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TAX INFORMATION
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Inland Revenue
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YOUR OPPORTUNITY TO COMMENT

Inland Revenue regularly produces a number of statements and rulings aimed at explaining how taxation law affects taxpayers and their agents. Because we are keen to produce items that accurately and fairly reflect taxation legislation and are useful in practical situations, your input into the process, as a user of that legislation, is highly valued.

A list of the items we are currently inviting submissions on can be found at **www.ird.govt.nz**. On the homepage, click on "Public consultation" in the right-hand navigation. Here you will find drafts we are currently consulting on as well as a list of expired items. You can email your submissions to us at **public.consultation@ird.govt.nz** or post them to:

Public Consultation
Office of the Chief Tax Counsel
Inland Revenue
PO Box 2198
Wellington 6140

You can also subscribe to receive regular email updates when we publish new draft items for comment.

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INTERPRETATION STATEMENTS

This section of the *TIB* contains interpretation statements issued by the Commissioner of Inland Revenue.

These statements set out the Commissioner's view on how the law applies to a particular set of circumstances when it is either not possible or not appropriate to issue a binding public ruling.

In most cases Inland Revenue will assess taxpayers in line with the following interpretation statements. However, our statutory duty is to make correct assessments, so we may not necessarily assess taxpayers on the basis of earlier advice if at the time of the assessment we consider that the earlier advice is not consistent with the law.

IS 13/01: TAX AVOIDANCE AND THE INTERPRETATION OF SECTIONS BG 1 AND GA 1 OF THE INCOME TAX ACT 2007

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

INTRODUCTION

1. This statement outlines the Commissioner's view of the law on tax avoidance in New Zealand. It sets out the approach the Commissioner will take to ss BG 1 and GA 1 of the Income Tax Act 2007. Section BG 1 is the general anti-avoidance provision in the Act. Section GA 1 enables the Commissioner to make an adjustment as a result of the application of s BG 1.
2. In *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 the Supreme Court indicated it intended to settle the approach regarding the relationship between s BG 1 and the rest of the Income Tax Act. This has been acknowledged in all relevant judicial decisions released since *Ben Nevis*. In particular, the *Ben Nevis* approach was subsequently confirmed as the proper approach to applying s BG 1 by the Supreme Court in *Penny v Commissioner of Inland Revenue* [2011] NZSC 95, [2012] 1 NZLR 433 (litigation known as *Penny & Hooper*). Accordingly, the Commissioner considers that this statement is based upon and reflects the view of the court in *Ben Nevis*.

Previous statements

3. In February 1990 the Commissioner issued a statement on s 99 of the Income Tax Act 1976, the general anti-avoidance provision in the Income Tax Act. It was published as an appendix to the *Tax Information Bulletin*, Vol 1, No 8 (February 1990). That statement set out the Commissioner's view on the function of the section, the relevance of case law and the process the Commissioner would follow when considering invoking the section.
4. A new draft statement was prepared and circulated for external comment during 2004, but that statement was not finalised.
5. These earlier published and draft statements no longer represent the Commissioner's view.

SUMMARY

6. Section BG 1 is only considered after determining whether other provisions of the Act apply or do not apply. That inquiry considers how specific provisions apply to particular parts of the arrangement. The words of a specific provision are interpreted in light of its purpose in accordance with s 5(1) of the Interpretation Act 1999.
7. The inquiry under s BG 1 considers whether the use of the Act is within Parliament's contemplation when viewed in light of the whole arrangement. Section BG 1 applies to arrangements that use or circumvent specific provisions.
8. The Commissioner's approach to analysing and applying s BG 1 is set out in a flow chart that outlines the sequence of analysis undertaken to establish whether an arrangement is a tax avoidance arrangement. This is included at the end of this summary. There are also examples illustrating how the approach is worked through from page 65.

Arrangement

9. Section BG 1 voids a tax avoidance arrangement. An "arrangement" is defined widely and includes formal, legally-enforceable contracts through to informal, unenforceable understandings.
10. An "arrangement":
    - includes "all steps and transactions by which it is carried into effect";
    - can include unilateral arrangements;
    - can comprise two or more documents or transactions together if they constitute a single "agreement, contract, plan or understanding";
    - can include steps or transactions carried out or brought into effect outside of New Zealand.

11. Also, a taxpayer may be considered party to an "arrangement" even if they did not know the details of how the arrangement would be carried out.
12. It is important to fully understand the arrangement, taking into account all pertinent facts and information relating to it. This includes understanding the commercial, private and other (including tax) objectives of the arrangement.
13. The tax effects and tax provisions at issue are then identified. The tax provisions at issue include specific provisions used by the arrangement and any potentially relevant provisions that do not apply to the arrangement.

Tax avoidance

14. The statutory definition of "tax avoidance" is not an exhaustive one. Parliament has left it to the courts to identify tax avoidance, and the function of the statutory definition is to confirm that certain defined circumstances, such as future tax liabilities, are not excluded from the scope of tax avoidance.
15. The Supreme Court in *Ben Nevis* set out the approach to be adopted to determine whether tax avoidance exists. The Commissioner refers to this approach as the Parliamentary contemplation test.
16. The Parliamentary contemplation test asks whether the arrangement, viewed in a commercially and economically realistic way, makes use of the Act in a manner that is consistent with what Parliament would have intended for the provisions that apply (or do not apply) to the arrangement. Applying this test involves identifying:
    - Parliament's purpose regarding the relevant provisions, and
    - the commercial reality and economic effects of the arrangement.
17. The Commissioner considers that the better approach is to identify Parliament's purpose for the relevant provisions first, even though it is recognised that these two aspects of the Parliamentary contemplation test are interrelated and inform each other.

Ascertaining Parliament's purpose regarding the relevant provisions

18. Parliament's purpose for provisions is the result Parliament intended to achieve, or the end Parliament had in mind. There may be multiple purposes. Parliament's purpose for combinations of provisions may need to be identified. It is Parliament's purpose at the time it enacted the provisions that is relevant. The test is not to discern whether Parliament contemplated the actual arrangement with all its steps and transactions. Instead, the question is a hypothetical one.
19. How Parliament's purpose is identified will depend on how the Act applies or does not apply to the arrangement. In some cases, the focus will be on the text of a particular provision. In others, a broader examination of the Act may be required to identify Parliament's purpose. Sometimes extrinsic materials and case law may help when reaching a view on Parliament's purpose for particular provisions.
20. Once Parliament's purpose for particular provisions has been ascertained, the facts, features and attributes required to be present (or absent) to give effect to Parliament's purpose for those provisions must be identified.

The commercial and economic reality

21. The commercial and economic reality of an arrangement is examined to see whether the use of the provisions is within Parliament's purpose. In particular, the arrangement is examined to see whether the facts, features and attributes required to give effect to Parliament's purpose for the provisions in question are in fact present (or absent).
22. Understanding what is actually achieved requires a complete understanding of the facts and a thorough grasp of the detail and workings of the arrangement as a whole. Identification of the commercial reality and economic effects is not limited by the form of the arrangement, nor does it involve identifying an arrangement that is economically equivalent.
23. Considering the commercial reality and economic effects of the arrangement may identify further relevant provisions or raise further questions as to Parliament's purpose for provisions already identified. If necessary, repeat these steps until Parliament's purpose has been sufficiently ascertained.
24. Determining whether a tax avoidance arrangement exists involves considering various factors, including the:
    - manner in which the arrangement is carried out;
    - role of all relevant parties and their relationships;
    - economic and commercial effect of documents and transactions;
    - duration of the arrangement;
    - nature and extent of the financial consequences;
    - presence of artificiality or contrivance;
    - presence of pretence;
    - presence of circularity;

- presence of inflated expenditure or reduced levels of income;
- undertaking of real risks by the parties;
- relevance of an arrangement being pre-tax negative.

The relevance of these factors will depend on the provisions used or circumvented and what facts, features and attributes Parliament would expect to be present (or absent).

Applying the Parliamentary contemplation test

25. The question is then, taking into account all of the above, does the arrangement, viewed in a commercially and economically realistic way, use (or circumvent) the relevant provisions in a manner that is consistent with Parliament's purpose? It may be necessary to exercise judgement over whether any of the requisite facts, features and attributes are present or absent to a sufficient degree.

Not all complex fact situations or undesirable policy outcomes amount to tax avoidance

26. Even when an arrangement is complex or unusual, or produces tax results that may be undesirable from a policy perspective, it may not be a tax avoidance arrangement. Taxpayers may structure arrangements to their best tax advantage, provided the use of the provisions is within what Parliament would have contemplated. However, literal compliance with provisions is not sufficient to establish that the use is within Parliament's contemplation.

Merely incidental

27. The merely incidental test applies to an arrangement that has a tax avoidance purpose or effect as one of its purposes or effects. It provides that even though the arrangement has a tax avoidance purpose or effect, it will not be a tax avoidance arrangement if the tax avoidance purpose is merely incidental to a non-tax avoidance purpose.

28. A "merely incidental" tax avoidance purpose or effect is something which follows from or is necessarily and concomitantly linked to, without contrivance, some other purpose or effect. Such a purpose is determined objectively by reference to the arrangement itself and not subjectively in terms of motive.

29. Purposes that are general in nature and do not explain the adoption of the specific structure of the arrangement will not establish that the tax avoidance purpose is merely incidental.

30. The merely incidental test is unlikely to apply where an arrangement that uses specific provisions in a way not contemplated by Parliament has been structured to gain a tax advantage in an artificial and contrived way.

Section GA 1 adjustment

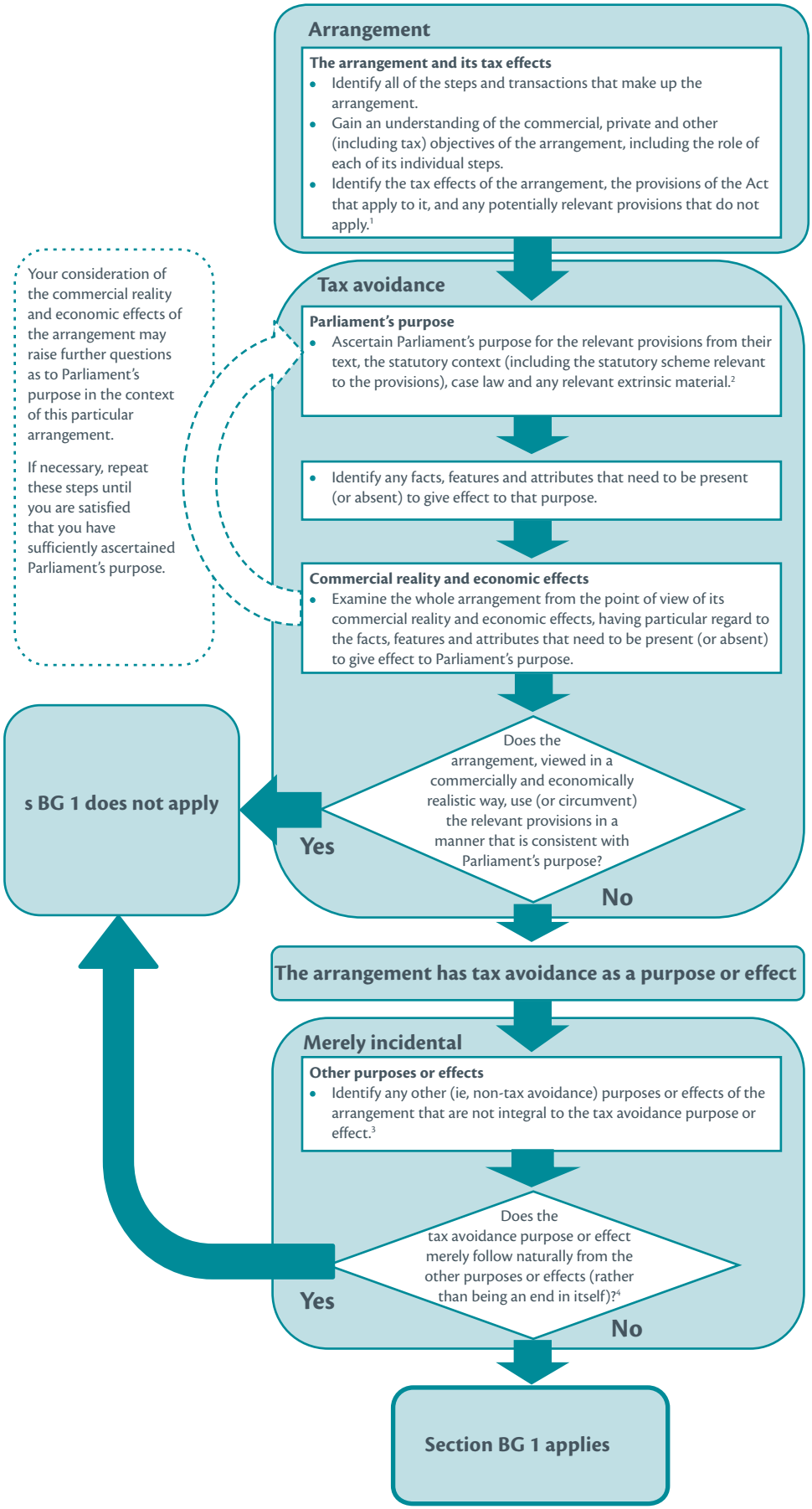
31. When the voiding of an arrangement under s BG 1 appropriately counteracts the tax advantages, and does no more than that, then the Commissioner will not be required to apply s GA 1. However, if the voiding has not appropriately counteracted the tax avoidance, or the voiding has removed legitimate outcomes, or there are consequential adjustments that need to be made, the Commissioner is required to apply s GA 1.

32. The Commissioner has a broad discretion as to the adjustments that can be made to counteract the tax advantage. There is no duty to describe precisely the actual basis for an adjustment. Further, the Commissioner may adjust the taxable income of any person affected by the arrangement. A person can be affected by an arrangement whether they are a party to the arrangement and whether they are aware that they benefited from a tax avoidance arrangement.

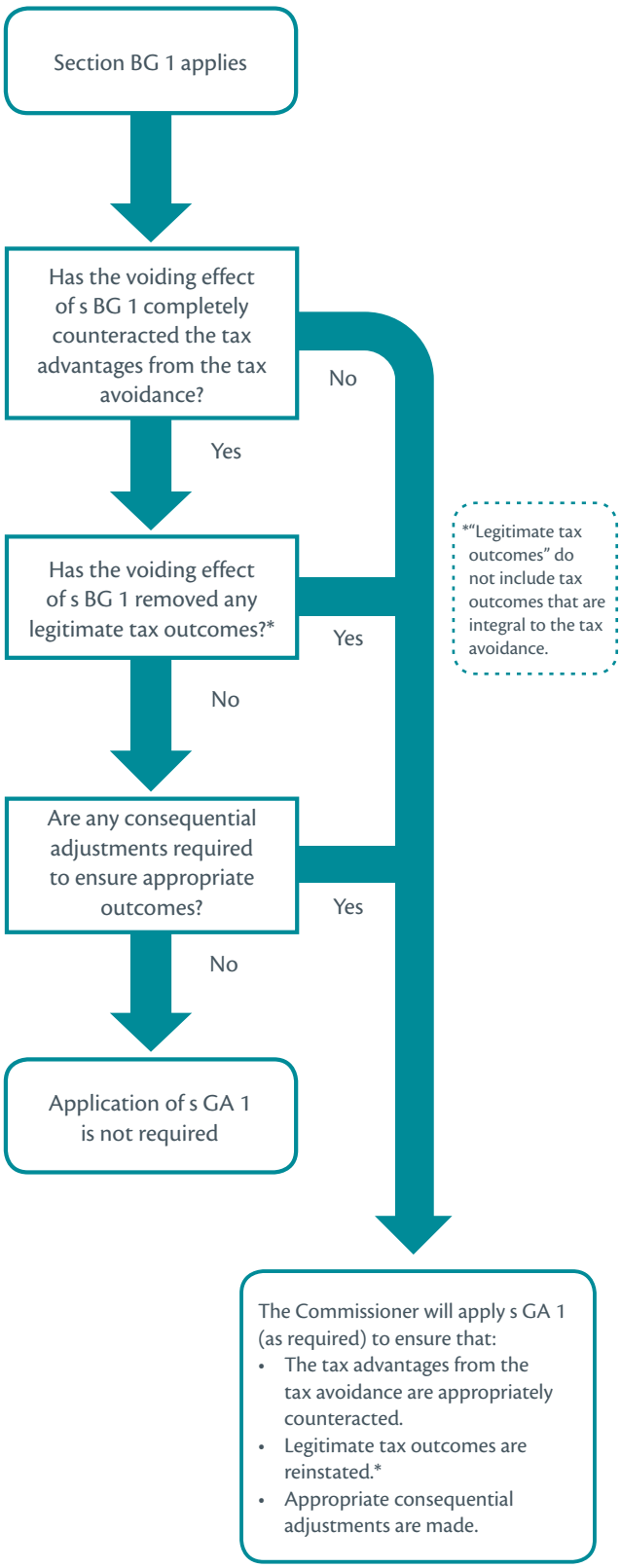
Flow Charts

33. The following flow chart illustrates the steps the Commissioner considers should be taken when analysing whether s BG 1 applies to an arrangement. It is followed by a further flow chart setting out the steps the Commissioner considers should be taken in applying s GA 1.

Section BG 1: a suggested approach



Approach to s GA 1



LEGISLATION

34. The general anti-avoidance provisions of the Income Tax Act 2007 are in ss BG 1 and GA 1, with relevant terms defined in s YA 1.

35. Many cases on tax avoidance refer to the predecessors to ss BG 1 and GA 1—ss BG 1 and GB 1 of the Income Tax Act 2004, ss BG 1 and GB 1 of the Income Tax Act 1994, s 99 of the Income Tax Act 1976 and s 108 of the Land and Income Tax Act 1954.

36. The relevance of those cases to the interpretation of the current provisions will sometimes depend upon the words used in the corresponding repealed provisions. In some instances the relevant wording is the same or similar and the cases remain authoritative. However, more recent court decisions have taken different views as to the meaning to be given to the wording. The most recent authoritative decision is the decision of the Supreme Court in *Ben Nevis*. The court indicated it intended to settle the approach that should be applied to the inter-relationship of the general anti-avoidance provision with specific provisions (at [100]). Therefore, to the extent that earlier decisions are inconsistent with *Ben Nevis* on that issue, they are no longer relevant.

37. The general anti-avoidance provisions of the 2007 Act and related provisions are as follows:

> **BB 3 Overriding effect of certain matters**
>
> *Tax avoidance arrangements: subpart BG*
>
> (1) Under Part G (Avoidance and non-market transactions), the Commissioner may counteract a tax advantage from a tax avoidance arrangement.
>
> **BG 1 Tax avoidance**
>
> *Avoidance arrangement void*
>
> (1) A tax avoidance arrangement is void as against the Commissioner for income tax purposes.
>
> *Reconstruction*
>
> (2) Under Part G (Avoidance and non-market transactions), the Commissioner may counteract a tax advantage that a person has obtained from or under a tax avoidance arrangement.
>
> **GA 1 Commissioner's power to adjust**
>
> *When this section applies*
>
> (1) This section applies if an arrangement is void under section BG 1 (Tax avoidance).
>
> *Commissioner's general power*
>
> (2) The Commissioner may adjust the taxable income of a person affected by the arrangement in a way the Commissioner thinks appropriate, in order to counteract a tax advantage obtained by the person from or under the arrangement.

Commissioner's specific power over tax credits

(3) The Commissioner may—

(a) disallow some or all of a tax credit of a person affected by the arrangement; or

(b) allow another person to benefit from some or all of the tax credit.

Commissioner's identification of hypothetical situation

(4) When applying subsections (2) and (3), the Commissioner may have regard to 1 or more of the amounts listed in subsection (5) which, in the Commissioner's opinion, had the arrangement not occurred, the person—

(a) would have had; or

(b) would in all likelihood have had; or

(c) might be expected to have had.

Reconstructed amounts

(5) The amounts referred to in subsection (4) are—

(a) an amount of income of the person:

(b) an amount of deduction of the person:

(c) an amount of tax loss of the person:

(d) an amount of tax credit of the person.

No double counting

(6) When applying subsection (2), if the Commissioner includes an amount of income or deduction in calculating the taxable income of the person, it must not be included in calculating the taxable income of another person.

Meaning of tax credit

(7) In this section, tax credit means a reduction in the tax a person must pay because of—

(a) a credit allowed for a payment by the person of an amount of tax or of another item; or

(b) another type of benefit.

YA 1 Definitions

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

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

tax avoidance arrangement means an arrangement, whether entered into by the person affected by the arrangement or by another person, that directly or indirectly—

(a) has tax avoidance as its purpose or effect; or

(b) has tax avoidance as 1 of its purposes or effects, whether or not any other purpose or effect is referable to ordinary business or family dealings, if the tax avoidance purpose or effect is not merely incidental.

THE ROLE OF SECTION BG 1 IN THE INCOME TAX ACT

38. Section BG 1 is a core provision of the Income Tax Act. It applies to an arrangement that has a tax avoidance purpose or effect. It also applies to an arrangement that has tax avoidance as one of its purposes or effects that is more than merely incidental, whether or not any other purpose or effect is referable to ordinary business or family dealings. The section is self-activating in that it does not require the Commissioner's intervention for it to apply. Under s BG 1 a tax avoidance arrangement is void against the Commissioner for income tax purposes. Where an arrangement is void under s BG 1, s GA 1 may operate to allow the Commissioner to counteract the tax advantage that would otherwise have been obtained through the voided arrangement. It follows that, where there is a tax avoidance arrangement, s BG 1 applies to deny the result under the Act that would otherwise apply.

39. Woodhouse P in *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 at 529 (CA) described the role of the section at 532:

> But be that as it may s 99 is obviously a central pillar of the income tax legislation (to use the language of counsel for Challenge in accepting the fact) and a reflection of the firm and understandable conclusion of Parliament that there must be a weapon able to thwart technically correct but contrived transactions set up as a means of exploiting the Act for tax advantages.

40. The Supreme Court put it this way in *Ben Nevis* at [106]:

> The general provision is designed to avoid the fiscal effect of tax avoidance arrangements having a more than merely incidental purpose or effect of tax avoidance. Its function is to prevent uses of the specific provisions which fall outside their intended scope in the overall scheme of the Act. Such uses give rise to an impermissible tax advantage which the Commissioner may counteract. The general anti-avoidance provision and its associated

> reconstruction power provide explicit authority for the Commissioner and New Zealand courts to avoid what has been done and to reconstruct tax avoidance arrangements.

41. And in *Penny* (SC) the Supreme Court said at [47]:

> [The New Zealand general anti-avoidance provision] continues to have work to do whenever a taxpayer uses specific provisions of the Act and otherwise legitimate structures in a manner which cannot have been within the contemplation of Parliament. The policy underlying the general anti-avoidance provision is to negate any structuring of a taxpayer's affairs whether or not done as a matter of "ordinary business or family dealings" unless any tax advantage is just an incidental feature.
>
> [Footnote omitted]

The relationship between section BG 1 and the rest of the Act

42. Section BG 1 voids tax avoidance arrangements and s GA 1 counteracts the tax outcomes that would otherwise apply. Consequently, an issue arises about the relationship between s BG 1 and the rest of the Act. The issue is that, read literally, the anti-avoidance provision would strike down any transaction that has the effect of reducing tax.

43. Determining the correct approach to take to reach a view on whether s BG 1 applies or the other provisions of the Act operate, has been difficult for taxpayers and their agents, the Commissioner and the courts. This is reflected in the fact that the courts in several leading cases have used different approaches to reach a view on whether an arrangement is a tax avoidance arrangement. In a dissenting judgment delivered in 1970 in *Mangin v Commissioner of Inland Revenue* [1971] NZLR 591 (PC), Lord Wilberforce outlined problems he saw with the general anti-avoidance provision, including at 602:

> (c) It fails to specify the relation between the section and other provisions in the Income Tax legislation under which tax reliefs, or exemptions, may be obtained. Is it legitimate to take advantage of these so as to avoid or reduce tax? What if the only purpose is to use them? Is there a distinction between "proper" tax avoidance and "improper" tax avoidance? By what sense is this distinction to be perceived?

44. In *Challenge* (CA) Woodhouse P made the same point at 532:

> A criticism levelled at s 99, as it has been levelled at the earlier s 108, is that on its face the language is so encompassing when read literally that major qualifications must be read into it if various deduction and other provisions of the Act are to be left effective. It cannot have been the purpose of the legislature, so it is said, to import into the Income Tax Act a general provision so spacious in operation that other sections would be virtually impotent.

See also *Elmiger v Commissioner of Inland Revenue* [1966] NZLR 683 (SC) at 687–688, *Challenge* (CA) Cooke J at 541, and Richardson J at 548, *Commissioner of Inland Revenue v BNZ Investments Ltd* [2002] 1 NZLR 450 (CA) [*BNZ Investments No 1* (CA)] at [40].

45. Most recently, the relationship between the specific provisions and the general anti-avoidance provision was the central issue for the Supreme Court in *Ben Nevis* (see [12], [83] and [100]). The court described the problem in this way:

> [12] The expanded provision, and its successors, did not, however, explicitly resolve a central issue that had arisen with s 108 of the 1954 Act. That was the relationship between the general anti-avoidance provision and the many "specific provisions" that allow tax concessions, principally through authorising deductions and depreciation allowances. Taxpayers enter into many transactions which have been structured with the purpose of taking advantage of specific provisions in order to reduce tax. While the general anti-avoidance provision is expressed broadly, its purpose cannot be to strike down arrangements which involve no more than appropriate use of specific provisions. On the other hand, strict compliance with the requirements of specific provisions cannot have been intended to immunise all arrangements involving their use against being categorised as tax avoidance arrangements, which it was the purpose of the general provision to avoid.
>
> [13] The present appeals are the first occasion this Court has had to consider when use of specific provisions will amount to proscribed tax avoidance. There is little explicit guidance in the legislation and the current case law has become complex, through being encumbered by considerations and tests that the legislation does not specify. Through a process of interpretation of all the relevant statutory provisions, we must identify a means for determining where permissible use of specific provisions ends and tax avoidance begins.

46. The Supreme Court in *Ben Nevis* acknowledged that the tax legislation does not explicitly address how to discern the relationship between allowing tax concessions for certain arrangements and applying the general anti-avoidance provision. After considering the various approaches adopted by the courts during the last twenty years, the majority concluded that in the face of continuing uncertainty it was desirable for the Supreme Court to settle the approach that should be applied (see *Ben Nevis* at [100]). The Supreme Court's approach is discussed from paragraph 193 of

this statement. In short, it is to determine whether the use of the Act is consistent with Parliament's purpose when the arrangement is viewed in a commercially and economically realistic way.

Using and circumventing provisions, and specific and general provisions

47. Section BG 1 can only apply if an arrangement is first subject to the other provisions of the Income Tax Act. In coming to a view on whether the tax provisions apply as claimed or s BG 1 applies, it is important to appreciate that a view may be required to be reached not only as to how particular sections apply (eg, the application of the financial arrangements rules to a particular loan structure), but also as to which sections an arrangement ensures do not apply (eg, sections applying to certain types of leases that the arrangement does not fall within). This is because, when the further inquiry is made under s BG 1, a decision must be reached not only on whether certain provisions apply, but also on whether certain provisions do not apply, in a way Parliament would have contemplated. Thus, some tax avoidance arrangements involve the positive utilisation of specific provisions in a way Parliament did not contemplate. Other tax avoidance arrangements have the effect that provisions of the Act do not apply at all, contrary to what Parliament contemplated for those provisions. The first type of arrangement might be said to involve a use of provisions and the second a circumvention.

48. In *Ben Nevis*, the facts involved the use of provisions rather than their circumvention. The taxpayers in that case argued that certain provisions of the Income Tax Act 1994 applied—s EG 1, which allowed a deduction for depreciation, and s DL 1(3), which provided for a deduction for insurance premiums. At [107], the court made it clear that the case before it concerned the use of particular specific provisions:

> [107] When, as here, a case involves reliance by the taxpayer on specific provisions, the first inquiry concerns the application of those provisions.

The court did not have to consider an arrangement that involved the circumvention of provisions.

49. However, the same approach adopted by the Supreme Court in *Ben Nevis* applies equally to arrangements that circumvent the Act. In the Commissioner's view, there is no logical reason or policy consideration why s BG 1 will not apply to an arrangement that was not within Parliament's contemplation because it circumvents the Act, as opposed to an arrangement that positively utilises particular provisions.

50. Other arrangements employ lawful structures recognised in the Act but use them in ways not contemplated by Parliament. One step in an otherwise unobjectionable arrangement might give rise to a tax advantage that was not intended by Parliament. In *Penny* (SC), the court said:

> [33] This case differs from *Ben Nevis*, in which this Court explained the proper approach to questions of tax avoidance. Here there can be no question of the taxpayers failing to comply with specific taxation provisions. The structure both taxpayers adopted when they transferred their businesses (orthopaedic practices) to companies owned by their family trusts was, as a structure, entirely lawful and unremarkable. The adoption of such a familiar trading structure cannot per se be said to involve tax avoidance. It was a choice the taxpayers were entitled to make. Nor is there anything unusual or artificial in a taxpayer then causing the company under his control to employ him on a salaried basis. What is said by the Commissioner to constitute tax avoidance is the fixing of the salaries at artificially low levels whereby the incidence of tax at the highest personal rate was avoided.

51. The court went on to conclude that fixing the taxpayer's salary in an artificial manner in combination with the operation of other features of the structure had the effect that the arrangement was a tax avoidance arrangement (at [34] and [47]).

52. *Russell v Commissioner of Inland Revenue (No 2)* (2010) 24 NZTC 24,463 (HC) was another example of an arrangement that used lawful structures in a way Parliament did not contemplate. In *Russell*, Wylie J observed that the taxpayer did not place reliance on any specific provision (at [106]). The arrangement in that case involved complicated arrangements incorporating payments between companies, partnerships and other companies that had losses. Although they were legitimate corporate and trust structures, the way those structures were used meant that, without the operation of s BG 1, the taxpayer was not taxed on income he earned through his personal exertion (at [115] and [116]).

53. It might also be that a single arrangement has the effect of *both* using and circumventing provisions in a way Parliament did not contemplate. Further, tax avoidance arrangements might involve either the use of general provisions, such as the general deductibility provision, or a particular detailed provision in the Act. In the same way, arrangements that circumvent provisions might circumvent general provisions, such as those establishing all income is taxed or general timing provisions, or they might circumvent a detailed set of specific provisions in the Act.

54. As will be explained later, the approach in *Ben Nevis* sets out how to decide whether s BG 1 or the other provisions of the Act apply. The Commissioner's opinion is that this approach applies to all of the categories of tax avoidance arrangement identified in paragraphs 47 to 53 above. In other words, the approach is not limited solely to arrangements that use specific provisions to achieve tax advantages, but will also apply when arrangements circumvent provisions to achieve similar advantages. Equally, the approach is not limited to specific, as opposed to general, provisions.

PROVISIONS OF THE ACT OTHER THAN SECTION BG 1

55. Section BG 1 is only considered after reaching a view on whether the other, more specific, provisions of the Act apply or do not apply. This inquiry as to the application of the other provisions is a separate inquiry that must be made before considering the application of s BG 1. This section of this statement discusses the approach to interpreting the other provisions and how that differs from the approach to applying s BG 1. It then discusses whether it must be established that those other provisions apply in a dispute.

Approach to interpretation

56. Legislation is interpreted in accordance with s 5(1) of the Interpretation Act 1999, which provides that the meaning of an enactment "must be ascertained from its text and in the light of its purpose": see *Commerce Commission v Fonterra Co-operative Group Ltd* [2007] NZSC 36, [2007] 3 NZLR 767. The Supreme Court in that case stated at [22] and [24] (footnotes included):

> [22] It is necessary to bear in mind that s 5 of the Interpretation Act 1999 makes text and purpose the key drivers of statutory interpretation. The meaning of an enactment [10] must be ascertained from its text and in the light of its purpose. Even if the meaning of the text may appear plain in isolation of purpose, that meaning should always be cross checked against purpose in order to observe the dual requirements of s 5. In determining purpose the Court must obviously have regard to both the immediate and the general legislative context. Of relevance too may be the social, commercial or other objective of the enactment.[11]
>
> [24] Where, as here, the meaning is not clear on the face of the legislation, the Court will regard context and purpose as essential guides to meaning.
>
> [Footnotes: [10] "Enactment" means "the whole or a portion of an Act or regulations" (see s 29 of the Interpretation Act 1999); [11] See generally *Auckland City Council v Glucina* [1997] 2 NZLR 1 (CA) at p 4 per Blanchard J for the Court, and Burrows, *Statute Law in New Zealand* (3rd ed, 2003), p 146 and following.]

57. While *Fonterra* was not a tax case, its approach is consistent with the most recent appellate decision on how tax legislation is to be interpreted in *Commissioner of Inland Revenue v Alcan New Zealand Ltd* [1994] 3 NZLR 439 (CA). In *Alcan* at 444, the Court of Appeal held that tax legislation is to be interpreted in the same way as other types of legislation and, as such, it must be given a meaning that is "consonant with the words used, having regard to their context in the Act as a whole, and to the purpose of the legislation to the extent that this is discernible".

58. The approach to statutory interpretation of legislative provisions used by an arrangement should give effect to those provisions.

59. In the context of discussing the approach to establishing the relationship between s BG 1 and the other sections of the Act, the court in *Ben Nevis* said the following about interpreting the other sections of the Act:

> [102] It is accordingly the task of the Courts to apply a principled approach which gives **proper overall effect to statutory language** that expresses different legislative policies. It has long been recognised those policies require reconciliation. The approach must ensure that the particular case before the court is examined by reference to the respective legislative policies. It must enable decisions to be made on individual cases through the application of a process of statutory construction focusing objectively on features of the arrangements involved, without being distracted by intuitive subjective impressions of the morality of what taxation advisers have set up.
>
> [103] We consider Parliament's overall purpose is best served by construing specific tax provisions and the general anti-avoidance provision so as to **give appropriate effect to each**. They are meant to work in tandem. Each provides a context which assists in determining the meaning and, in particular, the scope of the other. Neither should be regarded as overriding. Rather they work together. The presence in the New Zealand legislation of a general anti-avoidance provision suggests that our Parliament meant it to be the principal vehicle by means of which tax avoidance is addressed. The general anti-avoidance regime is designed for that purpose, whereas individual specific provisions have a focus which is determined primarily by their ordinary meaning, as established through their text in the light of their specific purpose. In short, the purpose of specific provisions must be distinguished from that of the general anti-avoidance provision.
>
> [Emphasis added]

60. And, the court said:

> [107] When, as here, a case involves reliance by the taxpayer on specific provisions, the first inquiry concerns the application of those provisions. The taxpayer must satisfy the Court that **the use made of the specific provision is within its intended scope**. If that is shown, a further question arises based on the taxpayer's use of the specific provision viewed in the light of the arrangement as a whole.
>
> [Emphasis added]

61. Thus, the inquiry into whether a specific provision applies is undertaken so as to be satisfied that the use made of a specific provision is within its *intended scope*. This inquiry takes place before any consideration of s BG 1 is undertaken. The approach to the specific provisions should therefore give effect to Parliament's intention for the provision. JF Burrows and RI Carter *Statute Law in New Zealand* (4th ed, LexisNexis, Wellington, 2009) state at 201–202 that words should be given a liberal interpretation to ensure the purpose of the legislation is achieved, and hand in hand with that is the:

> ... desire to examine the text of the Act in context. A section should be read in the context of the Act as a whole (the "scheme of the Act" as it is often called), and it is permissible to consult a much wider range of extrinsic materials than was once the case to understand the background to the Act and what its framers were trying to achieve by it.

62. Burrows also states that, however far the purposive approach extends, the actual words of the Act remain the most important single factor in statutory interpretation. However, the meaning is not the narrow purely literal meaning, but the most natural meaning of the words in the context and taking into account their purpose.

The relevance of the approach of English cases to interpreting tax legislation

63. To understand the approach to interpreting provisions other than s BG 1, it is relevant to consider what the Supreme Court in *Ben Nevis* said about certain English cases. The United Kingdom does not have a general anti-avoidance provision, and the courts there have developed ways of analysing transactions to give effect to Parliament's intention where avoidance is an issue: *W T Ramsay Ltd v Inland Revenue Commissioners* [1982] AC 300 (HL), *Furniss (Inspector of Taxes) v Dawson* [1984] AC 474 (HL), *MacNiven (HM Inspector of Taxes) v Westmoreland Investments Ltd* [2001] UKHL 6, [2003] 1 AC 311 and subsequent cases. This approach has allowed courts in recent years to take a more purposive approach to interpreting the statutory provisions, including taking into account the economics of an arrangement.

64. The minority in *Ben Nevis* considered that this approach applies in New Zealand. They wrote separately to express their reservations on the approach of the majority to the interpretation of the specific provisions. The minority's view was at [5]:

> We do not therefore accept that when considering the application of a specific tax provision, and before considering the question of avoidance, the Court is concerned primarily with the legal structures and obligations created by the parties, and not with the economic substance of what they do.

65. The majority, on the other hand, distinguished the English cases (at [110]). The majority considered that the English decisions were of limited assistance because, due to the lack of a general anti-avoidance provision, they were not concerned with reconciling potentially conflicting provisions.

66. The majority's view was, therefore, that although the English cases would suggest a more purposive approach should be taken to interpreting tax legislation than in the past, in New Zealand this means giving words their ordinary meaning in the context and taking into account their purpose. Generally the Income Tax Act taxes on the basis of the legal rights and obligations of parties based on the legal form. However, there may be instances where the statutory provisions require that in certain circumstances the substance of a transaction is taken into account: see *Sovereign Assurance Company Ltd v Commissioner of Inland Revenue* [2012] NZHC 1760, (2012) 25 NZTC ¶20–138. In the absence of such a statutory requirement, that is the role of s BG 1, as stated in *Ben Nevis* at [110]:

> A purposive approach is, in any event, limited in the extent to which it can avoid arrangements on its own. Such an approach is, however, reinforced in New Zealand by the presence in our legislation of the general anti-avoidance provision.

Whether the general anti-avoidance provision can apply when there are potentially applicable specific anti-avoidance provisions

67. It is sometimes argued that if a specific anti-avoidance provision has been enacted for a set of tax provisions, there is no scope for s BG 1 to apply because Parliament has made clear the type of arrangements it is not comfortable with. However, s BG 1 may apply even if there is a specific anti-avoidance provision that accompanies the provisions used or circumvented. The purpose of a specific anti-avoidance provision is to ensure that tax outcomes will not be as claimed in

certain defined circumstances. It does not implicitly rule out the application of s BG 1.

68. The taxpayer in *Challenge* (CA) argued that the presence of a specific anti-avoidance provision meant Parliament must, by implication, accept tax avoidance of a kind different than that covered by the specific provision. The Privy Council in *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 at 555 (PC) disagreed and said at 559:

> A likely explanation is that Parliament was indifferent to or unmindful of any overlap between the general provisions of s 99 and the particular provisions of s 191(1)(c)(i) or that, in view of the well known difficulties encountered in the formulation and enforcement of effective anti-tax avoidance provisions, Parliament thought that an overlap might be useful and could not be harmful. Parliament may have had in mind two different tax avoidance positions.

69. Section BG 1 may apply to the same or a similar situation as that covered by a specific provision. Section BG 1 might apply in a situation close to that covered by a specific anti-avoidance provision where, for example, the arrangement has the effect of carefully circumventing the scope of a specific anti-avoidance provision. Section BG 1 might also apply to arrangements that avoid tax in a different way than that covered by the specific anti-avoidance provision. In *Challenge* (PC), the Privy Council suggested some different scenarios that would avoid tax in a different way than was covered by the specific anti-avoidance provision. The Privy Council concluded that a construction of a specific anti-avoidance provision that 'silently repeals' the general anti-avoidance provision would be unlikely.

70. A similar view was taken by the Supreme Court in *Penny* (SC). The taxpayer argued that the existence of some special anti-avoidance rules for related party transactions, including the personal services attribution rules, left no room for the operation of s BG 1 in their case (at [45]). The Supreme Court rejected this argument, saying:

> [48] Nor, as the *Challenge* case shows, does the existence in the PSA rules and the cross-border services rules of some specific anti-avoidance provisions have the consequence that s BG 1 cannot operate where the tax avoidance arrangement employed by a taxpayer does not fall within those specific rules. The Select Committee Report on the Taxation (Annual Rates, GST and Miscellaneous Provisions) Bill commented that the PSA rules (which it called the attribution rule) "supports the general anti-avoidance provisions of the Income Tax Act 1994". The legislators thus recognised that the latter would continue to do their residual work, but no doubt with the hope that the delay and cost involved in using them could be obviated in specifically targeted situations. Unless the specific rules plainly are intended to cover the field in relation to the use of particular provisions by taxpayers or plainly exclude the use of the general anti-avoidance provision in a certain situation — which is not so here — then the Commissioner can rely upon s BG 1 to counter avoidance where that has occurred.

71. The court said there may be instances where the specific rules plainly are intended to cover the field or plainly exclude the use of the general anti-avoidance provision. Whether this is the case will be a matter of statutory interpretation, and it will need to be clear that Parliament intended to limit the use of s BG 1 in the situation. Given the approach taken by the courts in *Challenge* (PC) and *Penny* (SC) to arguments about specific anti-avoidance provisions, it will be unlikely that a taxpayer could argue successfully that Parliament has expressed the intention to exclude the operation of s BG 1 without statutory words supporting that conclusion.

Whether parts or the whole of the arrangement is considered when applying the sections of the Act other than section BG 1

72. When considering the application of sections of the Act other than s BG 1, the focus is on a particular section. The inquiry is limited to the particular part of the arrangement to which the provisions other than s BG 1 apply.

73. In contrast, as the court said in *Ben Nevis*, the role of s BG 1 is to examine the use made of the Act "viewed in the light of the arrangement as a whole" (at [107]). The focus is on understanding the arrangement in a commercially and economically realistic way. As the exercise involves looking at the whole arrangement, it may often involve examining the combination of steps by which it is carried out (see *Ben Nevis* at [105]). This may mean that sections and parts of the Act used are considered together that may not be considered together when reaching a view on the application of the specific provisions standing alone. Whether the exercise under s BG 1 will involve considering Parliament's purpose for a single provision, a combination of provisions, or the Act as a whole, will depend on the use the arrangement makes of the provisions. This last point is considered later in this statement under the heading "Parliament's purpose regarding the relevant provisions".

74. Wild J in *BNZ Investments Ltd v Commissioner of Inland Revenue* (2009) 24 NZTC 23,582 (HC) [*BNZ Investments No 2* (HC)] discussed the difference in approach:

> [122] I read *Ben Nevis* as requiring the court, at step 1, to undertake a discrete inquiry, determining whether the taxpayer has complied with the specific provisions, interpreted as directed by the court in the latter part of [103]. The court is engaged in interpreting the specific provisions standing alone, rather than in interpreting them in the context of the whole legislative scheme. If compliance is not conceded, the court must analyse the transaction and decide whether it complies with the applicable specific provisions.
>
> ...
>
> [125] At step 2 the focus shifts to a purposive interpretation of the specific provisions in the context of [the] legislative scheme as a whole.

75. In the Commissioner's view, Wild J was primarily emphasising the broader enquiry that is made under s BG 1 in comparison to the inquiry into sections of the Act that are not connected other than by the arrangement. Wild J was making the point that under s BG 1 it might be necessary to identify Parliament's purpose for combination of sections and parts of the Act that would not otherwise be considered together.

76. Determining whether s BG 1 applies involves looking at the whole arrangement, even though the objectionable use of the Act may be found in only one step of the arrangement. In *Penny* (SC), the court said that the use of the company and trust structure was unremarkable. However, a single step in the arrangement—an artificially low level of salary paid to the taxpayers—meant the arrangement was a tax avoidance arrangement. The court also looked at the whole arrangement to establish that the reality was that, although the taxpayers on the face of it received less salary, when the whole arrangement was looked at it could be seen that the taxpayers suffered no actual loss of income as they received the amounts through their family trusts.

Whether in a dispute it must be established the other provisions of the Act apply

77. As previously noted, s BG 1 applies when other provisions of the Act apply, or the application of potentially relevant provisions have been ruled out. Therefore, it must first be determined whether other provisions of the Act apply (or do not apply). However, in a dispute it is open to the Commissioner to argue that provisions of the Act apply in a certain way and also, in the alternative, that s BG 1 will apply. For example, the Commissioner might argue an amount is not deductible but also that, if the Commissioner is found to be wrong on that view, in the alternative s BG 1 would apply.

78. It might be thought this would mean the Commissioner was simultaneously holding contradictory views of the facts and the application of the law. The Commissioner's view is that it is open to the Commissioner to argue s BG 1 in the alternative. Harrison J approached his judgment in this way in *Westpac* where he said:

> [314] Accordingly, I am satisfied that the Commissioner has correctly disallowed Westpac's deductions for the GPFs. They were not paid according to a "financial arrangement" or in deriving gross income. In my judgment Westpac's use of the deductibility provisions was not within their ordinary meaning and scope in the light of their specific purposes.
>
> [315] That finding is not, however, determinative of the proceeding. I must still consider Westpac's claim that, regardless of the lawfulness of its GPF deductions, the transactions are not tax avoidance arrangements and, even if they are, that the Commissioner has wrongfully reconstructed them. In fiscal terms, the consequences are potentially much greater than disallowing the bank's total deductions for GPF expenditure. On the Commissioner's case, they extend to the lawfulness of all the bank's deductions claimed for the cost of funds.

79. This is consistent with the approach of the Court of Appeal in *Miller v Commissioner of Inland Revenue* [1999] 1 NZLR 275 (CA) when the court was considering whether the Commissioner can make an assessment that is inconsistent with an earlier assessment of a different taxpayer. The court said that although ultimately the assessments must be consistent, the Commissioner is allowed some flexibility in the timing of the adjustments to meet administrative demands and to enable the Commissioner to await the outcome of objection proceedings (at 292).

80. If a taxpayer's argument based on the application of some particular provisions of the Act fails, there may be no need or scope for the application of s BG 1 in relation to those particular provisions. However, even if some part of an arrangement does not, on closer examination, comply with some particular provisions of the Act (without considering s BG 1), s BG 1 may still apply to the arrangement as a whole in relation to some other use or circumvention of the Act. If this was not the case, it might be argued that, as some part of the arrangement does not comply with one or more

of the other provisions of the Act, this precludes the application of s BG 1 to the arrangement as a whole.

81. Authority for the position that s BG 1 can still apply in such cases can be found in *Westpac* at [187] to [189] where Harrison J said:

> [187] However, taking [107] as a whole and in context, I do not read *Ben Nevis* as mandating that the avoidance inquiry will not proceed unless the taxpayer shows that the use made of a specific provision is within its intended scope. I construe the first three sentences in [107] as reinforcing the court's point made in [106] that proof of a taxpayer's compliance with a specific provision does not exclude the scope for a wider inquiry into the arrangement as a whole. Wild J, when postulating a distinctive two step inquiry, was apparently of the same opinion: *BNZ Investments (No 2)* at [122] and [123].
>
> [188] An anomaly would arise otherwise; for example, a court might disallow a claim for a relatively minor deduction, thus barring it from proceeding to an avoidance inquiry into the transaction as a whole. That result would be contrary to the way the Commissioner has argued his case and to *Miller v C of IR*; *Managed Fashions Ltd v C of IR* (1998) 18 NZTC 13,961; [1999] 1 NZLR 275 (CA) at NZTC 13,977; NZLR 298–299.
>
> [189] There may be cases where the taxpayer's misuse of a specific provision is so extreme or clear cut that a finding of tax avoidance will inevitably follow. But a wider inquiry will necessarily be appropriate where the arrangement involves a number of composite or interdependent steps, including the step which is the subject of a disputed deductibility claim. Its resolution will not normally be decisive of the avoidance inquiry.

Summary

82. The approach to interpreting provisions of the Act should give proper effect to Parliament's intention for those provisions. The approach is to ascertain the meaning of an enactment from its text and in the light of its purpose. This is done by giving the words their ordinary meaning and taking into account the purpose of the legislation and its context, and, where appropriate, extrinsic materials, in accordance with normal statutory interpretation principles.

83. The inquiry at this first stage will generally involve considering the application of specific provisions to particular parts of the arrangement. In contrast, the inquiry under s BG 1 considers whether the tax outcomes sought were within Parliament's contemplation when viewed in light of the whole arrangement. The s BG 1 inquiry involves considering the Act as a whole (including any specific provisions).

84. The English courts' approach to interpreting specific provisions that takes into account economic substance does not apply in New Zealand, unless Parliament has indicated in the particular section that a substance approach is to be adopted. However, it is clear that this is the role of s BG 1.

85. It is open to the Commissioner to argue certain provisions of the Act do or do not apply and, in the alternative, that s BG 1 applies. Also, the fact that some part of an arrangement fails to comply with a specific provision does not preclude s BG 1 applying to the arrangement as a whole.

APPROACH TO SECTION BG 1

86. Section BG 1 provides:

- a tax avoidance arrangement is void as against the Commissioner, and
- the Commissioner may counteract a tax advantage obtained under the arrangement in accordance with Part G.

87. Under the legislation there are some key elements to applying ss BG 1 and GA 1:

- arrangement;
- tax avoidance;
- tax avoidance arrangement;
- section GA 1.

ARRANGEMENT

88. Section BG 1 applies to a "tax avoidance arrangement". The term "tax avoidance" will be considered later. The concept of an "arrangement" will be discussed first.

89. "Arrangement" is defined in s YA 1 as:

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

90. Paragraphs 91 to 135 discuss issues related to the meaning of arrangement and its scope. Paragraphs 136 to 142 deal with analysing and understanding the arrangement.

What is within the concept of "arrangement"?

"Agreement, contract, plan, or understanding, whether enforceable or unenforceable"

91. The predecessor to the s YA 1 definition was discussed by Richardson P in *BNZ Investments No 1* (CA). His Honour stated with respect to the definition of "arrangement" in s 99(1) of the Income Tax Act 1976:

> [45] The words contract, agreement, plan and understanding appear to be in descending order

> of formality. A contract is more formal than an agreement, and in ordinary usage is usually written while an agreement is generally more formal than a plan, and a plan more formal or more structured that an understanding. And it is accepted in the definition of arrangement that the contract, agreement, plan or understanding need not be enforceable. Section 99 thus contemplates arrangements which are binding only in honour.

92. Richardson P cited with approval the statement by the High Court of Australia in *Bell v Federal Commissioner of Taxation* (1953) 87 CLR 548 that "arrangement" in an earlier Australian general anti-avoidance provision extended beyond contracts and agreements "so as to embrace all kinds of concerted action by which persons may arrange their affairs for a particular purpose or so as to produce a particular effect" (at [46]). His Honour noted that statements to similar effect were made in *Newton*, where Lord Denning stated (at 465) that the word "arrangement" under the then Australian general anti-avoidance provision:

> ... is apt to describe something less than a binding contract or agreement, something in the nature of an understanding between two or more persons – a plan arranged between them which may not be enforceable at law.

93. The definition of "arrangement" in s 99(1) of the 1976 Act considered by Richardson P in *BNZ Investments No 1* (CA) differs from the definition of "arrangement" in s YA 1. The order of the words has been changed to be listed alphabetically in the 2007 Act (ie, "agreement" precedes "contract"). Despite this, the same observation can be made that the inclusion of the words "agreement, contract, plan, or understanding" mean that the term "arrangement" provides for varying degrees of enforceability and formality. As defined in s YA 1, an "arrangement" may be a legally enforceable contract, a less formal agreement or plan that may or may not be legally enforceable, or an informal, unenforceable understanding. Accordingly, the term "arrangement" is defined widely to include all kinds of concerted action by which persons seek to bring about the fulfilment of a particular purpose or the production of a particular effect. It includes agreements, contracts, plans or understandings that are not intended to be legally binding, and arrangements that are unenforceable at law, for example, contracts unenforceable due to reasons of public policy, contractual incapacity or illegality.

94. The words in the definition "an agreement, contract, plan, or understanding" are in the singular. This does not mean that the "arrangement" must be located in a single document or transaction. It is clear that two or more documents or transactions may together amount to one "arrangement". In *Tayles v Commissioner of Inland Revenue* [1982] 2 NZLR 726 (CA), the appellant farmer executed three documents—a deed of trust, a deed of partnership and an agreement for the bailment of stock. McMullin J stated at 734:

> It follows that before that section can be said to have application to a particular case there must be an inquiry as to whether there has been an arrangement at all and, if so, what is its nature or purpose. It has never been the case for the taxpayers that the three documents executed by each did not amount to an arrangement.

McMullin J examined the various individual transactions and documents in ascertaining the scope of the arrangement. His Honour held that the three documents combined constituted the arrangement.

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

95. Section YA 1 defines the term "arrangement" as "including all steps and transactions by which it is carried into effect". In *Ben Nevis*, the Supreme Court commented on the inclusion of these words at [105]:

> An arrangement includes all steps and transactions by which it is carried out. Thus, tax avoidance can be found in individual steps or, more often, in a combination of steps. Indeed, even if all the steps in an arrangement are unobjectionable in themselves, their combination may give rise to a tax avoidance arrangement.

96. To understand the meaning of the words "including all steps and transactions by which it is carried into effect", it is helpful to look at their relationship with the other words in the definition: "means an agreement, contract, plan, or understanding". This requires considering the effect of the words "means" and "including" in the definition.

97. Use of the words "means" and "including", in the two parts of the definition, indicates that Parliament intended to distinguish between these two parts of that definition: Burrows *Statute Law in New Zealand* at 419. In providing that "arrangement **means** an agreement, contract, plan, or understanding" (emphasis added), the definition makes clear that it is **exhaustive**: *BNZ Investments No 1* (CA) at [121] per Thomas J. Accordingly an "arrangement" must be "an agreement, contract, plan, or understanding".

98. The word "including" indicates that the scope of any "arrangement" is extended to cover "all the steps and transactions by which it is carried into effect". Given

that the words "means an agreement, contract, plan, or understanding" provide an exhaustive definition, a step or transaction by which the "arrangement" is carried into effect cannot itself be an "arrangement". It also means that to come within the scope of the "arrangement", the step or transaction must be related to the agreement, contract, plan, or understanding that constitutes the "arrangement".

99. This interpretation is supported by the majority's judgment in *BNZ Investments No 1* (CA). In that decision, Richardson P rejected the submission that the words "including all steps and transactions by which it is carried into effect" extended the term "arrangement" so as to include transactions that did not come within the agreement, contract, plan, or understanding reached by the parties. His Honour held that these words were concerned with the implementation of the established "contract, agreement, plan or understanding", stating that "[t]he word 'it' in 'by which it is carried into effect' refers back to the applicable 'arrangement' and does not extend it" (at [48]). The Supreme Court in *Penny* (SC) implicitly recognised that a step is not in itself an arrangement at [34].

100. The inclusion of the words "including all steps and transactions by which it is carried into effect" reflects that the "agreement, contract, plan, or understanding" between the parties may not delineate all, or some of, the practical steps and transactions to be undertaken by the parties. The parties may have discretion as to how to discharge their obligations under the agreement, contract, plan or understanding. Therefore the definition makes clear that an "arrangement" encompasses the various actions undertaken to carry it out even if they are not delineated in the "agreement, contract, plan, or understanding". This is consistent with *Commissioner of Inland Revenue v Penny* [2010] NZCA 231, [2010] 3 NZLR 360, where Randerson J stated:

> [78] I am satisfied that an "arrangement" is not limited to a specific transaction or agreement but may embrace a series of decisions and steps taken which together evidence and constitute an agreement, plan or understanding. Any such arrangement may be continued in each of the income years in question or may be varied from year to year.

101. The words "all steps and transactions by which it is carried into effect" may also have been included in the definition for the avoidance of doubt.

102. The practical effect of the words "including the steps and transactions by which it is carried into effect" was illustrated in *Hadlee v Commissioner of Inland Revenue* [1989] 2 NZLR 447 (HC). In this decision, Eichelbaum CJ considered the arrangement involved three different transactions that were the steps by which the arrangement was carried into effect. The Chief Justice stated at 466:

> I do not doubt that what occurred here properly comes within the definition [of arrangement]. The assignment was one step in a package or scheme, properly seen as a "plan", prepared for the benefit of those partners who wished to take advantage of it, encompassing the following steps:
>
> 1 Establishment of a family trust in standard form;
>
> 2 Incorporation of Sydney Bridge Nominees Ltd to act as trustee;
>
> 3 Execution of the assignment.

On appeal the Court of Appeal approved the Chief Justice's approach: *Hadlee v Commissioner of Inland Revenue* [1991] 3 NZLR 517 (CA), at 524.

103. In summary, the term "arrangement" provides for varying degrees of enforceability and formality. As defined in s YA 1, an "arrangement" may be a legally enforceable contract, a less formal agreement or plan that may or may not be legally enforceable, or an informal, unenforceable understanding. Accordingly, the term "arrangement" is defined widely to include all kinds of concerted action by which persons seek to bring about the fulfilment of a particular purpose or the production of a particular effect. The words "including all steps and transactions by which it is carried into effect" mean that the term "arrangement" covers the actions and transactions undertaken to implement the "agreement, contract, plan, or understanding". These steps and transactions may or may not be specifically delineated in the "agreement, contract, plan, or understanding".

Practical issues

104. Some practical aspects of the definition are commented on in the following paragraphs. These aspects are:

- whether the definition includes unilateral "arrangements";
- the extent of consensus/understanding required to be party to an "arrangement";
- the circumstances in which two or more documents and transactions will be regarded as constituting one "arrangement";
- whether parts of an "arrangement" can be severed; and
- extraterritorial limitations.

Can there be unilateral "arrangements"?

105. An arrangement is defined to mean "an agreement, contract, plan, or understanding". An issue in this context is whether a scheme or undertaking involving only one person can be an "arrangement". While the use of the word "arrangement" is arguably more consistent with the situation where two or more persons enter into a transaction together, "arrangement" is defined to include a "plan", which could apply to a single person undertaking or scheme.

106. In *Russell v Commissioner of Inland Revenue* [2012] NZCA 128, (2012) 25 NZTC 20-120, the Court of Appeal assumed a one-person plan could be an "arrangement", upholding the view of Wylie J in the court below:

> [54] We agree with the Judge [Wylie J] that if consensus is needed, the appellant provided any necessary consensus for the purposes of the overall plan. The appellant orchestrated the whole arrangement. **However, we note that the statutory definition of "arrangement" does not require such consensus: a plan will suffice**. Here the overall plan was that created, designed and executed by the appellant. We note also that an arrangement includes "all steps and transactions by which it is carried into effect". Again, no consensus is needed.
>
> [Emphasis added]

107. Additionally, Wylie J in the High Court decision in *Russell* (HC) stated in a footnote that a plan could be devised and carried out by one person (see *Russell* (HC) at footnote 33 to [101]).

108. In the Taxation Review Authority decision in *Case G43* (1985) 7 NZTC 1,163, Sheppard DJ suggested that the word "plan" in the definition of "arrangement" might apply to a course of action involving only one person (at 1,168):

> ... the definition of "arrangement" supplied by sec 99(1) expressly gives a meaning which includes "any ... plan". Although the other meanings (contract, agreement, understanding) imply participation by two or more persons, "plan" does not. The relevant meaning given to the word "plan" in the *Shorter Oxford Dictionary* (3rd edition) is:
>
> "A scheme of action ... the way in which it is proposed to carry out some proceeding."
>
> Such a scheme or way can be devised and adopted by a single person acting alone.
>
> However, what the objector did in this case was not only done by him alone without the participation of any other person, it was scarcely a scheme of action or the way in which it was proposed to carry out some proceeding; it did not involve any number of steps or transactions.

109. Accordingly, the Commissioner considers the law to be that a plan undertaken by one person could amount to an "arrangement".

Extent of consensus/understanding required to be party to an "arrangement"

110. In some cases, the evidence will indicate that the taxpayer knew, and agreed with, all of the relevant transactions carried out by another person that are part of a "tax avoidance arrangement". Accordingly, that taxpayer will be considered to be party to an "arrangement" that encompasses all those transactions. This will be so even if the taxpayer is unaware that the transactions constitute "tax avoidance", or if the taxpayer genuinely or reasonably believed that the transactions did not constitute "tax avoidance": *Peterson v Commissioner of Inland Revenue* [2005] UKPC 5, [2006] 3 NZLR 433 at [34] per Lord Millett; *BNZ Investments No 1* (CA) at [52], [127]–[128], [172].

111. In other situations the taxpayer may argue that it was unaware of, and therefore did not agree to, some or all of the transactions that were carried out by another person and which constitute tax avoidance. The taxpayer may argue that accordingly it should not be considered to be party to an "arrangement" that encompasses those transactions.

112. This type of submission was considered by the Court of Appeal in *BNZ Investments No 1* (CA). The taxpayer argued it was a party to an "arrangement" with another party involving certain transactions, but this "arrangement" did not encompass other transactions undertaken by the other party. The taxpayer argued this was so because it was unaware of what the other party intended to do in carrying out those other transactions. The majority of the Court of Appeal accepted this argument and held that the taxpayer was not party to an "arrangement" that encompassed those other transactions.

113. However, Thomas J rejected this argument in his dissenting judgment. His Honour considered that a taxpayer may be party to an "arrangement" regardless of whether it can be reasonably considered as having authorised or accepted the mechanism used by the other party. Thomas J considered there could be an "arrangement" even if the taxpayer is innocent, in the sense of lacking conscious involvement in, or awareness of, the tax avoidance transaction or steps (at [127] and [131]).

114. Thomas J considered such innocence was not relevant, as the definition did not incorporate any reference to such matters. The definition of "arrangement"

indicated that only the effect of the agreement, contract, plan or understanding (or any combination of these) was relevant. It did not contain any suggestion that the taxpayer must be privy to both the plan or understanding and the steps and transactions by which it is carried into effect (at [119]–[127]).

115. Importantly, the majority of the Privy Council in *Peterson* (PC) endorsed the approach of Thomas J, in preference to that of the majority. Delivering the majority's judgment in *Peterson*, Lord Millett stated at [34]:

> Their Lordships do not consider that the "arrangement" requires a consensus or meeting of minds; the taxpayer need not be a party to "the arrangement" and in their view he need not be privy to its details either. On this point they respectfully prefer the dissenting judgment of Thomas J in *Commissioner of Inland Revenue v BNZ Investments Ltd*.

116. In *Ben Nevis*, the Supreme Court noted the different approaches taken in *Peterson* (PC) and *BNZ Investments No 1* (CA) (see *Ben Nevis* at [160]). The court stated that "it is unnecessary for us to decide whether to depart from that aspect of the Privy Council's judgment in *Peterson* in this case" (at [161]).

117. Consequently, in the Commissioner's view the legal position remains as stated by the Privy Council in *Peterson*, and therefore, the term "arrangement" in s BG 1 does not require consensus or a meeting of minds.

118. As an aside, it is worth observing that the practical effect of the different approaches in *BNZ Investments No 1* (CA) should not be overstated. A taxpayer may still be liable to an income adjustment under s GA 1(2) even if the taxpayer is not considered to be party to an "arrangement" under the more restrictive approach of the majority in *BNZ Investments No 1* (CA). If there is a "tax avoidance arrangement" under s BG 1 and the taxpayer, as a "person affected", has obtained a "tax advantage … from or under the arrangement", s GA 1(2) authorises the Commissioner to adjust the taxpayer's taxable income to counteract the tax advantage. This point was emphasised in *Peterson* (PC) by both the majority (at [34]) and the minority (at [59]) of the Privy Council, and is clear from the words of the statute.

When two or more documents and transactions will be regarded as constituting one "arrangement"

119. As already noted, two or more documents and transactions may together constitute an "arrangement" for s BG 1 purposes: see paragraph 94 above. In *Peterson* (PC), the Privy Council stated that whether two or more transactions or documents together constitute an "arrangement" is a matter of fact (at [33]). The following paragraphs consider the circumstances in which this will occur.

120. This issue can be seen as following directly from the question of whether all of the parts are to be properly regarded as a single agreement, contract, plan or understanding. In some cases, the courts have found it useful to test whether documents and transactions should be together considered a single "arrangement" by looking at whether they are sufficiently interrelated and/or interdependent to constitute a single "agreement, contract, plan or understanding". This requires consideration of the nature and extent of the relationship between the documents and transactions.

121. In *Commissioner of Inland Revenue v Europa Oil (NZ) Ltd* [1971] NZLR 641 (PC) [*Europa* No 1], the Privy Council considered whether six agreements should be considered together as constituting a single interrelated complex of agreements. The Privy Council held that the agreements were "far too close, and far too carefully worked out" to isolate and treat the agreements as "a series of independent bargains". The objective evidence showed an "intimate connection" between the agreements. They were made on the same date and some of them contained references to the other agreements. The agreements indicated that one party never intended to bind itself without entering into the other agreements. The effect of one of the agreements was to enable one party to sue for any breach of the other agreements. Their Lordships concluded at 651–652:

> The documents therefore, in their Lordships' opinion, point unequivocally towards an interdependence of obligations and benefits under a complex of contracts which, though embodied in separate documents represents one contractual whole [….] — that the contractual arrangements were interdependent, one on the other.

122. In other decisions, the courts have held that two or more transactions were not sufficiently linked so as to constitute an "arrangement". These decisions suggest that two or more transactions are not regarded as constituting an "arrangement" simply because one person is party to both transactions and entered into one transaction as a result of the other.

123. *AMP Life Ltd v Commissioner of Inland Revenue* (2000) 19 NZTC 15,940 (HC) is authority for the proposition that a sequence of events will not constitute an "arrangement" merely because one follows the other and/or they are causally related. The Commissioner submitted, in that case, that there was an

"arrangement" between AMP and AFS (a subsidiary) that had the following steps:

- AMP and its various subsidiaries (including AFS) grouping losses (incurred as a result of the 1987 share market crash) and claiming deductions for these in the income year to 31 March 1988;
- AMP's subscription for capital in AFS in December 1989;
- AMP's sale of its shares in AFS to AMP Discount Corporation in October 1992; and
- AMP's claiming of a deduction for the loss on the disposal of the AFS shares.

124. The High Court rejected the Commissioner's submission. McGechan J held that a "mere sequence of events, each with knock-on causative consequences" does not constitute an "arrangement" (at [125]). His Honour stated that the "concepts of contract, agreement, plan or understanding predicate some prior planned linking or sequencing or both". The legislation was not "aimed at simple sequences of events … without prior overall planning" (at [126]).

125. On the evidence, McGechan J held there was an absence of some prior planned linking and/or sequencing between the four transactions identified by the Commissioner. His Honour stated at [126]:

> There were trading losses by the subsidiaries. They are not of course alleged to be part of the arrangement, but set the scene. AMP then procured the deduction for its own benefit of those trading losses. … There is no direct evidence AMP planned, at the time it took the s 191 deductions, to capitalise the loss-making subsidiaries and to procure repayment of debt in the way which eventually occurred. … **Much more importantly however, there is no direct evidence or room for inference on balance of probabilities that at the time AMP took the benefit of s 191 deductions AMP planned not only capitalisation and debt repayment, but also dissolution of AFS, or sale followed by dissolution of AFS. Indeed, the evidence is to the contrary.** AMP did not need to have such plans at the time of the s 191 deductions. Its plans, if any, for AFS and the other subsidiaries were a further and distinct issue which could await developments. …. On the evidence, not contested by the Commissioner, AMP did take its time. On 15 December 1989 AFS subsidiaries were transferred to AMP, and AFS became moribund. Considerably later, "at some stage during 1992" (in or before April 1992) it was decided AMP no longer needed to retain AFS. **This was a new decision. The timing was not challenged by the Commissioner in evidence. It was not, for example, suggested that all this involved carefully staged waiting so as to give the appearance of staged and separate decisions.** AFS then resolved to dissolve on 9 April 1992. Then, at some stage in April 1992 after the resolution for winding up, AMP became aware of a possible technical issue as to deductibility under s 204C in event of liquidation; and commencing 4 August 1992 the decision was made to interpose a sale within the group, eventually effected 14 October 1992.
>
> [Emphasis added]

These circumstances indicated that the four transactions identified by the Commissioner were only "a sequence of events" and could not be "strained to fit within concepts involving overall planning such as contracts, agreements, plans or understanding".

126. Courtney J, in *Krukziener v Commissioner of Inland Revenue (No 3)* (2010) 24 NZTC 24,563 (HC), approved of the approach in *AMP Life*, saying:

> [6] In *AMP Life v CIR*, McGechan J held that the discrete steps relied on by the Commissioner in that case, as amounting to an arrangement, were not sufficient because:
>
> > They are a mere sequence of events, each with knock-on causative consequences, but that situation does not suffice. The concepts of contract, agreement, plan or understanding predicate some prior planned linking or sequencing or both, and that element is missing.
>
> [7] In the present case, referring to *AMP Life*, the TRA correctly identified the need for an arrangement to be more than merely discrete steps, observing that:
>
> > These transactions must apply in a concerted way as part of a predetermined end.

127. In summary, whether two or more documents and transactions will be regarded as constituting one "arrangement" will depend on the facts and whether they can properly be regarded as part of the relevant "agreement, contract, plan or understanding". In many cases, this might be tested by asking if there is sufficient interrelatedness and/or interdependence between them so that they can be regarded as an "arrangement". It will not be sufficient that one person is a party to both transactions. A mere sequence of events will not be sufficient unless there is some element of prior planning linking or sequencing the events.

Whether parts of an "arrangement" can be severed

128. Another practical issue arises where an arrangement consists of several smaller transactions. The issue is whether one of these smaller transactions can, of itself, be an "arrangement". This can be an important distinction in practice. Taking a wider or narrower view of related transactions may impact on whether

a conclusion is reached that there is a tax avoidance arrangement.

129. The definition of "arrangement" does not provide that part of an "arrangement" is itself an "arrangement". However, the fact that a transaction is part of a wider "arrangement" does not preclude that transaction being considered as a separate, narrower "arrangement" under s BG 1. A transaction could be considered separately if, by itself, it satisfies the definition of "arrangement", being an "agreement, contract, plan or understanding". This is recognised by the majority's judgment in *Peterson* (PC). In that decision, Lord Millett stated at [33]:

> Their Lordships consider that the Commissioner is entitled at his option to identify the whole or any part or parts of a single composite scheme as the "contract, agreement, plan or understanding" which constitutes the "arrangement" for the purpose of s 99.

130. If, on the other hand, part of an arrangement does not, by itself, satisfy the definition of "arrangement", that part cannot be considered separately under s BG 1. In *Commissioner of Inland Revenue v Dandelion Investments Ltd* (2001) 20 NZTC 17,293 (HC), Tompkins J stated:

> [88] In considering the application of s 99, it is the overall effect of the arrangement that needs to be considered, not each discrete transaction that makes up the arrangement.

131. Similarly, in *Case U6* (1999) 19 NZTC 9,038, the Taxation Review Authority stated at 9,059:

> ... the offending transaction must be treated as a whole. It is impermissible to attempt to sever parts of it ... and characterise them as infringing s 99. Either this is an arrangement which is caught by s 99 or it is not.

132. This approach is consistent with the approach taken by the High Court of Australia under the general anti-avoidance provision in Part IVA of the Australian Income Tax Assessment Act 1936 (Cth): see, for example, *Federal Commissioner of Taxation v Hart* [2004] HCA 26, (2006) 217 CLR 216 at [55] and *Federal Commissioner of Taxation v Peabody* (1994) 181 CLR 359 at 383.

133. In summary, s BG 1 can apply to part of an arrangement if that part is itself an "arrangement" within the meaning in the Act.

Extraterritorial limitations

134. Sometimes arrangements involve steps or transactions carried out or brought into effect wholly or partly outside New Zealand. This raises a question about whether s BG 1 applies to such arrangements. No extraterritorial limitation appears in the relevant provisions. Therefore, any arrangement that has a more than merely incidental purpose or effect of avoiding New Zealand income tax is void under s BG 1 irrespective of where it is entered into or carried out. To this effect, McGechan J in *BNZ Investments Ltd v Commissioner of Inland Revenue* (2000) 19 NZTC 15,732 (HC) [*BNZ Investments No 1* (HC)] stated at [123]:

> While he [the Commissioner] must respect the building blocks of a transaction, foreign made, for what they are, that does not preclude his coming to a view that what has occurred abroad could have a purpose or effect of avoidance of income tax in New Zealand. **What is done abroad is done abroad, but can still be part of an 'arrangement' with the purpose or effect of tax avoidance in New Zealand**, with s 99 applicable to elements or consequences in New Zealand accordingly.
>
> [Emphasis added]

135. Accordingly, s BG 1 applies to a tax avoidance arrangement even if the arrangement is carried out or brought into effect outside of New Zealand.

Analysing and understanding the arrangement

136. The preceding discussion has considered some legal aspects of the definition of "arrangement", including what is within the scope of an "arrangement", and some practical aspects of the meaning of the term.

137. The next few paragraphs discuss how an arrangement is analysed so as to fully understand it. In some cases, arrangements may be very complex and difficult to understand, or aspects of the arrangement may be unclear when first examined. The aim is to fully understand all pertinent facts and information relating to the arrangement, and the effects of the whole transaction must be known.

138. This will include gaining an understanding of the commercial, private and other (including tax) objectives of the arrangement. Useful questions in this regard may include asking what benefits were sought in return for amounts paid, why the arrangement was structured the way it was, and what commercial outcomes were achieved. Initially, it may be helpful to be aware of this type of information to help understand the arrangement in its context, even though some of it may not ultimately be relevant when analysing the application of s BG 1. Such information might include facts that are outside the arrangement, such as the surrounding circumstances, the history of the transaction and statements by those involved.

139. The emphasis on gathering and examining all of the facts can also be seen in the approach of the courts. Wild J in *BNZ Investments No 2* (HC) undertook an extensive analysis of the facts before considering the application of s BG 1—see [11]–[106]. In *Westpac*, Harrison J took into account evidence from employees who were involved in negotiating and implementing transactions that were the subject of a s BG 1 inquiry (at [44]):

> Their accounts provided a linking narrative, supplementing and explaining the picture available from the primary documents, and were relevant to an assessment of the commercial or economic realities of aspects of the transactions.

140. How to decide what is relevant in analysing whether there is tax avoidance and whether any tax avoidance is merely incidental to a non-tax purpose will be explained later. In short, information will be relevant to reaching a view on whether there is tax avoidance if it objectively establishes the commercial and economic reality and relates to the particular use of the Act by the arrangement. Information will be relevant to the "not merely incidental" test if it evidences a non-tax avoidance purpose that explains the particular structure of the arrangement.

Tax effects

141. The task of identifying and understanding an arrangement will include identifying the tax effects and tax provisions at issue (for example, see *Ben Nevis* at [116] and *Westpac* at [56]). Understanding how the arrangement interacts with the Act will help to gain an understanding of the role of the steps and transactions in the arrangement and also the overall effects of the arrangement. It may also be that the subsequent analysis of the arrangement identifies additional potentially relevant provisions, the tax effects of which will then need to be understood.

142. Also, as discussed above from paragraph 47, some tax avoidance arrangements have the effect of positively utilising provisions, while others may have the effect that certain provisions do not apply. When identifying the tax effects, therefore, these might relate either to particular provisions used by the arrangement, or to any potentially relevant provisions that do not apply to the arrangement.

Summary of principles concerning "arrangement"

143. To summarise, for s BG 1 the relevant principles when considering whether an "arrangement" exists and determining its scope, are as follows:

- The definition of "arrangement" in s YA 1 provides for varying degrees of enforceability and formality. An "arrangement" may be a legally enforceable contract, a less formal agreement or plan that may or may not be legally enforceable, or an informal, unenforceable understanding. Accordingly, the term "arrangement" is defined widely to cover the various means by which persons may indicate their agreement to bring about the fulfilment of a particular purpose or the production of a particular effect (*BNZ Investments No 1* (CA), *Newton*, *Bell*).
- The definition of "arrangement" provides that it extends to include "all steps and transactions by which it is carried into effect". These steps and transactions may not be delineated in the "agreement, contract, plan or understanding". The word "it" in "by which it is carried into effect" refers back to the applicable "arrangement". It does not extend the "arrangement" by including steps and transactions that are not concerned with the implementation of the "agreement, contract, plan or understanding" (*Ben Nevis*, *BNZ Investments No 1* (CA), *Penny* (SC) and (CA), *Hadlee* (HC)).
- An action or transaction undertaken by one person can constitute an "arrangement" (*Russell* (HC) and (CA), *Case G43*).
- Where the taxpayer knew, and agreed with, all of the relevant transactions that amount to tax avoidance carried out by another person, the taxpayer will be considered to be party to an "arrangement" that encompasses all those transactions. This is so even if the taxpayer is unaware that the transactions constitute tax avoidance or if the taxpayer genuinely or reasonably believed that the transactions did not constitute tax avoidance (*Peterson* (PC), *BNZ Investments No 1* (CA)).
- A taxpayer may be considered party to an "arrangement" even if the taxpayer did not know all, or some of, the details or mechanisms by which the "agreement, contract, plan or understanding" would be carried out by another person (*Peterson* (PC), *BNZ Investments No 1* (CA), *Ben Nevis*).
- Whether two or more documents or transactions may together constitute an "arrangement" will depend on the facts, and whether they can be properly regarded as part of the relevant "agreement, contract, plan or understanding". This requires that they are more than a "mere sequence of events, each with knock-on causative consequences" (*Tayles* (CA), *Peterson* (PC), *AMP Life*, *Europa No 1*, *Krukziener*).
- A part of an "arrangement" may be considered separately under s BG 1 only if that part, by

itself, satisfies the definition of "arrangement" (*Peterson* (PC), *Dandelion* (HC), *Case U6*, *Hart*, *Peabody*).

- Section BG 1 applies to a tax avoidance arrangement whether or not the arrangement is carried out or brought into effect in New Zealand (*BNZ Investments No 1* (HC)).

144. When considering an actual arrangement, it is important to fully understand the arrangement, taking into account all pertinent facts and information relating to it, including the commercial, private and other (including tax) objectives. Understanding the arrangement will also involve identifying the tax effects and the provisions at issue.

TAX AVOIDANCE ARRANGEMENT

Statutory terms

Introduction

145. Like "arrangement", "tax avoidance arrangement" is also a defined term. The court in *Ben Nevis* described it as the key statutory concept:

> [105] The key statutory concept in the general anti-avoidance provision is of a tax avoidance arrangement, as Parliament has defined it. By means of the definition of "tax avoidance", a tax avoidance arrangement includes an arrangement which directly or indirectly alters the incidence of any income tax. It is arrangements of that and allied kinds which are void against the Commissioner under s BG 1(1). An arrangement includes all steps and transactions by which it is carried out. Thus, tax avoidance can be found in individual steps or, more often, in a combination of steps. Indeed, even if all the steps in an arrangement are unobjectionable in themselves, their combination may give rise to a tax avoidance arrangement.

146. "Tax avoidance arrangement" is defined in s YA 1 as follows:

> **tax avoidance arrangement** means an arrangement, whether entered into by the person affected by the arrangement or by another person, that directly or indirectly—
>
> (a) has tax avoidance as its purpose or effect; or
>
> (b) has tax avoidance as 1 of its purposes or effects, whether or not any other purpose or effect is referable to ordinary business or family dealings, if the tax avoidance purpose or effect is not merely incidental.

147. Thus, a tax avoidance arrangement is an arrangement that has a purpose or effect of tax avoidance that is more than merely incidental. "Tax avoidance" is itself defined in s YA 1 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.

148. The Commissioner's view is that Parliament's purpose in enacting the definition of "tax avoidance" was to confirm or clarify that certain circumstances will constitute tax avoidance, rather than to provide a comprehensive definition of what constitutes tax avoidance. This is supported by the fact that, in establishing whether there is tax avoidance, the courts (including the Supreme Court in *Ben Nevis*) have typically come to a conclusion without embarking on any detailed analysis of the statutory definition of "tax avoidance" and, at times, have not referred to the definition at all.

149. The next section of this statement deals briefly with the role and wording of the statutory definition of "tax avoidance". It also discusses the meaning of "purpose or effect" in the definition of "tax avoidance arrangement", before considering in detail the Supreme Court's approach in *Ben Nevis* to determining if an arrangement is a tax avoidance arrangement.

The statutory definition of "tax avoidance"

150. Prior to 1974, the statutory provision relating to tax avoidance (s 108 of the Land and Income Tax Act 1954) was an exhaustive definition of "tax avoidance". In *Marx v Commissioner of Inland Revenue* [1970] NZLR 182 (CA), at 194, North P recognised the deficiencies of the section and suggested that approaches to the words in the section should not involve "critical refinements and subtle distinctions" and the "obvious and popular meaning of the language should be preferred". As a result of uncertainties such as these about the scope of the words of the section, the courts tended to read down the provision. In 1974, the Act was amended to refer to "tax avoidance" and to provide that "tax avoidance" includes certain things. By amending the definition of "tax avoidance" to make it inclusive rather than exclusive, Parliament ensured the definition includes the "obvious and popular meaning" of "tax avoidance" consistent with North P in *Marx*. These amendments are also consistent with Parliament's intention to prevent the section being read down and to give it full effect.

151. Accordingly, the present statutory definition of "tax avoidance" is worded so that it "includes" certain things, rather than the definition being an exhaustive one (see *Miller v Commissioner of Inland Revenue (No 1)* (1997) 18 NZTC 13,001 (HC) at 13,033 and *Challenge* (CA) at 541).

152. The definition contains three paragraphs, each of which lists aspects that are within the defined meaning of the term "tax avoidance". Some words in the paragraphs, such as "avoiding ... tax" or "relieving a person from a liability to pay income tax", do not seem to add anything to what would commonly be understood to be meant by the term "tax avoidance". Other phrases, such as including a "potential or prospective liability to future income tax", might be considered to add to the ordinary meaning.

153. These features raise the issue of whether the definition is intended to form the basis of what is "tax avoidance" or whether it has been left to the courts to largely give meaning to the term. In the Commissioner's view, the approach of the courts is very strongly indicative of the latter proposition.

154. In the majority of the decisions prior to *Ben Nevis*, the courts have discussed the meaning of tax avoidance without undertaking a detailed analysis of the various limbs of the statutory definition—see, for example, *Miller v Commissioner of Inland Revenue* [2001] 3 NZLR 316 (PC), *Peterson* (PC) and *Dandelion Investments Ltd v Commissioner of Inland Revenue* [2003] 1 NZLR 600 (CA).

155. In *Ben Nevis*, the Supreme Court said it would settle the approach to s BG 1 (at [100]). It did this by outlining the Parliamentary contemplation test for determining whether an arrangement is a tax avoidance arrangement (discussed below). The court did not consider it necessary to analyse the statutory definition of tax avoidance to determine what constituted tax avoidance. Although the majority in *Ben Nevis* briefly referred to the definition (see *Ben Nevis* at [105], set out at paragraph 145 above), there was no discussion of the definition in the decision. The court simply went on to use the opening words of the definition by stating at [156]:

> Having regard to the various features of the arrangement we have discussed, our conclusion is that the appellants' use of the specific provisions was not within Parliament's purpose and contemplation when it authorised deductions of the kinds in question. The appellants **altered the incidence of income tax** by means of a tax avoidance arrangement which the Commissioner correctly treated as void against him.
>
> [Emphasis added]

156. Rather than base its decision on the definition of "tax avoidance", the court set out the approach to be adopted to determine whether there is tax avoidance:

> [101] In doing so we keep in mind that the present form of the general anti-avoidance provision remains largely the same as that adopted in 1974, when Parliament chose, in reframing the then s 108, not to specify with any particularity the kind of arrangements to which it would apply. This was left to the courts to work out. Parliament did not regard it as inconsistent with the judicial function for the courts to decide which arrangements, having a purpose or effect of saving tax, would be caught by the amended general anti avoidance provision. Of greater legislative concern was that however carefully the general provision might be drafted, the results of taxpayers' ingenuity in adapting the forms in which they did business could not be predicted.

157. Subsequently, the Court of Appeal in *Alesco New Zealand Ltd v Commissioner of Inland Revenue* [2013] NZCA 40 was even more explicit that the question of whether there is tax avoidance is answered by inquiring into whether the particular use of the Act was within Parliament's contemplation rather than by reference to the statutory definition (at [25]). Other decisions delivered since *Ben Nevis* also have not treated the statutory definition of "tax avoidance" as being of importance in determining whether an arrangement is a tax avoidance arrangement—see, for example, *Penny* (CA) and (SC), *Westpac, BNZ Investments No 2, Krukziener, Russell* (CA) and (HC) and *White v Commissioner of Inland Revenue* (2010) 24 NZTC 24,600 (HC). Although these cases quote the statutory definition, there is no analysis of it. Instead, the courts adopt the *Ben Nevis* approach and consider what Parliament would have contemplated for the use of the provisions and the commercial and economic reality of the arrangement before them to determine if there is tax avoidance.

158. Therefore, the Commissioner considers the Parliamentary contemplation test set out by the Supreme Court is the primary test to be applied to determine whether an arrangement involves tax avoidance (discussed in detail at paragraphs 210 to 394 below).

159. The courts sometimes incorporate some of the words from the definition in their judgments, but do not analyse them further. See, for example, the quote from *Ben Nevis* at paragraph 155 above. In *Westpac*, Harrison J concluded at [619]:

> In my judgment Koch and the other three transactions were tax avoidance arrangements. Their primary or a substantial purpose was to **reduce the incidence** of the bank's **liability to tax**.
>
> [Emphasis added]

160. Similarly in *BNZ Investments No 2* (HC), Wild J concluded at [526]:

> The transactions had the purpose or effect of substantially **altering the incidence of tax** for the BNZ.
>
> [Emphasis added]

161. Randerson J in *Penny* (CA) also concluded that the identified arrangements had the purpose or effect of altering the incidence of income tax (at [112]). See also *Penny* (SC) at [50], *Krukziener* at [58] and *Russell* (HC) at [115]–[116].

162. In summary, Parliament has not exhaustively defined the meaning of "tax avoidance". Instead, as the court said in *Ben Nevis*, Parliament left it to the courts to identify tax avoidance. The Commissioner's opinion, therefore, is that the function of the definition is to confirm that certain defined circumstances are not excluded from the scope of tax avoidance. Some of the words used provide no particular guidance, such as specific inclusion of the words "avoiding … tax", and are merely confirmatory in nature. There is nothing to be gained in analysing those words and this statement will not do so. Other words in the definition are included to confirm or even to extend the ordinary meaning of "tax avoidance" so as to make clear that certain things are included in the term when it is used in the section.

163. One example is the inclusion of future tax liabilities, and some comment on that may be helpful. It might be thought that all tax avoidance involves avoiding future liabilities because, as was pointed out in *Marx*, once a liability is determined for a taxpayer, it is no longer possible to avoid it. The Privy Council in *Newton* said the section applied to arrangements entered into for the purpose of avoiding future income tax (at 464). If a taxpayer was already liable for an amount of tax and the tax was not paid, that would be a matter of evasion, not avoidance. To give the words in the definition some meaning, therefore, the Commissioner considers the inclusion of "future liabilities" must have been intended to ensure an arrangement that would result in avoiding tax some time in the future is a tax avoidance arrangement. This is in addition to arrangements where tax is avoided in the short term. An instance of a tax avoidance arrangement that may affect future liability is an arrangement that involves accumulating tax losses. If the taxpayer is not able to set off losses in the current year, but does so in a future year, then there may not be any tax avoided in the current year. However, there can still be tax avoidance because the taxpayer's future liability may potentially be avoided.

164. Although it will not be necessary to work through the statutory definition of tax avoidance in every case, there must still be some income tax actually or potentially avoided by a taxpayer for the section to apply. Section BG 1 is concerned with the avoidance of income tax and, on the ordinary meaning of the word "avoidance", there would need to be an alteration of the tax liability of at least one taxpayer. The purpose of the section is also consistent with this view. The purpose of s BG 1 is to prevent parties altering or bringing about a tax position where this involves the use of provisions falling outside their intended scope in the overall scheme of the Act. The need for there to be a change in tax is accepted by all courts considering the application of the section; see, for example, at [101] of *Ben Nevis*: "[Parliament left it to] the courts to decide which arrangements, having a purpose or effect of **saving tax**, would be caught by the amended general anti-avoidance provision"; and at [106]: "The general provision is designed to avoid the **fiscal effect** of tax avoidance arrangements having a more than merely incidental purpose or effect of tax avoidance".

> [Emphasis added]

165. It should also be noted that absolute certainty of the amount and timing of the tax avoided is not needed for the section to apply. This is clear because the definition of "tax avoidance" includes a potential or prospective liability to future income tax.

Whether establishing "tax avoidance" requires identifying a specific alternative fact situation

166. It is sometimes argued that the legislative concept of "tax avoidance" inherently involves a comparison between the tax outcomes of an alleged tax avoidance arrangement and some other specific identified alternative fact situation. That other factual situation may be a hypothetical alternative arrangement the taxpayer could have entered into (sometimes referred to as a "counterfactual") or it may be what might have otherwise arisen had the arrangement not been entered into.

167. There is no mention at all in the words of s BG 1 about a requirement to identify a specific counterfactual. That contrasts with s GA 1(4), which provides that the Commissioner may identify a counterfactual for that section. However, even in s GA 1(4), reference to a counterfactual is at the Commissioner's discretion.

168. Establishing whether there is tax avoidance requires identifying whether the provisions of the Act apply to the arrangement in the way Parliament contemplated. (The Parliamentary contemplation test is discussed later from paragraph 210). As will be discussed,

reaching a view on this is an inquiry about the use of the Act, given the commercial and economic reality of the arrangement, and does not involve identifying what a taxpayer would have otherwise done.

169. New Zealand courts have not relied upon counterfactuals to reach a view on the application of s BG 1. Rather, following the Supreme Court decision in *Ben Nevis*, the courts apply the Parliamentary contemplation test to reach a view on whether there is tax avoidance. See, for example, the approach of the courts in *Penny* (SC), *Russell* (CA), *BNZ Investments No 2* (CA) and *Westpac*. Nothing in any of these cases supports the view that the Parliamentary contemplation test requires identifying a counterfactual and subsequently the Court of Appeal has rejected an argument based on identifying a counterfactual on the basis it has no legal ground (see *Alesco* (CA) at [38]–[40]).

170. This approach can be contrasted with the approach in Australia. The Australian legislation explicitly provides that reference may be made to what might reasonably be expected to have occurred.

171. It is sometimes argued that it is implicit in the words "potential or prospective liability to future income tax" in the statutory definition of "tax avoidance" that a comparison is needed with hypothetical tax outcomes. In the Commissioner's view, this element of foreseeability relates to the tax outcomes for the arrangement actually entered into that are yet to arise. It is not a case of looking to the tax outcomes of some alternative arrangement.

172. Therefore, the Commissioner considers that in New Zealand there is no requirement to identify a counterfactual in reaching a view on whether s BG 1 applies.

Purpose or effect

173. One more aspect of the relevant statutory definitions will now be considered before the Parliamentary contemplation test is discussed. The definition of "tax avoidance arrangement" states:

> **tax avoidance arrangement** means an arrangement, whether entered into by the person affected by the arrangement or by another person, that directly or indirectly—
>
> (a) has tax avoidance as its purpose or effect; or
>
> (b) has tax avoidance as 1 of its purposes or effects, whether or not any other purpose or effect is referable to ordinary business or family dealings, if the tax avoidance purpose or effect is not merely incidental

174. An arrangement will therefore be a tax avoidance arrangement if the arrangement has a purpose or effect of tax avoidance. The following paragraphs discuss what is meant by "purpose or effect" in this context.

Objective test

175. The courts have held that the "purpose or effect" of an arrangement is determined objectively and the motive of the parties is irrelevant. The Privy Council in *Ashton v Commissioner of Inland Revenue* [1975] 2 NZLR 717 (PC) agreed with the earlier Privy Council decision in *Newton*, stating at 721:

> In *Newton v Commissioner of Taxation* [1958] AC 450; [1958] 2 All ER 759 the Privy Council had to consider s 260 of the Commonwealth of Australia Income Tax and Social Services Contribution Assessment Act 1936–1951, a section very similar to s 108. In that case Lord Denning delivering the judgment of the Board said:
>
> "The word 'purpose' means, not motive but the effect which it is sought to achieve — the end in view. The word 'effect' means the end accomplished or achieved. The whole set of words denotes concerted action to an end — the end of avoiding tax" (ibid, 465; 763).
>
> And:
>
> "... the section is not concerned with the motives of individuals. It is not concerned with their desire to avoid tax, but only with the means which they employ to do it. It affects every 'contract, agreement or arrangement' (which their Lordships will henceforward refer to compendiously as 'arrangement') which has the purpose or effect of avoiding tax. In applying the section you must, by the very words of it, look at the arrangement *itself* and see which is *its* effect — which *it* does — irrespective of the motives of the persons who made it. Williams J put it well when he said: 'The purpose of a contract, agreement or arrangement must be what *it* is intended to effect and that intention must be ascertained from its terms. Those terms may be oral or written or may have to be inferred from the circumstances but, when they have been ascertained, their purpose must be what they effect'" ([1958] AC 450, 465).
>
> These observations of Lord Denning in relation to s 260 of the Australian Act are equally applicable to s 108.

176. The Privy Council in *Ashton* (PC) agreed with the Court of Appeal (*Commissioner of Inland Revenue v Ashton* [1974] 2 NZLR 321 (CA)) that evidence of the parties' purpose was not relevant. McCarthy P, delivering the Court of Appeal judgment, concluded that Wilson J in the High Court would probably

have thought the facts were sufficiently indicative of a tax avoidance purpose had it not been for the oral evidence of the taxpayers that the predominant purpose of the arrangement was to provide security for the taxpayers' families (see 721 (PC) and 327 (CA)). The taxpayers had given evidence of the motives that had actuated them, especially of their wish to provide for their families. However, the Court of Appeal confirmed the test was an objective one and excluded reliance on much of the evidence that had influenced Wilson J. The purpose of an arrangement must be determined by what the transaction effects and motive is irrelevant. The Privy Council specifically approved the Court of Appeal's view.

177. The interpretation of the words "purpose or effect" remains the same following *Ben Nevis*. *Glenharrow Holdings Ltd v Commissioner of Inland Revenue* [2008] NZSC 116, [2009] 2 NZLR 359 was a decision of the Supreme Court on GST avoidance and was given on the same day as the decision in *Ben Nevis* with a very similarly constituted court. Like the Privy Council in *Ashton* (PC) and *Newton*, the Supreme Court in *Glenharrow* also emphasised that it is the purpose of the **arrangement** that is relevant, and not the purpose of the **parties**. The court found the same objective test applied and relied on income tax cases to support its views on purpose. It is also significant that the court stated in *Glenharrow* at [38]:

> ... the general anti-avoidance provision was concerned not with the purpose *of the parties*, but with the purpose *of the arrangement*. That is a crucial distinction. Once you put the purpose of the parties to one side and seek by objective examination to find the purpose of the arrangement, you must necessarily do that by considering the effect which the arrangement has had — what it has achieved — and then, by working backwards as it were from the effect, you are able to determine what objectively the arrangement must be taken to have had as its purpose. That approach is inevitable once any subjective purpose or motive is ruled out of contention, as the authorities say it must be.

178. The court in *Glenharrow* commented, as the Privy Council had in *Ashton*, that it is not relevant whether the taxpayers had an intention of avoiding tax (see *Glenharrow* at [39]).

179. Although *Glenharrow* concerned s 76 of the Goods and Services Tax Act 1985, and not s BG 1, it is helpful in considering s BG 1. The approach in *Glenharrow* has also since been adopted in both GST and income tax cases—see, for example, *Penny* (CA) at [66]–[68], *Westpac* at [198]–[200], and *Krukziener* at [32].

180. The Court of Appeal decision in *Tayles* illustrates a court distinguishing between subjective and objective evidence, and excluding the subjective evidence when considering the avoidance provision. The taxpayers' counsel argued that the arrangements were ordinary business dealings to limit the taxpayers' liability for estate duty, to make provision for dependants, to provide incentives for their sons to take over the farm, and to provide vehicles for gifting. The Court of Appeal dismissed the appeal and confirmed that the court was only concerned with what was achieved as a result of the arrangement and not the motivation or intentions for entering into it. The court found that the objective purposes of the arrangement were:

- to create a suitable medium for the transfer of the farms;
- to peg the value of the taxpayers' interests in the farms to 1965 prices;
- to peg the number of stock owned by the farms to 1965 prices; and
- to shift into the hands of the trusts part of the income that would ordinarily fall to be enjoyed by the taxpayers.

The court concluded that the arrangement was implemented in the particular way it was so as to avoid tax.

181. It has been suggested that the courts take subjective evidence into account when assessing the purpose or effect of an arrangement. The Commissioner's view is that the courts still apply an objective test but may on occasion refer to subjective evidence in the course of their judgments. As seen in *Glenharrow* and *Ben Nevis*, the leading authorities remain clear the test is objective. In *Ben Nevis*, the Supreme Court observed (at [102]) that the approach necessitated:

> ... focusing objectively on features of the arrangements involved, without being distracted by intuitive subjective impressions of the morality of what taxation advisers have set up.

Comments to similar effect can be found in *Education Administration Ltd v Commissioner of Inland Revenue* (2010) 24 NZTC 24,238 (HC) at [37].

182. In *Alesco* (CA) at [28] the Court of Appeal stated the enquiry must be confined to the contractual instruments and the effect achieved by the taxpayer's use of the provisions of the Act. It considered that Heath J in the High Court was in error to approach the enquiry from the viewpoint of the taxpayer's motivation to employ the most tax effective structure.

183. However, often evidence presented to the courts will include subjective evidence. Inevitably, judges will at

times refer to this evidence in their judgments. This may be just by way of observation (*Ashton* (PC)), or as a way of leading into an examination of the possible non-tax avoidance effects and purposes of an arrangement (*Ben Nevis* and *Krukziener*) or to confirm a position taken under an objective examination of an arrangement's terms (*Westpac*). Referring to subjective evidence in this way does not mean that judges are relying on this type of evidence to work out the purpose or effect of an arrangement. It is clear that, although subjective evidence may at times be referred to in court, the section will only apply if it can be established objectively that the arrangement has a purpose or effect of tax avoidance.

184. In summary, all the leading authorities, in particular *Glenharrow*, *Ben Nevis* and *Alesco* (CA), have not stated anything that casts doubt on the proposition that the test to be applied when working out the purpose or effect of an arrangement is an objective one.

Oral evidence

185. The Privy Council in *Ashton* (PC) made a further point that oral evidence is relevant if it relates to the purpose or effect of the arrangement, but not if it relates to the purpose of the parties. At 721:

> A contract, agreement or arrangement to which s 108 applies may be wholly in writing, partly in writing and partly oral or wholly oral. When it appears that any part of it was oral, evidence is properly admissible to determine its terms, and when such evidence is given, it may not be easy to separate evidence relating to the terms of the contract, agreement or arrangement from evidence as to the purpose of the parties to it but it does not follow that their evidence as to their purpose is relevant to the question whether s 108 does or does not apply.

186. Oral evidence that is inconsistent with the purpose or effect of the arrangement is not relevant. The Privy Council said at 722:

> If an arrangement has a particular purpose, then that will be its intended effect. If it has a particular effect, then that will be its purpose and oral evidence to show that it has a different purpose or different effect to that which is shown by the arrangement itself is irrelevant to the determination of the question whether the arrangement has or purports to have the purpose or effect of in any way altering the incidence of income tax or relieving any person from his liability to pay income tax.

187. More recently, Harrison J in *Westpac* had the same view about oral evidence. He stated at [44]:

> Their accounts provided a linking narrative, supplementing and explaining the picture available from the primary documents, and were relevant to an assessment of the commercial or economic realities of aspects of the transactions. Subject to certain limited qualifications to be discussed later, oral evidence is otherwise inadmissible to establish that a transaction has a purpose or effect different from that disclosed by the documents themselves: *Tayles v Commissioner of Inland Revenue* [1982] 2 NZLR 726 (CA) at 733.

The distinction in the meanings of the words "purpose" and "effect"

188. The courts have commented on the use of both the words "purpose" and "effect" in the definition of "tax avoidance arrangement" and the difference in the meanings of the words. It has sometimes been argued that the words "purpose" and "effect" are indistinguishable. This is because the test is objective and "purpose" in this context means the purpose of the arrangement and not the parties' purpose.

189. In the Court of Appeal decision in *Tayles*, McMullin J said at 734:

> The issue before the Board of Review, the Supreme Court and this Court involved an inquiry into the purpose or effect of the arrangement admittedly made. Whatever difference of meaning there may be in dictionary terms between the words "purpose" or "effect", posed as they seem to be as alternatives in s 108, they usually have been looked on in the cases as a composite term. "The word 'purpose' means, not motive but the effect which it is sought to achieve – the end in view. The word 'effect' means the end accomplished or achieved. The whole set of words denotes concerted action to an end – the end of avoiding tax" (*Newton v Commissioner of Taxation* at p 465).

The Privy Council also approved Lord Denning's words in *Newton* (at 465) in *Ashton* (PC) (at 722).

190. The courts have distinguished between the purpose and effect by referring to the purpose of the arrangement as the "**intended** effect" (*Ashton* (PC)) and the purpose as "the effect which [the arrangement] **sought** to achieve" (*Tayles* (CA)). However, in almost all cases, the purpose and effect of an arrangement will be the same. The intended aim of the arrangement (the objective purpose), if successfully achieved, will be the arrangement's effect.

191. There may be instances where the purpose of the arrangement is not achieved or the arrangement does not achieve the intended effect, and therefore the effect is different from the purpose. In these instances, a tax avoidance arrangement may still exist, as the definition applies if there is either a purpose or an effect of tax avoidance. However, the Commissioner would have to consider whether pursuing the matter was warranted in such a case.

Summary of purpose or effect

192. The purpose or effect of an arrangement, including any tax avoidance purpose or effect, is determined objectively. The taxpayer's intentions are not relevant. "Purpose", in the context of tax avoidance, means the intended effect the arrangement seeks to achieve and not the motive of the parties. "Effect" means the end accomplished or achieved by the arrangement. Oral evidence is relevant if it relates to the purpose or effect of the arrangement, but not if it relates to the purpose of the parties. Oral evidence that is inconsistent with the purpose or effect of the arrangement is not relevant. In most cases, the purpose and effect of an arrangement will be the same because the purpose will be successfully achieved. In the exceptional cases where the purpose and effect are different, a tax avoidance arrangement may still exist, as the definition applies if there is either a purpose or an effect of tax avoidance.

THE SUPREME COURT DECISION IN *BEN NEVIS*

193. Having dealt with the above issues arising from the relevant statutory definitions, the Supreme Court's decision in *Ben Nevis* is now considered. The decision is the leading authority on how to determine whether an arrangement is a tax avoidance arrangement and has been approved and applied in all subsequent decisions, see, for example, *BNZ Investments No 2* (HC) at [118] and [124], and *Westpac* at [186] to [187]. The Supreme Court in *Penny* (SC) said the court in *Ben Nevis* had set out the "proper approach to questions of tax avoidance" (at [33]). The immediately following paragraphs set out the passages in *Ben Nevis* where the court outlined its approach and make observations about what the court said. The detail of the approach is discussed under later headings.

Relationship between general anti-avoidance provision and the rest of the Act

194. As was discussed earlier, the central issue in *Ben Nevis* was how to discern the relationship between the general anti-avoidance provision and the operation of the rest of the Act. The court made some general comments about the approach to discerning the relationship:

> [102] It is accordingly the task of the Courts to apply a principled approach which gives proper overall effect to statutory language that expresses different legislative policies. It has long been recognised those policies require reconciliation. The approach must ensure that the particular case before the court is examined by reference to the respective legislative policies. It must enable decisions to be made on individual cases through the application of a process of statutory construction focusing objectively on features of the arrangements involved, without being distracted by intuitive subjective impressions of the morality of what taxation advisers have set up.

195. This approach reconciles the different legislative policies underlying the relevant specific provisions and s BG 1. The court said that proper effect must be given to each:

> [103] We consider Parliament's overall purpose is best served by construing specific tax provisions and the general anti-avoidance provision so as to give appropriate effect to each. They are meant to work in tandem. Each provides a context which assists in determining the meaning and, in particular, the scope of the other. Neither should be regarded as overriding. Rather they work together. The presence in the New Zealand legislation of a general anti-avoidance provision suggests that our Parliament meant it to be the principal vehicle by means of which tax avoidance is addressed. The general anti-avoidance regime is designed for that purpose, whereas individual specific provisions have a focus which is determined primarily by their ordinary meaning, as established through their text in the light of their specific purpose. In short, the purpose of specific provisions must be distinguished from that of the general anti-avoidance provision.
>
> [104] Parliament must have envisaged that the way a specific provision was deployed would, in some circumstances, cross the line and turn what might otherwise have been a permissible arrangement into a tax avoidance arrangement. Ascertaining when that will be so should be firmly grounded in the statutory language of the provisions themselves. Judicial attempts to articulate how the line is to be drawn have in the past too often been seized on as if they were equivalent to statutory language. Judicial glosses and elaborations on the statutory language should be kept to a minimum.

196. The approach to interpreting provisions of the Act other than s BG 1 was dealt with earlier in this statement at paragraphs 55 to 85.

197. It is clear that simply satisfying the terms of a specific provision is not sufficient to dismiss a claim of tax avoidance. As the majority recognised in a footnote to [104]:

> The appellants' "threshold" argument accordingly cannot be correct. That argument was to the effect that once the ordinary meaning of a specific provision was satisfied there could be no tax avoidance.

198. Although the point was explicitly made only in a footnote, the judgment proceeds on that basis. The majority continued:

> [106] Put at the highest level of generality, a specific provision is designed to give the taxpayer a tax advantage if its use falls within its ordinary meaning. That will be a permissible tax advantage. The general provision is designed to avoid the fiscal effect of tax avoidance arrangements having a more than merely incidental purpose or effect of tax avoidance. Its function is to prevent uses of the specific provisions which fall outside their intended scope in the overall scheme of the Act. Such uses give rise to an impermissible tax advantage which the Commissioner may counteract. The general anti-avoidance provision and its associated reconstruction power provide explicit authority for the Commissioner and New Zealand courts to avoid what has been done and to reconstruct tax avoidance arrangements.

199. A similar view was expressed by the Supreme Court in *Penny* (SC) at [45]:

> ... Counsel also submitted that the prescription in the Act of the categories of taxpayers as individuals, companies, trusts and so forth, with some special anti-avoidance rules for related-party transactions including the PSA rules and rules about cross-border services, left no room for the operation of s BG 1 in a case such as the present.
>
> [46] We do not accept these arguments.

200. Thus, the use of a specific provision may be permissible when the provision is considered alone, but it may be impermissible when the arrangement as a whole is considered. At first glance it might seem that the court's statement in [106] is conflicting, that is, that the use of a provision may be permissible under the Act, yet also impermissible if the general anti-avoidance provision is considered. However, what the court meant here is that a use of a specific provision may be *otherwise* permissible, were it not for the operation of the anti-avoidance provision. The court spelt out this point in more detail at [13], and at [104]:

> ... the way a specific provision was deployed would, in some circumstances, cross the line and turn what might otherwise have been a permissible arrangement into a tax avoidance arrangement.

Approach when applying section BG 1 – key paragraphs of decision

201. The majority then went on to outline their view of the approach required when considering the application of s BG 1 in more detail:

> [107] When, as here, a case involves reliance by the taxpayer on specific provisions, the first inquiry concerns the application of those provisions. The taxpayer must satisfy the Court that the use made of the specific provision is within its intended scope. If that is shown, a further question arises based on the taxpayer's use of the specific provision viewed in the light of the arrangement as a whole. If, when viewed in that light, it is apparent that the taxpayer has used the specific provision, and thereby altered the incidence of income tax, in a way which cannot have been within the contemplation and purpose of Parliament when it enacted the provision, the arrangement will be a tax avoidance arrangement. For example the licence premium was payable for a "right to use land", according to the ordinary meaning of those words, which of course includes their purpose. But because of additional features, to which we will come, associated primarily with the method and timing of payment, it represented and was part of a tax avoidance arrangement.
>
> [108] The general anti-avoidance provision does not confine the Court as to the matters which may be taken into account when considering whether a tax avoidance arrangement exists. Hence the Commissioner and the courts may address a number of relevant factors, the significance of which will depend on the particular facts. The manner in which the arrangement is carried out will often be an important consideration. So will the role of all relevant parties and any relationship they may have with the taxpayer. The economic and commercial effect of documents and transactions may also be significant. Other features that may be relevant include the duration of the arrangement and the nature and extent of the financial consequences that it will have for the taxpayer. As indicated, it will often be the combination of various elements in the arrangement which is significant. A classic indicator of a use that is outside Parliamentary contemplation is the structuring of an arrangement so that the taxpayer gains the benefit of the specific provision in an artificial or contrived way. It is not within Parliament's purpose for specific provisions to be used in that manner.
>
> [109] In considering these matters, the courts are not limited to purely legal considerations. They should also consider the use made of the specific provision in the light of the commercial reality and the economic effect of that use. The ultimate question is whether the impugned arrangement, viewed in a commercially and economically realistic way, makes use of the specific provision in a manner that is consistent with Parliament's purpose. If that is so, the arrangement will not, by reason of that use, be a tax avoidance arrangement. If the use of the specific provision is beyond Parliamentary contemplation, its use in that way will result in the arrangement being a tax avoidance arrangement.

202. For present purposes, [107]–[109] are the key paragraphs in the case. In [107] the court said, in cases such as the one before it, the first inquiry is to consider the specific provisions in accordance with ordinary

statutory interpretation principles and without reference to s BG 1. The specific provision's meaning is determined from the ordinary meaning of the words as ascertained from their text and in light of their purpose. The approach to considering the specific provisions was discussed earlier at paragraphs 55 to 85.

203. The court said that if those specific provisions seem to be applicable, a further inquiry is required. This next inquiry, which is the s BG 1 inquiry, considers the use of the specific provisions in light of the arrangement as a whole to determine whether they have been used in a way that cannot have been within the contemplation and purpose of Parliament. The factors set out by the court in [108] will be relevant in this inquiry.

204. At [109], the court encapsulated the test for the s BG 1 inquiry:

> The ultimate question is whether the impugned arrangement, viewed in a commercially and economically realistic way, makes use of the specific provision in a manner that is consistent with Parliament's purpose.

205. This test is discussed in detail under the heading "Is there Tax Avoidance? Parliamentary contemplation test" below.

The focus is on the whole arrangement

206. The court made it clear in [107] that when making the inquiry under s BG 1 it is **the arrangement as a whole** that must be considered:

> The taxpayer must satisfy the court that the use made of the specific provision is within its intended scope. If that is shown, a further question arises based on the taxpayer's use of the specific provision viewed in the light of the arrangement as a whole.

207. As discussed above (at paragraphs 55 to 66), when considering the application of any specific provisions, proper effect is given to Parliament's purpose by ascertaining the meaning of a provision from its text and in light of its purpose. Thus, while a specific section is interpreted in the context of the Act and full effect is given to Parliament's purpose for that section, it is interpreted standing alone. The inquiry under s BG 1, however, considers whether the use of the provisions by the arrangement was within Parliament's contemplation when viewed in light of the whole arrangement and any combination of provisions used. This is the case even though parts of the arrangement may comply with specific provisions.

208. It is important to understand that the focus of the test on viewing the whole arrangement in a commercially and economically realistic way means it is often the combination of steps, and the overall commercial and economic effects, that give rise to avoidance. The court in *Ben Nevis* made this point at [105]:

> An arrangement includes all steps and transactions by which it is carried out. Thus, tax avoidance can be found in individual steps or, more often, in a combination of steps. Indeed, even if all the steps in an arrangement are unobjectionable in themselves, their combination may give rise to a tax avoidance arrangement.

209. The Commissioner acknowledges that individual parts of an arrangement may well have real commercial and economic consequences when looked at on a stand-alone basis. Nevertheless, an approach that restricted the analysis to considering only parts of an arrangement individually, ignoring the effects of the arrangement as a whole, is not correct as it may lead to an erroneous conclusion that the arrangement is within Parliament's contemplation. The focus must remain on the commercial reality and economic effects when the arrangement is viewed as a whole.

IS THERE TAX AVOIDANCE? – APPLYING THE PARLIAMENTARY CONTEMPLATION TEST

Introduction

210. The test to identify whether an arrangement involves tax avoidance is to ask if the arrangement, viewed in a commercially and economically realistic way, makes use of the Act in a manner that is consistent with Parliament's purpose. The court in *Ben Nevis* said at [109]:

> The ultimate question is whether the impugned arrangement, viewed in a commercially and economically realistic way, makes use of the specific provision in a manner that is consistent with Parliament's purpose.

211. Applying this test involves identifying:

- Parliament's purpose for the relevant provisions; and
- the commercial reality and economic effects of the arrangement.

The order of the analysis when applying the Parliamentary contemplation test

212. It has been established that applying the Parliamentary contemplation test involves identifying Parliament's purpose for the relevant provisions and the commercial and economic effects of the arrangement. This might raise the question as to the order in which these two tasks are undertaken. The courts are often not explicit about an order for considering these two aspects of the Parliamentary contemplation test. In the Commissioner's view,

it is preferable—and even necessary—to consider first Parliament's purpose for the provisions at issue, before the commercial and economic reality of the arrangement is examined. The main reason for this is that Parliament's purpose should, as a matter of logic and principle, guide the inquiry. The ultimate question under the Parliamentary contemplation test is whether the arrangement makes use of the Act in a manner that is consistent with Parliament's purpose. The role of s BG 1 is to give effect to provisions of the Act where an arrangement has the effect of defeating that purpose. Therefore, it is logical first to ascertain Parliament's purpose to see whether the arrangement makes use of the Act in a way that is consistent with its purpose. Knowledge of Parliament's purpose then provides a principled basis for the inquiry into the facts. This order also would seem to be most consistent with comments in *Ben Nevis* when the court said, in [102] and [104], the test is one of "statutory construction" and is "firmly grounded in the statutory language".

213. Also, ascertaining Parliament's purpose first can help in practice when analysing an arrangement, as knowledge of Parliament's purpose gives guidance as to what needs to be identified when considering the commercial and economic reality of the arrangement. This order can be particularly helpful with complex arrangements, as it can be difficult to identify the commercial and economic reality of such arrangements. It also makes sense to ascertain Parliament's purpose first if the provisions at issue concern a special tax concept created by the taxation legislation. Tax concepts or fictions may not necessarily have any real-world commercial or economic equivalent. An example is an arrangement involving a Portfolio Investment Entity subject to the PIE regime. Simply reducing such an arrangement to its most fundamental level of economic substance will not necessarily aid an understanding of whether Parliament's purpose for the tax concept is given effect. Instead, when the arrangement is examined with knowledge of Parliament's purpose for the provisions used, there is guidance as to how to approach and analyse the facts.

214. Therefore, the approach of beginning the Parliamentary contemplation test by identifying Parliament's purpose is, in the Commissioner's view, to be preferred as a matter of logic and principle and it is also consistent with *Ben Nevis* and the decision in *Alesco* (CA). In addition, this order helps with some practical difficulties when applying the Parliamentary contemplation test to certain types of arrangements.

215. Notwithstanding the order outlined in the previous paragraphs, the Commissioner acknowledges that these two inquiries are interrelated, and that each will potentially inform the other. Knowledge of Parliament's purpose for the relevant provisions will guide the inquiry into the facts. Similarly, consideration of the facts and commercial reality and economic effects of the arrangement will often raise questions about whether the use or non-application of the provisions gives effect to Parliament's purpose in the context of the particular arrangement.

216. However, it is important to understand that the approach of first considering the provisions is not at the expense of taking appropriate account of the facts of the arrangement and, in particular, its commercial reality and economic effects at the next step. It should also be emphasised that mere compliance with the black letter of the Act is not the appropriate exercise. The point is to give proper effect to Parliament's purpose when the commercial and economic effects of the arrangement are taken into account.

Parliament's purpose regarding the relevant provisions

What is meant by Parliament's purpose?

217. Deciding whether provisions are used or circumvented as Parliament contemplated involves identifying Parliament's purpose for those provisions. Parliament's purpose is the result Parliament intended to achieve, or the end in mind Parliament had, for the provisions. There may be multiple purposes for any provision. Sometimes Parliament's relevant purpose will be readily ascertainable from the words used. Other times it will be less obvious and a more in-depth analysis of the Act will be required.

Levels of purpose

218. To understand the concept of Parliament's purpose, it is helpful to appreciate that there can be different levels of purpose or purposes. For any particular provision, there will be a purpose specific to that provision that will pertain to the particular role of that provision in the Act. In addition, provisions may have other broader levels of purpose, which may relate to a part of the Act or a regime, or the Act as a whole, and may concern a particular policy or have been enacted to prevent certain uses of the Act. Burrows, *Statute Law in New Zealand* and *Bennion on Statutory Interpretation: A Code* (FAR Bennion, 5th ed, LexisNexis, London, 2008) both discuss the idea of different levels of legislative purpose (see Burrows at 219–224 and Bennion at 947). Examples of provisions with a quite specific purpose are s DA 2(4), that

denies a deduction for expenditure or loss incurred in deriving income from employment, and s DB 2, that provides rules for the treatment of GST for income tax purposes. Examples of provisions giving effect to a particular policy in the Income Tax Act are the mining regime and provisions relating to the ability to claim credits for foreign tax paid. Harrison J identified the legislative policy behind the foreign tax credit regime in *Westpac* at [612]:

> As demonstrated by s LC 1(3A), the FTC regime was intended to provide New Zealand taxpayers with credits for tax paid in a foreign jurisdiction.

219. The imputation regime illustrates a set of rules that may have a number of levels of purpose. At the most specific level, a provision in that regime, s OB 4, provides rules for when an imputation credit arises in a company's imputation credit account. At a broader level, the purpose of the regime can be seen from the context of s OB 4, including the scheme of subpart OB, to be to provide rules for a system under which tax is levied at the company and shareholder levels but shareholders receive a credit for company tax paid (see also *The Taxation of Distributions from Companies* (Consultative Committee on the Taxation of Income from Capital, Discussion paper, November 1990)). At an even broader level, the policy of the regime is to ensure that, as far as possible, income earned through a company is taxed at the marginal tax rates of the shareholders of the company in accordance with the economic objective of taxing capital income at the tax rates of the individual (see *Full Imputation: Report of the Consultative Committee* (Consultative Committee on Full Imputation and International Tax Reform, April 1988)). This is not to say these are the only purposes of the imputation regime, but these particular purposes are set out here to help explain the point that any provision may have more than one purpose.

220. As noted above, it is also possible to look at the Act as a whole, and this has been illustrated in a number of GST cases. The courts have held that Parliament intends that GST inputs and outputs balance (*Ch'elle Properties (NZ) Ltd v Commissioner of Inland Revenue* [2007] NZCA 256, [2008] 2 NZLR 342 at [38] and *Education Administration* at [43]) and that inputs and outputs have a certain degree of temporal connection (*Ch'elle* at [41] and *Education Administration* at [43]). The courts in each of these cases identified these principles from the scheme of the GST Act. In *Ch'elle*, at [50], the Court of Appeal observed that while the GST Act contemplates the possibility of parties using different accounting regimes, and hence a degree of timing mismatch between when input tax is claimed and when output tax is paid, the GST Act seeks to limit the nature and degree of such mismatching. This was followed in *Education Administration* at [43]. The court in *Ch'elle* agreed with the Commissioner's submission that conditions in the GST Act limiting who can register on a payments basis showed any mismatch between taxpayers accounting on a payments basis and an invoice basis was intended to be limited.

221. Similarly in *Glenharrow*, in the context of considering the secondhand goods provisions, the Supreme Court outlined Parliament's purpose for the GST Act as a whole. At [47]:

> The whole premise of the Act generally and of the secondhand goods provisions in particular is that transactions will be driven by market forces: that their commercial and fiscal effects will be produced by those forces and will not contain distortions which affect (that is, defeat) the contemplated application of the GST Act. It is when market forces do not prevail that s 76 is available to the Commissioner. Take an obvious example (which on the High Court's finding of fact is not the present case). An unregistered vendor and a registered purchaser, not being associated persons, inflate the price of goods in return for a non recourse loan to the purchaser by the vendor. The purchaser obtains the advantage of a higher input tax deduction/refund. This would plainly defeat the intent and application of the Act, namely that the purchaser's deduction would be no more than the tax fraction of the market value of the goods. If the price were influenced by the tax advantage, the purchaser would be achieving something not contemplated by the Act – an artificially enhanced deduction. It is the same if the structure of the transaction enables the purchaser to obtain an artificially early deduction, that is, one which is unrelated to the market realities of the transaction.

Combinations of provisions

222. In many cases, Parliament's purpose for a combination of provisions that are relevant to a particular arrangement must be ascertained. In such cases, Parliament may not have explicitly considered the interaction of the provisions when they were enacted. However, it can still be appropriate to consider whether Parliament would or would not have intended them to be used in combination in a particular way. Courts have recognised that Parliament's purpose may need to be ascertained in such a case. For example, Harrison J in *Westpac* found that the arrangement used a combination of provisions in a way that would not have been contemplated by Parliament:

> [606] Self-evidently, such a deployment would not have been within Parliament's contemplation when the ITA was enacted. The legislature would not have contemplated that a taxpayer might lawfully use the deductibility provisions, in conjunction with a pre-existing right to exempt income, to provide funding to a party at a price considerably below market by returning a share of the domestic taxation benefit derived from claiming a deduction for a non-existent expense.

What Parliament would have contemplated hypothetically

223. A question that is sometimes asked is whether Parliament's purpose is the purpose at the time it enacted the provisions, or whether it is what Parliament's purpose would be at the time the arrangement is being considered. The relevant time is when Parliament enacted the provision(s). The court in *Ben Nevis* said at [107]:

> If, when viewed in that light, it is apparent that the taxpayer has used the specific provision, and thereby altered the incidence of income tax, in a way which cannot have been within the contemplation and purpose of Parliament **when it enacted the provision**, the arrangement will be a tax avoidance arrangement.
>
> [Emphasis added]

224. The test is not, however, an attempt to discern whether Parliament contemplated the actual arrangement with all its steps and transactions. Instead, the question is a hypothetical one, as recognised by Wild J in *BNZ Investments No 2* (HC):

> [134] In [101] in *Ben Nevis* the Supreme Court again makes the point — it had earlier been made in the submissions of counsel for the Commissioner referred to by Cooke J at NZTC 5,013; NZLR 541 in *Challenge* — that no GAAR can anticipate all the results of taxpayers' ingenuity in crafting arrangements. Thus Parliament could not, and will not, have contemplated the particular arrangement in issue. That arrangement is likely to deploy a number of statutory regimes or provisions. I agree with Mr Brown's submission for the Commissioner that it is unreal to suggest that Parliament, when it enacted the deductibility and subvention provisions and the FTC and conduit regimes, might actually have contemplated transactions structured as are those in issue in these proceedings.
>
> [135] It follows that I agree with the Commissioner's submission that the question for the court at step 2 is necessarily an hypothetical one. Guided by the considerations and the approach set out by the Supreme Court in [108] and [109] in *Ben Nevis*, the court is essentially asking itself: had Parliament foreseen transactions of this type when enacting the specific provisions deployed in the transactions, would it have viewed them as within the scheme and purpose of those specific provisions?

225. Comments to this effect were also made in *Russell* (CA) at [39].

How to determine Parliament's purpose

226. Parliament's purpose is identified by considering the meaning of the text of the provisions, the context (including the statutory scheme relevant to the provision) and any relevant legislative history.

227. Generally, the more specific purposes of a provision will be derived primarily from the words of the provision, although the context and scheme may also be relevant. Such a purpose might be, for example, to provide for a specific taxation treatment for a particular type of receipt. An example can be found in *Ben Nevis* where it was clear from the words of the legislation that one of Parliament's purposes was to give a deduction for insurance premiums. With broader purposes, typically a greater examination of the statutory context and scheme, along with the words of the section, is required. Harrison J's consideration of the foreign tax credit regime in *Westpac*, and the GST cases referred to in paragraphs 218 and 220 above, are examples where the courts considered the context and scheme to identify broader purposes.

228. Where there is a specific anti-avoidance provision that accompanies the provision at issue, it will form part of the relevant context to consider in identifying Parliament's purpose. However, as discussed earlier in this statement, the presence of a specific anti-avoidance provision does not rule out the application of s BG 1.

229. Extrinsic materials may be of assistance when identifying and understanding Parliament's purpose (see further on this under the next heading), and sometimes it might also be helpful to refer to judicial decisions where the purpose of legislation has been considered.

The admissibility and weight given to extrinsic materials

230. There may be situations where it can be useful to go further than the legislation as enacted and consider extrinsic materials. In this context, extrinsic materials are documents produced in the course of enacting legislation. Some examples of extrinsic materials are law reform reports, discussion documents, Inland Revenue publications, select committee reports and Hansard. Reference to extrinsic materials might more commonly be useful when identifying broader purposes. Generally, New Zealand courts have

taken a pragmatic approach to the use of extrinsic materials, concerning themselves mostly with the appropriate weight to be given to the material, rather than its admissibility. As a result of that weighing exercise, courts have used the material as part of the background to a decision, or to confirm a decision that has been reached by other means, rather than being decisive in itself. (See *R v Aylwin* [2008] NZCA 154, (2008) 24 CRNZ 87 at [58] and also Burrows, *Statute Law in New Zealand*, 258–289.)

231. The courts have made reference to extrinsic materials in a s BG 1 context in a number of cases. In *BNZ Investments No 2* (HC), Wild J referred to a discussion document (at [232] and [237]) when identifying the legislative policies underlying the provisions of the conduit regime. However, Wild J ultimately determined Parliament's purpose by reference to the scheme of the Act. At [235]:

> But the [legislative] requirements I have listed at [229] b)–g) are consistent only with Parliament contemplating that some of the conduit relieved income would in due course be passed on to the foreign owner. Otherwise those requirements are pointless.

232. The extrinsic materials were used by Wild J in support of a decision based on the actual text of the relevant provisions, rather than being determinative of Parliament's purpose in themselves.

233. Harrison J referred to extrinsic materials in *Westpac*. In considering the purpose of the conduit regime, his Honour referred to a Consultative Committee report and a report to the Finance and Expenditure Committee (see [228]–[229]). However, in the Commissioner's view, these references were made for background purposes rather than to support the conclusion. In *Penny* (CA), the Court of Appeal considered the commentary to the relevant bill when reviewing the personal services attribution rules (see [91]–[92]). Again, this reference was made for background purposes, as the case did not turn on the meaning of those provisions.

234. Therefore, extrinsic material may, depending on the circumstances, be relevant to determining Parliament's purpose in a s BG 1 context. However, that material is generally used as part of the background to a decision, or to confirm a decision that has been reached by other means, rather than being decisive in itself. Extrinsic materials should be used with care and should not substitute for a careful examination of the legislation. Courts have not demonstrated any willingness to rely on extrinsic materials to arrive at an interpretation that is not consistent with the words.

Identifying which purposes are relevant

235. Once Parliament's purposes have been identified for the provisions used (or any provisions that potentially do not apply), then the purposes relevant to the arrangement's use of the Act need to be identified. Which purposes are relevant, whether specific or broader, will depend on the particular use made of the Act. All of the potentially relevant purposes should be identified to see if the arrangement uses the provisions in a way Parliament did not intend. It may be that not all purposes pertaining to a provision are ultimately relevant. However, it is important to consider them in analysing the use of the Act to ensure that a use that is outside Parliament's contemplation is not overlooked.

Consideration of the commercial and economic reality may raise further questions about Parliament's relevant purpose

236. There is an important interaction between the two steps of ascertaining Parliament's relevant purpose and identifying the commercial reality and economic effects of the arrangement. It will very often be the case that consideration of the commercial reality and economic effects of an arrangement at the next step will raise further questions as to what Parliament's purpose is in the context of the particular arrangement. Often an arrangement will, on the face of it, appear to comply with Parliament's purpose. However, once the arrangement is examined, and a better understanding is reached as to the particular way the arrangement uses the Act, that knowledge may suggest that Parliament's purpose is not sufficiently identified and understood.

237. An arrangement that uses a combination of provisions is one instance of a use of the Act that might commonly raise questions about Parliament's purpose that had not previously been identified. Another is the presence of artificiality and contrivance that relate to tax effects and that have not yet been taken into account.

238. This interaction between Parliament's purpose and the commercial and economic reality of the arrangement is reflected in the comments above at paragraph 215, and is shown by the curved arrow on the left-hand side of the flow chart at paragraph 439.

239. Consideration of the arrangement may also serve to focus more accurately the inquiry into Parliament's purpose. Sometimes it will be clear from an examination of the arrangement that some aspects of Parliament's purpose are not relevant. Accordingly, those aspects of Parliament's purpose need not be considered further.

There may be two different avoidance aspects in a single arrangement

240. On some occasions, arrangements might avoid tax in more than one way, and these ways might be unrelated. If there are unrelated uses of the Act, each may need to be considered separately, and the Parliamentary contemplation test undertaken for each use. For example, the court in *Ben Nevis* ascertained Parliament's purpose, and the relevant commercial and economic reality of the arrangement, for each of two specific provisions. The relevant sections of the 1994 Act were s EG 1 (and related definitions in s OB 1), which gave a deduction for depreciation on a right to use land, and s DL 1(3), which gave a deduction for insurance premiums. The court treated these two uses as two separate inquiries.

Identifying what Parliament would have expected would be present (or absent) to give effect to its purpose

241. To consider Parliament's relevant purposes in the context of taxpayers' arrangements, those purposes must be translated into facts Parliament would expect to see present or those that Parliament would expect to be absent. This is because taxpayers and arrangements operate in the real world and so the practical application of Parliament's purposes must be considered.

242. Sometimes the facts Parliament would expect to be present (or absent) will be readily ascertainable. For example, in the context of the depreciation rules, it may be concluded that Parliament's purpose is (at the very least) to allow deductions against income for owners of assets used to derive that income. Therefore, Parliament would expect that for the depreciation provisions to apply, there must be an asset, the asset must be used in deriving income and the asset must be owned by a taxpayer (see s EE 1).

243. An example of where a judge has identified facts Parliament would expect can be seen in *Westpac* when Harrison J considered the foreign tax credit regime. After identifying the purpose of the regime, Harrison J took the view that Parliament would have expected foreign tax actually to have been paid. At [612] his Honour said:

> As demonstrated by s LC 1(3A), the FTC regime was intended to provide New Zealand taxpayers with credits for tax paid in a foreign jurisdiction.
>
> ...
>
> I accept, as Wild J did, the Commissioner's argument that the actual payment of foreign tax is the policy foundation of the FTC regime and that, without such a payment, there is nothing against which to allow a credit.

244. Sometimes, some or all of the facts may not be specifically identified in the provision in question. If that is so, greater consideration will need to be given to what Parliament would have expected. For example, when considering the application of s CC 1(2), which specifically includes "rent" in income, it might be appropriate to identify that Parliament would expect there to be a landlord and a tenant in relation to a payment of rent, even though the section does not specify that.

245. The courts have also been prepared to identify necessary facts that are even less evident. For example, in *BNZ Investments No 2* (HC), Wild J found that for the conduit rules to apply Parliament would have expected dividends would be paid to a non-resident shareholder and so non-resident withholding tax would be paid (at [243]). In *Westpac*, Harrison J considered that Parliament would have expected NRWT would be capable of being paid, rather than that it would have to be paid (at [610]–[611]).

246. While often Parliament would be expecting quite specific facts to be present (or absent), at other times Parliament may expect a more general conceptual notion to be satisfied or be permissive of different combinations of facts. These latter instances could be described as "features" or "attributes" Parliament would expect to be present or absent. Examples might include legal, commercial or economic concepts. For example, a legal concept could arise if a deduction was available for a lease payment, but not for a licence payment. The relevant features or attributes would be those relating to the distinction between the legal concepts of leases and licences (involving, for example, looking at whether the party has exclusive possession).

247. *Ben Nevis* contains an example of a commercial concept. The court had to decide whether amounts the taxpayer had paid were "insurance premiums" under s DL 1(3) of the Income Tax Act 1994. This section provided a deduction for insurance premium expenses incurred by a person carrying on a forestry business. The court identified commercial features of insurance that it considered would be present in a contract of insurance, such as risk management, reinsurance and being open to the public rather than secret.

248. An example of an economic concept can be found in both *Ben Nevis* and *Westpac*. In those cases the courts took the view that a feature of an expense is that it needed to be incurred in an economic sense. In the Court of Appeal decision in the *Ben Nevis* litigation (*Accent Management Ltd v Commissioner of Inland*

Revenue [2007] NZCA 230, (2007) 23 NZTC 21,323), the court said at [126]:

> ... it will usually be safe to infer that specific tax rules as to deductibility are premised on the assumption that they should only be invoked in relation to the incurring of real economic consequences of the type contemplated by the legislature when the rules were enacted.

249. Similarly, in *Westpac*, Harrison J said:

> [596] Specific deductibility provisions are to be invoked where the taxpayer has by the transaction incurred "real economic consequences of the type contemplated by the legislature when the rules were enacted"; and where the taxpayer is "engag[ing] in business activities for the purpose of making a profit": *Accent* at [126].

250. It may also be noted that sometimes Parliament uses a term relying on the fact that it has been given a meaning by the courts, and those judicial decisions will need to be considered to understand Parliament's purpose. For example, the courts have identified a number of attributes of the concept of income according to ordinary concepts.

251. Therefore, a consideration of Parliament's purposes requires the identification of relevant facts, features and attributes that Parliament would expect to be present or absent. Importantly, these facts, features and attributes are generated from Parliament's relevant purpose or purposes.

The degree of precision needed to reach a view on the facts, features and attributes

252. It is important to recognise that this exercise of identifying what facts, features and attributes Parliament would expect does not demand absolute precision. It will frequently involve matters of degree and generality. There will often be a limit to the degree of precision that can be achieved in this regard, and in such cases an element of judgement will be necessary and unavoidable. In other words, a view formed as to Parliament's purpose will not always give rise to very specific facts, features and attributes, or exactness in terms of measures or quantification. However, this is simply a reality and does not undermine the need to translate Parliament's relevant purposes into facts, features and attributes to whatever degree this is possible.

253. It may not, therefore, be possible to reach an exhaustive and precise view on what Parliament would have expected. However, it can still be determined (at the stage when a decision on the arrangement is made) whether the use of the provisions in question exhibits the requisite facts, features and attributes to a sufficient degree. For example, it might be concluded that Parliament would have contemplated a substantial period of ownership of an asset for the operation of a particular provision. The legislation and other relevant background and sources can be examined to try and understand more exactly what Parliament would have anticipated as the duration of such a period, but sometimes there will be a point when there is no more guidance available. Ultimately, a decision will still have to be made whether the particular use of the Act by the arrangement in question is within what Parliament would have contemplated.

254. In *Ch'elle* the Court of Appeal said that while the GST Act permits a degree of mismatching in terms of accounting methods, it "seeks to limit the nature and degree of such mismatching" and that a "gross mismatch" in timing is relevant to the avoidance provision (at [50]). The court examined the arrangement to see whether there was such a gross mismatch. However, in doing so, the court did not find it necessary to reach any view on the precise point at which a mismatch would cease to give effect to Parliament's purpose. It was able to conclude at [51]:

> As a result, the degree of mismatch contemplated and tolerated by the Act escalated to a level which could never have been intended.

Identifying what Parliament would have expected would be present (or absent) can require giving effect to tax concepts

255. A concern is sometimes raised about how the Parliamentary contemplation test applies to special tax concepts that are unique to the Income Tax Act. The concern is that the requirement to identify commercial and economic reality may not recognise those tax concepts. However, this is not the case. Looking at the arrangement as a matter of commercial and economic reality does not require any departure from the requirements of the taxation legislation. What is required is to take what is in the legislation and ascertain what facts, features and attributes are needed to satisfy it. It does not matter that some terminology or concepts used in the Act are themselves artificial or only exist in the legislation. Underlying these terms and concepts, some real-world facts, features and attributes will always need to be present to give effect to Parliament's purpose.

Summary – identifying Parliament's purpose

256. The Parliamentary contemplation test involves considering both Parliament's purpose and the commercial and economic reality of the arrangement. The Commissioner considers that the better approach

is to identify Parliament's purpose first, before examining the arrangement. There is, however, an important interaction between the two steps. It is also important to appreciate that the approach of beginning with Parliament's purpose should not be done at the expense of taking appropriate account of the facts of the arrangement and, in particular, its commercial reality and economic effects.

257. Parliament's purpose is the result Parliament intended to achieve, or the end in mind Parliament had, for the provisions. There may be multiple purposes. These may include quite specific purposes, which arise from the particular role of a provision in the Act, and/or broader purposes. Parliament's purpose for combinations of provisions may also need to be identified. The relevant time to consider is Parliament's purpose at the time it enacted the provisions. The test is not an attempt to discern whether Parliament contemplated the actual arrangement with all its steps and transactions. Instead, the question is a hypothetical one.

258. How Parliament's purpose is identified for any arrangement will depend on how the Act applies or does not apply by virtue of the arrangement. In some cases, the exercise will be focused simply on the text of a particular provision. In others, a broader examination of the Act may be required to identify Parliament's purpose. Sometimes extrinsic materials and case law may help when reaching a view on Parliament's purpose.

259. All of Parliament's relevant purposes need to be identified, although ultimately not every potential purpose will be relevant. Whether a purpose is relevant will depend on the particular use the arrangement makes of the Act.

260. Once Parliament's relevant purpose has been ascertained, the facts, features and attributes required to be present (or absent) to give effect to Parliament's purpose must then be identified. There may be some variation in the degree of precision necessary, or even possible, in establishing these.

Commercial reality and economic effects of an arrangement

261. As has been discussed, determining whether there is tax avoidance involves ascertaining Parliament's purpose for the provisions used, or potentially relevant provisions that do not apply. This can provide the basis for identifying the facts, features and attributes that should be present or absent to give effect to that purpose. The commercial reality and economic effects of an arrangement can then be examined to see whether, and to what degree, the facts, features and attributes are present or absent in the particular case.

262. It is very clear from the Supreme Court decision in *Ben Nevis* that the question whether the required facts, features and attributes to give effect to Parliament's purpose are present or absent in the arrangement is to be answered from the point of view of the arrangement's commercial and economic reality. For example, Parliament will expect that if a payment is made or an asset is sold, that this happens in a real sense, and not just on the appearance of the arrangement. Identifying the commercial reality and economic effects of an arrangement goes beyond the legal form of an arrangement. It requires identifying the real outcomes for the parties and those affected by it over the duration of the arrangement, to the extent they are relevant to the provisions under consideration.

263. It might be observed that the court in *Ben Nevis* referred in one place to the "economic and commercial effect of documents and transactions", in another to the "commercial reality and economic effect" of a use of the Act, and also to an arrangement "viewed in a commercially and economically realistic way". The Commissioner's view is that these phrases are fundamentally about the same concept in this context, and so for convenience in the following discussion the phrase "commercial and economic reality" will generally be used.

How to determine the commercial and economic reality of an arrangement

264. Understanding what is actually achieved by or under an arrangement requires a complete understanding of the facts and a thorough grasp of the detail and workings of the arrangement as a whole. It requires identifying the real commercial and economic outcomes for the parties under that arrangement over its life that are relevant to the provisions at issue. This inquiry will be guided by the facts, features and attributes Parliament would expect to be present (or absent). In *Ben Nevis*, the court identified a number of factors that are relevant in this context. These include the manner in which the arrangement is carried out, the role of the parties and the nature and extent of the financial consequences for the taxpayer.

265. When determining the commercial and economic reality of an arrangement, steps in the arrangement that disguise the actual consequences for the parties, particularly steps that seem artificial or that involve pretence or circularity, may be ignored. It is only once the true commercial and economic outcomes of an

arrangement that are relevant to the provisions at issue have been identified, that these outcomes can then be tested against Parliament's purpose and contemplation for the relevant provisions.

Case law illustrations of examining the commercial and economic reality of the arrangement

266. In the Commissioner's view, the following cases illustrate how the courts have examined the arrangement before them to see if the necessary facts, features and attributes are present, and to what degree, when the commercial and economic reality of the arrangement is properly understood.

267. In the *Ben Nevis* case, the court proceeded on the basis that Parliament would have expected the licence premium expenses would be incurred in reality, in the sense of the taxpayers actually having to pay them (see [118]–[119]). At [128]:

> While the law treats the relevant costs as incurred, and shareholders are not generally held personally liable for a company's obligations, the court is permitted, when considering the question of tax avoidance, to examine the commercial nature of the incurred cost and any factors that might indicate that the expenditure will never be truly incurred.

268. The court examined the facts and concluded that the expenses were not truly incurred in this sense. The expenses were licence premiums for the right to use the land. The taxpayers claimed they had the ability to deduct a depreciation allowance of one-fiftieth of the licence premium expense. However, the premiums were paid by the use of promissory notes, and the obligation to pay under the promissory notes was to be satisfied from the proceeds of the trees harvested after 50 years. The court found that the prospect of the business being profitable when the net stumpage was received after harvest was unlikely, saying at [130]:

> It puts a different stamp on the nature of the obligation to pay the licence premium so that, as a matter of commercial reality, its discharge is dependent on the proceeds of the stumpage. There are so many contingencies around events that may occur prior to 2047 that **the obligation to pay the licence premium lacks real force**. The effect of the arrangement (if permitted) would be to provide a tax concession in circumstances where the commitment to make the payment is dependent on stumpage proceeds and otherwise is illusory. The result of this use of the specific provision is to take the arrangement, insofar as it depends on the licence premium promissory note, outside of the scope of the provision allowing for a deduction for depreciable property and to make what the investors entered into a tax avoidance arrangement.
>
> [Emphasis added]

269. As well as claiming to deduct licence premiums for the right to use land, the taxpayer also claimed to have incurred insurance premiums. The court examined the facts to determine whether the payments were actually for insurance—as this was what Parliament would expect. The court found that, when analysed commercially, there was no risk involved, no reinsurance and no offers of insurance to the public by the insurance entity. It concluded that the insurance dimension of the arrangement was not insurance as a matter of commercial reality but "was simply a method whereby substantial tax benefits could be obtained by deducting in one lump sum in 1997 a premium not payable in commercial terms until 2047" (at [146]).

270. Similarly to the finding on the licence premiums, the court reached the view that the use of a promissory note to pay the insurance premiums meant the insurance premiums were not economically incurred. At [147]:

> As already mentioned, this is technically correct in law, but, **in substance, the debt remains unpaid**. There is no transfer of real value to the creditor by substituting one form of obligation for another. Hence the promissory note was an artificial payment implemented for taxation purposes. The simple fact is **that the second premium was not paid in any real sense** by means of the promissory note. The use of the promissory note as an aspect of the whole arrangement reinforces its artificiality. CSI undertook no real risk and was simply a vehicle to achieve the deductibility of a premium which was not truly paid. The purported payment did not give rise to any economic consequences on either side.
>
> [Emphasis added]

271. In *Westpac*, Harrison J also took the view that Parliament would have expected an expense to be economically incurred, in the sense of the taxpayer actually bearing the cost of it. After considering the facts, he concluded that the expense was not in fact incurred economically at [596]:

> The dividend formula explains why Westpac claimed a deduction for an expense **which did not incur real economic consequences of the type envisaged by the deductibility provisions**. The financial returns enjoyed by both parties were the result of a formula designed to share deductions derived by Westpac where in substance the economic burden and benefit were non-existent.
>
> [Emphasis added]

And at [597]:

> The contrived expense was also, by virtue of the self-cancelling effect of the exchanges inherent in the pricing structure, illusory.

272. The court in *Westpac* was also concerned with whether, in fact, foreign tax had been paid. At [612]:

> As demonstrated by s LC 1(3A), the FTC regime was intended to provide New Zealand taxpayers with credits for tax paid in a foreign jurisdiction. **Yet the economic burden of the US tax on the gross distribution was not in fact paid or economically suffered by either Westpac or the counterparty.** As Coopers & Lybrand wrote to Westpac on 25 June 1998:
>
> "... the US counter party enjoys what is effectively a double deduction in the United States (for the interest paid, and second in relation to the partnership distribution), in substance the tax in relation to which a credit is claimed in New Zealand is not real. In practical terms, it is refunded."
>
> I accept, as Wild J did, the Commissioner's argument that the actual payment of foreign tax is the policy foundation of the FTC regime and that, without such a payment, there is nothing against which to allow a credit. **The CSFB transaction was, in economic substance, incompatible with the FTC regime.**
>
> [Emphasis added]

273. The Court of Appeal in *Alesco* (CA) concluded that the word "expenditure" required an actual outflow of money or an obligation to make payment (at [70]) and that features of the financial arrangements rules suggested Parliament would not have intended for the rules to be used to claim interest deductions for which the taxpayer was not liable or did not pay (at [71]–[72]).

274. In *Education Administration*, French J considered that the fact the taxpayer paid only 10% of each invoice, with the remainder being a purely contingent liability, meant there was no real economic burden as would have been anticipated by Parliament for the relevant provision. At [61]:

> As Mr Clews himself elegantly put it, **a core value upon which the granting of the GST input tax credit is based is that the party claiming it should have been subjected to a real and genuine economic burden**. On the facts of this case Education Administration was not in my view subject to a real economic burden, and accordingly was using the Act in a way Parliament did not intend.
>
> [Emphasis added]

275. In the Supreme Court decision in *Glenharrow*, the court considered both the commercial and economic aspects of the arrangement. The taxpayer had paid an amount for a mining licence. Payment was made by way of a relatively small cash payment and the balance by vendor finance. The purchaser was to repay the vendor finance with proceeds from using the licence. The court identified that Parliament's broad purpose for GST is that GST would remain neutral as a value-added tax levied on final consumers. From this, the court considered that the premise of the GST Act, and the secondhand provisions in particular, is that transactions will be driven by market forces (see [46] and [47]). In examining the arrangement, the court recognised the very high price paid for the mining licence and questioned whether the commercial reality was such that there was any likelihood of the taxpayer mining enough stone to generate sufficient sales. In a similar way to the cases already discussed, the court considered the economic aspect of the way payment was to be achieved and considered that there was little likelihood of payment in economic terms:

> [52] In reality the only part of the price which in economic terms would ever be paid — disregarding the possible use of any GST refund for this purpose — was such as could be funded from sales during the third year. An objective observer, when the arrangement was made, would have said that Glenharrow would never be able to mine enough stone during the term of the licence in order to generate sufficient sales. It certainly would not be able to pay the first two annual instalments of the price because it would not have begun mining. Yet the structure adopted was for a "payment" and a "re-advance". **This achieved no economic effect and nothing significant in commercial terms.**
>
> [Emphasis added]

And at [53]:

> **In economic terms there was no consideration in money given** by Glenharrow because of the **commercial impossibility** of payment by it in circumstances where it was virtually uncapitalised and its obligation was not supported by its shareholder. The terms of the arrangement may well have made business sense from the perspective of each party as a transaction which enabled Glenharrow to exploit the licence and pay the price as and when stone was extracted and sales eventuated. It safeguarded Mr Fahey and Mr Meates to some extent against the risks of the venture. **But it had no such reality as a "cash" transaction, despite being structured as if it were.**
>
> [Emphasis added]

276. The cases discussed so far illustrate that in many recent cases the common fact, feature or attribute that is absent is an expense or outgoing that has been incurred **in a real sense**. In *Alesco New Zealand Ltd v Commissioner of Inland Revenue* [2012] 2 NZLR 252 (HC), Heath J analysed Parliament's purpose and established the financial arrangements rules are intended to match "*real* income and *real* expenditure".

His Honour then analysed the facts to establish the "real nature of the transactions effected through the Notes". The Court of Appeal concluded that the underlying premise for the deductibility rules was that they were to apply only when "real economic consequences are incurred" (see *Alesco* (CA) at [83]).

277. *Penny* (SC) concerned in part the circumvention of the provisions in Part C of the Act that provide that income according to ordinary concepts and business income are income of the taxpayer who derives them. In the Commissioner's view, Parliament's relevant purpose at the heart of the *Penny* (SC) case was that income should be taxed to the person who derives it. The court examined the arrangement to reach a view on who in reality was the person who derived the income. The court concluded that the taxpayers retained control of the economic benefit of earnings that were essentially generated through their personal exertion despite the structure of the arrangement, so the reality was that they continued to derive the income. The court said at [35] and [47]:

> The fixing of the low salary enabled most of the profits of the company from the professional practice to be transferred by way of dividends straight through to the trust, avoiding payment of the highest personal tax rate, and then use[d] by the trust for the taxpayer's family purposes, including benefiting him by loans (Mr Penny) or funding the family home and holiday home (Mr Hooper). Although neither taxpayer was a trustee, each could naturally expect that the trustees whom they had chosen would act as they in fact did, and that the benefits of the use of the funds would thereby be secured without the impost of the highest personal tax rate.
>
> ...
>
> That is what the artificially low salary settings did in this case. They reduced each taxpayer's earnings but at the same time enabled the company's earnings (derived only because of the setting of the salary levels) to be made available to him through the family trusts. **In reality, the taxpayers suffered no actual loss of income** but obtained a reduction in liability to tax as if they had, to adapt Lord Templeman's dictum in *Challenge*.
>
> [Emphasis added]

Factors that may be taken into account when determining the commercial reality and economic effects of an arrangement

278. As noted above at paragraph 264, the court in *Ben Nevis* (at [108]) set out some of the factors that may be taken into account as part of the inquiry into the commercial reality and economic effects of an arrangement. These include:

- 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 duration of the arrangement;
- the nature and extent of the financial consequences.

279. The court also said that a "classic indicator" of a use that is outside Parliament's contemplation is an arrangement structured so the taxpayer gains the benefit of the relevant provision in an artificial or contrived way.

280. The court in *Ben Nevis* confirmed that the matters to be considered are not limited to the factors listed above:

> [108] The general anti-avoidance provision does not confine the court as to the matters which may be taken into account when considering whether a tax avoidance arrangement exists. Hence the Commissioner and the courts may address a number of relevant factors, the significance of which will depend on the particular facts.

281. These factors are considered when reaching a view on the commercial and economic reality of the arrangement that is relevant to the provisions at issue. They will help to identify which aspects of the arrangement to focus on when reaching a view on whether the provisions are being used as Parliament intended. In particular, they will help with determining whether the necessary facts, features and attributes are present or absent (and to what degree). The relevance of factors will depend on the provisions used, or that it is argued do not apply, and what Parliament would expect to be present (or absent) (*Ben Nevis* at [108] and *BNZ Investments No 2* (HC) at [128]). For example, the mechanism used in the arrangement in *Ben Nevis* to separate legal and economic payment meant that the *duration* of the arrangement was relevant (see *Ben Nevis* at [120], [128], [130] and [147]). For other arrangements and uses of the Act, duration may not be a helpful factor.

282. The following paragraphs discuss each of the factors set out in *Ben Nevis*. Some of these factors are closely connected and there is some overlap. However, because the factors were specifically listed in *Ben Nevis* they are dealt with individually below. Factors that may be particularly closely related are artificiality, the economic and commercial effect of documents and transactions, and the nature and extent of the financial consequences the arrangement will have for the taxpayer. Some other factors found to be significant in

cases, and not specifically mentioned in *Ben Nevis*, are also discussed. These are:

- Does the arrangement involve pretence?
- Is the arrangement circular?
- Does the arrangement involve inflated expenditure or reduced levels of income?
- Have the parties undertaken real risk?
- The relevance of an arrangement being pre tax negative.

283. Cases are used to illustrate the presence of the factors in tax avoidance arrangements.

The manner in which the arrangement is carried out

284. The manner in which the arrangement is carried out refers to the **particular way** the arrangement has been structured. It will be relevant to consider whether the particular structure chosen differs from usual commercial practice, whether there are unusual features of the arrangement, whether the structuring is hard to understand from a commercial point of view and whether the structure adopted has the effect that sections of the Act apply or do not apply. Examining these aspects will generally help in reaching a view on what is really achieved commercially and economically and whether the provisions have been used in a way Parliament intended.

285. The court in *Ben Nevis* referred to the specific way the arrangement was structured in that case:

> [128] All this arises from the manner in which the specific provision has been used. Execution of promissory notes has created a timing mismatch between the dates for legal and economic payment. While the law treats the relevant costs as incurred, and shareholders are not generally held personally liable for a company's obligations, the court is permitted, when considering the question of tax avoidance, to examine the commercial nature of the incurred cost and any factors that might indicate that the expenditure will never be truly incurred.

286. In *Penny* (SC), the company and trust structure used was not remarkable, but part of the arrangement involved fixing the taxpayers' salaries in an artificial manner (at [47]).

287. Wild J in *BNZ Investments No 2* (HC) also commented on the manner in which the arrangement was carried out:

> [404] To summarise, I answer the points I set out in [360] as follows:
>
> a) The primary purpose of the swap was to facilitate a fixed distribution rate under the transaction, and thus fix the tax benefits shared by the parties.
>
> b) The manner in which the interest rate swaps were transacted was not in accordance with market practice in several respects. This had the consequence that the fixed interest rate in at least two of the transactions was well out of line with the market rate.

288. His Honour also commented on a number of features of the transactions and how they were carried out before reaching the conclusion that the transactions were tax avoidance. For example, he made the following findings on the facts:

- The transactions were template transactions. His Honour said a template transaction was a standard form transaction replicated for different businesses (at [516]). Wild J noted that this feature, when considered in conjunction with other factors such as the BNZ's controlled use of its tax capacity to generate exempt income, indicated that the "BNZ used the transactions for a 'tax avoidance' purpose" (at [259]).
- The transactions were complex given that in substance they were straightforward loans (at [284]).
- Each transaction split the New Zealand tax benefits between the BNZ and the counterparty and moved progressively in favour of the BNZ, reflecting its increasing awareness of the commercial value of its ability to generate exempt income (at [285]).
- No counterparty approached the BNZ seeking funding. The BNZ attracted the counterparties to these transactions by offering them funds at well below their normal cost of funds, as compensation for their participation (at [421]).

289. In *Education Administration*, French J said:

> [57] On anyone's view of it, there were some unusual aspects to the agreement between the two companies, most notably the fact that Education Administration was only required to pay 10 per cent of each invoice immediately with the remaining 90 per cent payable at some unspecified time in the future, without any component of interest being charged, and only from revenue generated by sales which were not guaranteed.

The role of all relevant parties and their relationships

290. Considering the roles of the relevant parties and any relationships they may have (including with the taxpayer) can be useful in both understanding and analysing the commercial reality and economic effects of the arrangement. Instances where the roles of the parties might be relevant are where that has enabled the parties to put a different appearance on the facts—which might particularly be the case where they are associated parties—and also where different

parties should economically be considered part of the same group.

291. An example where the presence of related parties is relevant is where the taxpayer is legally separate from the other parties (eg, by company and trust structures) but effectively controls those other parties through, for example, directorial influence, shareholding or trustee capacity. In *Penny* (SC), the Supreme Court accepted that the company and trust structures were legitimate business vehicles to be adopted by taxpayers. However, the court concluded it was a tax avoidance arrangement in that case because the taxpayers derived all of the income but were not taxed as if they had. The structures enabled the taxpayers to receive an artificially low salary and to avoid the impost of the highest personal tax rate, while still enjoying the full benefit of the use of the funds. The court commented:

> [35] The fixing of the low salary enabled most of the profits of the company from the professional practice to be transferred by way of dividends straight through to the trust, avoiding payment of the highest personal tax rate, and then use by the trust for the taxpayer's family purposes, including benefiting him by loans (Mr Penny) or funding the family home and holiday home (Mr Hooper). **Although neither taxpayer was a trustee, each could naturally expect that the trustees whom they had chosen would act as they in fact did**, and that the benefits of the use of the funds would thereby be secured without the impost of the highest personal tax rate.
>
> [Emphasis added]

292. Another example of a taxpayer retaining control, despite the presence of other parties, can be seen in *Russell* (HC). The court observed in that case at [131]:

> Very significantly, Mr Russell retained control of the whole of the income generated; only he could direct how it was to be applied. The income of the Commercial Management partnership was in my judgment derived from Mr Russell's personal exertions and he retained control over it.

293. The relationship between the parties can also be relevant when the parties are not associated or related. For example, parties might agree to share the tax benefits of an arrangement in a way that is outside Parliament's contemplation. This may arise in cross-border tax arbitrage where there is a differing tax treatment for cash flows between tax jurisdictions and the parties agree to share the New Zealand tax benefits. An example of this is *BNZ Investments No 2* (HC), where the taxpayer and counterparties were unrelated and at arm's length but there was an arrangement to generate and share tax benefits, as revealed by the negotiations over the splitting of the New Zealand tax benefits.

The economic and commercial effect of documents and transactions

294. The documents and transactions can be examined to see whether they are consistent with the real outcomes under the arrangement. In *Westpac*, Harrison J said:

> [603] The bank's payment of a gratuitous (and substantial) fee, and its unexplained indifference to critical elements of the transaction, establishes the artificiality of the legal structure which it superimposed and its consequential rights and obligations. This was not a case of a taxpayer choosing the most advantageous structure of a transaction for tax purposes; I am satisfied it was a case of a taxpayer selecting a form which was contrary to and designed to re-characterise the transaction's economic substance as a loan for the purpose of avoiding liabilities to tax.

295. The court in *Glenharrow* said at [53]:

> In economic terms there was no consideration in money given by Glenharrow because of the commercial impossibility of payment by it in circumstances where it was virtually uncapitalised and its obligation was not supported by its shareholder … But it had no such reality as a "cash" transaction, despite being structured as if it were.

296. In *Erris Promotions Ltd v Commissioner of Inland Revenue* (2003) 21 NZTC 18,330 (HC), a joint venture acquired software at grossly inflated prices funded by non-recourse vendor finance (at [335]). The High Court described the software purchases as an arrangement to avoid tax, with "little commercial reality about the purchases" (at [329]). There were no valuations, no technical due diligence, and a superficial inquiry of markets by the purchasers. In some cases, the persons claiming to be the vendors did not own the software and, in others, the software did not exist. The transactions had no commercial base and were essentially a means of creating a tax advantage by creating inflated depreciation losses. Ordinary commercial tensions did not exist between the vendor and purchaser. It was clear from the so-called negotiations between the vendors and purchasers that the higher the price the better (at [338]). The higher the price the greater the depreciation losses and the greater the attraction to investors.

The duration of the arrangement

297. In some cases, the timing aspects of a transaction may evidence that the transaction has been structured in a manner that has the effect that the facts, features and attributes expected by Parliament for the operation of the provisions are not present (or absent). Timing aspects include the duration of the arrangement and the intervals between particular

events in a transaction. For example, the duration of an arrangement may artificially increase the size of a timing or real economic advantage. In *Ben Nevis*, the tax advantage of the licence premiums was based on the timing difference between, on one hand, incurring expenditure and the amortising licence premiums, and, on the other, the ultimate economic payments to be made in 50 years' time. The Supreme Court agreed with the Court of Appeal's description of the mismatch as an unusual feature of the licence premium. The court considered that a consequence of the length of time that had to elapse was that the taxpayer might not actually pay the premium in 2048, for which they had already claimed a depreciation allowance, as the LAQCs might not be in existence and the shareholders may not be still alive. The court also observed that there was likely to be mutual benefit in the arrangement being unwound well before 2048.

298. In *Ch'elle*, the arrangement involved a mismatch between the invoice and payments bases of accounting for GST. Ch'elle accounted for GST on an invoice basis, while the vendor companies were on a payments basis. The invoice prices for the properties were based on their future value in 10–20 years' time, with cash settlement also deferred for the same period. This provided for a material GST timing advantage. The Court of Appeal observed that the wider the temporal gap between the taxpayer's eligibility for an input tax credit and a corresponding liability for output tax, the less likely the arrangement would fall within the intent of the GST Act. In the circumstances of the case, the balance between outputs and inputs was grossly distorted by the 10–20 year delay between input and output recognition. Both the TRA and High Court commented that there was doubt as to whether the output would ever arise because of the length of the deferred settlement and the uncertainty of the underlying contractual arrangements.

299. Duration was relevant in a different way to the court's findings in *Glenharrow*. In that case, the Supreme Court found it was unlikely there would be commercial returns given the term of the licence that was part of the arrangement. At [51]:

> *Glenharrow* accepted the legal obligation to pay the full price but at the outset the parties were well aware, and any objective observer in 1997 would have seen, that payment in full would certainly not occur. The licence had only a little over three years to run. Whatever the parties may have thought, no renewal was available as a matter of law. The parties themselves believed and the objective observer would have concluded, that it would take two years to get started on mining because of the need first to obtain various consents and approvals. The parties to the arrangement may have had an intention to implement their agreement according to its terms but that was plainly an impossible task. No one has ever suggested that the remainder of the term would suffice for the success of the project to a point where it would produce enough extraction of stone to pay the $45m. There was no prospect of the payment being made by any other means.
>
> [Footnotes omitted]

300. Another example of where the duration of the arrangement may be a relevant factor in the inquiry into the commercial reality and economic effects of an arrangement is where a financial instrument is entered into for an unusually long period. This might indicate a departure from normal practice that, in turn, could indicate that the provisions of the Act are not being applied in the way Parliament contemplated. The duration of an arrangement, however, is merely to be taken into account, rather than being something that gives rise to a rule. It should not be presumed that instruments such as, for example, perpetual notes amount to tax avoidance simply because of their duration.

The nature and extent of the financial consequences

301. Considering the nature and extent of the financial consequences that an arrangement has for a taxpayer is at the core of a commercial and economic analysis, and will be necessary to reach a view on whether the facts, features and attributes envisaged by Parliament for the provisions are present (or absent). Examples of this include situations where a taxpayer does not actually suffer the financial consequences for which the tax outcome is claimed (such as where a deduction is claimed but the necessary expenditure is never actually incurred) or where the nature of the transaction is not as claimed (such as where an amount is actually paid for something other than what is claimed).

302. The Supreme Court in *Glenharrow* took the nature and extent of the financial consequences into account when it summed up its view at [54]:

> ... on an objective view of the present case, the effect of the structure, given the gross disparity between the price and the size of the purchaser and given, particularly, the shrinking value of the asset, with its very limited practical life, was to produce a GST refund totally disproportionate to the economic burden undertaken by Glenharrow or the economic benefit obtained by Mr Meates. Indeed, there can be no issue that Glenharrow undertook liability for the $44,920,000 funded by vendor finance. But Glenharrow was a shell company with a share capital

> of just $100. And as Mr Meates was unregistered, there was no GST impost on the other side of the transaction.

303. Similarly, in *Ben Nevis*:

> [147] This is a convenient place at which to revert to the promissory note. The syndicate was contractually liable to pay the second premium in 2047. Payment of that premium was secured by debenture. … [The promissory note's] true purpose was to enable the contractual debt for the premium to be treated as discharged by the giving of the promissory note. By this means the premium payable in 2047 could be said to have been paid in 1997. As already mentioned, this is technically correct in law, but, in substance, the debt remains unpaid. There is no transfer of real value to the creditor by substituting one form of obligation for another. Hence the promissory note was an artificial payment implemented for taxation purposes. The simple fact is that the second premium was not paid in any real sense by means of the promissory note. The use of the promissory note as an aspect of the whole arrangement reinforces its artificiality. CSI undertook no real risk and was simply a vehicle to achieve the deductibility of a premium which was not truly paid. The purported payment did not give rise to any economic consequences on either side.
>
> [148] It is inherent in all we have said on this topic that we regard the insurance dimension of the Trinity scheme as both artificial and contrived. The payment of the second premium by means of the promissory note was, in commercial terms, no payment at all. The economic impact of the payment was deferred for 50 years, that being an extreme use of the proposition that a commitment to pay is equivalent to payment, with the time value of money being ignored.

304. And in *Education Administration*:

> [74] In my view, the fact that Education Administration had no capital of its own would not in itself be sufficient to bring the arrangement within the ambit of s 76. However, when taken in combination with the other factors I have mentioned, it does assume some significance. Those other factors being the creation of two companies by parties essentially engaged in a joint venture, the inflated hourly rate, the registration of those companies on different accounting bases, the issuing of invoices for the full amount but only requiring immediate payment of 10 per cent, and the contingent nature of the liability to pay the remaining 90 per cent.

305. The Privy Council in *Challenge* (PC) observed that in a tax avoidance arrangement the financial position of the taxpayer may be unaffected, save for the costs of devising and implementing the arrangement (at 562). The Board said that by a tax avoidance arrangement the taxpayer seeks to obtain a tax advantage without suffering the reduction in income, the loss or the expenditure that other taxpayers suffer and that Parliament intended to be suffered by any taxpayer qualifying for a reduction in their liability to tax.

306. See also *Westpac*:

> [596] Specific deductibility provisions are to be invoked where the taxpayer has by the transaction incurred 'real economic consequences of the type contemplated by the legislature when the rules were enacted'; and where the taxpayer is 'engag[ing] in business activities for the purpose of making a profit': *Accent* at [126].

307. In *Penny* (SC) and (CA), the taxpayers asserted a reduction in personal services income and sought to obtain the benefit of the lower corporate tax rate while still receiving, in economic terms, the benefit of the company's entire net income for themselves and their families. In *Challenge* (CA), the taxpayer company grouped its profits with losses that were suffered by an unrelated company. In that way they sought to take advantage of losses they had not truly incurred in the first place. The taxpayer in *Dandelion* (CA) sought to claim an interest deduction without actually having suffered the expense. It achieved this by contemporaneously deriving exempt dividend income as part of the circular tax avoidance arrangement. The Court of Appeal commented that there was no financial effect for the taxpayer other than a net outlay of $86,080 and advisory fees, as the exempt dividend funded the deductible interest expense.

Is the arrangement artificial or contrived?

308. Artificiality and contrivance have for many years been recognised as strong indicators of tax avoidance, and they are particularly relevant to the examination of the commercial reality and economic effects of an arrangement. Often this is because the presence of artificiality and contrivance may indicate an arrangement has been structured in a particular way to ensure the provisions of the Act are applied to the legal form of the arrangement in a manner that does not reflect the commercial reality and economic effects of that arrangement. In other words, the form of the arrangement is artificial and contrived as it creates the appearance that certain facts, features and attributes are present or absent when that is not the reality of the arrangement. As the Supreme Court stated in *Ben Nevis* at [108]:

> A classic indicator of a use that is outside Parliamentary contemplation is **the structuring of**

> **an arrangement so that the taxpayer gains the benefit of the specific provision in an artificial or contrived way**. It is not within Parliament's purpose for specific provisions to be used in that manner.
>
> [Emphasis added]

309. Implicit in the *Ben Nevis* test is the acceptance that generally Parliament contemplates that provisions apply to transactions that correctly reflect their commercial reality and economic effects. In most cases, therefore, if the provisions are sought to be applied in a way that does not reflect this and their use achieves a tax advantage, the use of the provisions will fall outside Parliament's contemplation and the arrangement will be a tax avoidance arrangement. A strong indicator would be required from within the Act before a conclusion could be reached that a clearly artificial or contrived use was within Parliament's contemplation and purpose.

310. As to the meaning of "artificiality" and "contrivance", the *Oxford English Dictionary* (online ed, Oxford University Press, New York, 2012) defines "artificiality" as the quality of being "artificial", which in turn includes a situation that "does not occur or result naturally, spontaneously, or in the expected manner" or something which is "...fabricated for a particular purpose, esp. for deception; resulting from artifice; feigned, fictitious". "Contrivance" is defined as including "the bringing to pass by planning, scheming, or stratagem; manoeuvring, plotting; deceitful practice" and "the action of inventing or making with thought and skill". These definitions tend to point to a thing or situation being unnatural or unexpected and emphasise elements of deception or pretence in bringing about a certain outcome. In the case of a tax avoidance arrangement, this outcome would be one where, viewed objectively, the arrangement gains the benefit of specific provisions on the Act in circumstances outside of Parliament's contemplation.

311. While the courts often refer to artificiality and contrivance as indicators of avoidance, none have comprehensively analysed what is meant by these terms. In *Seramco Ltd Superannuation Fund Trustees v Commissioner of Income Tax* [1977] AC 287 (PC) Lord Diplock considered (at 298) that "artificial" was not "a term of legal art" and was "capable of bearing a variety of meanings according to the context in which it is used". N. Orow, in *General Anti-Avoidance Rules: A Comparative International Analysis* (Jordans, Bristol, 2000) at 28, identifies four distinct but related concepts of artificiality that have been used by the courts internationally in the anti-avoidance context. These refer to the extent to which a transaction:

- is abnormal or uncommon;
- lacks any business or other non-tax purpose;
- deviates from economic reality;
- is structured in such a way or takes a particular form that is contrary to legislative intentions and objectives as expressed in the Act.

312. The first sense in which courts sometimes use the term "artificiality" is that of something that is abnormal or uncommon (see, for example, *Commissioner of Taxpayer Audit and Assessment v Cigarette Co of Jamaica Ltd (in liq)* [2012] UKPC 9, [2012] 1 WLR 1794 at [22]). While abnormal or uncommon structures might indicate tax avoidance, some qualifying comments should be made. A structure in common usage can still be a tax avoidance arrangement. Accordingly, just because a tax avoidance arrangement may have become widely used, for instance, where a scheme is used by several taxpayers in an industry, will not make it any less an avoidance arrangement. It is also true that the mere fact a transaction has unusual aspects will not necessarily be suggestive of tax avoidance. Innovation, novelty, uniqueness and new products may be unassociated with tax avoidance. On the other hand, unusual commercial practice may be indicative of a tax avoidance arrangement. Harrison J, in *Westpac*, said that novelty is "sometimes" associated with avoidance (at [581]), although it was not relevant in the case before him. In *Tayles* (CA), the Court of Appeal said at 737:

> But I would not regard the novelty of the scheme as sufficient in itself to bring it within s 108. Nevertheless novelty may be relevant in that a documentary structure not consonant with normal commercial practice may go some distance towards giving it the character of business unreality and taking it outside the ambit of what is ordinary family dealing.

313. In many instances, the relevant unusual aspect when considering tax avoidance is that the arrangement does not give the commercial returns that would be expected in arm's length transactions.

314. Another sense of "artificiality" sometimes used by the courts is the lack of any business or other non-tax purpose which is not, in itself, a component of the Parliamentary contemplation test. While is it true that an arrangement that exhibits a complete lack of business or other non-tax avoidance purposes would be very *likely* to be a tax avoidance arrangement, the lack of any business or other non-tax avoidance purpose is not the reason it would be a tax avoidance

arrangement. Something is tax avoidance if the arrangement, when the commercial and economic reality is understood, lacks the facts, features and attributes that need to be present or absent to give effect to Parliament's purpose. The relevance of commercial or other non-tax avoidance purposes to the Parliamentary contemplation test is discussed below at paragraphs 358 to 359 and 362 to 371.

315. The other two concepts mentioned in paragraph 311 above—arrangements that deviate from economic reality and arrangements that are structured in such a way that is contrary to legislative intentions and objectives—are relevant to the Parliamentary contemplation test. They capture the idea of the structure disguising the reality of the arrangement so as to obtain tax results that would not otherwise be obtainable. In these senses of artificiality an arrangement is artificial in that it disguises the commercial and economic reality, making it appear that the facts, features and attributes Parliament would expect are present or absent in the arrangement when that is not the commercial and economic reality.

316. Undue complexity is also a concept that is sometimes referred to in relation to artificiality or contrivance. However, complexity does not necessarily equate to tax avoidance. An arrangement that is artificially structured so that it uses the Act in a way Parliament did not contemplate may still be a relatively simple transaction. Equally, the fact an arrangement is complex does not necessarily mean the arrangement uses the Act in a way that is outside Parliament's contemplation. It is true, however, that complexity, and particularly complex steps that do not achieve or alter commercial or economic outcomes, will often indicate that the form of the arrangement does not reflect the commercial and economic reality. Such situations will raise questions about whether the necessary facts, features and attributes are present (or absent).

317. The following cases are some examples of where a court has held that the arrangement or elements of the arrangement were artificial and/or contrived, in the sense of being unusual commercial practice. *Ben Nevis* involved investors in a LAQC that purported to incur expenditure for insurance and licence premiums on an accelerated basis prior to the actual cash outlay to occur some 50 years in the future. The court said at [119]:

> The commercial aspects must, however, be considered because the context is suggestive of tax avoidance. In part that is because requiring that promissory notes be given, before the expenditure was to be incurred in reality, introduced an artificial element into the arrangement. From a business point of view the promissory note was a gratuitous mechanism. We do not accept the appellants' argument that it secured or facilitated the payment of the licence premium by the syndicate in 2048 in any real sense.

318. At [120], the court said there were two other unusual features of the arrangement. One was that there was a "real risk that the … scheme will never be a profitable one". The second was the timing mismatch between when expenditure is legally incurred and the point at which it is required to be paid in an economic sense. In relation to the insurance dimension of the scheme, the court found on the facts:

> [142] As at 31 March 1997 CSI was formally incorporated and registered in the British Virgin Islands. It had been incorporated and registered there on the instructions of Dr Muir, the architect of the Trinity scheme. Dr Muir was instrumental in formulating CSI's business plan which must be good evidence of the purpose for which CSI was established. It is not unreasonable to say that CSI was a single purpose company, without any independent substance, brought into being to provide pro forma insurance cover in terms of which the investors in the scheme could achieve substantial tax advantages by deduction of the second premium, without suffering any corresponding economic outlay.

319. The court found it significant that the insurance company did not undertake other insurance business, and the emphasis on secrecy was "hardly consistent with CSI being an arm's length insurer" (at [143]). The court also commented that 90% of the initial premiums were paid to a company that was under the control of the architect of the scheme on terms providing that the loans were not repayable until 2047. The court said at [144]:

> Whether this was justifiable in strictly legal terms is not our present concern, but it demonstrates the extremely unorthodox nature of what was going on.

320. The Supreme Court in *Glenharrow*, after noting that the price agreed on was the subject of a genuine bargain, said at [51]:

> But, even on that basis, the arrangement still had a very artificial element: the price was not paid in economic terms, even though as between the parties a debt was discharged. In this case it is not the price but the "payment" that created the distorting effect. Glenharrow accepted the legal obligation to pay the full price but at the outset the parties were well aware, and any objective observer in 1997 would have seen, that payment in full would certainly not occur.

321. In *Penny* (SC), the court said in several places that the level of salary paid was artificially low. The taxpayers had agreed in evidence that the salaries were at levels substantially below what could have been expected had they been employed independently at arm's length (see [24]).

322. In the Court of Appeal decision in *Penny* (CA), Randerson J found not only that the level of salaries were artificial, but also that the transactions to transfer goodwill were not commercial:

> [124] There are further facts which tend to emphasise the artificiality of the arrangement. For example, when Mr Hooper established his company, the goodwill paid was only $300,000 representing less than half his net annual income before tax. And, in Mr Penny's case, the goodwill paid by POS was a mere $100,000 and was then increased to just over $1 million at the time of the immediate on-sale to OSCL. The ten year employment contract he entered into with POS was not in fact assigned to OSCL and, in any event, was not sufficiently substantial to justify such a large goodwill figure. In reality, the company was most unlikely to have enforced the contract against the wishes of Mr Penny, yet the $1 million goodwill figure enabled him to receive a tax free capital dividend of $900,000 from POS.

323. In *BNZ Investments No 2* (HC), the High Court concluded that the structured finance transactions entered into by the BNZ were tax avoidance. In simple terms, the arrangements involved a "circular" transaction where the BNZ claimed tax deductible expenditure through fixed rate swap payments and a guarantee procurement fee (GPF) and derived effectively exempt income (because of conduit tax relief or having foreign tax credits attached). The High Court concluded that the GPF was a contrivance and its primary function was to create a deductible expense. Instead of the normal commercial tension between one party trying to negotiate the GPF down and the other trying to get it up as high as it could, there was a common interest for both the BNZ and the counterparty to set the GPF as high as possible. This would generate larger tax benefits to be shared between the parties.

324. The High Court also thought the swap was artificial and contrived:

> [388] I conclude that the setting of the fixed swap rate well in advance of the transaction, and/or the failure to re-set it shortly before the transaction closed, was not in accordance with normal commercial practice. Given the analysis I have set out at [380]–[384], and the differences in the table at [396], I find this was contrived to increase the tax benefits flowing from the transactions. For example, when the rate was fixed for the Gen Re 1 and CSFB transactions, the NZ yield curve was significantly downward sloping ie shorter term swap rates were significantly higher than longer term swap rates. Thus, by taking the one year rate the BNZ artificially boosted the tax benefits from those two transactions. Mr Stanton calculated that this boosted the annual tax reductions obtained by the BNZ by NZ$2 million approximately in the Gen Re 1 transaction, and by NZ$1.5 million in the CSFB transaction (PB 5.42–5.43).

325. The High Court considered the level of funding provided by the counterparty and degree of return to be relevant:

> [423] At peril of unnecessarily dealing further with this aspect, I think there is a point to be made. Its relevance is that it further evidences how exceptional the level of funding obtained by the counterparty was, compared with conventional returns on structured transactions.

326. The court concluded by stating (amongst other things) at [526]:

> e) The transactions generated the claimed deductible expenses in a contrived or artificial way:
>
> - The 2.95% pa GPF was a contrivance. A guarantee from the parent of the counterparty would have been forthcoming for no fee, or for a fee of no more than 0.65% pa.
> - The BNZ contrived to set the fixed rate on the interest rate swap at the highest rate it thought defensible, and in the case of some of the transactions this was significantly outside market parameters.

327. In summary, the terms "artificiality" and "contrivance" can have several meanings but, in the context of tax avoidance, together they involve the concept that an arrangement can deviate from commercial and economic reality by being structured in a way that disguises that reality. Artificiality and contrivance can then contribute to making it appear as if the arrangement involves (or does not involve) the facts, features and attributes Parliament would expect to be present or absent to give effect to the relevant provisions of the Act. In this sense, they are strong indicators that an arrangement involves tax avoidance.

Does the arrangement involve pretence?

328. The existence of pretence has long been recognised by the courts as an indicator of tax avoidance. In *Ben Nevis*, it was observed that "whether an arrangement is an artifice or involves a pretence will often be highly relevant to whether there is an arrangement that has a purpose of tax avoidance" (at [97]). Again, the

main relevance of this factor lies in whether there is a pretence that the facts, features and attributes are present (or absent) when the commercial and economic reality is that they are not. Where some aspects of the transaction may not actually be, or produce, what they claim, this will impact upon whether Parliament would have contemplated the particular tax outcome for that transaction. In *Challenge* (PC), the taxpayer entered into an arrangement to acquire an unrelated loss company to offset the losses against the taxpayer's assessable income. The Privy Council commented that most tax avoidance involves a pretence and described the Challenge group as pretending to suffer the losses, when in truth they were suffered by unrelated companies (at 562).

329. The taxpayer in *Dandelion* (CA) entered into a "financing" transaction for the sole purpose of obtaining an interest deduction under an arrangement whereby the taxpayer derived exempt dividend income of approximately the same amount. Interest was deductible under a provision that permitted interest deductions on money borrowed to acquire shares in another group company. The Court of Appeal, confirming the application of s 99, described the transaction as an "artifice involving pretence and not a real group investment transaction at all".

330. The concept of "pretence" for tax avoidance purposes needs to be distinguished from a sham. A sham is intended to mislead the Commissioner into viewing documentation as representing what the parties have agreed when in fact it does not actually record the true agreement. In the majority of tax avoidance cases, taxpayers will not enter into an arrangement to perpetrate a sham, as they will be relying on the black letter law to deliver the intended tax consequences. In the tax avoidance context, a pretence generally reflects a situation where, although the contractual arrangements are to be respected, the commercial or economic reality of the arrangement is quite different.

Is the arrangement circular?

331. The circularity of movements of money in an arrangement is often an indicator of tax avoidance. This is because it will often result in a transaction being self-cancelling or otherwise that the economic outcomes claimed for tax are not in fact sustained.

332. Examples of circularity from case law include *BNZ Investments No 2* (HC), as noted at paragraph 323 above, and the majority decision of the Privy Council in the *Peterson* (PC) case. In *Peterson* (PC) the majority observed that the "circular movement of money sometimes conceals the fact that there is no underlying activity at all" (at [45]). As part of the reasoning in *Dandelion* (CA) that the arrangement was tax avoidance, the Court of Appeal observed that the "transaction was circular in its inception and unwinding". In *Glenharrow*, the court gave the example of parties inflating the price of goods in return for a non-recourse loan to the purchaser by the vendor. (A non-recourse loan is a loan under which repayment of the loan is limited to the collateral securing the loan, and the lender cannot hold the borrower personally liable in the event of a default.) In the court's example the purchaser would obtain the advantage of a higher input tax deduction and a refund of GST. The High Court in *Erris Promotions* concluded that the arrangements to acquire software for grossly inflated prices, accompanied by the vendor providing non-recourse loans, were tax avoidance arrangements enabling investors to access inflated depreciation deductions.

333. In *Ben Nevis*, circularity was relevant in identifying that there was no commercial reality to the insurance arrangements:

> [146] The letter of comfort dated 3 February 1997 given to CSI by the Trinity Foundation Charitable Trust, which was the ultimate beneficial owner of the Trinity Foundation, demonstrates that although technically CSI was at risk, it was, at least in part, an indemnified risk leading to a substantial element of circularity in the whole insurance arrangement.

334. However, transactions may demonstrate some elements of circularity without being offensive. Harrison J in *Westpac*, while referring to *Peterson* (PC) at [45], said that circularity in this context is a catchphrase frequently cited but infrequently enlightening. In that case, his Honour thought there was no circularity of the type the Privy Council identified because the payments made discharged a genuine contractual liability (*Westpac* at [580]). Many transactions will demonstrate some elements of circularity without being offensive. For example, the borrowing and repaying of money could be said to be circular in one sense.

335. However, in the context of tax avoidance, what is relevant is circularity that leads to the effective neutralisation or distortion of the economic outcomes. The use of circular arrangements may disguise the reality of the absence of genuine economic outlays. Thus, when taking into account form alone, circularity is often encountered in a tax avoidance context when different parts of a circular movement of funds are afforded different tax treatments, such as

an arrangement where expenditure is claimed to be deductible but the equivalent receipt is not assessable. An example of circular movement of funds can be found in *Dandelion* (CA).

336. Circularity is often accompanied by inflated expenditure or reduced levels of income, which is discussed next.

Does the arrangement involve inflated expenditure or reduced levels of income?

337. The courts have often found that where amounts of expenditure or income are greater, or less, than might be expected, they may not reflect the economic reality. In *Education Administration*, French J said that "another important feature of the arrangement was the high hourly rate" charged by the taxpayer's company. French J said the higher the hourly rate, the larger each invoice and the larger the resulting GST refund (at [62], [66] and [67]).

338. Accordingly, in understanding the commercial and economic reality of an arrangement, it will be relevant to understand how the amounts under the arrangement are arrived at. The court in *Ben Nevis* commented that there was no evidence that the amount of over two million dollars per plantable hectare was fixed on any assessment of the value of the land or of its use (at [124]). Later, the court said there did not appear to have been any independent assessment of the cost of undertaking the risk under the insurance contract (at [133]).

339. In *Westpac*, Harrison J said:

> [439] In summary, I am not satisfied that Westpac has identified a reliable open market value for the GPFs in the relevant years between 1999 and 2002. The bank's credit enhancement approach could not provide an accurate or realistic measure of fair value. But, if that was possible, I repeat that the GPFs actually agreed did not satisfy any objective or fair measure of value and were not within an acceptable market range.

340. And, in *BNZ Investments No 2* (HC), Wild J found:

- The fixed interest rate in at least two of the transactions was well out of line with the market rate (at [404]);
- The guarantee procurement fee was substantially overpriced (at [511]);
- The returns to the BNZ and counterparties via a structured finance transaction were substantially in excess of what could have been expected from a risk free investment negotiated at arm's length (at [526]).

341. As mentioned, a circular flow of money may often be associated in an avoidance context with inflated expenditure and used to increase the tax benefits of the arrangement. One mechanism used is a non-recourse loan (although the presence of a non-recourse loan does not necessarily mean there is avoidance).

342. *Erris Promotions* is an example of inflated expenditure and circular flows of money. The High Court in that case said that the inflation of the purchase price of the software packages was an important feature of the arrangement and an indicator of tax avoidance (at [335]).

343. In other arrangements, particularly those involving altering levels of income, amounts of income received under an arrangement may be low. The Court of Appeal in *Penny* (CA) noted that the taxpayers accepted "without hesitation" that the salaries they received under the arrangement were at levels substantially below what could have been expected if they had been employed independently at arm's length (at [114]). In *Russell* (HC), the High Court observed that the salary Mr Russell received bore no relationship to the work Mr Russell undertook or to salaries payable in the marketplace (at [131]).

Have the parties undertaken real risks?

344. It is a common feature of avoidance arrangements that the tax consequences sought suggest participants are undertaking financial or commercial risks, when in fact there are no or minimal risks.

345. In *Glenharrow*, the purchaser company paid the $45 million purchase price (ignoring the $80,000 deposit actually paid) and contemporaneously received vendor finance from Mr Meates of the same amount. Glenharrow was capitalised to $100 and its shareholder, Mr Fahey, did not provide a personal guarantee. The vendor finance was secured by way of mortgage over the licence so that, on default by Glenharrow, Mr Meates would simply receive his licence back. Had s 76 of the GST Act not applied, the effect of the transaction would have been that Mr Fahey was never personally at risk for the $45 million and Glenharrow would have had the benefit of a $5 million GST credit.

346. The High Court in *BNZ Investments No 2* (HC) commented that there was no risk for either party, other than the tax risk for the BNZ (at [523]). In *Erris Promotions*, there was no risk to the investors for the payment of the grossly inflated purchase price as the vendor provided 100% finance with no recourse beyond repossession of the software (at [339]).

347. In *Dandelion* (CA), the Court of Appeal concluded there was no risk to the taxpayer arising from

the arrangement. This was because the taxpayer borrowed from a third party and effectively reinvested through a tax haven with that third party. The taxpayer, therefore, did not use its own funds and the counterparty received back on the same day the cash it outlaid. In terms of the taxpayer's obligation to repay the loan, the effect of the security arrangements was that the taxpayer was not obliged to repay the loan unless it had received repayment of the fund from its investment.

Relevance of an arrangement being pre-tax negative

348. A transaction where a party is worse off financially before tax is taken into account can be described as "pre-tax negative". Where the tax effect is what makes the arrangement profitable, the arrangement can be described as "pre-tax negative, post-tax positive". The relevance of a transaction being considered to be pre-tax negative, post-tax positive was discussed in *Peterson* (PC) at [44] and *BNZ Investments No 2* (HC). In *BNZ Investments No 2* (HC) the court stated:

> [462] In *Petersen* [sic] at [44] the Privy Council stated the legal position in this way:
>
> "Tax relief often makes the difference between profit and loss after tax is taken into account; and the transaction does not become tax avoidance **merely** because it does so ... (my emphasis)
>
> [463] It follows that the fact that the BNZ provided the NZ$500 million funding in each of these transactions at substantially less (up to 2.5% less) than its cost of funds is a factor for me in deciding whether these transactions were tax avoidance arrangements. It certainly is not conclusive. It is best approached as one aspect of viewing the transactions in a commercially and economically realistic way, and I now do that.

349. The Commissioner agrees with the statement that a pre-tax negative, post-tax positive arrangement is not necessarily a tax avoidance arrangement. However, it can be a significant indicator of tax avoidance. As Wild J said in *BNZ Investments No 2* (HC), lending or investing at a substantial loss is a "classic indicator" of tax avoidance (at [512]): see also *Westpac* (at [529] and [546]), *Miller* (PC) and *Dandelion* (CA).

Some misconceptions about the concept of commercial and economic reality

350. When examining an arrangement to establish the commercial and economic reality, there are several points that, in the Commissioner's opinion, are important but are not always well understood. In brief, they are:

- the inquiry is not limited to the legal form;
- an arrangement may still be a tax avoidance arrangement even if it has commercial or other non-tax avoidance purposes;
- the relevance of commercial and other non-tax avoidance purposes;
- examining the economic effects does not involve identifying arrangements that are economically equivalent.

The inquiry is not limited to the legal form

351. The point has already been made that the s BG 1 inquiry is not limited to the legal form of the arrangement when considering the commercial and economic reality of the arrangement. It has occasionally been suggested that the idea that the legal form can be ignored under s BG 1 is contrary to legal principle. However, it is well-established in the case law that legal form may be ignored under s BG 1. The courts have consistently contrasted the purely legal or juristic analysis with the commercial reality of an arrangement. In the Commissioner's view, the courts' reference in these cases to a commercial perspective being applied should not be regarded as different from the *Ben Nevis* commercial and economic reality concept. Economic impacts and effects would be taken into account in any commercial perspective. This is illustrated in *Challenge* (PC), where the Privy Council acknowledged the necessity to consider the commercial reality of an arrangement, finding the reality in that case was that Challenge never suffered the loss claimed. In *Commissioner of Inland Revenue v Auckland Harbour Board* [2001] 3 NZLR 289 (PC) at [11], the Privy Council said the anti-avoidance provision is:

> ... aimed at transactions which in commercial terms fall within the charge to tax but have been, intentionally or otherwise, structured in such a way that on a purely juristic analysis they do not.

352. In *Miller* (PC) at [10], the Board drew the distinction between viewing an arrangement in commercial terms as a single arrangement and simply analysing the juristic form of each of its parts.

353. The Supreme Court in *Ben Nevis* specifically approved of the approach adopted by the Privy Council in *Challenge* (PC) and later decisions to consider the commercial and economic reality of a transaction and to contrast that with the legal form:

> [95] Subsequent case law generally has proceeded, sometimes implicitly, on the basis of this scheme and purpose approach, but consistently with the underlying reasoning of the Privy Council by paying attention to whether the commercial reality of a

> transaction is consistent with its legal form. ... The underlying reasoning of the Privy Council was later encapsulated by reference to the "commercial" meaning as against the "juristic" meaning of a specific provision. Whatever terminology is used, the important aspect of *Challenge Corporation*, however, is the underlying approach.

354. The Supreme Court in *Ben Nevis* confirmed that the courts are not limited to the legal form of an arrangement and that an arrangement must be viewed in a commercially and economically realistic way:

> [109] In considering these matters, the courts are not limited to purely legal considerations. They should also consider the use made of the specific provision in the light of the commercial reality and the economic effect of that use. The ultimate question is whether the impugned arrangement, viewed in a commercially and economically realistic way, makes use of the specific provision in a manner that is consistent with Parliament's purpose. If that is so, the arrangement will not, by reason of that use, be a tax avoidance arrangement. If the use of the specific provision is beyond Parliamentary contemplation, its use in that way will result in the arrangement being a tax avoidance arrangement.

355. In *Penny* (SC), the court looked at the reality of the whole arrangement, rather than confining itself to looking solely at the structure used. The court said at [34]:

> Whether that [arrangement] involved tax avoidance can be answered by looking at the effect produced by the fixing of the level of the salary in combination with the operation of the other features of the structure.

356. The Supreme Court found the arrangement to be a tax avoidance arrangement, despite the fact the structures used were "entirely lawful and unremarkable" (at [33]). See also, Randerson J in the Court of Appeal, where his Honour stated:

> [110] The Supreme Court has made it clear in *Ben Nevis* that **the adoption of legitimate legal structures or entities will not be a barrier to a finding of tax avoidance** if the arrangements are artificial, contrived, or amount to a pretence. Findings of that character will be influenced by assessing them in the light of commercial reality and the economic effect of the arrangements. The conclusion of the Supreme Court in this respect is supported by a substantial body of precedent both in this Court and the Privy Council.
>
> [Emphasis added]

357. Also, in *Westpac*, Harrison J stated:

> [195] I read *Ben Nevis* as prescribing a combined form and substance test. An analysis of the form or nature of the contractual relationship remains as the starting point in a tax avoidance inquiry; I agree with Mr Farmer that *Ben Nevis* does not authorise a court to bypass the legal structure and move straight to a substance assessment ...
>
> [196] **Conversely, the legal structure cannot shield a transaction from substantive scrutiny where the general anti-avoidance provision is invoked:** *Re Securitibank Ltd (No 2)* [1978] 2 NZLR 136 (CA) per Richardson J at 168; *Buckley & Young Ltd v C of IR* (1978) 3 NZTC 61,271; [1978] 2 NZLR 485 (CA) per Richardson J at NZTC 61,276; NZLR 490; *Glenharrow* at [40]. Mr Farmer does not suggest otherwise or that the form of the transaction prevails over its substance. The ratio of *Ben Nevis* at [107] and [108] is, I think, designed to prescribe the permissible scope of the substance inquiry.
>
> [Emphasis added]

An arrangement may still be a tax avoidance arrangement even if it has commercial or other non-tax avoidance purposes

358. Often taxpayers will point to or assert a commercial or other non-tax purpose or driver for an arrangement, thinking it to be a defence against the application of s BG 1. However, the legislation explicitly provides that a tax avoidance arrangement may have more than one purpose, and those other purposes may not be tax avoidance purposes. The section was amended in 1974 to make clear that an arrangement could be a tax avoidance arrangement whether or not other purposes of the arrangement were referable to ordinary business or family dealings (see the discussion in *Ben Nevis* at [81]). This change was made to counteract the case law that had held an arrangement would only be a tax avoidance arrangement if the sole or principal purpose of the arrangement was to avoid tax (see the Privy Council in *Mangin* at 598).

359. It follows from the legislation, therefore, that the question of whether an arrangement makes use of the provisions within Parliament's contemplation is not answered simply by pointing to the existence of commercial or other non-tax avoidance purposes of the arrangement. Consequently, the existence of a commercial purpose does not prevent, and is not in any way inconsistent with, the consideration of whether s BG 1 applies.

The relevance of non-tax avoidance purposes to s BG 1

360. Non-tax avoidance purposes, including commercial purposes, may be relevant to considering the application of s BG 1, but their relevance will depend on the particular aspect of s BG 1 being considered. Analysing the application of s BG 1 is not a general

inquiry into non-tax avoidance purposes. The following paragraphs discuss how and when non-tax avoidance purposes can be relevant.

The relevance of non-tax avoidance purposes to understanding the arrangement

361. First, identifying commercial and other non-tax avoidance purposes is part of understanding the arrangement. As discussed from paragraph 136, it is important that the arrangement is fully understood. It may be helpful in reaching this initial understanding to take into account explanations for the commercial or other aims sought, and whether any commercial or other non-tax outcomes were achieved. It is only once the arrangement is fully understood that the inquiry can turn to an analysis of whether the arrangement involves tax avoidance, and then, if it does, to the question of whether any tax avoidance purposes are merely incidental to a non-tax avoidance purpose. However, as will be outlined below, some of the information considered when reaching an understanding of the arrangement will not be relevant when applying the Parliamentary contemplation or merely incidental tests.

The relevance of non-tax avoidance purposes to the Parliamentary contemplation test

362. Taxpayers often argue that the fact that non-tax avoidance purposes exist is relevant to the Parliamentary contemplation test. The Commissioner disagrees with this argument and considers that:

- Commercial and other non-tax avoidance purposes are not, of themselves, directly relevant to the test.
- If commercial and other non-tax purposes coincide with the facts, features and attributes Parliament would have expected, then they may be relevant.
- Some things that may be incorrectly described as commercial and other non-tax avoidance purposes are not relevant.

These are discussed in more detail below.

363. According to the court in *Ben Nevis*, the test to be applied is whether the taxpayer's use of the Act is consistent with Parliament's contemplation. Nowhere did the court indicate that the existence of non-tax purposes was relevant to this inquiry. As discussed, the Commissioner considers that determining tax avoidance using the Parliamentary contemplation test requires identifying the facts, features and attributes necessary to give effect to Parliament's relevant purpose for the provisions used, or those provisions that potentially do not apply. When the arrangement is examined, it is to see if those facts, features and attributes are present (or absent) in the arrangement to the degree necessary, as a matter of commercial and economic reality. Therefore, commercial and other non-tax avoidance purposes are not directly relevant to the Parliamentary contemplation test.

364. If, however, the commercial and other non-tax purposes coincide with the facts, features and attributes Parliament would expect to be present or absent, they will be considered. However, if they do not, they will not generally be helpful in determining whether Parliament's purposes are being fulfilled. For this reason, the Parliamentary contemplation test is not a general inquiry into all of the non-tax avoidance purposes achieved under an arrangement. Nor does the exercise of identifying the commercial and economic reality relevant to the provisions at issue simply involve pointing to the various commercial features of an arrangement.

365. The Commissioner considers this is what Harrison J in *Westpac* meant when he made the point that the exercise to understand the commercial and economic reality is a different one from that of identifying any commercial purposes:

> [590] I agree with Mr Farmer that each transaction had a genuine commercial purpose. In my judgment the structural aspects, and in particular its taxation benefits, do not derogate from the existence of an objectively ascertainable commercial purpose. That purpose must be distinguished from the transaction's underlying commerciality or business viability. They are conceptually separate.

366. So, the Parliamentary contemplation test is concerned with determining the commercial reality and economic effects of the arrangement, and that is not necessarily the same exercise as identifying any commercial or non-tax avoidance purposes. For example, if a provision applies to the owner of an asset for the depreciation rules, examining whether the taxpayer is commercially and economically the owner of that asset will be relevant. That the arrangement also had an effect that is unrelated to the depreciation provisions, such as the raising of finance, may not be relevant when determining what Parliament contemplated for the use of that depreciation provision.

367. Another illustration is where an arrangement is not subject to the land sale provisions of the Act because of the non-application of the rules relating to associated persons. In such a circumstance the taxpayers may argue that a purpose of the arrangement is to put in place a structure that will

enable the taxpayer's family members to have an interest in the business. As the question is whether the associated persons provisions have been circumvented, examining whether, when the arrangement is viewed in a commercially and economically realistic way, the parties are in fact associated will be relevant. The fact that the arrangement may also enable other family members to have an interest in the business does not help with this inquiry. The reasons for the structure may be pertinent later when considering whether any tax avoidance is merely incidental to another purpose. In *Ben Nevis*, when reaching a view on whether the use of the Act was tax avoidance, the court did not identify the commercial purpose of forestry investment as being relevant.

368. It might be thought by some that the Commissioner's view on this issue appears to be inconsistent with the decision of the Supreme Court in *Penny* (SC). The court there appeared to have some regard for commercial purposes, which may have affected the setting of the salary levels, when considering the Parliamentary contemplation test and whether the arrangement amounted to tax avoidance. In the Commissioner's view, on a close analysis of the judgment the court should be interpreted as examining commercial and other non-tax avoidance purposes in relation to the merely incidental test. This can be seen where the court stated at [49]:

> Parliament must have contemplated and been content that people may structure their transactions for commercial reasons or for family reasons in which any tax advantage is merely incidental, but that they will not be permitted to do so when tax avoidance is more than a merely incidental purpose or effect of the steps they have taken.

369. Even so, if the taxpayer's commercial and non-tax avoidance purposes coincide with the things that Parliament would have expected would be present or absent, they will be considered in the Parliamentary contemplation test. In *Penny* (SC), the arrangement had the apparent effect that the taxpayers received just salary income and the company derived the remainder of the income relating to their personal services. The commercial and economic reality, however, was that they still received the full benefit of the income and effectively derived it. The court said that if, instead, the money had stayed in the company and the taxpayer or their families had not received the benefit of the money, the commercial and economic reality would have been different. The Supreme Court said at [34]:

> ... If, for example, in one year the salary was set so as to absorb all the company profits, it could hardly be said that any avoidance was involved. Similarly, the salary might be set at a relatively low level because the company had a commercial need to retain funds in order to make a capital expenditure. Again, no question of avoidance could arise. That would also be the position if the company was experiencing financial difficulties or reasonably considered that it might do so in the future, and could not afford to pay the family member employee the equivalent of a commercial rate for the time being, or reasonably took the view that it was not in the meantime financially prudent to do so.

370. The discussion so far has been about non-tax avoidance purposes that are achieved under the arrangement. There are other things that might be described as non-tax avoidance purposes that are not relevant to the Parliamentary contemplation test. Remembering that the inquiry is only concerned with the arrangement, and with what is objectively achieved under the arrangement, it will not be relevant in reaching a view on how the Parliamentary contemplation test applies to consider:

- purposes that are claimed to be achieved but on the facts are not achieved;
- subjective purposes and motivations for entering into an arrangement.

371. As was set out in the discussion above on "purpose or effect", the courts have made it clear that subjective elements are not part of the s BG 1 test. Courtney J in *Krukziener* said at [15]:

> Evidence of what Mr Krukziener and other witnesses actually said and did at the relevant times is relevant and helpful. However, subjective evidence of what they claim to have believed or intended is not.

See also *Newton*, *Ashton* (PC), *Tayles* (CA), *Glenharrow* and *Alesco* (CA).

The relevance of non-tax avoidance purposes to the "merely incidental" test

372. Non-tax avoidance purposes will be more directly relevant later in the s BG 1 inquiry when considering whether any tax avoidance purpose identified is merely incidental to any non-tax avoidance purpose. This stage of the analysis is discussed later in this statement (from paragraph 395). Briefly, a tax avoidance purpose or effect will be merely incidental to a non-tax avoidance purpose of an arrangement if it follows as a natural concomitant of the non-tax avoidance purpose and it is not in any way pursued as an end in itself. If the tax avoidance purpose is merely

incidental, the arrangement will not be a tax avoidance arrangement.

Summary of when non-tax avoidance purposes may be relevant

373. Non-tax avoidance purposes may be relevant at the initial stage of reaching an understanding of the arrangement, before the Parliamentary contemplation and merely incidental tests are considered.

374. Non-tax avoidance purposes may be relevant to the Parliamentary contemplation stage of the inquiry in a particular case if they coincide with the facts, features and attributes Parliament would expect to be present or absent.

375. Non-tax avoidance purposes not achieved and subjective purposes are not relevant.

376. Non-tax avoidance purposes will be relevant when considering whether a tax avoidance purpose or effect is merely incidental to a commercial or other non-tax avoidance purpose of the arrangement.

Examining the economic effects does not involve identifying arrangements that are economically equivalent

377. Identifying the economic effects of an arrangement should not be confused with an approach that considers economic equivalence. Economic equivalence looks at identifying an arrangement, or one of several arrangements, that is economically equivalent to the arrangement entered into. In contrast, identifying the commercial reality and economic effects involves identifying the real commercial and economic outcomes of the arrangement actually entered into, with a view to seeing whether the facts, features and attributes Parliament would have expected for the operation of the provisions are present.

Summary of points about the commercial reality and economic effects of an arrangement

378. The commercial and economic reality of an arrangement is examined to see whether the use of the provisions is within Parliament's purpose. In particular, the arrangement is examined to see whether, as a matter of commercial and economic reality, the facts, features and attributes required to be present (or absent) to give effect to Parliament's purpose for the provisions in question are in fact present (or absent) and to what degree. Understanding what is actually achieved requires a complete understanding of the facts and a thorough grasp of the detail and workings of the arrangement as a whole. Identification of the commercial reality and economic effects is not limited by the form of the arrangement.

379. Determining whether a tax avoidance arrangement exists involves a consideration of various factors set out in *Ben Nevis*, including:

- 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 duration of the arrangement;
- the nature and extent of the financial consequences;
- the presence of artificiality or contrivance.

380. Some other useful factors in this context are:

- the presence of pretence;
- the presence of circularity;
- the presence of inflated expenditure or reduced levels of income;
- the undertaking of real risks by the parties;
- the relevance of an arrangement being pre-tax negative.

381. Consideration of these factors will help when reaching a view on whether the facts, features and attributes are present (or absent) as a matter of commercial and economic reality, and to what degree. The relevance of factors will depend on the provisions used, or the potentially relevant provisions that do not apply, and what facts, features and attributes Parliament would expect to be present (or absent).

382. The existence of a commercial purpose does not prevent the application of s BG 1. Commercial and other non-tax avoidance purposes put forward for a particular arrangement are not, of themselves, directly relevant to the Parliamentary contemplation test. If they coincide with the facts, features and attributes Parliament would expect to be present or absent, they will be considered. However, if they do not, they will not generally be helpful in determining whether Parliament's purposes are being fulfilled. Commercial and other non-tax avoidance purposes may be relevant when considering the merely incidental test.

383. Identifying the economic effects of an arrangement does not involve identifying an arrangement that is economically equivalent.

Apply the Parliamentary contemplation test to reach a view on tax avoidance

384. Having discussed the two elements of the Parliamentary contemplation test in detail, the test can now be applied:

> Does the arrangement, viewed in a commercially and economically realistic way, make use of the Act in a manner that is consistent with Parliament's purpose?

385. To do this, each of the steps discussed in the paragraphs above are worked through. To summarise, these are:

Ascertain Parliament's purpose

- Ascertain Parliament's purpose for the relevant provisions from their text, the statutory context (including the statutory scheme relevant to the provisions), case law and any relevant extrinsic material. Parliament's purpose for combinations of provisions may need to be identified at this step.
- Then identify any facts, features and attributes that need to be present (or absent) to give effect to that purpose. (It may not be necessary, or even possible, to identify these with absolute precision.)

Commercial and economic reality

- Examine the whole arrangement with a view to determining its commercial reality and economic effects, having particular regard to the facts, features and attributes that need to be present or absent to give effect to Parliament's purpose. Use relevant factors, including those from *Ben Nevis* at [108], to see whether, and to what degree, the facts, features and attributes are present as a matter of commercial and economic reality.

386. Consideration of the commercial reality and economic effects of the arrangement may raise further questions as to Parliament's purpose in the context of the particular arrangement. If necessary, repeat these steps until Parliament's purpose has been sufficiently ascertained.

387. The question is then, taking into account all of the above, does the arrangement, viewed in a commercially and economically realistic way, use (or circumvent) the relevant provisions in a manner that is consistent with Parliament's purpose? It may be necessary to exercise judgment over whether any of the requisite facts, features and attributes are present or absent to a sufficient degree.

388. There are some examples from page 65 illustrating how this analytical approach is worked through.

Not all complex fact situations or undesirable policy outcomes amount to tax avoidance

389. The Commissioner recognises that not all uses or non-applications of the Act constitute tax avoidance. Section BG 1 will not apply merely because of a particularly complex or unusual set of facts, undesirable policy outcomes, or very substantial tax advantages compared to alternative structures.

390. As a first point, it should be noted that Parliament contemplates that transactions and arrangements may be structured in different ways. Taxpayers may structure arrangements to their best tax advantage, provided the use of the provisions is within what Parliament would have contemplated. In *Ben Nevis*, the court stated:

> [111] The appellants made a sustained plea that the courts should not deprive commercial and other parties of tax beneficial choices. On the approach we have set out, taxpayers have the freedom to structure transactions to their best tax advantage. They may utilise available tax incentives in whatever way the applicable legislative text, read in the light of its context and purpose, permits. They cannot, however, do so in a way that is proscribed by the general anti-avoidance provision.

391. The Supreme Court in *Penny* (SC) referred to the example of the provisions enabling the setting up of investment vehicles in the form of Portfolio Investment Entities (PIEs). PIEs can be taxed at a lower rate than the rates applying to individual investors. Simply using those provisions as intended by Parliament and receiving a tax advantage, without more, would not attract the application of s BG 1 (see [49]).

392. In *Penny* (CA), Randerson J said "[t]here is, and could be, no valid criticism of the adoption of the corporate vehicle as such" (at [113]), and "I accept Mr Harley's submission that, in general terms, the Act is not concerned with the level of salaries paid to employees in family-owned companies such as those incorporated by the respondents" (at [116]). However, on the facts of the case, when the commercial and economic reality of the arrangement was examined, it could be seen that the company/trust structure was used in such a way that, while the taxpayers were paid at a level well below market rate, they still retained the economic benefit of earnings generated largely through their personal exertion.

393. However, even though Parliament might specifically provide for a certain use of the Act, and those provisions apply to an arrangement based on its form, s BG 1 will still apply if the provisions have not been used as Parliament contemplated. A literal compliance with provisions will not establish that the use is within Parliament's contemplation. When considering s BG 1 there is a focus on the commercial and economic reality of the arrangement, and also combinations of provisions that are used (or that are potentially relevant and do not apply) can be taken into account. The law has clearly moved on from the House of Lords decision in *Inland Revenue Commissioners v Duke of Westminster* [1936] AC 1 (HL) (discussed in

more detail from paragraph 529). That case stood for the proposition that taxpayers are always entitled to order their affairs so the tax attaching is less than it otherwise would be. In the context of s BG 1, the New Zealand courts have unambiguously held that a use of the Act to reduce tax is only acceptable if the use is within Parliament's contemplation for the relevant provision.

394. A second point relates to whether the Commissioner can use s BG 1 to plug "gaps" in the legislation. This raises the question of what is meant by a "gap" in the legislation. If Parliament did not intend that the legislation extend to a certain situation, s BG 1 will not apply to bridge that gap, even though there might be undesirable outcomes from a policy point of view. In such a situation, the Commissioner may consider whether the legislation needs amendment. If, on the other hand, the Act is being used or circumvented in a way that does not give effect to Parliament's purpose, even though the particular use (or non-application) is not explicitly dealt within the legislation, s BG 1 will appropriately apply.

MERELY INCIDENTAL

395. If tax avoidance is the only purpose or effect of an arrangement, the arrangement is a tax avoidance arrangement (see paragraph (a) of the definition of "tax avoidance arrangement" in s YA 1). If an arrangement has more than one purpose or effect, the arrangement will be a tax avoidance arrangement if the tax avoidance purpose or effect is "not merely incidental" to the other purposes or effects (see paragraph (b) of the definition of "tax avoidance arrangement" in s YA 1). The result is that an arrangement may be outside Parliament's contemplation but still not be a tax avoidance arrangement if the tax avoidance purpose is merely incidental to a non-tax avoidance purpose. Thus Parliament accepts that tax avoidance (meaning an outcome under the Act that is outside what Parliament would have contemplated) can be permissible in some situations, provided the tax avoidance arose only because it naturally follows from some other purpose.

Non-tax avoidance purposes

396. The merely incidental test involves identifying any non-tax avoidance purposes of an arrangement so that their relationship with the tax avoidance purpose(s) can be identified.

397. Non-tax avoidance purposes in this context include 1) commercial and private purposes and 2) tax purposes where the use or non-application of the Act is within Parliament's contemplation (referred to here as "legitimate" tax purposes).

398. It is important to understand that, in the Commissioner's view, any tax purposes that are integral to a tax avoidance use of the Act will be part of the tax avoidance purpose, and not treated as a legitimate tax purpose. An example is where a complicated tax avoidance arrangement requires borrowing from a third party at market rates to fund the arrangement. This will be the case even though the tax purpose may seem to be within Parliament's purpose when viewed in isolation. Harrison J in *Westpac*, in the contexts of identifying the scope of the arrangement and of s GA 1, found that the purpose put forward by the taxpayer was integral to a tax avoidance purpose (see [573] and [641]).

399. When identifying purposes and effects of an arrangement to apply the merely incidental test, the purposes and effects must be objectively ascertainable from the arrangement. As noted above, this is because s BG 1 applies to the arrangement (as distinct from the motives or intentions of the parties to it). Also, it is necessary to remember that "purpose" and "effect" in s BG 1 have related, but slightly different, meanings. As discussed earlier in this statement, the purpose is the intended effect and the effect is the effect itself, or actual result achieved by the arrangement (*Ashton* (PC) and *Tayles* (CA)). This means it will generally be necessary for the purposes and effects to be achieved by the arrangement. However, something may still be objectively concluded to be a purpose of an arrangement even if it fails to come to fruition, where that failure happens as a result of unforeseen intervening events. Such a purpose would still be a purpose of the arrangement, as it would be an objectively ascertainable intended effect.

400. Generally, in the following discussion of the merely incidental test the word "purpose" is used to refer to both "purposes" and "effects".

The meaning of "incidental"

401. It is important to understand the meaning of the word "incidental" in this context. "Incidental" is defined in the *Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York, 2011) to mean: **incidental *adj*. 1** occurring as a minor accompaniment. ›occurring by chance in connection with something else. **2 (incidental to)** liable to happen as a consequence of. **n** an incidental detail, expense, event, etc.

402. Thus, there are two possible meanings of "incidental" in this context. One is that a purpose or effect could be "incidental" if it is relatively minor or small compared to the other purpose or purposes. The second meaning is that a purpose or effect is "incidental" if it follows on from other relevant purposes or effects.

403. A possible example of the first meaning can be found in the High Court decision of *Hadlee* (HC) (which was approved by Cooke P at the Court of Appeal level), where Eichelbaum CJ concluded at 470:

> In my opinion the purpose and effect of the arrangement was tax avoidance. Even if it were possible to regard that as one purpose and effect only (the other being to enable the objector's dependants to accumulate assets which would be secure from the risk of claims against the partnership) I cannot view it as "merely incidental". The potential tax benefits were too significant and obvious. I agree with the submission on behalf of the Commissioner, that it would require a considerable degree of naivety to conclude that they played merely an incidental part in the scheme.

404. However, it is the second approach which has the greater authoritative and legislative support. In *Challenge* (CA), Woodhouse P, in his dissenting judgment, discussed the meaning of "merely incidental" in this context at 533:

> Does it have the rather exiguous meaning and effect of excusing only "the casual" or "the minor" or "the inconsequential" tax avoidance purposes? If so, many "ordinary" dealings would probably be caught by s 99 because inevitably the associated tax purpose could seem stronger than that. And the problem would be magnified if as well the assessment had to include estimates of the taxpayer's motives. However, I do not think the phrase "merely incidental" does have such a limited effect and in accord with *Newton v Commissioner of Taxation* [1958] AC 450 I am satisfied as well that the issue as to whether or not a tax saving purpose or effect is "merely incidental" to another purpose is something to be decided not subjectively in terms of motive but objectively by reference to the arrangement itself.
>
> As a matter of construction I think the phrase "merely incidental purpose or effect" in the context of s 99 points to **something which is necessarily linked and without contrivance to some other purpose or effect so that it can be regarded as a natural concomitant**.
>
> [Emphasis added]

405. This suggests that a "merely incidental" tax avoidance purpose or effect is something which naturally follows from or is necessarily linked (without contrivance) to some other purpose or effect. The tax avoidance must only follow as a result of that other purpose and must not in any way be an end in itself. Also, his Honour makes the additional point that whether this is the case is determined objectively by reference to the arrangement itself and not subjectively in terms of motive.

406. The approach taken by Woodhouse P to the meaning of "merely incidental" is consistent with his Honour's previous judgment in the Supreme Court decision of *Elmiger*. In that case, Woodhouse J stated that family or business dealings come within the section if the tax avoidance purpose is not in any respect "pursued as a goal in itself" of the arrangement. At 694:

> Accordingly it is my opinion that family or business dealings will be caught by s. 108 despite their characterisation as such, if there is associated with them the additional purpose or effect of tax relief ... **pursued as a goal in itself and not arising as a natural incident of some other purpose**.
>
> [Emphasis added]

407. The legislative history strongly supports the view that "incidental" means something that naturally follows from something else rather than something that is minor. The merely incidental test was introduced into the predecessor to s BG 1 in 1974 and it is clear that Parliament's intention in redrafting the provision in 1974 was to amend the law, among other things, so that it was consistent with the views of Woodhouse J in *Elmiger*. During the second reading of the Bill (which was later enacted as the Land and Income Tax Amendment Act (No. 2) 1974), Hon Dr A M Finlay (then Minister of Justice) discussed the new clause and referred to the decision of Woodhouse J in *Elmiger*. This was reported in the *New Zealand Parliamentary Debates* (30 August 1994) 393 NZPD 4,192:

> That [*Elmiger*] is a decision which I, for my part, regard as a landmark in our legal and social history, and typical of the enlightened approach one has come to expect from Mr Justice Woodhouse.
>
> ...
>
> The Elmiger case unfortunately represented something of a high point, and since that time the courts have tended to retire from the position that was taken up. At any rate this is what has been happening in New Zealand; not so in Australia, where there is a difference of opinion and where the Elmiger approach still prevails – they are satisfied that if one of the purposes of a device or scheme that is adopted, and that is of an unusual character, is for the purpose of evading taxation, then it may be struck down, and they need not be satisfied that that is the sole purpose of the arrangement.

408. The Minister continued by citing the decision of *Hollyock v Federal Commissioner of Taxation* (1971) 125 CLR 647, where the High Court of Australia rejected the *Mangin* "sole or principal purpose" test. He concluded at 4,194:

> The courts ought to be armed, as they have been on the example of Elmiger, to strike it [tax avoidance] down, and I am very much in favour of restoring the authority of Elmiger ...

409. This approach has subsequently been adopted in a number of decisions. For example, in *Case M72* (1990) 12 NZTC 2,419 at 2,424; *Case S95* (1996) 17 NZTC 7,593 at 7,602; *Case X1* (2005) 22 NZTC 12,001 at [359]–[362] and [392]; *Accent Management Ltd v Commissioner of Inland Revenue* (2005) 22 NZTC 19,027 (HC) at [300]; *Ben Nevis* at [8]–[9]; and *Westpac* at [209].

410. In *Westpac*, Harrison J described Woodhouse P's comments in *Challenge* (CA) as continuing to provide authoritative guidance on the merely incidental test (at [208]). Harrison J also said at [205]:

> ... A tax avoidance purpose or effect must be more than merely incidental to any other purpose or effect, such as ordinary business or family dealings, to constitute statutory avoidance. Inclusion of an adjectival phrase such as "not merely" is unusual in a statute; and its presence is not without difficulty in the context of tax legislation.
>
> [206] However, when used in conjunction with the word "incidental", I think the phrase "not merely" is designed to emphasise that a tax avoidance purpose, if found, will offend s BG 1 unless it naturally attaches or is subordinate or subsidiary to a concurrent legitimate purpose or effect, whether of a commercial or family nature. Identification of a business purpose will not immunise a transaction from scrutiny where tax avoidance can be viewed as "a significant or actuating purpose which ha[s] been pursued as a goal in itself": see *Tayles* per McMullin J at NZTC 61,318; NZLR 736. Conversely, a transaction will not offend where tax avoidance naturally attaches to that other acceptable purpose or effect.

411. Harrison J reiterated the point that something that is "merely incidental" cannot be a goal in itself:

> [618] The tax avoidance purpose here could never be regarded "as a natural concomitant" of a dominant commercial purpose. Deployment of the deductibility provisions to reduce the bank's liability to income forecast in the following year in accordance with its tax shelter or capacity calculation became a discrete and real end or objective on its own. I find that Westpac's use of its tax shelter was a significant or actuating purpose which was pursued as a goal in itself in each transaction. As a matter of fact and degree, Westpac's tax avoidance purpose was more than merely incidental to any legitimate commercial purpose.

412. Similar comments can be found in the Court of Appeal decision of *Alesco* at [30].

413. In summary, the Commissioner considers, from the decided authority and legislative background, that "merely incidental" in this context means that the tax avoidance purpose must merely follow as a natural concomitant of the arrangement being structured in the particular way to achieve a non-tax avoidance purpose or purposes.

Where a non-tax avoidance purpose is underpinned by a tax avoidance purpose

414. Sometimes a taxpayer will put forward as a non-tax avoidance purpose a purpose that is actually underpinned by tax avoidance. For example, it might be argued that an arrangement's non-tax avoidance purpose is to achieve a better rate of return on an investment. However, if that better rate of return is achieved by amounts not being subject to tax due to a tax avoidance use of the Act, then that purpose is underpinned by tax avoidance. The Commissioner considers that where a non-tax avoidance purpose is underpinned in such a way by a tax avoidance purpose, then that tax avoidance purpose will be an end in itself and will not be merely incidental to the purpose put forward.

415. In the Commissioner's view, this follows from Woodhouse P's comments in *Challenge* (CA) (at 535) and is consistent with the approach adopted by the Australian High Court in *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 186 CLR 404 at 415.

Whether the adoption of the particular structure can be explained by a non-tax avoidance purpose

416. Sometimes, taxpayers will put forward quite general purposes to explain arrangements (such as raising finance), and there is a question how to treat such purposes in the context of the merely incidental test.

417. Section BG 1, including the merely incidental test, is applied to the specific arrangement entered into. Woodhouse P said that whether a tax avoidance purpose is merely incidental is considered "by reference to the arrangement itself". General purposes that can potentially be achieved in several different ways will not explain the particular structure of the arrangement. Consequently, the existence of such a purpose will not be sufficient to establish that a tax avoidance purpose is merely incidental to it. More

information about the specific requirements that led to the adoption of the particular structure would be needed before it could be assessed whether the tax avoidance purpose is merely incidental to any more specific non-tax avoidance purpose(s).

418. McGechan J talked about the specific way the arrangement was structured in *BNZ Investments No 1* (HC) at 15,732:

> [103] I am quite unable to accept submission (a). Clearly, and at the very least, one of the purposes or effects of the downstream transactions was tax avoidance, and that was not a merely incidental purpose or effect. One need not look very far. There was, of course, an ordinary business purpose or a degree of ordinary business purpose in what was done. Fay Richwhite and CML intended to make profits. That is true in all business, including business carried forward in a tax effective way: it is not done for amusement or to tantalise the tax man. They went about it, however, in a way which – tax factors apart – was extraordinarily and unnecessarily complicated. There was no reason – tax factors apart – for the elaborate downstream chain and auxiliary activities being included in something which in essence was a lending of money raised by the RPS transactions on secure investments earning interest. To say otherwise is like travelling from Wellington to Auckland through Stewart Island, the Chathams and Kermadecs (if not Easter Island), then claiming that is just another available route.

419. In *Alesco* (CA), the court referred to the specific way the arrangement was structured. This was in response to the taxpayer highlighting that their arrangement had an underlying commercial rationale to fund acquisitions. The taxpayer said that their arrangement was unlike other tax avoidance cases where transactions would not have been entered into but for their tax benefits. The court stated:

> [112] However, this distinctive factor does not protect Alesco NZ. The question is whether the particular arrangement, regardless of whether it was the originating or intermediate step, had the purpose or effect of tax avoidance.

Size of a tax benefit may be relevant

420. It follows from the meaning of "incidental" adopted earlier that the size of the tax benefit achieved under the arrangement will not on its own establish whether a tax avoidance purpose is merely incidental. Nevertheless, it may be a strong evidential factor a court will consider in reaching a view on whether a tax avoidance purpose follows naturally from a non-tax avoidance purpose. If the tax benefits are very large, it may be difficult to establish that the tax benefits follow naturally from, or are necessarily and concomitantly linked to, some other purpose (*Hadlee* (HC) at 470; *Westpac* at [597]).

Relationship with the Parliamentary contemplation test

421. Two further questions arise in the context of the relationship between the Parliamentary contemplation test and the merely incidental test. One is about the role of artificiality and contrivance to both tests, and the other is whether the merely incidental test has a place following the decision in *Ben Nevis*.

422. On the first of these—artificiality and contrivance are relevant to both the question of whether the use of the Act falls outside Parliament's contemplation, and whether any tax avoidance purpose is merely incidental to a non-tax avoidance purpose. As explained above, they are "classic indicators" of a use that is outside Parliament's contemplation. This is because, as the court in *Ben Nevis* said, if artificiality and contrivance are used to achieve the benefit of a provision, that will generally not be how Parliament contemplated the provision would apply. If it appears from the form of the arrangement alone that the facts, features and attributes Parliament would expect for the provision to operate are present, but the form of the arrangement is artificial and contrived (being at odds with the commercial and economic reality), then that will not be how Parliament contemplated the provision applying.

423. Artificiality and contrivance are also relevant to the merely incidental test because if artificiality and contrivance are involved in achieving the tax avoidance purpose, then it is likely that tax avoidance is an end in itself rather than it being merely incidental to another purpose. Woodhouse P in *Challenge* (CA) commented on the relevance of artificiality or contrivance to the merely incidental test at 535:

> When construing s 99 and the qualifying implementations of the reference in subs (2)(b) to "incidental purpose" I think the questions which arise need to be framed in terms of the degree of economic reality associated with a given transaction in contrast to artificiality or contrivance or what may be described as the extent to which it appears to involve exploitation of the statute while in direct pursuit of tax benefits. To put the matter in another way, there is all the difference in the world, I think, between the prudent attention on the one hand that can always be given sensibly and quite properly to the tax implications likely to arise from a course of action when deciding whether or not to pursue it and its pursuit on the other hand simply to achieve a manufactured tax advantage.

424. Artificiality and contrivance may also indicate that an arrangement is structured so that a tax purpose is contrived to appear as if it were incidental to a commercial purpose. Woodhouse P made this point in *Challenge* (CA) at 533:

> As a matter of construction I think the phrase "merely incidental purpose or effect" in the context of s 99 points to something which is necessarily linked and **without contrivance** to some other purpose or effect so that it can be regarded as a natural concomitant.
>
> [Emphasis added]

425. On the second issue, some commentators have discussed the possibility that the court in *Ben Nevis* intended to reduce the significance of, or even nullify, the merely incidental test. The court in *Ben Nevis* made the following observations about the application of the Parliamentary contemplation test and the merely incidental test:

> [113] Before concluding this section of our reasons, we should recognise that paragraph (b) of the definition of a tax avoidance arrangement refers to cases where the tax avoidance purpose or effect of an arrangement is "merely incidental". If that is so, the arrangement is not a tax avoidance arrangement. It is apparent therefore that the use of a specific provision which alters the incidence of tax is permitted in two situations.
>
> [114] The first is when the specific provision is used in a manner which is within Parliamentary contemplation, as discussed above. The second is when the tax avoidance purpose or effect of the arrangement is "merely incidental". **It will rarely be the case that the use of a specific provision in a manner which is outside Parliamentary contemplation could result in the tax avoidance purpose or effect of the arrangement being merely incidental.** In the present case the appellants did not seek to rely on the merely incidental concept, so nothing more need be said on that subject.
>
> [Emphasis added]

426. In the Commissioner's view, it is clear the court in *Ben Nevis* did not mean by these comments that the merely incidental test no longer has a role. As a matter of interpretation, the court in fact explicitly recognised the separate existence of the merely incidental test. The court was simply saying that if an arrangement is outside Parliament's contemplation it is more likely it would also fail the merely incidental test. This will be particularly so where an arrangement has been artificially structured to obtain certain benefits under the Act, as it would often also be the case that the tax avoidance purpose has been pursued as a goal in itself and is therefore not merely incidental to a non-tax avoidance purpose.

427. *Penny* (SC) demonstrates that the merely incidental test has a continuing role in the s BG 1 inquiry. In *Penny* (SC) the court said it approved of the approach in *Ben Nevis*, and so did not need to set out in detail the analytical approach to tax avoidance. The court instead made some comments about particular aspects of avoidance as far as they were relevant to the case before it. As a result, it is sometimes not entirely clear whether the court was discussing whether something was tax avoidance or whether it was talking about the merely incidental test.

428. One thing that is clear is that the court took the view that the tax avoidance purpose in the case was more than merely incidental. At [34]:

> On the other hand, if the setting of the annual salary is influenced in more than an incidental way by a consideration of the impact of taxation, the use of the structure in that way will be tax avoidance.

429. At [34], the court discussed possible non-tax avoidance purposes that would have, had they been present, been relevant to the merely incidental test. These purposes included paying a relatively low level of salary because the company had a commercial need to retain funds to make a capital expenditure, or because the company was experiencing financial difficulties and could not afford to pay the equivalent of a commercial rate for the time being.

430. Accordingly, while the court in *Ben Nevis* indicated it would be very rare to find a tax purpose is merely incidental when it has already been concluded that the use of the Act was not what Parliament contemplated, *Penny* (SC) illustrates that the merely incidental test has a continuing and important role in the s BG 1 inquiry.

Summary

431. The merely incidental test applies to an arrangement that has a tax avoidance purpose or effect as one of its purposes or effects. It provides that even though the arrangement has a tax avoidance purpose or effect, it will not be a tax avoidance arrangement if the tax avoidance purpose is merely incidental to a non-tax avoidance purpose.

432. Non-tax avoidance purposes in this context are commercial and private purposes and legitimate tax purposes. Legitimate tax purposes do not include purposes that are integral to a tax avoidance purpose.

433. If purposes are not either actual effects or objectively intended effects of the arrangement, they will not be relevant. If, however, a purpose is an objectively intended effect but, because of unforeseen intervening events, the purpose is not achieved, that purpose may still be a purpose of the arrangement.

434. A "merely incidental" tax avoidance purpose or effect is something which follows from or is necessarily and concomitantly linked to, without contrivance, some other purpose or effect. Such a purpose is determined objectively by reference to the arrangement itself and not subjectively in terms of motive.

435. If a purpose, when examined, is actually underpinned by a tax avoidance purpose, then that purpose will not be merely incidental but will be a tax avoidance end in itself.

436. Purposes that are general in nature and do not explain the adoption of the specific structure of the arrangement will not establish that the tax avoidance purpose is merely incidental.

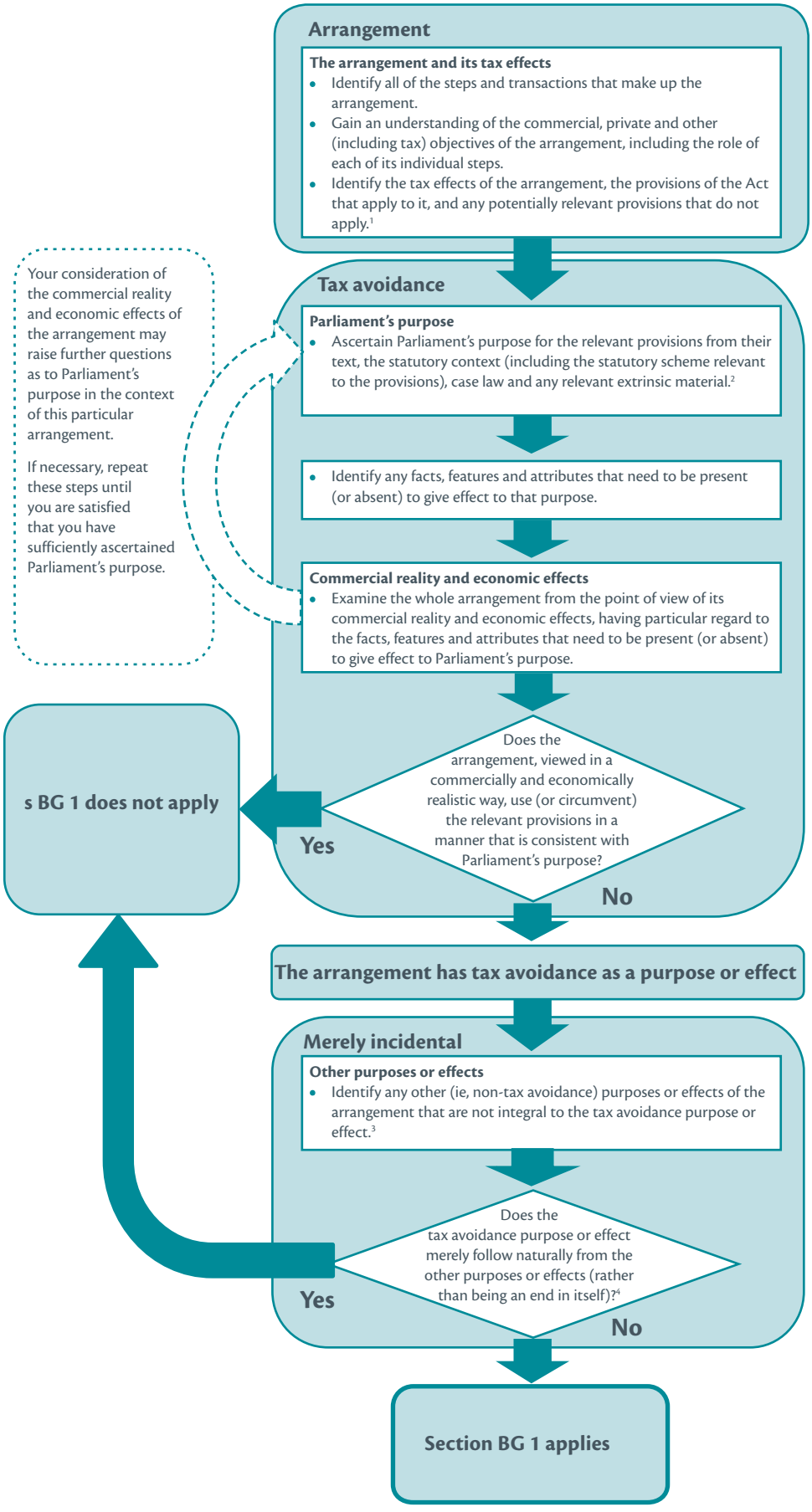
437. The magnitude or significance of the tax advantage will not on its own establish whether tax avoidance is more than merely incidental. The size of the tax benefit may, however, be relevant in reaching a view on whether the tax avoidance purpose follows naturally from another purpose.

438. Artificiality and similar indicia are relevant to both the Parliamentary contemplation test and the merely incidental test. Where an arrangement that uses specific provisions in a way not contemplated by Parliament has been structured to gain a tax advantage in an artificial and contrived way, that artificiality and contrivance will also often indicate that the tax advantage has been pursued as a goal in itself and does not naturally follow from another purpose or effect of the arrangement. This is the reason the court in *Ben Nevis* indicated it would be rare to find a tax purpose is merely incidental when it has already been concluded that the tax outcomes are not what Parliament contemplated.

SEQUENCE OF ANALYSIS IN COMING TO A VIEW ON WHETHER SECTION BG 1 APPLIES TO AN ARRANGEMENT

439. The following flow chart illustrates in simplified form the suggested steps to take in analysing whether s BG 1 applies to an arrangement.

Section BG 1: a suggested approach



EXAMPLES

The following three examples are intended to illustrate how the Commissioner's approach outlined in this statement (and summarised in the flow chart) is used to reach a view on whether an arrangement is a tax avoidance arrangement. The examples are set out using the same headings and structure as that set out in the flow chart.

Each example is based on a relatively common fact situation that Inland Revenue has been asked about. The examples are deliberately simplified and do not include all the facts that would arise in a real-life situation if s BG 1 were under consideration. This is because the purpose of the examples is not to give the Commissioner's view on whether s BG 1 would apply to particular fact situations that might be close to the line. Instead, these examples are only intended to illustrate the analytical process or approach that is to be applied when considering the application of s BG 1. They are not, therefore, intended for application to specific taxpayer situations. It is very possible that further, or even slightly different facts, may lead to a different conclusion when considering the application of s BG 1.

There may also be further provisions that could be relevant to the examples but for the sake of simplicity are not considered. For example, in Example 3 in appropriate cases the Commissioner could consider the application of the remuneration provisions as well as the dividend provisions.

Example 1

A taxpayer borrows from one of the major banks to invest long-term in a residential rental property on standard terms and conditions. The taxpayer rents out the property to a non-associated person on market terms and conditions. Expenses are incurred by the taxpayer on interest, insurance and rates, and these expenses are deducted from his income. The expenses exceed the taxable rental income. The taxpayer has other income that he derives from salary and wages. Does s BG 1 apply to this arrangement in light of the fact that the rental expenses exceed the rental income and can be offset against the taxpayer's other income?

Arrangement

The arrangement and its tax effects

Identify all of the steps and transactions that make up the arrangement.

The steps of the arrangement are:

- the taxpayer obtaining a loan at interest from a bank to fund the purchase of the property;
- the taxpayer purchasing the property;
- the taxpayer renting out the property (to a non-associated person);
- the taxpayer incurring expenses (ie, interest, insurance and rates expenses) in relation to the property that exceed the rental income received for the property.

Gain an understanding of the commercial, private and other (including tax) objectives of the arrangement, including the role of each of its individual steps.

Under the arrangement the taxpayer acquires an income-producing capital asset, in the form of a rental property. The rental property generates income for the taxpayer. To generate that income the taxpayer incurs interest costs and other expenses.

Identify the tax effects of the arrangement, the provisions of the Act that apply to it, and any potentially relevant provisions that do not apply.

The income derived from the rental property is assessable income (s CC 1 (income from holding property)). The interest, rates and insurance expenses incurred by the taxpayer in deriving the rental income are deductible against the rental income (ss DA 1 and DA 2 (general permission and general limitations), and s DB 6 (interest: not capital expenditure)). The taxpayer's annual interest, rates and insurance expenses are offset against the taxpayer's annual rental and salary and wages income. If the taxpayer's annual rental expenses are more than his annual income the difference is the taxpayer's net loss. If the taxpayer's annual rental expenses are less than his annual income the difference is the taxpayer's net income (s BC 2 (annual gross income), s BC 3 (annual total deductions), s BC 4 (net income and net loss) and s BC 5 (taxable income)).

Tax Avoidance: the "Parliamentary contemplation" test

Parliament's purpose

Ascertain Parliament's purpose for the relevant provisions from their text, the statutory context (including the statutory scheme relevant to the provisions), case law and any relevant extrinsic material.

Parliament intended that:

- rental income is assessable (ss BC 2, BD 3 and CC 1);
- under the interest and general deductibility provisions that expenditure incurred in deriving assessable income is deductible from assessable income (s DA 1, *Ben Nevis* at [128] and *Westpac* at [605]–[606]);
- any non-capital and non-private expenses incurred

in deriving income are deductible from that income (ss DA 1 and DA 2);

- interest is deductible where the loan capital, relating to that interest, is used in the production of assessable income (s DB 6, *Pacific Rendezvous Ltd v CIR* [1986] 2 NZLR 5,67 (CA));
- the deduction of interest and other expenses is not limited to just the amount of income received (s BC 5, *Eggers v CIR* [1988] 2 NZLR 365 (CA));
- where expenses exceed the amount of income received, the excess is to be deducted against the taxpayer's other assessable income (ss BC 2, BC 3, BC 4, BC 5 and *Grieve v CIR* [1984] 1 NZLR 101 (CA)); and
- if the taxpayer does not have any other assessable income, that excess is to become the taxpayer's net loss to carry forward into the next tax year (ss BC 2, BC 3, BC 4 and BC 5).

Identify any facts, features and attributes that need to be present (or absent) to give effect to that purpose.

From the provisions identified, the following facts, features and attributes need to be present (or absent) to give effect to Parliament's purpose:

- income is derived from rent;
- any expenses are incurred in deriving rental income;
- any expenses are not of a capital or private nature;
- any interest expenses are for loan capital used to produce assessable income; and
- assessable income is derived from another income source (eg, salary and wages).

Commercial reality and economic effects

Examine the whole arrangement from the point of view of its commercial reality and economic effects, having particular regard to the facts, features and attributes that need to be present (or absent) to give effect to Parliament's purpose.

Under the arrangement the taxpayer personally derives real income and personally incurs real expenses to derive that income. There is no evidence of artificiality, pretence and circularity in the arrangement. The income is actually derived by the taxpayer and the expenses are actually incurred by the taxpayer. The interest, rates and insurance costs are personally borne by the taxpayer to derive the rental income. The interest expenses are for the loan used to buy the rental property. Under the arrangement there was a net cash outlay. By incurring the expenses the taxpayer is personally subject to a genuine economic burden and so in reality suffers any economic losses claimed. The loan and lease arrangements are on arm's length terms and conditions. The expenses are not of a capital or private nature. Under the arrangement the economic reality is that the expenses incurred are greater than the rental income derived.

Reach a view on whether the arrangement has a tax avoidance purpose or effect

Does the arrangement, viewed in a commercially and economically realistic way, use (or circumvent) the relevant provisions in a manner that is consistent with Parliament's purpose?

The two different types of income (ie, rental income and salary and wages income) derived by the taxpayer are, in an economic sense, amounts of actual income derived, as Parliament would expect for the income provisions. The expenses are incurred in an economic sense, as Parliament would expect for the deductibility provisions and they are incurred in deriving assessable income. The expenses incurred by the taxpayer may be deducted against any assessable income derived by the taxpayer in that same tax year. This will reduce the amount of tax payable on that income, as Parliament would expect under the core provisions. The facts, features and attributes Parliament would expect to be present for the relevant provisions are present under this arrangement. As such, the arrangement, viewed in a commercially and economically realistic way, uses the relevant provisions in a manner that is consistent with Parliament's purpose.

Conclusion: the arrangement does not have a tax avoidance purpose or effect.

Merely incidental

Other purposes or effects

Identify any other (ie, non-tax avoidance) purposes or effects of the arrangement that are not integral to the tax avoidance purpose or effect.

The arrangement does not have a tax avoidance purpose or effect, so there is no need to consider whether a tax avoidance purpose or effect is merely incidental to another purpose or effect.

Example 2

The taxpayer, a salary and wage earner on the top marginal tax rate (ie, 33%), has a term deposit with her local bank that has just matured. The taxpayer wants to reinvest the amount with her bank for a year. The taxpayer's bank offers the taxpayer the option of investing the amount in another term deposit earning

5% interest and taxed at 33% or in an investment trust of the bank that is a multi-rate Portfolio Investment Entity (PIE). The PIE is a collective investment vehicle. The PIE is also expected to earn a 5% return but is taxed at 28%. The PIE is effectively equivalent to other collective investment vehicles offered by other banks. The taxpayer chooses to invest the amount in the PIE as it will generate a higher after-tax return than that generated by the term deposit and there seems to be no significantly greater risk. The taxpayer notifies the PIE of her correct prescribed investor rate and provides her IRD number. Does s BG 1 apply to this arrangement in light of the fact that the taxpayer pays a lower rate of tax on her PIE income?

Arrangement

The arrangement and its tax effects

Identify all of the steps and transactions that make up the arrangement.

The arrangement is the taxpayer investing her money in a PIE.

Gain an understanding of the commercial, private and other (including tax) objectives of the arrangement, including the role of each of its individual steps.

Under the arrangement the taxpayer acquires an investment that generates a 5% return before tax. The after tax-return generated by the PIE is greater than that generated by the term investment offered by the bank but at no greater appreciable risk.

Identify the tax effects of the arrangement, the provisions of the Act that apply to it, and any potentially relevant provisions that do not apply.

The PIE attributes income from the proceeds of the taxpayer's investment to the taxpayer and pays the tax on the income attributed to the taxpayer at her prescribed investor rate of 28% (s HM 31 and ss HM 34–40 (rules for multi-rate PIEs) and sch 6). The PIE meets the requirements set out in subpart HM and is a PIE under the Act (ss HM 7 to HM 20 (entry rules), s HM 71 (choosing to become a PIE) and Subpart YA (definition of multi-rate PIE)).

The taxpayer has not provided the PIE with a rate lower than her correct prescribed investor rate and so is not liable for tax on her PIE income for which the PIE has a tax liability (s HM 6(2) (intended effects for investors) and sch 6 (prescribed rates: PIE investments and retirement scheme contributions)).

The taxpayer has notified the PIE of her IRD number and her prescribed investor rate and so a default rate will not apply to her investment (s HM 32 (rules and treatment of investors in multi-rate PIEs)). The prescribed investor rate for the taxpayer, a natural person who is a New Zealand resident and on the top tax rate, is in most cases 28% (s HM 56 (prescribed investor rates: schedular rates) and sch 6).

The income attributed by the PIE to the taxpayer is her excluded income. This is because the taxpayer's prescribed investor rate in the relevant calculation period is more than zero and is not more than her notified prescribed investor rate (ss CP 1 and CX 56 (attributed income of certain investors in multi-rate PIEs)). The taxpayer's excluded income is not assessable income (s BD 1 (income, exempt income, excluded income, non-residents' foreign-sourced income, and assessable income)).

The distribution of the net after-tax return on the taxpayer's investment is also her excluded income (s CX 56B (distributions to investors in multi-rate PIEs)).

Potentially relevant provisions that do not apply to this arrangement: s BC 6 (income tax liability of filing taxpayer), s CC 4 (payments of interest), s CD 1 (income from equity), sub part YA (definition of basic tax rate, and taxpayer) and sch 1—Part A (basic income tax rates).

Tax Avoidance: the "Parliamentary Contemplation" test

Parliament's purpose

Ascertain Parliament's purpose for the relevant provisions from their text, the statutory context (including the statutory scheme relevant to the provisions), case law and any relevant extrinsic material.

Parliament intended that:

- in general a person deriving interest and dividend income includes that income as their assessable income and that income is taxed at their marginal rate;
- in the case of income attributed by a PIE to an investor that income is the investor's excluded income. This is as long as the investor's prescribed investor rate in the relevant calculation period is more than zero and is not more than the rate provided to the PIE by the investor (ss CP 1 and CX 56);
- the tax treatment under the PIE rules would be available to orthodox investment vehicles that met the requirements of the PIE rules (ss HM 7 to HM 20, s HM 71, Subpart YA) [It is not necessary for present

purposes to identify the whole range of entities that Parliament would expect to come within the PIE rules. This is because it is clear that Parliament would intend that an orthodox collective investment vehicle run by a major bank would be within Parliament's intention for the PIE rules.];

- PIEs pay the tax on any income attributed to their investors at the investor's prescribed investor rate with a maximum applicable rate of 28% (ss HM 31, HM 34 to 40 and sch 6);
- there should be no tax liability on the PIE income of New Zealand resident natural persons who have provided their prescribed investor rate to the PIEs in which they have invested; and
- the PIE regime provides an incentive to New Zealand residents to save through the use of collective investment vehicles (Commentary on the Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill).

Identify any facts, features and attributes that need to be present (or absent) to give effect to that purpose.

From the provisions identified, the following facts, features and attributes need to be present (or absent) to give effect to Parliament's purpose:

- a natural person who is a New Zealand resident;
- an investment in a PIE;
- notification to the PIE by an investor of their prescribed investor rate and their IRD number; and
- income attributed by the PIE to the investor less the amount of tax calculated at the investor's prescribed investor rate.

Commercial reality and economic effects

Examine the whole arrangement from the point of view of its commercial reality and economic effects, having particular regard to the facts, features and attributes that need to be present (or absent) to give effect to Parliament's purpose.

Under the arrangement there is a real investment by the taxpayer in a PIE. The PIE is in commercial and economic terms a collective investment vehicle as envisioned by the PIE provisions and is similar to other collective investment vehicles offered by other banks. The taxpayer is a natural person and is a New Zealand resident. The PIE has been notified of the taxpayer's correct prescribed investor rate. The taxpayer derives income from their investment in the PIE. The PIE pays tax on any income it attributes to the taxpayer at the taxpayer's prescribed investor rate. The taxpayer's prescribed investor rate is the rate set by Parliament. The income the PIE attributes to the investor in a tax year is the investor's excluded income and is not returned by the taxpayer as assessable income. The income attributed to the investor from their PIE investment is taxed at the rate Parliament intended for that type of investment.

Reach a view on whether the arrangement has a tax avoidance purpose or effect

Does the arrangement, viewed in a commercially and economically realistic way, use (or circumvent) the relevant provisions in a manner that is consistent with Parliament's purpose?

The taxpayer has invested in and derived income from a PIE in both a commercial and economic sense as Parliament would expect under the provisions of the PIE regime. The PIE in which the taxpayer has invested is also, in a commercial and economic sense, the type of vehicle Parliament would expect under the provisions of the PIE regime. The facts, features and attributes Parliament would expect to be present for the relevant provisions are present under this arrangement. As such, the arrangement, viewed in a commercially and economically realistic way, uses the relevant provisions in a manner that is consistent with Parliament's purpose.

Conclusion: the arrangement does not have a tax avoidance purpose or effect.

Merely incidental

Other purposes or effects

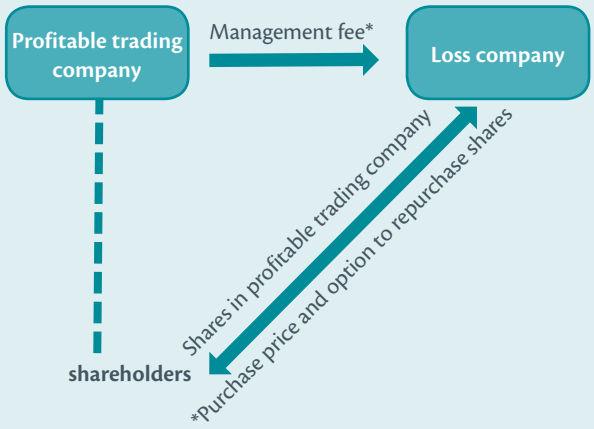
Identify any other (ie, non-tax avoidance) purposes or effects of the arrangement that are not integral to the tax avoidance purpose or effect.

The arrangement does not have a tax avoidance purpose or effect, so there is no need to consider whether a tax avoidance purpose or effect is merely incidental to another purpose or effect.

Example 3

Shareholders in a profitable trading company sell their shares to a promoter's loss company, with the purchase price remaining outstanding on an interest-free basis. There is an option granted to the shareholders to buy back the shares in five years' time for the outstanding balance of the purchase price or, if fully paid, a nominal amount. Every year the profitable trading company pays an amount equal to its annual net profit to the loss company as a management fee. Simultaneously the loss company pays the same amount to the shareholders in partial repayment of the purchase price for the shares.

The shareholders retain their management roles in the profitable trading company and there is little, if any, evidence of the loss company providing management services to the profitable trading company.



*Management fee and purchase price are the same amount as the profitable trading company's net profits before the management fee is deducted.

Does s BG 1 apply to this arrangement in light of the fact that:

- the shareholders' receipt of the share purchase price will not be subject to tax, whereas any distributions paid by the profitable trading company to the shareholders would have been taxable to the shareholders;
- the management fees paid to the loss company reduce the profitable trading company's yearly assessable income to nil; and
- the loss company's net losses from previous tax years mean that it is not required to pay tax on the management fees paid to it by the profitable trading company.

Arrangement

The arrangement and its tax effects

Identify all of the steps and transactions that make up the arrangement.

The steps of the arrangement are:

- the shareholders selling their shares to a loss company, leaving the purchase price outstanding on an interest-free basis;
- the loss company granting an option to the shareholders to repurchase the shares in five years' time for the outstanding balance of the purchase price or, if fully paid, a nominal amount;
- the profitable trading company paying the loss company annual management fees that are the same amount as the profitable trading company's annual net profits; and
- the loss company making annual repayments of the purchase price for the shares that are the same amount as the annual management fees it receives from the profitable trading company.

Gain an understanding of the commercial, private and other (including tax) objectives of the arrangement, including the role of each of its individual steps.

Under the arrangement the shareholders of the profitable trading company transfer their shares in the profitable trading company to the loss company. The loss company repays the purchase price for the cost of the shares out of the management fees it charges the profitable trading company. The management fee paid to the loss company is the same amount as the profitable trading company's annual net profit.

The parties state that a commercial objective was that the shareholders wanted to maximise their financial return from the profitable trading company. The parties also state that the shareholders' continued roles with the company provided them with employment.

Identify the tax effects of the arrangement, the provisions of the Act that apply to it, and any potentially relevant provisions that do not apply.

Any business income derived by the loss company or by the profitable trading company is assessable to that company (s BC 6 (income tax liability of filing taxpayer), s CB 1 (business income), sub part YA (definition of basic tax rate, company and taxpayer) and sch 1—Part A (basic income tax rates)). The capital gains derived from the sale of the shares are not taxable to the shareholders (Part C and specifically s CA 1(2) (income under ordinary concepts)).

The expenses incurred by the profitable trading company and the loss company in deriving business income are deductible provided they are not capital or private expenses (s BD 2 (deductions), ss DA 1 and DA 2 (general permission and general limitations)).

Potentially relevant provisions that do not apply to this arrangement: ss CD 1–CD 6 (income from equity) and possibly other provisions in Part C (income), ss IA 2 and IA 3 (tax losses and using tax losses in tax year), s IC 1 (company making a tax loss available to company B) and s IC 3 (common ownership: group of companies).

Tax Avoidance: the "Parliamentary contemplation" test

Parliament's purpose

Ascertain Parliament's purpose for the relevant provisions from their text, the statutory context (including the statutory scheme relevant to the provisions), case law and any relevant extrinsic material.

Parliament intended that:

- a company is taxed on any business profit it derives (ss BC 6 and s CB 1, sub part YA and sch 1—Part A);
- shareholders are taxed on any amounts paid out to them by the companies in which they have shares (ss CD 1–CD 6 and possibly other provisions in Part C); and
- capital receipts are generally not taxed (this intention can be ascertained from the fundamental common law distinction between income and capital, evidenced in the Act by, among other things, the specified lists of what amounts are income in Part C (including the meaning of income under ordinary concepts) and the prohibition for deductions of a capital nature (Part C, specifically s CA 1(2), s DA 2(1) and *BP Australia Ltd v FCT* (1965) 112 CLR 386)).

Parliament's purpose for the general deductibility provisions is that:

- expenditure incurred in deriving assessable income is deductible from assessable income (s DA 1, *Ben Nevis* at [128] and *Westpac* at [605]–[606]); and
- expenses incurred in deriving business income are deductible as long as they are not capital or private expenses (ss DA 1 and DA 2).

Parliament intended that a company with tax losses could permit another company to use those tax losses to reduce that second company's taxable income where both of those companies have a specified degree of common ownership. If there is not the specified degree of common ownership, Parliament did not intend that a company would be able to use the tax losses of another company to reduce its taxable income (ss IA 2, IA 3, IC 1 and IC 3, and *Challenge* (PC) at 561).

Identify any facts, features and attributes that need to be present (or absent) to give effect to that purpose.

From the provisions identified, the following facts, features and attributes need to be present (or absent) to give effect to Parliament's purpose:

- there is a company;
- the company carries on a business and derives business income;
- the company's net profits are paid out as dividends or remuneration (unless accumulated in the company);
- there are capital receipts;
- any expenses are incurred for something (eg, goods or services) relating to the production of business income;
- any expenses deducted are not of a capital or private nature;
- there is another company with a net loss; and
- the company with the net loss has the specified degree of common ownership with the other company.

Commercial reality and economic effects

Examine the whole arrangement from the point of view of its commercial reality and economic effects, having particular regard to the facts, features and attributes that need to be present (or absent) to give effect to Parliament's purpose.

Under the arrangement there are two companies. One of the companies, the profitable trading company, is commercially and economically carrying on a business and deriving income from that business. However, there is evidence of artificiality, pretence and circularity in the arrangement. In a commercial and economic sense, the shareholders have retained all significant elements of their original ownership and management of the profitable trading company. The profitable trading company's payment of its net profit as management fees to the loss company is the same as the amount the loss company pays to the shareholders as the purchase price. The shareholder's supposed sale of the shares has not in a real sense improved or changed their economic position. These two facts, combined with the shareholders' option to later repurchase the shares at no genuine economic cost to themselves, demonstrates that they have not in reality disposed of their shares to the loss company.

A second feature of the arrangement is the management fees paid by the profitable company to the loss company. As stated above the profitable trading company's annual net profit determines both the annual amount paid to the loss company as a management fee and the annual amount paid to the shareholders as repayment of the purchase price of the shares. If the profitable trading company does not have a net profit before paying out the management fees, there is no requirement to pay the management fee or to repay the purchase price of

the shares. There is little, if any, evidence of the loss company providing any services to the profitable trading company. The management fees are not incurred by the profitable trading company to generate business income in any real sense.

Because the shareholders have not in terms of commercial reality disposed of their shares, the loss company's payments to the shareholders would, therefore, not be regarded as repayments of the purchase price of the shares. Instead, as these payments are the same amounts as that paid by the profitable trading company to the loss company, and then in turn the same amounts as the profitable trading company's annual net profits, it can be concluded that the loss company's payments to the shareholders are effectively payments of the profitable trading company's annual net profits.

The purchasing company has net losses. In a commercial and economic sense, the profitable trading company's annual net profits are being offset by the purchasing company's net losses. There is not the specified degree of commonality of ownership between the profitable trading company and the purchasing company that Parliament intended.

Reach a view on whether the arrangement has a tax avoidance purpose or effect

Does the arrangement, viewed in a commercially and economically realistic way, use (or circumvent) the relevant provisions in a manner that is consistent with Parliament's purpose?

The annual amounts paid to the shareholders as repayment of the purchase price for the shares are not, in a commercial and economic sense, capital payments. They are payments of income that Parliament would expect to be subject to the income provisions. In a commercial sense, no services were provided by the loss company in return for the management fees, unlike what Parliament would expect under the deductibility provisions. As there is no real commonality of ownership between the loss company and the profitable trading company, the effective use of the loss company's losses to reduce the profitable trading company's net profit means that the loss company's losses are not applied as Parliament would expect under the company loss provisions. The facts, features and attributes Parliament would expect to be present for the relevant provisions are not present under this arrangement. As such, the arrangement, viewed in a commercially and economically realistic way, does not use the relevant provisions in a manner that is consistent with Parliament's purpose.

Conclusion: the arrangement has a tax avoidance purpose or effect.

Merely incidental

Other purposes or effects

Identify any other (ie, non-tax avoidance) purposes or effects of the arrangement that are not integral to the tax avoidance purpose or effect.

The parties state a commercial objective is that the shareholders want to maximise their financial return from the profitable trading company. However, this objective is underpinned by tax avoidance. The shareholders' financial returns from the profitable trading company are only improved because of the tax that was avoided under the arrangement. This is because the way the arrangement seeks to maximise the shareholders' returns is by the profitable trading company's profits being effectively paid to the shareholders as tax-free capital amounts, rather than as taxable distributions.

The parties also state that the arrangement provides for the continued employment of the former shareholders. When considering the merely incidental test, the non-tax avoidance purpose or effect needs to explain why the arrangement was structured in that particular way. Under these facts, the purpose of providing continued employment of the shareholders does not explain why the arrangement was structured in the particular way that it was.

The tax avoidance purpose or effect of this particular structure is not merely incidental to any non-tax avoidance purposes or effects.

SECTION GA 1

440. Sections BG 1(2) and GA 1 give the Commissioner the power to counteract a tax advantage.

The effect of s BG 1 and the application of s GA 1

441. The effect of s BG 1(1) is that a tax avoidance arrangement is void from the beginning of the arrangement against the Commissioner. Section BG 1 always voids the whole arrangement. The words of s BG 1 do not allow for apportionment, so all tax outcomes of the arrangement, including legitimate outcomes, are void. There is no scope under s BG 1 to leave in place part of a tax avoidance arrangement.

442. Section BG 1 is an annihilating provision; it does not of itself create a tax liability (*Challenge* (CA) at 548; *Wisheart, Macnab and Kidd v Commissioner of Inland Revenue* [1972] NZLR 319 (CA) at 337). The Commissioner applies s 113 of the Tax Administration Act 1994 to give effect to an assessment following voiding.

443. Subsections GA 1(1) and (2) provide:

> *When this section applies*
>
> (1) This section applies if an arrangement is void under section BG 1 (Tax avoidance).
>
> *Commissioner's general power*
>
> (2) The Commissioner may adjust the taxable income of a person affected by the arrangement in a way the Commissioner thinks appropriate, in order to counteract a tax advantage obtained by the person from or under the arrangement.

444. The word "may" in s GA 1(2) (and in s BG 1(2)) does not mean that the Commissioner has complete choice whether to apply s GA 1. Instead, the word "may" recognises that there may be circumstances where it is not necessary to exercise the power in s GA 1. When the voiding appropriately counteracts the tax advantages, and does no more than that, then the Commissioner will not be required to apply s GA 1. However, if the voiding has not appropriately counteracted the tax avoidance, or the voiding has removed legitimate outcomes, or there are consequential adjustments needed to be made, the Commissioner is required to apply s GA 1. The Privy Council in *Miller* (PC) stated at [23]:

> The Act says that an arrangement falling within the terms of the section "shall be absolutely void". **Likewise, the Commissioner is under a statutory duty to reassess the taxpayer's assessable income to counteract any tax advantage.** Discretion enters into the matter only as to the method of calculation by which the Commissioner discharges that duty.
>
> [Emphasis added]

The types of adjustments that can be made under s GA 1

445. Section GA 1(2) provides that the adjustment is to be in a manner the Commissioner thinks appropriate to counteract the tax advantage obtained from or under the arrangement. This gives the Commissioner a broad discretion as to how to make adjustments in order to counteract a tax advantage. Blanchard J referred to the broad nature of the discretion in *Miller* (CA) at 302:

> **Section 99(3) gives the Commissioner a wide reconstructive power.** He [the Commissioner] "may" have regard to the income which the person he is assessing would have or might be expected to have or would in all likelihood have received but for the scheme, but **the Commissioner is not inhibited from looking at the matter broadly** and making an assessment on the basis of the benefit directly or indirectly received by the taxpayer in question.
>
> [Emphasis added]

446. The Commissioner considers that the broad nature of the power under s GA 1(2) empowers the Commissioner to make adjustments to do any of the following:

- negate any tax avoidance purposes or effects that have not been counteracted by the annihilation;
- reinstate legitimate tax outcomes voided by the arrangement;
- make appropriate consequential adjustments.

447. The ability to make this range of adjustments derives from the wording of s GA 1(2). Section GA 1(2) empowers the Commissioner to adjust the "taxable income of a person affected by the arrangement in a way the Commissioner thinks appropriate". The section provides that the Commissioner exercises this power "in order to counteract a tax advantage obtained … from or under the arrangement". Even though it provides a broad and flexible discretion, the Commissioner is required to exercise this adjustment power with a particular object in mind. This follows from the fact that the purpose of ss BG 1 and GA 1 is to counteract tax avoidance. It would be outside the purpose for the provisions to apply the power in a way that did more than counteract tax avoidance. Removal of legitimate tax effects, and an inability to put in place consequential adjustments, would potentially be inconsistent with this purpose.

448. The legislative history does not shed particular light on the issue of the type of adjustments open to the Commissioner, but neither does it suggest the power is limited. Prior to the enactment of an adjustment power, the courts had recognised the specific problem

of arrangements involving income diversion not being counteracted by voiding (*Mangin*). Parliament nevertheless enacted a power that was worded in general terms.

449. The scope of the types of adjustments that the Commissioner can make has not been expressly considered by the courts. However, there is some judicial authority for each of the three types of adjustment.

Negating tax avoidance purposes or effects not counteracted by the annihilation

450. The adjustments made in *Miller* (PC) and (CA) are examples of where voiding the arrangement did not sufficiently negate the tax advantages. That litigation involved an arrangement that produced tax advantages for different people at a number of different points that may not have been counteracted by simply voiding the arrangement.

Reinstating legitimate tax outcomes voided by the arrangement

451. In a number of cases, the courts have appeared to approve of the Commissioner's approach of reinstating some tax outcomes from the arrangement (the second category); see *Ben Nevis* at [31], *Glenharrow* at [55], and *Peterson v Commissioner of Inland Revenue (No 2)* (2002) 20 NZTC 17,761 (HC) at [70].

452. In *Ben Nevis*, the Commissioner's reconstruction provided for some of the deductions claimed by the taxpayers, namely the planting and tending costs related to the trees, to be reinstated. The Supreme Court stated:

> [31] None of the expenses claimed related to the costs to the syndicate of planting and tending trees. No issue has arisen concerning the tax treatment of those costs.

453. The Commissioner's power does not extend beyond making adjustments to counteract the tax advantages. Parliament would not have intended that legitimate tax outcomes would be nullified. In *BNZ Investments No 1* (HC), McGechan J considered that it is only a tax advantage obtained out of tax avoidance that may be counteracted:

> [200] While the law does not allow a taxpayer to contend that if there had been no such tax advantage he would never have entered the transaction, and accordingly there can be nothing to reconstruct, I have no doubt s 99(3) is intended to counteract tax advantages obtained out of avoidance, but not otherwise. Where tax advantages are increased through avoidance over a base level which would have existed in any event, it is that increment above base level which is to be counteracted, not the legitimate base level itself. That is all preservation of the tax base – the purpose of the section – requires.

454. However, adjustments to reinstate legitimate tax effects are ones the Commissioner thinks are appropriate. When considering whether a tax effect is legitimate, the Commissioner considers that parts of the arrangement that are so interdependent and interconnected with the tax avoidance parts as to be integral to them would not be reinstated by the operation of s GA 1. This will be the case even if the part of the arrangement, when viewed in isolation, or in the context of a different arrangement, could be argued to be legitimate.

455. This point is well illustrated in *Westpac*, given Harrison J's finding that the funding costs could not, in the context of the particular arrangement, be distinguished from the guarantee procurement fee. His Honour said:

> [641] Third, the Commissioner is not bound to isolate out and counteract only particular elements giving rise to a tax advantage. Westpac's tax advantage combined two principal elements of deductibility falling within the composite label of the cost of funds – funding costs and the GPF. There was no hierarchy or ranking between them. While only the GPF was unlawfully deducted and the separate source of a finding of avoidance, none of the deductions would have been generated without completion of the transaction as a whole. All its elements were integral. The bank was able to set off or deduct all expenses against its other New Zealand income as a result.

Making appropriate consequential adjustments

456. There is some authority for the Commissioner's ability to make consequential adjustments (the third category). In *Miller* (CA) the court seemed to accept the Commissioner had power to make consequential adjustments without overtly linking this power to the specific section (now s GA 1(6)) that prevents double counting (at 304). It has long been the Commissioner's practice to make consequential adjustments and this approach has never been the subject of adverse comment in the courts.

The section conveys a broad discretion as to manner in which adjustments are made

457. As noted above, the Commissioner has a broad discretion as to how to make adjustments to counteract a tax advantage. An issue that arises in this context is the degree of specificity the Commissioner must reach in applying s GA 1. The Commissioner is not under a duty to describe precisely the actual basis for an adjustment. In response to a submission that

the Commissioner must determine precisely what constitutes tax avoidance, Harrison J, in *Westpac*, said:

> [639] I do not accept Mr Green's submission as a matter of principle for a number of reasons. First, the Commissioner's statutory obligation to reconstruct is simply to counteract a tax advantage obtained from and under a transaction. He is not under any further duty to determine precisely what constitutes the tax avoidance or identify a particular aspect giving rise to a tax advantage.

458. *Westpac* confirms that the Commissioner may have different options available when counteracting a tax advantage. Harrison J upheld the Commissioner's adjustment and went on to confirm that an alternative adjustment may also have been appropriate (at [624] and [668]).

459. Similarly, in *Miller* (HC) at 13,036, Baragwanath J said:

> Where the legal construct of a company is used there is likely to be more than one way of defining and counteracting the tax advantage. … In this sphere there is not inexorably any single right answer …

460. The breadth of the discretion was confirmed by the Court of Appeal in *Dandelion* (CA). McGrath J made the following observations in respect of the adjustment made by the Commissioner under s 99(3) at [86]:

> But in any event the Commissioner was entitled in the exercise of the discretion under s 99(3) to disallow the appellant's claim for deduction and as long as the Commissioner was of the opinion it was a proper adjustment to make under s 99(3) it cannot be attacked on the basis that the Commissioner has not simultaneously amended an inconsistent assessment of another taxpayer: *Miller v Commissioner of Inland Revenue* [1999] 1 NZLR 275 (CA) at pp 289 and 292.

461. Harrison J in *Westpac* also stated that the "traditional principles of judicial restraint" apply to this discretion (at [622]):

> First, once the Commissioner avoids an arrangement he "may" adjust the amounts of gross income, allowable deductions and available net losses including calculating taxable income "in the manner [he] thinks appropriate". The traditional principles of judicial restraint in determining a challenge to a discretionary power apply; **the question is whether the Commissioner "adopted a reconstruction which was outside the scope of his powers"**: *Ben Nevis* at [170].
>
> [Emphasis added]

462. While the discretion is broad, the statutory language employed in s GA 1(2) requires that the adjustment be undertaken so as to "… counteract a tax advantage …". The references in various cases to the Commissioner's discretion are to be read subject to that requirement.

The section applies to future tax advantages

463. The point was made earlier in this statement that an arrangement may be a tax avoidance arrangement even though the tax liability avoided is a prospective or potential future liability to income tax. It is possible that the tax advantage eventuates some time after the arrangement is put in place, in which case a s GA 1 adjustment will be the result of something that may have happened in a previous year.

Who is a "person affected" by the arrangement?

464. Under s GA 1(2) the Commissioner may adjust not only the taxable income of the parties to a tax avoidance arrangement, but also the taxable income of persons "affected" by the arrangement.

465. In *Peterson* (PC), Lord Millett stated that a person could be affected by an arrangement whether or not they were a party to it and whether or not they were privy to its details:

> [34] Their Lordships are satisfied that the "arrangement" which the commissioner has identified had the purpose or effect of reducing the investors' liability to tax and that, **whether or not they were parties to the arrangement or the relevant part or parts of it, they were affected by it**. Their Lordships do not consider that the "arrangement" requires a consensus or meeting of minds; **the taxpayer need not be a party to "the arrangement" and in their view he need not be privy to its details either**.
>
> [Emphasis added]

466. Further, in *Ben Nevis*, the court stated:

> [164] On the ordinary meaning of the emphasised language in s GB 1 [the predecessor to s GA 1], once the existence of a tax avoidance arrangement has been established, all those taxpayers who have benefited from it may be subject to corrective adjustments by the Commissioner in the exercise of the reconstruction power. **No question of mutuality or even awareness by a benefiting taxpayer is a necessary element.**
>
> [Emphasis added]

467. Therefore, "a person affected" may include:

- a person whether or not party to the arrangement (*Peterson* (PC) at [33]–[34], and *BNZ Investments No 1* (CA) at [175];
- a person who is unaware that he or she has benefited from the tax avoidance arrangement (*Ben Nevis* at [164]–[168]).

468. For example, the beneficiaries of a trust could be persons affected by a tax avoidance arrangement (and, therefore, have their income adjusted) even though they may not be parties to the arrangement or even be aware of it.

469. There may be more than one person affected by an arrangement. Consequently, the Commissioner may need to adjust the taxable income of multiple persons affected to appropriately counteract the tax advantage from the arrangement.

Section GA 1 applies to tax credits: s GA 1(3)

470. Section GA 1(3) confirms that the Commissioner can adjust tax credits when using the s GA 1(2) power to counteract a tax advantage. It provides:

> *Commissioner's specific power over tax credits*
>
> (3) The Commissioner may—
>
> (a) disallow some or all of a tax credit of a person affected by the arrangement; or
>
> (b) allow another person to benefit from some or all of the tax credit.

The Commissioner may have regard to hypothetical situations: s GA 1(4) and (5)

471. Subsections (4) and (5) of s GA 1 supplement the Commissioner's general power in subs (2) by allowing the Commissioner to consider hypothetical alternative situations when deciding on an adjustment:

> *Commissioner's identification of hypothetical situation*
>
> (4) When applying subsections (2) and (3), the Commissioner may have regard to 1 or more of the amounts listed in subsection (5) which, in the Commissioner's opinion, had the arrangement not occurred, the person -
>
> (a) would have had; or
>
> (b) would in all likelihood have had; or
>
> (c) might be expected to have had.
>
> *Reconstructed amounts*
>
> (5) The amounts referred to in subsection (4) are—
>
> (a) an amount of income of the person:
>
> (b) an amount of deduction of the person:
>
> (c) an amount of tax loss of the person:
>
> (d) an amount of tax credit of the person.

472. Section GA 1(4) provides that the Commissioner may have regard to various factors in determining the most appropriate adjustment. These are an amount of income, deduction, tax loss, or tax credit that, had the arrangement not occurred, a person:

- would have had; or
- would in all likelihood have had; or
- might be expected to have had.

473. However, the Commissioner does not have to base the adjustment on an analysis of these factors. In *Ben Nevis*, the Supreme Court said at [169] that the "general power" of adjustment is supplemented by the "specific powers" in s GB 1(1)(a) (the predecessor to s GA 1(4) and (5)) under which the Commissioner "could have regard to" the amounts listed. The Court of Appeal in *Alesco* (CA) clearly rejected an argument that the Commissioner is required to identify a counterfactual:

> [123] Mr McKay's argument fails for two reasons which we can articulate briefly. First, his submission is wrong in law. The terms of s GB 1 are plain. In exercising her discretion the Commissioner "may have regard to" an alternative funding arrangement. But she is not bound to take that step, and nor should she be where the tax advantage can be counteracted simply by disallowing the impermissible deductions. It is immaterial that Alesco NZ required the funding for a new acquisition. That is because the appropriate comparison was available within the available taxation treatments of the OCNs: that was precisely how she adjusted Alesco NZ's liability.

Similarly, in *Westpac* at [623], Harrison J stated that the Commissioner "is entitled" to have regard to such amounts.

474. Consistent with this, Blanchard J noted in *Miller* (CA) at 302 that the Commissioner:

> ... **"may"** have regard to the income which the person he is assessing would have or might be expected to have or would in all likelihood have received but for the scheme, **but the Commissioner is not inhibited from looking at the matter broadly and making an assessment on the basis of the benefit directly or indirectly received by the taxpayer in question**.
>
> [Emphasis added]

475. The Privy Council in *Miller* (PC) stated:

> [22] Their Lordships consider that this argument is based upon a misapprehension about the effect of a reconstruction. The Commissioner's duty is to make an assessment with regard to what in his opinion was likely to have happened if there had been no scheme. But that does not mean that he is actually rewriting history. The reconstruction is purely hypothetical and provides a yardstick for the assessment. Although the income is deemed to have been derived by the person assessed (see s 99(4)), the nature and source of the income remains what it is was, namely the company's net profits routed to the shareholders through Mr Russell's company. None of this was disclosed.

476. The above quote could be seen to suggest that the Commissioner is required to have regard to what was likely to have happened if there had been no arrangement. However, the comment was made in the context of a situation where the Commissioner had put forward an alternative and was made as part of a discussion relating to the application of the time bar provisions. Consequently, the Commissioner's view is

that the Privy Council was not considering whether the Commissioner is required to have regard to a likely alternative. Rather, it was setting out the effect of a reconstruction—that is, it is purely hypothetical, intended to provide a yardstick for assessment and does not change the actual nature or source of the amounts reconstructed. The Commissioner's view is consistent with *Alesco* (CA) (at [126]) where the Court of Appeal considered that the Privy Council in *Miller* was not saying the Commissioner is under an affirmative duty to adjust by having regard to what is said to be the most likely counterfactual transaction.

477. Where the Commissioner applies s GA 1(4) and (5), the Commissioner can choose to have regard to one or more amounts of income, deduction, tax loss or tax credit. It is not necessary for the Commissioner to compare the arrangement entered into with a hypothetical alternative arrangement.

478. Further, where the Commissioner applies s GA 1(4) and (5):

- They must be applied so as to counteract any tax advantage obtained (*Westpac* at [623]; *Ben Nevis* at [169]);
- The Commissioner does not need to determine an alternative **beneficial** transaction that the taxpayer might have entered into but did not (*Westpac* at [623]; *Accent* (CA) at [155]).

479. In determining what is likely to have happened if there had been no arrangement, the Commissioner can consider what was actually done. In the Court of Appeal in *Miller* (CA), Blanchard J disagreed with the taxpayer's argument that, in the absence of the arrangement, the taxpayers would likely have retained the profit within the company, rather than the profits being distributed to the shareholders. In determining what was likely in the absence of the arrangement actually entered into, Blanchard J said at 301:

> We consider that the likelihood of receipt of moneys by the former shareholders must be judged by what they have actually done. They caused all the profits to be removed from the company. It must therefore be taken that these sums would have been distributed in the form of additional salaries, management bonuses, dividends or in some other manner in the years in which they were earned by Fiorucci and would not have been left in the company. The desire of the shareholders to extract them is demonstrated by what they actually did. They were unlikely to have waited 10 years to get their hands on each instalment of earnings.

No double counting of income or deduction

480. A further limit on the Commissioner's power of adjustment is set out in s GA 1(6). It provides:

> *No double counting*
>
> (6) When applying subsection (2), if the Commissioner includes an amount of income or deduction in calculating the taxable income of the person, it must not be included in calculating the taxable income of another person.

481. A predecessor to s GA 1(6) was considered in *Miller* (CA). Blanchard J, delivering the judgment of the Court of Appeal, stated at 292:

> It is not necessary on each occasion when the Commissioner makes an assessment of one taxpayer which is inconsistent with his earlier assessment of a different taxpayer that he simultaneously should amend that earlier assessment. **That must ultimately be done or the Commissioner would, in effect, be collecting the same tax twice over, but he is to be allowed some flexibility in the timing of the adjustment to meet administrative demands** and to enable him to await the outcome of objection proceedings in relation to the assessments.
>
> [Emphasis added]

482. In the Commissioner's view, this approach would also be followed under s GA 1(6). Therefore, when determining an appropriate adjustment, the Commissioner cannot ultimately include an amount of income or deduction in the taxable income of more than one person.

Onus on taxpayer to show adjustment wrong and by how much

483. In *Ben Nevis*, the court said that in any challenge to an adjustment made by the Commissioner under s GB 1 (the corresponding provision to s GA 1 under the Income Tax Act 2004), the onus is on the taxpayer to show that the adjustment is wrong and by how much it is wrong. The court stated:

> [171] **Furthermore, when taxpayers challenge an assessment based on a reconstruction adopted by the Commissioner, the onus is on them to demonstrate, not only that the reconstruction was wrong, but also by how much it was wrong.** Unless the taxpayer can demonstrate with reasonable clarity what the correct reconstruction ought to be, the Commissioner's assessment based on his reconstruction must stand. This is settled law. In this case we are of the view that the appellants have not shown that the Commissioner's assessment based on his reconstruction was wrong. Even if they had shown that to be so, they have not shown on any reasonably clear basis to what extent it should be

> varied. The appellants did not submit any specific proposed reconstruction of their own, the validity of which the Court could then have evaluated. The Commissioner's assessment must therefore stand.
>
> [Footnote omitted. Emphasis added]

Similar comments were also made in *Westpac* at [631].

Summary

484. When the voiding of an arrangement under s BG 1 appropriately counteracts the tax advantages, and does no more than that, then the Commissioner will not be required to apply s GA 1. However, if the voiding has not appropriately counteracted the tax avoidance, or the voiding has removed legitimate outcomes or there are consequential adjustments needed to be made, the Commissioner is required to apply s GA 1.

485. The Commissioner has a broad discretion as to the adjustments that can be made to counteract the tax advantage. The broad nature of the power under s GA 1 empowers the Commissioner to make any of the following three types of adjustments to parties or persons affected:

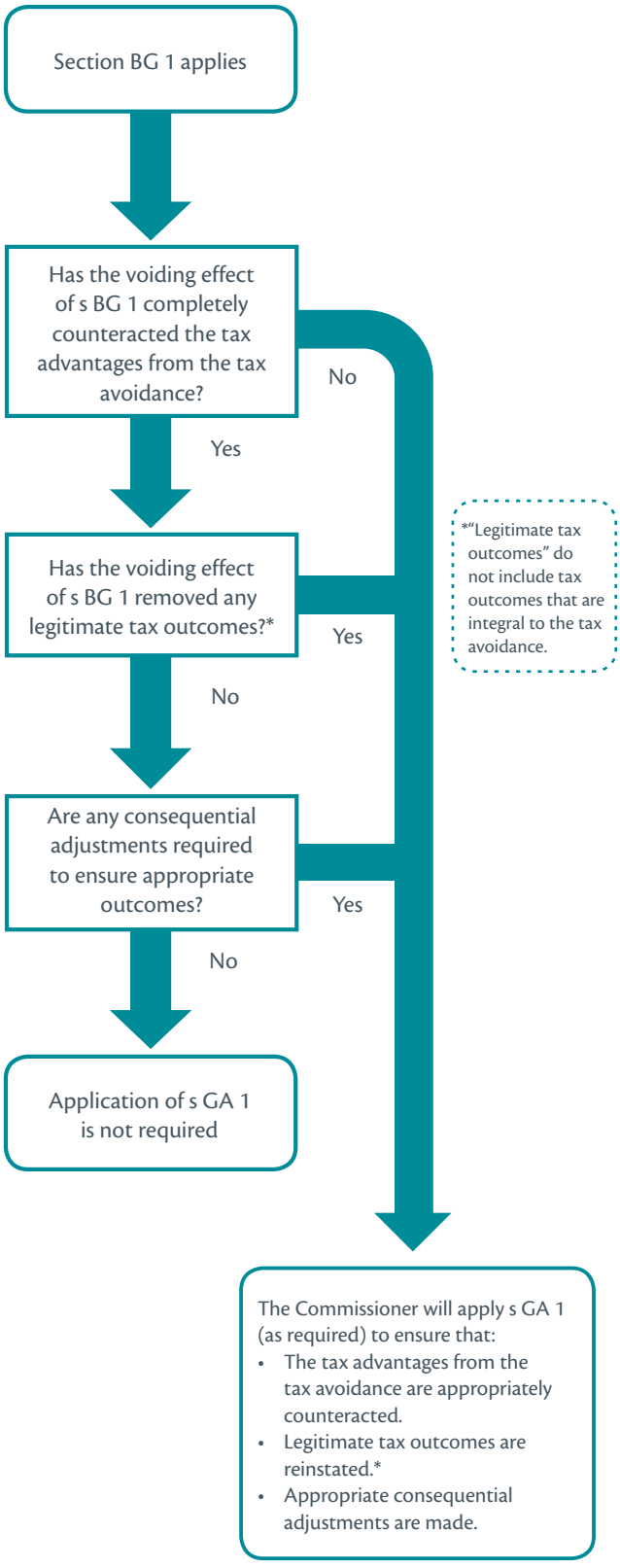
- negate the tax avoidance purposes or effects that have not been countered by the annihilation;
- reinstate legitimate tax outcomes voided by the arrangement;
- make appropriate consequential adjustments.

486. Also, in relation to this discretion:

- Parts of the arrangement that are so interdependent and interconnected with the tax avoidance parts as to be integral to them would not be reinstated by the operation of s GA 1. This will be the case even if the part of the arrangement, when viewed in isolation, or in the context of a different arrangement, could be argued to be legitimate.
- The Commissioner is not under a duty to describe precisely the actual basis for an adjustment.
- The Commissioner may adjust the taxable income of any person affected by the arrangement. A person can be affected by an arrangement whether they are a party to the arrangement and whether they are aware that they benefited from a tax avoidance arrangement.
- A s GA 1 adjustment may be the result of something that has happened in a previous year.
- The Commissioner can adjust tax credits.
- The Commissioner may (but does not have to) have regard to the factors and amounts in s GA 1(4) and (5).
- Section GA 1(6) provides that the Commissioner cannot ultimately include an amount of income or deduction in the taxable income of more than one person.
- If a taxpayer wishes to dispute an adjustment made by the Commissioner, the onus is on the taxpayer to show that the adjustment is wrong and by how much it is wrong.

487. The following flow chart sets out the steps the Commissioner will take in considering the application of s GA 1.

Approach to s GA 1



ADDITIONAL ISSUES

488. There are several additional issues that might arise when considering the application of the anti-avoidance provision. They are as follows:

- The relevance of pre-*Ben Nevis* judicial approaches, including the "scheme and purpose" approach, the choice principle, the predication test, the new source doctrine and the approach adopted in the *Duke of Westminster* decision.
- The argument that the Commissioner is not able to use the anti-avoidance provision to dictate how taxpayers should do business.
- Whether an arrangement that results in more tax paid overall can be a tax avoidance arrangement.
- The relevance of obtaining a tax advantage from another country.
- The argument for certainty in how tax laws are applied.

These issues are discussed in the following paragraphs.

The relevance of pre-*Ben Nevis* judicial approaches

489. As was discussed at the beginning of this statement, for many years the courts have not been consistent in their approach to reaching a view on whether the provisions of the Act apply as claimed or whether s BG 1 applies. One of the approaches developed was the approach of Richardson J in *Challenge* (CA) and *BNZ Investments No 1* (CA). This approach has become known as the "scheme and purpose" approach. There is a question whether the approach survives following *Ben Nevis* and this is discussed in the following paragraphs.

490. Also discussed below are the choice principle, the predication test and the new source principle, as well as the approach adopted in the *Duke of Westminster* decision.

Scheme and purpose

491. In *Challenge* (CA), Richardson J said that considering whether the anti-avoidance provision applies will involve examining the scheme of the legislation and the relevant objectives of the legislation (at 549):

> Section 99 thus lives in an uneasy compromise with other specific provisions of the income tax legislation. In the end the legal answer must turn on an overall assessment of the respective roles of the particular provision and s 99 under the statute and of the relation between them. That is a matter of statutory construction and the twin pillars on which the approach to statutes mandated by s 5(j) of the Acts Interpretation Act 1924 rests are the scheme of the legislation and the relevant objectives of the

> legislation. Consideration of the scheme of the legislation requires a careful reading in its historical context of the whole statute, analysing its structure and examining the relationships between the various provisions and recognising any discernible themes and patterns and underlying policy considerations.
>
> ...
>
> For the inquiry is as to whether there is room in the statutory scheme for the application of s 99 in the particular case. If not, that is because the state of affairs achieved in compliance with the particular provision relied on by the taxpayer is not tax avoidance in the statutory sense. Reading s 99 in this way is to give it its true purpose and effect in the statutory scheme and so to allow it to serve the purposes of the Act itself. It is not the function of s 99 to defeat other provisions of the Act or to achieve a result which is inconsistent with them.

492. People have adopted different meanings when they have referred to the scheme and purpose approach. Some have taken the scheme and purpose approach to mean that literal compliance with the specific provisions will establish that Parliament's purpose for those provisions is met and that will be sufficient to conclude that the anti-avoidance provision does not apply. This view is, or is very similar to, the "threshold argument". The threshold argument is that once the ordinary meaning of a specific provision has been satisfied there can be no avoidance. As noted above (at paragraph 197), this argument was rejected by the court in *Ben Nevis*. In the Commissioner's view, this argument does not reflect Richardson J's view.

493. Another interpretation, and one the Commissioner thinks better reflects Richardson J's meaning, has understood the scheme and purpose approach to mean that a careful analysis of the Act is required to understand Parliament's intention. Arrangements that have tax-induced features outside usual commercial practice or pretence will be subject to the section under this approach (see *BNZ Investments No 1* (CA) at [40]).

494. There has also been on-going debate about whether Richardson J's approach has continuing relevance following *Ben Nevis*. This debate has been kept alive by the continuing use of the phrase "scheme and purpose" in *Ben Nevis* and in subsequent judgments (see, for example, *Ben Nevis* at [96], [98]–[99], *Glenharrow* at [48] and *Penny* (CA) at [88]).

495. The Supreme Court in *Ben Nevis* outlined its view of the scheme and purpose test at [84]–[99], including Richardson J's application of it in *Challenge* (CA):

> [88] In *Challenge Corporation*, Richardson J decided that taking advantage of the statutory provisions in relation to the tax treatment of subvention payments was consistent with the very specific scheme and purpose of the statutory provisions relating to grouping of companies and treatment of losses. These provisions had no purpose but to allow an offset for tax purposes. The transactions contemplated were simply tax concepts which had no reality except in relation to income tax. Parliament could not have intended that s 99 would deprive taxpayers of a specific structure provided for by the Act. Richardson J held, in effect, that literal compliance met the statutory purposes and it was not necessary for him to take into consideration the circumstances in which the loss company became part of the group. It was not consistent with the statutory purposes to treat such subvention arrangements as tax avoidance.
>
> [89] The effect was to reconcile conflicting provisions by reading down the scope of s 99 so that it did not operate on arrangements that complied with the particular specific provision in the legislation. The scheme and purpose of the legislation required that s 99 be read in the context of the special concession provisions which were dominant.

496. Richardson J's decision was overturned by the Privy Council. The Supreme Court in *Ben Nevis* preferred the approach of the Privy Council. While still seeing the scheme and purpose of the specific provision as of central importance, the Privy Council differed in its application. The Privy Council took the view that Richardson J's approach had not taken due account of the economic reality of the arrangement in deciding whether Parliament's purpose had been given effect. The Supreme Court in *Ben Nevis* discussed the Privy Council's view:

> [93] Finally, the Privy Council took a different view of the outcome of the application of the scheme and purpose approach. Lord Templeman classified the circumstances as tax avoidance, and not tax mitigation, because the Challenge group "never suffered the loss ... which would entitle them to a reduction in their tax liability". Earlier, the Privy Council had said that s 191 of the 1976 Act, the specific provision, "was intended to give effect to the reality of group profits and losses". The reality was that the Challenge group did not make a loss. There was, therefore, a failure to construct the transaction in a way that met the purpose of s 191. It was that element in the transaction that meant s 99 applied to strike down an arrangement which otherwise complied with s 191.
>
> [94] The Privy Council majority accepted the central importance of the scheme and purpose of the specific provision. But it differed from Richardson J's conclusions on the application of that approach to

> the case. The Privy Council did not accept that on a purposive approach the application of s 99 could be limited in a way that ignored the economic reality of the transaction as contemplated by the specific provision. For a profitable company to buy into the shareholding of a loss company outside its group, and then to offset those losses, involved "pretence". When a taxpayer sought to obtain a tax advantage without suffering the cost Parliament intended be suffered, this would amount to tax avoidance.

497. The court in *Ben Nevis* thought the Privy Council was correct in taking into account Parliament's intention to give effect to the reality of group profits and losses, **as well as** the reality that Challenge did not make a loss. The court referred to "this kind of scheme and purpose approach" (at [96]) and referred to examples of this kind of approach in *BNZ Investments No 1* (CA) and the Privy Council decision in *Peterson* (PC). The Supreme Court emphasised a passage from *BNZ Investments No 1* (CA) (at [40]) where the Court of Appeal in that case said (quoted in *Ben Nevis* at [96]):

> > ... that what should reasonably be struck at are artifices and other arrangements which have tax induced features outside the range of acceptable practice ...

and also a passage from *Peterson* (PC) (at [42]) where the majority of the Privy Council said (quoted in *Ben Nevis* at [98]):

> > If the commissioner had shown that the features on which he relied, singly or in combination, had the effect that the investors, while purporting to incur a liability to pay $x+y to acquire the film, had not suffered the economic burden of such expenditure before tax which Parliament intended to qualify them for a depreciation allowance, then he could invoke s 99 to disallow the deduction.

498. Therefore, the difference following *Ben Nevis* is that there is increased clarity that the approach to s BG 1 must take into account the commercial and economic reality of the arrangement when understanding whether the use of the specific provisions is within Parliament's contemplation. This increased emphasis on commercial and economic reality means it is possible that not all previously decided cases would be decided the same way following *Ben Nevis*.

499. Harrison J in *Westpac* commented on the continuing relevance of the scheme and purpose approach:

> > [176] I read *Ben Nevis* at [84]–[89] as expressing what Ms Ellis called a "diplomatic rejection" of Richardson J's judgment in *Challenge* while endorsing Woodhouse P's approach in the same case.
> > *Ben Nevis* marked out two clear points of departure from Richardson J. One was from his emphasis on the specific provision, thereby reading down or negating the reach of the general anti-avoidance section. The other was from a formalistic or juristic approach which necessarily excluded an examination of the circumstances in which the deductible loss arose.

And later:

> > [194] In summary, *Ben Nevis* represents, I think, a significant shift in identifying the principles to be applied when construing s BG 1, mandating a broader inquiry than was previously required – a "wider perspective" – consistent with settled principles of statutory interpretation: at [99].
> > Ms Ellis observes that the phrase "scheme and purpose" is conspicuously absent from the ratio.
> > I doubt that the court was rejecting the scheme and purpose approach of itself but was instead expanding its scope. The previous constraints imposed by a legalistic focus, to the exclusion of economic realism, have gone.

500. Randerson J expressed a similar view in *Penny* (CA) in the Court of Appeal at [62]:

> > The scheme and purpose approach adopted in earlier decisions has been endorsed in general terms but with some important clarifications. A key concept clarified by the Court is the relationship between specific tax provisions and a general anti-avoidance provision. While it has long been accepted that compliance with specific tax provisions does not oust the application of the general anti-avoidance provision, the Supreme Court has rejected the approach adopted by Richardson J in the *Challenge Corporation* case which effectively reconciled conflicting provisions by reading down the scope of the general avoidance provision.

501. It is clear that any approach under which it would be sufficient to merely comply with the ordinary meaning of the words of the provisions of the Act (other than s BG 1) would leave no room for the application of s BG 1 and is not correct. That leaves the question of whether a broader "scheme and purpose" approach still has relevance. The Commissioner's view is that the Parliamentary contemplation test is different in important respects to the scheme and purpose approach as associated with Richardson J's approach in *Challenge* (CA). An important difference is the emphasis placed on the commercial and economic reality of the arrangement under the Parliamentary contemplation test. This difference can be seen to be illustrated in the different approaches taken by the Privy Council and Richardson J in *Challenge* (PC and CA), a difference observed by the Supreme Court in *Ben Nevis*.

502. Therefore, even though aspects of the Parliamentary contemplation test might be traced to the scheme

and purpose approach, as a result of the Supreme Court's comments and the association of "scheme and purpose" with the reading down of the Act, the term should be used with caution. The Commissioner's view is that any approach where mere compliance with sections when considered in isolation will be within Parliament's purpose, without the ability to look at the reality of the whole arrangement, is not the law.

The choice principle

503. From time to time taxpayers and judges have referred to a principle known as the "choice principle". The choice principle refers to a proposition that if a taxpayer chooses between alternative courses of action recognised in the Act, the application of s BG 1 to the choice would remove an advantage Parliament intended to give.

504. This principle was initially developed in the Australian High Court in cases such as *WP Keighery Pty Ltd v Federal Commissioner of Taxation* (1957) 100 CLR 66 and *Federal Commissioner of Taxation v Casuarina Pty Ltd* (1971) 127 CLR 62. In *Keighery*, the court took the view that the anti-avoidance provision was not intended to deny the taxpayers the choice between two or more options expressly provided for in the Act. The taxpayers allotted shares in a way to ensure that the company was taxed as a public company rather than a private company. The court said there was no pretence or unreality about the allotments of the shares.

505. The principle was subsequently expanded in cases such as *Mullens v Federal Commissioner of Taxation* (1976) 135 CLR 290, *Slutzkin v The Commissioner of Taxation* (1977) 140 CLR 314 and *Cridland v The Commissioner of Taxation* (1977) 140 CLR 330. In *Mullens*, Stephen J said the principle was not "confined to cases where the Act offers to the taxpayer a choice of alternative tax consequences either of which he is free to choose", but should apply also when the Act "offers certain tax benefits to taxpayers who adopt a particular course of conduct" (at 318). Barwick CJ said at 298, "a taxpayer is entitled to create a situation to which the Act attaches taxation advantages for the taxpayer".

506. The principle was discussed in New Zealand in *Challenge* (CA). Richardson J supported the principle from the earlier *Keighery* case that if the Act intends to present taxpayers with a choice of alternative courses of action, and the taxpayer exercises that choice, then that would not be tax avoidance. Woodhouse P, on the other hand, considered the choice principle was not part of New Zealand law (at 538).

507. The choice principle is used to support the argument that by taking advantage of choices recognised in the Act the taxpayer is simply making a choice expressly made available by Parliament, and the arrangement should in such cases be immune from s BG 1. The Commissioner's view is that there is no such immunity from s BG 1. No matter what provisions are used, the same question always needs to be asked: whether the use of the provisions is within Parliament's contemplation when the reality of the arrangement is considered.

508. The taxpayers argued in *Ben Nevis* that the courts should recognise choices in the Act. The court said:

> [111] The appellants made a sustained plea that the courts should not deprive commercial and other parties of tax beneficial choices. On the approach we have set out, taxpayers have the freedom to structure transactions to their best tax advantage. They may utilise available tax incentives in whatever way the applicable legislative text, read in the light of its context and purpose, permits. They cannot, however, do so in a way that is proscribed by the general anti-avoidance provision.

509. The general anti-avoidance provision proscribes arrangements that use the Act in a way Parliament did not contemplate. While taxpayers are free to structure their arrangements using structures recognised in the Act, if those structures use provisions in a way that is outside Parliament's contemplation, then the arrangement may be a tax avoidance arrangement. For example, a taxpayer may choose to sell or lease an asset and different tax consequences will follow from that choice. If a taxpayer structures an arrangement to use the lease provisions but, when the commercial and economic reality of the arrangement is examined, the reality is that the arrangement is a sale, then the use of the lease provisions may be outside Parliament's contemplation.

510. The Supreme Court in *Penny* (SC) said that while the taxpayers had a choice to transfer their businesses to companies owned by their family trusts (at [33]), other aspects of the arrangement meant it was still a tax avoidance arrangement. The commercial and economic reality of the arrangement, when looked at as a whole, was that the taxpayers still received the full benefit of the income and effectively derived it.

The predication test

511. In *Newton*, Lord Denning outlined what became known as the predication test. Under the predication test an arrangement might not be a tax avoidance arrangement if it could be explained as ordinary business or family dealing. Lord Denning said at 466:

> In order to bring the arrangement within the section you must be able to predicate – by looking at the overt acts by which it was implemented – that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section.

512. This test limited the anti-avoidance provision to arrangements that had a sole or principal purpose or effect of tax avoidance. In *Mangin*, the Privy Council said the relevant purpose of tax avoidance had to be the sole or at least principal purpose of the arrangement (which overturned the view of Woodhouse J in *Elmiger*). Amendments were made to s 108 (a predecessor to s BG 1) by s 9 of the Land and Income Tax Amendment Act (No 2) 1974 to counter this restrictive gloss on how s 108 applied. The amendments had the effect of clarifying that arrangements that have a more than "merely incidental purpose or effect" of tax avoidance can be tax avoidance arrangements, whether or not such a purpose or effect is referable to ordinary business or family dealings.

513. The MP for Kapiti, Mr Frank O'Flynn QC, explained the reasons for the new s 108 (*New Zealand Parliamentary Debates* (17 September 1994) 394 NZPD 4,240):

> ... the new section clears up quite a number of points that have been litigated on in Wellington, before the High Court of Australia, and in the Privy Council in London. For example, it deals with the question of whether you have to show that the only purpose of the arrangement is tax avoidance, or whether it is enough to show that that is one of the purposes, and what happens if it is merely an incidental purpose. To cut the matter short, it really seeks to restore much of the interpretation that was applied to the section after the New Zealand Court of Appeal decision in Elmiger as long ago as 1966.

514. Woodhouse J had said in *Elmiger* at 694:

> Accordingly it is my opinion that family or business dealings will be caught by s. 108 despite their characterisation as such, if there is associated with them the additional purpose or effect of tax relief (in the sense contemplated by the section) pursued as a goal in itself and not arising as a natural incident of some other purpose. If this were not so I suppose an appropriate legal window dressing could still be devised to defeat the general objects of the section.

515. Thus the merely incidental test introduced in 1974 was clearly intended to return the law to the position in *Elmiger* rather than continue with the position in the Privy Council decisions in *Newton* and *Mangin*. The introduction of the phrase "merely incidental" was to ensure if tax avoidance was merely an incidental feature of the transaction then the transaction would not be labelled as tax avoidance.

516. When discussing the 1974 amendments and the legislative history, the majority in *Ben Nevis* referred to the definition of "tax avoidance arrangement", and stated at [81]:

> ... the legislation [has] dispensed with Lord Denning's predication test in *Newton* by stating that an arrangement could amount to tax avoidance whether or not other purposes or effects of the arrangement were referable to ordinary business or family dealings.

517. Therefore, in the light of the amendments made in 1974 and the *Ben Nevis* decision, it would appear that the predication test, as set out in *Newton*, has been dispensed with or, at the very least, extensively modified in the modern jurisprudence.

518. If the predication test still has any application in modern day avoidance jurisprudence it is simply that, for s BG 1 to apply, it is necessary to "predicate" (in the sense of positively determining or objectively classifying) a purpose or effect of the arrangement as being one of tax avoidance. This will require nothing more than that an objective (predicative), and not subjective, standpoint should be adopted.

519. It has sometimes been argued that the predication test has continuing relevance for the proposition that to be a tax avoidance arrangement there must be certainty at the outset that the arrangement has been entered into to avoid tax. However, there does not appear to be any requirement that it be certain that the arrangement will result in an immediate avoidance of tax. "Tax avoidance" is defined to include relieving a person from a **potential or prospective** liability. Whether an arrangement gives rise to tax avoidance needs to be established not by pointing to a particular amount of tax that has definitely been avoided, but by applying the principles established in *Ben Nevis*.

"New source" doctrine

520. Sometimes taxpayers argue that tax avoidance cannot exist when the arrangement involves a new source of income. The argument is that if the income was not previously derived, and so not previously taxed, then it cannot be said that any tax was avoided by the arrangement. Lord Diplock in *Europa No 2* considered that s 108 did not strike at arrangements dealing with new sources of income. His Lordship stated at 556:

> Secondly, the description of the contracts, agreements and arrangements which are liable to

> avoidance presupposes the continued receipt by the taxpayer of income from an existing source in respect of which his liability to pay tax would be altered or relieved if legal effect were given to the contract, agreement, or arrangement sought to be avoided as against the Commissioner. The section does not strike at new sources of income or restrict the right of the taxpayer to arrange his affairs in relation to income from a new source in such a way as to attract the least possible liability to tax. Nor does it prevent the taxpayer from parting with a source of income.

521. The doctrine was applied in *Federal Commissioner of Taxation v Gulland* (1985) 160 CLR 55 amongst other cases. The Full Federal Court in *Bunting v Federal Commissioner of Taxation* 89 ATC 5,245 (FCAFC) said the argument was supported by the absence in Australia (at that time) of an ability to reconstruct a tax avoidance arrangement. Voiding an arrangement involving a new source of income would usually not have the effect of the taxpayer having tax to pay, so, it was argued, such transactions could not have been meant to be subject to the anti-avoidance provision.

522. The new source doctrine, if accepted, would mean s BG 1 could apply differently to two identical uses of the Act. It would not apply if a new arrangement was entered into using the Act in a certain way, but if another taxpayer made the same use of the Act with an existing source of income, then it could be avoidance. This cannot be correct.

523. This new source doctrine was rejected in New Zealand in the High Court in *BNZ Investments No 1* (HC). McGechan J expressed the view that Lord Diplock's approach was based on the legislation at the time. At [122]:

> I regard the "new source" doctrine as obsolete. Observations made in *Europa Oil (NZ) Limited v C of IR* [1976] 1 NZLR 546 (PC) [also reported as *Europa Oil (NZ) Ltd v C of IR (No 2); C of IR v Europa Oil (No 2)* (1976) 2 NZTC 61,661] were based on former s 108 which pivoted on "alteration of incidence". Section 99, in the expanded definition of "tax avoidance" contained in s 99(1), now extends beyond "alteration of incidence" to include even "directly or indirectly avoiding" liability. While there were obvious logical difficulties in regarding creation of a new source of income as "altering incidence", that does not apply in relation to "avoiding", and even less so in relation to "indirectly avoiding".

524. The general anti-avoidance provision was substantially amended in 1974 to make the provision more effective than the section under consideration by Lord Diplock. The Privy Council in *Challenge* (PC) made this observation at 560:

> In the words of Richardson J in the present case "the old section 108 was found to be both unreasonably restrictive and too broad in its application" .... Section 108 was amended and replaced by a more extensive general anti-avoidance measure in 1974.

525. As was explained earlier, the *Ben Nevis* test focuses on whether the use of a provision or provisions is what Parliament would have intended, when the commercial and economic reality of the arrangement is understood. There is no distinction in applying this test between existing or new sources of income.

526. A further aspect of the argument that tax avoidance cannot exist when the arrangement involves a new source of income is the suggestion that a change to an existing structure is more likely to invoke s BG 1 than a structure involving a new source of income. That is, if a change is made to an existing structure and a tax advantage is achieved, it may seem more likely that the change was made for that reason. If, instead, a structure is set up to obtain a new source of income, it is less readily apparent that a savings in tax must have been behind the structure. This argument might seem even more sustainable if a structure is set up and then later the law changes and a tax advantage is achieved.

527. If special considerations were to apply when a taxpayer has a new source of income, this might suggest subjective factors are incorrectly being taken into account. These types of arguments are based on the taxpayer's knowledge about whether the arrangement is a tax avoidance arrangement. However, the courts are clear that the test is not a subjective one (*Newton* at 465, *Ashton* (PC) at 721, and *Glenharrow* at [38]), and that an arrangement can be a tax avoidance arrangement whether or not the taxpayer has any knowledge that it constitutes tax avoidance (*Peterson* (PC) at [34] and *BNZ Investments No 1* (CA) at [52], [127]–[128] and [172]). Therefore, whether the arrangement is an existing one or set up for a new source of income is not relevant in considering whether s BG 1 applies.

528. Accordingly, the Commissioner considers the presence of a "new source" of income will not, of itself, exclude the potential application of s BG 1, and variations of this argument based on similar propositions will also fail.

Duke of Westminster

529. Taxpayers have also sometimes argued that the decision in *Duke of Westminster* stands for the proposition that taxpayers are entitled to order their affairs so the tax attaching is less than it otherwise would be. It follows from this argument that arrangements that satisfy the specific provisions will

not be tax avoidance. The often quoted passage comes from the judgment of Lord Tomlin in that case at 19:

> Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.

530. There is a long line of authority that this case is no longer relevant in considering the application of the anti-avoidance provision. See, for example, Woodhouse J in the Supreme Court decision in *Elmiger* at 686–687. Baragwanath J in the High Court in *Miller* (HC) said at 13,032:

> Section 99 is not to be construed according to the *Duke of Westminster's* case or Rowlatt J's dictum [that there is no equity to tax].

531. The Australian High Court in *Spotless Services* said Lord Tomlin's statement in the *Duke of Westminster* had no significance in Australia where there is a statutory anti-avoidance provision (at 415).

532. Even in the absence of a specific legislative anti-avoidance measure, Lord Diplock in the House of Lords in *Commissioners of Inland Revenue v Burmah Oil Company Ltd* (1982) SC (HL) 114 at 124 said that Lord Tomlin's dicta was not very helpful in deciding whether a transaction would be recognised by the courts as effective. Also, in *Inland Revenue Commissioners v McGuckian* [1997] 1 WLR 991 (HL) at 999, Lord Steyn said that the dictum from *Duke of Westminster* was not consistent with the modern approach to statutory interpretation, where the correct approach was said not to be literal but to consider the clear words of the section in the context and scheme of the Act as a whole.

533. The Commissioner considers there is no place in avoidance law for any principle taken from the *Duke of Westminster* case that a structure that complies with specific provisions cannot be tax avoidance. The case was not referred to at all in *Ben Nevis*. Following *Ben Nevis* and other authority, taxpayers can structure their transactions to the best tax advantage if the use made of the Act is within Parliament's contemplation. However, if, when an arrangement is viewed in a commercially and economically realistic way, it can be seen that the use made of the Act is outside Parliament's contemplation, the arrangement will be a tax avoidance arrangement, regardless of whether the arrangement satisfies the specific provisions.

The argument that the Commissioner cannot dictate how taxpayers do business

534. Another argument sometimes put by taxpayers in avoidance cases is that the Commissioner is not allowed to dictate how taxpayers run their businesses. The High Court of Australia in *Cecil Bros Pty Ltd v FCT* (1964) 111 CLR 430 at 434 is often quoted in support of this proposition. The court said in that case, quoting from *Ronpibon Tin NL and Tongkah Compound NL v Federal Commissioner of Taxation* (1949) 78 CLR 47 at 60, "it is not for the Court or the Commissioner to say how much a taxpayer ought to spend in obtaining his income". The argument is that in examining the amounts paid and received in an arrangement, and potentially adjusting these under s GA 1, the Commissioner is effectively telling taxpayers how much they should pay and receive in their business dealings.

535. *Peterson* (PC) is also used to support this argument. In that case, the Privy Council held that once the Commissioner had accepted that the taxpayers had paid an amount of $x+y to acquire a film, the Commissioner could not challenge the legitimacy of that amount. It was not relevant that the production company had made a "secret profit" of the amount of "y" at the expense of the investors (*Peterson* (PC) at [42]–[43], applying *Europa No 2*, which had in turn followed *Cecil Bros*).

536. It is true that when the specific provisions are considered alone, generally the bargains and pricing agreed on by the parties are taken at face value. In *Penny* (SC), the Supreme Court said it is accepted there is no concept of a commercially realistic salary in the Act—that it does not require an employee to be remunerated on such a basis and that family transactions may commonly not be based on market valuations. However, the court said if the salary is not commercially realistic, it will be open for the Commissioner to consider the arrangement further and test whether it amounts to a tax avoidance arrangement (at [49]).

537. *Ben Nevis* makes clear that under s BG 1 the true commercial and economic outcomes must be identified. Doing that may involve looking through the legal form to establish what the real outcomes are to identify, for example, inflated expenditure or pricing and circular flows of money. In *Penny* (CA), Randerson J took into account the fact that reduced salaries were paid while the taxpayers continued to devote their personal exertions to the generation of income exactly as they had before and while they also effectively retained control of the money.

538. The court in *Glenharrow* made this comment about the relationship between respecting bargains and promoting certainty in the tax system, and the application of s BG 1:

> [48] It may be said, and indeed the appellant does say, that to approach the question of the intent and application of the Act in this way is not to respect the bargain struck by the parties and would allow the Commissioner to restructure their bargain for them, with different GST consequences, and would thus be productive of uncertainty. But that uncertainty is inherent where transactions have artificial features combined with advantageous tax consequences not contemplated by the scheme and purpose of the Act. There will also inevitably be uncertainty whenever a taxing statute contains a general anti-avoidance provision intended to deal with and counteract such artificially favourable transactions. It is simply not possible to meet the objectives of a general anti-avoidance provision by the use, for example, of precise definitions, as may be able to be done where an anti-avoidance provision is directed at a specified type of transaction.

539. The point is, therefore, that while it is true the Commissioner has no ability to tell taxpayers how much they should pay or receive in their businesses under s BG 1, the tax outcomes sought under an arrangement may not be effective if the amounts paid and received do not accord with the commercial and economic reality. So, for example, some or all of an amount 'paid' based on the form of an arrangement may not be deductible when the true economic outlay is identified under s BG 1. Similarly, an amount received for a sale may be found not to reflect the true extent of the return for the taxpayer when the arrangement is viewed in a commercially and economically realistic way.

Whether an arrangement that results in more tax paid overall can be a tax avoidance arrangement

540. Sometimes a taxpayer might argue that if an arrangement results in the payment of tax, it cannot be a tax avoidance arrangement. This argument might be made when the arrangement results in more tax paid overall, when the arrangement as a whole is considered, than if the arrangement had not been entered into. The same argument might be made in the related factual situation where an arrangement results in more tax being paid in total and, as a defence, the taxpayer points to an alternative arrangement not undertaken under which less tax would have been paid overall.

541. However, it is still possible that such arrangements can be tax avoidance arrangements provided at least one taxpayer affected by the arrangement has avoided tax. The Commissioner considers that this stance is supported by the following propositions.

The Act applies on a single taxpayer basis

The primary reason is that the Act does not apply in a global way—rather, the specific provisions apply to individual taxpayers. Therefore, even if an arrangement results in the payment of more tax overall, if it results in an alteration of a single taxpayer's liability to tax (either now or in the future) or to pay tax, in a way not contemplated by Parliament, there will have been tax avoidance in relation to that taxpayer.

In taking a view on whether there has been tax avoidance, it should be borne in mind that the test for a tax avoidance arrangement is to establish whether an arrangement makes use of the Act in a way that would not have been within Parliament's contemplation. The focus is on the use made of the Act, and not simply on how much tax is paid overall.

This could mean that an arrangement may result in some taxpayers paying more tax as a result of entering into the arrangement while at least one other taxpayer has avoided tax. In such a case, the Commissioner may have regard to care and management responsibilities, and consider whether to allocate resources to investigating and pursuing a dispute because the application of s BG 1, if successful, may result in tax being refunded or a very small amount of tax being paid. Even then, the fact that an arrangement may result in tax being refunded or a very small amount of tax being paid will not necessarily be determinative. The Commissioner's decision would be based on the factors in ss 6 and 6A of the Tax Administration Act 1994, and would include considering the facts of the case and the degree of concern about the particular tax outcomes under the Act.

No conflict with looking at the arrangement as a whole

The Commissioner considers that the fact that the Act applies on a single taxpayer basis does not conflict with the principle that under s BG 1 the overall result of the arrangement is examined. Applying s BG 1 entails looking at the overall result of the arrangement to identify the real outcomes for the parties relevant to the provisions. However, once these real outcomes have been identified, the specific provisions used by, or that potentially apply to, each of the taxpayers involved are examined.

In some situations, Parliament would have contemplated even more tax paid

Even though, in some situations, some tax may have been paid under an arrangement had the arrangement not involved tax avoidance, Parliament could well have contemplated that a taxpayer would have paid even more tax under the provisions used or circumvented.

Some tax avoidance arrangements require the payment of tax

Some tax avoidance arrangements actually require the payment of tax to achieve the result that is outside of Parliament's contemplation. For example, the tax avoidance aspect of an arrangement might require a taxpayer to pay tax to generate imputation credits, so as to stream them to particular shareholders or as part of an arrangement to lower the cost of funding.

The relevance of obtaining a tax advantage from another country

542. Some arrangements might have the effect of obtaining a tax advantage from another country's tax system. The question arises whether this feature of an arrangement is relevant to considering whether s BG 1 applies.

543. The issue of whether this feature is relevant needs to be considered at two stages of the s BG 1 analysis—the Parliamentary contemplation test and the merely incidental test.

544. The Parliamentary contemplation test examines whether there is any tax avoidance. "Tax" for this purpose is defined in the Act to be New Zealand tax. Therefore, avoidance of foreign tax will not be "tax avoidance" for the purposes of applying s BG 1.

545. Under the merely incidental test, a non-tax avoidance purpose for the adoption of the particular specific structure may be relevant. Again, tax for this purpose is New Zealand tax, so avoidance of foreign tax would count as a non-tax avoidance purpose. If the New Zealand tax avoidance purpose or effect is merely incidental to a non-tax avoidance purpose, the arrangement is not a tax avoidance arrangement. As was explained, a tax avoidance purpose will be merely incidental if it follows as a natural incident from an arrangement structured a certain way for a non-tax avoidance purpose. If it can be shown that a structure was put in place in the specific way it was to gain a tax advantage from another country, then it is possible that the New Zealand tax avoidance purpose follows as a natural concomitant. If the New Zealand tax avoidance purpose is pursued as a goal in itself in any respect, however, the tax avoidance purpose will not be merely incidental.

546. It might be suggested that the Court of Appeal in *Alesco* (at [116]) took the view that foreign tax purposes are irrelevant to s BG 1 in all circumstances. The Commissioner considers foreign tax purposes can be relevant to the merely incidental test and that the court should not be interpreted as rejecting this proposition. In that case the taxpayer argued that the tax benefits of an arrangement that took advantage of trans-Tasman tax asymmetry primarily arose in Australia. Although the Court of Appeal stated that "any consideration of the Australian [tax] position is rendered irrelevant once an arrangement is impugned in this country", this was in the context of a discussion primarily concerned with subjective motives versus objective purposes or effects and not the merely incidental test. Therefore, the court can be seen to be saying Alesco's perception of the Australian tax position was irrelevant.

547. More crucially, the court concluded that the fact that an arrangement was taking advantage of a foreign tax advantage does not immunise the arrangement from s BG 1. The court was emphasising that it will not be enough to simply assert a foreign tax purpose. If the New Zealand tax avoidance purpose is an end in itself and not merely incidental the fact that there is a foreign tax purpose will not preclude the application of s BG 1.

548. It should also be noted that New Zealand has responsibilities under various legal instruments, including tax treaties, to exchange information with other tax authorities. If an arrangement has the effect of gaining a tax advantage from another tax system, New Zealand may provide details and documentation to that other country.

Argument for certainty

549. One argument often raised is that taxpayers should have certainty about how the tax laws apply so they can enter into transactions knowing the financial outcomes. It is not desirable, it is argued, that taxpayers do not know for sure whether s BG 1 applies to an arrangement. It is argued that certainty about tax outcomes will assist voluntary compliance, and that any approach to the section that does not give a sufficient level of certainty should not be adopted.

550. It is not as clear cut as might be suggested that such certainty is either possible or desirable. In 1998 the government established a Committee of Experts to consider and make recommendations on (amongst other things) avoidance and evasion. The Committee recognised that an alternate approach of legislating only specific anti-avoidance provisions could not be effective on its own because tax policy makers cannot identify and deal with all the various arbitrage opportunities inherent in the tax system (*Tax Compliance: Report to the Treasurer and Minister of Revenue by a Committee of Experts on Tax Compliance* (December 1998) at [6.36]). In her article *Defining taxpayer responsibility: In support of a general anti-avoidance principle* [2004] BTR 332, United Kingdom author Judith Freedman has gone as far as arguing that clear lines may be an impossibility in avoidance law, and that the focus should be on a framework within which fair decisions can be made on an individual basis (at 344 and 353). She suggests that any attempt to create certainty through ever more detailed rules is not desirable because it leads to creative compliance through manipulation of those rules.

551. The courts have been clear when dealing with this argument that Parliament has deliberately chosen not to provide the desired level of certainty. In *Ben Nevis*, the Supreme Court said:

> [112] The appellants also argued that tax avoidance legislation should be interpreted in a way which gives taxpayers reasonable certainty in tax planning. But Parliament has left the general anti-avoidance provision deliberately general. That approach has been retained despite the introduction of a civil penalties regime in relation to taxpayers who take certain types of incorrect tax position. The courts should not strive to create greater certainty than Parliament has chosen to provide. We consider that the approach we have outlined gives as much conceptual clarity as can reasonably be achieved. As in many areas of the law, there are bound to be difficult cases at the margins. But in most cases we consider it will be possible, without undue difficulty, to decide on which side of the line a particular arrangement falls.

552. The taxpayer argued in *Glenharrrow* that the approach adopted to the anti-avoidance provision in the GST Act would enable the Commissioner to restructure the parties' bargain and thus produce uncertainty for taxpayers. The Supreme Court said in response at [48]:

> But that uncertainty is inherent where transactions have artificial features combined with advantageous tax consequences not contemplated by the scheme and purpose of the Act. There will also inevitably be uncertainty whenever a taxing statute contains a general anti-avoidance provision intended to deal with and counteract such artificially favourable transactions.

The above quotes were cited with approval by Randerson J in *Penny* (CA) at [127]–[128].

553. The task for the court in any particular case is to resolve the dispute between the parties on the facts that are before it. In each case, it is for the court to decide on which side of the line each set of facts lies rather than prescribe whether a type of arrangement is in general a tax avoidance arrangement. In *Penny* (CA), Hammond J makes the following comment about the degree to which certainty can be attained or the form in which any certainty can take at [162]:

> Finally, courts exist to resolve particular controversies. Much as professional advisers may yearn for all-encompassing templates, to ask courts to attempt to anticipate other possible situations and produce clear, bright-line rules is undesirable and impracticable in taxation law. The function of the court is to see that the legislative purpose of Parliament is not overtaken by "merely clever" manipulation of particular rules, as happened in this case. And the court can only determine one case at a time.

554. Wild J, in *BNZ Investments No 2* (HC), makes the same point (referring to paragraphs in *Ben Nevis*):

> [131] It is at step 2 that the court must decide "on which side of the line a particular arrangement falls" ([112]). Thus, line-calling remains the court's function. By contrast, it is not the court's function "to articulate how the line is to be drawn" ([104]). The certainty which tax advisers desire must continue to elude them.

555. Therefore, as with any other area of law, it is for the taxpayers and the Commissioner to apply the law in each case to reach a view on whether the facts before them may be subject to s BG 1.

556. Even though it is not possible for there to be the level of certainty taxpayers might desire about whether arrangements are tax avoidance arrangements, it is to be borne in mind that the scope of s BG 1 does not extend to every arrangement. If a use of provisions, or non-application of provisions, is contemplated by Parliament, then that use or non-application will not be tax avoidance. As discussed above (at paragraphs 389 to 394) a taxpayer may structure arrangements to their best tax advantage, provided the use of the provisions is within what Parliament would have contemplated.

557. It might also be that in many cases the level of uncertainty may not be as great as might be claimed. Many avoidance arrangements are not close to a line that would be discerned by a reasonable application of the *Ben Nevis* test. A number of the cases that have been held to be tax avoidance in recent years have involved more extreme facts. For example, the Court of Appeal in *Accent* (CA) said "we are satisfied that this scheme is well and truly across the 'line'" (at [146]), and the Privy Council in *Miller* (PC) said at [9]:

> Given the highly artificial nature of the scheme, Their Lordships are not surprised that the Commissioner and every Judge who has considered the matter have been of opinion that it amounted to an arrangement which had the purpose or effect of tax avoidance within the meaning of s 99(2). As this is such a plain case, Their Lordships think it unnecessary to examine in any depth the criteria by which arrangements caught by s 99 may be distinguished from those which are not.

558. The fact that many tax avoidance arrangements are not close to the line is, in the Commissioner's view, consistent with the point about certainty being made by the court in *Ben Nevis* where it said (at [112]):

> As in many areas of the law, there are bound to be difficult cases at the margins. But in most cases we consider it will be possible, without undue difficulty, to decide on which side of the line a particular arrangement falls.

559. Consequently, the Commissioner is of the view that the tax avoidance law in New Zealand, including the Parliamentary contemplation test, does provide an acceptable degree of clarity for the great majority of taxpayers. In this statement the Commissioner has sought to provide a framework and an approach to ss BG 1 and GA 1 that will guide taxpayers and their agents in their consideration of whether the tax avoidance provisions apply to their arrangements.

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Arrangement; Incidental; Merely incidental; Tax avoidance; Tax avoidance arrangement
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BINDING RULINGS

This section of the *TIB* contains binding rulings that the Commissioner of Inland Revenue has issued recently. The Commissioner can issue binding rulings in certain situations. Inland Revenue is bound to follow such a ruling if a taxpayer to whom the ruling applies calculates their tax liability based on it.

For full details of how binding rulings work, see *Binding rulings: How to get certainty on the tax position of your transaction (IR 715)*. You can download this publication free from our website at **www.ird.govt.nz**

PRODUCT RULING BR PRD 13/08: BANK OF NEW ZEALAND

This is a product ruling made under s 91F of the Tax Administration Act 1994.

Name of the Person who applied for the Ruling

This Ruling has been applied for by Bank of New Zealand.

Taxation Laws

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

This Ruling applies in respect of ss CA 1(2), CB 4, CC 3, CE 1, CP 1 and BG 1.

This Ruling does not apply if there is an employment relationship between the Fly Buys member who redeems their Fly Buys points for a contribution and the BNZ KiwiSaver member who receives the contribution.

This Ruling does not apply if there is a contract for services (ie, independent contractor relationship) between the Fly Buys member who redeems their Fly Buys points for a contribution and the BNZ KiwiSaver member who receives the contribution.

This Ruling does not apply to a Fly Buys member who is a participant in the Fly Buys for Business programme.

The Arrangement to which this Ruling applies

The Arrangement is for the redemption of Fly Buys points for a contribution to a KiwiSaver account in a KiwiSaver scheme that Bank of New Zealand (the Bank) has established (the BNZ KiwiSaver Scheme). Under an agreement between the Bank and Loyalty New Zealand Limited (Loyalty NZ), persons who are members of the Fly Buys loyalty programme will be able to request the redemption of their Fly Buys points for a contribution to their own, or another person's, member's account in the BNZ KiwiSaver Scheme. In order to request the redemption of Fly Buys points a person does not have to be a Bank customer. As a separate and independent obligation under an agreement between the Bank and Loyalty NZ and signed on 13 May 2013, the Bank will make a payment to Loyalty NZ in relation to each contribution Loyalty NZ makes to a member's account in the BNZ KiwiSaver Scheme.

Further details of the Arrangement are set out in the paragraphs below.

KiwiSaver Act 2006

1. The KiwiSaver Act 2006 enables the establishment of KiwiSaver schemes. These schemes aim to encourage individuals to save for their retirement, principally through the workplace.
2. Section 3 of the Act KiwiSaver Act 2006 states:
   - the purpose of the Act is encourage a long-term savings habit and asset accumulation by individuals who are not in a position to enjoy standards of living in retirement similar to those in pre-retirement; and
   - the Act aims to increase individuals' well-being and financial independence, particularly in retirement, and to provide retirement benefits.
3. Savings are primarily for retirement and are "locked in", subject to permitted withdrawals, until a member reaches the New Zealand superannuation qualification age (which is currently 65 years). Permitted withdrawals include withdrawals to purchase a first home, on death, in cases of significant financial hardship, and in cases of serious illness, and withdrawals or transfers to a foreign scheme in cases of permanent emigration.
4. Inland Revenue administers Parts 1 to 3 and Schedule 3 of the KiwiSaver Act 2006. The Commissioner of Inland Revenue oversees the provisions of the KiwiSaver Act 2006 that Inland Revenue administers. Among other administrative functions, Inland Revenue collects contributions from employers as part of the PAYE rules, and pays contributions to providers of KiwiSaver schemes.

The Bank's KiwiSaver Scheme

5. Until recently, the Bank directed its customers who wished to enrol in a KiwiSaver scheme to the AXA KiwiSaver Scheme, which AMP Wealth Management Limited (AMP) manages and promotes. The Bank is not a promoter of the AXA KiwiSaver Scheme.

However, the Bank distributed information about the AXA KiwiSaver Scheme to its retail customers and received fees from AMP in respect of retail customers who became members of the AXA KiwiSaver Scheme.

6. The Bank has now established its own KiwiSaver scheme.
7. The BNZ KiwiSaver Scheme was established by a trust deed dated 8 January 2013 (the Trust Deed).
8. For the purposes of the Securities Act 1978, the manager and issuer of the BNZ KiwiSaver Scheme is BNZ Investment Services Limited (a wholly owned subsidiary of the Bank). The Bank and its directors are (for the purposes of the Securities Act 1978) the promoters of the BNZ KiwiSaver Scheme.
9. As at the date of the Bank's application for this ruling, the registrar, trustee, investment manager, and accountant for the BNZ KiwiSaver Scheme are respectively Trustees Executors Limited, the New Zealand Guardian Trust Company Limited, Russell Investments Limited and MMC Limited.
10. The BNZ KiwiSaver Scheme will be a portfolio investment entity for the purposes of the Income Tax Act 2007. Specifically, the BNZ KiwiSaver Scheme will be a multi-rate portfolio investment entity.
11. The five funds in the BNZ KiwiSaver Scheme at the date of establishment are as follows:
    - cash fund;
    - conservative fund;
    - balanced fund;
    - moderate fund; and
    - growth fund.
12. It is possible that additional funds could be established within the BNZ KiwiSaver Scheme from time to time, pursuant to and in accordance with the terms of the Trust Deed.

Fly Buys

13. Fly Buys is New Zealand's largest loyalty programme.
14. Loyalty NZ administers Fly Buys. The Bank, Foodstuffs Ventures (NZ) Limited, IAG New Zealand Limited, and Z Energy Limited own Loyalty NZ in equal shares.
15. The Bank has an existing relationship with Loyalty NZ whereby the Bank's customers may accrue Fly Buys points on various Bank products, for example, by making purchases using a Bank credit card and on the outstanding balance on certain home loans.
16. Any person may become a Fly Buys account holder by completing the appropriate Loyalty NZ application form. Membership is free. Under the terms and conditions established by Loyalty NZ, Fly Buys points have no cash or monetary value and cannot be sold, transferred or assigned for cash or other consideration. Additionally, a member cannot redeem or refund Fly Buys points for the payment of an amount of money directly to the member. Any Fly Buys points awarded but unused expire after 36 months. The terms and conditions of the Fly Buys loyalty programme do not prohibit a member redeeming points for any particular reward or class of rewards. Following the redemption of Fly Buys points for a reward, a member may (as a subsequent and separate transaction) transfer or assign the reward for money or other consideration (ie sell it).
17. Once a person is a Fly Buys account holder, they "collect" Fly Buys points (by way of a credit to an account maintained by Loyalty NZ) as a consequence of purchasing goods or services from participating reward partners (Partners). Fly Buys members pay the same price for qualifying goods and services as non-Fly Buys members. There are currently more than 40 Partners. Loyalty NZ and Partners agree on the level of Fly Buys points that Loyalty NZ may award to account holders. For example, one point may be awarded to an account holder for every $25 (or some other amount) spent with a Partner. From time to time, Loyalty NZ provides account holders with a points summary statement that details the holder's opening points balance, credits and debits of points, and closing points balance.
18. Once an account holder has collected sufficient Fly Buys points, the account holder may redeem the Fly Buys points for specified rewards, being goods and services provided by Partners or other third parties that have entered into an agreement with Loyalty NZ to provide such rewards. The account holder contacts Loyalty NZ to request the redemption of their Fly Buys points, and Loyalty NZ arranges for the relevant Partner or other reward provider to provide the reward to the account holder. At Loyalty NZ's option, rewards are posted or delivered to the address of the account holder or made available for collection at a location notified to the account holder.

Fly Buys and contributions to the BNZ KiwiSaver Scheme

19. The Bank proposes to integrate a Fly Buys feature with the BNZ KiwiSaver Scheme.
20. Under an agreement between the Bank and Loyalty NZ, a Fly Buys member will be able to redeem their Fly Buys points for a contribution to their own, or another person's, member's account in the BNZ KiwiSaver Scheme. Where a Fly Buys member redeems his or her Fly Buys points for a contribution to another person's

member's account, the contribution will be a gift from the Fly Buys member to the other person.

21. In the case of a redemption request for a BNZ KiwiSaver contribution, the Fly Buys account holder will contact Loyalty NZ and request the redemption of a specified number of Fly Buys points for a contribution of a specified amount of money to a nominated member's account in the BNZ KiwiSaver Scheme.

22. Loyalty NZ will provide details of the BNZ KiwiSaver member who is receiving the contribution reward and the dollar amount of the reward to the Bank. Loyalty NZ will pay the money into a BNZ suspense account. The contribution will be applied to the nominated member's account in the BNZ KiwiSaver Scheme and to the relevant fund(s) most recently selected by the member.

23. As a separate and independent obligation, the Bank will make a payment to Loyalty NZ in relation to each contribution made by Loyalty NZ to a member's account with the BNZ KiwiSaver Scheme.

24. Contributions to a member's account in the BNZ KiwiSaver Scheme arising from the redemption of Fly Buys points will be treated no differently under the BNZ KiwiSaver Scheme than any other voluntary contributions to the scheme.

25. A Bank customer's membership in the Fly Buys programme will be contractually separate to the customer's agreement (if any) relating to their investment in the relevant fund within the BNZ KiwiSaver Scheme. Each arrangement will exist independently.

Bank's objectives

26. The Bank's goals and objectives in integrating the Fly Buys feature into the BNZ KiwiSaver scheme are to:

- increase customer benefits, satisfaction and customer retention;
- encourage retirement savings by providing an innovative savings solution to its customers; and
- improve the Bank's brand awareness among the public, so the Bank is seen as a market leader.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

a) No income arises under s CA 1(2) for a BNZ KiwiSaver member in relation to the Arrangement.

b) No income arises under s CB 4 for a Fly Buys member or for a BNZ KiwiSaver member in relation to the Arrangement.

c) No income arises under s CC 3 for a BNZ KiwiSaver member in relation to the Arrangement.

d) No income arises under s CE 1 for a BNZ employee in relation to the Arrangement.

e) No income arises under s CP 1 for a BNZ KiwiSaver member in relation to the Arrangement.

f) Section BG 1 does not apply to the Arrangement.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 10 June 2013 and ending on 31 March 2016.

This Ruling is signed by me on the 7th day of June 2013.

Howard Davis

Director (Taxpayer Rulings)

LEGISLATION AND DETERMINATIONS

This section of the *TIB* covers items such as recent tax legislation and depreciation determinations, livestock values and changes in FBT and GST interest rates.

GENERAL DEPRECIATION DETERMINATION DEP85: BUILDINGS WITH REINFORCED CONCRETE FRAMING (DEFAULT CLASS), BUILDINGS WITH STEEL OR STEEL AND TIMBER FRAMING (DEFAULT CLASS), BUILDINGS WITH TIMBER FRAMING (DEFAULT CLASS)

Note to Determination DEP85

The Commissioner has set general economic depreciation rates for various categories of buildings by adding new default asset classes to the "Building and Structures" asset category. The Commissioner has also deleted the asset classes for these same categories of buildings that are not default classes.

GENERAL DEPRECIATION DETERMINATION DEP85

1. Application

This determination applies to taxpayers who own depreciable property of the kind listed in the table below.

This determination applies from the 2012/13 and subsequent income years.

2. Determination

Pursuant to section 91AAG of the Tax Administration Act 1994 this determination will apply to the kind of items of depreciable property listed in the table below by:

- deleting from the "Building and structures" asset category the general asset classes, estimated useful lives, and general diminishing value and straight line depreciation rates as listed across:

Buildings and structures	Estimated useful life (years)	DV rate (%)	SL rate (%)
Buildings with reinforced concrete framing [before 2011/12 income year]	50	3	2
Buildings with reinforced concrete framing [from 2011/12 income year]	50	0	0
Buildings with steel or steel and timber framing [before 2011/12 income year]	50	3	2
Buildings with steel or steel and timber framing [from 2011/12 income year]	50	0	0
Buildings with timber framing [before 2011/12 income year]	50	3	2
Buildings with timber framing [from 2011/12 income year]	50	0	0

- adding to the "Building and Structures" asset category the general asset classes, estimated useful lives, and general diminishing value and straight line depreciation rates as listed below:

Buildings and structures	Estimated useful life (years)	DV rate (%)	SL rate (%)
Buildings with reinforced concrete framing (default class) [before 2011/12 income year]	50	3	2
Buildings with reinforced concrete framing (default class) [from 2011/12 income year]	50	0	0
Buildings with steel or steel and timber framing (default class) [before 2011/12 income year]	50	3	2
Buildings with steel or steel and timber framing (default class) [from 2011/12 income year]	50	0	0
Buildings with timber framing (default class) [before 2011/12 income year]	50	3	2
Buildings with timber framing (default class) [from 2011/12 income year]	50	0	0

3. Interpretation

In this determination, unless the context otherwise requires, words and terms have the same meaning as in the Income Tax Act 2007 and the Tax Administration Act 1994.

This determination is signed by me on the 10th day of July 2013.

Rob Wells

LTS Manager, Technical Standards

DEP83: DEPRECIATION RATES FOR MACHINERY USED FOR GRADING, SORTING AND PACKING PRODUCE

The Commissioner has been asked to set a depreciation rate for machinery used for grading, sorting and packing food and agricultural products.

These machines grade and sort a range of produce by scanning the items for defects such as size, colour and quality. The produce then passes further along the production line where they are weighed and packed into containers.

There is a range of machines, some more mechanically operated and some computerised and software dependent. Some of the machines are used in a person's own produce operation and some of the machines are hired on a short term basis.

The proposed new economic depreciation rates are aimed at covering the range of machines described above. We have also rationalised the Commissioner's table of depreciation rates by deleting those asset classes that are no longer necessary as they would come within the new asset classes.

This determination may be cited as "Determination DEP83: Machinery used for grading, sorting and packing produce".

1. Application

This determination applies to taxpayers who own items of depreciable property of the kind/s listed in the tables across:

The proposed new economic rates apply for the 2012 and subsequent income years. The rates being deleted continue to apply up to the date this determination is published in the *Gazette*.

2. Determination

Pursuant to section 91AAF of the Tax Administration Act 1994 I set in this determination the economic rate/s to apply to the kind/s of items of depreciable property listed in the table across by:

- deleting from the category "Agriculture, horticulture and aquaculture" industry category, the asset class, estimated useful life, and diminishing value rate and straight-line depreciation rate listed below:

Asset class	Estimated useful life (years)	DV rate (%)	SL rate (%)
Grading machinery	15.5	13	8.5
Grader (capsicums)	8	25	17.5
Graders (tomatoes)	8	25	17.5
Sorting machinery	15.5	13	8.5

- adding into the category "Agriculture, horticulture and aquaculture" industry category, the new provisional asset class, estimated useful life, and diminishing value rate and straight-line depreciation rate listed below:

Asset class	Estimated useful life (years)	DV rate (%)	SL rate (%)
Grading machinery (computerised)	8	25	17.5
Grading machinery (non-computerised)	15.5	13	8.5
Sorting machinery (computerised)	8	25	17.5
Sorting machinery (non-computerised)	15.5	13	8.5
Packing machinery (computerised)	8	25	17.5
Packing machinery (non-computerised)	15.5	13	8.5

- deleting from the category "Food processing" industry category, the asset class, estimated useful life, and diminishing value rate and straight-line depreciation rate listed below:

Asset class	Estimated useful life (years)	DV rate (%)	SL rate (%)
Grader (capsicums)	8	25	17.5
Graders	15.5	13	8.5
Graders (tomatoes)	8	25	17.5
Sorters	15.5	13	8.5
Packing machines (not elsewhere specified)	15.5	13	8.5

- adding into the category "Food processing" industry category, the new provisional asset class, estimated useful life, and diminishing value rate and straight-line depreciation rate listed below:

Asset class	Estimated useful life (years)	DV rate (%)	SL rate (%)
Grading machinery (computerised)	8	25	17.5
Grading machinery (non-computerised)	15.5	13	8.5
Sorting machinery (computerised)	8	25	17.5
Sorting machinery (non-computerised)	15.5	13	8.5
Packing machinery (computerised) (not elsewhere specified)	8	25	17.5
Packing machinery (non-computerised) (not elsewhere specified)	15.5	13	8.5

- adding into the category "Hire equipment (short-term hire of 1 month or less only)" asset category, the new provisional asset class, estimated useful life, and diminishing value rate and straight-line depreciation rate listed below:

Asset class	Estimated useful life (years)	DV rate (%)	SL rate (%)
Agriculture, horticulture and aquaculture machines for hire with a general DV rate based on an estimated useful life of 8 years	5	40	30

3. Interpretation

In this determination, unless the context otherwise requires, words and terms have the same meaning as in the Income Tax Act 2007 and the Tax Administration Act 1994.

This determination is signed by me on the 3rd day of April 2013.

Rob Wells

LTS Manager, Technical Standards

QUESTIONS WE'VE BEEN ASKED

This section of the *TIB* sets out the answers to some day-to-day questions people have asked. They are published here as they may be of general interest to readers.

QB 13/03: GOODS AND SERVICES TAX – WHETHER A COMPULSORY ACQUISITION OF LAND IS A "SUPPLY BY WAY OF SALE"

All legislative references are to the Goods and Services Tax Act 1985 (GST Act) unless otherwise stated.

This Question We've Been Asked applies in respect of ss 3A, 5(1), 8(1), 11(1)(mb), and 20(3).

Question

1. We have been asked whether:
   - a compulsory acquisition of land under the Public Works Act 1981 (PWA 1981) is a "supply" for GST purposes; and
   - if so, whether it is a "supply by way of sale" such that the recipient is entitled to a second-hand goods input tax deduction under ss 3A(2) and 20(3) of the GST Act where the supplier is not registered.

Answer

2. A compulsory acquisition of land under the PWA 1981 is a "supply" for GST purposes from the land owner to the Crown or local authority. Where such a supply is made by a registered person, it will generally be zero-rated under s 11(1)(mb).

3. Land compulsorily acquired from a non-registered person under the PWA 1981 will be a "supply by way of sale" for the purposes of ss 3A(2) and 20(3). The recipient (the Crown or local authority) will be entitled to an input tax deduction for the amount paid for the acquisition of that land (provided the other requirements of ss 3A(2) and 20(3) are met).

4. It is noted that, while this QWBA analyses compulsory acquisitions under the PWA 1981, the above answer also applies to compulsory acquisitions of land under the Canterbury Earthquake Recovery Act 2011.

Explanation

Background

5. The Minister of Lands or a local authority has the power under the PWA 1981 to acquire land under an agreement with the owner of the land or, where an agreement cannot be reached, under a compulsory acquisition. Where land is compulsorily acquired under the PWA 1981, the person whose land is acquired is entitled to full compensation from the Crown or local authority.

6. Public authorities and local authorities will be registered for GST. Consequently, the recipient of any compulsorily acquired land will be a registered person. There has been confusion about whether an input tax deduction is allowed when land is compulsorily acquired.

Meaning of "supply"

7. The New Zealand courts have not considered whether a supply requires an act on the part of the supplier. "Supply" has a wide meaning with potentially both active and passive senses. It is, therefore, necessary to consider the context and purpose of the GST Act to determine whether "supply" was intended to be limited to situations where there was an act on the part of the supplier. The GST Act was intended to be comprehensive and as non-distortionary as possible. This purpose is consistent with compulsory acquisitions being supplies for GST purposes.

8. GST is chargeable on the **supply** of goods and services by a registered person in the course or furtherance of a taxable activity carried on by that person: s 8(1).

9. Under s 5(1), supply "includes all forms of supply". In *Case S84* (1996) 17 NZTC 7,526, Judge Barber considered that the effect of s 5(1) was that virtually any transaction constitutes a supply (at 7,533):

> Section 5(1) defines "supply" to include all forms of supply. Accordingly, virtually any transaction constitutes a supply; but a supply is only subject to GST if it is made in the course or furtherance of a taxable activity (s 8).

10. At issue is whether a supply for GST purposes requires an act on the part of the supplier. If so, then a compulsory acquisition would not be a supply.

11. In *Databank Systems Ltd v CIR* (1987) 9 NZTC 6,213, Davison CJ considered that in the context of s 5(1) "supply" meant "to furnish with or provide". The definitions of "provide" and "furnish" in the *Concise Oxford English Dictionary* include "make available for

use; supply" (provide) and "be a source of; provide" (furnish). The meaning of "supply" is, therefore, wide enough to include both active and passive senses.

12. New Zealand courts have not expressly considered whether a supply requires an act on the part of the supplier.

13. Comments made by Judge Willy in *Case T22* (1997) 18 NZTC 8,124 may be taken to suggest that a compulsory acquisition of property from a taxpayer could not amount to a supply. However, that case did not involve a compulsory acquisition of property. Rather, the Government passed legislation preventing the taxpayer from operating a marron farm, which it was previously permitted to do. Subsequent to that, the Government made a payment to the taxpayer in full and final settlement to any claim related to those events. The case is, therefore, concerned with a compensation payment, rather than a compulsory acquisition of property.

14. South African and Australian authority establishes that for there to be a supply, there must be an act on the part of the supplier. These cases support the view that a compulsory acquisition of land under the Public Works Act, which occurs because the Governor-General makes a proclamation, does not involve a supply of the land: *Shell's Annandale Farm (Pty) Ltd v Commissioner for South African Revenue Service* (1999) 62 SATC 97; *Shaw v Director of Housing (No 2)* (2001) ATC 4,054. However, cases decided under other indirect tax legislation are not necessarily applicable in interpreting the New Zealand GST Act, although they may be helpful: *CIR v Databank Systems Ltd* (1989) 11 NZTC 6,093; *CIR v Gulf Harbour Development Ltd* (2004) 21 NZTC 18,915.

15. UK legislation provides that a compulsory acquisition for which compensation is paid is a supply, but one case has suggested that even without an express provision, a compulsory acquisition would have been a supply: *Landau* [1996] BVC 2,577.

16. In *Shell's Annandale Farm*, Davis J acknowledged that the ordinary meaning of "supply" included a passive sense, but found that it was necessary to consider the text and purpose of the Act as a whole. He considered that in the context of the South African value-added tax legislation, a "supply" required some act on the part of the supplier.

17. Even where the meaning of the text of the legislation is clear, it is necessary to cross-check the plain meaning against the purpose of the legislation to comply with s 5 of the Interpretation Act 1999. The Interpretation Act 1999 makes the text and purpose the key drivers of statutory interpretation. Further, consideration of the context and purpose is essential where the meaning is not clear on the face of the legislation: *Commerce Commission v Fonterra Co-operative Group Ltd* [2007] 3 NZLR 767 (SC). As "supply" can be used in active and passive senses, it is necessary to consider contextual matters and the scheme and purpose of the New Zealand legislation to decide whether "supply" requires an act on the part of the supplier.

Context and purpose

18. GST is imposed on the supply of goods and services by a registered person in the course or furtherance of a taxable activity by reference to the value of the supply (the consideration for the supply): ss 8(1) and 10. In *CIR v Databank Systems Ltd* (1989) 11 NZTC 6,093, Richardson J commented that the definitions of the terms used in s 8(1) ("supply", "goods", "services", "registered person" and "taxable activity") breathed comprehensiveness into the legislation. Richardson J also said that a feature of the legislation in this regime compared with that in other indirect tax regimes was its breadth of coverage and limited number of exemptions.

19. "Consideration" is relevantly defined in the Act as:

> in relation to the supply of goods and services to any person, includes any payment made or any act or forbearance, whether or not voluntary, in respect of, in response to, or for the inducement of, the supply of any goods and services, whether by that person or by any other person ...

20. For payment to be consideration for a supply, a sufficient connection must exist between the supply and the payment: *CIR v NZ Refining Co Ltd* (1997) 18 NZTC 13,187; *Chatham Islands Enterprise Trust v CIR* (1999) 19 NZTC 15,075. The supply need not be made to the person providing consideration and consideration need not be paid under a contract between the supplier and the person providing the consideration, so long as a connection exists between the supply and the payment: *Turakina Maori Girls' College Trust Board v CIR* (1993) 15 NZTC 10,032; *NZ Refining Co; Chatham Islands Enterprise Trust*. In determining whether the necessary relationship exists, the legal nature of the transaction and the rights and obligations of the parties need to be considered: *NZ Refining Co; Chatham Islands Enterprise Trust*.

21. As the definition of "consideration" contemplates that a supply need not be made under a contract (the making of which requires an act on the part of the supplier), the definition provides some support for the

argument that a "supply" does not require an act on the part of the supplier. However, for a payment to be consideration there must be an element of reciprocity in the relationship between the supplier and the recipient and a sufficient connection between a supply and a payment. In the context of a compulsory acquisition, a sufficient connection exists between the transfer of the land and the payment made by the Crown or local authority for the acquisition of that land. The right to compensation arises only because the land is taken. The payment is, therefore, in response to the acquisition of the land.

22. The definition of "supplier" refers to "the person who makes the supply" of goods and services. The definition of "make" in the *Concise Oxford Dictionary* includes "bring about or perform; cause". The use of the word "makes" in the definition of "supplier" indicates that "supply" in the GST Act has an active connotation. However, this factor must be weighed against other contextual matters.

23. Although not exactly analogous, there are examples where the GST Act deems a supply to be made although there is no act by the supplier in respect of the supply. For example, a person must pay registration fees, licence fees and road user charges to be entitled to operate a motor vehicle (or certain motor vehicles) on the road. These fees are treated as consideration for a supply of services by the New Zealand Transport Agency: s 5(6A) and (6B); see also s 5(6C), (7B), and (7C)).

24. Deeming can be used to extend the meaning of a term. However, deeming can also be used to put beyond doubt a particular meaning that might otherwise be uncertain. Therefore, it is possible that Parliament did not intend to extend the concept of supply beyond the circumstances in which these specific provisions apply. The alternative argument, which the court in *Landau* suggested, is that provisions deeming a supply to be made in certain circumstances were included for the avoidance of doubt and are not intended to limit the concept of "supply". Although of limited analytical weight, the inclusion of these deeming provisions means it is not possible to argue that Parliament intended that GST would be imposed only in circumstances where a supply is voluntary. These provisions and s 5(1), which provides that "supply" includes all forms of supply, suggest that Parliament intended that "supply" should be given a wide interpretation and should encompass almost any type of transaction under which a person acquires goods or services.

25. A "transaction" can include any dealings with property (*Littman v Barron* (1952) 33 TC 373) and can be a unilateral activity (*Greenberg v IR Commrs* [1971] 3 All ER 136; *Case K60* (1988) 10 NZTC 487). A compulsory acquisition is a transaction within that meaning, being a dealing with property involving the acquisition by the Crown or the local authority of title to land owned by another person.

26. In *Glenharrow Holdings Ltd v CIR* (2009) 24 NZTC 23,236, the Supreme Court noted that GST was intended to be as non-distortionary as possible, and that to that end GST was intended to be broad-based, efficient and neutral. A governing principle of the GST Act is that GST is paid by the ultimate consumer and is neutral for registered persons, who collect GST on behalf of the Crown (see *L R McLean & Co Ltd v CIR* (1994) 16 NZTC 11,211). To achieve neutrality, registered persons are allowed input tax deductions for their purchases. The legislation contemplates that there will be a balancing out of or netting off of the GST components of sales and purchases made by a registered person. If a registered person obtained an input tax deduction on the acquisition of land and was not required to account for GST on the land's disposal, the person would receive a gain that the legislation does not contemplate. Therefore, it would be inconsistent with the scheme of the legislation if a registered person from whom land was compulsorily acquired were entitled to an input tax deduction on the acquisition of the land but not required to account for GST on compensation for the land where the land was compulsorily acquired. [Although the zero-rating rules have changed the position for supplies of land between registered persons, ultimately when the land is sold to an unregistered person, GST will be payable. In any event, it is considered that the general principle is still relevant.]

27. It would be inconsistent with the principles of neutrality and efficiency that underlie the broad definitions of the main concepts in the GST Act ("goods", "services", "supply" and "taxable activity"), if a different GST outcome occurred depending on whether an agreement for sale and purchase was entered into or whether land was compulsorily acquired. Whether the land is acquired under an agreement entered into with the owner of the land or under a compulsory acquisition, land is acquired by the Crown in return for payment.

28. If "supply" were limited to transactions where there was an act on the part of the supplier, it would create an anomaly in that compulsory acquisitions would

be outside the GST net (although a compulsory acquisition of land would have the same legal and economic effect as an agreement for the purchase of the land). Such an interpretation is not required on a literal interpretation. Further, the scheme and purpose of the legislation supports the view that the treatment should be the same. GST is intended to be imposed on the value added at every stage by which goods and services reach the ultimate consumer. Therefore, it is considered that the better view is that the GST treatment should be the same whether the supplier has taken some action that results in another person receiving goods or services or whether a person receives goods or services without there being an act by the supplier.

29. The interpretation of "supply" remains relevant in considering whether a second-hand goods deduction (which requires a supply by way of sale) would be allowable where land is acquired from a non-registered person.

Supply by way of sale

30. Whether a compulsory acquisition is a "sale" depends on the context in which the term "sale" is used. The context of the GST Act is not decisive about whether a compulsory acquisition is a "supply by way of sale". However, allowing a second-hand goods deduction is more consistent with the policy of allowing input tax deductions for second-hand goods, because it achieves GST neutrality.

31. Case law shows that whether a compulsory acquisition is a "sale" depends on the context of the legislation in which the term "sale" is used: *John Hudson & Co Ltd v Kirkness* (1955) 36 TC 28; *Ridge Nominees Ltd v IRC* [1961] 3 All ER 1,108.

32. In *Smith v FCT* (1932) 48 CLR 178 and *Coburg Investment Co Pty Ltd v FCT* (1960) 12 ATD 242, the court considered that a compulsory acquisition of land was a sale. In *Smith*, Rich J considered that the word "sale" did not have a precise meaning and that in some contexts the essence of a sale was the conversion of property into money. In *Coburg Investment*, the issue was whether a compulsory acquisition was a sale of land for the purpose of the equivalent of s CB 6 of the Income Tax Act 2007. Windeyer J considered that the provision should be read in the light of the principle that if property is acquired for the purpose of sale (rather than for the purpose of retaining it as an income-producing capital asset), the surplus received when it is realised is income. Under that principle it is irrelevant whether the realisation occurred as a result of compulsion or voluntarily. See also *FCT v Salenger* 88 ATC 4,449, where the court found that, where a sale is made under a contract, mutual consent is required. However, a sale is not necessarily made under a contract.

33. New Zealand case law established that a compulsory acquisition of land is not a sale for the purpose of the predecessor of s CB 6. In *Public Trustee v CIR* [1961] NZLR 1,034, Hutchison J did not consider that a wider meaning of "sale" applied in the particular context. However, Hutchison J accepted that in a suitable context a sale for income tax purposes could include a compulsory acquisition (at 1,044). *Public Trustee* was followed in *Railway Timber Co Ltd v CIR* [1977] 1 NZLR 655 and *Duff v CIR* (1979) 4 NZTC 61,420. (The legislation has since been amended so that a disposal of land for the purpose of these provisions now includes a compulsory acquisition.)

34. The fact New Zealand case law establishes that a compulsory acquisition is not a sale for income tax purposes does not necessarily mean that "sale" should be interpreted in the same way for GST purposes. The meaning to be given to "sale" depends on the context in which it is used. It is, therefore, necessary to consider the context in which "sale" is used in s 3A(2).

35. A sale is a supply. Section 3A(2) refers to "a supply by way of sale". "By way of" means "in the form of": *Concise Oxford Dictionary*. A supply for GST purposes need not be made under a contract: Turakina.

36. Section 3A(3)(a)–(d), which relates to the determination of the amount of a second-hand goods input tax credit, refers to "the purchase price" as a basis for determining the amount of the input tax credit. A possible argument is that compensation paid under a compulsory acquisition cannot be described as a purchase price. Therefore, the legislation contemplates a second-hand goods input tax deduction could not be obtained for a compulsory acquisition. However, in *Horn v Sunderland Corporation* [1941] 1 All ER 480 (CA), Scott LJ considered that "purchased" was synonymous with "taken" and that the compensation paid for compulsorily acquired land was a purchase price (at 492).

37. Also, the paragraphs in s 3A(3) that refer to the purchase price are unlikely to apply where a compulsory acquisition is made. Section 3A(3)(a)–(c) applies where the supplier and the recipient are associated persons. The Crown or a local authority is unlikely to be an associated person of any person from whom land may be compulsorily acquired. Section

3A(3)(d) applies where the supply is not the only matter to which the consideration relates. This is also unlikely to be relevant in the context of a compulsory acquisition.

38. Where the supplier and recipient are not associated persons and the supply is the only matter to which the consideration relates, the amount of the input tax deduction is based on the consideration in money for the supply: s 3A(3)(e). Therefore, the amount of the input tax deduction where a compulsory acquisition is made would be based on the amount of the compensation paid for the acquisition.

39. Originally, a second-hand goods input tax deduction was allowable on a supply that was not a taxable supply. *Public Information Bulletin* 181 (June 1989) set out commentary on the Goods and Services Tax Amendment Act 1989. The bulletin explains that before the amendment, a registered person could have obtained a second-hand goods input tax deduction on goods that were leased. The bulletin also explains that the words "supply by way of sale" were inserted in the definition of "input tax" in the GST Act to ensure the second-hand goods input tax deduction was not obtained where a registered person did not obtain ownership of the goods. Therefore, the limitation of the second-hand goods input tax deduction to supplies by way of sale was not intended to introduce a requirement for consent from the supplier to the supply before there could be a sale. The words "supply by way of sale" were added to ensure a second-hand goods input tax deduction could be obtained only where the recipient acquired ownership of the goods. The definition of "sale" referred to in the bulletin refers to an exchange of a commodity for money. This exchange occurs under a compulsory acquisition.

40. The allowance of an input tax deduction in respect of a compulsory acquisition of land is consistent with the policy underlying the second-hand goods input tax deduction. Allowing a second-hand goods input tax deduction recognises that as the non-registered supplier was charged GST on the acquisition of the goods, the consideration for the goods includes a notional GST component. The allowance of an input tax deduction to a registered person who purchases second-hand goods from a non-registered person achieves GST neutrality for the registered person: *Glenharrow*. Supplies of land between registered persons are now zero-rated. However, there are still GST consequences where land is supplied either by or to an unregistered person. Allowing a second-hand goods input tax deduction is also consistent with the treatment of land that is acquired by agreement under s 17 of the PWA 1981.

41. Although, it is not completely free from doubt, on balance, the Commissioner's view is that, in the context of the GST legislation, a compulsory acquisition is a supply by way of sale.

Interpretation Statement

42. The Interpretation Statement "GST treatment of court awards and out of court settlements: IS3387" *Tax Information Bulletin* Vol 14, No 10 (October 2002) states the proposition that "[t]he concept of supply is active; to supply is to furnish or provide".

43. The principle referred to above was not central to the matters considered in the Interpretation Statement. In the Commissioner's view, the conclusions reached in the Interpretation Statement are still correct. However, to the extent that the analysis in the Interpretation Statement suggests that the concept of "supply" is always active, the Commissioner now considers that it is incorrect.

Examples

44. The following examples are included to help explain the application of the law.

Example 1 – unregistered landowner

45. Bob is not registered for GST. Bob owns a 400m2 block of land. The local district council requires Bob's land to undertake some local work. Bob does not want to sell his land to the council. The council compulsorily acquires Bob's land under the PWA 1981 and pays him $400,000 (the market value of the land).

46. Bob is not GST registered, so there are no GST implications for him. The council is GST registered. The transfer of the land from Bob to the council is a "supply by way of sale" for the purposes of ss 3A(2) and 20(3). The council is entitled to an input tax deduction (provided the other requirements of ss 3A(2) and 20(3) are met).

Example 2 – registered landowner

47. Charles carries on a taxable activity of farming and is registered for GST. Charles owns 100 hectares of land. The local council requires 100m2 of Charles' land to widen an adjacent road. Charles does not wish to sell his land to the council. The council compulsorily acquires Charles' land under the PWA 1981 and pays him $40,000 (the market value of the land).

48. The transfer of the land from Charles to the council is a "supply". The supply is of land, so it will be zero-rated under s 11(1)(mb).

References

Related rulings/statements
"GST treatment of court awards and out of court settlements: IS3387" *Tax Information Bulletin* Vol 14, No 10 (October 2002)
Subject references
Compulsory acquisition; Supply; Supply by way of sale
Legislative references
Goods and Services Tax Act 1985: ss 2 ("consideration", "supplier"), 3A, 5, 8, 11(1)(mb), 20(3)
Public Works Act 1981
Case references
Case K60 (1988) 10 NZTC 487
Case S84 (1996) 17 NZTC 7,526
Chatham Islands Enterprise Trust v CIR (1999) 19 NZTC 15,075
CIR v Gulf Harbour Development Ltd (2004) 21 NZTC 18,915
CIR v NZ Refining Co Ltd (1997) 18 NZTC 13,187
Coburg Investment Co Pty Ltd v FCT (1960) 12 ATD 242
Commerce Commission v Fonterra Co-operative Group Ltd [2007] 3 NZLR 767 (SC)
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Duff v CIR (1979) 4 NZTC 61,420
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Shaw v Director of Housing (No 2) (2001) ATC 4,054
Shell's Annandale Farm (Pty) Ltd v Commissioner for South African Revenue Service (1999) 62 SATC 97
Smith v FCT (1932) 48 CLR 178
Turakina Maori Girls' College Trust Board v CIR (1993) 15 NZTC 10,032
Other references
Public Information Bulletin 181 (June 1989)

LEGAL DECISIONS – CASE NOTES

This section of the *TIB* sets out brief notes of recent tax decisions made by the Taxation Review Authority, the High Court, Court of Appeal, Privy Council and the Supreme Court.

We've given full references to each case, including the citation details where it has already been reported. Details of the relevant Act and section will help you to quickly identify the legislation at issue. Short case summaries and keywords deliver the bare essentials for busy readers. The notes also outline the principal facts and grounds for the decision.

These case reviews do not set out Inland Revenue policy, nor do they represent our attitude to the decision. These are purely brief factual reviews of decisions for the general interest of our readers.

INTERLOCUTORY APPEAL IN ADVANCE OF SUBSTANTIVE HEARING

Case	Ben Nevis Forestry Ventures Ltd & Others v Commissioner of Inland Revenue
Decision date	Judgment: 9 May 2013 Reasons: 22 May 2013
Act(s)	High Court Rules rule 1.2, Judicature Act 1908
Keywords	Interlocutory appeal, postponement, judicial discretion, Trinity, tax avoidance

Summary

This was an appeal of a High Court decision that the Commissioner's interlocutory application should be heard before the appellant's interlocutory application. The Court of Appeal did not disturb the High Court's decision and exercised their discretion not to hear this interlocutory appeal matter before the substantive hearing in the High Court.

Impact of decision

The Court of Appeal has the discretion to decline to hear an interlocutory appeal in advance of a substantive hearing in a lower court if the Court decides that the issues on appeal may be overtaken by the substantive hearing or that the appellant is unlikely to be prejudiced by postponement (*Reid v Attorney-General* [2012] NZCA 174).

Facts

The appellants in this case were investors in the Trinity tax avoidance scheme. The appellants have applied to the High Court for an order that the judgment of the High Court in *Accent Management Ltd v Commissioner of Inland Revenue* [2004] 22 NZTC 19,027 (HC) (*"Accent Management"*) be set aside. Venning J found that the Trinity scheme (in which the appellants are investors) was a tax avoidance arrangement. This decision was also upheld in the Court of Appeal (*Accent Management Ltd v Commissioner of Inland Revenue* [2007] NZCA 230, (2007) 23 NZTC 21,323) and in the Supreme Court (*Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289).

The appellants claim that the decision in *Accent Management* is voidable on the ground that Venning J was or may have been seen to be biased because he was beholden to the Commissioner, in respect of an alleged stamp duty debt.

An interlocutory application to join the Attorney-General to the proceeding was also filed by the appellants. A draft amended claim for compensation under the New Zealand Bill of Rights Act 1990 was attached to that application.

In response to the challenge of Venning J's judgment, the Commissioner filed an appearance under protest to jurisdiction and an interlocutory application for dismissal or strike out. The Commissioner argued that if the claim had to be properly considered in any court, that consideration would have to occur in the Court of Appeal.

Katz J in the High Court was asked to determine which interlocutory application should be heard first. The Judge determined it was premature to consider adding additional defendants or causes of actions before the Commissioner's protest to jurisdiction application was determined. The second issue for the High Court was the appellants' application that this matter be heard by a Full Court of the High Court. This issue was referred to the Chief High Court Judge, Winkelmann J, who decided that there were no grounds which would justify constituting a Full Court in respect of the interlocutory applications or the substantive proceeding (*Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* HC Auckland CIV-2012-404-7682, 17 April 2013).

Decision

The Court of Appeal decided to defer the appeal. The Court recognised that *Siemer v Heron* ([2011] NZSC 133, [2012] 1 NZLR 309 at [32]) allowed an appeal as of right

to the Court of Appeal against interlocutory decisions. However, it was also recognised that there is discretion to decline to hear an interlocutory appeal in advance of the substantive hearing in a lower court. This discretion can be exercised if the issues on appeal may be overtaken by the substantive hearing or if the appellant is unlikely to be prejudiced by postponement.

Mr Judd QC argued for the appellants that the Court of Appeal should hear the appeal prior to the Commissioner's protest to jurisdiction, because otherwise the appeal would be rendered nugatory. The Court of Appeal concluded that the decision as to the order in which these interlocutory matters are heard is not dispositive in any substantive or practical way and that the appellants are not prejudiced by deferral of the appeal.

Mr Judd QC indicated that the appeal against Winkelmann J's refusal to constitute a Full Court was not a focus of the appellants' concern. The Court of Appeal decided it was therefore not necessary to decide that matter.

The Court of Appeal made no order as to costs and the fixture to deal with the appeal was vacated.

TAXPAYER FOUND TO HAVE HONESTLY RELIED ON INLAND REVENUE FORMS

Case	Lim v Commissioner of Inland Revenue
Decision date	28 May 2013
Act(s)	Income Tax (Withholding Payments) Regulations 1979
Keywords	Honestly relied, withholding tax

Summary

The Court concluded that Mr Lim honestly relied on the IR 330 forms when he stopped deducting withholding tax.

Facts

The disputant, Chye Heng Lim ("Mr Lim"), operated a partnership ("the partnership") with a Ms Sia running a painting and decorating business. On 31 March 2005, the partnership business was taken over by K L Decorators Limited ("the company"). The company was owned by Mr Lim and his wife, Foong Ling Lim ("Mrs Lim").

The business involved entering into contracts to paint houses. The work would then be completed by subcontractors who either supplied labour only or labour as well as materials. The majority of subcontractors were labour and materials subcontractors.

The Income Tax (Withholding Payments) Regulations 1979 ("the regulations") specified that "payments for work done or services done under contracts or arrangements which are wholly or substantially for the supply of labour …" were subject to withholding tax.

In March 2000, Inland Revenue issued a tax declaration form being an IR 330 form ("the 2000 IR 330") which listed the categories of persons in respect of whom withholding payments must be deducted including "labour only contracts in the building industry".

Mrs Lim took primary responsibility for the tax affairs of the partnership and company although she had access to independent tax agents.

For the years ending 31 March 2001 and 2002, the partnership complied with the regulations and paid the full amount of withholding tax owing. In 2003, the partnership stopped deducting withholding payments from all of its subcontractors and only deducted a portion of the amount owing to Inland Revenue. The partnership and later company failed to make deductions for the 2004–2007 tax years. The company started making deductions again in 2008.

In January 2003, Inland Revenue issued another IR 330 form which was materially identical to the 2000 IR 330.

In January 2006, Inland Revenue issued another IR 330 form. The new form said that "contracts wholly or substantially for labour only in the building industry" were to be subject to withholding tax.

In 2006, the Commissioner began an audit of the partnership's tax affairs. During this audit, two records relate to the alleged reliance on the IR 330:

1. In notes of an interview in October 2007 between Inland Revenue and the Lims, Mrs Lim mentioned an IR 330 and also stated that if the subcontractors provided their own materials she did not have to deduct withholding tax.
2. A note of a meeting with a tax advisor recording "no w/h tax from subbies. IR 330 believes not just labour".

Mr Lim signed agreed adjustments in 8 April 2009 for the tax in dispute. He then began to negotiate with Inland Revenue to settle the debt for a lesser sum. During these debt proceedings, both his local MP and his barrister wrote to the Commissioner explaining that they had relied on the 2000 IR 330.

On 21 July 2011 Inland Revenue issued a bankruptcy notice against Mr Lim.

Mr Lim commenced court proceedings against the Commissioner. These proceedings initially contained seven causes of action however, both parties agreed to limit the issue to a question of fact. The parties agreed that if the Court was satisfied Mr Lim relied honestly on the IR 330's when he decided not to deduct withholding tax, the Commissioner would set aside the outstanding debt and penalty payments.

Decision

Collins J found that the Lims did act honestly when they relied on the IR 330s for the following reasons:

1. While Mr and Mrs Lim had given various accounts about relying on the IR 330s, this did not undermine their credibility as, considering the amount of time that had passed, it was understandable why there were some inconsistencies. Contemporaneous evidence also supported their claim.
2. Mr and Mrs Lim raised their reliance on the IR 330s as early as October 2007 undermining any suggestion that any reliance was a recent invention.
3. It is logically more likely that the Lims did rely on the IR 330s by interpreting the forms in a way which was objectively logical, especially considering they did not have a sophisticated knowledge of New Zealand tax law. They also changed their business practice when they received clear and competent advice about the significance of their error.

Although Collins J considered that there was an advantage to the Lims in not deducting withholding tax, he did not consider this enough to outweigh the other factors. His Honour concluded that Mr Lim honestly relied on the IR 330 forms when he stopped deducting withholding tax.

The issue of costs was reserved.

COLLATERAL ATTACK ON SUPREME COURT JUDGMENTS

Case	Accent Management Ltd v The Attorney-General of New Zealand and the Commissioner of Inland Revenue
Decision date	17 June 2013
Act(s)	Subparts EG and EH Income Tax Act 1994, sections 138B and 138P Tax Administration Act, High Court Rules rule 5.49
Keywords	Indemnity costs, collateral attack, jurisdiction of the High Court, Trinity, tax avoidance

Summary

This was an application by the Commissioner to dismiss the claim on the grounds that the High Court did not have jurisdiction to hear the taxpayer's claim. The Court found that the taxpayer's application was a collateral attack on two Supreme Court judgments.

Impact of decision

Another success and an indemnity costs award for the Commissioner in the Trinity litigation.

Facts

This claim relates to the Trinity tax avoidance litigation. The taxpayer's deductions had been claimed under subpart EG of the Income Tax Act 1994 ("ITA") for the 1997 and 1998 tax years. These deductions were disallowed by the Commissioner on the basis of section BG 1 and penalties were imposed. The Commissioner's decision was upheld by the Supreme Court in *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 ("*Ben Nevis*"). During the course of submissions in the Supreme Court, counsel for the plaintiff submitted that, in fact, the taxpayer's deductions and spreading issues should have been claimed under subpart EH of the ITA, instead of subpart EG. The Supreme Court declined to hear this new argument.

Some investors in the Trinity scheme have continued to litigate various issues and this present claim was to set aside the High Court judgment delivered by Venning J in December 2004, which has been upheld twice by the Supreme Court. The plaintiffs also sought declarations that the High Court exceeded the jurisdiction and powers conferred on it by sections 138B and 138P of the Tax Administration Act 1994 ("TAA").

The request to have Venning J's judgment in the High Court set aside was primarily based on the plaintiff's allegation

that the High Court, as a "deemed hearing authority", purportedly exercised powers under section 138P of the TAA but made orders which were of no effect.

The Commissioner applied to dismiss the claim on the grounds that the High Court had no jurisdiction to entertain the claim by the plaintiff.

Decision

Priestley J concluded that rule 5.49 of the High Court Rules applied and that it couldn't determine Accent Management's current proceeding, because the High Court was *functus officio* and that it lacked jurisdiction to determine whether the Supreme Court's legal conclusions in *Ben Nevis* were wrong.

The Judge considered that the proceeding represented a collateral attack, an "impermissible attack," on not one but two judgments of the Supreme Court.

Priestley J found the proceeding as being untenable from the outset, the plaintiff has twice exhausted its appellate pathways and its persistence was untenable.

The Court dismissed the plaintiff's proceeding and awarded reasonable indemnity costs to the Commissioner.

REGULAR CONTRIBUTORS TO THE TIB

Office of the Chief Tax Counsel

The Office of the Chief Tax Counsel (OCTC) produces a number of statements and rulings, such as interpretation statements, binding public rulings and determinations, aimed at explaining how tax law affects taxpayers and their agents. The OCTC also contributes to the "Questions we've been asked" and "Your opportunity to comment" sections where taxpayers and their agents can comment on proposed statements and rulings.

Legal and Technical Services

Legal and Technical Services contribute the standard practice statements which describe how the Commissioner of Inland Revenue will exercise a statutory discretion or deal with practical operational issues arising out of the administration of the Inland Revenue Acts. They also produce determinations on standard costs and amortisation or depreciation rates for fixed life property used to produce income, as well as other statements on operational practice related to topical tax matters.

Legal and Technical Services also contribute to the "Your opportunity to comment" section.

Policy Advice Division

The Policy Advice Division advises the government on all aspects of tax policy and on social policy measures that interact with the tax system. They contribute information about new legislation and policy issues as well as Orders in Council.

Litigation Management

Litigation Management manages all disputed tax litigation and associated challenges to Inland Revenue's investigative and assessment process including declaratory judgment and judicial review litigation. They contribute the legal decisions and case notes on recent tax decisions made by the Taxation Review Authority and the courts.

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