SHORTFALL PENALTY FOR TAKING AN ABUSIVE TAX POSITION

1. SUMMARY

1.1 All legislative references in this statement are to the Tax Administration Act 1994 unless otherwise stated.

1.2 This statement provides an interpretative explanation of the shortfall penalty imposed by the Commissioner under section 141D of the Act on taxpayers who take an abusive tax position. Where a taxpayer takes an abusive tax position, the result may be that too little tax is paid or payable, as tax liabilities are reduced, removed, deferred or postponed, or tax benefits claimed.

1.3 The abusive tax position penalty is 100% of the tax shortfall. "Abusive tax position" is defined in section 141D. For the penalty to apply, the taxpayer must have taken an unacceptable tax position, and either:

- under section 141D(7)(b)(i), have entered into an arrangement, where the dominant purpose of the arrangement is of avoiding tax, whether directly or indirectly, or
- under section 141D(7)(b)(ii), where there is no arrangement, or no arrangement of the type outlined in section 141D(7)(b)(i), have taken the taxpayer's tax position with a dominant purpose of avoiding tax, whether directly or indirectly.

2. BACKGROUND

2.1 Following a review of the compliance and penalties legislation, the Tax Administration Amendment Act (No 2) 1996 introduced new rules. The purpose of the new rules, as set out in section 139, is to encourage voluntary compliance and to impose consistent and impartial penalties which reflect the seriousness of the breach of tax obligations.

2.2 The penalties rules have again been reviewed and a discussion document *Taxpayer Compliance, Standards and Penalties: a review* was released in August 2001. To date, some amendments have been made as a result of this review. Those amendments include – reductions in the rate of some shortfall penalties on the basis of the taxpayer's previous behaviour (section 141FB), and the amendment to the shortfall penalty imposed under section 141B – to one which applies when a taxpayer takes an unacceptable tax position. Further amendments were made in the Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003. The amendments that have already been passed have prompted the withdrawal of various shortfall penalty standard practice statements about tax positions taken on or after 1 April 2003.

2.3 This Interpretation Statement provides an explanation of some interpretative aspects of one of the shortfall penalties – the shortfall penalty for taking an abusive tax position covered by section 141D. The statement applies, except

as otherwise specified, to tax positions taken on or after 1 April 2003 (although all associated references to the Income Tax Act are to the provisions of the 2004 Act for ease of reference). The now withdrawn *Standard Practice Statement* INV-215 *Shortfall penalties – abusive tax position* (published in *Tax Information Bulletin*, Vol 10, No 3, March 1998) applies to tax positions taken before 1 April 2003.

3. LEGISLATION

3.1 A shortfall penalty for taking an abusive tax position is imposed under section 141D:

> **141D** Abusive tax position
>
> (1) The purpose of this section is to penalise those taxpayers who, having taken an unacceptable tax position, have entered into or acted in respect of arrangements or interpreted or applied tax laws with a dominant purpose of taking, or of supporting the taking of, tax positions that reduce or remove tax liabilities or give tax benefits.
>
> (2) A taxpayer is liable to pay a shortfall penalty if the taxpayer takes an abusive tax position (referred to as an "abusive tax position").
>
> (3) The penalty payable for taking an abusive tax position is 100% of the resulting tax shortfall.
>
> (3B) The penalty payable for taking an abusive tax position is reduced to 20% of the resulting tax shortfall if—
>
> (a) The taxpayer is a party to an arrangement to which section 141EB applies and becomes liable to a shortfall penalty for an abusive tax position as a result of that arrangement, irrespective of whether a promoter penalty has been imposed in respect of the arrangement; and
>
> (b) The sum of the tax shortfall from the arrangement for the taxpayer and the tax shortfalls from the arrangement for persons with whom the taxpayer is associated under section OD 7 of the Income Tax Act 1994 is less than $50,000; and
>
> (c) The taxpayer has independent advice stating that the taxpayer's tax position is not an abusive tax position.
>
> (4) This section applies to a taxpayer if the taxpayer has taken an unacceptable tax position and the tax shortfall from the tax position is more than $20,000.
>
> (5) Section 141B(6) applies for determining the time when a taxpayer takes an abusive tax position.
>
> (6) A taxpayer's tax position may be an abusive tax position if the tax position is an incorrect tax position under, or as a result of, either or both of—
>
> (a) A general tax law; or
>
> (b) A specific or general anti-avoidance tax law.
>
> (7) For the purposes of this Part and section 177C, an "abusive tax position" means a tax position that,—

(a) Is an unacceptable tax position at the time at which the tax position is taken; and

(b) Viewed objectively, the taxpayer takes—

(i) In respect, or as a consequence, of an arrangement that is entered into with a dominant purpose of avoiding tax, whether directly or indirectly; or

(ii) Where the tax position does not relate to an arrangement described in subparagraph (i), with a dominant purpose of avoiding tax, whether directly or indirectly.

3.2 The following terms are defined in section 3(1):

In this Act, unless the context otherwise requires,—

…

"Arrangement" –

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

…

"Correct tax position" means the correct tax position established under one or more tax laws:

…

"Shortfall penalty" means a penalty imposed under any of sections 141A to 141K for taking an incorrect tax position or for doing or failing to do anything specified or described in those sections:

…

"Tax law" means—

(a) A provision of the Inland Revenue Acts or an Act that an Inland Revenue Act replaces:
(b) An Order in Council or a regulation made under another tax law:
(c) A non-disputable decision:
(d) In relation to an obligation to provide a tax return or a tax form, also includes a provision of the Accident Rehabilitation and Compensation Insurance Act 1992 or a regulation made under that Act or the Accident Insurance Act 1998 or a regulation made under that Act.

…

"Tax position" means a position or approach with regard to tax, under one or more tax laws, including without limitation a position or approach with regard to–
(a) A liability for an amount of tax, or the payment of an amount of tax:
(b) An obligation to deduct or withhold an amount of tax, or the deduction or withholding of an amount of tax:
(c) A right to a tax refund, or to claim or not to claim a tax refund:
(d) A right to a credit of tax, or to claim or not to claim a credit of tax:

(e) The provision of a tax return, or the non-provision of a tax return:
(f) The derivation of an amount of gross income or exempt income or a capital gain, or the inclusion or non-inclusion of an amount in gross income:
(g) The incurring of an amount of expenditure or loss, or the allowing or disallowing as a deduction of an amount of expenditure or loss:
(h) The availability of net losses, or the offsetting or use of net losses:
(i) The attaching of a credit of tax, or the receipt of or lack of entitlement to receive a credit of tax:
(j) The balance of a tax account of any type or description, or a debit or credit to such a tax account:
(k) The estimation of the provisional tax payable:
(l) Whether the taxpayer must request an income statement or respond to an income statement issued by the Commissioner:
(m) The application of section 33A(1):
(n) A right to a rebate:

…

"Tax shortfall", for a return period, means the difference between the tax effect of –

(a) A taxpayer's tax position for the return period; and

(b) The correct tax position for that period, –

when the taxpayer's tax position results in too little tax paid or payable by the taxpayer or another person or overstates a tax benefit, credit, or advantage of any type or description whatever by or benefiting (as the case may be) the taxpayer or another person.

…

"Taxpayer's tax position" means—

(a) A tax position taken by a taxpayer in or in respect of–
  (i) A tax return; or
  (ii) An income statement; or
  (iii) A due date:

4. SHORTFALL PENALTY FOR TAKING AN ABUSIVE TAX POSITION

INTRODUCTION

4.1 Section 141D imposes a shortfall penalty on a taxpayer for taking an "abusive tax position" in the taking of a taxpayer's tax position, with application to tax obligations for periods commencing on or after 1 April 1997.

4.2 The shortfall penalty for an abusive tax position is 100% of the resulting tax shortfall (section 141D(3)).

4.3 An "abusive tax position" is defined in section 141D(7) as follows:

> (7) For the purposes of this Part and section 177C, an "abusive tax position" means a tax position that,—

(a) Is an unacceptable tax position at the time at which the tax position is taken; and

(b) Viewed objectively, the taxpayer takes—

(i) In respect, or as a consequence, of an arrangement that is entered into with a dominant purpose of avoiding tax, whether directly or indirectly; or

(ii) Where the tax position does not relate to an arrangement described in subparagraph (i), with a dominant purpose of avoiding tax, whether directly or indirectly.

4.4 Under section 141D(7), an "abusive tax position" means a tax position that is an unacceptable tax position which the taxpayer takes, either:

- in respect or as a consequence of an arrangement that is entered into with a dominant purpose of avoiding tax (in situations involving an arrangement), or
- with a dominant purpose of avoiding tax (in situations not involving an arrangement).

4.5 Before answering the question of whether there is an abusive tax position, in terms of section 141D(7), it should be noted that there are some preliminary requirements that must also be satisfied before the penalty can potentially apply:

(1) the taxpayer must have taken a tax position

(2) the tax position must be an incorrect tax position under or as a result of a general tax law or a specific or general anti-avoidance tax law

(3) the time at which a taxpayer's tax position has been taken has been determined in accordance with section 141B(6)

(4) the taxpayer's tax position leads to a tax shortfall, and the tax shortfall exceeds $20,000

(5) the taxpayer has taken an unacceptable tax position.

4.6 "Unacceptable tax position" is a separate shortfall penalty and is defined in section 141B(1). A separate Interpretation Statement for the unacceptable tax position shortfall penalty has been published in *Tax Information Bulletin* Vol 17, No 9, November 2005. For tax positions taken before 1 April 2003, the requirement was for an "unacceptable interpretation", which was defined under the previous version of section 141B(1). For ease of reference, the remainder of this Interpretation Statement will only refer to an "unacceptable tax position".

4.7 It should also be noted that the penalty for an abusive tax position under section 141D has had minor amendments (with effect from 1 April 2003,

except for the introduction of section 141D(3B) which applies with effect from 26 March 2003). The changes to the abusive tax position penalty are:

- the link with the section 141B requirement for an "unacceptable tax position" (which was previously an "unacceptable interpretation" in both sections)
- an increase in the previous threshold of $10,000 to the current threshold of $20,000, and
- the introduction of the section 141D(3B) reduction provision.

4.8 The penalty for taking an abusive tax position is 100% of the resulting tax shortfall (section 141D(3)). This is subject to various reductions potentially available under sections 141FB (previous behaviour), 141G (voluntary disclosure), 141H (reduction for disclosure of unacceptable tax position), 141I (temporary shortfall) and 141J (limitation of reduction). The penalty is also subject to a 25% increase under section 141K if the taxpayer obstructs the Commissioner in determining the correct tax position. The following related standard practice statements may assist in the interpretation and application of these adjustment provisions:

- INV-231 *Temporary shortfall - permanent reversal* (published in *Tax Information Bulletin* Vol 11, No 8, September 1999)
- INV-251 *Voluntary disclosures* (published in *Tax Information Bulletin* Vol 14, No 4, April 2002)
- INV-260 *Notification of a pending audit or investigation* (published in *Tax Information Bulletin* Vol 12, No 2, February 2000)
- INV-295 *Reduction of shortfall penalties for previous behaviour* (published in *Tax Information Bulletin* Vol 16, No 3, April 2004)
- INV-490 *GST returns – correcting minor errors* (published in *Tax Information Bulletin* Vol 10, No 6, June 1998)
- INV-570 *Shortfall penalties – application where returns are amended before due date* (published in *Tax Information Bulletin* Vol 11, No 2, February 1999).

4.9 Section 141D(3B) also allows for a reduction of the abusive tax position shortfall penalty to 20% of the resulting tax shortfall if:

(a) The taxpayer is a party to an arrangement to which section 141EB applies and becomes liable to a shortfall penalty for an abusive tax position as a result of that arrangement, irrespective of whether a promoter penalty has been imposed in respect of the arrangement; and

(b) The sum of the tax shortfall from the arrangement for the taxpayer and the tax shortfalls from the arrangement for persons with whom the taxpayer is associated under section OD 7 of the Income Tax Act 1994 is less than $50,000; and

(c) The taxpayer has independent advice stating that the taxpayer's tax position is not an abusive tax position.

4.10 *Standard Practice Statement* INV-290 (published in *Tax Information Bulletin* Vol 16, No 2, March 2004) describes how the Commissioner will apply the section 141EB Promoter Penalties provision. In discussing the various requirements of section 141EB, the SPS also comments on what the Commissioner considers to be "independent advice" at paragraphs 42 to 45 of that statement. Those comments are also considered relevant as guidance in the application of section 141D(3B)(c).

4.11 Section 94A states that the Commissioner may make or amend an assessment of a civil penalty (which includes the section 141D shortfall penalty in question) in the same way as the Commissioner may make or amend an assessment of the substantive tax. In challenging the imposition of the penalty, the onus of proof rests with the taxpayer to show that they did not take an abusive tax position (section 149A(2)(b)). The standard of proof is the balance of probabilities (section 149A(1)).

4.12 The remainder of this Interpretation Statement will focus on the interpretation and application of the abusive tax position shortfall penalty under section 141D.

ABUSIVE TAX POSITION

Section 141D(7)

4.13 If all the other requirements for section 141D are satisfied, it is then necessary to determine whether section 141D(7) applies. Section 141D(7) defines an "abusive tax position", which will apply either under section 141D(7)(b)(i) in situations involving an arrangement, or under section 141D(7)(b)(ii) in situations not involving an arrangement of the type in section 141D(7)(b)(i). Section 141D(7)(b)(i) and section 141D(7)(b)(ii) will be dealt with separately.

Dominant purpose of avoiding tax

4.14 It is noted that for the section 141D abusive tax position penalty to apply, either the arrangement or the taxpayer (depending on whether section 141D(7)(b)(i) or section 141D(7)(b)(ii) is applied) must have a dominant purpose of avoiding tax.

4.15 The term "dominant purpose" is not defined in the TAA. The Concise Oxford Dictionary (10th ed, Oxford University Press) defines "dominant" as follows:

> **1** most important, powerful, or influential.

4.16 The same dictionary defines "purpose" as follows:

> **1** the reason for which something is done or for which something exists.

4.17 The Court of Appeal case *CIR v National Distributors Ltd* [1989] 3 NZLR 661, while only needing to interpret the word "purpose" in terms of the

legislation at issue, noted that where there is more than one purpose present, taxability turns on what was the dominant purpose. In terms of the "dominant purpose", Richardson J (as he then was) stated the following at page 666 of that decision:

> Adoption of a dominant purpose test in relation to the particular property purchased allows a sensible **focus** as a practical matter **on what was truly important to the taxpayer at the time of acquisition.**
>
> [Emphasis added]

4.18 At page 667, His Honour also stated the following:

> In *Hunter* at p 125 Turner J observed that the motive which inspired the transactions was no doubt that they provided an advantageous method of remitting funds from England to New Zealand, but that in acquiring the stock the taxpayer had done so for the purpose of selling it again. And McCarthy J noted a p 127 that **purpose must, naturally, be distinguished from motive or expectations**…
>
> [Emphasis added]

4.19 Therefore, according to the dictionary meaning of the words, and Richardson J's judgment in *National Distributors*, it is considered that the "dominant purpose" is the most important or influential reason to the taxpayer at the relevant time.

4.20 This is consistent with how the term was considered by the Full High Court of Australia in *FCT v Spotless Services Limited & Anor* 96 ATC 5,201 (in the context of the Australian general anti-avoidance provision which focuses on the dominant purpose of the arrangement). The following was stated at page 5,206:

> Much turns upon the identification, among various purposes, of that which is "dominant". **In its ordinary meaning, dominant indicates that purpose which was the ruling, prevailing, or most influential purpose.** In the present case, if the taxpayers took steps which maximised their after-tax return and they did so in a manner indicating the presence of the "dominant purpose" to obtain a "tax benefit", then the criteria which were to be met before the Commissioner might make determinations under s 177F were satisfied.
>
> [Emphasis added]

The meaning of "avoiding tax"

4.21 The term "avoiding tax" is not defined in the TAA. However, the term "tax avoidance" is defined in section OB 1 of the ITA as follows:

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

(c) directly or indirectly avoiding, postponing, or reducing any liability to income tax or any potential or prospective liability to future income tax

4.22 The term "tax avoidance" is also defined in the GST Act, for the purposes of the GST Act, as follows:

> **76(8)** For the purpose of this section—
>
> …
>
> **"Tax avoidance"**
>
> includes—
>
> (a) A reduction in the liability of a registered person to pay tax:
>
> (b) A postponement in the liability of a registered person to pay tax:
>
> (c) An increase in the entitlement of a registered person to a refund of tax:
>
> (d) An earlier entitlement of a registered person to a refund of tax:
>
> (e) A reduction in the total consideration payable by a person for a supply of goods and services.

4.23 As noted in the Commentary on the Bill and section 141D(6)(a), the term "avoiding tax" is not limited to the concept of "tax avoidance". It is considered that section 141D(6) and the Commentary on the Bill show that the term "avoiding tax" should be interpreted widely. Section 141D(6) states:

> **141D(6)** A taxpayer's tax position may be an abusive tax position if the tax position is an incorrect tax position under, or as a result of, either or both of—
>
> (a) A general tax law; or
>
> (b) A specific or general anti-avoidance tax law.

4.24 At pages 15 and 16 of the Commentary on the Bill the wide interpretation of the term "avoiding tax" is again stated:

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

4.25 The abusive tax position penalty can apply in situations where there has been "tax avoidance" (and therefore section BG 1 of the ITA or section 76 of the GST Act are invoked) or where neither of these provisions apply, but there is nevertheless evidence of a dominant purpose of avoiding tax. In practice, in situations where section BG 1 of the ITA or section 76 of the GST Act is successfully invoked, determining whether the requirement of "avoiding tax"

is satisfied for the abusive tax position shortfall penalty will usually be resolved by the "tax avoidance" inquiry for the anti-avoidance provisions.

4.26 However, the abusive tax position shortfall penalty is also chargeable in situations where the anti-avoidance provisions do not apply, but the conduct nevertheless shows a dominant purpose of avoiding tax (section 141D(6)(a)). Thus, the term "avoiding tax" is a wider concept than "tax avoidance", to ensure the penalty applies whether or not the anti-avoidance provisions have been invoked.

4.27 In summary, the term "avoiding tax" includes the concept of "tax avoidance" under the general or specific anti-avoidance provisions, and those situations where tax is avoided or is attempted to be avoided, but the general or specific anti-avoidance provisions are not invoked. The term "dominant purpose of avoiding tax" means that the arrangement's (section 141D(7)(b)(i)) or the taxpayer's (section 141D(7)(b)(ii)) most influential and prevailing or ruling purpose is to avoid tax.

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

4.28 The Commentary on the Bill discussed indicators that may suggest a dominant purpose of avoiding tax at page 15 as follows:

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

4.29 The indicators referred to in the Commentary on the Bill can be of assistance in determining whether an arrangement or a taxpayer has a dominant purpose of avoiding tax. The following are some of the factors that may be taken into account when considering whether there is a dominant purpose of avoiding tax.

Artificiality and contrivance

4.30 Have the transactions been designed to appear to comply with the legislation? The legal form may not reflect the substance (even though the legal form is effective).

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

4.32 The importance of the commercial purpose of the transaction as compared to the tax benefit that the relevant taxpayer obtained must be examined.

Circularity of funding

4.33 Funding going around in a circle, usually through a tax haven, resulting in income being tax exempt and the related expenditure tax deductible may be considered as an indicator of a tax avoiding arrangement.

Concealment of information and non-availability of evidence

4.34 Concealment of information may occur through the use of a tax haven. By going through a tax haven, disclosure protection may result due to the particular tax haven's secrecy laws. These laws usually do not allow information to be released to tax authorities, thereby providing an obstacle to the gathering of information to establish whether the transaction or arrangement is artificial or contrived.

Spurious interpretations

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

"Directly" or "indirectly"

4.36 Sections 141D(7)(b)(i) and (ii) refer to a tax position taken with a dominant purpose of avoiding tax "whether directly or indirectly". It is considered that in some situations the avoiding of tax may be direct and in other situations it may be indirect.

4.37 There is no discussion about the inclusion of the words "directly or indirectly" in the discussion documents relating to the abusive tax position penalty or in the Commentary on the Bill. It appears that the use of the words "directly or indirectly" in limbs (i) and (ii) was to ensure that the abusive tax position penalty applies as widely as possible and maintain consistency with the definition of "tax avoidance" in section OB 1 of the Income Tax Act.

Section 141D(7)(b)(i) – the first limb

4.38 Section 141D(7)(b)(i) applies in situations where there is an arrangement with a dominant purpose of avoiding tax:

> (7) For the purposes of this Part and section 177C, **an "abusive tax position" means a tax position that**,—
>
> (a) **Is an unacceptable tax position** at the time at which the tax position is taken; **and**
>
> (b) Viewed objectively**, the taxpayer takes**—
>
> (i) **In respect, or as a consequence, of an arrangement** that is entered into with a dominant purpose of avoiding tax, whether directly or indirectly; or
>
> ...
>
> [Emphasis added]

4.39 For section 141D(7)(b)(i) to apply, the taxpayer must have taken a tax position that is an unacceptable tax position, and taken it "in respect, or as a consequence, of an arrangement that is entered into with a dominant purpose of avoiding tax…"

Whose purpose is to be tested?

4.40 Section 141D(7)(b)(i) does not indicate who or what the "dominant purpose" is to be tested in respect of, and could arguably be about either the dominant purpose of the taxpayer or the dominant purpose of the arrangement. While it could be argued that the test of the "dominant purpose" in section 141D(7)(b)(i) should be as to the dominant purpose of the taxpayer (particularly given the use of the words "entered into"), it is considered that the better view is that the dominant purpose of the *arrangement* is tested.

Grammatical connection

4.41 Section 141D(7)(b)(i) provides for a taxpayer's tax position, viewed objectively, having been taken "in respect, or as a consequence, of an arrangement that is entered into with a dominant purpose of avoiding tax, whether directly or indirectly". Therefore, the grammatical connection of the "dominant purpose" in section 141D(7)(b)(i) is not clearly to the arrangement or the taxpayer. The provision merely suggests that the taxpayer's tax position would need to flow from (in respect of, or as a consequence of) an arrangement which is entered into with a dominant purpose of tax avoidance. However, it is considered that the wording of the provision does not require the taxpayer to have a dominant purpose of tax avoidance for it to apply.

4.42 In support of the proposition that the arrangement's "dominant purpose" is to be tested in section 141D(7)(b)(i), it is noted that the provision is split into two limbs. The first limb applies in situations involving an arrangement, and the second limb applies in situations <u>not</u> involving an arrangement (or not involving an arrangement of the type in the first limb). Reading the provision in such a way as to link the dominant purpose in the first limb to the taxpayer would make the splitting of the section into two limbs entirely unnecessary. The same result could have been reached by providing in one provision or limb that in all situations it is the dominant purpose of the taxpayer that is to be tested.

Case law

4.43 That it is the purpose of the arrangement that is to be tested was also stated by Ronald Young J, in *Erris Promotions and others v CIR* (2003) 21 NZTC 18,330 at paragraph 374:

> The second part of the definition requires an abusive tax position to be taken. As has been said, this requires, in addition to an unacceptable interpretation, that at the same time, viewed objectively, the position of the taxpayer must be as a consequence of **an arrangement** that is entered into **which has as its dominant purpose tax avoidance.** And so I must consider if the dominant purpose of the joint venture, viewed objectively, was tax avoidance. **Here s141D(7)(b)(i) is concerned not with the taxpayers intent or knowledge but with whether their claim for depreciation losses arose as a consequence from a scheme which had as its dominant purpose tax avoidance.**
>
> [Emphasis added]

4.44 Such an interpretation is also consistent with the operation of the Income Tax Act 2004 ("the ITA") general anti-avoidance provision. Section BG 1 of the ITA refers to a "tax avoidance arrangement" being void. The definition of "tax avoidance arrangement" in section OB 1 of the ITA refers to the *purpose or effect* of the *arrangement* being tax avoidance.

4.45 In *Accent Management Ltd v CIR* (2005) 22 NZTC 19,027, Venning J discussed the abusive tax position shortfall penalty. At paragraph 327, His Honour stated that the plaintiffs challenged the Commissioner's imposition of 100% abusive tax position penalty for the 1998 income year on two principal grounds. The first ground was that the penalties were not validly imposed; and the second that, in the circumstances, the penalties were not appropriate, or if they were appropriate, the penalties ought not to have been imposed at 100% on the basis of an abusive tax position. After concluding that the penalty was validly imposed, Venning J concluded that the plaintiffs had taken an abusive tax position. He referred to the decision of Ronald Young J in *Erris Promotions* and stated at paragraphs 367 to 370:

> [367] Mr Stewart [counsel for the plaintiffs] emphasised the need for the Court to make a finding of dominant purpose. He submitted that Ronald Young J was incorrect in *Erris Promotions* to suggest the dominant purpose relates to the arrangement itself. He submitted that the better view was it is the purpose of the taxpayer to which the section is directed.
>
> [368] In *Erris Promotions v CIR* (2003) 21 NZTC 18,330 Ronald Young J said at para 374:
>
> > The second part of the definition requires an abusive tax position to be taken. As has been said, this requires, in addition to an unacceptable interpretation, that at the same time, viewed objectively, the position of the taxpayer must be as a consequence of an arrangement that is entered into which has as its dominant purpose tax avoidance. And so I must consider if the dominant purpose of the joint venture, viewed objectively, was tax avoidance. Here s 141D(7)(b)(i) is concerned not with the taxpayers intent or knowledge but with whether their claim for depreciation losses arose as a consequence from a scheme which had as its dominant purpose tax avoidance.
>
> [369] I agree with Ronald Young J's approach. The only matter that can be viewed objectively, as the subsection is drawn, is whether the arrangement was entered [into] with a dominant purpose of avoiding tax. The purpose of the section "to penalise those taxpayers who … have entered into … arrangements … with a dominant purpose of taking … tax positions that reduce or remove tax liabilities or give tax benefits" as set out in subsection 141D(1) is not met if the objective test is to be applied only to whether the taxpayer took a tax position in respect or as a consequence of an arrangement. The objective test applies to the assessment of dominant purpose.
>
> [370] In the present case the plaintiffs may well have had a general interest in investing long-term in a douglas fir forest. But for the reasons set out earlier, viewed objectively the dominant purpose of the arrangement entered in this case was undoubtedly to achieve the taxation benefits of the arrangement, at least for the first years before any corrective legislation was passed. The evidence satisfies me that were it not for those tax benefits the plaintiffs would not have entered into the investment in the Trinity Scheme. The plaintiffs became part of the Trinity Scheme with the dominant purpose of achieving those tax benefits.

4.46 Thus, the High Court has considered the dominant purpose in section 141D(7)(b)(i) on two occasions. Ronald Young J in *Erris Promotions* stated that section 141D(7)(b)(i) is concerned with the arrangement's dominant purpose and is not concerned with the taxpayer's purpose. Venning J in *Accent Management* considered a submission from counsel for the plaintiff that Ronald Young J in *Erris Promotions* was incorrect to suggest the dominant purpose relates to the arrangement itself, with counsel arguing that it was the purpose of the taxpayer that was relevant. After quoting the paragraph from *Erris Promotions* in which Ronald Young J stated that section 141D(7)(b)(i) concerns the dominant purpose of the arrangement rather than the taxpayer, Venning J commented that he agreed with Ronald Young J's approach. Thus, the High Court has confirmed on two occasions that section 141D(7)(b)(i) tests the dominant purpose of the arrangement.

Pre-legislative materials

4.47 That it is the purpose of the arrangement that is to be tested (rather than the purpose of the particular taxpayer) in section 141D(7)(b)(i) is further confirmed in the pre-legislative materials that led to the enactment of the provision. In the second discussion document, *Taxpayer compliance, standards and penalties 2: detailed proposals and draft legislation* (April 1995) (the "second discussion document"), draft legislation of what became section 141D was published. In the draft legislation, the words chosen more clearly indicated that it was the arrangement's dominant purpose that was to be tested. The following is the draft legislation and commentary for what is now section 141D, as it appeared in the second discussion document:

> **Draft Legislation**
>
> (5) In this section –
>
> (a) "Abusive tax position" means a tax position which –
>
> (i) At the time the taxpayer takes the taxpayer's tax position is not a reasonably arguable position; and
>
> (ii) Is taken in respect of, or as a consequence of entering into, an abusive arrangement;
>
> (b) "Abusive arrangement" means **an arrangement that**, viewed objectively, **has a dominant purpose of avoiding tax**, whether directly or indirectly;
>
> …
>
> **Commentary**
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> …
>
> ***Subsection (5)(b)***
>
> An abusive arrangement means **an arrangement which**, viewed objectively, **has a dominant purpose of avoiding tax**. …
>
> [Emphasis added]

4.48 As is apparent from the wording, the section as it was published as draft legislation, could *only* apply in situations in which there was an arrangement.

4.49 However, it was always intended that the penalty could potentially be applicable even where general or specific anti-avoidance provisions were not invoked in respect of the substantive tax issue. The intention that the section was to apply to a wide range of situations, including situations that did not involve an arrangement, is evidenced by a comment at paragraph 7.12 of the second discussion document:

> It is intended that the penalty for abusive arrangements apply not only in situations where a general or specific anti-avoidance provision is invoked, but also where other provisions have been applied. This recognises that the need to rely on an anti-avoidance provision does not necessarily indicate that the arrangement or tax position in question is inherently more deserving of a high penalty than are abusive interpretations of other provisions of the Acts.

4.50 However, before the legislation was enacted, it was realised that this original intention was at risk, and that (on the wording of the draft legislation) the penalty was potentially applicable only when there was an arrangement. By splitting the provision into two limbs, the scope of the provision was widened and therefore all potential "abusive tax positions" were able to be covered by the section.

4.51 In the Commentary on the Bill that enacted the provision, *Taxpayer Compliance, Penalties, and Disputes Resolution Bill: Commentary on the Bill* (September 1995), it was stated in the introductory section of the Commentary on the Bill that any significant policy changes (from the draft legislation to the sections as published in the Bill) would be commented on, in the commentary for each section. There was no statement in the commentary that the policy intention behind the abusive tax position provision had changed.

4.52 Therefore, while there were in fact changes made to the provision, which resulted in somewhat ambiguous wording, the original intention of the drafters in relation to an arrangement's purpose in certain situations did not change.

Conclusion on the first limb

4.53 Accordingly, it is considered that the better view is that the dominant purpose of tax avoidance in section 141D(7)(b)(i) relates to the arrangement rather than the purpose of the taxpayer that is taking the tax position in question. Section 141D(7)(b)(i) will be satisfied where a taxpayer has taken their tax position directly or indirectly in respect of or as a consequence of an arrangement that they have personally entered into, and the dominant purpose of the arrangement is tax avoidance.

Section 141D(7)(b)(ii) – the second limb

4.54 Section 141D(7)(b)(ii) applies where the taxpayer has a dominant purpose of avoiding tax, either in situations where there is no arrangement, or in situations where it is not shown that the arrangement has a dominant purpose of avoiding tax:

(7) For the purposes of this Part and section 177C, **an "abusive tax position" means a tax position that**,—

(a) **Is an unacceptable tax position** at the time at which the tax position is taken; **and**

(b) Viewed objectively, **the taxpayer takes**—

…

(ii) Where the tax position does not relate to an arrangement described in subparagraph (i), **with a dominant purpose of avoiding tax**, whether directly or indirectly.

[Emphasis added]

What is the scope of the second limb?

4.55 Section 141D(7)(b)(ii) applies where the tax position in question does not relate to an arrangement described in subparagraph (i). In such cases, the subparagraph will apply where there is an unacceptable tax position, and the taxpayer takes the tax position with a dominant purpose of avoiding tax. The "dominant purpose" of avoiding tax under section 141D(7)(d)(ii) is clearly a test of the taxpayer's purpose, and will be tested at the time at which the taxpayer's tax position is taken.

4.56 Section 141D(7)(b)(ii) is potentially applicable when there is no arrangement, or where there is an arrangement, but it cannot be shown that the arrangement itself has a dominant purpose of avoiding tax. In such situations, the provision will apply where the taxpayer has a dominant purpose of avoiding tax.

Campbell Investments decision

4.57 The decision in *CIR v Campbell Investments & Anor* (2004) 21 NZTC 18,559 provides an example of the application of the abusive tax position shortfall penalty to a particular set of facts. In *Campbell Investments* the taxpayer was a syndicate with a taxable activity of leasing commercial properties. The syndicate members were Mr Montgomery, Mrs Montgomery and a family trust (the trustees of which also included Mr and Mrs Montgomery). The syndicate claimed that it transferred its 2 commercial properties to the syndicate members on 5 October 1997 for consideration of 1 peppercorn. On 22 May 1998 Mr and Mrs Montgomery executed an agreement for sale and purchase between themselves and the trustees of the family trust purporting to sell their interests in the properties, with settlement occurring on the earlier date of 30 January 1998. Payment was effected by way of a mortgage executed in favour of the trustees of the family trust on 30 July 1998.

4.58 The syndicate returned GST on the rentals for the properties for the 2 month period ended 31 January 1998. On 19 August 1998 the syndicate filed an amended return requesting a refund of the GST on the rentals that it claimed it had wrongly returned, as it claimed that the properties had been transferred to the syndicate members on 5 October 1997. The syndicate argued that it was no longer required to return GST on the rentals (and the syndicate members

were not GST registered, so also were not required to return GST on the rentals).

4.59 The Commissioner assessed the syndicate for GST output tax for the GST period ending 31 January 1998 on the transfer of the properties that was purported to have occurred on 30 January 1998. The Commissioner also sought to impose a shortfall penalty on the syndicate for taking an abusive tax position.

4.60 In the High Court decision, Wild J held that the 5 October 1997 transaction was not a supply of the property from the syndicate to the syndicate members. His Honour stated that all that occurred on 5 October 1997 was a transfer of legal title in the properties to the beneficial owners for a peppercorn, which was irrelevant to the syndicate's continuing taxable activity. Further, Wild J held that the agreement for sale and purchase of the properties dated 22 May 1998 was not effective to create a supply of the properties on 30 January 1998. He held that the syndicate supplied the properties to the family trust on 30 July 1998 – the time when payment was made through the execution of the mortgages.

4.61 As a result, Wild J concluded that the syndicate was liable for output tax on the supply of the properties to the trust in the GST period ending 31 July 1998 – not in the period ending 31 January 1998 as assessed. This meant that no tax shortfall from the supply of the properties arose in the January 1998 GST period. However, Wild J held that the amended return for the period ending 31 January 1998 excluding the rentals received by the syndicate did give rise to a tax shortfall.

4.62 While not discussing the application of the abusive tax position penalty in significant detail, Wild J considered that the various steps taken by the parties were an arrangement that had a dominant purpose of avoiding tax. His Honour concluded that the syndicate was liable to account for GST on the rents received as indicated by the original return filed and the continued payment of the rents into the syndicate's bank account. Wild J stated at paragraph 51 as follows:

> I regard the Syndicate's tax position as abusive because it attempted (retrospectively) to give the 5 October 1997 transaction a GST significance it was not intended to have at the time it was entered into and did not have. That is established by the continued payment of rents from the properties into the Syndicate's bank account…

4.63 Accordingly, Wild J upheld the imposition of the abusive tax position shortfall penalty in relation to the rents. While Wild J did not work through and comment on each of the statutory requirements as set out in this Interpretation Statement, he appears to have been influenced by the arrangement being "artificial and contrived" and involving "spurious interpretations".

4.64 Wild J further stated (*obiter*) that the syndicate should have accounted for GST on the supply of the properties to the family trust on 30 July 1998. He noted that this gave rise to a tax shortfall, and in his view, the syndicate took an abusive tax position by not accounting for the supply in its GST return for the

period ending 31 July 1998. The position was abusive as the syndicate had attempted to backdate the sale and purchase agreement on 22 May 1998, and had attempted to give the 5 October 1997 transaction GST significance (as a supply of the properties for a peppercorn) when it was not a supply of the properties at all.

RELATIONSHIP WITH OTHER SHORTFALL PENALTIES

4.65 Determining which of the shortfall penalties applies to a tax shortfall will always depend upon the facts of any given situation. Each of the shortfall penalties is charged as a percentage of the tax shortfall, depending on the seriousness of the breach.

4.66 The not taking reasonable care and unacceptable tax position shortfall penalties are the lowest of the penalties in terms of culpability and are charged at a rate of 20% of the tax shortfall.

4.67 The gross carelessness shortfall penalty is chargeable where a taxpayer is grossly careless in taking their tax position. This will usually be where, objectively, the taxpayer has acted recklessly in taking their tax position and the circumstances suggest a complete or high level of disregard for the consequences of their actions. The penalty for gross carelessness is chargeable at 40% of the tax shortfall. This is higher than the not taking reasonable care and unacceptable tax position shortfall penalties, but less than the penalty for taking an abusive tax position, reflecting the relative levels of culpability.

4.68 The abusive tax position shortfall penalty requires a higher level of culpability. As shown above, the penalty requires the dominant purpose of either the taxpayer or the arrangement to be to avoid tax, which is a higher level of culpability than the recklessness required for the gross carelessness penalty. For a taxpayer charged with the gross carelessness shortfall penalty the circumstances will suggest the taxpayer had a complete or high level of disregard for the consequences, rather than a dominant purpose, or even any purpose, of avoiding tax. The percentage of the tax shortfall chargeable for the abusive tax position penalty reflects the relative seriousness of the breach, at 100% of the tax shortfall.

4.69 The onus of proof for the abusive tax position, gross carelessness, unacceptable tax position, and not taking reasonable care penalties rests with the taxpayer.

4.70 The highest shortfall penalty in terms of culpability and the percentage of the tax shortfall chargeable is the evasion shortfall penalty. An example of a situation where the evasion shortfall penalty would apply is where the taxpayer knows that an obligation to pay tax exists, but evades the assessment of tax by simply not paying that which is known to be owing (section 141E(1)(a)). The penalty will also apply, for example, if the taxpayer knowingly does not make a deduction which is required to be made by a tax law (section 141E(1)(c)). The level of the penalty, at 150% of the resulting tax shortfall, reflects the seriousness of the breach.

4.71 For the evasion shortfall penalty the onus of proof rests with the Commissioner.

4.72 The distinction between the dominant purpose of avoiding tax required for the abusive tax position penalty to apply, and knowingly evading tax for the evasion shortfall penalty to apply, goes beyond the difference in the onus of proof. In situations where (for example) the actions of a taxpayer or an arrangement show that the taxpayer's affairs are structured to *reduce or defer a potential or prospective liability* to tax and this is done with a dominant purpose to avoid tax, the abusive tax position penalty will apply. In contrast, for the evasion penalty to apply (for example) the taxpayer knows that a liability to tax exists, but knowingly *ignores that liability* and completely fails to pay the amount of tax the taxpayer knows it is required to pay.

CONCLUSION

4.73 The section 141D abusive tax position shortfall penalty can apply whether or not there is an arrangement. For section 141D(7)(b)(i) to apply, there must be an arrangement, and the dominant purpose of that arrangement must be tax avoidance. Section 141D(7)(b)(ii) applies where there is no arrangement, or there is no arrangement of the kind described in section 141D(7)(b)(i) and the dominant purpose of the taxpayer in taking their tax position is tax avoidance. The phrase "dominant purpose of avoiding tax" means that the most influential and prevailing purpose of the arrangement, or the taxpayer (depending on whether section 141D(7)(b)(i) or section 141D(7)(b)(ii) is applied) is to avoid tax.

5. EXAMPLES

EXAMPLE 1

The taxpayers are a clothing manufacturing company and the four individuals who are shareholders in that company. Two of those individuals are executive directors and full-time employees of the company and the other two shareholders are the respective wives of those executives.

The shares in the company are sold by the individuals to C, a company controlled by W, through a tax loss group of companies also controlled by W. Declarations of trust are completed so that the four shareholders hold the shares on trust for C. The share purchase is funded by a loan from the vendor shareholders to C. The net profit of the taxpayer company is paid as an administration charge to C at six-monthly intervals. Approximately 77.5% of that administration charge is paid to the taxpayers in reduction of the loan secured by the mortgage of shares.

The shareholders also operate the company business under a management contract and receive income for doing that. An important part of the deal is that the individual taxpayers have a buy-back option over the taxpayer company's business. The deal is subsequently extended for a further three

years by surrendering the buy-back option for $4.5 million. The business is then reacquired by the taxpayers several years later.

Is the abusive tax position shortfall penalty chargeable on these facts, under either of section 141D(7)(b)(i) or (ii)?

The transactions involved amount to an arrangement. The activities of the taxpayers and the arrangement entered into by the taxpayers are primarily designed to relieve the taxpayer company and the individual taxpayers from liability to pay income tax or, at least, to reduce or postpone any such liability. The arrangement is a tax avoidance arrangement which is void under section BG 1 of the ITA. In fact, the High Court in *Miller and Ors v Commissioner of Inland Revenue*; *McDougall and Anor v Commissioner of Inland Revenue*; *Managed Fashions Ltd and Ors v CIR* (1997) 18 NZTC 13,219 described a situation such as this as being as "blatant an example of tax avoidance as can be imagined."

The tax positions taken by the taxpayers in entering into the arrangement are not about as likely as not to be correct. The individual taxpayers retained the benefit of all significant elements of their original ownership and management of the company in addition to allowing them the benefit of receiving tax-free revenue less the administration and consulting fees. By filing their individual tax returns each taxpayer has taken an incorrect tax position. Therefore, the taxpayers have each taken an unacceptable tax position, and assuming the $20,000 threshold is met, would satisfy section 141D(4).

The next requirement is that either the arrangement or the individual taxpayers have a dominant purpose of avoiding tax. The arrangement entered into by the taxpayers was convoluted and unnecessarily complex. The transactions in the arrangement show that the arrangement had a dominant purpose of avoiding tax. As stated by Baragwanath J in the High Court decision in *Miller* at page 13,235:

> Whether the transactions are examined minutely according to their black letter or more broadly in context I am unable to escape the conclusion that they constitute a device the dominant purpose and effect of which is tax avoidance. In my view they clearly infringe s 99 both literally and according to the "propriety test" that I have employed.

Therefore, on these facts, the abusive tax position penalty would be chargeable under section 141D(7)(b)(i), as the dominant purpose of the arrangement entered into by the taxpayers was avoiding tax. If the arrangement did not have a dominant purpose of avoiding tax, the abusive tax position shortfall penalty would instead be chargeable under section 141D(7)(b)(ii), as the dominant purpose of the taxpayers in taking their tax positions was avoiding tax.

[This example is based on the facts and decision in *Case R25* (1994) 16 NZTC 6,120 and the appeal decision, *Miller and Ors v Commissioner of Inland Revenue*; *McDougall and Anor v Commissioner of Inland Revenue*; *Managed Fashions Ltd and Ors v CIR* (1997) 18 NZTC 13,219.]

EXAMPLE 2

The taxpayer is a shareholder in a loss attributing qualifying company (LAQC). The LAQC is an investor in a mass marketed investment scheme. The investment is made by way of acquiring an interest in a joint venture.

The taxpayer, who is on the top marginal tax rate, is interested in the losses the investment scheme would generate and which could be off-set against his other income. The taxpayer is aware that his/her return from the investment would arise from the tax savings the scheme generated, rather than the ultimate profitability of the scheme.

The joint venture claims deductions resulting in losses allocated to the investors. For investors on the top marginal tax rate the tax benefits of the losses over the first 3 years exceeds the amount of the original investment made by the taxpayer. The ultimate profitability of the joint venture is highly uncertain.

Is the abusive tax position shortfall penalty chargeable on these facts, under either of section 141D(7)(b)(i) or (ii)?

The mass marketed investment scheme is a tax avoidance arrangement which is void for tax purposes under section BG 1 of the Income Tax Act. Even if no sales of the joint venture's product take place, every investor will still obtain a substantial return on their investment due to the tax benefits from the deductions claimed. There is little or no commercial aspect to the scheme that can be substantiated.

The dominant purpose of the joint venture arrangement is the avoidance of tax. The taxpayer, in entering into the scheme also has a dominant purpose of avoiding tax. In these circumstances the tax position taken in claiming the deductions is incorrect because of the application of section BG 1. It is not about as likely as not to be correct. Therefore, assuming the tax shortfall exceeds $20,000, both the LAQC and the taxpayer have taken unacceptable tax positions and section 141D(4) will be satisfied. Further, both the LAQC and the taxpayer have taken tax positions as a consequence of the joint venture arrangement that has a dominant purpose of avoiding tax. However, pursuant to section 141FD of the TAA (or section 141FC for tax positions taken between 1 April 1998 and 1 April 2005), the abusive tax position shortfall penalty can only be applied to either the LAQC or the taxpayer.

Therefore, on these facts, the abusive tax position shortfall penalty would be chargeable under section 141D(7)(b)(i), as claiming the deductions involved taking a tax position in respect or as a consequence of an arrangement which had a dominant purpose of avoiding tax. If the arrangement did not have a dominant purpose of avoiding tax (yet was still void under section BG 1), the abusive tax position shortfall penalty would instead be chargeable under section 141D(7)(b)(ii). The taxpayer, in claiming the deductions, has taken a tax position with the dominant purpose of avoiding tax.

[The facts in this example are similar to the facts in *Accent Management Ltd v CIR* (2005) 22 NZTC 19,027 and *Erris Promotions and others v CIR* (2003) 21 NZTC 18,330 where the High Court held in each case that the arrangement had a dominant purpose of avoiding tax, and therefore section 141D applied.]