

Information Sheet

Draft statement on tax avoidance released for public comment

What is the draft statement about?

The Commissioner has released for public comment a draft interpretation statement – IS XX/XX: “Tax avoidance and the interpretation of the general anti-avoidance provisions sections BG and GA 1 of the Income Tax Act 2007”.

The draft statement explains the Commissioner’s view of the law on tax avoidance in New Zealand. Section BG 1 is the general anti-avoidance provision in the Income Tax Act 2007. Section GA 1 enables the Commissioner to make adjustments as a result of the application of section BG 1.

The draft statement is also relevant to the general anti-avoidance provision in the Goods and Services Tax Act 1985 (section 76).

When finalised, the draft statement will replace the Commissioner’s current interpretation statement: IS 13/01.¹ The following Questions we’ve been asked (QWBA) are also withdrawn:

- QB 14/11: Income tax – scenarios on tax avoidance
- QB 15/01: Income tax – tax avoidance and debt capitalisation
- QB 15/11: Income tax – scenarios on tax avoidance – 2015.

The QWBA are withdrawn because they no longer reflect the Commissioner’s approach and a number of the scenarios dealt with in them are outdated because of changes in legislation.

To the extent the scenarios continue to have relevance, they have been updated and released in two draft QWBAs,² and are released in conjunction with the draft statement. Although the scenarios have been updated, there has been no change in the conclusions reached on each scenario.

Submissions on the draft can be made to public.consultation@ird.govt.nz up until 31 March 2021.

When will the statement apply from?

The statement, when finalised, will apply from the date of publication.

This information sheet explains how the draft statement differs from the Commissioner’s current statement on tax avoidance (IS 13/01) that the draft when finalised will replace.

For detailed information please refer to the draft statement.

¹ “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.

² 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*.

Why is the Commissioner issuing a replacement statement?

Inland Revenue announced a review of the Commissioner's current statement on tax avoidance in August 2017 because four years had passed since its publication and a review was considered timely to ensure that the statement was useful, practical and up to date. External submissions on the current statement were invited at that time. The period since then has involved a lengthy consideration of the public submissions received from the tax professional community, Inland Revenue's experience with the current statement, subsequent court cases and discussions with the Crown Law Office. This draft statement represents the Commissioner's proposed revised view at this time.

How does the draft statement differ from the current statement?

Change in relation to the Parliamentary contemplation test

The draft statement emphasises that the focus when applying section BG 1 is on answering the "ultimate question" posed by the Supreme Court in *Ben Nevis* when it set out the Parliamentary contemplation test.³ The ultimate question is **whether the arrangement, viewed in a commercially and economically realistic way, uses or circumvents the specific provisions in a manner that is consistent with Parliament's purpose.**

Answering this question requires viewing the arrangement as a whole in a commercially and economically realistic way, using the factors the courts have found relevant. 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.

Of those 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 purpose.

This change in emphasis arises from the Commissioner re-evaluating the Parliamentary contemplation test set out in the Supreme Court's decision in *Ben Nevis* and, in particular, seeking to be more consistent with how that test was subsequently applied by the same court in *Penny*.⁴

The current statement gives significant emphasis to identifying whether there is a mismatch of facts, features and attributes between what Parliament would have contemplated and those that appear in the arrangement in economic substance. Facts, features and attributes

³ *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 155, [2009] 2 NZLR 289 at [109].

⁴ *Penny v CIR* [2011] NZSC 95, [2012] 1 NZLR 433.

are those things Parliament would contemplate being present (or absent) when permissible tax advantages arise under the specific provision. The draft statement still accepts that considering whether any facts, features or attributes are present (or absent) in the arrangement can be useful. However, it makes it clearer that the emphasis and focus must be on answering the ultimate question. That is, whether the arrangement as a whole, viewed in a commercially and economically realistic way, uses or circumvents the specific provisions in a manner that is consistent with Parliament's purpose. The Commissioner is particularly interested in receiving submissions on this change to the statement and the continued role of facts, features and attributes.

The draft statement also adopts a greater focus on an arrangement's commercial and private purposes (ie, non-tax avoidance purposes) at the stage of answering the Parliamentary contemplation test. In the current statement, the focus on non-tax avoidance purposes arose when applying the merely incidental test, where non-tax avoidance purposes are also relevant.

Other changes in the draft statement – economic equivalence and counterfactuals

In the draft statement, the Commissioner has also taken the opportunity to clarify the relevance of economic equivalence, and of counterfactuals, in the context of applying section BG 1.

The brief discussion of economic equivalence in paragraph [377] of the current statement has been expanded to clarify that this is a well-established principle of law concerning the proper approach to the application of specific provisions and not section BG 1. The principle of economic equivalence precludes considering the economic substance of a transaction when applying a specific provision. The application of specific provisions is determined by the true legal nature of the transaction and the legal rights and obligations created.

In contrast, an economic substance approach is permitted and required when applying section BG 1. This is because the tax avoidance inquiry includes determining whether the arrangement has a "tax avoidance" purpose or effect. That is determined by asking under the Parliamentary contemplation test whether the arrangement, viewed in a commercially and economically realistic way, uses or circumvents the specific provision in a manner that is consistent with Parliament's purpose.

The draft statement also re-emphasises that, while an economic substance approach is permitted under section BG 1, it is incorrect to contend that an arrangement has a tax avoidance purpose or effect by comparing the arrangement with what is sometimes referred to as a "counterfactual". A "counterfactual" in this context is a hypothetical alternative arrangement that the taxpayer may have entered into or is economically equivalent to the arrangement actually entered into.

The requirement under the Parliamentary contemplation test to view the arrangement in a commercially and economically realistic way does not require identifying a counterfactual.

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. Nor does it 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.

The approach to applying section BG 1 taken in the draft statement

The draft statement emphasises that applying section BG 1 requires reaching a reasonable conclusion from:

- the established facts;
- the arrangement's effects; and
- Parliament's purpose for the specific provisions.

The conclusion on whether section BG 1 applies 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.

In the draft statement, the Commissioner suggests that a useful approach to applying section BG 1 includes:

- understanding the legal form of the arrangement (its steps, transactions and tax effects);
- 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; and
- answering the ultimate question of 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.

Answering the ultimate question requires considering whether there are any elements in the arrangement from which it can be inferred that Parliament would not have contemplated the gaining of the tax advantages in the particular circumstances. This requires viewing the arrangement as a whole and in a commercially and economically realistic way. Considering the factors referred to by the courts assists in answering the ultimate question.

This also includes considering the particularly significant factor of whether the tax advantages have been obtained by way of artificiality or contrivance. The Supreme Court in *Ben Nevis* stated that the structuring of an arrangement so that a taxpayer gains the benefit of the specific provision in an artificial or contrived way is outside Parliament's 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.

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.

Consistent with the current statement, 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.

If tax avoidance is not the sole purpose of an 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; and
- whether the tax avoidance purpose or effect follows as a natural incident of another purpose.

The merely incidental test involves the consideration of many of the same factors that are considered under the Parliamentary contemplation test.⁵ A conclusion under the Parliamentary contemplation test that an arrangement has a tax avoidance purpose or effect means it is very unlikely that the arrangement's tax avoidance purpose will be merely incidental.⁶

⁵ *Russell v CIR* [2012] NZCA 128, (2012) 25 NZTC 20–120 at [42].

⁶ *Ben Nevis* at [114].