

# Income tax: scenarios on tax avoidance – 2023 No 2

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QB 23/02

This Question we've been asked (QWBA) is one of two QWBAs that updates tax avoidance scenarios from earlier QWBAs that have become outdated. The earlier QWBAs were based on the Commissioner's statement on tax avoidance published in 2013 (IS 13/01). IS 13/01 has been replaced by [IS 23/01](#): "Tax avoidance and the interpretation of the general anti-avoidance provisions sections BG 1 and GA 1 of the Income Tax Act 2007".

## Key provisions | Whakaratonga tāpua

Income Tax Act 2007 – ss BG 1, GA 1

**REPLACES | WHAKAKAPIA: QB 15/11 scenarios 1 and 3**

## Background | Horopaki

1. This Question we've been asked (QWBA) is one of two QWBAs that replaces some of the scenarios on tax avoidance that appeared in the following QWBAs that are withdrawn from the date of this QWBA:
  - QB 14/11: Income tax – scenarios on tax avoidance
  - QB 15/01: Income tax – tax avoidance and debt capitalisation
  - QB 15/11: Income tax – scenarios on tax avoidance – 2015.<sup>1</sup>
2. The withdrawn QWBAs were based on the Commissioner's statement on tax avoidance IS 13/01.<sup>2</sup> IS 13/01 has been replaced by IS 23/01 "Tax avoidance and the interpretation of the general anti-avoidance provisions sections BG 1 and GA 1 of the Income Tax Act 2007". This QWBA updates some of the earlier scenarios to reflect the new statement. The answers as to whether or not s BG 1 applies in each of the scenarios have not changed. Due to subsequent legislative changes, some of the scenarios in the withdrawn QWBAs have not been updated.<sup>3</sup>
3. Section BG 1 is the principal vehicle to address tax avoidance in the Income Tax Act 2007. The Supreme Court in *Ben Nevis* considered it desirable to settle the approach to the relationship between s BG 1 and the specific provisions in the rest of the Act with the Parliamentary contemplation test.<sup>4</sup> The Supreme Court confirmed the Parliamentary contemplation test as the proper and authoritative approach to applying s BG 1 in *Penny and Frucor*.<sup>5</sup>
4. The test involves ensuring Parliament's purpose for the specific provision and its purpose for s BG 1, as the principal vehicle in the Act to address tax avoidance, are achieved. This occurs by the specific provision and s BG 1 working in tandem with each providing the context that defines the meaning and scope of the other. Hence, the Parliamentary contemplation test requires consideration of Parliament's purpose for the specific provision and its purpose for s BG 1. Parliament's overall purpose comprises both of these purposes.

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<sup>1</sup> Published in: *Tax Information Bulletin* Vol 26, No 11 (December 2014): 3 (QB 14/11), *Tax Information Bulletin* Vol 27, No 3 (April 2015): 25 (QB 15/01) and *Tax Information Bulletin* Vol 27, No 10 (November 2015): 27 (QB 15/11).

<sup>2</sup> IS 13/01: *Tax avoidance and the interpretation of ss BG 1 and GA 1 of the Income Tax Act 2007* published in *Tax Information Bulletin* Vol 25, No 7 (August 2013): 4.

<sup>3</sup> This QWBA comprises scenarios 1 and 3 from QB 15/11. Scenario 2 has been updated separately in QB 23/01 "Income tax: scenarios on tax avoidance – 2023 No 1".

<sup>4</sup> *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115, [2009] 2 NZLR 289 at [100].

<sup>5</sup> *Penny v CIR* [2011] NZSC 95, [2012] 1 NZLR 433 (also known as *Penny & Hooper*) at [33] and *Frucor Suntory New Zealand Ltd v CIR* [2022] NZSC 113 at [53].

5. The Commissioner's view as to whether s BG 1 applies in these scenarios must be understood in the following terms:
  - The arrangements are framed broadly.
  - The conclusions reached are limited to the arrangements as set out.
  - Additional relevant facts or variations to the stated facts might materially affect how the arrangements operate and different outcomes under s BG 1 could arise.
  - Because the objective is to consider the application of s BG 1, the analysis proceeds on the basis that the tax effects under the applicable specific provisions of the Act are achieved as stated.
  - The implications of any relevant specific anti-avoidance provisions are not considered.
6. Applying s BG 1 requires answering the "ultimate question" under the Parliamentary contemplation test: does the arrangement, when viewed in a commercially and economically realistic way, make use of or circumvent the specific provisions in a manner consistent with Parliament's purpose?<sup>6</sup>
7. If the arrangement uses or circumvents a specific provision in a manner that is outside Parliament's purpose, it has a tax avoidance purpose or effect. Where an arrangement has two or more purposes or effects and one purpose or effect is tax avoidance, s BG 1 will apply only if the tax avoidance purpose or effect is more than merely incidental to another purpose or effect of the arrangement.
8. The merely incidental test involves the consideration of many of the same factors that are considered under the Parliamentary contemplation test. A conclusion under the Parliamentary contemplation test that an arrangement uses or circumvents a specific provision in a manner that is outside Parliament's purpose (ie, it has a tax avoidance purpose or effect) means it is unlikely that the arrangement's tax avoidance purpose will be merely incidental.<sup>7</sup>
9. Where it applies, s BG 1 voids a tax avoidance arrangement. Voiding an arrangement may or may not appropriately counteract the tax advantages arising under the arrangement. If the voiding of the arrangement does not appropriately counteract the tax advantages, the Commissioner is under a duty to apply s GA 1 to ensure this outcome is achieved.

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<sup>6</sup> *Ben Nevis* (SC) at [109].

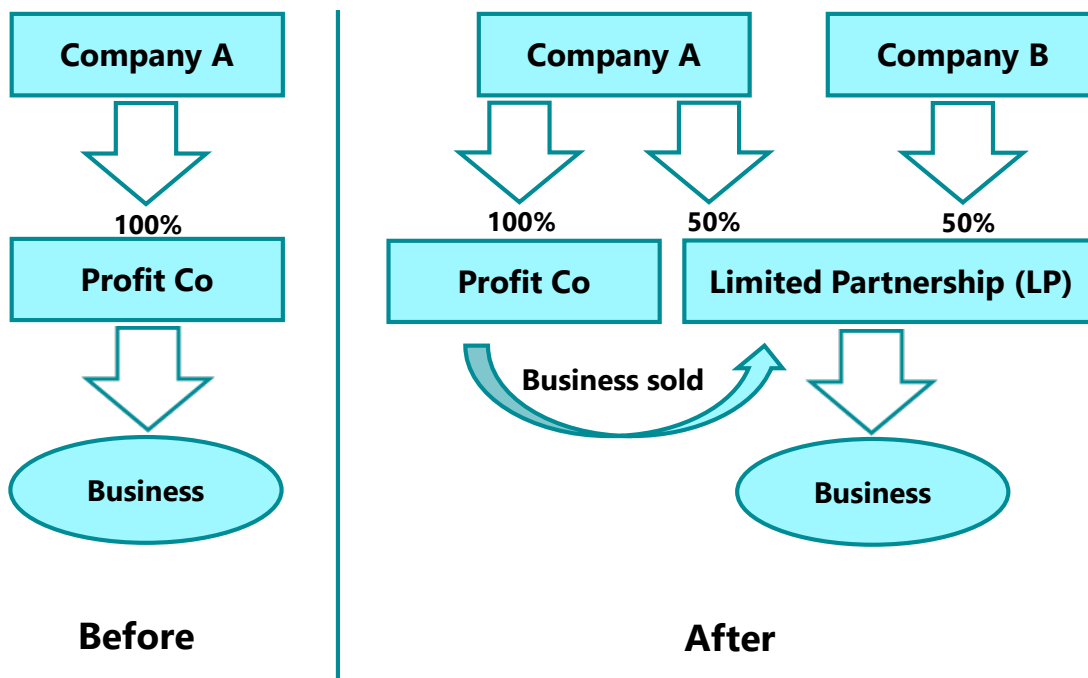
<sup>7</sup> *Ben Nevis* (SC) at [114].

10. For a comprehensive explanation of the Commissioner’s view of the law concerning applying ss BG 1 and GA 1 see 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”.

## Scenario 1 — Use of a limited partnership

### Question | Pātai

11. Does s BG 1 apply in the following circumstances:
- There are three New Zealand resident companies:
    - Company A, a tax loss company;
    - Profit Co, a wholly-owned subsidiary company of Company A that is operating a profitable business; and
    - Company B, a company that is unassociated with Company A and Profit Co;
  - Companies A and B establish a limited partnership registered under the Limited Partnerships Act 2008 (the LP);
  - Companies A and B make equal contributions to the capital of the partnership and agree to each receive a 50% share of partnership profits and losses; and
  - Profit Co sells its business operations to the LP at the open market value of those operations.
12. The following diagram shows the situation before and after the above events:



## Answer | Whakautu

13. No. The Commissioner's view is that, without more, s BG 1 would not apply to this arrangement.

## Explanation | Whakamāramatanga

### Introduction

14. The Commissioner's approach to applying s BG 1 is as follows. First, understand the legal form of the arrangement in terms of its scope, commercial or private purposes and tax effects.
15. Then, ascertain Parliament's purpose for the specific provisions the arrangement uses or circumvents.
16. The Commissioner considers that, in some cases, a helpful practical technique may be to consider "facts, features or attributes" for a specific provision. Once Parliament's purpose for a specific provision has been ascertained, that purpose may be translated into facts, features or attributes that Parliament would contemplate being present (or absent) to give effect to that purpose. This is because a specific provision sets out a legal rule that will be activated or satisfied by the existence (or non-existence) of certain explicit and implicit facts, features or attributes. These might include legal, commercial, economic, or other concepts.
17. Next, understand the commercial and economic reality of the arrangement as a whole. Factors the courts have referred to that may be helpful to consider include:
- whether the taxpayer has gained the benefit of the specific provision in an artificial or contrived way, or by pretence;
  - the manner in which the arrangement is carried out;
  - the role of all relevant parties and their relationships;
  - the economic and commercial effect of documents and transactions;
  - the nature and extent of the financial consequences;
  - the duration of the arrangement;
  - whether there is circularity in the arrangement;
  - whether there is inflated expenditure or reduced levels of income in the arrangement;
  - whether the parties to the arrangement have undertaken limited or no real commercial or economic risks; and

- whether the arrangement is pre-tax negative.
18. Then consider the implications of the preceding analysis of Parliament's purposes for the specific provisions and the arrangement's purposes, tax effects and commercial and economic reality as a whole. Bearing in mind s BG 1's purpose as the principal vehicle in the Act to address tax avoidance, the analysis is likely to highlight a number of 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).
  - Whether or not the use or circumvention of the relevant specific provisions is consistent with Parliament's purposes for the specific provisions.
19. 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 will also be highly relevant.
20. Artificiality, contrivance or pretence must be considered in the context of the arrangement as a whole and can be described as including 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.
21. The analysis of the arrangement's commercial and economic reality may show the arrangement's apparent commercial or private purposes as previously analysed may not be consistent with its commercial and economic reality. The analysis may show that the arrangement may not, in reality, have any commercial or private purposes or that aspects of the arrangement suggest those purposes lack a rationale or justification once shorn of the tax advantages. 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.
22. Understanding the commercial and economic reality of the arrangement as a whole may indicate the arrangement uses (or circumvents) specific provisions in a manner that is not consistent with Parliament's purposes.
23. Practically, the technique of using facts, features or attributes may be helpful in some cases with ascertaining whether an arrangement has crossed the line into tax avoidance. This involves considering whether the facts, features or attributes previously translated from Parliament's purpose for the specific provision are consistent with those that are present (or absent) in the arrangement when viewed as a whole and in a commercially and economically realistic way.
24. A lack of consistency under the facts, features or attributes technique may indicate that Parliament's purpose for the specific provisions is not being met. On the other hand, consistency under the facts, features or attributes technique does not prevent the application of s BG 1. The technique can only assist in assessing whether Parliament's overall purpose for the specific provisions and s BG 1 is being met. It is not a bright-line test nor a substitute for considering all the relevant facts and reaching a reasonable inference or conclusion.
25. Also, some types of arrangements do not lend themselves as readily as others to the use of the facts, features or attributes technique. See, for example, *Penny* (SC) where there was "no failure to comply with any express requirement of the Act in the setting of salaries, since there is none".<sup>8</sup>
26. Finally, taking into account all of the matters considered above, 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? The answer must be a reasonable inference that is:
- open on the evidence and on the facts established from the evidence;
  - logical and convincing;
  - not mere speculation; and
  - not an intuitive subjective impression.

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<sup>8</sup> At [33].

27. If tax avoidance is not the sole purpose or effect of the arrangement, consideration will need to be given to whether the tax avoidance purpose or effect is merely incidental. Applying the merely incidental test involves considering:
- the relationship between the tax avoidance purpose or effect of the arrangement and other purposes or effects of the arrangement (non-tax avoidance purposes); and
  - whether the tax avoidance purpose or effect follows as a natural incident of another purpose.
28. Therefore, the non-tax avoidance purposes of the arrangement (which generally are identified when considering the arrangement under the Parliamentary contemplation test) are also relevant to the merely incidental test. Non-tax avoidance purposes include:
- commercial purposes;
  - private purposes; and
  - purposes giving rise to legitimate tax advantages (ie, where the use or the circumvention of specific provisions is within Parliament's contemplation).

### **The arrangement's scope, purposes and tax effects**

29. The steps and transactions that make up the arrangement described at [11] are:
- Companies A and B establish a limited partnership registered under the Limited Partnerships Act 2008 (the LP);
  - Companies A and B make equal contributions to the capital of the partnership and agree to each receiving a 50% share of partnership profits and losses;
  - Profit Co sells its business operations to the LP at the open market value of those operations;
  - Company A and Profit Co apply the group company rules of subpart IC to their respective tax positions taken for income tax purposes; and
  - Company A and Company B return for income tax purposes a 50% share each of the LP's profits.
30. On the face of it, the arrangement serves the commercial purposes of Company B taking a financial interest in the business of Profit Co.
31. The tax effects of the arrangement are:
- Profit Co no longer derives business income;
  - the LP derives business income;



- the LP is transparent for tax purposes with Companies A and B each deriving 50% of the LP's income;
  - Company A can offset its share of LP income against its tax losses; and
  - Company A's ability to group tax losses with Profit Co under subpart IC is unaffected.
32. These tax effects arise under the following specific provisions:
- s CB 1 (Amounts derived from business)
  - subpart HG (Joint venturers, partners, and partnerships)
  - subpart IA (General rules for tax losses)
  - subpart IC (Grouping tax losses).
33. There may also be tax effects arising from the sale of the business (eg, depreciation recovered), although these are not of significance to the subsequent s BG 1 analysis.

## Parliament's purposes for the specific provisions

### Business income

34. Parliament contemplates that amounts a person derives from a business are treated as income and taxed. This is made clear by Parliament explicitly legislating s CB 1 to ensure this is the case. As stated by Richardson J of a predecessor of s CB 1 in *AA Finance Ltd (CA)*, "[a] gain made in the ordinary course of carrying on the business is thus stamped with an income character".<sup>9</sup>

### Losses

35. Parliament contemplates taxpayers incurring losses where their annual total deduction is more than their annual gross income (s BC 4(3)). It contemplates the net loss being dealt with in certain ways. A net loss is dealt with under Part I (Treatment of tax losses) and it may be offset against future income, made available to certain other persons or dealt with in certain other ways (s BC 4(4)). A person's taxable income for a tax year is determined after subtracting any available tax losses under Part I (s BC 5).
36. Generally, Part I provides that a person's tax loss for a tax year is the sum of their loss balance brought forward, current year net loss and certain other amounts (eg, unused imputation credits) (s IA 2). Any tax losses not able to be offset against current income

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<sup>9</sup> *AA Finance v CIR* (1994) 16 NZTC 11,383 (CA) at 11,391.

can be carried forward to subsequent income years and offset (s IA 4). Temporary rules also permit some losses to be carried back to prior years (s IZ 8).<sup>10</sup>

37. However, Parliament has also provided specific restrictions for companies (s IA 5).<sup>11</sup> These restrictions require a minimum of 49% continuity of voting interests to be held by the same group of people from when the losses are incurred to when they are ultimately offset against income. That is, within some limits, Parliament generally expects the same group of people with a financial interest in the company when the losses are incurred get to enjoy the benefit of those losses being offset against income in the future.
38. Similarly, where a tax loss is to be made available to another person and the parties are companies, Parliament expects a 66% commonality of shareholding to exist between the profit and loss companies from the start of the period when the loss was incurred to the end of the year of offset (subpart IC).

### Limited partnerships

39. The primary objective of the limited partnership rules is to facilitate sustainable growth in New Zealand's investment capital sectors, such as venture capital, by providing a legal and tax structure recognised and accepted by investors.<sup>12</sup>
40. A limited partnership under the Act means a limited partnership registered under the Limited Partnerships Act 2008. It includes an overseas limited partnership but does not include a "listed limited partnership" or a "foreign corporate limited partnership" (s YA 1 definition of "limited partnership").
41. Generally, limited partnerships are treated as transparent for tax purposes (s HG 2). For the purposes of calculating partners' obligations and liabilities, the partners are treated as carrying on the partnership's activities and having the status, intention and purpose of the partnership (s HG 2(1)). Any income, expenses, tax credits, rebates, gains and losses arising for the partnership flow through to the partners in proportion to their interest in the partnership (s HG 2(2)). There are rules concerning the entry and exit of partners (ss HG 3 to HG 10). There are also rules placed on limited partners that ensure the partners' tax losses are restricted if the amount of the loss exceeds the tax book value of their investment (s HG 11).

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<sup>10</sup> The *COVID-19 Response (Taxation and Other Regulatory Urgent Measures) Act 2020* introduced a temporary loss carry back regime applicable to the 2018-19 and 2019-20 income years.

<sup>11</sup> With effect on 1 April 2020, subpart IB provides that in certain situations a tax loss may be carried forward despite a breach of s IA 5 if there is no major change in the nature of the business. For the purposes of this scenario, it is assumed the parties could not rely on the rules in subpart IB.

<sup>12</sup> *New legislation – Taxation (Limited Partnerships) Act 2008, Tax Information Bulletin Vol 20, No 8 (September/October 2008): 4.*

### **Facts, features or attributes**

42. Having identified Parliament's purposes for the specific provisions in this scenario, it is possible to translate Parliament's purposes into the following facts, features or attributes that Parliament would contemplate being present:
- The formation of a partnership relationship between Companies A and B.
  - The registration of the partnership as a limited partnership under the Limited Partnerships Act 2008.
  - Companies A and B contributing equally to the capital of the LP as agreed between them.
  - The disposal of Profit Co's business to the LP, with the consequences that Profit Co no longer conducts the business and ceases to derive business income.
  - The LP acquiring the business of Profit Co at its open market value, with the consequences that the LP conducts the business and commences deriving business income.
  - Companies A and B sharing equally in the profits or losses of the LP, returning these as income or losses in their respective tax returns each year the arrangement remains operative.
  - A minimum of 49% continuity of shareholding in the group of persons holding voting interests in Company A from the beginning of the year in which the company's tax losses were incurred until the end of any year in which they are offset against LP income (or failing that, the business continuity provisions of subpart IB are met).
  - A minimum of 66% commonality of shareholding between the group of persons holding voting interests in Company A and Profit Co from the time Company A incurred the tax losses until the end of any year in which they are offset against any future income of Profit Co.

### **Viewing the arrangement as a whole and in a commercially and economically realistic way**

43. In the Commissioner's opinion, when the arrangement is viewed as a whole and in a commercially and economically realistic way using the factors mentioned at [17], it can be seen that there are real economic consequences to the parties that reflect the arrangement's legal form and there are no indications of tax advantages arising as a result of artificiality or contrivance.
44. That is, the reality of the arrangement accords with:

- Companies A and B contributing equally to the formation of a registered limited partnership from which they return equal shares of income and losses for tax purposes;
  - an arm's-length sale of Profit Co's business to the LP;
  - the LP, and not Profit Co, conducting the business and deriving business income; and
  - no change in the composition of the group of persons holding voting interests in Company A or Profit Co.
45. In reality, a limited partnership has been formed through which a third-party investor, Company B, has contributed capital to take an interest in an actual and existing profitable business. The nature and extent of the financial consequences for the parties is consistent with this arm's-length investment by Company B.
46. For its part, Company A divests itself of half of its interests in the business and suffers the economic burden of no longer having full access to the profits of the business. It does, however, continue to have the ability to offset losses against half of those profits when those profits are received in the form of LP income. This is because there has been no change in shareholding in Company A that could have meant the company was not able to offset its losses against its share of the LP income or any future income of Profit Co.

### Answering the ultimate question

47. Applying s BG 1 requires answering the "ultimate question" of whether the arrangement, viewed in a commercially and economically realistic way, uses or circumvents the specific provisions in a manner that is consistent with Parliament's purpose.
48. As mentioned, viewing the arrangement in this scenario as a whole in a commercially and economically realistic way does not highlight that tax advantages have been obtained by artificiality, contrivance or pretence.
49. The arrangement serves the commercial purposes of Company B taking a financial interest in the business of Profit Co.
50. There is a partnership between Companies A and B registered under the Limited Partnerships Act 2008 which the partners are contributing to and benefiting from equally. Accordingly, Company B's investment through a limited partnership is consistent with Parliament's purposes that limited partnerships are used as investment vehicles.

51. There has been no change in who holds shares in Company A or Profit Co affecting the commonality or continuity of shareholding requirements of the Act. This means the arrangement does not defeat Parliament's general expectation that the group of people with a financial interest in a company when losses are incurred should also enjoy the benefit of those losses being offset against income in the future.
52. Accordingly, the arrangement does not appear to use or circumvent specific provisions of the Act in a manner outside Parliament's contemplation. This can also be (optionally) analysed in terms of the facts, features or attributes Parliament would expect to be present or absent (see [[16], [[23] and [42] above).
53. All the facts, features or attributes mentioned earlier are present in the arrangement as matters of commercial and economic reality, further reinforcing the view that the arrangement does not appear to use or circumvent specific provisions of the Act in a manner outside Parliament's contemplation.
54. It may be thought that the step of selling the business to the LP was included in the arrangement for tax reasons. That is, to invest in the business activity of Profit Co, Company B could have bought shares in that company. Had this been the arrangement instead, one of the tax effects of this alternative arrangement would have been to breach the loss grouping provisions of the Act. Company A would then have been unable to offset its losses against any of the profits generated by the business activity.
55. However, applying the Parliamentary contemplation test requires determining the commercial and economic reality of the arrangement actually entered into. Establishing tax avoidance does not require identifying some hypothetical alternative arrangement the taxpayer may have entered into (sometimes referred to as a "counterfactual"). New Zealand's courts have not relied on counterfactuals to reach a view on whether an arrangement has a tax avoidance purpose or effect.
56. In addition, the Supreme Court in *Ben Nevis* considered that taxpayers have the freedom to structure transactions to their best tax advantage. They cannot, however, do so in a way that is proscribed by the general anti-avoidance provision. That is, provided taxpayers make use of the provisions of the Act in a way contemplated by Parliament, they have freedom to choose how they structure their arrangements.<sup>13</sup> Accordingly, there is no general requirement for the parties in this scenario to adopt an alternative, less tax-favourable, arrangement.
57. In the Commissioner's opinion, taking into account all of the above matters, this arrangement does not use or circumvent the specific provisions in a manner that is outside Parliament's purposes for those provisions. As such, it is not a tax avoidance

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<sup>13</sup> *Ben Nevis* (SC) at [111] and *Penny* (SC) at [49].

arrangement as it does not have a tax avoidance purpose or effect and, without more, s BG 1 would not apply.

## Scenario 2 — Use of a discretionary trust

### Question | Pātai

58. Does s BG 1 apply in the following circumstances:

- trustees of a trust pay or vest income in an income year to beneficiaries that are either:
  - an individual adult beneficiary who is taxed on the beneficiary income at the lowest marginal tax rate; or
  - a corporate beneficiary (that may or may not be solvent) with total tax losses available in that year equal to, or greater than, the beneficiary income; or
  - a corporate beneficiary, where the beneficiary income is a dividend from a foreign company and exempt income of the beneficiary under s CW 9;
- the trust was validly established and the trustees have fully complied with the Trusts Act 2019, the terms of the trust deed and with their obligations under general trust law to distribute income to the beneficiaries;
- the terms of the trust deed do not require the trustees to distribute any or all of the income derived each year;
- the trustees also have the discretion to choose the beneficiaries or class of beneficiaries that are to receive trust property;
- all beneficiaries of the trust are existing beneficiaries of the trust and New Zealand tax residents; and
- for tax purposes, the trust is classified as a complying trust under s HC 10.

### Answer | Whakautu

59. No. The Commissioner's view is that, without more, s BG 1 would not apply to the arrangement. Variations to the facts that may lead the Commissioner to reach a different view are discussed from [92] below.

## Explanation | Whakamāramatanga

### Introduction

60. The Commissioner's approach to applying s BG 1 is set out in scenario 1 at [14] to [28] above.

### The arrangement's scope, purposes and tax effects

61. The steps and transactions that make up the arrangement are:

- The trustees of the trust appointing the beneficiaries.
- The trustees deriving income and paying or vesting that income to the beneficiaries.

62. On the face of it, the arrangement serves the commercial or private purposes of vesting income in, or paying income to, a beneficiary taking into account the beneficiary's tax position.

63. The tax effect of the arrangement is that the income derived by the trustees and vested in or paid to the beneficiary is not trustee income and not subject to tax at the trustee tax rate of 33%.

64. Instead, the tax effect is that the income is beneficiary income and:

- in the case of the individual, is taxed at a rate of tax that is less than the trustee tax rate;
- in the case of the loss company, is not taxed because of the availability to the beneficiary of sufficient tax losses to offset against the income; and
- in the case of the dividend from a foreign company paid or vested to a corporate beneficiary, is not taxed because the income retains its identity as foreign dividends and is exempt income of the beneficiary under s CW 9.

65. The relevant provisions of the Act are the trust rules in subpart HC relating to beneficiary income and the core provisions in Part B.

### Parliament's purposes for the specific provisions

#### Beneficiary income

66. Subpart HC provides rules for the taxation of trusts, including the taxation of beneficiary income. Income derived by a trustee is treated as trustee income and taxed at the rate of 33% unless it is distributed as beneficiary income (s HC 5). Beneficiary

income is taxed at the beneficiary's marginal tax rate. An amount derived by a person is income under s CV 13(a) if it is beneficiary income under s HC 6.

67. In order to be a valid distribution, an amount must be vested or paid in accordance with the terms of the trust. The terms of some trusts may limit the amount of the gross income the trustees can distribute to an amount equal to the net income of the trust. Otherwise, if it is permitted, a trustee could distribute all the gross income meaning any expenditure incurred has to be paid out of other sources (previous income, capital or corpus) and possibly lead to the trustee incurring a tax loss.
68. Also, if an amount of income derived by a trustee is of a particular character (eg, interest income), the income will retain this character in the hands of the beneficiary when the amount becomes beneficiary income. Similarly, if an amount of income has a source in New Zealand it will have the same source in the hands of the beneficiary when the amount becomes beneficiary income.
69. Under s HC 6, for income to be treated as beneficiary income it must be income derived by a trustee that:
  - “vests absolutely in interest” in a beneficiary in the income year, or
  - is “paid” to a beneficiary either in the income year or within a certain period after the end of the income year (ie, within six months of the end of the income year or the earlier of when the trust tax return is filed or is due).
70. Accordingly, beneficiary income can arise in two ways—where it vests absolutely in interest in the beneficiary or where it is paid to the beneficiary (although there is some overlap between the two).
71. Beneficiary income is discussed in Part 5 of the Commissioner's Interpretation Statement IS 18/01.<sup>14</sup> IS 18/01 makes the following additional points concerning beneficiary income:
  - the amount vested or paid can take the form of money or money's worth;
  - the exact amount vested or paid need not be specified at the time as long as the amount can be calculated when the assessment of income is made for the income year;
  - where an amount is future property or an expectancy, the vesting or payment will not be effective until the amount is received or receivable;
  - an amount may vest in a beneficiary as a result of a clause in a trust deed or as a result of the exercise of a discretion given to a trustee to allocate an amount to a beneficiary;

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<sup>14</sup> IS 18/01: *Taxation of trusts – Income tax*, *Tax Information Bulletin* Vol 30, No 7 (August 2018): 17.



- an amount will vest in a beneficiary only if the beneficiary is given an indefeasible right to the amount (ie, the trustee cannot later change their mind and decide not to give the amount to the beneficiary);
  - on vesting, a beneficiary obtains an absolute interest in the amount vested. The interest can be a right to present or future possession of the amount;
  - even if there is a right to present possession, the trustee may hold the amount until the beneficiary demands it;<sup>15</sup>
  - the vesting cannot be subject to a condition being met or an event occurring;
  - beneficiary income will be paid to a beneficiary either when it is distributed to the beneficiary; credited to the beneficiary or is dealt with in their interest or on their behalf in some other way;
  - making a loan to a beneficiary will not constitute payment of beneficiary income because of the obligation to repay the loan amount; and
  - where a beneficiary has a discretionary interest in income, it is necessary for the trustee to pass a resolution that initiates the making of a payment to that beneficiary.
72. Section GB 22 is a specific anti-avoidance provision applying to situations where a trustee enters into an arrangement to defeat the intent and application of the rules relating to beneficiary income and taxable distributions. However, the existence of a specific anti-avoidance provision does not preclude the application of s BG 1.<sup>16</sup>
73. The phrase used in the legislation for beneficiary income that “vests absolutely in interest” is discussed in more detail in the Commissioner’s Interpretation Statement IS 12/02.<sup>17</sup>

### **Discretionary trusts and allocating beneficiary income**

74. Subpart HC is silent on how trustees of discretionary trusts that are classified as complying trusts should determine who receives beneficiary income or the amount of that income. Parliament has generally left it to general trust law to determine this aspect of trust taxation. However, once trustees make decisions within the constraints

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<sup>15</sup> Note, that since IS 18/01 was published it has been accepted that the income tax law around whether a beneficiary who leaves distributions in a trust is considered a settlor of the trust has been unclear (see *Commissioner’s Operational Position – New section HC 27(6) – treatment of beneficiary as a settlor in certain circumstances*, *Tax Information Bulletin* Vol 31, No 8 (September 2019): 113. From 1 April 2020, s HC 27(6) provides that a beneficiary is not a settlor of the trust solely as a result of being owed money by a trustee if the amount owing is not more than \$25,000 or the trustee pays market rate interest on the amount.

<sup>16</sup> *Penny* (SC) at [48].

<sup>17</sup> IS 12/02: *Income tax — Whether income deemed to arise under tax law, but not trust law, can give rise to beneficiary income*, *Tax Information Bulletin* Vol 24, No 7 (August 2012): 49.

of general trust law, Parliament has indicated its expectations as to the tax consequences that arise. It can be seen that in some areas Parliament has placed practical limitations on trustees in terms of amounts allocated to beneficiaries.

75. For example, where beneficiary income includes imputation credits trustees are effectively prevented by s LE 5 from streaming the credits to one beneficiary. Section LE 5 limits the imputation credit available to a beneficiary by pro-rating the credits over all distributions made to all beneficiaries in the relevant income year. Similarly, in certain circumstances trustees are deterred by s HC 35 from distributing beneficiary income of more than \$1,000 in an income year to a beneficiary that is a minor as amounts in excess of that are taxed at the trustee tax rate.
76. Under trust law, where a trust instrument provides trustees with a discretion to choose which beneficiaries should receive trust property, the trustees are entitled to prefer some beneficiaries over others. The House of Lords' decision in *Gartside* made it clear that the beneficiaries of a discretionary trust have no proprietary interest in the trust property or its income.<sup>18</sup> Their rights are restricted to a right to be considered for nomination as a beneficiary by the trustees and a right to compel proper administration of the trust.
77. *Gartside* also confirmed that the trustees of a discretionary trust owe fiduciary duties to discretionary beneficiaries. The beneficiaries have a right that would attract the protection of a court of equity to ensure the trustees carry out their duties fairly, reasonably or properly. This means trustees of a trust must not exercise their discretion without properly considering all relevant matters as directed by the Trusts Act 2019, the trust deed and general trust law.
78. Parliament's purposes for trustee income and beneficiary income can be found in a combination of the Trusts Act 2019, general trust law, Part B and subpart HC of the Act. From this, it can be concluded that neither the Trusts Act 2019, general trust law nor the Act prevents trustees of a discretionary trust taking into account the tax consequences arising for a beneficiary if they were to receive beneficiary income. These tax consequences arise in the context of the core provisions of the Act from which income tax obligations and entitlements are determined, taking into account such things as tax rates, credits and deductions. Parliament contemplated that tax rates, credits and deductions apply to the income actually derived by the taxpayer. Income derived by a taxpayer could include beneficiary income.
79. In other circumstances, the Act provides for tax losses to arise and for these to be offset against income actually derived by taxpayers. Also, s HC 22 shows that

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<sup>18</sup> *Gartside v IRC* [1968] 1 All ER 121 (HL).

Parliament contemplates that, in some contexts in relation to non-complying trusts, taxpayers deriving beneficiary income may also have tax losses.

### **Facts, features or attributes**

80. Having identified Parliament's purposes for the specific provisions in this scenario, it is possible to translate Parliament's purposes into the following facts, features or attributes that Parliament would contemplate being present:
- A valid trust exists, where the trustees act in accordance with the trust deed and general trust law:
    - The necessary prerequisites to the formation of a trust are met, including the certainty of:
      - an intention to establish a trust;
      - the trust assets being unambiguously defined; and
      - the beneficiaries being able to be ascertained.
    - The trustees are holding and dealing with trust property, including deriving income from the trust property, on behalf of beneficiaries in accordance with the trust deed and general trust law.
  - Income derived by the trustees is paid or vested as beneficiary income to beneficiaries.
  - The beneficiaries receiving distributions of income are eligible to benefit under the trust. That is, they are, in reality, beneficiaries of the trust.
  - The beneficiaries receive the distributions of income. That is, they benefit in some way, either immediately or from future possession of the income so that, in reality, there is a distribution of income to them.
  - The core provisions of the Act, including the rules concerning income, exempt income, basic tax rates and tax losses, apply according to the individual circumstances of the beneficiary.

### **Viewing the arrangement as a whole and in a commercially and economically realistic way**

81. In the Commissioner's opinion, when the arrangement is viewed as a whole and in a commercially and economically realistic way using the factors mentioned at [17], it can be seen that the arrangement's commercial and economic reality is consistent with its legal form and tax advantages do not arise as a result of artificiality or contrivance.

82. That is, in reality, there is in this scenario a validly established trust. The distributions of beneficiary income have been undertaken in compliance with the Trusts Act 2019, the trust deed, general trust law requirements and subpart HC of the Act. There is no suggestion the beneficiaries are not, in reality, entitled under the trust, or that they will not benefit from the distribution of income to them.

### Answering the ultimate question

83. Applying s BG 1 requires answering the “ultimate question” of whether the arrangement, viewed in a commercially and economically realistic way, uses or circumvents the specific provisions in a manner that is consistent with Parliament’s purpose.
84. As mentioned, viewing the arrangement in this scenario as a whole, in a commercially and economically realistic way does not indicate tax advantages have been obtained by artificiality, contrivance or pretence.
85. As stated, in the arrangement for this scenario there is a validly established trust. The distributions of beneficiary income have been undertaken in compliance with the trust deed, general trust law requirements and subpart HC of the Act. There is no suggestion the beneficiaries are not, in reality, entitled under the trust, or that they will not benefit from the distribution of income to them.
86. The arrangement serves the commercial or private purposes of vesting income in, or paying income to, a beneficiary taking into account the beneficiary’s tax position. In short, the arrangement achieves the usual purposes of a discretionary trust.
87. Accordingly, the arrangement does not appear to use or circumvent specific provisions of the Act in a manner outside Parliament’s contemplation. This can also be (optionally) analysed in terms of the facts, features or attributes Parliament would expect to be present or absent (see [16], [23] and [80] above).
88. All these facts, features or attributes are present in the arrangement as matters of commercial and economic reality, further reinforcing the view that the arrangement does not appear to use or circumvent specific provisions of the Act in a manner outside Parliament’s contemplation.
89. In the Commissioner’s opinion, taking into account all of the above matters, this arrangement does not use or circumvent the specific provisions in a manner that is outside Parliament’s purposes for those provisions. As such, it is not a tax avoidance arrangement as it does not have tax avoidance as a purpose or effect and, without more, s BG 1 would not apply.
90. The Commissioner considers this is the correct conclusion despite the implication that the trustees’ choices in this scenario were significantly influenced by tax considerations.

The Supreme Court in *Ben Nevis* considered that taxpayers could structure their arrangements to their best tax advantage, provided the use of the provisions is consistent with what Parliament would have contemplated.<sup>19</sup> Where the use of the provisions is outside what Parliament would have contemplated for them it is appropriate for s BG 1 to apply.

91. Accordingly, arrangements strongly influenced by tax outcomes are not necessarily tax avoidance arrangements subject to s BG 1. Such influences on arrangements would be relevant to whether tax outcomes were merely incidental, but this only becomes important if the arrangement has a tax avoidance purpose or effect in the first instance. Note that, prior to *Ben Nevis* (SC), Richardson J recognised this for trusts in *Challenge Corporation* (CA):<sup>20</sup>

... but it was obviously never intended that the use of trusts, which in New Zealand practice in the vast majority of cases is substantially influenced by tax considerations, should be automatically voided under its provisions.

## Factual variations

92. While the Commissioner considers s BG 1 does not apply on the simple facts of the arrangement in this scenario, there may be arrangements involving distributions of beneficiary income where the Commissioner may reach a different conclusion.

## Factual variations in relation to Parliament's purposes for the trust rules

93. Different facts may call into question whether Parliament's purposes for the trust rules are being given effect to. On some facts, it will be arguable that no distribution of income to a beneficiary of the trust was made from a commercial or economic perspective and this may be because of artificial or contrived elements or steps in the arrangement or the use of pretence.
94. That is, where it is arguable whether, in commercial or economic reality:
- the beneficiary is a beneficiary of the trust, or
  - a distribution of income was made to the beneficiary.
95. Consideration would need to be given to various facts, including (but not limited to):
- the timing and pattern of the addition or removal of beneficiaries;

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<sup>19</sup> At [111].

<sup>20</sup> *CIR v Challenge Corporation Ltd* [1986] 2 NZLR 513 (CA) at 548–549.

- how and when the income was distributed (eg, whether authorised distributions are paid in cash or credited to beneficiaries' current accounts);
  - any facts indicating that, in commercial and economic reality, parties other than the trustees or the beneficiaries nominated to receive distributions obtain the use and benefit of the income; and
  - any facts indicating that, in commercial and economic reality, there is no realistic prospect of the beneficiaries ever benefiting from the income allocated to them.
96. However, the fact that in any income year the trustees have resolved to pay beneficiary distributions by credit to account and retain the funds for use within the trust would not, on its own, indicate Parliament's purposes for the distribution of beneficiary income were not being given effect to.<sup>21</sup>
97. Although argued under provisions other than the trust rules, *Krukziener (No 3)* is an example of where, in the context of s BG 1, a court clearly considered that the use and benefit of income distributed by trustees was enjoyed by a person other than the beneficiaries nominated to receive the distributions.<sup>22</sup>

### **Factual variations in relation to Parliament's purposes for other provisions**

98. Another situation where the Commissioner may reach a different conclusion is where an arrangement is contrary to Parliament's purposes for provisions of the Act, other than the trust rules. It is not possible to be specific about such arrangements due to the range of arrangements and other provisions of the Act that could arise. It is likely that, unlike the current scenario, such arrangements would involve additional entities and steps that contribute to the potential for these arrangements to be regarded as tax avoidance arrangements.

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<sup>21</sup> However, see footnote 15 regarding s HC 27 and the potential for a beneficiary to be treated as a settlor of the trust.

<sup>22</sup> *Krukziener v CIR (No 3)* (2010) 24 NZTC 24,563 (HC).

## References | Tohutoro

### Legislative References | Tohutoro whakatureture

COVID-19 Response (Taxation and Other Regulatory Urgent Measures) Act 2020  
Income Tax Act 2007: ss BC 4, BC 5, BG 1, CB 1, CV 13(a), CW 9, GA 1, GB 22, HC 6, HC 10, HG 2 to HG 11, subparts IA, IB and IC, IA 2, IA 4, IA 5, IB 3, IZ 8, LE 5, YA 1  
Limited Partnerships Act 2008  
Trusts Act 2019

### Case References | Tohutoro kēhi

*AA Finance v CIR* (1994) 16 NZTC 11,383 (CA)  
*Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115, [2009] 2 NZLR 289  
*CIR v Challenge Corporation Ltd* [1986] 2 NZLR 513 (CA)  
*Frucor Suntory New Zealand Ltd v CIR* [2022] NZSC 113  
*Gartside v IRC* [1968] 1 All ER 121 (HL)  
*Krukziener v CIR (No 3)* (2010) 24 NZTC 24,563 (HC)  
*Penny v CIR* [2011] NZSC 95, [2012] 1 NZLR 433 (also known as *Penny & Hooper*)

### Other References | Tohutoro anō

*Commissioner's Operational Position – New section HC 27(6) – treatment of beneficiary as a settlor in certain circumstances, Tax Information Bulletin Vol 31, No 8* (September 2019): 113  
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## About this document | Mō tēnei tuhinga

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