Inland Revenue
Te Tari Taake

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Notes | Pitopito kōrero: This draft item is intended to update and replace Interpretation Statement IS0061: Shortfall penalty for taking an abusive tax position.

INTERPRETATION STATEMENT | PUTANGA WHAKAMĀORI

Shortfall penalty for taking an abusive tax position

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IS XX/XX

This interpretation statement explains the meaning of "abusive tax position" in relation to the abusive tax position shortfall penalty in s 141D(7) of the Tax Administration Act 1994.

All legislative references are to the Tax Administration Act 1994 (the Act), unless otherwise stated.

REPLACES | WHAKAKAPIA

- IS0061: Shortfall penalty for taking an abusive tax position

RELATED ITEMS

- IS XX: Shortfall penalties – requirements for a "tax position" and a "tax shortfall"
- IS XX: Shortfall penalties – reductions and other matters
- IS XX: Shortfall penalty for taking an unacceptable tax position
- IS XX: Shortfall penalty for not taking reasonable care

- IS XX: Shortfall penalty for gross carelessness
- IS XX: Shortfall penalty – evasion
- IS 23/01: : Tax avoidance and the interpretation of the general anti-avoidance provisions sections BG 1 and GA 1 of the Income Tax Act 2007
- QB 12/12: Abusive tax position penalty and the anti-avoidance provision

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Introduction | Whakataki

1. Section 141D imposes an abusive tax position shortfall penalty on a taxpayer where:
   - the taxpayer takes a tax position;
   - a tax shortfall arises from the tax position;
   - the taxpayer's tax position is an unacceptable tax position;
   - the taxpayer's tax position is an abusive tax position.

2. This interpretation statement explains the requirement that a taxpayer has taken an abusive tax position.

3. The amount of the abusive tax position penalty is 100% of the resulting tax shortfall.

4. The penalty is reduced to 20% of the resulting tax shortfall if the requirements of s 141D(3B)(a) to (c) are met. Broadly, those provisions require that:

   - the taxpayer is a party to an arrangement in respect of which a promoter is liable for a promoter penalty under s 141EB;
   - the sum of the tax shortfalls from the arrangement for the taxpayer and associated parties is less than $50,000; and
   - the taxpayer has received independent advice stating that the taxpayer's tax position is not an abusive tax position.

5. Standard practice statement INV-290 describes how the Commissioner will apply the s 141EB promoter penalties provision.[1] In discussing the requirements of s 141EB, the statement also comments on what the Commissioner considers to be "independent advice" (at [42] to [45]). Those comments are also considered relevant as guidance in the application of s 141D(3B).

6. The requirements for a taxpayer to have taken a "tax position" and for a "tax shortfall" to have arisen from that tax position are considered in IS XX**: Shortfall penalties – requirement for a "tax position" and a "tax shortfall"**.

7. An unacceptable tax position is a prerequisite to an abusive tax position shortfall penalty applying. Section 141B(1) provides that an unacceptable tax position is a tax position that, viewed objectively, fails to meet the standard of being about as likely as not to be correct. Section 141B(2) limits the application of UTP penalties to tax shortfalls that relate to income tax and that exceed a specified monetary threshold. Those limitations do not apply to the abusive tax position shortfall penalty. Section 141B is only relevant to the extent that it defines what an unacceptable tax position is. The requirements for a tax position to be an unacceptable tax position are not discussed further in this interpretation statement. A full discussion of those requirements is set out in IS XX**: Shortfall penalty for taking an unacceptable tax position**.

8. IS XX/XX**: Shortfall penalties – reductions and other matters** discusses when a shortfall penalty may be reduced (or increased), what happens when a taxpayer could be liable for more than one penalty, the assessment of a penalty, the payment of a penalty and disputing a penalty.

[1] IR-SPS INV 290: Promoter penalties *Tax Information Bulletin* Vol 16, No 2, (March 2004): 18.

Summary | Whakarāpopoto

9. This statement can be summarised as follows:

- An unacceptable tax position is an abusive tax position under s 141D(7)(b)(i) or s 141D(7)(b(ii) if the taxpayer took the tax position:
  - in respect or as a consequence of an arrangement entered into with a dominant purpose of avoiding tax (s 141D(7)(b)(i)); or
  - with a dominant purpose of avoiding tax (s 141D(7)(b)(ii)).
- Section 141D(7) requires an objective assessment of dominant purpose. Under s 147D(7)(b)(i), it is the dominant purpose of the arrangement that must be ascertained. The subjective purpose or motives of the parties who entered into the arrangement are not relevant.
- Under s 147D(7)(b) (ii), it is the dominant purpose of the taxpayer that must be ascertained. As the assessment is objective, the taxpayer's purpose must be ascertained by reference to objective facts. The subjective purpose or motives the taxpayer had when taking their tax position are not relevant.
- Purpose is the result or effect intended or sought by an arrangement (under s 141D(7)(b)(i)) or by a taxpayer (under s 141D(7)(b)(ii)).
- When there is more than one purpose, the "dominant purpose" will be the ruling, prevailing, governing, commanding or most influential or important purpose.
- The term "avoiding tax" is to be interpreted widely and is not limited to the statutory concept of "tax avoidance".
- The term "arrangement" is defined in s 3(1). The definition embraces all kinds of concerted action by which people may arrange their affairs for a particular purpose or to produce a particular effect.
- The factors that may indicate a dominant purpose of avoiding tax include artificiality, contrivance, circularity of funding, concealment of information, non-availability of evidence and spurious interpretations of tax laws.
- In determining whether an arrangement that has more than one purpose has a dominant purpose of avoiding tax, it is necessary to ask whether the particular way the arrangement has been put together can be explained by a non-tax purpose or purposes.
- An abusive tax position penalty does not apply automatically where there is a "tax avoidance arrangement" under s BG 1 of the ITA 2007 or s 76 of the GSTA. Section BG 1 of the ITA 2007 and s 76 of the GSTA apply when an arrangement has a more than merely incidental purpose of tax avoidance. Under s 141D, an arrangement must have a dominant purpose of avoiding tax before an abusive

tax position penalty can be applied. The dominant purpose requirement under s 141D is a higher threshold than the merely incidental requirement under s BG 1 of the ITA 2007.

- An abusive tax position penalty may be imposed in respect of an arrangement that is caught by an anti-avoidance provision or in respect of arrangement that is not caught by an anti-avoidance provision. In both cases, the penalty will only apply if the arrangement has a dominant purpose of avoiding tax.

Analysis: Taxpayer's tax position | Tātari

10. Section 141D(6) and (7) defines an "abusive tax position" as follows:

> **141D Abusive tax position**
>
> ...
>
> (6) A taxpayer's tax position may be an abusive tax position if the tax position is an incorrect tax position under, or as a result of, either or both of
>
> (a) a general tax law; or
>
> (b) a specific or general anti-avoidance tax law.
>
> (7) For the purposes of this Part and section 177C, an abusive tax position means a tax position that,—
>
> (a) is an unacceptable tax position at the time at which the tax position is taken; and
>
> (b) viewed objectively, the taxpayer takes—
>
> (i) in respect, or as a consequence, of an arrangement that is entered into with a dominant purpose of avoiding tax, whether directly or indirectly; or
>
> (ii) where the tax position does not relate to an arrangement described in subparagraph (i), with a dominant purpose of avoiding tax, whether directly or indirectly.

Two limbs to s 141D(7)

11. An unacceptable tax position may be an abusive tax position under either s 141D(7)(b)(i) or s 147D(b)(ii). To come within those provisions, the tax position must be taken:

- in respect or as a consequence of an arrangement that is entered into with a dominant purpose of avoiding tax (s 141D(7)(b)(i)); or
- where the tax position does not relate to an arrangement described in subpara (i), with a dominant purpose of avoiding tax (s 141D(7)(b)(ii).

Whose purpose is tested

12. Both limbs of s 141D(7)(b) require a dominant purpose of avoiding tax. In *Ben Nevis Forestry Ventures Ltd v CIR*,[2] the Supreme Court had to determine whether it was the dominant purpose of the taxpayer in taking their tax position or the dominant purpose of the arrangement that is relevant under s 141D(7)(b)(i). The Court held that the qualification in s 141D(7) that a tax position must be "viewed objectively" means it is the dominant purpose of the arrangement and this must be ascertained from the terms of the arrangement and not the subjective purpose or motives of the parties to the arrangement. The Court said:[3]

> …it is the purpose of the arrangement itself, not the purpose in the mind of the taxpayer, that is referred to in s 141D(7)(b)(i). This aspect of the definition of an "abusive tax position" is concerned with the means employed rather than intentions of taxpayers in taking a tax position. The section requires that the arrangement itself be examined to ascertain its dominant purpose from its terms, irrespective of what may be known or inferred concerning the motives of individual investors.

13. In contrast to s 141D(7)(b)(i), the dominant purpose of avoiding tax under s 147D(b)(ii) is a test of the taxpayer's purpose and is tested at the time the taxpayer's tax position is taken. As was the case with s 147D(7)(b)(i), the qualifying words "viewed objectively" require an objective assessment. This means that the taxpayer's purpose is ascertained by reference to objective facts such as the nature of the tax position taken, the taxpayer's conduct in taking the tax position, and any other surrounding circumstances that may assist. The taxpayer's subjective purpose or motives in taking the tax position are not relevant.

Dominant purpose of avoiding tax

14. The term "dominant purpose" is not defined in the Act. The *Oxford English Dictionary* defines "purpose" as follows:[4]

> 1. a. That which a person sets out to do or attain; an object in view; a determined intention or aim.
>
> 2. The reason for which something is done or made, or for which it exists; the result or effect intended or sought; the end to which an object or action is directed; aim.

15. The courts have held that the test of whether an arrangement has a tax avoidance purpose or effect under s BG 1 of the ITA 2007 and s 76 of the GSTA is objective. The

[2] *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115, (2009) 24 NZTC 23,188.

[3] *Ben Nevis* at [207].

[4] *Oxford English Dictionary* (online ed, Oxford University Press, accessed 6 May 2025).

courts have also held that purpose in this context means the intended effect an arrangement seeks to achieve and not the parties' motives, and that "effect" means the end accomplished or achieved by the arrangement. The Commissioner considers this approach also applies under s 141D.

16. The *Oxford English Dictionary* defines the word "dominant" as follows:[5]

> 1. ruling, governing, commanding; most influential

17. In *Case Y18*,[6] Judge Barber referred to the decision of the High Court of Australia in *FCT v Spotless Services Ltd*[7] when discussing the meaning of "dominant purpose" in s 141D:[8]

> The additional requirement for s 141D to apply, if s 141B already applies, is that, viewed objectively, the dominant purpose of entering into the arrangement was avoiding tax. In *FCT v Spotless Services Ltd & Anor* (1996) 186 CLR 404 (HCA), the High Court of Australia considered the meaning of the "dominant purpose" of enabling a taxpayer to obtain a "tax benefit". It held that: "In its ordinary meaning, dominant indicates that purpose which was the ruling, prevailing, or most influential purpose."

18. Judge Barber referred to *Spotless Services* in interpreting dominant purpose in s 141D. The High Court of Australia in *Spotless Services* considered the dominant purpose to be the ruling, prevailing or most influential purpose.

19. In summary, it is considered that purpose in the context of s 141D(7) is the result or effect intended or sought by a taxpayer (s 141D(7)(b)(ii)) or by an arrangement (s 141D(7)(b)(i)). In both cases, the test is objective and, where there is more than one purpose, the dominant purpose will be the ruling, prevailing, governing, commanding, or most influential or important purpose.

[5] *The Oxford English Dictionary* (online ed, Oxford University Press, accessed 6 May 2025).

[6] *Case Y18* (2008) 23 NZTC 13,180 (TRA).

[7] *FCT v Spotless Services Ltd* (1996) 186 CLR 404 (HCA).

[8] *Case Y18* at [73]. Judge Barber described the test for a "dominant purpose" as an objective test but, arguably, relied on subjective factors when applying the test. Despite this, Judge Barber's discussion on the meaning of dominant purpose remains relevant.

Meaning of "avoiding tax"

20. The term "avoiding tax" is not defined in the Act or the ITA 2007. However, the term "tax avoidance" is defined in s YA 1 of the ITA 2007 as follows:

> **YA 1 Definitions**
>
> In this Act, unless the context requires otherwise,—
>
> …
>
> **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

21. The term tax avoidance is also defined in s 76(8) of the GSTA, for the purposes of the GSTA, as follows:

> **76 Avoidance**
>
> …
>
> (8) For the purpose of this section—
>
> …
>
> **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.

22. The Commissioner considers that the term "avoiding tax" should be interpreted widely and is not limited to the statutory concept of tax avoidance. This is consistent with s 141D(6)(a) which provides that a taxpayer's tax position may be an abusive tax position if it is an incorrect tax position under either or both of an anti-avoidance provision or a general provision. Consequently, even when an adjustment is made

under a provision other than an anti-avoidance provision, an abusive tax position shortfall penalty may apply provided there is a dominant purpose of avoiding tax.

23. Applying a wide interpretation to the term tax avoidance is also consistent with the commentary on the Bill that introduced s 141D into the Act, which states:[9]

> The penalty for abusive tax positions will apply not only in situations where a general or specific anti-avoidance provision is invoked, but also where other provisions have been applied. The need for the Commissioner to rely explicitly on an anti-avoidance provision does not necessarily indicate that the tax position is more deserving of a high penalty than an aggressive interpretation intended to avoid tax but which fails under another provision.
>
> The concept of "avoiding tax" encompasses the deferral of tax and the claiming of tax credits.

"Directly" or "indirectly"

24. Section 141D(7)(b)(i) and (ii) refers to a tax position taken with a dominant purpose of avoiding tax "whether directly or indirectly".

25. There is no discussion about the inclusion of the words "directly or indirectly" in the discussion documents relating to the abusive tax position penalty or in the commentary.[10] It appears the use of the words directly or indirectly in subparas (i) and (ii) was to ensure the abusive tax position penalty applies as widely as possible and to maintain consistency with the definition of tax avoidance in s YA 1 of the ITA 2007 and s 76(8) of the GSTA.

Meaning of "arrangement"

26. Section 141D(7)(b)(i) requires an arrangement that is entered into with a dominant purpose of avoiding tax.

27. "Arrangement" is relevantly defined in s 3(1) as follows:

> "a**rrangement**" –
>
> (a) Means a contract, agreement, plan or understanding, whether enforceable or unenforceable, including all steps and transactions by which it is carried into effect:

[9] *Taxpayer Compliance, Penalties, and Disputes Resolution Bill: Commentary on the Bill* (Inland Revenue, September 1995) at 15 and 16.

[10] *Taxpayer Compliance, Standards and Penalties: A government discussion document* (government discussion document, Policy Advice Division of Inland Revenue, August 1994) and *Taxpayer Compliance, Standards and Penalties 2: Detailed proposals and draft legislation* (government discussion document, Policy Advice Division of Inland Revenue, April 1995).

28. 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.

29. There is case law on the meaning of arrangement in the income tax context, particularly in the context of the general anti-avoidance provision.[11] An arrangement has been described as embracing all kinds of concerted action by which people may arrange their affairs for a particular purpose or to produce a particular effect.[12]

30. An arrangement may involve more than one transaction or document. Whether it does or not is a matter of fact.[13]

31. In determining whether transactions or documents (or both) are part of an arrangement, the courts ask whether:

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

32. This requires consideration of the nature and extent of the relationship between the transactions or documents.

33. An arrangement, as defined, includes "all steps and transactions by which it is carried into effect". These words reflect that an "agreement, contract, plan, or understanding" may not describe all the practical steps and transactions needed to carry out an arrangement.

34. Therefore, the definition makes clear that an arrangement includes the various actions undertaken to carry the arrangement into effect even if those actions are not by themselves an agreement, contract, plan or understanding.

[11] The term arrangement is defined is s YA 1 of the Income Tax Act 2007.

[12] *CIR v BNZ Investments Ltd* [2002] 1 NZLR 450 (CA) at [45].

[13] *Peterson v CIR* [2005] UKPC 5 at [33].

35. Other aspects of an arrangement include the following:

- An arrangement is defined to include a "plan", which could involve a single person.[14]
- An arrangement does not require a consensus or a meeting of minds of two or more people, so a taxpayer could be party to an arrangement even if they are not consciously involved in or aware of its details.[15]
- An arrangement may consist of more than one agreement, contract, plan or understanding, so an agreement, contract, plan or understanding may be part of a wider arrangement as well as being part of a separate narrower arrangement.
- An arrangement includes steps and transactions that are entered into or carried out outside New Zealand.[16]

Factors that may indicate a "dominant purpose of avoiding tax"

36. The commentary discussed indicators that may suggest a dominant purpose of avoiding tax:[17]

> Indicators of a dominant purpose of avoiding tax may include artificiality, contrivance, circularity of funding, concealment of information and non-availability of evidence, and spurious interpretations of tax laws.

37. The indicators referred to in the commentary can help to determine whether an arrangement or a taxpayer has a dominant purpose of avoiding tax. Factors that may be taken into account when considering whether there is a dominant purpose of avoiding tax include artificiality and contrivance, circularity of funding, concealment of information and non-availability of evidence, and spurious interpretations.

Artificiality and contrivance

38. Have the transactions been designed to appear to comply with the legislation? The legal form may not reflect the substance.

39. Consideration will be given to the commercial reality of the arrangement. Are the arrangements or schemes "self-cancelling" (ie, otherwise neutral commercial consequences, leaving only tax effects)?

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[14] *Russell v CIR (No 2)* (2010) 24 NZTC 24,463 (HC) (footnote 33 at [101]) and *Russell v CIR* [2012] NZCA 128 at [54].

[15] *Peterson v CIR* at [34].

[16] *BNZ Investments Ltd v CIR* (2000) 19 NZTC 15,732 (HC) at [123].

[17] *Taxpayer Compliance, Penalties, and Disputes Resolution Bill: Commentary on the Bill* (Inland Revenue, September 1995) at 15.

40. The importance of the transaction's commercial purpose as compared with the tax benefit the relevant taxpayer obtained must be examined.

Circularity of funding

41. Circularity may arise in two types of arrangement:

- An arrangement that involves circular movements of money that have the economic effect of being self-cancelling and are, in reality, not suffered.
- An arrangement, or a part of it, that 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.

Concealment of information and non-availability of evidence

42. Concealment of information may occur through the use of a tax haven or by other means. By going through a tax haven, disclosure protection may result due to the particular tax haven's secrecy laws. These laws usually do not allow information to be released to tax authorities. Concealment of information may provide an obstacle to the gathering of information to establish whether the transaction or arrangement is artificial or contrived. In these circumstances, the burden of proof remains on the taxpayer to establish their position.

Spurious interpretations

43. Spurious interpretation covers situations where a tax position taken has no or little basis at law or the interpretation made or position taken is frivolous.

No exhaustive list of factors

44. The factors discussed above are not an exhaustive list of the factors that may indicate a dominant purpose of avoiding tax. A discussion document published before the introduction of s 141D(7) stated:[18]

> 7.10 The draft legislation does not include a list of indicators of dominant purpose. Although such a list could highlight some of the factors to be considered in determining whether a penalty should be applied for abusive avoidance, rather than lack of a reasonably arguable position, the list could not be exhaustive, and the absence or inclusion of one factor might take on a significance which is unintended.

[18] *Taxpayer Compliance, Standards and Penalties 2: Detailed proposals and draft legislation* (government discussion document, Policy Advice Division of Inland Revenue, April 1995).

45. The factors were not listed in the legislation to prevent the absence of any factor having the unintended consequence of the penalty not applying. As discussed above, the test is whether the dominant purpose is avoiding tax. It is considered, therefore, that the absence of any of the factors will not indicate the penalty does not apply. Further, the penalty may still apply if none of the listed factors are present. For example, other factors (such as inflated values or a lack of economic substance) may indicate that the dominant purpose of an arrangement is avoiding tax.

Ascertaining the dominant purpose of an arrangement

46. When applying s 141D(7)(b)(i), the purposes of an arrangement must be identified and weighed to determine whether the arrangement has a dominant purpose of avoiding tax. If the only purpose of the arrangement is avoiding tax, that will be the dominant purpose. If there are other purposes, these must be weighed against the purpose of avoiding tax to see which, if any, is dominant.

47. Purposes are identified and weighed in the context of the arrangement's specific structure. As the test is to establish the dominant purpose of the arrangement, purposes are relevant if they explain the arrangement's specific structure. The fact that non-tax purposes may be able to be achieved by other structures does not in itself make the non-tax purposes irrelevant. The point is whether the particular way the arrangement has been put together can be explained by a non-tax purpose or purposes. If the arrangement's specific features are mainly explicable by the tax purposes, this suggests the dominant purpose is avoiding tax. If the arrangement's specific features are mainly explicable by the non-tax purposes, this supports the conclusion that the dominant purpose of the arrangement is not avoiding tax. If none of the purposes (tax or non-tax) is dominant, the penalty will also not apply.

48. The factors discussed in the commentary may be the same factors that indicate there is a tax avoidance arrangement.[19] However, the factors must be considered again in the context of the different standard in the dominant purpose test in s 141D. In other words, it is necessary to consider whether the factors support the conclusion that the dominant purpose of the arrangement is avoiding tax.

Case law

49. The cases on s 141D(7) have generally considered whether an abusive penalty applied because there was an arrangement within s 141D(7)(b)(i) that had a dominant purpose of avoiding tax. Those cases have weighed the tax purposes of the relevant

[19] *Taxpayer Compliance, Penalties, and Disputes Resolution Bill: Commentary on the Bill* (Inland Revenue, September 1995).

arrangements against the non-tax purposes: *Accent Management Ltd v CIR* (HC),[20] *Case Z23*[21] and *Krukziener v CIR*.[22] The cases also looked at various indicators to help to determine whether an arrangement's dominant purpose was to avoid tax. For example, the courts have looked at the substance of the arrangement, the presence of artificiality, and the extent to which the economic position of the person was altered by entry into the arrangement: *Erris Promotions Ltd v CIR*,[23] *CIR v Campbell Investments Ltd*,[24] *Alesco NZ Ltd v CIR*[25] and *Case 10/2015*.[26]

50. Consistent with the discussion at [47], the courts have also considered whether the form of an arrangement can be explained by a non-tax purpose. In *Vinelight Nominees Ltd v CIR*,[27] the Court of Appeal found that an arrangement had a dominant purpose of tax avoidance and, in doing so, observed that family objectives did not explain the form of the arrangement.[28] Similarly, in *Frucor Suntory NZ Ltd,* the Supreme Court found there was no plausible commercial reason other than tax avoidance for the way a funding arrangement had been structured.[29] Although this observation was made in the context of the court's discussion of the merely incidental test in s BG 1 of the ITA 2007, the court went on to hold that the arrangement had a dominant purpose of avoiding tax. The structuring of the arrangement together with the court's finding that the arrangement had substantial elements of artificiality, contrivance, circularity and cancellation appear to have been important factors that supported this decision.[30]

Relationship with general anti-avoidance provisions

51. An abusive tax position penalty does not apply automatically under s 141D where there is a tax avoidance arrangement under s BG 1 of the ITA 2007 or s 76 of the GSTA. Section BG 1 of the ITA 2007 and s 76 of the GSTA require the arrangement's tax avoidance purpose or effect to be more than merely incidental. Section 141D requires the dominant purpose to be avoiding tax. Therefore, the tests are fundamentally

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[20] *Accent Management Ltd v CIR* (2005) 22 NZTC 19,027 (HC) at [370] (upheld in *Ben Nevis*).

[21] *Case Z23* (2010) 24 NZTC 14,334 (TRA) at [125].

[22] *Krukziener v CIR (No 3)* (2010) 24 NZTC 24,563 (HC) at [71].

[23] *Erris Promotions Ltd v CIR* (2003) 21 NZTC 18,330 (HC) at [375]–[376] per Ronald Young J.

[24] *CIR v Campbell Investments* (2004) 21 NZTC 18,559 at [51] per Wild J.

[25] *Alesco NZ Ltd v CIR (No 2)* (2011) 25 NZTC ¶20-099 at [178]–[179] (HC) per Heath J (upheld in *Alesco NZ Ltd v CIR* (2013) 26 NZTC ¶21-003 (CA)).

[26] *Case 10/2015* (2015) 27 NZTC 17,261 (TRA) at [117]–[118] (upheld by the High Court in in *Honk Land Trustees v CIR* (2016) 27 NZTC ¶22-055 and by the Court of Appeal in *Honk Land Trustees Ltd v CIR* (2017) 28 NZTC ¶23-006).

[27] *Vinelight Nominees Ltd v CIR* (2013) 26 NZTC ¶21-055 (CA).

[28] *Vinelight* at [68].

[29] *Frucor Suntory NZ Ltd v CIR* (2022) 30 NZTC C ¶25-024 at [76] (SC).

[30] *Frucor Suntory NZ Ltd* at [81]–[85].

different and the "dominant purpose" requirement imposes a higher threshold than the "merely incidental" requirement. The Commissioner's view on the relationship between s BG 1 of the ITA 2007 and s 141D is set out in **QB 12/12: Abusive tax position penalty and the anti-avoidance provision**.[31]

52. In all the Taxation Review Authority and court cases where an arrangement was caught by s BG 1 of the ITA 2007 and the abusive tax position penalty was at issue, it was ultimately found that each arrangement had a dominant purpose of avoiding tax. No cases, therefore, have found that the arrangement's tax avoidance purpose or effect was more than merely incidental under s BG 1 of the ITA 2007 but the arrangement's purpose of avoiding tax was not dominant under s 141D. As a result, the courts have provided no guidance as to when a tax avoidance arrangement could be said to not have a dominant purpose of avoiding tax.

53. An abusive tax position penalty may be imposed in respect of an arrangement that is caught by an anti-avoidance provision or in respect of an arrangement that is not caught by an anti-avoidance provision. In both cases, the penalty will only apply if the arrangement has a dominant purpose of avoiding tax.

Examples | Tauira

54. The following examples demonstrate the abusive tax position penalty applying in three situations. In Example | Tauira 1, there is an arrangement that is not caught by an anti-avoidance provision, in Example | Tauira 2 there is an arrangement that is caught by an anti-avoidance provision, and in Example | Tauira 3 there is no arrangement.

Example | Tauira 1 – Application of s 141D(7) where there is an arrangement

Facts

Mr A is a trustee of the A Family Trust. Mr A and his family members are beneficiaries of the trust.

In the 2020 tax year, the trust acquires bare land with an intention of building a dwelling on the land, then selling it for a profit. The dwelling is completed in 2020. However, due to a downturn in the market, Mr A decides to rent the property to tenants. Mr A manages and maintains the property while it is rented. The work is not carried out under a contractual arrangement and Mr A does not charge a fee for his services, which are minimal.

[31] QB 12/12: Abusive tax position penalty and the anti-avoidance provision *Tax Information Bulletin* Vol 24, No 9 (October/November 2012): 20.

After 3 years, Mr A decides to sell the property as the market has improved and he wishes to change the trust's investment focus. The sale yields a $100,000 taxable profit in the 2023 tax year.

Mr A is the sole shareholder and director of A Ltd, a company through which he carries on a business. In the 2023 tax year, A Ltd has a loss balance of $200,000. At the end of the 2023 tax year, Mr A prepares a $100,000 invoice on A Ltd's behalf and issues it to the A Family Trust. The invoice is for the work Mr A carried out during the 2020–2023 tax years. The invoiced transaction is recorded in the 2023 accounts of the A Family Trust and A Ltd.

In its return for the 2023 tax year, the Trust claims a deduction for the $100,000 payment. A Ltd includes the payment as income in its return, reducing its loss balance to $100,000.

When questioned about the deduction, Mr A says he considers:

- the $100,000 payment meets the requirements of the general permission in s DA 1 because it was a payment for services;
- it was permissible to charge a fee on a retrospective basis because services had been provided and the services were of value to the A Family Trust;
- although the fee was calculated to match the A Family Trust's taxable profit, this is not objectionable as this is common practice in related-party situations; and
- even if the transaction could be viewed as loss sharing, this would not be objectionable as the loss grouping rules show Parliament tolerates the sharing of losses between closely related entities.

Analysis

Did the trust take an unacceptable tax position?

The A Family Trust did not incur the $100,000 payment in deriving its income. While the amount purports to be a payment for minimal services provided by A Ltd, this is not what occurred during the 2020–2023 tax years as there was no contract for services between A Ltd and the trust. Instead, the services were provided without charge by Mr A. Consequently, the trust is not entitled to deduct the $100,000 payment under the general permission (and the Commissioner does not have to consider the potential application of s BG 1).

The arguments raised by Mr A do not support his contention that the requirements of the general permission are met. Consequently, the A Family Trust's tax position does not meet the standard of being about as likely as not to be correct.

Did the trust take its tax position in respect, or as a consequence, of an arrangement?

Mr A's decision to issue an invoice to the Trust and the recording of the $100,000 payment in the accounts of the Trust and A Ltd constitute an arrangement. The Trust's tax position was taken in respect of this arrangement because the arrangement was the basis upon which the Trust claimed an entitlement to deduct the $100,000 amount. Accordingly, it is necessary to consider whether the arrangement is within s 141D(7)(b)(i), being an arrangement that has a dominant purpose of avoiding tax.

Does the arrangement have a dominant purpose of avoiding tax?

The Arrangement was entered at the end of the 2023 tax year when the A Family Trust's tax liability arose. The $100,000 payment made under the arrangement appears inflated when considered against the minimal services provided by Mr A and also appears calculated to match the amount of the trust's taxable profit. These circumstances indicate that the intended effect of the arrangement was to retrospectively re-characterise the service arrangement between the A Family Trust and Mr A when it became apparent the A Family Trust would be liable to pay tax on the profit from the property sale. The arrangement and the resulting tax position taken by the trust are spurious in this respect as there was no legal basis which would support a conclusion the arrangement had the effect of the A Family Trust incurring $100,000 of deductible expenditure in the 2023 tax year.

These circumstances show that the dominant purpose of the arrangement was avoiding tax payable on the property sale.

Accordingly, the abusive tax position shortfall penalty applies.

55. Example | Tauira 2 involves the application of s BG 1 of the ITA 2007. The leading authority on whether an arrangement has a tax avoidance purpose or effect under s BG 1 of the ITA 2007 is the decision of the Supreme Court in *Ben Nevis*. *Ben Nevis* sets out the parliamentary contemplation test. The parliamentary contemplation test is applied to determine whether an arrangement has a tax avoidance purpose. The test is whether the arrangement, viewed in a commercially and economically realistic way, makes use of or circumvents a specific provision in a manner that is consistent with Parliament's purpose.

56. Detailed guidance on the Commissioner's approach when applying s BG 1 of the ITA 2007 and the parliamentary contemplation test is set out in IS 23/01.[32] Broadly, that approach involves several steps, which are set out in Example | Tauira 2.

[32] IS 23/01: Tax avoidance and the interpretation of the general anti-avoidance provisions sections BG 1 and GA 1 of the Income Tax Act 2007 *Tax Information Bulletin* Vol 35, No 2 (March 2023): 8.

Example | Tauira 2 – Application of s 141D(7) where a tax avoidance arrangement exists

Facts

Ms B carries on a business through her company, C Ltd. In each of the 2012–2017 tax years she provides management services to C Ltd and, in return, C Ltd pays her a salary of between $150,000 and $200,000.

In the 2018 tax year, C Ltd's revenue reduces due to adverse market conditions. C Ltd also requires funds to meet capital expenditure. Ms B decides to forego her salary so C Ltd can pay for the capital expenditure and meet its ongoing operating costs.

By the start of the 2020 tax year, market conditions have improved, and C Ltd has met its capital expenditure needs and is trading near the levels it was trading at before the 2018 tax year. Despite this, C Ltd does not resume paying Ms B a salary. This creates a shortfall in the funds Ms B needs to meet her private expenditure. Ms B funds the shortfall using periodic borrowings obtained from C Ltd, and C Ltd funds the borrowings out of retained earnings. The borrowings are repayable on demand and interest is charged at the fringe benefit tax rate. All interest is capitalised at year end. The advances are recorded in a loan account Ms B maintains with C Ltd. At the end of the 2025 tax year, the account balance is $950,000.

The Commissioner considers s BG 1 of the ITA 2007 applies to the loan advances in the 2020–2025 tax years and proposes to treat the advances as income under s GA 1 of the ITA 2007. Ms B disputes this. In support of her position, she contends:

- the amounts she received cannot be taxed as income because they are loan advances;
- the terms on which the advances were made are not objectionable because they are typical of the terms used in related-party transactions;
- her initial decision to stop being paid a salary had a commercial purpose of leaving funds in C Ltd to be used for business purposes; and
- a person is entitled to live off capital, and under the loan she received advances of capital that she intends to repay.

Section BG 1 of the ITA 2007

As the Commissioner's position is that BG 1 of the ITA 2007 applies, it is necessary to set out the steps involved in applying that section before going on to consider the application of s 141D.

Step 1: Identify and understand the arrangement

In each of the 2020–2025 tax years there is an arrangement comprising:

- the decision to not pay a salary to Ms B;
- the provision of periodic loan advances that Ms B uses to fund her private expenditure;
- the capitalisation of the interest charged on the loan advances; and
- Ms B's decision not to make any repayments.

The relevant tax effect is that the loan advances are not assessable income of Ms B.

Step 2: Identify Parliament's purpose for the specific provisions that are relevant

The specific provisions that are relevant are ss CE 1 (income from employment) and CA 1 (ordinary income) of the ITA 2007. Parliament's purposes for these provisions include taxing income from personal services.

Step 3: Understand the commercial and economic reality of the arrangement

In the 2020–2024 tax years, the service arrangement between Ms B and C Ltd was commercially unrealistic. Ms B provided valuable services to C Ltd but was not remunerated for her work even though her personal skills and exertions were the principal source of the income. While a commercial explanation existed for the non-payment of a salary in the 2018 and 2019 tax years, this no longer applied from the 2020 tax year as by then C Ltd had met its need for capital expenditure and was trading profitably under improved market conditions.

Although Ms B did not receive remuneration, she was able to meet her living expenses out of the advances she received periodically from C Ltd. Those advances were made on uncommercial terms. Ms B was not required to make any repayments and, although interest was charged, it was added to the loan principal.

These circumstances are indicative of artificiality in the arrangement. In reality, the commercial and economic effect of the arrangement was that the advances functioned as an income substitute for Mrs B and represented her financial return for the services she provided to C Ltd.

Step 4: Consider whether the arrangement circumvents the specific provisions in a manner consistent with Parliament's purpose

Parliament's purposes for ss CA 1 and CE 1 of the ITA 2007 include treating amounts a person receives as remuneration for their services as assessable income. Under the arrangement, Ms B received amounts that were, in economic and commercial reality, remuneration for services. However, the amounts were not taxable because they were paid as loan advances. The arrangement achieved this outcome by artificially reducing

Ms B's remuneration to zero and by providing the advances on uncommercial terms. This shows the arrangement circumvented ss CA 1 and CE 1 of the ITA 2007 in a manner that is outside Parliament's contemplation because it avoided the application of those provisions in an artificial and contrived way.

Step 5: Decide whether a tax avoidance purpose or effect exists

The arrangement has a tax avoidance purpose because it circumvents ss CA 1 and CE 1 of the ITA 2007 in a manner inconsistent with Parliament's purpose for those provisions.

Step 6: Determine whether the tax avoidance purpose or effect is merely incidental

The arrangement's tax avoidance purpose is not merely incidental as it is not a natural incident of another non-tax purpose.

Reconstruction

To counteract the tax advantages under the arrangement, it is appropriate to apply s GA 1 of the ITA 2007 in the 2020–2025 tax years to treat the loan advances as taxable remuneration received by Ms B.

Shortfall penalty

Did Ms B take unacceptable tax positions?

Ms B argued that the amounts she received from C Ltd cannot be taxed as income because they were loan advances. To succeed with this argument, Ms B must show that the arrangement was within Parliament's contemplation. However, the high levels of artificiality and contrivance in the arrangement mean that such an argument could not meet the "about as likely as not to be correct" standard. This conclusion is consistent with the decision in *Krukziene*r where the High Court held that an arrangement like the one Ms B was a party to was also caught by s BG 1 of the ITA 2007.

Were the tax positions taken in respect, or as a consequence, of an arrangement?

Ms B took her tax positions as a consequence of the arrangement discussed in relation to s BG 1 of the ITA 2007. Accordingly, it is necessary to consider whether the arrangement is also within s 141D(7)(b)(i), being an arrangement that has a dominant purpose of avoiding tax.

Did the arrangement have a dominant purpose of avoiding tax?

The high levels of artificiality and contrivance and the significant tax advantages obtained as a result of Ms B's income being converted into non-taxable capital support a conclusion the arrangement had a dominant purpose of avoiding tax.

Further, the way the arrangement was structured and implemented appears wholly explicable by the tax advantages, and this also supports a conclusion the arrangement had a dominant purpose of avoiding tax. And while Ms B argued that she reduced her salary to meet a need C Ltd had for funds to meet business expenditure, that need had diminished by 2020, so could not be considered a non-tax purpose that would explain why the arrangement took the form that it did in subsequent years.

Accordingly, the abusive tax position shortfall penalty applies.

Example | Tauira 3 – Application of s 141D(7) when there is no arrangement

Facts

In the 2018 tax year, Mr D receives a large inheritance that he uses to acquire an investment. The investment documentation Mr D fills out records that he is the sole investor. Accordingly, Mr D holds the investment in his own name.

The investment returns $80,000 of income annually from the start of the 2020 tax year. Mr D receives the income into his bank account and uses it to pay private expenditure, make lump sum mortgage repayments and fund other investments.

In the 2020–2024 tax years, Mr D derives a salary of $100,000 and his partner derives a salary of $50,000. In each of those years, Mr D prepares his own tax return and prepares tax returns on behalf of his partner and their three young children.

Mr D includes $14,000 of the investment income in each child's return (the children's returns do not include any other income), $20,000 in his partner's return and the balance of $18,000 in his return.

When asked why he split the income in this manner, Mr D says he did this because the income was family income. When asked if the family members received the amounts in their returns or, if not, whether they would receive them in the future, Mr D said they received some as the income was used to pay family expenditure. He also said they could expect to receive more in the future as the income was also used to pay for the family home and other investments, and he has left these assets to his family in his will.

Analysis

Did Mr D take unacceptable tax positions?

Mr D legally derives all $80,000 of annual income that the investment produces because he owns the investment. Consequently, the tax positions that he took in his returns for the 2020–2024 tax years are incorrect as he included only $18,000 of the income in the returns.

Mr D's tax positions do not meet the standard of being about as likely as not to be correct as there is no evidence and no authority that supports his contention the income is family income. There is nothing that suggests anyone other than Mr D was the legal owner of the investment, there is no evidence Mr D held the investment on trust for this family, and there is no evidence that any income from the investment was assigned to anyone else.

Were the tax positions taken in respect, or as a consequence, of an arrangement?

Mr D acted alone in apportioning his income between himself and his family members. It is arguable this constitutes an arrangement as the definition of arrangement includes a plan, and a plan can be carried out by a single person. However, there were no transactions, documents or steps underlying Mr D's tax position that effected, or attempted to effect, a reduction in his income. Instead, Mr D's tax position was based on his view that the income was family income and could be divided amongst his family for assessment purposes. These circumstances indicate there was no arrangement. This means it is necessary to consider whether Mr D's tax positions, viewed objectively, are within s 141D(7)(b)(ii), being tax positions taken with a dominant purpose of avoiding tax.

Did Mr D take his tax positions with a dominant purpose of avoiding tax?

Mr D allocated $14,000 of the investment income to each of his children and an amount to his partner that increased her income to $70,000. Both amounts are close to threshold amounts above which a person's marginal tax rate increases and Mr D's children and his partner are on lower marginal tax rates than he is. This indicates that in taking his tax positions, Mr D had a purpose of avoiding the tax that would otherwise have been payable had all the income been included in his returns. Further, there was no substantial evidential or legal basis that would support treating the income, in part, as belonging to Mr D and his family members for assessment purposes. This is indicative of a spurious interpretation and application of the applicable tax laws. These circumstances show the Mr D's tax positions were taken with a dominant purpose of avoiding tax.

Accordingly, the abusive tax position shortfall penalty applies.

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, or practitioners. Only finalised items represent authoritative statements by Inland Revenue of its stance on the particular issues covered.

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