed at the trustee rate of 33 cents in the dollar.[154]

8.18 The Supreme Court concluded that the purpose of the setting by the company of the taxpayer's salary at a low level was to obtain a tax advantage through the avoidance of the highest personal tax rate of 39 cents in the dollar.[155]

8.19 It was a reasonable inference from the arrangements and their effects that the setting of the low salary level, in combination with the operation of the other features of the arrangements, was to obtain a more than merely incidental tax advantage. This was because the tax advantage in each arrangement was not explicable as an incidence of any commercial purpose or effect, such as an inability to pay a higher salary due to financial difficulties or a need to retain funds for capital expenditure.

8.20 The inference was also supported by the dividend payment to each of the taxpayer's family trust, which showed that each company had:

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[153] At [34],

[154] At [35].

[155] At [36].

- the financial capacity to pay a higher salary; and
- no need to retain funds.

The Commissioner's approach to applying s BG 1

8.21 The Commissioner considers that a useful approach to applying s BG 1 to an arrangement involves:

- Understanding the legal form of the arrangement by:
  - Identifying all of the steps and transactions that make up the arrangement.
  - Understanding 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 Parliament's purpose for the specific provisions that are used or circumvented by the arrangement.
- Viewing the arrangement as a whole in a commercially and economically realistic way, including considering any non-tax avoidance purposes or effects. Factors 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 taken limited or no real risks; and
  - whether the arrangement is pre-tax negative.
- Determining, by inference from the facts and objectively determined non-tax avoidance purposes of the arrangement when viewed in a commercially and economically realistic way, whether the arrangement makes use of, or circumvents, the specific provision in a manner consistent with Parliament's purpose.

8.22 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. Viewing the arrangement in that way may give rise to the need to further analyse Parliament's purpose for a specific provision. This order of analysis is suggested because:

- Parliament's purpose for the specific provision under the Parliamentary contemplation test is the same as the purpose identified under the initial inquiry into whether the application or non-application of the specific provision is within its ordinary meaning and intended scope.
- Frequently, Parliament's purpose will already have been considered under the initial inquiry into whether the legal form of the arrangement comes within the ordinary meaning of the specific provisions. Therefore, when applying the Parliamentary contemplation test, identifying Parliament's purpose for the specific provision may not be needed as a separate exercise. When a detailed consideration of 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.
- Understanding Parliament's purpose for the specific provisions:
  - informs the analysis of whether the arrangement, when viewed in a commercially and economically realistic way, makes use of or circumvents the provision in a manner consistent with Parliament's purpose; and
  - provides 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.

8.23 Answering the question of whether the arrangement makes use of or circumvents the specific provision in a manner that is consistent with Parliament's purpose requires:

- viewing the arrangement as a whole and in a commercially and economically realistic way; and
- considering whether there is any elements of the arrangement from which it can be inferred that Parliament would not have contemplated the gaining of the tax advantages in the particular circumstances.

8.24 Considering the factors referred to by the courts assists in answering the question. This includes considering the particularly significant factor of whether the tax advantages have been obtained by way of artificiality or contrivance. The structuring of an arrangement so that a taxpayer gains the benefit of a specific provision in an artificial or contrived way is outside Parliamentary contemplation.[156] Therefore, it can assist to specifically consider whether, objectively determined, the arrangement has been structured so that a tax advantage is obtained by artificiality or contrivance.

8.25 Whether or not artificiality or contrivance is present, the Commissioner also considers that in some cases it can be useful to consider whether there are any facts, features or attributes that Parliament would contemplate being present (or absent) when permissible tax advantages arise under the specific provision. If such facts, features or attributes can be identified, they could be compared with the facts, features or attributes that are present (or absent) in the arrangement when viewed as a whole and in a commercially and economically realistic way.

8.26 Arrangements are likely to be outside of Parliament's purpose for specific provisions where:

- the arrangement has no commercial or private purpose;

[156] See *Ben Nevis* (SC) at [108].

- 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 such that the commercial or private purposes are dependent on a tax advantage being achieved.

Considering whether the tax avoidance purpose or effect is merely incidental

8.27 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.

8.28 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 permissible tax advantages (ie, where the use or the circumvention of specific provisions is within Parliament's contemplation).[157]

8.29 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 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 very unlikely that the arrangement's tax avoidance purpose will be merely incidental.

[157] See *Ben Nevis* (SC) at [106].

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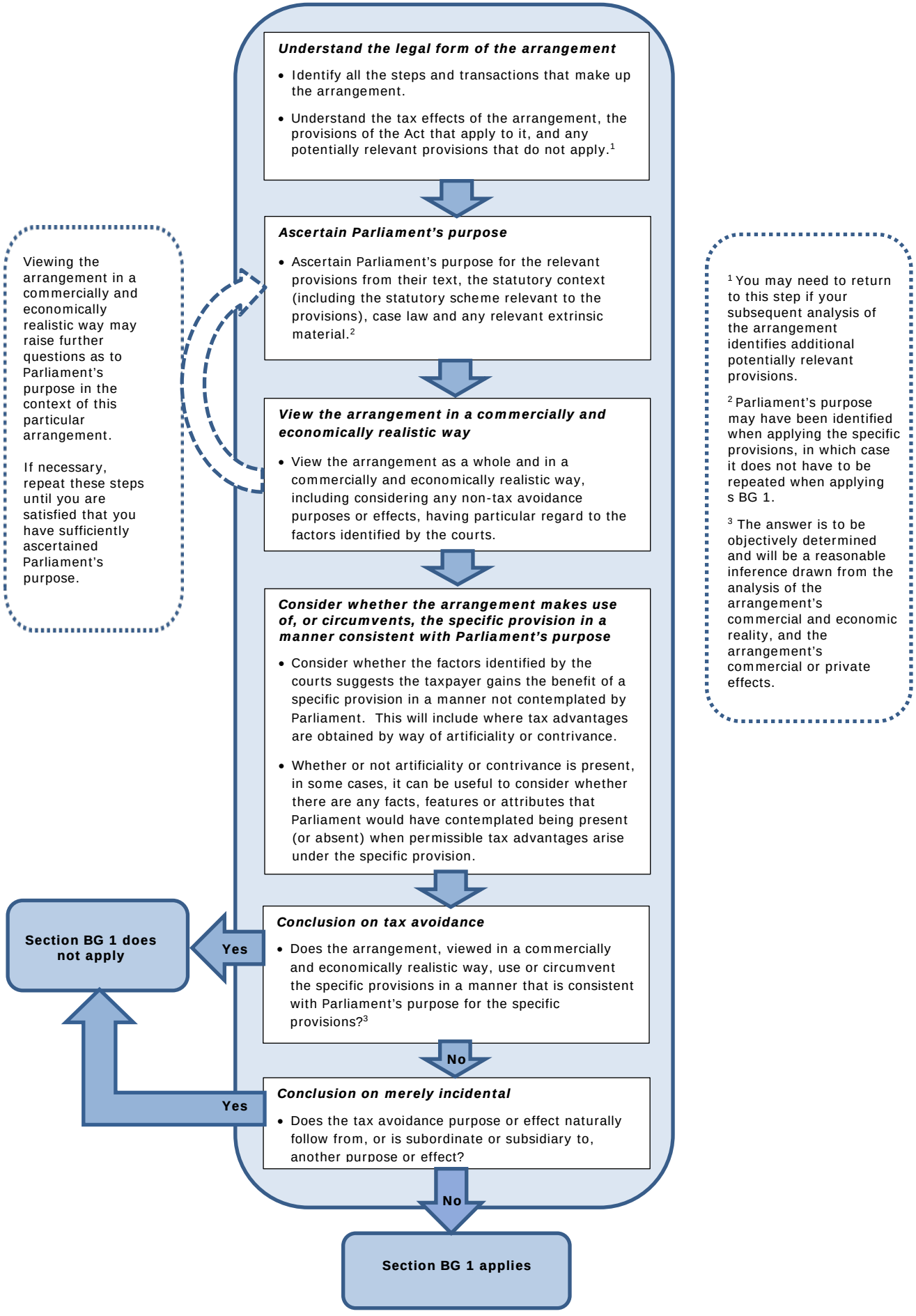
Flow chart 1: An approach to the tax avoidance inquiry



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Part 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.[158] 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.[159] 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. However, if the voiding does not do this, the Commissioner can apply s GA 1 to counteract the tax advantage.

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.[160] The word "may", recognises that there may be circumstances where it is not necessary to exercise the power in s GA 1. In other circumstances, the Commissioner is under a duty to apply s GA 1. The Privy Council in *Miller* stated:

> [23] … 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.

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[158] *Challenge* (CA) at 548; *Wisheart, Macnab and Kidd v CIR* [1972] NZLR 319 (CA) at 337.

[159] Section GA 1(1).

[160] 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.

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The nature of the adjustment power in s GA 1

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. That is, the impermissible tax advantages referred to be the Supreme Court in *Ben Nevis.*[161] The Supreme Court in *Ben Nevis* describes these types of tax outcomes as "impermissible" tax advantages.

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.[162] 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

[161] At [106].

[162] *Miller v CIR* [1999] 1 NZLR 275 (CA) at 302.

> 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.[163] 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.[164] However, the Court's earlier discussion of concurrent assessments and consequential adjustments suggests this link.[165]

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.[166]

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:

> [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**

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[163] At 304.

[164] The section that prevents double counting is now s GA 1(6).

[165] At 292.

[166] For example, *Ben Nevis* (SC) at [31]; *Glenharrow* (SC) at [55]; *Peterson v CIR (No 2)* (2002) 20 NZTC 17,761 (HC) at [70].

> **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".[167] 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 Commissioner's power under s GA 1 does not extend beyond making adjustments to counteract tax advantages. 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 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**

[167] At [64].

> **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]

Commissioner may choose from different options to counteract a tax advantage

9.27 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.[168]

9.29 Similarly, the High Court in *Miller* said:[169]

> 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.

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:

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[168] At [624] and [668].

[169] At 13,036.

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.

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.[170]

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 treatment 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.[171]

9.38 Blanchard J also noted in *Miller* (CA) that the Commissioner:[172]

> … **"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]

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[170] At 169.

[171] At 623.

[172] At 302.

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 is 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 a hypothetical alternative arrangement.

9.44 Further, where the Commissioner applies s GA 1(4) and (5), the Commissioner:

- must counteract any tax advantage obtained;[173] and
- does not need to determine an alternative beneficial transaction that the taxpayer might have entered into but did not.[174]

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:[175]

> **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**

[173] *Westpac* (HC) at [623]; *Ben Nevis* (SC) at [169].

[174] *Westpac* (HC) at [623]; *Accent* (CA) at [155].

[175] At 301.

> **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]

The scope of the adjustment power in s GA 1

Taxable income of a "person affected" by the arrangement may be adjusted

9.46 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.

9.47 Lord Millett in *Peterson* (PC) considered a person could be affected by an arrangement whether or not they were a party to it and privy to its details:

> [34] Their Lordships are satisfied that the "arrangement" which the commissioner 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]

9.48 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]

9.49 Therefore, "a person affected" by a tax avoidance arrangement may include a person whether they are:

- party to the arrangement;[176] or
- unaware they have benefited from the arrangement.[177]

9.50 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.

9.51 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.

The timing of when taxable income may be adjusted

9.52 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

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[176] *Peterson* (PC) at [33]–[34]; *BNZ Investments No 1* (CA) at [175].

[177] *Ben Nevis* (SC) at [164]–[168].

tax losses may mean the tax advantage from or under the arrangement relates to future tax liabilities.

9.53 Thus, a tax advantage may eventuate after the arrangement is put in place. If so, the s GA 1(2) adjustment will be the result of an arrangement put in place in a previous year.

Tax credits may be adjusted

9.54 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

9.55 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.

9.56 A predecessor to s GA 1(6) was considered in *Miller* (CA) Blanchard J stated:[178]

> 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]

9.57 The Commissioner cannot ultimately include an amount of income or deduction in the taxable income of more than one person when determining an appropriate adjustment.

Ancillary taxes may be adjusted

9.58 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".

9.59 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".

9.60 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.

[178] At 292.

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Onus is on taxpayer to show adjustment is wrong and by how much

9.61 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]

9.62 This is a long-established proposition and similar comments were made in *Westpac* (HC).[179]

[179] At 631.

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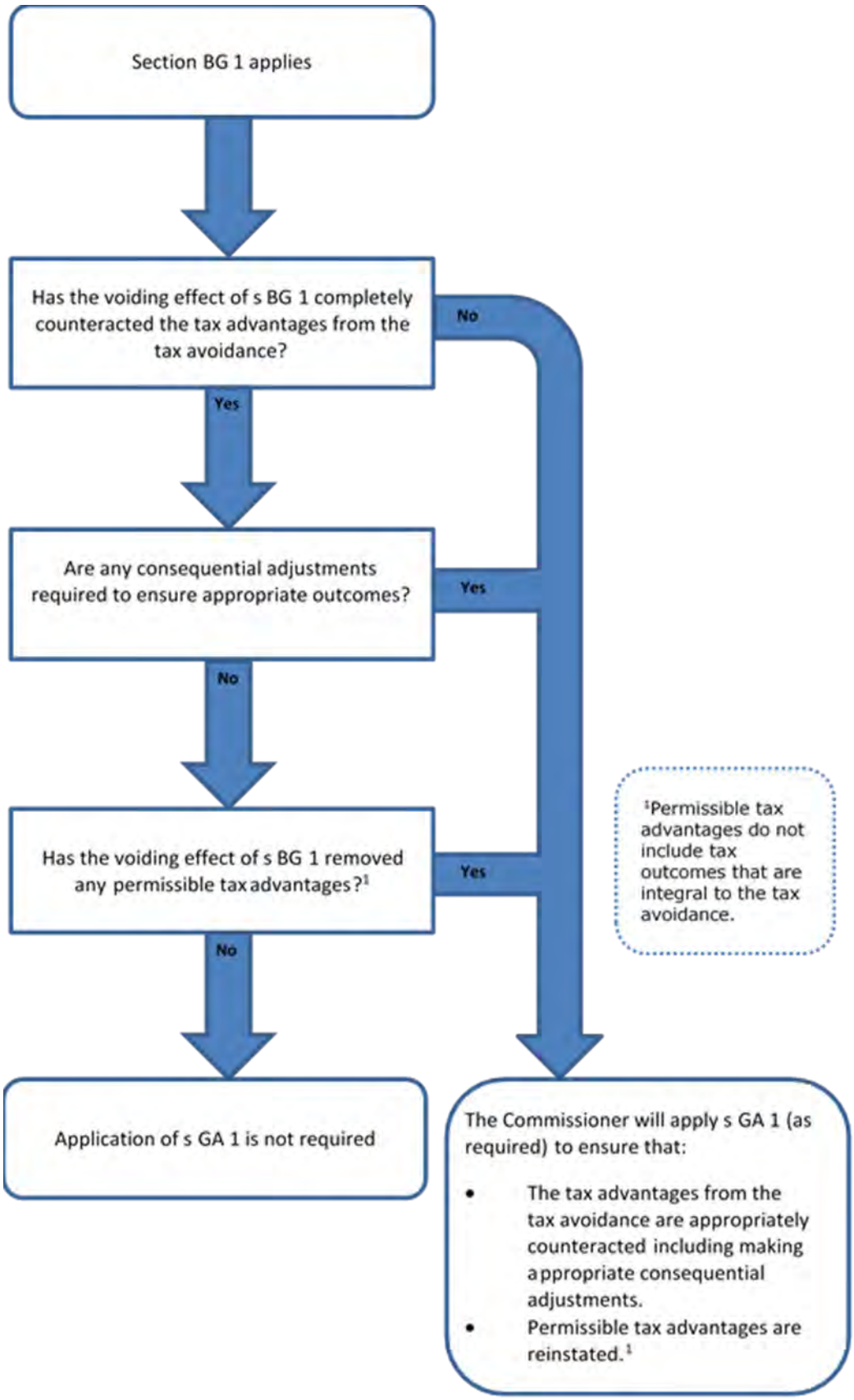
Flow chart 2: An approach to s GA 1



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Part 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 approach to s BG 1 was settled by the Supreme Court in *Ben Nevis* (as reiterated by the Supreme Court in *Penny*).

10.3 Despite this, questions sometimes arise as to whether the following judicial approaches from before *Ben Nevis* and *Penny* 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 under the Parliamentary contemplation test

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:[180]

> 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 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.*[181]

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 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.[182]

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[180] At 549.

[181] At footnote 113.

[182] At 558.

- 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.[183]

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.[184]
- 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.[185]

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.[186] The Privy Council did not accept that on a purposive approach the application of the general anti-avoidance 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 Supreme Court in *Glenharrow* referred to the phrase "scheme and purpose" in the context of addressing a submission from a taxpayer that the general anti-avoidance provision in the GST Act produces uncertainty. The Court said:

> [48] … But that uncertainty is inherent where transactions have artificial features combined with advantageous tax consequences not contemplated by the scheme and purpose of the [GST 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.

10.13 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.
- 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

[183] At 562–563.

[184] At [88].

[185] At [89].

[186] At [94].

provisions and placed significantly less, if any, emphasis on an arrangement's commercial and economic reality.

10.14 The Commissioner considers that case law after *Ben Nevis* (SC) supports the Commissioner's view of Richardson J's "scheme and purpose" approach.

10.15 For example, 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.

10.16 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.

10.17 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

10.18 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.

10.19 The choice principle originates from the decision of the High Court of Australia in *Keighery*.[187] 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 J and Dixon J in their joint judgment said:[188]

> 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.

10.20 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:[189]

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[187] *WP Keighery Pty Ltd v FCT* (1957) 100 CLR 66 (HCA).

[188] At 92.

[189] *Mullens v FCT* (1976) 135 CLR 290 (HCA) at 318.

> 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]

10.21 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.[190]
- Richardson J, on the other hand, and perhaps reflecting the legalistic nature of his "scheme and purpose" approach, 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.[191]

10.22 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.

10.23 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.[192] 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.

10.24 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.

10.25 The Commissioner's view is that, guided by the comments made by the Supreme Court in *Ben Nevis* at [111] and the comments and approach of the Court in *Penny*, the choice principle does not provide immunity from s BG 1. 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 in a commercially and economically realistic way.

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[190] At 538–539.

[191] At 552.

[192] At [33].

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Predication test remains relevant to the extent it is necessary to objectively determine that tax avoidance is a purpose

10.26 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:[193]

> 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.

10.27 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:[194]

> 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.

10.28 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:[195]:

> 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.

10.29 Lord Donovan, in delivering the majority judgment of the Privy Council in *Mangin*, said that:[196]

- 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.

10.30 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

[193] At 466.

[194] At 467.

[195] At 694.

[196] At 598.

general anti-avoidance provision applied to an arrangement only if tax avoidance was the sole or principal purpose of the arrangement.

10.31 However, five years after *Mangin*, the Privy Council in *Ashton* referred to Lord Denning's predication test (at 723). The Privy Council said that if one purpose or effect of an arrangement is tax avoidance, then the general anti-avoidance provision will apply:[197]

> 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

10.32 McMullin J in *Tayles* (CA) said:[198]

- 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.

10.33 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.[199]
- 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).[200] 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

[197] At 723.

[198] At 735.

[199] At 535.

[200] At 539.

arrangement as a tax avoidance arrangement would defeat, and not promote, the purpose of the provision.[201]

10.34 In the Privy Council in *Challenge*, neither the majority nor minority, referred to the predication test.

10.35 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]

10.36 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]

10.37 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 continues to remain relevant in that it is necessary to objectively determine or "predicate" that tax avoidance is a purpose or effect of the arrangement; and
- predicating that tax avoidance is a purpose or effect of the arrangement will principally be a matter of inference from the arrangement (viewed in a commercially and economically realistic way) and its effect.

Section BG 1 can apply to a "new source" of income

10.38 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*.[202] Lord Diplock stated:[203]

> 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 legal effect were given

[201] At 551.

[202] *Europa Oil (NZ) Ltd v CIR* [1976] 1 NZLR 546 (PC) (*Europa No 2* (PC)).

[203] At 556.

> to the contract, agreement, or arrangement sought to be avoided as against the Commissioner. T**he 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]

10.39 The doctrine was considered in *Gulland* (HCA) and *Bunting* (FCAFC).[204] 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.

10.40 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".

10.41 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

10.42 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*:[205]

> 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.

10.43 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.

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[204] *FCT v Gulland* (1985) 160 CLR 55 (HCA) and *Bunting v FCT* 89 ATC 5,245 (FCAFC).

[205] At 19.

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10.44 For instance, Woodhouse J in *Elmiger* (SC) said:[206]

> … 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.

10.45 Woodhouse J went on to find that the general anti-avoidance provision applied to the arrangement. He examined the overt acts by which the arrangement had been carried out. He said a clear inference could be drawn that one of the designed (actuating) purposes of the arrangement was to reduc come by fictitious deductions, which altered the incidence of income tax.

10.46 Baragwanath J in *Miller* (HC) said:[207]

> 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].

10.47 The Australian High Court in *Spotless Services* said Lord Tomlin's statement in the *Duke of Westminster* had no significance in Australia where there is a statutory anti-avoidance provision.[208]

10.48 The Supreme Court in *Ben Nevis*, *Glenharrow,* and *Penny* did not mention the *Duke of Westminster* principle.

10.49 The Commissioner considers that it is settled law that the *Duke of Westminster* principle is not relevant when applying s BG 1.

Whether the Commissioner's inability to dictate how taxpayers do business is relevant

10.50 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.[209]

10.51 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.

10.52 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

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[206] At 686–687.

[207] At 13,032.

[208] *FCT v Spotless Services Ltd* 96 ATC 5201 (HCA) at 5205.

[209] *Cecil Bros Pty Ltd v FCT* (1964) 111 CLR 430 (HCA); *Europa No 1* (PC); *Europa No 2* (PC).

how much a taxpayer ought to spend in obtaining his income".[210] The Privy Council cited that statement with approval in *Europa No 1*, *Europa No 2*, and *Peterson*.

10.53 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.

10.54 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 in a commercially and economically realistic way.

10.55 Viewing an arrangement 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.

10.56 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:[211]

> 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.

10.57 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.

10.58 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.

10.59 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**

[210] At 434.

[211] At [49].

> **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]

10.60 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.

10.61 The Commissioner, however, does not accept that the above principle 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 her 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.

10.62 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.

Whether complex arrangements are necessarily tax avoidance arrangements

10.63 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).

10.64 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.

10.65 For example, in *BNZ Investments No 2* (HC) and *Westpac* (HC) the transactions were in economic substance straightforward loans but involved complex structuring to achieve tax advantages. In both cases, the High Court held that the transactions had no independent commercial rational or logic because they were loss making. The Court said that the only, or primary purpose, of the transactions was to obtain tax advantages.

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10.66 The Supreme Court in *Ben Nevis* observed that taxpayers have the freedom to structure transactions to their best tax advantage.[212] However, they cannot do so in a way proscribed by s BG 1.

Whether s BG 1 can be used by the Commissioner to fill in a legislative gap

10.67 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.

10.68 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.

10.69 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.

10.70 The leading case in New Zealand on "gap filling" is the decision of the Court of Appeal in *Northland Milk Vendors.*[213] 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.

10.71 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.

10.72 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.

10.73 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 interpretation of s BG 1. Nor is it a principle applicable to the application of the Parliamentary contemplation test. The Parliamentary contemplation test is not concerned with how an arrangement uses or circumvents a non-existent provision.

[212] At [111].

[213] *Northland Milk Vendors Association v Northern Milk Ltd* [1988] 1 NZLR 530 (CA).

- Using s BG 1 and s GA 1 to fill a gap would involve the Commissioner making policy, which is a function solely for Parliament.

Whether an arrangement resulting in tax being paid can involve tax avoidance

10.74 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 if an arrangement results in the payment of more tax when all affected parties are considered then it cannot be a tax avoidance arrangement for the parties who might be considered to have, despite this overall effect, paid less tax.

10.75 The Commissioner does not accept these arguments for the following reasons:

- Specific provisions apply to individual taxpayers and not in an aggregated (global) way such that the taxpayers involved in an arrangement are treated as a single taxpayer.
- The Parliamentary contemplation test is applied to the arrangement (actually) entered into. As the Court of Appeal made clear in *Alesco*, the Parliamentary contemplation test does not require undertaking a comparative analysis between the arrangement (actually) entered into and one or more counterfactual arrangements.
- 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.

Whether a tax advantage in another country is a tax avoidance purpose or effect

10.76 A cross-border arrangement is an arrangement that has steps in two or more countries. An effect of a cross-border arrangement might be the gaining of 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.

10.77 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.[214] 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 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.

[214] Under the definitions in s YA 1 of "income tax", "tax avoidance arrangement" and "tax avoidance".

10.78 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.

10.79 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.

10.80 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, the tax avoidance purpose will not be merely incidental.

10.81 And also, 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.

Whether double tax agreements affect how s BG 1 applies

10.82 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.

10.83 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.

10.84 The Commissioner's view on the interaction of s BG 1 and a DTA is explained in a *Tax Information Bulletin* item:[215]

> … 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. …

10.85 If an arrangement uses or circumvents specific provisions of the Act and a DTA also applies, then 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,

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[215] *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.

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.

10.86 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.

10.87 In addition, the articles of a DTA are effectively incorporated into New Zealand domestic law.[216] As such, in a s BG 1 inquiry the articles of a DTA are treated as if they were specific provisions of the Act. Thus, if an arrangement uses or circumvents an article of a DTA, under s BG 1 the DTA applies to the 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.

10.88 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.

Whether s BG 1 produces uncertainty

10.89 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.

10.90 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:

> [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 [of the Land and Income Tax Act 1954], 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.**
>
> ...
>
> [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

[216] *CIR v Lin* [2018] NZCA 38 at [8].

> 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]

10.91 The Supreme Court in *Glenharrow* said that there will inevitably 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.**
>
> [49] Transactions which are driven only by commercial imperatives are unlikely to produce tax consequences outside the 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]

10.92 Hammond J in *Penny* (CA) observed that in taxation law the function of the courts is to see that 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.

10.93 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 inevitable 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.

10.94 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.

10.95 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.

10.96 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.

Draft items produced by the Tax Counsel Office represent the preliminary, though considered, views of the Commissioner of Inland Revenue.

In draft form these items may not be relied on by taxation officers, taxpayers, and practitioners. Only finalised items represent authoritative statements by Inland Revenue of its stance on the particular issues covered.

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APPENDIX 1 – LEGISLATION

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.

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APPENDIX 2 – EXAMPLES FROM THE COURTS

This appendix contains examples of how the courts have used the relevant factors mentioned in Part 7 to view an arrangement in a commercially and economically realistic way

Factors identified by the courts

1. Determining whether an arrangement makes use of, or circumvents, the specific provisions in a manner consistent with Parliament's purpose includes viewing an arrangement in a commercially and economically realistic way. This can be assisted by considering the factors that the courts have referred to:[217]

   - whether the arrangement involves artificiality, contrivance or 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 undertaking limited or no real risks; and
   - whether the arrangement is pre-tax negative.

2. The following paragraphs discuss the factors with reference to examples from tax avoidance case law. Due to the factual focus of viewing the arrangement in a commercially and economically realistic way, these examples discuss the facts of the cases in some detail.

Artificiality or contrivance

Promissory notes in Ben Nevis *(SC) were an artificial component of the arrangement*

3. The Supreme Court in *Ben Nevis* said that the licence premium promissory notes were an artificial element. From a commercial point of view, they were a gratuitous mechanism. The Court held that the primary, if not sole, purpose of the promissory notes was to generate a tax deduction. The notes were an artificial component that had been included in the arrangement for the purpose of tax avoidance. The Court said:

> [119] … The commercial aspects must, however, be considered because the context is suggestive of tax avoidance. In part that is because requiring that promissory notes be given, before the expenditure was to be incurred in reality, introduced an artificial element into the arrangement. From a business point of view the promissory note was a gratuitous mechanism. We do not accept the appellants' argument that it secured or facilitated the payment of the licence premium by the syndicate in 2048 in any real sense.

[217] As discussed in Part 7.

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...

> [122] ... The clarity of the tax advantages was in marked contrast to the obscurity of the prospect of any ultimate commercial profit. **This leads us to the conclusion that the primary if not the sole purpose of the promissory note,** with its link to the licence premium obligation**, is to generate a tax deduction for the licence premium. It is an artificial component of the arrangement which we are satisfied was included for the purpose of tax avoidance.** [Emphasis added]

4. 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 dimension of the arrangement was both artificial and contrived . For these reasons, the taxpayer's use of the relevant specific provisions was not within the contemplation of Parliament. The Court said:

> [147] ... We do not accept this as being the principal purpose of the promissory note. Its true purpose was to enable the contractual debt for the premium to be treated as discharged by the giving of the promissory note. By this means the premium payable in 2047 could be said to have been paid in 1997. As already mentioned, this is technically correct in law, but, in substance, the debt remains unpaid. There is no transfer of real value to the creditor by substituting one form of obligation for another. **Hence the promissory note was an artificial payment implemented for taxation purposes.** The simple fact is that the second premium was not paid in any real sense by means of the promissory note. **The use of the promissory note as an aspect of the whole arrangement reinforces its artificiality**. CSI [the insurer] undertook no real risk and was simply a vehicle to achieve the deductibility of a premium which was not truly paid ...
>
> [148] It is inherent in all we have said on this topic that we regard the insurance dimension of the Trinity scheme as both artificial and contrived. The payment of the second premium by means of the promissory note was, in commercial terms, no payment at all ... The insurance arrangements, as constructed, cannot have been within the contemplation of Parliament when it enacted s DL 1(3). In short, the insurance dimension is a material contributor to making the whole Trinity scheme a tax avoidance arrangement. [Emphasis added, footnotes omitted]

Payment of the price for the mining licence in Glenharrow *(SC) was artificial*

5. The Supreme Court in *Glenharrow* noted the trial Judge's finding of fact that the price of $45m for the mining licence was the subject of a genuine bargain and not artificially inflated.[218] However, the Court held that the arrangement still had a very artificial element.[219]

6. That artificial element was not the price of the mining licence but the payment of the price. The price was paid in legal terms by an exchange of cheques and vendor finance. But, objectively determined at the time the arrangement was entered into, the payment in commercial and economic terms was an impossibility.

7. The artificial payment created a distorting effect and the Court held that this distorting effect defeated the intent and application of the GST Act.[220]

Salaries in Penny *(SC) were set at an artificially low level*

8. The Supreme Court in *Penny*:[221]

   - Said that s BG 1 has "work to do whenever a taxpayer uses specific provisions of the Act and otherwise legitimate structures in a manner that

[218] At [50].

[219] At [51].

[220] At [54].

[221] At [47].

cannot have been within the contemplation of Parliament". This includes where a taxpayer uses a legitimate structure in an artificial manner to obtain a tax advantage.

- Adopted the observation of Woodhouse P in *Challenge* (PC) that the general anti-avoidance provision is a "weapon to thwart technically correct but contrived transactions set up as a means of exploiting the Act for tax advantages."

9. The Supreme Court in *Penny* held that s BG 1 applied to each arrangement. The Court held that each taxpayer's salary had been set at a low level by the respective companies that employed them for the predominant purpose of obtaining a tax advantage (although the Court acknowledged that the Commissioner does not have to establish a predominant purpose).[222]

10. The Court 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.[223] 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.

11. Each arrangement sought to take advantage of the specific provisions 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.

12. The use of the company structure to set the taxpayer's salary at an artificially low level to obtain a tax advantage was a contrivance set up as a means of exploiting the Act. The arrangement was within the scope of s BG 1 because it is the provision in the Act to thwart technically correct but contrived transactions set up as a means of exploiting the Act for tax advantages.

Guarantee procurement fee and the swap rate in BNZ Investments No 2 *(HC) were contrivances*

13. The High Court in *BNZ Investments No 2* considered the factual issue of whether a GPF was a contrivance.[224] 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:

> [327] At one level — that favoured in the Bank's closing submissions — the GPF is commercially explicable and reasonable. But I am required to view these transactions in a commercially and economically realistic way. **So viewed, I am unable to avoid the conclusion that the GPF was a contrivance, in that its genesis and primary function was tax advantage: to create a deductible expense, and to contribute to the income produced by the transaction (in the case of the BNZ, tax relieved income)** … [Emphasis added]

14. The Court also concluded that the setting of the swap rate was contrived to increase the tax benefits flowing from the transactions. The Court stated:

> [388] **I conclude that the setting of the fixed swap rate well in advance of the transaction, and/or the failure to re-set it shortly before the transaction closed, was** not **in accordance with normal commercial practice. Given the analysis I have set out at [380]–[384], and the differences in the table at [396], I find this was contrived to increase the tax benefits flowing from the transactions.** For example, when the rate was fixed for the Gen Re 1 and CSFB transactions, the NZ yield curve was significantly downward

[222] At [34]–[36].

[223] At [47].

[224] At [306]–[330].

> sloping ie shorter term swap rates were significantly higher than longer term swap rates. Thus, by taking the one year rate the BNZ artificially boosted the tax benefits from those two transactions. [The expert witness] calculated that this boosted the annual tax reductions obtained by the BNZ by NZ$2 million approximately in the Gen Re 1 transaction, and by NZ$1.5 million in the CSFB transaction (PB 5.42–5.43). [Emphasis added]

15. 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.[225]

Guarantee procurement fee in Westpac *(HC) was a contrivance*

16. The High Court in *Westpac* similarly concluded that the GPF was a contrivance in the arrangements in issue. The Court said:

> [595] Why then did Westpac agree without question to pay the GPF? I am in no doubt that the GPF's function was to generate a statutory deduction for an expense which appeared genuine but was in truth a contrivance: *Ben Nevis* at [122]. Its existence is a "classic indicator" of a tax avoidance purpose: *Ben Nevis* at [108]. Westpac claimed a deduction for the GPF on the misleading representation, which it must have expected the Commissioner to accept in good faith, that the expense was commercially justifiable and fixed at a market rate.
>
> ...
>
> [597] As Mr Brown submits, all the evidence points to a unity of purpose in obtaining and dividing the maximum possible tax benefits available to Westpac. **This purpose was successfully achieved by means of a contrivance, both in concept and amount.** The contrived expense was also, by virtue of the self-cancelling effect of the exchanges inherent in the pricing structure, illusory. The disparity between the underlying economics of the transaction and the resulting taxation treatment confirms that the anticipated tax effect was the true purpose of the transaction. [Emphasis added]

Arrangement in Education Administration *(HC) was artificial and contrived*

17. 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.

18. 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 factors were that:

- 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.

19. 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.

[225] At [526].

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20. 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:

> [84] The Commissioner's decision in this case does not mean that every mismatch, every timing advantage will be susceptible to the application of s 76. The reason this particular mismatch crossed the line is because it was part of an arrangement that, viewed objectively, was structured so as to gain a tax benefit in an artificial and contrived way.

Agreed value of shares in Frucor *(CA) was an artificial and contrived figure*

10.97 The Court of Appeal in *Frucor* 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 Court of Appeal concluded that the taxpayer had used the specific provisions to claim deductions for interest in an artificial and contrived manner that cannot have been with Parliament's contemplation.[226]

10.98 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, she disallowed interest deductions claimed for the balance ($149m). In its assessment, the Court of Appeal noted, among other things, that the agreed value of the shares at conversion was artificial and contrived, stating:

> [97] [The taxpayer]'s fall-back position is that even if it can be said that Frucor effectively received $149 million from DAP in return for the issue of shares in five years' time, this would be a financial arrangement entitling Frucor to a $55 million deduction based on the difference between the amount paid and the agreed value of the shares at the end of the period. **The difficulty with this proposition is that the figure of $204,421,565 was an artificially contrived figure and had nothing to do with the value of the shares.** The capital requirement was $147 million (plus the fee). That was the amount DAP subscribed for the additional non-voting shares. These additional shares conferred no additional rights on DAP and their "value" to DAP would not grow over the five-year period. In reality, these shares had no value to DAP (as the 100 per cent parent) as long as they did not end up with a third party. The funding arrangement was designed to ensure that would not happen. [Emphasis added]

Pretence

Taxpayer and its subsidiaries in Challenge *(PC) pretended they had suffered a loss*

21. 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:[227]

> Stripped of pretence, one taxpayer, Challenge, was purchasing the tax benefit of a loss sustained by another taxpayer, Perth. If successful, Challenge would obtain a tax advantage of $2.85 million by means of an arrangement and the benefit of that tax advantage would then be divided between Challenge and Merbank. A clearer case for the application of s [BG 1] cannot be imagined. If such an arrangement were not caught by s [BG 1] and were recognised by the Courts for tax purposes, income tax would only be collected from those profitable companies which failed to come to terms with loss making companies.

22. 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

[226] At [59].

[227] At 558.

company outside the taxpayer's group of companies. The sole purpose of the arrangement was tax avoidance. The Privy Council majority said:[228]

> **Most tax avoidance involves a pretence**; see the analysis in *W T Ramsay Ltd v Inland Revenue Commissioners* [1979] 1 WLR 974, 975 (CA). **In the present case Challenge and their taxpayer subsidiaries pretend that they suffered a loss when in truth the loss was sustained by Perth and suffered by Merbank**. In New Zealand s [BG 1] would apply to all the cited English cases of income tax avoidance. Section [BG 1] also applies where, as in this case, the taxpayer alleges that he has achieved the magic result of creating a tax loss by purchasing the tax loss of another taxpayer. In order to escape s [BG 1] a transferable loss must be sustained by a member of a group which suffers the loss.
>
> In the present case the facts are starkly simple. Perth appears to have had no assets and no debts. The only purpose of the agreement dated 28 February 1978 was tax avoidance. [Emphasis added]

Taxpayer in Dandelion *(CA) pretended to make an investment in another group company*

23. 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.

24. 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".[229]

Manner in which the arrangement is carried out

Licence premiums and promissory notes in Ben Nevis *(SC)*

25. The structure of the arrangement in *Ben Nevis* (SC) included:

- the granting of a licence to use land to grow Douglas fir to a syndicate of investors that included the taxpayers; and
- the syndicate's payment of a licence premium of $2,050,518 per plantable hectare by promissory notes which were written promises to pay the premium in 50 years.

26. The Supreme Court held that from a business point of view the promissory notes were a gratuitous mechanism in the structure.[230] That is, the notes served no commercial purpose and did not secure or facilitate the payment in cash of the premium in 2048 in any real sense.

27. The Court considered that two other features of the structuring of the arrangement were also relevant:[231]

- the real risk that the arrangement would never be commercially profitable; and
- the timing mismatch between when the expenditure on the licence premium was legally incurred (1997) and when it would be payable in an economic sense (2047).

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[228] At 562-563.

[229] At [85].

[230] At [119].

[231] At [120].

28. These two features are discussed below from [44] as part of the economic and commercial effect of documents and transactions factor.

29. The structure of the arrangement in *Ben Nevis* (SC) also included:

- incorporation of a single purpose company (CSI) in a tax haven to provide insurance against the risk that the market value of the net stumpage would not reach $2,050,518 per plantable hectare in 2048; and
- payment of the second insurance premium by promissory note (to pay the premium in 50 years).

30. The Supreme Court concluded that:[232]

- 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.

Guarantee procurement fee and interest rate swaps in BNZ Investments No 2 *(HC)*

31. The High Court in *BNZ Investments No 2* commented on various unusual features of the arrangements and how they were structured and carried out:[233]

- Each of the six arrangements was a template transaction. That is, a standard form transaction replicated for different businesses. Although a standard form transaction can be entirely commercial, a template replicated for different businesses 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 (GPF), where a lender pays the parent of the borrower to provide a guarantee of the borrower's obligations, in each arrangement was:
  - commercially unusual;
  - not commercially justifiable;
  - a contrivance; and
  - even if commercially justifiable, at a rate that was grossly inflated above any market rate.
- The structure of each arrangement enabled the New Zealand tax benefits to be shared between the BNZ and the counterparty. And the split moved progressively in favour of BNZ over the course of the arrangements. This reflected BNZ's increasing awareness of the commercial value of its ability to generate exempt income and use its tax capacity.
- The interest rate swap was included in the structure of each arrangement for the primary purpose of facilitating a fixed distribution rate that then fixed the tax benefits shared by the parties to each arrangement.

[232] At [148]–[149].

[233] At [284]–[285], [359], [404] and [516].

- The manner in which the interest rate swaps were transacted were not in accord with market practice. It resulted in the rates, in at least two arrangements, being well out of line with the prevailing market rate.

Guarantee procurement fee in Westpac *(HC)*

32. The High Court in *Westpac* examined four arrangements. The Court considered one arrangement, the Koch arrangement, was representative of the key elements in all four arrangements, so examined it in detail. The Court found on an objective analysis of the evidence that the structure of the Koch arrangement did not make commercial sense and contained commercially unusual features.[234]

33. The Court observed that the contemporaneous documents did not justify nor explain why:[235]

- Westpac, a lower rated entity, was providing funds to Koch, a higher rated entity, contrary to usual market theory and practice;
- Koch agreed to pay a price for the funds from Westpac well in excess of the market price payable by an entity with Koch's credit rating; and
- Westpac and Koch agreed to exchange equivalent amounts.

34. The Court held:[236]

- The inclusion of the GPF in the arrangement did not serve an objectively ascertainable business purpose. It was a gratuitous mechanism. 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.
- Due to the self-cancelling effect of the exchanges in the pricing structure, the GPF expense was illusory.
- Due to the way in which the arrangement had been structured, there was no underlying prospect of commercial profit for Westpac and no commercial justification or rationale for the arrangement.

Payments in Education Administration *(HC)*

35. *Education Administration* (HC) is a further example of where the way the arrangement was carried out was significant. The High Court described aspects of the arrangement as unusual:

> [57] On anyone's view of it, there were some unusual aspects to the agreement between the two companies, most notably the fact that Education Administration was only required to pay 10 per cent of each invoice immediately with the remaining 90 per cent payable at some unspecified time in the future, without any component of interest being charged, and only from revenue generated by sales which were not guaranteed.

[234] At [586].

[235] At [586].

[236] At [594], [601] and [603].

Artificially low salaries in Penny *(SC)*

36. The Supreme Court in *Penny* said that the structure each taxpayer adopted was, as a structure, entirely lawful and unremarkable. The structure involved each taxpayer transferring his business, an orthopaedic practice, to a company owned by his family trust. And the company employing the taxpayer on a salaried basis. The Court stated:

> [33] … The structure both taxpayers adopted when they transferred their businesses (orthopaedic practices) to companies owned by their family trusts was, as a structure, entirely lawful and unremarkable. The adoption of such a familiar trading structure cannot per se be said to involve tax avoidance. It was a choice the taxpayers were entitled to make. Nor is there anything unusual or artificial in a taxpayer then causing the company under his control to employ him on a salaried basis …

37. 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 taxpayer's professional services, to be transferred by way of dividends to his family trust and used by the trust to benefit the taxpayer; and
- each taxpayer to obtain a reduction in liability to tax but, in reality, suffer no actual loss of income.

Role of all relevant parties and their relationships

Single purpose company in Ben Nevis *(SC)*

38. The role and relationship of the scheme's architect with the insurer (CSI), was significant in *Ben Nevis* (SC). The insurance aspect was a key feature of the arrangement's structure. CSI was incorporated on the instructions of the scheme's architect and he was instrumental in the formulation of CSI's business plan.

39. The Supreme Court said that it was not unreasonable to describe CSI as a single purpose company brought into being to provide insurance cover in terms of which the investors could achieve substantial tax advantages.[237] The tax advantages were achieved by the deduction of the second insurance premium, without suffering any actual economic outlay and this was made possible due to the role of the scheme's architect.

Company and the family trust in Penny *(SC)*

40. The roles and relationships of the parties was also a significant factor in *Penny* (SC). The company and family trust enabled each taxpayer to use funds without the impost of the highest personal tax rate. The Supreme Court stated:

> [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). **Although neither taxpayer was a trustee, each could naturally expect that the trustees whom they had chosen would act as they in fact**

[237] At [142].

> **did, and that the benefits of the use of the funds would thereby be secured without the impost of the highest personal tax rate.** [Emphasis added]

Companies and partnerships in Russell *(HC)*

41. The roles and relationships of the taxpayer with various companies and partnerships were also a significant factor in *Russell* (HC). The High Court described the arrangement as contrived. The arrangement was designed to ensure the income the taxpayer earned through his personal exertions was diverted through a myriad of companies and partnerships under his control. This had the effect that the taxpayer paid no tax and could control how the untaxed money was used. The Court said:

> [131] … Like the taxpayers in *Penny*, Mr Russell continued to devote his personal exertions to the generation of income. He allocated to himself a nominal salary each year. That salary was first paid by CSL and later by the trusts. It did not bear any relationship to the work Mr Russell undertook, or to salaries properly payable in the marketplace**. Very significantly, Mr Russell retained control of the whole of the income generated; only he could direct how it was to be applied. The income of the Commercial Management partnership was in my judgment derived from Mr Russell's personal exertions and he retained complete control over it.** [Emphasis added]

Intermediaries in Cullen Group *(HC)*

42. The High Court in *Cullen* questioned whether, for the relevant specific provisions, Parliament contemplated transactions between highly-related parties:

> [65] As Mr Cooper acknowledges, although Modena and Mayfair were intermediaries, Mr Watson was the ultimate lender. And it appears Mr Watson may not have been tax resident in New Zealand at the time, though I do not decide that. So, in this sense – in form – there may have been lending from a foreign lender to a New Zealand borrower, Cullen Group. But neither the lender nor the borrower were independent. Mr Watson had exchanged equity in CIL for debt owed by Cullen Group to Modena and Mayfair and, ultimately, back to him. **As I found above, Mr Watson retained a determining level of control over Modena and Mayfair through the terms of the loans. And he retained a very high level of control over Cullen Group, through the trust ownership structure involving VEL, the Valley Trust, the Cullen Business Trust, CBTL and the Gulf Trust. That level of control is usually an incident of ownership of equity, rather than of debt. In reality, Mr Watson was on both sides of the loan transactions, instead of his previous position as a holder of equity.** The ownership and debt relationships were structured in such as a way as to allow Mr Watson, through Cullen Group in New Zealand, to use the AIL regime to pay AIL at two per cent rather than NRWT at 15 per cent. **Did Parliament contemplate that AIL rather than NRWT should be payable when the loan is between such highly related parties?** [Emphasis added]

43. The Court considered the taxpayer retained a high degree of control over the relevant entities, he was on both sides of the loans, and such an arrangement was not within Parliament's contemplation or purpose.[238]

Unity of purpose in BNZ Investments No 2 *(HC) and* Westpac *(HC)*

44. The taxpayer and the counterparties were unrelated in *BNZ Investments No 2* (HC) and *Westpac* (HC). However, they had a unity of purpose in obtaining and dividing the maximum possible tax benefits available to the taxpayer.

45. The High Court in *Westpac* stated:

> [597] As Mr Brown submits, **all the evidence points to a unity of purpose in obtaining and dividing the maximum possible tax benefits available to Westpac.** This purpose was successfully achieved by means of a contrivance, both in concept and amount. The contrived expense was also, by virtue of the self-cancelling effect of the exchanges inherent in the pricing structure, illusory. The disparity between the underlying economics of the

[238] At [73]–[74].

transaction and the resulting taxation treatment confirms that the anticipated tax effect was the true purpose of the transaction. [Emphasis added]

Economic and commercial effect of documents and transactions

Unlikelihood of commercial profit in Ben Nevis *(SC)*

46. The obscurity of ultimate commercial profit, in contrast to the clarity of the tax advantages, was a factor considered by the Supreme Court in *Ben Nevis.*

47. The Court agreed with the findings of the High Court and Court of Appeal that the ultimate commercial profitability of the arrangement was unlikely.[239] It also agreed with the Court of Appeal that there appeared to be no commercial reason for the syndicate of investors to pay a licence to use the land when the syndicate had already funded the purchase of the land. The Court explained that the relevance of these factors raised a serious question over whether the arrangement had a true commercial purpose as distinct from a tax-saving purpose.

48. The Court said that the clarity of the tax advantages, in contrast to the obscurity of ultimate commercial profit, lead to the conclusion that the promissory note for the licence premium:[240]

- had a primary, if not sole, purpose of obtaining a tax advantage; and
- was an artificial component of the arrangement included for the purpose of tax avoidance.

49. The Supreme Court said that the courts are permitted when considering tax avoidance to examine:[241]

- the commercial nature of the cost incurred; and
- any factors that might indicate that the expenditure will never be truly incurred.

50. The Court identified various matters that indicated the expenditure on the licence premium would never be truly incurred and the expenditure was, in reality, illusory:[242]

- the 50-year timing mismatch between the dates for legal payment of the premium (in 1997) and its economic payment (in 2047);
- payment in economic terms was entirely dependent on the proceeds of stumpage from harvesting the forest in 2047; and
- the obligation to make payment in 2047 from stumpage lacked real force because:
  - the ultimate commercial profitability of the forest was unlikely; and
  - there were so many contingencies around events that might occur over a 50-year period.

[239] At [122].

[240] At [122].

[241] At [128].

[242] At [130].

51. The Court also considered the payment of the second insurance premium by promissory note was not, in commercial terms, payment at all.[243] This was because the economic impact of the payment was deferred for 50 years.

No cash transaction in economic terms in Glenharrow *(SC)*

52. The Supreme Court in *Glenharrow* held that the exchanging of cheques produced an artificial effect. The exchanging of cheques was payment in legal terms. However, 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.

53. Although the transaction had been structured as a cash transaction through the exchanging of cheques, the arrangement, when viewed in a commercially and economically realistic way, was not a cash transaction. The Court said:

> [53] This is not to say that an exchange of cheques accompanied by a transfer of property and a mortgage back to the vendor can ordinarily be regarded as an artificial procedure. The contrary is true. Ordinarily an exchange of cheques, with accompanying conveyancing documentation, is a routine commercial procedure which does not give rise to an impermissible tax advantage. However, in this case that procedure was inserted into a "pay as you go" transaction so as to produce an artificial effect with consequent tax advantage, contrary to all economic reality. **In economic terms there was no consideration in money given by Glenharrow because of the commercial impossibility of payment by it in circumstances where it was virtually uncapitalised and its obligation was not supported by its shareholder … But it had no such reality as a "cash" transaction, despite being structured as if it were**. [Emphasis added]

Absence of commercial rationale in BNZ Investments No 2 *(HC)*

54. The High Court in *BNZ Investments No 2* said that, putting aside the tax advantages, the arrangements had no commercial rationale or logic for the taxpayer.[244] This was because the arrangements were, in economic substance, loans and involved lending or investing at a substantial loss.

No commercial viability or real economic consequences in Westpac *(HC)*

55. In *Westpac,* the High Court's commercially and economically realistic view of the arrangement focused on:

- the absence of any underlying commercial profitability of the arrangements;
- the commercial and economic effect of the GPF; and
- whether the taxpayer incurred real economic consequences of the type envisaged for the deductibility provisions and the foreign tax credit regime used by the arrangements.

56. The Court accepted that each arrangement had a commercial purpose of providing funding to the counterparty. However, that purpose had to be distinguished from the arrangement's underlying commerciality or business viability. The Court said:

> [590] I agree with [counsel for the taxpayer] that each transaction had a genuine commercial purpose. In my judgment the structural aspects, and in particular its taxation benefits, do not derogate from the existence of an objectively ascertainable commercial purpose. That purpose must be distinguished from the transaction's underlying commerciality or business viability. They are conceptually separate.

[243] At [148].

[244] At [512].

57. The Court concluded:[245]

- The arrangements were structured to be loss making with no prospect of commercial profit. The arrangements had a commercial purpose of providing funding to the counterparties. However, no commercial justification existed for the arrangements due to the absence of any underlying prospect of commercial profit. The disparity between the loss-making commercial reality of the arrangements and their resulting tax treatment confirmed that the tax effects were the true purpose of each arrangement.
- The GPF was a gratuitous mechanism that did not have an objectively ascertainable commercial purpose. It was a contrivance, both in concept and amount, to obtain a tax advantage (a deduction). In economic terms, the GPF did not involve any real economic consequences. The expenditure on the GPF was illusory and non-existent due to the self-cancelling effect of the exchanges in the dividend pricing structure.
- The legal structures of the arrangement superimposed a legal form that was contrary to and designed to re-characterise the economic substance as loans to obtain a tax advantage.
- For the arrangement that used the foreign tax credit regime, the economic burden of United States tax on the gross distribution was not, in fact, paid or economically suffered by the taxpayer (nor the United States counterparty).

No real and genuine economic burden suffered in Education Administration *(HC)*

58. The High Court in *Education Administration* 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.

59. The Court held that the taxpayer, in reality, did not suffer a real and genuine economic burden.[246] 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.

No real economic consequences incurred in Alesco *(CA)*

60. The Court of Appeal in *Alesco* 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.[247] 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.

61. 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.[248]

[245] At [597], [599], [601], [603] and [612].

[246] At [61].

[247] At [83].

[248] At [112]–[113].

Non-tax avoidance purposes in Penny *(SC)*

62. The Supreme Court in *Penny* said that each arrangement had the non-tax avoidance purposes of:

- protecting assets from negligence claims; and
- accumulating assets for the benefit of family.

63. However, the Court concluded that the tax advantage obtained by the contrived setting of an artificially low salary was, objectively, the predominant purpose of each arrangement (although the Court acknowledged that the Commissioner does not have to establish a predominant purpose). Each arrangement was a tax avoidance arrangement.[249]

Nature and extent of the financial consequences

Financial benefit from the use of promissory notes in Ben Nevis *(SC)*

64. The use of promissory notes in *Ben Nevis* (SC) created a 50-year mismatch between the legal and economic payments. This mismatch had the financial consequence that the taxpayers:

- obtained a financial benefit, a deduction against current income, at the time of legal payment; and
- deferred actual payment, in economic (cash) terms, for 50 years.

Disproportionate GST refund in Glenharrow *(SC)*

65. The Supreme Court in *Glenharrow* observed that the financial consequence of the structure adopted was to produce a GST refund of $5m for the taxpayer. The refund was totally disproportionate to the:

- real economic burden the taxpayer had undertaken; and
- economic benefit that the taxpayer had obtained from the vendor.

66. The Court said:

> [54] In contrast to the position in the United Kingdom, the New Zealand GST Act does have a general anti-avoidance provision and on an objective view of the present case, **the effect of the structure, given the gross disparity between the price and the size of the purchaser and given, particularly, the shrinking value of the asset, with its very limited practical life, was to produce a GST refund totally disproportionate to the economic burden undertaken by Glenharrow or the economic benefit obtained by Mr Meates.** Indeed, there can be no issue that Glenharrow undertook liability for the $44,920,000 funded by vendor finance. But Glenharrow was a shell company with a share capital of just $100. And as Mr Meates was unregistered, there was no GST impost on the other side of the transaction. [Emphasis added]

Sharing of tax advantages from deductions in Westpac *(HC)*

67. The financial consequences in *Westpac* were significant to the High Court's analysis of what the arrangement achieved in commercial and economic reality. Each arrangement was, pre-tax, loss-making.

68. The Court held that the financial returns the taxpayer and counterparties enjoyed resulted from a formula designed to share the tax advantages arising from the

[249] At [36].

deductions the taxpayer claimed. However, in reality, the economic burden and benefit of the expenditure claimed was non-existent:

> [596] Specific deductibility provisions are to be invoked where the taxpayer has by the transaction incurred "real economic consequences of the type contemplated by the legislature when the rules were enacted"; and where the taxpayer is "engag[ing] in business activities for the purpose of making a profit": *Accent* [*Management v CIR* (2007) 23 NZTC 21,323 (CA)] at [126]. The dividend formula explains why Westpac claimed a deduction for an expense which did not incur real economic consequences of the type envisaged by the deductibility provisions. **The financial returns enjoyed by both parties were the result of a formula designed to share deductions derived by Westpac where in substance the economic burden and benefit were non-existent.** [Emphasis added, footnotes omitted]

Refunds for full amounts of invoices in Education Administration *(HC)*

69. The High Court in *Education Administration* held that the general anti-avoidance provision in the GST Act applied to the arrangement. One factor leading to that conclusion was the financial consequence for the taxpayer. The taxpayer claimed a refund for the full amount of each invoice but paid only 10% of the invoiced amount.

Reduction in personal earnings in Penny *(SC)*

70. Each taxpayer in *Penny* (SC) suffered a reduction in their personal earnings as a result of the setting of their salaries at artificially low levels for the purpose of obtaining a tax advantage. Those settings enabled the business income of each company that employed the taxpayers to be made available to them through their respective family trust.

71. The Supreme Court in *Penny*, adapting the statement of Lord Templeman from *Challenge* (PC), said that "[i]n reality, the taxpayers suffered no actual loss of income but obtained a reduction in liability as if they had".[250]

Offsetting profits with losses from an unconnected company in Challenge *(PC)*

72. The arrangement in *Challenge* (PC) involved the taxpayer company taking into its group of subsidiary companies an unconnected company with no assets or debts but having large tax losses. The taxpayer then offset its profits to take advantage of losses the group, in reality, had not incurred.

73. The majority of the Privy Council in *Challenge* held that the arrangement was a tax avoidance arrangement because the taxpayer, in reality, never suffered the loss that would entitle it to claim a reduction in its income. The majority said:[251]

> In an arrangement of tax avoidance the financial position of the taxpayer is unaffected (save for the costs of devising and implementing the arrangement) and by the arrangement the taxpayer seeks to obtain a tax advantage without suffering that reduction in income, loss or expenditure which other taxpayers suffer and which Parliament intended to be suffered by any taxpayer qualifying for a reduction in his liability to tax.
>
> … **if a taxpayer asserts a reduction in assessable income, or if a taxpayer seeks tax relief without suffering the expenditure which qualifies for such relief, then tax avoidance is involved** and the Commissioner is entitled and bound by s [BG 1] to adjust the assessable income of the taxpayer so as to eliminate the tax advantage sought to be obtained. [Emphasis added]

[250] At [47].

[251] At 562–563.

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Duration of the arrangement

Mismatch of 50 years between legal and economic payments in Ben Nevis *(SC)*

74. The duration of the entire arrangement in *Ben Nevis* (SC), in combination with other factors, distorted the use of specific provisions in a manner outside Parliament's purpose for the provisions.

75. The payment of the licence premium and the second insurance premium by promissory notes created a 50-year timing mismatch between the:

- legal payment of the premium in 1997; and
- economic payment of the premium in 2047.

Property settlements over a period of 10–20 years in Ch'elle *(CA)*

76. *Ch'elle* (CA) involved a timing mismatch that created a distortion between the invoice and payments bases of accounting for GST. The facts were as follows:

- One hundred and fourteen companies had been incorporated and registered for GST on a payments basis.
- Each company entered into a contract to purchase a lot in a subdivision.
- The taxpayer was registered for GST on an invoice basis.
- The taxpayer entered into separate contracts with each of the companies to purchase the properties.
- Settlement was to take place on various dates over a period of 10–20 years with the purchase prices based on the value of the properties at settlement.
- The taxpayer claimed input tax deductions and resulting refunds on receipt of the invoices for the properties.
- The vendor did not have to account for the GST output tax on the sales until payment in 10–20 years' time.

77. The Court of Appeal said that the general anti-avoidance provision in the GST Act applied to the arrangement for two reasons:[252]

- The invoices the companies issued were not going to be paid for 10–20 years, so no output tax was payable. The taxpayer, however, was immediately entitled to input tax deductions and refunds. This timing mismatch defeated the intended balance between input and output tax.
- The use of the companies had no commercial purpose. They were simply a mechanism to obtain a tax advantage by:
  - coming under the $1m threshold for registration on the payments basis; and
  - exploiting the timing mismatch between the invoice and accounting bases.

Short duration to commence mining operations in Glenharrow *(SC)*

78. The long duration of the arrangements in *Ben Nevis* (SC) and *Ch'elle* (CA) was a significant factor. In contrast, the short duration (3 years) of the arrangement in *Glenharrow* (SC) was a significant factor.

[252] At [52].

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79. The Supreme Court in *Glenharrow* held that due to the short duration of the arrangement it was, in reality, impossible for the taxpayer to commence mining operations and extract sufficient stone to repay the vendor finance of $44,920,000. The Court said:

> [51] But, even on that basis, the arrangement still had a very artificial element: the price was not paid in economic terms, even though as between the parties a debt was discharged. In this case it is not the price but the "payment" that created the distorting effect. **Glenharrow accepted the legal obligation to pay the full price but at the outset the parties were well aware, and any objective observer in 1997 would have seen, that payment in full would certainly not occur. The licence had only a little over three years to run.** Whatever the parties may have thought, no renewal was available as a matter of law. The parties themselves believed and the objective observer would have concluded, that it would take two years to get started on mining because of the need first to obtain various consents and approvals. **The parties to the arrangement may have had an intention to implement their agreement according to its terms but that was plainly an impossible task. No one has ever suggested that the remainder of the term would suffice for the success of the project to a point where it would produce enough extraction of stone to pay the $45m. There was no prospect of the payment being made by any other means.** [Emphasis added]

Circularity in the arrangement

Circularity of insurance dimension in Ben Nevis *(SC)*

80. Circularity was relevant in *Ben Nevis* (SC) to understanding the commercial reality of the insurance aspect of the arrangement. The Supreme Court said:

> [146] The letter of comfort dated 3 February 1997 given to CSI by the Trinity Foundation Charitable Trust, which was the ultimate beneficial owner of the Trinity Foundation, demonstrates that **although technically CSI was at risk, it was, at least in part, an indemnified risk leading to a substantial element of circularity in the whole insurance arrangement**. It is a strong inference from this fact alone that the insurance was simply a method where substantial tax benefits could be obtained by deducting in one lump sum in 1997 a premium not payable in commercial terms until 2047.
>
> …
>
> [148] It is inherent in all we have said on this topic that we regard the insurance dimensions of the Trinity scheme as both artificial and contrived … **The insurance arrangement was, at least in substantial part, circular as a result of the letter of comfort. As** [a friend of the scheme's promoter] **rightly said, "there was no real risk in the whole thing"** … [Emphasis added]

No circularity of exchange of funds of similar amounts in Westpac *(HC)*

81. The High Court in *Westpac* said that circularity is a catchphrase frequently cited but infrequently enlightening. There was no circularity in the arrangement in *Westpac* because a commercial basis for the currency swaps existed:

> [580] Nor do I accept that there was significant circularity of the type suggested by some of the Commissioner's witnesses. **Circularity is a catchphrase frequently cited but infrequently enlightening.** Circularity in this context is normally understood to refer to movements of money which conceal the fact that there was no underlying activity at all: *Peterson* [(2006) 3 NZLR 433 (PC)] per Lord Millett at [45]. But here each payment discharged a genuine contractual liability. **And the existence of exchanges of funds of similar amounts to meet quarterly interest obligations does not connote circularity, given that there was a proper commercial basis for the underlying currency swaps**. [Emphasis added]

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Interdependent payments and receipts in Peterson *(PC)*

82. The majority of the Privy Council in *Peterson* (PC) observed that the "circular movement of money sometimes conceals the fact that there is no underlying activity at all".[253] In *Peterson,* certain payments were interdependent because:

- the payments were dependent on the receipts that funded them; and
- the receipts were dependent on the payments by which they were funded.

83. The majority of the Privy Council said:

> [45] **The circular movement of money sometimes conceals the fact there is no underlying activity at all**. But each of the payments in the circle must be examined in turn to see whether it discharged a genuine liability of the party making the payment. It does not matter whether external funds were introduced into the circle or whether cheques were handed over and duly honoured. If the money movements did not discharge a genuine liability the introduction of external funds will not save it; if they did, their absence will not affect it. **In either case the payments are interdependent, in the sense that each of the payments is dependent on the receipt which funds it and each receipt on the payment by which it is funded** …. [Emphasis added]

Passing of the same funds through multiple companies in Dandelion *(CA)*

84. Factors that lead the Court of Appeal in *Dandelion* to conclude that the arrangement was a tax avoidance arrangement were that the:

- arrangement involved a circular flow of funds; [254] and
- "transaction was circular in its inception and unwinding".[255]

85. The arrangement involved a series of steps by which the same funds were passed on one day through companies in New Zealand, the United Kingdom, and the Cook Islands. Sometimes the funds passed as a loan and sometimes as a subscription for, or purchase of, shares. After a year, the transaction was unwound. The net effect was that the taxpayer received a tax-free dividend of $480,000 and claimed an interest deduction of $570,000 against its taxable income.

86. The Court of Appeal, in concluding the arrangement was a tax avoidance arrangement, said:

> [85] … In reality there was no true business purpose to be achieved by the appellant in entering into the transaction other than to obtain the benefit of a deduction of an interest expense of $570,080 by making a payment of that sum which was to be offset by a tax-free dividend receipt of $484,000**. The transaction was circular in its inception and unwinding. Once unwound after the 12-month term of the loan it had no financial effects for the appellant, other than its net outlay of $86,080 and, presumably a liability for the fees of its advisers**. There was no risk to the appellant during that period. No element of business dealing other than tax avoidance can be identified as a purpose of the arrangement. It is an artifice involving a pretence and not a real group investment transaction at all. The concessional treatment of interest expenses under s 106(1)(h)(ii) of the [Income Tax Act 1976] for borrowings to acquire shares in what would be a group company was not, on its true construction, intended to give the taxpayer the opportunity of obtaining a deduction in this way. [Emphasis added]

[253] At [45].

[254] At [12].

[255] At [85].

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Inflated expenditure or reduced levels of income in the arrangement

Inflated price of goods in return for non-recourse loan in Glenharrow *(SC)*

87. The Supreme Court decision in *Glenharrow* concerned the application of the general anti-avoidance provision in the GST Act. The decision contains an example of how inflated expenditure would introduce a distortion affecting (and defeating) the contemplated application of the GST Act. The Court said:

> [47] … The whole premise of the [GST] 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]

Overpriced guarantee procurement fees in BNZ Investments No *2 (HC) and* Westpac *(HC)*

88. The High Court in *BNZ Investments No 2* held that the GPFs were substantially overpriced.[256]

89. In *Westpac*, the High Court said that the GPF did not satisfy any objective or fair measure of value and was not within an acceptable range:

> [439] In summary, I am not satisfied that Westpac has identified a reliable open market value for the GPFs in the relevant years between 1999 and 2002. The bank's credit enhancement approach could not provide an accurate or realistic measure of fair value. But, if that was possible, I repeat that the GPFs actually agreed did not satisfy any objective or fair measure of value and were not within an acceptable market range.

Inflated hourly rate in Education Administration *(HC)*

90. The High Court in *Education Administration* held that, on the evidence, the hourly rate aspect of the arrangement was not set at a market rate.[257] The Court then said:

> [67] The effect of adopting an inflated hourly rate was of course to artificially increase the amount of the invoices and hence the amount of the GST refund that could be claimed.

91. The Court went on to conclude that the general anti-avoidance provision in the GST Act applied to the arrangement. This was due to several factors, including the inflated hourly rate, that in combination lead to the conclusion that the arrangement was artificial and contrived.

[256] At [511].

[257] At [66].

Inflated purchase prices in Erris Promotions *(HC)*

92. Inflated expenditure was a significant factor in the High Court's conclusion in *Erris Promotions* that the arrangement was a tax avoidance arrangement.[258] The Court said:

> [335] I have concluded that this was a plan by Mr Anderson to avoid tax by creating inflated depreciation losses. The plan firstly involved the purchase of second-hand software from a non GST registered person to create a GST refund. **The purchase prices bore no relationship to the actual value of the software bought and sold. They were grossly inflated to ensure largest possible depreciation losses. This was the essence of the scheme.** Mr Anderson used the technology boom to provide an added attraction for investors.
>
> …
>
> [337] These factors illustrate that this was a plan to avoid tax by claiming millions of dollars of depreciation losses through inflated purchase prices. [Emphasis added]

Artificially low salaries in Penny *(SC)*

93. The setting of artificially low salaries and the resulting reduction in the taxpayers' incomes in *Penny* (SC) was a significant factor. So too was the feature that, in reality, the taxpayers suffered no actual loss of income. The combination of these features led to the Supreme Court's conclusion that the arrangements were tax avoidance arrangements.

Low salary in Russell *(HC)*

94. The High Court in *Russell* observed that the low salary Mr Russell received bore no relationship to:[259]

- the work he undertook; or
- salaries payable in the marketplace.

95. Also, Mr Russell retained control of the income derived by his employer from the work he carried out.

The parties to the arrangement undertaking limited or no real risks

No risks undertaken in Ben Nevis *(SC) and* BNZ Investments No 2 *(HC)*

96. The Supreme Court in *Ben Nevis* held that the insurance dimension was, at least in substantial part, circular as a result of a letter of comfort. The Court held there was no "real risk in the whole thing".[260]

97. Similarly, the High Court in *BNZ Investments No 2* held that the arrangements held no risk for either party, other than the tax risk for BNZ.[261]

Non-recourse vendor finance in Glenharrow *(SC) and* Erris Promotions *(HC)*

98. The purchase price of $45m for the mining licence in *Glenharrow* (SC) was paid by non-recourse vendor finance (less a deposit of $80,000 actually paid). The loan was secured by a mortgage over the licence.

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

[259] At [131].

[260] At [148].

[261] At [523].

99. There was no risk to the taxpayer or to its sole shareholder. The taxpayer had capital of $100 and, in the event of its default in repayment of the loan, the vendor would receive the licence back under the mortgage. Also, the shareholder had not guaranteed the taxpayer's loan repayment obligations, so was never personally at risk for the vendor finance.

100. Similarly, there was no risk to the taxpayer investors in *Erris Promotions* (HC) for the payment of grossly inflated purchase prices. This was because the vendors had provided 100% vendor finance on a non-recourse basis. The High Court said:

> [339] Because of the way the plan was structured neither the joint venture, its individual members, Mr Anderson nor any of his associated companies took any risk at all. The purchases were 100% financed by the vendor with no recourse beyond repossession of the software. The structure and restructuring of the debt repayments illustrates that the so-called purchase prices were fantasy.

Borrowing from and reinvesting in third party in Dandelion *(CA)*

101. The Court of Appeal in *Dandelion* held there was no risk to the taxpayer arising from the arrangement.[262] This was because the taxpayer borrowed from a third party and, in effect, reinvested the funds through a tax haven with that third party. The taxpayer did not use its own funds, and the third-party received back on the same day the cash it outlaid.

102. Also, the security arrangements had the effect that the taxpayer was not obliged to repay the loan unless it received repayment of the investment.

Arrangement being pre-tax negative

Pre-tax negative arrangements in BNZ Investments No 2 *(HC)*

103. The relevance of an arrangement being pre-tax negative and post-tax positive was discussed in *BNZ Investments No 2* (HC). The High Court referred to the Privy Council decision in *Peterson* and said:

> [462] In [*Peterson v CIR* [2006] 3 NZLR 433] at [44] the Privy Council stated the legal position in this way:
>
> > "Tax relief often makes the difference between profit and loss after tax is taken into account; and the transaction does not become tax avoidance ***merely*** because it does so ..."
> > (my emphasis)
>
> [463] It follows that the fact that the BNZ provided the NZ$500 million funding in each of these transactions at substantially less (up to 2.5% less) than its cost of funds is a factor for me in deciding whether these transactions were tax avoidance arrangements. It certainly is not conclusive. It is best approached as one aspect of viewing the transactions in a commercially and economically realistic way, and I now do that.

104. The Court later said:

> [512] Putting aside the tax benefits they generated, these transactions had no commercial rationale, logic or purpose for the BNZ. They involved lending/investing at a substantial loss. As the BNZ accepted in closing (at 1.17(a)), that is a "classic indicator" of tax avoidance: *Miller* [[2001] 3 NZLR 316 (PC)] and *Dandelion* [[2003] 1 NZLR 600 (CA)]. The transactions involved the BNZ lending/investing at a substantial loss. The BNZ accepts that; it is an undeniable fact.
>
> ...

[262] At [85].

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> [514] Unless lending or funding at a substantial loss is termed banking business, there was no business to be done here …
>
> …
>
> [526] Drawing together the conclusions I have set out in [478]–[525], I reach the conclusion that all six transactions in issue are caught by s BG 1 … I have reached that conclusion for the following principal reasons, which I list in order of importance:
>
> …
>
> b) The transactions had no commercial purpose or rationale. Shorn of the tax benefits they were anticipated to generate, they involved the BNZ providing funds to the counterparties at a substantial loss. Their only purpose was to use the Bank's tax capacity to generate exempt income.

Pre-tax negative arrangements in Westpac *(HC)*

105. In *Westpac* (HC), the fact that the arrangements were pre-tax negative and post-tax positive was a factor in the High Court's conclusion that the arrangements were tax avoidance arrangements. The Court said:

> [598] Westpac's constant, indeed predominant, expectation that [the Koch arrangement] would yield a loss is consistent with this conclusion. The prospect of generating substantial deductible expenses and altering the incidence of its income tax was, I am satisfied, the bank's primary purpose in proceeding with Koch.
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> [599] In distinguishing *Ben Nevis*, [the taxpayer] referred to the majority's conclusion that the forestry investment was a tax avoidance arrangement because "there was no real business purpose as there was a real risk that the transaction would not be profitable". Similarly, in my judgment, there was according to Westpac's contemporaneous documents no underlying prospect of profitability and thus no commercial justification for the Koch transaction.
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> …
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> [604] Taxpayers are free to structure their affairs in the most tax effective way, and to take the post-tax consequences into account when deciding whether to proceed with a transaction. But that right is exercised on the assumption that the transaction has an independently justifiable commercial rationale. **In this case the "clarity of the tax advantages was in marked contrast to the obscurity of the prospect of any ultimate commercial profit": *Ben Nevis* at [122]. The profits that accrued to both parties were, I find, essentially a product of Westpac's impermissible use of the specific provisions.**
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> …
>
> [611] The fact that conduit relief enabled a taxpayer to obtain dividends which accrued credits is not problematic in itself. It is the fact that the transactions were loss making, and thus never resulted in dividends being paid to non-resident shareholders, which is an objectionable consequence of the transaction as a whole. In my judgment it would not have been within Parliament's intention to allow a taxpayer to structure a transaction in such a way that [non-resident withholding tax] would never be paid. [Emphasis added]