QUESTION WE'VE BEEN ASKED QB 12/12

Abusive tax position penalty and the anti-avoidance provision

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

This Question We've Been Asked is about s 141D: abusive tax position. The item answers a question raised about Interpretation Statement IS0061: Shortfall penalty for taking an abusive tax position (*Tax Information Bulletin* Vol 18, No 1 (February 2006): 24).

Question

1. Does the abusive tax position penalty under s 141D apply automatically where there is a "tax avoidance arrangement" under s BG 1 of the Income Tax Act 2007 (s BG 1)? If not, what differentiates a case where s BG 1 applies but the penalty does not?

Answer

2. The abusive tax position penalty under s 141D does not apply automatically where there is a "tax avoidance arrangement". This is because:

    - Section BG 1 requires the tax avoidance purpose or effect of the arrangement to be more than merely incidental. Section 141D requires the dominant purpose to be avoiding tax. Therefore, the tests in the two provisions are fundamentally different.

    - The intention expressed in the pre-legislative material was that the abusive tax position penalty would only apply to "abusive avoidance".

    - The courts have identified that there is a different test under s 141D than under s BG 1.

3. To determine whether the abusive tax position penalty applies it is necessary to decide whether the dominant purpose of the arrangement is avoiding tax. In order to determine that, the tax purposes must be weighed against any other purposes of the arrangement (such as commercial or family purposes) with reference to the specific structure of the arrangement. The presence or absence of certain factors may be relevant in weighing the different purposes. The factors may include artificiality, contrivance, circularity of funding, concealment of information and non-availability of evidence, and spurious interpretations of tax laws.

Explanation

4. Penalties can be imposed on taxpayers who take incorrect tax positions that result in tax shortfalls. The level of the penalty is intended to reflect the seriousness of the breach. Section 141D applies a 100% penalty where a taxpayer has taken an abusive tax position.

Does the abusive tax position penalty apply automatically where there is a "tax avoidance arrangement"?

5. The abusive tax position penalty under s 141D does not apply automatically where there is a "tax avoidance arrangement" under s BG 1 of the ITA 2007 because:
   - there are different tests in the different provisions,
   - the legislative intent was that the penalty would only apply to abusive tax avoidance, and
   - the courts have recognised the need for a dominant purpose of avoiding tax for an abusive tax position penalty to apply.

There are different tests in the different provisions

Section 141D

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

> (7) For the purposes of this Part and section 177C, an **abusive tax position** means a tax position that,—
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> (a) Is an unacceptable tax position at the time at which the tax position is taken; and
>
> (b) Viewed objectively, the taxpayer takes—
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> (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.

7. As a result, there are two key requirements for s 141D to apply. Firstly, under s 141D(7)(a) the tax position must be an "unacceptable tax position". A tax position is an unacceptable tax position if, viewed objectively, the tax position fails to meet the standard of being about as likely as not to be correct: s 141B(1). The unacceptable tax position requirement is discussed in more detail in IS0055: Shortfall penalty – unacceptable interpretation and unacceptable tax position (*Tax Information Bulletin* Vol 17, No 9 (November 2005): 26).

8. Secondly, under s 141D(7)(b) there must be a dominant purpose of avoiding tax. Section 141D(7)(b) provides that an abusive tax position will occur in two situations. The first situation is where the taxpayer takes the tax position in respect of an arrangement with a dominant purpose of avoiding tax: s 141D(7)(b)(i). The second situation is where there is no such arrangement, and the taxpayer has taken the tax position with a dominant purpose of avoiding tax: s 141D(7)(b)(ii). Both of the situations require a "dominant purpose of avoiding tax".

9. This item only discusses the issue of whether the penalty applies where there is a tax avoidance arrangement. This item, therefore, is limited to situations where there is an arrangement under s 141D(7)(b)(i) (and does not discuss s 141D(7)(b)(ii)). The courts have held that it is the purpose of the arrangement that is relevant under s 141D(7)(b)(i): *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115, (2009) 24 NZTC 23,188 at [207]. Under s 141D(7)(b)(i)

"purpose" does not involve any focus on the motives or intentions of the taxpayer.

10. The term "dominant purpose" is not defined in the TAA 1994. The *Oxford English Dictionary* (online ed updated March 2012, 2nd edition, Oxford University Press, 1989, accessed 28 August 2012) defines "dominant" as follows:

> **1.** governing, commanding; most influential

11. The same dictionary defines "purpose" as follows:

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

12. There are aspects of the ordinary meaning of "purpose" that imply an element of motive or intention. However, the courts have held that the "purpose or effect" of an arrangement in the tax avoidance context is determined objectively: *Newton v FC of T* [1958] AC 450 (PC), *Ashton & Anor v CIR* (1975) 2 NZTC 61,030 (PC) and *Glenharrow Holdings Ltd v CIR* [2008] NZSC 116, (2009) 24 NZTC 23,236 at [38]. "Purpose", in the context of tax avoidance, means the intended effect the arrangement seeks to achieve and not the motive of the parties, and "effect" means the end accomplished or achieved by the arrangement.

13. The Court of Appeal discussed the meaning of "dominant purpose" in *CIR v National Distributors Ltd* (1989) 11 NZTC 6,346. Richardson J stated at 6,350:

> 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]

14. While the case discusses "dominant purpose" in the context of a provision that refers to the subjective purpose of a taxpayer, the reference to what is "truly important" is considered to be relevant in the current context.

15. Judge Barber commented on the dominant purpose requirement in s 141D in *Case Z1* (2009) 24 NZTC 14,001 as follows at [119]:

> I also find that the disputant entered into the arrangement with the dominant purpose of avoiding tax - refer s.141D(7). The arrangement could not be properly explained by any charitable purpose. The prime objective purpose was to avoid tax (and tax was avoided).

16. Judge Barber, therefore, referred to the dominant purpose as the "prime objective purpose".

17. In *Case Y18* (2008) 23 NZTC 13,180, Judge Barber also discussed "dominant purpose" in s 141D. Judge Barber described "dominant purpose" as an objective test, but arguably relied on subjective factors in applying the test to the facts at issue. As a result, the application of the test to the facts is arguably inconsistent with *Ben Nevis*. However, the discussion of "dominant purpose" is consistent with the other cases. Judge Barber stated at [73]:

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

> "In its ordinary meaning, dominant indicates that purpose which was the ruling, prevailing, or most influential purpose."

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

19. It is considered, therefore, that the purpose is the result or effect intended or sought. The "dominant purpose" is the ruling, prevailing, governing, commanding or most influential or important purpose. The listed terms are synonyms.

Section BG

20. In contrast, the general anti-avoidance provision applies if the tax avoidance purpose or effect of an arrangement is not merely incidental: s YA 1 "tax avoidance arrangement" of the Income Tax Act 2007. The definition of "tax avoidance arrangement" states that there can be one or more purposes or effects of the arrangement. The tax avoidance purpose or effect does not need to be the only or dominant purpose or effect. Instead, the tax avoidance purpose or effect needs to be only more than merely incidental. A merely incidental tax avoidance purpose or effect is something which "naturally attaches or is subordinate or subsidiary to a concurrent legitimate purpose or effect, whether of a commercial or family nature": *Westpac Banking Corporation v CIR* (2009) 24 NZTC 23,834 (HC) at [206]. For a tax avoidance purpose to be merely incidental, it must be necessarily linked, without contrivance, to a non-tax purpose or effect. In that circumstance, the tax avoidance purpose or effect would be regarded objectively as a natural concomitant to the non-tax purpose or effect: *CIR v Challenge Corporation Ltd* (1986) 8 NZTC 5,001 (CA) at 5,005.

Difference between the two tests

21. The "more than merely incidental purpose" requirement for s BG 1, therefore, is fundamentally different from the "dominant purpose" requirement in s 141D. The "dominant purpose" test determines which is the most important or influential purpose. The "merely incidental" test determines whether the relevant purpose naturally attaches to some other purpose or effect.

Legislative intent was that penalty would only apply to abusive avoidance

22. Section 141D must be interpreted consistently with its immediate and general context: *Commerce Commission v Fonterra Co-Operative Group Ltd* [2007] NZSC 36 (SC). Relevantly, there is a graduated scale of penalties that apply to taxpayers who take tax positions that result in tax shortfalls. The shortfall penalties apply to tax positions that relate to tax avoidance arrangements and tax positions that breach other provisions. The range of possible penalties for tax avoidance arrangements is consistent with s 141D not applying automatically. In other words, another penalty (or no penalty) might apply to a tax position in respect of a tax avoidance arrangement.

23. The intention expressed in the pre-legislative material was that the abusive tax position penalty would only apply to "abusive avoidance". The penalty was not intended to apply to all tax avoidance arrangements. The abusive tax position penalty was introduced as part of the penalties regime in the Tax Administration Amendment Act (No 2) 1996. This amending Act had previously been part of the Taxpayer Compliance, Penalties, and Disputes Resolution Bill 1995. There were two discussion documents before the Bill. The first discussion document, *Taxpayer Compliance, Standards and Penalties* (Government discussion

document, Legislative Affairs, Inland Revenue, August 1994), discussed the penalty as follows:

> 5.44 It will more clearly define the situations in which a penalty should be imposed. It will focus the penalty provisions on blatant and serious tax avoidance activity while recognising that not all tax avoidance necessarily merits a significant penalty.

24. The second discussion document, *Taxpayer Compliance, Standards and Penalties 2: Detailed proposals and draft legislation* (Government discussion document, Legislative Affairs, Inland Revenue, April 1995 (the Second Discussion Document), stated:

> 7.3 The earlier discussion document proposed a special penalty aimed at a narrow band of tax avoidance behaviour which was considered abusive. "Abusive avoidance" was considered to occur where arrangements had as their principal purpose the gaining of a tax advantage and the taxpayer's interpretation was not "more likely than not" to be correct. Such arrangements would be defined by characteristics such as artificiality, contrivance and lack of commerciality. They might also involve concealment of information.
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> ...
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> 7.8 If a taxpayer does not have a reasonably arguable position a second test will be applied to determine whether a tax position taken is "abusive". The second test is whether the dominant purpose of the arrangement was to avoid tax. The purpose will be determined by an objective consideration of the arrangement.
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> ...
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> 7.12 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.

25. The intention, therefore, was that the abusive tax position penalty would only apply to "abusive avoidance". In other words, the penalty was not intended to apply to all tax avoidance arrangements.

Courts have recognised the need for a dominant purpose of avoiding tax

26. There has been some uncertainty from various commentators about whether the approach adopted by the courts differs from the approach discussed above. Specifically, the various commentators have argued the approach adopted in *Ben Nevis* implies the abusive tax position penalty applies automatically if there is a tax avoidance arrangement.

27. *Ben Nevis* was called *Accent Management v CIR* in the High Court ((2005) 22 NZTC 19,027) and the Court of Appeal ([2007] NZCA 230, (2007) 23 NZTC 21,323). In the High Court, Venning J held the arrangement was a tax avoidance arrangement under s BG 1. However, Venning J held a tax avoidance arrangement was not a sufficient condition for the assessment of an abusive tax position penalty. Venning J emphasised the need for a dominant purpose of avoiding tax for an abusive tax position penalty to apply. On the facts, Venning J held the dominant purpose of the arrangement "was undoubtedly to achieve the taxation benefits of the arrangement" (at [370]). Venning J concluded, therefore, the abusive tax position penalty applied. On appeal, the Court of Appeal upheld the findings of the High Court.

28. Tipping, McGrath and Gault JJ delivered the majority judgment of the Supreme Court in *Ben Nevis*. The majority started by discussing the overall context of the penalty regime at [180]. This shows the majority considered it necessary to understand the context before looking at the specific requirements of the penalty.

This in turn suggests the majority did not consider the penalty automatically applied because there was a tax avoidance arrangement.

29. The majority discussed the dominant purpose test as follows at [176]:

> ... the tax position must be one that, viewed objectively, is taken by the taxpayer in respect, or as a consequence, of an arrangement that is entered into with a dominant purpose of avoiding tax, whether directly or indirectly. Alternatively, where there is no arrangement, the tax position itself must be taken by the taxpayer for that dominant purpose.

30. The majority then discussed the requirements of the purpose test at [205]-[208]. The discussion focused on whether it was the taxpayer's or the arrangement's purpose that needed to be considered. The Supreme Court concluded it was the purpose of the arrangement that was relevant under s 141D(7)(b)(i). The differences between the purpose requirement under the anti-avoidance provision and the abusive tax position penalty were not the issue. As noted above, the High Court and the Court of Appeal (in the decisions cited as *Accent Management*) concluded the Trinity scheme had the dominant purpose of avoiding tax. The fact the majority of the Supreme Court did not comment on this factual finding does not mean the court considered the issue to be answered by the existence of a tax avoidance arrangement.

31. Various other cases have applied the abusive tax position penalty. Several cases have not analysed the issue discussed above but have concluded that the penalty applied on the facts: *Alesco New Zealand Ltd v CIR* (2011) 25 NZTC ¶20-099 (HC), *Krukziener v CIR* (2010) 24 NZTC 24,563 (HC), *Case Z23* (2010) 24 NZTC 14,334, *Case Z19* (2009) 24 NZTC 14,217, *Case X25* (2006) 22 NZTC 12,303, *CIR v Campbell Investments* (2004) 21 NZTC 18,559 (HC) and *Erris Promotions Ltd v CIR* (2003) 21 NZTC 18,330 (HC). The cases have generally referred to the relevant dominant purpose. Judge Barber has more fully discussed s 141D in two Taxation Review Authority decisions: *Case Y18* (2008) 23 NZTC 13,180 and *Case Z1* (2009) 24 NZTC 14,001. In both cases Judge Barber emphasised the need for there to be a dominant purpose of avoiding tax for s 141D to apply. Judge Barber also noted the need for there to be a dominant purpose of avoiding tax for the penalty to apply in *Case 11/2011* (2011) 25 NZTC ¶1-011. In *Case 11/2011*, Judge Barber held the dominant purpose of the relevant arrangement was avoiding tax but there was not an unacceptable tax position.

32. It is considered the courts have recognised the need for a dominant purpose of avoiding tax for an abusive tax position penalty to apply. The courts have recognised that the abusive tax position penalty does not apply automatically if there is a tax avoidance arrangement.

Summary

33. In summary, the abusive tax position penalty under s 141D does not apply automatically where there is a "tax avoidance arrangement" under s BG 1. To determine whether the abusive tax position penalty applies it is necessary to decide whether the **dominant purpose** of the arrangement is avoiding tax.

What differentiates a case where s BG 1 applies but the penalty does not?

34. The second question this item answers is what differentiates a case where s BG 1 applies but the penalty does not. This part, therefore, describes how to determine when the abusive tax position penalty will apply where there is a tax avoidance arrangement under s BG 1.

Key difference

35. As determined above, there is a key difference between the circumstances where s BG 1 applies and those where the abusive tax position penalty applies. The difference is that the abusive tax position penalty only applies where the dominant purpose is avoiding tax. If there is an arrangement, the abusive tax position penalty only applies where the dominant purpose of the arrangement is avoiding tax. As noted above at [30], under s 141D(7)(b)(i) "purpose" does not mean the motives or intentions of the taxpayer: *Ben Nevis* at [207], *Erris Promotions* at [374].

36. To work out whether an arrangement has a dominant purpose of avoiding tax, the purposes of the arrangement will need to be identified and weighed. If the only purpose of the arrangement is avoiding tax then that will be the dominant purpose. If there are other purposes, these will need to be weighed against the purpose of avoiding tax to see which, if any, is dominant.

37. Purposes are identified and weighed in the context of the specific structure of the arrangement. As the test is to establish the dominant 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 would suggest that the dominant purpose is avoiding tax. If the specific features of the arrangement are mainly explicable by the non-tax purposes, then this would support the conclusion that the dominant purpose of the arrangement is not avoiding tax. If none of the purposes (tax or non-tax) are dominant, then the penalty will also not apply.

Factual indicators

38. A number of possible factual indicators are likely to be relevant in determining whether the dominant purpose of the arrangement is avoiding tax. The Second Discussion Document and *Taxpayer Compliance, Penalties, and Disputes Resolution Bill 1995*: *Commentary on the Bill* (Legislative Affairs, Inland Revenue, September 1995) listed artificiality, contrivance, circularity of funding, concealment of information and non-availability of evidence, and spurious interpretations of tax laws as relevant indicators. However, the indicators were not included in the legislation.

39. The listed factors may be the same factors that indicate there is a tax avoidance arrangement. However, the factors have to be considered again in the context of the different standard in the dominant purpose test in s 141D. In other words, it is necessary to consider whether the factors support the conclusion that the dominant purpose of the arrangement was avoiding tax.

40. The Second Discussion Document stated relevantly:

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

41. The reason the factors were not included in the legislation, therefore, was to prevent the absence of any factor having the unintended consequence of the penalty not applying. As discussed above, the test is whether the dominant

purpose is avoiding tax. It is considered, therefore, that the absence of any of the factors will not indicate that the penalty does not apply. Further, the penalty may still apply if none of the listed factors are present. For example, there may be other factors (such as inflated values or a lack of economic substance) that may indicate that the dominant purpose of the arrangement is avoiding tax.

Cases

42. The cases have weighed the tax purposes of the relevant arrangements against the non-tax purposes: *Accent Management* (HC) at [370] (upheld in *Ben Nevis*), *Case Z23* at [125], *Krukziener* at [71]. The relevant cases have also looked at various indicators to help to determine if the dominant purpose of an arrangement is avoiding tax. For example, the courts have looked at the substance of the arrangement, the presence of artificiality and the extent to which the economic position of the person was altered by entry into the arrangement: Ronald Young J in *Erris Promotions* at [375] – [376], Wild J in *Campbell Investments Ltd* at [51] and Heath J in *Alesco* at [178] – [179].

43. The Commissioner has not imposed an abusive tax position penalty in respect of all tax avoidance arrangements. In all the cases where the penalty was at issue and the relevant arrangements were held to give rise to unacceptable tax positions, the courts found that each of the arrangements had a dominant purpose of avoiding tax. There are no cases, therefore, that have found that the tax avoidance purpose or effect of the arrangement was more than merely incidental under s BG 1 but the arrangement's purpose of avoiding tax was not dominant under s 141D. As a result, the courts have provided no guidance as to when a tax avoidance arrangement could be said to not have a dominant purpose of avoiding tax.

Summary

44. There is a key difference between the circumstances where s BG 1 applies and those where the penalty applies. Section BG 1 requires the tax avoidance purpose or effect of the arrangement to be more than merely incidental. In contrast, s 141D applies where there is a dominant purpose of avoiding tax. The key difference, therefore, is the requirement for the arrangement to have a dominant purpose of avoiding tax for s 141D to apply.

45. To determine whether the dominant purpose of the arrangement is avoiding tax, the tax purposes must be weighed against any non-tax purposes with reference to the specific structure used. The pre-legislative material suggests that 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. The list is not exhaustive. These indicators were not specifically included in the legislation. However, the courts have held that the factors are relevant in helping to weigh the different purposes to determine whether the dominant purpose of an arrangement is avoiding tax. The factors are not independent indicators that the penalty applies.

References

Related rulings/statements

IS0055: Shortfall penalty – unacceptable interpretation and unacceptable tax position (*Tax Information Bulletin* Vol 17, No 9 (November 2005): 26)

IS0061: Shortfall penalty for taking an abusive tax position (*Tax Information Bulletin* Vol 18, No 1 (February 2006): 24)

Subject references

Avoiding tax
Dominant purpose

Legislative references

Section 141D of the Tax Administration Act 1994
Section BG 1 of the Income Tax Act 2007

Case references

Accent Management Ltd v CIR (2005) 22 NZTC 19,027 (HC)
Accent Management Ltd v CIR [2007] NZCA 230, (2007) 23 NZTC 21,323
Alesco New Zealand Ltd v CIR (2011) 25 NZTC ¶20-099 (HC)
Ashton & Anor v CIR (1975) 2 NZTC 61,030 (PC)
Ben Nevis Forestry Ventures Ltd v CIR [2008] NZSC 115, (2009) 24 NZTC 23,188
Case X25 (2006) 22 NZTC 12,303
Case Y18 (2008) 23 NZTC 13,180
Case Z1 (2009) 24 NZTC 14,001
Case Z19 (2009) 24 NZTC 14,217
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Case 11/2011 (2011) 25 NZTC ¶1-011
CIR v Campbell Investments (2004) 21 NZTC 18,559 (HC)
CIR v Challenge Corporation Limited (1986) 8 NZTC 5,001 (CA)
CIR v National Distributors Ltd (1989) 11 NZTC 6,346 (CA)
Commerce Commission v Fonterra Co-Operative Group Ltd [2007] NZSC 36 (SC)
Erris Promotions Ltd v CIR (2003) 21 NZTC 18,330 (HC)
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Glenharrow Holdings Ltd v CIR [2008] NZSC 116, (2009) 24 NZTC 23,236
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Other references

Taxpayer compliance, standards and penalties (Government discussion document, Legislative Affairs, Inland Revenue, August 1994)
Taxpayer compliance, standards and penalties 2: Detailed proposals and draft legislation (Government discussion document, Legislative Affairs, Inland Revenue, April 1995)
Taxpayer Compliance, Penalties, and Disputes Resolution Bill 1995: Commentary on the Bill (Legislative Affairs, Inland Revenue, September 1995)