Inland Revenue
Te Tari Taake

INTERPRETATION STATEMENT | PUTANGA WHAKAMĀORI

Income tax – arrangements involving tax losses carried forward under the business continuity rules

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IS 25/14

This interpretation statement sets out the Commissioner's view on the potential application of the specific anti-avoidance rules in ss GB 3BA, GB 3BAB and GB 3BAC when a company carries a tax loss forward under the business continuity rules.

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

RELATED ITEM

- **IS 22/06**: Loss carry-forward – continuity of business activities *Tax Information Bulletin* Vol 34, No 11 (December 2022): 23

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Summary | Whakarāpopoto

1. The business continuity rules in subpart IB allow a company that has breached continuity of ownership to carry a tax loss forward in specified circumstances.
2. This statement discusses the potential application of ss GB 3BA, GB 3BAB and GB 3BAC. Those sections contain specific anti-avoidance rules designed to counteract the trading of losses carried forward under the business continuity rules.

Section GB 3BAB

3. Section GB 3BAB counteracts arrangements under which income is injected into a loss company enabling another person to enjoy the benefit of the company's losses when they would otherwise have been prohibited from doing so by the ownership commonality requirements of the loss grouping provisions.
4. Section GB 3BAB applies if the following requirements in s GB 3BAB(1) are present:
    - Tax loss components of a company are carried forward under the business continuity rule in s IB 3(2). Broadly, a company is entitled to carry its tax loss forward under s IB 3(2) if there has not been a major change in the nature of the company's business activities during an applicable business continuity period, other than a change permitted under s IB 3(5).
    - An arrangement exists between two people, person A and person B. The term "arrangement" is defined in s YA 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.
    - Person A and person B are associated persons at the time they enter into the arrangement.
    - An effect of the arrangement is the company derives an amount of income and it is either certain, very likely or likely another person would have derived the income had the arrangement not been entered into.
    - The arrangement has a sole or main purpose of tax avoidance. Under this requirement it is necessary to determine whether the arrangement has an objective purpose of tax avoidance. This involves applying the parliamentary

contemplation test set out by the Supreme Court in *Ben Nevis Forestry Ventures Ltd v CIR*.[1]

- An arrangement's main purpose is its chief, principal, pre-eminent, leading or most important purpose. To work out whether tax avoidance is an arrangement's main purpose, the arrangement's non-tax purpose or purposes must be weighed against its tax avoidance purpose to see which is the main purpose. If the arrangement's specific features are mainly explicable by tax purposes, this suggests the main purpose is tax avoidance. If the specific features are mainly explicable by non-tax purposes, this suggests the arrangement's main purpose is not tax avoidance.

5. If all the requirements of s GB 3BAB(1) are present, the amount of income the loss company derives under the arrangement is treated as schedular income. The loss company must calculate an income tax liability for that income separate from the income tax liability it calculates for its non-schedular income. When calculating its schedular income tax liability, the loss company is prohibited from taking its tax loss into account.

Section GB 3BAC

6. Section GB 3BAC counteracts arrangements under which expenses are shifted away from a loss company enabling another person to enjoy the benefit of the company's losses when they would otherwise have been prohibited from doing so by the ownership commonality requirements of the loss grouping provisions.

7. Section GB 3BAC applies if the requirements of s GB 3BAC(1) are present. All but one of those requirements are the same as the requirements that apply under s GB 3BAB. The exception is the fourth requirement. Under s GB 3BAC, that requirement is that an effect of the arrangement is a person other than the company is allowed a deduction for an amount of expenditure or loss and it is either certain, very likely or likely the expenditure or loss would have been incurred by the company had the arrangement not been entered into.

8. If all the requirements of s GB 3BAC(1) are present, the expenditure or loss incurred by the other person is treated as not having been incurred. This means they are denied a deduction for the expenditure or loss under the general permission in s DA 1. The expenditure or loss is also treated as having been incurred by the loss company in the course of carrying on a business for the purpose of deriving assessable income. This means the loss company is entitled to a deduction for the expenditure or loss under s DA 1(1)(b).

[1] *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115, [2009] 2 NZLR 289.

9. Where a loss company is acquired, the acquiring company or group may enter into a service arrangement with the loss company. A key consideration in determining whether the arrangement has a sole or main purpose of tax avoidance for the purposes of the cost shifting rule in s GB 3BAC will be the existence of intra-group recharges for expenditure shifted out of the loss company and the level of any such recharge. In general, the Commissioner considers that a level of recharge that at least recovers the cost of the performance of the function by the associated company will not be uncommercial. Where an apportionment is required, the method chosen should be appropriate in the circumstances and result in a fair and reasonable allocation of costs to the loss company.

Section GB 3BA

10. Section GB 3BA is intended to prevent pre-emptive changes to business activities that enable a loss company to satisfy the business continuity rule where it otherwise would not.

11. Section GB 3BA applies if the following requirements in s GB 3BA(1) are present:

- A share in a company known as the "loss company" or a share in another company is subject to an arrangement. A share is subject to an arrangement if the share or the rights attached to the share are the subject matter of the arrangement.
- The arrangement is entered into within the 2 years immediately preceding a breach of the continuity of ownership requirements in s IA 5.
- The arrangement allows (that is, permits or enables) the loss company to meet the requirements of s IB 3(2) for carrying a tax loss forward despite the breach of the continuity of ownership requirements in s IA 5.
- A purpose of the arrangement is to defeat the intent and application of s IB 3. The intent and application of s IB 3 will be defeated by an arrangement that allows a company to carry a loss balance forward after a breach of continuity of ownership if the arrangement, when viewed in terms of its commercial and economic reality, involves the company carrying on a business after the breach that is not the same business it carried on before the breach.

12. If all the requirements of s GB 3BA(1) are present, the loss company is treated as not meeting the requirements of s IB 3(2). Therefore, the company is prohibited from carrying its tax loss forward.

Relationship with section BG 1

13. Section BG 1 may equally apply to an arrangement that is the same, similar or close to an arrangement covered by ss GB 3BA, GB 3BAB or GB 3BAC. Section BG 1 may also apply to arrangements that avoid tax in a way that is different from the way tax is avoided under arrangements caught by those provisions.

Introduction | Whakataki

14. The business continuity rules were introduced to help stimulate growth and innovation in the economy by loosening the loss continuity rules.[2] The rules allow a company that has breached continuity of ownership to carry a tax loss forward if there has not been a major change in the nature of the business activities the company carries on during an applicable continuity period (other than a permitted major change).

15. The business continuity rules are set out in ss IB 1, IB 2, IB 2B, and IB 3 to IB 5. Associated targeted anti-avoidance rules are set out in ss GB 3BA, GB 3BAB and GB 3BAC.

16. The anti-avoidance rules are designed to counteract the trading of losses carried forward under the business continuity rules. Sections GB 3BAB and GB 3BAC achieve this by acting as a buttress to the loss grouping provisions in subpart IC that prescribe the circumstances under which a company may make a tax loss available to another company. Section GB 3BA prevents pre-emptive changes to business activities that enable a loss company to satisfy the business continuity rule where it otherwise would not.

17. The Commissioner's view on the application of ss IB 1, IB 2, IB 2A, and IB 3 to IB 5 is set out in interpretation statement **IS 22/06**.[3] This current statement sets out the Commissioner's view on the potential application of the targeted anti-avoidance provisions in ss GB 3BA, GB 3BAB and GB 3BAC. The following analysis considers those provisions and is in two parts. The first part (from [18]) considers ss GB 3BAB and GB 3BAC together, and the second part (from [114]) considers s GB 3BA.

[2] Supplementary Order Paper to the Taxation (Annual Rates for 2020–21, Feasibility Expenditure, and Remedial Matters) Bill (March 2021): 24.

[3] IS 22/06: Loss carry-forward – continuity of business activities *Tax Information Bulletin* Vol 34, No 11 (December 2022): 23 (IS 22/06 was issued 28 October 2022 before being published in the *Tax Information Bulletin*).

Analysis | Tātari – ss GB 3BAB and GB 3BAC

18. Sections GB 3BAB ad GB 3BAC contain similar criteria so are considered together.

19. Section GB 3BAB provides as follows:

> **GB 3BAB Arrangements to inject income into companies carrying forward loss balances**
>
> *When this section applies*
>
> (1) This section applies when—
>
> (a) a person (**person A**) enters into an arrangement with another person (**person B**); and
>
> (b) person A and person B are associated persons at the time they enter into the arrangement; and
>
> (c) an effect of the arrangement is that a company derives an amount of assessable income for an income year that, but for the arrangement, a person other than the company—
>
> (i) would have derived; or
>
> (ii) would in all likelihood have derived; or
>
> (iii) might be expected to have derived; and
>
> (d) tax loss components of the company are carried forward under section IB 3(2) (When tax loss components of companies carried forward despite ownership continuity breach) to the tax year corresponding to the income year; and
>
> (e) the arrangement has tax avoidance as its sole or main purpose.
>
> *Treatment of injected income*
>
> (2) The amount is schedular income of the company for the tax year corresponding to the income year.

20. In summary, s GB 3BAB counteracts arrangements under which a person associated with a company carrying losses forward under the business continuity rule injects income into that company and an effect of the arrangement is that the person enjoys the benefit of those losses when they would otherwise have been prohibited from doing so by the ownership commonality requirements of the loss grouping provisions.

21. Section GB 3BAB has the following requirements:

- Tax loss components of a company are carried forward under the business continuity rule in s IB 3(2).
- An arrangement exists between two people, person A and person B.

- Person A and person B are associated persons at the time they enter into the arrangement.
- An effect of the arrangement is that the company derives an amount of income that, but for the arrangement, another person would have derived, would in all likelihood have derived or might be expected to have derived.
- The arrangement has a sole or main purpose of tax avoidance.

22. If the above five requirements are present, the amount of income the company derives is treated as schedular income.

23. Section GB 3BAC provides as follows:

GB 3BAC Arrangements to shift expenditure from companies carrying forward loss balances

When this section applies

(1) This section applies when—

(a) tax loss components of a company are carried forward under section IB 3(2) (When tax loss components of companies carried forward despite ownership continuity breach) to a tax year; and

(b) a person (**person A**) enters into an arrangement with another person (**person B**); and

(c) person A and person B are associated persons at the time they enter into the arrangement; and

(d) an effect of the arrangement is that, in the absence of this section, a person other than the company is allowed a deduction for an amount of expenditure or loss the person incurs that, but for the arrangement, the company—

(i) would have incurred in the income year corresponding to the tax year; or

(ii) would in all likelihood have incurred in the income year corresponding to the tax year; or

(iii) might be expected to have incurred in the income year corresponding to the tax year; and

(e) the arrangement has tax avoidance as its sole or main purpose.

Treatment of company

(2) The company is treated as having incurred the amount of expenditure or loss—

(a) in the course of carrying on a business for the purpose of deriving assessable income; and

(b) in the income year corresponding to the tax year.

Treatment of other person

(3) The person referred to in subsection (1)(d) that is not the company is treated as not having incurred the amount of expenditure or loss.

24. In summary, s GB 3BAC counteracts arrangements under which a person associated with a company carrying losses forward under the business continuity rule shifts expenses away from that company and an effect of the arrangement is that a person other than the company enjoys the benefit of those losses when they would otherwise have been prohibited from doing so by the ownership commonality requirements of the loss grouping provisions.

25. The requirements of s GB 3BAC are the same as those for s GB 3BAB except for the fourth requirement which in the case of s GB 3BAC is that an effect of the arrangement is that a person other than the company is allowed a deduction for an amount of expenditure or loss that, but for the arrangement, the company would have incurred, would in all likelihood have incurred or might be expected to have incurred.

26. If the five requirements of s GB 3BAC are present, the company is treated as having incurred the expenditure or loss in the course of a business carried on for the purpose of deriving assessable income and the other person is treated as not having incurred the expenditure or loss.

27. Each of the five requirements that must be met for ss GB 3BAB and GB 3BAC to apply are discussed next. This is followed by a discussion of the tax consequences that result when those sections apply.

Tax loss components of the company are carried forward under the business continuity rule in s IB 3(2)

28. The first requirement of ss GB 3BAB and GB 3BAC is that tax loss components of a company are carried forward under the business continuity rule in s IB 3(2).

29. Tax loss components are amounts included in a person's tax loss for a tax year. Tax loss components include current year net losses and unused net losses from previous years. A company carries tax loss components forward in a loss balance.[4] A company may do this only if it meets the minimum continuity of voting interest threshold in s IA 5.[5] Broadly, the requirement is that a group of persons holds at least 49% of the voting

[4] Section IA 3(4).

[5] If a market value circumstance exists, the group of persons must also hold at least 49% of the market value interests in the company (s IA 5(3)).

interests in a company over an applicable continuity period.[6] The continuity period for a tax loss component is the period from the beginning of the income year in which it first arises to the end of the income year in which it is used.[7]

30. The business continuity rule provides an exception to this. Broadly, if a loss company does not maintain continuity under s IA 5, it will, nevertheless, be entitled to carry a tax loss component forward if:

- it does not cease to carry on business activities during an applicable business continuity period; and
- there has not been a major change in the nature of the business activities carried on by the company during the business continuity period, other than a change permitted under s IB 3(5).

31. The business continuity period is typically the period starting immediately before an ownership continuity breach and ending on the earlier of the last day of the income year in which the:

- tax loss component in question is used; or
- fifth anniversary of the ownership continuity breach falls.[8]

32. The application of the business continuity rule is illustrated in Example | Tauira 1.

Example | Tauira 1 – Application of the business continuity rule

Loss Co carries on a business repairing and servicing stringed instruments. In recent years, Adrian, the owner of Loss Co, has neglected the business. This has resulted in Loss Co incurring successive losses that it is now carrying forward as a loss balance.

Janine buys all of Loss Co's shares from Adrian. After the sale, Janine continues to carry on Loss Co's business using the same assets and servicing the same market as before. At the end of her first year of ownership (the 2022 income year), Janine's hard work and good management have returned Loss Co to profit. Consequently, Loss Co has an amount of net income.

The sale of Loss Co's shares results in Loss Co failing to meet the 49% continuity of ownership requirement in s IA 5 for carrying its loss balance forward. However,

[6] Section IA 5(2). For more information on the continuity of voting interest threshold and the other rules in subpart IA see: IS 22/07 Company losses – ownership continuity, sharing and measurement *Tax Information Bulletin* Vol 34, No 11 (December 2022): 53.

[7] Section IA 5(6).

[8] The five-year cap does not apply to companies that come within s IB 4(1)(a). Broadly, that section applies to companies that have a carried forward loss balance that, at least to the extent of 50%, arose from bad debt deductions.

Loss Co meets the requirements of the business continuity rule in s IB 3(2) because there has not been a major change in Loss Co's business activities. This means Loss Co is entitled to offset its loss balance against its net income in the 2022 income year.

Meaning of "arrangement"

33. The second requirement of ss GB 3BAB and GB 3BAC is that an "arrangement" exists between person A and person B. The term arrangement is defined in s YA 1 as follows:

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

34. 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.

35. The courts have considered the predecessor definitions of arrangement to that in s YA 1, particularly in the context of the general anti-avoidance provision. 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.[9]

Arrangement may involve more than one transaction or document

36. 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.[10]

37. 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;
- there is prior planned linking or sequencing (or both).

[9] *CIR v BNZ Investments Ltd* [2002] 1 NZLR 450 at [45].

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

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

39. In *CIR v Europa Oil (NZ) Ltd*, the Privy Council considered that six agreements constituted a single agreement because they were "far too close, and far too carefully worked out" to isolate and treat as "a series of independent bargains".[11] The Privy Council considered an interdependence existed 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.

40. In *AMP Life v CIR*, the High Court held that four transactions did not constitute an arrangement because they were only "a mere sequence of events, each with knock-on causative consequences".[12] As mentioned, an arrangement requires an overall plan or some prior planned linking or sequencing (or both) of transactions or documents.

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

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

42. 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".

43. This interpretation is consistent with *CIR v Penny* where Randerson J stated:[13]

> [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.

[11] *CIR v Europa Oil (NZ) Ltd* [1971] NZLR 641 at [651] (PC).

[12] *AMP Life v CIR* (2000) 19 NZTC 15,940 (HC) at [125].

[13] *CIR v Penny* [2010] NZCA 2,310.

Other aspects of an arrangement

44. 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 persons, 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]

Person A and person B are associated persons

45. The third requirement of ss GB 3BAB and GB 3BAC is that person A and person B are associated persons at the time they enter into their arrangement. To determine whether two people are associated, the general associated persons rules in subpart YB apply. In summary, those rules treat two people as being associated where they are:

- two companies, if either a group of persons holds total voting interests in each company of 50% or more or the group of persons controls both companies by any other means (s YB 2);
- a company and a person (other than a company) if the person has a voting interest in the company of 25% or more (s YB 3);
- relatives (s YB 4);
- a trustee of a trust and:
  - a beneficiary of the trust (s YB 6);
  - the settlor of the trust (s YB 8);
  - a person who is related to a beneficiary of the trust (s YB 5);
  - a trustee of another trust with the same settlor (s YB 7); or
  - a person with the power to appoint or remove the trustee (s YB 11);

[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* [2005] UKPC 5 (PC) at [34].

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

- a settlor of a trust and a beneficiary of the trust (s YB 9);
- a partnership and a partner (excluding limited partnerships, which are treated as companies) (s YB 12);
- a look-through company and a look through owner who is a director or employee (s YB 13); or
- each associated with a third person (s YB 14).

Income would have been derived by another person

46. The fourth requirement for s GB 3BAB is in subparas (i)–(iii) of s GB 3BAB(1)(c). They require that an arrangement has the effect of a company deriving an amount of assessable income that, but for the arrangement, another person:
    - would have derived (s GB 3BAB(1)(c)(i));
    - would in all likelihood have derived (s GB 3BAB(1)(c)(ii)); or
    - might be expected to have derived (s GB 3BAB(1)(c)(iii)).
47. The requirements in subparas (i)–(iii) are in descending order of certainty. At the highest level, subpara (i) requires that a person would have derived an amount of income. Consequently, to satisfy subpara (i) it must be certain that the income would have been derived by the person had an arrangement not been entered into.
48. Subparagraph (ii) applies if the income would "in all likelihood" have been derived by another person. The term "in all likelihood" is defined in the *Shorter Oxford English Dictionary* (6th ed, New York, Oxford University Press) to mean "in all probability, very probably". The word "probability" is defined to mean "degree of likelihood" and "probably" to mean "most likely". Therefore, on the ordinary meaning of these terms the requirements of subpara (ii) will be met if it is very likely another person would have derived the income had an arrangement not been entered into.
49. Subparagraph (iii) requires that the income "might be expected" to have been derived by another person. The *Shorter Oxford English Dictionary* defines the word "might" to mean "have the possibility, opportunity, or suitable conditions to; and the word "expect" to mean "regard as about or likely to happen". Therefore, on the ordinary meaning of these terms the requirements of subpara (iii) will be met if it is possible to regard it as likely another person would have derived the income had the arrangement not been entered into.
50. In summary, to satisfy the requirements of s GB 3BAB(1)(c) a mere possibility that income would have been derived by another person is not enough. Instead, it must be shown that it is either certain, very likely or likely the income would have been derived

by another person had the arrangement not been entered into. These requirements are illustrated in Example | Tauira 2 in the context of s GB 3BAC.

51. Example | Tauira 3 demonstrates an arrangement that does not meet the requirements of s GB 3BAB(1)(c) because the arrangement does not have the effect of a company deriving an amount of income.

Another person would have been allowed a deduction

52. The fourth requirement for s GB 3BAC is in subparas (i)–(iii) of s GB 3BAC(1)(d). They require that an arrangement has the effect of a person other than the company being allowed a deduction for an expenditure or loss the person incurs that, but for the arrangement, the company:

- would have incurred (s GB 3BAC(1)(d)(i));
- would in all likelihood have incurred (s GB 3BAC(1)(d)(ii)); or
- might be expected to have incurred (s GB 3BAC(1)(d)(iii)).

53. The Commissioner considers that s GB 3BAC relates to expenditure a company was incurring before a breach of continuity of ownership occurs. This is because s GB 3BAC is directed at arrangements that allow expenditure existing at that time to be shifted out of a loss company. This does not mean that the expenditure must be identical to expenditure incurred by the loss company before the breach of continuity of ownership, but that the expenditure must be of the same type or nature and have the same or a similar purpose. This is illustrated in Example | Tauira 3.

54. Subparagraphs (i)–(iii) of s GB 3BAC(1)(d) use the same wording that is used in subparas (i)–(iii) of s GB 3BAB(1)(c) when expressing the degree of uncertainty allowed under each subparagraph. Therefore, to satisfy the requirements of s GB 3BAC(1)(d) a mere possibility that the company would have incurred the expenditure or loss is not enough. Instead, it must be shown that it is either certain, very likely or likely the expenditure or loss would have been incurred by the company had an arrangement not been entered into. These requirements are illustrated in Example | Tauira 2.

Example | Tauira 2 – Shifting costs out of target company

Facts

Loss Co incurs rent (leasing business premises), salaries (paying staff) and marketing expenditure (promoting its business). Profit Co acquires Loss Co and after the acquisition Profit Co and Loss Co enter into an agreement under which Profit Co agrees to provide business premises, staff and marketing services to Loss Co. This arrangement involves Loss Co assigning its existing lease to Profit Co, terminating

employee contracts and ending its marketing functions, and Profit Co incurring deductible expenditure providing those services to Loss Co.

Application of s GB 3BAC

The service agreement is not a major change in the nature of Loss Co's business activities as it only affects the way in which Loss Co meets its need for staff, premises and marketing functions. The agreement does not affect matters such as the assets used in the business (Loss Co uses the same premises and the same staff as before), the type of services provided, the scale of the business or the markets the business serves. Consequently, Loss Co is entitled to carry its loss forward under s IB 3(2).

Section GB 3BAC(1)(d)(i) applies to the rent. If the arrangement had not been entered into, it is certain Loss Co would have incurred the rent as Loss Co would have continued to be the lessee under the lease, so liable to pay the rent.

Section GB 3BAC(1)(d)(ii) applies to the salary expenditure. Although staffing requirements can fluctuate within a business, the implementation of the arrangement does not affect Loss Co's need for staff. Therefore, it is very likely Loss Co would have incurred the salary expenditure had the arrangement not been entered into.

Section GB 3BAC(1)(d)(iii) applies to the marketing expenditure. Marketing expenditure is discretionary expenditure that can vary from year to year and in some years may be nil. However, it is likely Loss Co would have incurred marketing expenditure if the arrangement had not been entered into, because Loss Co typically incurs marketing expenditure each year.

Example | Tauira 3 – Financing arrangement to acquire new business

Facts

Loss Co owns a furniture retail business. Loss Co has accumulated losses that it is carrying forward in a loss balance.

Aroha acquires Loss Co through a holding company, Hold Co. After 18 months, Aroha decides to expand her business acquiring another furniture retail business from a third party, Vendor Co. The business is profitable and of the same type as Loss Co's existing business. The new business is purchased by Loss Co and merged with Loss Co's existing business. Loss Co funds the purchase using money provided by Hold Co in an exchange for shares. Hold Co acquired the funds under a bank loan and Hold Co is entitled to deduct the interest that it pays to the bank.

Application of s GB 3BAB

When Loss Co acquires the new business there is a change in the nature of its business activities as the acquisition expands Loss Co's business. As the change is caused by an increase in the scale of the business, the change will be permitted under s IB 3(5)(c) to the extent that it is a major change.

Loss Co's agreement to issue shares to Hold Co in exchange for cash is an arrangement between two associated persons. The arrangement provides Loss Co with funds to purchase the new business. After acquisition, Loss Co derives income from the business. However, this is not an effect of the arrangement, it is an effect of the sale agreement between Loss Co and Vendor Co as Loss Co obtains ownership of the income producing assets of the new business under the sale agreement. As the arrangement does not have an effect of Loss Co deriving an amount of income, s GB 3BAB cannot apply.

Application of s GB 3BAC

Hold Co incurs deductible interest on the funds that it borrowed and provided to Loss Co. As Loss Co was not incurring the same interest expenditure before it was acquired by Hold Co, the interest cannot come within s GB 3BAC(1)(d). As is noted at [53] above, s GB 3BAC(1)(d) can only apply to expenditure that is of the same type or nature and has the same or a similar purpose as expenditure Loss Co incurred before being acquired. Therefore, even if it could be concluded that Loss Co would have borrowed the money and incurred the interest had the arrangement not been entered into, s GB 3BAC would not apply.

Interest free loan

The same outcomes would arise under ss GB 3BAB and GB 3BAC if instead of providing money in exchange for shares, Hold Co funded Loss Co by providing an interest free loan.

Arrangement has a sole or main purpose of tax avoidance

55. If an arrangement exists between associated persons and the requirements of s GB 3BAB(1)(c) or s GB 3BAC(1)(d) are present, it is necessary to determine, under the fifth and final requirement, whether "the arrangement has tax avoidance as its sole or main purpose". This question may be divided into two steps:

- Determine whether the arrangement has a tax avoidance purpose.
- If it does, determine whether the tax avoidance purpose is the arrangement's sole or main purpose.

Whether the arrangement has a tax avoidance purpose

56. The question of whether an arrangement has a tax avoidance purpose also arises under the general anti-avoidance provision, s BG 1. For this reason, it is considered that the approach to applying s BG 1 is relevant when applying ss GB 3BAB and GB 3BAC.

57. Section BG 1(1) provides that a "tax avoidance arrangement is void as against the Commissioner for income tax purposes". The term "tax avoidance arrangement" is relevantly defined in s YA 1 to mean:

> an arrangement … that **has tax avoidance as its purpose or effect** … or has tax avoidance as 1 of its purposes or effects … if the tax avoidance purpose or effect is not merely incidental. [Emphasis added]

58. It is well established that the test of whether an arrangement has a tax avoidance purpose or effect under s BG 1 is objective.[17] This means the subjective motives and purposes of the parties who enter into an arrangement are not relevant when applying the test. Instead, the courts treat the phrase "purpose or effect" as a composite term that requires an arrangement's objective purpose to be determined by working backwards from the arrangement's effect; that is, what the arrangement actually achieves.[18] The objective nature of the test also means the arrangement's effect must be ascertained from its terms.[19] Consequently, if the terms of an arrangement show it has a tax avoidance effect, then it has a tax avoidance purpose.

59. Similarly, it is considered that when applying ss GB 3BAB and GB 3BAC the issue of whether an arrangement has a tax avoidance purpose is also objective. This is evident from the words of those sections, which require that it is "the arrangement" that has a sole or main purpose of tax avoidance.

60. Therefore, the initial question that must be answered under ss GB 3BAB and GB 3BAC is the same as the one that must be answered under s BG 1; that is, does the arrangement have an objective purpose of tax avoidance? Consequently, the approach that applies when determining whether an arrangement has a tax avoidance purpose under ss GB 3BAB and GB 3BAC is the same as the approach that applies under s BG 1.

Parliamentary contemplation test

61. Although s YA 1 contains a definition of the term "tax avoidance", the courts typically decide whether tax avoidance exists without any detailed analysis of the statutory

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[17] *Newton v Commissioner of Taxation* [1958] AC 450 (PC) and *Ashton v CIR* [1975] 2 NZLR 717 (PC) at 721–722.

[18] *Glenharrow Holdings Ltd v CIR* [2008] 2 NZLR 359 (SC) at [38].

[19] *Ashton* at 722.

definition or the term's ordinary meaning. At times, the courts have not referred to the definition at all.

62. The leading authority on whether an arrangement has a tax avoidance purpose or effect under s BG 1 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.

63. Detailed guidance on the Commissioner's approach when applying s BG 1 and the Parliamentary contemplation test is set out in interpretation statement **IS 23/01**.[20] Broadly, that approach involves the following steps:

- Identify and understand the arrangement.
- Identify and understand Parliament's purpose for the specific provisions that are relevant.
- Understand the commercial and economic reality of the arrangement as a whole.
- Consider whether the arrangement makes use of or circumvents the specific provisions in a manner consistent with Parliament's purpose.
- Decide whether there is a tax avoidance purpose or effect.

Identify and understand the arrangement

64. This step involves understanding the legal form of an arrangement by identifying and understanding:

- all of the steps and transactions that make up the arrangement (see [33] to [44] about what is an "arrangement");
- the commercial or private purposes of the arrangement;
- the arrangement's tax effects and how they have been achieved by the arrangement based on the legal rights and obligations created, which requires identifying and understanding:
    - the specific provisions that apply to the arrangement and why they apply; and
    - any relevant provisions that do not apply and why they do not apply.

[20] 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.

65. The specific provisions that ss GB 3BAB and GB 3BAC are intended to buttress are relevant under this step.

66. Under the loss grouping provisions, a loss company may make its tax loss available to another company to subtract from its income if the requirements of s IC 5(1) are present.[21] The loss company does this by giving notice to the Commissioner or by agreeing that the profit company will bear the tax loss, or take a share in it, in return for a payment from the profit company.[22] Payments of this nature are known as subvention payments. A profit company that makes a subvention payment must deduct the payment from its net income.[23]

67. Section IC 5(1) contains an ownership commonality requirement that must be met before a loss company can make its tax loss available to a profit company. The requirement is that there must be a group of persons who hold common voting interests of at least 66% in both companies during the applicable commonality period. The commonality period is the period that begins at the start of the income year in which the loss company has a tax loss component included in the tax loss, and finishes at the end of the income year in which the profit company subtracts the tax loss component from its net income.[24]

68. Sections GB 3BAB and GB 3BAC apply when a company carries a loss forward under the business continuity rule and there is an arrangement that has a tax avoidance purpose. The arrangement must involve the injection of income into the company or deductible expenditure being shifted out of the company with the consequence that another person effectively enjoys the benefit of the company's loss.

69. In these circumstances, ss GB 3BAB and GB 3BAC counteract the tax benefit by imposing a tax liability on the income or by shifting the expenditure back to the loss company.

Identify and understand Parliament's purpose for the specific provisions that are relevant

70. This step involves identifying and understanding Parliament's purpose for the specific provisions that are used or circumvented by an arrangement. Parliament's purpose is ascertained from the text of the provisions, the statutory context (including the statutory scheme relevant to the provision), case law and any relevant extrinsic material.

[21] Section IC 5(1).

[22] Section IC 5(2)(a) and (b).

[23] Section IC 5(3).

[24] Sections IC 5(1)(a), IC 2(2), IC 3 and IC 6.

71. Section IB 1(a) is also relevant when considering Parliament's purpose. It provides that the purpose of subpart IB and ss GB 3BA, GB 3BAB and GB 3BAC is to enable companies to carry forward tax loss components despite not meeting the requirements for continuity of ownership in s IA 5 in order to reduce impediments to:

- innovation and economic growth:
- corporate reorganisations:
- changes in the direct or indirect ownership of companies:
- companies accessing new sources of share capital:
- companies adapting their business activities in order to grow or be resilient.

72. However, s IB 1(b) also provides that subpart IB 1 and ss GB 3BA, GB 3BAB and GB 3BAC have a purpose of not encouraging tax avoidance arrangements that involve the acquisition of ownership interests in companies (that is, loss trading).

73. The purpose of not encouraging tax avoidance arrangements involving the acquisition of interests in companies was explained in the commentary to the Supplementary Order Paper that introduced the business continuity rules (SOP Commentary), as follows (at p25):[25]

> To support the test and ensure it is not manipulated to enable loss trading the following measures are proposed:
>
> - A purpose provision setting out the objective of the test (that is, permit capital raising while preventing loss trading).
> - Exclusion of companies where the scale of activities in its business have reduced to nothing or almost nothing (dormant or "zombie" companies) from the rules.
> - **Anti-injection rules to prevent schemes that would permit the purchaser of a company to use up losses by diverting income into the company or by reducing expenditure of the company.**
> - A rule to stop pre-emptive changes to the business being made before the change in ownership to defeat the purpose of the business continuity test.
> - **Maintaining the current approach to loss grouping. Companies acquired as part of a corporate group may continue to offset losses within that group, however, a company cannot be purchased and have its losses made available within a new group.** [Emphasis added]

74. And further (at p35):

[25] Supplementary Order Paper to the Taxation (Annual Rates for 2020–21, Feasibility Expenditure, and Remedial Matters) Bill; Commentary on the proposed amendments to: extend the residential property bright-line test, and loosen the loss continuity rules.

> **The proposal leaves the commonality requirements unchanged.** Companies in the original group that are acquired together would meet the group test (for example, they were 100% commonly owned when the loss was made and remain 100% commonly owned when the loss is to be offset). **The acquired group will also form a new group with the acquiring company/group, however, because the commonality rules would fail to allow offsetting within the "new" group the pre-acquisition losses cannot be offset with other companies in that "new" group.** [Emphasis added]

75. This confirms that the ownership commonality rules within the loss grouping provisions in subpart IC are intended to apply unchanged to losses carried forward under the business continuity test.[26] It follows that the purpose of the ownership commonality rules is also relevant when considering Parliament's purpose as ss GB 3BAB and GB 3BAC are intended to buttress those provisions.

76. At the time they were introduced, the requirements of the loss carry forward and grouping rules were explained by the then Minister of Revenue:[27]

> The new rules are designed to tighten the criteria under which companies can carry forward and offset losses against the profits of other companies. **The intention of the new rules includes that of preventing the commercial trafficking of company tax losses to the detriment of revenue. Those rules follow a determination made by the Government that losses should not be tradable property.** In that determination the treatment parallels that received by individuals. It is notable that trading in tax losses is not provided for in other countries. There is also a recognition problem, which has given people a considerable advantage.
>
> The decision does not represent a new policy for Parliament. Loss-trafficking has never been allowed, but the rules as they were in place did not have the effect of stopping it from happening in the corporate sector. **The current restrictions on the ability of companies to carry forward and group losses have proved to be inadequate and losses have been carried forward and offset in circumstances in which those individuals who have gained the benefit of the tax losses are not the same as the persons who have borne the losses.** The losses are negative income, and, like positive income, they should not be able to be traded between individuals. [Emphasis added]

77. A policy document released at the time the loss carry forward and loss grouping provisions rules were introduced provides:[28]

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[26] For more information on the loss grouping provisions see: IS 22/07 Company losses – ownership continuity, sharing and measurement *Tax Information Bulletin* Vol 34, No 11 (December 2022): 53.

[27] Hansard Parliamentary Debates (5 August 1991) 518 NZPD 3861–3863.

[28] *Taxation Policy: Business Tax Policy 1991 – a statement* on *government taxation policy* (Minister of Finance and Minister for Revenue, 30 July 1991) at 82.

> The Government announced in the Budget a number of measures to change the tax rules that apply to the carry-forward and offset of company losses. These changes are aimed at:
>
> a providing rules that are more clear and certain as to the circumstances in which a company can either carry forward its tax losses into future income years for offset against its future income ("loss carry-forward") or offset its losses against the assessable income of other companies ("loss offset")
>
> **b limiting the carry-forward or offset of losses so that, as far as practicable, only the individuals who directly incur the initial economic burden of those losses are able to take advantage of them for tax purposes. The new rules in relation to company loss-carry-forward and offset seek to treat companies in a similar manner to individuals**
>
> c enabling profit companies that are eligible to offset their profits against the losses of one or more loss companies in a group to do so with minimum complexity. [Emphasis added]

78. In *Case Z19*, Judge Barber stated:[29]

> [180] … When the [loss continuity and grouping] rules were implemented the then Ministry of Finance Honourable Ruth Richardson stated in this 1991 Budget at page 41:
>
> > "[a]s far as practicable, only the individuals who directly incur the economic burden of those losses are able to take advantage of them for tax purposes. These rules in effect seek to treat companies in a manner similar to individuals."
>
> [181] Unrestricted transfer of losses is not found in any jurisdiction because Revenue authorities have a concern with protecting their tax bases. …

79. Similarly, in *Concepts 124 Ltd v CIR* Clifford J stated:[30]

> The continuity provisions have the policy intent of ensuring that the future benefit of tax losses is enjoyed by the economic owners of the company at the time the underlying economic losses were incurred.

80. On the basis of the above, the Commissioner considers Parliament's purpose in enacting the loss grouping provisions was to:

- prevent loss trading; and
- ensure the owners of a profit company who receive the benefit of a loss carried forward by another company are, at least to the extent of 66%, the same people who suffered the economic burden of the loss when it was incurred.

[29] *Case Z19* (2009) 24 NZTC 14,217 (TRA).

[30] *Concepts 124 Ltd v CIR* [2014] NZHC 2,140 at [71].

Understand the commercial and economic reality of the arrangement as a whole

81. The next step is to understand the commercial and economic reality of the arrangement as a whole. The Supreme Court in *Ben Nevis* identified factors that are helpful to consider in this context. These factors include the:

- manner in which the arrangement is carried out;
- role of all relevant parties and their relationships;
- economic and commercial effect of documents and transactions;
- nature and extent of the financial consequences; and
- duration of the arrangement.

82. In addition, the court stated that a classic indicator of a use that is outside Parliamentary contemplation is the structuring of an arrangement so the taxpayer gains the benefit of the specific provision in an artificial or contrived way.[31] 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.[32]

83. Artificiality, contrivance or pretence must be considered in the context of the arrangement as a whole. Artificiality is something that in commercial and economic reality (as objectively determined):

- is not commercially realistic;
- would not happen in that particular way or would not happen at all in commercial or private dealings, independent of the tax advantages;
- has no commercial or private purpose;
- has a commercial or private purpose, but that purpose has no commercial or private rationale or logic, independent of the tax advantages; or
- distorts the application or non-application of specific provisions.

84. In other cases, the courts have found factors to be significant that include whether:

- there is circularity in the arrangement;
- there is inflated expenditure or reduced levels of income in the arrangement;

[31] 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.

[32] At [97].

- the parties to the arrangement have undertaken limited or no real commercial or economic risks; and
- the arrangement is pre-tax negative.

Consider whether the arrangement makes use of or circumvents the specific provisions in a manner consistent with Parliament's purpose

85. Under this step, the implications of the preceding analysis are considered. Bearing in mind Parliament's purposes for ss GB 3BAB and GB 3BAC are to buttress the ownership commonality rules within the loss grouping provisions and the further purposes set out in s IB 1, the analysis is likely to highlight interrelated matters, including those concerning:

- the presence (or absence) of artificiality, contrivance or pretence;
- the veracity of the arrangement's commercial or private purposes (in contrast to the clarity or otherwise of the arrangement's tax advantages); and
- whether or not the use or circumvention of the relevant specific provisions is consistent with Parliament's purposes for the provisions.

86. The preceding analysis of the arrangement may highlight that tax advantages have been obtained by artificiality or contrivance. Artificiality or contrivance is a significant factor because the courts have confirmed that using or circumventing specific provisions to obtain tax advantages in artificial or contrived ways is outside Parliament's contemplation for those specific provisions. The related concept of pretence is also highly relevant.

87. The preceding analysis may show the arrangement's apparent commercial or private purposes may not be consistent with its commercial or economic reality. Arrangements are likely to be outside Parliament's purpose for the specific provision where:

- the arrangement has no commercial or private purpose;
- a step in the arrangement has no commercial or private purpose and the step uses or circumvents the specific provision;
- the arrangement (or a step) has a commercial purpose but that purpose has no commercial rationale or viability independent of the tax advantage; or
- the arrangement (or a step) is structured in a manner where the commercial or private purposes are dependent on a tax advantage being achieved.

88. Understanding the commercial and economic reality of the arrangement as a whole may indicate the arrangement uses or circumvents a specific provision in a manner that is not consistent with Parliament's purpose. This is because such understanding may

raise doubts as to whether Parliament would have contemplated permissible tax advantages arising under the specific provision in those circumstances.

Decide whether a tax avoidance purpose exists

89. This step involves taking into account all of the matters considered above to answer the ultimate question: does the arrangement, viewed in a commercially and economically realistic way, use or circumvent the specific provisions in a manner that is consistent with Parliament's purpose?

90. The answer must be a reasonable inference that is open on the evidence, is able to be drawn from the facts, and is logical and convincing. It cannot be the result of mere speculation or subjective intuitive impression.

91. The application of the of the Parliamentary contemplation test is illustrated in Example | Tauira 6 and Example | Tauira 7.

Whether tax avoidance is the sole or main purpose of the arrangement

92. If, after applying the Parliamentary contemplation test, it is found that an arrangement has a tax avoidance purpose, it is necessary to determine whether that purpose is the arrangement's sole or main purpose. The word "sole" is defined in the *Shorter Oxford English Dictionary* to mean "[o]ne and only, single: only". Therefore, if the arrangement has tax avoidance as its only purpose, s GB 3BAB or s GB 3BAC (as the case may be) will apply.

93. If the arrangement has a tax avoidance purpose and one or more other non-tax purposes, ss GB 3BAB and GB 3BAC will apply only if the arrangement "has tax avoidance as its … main purpose". The word "main" is defined in the *Shorter Oxford English Dictionary* to mean "[c]hief or principal in size or extent" and "[g]reater or more important than others of the same kind: pre-eminent: leading". Therefore, an arrangement's main purpose will be its chief, principal, pre-eminent, leading or most important purpose.

94. To work out whether tax avoidance is an arrangement's main purpose, the arrangement's non-tax purpose or purposes must be identified and weighed against the tax avoidance purpose to see which is the main purpose.

95. Purposes are identified and weighed in the context of the specific structure of the arrangement. As the test is to establish the main purpose of the arrangement, purposes will be relevant if they explain the specific structure of the arrangement. The fact that non-tax purposes may be able to be achieved by other structures does not in itself make them irrelevant. The point is: can the particular way the arrangement has been put together be explained by a non-tax purpose or purposes? If the specific

features of the arrangement are mainly explicable by the tax purposes, then this suggests the main purpose is tax avoidance. If the specific features of the arrangement are mainly explicable by the non-tax purposes, then this suggests the main purpose of the arrangement is not tax avoidance.

96. In practice, the factual indicators likely to be relevant in determining whether the main purpose of an arrangement is tax avoidance may be the same factors that indicate a tax avoidance arrangement exists. However, the factors have to be considered again in the context of the different standard required under a main purpose test. In other words, it is necessary to consider whether the factors support the conclusion that the main purpose of the arrangement is tax avoidance.

97. This approach is consistent with the approach the courts have taken in relation to s 141D(7) of the Tax Administration Act 1994. Section 141D(7) contains a test of whether an arrangement has a dominant purpose of avoiding tax that applies when determining whether a person is liable to pay an abusive tax position penalty. This test is similar to the main purpose test in ss GB 3BAB(1)(e) and GB 3BAC(1)(e). Case law on the application of s 141D(7) has also weighed the tax purposes of an arrangement against its non-tax purposes: *Accent Management v CIR*[33] (upheld in *Ben Nevis*), *Case Z23*[34] and *Krukziener v CIR*.[35]

98. In summary, an arrangement's main purpose is its chief, principal, pre-eminent, leading or most important purpose. In determining whether tax avoidance is an arrangement's main purpose, its non-tax purpose or purposes must be weighed against its tax avoidance purpose. This involves determining whether a purpose explains the structure of the arrangement. If the specific features of the arrangement are mainly explicable by tax purposes, this suggests the main purpose is tax avoidance. In practice, the factual indicators likely to be relevant in determining whether the main purpose of an arrangement is tax avoidance may be the same factors that indicate there is a tax avoidance arrangement such as the presence of artificiality and contrivance.

99. These concepts are illustrated by the application of the Parliamentary contemplation test in Example | Tauira 6 and Example | Tauira 7.

Intra-group recharging

100. A key consideration in determining whether an arrangement has a sole or main purpose of tax avoidance for the purposes of the cost shifting rule in s GB 3BAC will be

[33] *Accent Management v CIR* (2005) 22 NZTC 19,027 (HC) at [370].

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

[35] *Krukziener v CIR* (2010) 24 NZTC 24,563 (HC) at [71].

the existence or otherwise of intra-group recharges for expenditure shifted out of the loss company and the level of any such recharge.

101. Where a loss company is acquired, the acquiring company or group may seek to obtain efficiencies by having duplicated functions performed by an associated company rather than the loss company. This would commonly include functions such as payroll, accounting, sales and marketing, but could be any function. Such an arrangement will typically result in the associated company being allowed a deduction for expenditure that the loss company would otherwise have been likely to incur, and so it will be necessary to determine whether the arrangement has tax avoidance as a sole or main purpose.

102. The presence of artificiality or contrivance is important in this respect. As set out from [82], artificiality may be present in an arrangement where something is not commercially realistic or where there is inflated expenditure or reduced levels of income. In the Commissioner's view, the absence of an intra-group recharge or an uncommercial level of recharge for functions performed by an associated company will indicate that artificiality is present in an arrangement. This, in turn, may suggest that the arrangement has tax avoidance as a sole or main purpose.

103. This is consistent with the SOP Commentary which states that the cost-shifting rule in s GB 3BAC "would not apply where, for example, employment contracts are shifted to a group member and there is a recharge to the loss company….".[36] It is also consistent with Example 20 in the SOP Commentary which demonstrates the rule applying to an arrangement under which there is no recharge.[37]

104. Whether or not the level of recharge is uncommercial is a question of fact and will depend on the particular circumstances. In general, the Commissioner considers that a level of recharge that at least recovers the cost of the performance of the function by the associated company will not be uncommercial. Where the associated company performs the same function for more than one company within a group of companies, some form of apportionment of the cost between those companies will be required. The most appropriate way of determining any apportionment will depend on the context and should result in a fair and reasonable allocation to the loss company.

105. As discussed earlier, the cost-shifting rule only applies to existing costs. If the loss company received services under a service agreement with a member of its previous group and was not charged a fee, there will not for those services be any costs that the cost shifting rule could apply to.

106. This is illustrated in Example | Tauira 6.

[36] At p37.

[37] At p38.

Treatment of income under s GB 3BAB

107. If the five requirements of s GB 3BAB(1)(a)–(e) are present, the income derived by the loss company under the arrangement is treated as schedular income (s GB 3BAB(2)).

108. A person who has schedular income must calculate a separate income tax liability for each kind of schedular income they have and an income tax liability for their non-schedular income. The person adds the results of these calculations together to obtain their final income tax liability.[38]

109. Section IA 8(1)(f) prohibits a company from taking a tax loss into account when calculating a schedular income tax liability if the income for which the calculation is being performed is schedular income under s GB 3BAB(2). Therefore, if a company derives income under an arrangement that is caught by s GB 3BAB, the company is prohibited from offsetting the loss it carried forward under the business continuity rule against that income.

110. Example | Tauira 4 illustrates the application of s GB 3BAB(2) to an amount of income derived under an arrangement in which the five requirements of s GB 3BAB(1)(a)–(e) are present. The application of s GB 3BAB(2) is also illustrated in Example | Tauira 7.

Example | Tauira 4 – Treatment of income under s GB 3BAB(2)

Loss Co carries on a business and has a carried forward loss balance of $20,000 that it incurred in the 2021 tax year. At the start of the 2022 year, Loss Co's shares are sold, resulting in a breach of continuity of ownership. The new owner continues to carry on Loss Co's business and there is no major change in the nature of Loss Co's business activities. This means Loss Co is entitled to carry its loss balance forward under the business continuity rule. At the end of the 2022 year, Loss Co has assessable income of $50,000 and deductible expenditure of $30,000.

However, Loss Co is party to an arrangement in which the five requirements of s GB 3BAB(1)(a)–(e) are present. The arrangement involves an income assignment under which Loss Co, as assignee, derived $10,000 of its assessable income. Accordingly, s GB 3BAB(2) requires Loss Co to treat that income as schedular income.

Consequently, Loss Co must calculate a schedular income tax liability and an income tax liability for its non-schedular income. Loss Co has schedular income of $10,000. As Loss Co is prohibited from offsetting its loss balance against this amount, it must pay tax on the income at the company rate of 28%. Therefore, Loss Co has a schedular income tax liability of $2,800.

[38] Section BC 7(1)–(3).

Loss Co's non-schedular net income is $40,000 less $30,000, which equals $10,000. Loss Co is entitled to offset its loss balance against this amount. Therefore, Loss Co does not have any further income tax to pay and has a $10,000 remaining loss balance to carry forward.

Treatment of expenditure under s GB 3BAC

111. If the five requirements of s GB 3BAC(1)(a)–(e) are present, the expenditure or loss mentioned in s GB 3BAC(1)(d) incurred by a person other than the loss company is treated as not having been incurred by the person (s GB 3BAC(3)). The consequence is that the person is denied a deduction for the expenditure or loss under the general permission in s DA 1. The expenditure or loss is also treated as having been incurred by the loss company in the course of carrying on a business for the purpose of deriving assessable income. The consequence is that the loss company is entitled to a deduction for the expenditure or loss under s DA 1(1)(b) of the general permission.

112. Example | Tauira 5 illustrates the application of s GB 3BAC(3) to an amount of expenditure incurred under an arrangement in which the five requirements of s GB 3BAC(1)(a)–(e) are present. The application of s GB 3BAC(3) is also illustrated in Example | Tauira 6.

Example | Tauira 5 – Treatment of expenditure under s GB 3BAC(2)

Loss Co carries on a business and has a carried forward loss balance of $250,000 that it incurred in the 2021 tax year. At the start of the 2022 tax year, Jasmine, Loss Co's owner, sells her shares in Loss Co, resulting in a breach of continuity of ownership. Joshua, Loss Co's new owner, continues to carry on Loss Co's business after the share sale. This does not result in any change in Loss Co's business activities that would constitute a major change under the business continuity rule in s IB 3(2). Consequently, Loss Co is entitled to carry its loss balance forward.

Joshua owns another company, Profit Co, that carries on a separate business. In the 2022 tax year Profit Co has net income of $100,000. Profit Co's net income is made up of $200,000 of assessable income and $100,000 of deductible expenditure. In the same year, Loss Co has net income of $5,000, that amount being made up of assessable income of $50,000 and deductible expenditure of $45,000.

However, Loss Co and Profit Co are parties to an arrangement in which the five requirements of s GB 3BAC(1)(a)–(e) are present. Under the arrangement, $50,000 of Profit Co's deductible expenditure is expenditure that, but for the arrangement, Loss Co would have incurred. Accordingly, s GB 3BAC(2) requires that this expenditure is

treated as not having been incurred by Profit Co and is treated as having been incurred by Loss Co in the course of carrying on a business for the purpose of deriving assessable income. This results in Profit Co's net income increasing by $50,000 to $150,000 and Loss Co's net income decreasing from $5,000 to a net loss of $45,000.

Examples | Tauira

113. The following two examples illustrate the concepts discussed above.

Example | Tauira 6 – Arrangement involving shifting of costs

Facts

Transport Group carries on business providing transport services through two profitable trading companies, Trade Co 1 and Trade Co 2. Hold Co, the group's holding company, owns each of the trading companies.

Hold Co employs a team of people who provide human resources (HR), marketing and accounting services to the trading companies. The applicable service agreements provide for a service fee to be charged on a cost recovery basis. Hold Co calculates the fees by allocating to each company a share of Hold Co's expenditure that is proportionate to the amount of group revenue each company generates.

Loss Co is an unprofitable company that provides transport services and has a carried forward loss balance. Hold Co acquires Loss Co as it wishes to expand its business. The acquisition occurs at the start of the 2022 income year. Under Hold Co's direction, Loss Co continues to carry on the same business activities following its acquisition.

Before the acquisition, Loss Co incurred $300,000 of annual expenditure on its HR, marketing and accounting functions. Following the acquisition, Hold Co enters into a service agreement with Loss Co on the same terms as those that apply between Hold Co and the other trading companies.

In the 2022 income year, Transport Group has total revenue of $5 million. Of this, 20% was generated by Loss Co. In the same year, Hold Co incurs $1 million of expenditure providing services to the trading companies, including Loss Co. Therefore, Hold Co charges Loss Co a fee of $200,000.

At the end of the 2022 income year, Loss Co has an amount of net income that it offsets against its loss balance leaving a tax loss of $500,000. Trade Co 1 and Trade Co

2 both have taxable income on which they pay tax, and Hold Co has no taxable income as its assessable income equals its deductible expenditure.

Application of s GB 3BAC

Tax loss components are carried forward under s IB 3(2)

Hold Co's acquisition of Loss Co results in a breach of continuity under subpart IA. Despite this, Loss Co is entitled to carry its loss forward under s IB 3(2) if there has not been a major change in the nature of its business activities (other than a permitted major change). This requirement is met as the only change that has occurred is the service agreement with Hold Co. This change is not significant enough to qualify as a major change as it only affects the way in which Loss Co meets its need for HR, marketing and accounting functions and does not affect matters such as the assets used in the business, the type of services provided, the scale of the business or the markets the business serves.

Arrangement exists between person A and person B

The agreement under which Hold Co provides services to Loss Co is an arrangement.

Persons A and B are associated persons when they enter into the arrangement

Hold Co and Loss Co are associated persons because the same group of people own all of the voting interests in each company.[39]

Arrangement's effect is that a person other than Loss Co is allowed a deduction for expenditure that, but for the arrangement, Loss Co would have, would in all likelihood have, or might be expected to have incurred

In the 2022 income year, Hold Co incurs expenditure providing services to the trading companies, including Loss Co. Hold Co is entitled to a deduction for the expenditure as Hold Co incurs the expenditure deriving service fee income. Prior to the acquisition Loss Co incurred expenditure on the functions now being carried out by Hold Co under the service agreement. In view of this, it is likely that if the arrangement had not been entered into Loss Co would have continued to incur expenditure on those functions in the 2022 income year.

Arrangement has a purpose of tax avoidance

Identify and understand the arrangement

[39] Under the look through rule in s YC 4, the owners of Hold Co are treated as owning all the voting interests in Loss Co, and Hold Co is treated as not owning those interests.

The arrangement has a commercial purpose of reducing costs through the removal of duplication by moving Loss Co's HR, marketing and accounting functions to Hold Co.

The relevant tax effects for the 2022 income year are as follows:

- Loss Co is prohibited from making its $500,000 tax loss available to the profitable trading companies because the 66% commonality of ownership requirement in s IC 5 is not met.
- Loss Co no longer deducts $300,000 of expenditure incurred on HR, marketing and accounting functions.
- Hold Co is entitled to deduct the expenditure it incurs providing services to Loss Co.
- Hold Co includes the $200,000 service fee received from Loss Co in its assessable income.
- Loss Co is entitled to deduct the $200,000 service fee it pays to Profit Co.

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

Parliament's purposes for the commonality rules are to prevent loss trading and to achieve this by requiring that the owners of a profit company who receive the benefit of another company's loss are, at least to the extent of 66%, the same people who suffered the economic burden of the loss.

Understand the commercial and economic reality of the arrangement as a whole

Under the arrangement, Loss Co's HR, marketing and accounting functions are taken over by the group servicing entity, Hold Co. In the 2022 income year this results in Loss Co's direct expenditure on these matters reducing by $300,000 to zero and being replaced by a $200,000 service fee. The service fee is commercially realistic because it is priced at a level that reimburses Hold Co for the expenditure it incurs providing those services and the apportionment appears fair and reasonable. The arrangement also achieves a commercial purpose of reducing costs within Transport Group by removing duplication by a net amount of $100,000. The reduction in costs results in a genuine increase in Loss Co's profitability. These circumstances suggest no artificiality or contrivance exists in the arrangement.

Consider whether the arrangement makes use of or circumvents the specific provisions in a manner consistent with Parliament's purpose

Loss Co has a tax loss and the trading companies are both in profit. Loss Co is prohibited from sharing its tax loss with the other group companies because the 66% commonality threshold in s IA 5 is not met.

Under the arrangement, Hold Co incurs $200,000 of expenditure providing services to Loss Co in the 2022 income year. This has the effect of increasing Hold Co's deductible expenditure by $200,000 and decreasing Loss Co's deductible expenditure by $300,000. Therefore, deductible costs shift from Loss Co to Hold Co. However, the tax effect of the increase in Hold Co's deductible expenditure is offset by the $200,000 service fee that Loss Co pays to Hold Co as the service fee is assessable income of Hold Co. The difference of $100,000 represents genuine cost savings achieved by removing duplication. For this reason, the arrangement cannot be characterised as one under which Loss Co's loss is effectively enjoyed by the other group companies. Therefore, the arrangement does not avoid the application of the ownership commonality rules that prohibit Loss Co from sharing its loss with Hold Co and the profit companies.

Decide whether a tax avoidance purpose exists

The arrangement does not have a tax avoidance purpose.

Alternative facts

Instead of paying a fee to Hold Co on a cost recovery basis, Loss Co pays no fee.

In this case, the pricing under the arrangement is not commercially realistic as Hold Co incurs $200,000 of expenditure providing services to Loss Co but receives no payment in return. This is indicative of artificiality and contrivance in the arrangement.

The expenditure Hold Co incurs providing services to Loss Co results in a $200,000 deduction for Hold Co and increases Loss Co's net income by the same amount, enabling it to utilise a proportion of its carried forward losses. As the expenditure in Hold Co is no longer offset by a service fee, the overall tax effect is the same as would have applied had Hold Co made a $200,000 subvention payment to Loss Co. Therefore, the arrangement achieves a tax advantage (the sharing of Loss Co's loss) otherwise denied under the ownership commonality rules because Loss Co and the other group companies do not meet the commonality requirements of those rules.

The arrangement is able to achieve this outcome only because it contains artificial and contrived features (ie, the lack of a service fee). The effect of this is that, contrary to Parliament's purpose, the group companies who obtain the benefit of Loss Co's loss are not, at least to the extent of 66%, the same people who suffered the economic burden of the loss. This shows that the arrangement avoids the application of the ownership commonality rules in a manner that is outside Parliament's contemplation.

Determine whether the tax avoidance purpose is the arrangement's sole or main purpose

Transport Group claims the purpose of the arrangement is reducing costs through the removal of duplication. However, this broad purpose does not explain the particular way in which the arrangement is carried out – in particular, the lack of a service fee. The pricing (that is, the lack of a service fee) under the arrangement is artificial. The pricing has the effect of shifting costs from Loss Co to Hold Co so that Loss Co's taxable income increases, enabling it to utilise a proportion of its losses carried forward that it otherwise would not have been able to. The tax advantage obtained from this is significant. These factors indicate that the main purpose of the arrangement is tax avoidance.

Reconstruction

As all the requirements of s GB 3BAC(1) are present, s GB 3BAC(2) and (3) apply with effect that in the 2022 income year:

- Hold Co is denied a deduction for the $200,000 of costs it incurs and which, but for the arrangement, Loss Co would have incurred.
- Loss Co is treated as having incurred those costs in the course of a business carried on with a purpose of deriving income, so is entitled to deduct them under the general permission in s DA 1.

Example | Tauira 7 – Arrangement involving injection of income

Facts

Anna owns Profit Co, a profitable company that carries on a popular and successful restaurant business with a loyal customer base.

Cheryl owns Loss Co, an unprofitable company that also carries on a restaurant business from a different area in the same city as Profit Co's business. Unlike Profit Co's restaurant, Loss Co's is unpopular, poorly run and unprofitable, and the company has poor relationships with its suppliers and lenders. Loss Co has also dealt with a number of employment issues and there is a risk of future legal disputes.

As a result of the problems it has had, Loss Co has accumulated losses that it is carrying forward in a loss balance.

Frustrated by her inability to make Loss Co profitable, Cheryl agrees to sell Loss Co to Anna who sees the acquisition as an opportunity to expand her business. Anna acquires Loss Co through Profit Co so Loss Co becomes a wholly owned subsidiary of Profit Co.

After the acquisition, Profit Co transfers its entire business down to Loss Co and the companies switch names. From that time, the company formerly known as Loss Co operates a single business consisting of two restaurants that now trade under the Profit Co name.

As a consequence of its acquisition of Profit Co's business, Loss Co's turnover increases by 200% and Loss Co has net income for assessment purposes. The acquisition does not, however, result in any efficiency gains for the newly merged business. Nor were there any compelling commercial reasons to transfer Profit Co's business to Loss Co.

Application of s GB 3BAB

Tax loss components are carried forward under s IB 3(2)

Profit Co's acquisition of Loss Co results in a breach of continuity under subpart IA. Despite this, Loss Co is entitled to carry its loss balance forward if there has not been a major change in the nature of its business activities or, if there has, it is a permitted major change under s IB 3(5).

The transfer of Profit Co's business assets to Loss Co does not result in any change to Loss Co's business processes or the type of products it sells. However, there has been a change in the assets that Loss Co uses to derive its income. Loss Co has acquired Profit Co's restaurant business and trades under a new name and has obtained new customers. Loss Co also employs more staff. These changes result in increased sales. Loss Co's 200% increase in turnover shows that these changes are substantial and suggest a major change has occurred in the nature of Loss Co's business activities. However, the change is caused by an increase in the scale of Loss Co's business. This means the change qualifies as a permitted major change under s IB 3(5)(c). Consequently, Loss Co is entitled to carry its loss balance forward under s IB 3(2).

Arrangement exists between persons A and B

The agreements under which Profit Co acquires Loss Co and transfers its business to Loss Co together constitute an arrangement.

Persons A and B are associated persons when they enter into the arrangement

Profit Co and Loss Co are associated persons because Anna owns all of the voting interests in both companies.[40]

Arrangement's effect is that a company derives an amount of income that, but for the arrangement, a person other than the company would have, would in all likelihood have, or might be expected to have derived

Under the arrangement, Loss Co acquires Profit Co's business. This has the effect of Loss Co deriving the income from that business. If Profit Co's business had not been transferred to Loss Co, it is likely Profit Co would have derived the income.

Arrangement has a purpose of tax avoidance

Identify and understand the arrangement

The arrangement has a commercial purpose of business expansion.

The relevant tax effects are as follows:

- Loss Co is prohibited from making its loss balance available to Profit Co as the 66% commonality requirement in s IC 5 is not met.
- Loss Co derives additional assessable income as a result of Profit Co transferring its business assets to Loss Co.
- Loss Co offsets its net income against its carried forward loss balance.

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

Parliament's purposes for the commonality rules are to prevent loss trading and to achieve this by requiring that the owners of a profit company who receive the benefit of another company's loss are, at least to the extent of 66%, the same people who suffered the economic burden of the loss.

Understand the commercial and economic reality of the arrangement as a whole

When Anna acquired Loss Co she had a commercial purpose of expanding her business into a new geographical area. The arrangement achieved this purpose.

However, the manner in which the arrangement was carried out was commercially unusual. While the commercial purpose was to expand Anna's existing business, under the arrangement Profit Co transferred its business down to Loss Co and thereafter Loss Co adopted Profit Co's name and carried the combined business on.

The structuring of the arrangement in this way is at variance with usual commercial practice. Unless there are compelling commercial reasons, valuable assets are usually

transferred out of a troubled company in order to ring-fence them from operational risk. In the current instance, a valuable business was transferred into Loss Co, a troubled company at risk of future legal disputes. Further, the merging of the two businesses did not achieve any efficiency gains and there were no compelling commercial reasons to transfer Profit Co's business to Loss Co. These circumstances are indicative of artificiality and contrivance in the arrangement.

Consider whether the arrangement makes use of or circumvents the specific provisions in a manner consistent with Parliament's purpose

Loss Co is prohibited from sharing its loss with Profit Co because Loss Co and Profit Co do not meet the requirements of the ownership commonality rules.

Under the arrangement, Profit Co's business is transferred to Loss Co. This results in Loss Co's loss being available for offset against the income generated by the transferred business assets. This is the same tax result that would arise when a loss company shares its loss with a profit company under the grouping rules. In effect, Profit Co received the benefit of Loss Co's loss but did not to any extent suffer the burden of that loss when it was incurred.

While the transfer of the assets achieved Anna's purpose of expanding her business into a new geographical area, that purpose does not explain the way in which the arrangement was structured. The structuring of the arrangement was at variance with usual commercial practice, so is indicative of artificiality and contrivance.

It follows that the arrangement avoids the application of the commonality rules in a manner that is inconsistent with Parliament's purpose for those rules.

Decide whether there is a tax avoidance purpose

The arrangement has a tax avoidance purpose because it avoids the application of the ownership commonality rules in a manner that is outside Parliament's contemplation for those rules.

Determine whether the tax avoidance purpose is the arrangement's sole or main purpose

While the arrangement had a non-tax purpose of expanding Anna's business into a new location, this does not explain the specific way the arrangement was structured. The structuring of the arrangement was artificial, which indicates that tax avoidance was the arrangement's main purpose.

[40] Under the look through rule in s YC 4, Anna is treated as owning all the voting interests in Loss Co and Profit Co is treated as not owning those interests.

Reconstruction

As s GB 3BAC applies, the income from the transferred business assets is treated as schedular income of Loss Co. This means Loss Co must calculate a separate income tax liability for the income. In calculating the liability, Loss Co deducts allowable deductions from the income generated by the transferred business. As the income is schedular income, Loss Co is prohibited from offsetting its loss against any positive balance remaining after the deductions. Consequently, Loss Co must pay tax on the balance.

Analysis | Tātari – s GB 3BA

114. Section GB 3BA provides as follows:

GB 3BA Arrangements for carrying forward loss balances: companies' business activities

When this section applies

(1) This section applies when—

(a) a share in a company (the **loss company**) or another company has been subject to an arrangement, including an arrangement—

(i) directly or indirectly altering rights attached to the shares:

(ii) to change the nature of business activities carried on by the loss company; and

(b) the arrangement is entered into within the 2 years immediately preceding a breach of the requirements for continuity of ownership of section IA 5 (Restrictions on companies' loss balances carried forward: continuity of ownership) that, if they had been met, would have enabled a tax loss component of the loss company to be carried forward to a tax year in a loss balance; and

(c) the arrangement allows the loss company to meet the requirements of section IB 3(2) (When tax loss components of companies carried forward despite ownership continuity breach) for the carrying forward of the tax loss component to the tax year; and

(d) a purpose of the arrangement is to defeat the intent and application of section IB 3.

Company treated as not meeting requirements

(2) The loss company is treated as not meeting the requirements of section IB 3(2) in relation to the tax loss component.

115. In summary, s GB 3BA is intended to prevent pre-emptive changes to business activities that enable a loss company to satisfy the business continuity rule where it otherwise would not. Section GB 3BA has the following requirements:

- A share in a company known as the "loss company" or a share in another company is subject to an arrangement.
- The arrangement is entered into within the 2 years immediately preceding a breach of the continuity of ownership requirements in s IA 5.
- The arrangement allows the loss company to meet the requirements of s IB 3(2).
- A purpose of the arrangement is to defeat the intent and application of s IB 3.

116. If the above requirements are present, the loss company is treated as not meeting the requirements of s IB 3(2) in relation to the tax loss component.

117. Each of the requirements that must be present for s GB 3BA to apply are discussed next.

Shares are subject to an arrangement

118. The first requirement of s GB 3BA(1) is that a share in a company known as the "loss company" or a share in another company is subject to an "arrangement". The meaning of the term "arrangement" is discussed at [33] to [44] above.

119. A share will be subject to an arrangement if the share is the subject matter of the arrangement, meaning that the agreement, contract, plan or understanding concerns the share or the rights attached to the share.

120. Section GB 3BA(1)(a) includes "an arrangement directly or indirectly altering rights attached to the shares" and an arrangement "to change the nature of business activities carried on by the loss company" as types of arrangement that may be caught by the provision. However, as this definition is non-exhaustive, other types of arrangements concerning shares may also be subject to the section.

Time of commencement of the arrangement

121. As set out at [29] above, a company may only carry a tax loss component forward if it meets the 49% continuity of voting interest threshold in s IA 5 during an applicable continuity period. Section GB 3BA(1)(b) requires that an arrangement must have been entered into within the 2 years immediately preceding a breach of this requirement and that the loss company would have been entitled to carry a tax loss component forward if that requirement had been met.

Arrangement allows a loss company to meet the requirements of section IB 3(2)

122. A company that does not maintain the continuity of ownership required by s IA 5 will, despite this, be entitled to carry a tax loss component forward if it meets the requirements of the business continuity rule in s IB 3(2). Therefore, s GB 3BA(1)(c) requires that the arrangement must allow (that is, permit or enable) the loss company to meet the requirements of s IB 3(2). The business continuity rule is discussed at [30] above.

A purpose of the arrangement is to defeat the intent and application of s IB 3

Purpose does not have to be the main purpose

123. Section GB 3BA(1)(d) requires that an arrangement has a purpose of defeating the intent and application of s IB 3. The section does not require that the purpose to defeat the intent and application of s IB 3 is a dominant or main purpose, so any such purpose will suffice. However, a purpose of the arrangement must be to defeat the intent and application of s IB 3.

124. As set out at [58] above, the courts have held that when applying s BG 1 the "purpose or effect" of an arrangement is determined objectively and the motives or intentions of the parties are not relevant. While the relevant cases relate to the general anti-avoidance provisions, the Commissioner considers that the same principles apply to s GB 3BA. This means that if the effect of an arrangement, determined objectively, is to defeat the intent and application of s IB 3, that will be the purpose of the arrangement.

Defeat the intent and application

125. The courts considered the meaning of provisions with similar wording to s GB 3BA(1)(d) in *Auckland Harbour Board v CIR*, *Ch'elle Properties (NZ) Ltd v CIR* (HC), *Ch'elle Properties (NZ) Ltd v CIR* (CA) and *Glenharrow*.[41]

126. *Auckland Harbour Board* concerned the application of s 64J(1) of the Income Tax Act 1976 (now s GB 21). Section 64J(1) gave the Commissioner the power to adjust the consideration on the issue or transfer of a financial arrangement if he was of the opinion the parties to the transaction were dealing with each other in a manner that

[41] *Auckland Harbour Board v CIR* (2001) 20 NZTC 17,008 (PC); *Ch'elle Properties (NZ) Ltd v CIR* (2004) 21 NZTC 18,618 (HC), *Ch'elle Properties (NZ) Ltd v CIR* (2007) 23 NZTC 21,442 (CA) and *Glenharrow Holdings Ltd v CIR* [2008] 2 NZLR 359 (SC).

had the effect of defeating the intent and application of various provisions in the financial arrangement rules.

127. In *Auckland Harbour Board*, Lord Hoffmann made the following comments in relation to s 64J(1) of the Income Tax Act 1976:

> [11] … The section appears to their Lordships to contemplate that the circumstances which justify its application will be specific to a particular transaction, arising out of the relationship between the parties and other relevant circumstances. In this respect it is similar to other anti-avoidance provisions such as s 99. Their Lordships do not of course suggest that the two sections necessarily cover the same ground, but what they have in common is that they are **generally speaking aimed at transactions which in commercial terms fall within the charge to tax but have been, intentionally or otherwise, structured in such a way that on a purely juristic analysis they do not**. This is what is meant by defeating the intention and application of the statute. [Emphasis added]

128. In summary, Lord Hoffmann considered s 64J(1) of the Income Tax Act 1976 to be in the nature of an anti-avoidance provision, which applied where a transaction fell within the charge to tax in commercial terms but had been structured in such a way that on a purely juristic analysis it did not.

129. *Ch'elle* (HC and CA) was concerned with s 76 of the Goods and Services Tax Act 1985 (GST Act) as it applied before 10 October 2000. Section 76 provided that where the Commissioner was satisfied an arrangement had been entered into to defeat the intent and application of the GST Act or any of its provisions, the Commissioner was required to treat the arrangement as void and adjust the tax payable by any registered person affected by the arrangement.

130. In *Ch'elle* (HC), Rodney Hansen J made the following comments in relation to s 76 of the GST Act at [39]:

> Section 76 calls for a more broadly based enquiry than is required to establish technical compliance. It is whether the arrangement has been entered into "to defeat the intent and application of the Act". I agree with Ms Ellis that this goes beyond the technical legality of the constituent parts of the arrangement. It requires the arrangement to be assessed by reference to the principles which underly the Act.

131. In *Ch'elle* (CA), Robertson J upheld the High Court's judgment and confirmed at [31] that "[i]n order to assess whether s 76 [of the GST Act] is triggered it is necessary to assess the scheme and purpose of the GST Act". He also stated:

> [29] … As with all general anti-avoidance provisions, its purpose is to strike down arrangements that frustrate the taxing regime, despite the arrangement's technical compliance with substantive taxing provisions.

132. *Glenharrow* also concerned s 76 of the GST Act as it applied before 10 October 2000. In the Supreme Court decision, Blanchard J stated:

> **The operation of s 76**
>
> …
>
> [34] In order for the Commissioner to be able to invoke s 76 he must be satisfied that the arrangement which he wishes to treat as void has been "entered into between persons to defeat the intent and application" of the GST Act or of any provision of the Act. Consistent with the approach to interpretation of General Anti-Avoidance Rules (GAARs) in the income tax context, and as foreshadowed in the preceding paragraph, **this determination requires an assessment that goes beyond the technical legality of the constituent parts of the arrangement**. The onus is on the taxpayer to show that the Commissioner could not properly have been satisfied in terms of the section.
>
> …
>
> **The intent and application of the Act**
>
> [40] The application to an arrangement of tax legislation such as s 76 of the GST Act is concerned with the "aim or end in view" of the arrangement. It is to be objectively assessed. And the assessment **will principally be a matter of inference from the arrangement and its effect**. The purpose of an arrangement will be deduced from the arrangement itself and its effect. **The intention of the Act will be defeated if an arrangement has been structured to enable the avoidance of output tax, or the obtaining of an input deduction in circumstances where that consequence is outside the purpose and contemplation of the relevant statutory provisions**. Lord Hoffmann in *C of IR v Auckland Harbour Board* (2001) 20 NZTC 17,008 (PC) commented that, generally speaking, GAARs were:
>
> > "aimed at transactions which in commercial terms fall within the charge to tax but have been, intentionally or otherwise, structured in such a way that on a purely juristic analysis they do not. This is what is meant by defeating the intention and application of the statute. An arrangement of this kind is not in accordance with the overall purpose of the Act because it produces a 'tax advantage' not within the contemplation of the statute." [Emphasis added]

133. Having regard to principles identified in *Auckland Harbour Board*, *Ch'elle* and *Glenharrow*, the Commissioner considers the test as to whether an arrangement "defeats the intent and application" of a particular provision is in effect the same test as the Parliamentary contemplation test under the general anti-avoidance provision (s BG 1). Both tests are aimed at transactions and arrangements that in juristic or legal terms (that is, in legal substance) satisfy the requirements of the particular provision but, when viewed in terms of their commercial and economic reality, make use of (or circumvent) the provision in a manner that is inconsistent with the purpose of that provision.

134. This means that when applying ss GB 3BA it is necessary to consider:

- the purpose of s IB 3; and
- whether the facts of the arrangement have the consequence (effect) that the arrangement's purpose is inconsistent with the purpose of s IB 3.

135. As discussed at [30]–[31], s IB 3 allows a loss company that has breached continuity of ownership to carry its loss balance forward if there has not been a major change in the nature of the business activities the company carries on during an applicable business continuity period (other than a permitted major change). The requirement for business continuity shows that Parliament's specific purpose for s IB 3 is to allow a company to carry a loss balance forward despite a continuity of ownership breach if the business the company carried on before the breach is the same business the company carries on after the breach, subject to any variations that are allowed under s IB 3.

136. Therefore, the intent and application of s IB 3 will be defeated by an arrangement that allows a company to carry a loss balance forward after a breach of continuity of ownership if the arrangement, when viewed in terms of its commercial and economic reality, involves the company carrying on a business after the breach that is not the same business it carried on before the breach after allowing for any permitted changes.

Reconstruction

137. If a share in a loss company is subject to an arrangement in respect of which s GB 3BA applies, s GB 3BA(2) provides that the loss company is treated as not meeting the requirements of s IB 3(2) in relation to the tax loss component the arrangement allowed the company to carry forward.

138. The following example illustrates the concepts discussed above.

Example | Tauira 8 – Arrangement involving pre-emptive change to business activities

Facts

Amy owns Loss Co, a company through which she carried on a property development business. The business was not a success and Amy ceased the business leaving Loss Co with no assets and a loss balance of $250,000 at the start of the 2023 tax year.

Jenny recently started a business as a sole trader leasing office equipment. She has entered into a small number of leases, but intends to significantly grow the business.

On 1 May 2022, Amy and Jenny agree Amy will sell her shares in Loss Co to Jenny for $25,000 and that before the sale Loss Co will acquire the equipment leases Jenny has entered into. They also agree that Jenny will manage the leases pending the share

sale. The transfer of the leases is duly completed and 1 month later, on 1 June 2022, the share sale settles. From that time, Jenny carries her leasing business on through Loss Co.

Share in a loss company is subject to an arrangement, including an arrangement to change the nature of the business activities carried on

The shares in Loss Co are subject to an arrangement because they are the subject matter of the share sale agreement between Amy and Jenny. Further, as the arrangement involves both an agreement for the sale of shares and the transfer of Jenny's leases to Loss Co, it is both an agreement to alter rights attached to shares and an arrangement to alter a loss company's business activities.

Arrangement is entered into within 2 years preceding a breach of continuity of ownership under s IA 5 that, if met, would have enabled a tax loss component to be carried forward

Under the share sale, all of Amy's voting interests in Loss Co were transferred to Jenny. Therefore, the share sale resulted in a breach of the requirement in s IA 5 that there is a group of persons whose minimum voting interests in Loss Co add up to 49% during an applicable continuity period. The breach occurred when the share sale settled on 1 June 2022 and the arrangement was entered into on 1 May 2022. Therefore, the arrangement was entered into within the 2-year period that immediately precedes the continuity breach.

Arrangement allows the loss company to carry a loss forward under s IB 3(2)

Despite the continuity breach, Loss Co is broadly entitled to carry its loss forward under s IB 3(2) if, during the business continuity period that applies to Loss Co, there has not been a major change in the nature of its business activities (other than a permitted major change), and none of the prohibitions in s IB 3(3) apply.

For Loss Co, the business continuity period starts immediately before the continuity of ownership breach on 1 June 2022. At that time, Loss Co had obtained a sufficient number of leases from Jenny to meet the threshold for carrying on a leasing business. As the nature of that business has not changed s IB 3(2) is satisfied. Further, the cessation rule in s IB 3(3)(a) does not apply as the acquisition of the leases revived Loss Co's business activities. Therefore, the arrangement allowed Loss Co to carry its loss forward under s IB 3(2).

Purpose of the arrangement is to defeat the intent and application of s IB 3

Under the arrangement, Jenny paid $25,000 for the shares in Loss Co. The sale of the shares was not commercial as Loss Co had no value for Jenny aside from the potential future tax savings represented by Loss Co's carried forward loss balance.

The arrangement also involved Loss Co acquiring Jenny's leases. This appears commercially unnecessary as it was not directed at attaining any identifiable commercial purpose. Amy, the owner of Loss Co, did not acquire the leases with a purpose of carrying on a leasing business and making a profit from it, and she did not obtain an economic interest in the leasing operation as under the arrangement it was agreed that Loss Co's shares would be transferred to Jenny.

This shows that in commercial and economic reality the leasing business continued to be Jenny's and not Loss Co's. Further, the lack of any commercial rationale for the share sale and the lease transfers shows the arrangement was contrived for the purpose of making Loss Co's loss balance available for offset against the income from Jenny's business. In short, the arrangement was a loss trading transaction.

In conclusion, these circumstances show the arrangement is inconsistent with Parliament's purpose for s IB 3 because Parliament:

- intends that a loss will be carried forward under s IB 3 only if the business a loss company carries on before a breach of continuity is in commercial and economic reality the same as the business it carries on after the breach; and
- does not intend that a loss will be carried forward under s IB 3 as part of a loss trading transaction.

Reconstruction

As s GB 3BA(1)(a)–(d) apply, s GB 3BA(2) treats Loss Co as not meeting the requirements of s IB 3(2) in relation to the tax loss components the arrangement allowed Loss Co to carry forward. Consequently, Loss Co is prohibited from carrying forward its $250,000 loss balance to the 2023 year.

Additionally, the Commissioner may seek to apply ss BG 1 and GA 1 to prevent any income derived by Loss Co from the leases during May 2022 from being offset against the loss balance on a part-year basis.

Relationship with s BG 1

139. In *Penny v CIR* the Supreme Court said that, unless a specific anti-avoidance rule is plainly intended to cover the field in relation to the use of particular provisions or plainly excludes the use of s BG 1 in a certain situation, the Commissioner may rely on s BG 1 to counter a tax avoidance arrangement.[42]

140. The Commissioner considers that there is no clear indication Parliament intended to exclude s BG 1 from applying to the types of arrangements or the types of tax avoidance ss GB 3BA, GB 3BAB and GB 3BAC are intended to cover. There is no targeted anti-avoidance provision in the Act that explicitly excludes s BG 1 and there is no extrinsic material that indicates Parliament had this intention when enacting ss GB 3BA, GB 3BAB and GB 3BAC.

141. Consequently, the Commissioner considers that s BG 1 may equally apply to an arrangement that is the same, similar or close to an arrangement covered by ss GB 3BA, GB 3BAB or s GB 3BAC. Further, the Commissioner considers that s BG 1 may apply to arrangements that avoid tax in a way that is different from the way tax is avoided under arrangements caught by those provisions.

142. Examples of the type of arrangement s BG 1 could potentially apply to include cost-shifting or income injection arrangements that circumvent the specific non-tax avoidance requirements set out in the anti-avoidance rules. For instance, the requirement in ss GB 3BAB and s GB 3BAC that an arrangement must be between persons who are associated with each other at the time the arrangement is entered into.

[42] *Penny v CIR* [2011] NZSC 95, [2012] 1 NZLR 433 (SC) at [48].

Appendix – Legislation | Āpititanga – Whakature

GB 3BA Arrangements for carrying forward loss balances: companies' business activities

When this section applies

(1) This section applies when—

(a) a share in a company (the **loss company**) or another company has been subject to an arrangement, including an arrangement—

(i) directly or indirectly altering rights attached to the shares:

(ii) to change the nature of business activities carried on by the loss company; and

(b) the arrangement is entered into within the 2 years immediately preceding a breach of the requirements for continuity of ownership of section IA 5 (Restrictions on companies' loss balances carried forward: continuity of ownership) that, if they had been met, would have enabled a tax loss component of the loss company to be carried forward to a tax year in a loss balance; and

(c) the arrangement allows the loss company to meet the requirements of section IB 3(2) (When tax loss components of companies carried forward despite ownership continuity breach) for the carrying forward of the tax loss component to the tax year; and

(d) a purpose of the arrangement is to defeat the intent and application of section IB 3.

Company treated as not meeting requirements

(2) The loss company is treated as not meeting the requirements of section IB 3(2) in relation to the tax loss component.

GB 3BAB Arrangements to inject income into companies carrying forward loss balances

When this section applies

(1) This section applies when—

(a) a person (**person A**) enters into an arrangement with another person (**person B**); and

(b) person A and person B are associated persons at the time they enter into the arrangement; and

(c) an effect of the arrangement is that a company derives an amount of assessable income for an income year that, but for the arrangement, a person other than the company—

(i) would have derived; or

(ii) would in all likelihood have derived; or

(iii) might be expected to have derived; and

(d) tax loss components of the company are carried forward under section IB 3(2) (When tax loss components of companies carried forward despite ownership continuity breach) to the tax year corresponding to the income year; and

(e) the arrangement has tax avoidance as its sole or main purpose.

Treatment of injected income

(2) The amount is schedular income of the company for the tax year corresponding to the income year.

GB 3BAC Arrangements to shift expenditure from companies carrying forward loss balances

When this section applies

(1) This section applies when—

(a) tax loss components of a company are carried forward under section IB 3(2) (When tax loss components of companies carried forward despite ownership continuity breach) to a tax year; and

(b) a person (**person A**) enters into an arrangement with another person (**person B**); and

(c) person A and person B are associated persons at the time they enter into the arrangement; and

(d) an effect of the arrangement is that, in the absence of this section, a person other than the company is allowed a deduction for an amount of expenditure or loss the person incurs that, but for the arrangement, the company—

(i) would have incurred in the income year corresponding to the tax year; or

(ii) would in all likelihood have incurred in the income year corresponding to the tax year; or

(iii) might be expected to have incurred in the income year corresponding to the tax year; and

(e) the arrangement has tax avoidance as its sole or main purpose.

Treatment of company

(2) The company is treated as having incurred the amount of expenditure or loss—

(a) in the course of carrying on a business for the purpose of deriving assessable income; and

(b) in the income year corresponding to the tax year.

Treatment of other person

(3) The person referred to in subsection (1)(d) that is not the company is treated as not having incurred the amount of expenditure or loss.

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About this document | Mō tēnei tuhinga

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