GENERAL ANTI-AVOIDANCE

CONTENTS:

INTRODUCTION

1. The interpretation of the general anti-avoidance provision by the New Zealand Courts has changed significantly in recent years. The current approach, set out by the Supreme Court in *Ben Nevis Forestry Ventures Ltd & Ors v C of IR; Accent Management Limited & Ors v C of IR* [2008] NZSC 115 (19 December 2008); (2009) 24 NZTC 23,188, involves a two-pronged analysis concerning:

- The actual use of specific provisions based on the legal transactions; and
- Whether the specific provisions have been used in a manner that is within Parliament's purpose and contemplation when the specific provisions were enacted, based on the commercial and economic outcome of the arrangement.

2. The approach distinguishes between the use of specific tax provisions in a strictly legal sense, and the manner in which those provisions have been used having regard to the overall commercial and economic outcome. The Supreme Court has explicitly acknowledged that there will be circumstances in which the use of a specific provision may be legally permitted but is beyond Parliament's purpose and contemplation when the specific provision was enacted. In that sense, the Supreme Court's approach represents an expansion of the English purposive approach (see paragraph 38(o) below).

3. The starting point, when trying to determine whether a particular arrangement constitutes tax avoidance, is an investigation into whether the specific tax provisions that are relied on are used in a manner that is within Parliamentary contemplation when the provisions were enacted. If there is a tax avoidance purpose or effect, the question becomes one of whether the tax avoidance purpose or effect is "merely incidental". In this regard, it is worth noting the Supreme Court's warning, in *Ben Nevis* at p. 23,213: "[114] … It will rarely be the case that the use of a specific provision in a manner that is outside Parliamentary contemplation could result in the tax avoidance purpose or effect of the arrangement being merely incidental".

4. In *Penny and Hooper v C of IR* [2011] NZSC 95 (24 August 2011); (2011) 25 NZTC 20-073 the Supreme Court accepted that a tax advantage that is within Parliamentary contemplation will be permitted, when Blanchard J stated, at p. 25,649: "[49] … what the Act does require of taxpayers is that they should not structure their transactions with a more than merely incidental purpose of obtaining a tax advantage unless that advantage was within the contemplation of Parliament".

THE GENERAL ANTI-AVOIDANCE RULES

5. The General Anti-Avoidance Rules or GAARs (following the acronym coined by the Supreme Court in *Glenharrow Holdings Ltd v C of IR* [2008] NZSC 116 (19 December 2008); (2009) 24 NZTC 23,236, at [34] p. 23,244) that apply for income tax purposes are contained in section BG 1 and section YA 1 (which contains the definitions of the terms used) of the Income Tax Act 2007.

6. Section BG 1(1) states that:

> "A tax avoidance arrangement is void as against the Commissioner for income tax purposes."

7. "Tax avoidance arrangement" is defined in section YA 1 as meaning:

> "an arrangement, whether entered into by the person affected by the arrangement or by another person, that directly or indirectly–
>
> (a) has avoidance as its purpose or effect; or
>
> (b) has tax avoidance as one 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".

8. An "arrangement" is defined in section YA 1 as meaning:

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

9. "Tax avoidance" as defined in section YA 1 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.

10. The general anti-avoidance rule that applies for GST purposes is contained in section 76 of the Goods and Services Tax Act 1985. Section 76(1) provides that:

> "A tax avoidance arrangement entered into by a person is void against the Commissioner for tax purposes."

11. Section 76(2) states that:

> "A tax avoidance arrangement is one that directly or indirectly–
>
> (a) Has tax avoidance as its purpose or effect; or
>
> (b) Has tax avoidance as one of its purposes or effects, whether or not another purpose or effect relates to ordinary business or family dealings, if the purpose or effect is not merely incidental."

12. The definition of "arrangement" in section 76(8) of the GST Act is the same as the definition for income tax purposes set out in paragraph 8 above.

13. "Tax avoidance" is defined for GST purposes in section 76(8) as follows:

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

RECENT DEVELOPMENTS

14. Three anti-avoidance cases have been heard in the New Zealand Supreme Court in recent years. And another three anti-avoidance cases have been heard in the High Court. The most recent Supreme Court hearing was *Penny and Hooper* which concerned the salaries paid to the taxpayers by their family-owned companies. The Supreme Court's judgment in favour of the Commissioner has generated considerable discussion regarding what a commercially realistic salary might be in the context of a family owned company, when the income is derived through the taxpayer's personal exertion.

15. The most recent High Court hearing was *Alesco New Zealand Ltd and Ors v Commissioner of Inland Revenue (No. 2)* [2011] NZHC 1750 (12 December 2011); HC AK CIV 2009-404-2145. The case concerned interest deductions claimed on optional convertible notes (OCNs) issued by a New Zealand subsidiary to its Australian parent company. This judgment was also in the Commissioner's favour, and will influence the court proceedings of another 15 taxpayers.

16. In *Penny and Hooper* the Supreme Court found that the setting of salary levels by family-owned companies, which were otherwise perfectly legal and acceptable, were part of a tax avoidance arrangement. Therefore, from an anti-avoidance perspective, the relevant question is: What are the circumstances in which a legally effective series of transactions can be ignored and treated as a tax avoidance arrangement?

17. In *Glenharrow* a legally effective payment made by way of a promissory note was disregarded for GST purposes and the taxpayer was denied an input tax credit. The settlement of the promissory note was seen as commercially impossible and therefore, despite the legal transactions undertaken, the payment was treated, under section 76 of the GST Act, as not having been made.

18. In *Ben Nevis* depreciation deductions that arose as a result of a series of legal transactions were denied because the settlement of the promissory note that gave rise to those deductions was very doubtful, given that there appeared to be no intention to make the profit necessary to finance the settlement. There was no necessary business connection between the giving of the promissory note and the timing of the settlement 50 years later. The series of legal transactions under

which the depreciation deductions would have arisen were ignored under the general anti-avoidance rule.

19. In *Penny and Hooper* it was found under the general anti-avoidance provision that the taxpayers' salaries, fixed using legal company structures, had been correctly increased by the Commissioner to commercially realistic levels, because the overall commercial outcome of the low salaries paid was that profits retained in the taxpayers' companies (which were taxed at a lower rate than their salaries) quite quickly ended up in the taxpayers' hands without any more tax paid.

20. On the other hand, in *White v C of IR* [2010] NZHC 1826 (12 October 2010); (2010) 24 NZTC 24,600, a lower than market salary had also been paid, but the legal transactions were not ignored because the commercial result was not one where the income from personal exertion ended up in the hands of the taxpayer. This was a case where a commercially unrealistic salary did not result in the legal transactions being ignored under the general anti-avoidance rule.

21. In *Krukziener v C of IR (No 3)* [2010] NZHC 1714 (17 September 2010); (2010) 24 NZTC 24,563, the legal transactions (loans from the companies to Mr. Krukziener) were ignored because the commercial result was that Mr. Krukziener was remunerated for his personal efforts without paying any income tax. The case also raises questions about the circumstances in which drawings from a current account with a company could be treated as income.

22. In *Alesco* interest deductions were denied because of the finding that the option element of the OCNs (issued by a wholly-owned subsidiary to its parent company) had no real value and that therefore, an interest-free loan had in effect been provided at the commencement of the arrangement. Notably, compliance with the relevant international accounting standards, which resulted in a discounted fair value of the loan at commencement, was held to be an insufficient basis for claiming the deductions.

WHAT ARE THE RELEVANT QUESTIONS AND WHERE DOES THE AVOIDANCE ANALYSIS BEGIN?

23. The question, as suggested in paragraph 16, is: When will a New Zealand Court ignore a series of legal transactions and focus on the commercial outcome for tax avoidance purposes? The answer is: When the commercial outcome is beyond the scope and contemplation of Parliament when the relevant tax provisions were enacted.

24. As Blanchard J stated in the Supreme Court in *Penny and Hooper*:

> "[47] …the New Zealand general anti-avoidance provision…continues to have work to do whenever a taxpayer uses specific provisions in the Act and otherwise legitimate structures in a manner which cannot have been within the contemplation of Parliament."

25. The question then becomes: When will the commercial outcome be regarded as being beyond Parliamentary intention when the tax provisions were enacted? The answer to this question lies in the approach adopted by the Court when reviewing the facts of a case and the application of the relevant specific provisions and the general anti-avoidance provision to those facts.

26. The conclusion by a taxpayer or a tax advisor as to whether or not a particular plan of action constitutes tax avoidance must be based on a thought process that follows the likely legal analysis that would be undertaken by a Court.

27. Assuming the specific transactions stack up and are legally effective (i.e. they are not a "sham" – see paragraphs 28-30 below), the legal analysis must begin with a recognition of the distinction drawn by the Supreme Court between the specific provisions and the general anti-avoidance provision and the necessity to reconcile their potentially conflicting nature.

"SHAM" VS AVOIDANCE

28. First of all, the legal documentation must "stack up" – i.e. it must not be a sham. In *Ben Nevis* the Supreme Court described the concept of a "sham" at [33]-[34] as follows:

> "In essence, a sham is a pretence. It is possible to derive the following propositions from the leading authorities (*Snook v London & West Riding Investments Ltd* (1967) 2 QB 786 (CA); *Paintin & Nottingham Ltd v Miller Gale and Winter* (1971) NZLR 164 (CA) and *NZI Bank Ltd v Euro-National Corporation Ltd* (1992) 6 NZCLC 67,913):
>
> - A document will be a sham when it does not evidence the true common intention of the parties. They either intend to create different rights and obligations from those evidenced by the document or they do not intend to create any rights and obligations, whether of the kind evidenced by the documents or at all.
> - A document which originally records the true common intention of the parties may become a sham if the parties later agree to change their arrangement but leave the original document standing and continue to represent it as an accurate reflection of their arrangement.
> - A sham in the taxation context is designed to lead the taxation authorities to view the documentation as representing what the parties have agreed when it does not record their true agreement. The purpose is to obtain a more favourable taxation outcome than that which would have eventuated if documents reflecting the true nature of the parties' transaction had been submitted to the Revenue authorities."
>
> (formatting added)

29. The Supreme Court distinguished a "sham" from "avoidance" as follows:

> "[34] … A sham exists when documents do not reflect the true nature of what the parties have agreed. *Avoidance occurs, even though the*

documents may accurately reflect the transaction which the parties intend to implement, when, for (various) reasons…the arrangement entered into gives a tax advantage which Parliament regards as unacceptable….
[38] … The fact that… arrangements (are)… put in place with the purpose or effect of obtaining a tax advantage does not mean they (are)… a sham. … Those engaging in a sham are in reality seeking to deceive others as to the true nature of what they have agreed and are intending to achieve." (emphasis added)

30. If the documents evidencing the legal arrangements are not a sham, the next step is to review the use of the specific provisions in the light of those legal arrangements.

SPECIFIC RULES VS THE GENERAL ANTI-AVOIDANCE RULE : A GAME OF TWO HALVES?

31. In *Ben Nevis* the Supreme Court noted that the central issue was the difficulty in discerning the relationship between specific rules that allow tax concessions for certain arrangements and the general anti-avoidance rule. They referred at [82] to the following statement by Lord Wilberforce in *Mangin v C of IR* [1970] UKPC 23 (21 October 1970); (1970) NZLR 591 at p. 662:

> "(The general anti-avoidance section) 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?"

32. The Supreme Court in *Ben Nevis* referred to:

> "[102] …statutory language that expresses different legislative policies."

33. The Supreme Court then stated:

> "[102] … It has long been recognised those policies require reconciliation."

34. The Supreme Court went on to state that specific tax provisions and the general anti-avoidance provision are meant to work in tandem:

> "[103] 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)

A MOVE AWAY FROM RULE BASED JURISPRUDENCE

35. Hammond J in his concurring judgment in the Court of Appeal in *C of IR v Penny and Hooper* [2010] NZCA 231 (4 June 2010); (2010) 24 NZTC 24,287 noted:

> "[143] … Rule based jurisprudence is, intrinsically, easier and more certain: either something is within the rule, when it is properly understood, or it is not.
>
> [144] The effect of the construction placed on the taxation legislation by the Supreme Court is that the wider considerations postulated by Parliament are always going to be present. Whatever views may be taken of that as a matter of jurisprudential approach, or as to the practicalities of giving advice, that is what Parliament has done. And in avoidance cases it requires a more rigorous, and for that matter nuanced, approach by taxation advisers then a simple, "but this was within Rule X". *What might be termed a purely doctrinal approach to taxation advice on avoidance is thereby left in its twentieth century waste-paper basket*." (emphasis added)

36. Hammond J went on at [146]-[147] to discuss a statement by the American judge Learned Hand J in *Gregory v Helvering* 69 F 2d 809 (2nd Cir. 1934) denying the taxpayer in that case the tax benefits that should have arisen as a result of a share reorganisation:

> "… the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear and which all collectively create…. All (the) steps were real and their only defect was that they were not what the statute means by a reorganisation."

37. *The rigorous approach required is the legal analysis likely to be followed by the Courts to discern Parliamentary intention*. In *Ben Nevis* the Supreme Court's rationale for setting out the approach to be followed in tax avoidance cases was stated as follows:

> "[100] There has… been a recent judgment of the Privy Council in a tax avoidance case (*C of IR v Auckland Harbour Board* [2001] UKPC 1 (24 January 2001); (2001) 20 NZTC 17,008) which, while generally endorsing a scheme and purpose approach, appears to have placed significantly less emphasis on the application of the general anti-avoidance provision than did the majority judgment (of the Privy Council) in *Challenge Corporation Ltd v C of IR* [1986] UKPC 45 (20 October 1986); (1986) 8 NZTC 5,219. The Privy Council (in *Auckland Harbour Board)* has suggested that its role may be as a long stop. There is therefore continuing uncertainty about the interrelationship of the general anti-avoidance provision with specific provisions. *That makes it desirable for this Court to settle the approach which should be applied in New Zealand*." (emphasis added)

THE APPROACH SET OUT BY THE SUPREME COURT IN *BEN NEVIS*

38. The approach set down by the Supreme Court In *Ben Nevis* at [102]-[112] and [46]-[48] is as follows:

(a) The Courts must apply a principled approach that gives proper overall effect to statutory language that expresses different legislative policies. The approach must ensure that the particular case before the Court is examined by reference to the respective legislative policies.

(b) The approach 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.

(c) Neither specific tax provisions nor the general anti-avoidance provision should be regarded as overriding. They must be construed so as to give appropriate effect to each. They are meant to work in tandem. Each provides a context that assists in determining the meaning and, in particular, the scope of the other. They work together.

(d) The purpose of specific provisions must be distinguished from that of the general anti-avoidance provision. The presence in the New Zealand legislation of a general anti-avoidance provision suggests that 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 that is determined primarily by their ordinary meaning, as established through their text in the light of their specific purpose.

(e) Ascertaining when the "line is crossed" should be firmly grounded in the statutory language of the provisions themselves. Parliament must have envisaged that the way a specific provision was deployed would, in some circumstances, cross the line and turned what might otherwise have been a permissible arrangement into a tax avoidance arrangement. 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.

(f) A tax avoidance arrangement can be found in individual steps or in a combination of steps. Even if all the steps in arrangement are unobjectionable in themselves, their combination may give rise to a tax avoidance arrangement.

(g) A permissible tax advantage must be distinguished from an impermissible tax advantage. 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 anti-avoidance 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 that fall outside their intended scope in the overall scheme of the Act. Such uses give rise to an impermissible tax advantage that the Commissioner may counteract.

(h) The taxpayer must satisfy the Court that the use made of the specific provision is within its intended scope.

(i) The Court must construe the relevant documents in their commercial context, to ascertain the parties' obligations to each other, as if it were determining a dispute between them over the meaning and effect of their contractual arrangements.

(j) In proceeding in this way, the Court must also respect the fact that frequently in commerce there are different means of producing the same economic outcome which have different tax consequences. When considering the application of a specific tax provision, *before reaching any question of avoidance, the Court is concerned primarily with the legal structures and obligations the parties have created and not with conducting an analysis in terms of their economic substance and consequences, or of alternative means that were available for achieving the substantive result*.

(k) However, it is the true meaning of all provisions in a contract that will determine the character of a transaction rather than the label given to it.

(l) The next question is whether, when viewed in the light of the arrangement as a whole, the taxpayer has altered the incidence of income tax by use of the specific provision in a way which cannot have been within the contemplation and purpose of Parliament when it enacted the provision. If that is so, the arrangement will be a tax avoidance arrangement.

(m) The Court is not confined as to the matters which may be taken into account when considering whether a tax avoidance arrangement exists under the general anti-avoidance provision. The Commissioner and the Courts may address a number of relevant factors, the significance of which will depend on the particular facts. It will often be the combination of factors such as these in an arrangement that will be significant:

- 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.

- A classic indicator of the use being 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.

(n) 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 arrangements, 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.

(o) Care must be taken when applying English cases in the New Zealand context. To the extent that they have, over recent decades, adopted a more purposive approach to interpretation of tax legislation, English decisions, although not concerned with the reconciliation of potentially conflicting provisions, can provide helpful insights. The purposive approach is, however, limited in the extent to which it can avoid arrangements on its own. Such an approach is reinforced in New Zealand by the presence of the general anti-avoidance provision.

39. The Supreme Court noted that Courts should not strive to create greater certainty than Parliament has chosen to provide. Parliament has left the general anti-avoidance provision deliberately general. The approach outlined, in the Supreme Court's view, gives as much conceptual clarity as can reasonably be achieved. The Supreme Court felt that in most cases it will be possible, without undue difficulty, to decide on which side of the line a particular arrangement falls.

40. The detailed approach set out above was summarised as follows by Heath J in *Alesco* at [86]:

(a) An "arrangement" must exist, into which a taxpayer has entered;

(b) The "arrangement" must use specific provisions of the tax legislation to effect its purpose;

(c) The purpose or effect for which the specific provisions of the legislation have been used must fall outside those contemplated by Parliament; (Justice Heath stated that this third element appears to be derived from the definition of "tax avoidance arrangement");

(d) The use of the specific provisions for a purpose or effect outside Parliament's contemplation must result in a tax advantage producing purpose or effect that is more than "merely incidental".

WHAT IS AN ARRANGEMENT

41. The statutory definition of "arrangement" has been set out in paragraph 8.

42. There does not need to be an enforceable contract in order for there to be an arrangement. The Court of Appeal in *Penny and Hooper* had this to say about "arrangement":

> "[70] As already noted, the expression 'arrangement' is very broadly defined. Something less than an enforceable contract may constitute an arrangement for tax purposes. It may include a plan or understanding and also embraces all steps and transactions by which an arrangement is carried into effect."

43. An arrangement can consist of an individual step in a series of steps. In *Ben Nevis* the Supreme Court, described a tax avoidance arrangement as follows:

> "[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."

44. An arrangement remains so even if the decisions and steps constituting it are varied from year to year. On behalf of the majority in the Court of Appeal in *Penny and Hooper*, 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."

45. The Supreme Court stated in *Penny and Hooper* that there could be a tax avoidance arrangement in one year and not in another, depending on the purpose or effect on each occasion:

> "[34] Tax avoidance can be found in an individual step in a wider arrangement. That step, when taken, can make the wider arrangement a tax avoidance arrangement. Where a particular step is done repetitively, such as in this case in the annual setting of the salary levels, the step may or may not amount to a tax avoidance depending on its purpose or effect on each occasion."

46. In *Penny and Hooper*, the essential elements relied on by the Commissioner as constituting the tax avoidance arrangement were stated in the Court of Appeal judgment at [71] as follows:

(a) The decisions of the taxpayers in the relevant income years to operate their private practices through the company and family trust structure.

(b) The decisions by the relevant companies and the individual taxpayers to pay the respondents a salary that was substantially less than a commercially realistic salary.

(c) Channelling the company profits to the trusts and allowing the taxpayers to have the benefit of those funds without deriving such funds as their personal income.

(d) In Mr. Penny's case, the decision to advance funds to him from the trust which enabled him to access those funds for his personal benefit.

47. In *Krukziener* it was held that there was an arrangement resulting from the loans to Mr. Krukziener from various trusts and companies. Courtney J observed:

> "[24] Looking back over the relevant period, there emerges a pattern of substantial advances in respect of which only sporadic repayments were made, seemingly at the will of Mr. Krukziener and, apparently, coinciding with the availability of non-taxable capital distributions. The ever increasing level of advances, coupled with a relative lack of repayments over a long period of time, suggests a deliberate plan that there would be no requirement for Mr. Krukziener to repay the advances unless and until there was a capital distribution available to apply for that purpose. I therefore find that the TRA was correct in holding that an arrangement existed."

COMPLIANCE WITH SPECIFIC PROVISIONS

48. Where there is found to be an arrangement, the general anti-avoidance analysis proceeds to determining whether the use of the specific tax provisions (that have been relied on) is within the intended scope of those provisions. This was the rule set down by the Supreme Court in *Ben Nevis*:

> "[103] … 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….
> [106] … A specific provision is designed to give the taxpayer a tax advantage if it's use falls within its ordinary meaning. That will be a permissible tax advantage…
> [107] … *The taxpayer must satisfy the Court that the use made of the specific provision is within its intended scope*…." (emphasis added)

49. When considering whether the specific provisions have been complied with, the approach set down by the Supreme Court in *Ben Nevis* is as follows:

> "[46] …The Court must construe the relevant documents in their commercial context, to ascertain the parties' obligations to each other, as if it were determining a dispute between them over the meaning and effect of their contractual arrangements.
>
> [47] In proceeding in this way, the Court must also respect the fact that frequently in commerce there are different means of producing the same economic outcome which have different tax consequences. When considering the application of a specific tax provision, *before reaching any question of avoidance, the Court is concerned primarily with the legal structures and obligations the parties have created and not with conducting*

an analysis in terms of their economic substance and consequences, or of alternative means that were available for achieving the substantive result.

[48] (However)… it is the true meaning of all provisions in a contract that will determine the character of a transaction rather than the label given to it."

50. In *Glenharrow* the Supreme Court accepted that the specific provisions of the GST Act were satisfied because the parties were at arm's length:

"[44] …There is limited opportunity for manipulation if the parties are at arm's length. The consideration they agree upon can be expected to be an open market value as defined in s. 4…."

51. In *Ben Nevis* the requirements of the specific provisions that allowed depreciation of the license premium were satisfied:

"[43] … putting aside at this stage the question of tax avoidance, which must be considered separately, we are satisfied that the effect of the legislative provisions is that the license premium payable by the syndicate is depreciable property and deductible if, on the proper meaning of the words, the payment is for the "right to use land"…

[54] The ultimate question in this aspect of the appeals is whether, under the agreements, the license premium is paid for the right to use land in terms of the specific provision… The license provides the syndicate with the necessary access to Trinity 3's land to perform its forestry obligations, for which it incurs the license premium as a cost. To treat the agreement as linking the premium payment to the right to share in profits… would be to allow overall economic consequences to dictate the character of the payment. That character is plain on the terms of the documents. That the access is to enable the syndicate to perform obligations to the land-owner does not in any sense contradict the contractual terms. Nor does it make the legal construct something other than what on its face it is – a right of the taxpayer to go onto land to conduct an aspect of its business. In these circumstances the character of the payment, which the parties called a license premium, is a "right to use land" within the terms of the specific provision. It follows that, subject to the issue of avoidance, the payment is deductible as depreciation on depreciable property."

52. In *Penny and Hooper* the requirements of the specific provisions that allowed the taxpayers to determine the salaries they received from their private companies were satisfied. The Supreme Court stated:

"[33] … 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… 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…. But again, there was no failure to comply with any

> express requirement of the Act in the setting of the salaries, since there is none. This is therefore a case in which compliance in other respects being accepted, it is possible to move straight to s BG 1…."

53. Similarly, in *White* both the Taxation Review Authority and the High Court accepted that the specific provisions were met. In the High Court Heath J stated:

> "[67] The relevant uncontested findings of fact made by the Authority were:….
>
> > b) Dr White and her husband reconstructed their financial affairs to overcome a genuine concern about potential exposure to claims by clients in respect of their separate private professional services/business and, consequentially, to protect their family. In doing so they adopted a legitimate corporate structure approved by the Act."

54. In *Krukziener* also it was undisputed that the specific provisions had been complied with:

> "[39] …If the true character of the advances was a loan, then it would also be true that it had not been received by Mr Krukziener in the sense discussed. I did not, however, apprehend (the Commissioner's Counsel) to dispute that; rather, the Commissioner's case focused on the second aspect of the *Ben Nevis* enquiry…"

55. And similarly, in *Alesco*:

"[88] … the Commissioner accepts that Alesco NZ claimed interest deductions to which it was entitled on a strict application of the provisions of the financial arrangement rules, including G22 and G23…"

THE CHOICE PRINCIPLE: ENDORSED WITH QUALIFICATIONS

56. As noted previously in paragraph 49, in *Ben Nevis* the Supreme Court accepted that there may be different ways of achieving the same economic outcome, and the review of adherence with specific provisions should look at the actual means adopted:

> "[47] … the Court must also respect the fact that frequently in commerce there are different means of producing the same economic outcome which have different tax consequences….. before reaching any question of avoidance, the Court is concerned primarily with the legal structures and obligations the parties have created and *not with conducting an analysis* in terms of their economic substance and consequences, or *of alternative means that were available for achieving the substantive result*. (emphasis added)

57. However, further in *Ben Nevis* the Supreme Court cautioned that the taxpayer's choice may be curtailed by the general anti-avoidance provision:

> "[111] … 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*." (emphasis added)

58. In *MacNiven v Westmoreland Investments Ltd (HMIT)* [2001] UKHL 6 (8 February 2001); (2001) BTC 44, Lord Hoffman in the House of Lords judgment quoted the 'celebrated passage' by Lord Greene MR in *IR Commrs v Wesleyan and General Assurance Society* (1946) 30 TC 11, 16 at [60]:

> "In dealing with income tax questions it frequently happens that there are two methods at least of achieving a particular financial result. If one of those methods is adopted, tax will be payable. If the other method is adopted, tax will not be payable. It is sufficient to refer to the quite common case where property is sold for a lump sum payable by instalments. If a piece of property is sold for £1000 and the purchase price is to be paid in 10 instalments of £100 each, no taxes payable. If, on the other hand, the property is sold in consideration of an annual fee of £100 a year for 10 years, tax is payable. The net result from the financial point of view is precisely the same in each case, but one method of achieving it attracts tax and the other method does not."

59. In *Ben Nevis* the Supreme Court referred at [193] to Richardson J's famous dictum in the Court of Appeal judgment in *Challenge Corporation v C of IR* (1986) 8 NZTC 5,001:

> "Clearly the legislature could not have intended that (the general anti-avoidance section) should override all other provisions of the Act so as to deprive the taxpaying community of structural choices, economic incentives, exemptions and allowances provided for by the Act itself…
>
> On the other hand (the general anti-avoidance section) would be a dead letter if it were subordinate to all the specific provisions of the legislation. It, too, is specific in the sense of being specifically directed against tax avoidance and it is inherent in the section that but for its provisions the impugned arrangements would meet all the specific requirements of the income tax legislation. In some cases then this section imposes an additional requirement. In others, this is a common application of the section in cases where trusts and companies are employed for planning purposes, while the use of that machinery is regarded as perfectly legitimate and not on its own affected by (the general anti-avoidance section), it may be only one element in a wider arrangement which is caught by the section."

60. Similarly, in the context of the GST Act, Robertson J in the Court of Appeal judgment in *Glenharrow Holdings Limited v C of IR* (2007) 23 NZTC 21,564 stated:

> "[55] A general tax avoidance provision like s 76 (of the GST Act) is not about denying taxpayers choices as to how they arrange their affairs. Nor does it prevent the securing of tax advantages for which the legislation

legitimately provides" *Challenge Corporation v C of IR* (CA) per Richardson J. *General tax avoidance provisions are aimed at transactions that undermine the integrity of the tax legislation*." (emphasis added)

COMPLIANCE WITH THE GENERAL ANTI-AVOIDANCE RULE

61. Where the specific provisions have been properly complied with, following the Supreme Court's approach in *Ben Nevis*:

> "[107] … 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."

62. The Supreme Court made it clear in *Ben Nevis* that the Courts are not limited to purely legal considerations when considering general anti-avoidance:

> "[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 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." (emphasis added)

CROSSING THE LINE: PERMISSIBLE VS IMPERMISSIBLE ARRANGEMENTS

63. The distinction between a permissible arrangement and a tax avoidance arrangement depends on the way in which the specific provision is used. In *Ben Nevis* the Supreme Court said:

> "[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…."

64. In the Court of Appeal judgment of in *C of IR v BNZ Investments Limited* [2001] NZCA 184; (2001) 20 NZTC 17,103, Richardson P stated:

> "[42] Line drawing represents the legislature's balancing of the relevant public interest considerations. In terms of (the general anti-avoidance section), that *line drawing is directed to three elements*, each of which contains its own limits. There must be an arrangement coming within the section. The arrangement must have a more than merely incidental purpose or effect of tax avoidance. And where those two ingredients are present, the assessable income of any person affected by the arrangement is adjusted so as to counteract any tax advantage obtained by that person

from or under that arrangement." (emphasis added)

65. Crossing the line in a GST context was considered by the Court of Appeal in *Glenharrow*:

> [56] It follows that in order to decide whether an arrangement involves tax avoidance the courts must look for something more than a taxpayer merely taking steps to alter, avoid, reduce or postpone the incidence of their tax liability. *A line must be crossed*.
>
> [57] The importance of the concept of line drawing was summarised by Lord Millett in *Peterson v C of IR* [2005] UKPC 5 (28 February 2005; 2005) 22 NZTC 19,098 when he said:
>
> > "The critical question is whether the tax advantage they obtained amounted to 'tax avoidance' capable of being counteracted by (the general anti-avoidance provision), for the Courts of New Zealand have long recognised that not every tax advantage comes within the scope of the section; only those which constitute tax avoidance as properly understood do so."….
>
> [59] …. *tax avoidance can be found where there is a significant divergence between the legal reality of the transaction and its actual or economic reality*. In *Commissioners of Inland Revenue v Willoughby* [1997] UKHL 29; [1997] 1 WLR 1071 at 1079 (HL), Lord Nolan stated:
>
> > "The hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be suffered by any taxpayer qualifying for such reduction in his tax liability."
>
> (emphasis added)

66. Hammond J, in his judgment concurring with the majority Court of Appeal judgment in *Penny and Hooper* referred at [156] to "another of the succinct observations of (American judge) Learned Hand J in *Gregory v Helvering* as to the choice principle" as follows:

> "A transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one chose, to evade, taxation. Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."

67. The Supreme Court in *Penny and Hooper* defended the taxpayers' right to choose as follows:

> "[33] … The structure both taxpayers adopted when they transferred their business (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 be tax avoidance. It was a choice the taxpayers were entitled to make."

68. The problem in *Penny and Hooper* was stated as follows by Hammond J in the Court of Appeal:

> "[157] … the intertwined economic and commercial effects of what was done, in their proper legislative context, seems to me to be as follows:
>
> > (i) Income derived from personal exertion should belong in its appropriate taxation band – here the highest band - in a graduated personal tax scheme. It should not be inappropriately diverted away….
> >
> > (iv) Very significantly they (the respondents) retained control over the whole of the income generated (notwithstanding the company/trust structure)
>
> [159] Some comments are appropriate with respect to proposition (i) above. That issue turns on the overall Parliamentary intent and scheme…. Did Parliament intend that individual taxpayers could "band-hop", as these respondents did, by interposing other legally cognisable vehicles in response to tax band alterations?...
>
> [160] The answer, or so it seems to me, is to be found in the very structure of the legislation itself, or as it is sometimes put, the scheme of the Act. The New Zealand legislation before us has a graduated rate structure. It is one of the most elemental features of that legislation, which rests on facets of public policy (including social justice) which Parliament saw to be very important. Artificial endeavours to avoid that structure have been firmly discouraged by this Court…"

69. In *Alesco* Heath J commented on the use of the OCNs as follows:

> "[108] The way in which the intercompany advances were to be structured was driven solely by tax considerations. This was not an "agreement" to lend money on particular terms. It was a way for members of the Alesco Group to obtain New Zealand tax benefits, thereby reducing the transaction costs of acquiring the two businesses.
>
> [109] … The Notes were nothing more than a means of attaining the New Zealand tax benefits identified by KPMG."

70. Taxpayers are therefore free to choose how they structure their arrangements and they are free to alter the incidence of their tax liability as a result of doing so. They are not, however, allowed to "cross the line" which can be drawn between the use of specific provisions that are within the purpose and contemplation of Parliament and those that are not.

71. The limitation of the choice principle was nicely summarised by Hammond J in the Court of Appeal in *Penny and Hooper* when he described the approach adopted by the US Federal Courts:

> "[153] … what cannot be allowed is an approach that allows taxpayers not only to take advantage of loopholes, but to in effect manufacture circumstances in which they arise. That would be ruinous to the revenue and wrong."

WHEN ALTERING THE INCIDENCE OF TAX IS PERMITTED

72. The Supreme Court in *Ben Nevis* stated at [113]-[114] that the use of specific provisions that alter the incidence of tax is permitted in two situations:

- The first situation where an alteration in the incidence of tax is permitted is when the specific provision is used in a manner that is within Parliamentary contemplation.

- The second situation where an alteration in the incidence of tax is permitted is when the tax avoidance purpose or effect of the arrangement is "merely incidental" (following paragraph (b) of the definition of a "tax avoidance arrangement" – see paragraph 7 above). If that is so, the arrangement is not a tax avoidance arrangement.

73. As already noted in paragraph 3**,** the Supreme Court took the view that it will rarely be the case that the use of a specific provision in a manner which is outside Parliament contemplation could result in the tax avoidance purpose or effect of the arrangement being merely incidental.

THE *CHALLENGE* HERITAGE AND THE ENGLISH PURPOSIVE APPROACH

74. The Supreme Court in *Ben Nevis* commented on the use of the English purposive approach to identify a permissible tax advantage when a specific provision is used in a manner that is within Parliamentary contemplation:

> "[110] English decisions provide limited direct assistance. To the extent that they have, over recent decades, adopted a more purposive approach to interpretation of tax legislation, they provide helpful insights. They are not, however, concerned with the reconciliation of potentially conflicting provisions. United Kingdom tax legislation has never had a general anti-avoidance provision. As a result of this difference it has been suggested that the English purposive approach involves considerations that are somewhat removed from the wording of the New Zealand statute (Freedman *Interpreting Tax Statutes: Tax Avoidance and the Intention of Parliament* (2007) 123 LQR 53, p 65). 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. Care must, therefore, be taken when applying English cases in the different New Zealand context in which the meaning and scope of the general anti-avoidance provision, as well as that of specific provisions, must be addressed and applied."

75. In reading down the English purposive approach and identifying a clear distinction between compliance with specific provisions and compliance with the general anti-avoidance rule, the Supreme Court appears to have been significantly influenced by the purposive approach apparently adopted by the Court of Appeal in *Challenge Corporation v C of IR* (1986) 8 NZTC 5,001 and the subsequent different interpretation placed on the purposive approach by the

Privy Council in the same case: *C of IR v Challenge Corporation* [1986] UKPC 45 (20 October 1986); (1986) 8 NZTC 5,219. The Court of Appeal held that the general anti-avoidance section was not applicable because the specific provisions had been properly complied with. The Privy Council's view was that the general anti-avoidance section overrode compliance with the specific provisions, and legal compliance with the specific provisions did not exclude the application of the general anti-avoidance section if, when an arrangement is viewed in the light of its overall commercial outcome, a tax avoidance purpose or effect is more than merely incidental.

76. In *Ben Nevis* the Supreme Court referred, at [87], to the following famous dictum of Richardson J in the Court of Appeal judgment in *Challenge*:

> "(The general anti-avoidance section) 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 (the general anti-avoidance section) 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 (the general anti-avoidance section) 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. It is not the function of (the general anti-avoidance section) to defeat other provisions of the Act or to achieve a result which is inconsistent with them."

77. The problem with the approach adopted by Richardson J in *Challenge*, as the Supreme Court noted in *Ben Nevis*, was that:

> "[89] The effect (of the Richardson J approach) was to reconcile conflicting provisions by reading down the scope of (the general anti-avoidance section) so that it did not operate on arrangements that complied with the specific provision in the legislation. The scheme and purpose of the legislation required that (the general anti-avoidance section) be read in the context of the special concession provisions which were dominant."

78. The Supreme Court noted with approval, at [92], the rejection of this argument by the Privy Council and quoted Lord Templeman as follows:

> "That argument cannot be correct. Tax avoidance schemes largely depend on the exploitation of one or more exemptions or reliefs or provisions or principles of tax legislation. (The general anti-avoidance section) would

be useless if a mechanical and meticulous compliance with some other section of the Act was sufficient to oust (the general anti-avoidance section). Richardson J, giving judgment in the Court of Appeal in favor of *Challenge*, nevertheless recognised that '(the general anti-avoidance section) would be a dead letter if it were subordinate to all the specific provisions of the legislation'."

79. *The crucial aspect of the Privy Council's judgment in Challenge in the Supreme Court's view was the finding that there was a failure to construct the transaction in a way that met the purpose of the specific provision of the legislation*. That element of the transaction meant that the general anti-avoidance section applied to strike down the arrangement which otherwise complied with the specific provision. *The Privy Council in Challenge did not accept that on a purposive approach the application of (the general anti-avoidance provision) could be limited in a way that ignored the economic reality of the transaction as contemplated by the specific provision. In essence, the reasoning of the Privy Council in Challenge required the commercial reality of a transaction to be consistent with its legal form.*

80. The Supreme Court appears to have reconciled these conflicting views by elevating Lord Templeman's views in the Privy Council in *Challenge Corporation* to the second stage of the general anti-avoidance analysis.

81. There are two conclusions that can be drawn here:

(a) First, a purposive approach can be helpful in determining whether an arrangement is within the purpose and contemplation of Parliament insofar as adherence to the relevant specific provisions is concerned. The Supreme Court referred to the approach being *reinforced* by the presence of the general anti-avoidance provision.

(b) Second, an arrangement that may not be tax avoidance based on the purposive approach alone, could be found to be tax avoidance under the general anti-avoidance provision. This will be so when the tax avoidance purpose or effect of the arrangement is more than merely incidental. English case precedents cannot be used *per se* to argue that there has been no tax avoidance.

82. The English purposive approach focuses solely on the purpose for which a particular provision was enacted, given that there is no separate general anti-avoidance provision in the English legislation. Hence the limitations referred to by the Supreme Court, which implies that the English purposive approach does not go far enough when considering the overall economic effects of an arrangement. The various doctrines and rules developed over the years by the English Courts limit the extent to which the overall commercial outcome of an arrangement can be examined in the light of Parliament's contemplation and purpose when the specific provision was enacted.

83. The issue that the Supreme Court wants Courts at first instance to address is: what did Parliament intend when enacting a particular provision, which will determine whether a series of legal transactions will be ignored on the basis of the commercial outcome. Where the specific tax provision relates to a

commercial outcome, Parliamentary intention should be discerned on the basis of the commercial outcome. In this regard, the more recent English cases remain useful as a first point of reference. As Lord Hoffman said in *Westmoreland Investments*:

> "[39] …. If 'the legal position' is that tax is imposed by reference to a legally defined concept, such as stamp duty payable on a document which constitutes a conveyance on sale, the court cannot tax a transaction which uses no such document on the ground that it achieves the same economic effect. On the other hand, if the legal position is that tax is imposed by reference to a commercial concept, then to have regard to the business 'substance' of the matter is not to ignore the legal position but to give effect to it."

84. A New Zealand example of this is the circumstances in which a tax liability arises upon the forgiveness of debt under the financial arrangements rules. In a commercial sense, there is no income in such circumstances. However there will be a tax liability that is unrelated to the commercial outcome. If there is no forgiveness of debt there will be no tax even if the debt remains unpaid and may not be able to be repaid.

85. In *Westmoreland Investments*, Lord Nicholls of Birkenhead referred to the decision in *Ramsay (WT) Ltd v IR Commrs* [1981] UKHL 1 (12 March 1981); (1982) AC 300 and noted at paragraphs 2 - 5 that *Ramsay* brought out three points in particular:

> "[2] … First, when it is sought to attach a tax consequence to a transaction, the task of the courts is to ascertain the legal nature of the transaction….
>
> [4] Second, this is not to treat a transaction, or any step in a transaction as though it were a 'sham', meaning thereby, that it was intended to give the appearance of having a legal effect different from the actual legal effect intended by the parties…. Nor is this to go behind a transaction for some underlying substance…
>
> [5] Third, *having identified the legal nature of the transaction, the courts must then relate this to the language of the statute*. For instance, if the scheme has the apparently magical result of creating a loss without the taxpayers suffering any financial detriment, is this artificial loss a loss within the meaning of the relevant statutory provision? Thus, in *Ramsay*… Lord Wilberforce at p. 326, observed that a loss which comes and goes as part of a pre-planned, single continuous operation 'is not such a loss (or gain) as the legislation is dealing with'." (emphasis added)

86. Lord Nicholls went on to state:

> "[6] As noted by Lord Steyn in *IR Commrs v McGuckian* [1997] UKHL 22 (12 June 1997); (1997) 1 WLR 991 at p. 1000, this is an *exemplification of the established purposive approach* to the interpretation of statutes. *When searching for the meaning with which Parliament has used the statutory language in question, courts have regard to the underlying purpose that the statutory language is seeking to achieve*. Likewise, Lord Cooke of Thorndon regarded *Ramsay* as an application to taxing Acts of the general

> approach to statutory interpretation whereby, in determining the natural meaning of particular expressions in their context, weight is given to the purpose and spirit of the legislation…". (emphasis added)

87. Also in *Westmoreland*, Lord Hoffman when discussing the *Ramsay* case stated:

> "[29] … There is ultimately only one principle of construction, namely to ascertain what Parliament meant by using the language of the statute. All other 'principles of construction' can be no more than guides which past judges have put forward, some more helpful or insightful than others, to assist in the task of interpretation."

88. Lord Hoffman then discussed Lord Wilberforce's judgment in *Ramsay* as follows:

> "[32] My lords, it is worth pausing at this point to examine the characteristically compressed reasoning in a little more detail. A loss which arises at one stage of an indivisible process and is cancelled out at a later stage of the same process is 'not such a loss as the legislation is dealing with'…. The contrast being made throughout Lord Wilberforce's speech is between juristic or arithmetical realities on the one hand and commercial realities on the other… The innovation in the *Ramsay* case was to give the statutory concepts of 'disposal' and 'loss' a commercial meaning. *The new principle of construction was a recognition that the statutory language was intended to refer to commercial concepts, so that in the case of a concept such as a 'disposal', the court was required to take a view of the facts which transcended the juristic individuality of the various parts of a pre-planned series of transactions*." (emphasis added)

89. Further on in *Westmoreland* at [36] Lord Hoffman quoted from the judgment of Learned Hand J in *Helvering v Gregory* when, in holding that the transfer of shares from a company to its subsidiary in that case did not fall within the terms of the statutory exemption, he stated:

> "We cannot treat as inoperative the transfer of… shares by [A] [or] the issue of shares by [B] of its own shares… [B] had a juristic personality… All the steps were real, and, *their only defect was that they were not what the statute means*." (Lord Hoffman's emphasis)

90. The English purposive approach can be reconciled with the New Zealand Supreme Court's approach to some extent by reference to Lord Hoffman's comments later in *Westmoreland* when he discusses the *McGuckian* case. In *McGuckian* the right to receive a dividend was assigned in consideration of the payment of a sum equal to 99% of the expected dividend. Lord Hoffman stated:

> "[54] … The fact that the assignment had no commercial purpose did not mean that it had to be disregarded. <u>But it failed to perform the alchemy of transforming the receipt of a dividend from the company into the receipt of a capital sum from someone else. For the purpose of the fiscal concept at stake, namely the character of the receipt as income derived from the company, it made no difference</u>."

91. In *Glenharrow* and *Ben Nevis* the giving of the promissory notes failed to create a payment that was effective for GST and tax depreciation purposes, respectively. In *Penny and Hooper* the reduced salaries were not recognised as legitimate means of increasing the companies' profits and in *Krukziener* income was derived as a result of the interest-free loans. In *Alesco* the option element of the OCNs failed to create a loan advanced at a discount. However, the reason advanced by the Courts in all of these cases was the application of the general anti-avoidance provision, and not the specific fiscal concept involved.

92. The limits of the English purposive approach can be discerned from the following statements by Lord Hoffman in *Westmoreland*:

> [61] "It follows that a transaction which, for the avoidance of tax, has been structured to produce, say capital, and does produce capital in the ordinary commercial sense of that concept…cannot be "recharacterised" as producing income: see *IR Commrs (New Zealand) v Wattie & Anor* [1998] UKPC 43 (29 October 1998); 18 NZTC 13,991.
>
> [62] … If I may be allowed to repeat what I said in *Norglen Ltd v Reeds Rains Prudential Ltd* (1999) 2 AC 1, at pp. 13-14:
>
> > "Tax avoidance schemes… either work… or they do not… If they do not work, the reason as… Lord Steyn, pointed out in *McGuckian*…, is simply that upon the true construction of the statute, the transaction which was designed to avoid the charged tax actually comes within it. *It is not that the statute has a penumbral spirit which strikes down devices or stratagems designed to avoid its terms or exploit its loopholes*." (emphasis added)

93. The Supreme Court effectively endorsed the focus on "the true construction of the statute" in *Ben Nevis:*

> "[104]… Ascertaining when (the deployment of a specific provision will cross the line into tax avoidance) 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."

94. However, it is the last sentence in the quote from Lord Hoffman (emphasised) above where the New Zealand Supreme Court has decided that the New Zealand legislation diverges from the UK legislation. The Supreme Court has made it clear that *in New Zealand we do have a penumbral spirit in the form of a general anti-avoidance provision*. In effect, the Supreme Court has required a purposive approach to be taken in relation to the application of the general anti-avoidance provision itself – i.e. a review of the economic and commercial outcome of an arrangement in light of Parliament's purpose in enacting section BG 1 read in the context of the scheme and purpose of the tax legislation as a whole.

MERELY INCIDENTAL PURPOSE OR EFFECT OF TAX AVOIDANCE

95. The second situation where an alteration in the incidence of tax is permitted is when the tax avoidance "purpose or effect" of the arrangement is "merely incidental" (following paragraph (b) of the definition of a "tax avoidance arrangement" – see paragraph 7 above). If that is so, the arrangement is not a tax avoidance arrangement.

96 The converse of this proposition was stated by the Supreme Court in *Ben Nevis*:

> "[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." (emphasis added)

97. The phrase "merely incidental purpose or effect" requires there to be a "purpose or effect" of tax avoidance which must be "merely incidental".

98. It is generally accepted that "merely incidental" is not a reference to the scale of the tax benefit obtained. There is a useful discussion by Willy DCJ in *Case X1* (2005) 22 NZTC 12,001 of what the words "merely incidental" mean in the context of the definition of "tax avoidance":

> "[375] Mr. Clews submits:
> 'If the income tax outcomes are the product of transactions which achieve real and tangible commercial ends such outcomes are in the classic sense incidental to the commercial ends that were achieved.'
> [376] I agree that such a proposition accords with the dictionary definition of 'incidental':
> 'Occurring in connection with or as a result of something else'…
>
> [377] There is in my view nothing pejorative about the use of the adverb 'merely' in the sense that Parliament intended to dilute the meaning of 'incidental'. To the contrary, I take the view that in exempting from the tax avoidance net, the incidental purposes or effects of transactions which result in less tax being paid… Parliament has recognised the common law jurisprudence discussed (earlier in the case)."
>
> [379] In a most helpful memorandum Mr. Clews has traced the origin of the "incidental" test to the speech of Lord *Diplock* in *Europa Oil (NZ) Limited v C of IR (2); C of IR v Europa Oil (NZ) Limited (2)* [1976] UKPC 1 (13 January 1976); (1976) 2 NZTC 61,066, in which His Lordship said at p. 61,074:
>
> > "Fourthly the section in any case does not strike down transactions which do not have as their main purpose or one of their main purposes tax avoidance. It does not strike down ordinary business or commercial transactions which *incidentally result in some saving of tax*. There may be different ways of carrying out such transactions. They will not be struck down if the method chosen

> for carrying them out involves a payment of less tax than would be payable if another method was followed. In such cases *the avoidance of tax will be incidental to and not the main purpose of the transaction or transactions which will be the achievement of some business or commercial object*…". (Counsel's emphasis)"

99. "Purpose or effect" was considered by the Supreme Court in *Glenharrow* in the context of section 76 of the GST Act:

> "[35] … the Commissioner must have been properly satisfied that the arrangement was entered into between the parties to it to defeat the intent and application of the Act or any provision of the Act. This does not mean that the Commissioner must be satisfied that the parties subjectively had that defeating purpose, i.e. that they were consciously trying to achieve the end of defeating the intent and application of the Act…. Whether or not a particular arrangement constitutes tax avoidance should not depend on difficult judgments about what the taxpayer had in mind. If it did, a scheme which was void if devised and implemented by one taxpayer could be immune from s 76 if developed by another in different circumstances…."

100. What is required of the Commissioner and the Court is to ask what objectively was the purpose of the arrangement, which in turn requires examination of the effect of the arrangement. In *Glenharrow* the Supreme Court referred to *Newton v Commissioner of Taxation of the Commonwealth of Australia* (1958) AC 450 at p 465 where Lord Denning said that in the phrase "purpose or effect", in the Australian general anti-avoidance provision of that time, the word "purpose" meant not motive but the effect which it was thought to achieve – the end in view:

> "[38] What Lord Denning was emphasising was that 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….
>
> It is because the objective purpose is deduced from the effect that the phrase "purpose or effect" in general anti-avoidance provisions has been said to be a composite term….
>
> [40] … The assessment will principally be a matter of inference from the arrangement and its effect. The purpose of an arrangement will be deduced from the arrangement itself and its effect…"

101. Among the recent cases reviewed: *Glenharrow*, *Ben Nevis*, *White*, *Krukziener*, *Penny and Hooper* and *Alesco*, the only case in which the tax avoidance purpose or effect was held to be merely incidental was in *White*, where Heath J stated:

> "[75] The fact that the company happened to make a loss should not turn an otherwise acceptable business arrangement into one characterized as artificial or a contrivance. While the *effect* of the arrangement was (for unforeseen reasons) to negate the need for Dr White to pay income tax, its purpose was not to obtain an impermissible tax advantage. In my view, the purpose or effect of the arrangement was not to avoid the payment of tax, having regard to the way in which the authorities have defined the words "purpose or effect" as a composite phrase. Even if that conclusion were wrong, I consider that purpose or effect was "merely incidental" and therefore fall outside the scope of the definition of tax avoidance."

102. As a final note, it is worth mentioning that the distinction between tax mitigation and tax avoidance has no bearing on the analysis. In noting that the distinction is now seen as conclusory and unhelpful, the Supreme Court appears to have adopted the reasoning of Lord Hoffman in *Westmoreland*:

> "[62] … But when the (English) statutory provisions do not contain words like 'avoidance' or 'mitigation' I do not think that it helps to introduce them. The fact that steps taken for the avoidance of tax are acceptable or unacceptable is the conclusion at which one arrives by applying the statutory language to the facts of the case. It is not a test for deciding whether it applies or not."

ARTIFICIALITY: TAX AVOIDANCE MORE THAN MERELY INCIDENTAL

103. If an arrangement has a purpose or effect of tax avoidance, the question is whether such a purpose or effect is merely incidental. It is when looking at this aspect that the Supreme Court has sanctioned the Courts going beyond purely legal considerations, and looking at the commercial reality and the economic effect of the use of specific provisions. Other non-tax avoidance purposes or effects will be important. But the artificiality of the arrangement, if any, will be a crucial determinant of whether the arrangement amounts to tax avoidance.

104. The focus is on contrivance, as the Supreme Court noted in *Penny and Hooper*:

> "[47] … Woodhouse P said (in the Court of Appeal) in *Challenge Corporation* 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…."

105.In this respect, the Supreme Court's approach is not significantly different from Lord Brightman's statement in *Furniss v Dawson & Ors* (1984) BTC 71; (1984) AC 474, at 527, of the conditions under which the commercial nature of a transaction as a whole would transcend the juristic individuality of its parts:

> "First, there must be a pre-ordained series of transactions; or, if one likes, one single composite transaction….Secondly, there must be steps inserted which have no commercial (business) *purpose* apart from the avoidance of a liability to tax – not "no business *effect*". If these two ingredients exist,

the inserted steps are to be disregarded for fiscal purposes. The court must then look at the end result. Precisely how the end result will be taxed will depend on the terms of the taxing statute sought to be applied."

106. In *Westmoreland Investments* Lord Hoffman discussed *Furniss v Dawson* and noted at [49] that before one can apply Lord Brightman's words, "*it is first necessary to construe the statutory language and decide that it refers to a concept which Parliament intended to be given a commercial meaning capable of transcending the juristic individuality of its component parts*". (emphasis added)

107. In *Glenharrow* the Supreme Court stated:

> "[53] This is not to say that an exchange of cheques accompanied by a transfer of property and a mortgage back to the vendor can ordinarily be regarded as an artificial procedure. The contrary is true…. However in this case that procedure was inserted into a "pay as you go" transaction so as to produce an artificial effect with consequent tax advantage, contrary to all economic reality."

108. In *Ben Nevis* the Supreme Court stated:

> "[147] … We do not accept this as being the principal purpose of the promissory note. Its 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…. Hence the promissory note was a artificial payment implemented for taxation purposes…. The purported payment did not give rise to any economic consequences on either side."

109. And in *Penny and Hooper* the Supreme Court said:

> "[49] … If the salary is not commercially realistic or, objectively, is not motivated by a legitimate (that is, non-tax driven) reason, it will be open to the Commissioner to assert that it was, or was part of, a tax avoidance arrangement….
>
> [50] … it would be strange if someone were not for tax purposes permitted to assign income of this kind but could still construct artificially a means of obtaining the same effect for a purpose of altering the incidence of taxation…"

110. In *Alesco* Heath J noted that:

> "[108] The way in which the intercompany advances to be made by Alesco Corporation to Alesco NZ were to be structured was driven solely by tax considerations. This was not an "agreement" to lend money on particular terms. It was a way for members of the Alesco Group to obtain New Zealand tax benefits, thereby reducing the transaction costs of acquiring the two businesses.
>
> [109] … The Notes were nothing more than a means of attaining the New Zealand tax benefits identified by KPMG."

111. In *Ben Nevis* the Supreme Court at [96] quoted the joint judgment of Richardson P, Keith and Tipping JJ in *C of IR v BNZ Investments Limited* [2001] NZCA 184 (22 May 2001); (2001) 20 NZTC 17,103:

> "[40] Line drawing and the setting of limits recognise the reality that commerce is legitimately carried out through a range of entities and in a variety of ways; that tax is an important and proper factor in business decision-making and family property planning; that something more than the existence of a tax benefit in one hypothetical situation compared with another is required to justify attributing a greater tax liability; *that what should reasonably be struck at are artifices and other arrangements which have tax induced features outside the range of acceptable practice*–as Lord *Templeman* put it in *Challenge*, most tax avoidance involves a pretence; and that certainty and predictability are important but not absolute values." (emphasis added by the Supreme Court)

112. The Supreme Court then stated:

> "[97] … As the passage (above) we have emphasised makes plain, 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…."

113. In *Glenharrow*, after noting that the arrangement "produce(d) an artificial effect with consequent tax advantage, contrary to all economic reality", the Supreme Court concluded that:

> "[54] … It cannot be said that, looked at objectively, the tax advantage was merely incidental to the commercial decisions of the parties to the arrangement."

114. In *Ben Nevis* the Supreme Court after noting that "the giving of the promissory note had no necessary business connection with (the 50 year) period" stated:

> "[147] … The promissory note was an artificial payment implemented for taxation purposes…
>
> [148] … We regard the insurance dimension of the Trinity scheme as both artificial and contrived…. The insurance arrangements, as constructed cannot have been within the contemplation of Parliament when it enacted (the specific provision). In short, the insurance dimension is a material contributor to making the whole Trinity scheme a tax avoidance arrangement."

115. In *Penny and Hooper* the Supreme Court stated:

> "[47] … The policy underlying the general anti-avoidance provision is to negate any structuring of the 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. That must include using a company structure to fix the taxpayer's salary in an artificial manner….
> (The artificially low salary settings) 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*."

116. In *Alesco* Heath J stated:

> "[112] … Alesco Corporation held a 100% of Alesco NZ's capital. Had Alesco Corporation exercised the option, it would have held 78,100,000 shares. Yet, no change to Alesco NZ's status as a wholly-owned subsidiary would have been effected. No commercial purpose was served by Alesco NZ providing an option for Alesco Corporation to convert the debt to shares. This aspect of the arrangement was artificial…
>
> [113] In this case, unlike an arm's length transaction, there was no negotiation… no account was taken of factors such as appropriate coupon rate, the number of shares that may be offered to discharge the debt on conversion, and the time at which the holder may elect to convert from debt to equity. Rather, the terms of the subscription agreement were crafted to suit the tax advantages promised by the HINZ (Hybrid Into New Zealand) structure. In that sense also, the arrangement was artificial.
>
> [114] … the protections "agreed" between the parent and the subsidiary… were no more than window dressing, to make the transaction look more justifiable from a commercial perspective."

ECONOMIC COST

117. The question of the actual economic cost to the taxpayer(s) features strongly in all of the recent tax avoidance cases. As Lord Templeman stated in the Privy Council in *Challenge Corporation*:

> "The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had."

118. In *Glenharrow* a GST input tax deduction was denied because the price payable "[53]… had no.. reality as a 'cash' transaction despite being structured as if it were".

119. In *Ben Nevis*:

> "[147] … 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."

120. In *Penny and Hooper*:

"[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."

121. In contrast, *White* "[71]… was a case in which salary was not paid because the company lacked funds to do so".

122. In *Krukziener* Courtney J stated:

"[42] … there is an obvious question on the facts of this case as to why Mr Krukziener would not have received any income over such a long period…

[43] … (The) submission that Mr Krukziener did not account for, and pay tax on, distributions because there were no income profits to distribute, does not accord with the evidence… in relation to the commercial rationale for the arrangement…

[52]… A long-term arrangement under which a trust or company borrows externally at commercial rates to lend to a beneficiary or shareholder interest-free has no apparent commercial rationale. This is all the more so when the entities… have profit that might be distributed to the beneficiary/shareholder but choose not to do so."

123. In *Alesco* Heath J stated:

'[121] … Compliance with the requirement to present a true and fair view of a company's financial position does not determine whether a transaction reported in accordance with generally accepted accounting practice is capable of securing a "permissible" tax advantage…

[124] … The Commissioner contends that the Notes are no more than "an interest free advance with a valueless option attached, dressed up in the form of a valuable option and a discounted debt"….

[130] Professor Choudhry's evidence was that not only was no economic cost incurred by Alesco NZ but, in fact, it obtained an economic benefit through its ability to use the $78 million received from Alesco Corporation for its own purposes, pending repayment or conversion to equity on maturity. He saw no commercial reason for a wholly owned subsidiary to issue an optional convertible note to its parent company at par, because the parent already owned 100% of the issued share capital.

[131] I accept Professor Choudhry's views on this topic. My focus is on the economic reality of the transaction. There was no economic cost actually incurred. Rather, Alesco NZ had the use of an interest free loan from its parent from the time of advance to the maturity date. Alesco NZ, as a result of the subscription agreements, would not (and did not) incur any

actual expense on an annual basis during the period from the issue of the Notes until maturity."

UNFAIRNESS TO THE GENERAL BODY OF TAXPAYERS

124. In the Privy Council judgment in *Challenge* Lord Templeman said:

> "An overlap between (the general anti-avoidance section) and (the specific provisions in that case - the company grouping rules) cannot be unfair to the tax avoider but the construction of (the company grouping rules) which silently repeals (the general anti-avoidance section) would be unfair to the general body of taxpayers."

125. A little further on in *Challenge*, Lord Templeman said:

> "The frequent argument by the tax avoider that he seeks to protect the interests of a taxpayer who does not indulge in tax avoidance requires serious but sceptical consideration."

126. Lord Templeman then compared the advantage gained by tax avoiders over other taxpayers as follows:

> "In an arrangement of tax avoidance the financial position of the taxpayer is unaffected (save for the cost of devising and implementing the arrangement) and by the arrangement the taxpayer seeks to obtain a tax advantage without suffering that reduction in income, loss or expenditure which other taxpayers suffer and which Parliament intended to be suffered by any taxpayer qualifying for a reduction in his liability to tax.
>
> In *C of IR v Duke of Westminster* (1936) AC 1, the Duke… gained a tax advantage over other taxpayers who paid wages to their working gardeners.
>
> In *Black Nominees Ltd v Nicol* (1975) 50 TC 229 an actress… attempted to obtain a tax advantage over other actresses and other taxpayers who pay tax on their earnings.
>
> In *Chinn v Collins* (1981) 1 All ER 189 the… beneficiary attempted to obtain a tax advantage over other beneficiaries who paid capital gains tax when they became entitled to trust property.
>
> In *WT Ramsay* (1979) 3 All ER 213 and *Eilbeck v Rawling* (1982) AC 300 the taxpayer… attempted to obtain a tax advantage over other taxpayers who pay capital gains tax on chargeable gains.
>
> In *C of IR v Burmah Oil Co* (1980) 54 TC 200 the House of Lords refused to accept that the taxpayer "had achieved the magic result of creating a tax loss that was not a real loss…".

127. The reasoning of the Supreme Court in *Penny and Hooper* followed similar lines when comparing the situation in that case to that in *Hadlee and Sydney Bridge Nominees Ltd v Commissioner of Inland Revenue* (1991) 13 NZTC 8,116 (CA):

> "[50] …it would be strange if someone were not for tax purposes permitted to assign income of this kind but could still construct artificially a means of obtaining the same effect for a purpose of altering the incidence of taxation."

RESTRUCTURES ARE MORE LIKELY TO BE CLASSED AS TAX AVOIDANCE

128. New Zealand Courts have historically been much more inclined to treat restructuring of existing business arrangements which result in a lower income burden because of rate differentials (giving rise to "income splitting") as avoidance. The line of cases in this area include *Elmiger v CIR* (1967) NZLR 161, *Marx and Carlson v CIR* [1970] NZLR 182, *Mangin v CIR* [1971] NZLR 591, *Wisheart McNabb and Kidd v CIR* [1972] NZLR 319, *Udy v CIR* [1972] NZLR 714, *McKay v CIR* [1973] 1 NZLR 592, *Gerard v CIR* [1974] 2 NZLR 279, *Ashton and Wheelans v CIR* [1975] 2 NZLR 717, *Halliwell v CIR* (1977) 3 NZTC 61,208, and of course, most recently *Penny and Hooper*.

129. *Marx and Carlson*, *Mangin* and *Gerard* are "paddock trust" cases where the farmer leased off valuable crop land to the family trust while no "real" change occurred to how the farm, including the crop production itself, was operated by the farmer. The *Wisheart* and *McKay* cases concerned lawyers who restructured their practices so that assets formerly belonging to the law firm or partner became owned by a family trust. *Halliwell's* case involved a restructure of a dentistry practice into ownership by a family trust.

130. Noteworthy however, is that there was no tax avoidance despite a restructure in *White* because, as Heath J noted:

> "[67] The relevant (uncontested) findings of fact made by the (Taxation Review) Authority were:…
>
> b) Dr White and her husband reconstructed their financial affairs to overcome a genuine concern about potential exposure to claims by clients in respect of their separate private professional services/business and, consequentially, to protect their family…"

INLAND REVENUE *REVENUE ALERT* : NON-MARKET SALARIES

131. On 1 September 2011 Inland Revenue released *Revenue Alert* RA 11/02. The issue addressed was: *Diverting personal services income by structuring revenue earning activities through an associated entity such as a trading trust or a company: the circumstances when Inland Revenue will consider this arrangement is tax avoidance*.

132. Inland Revenue states that:

> "Inland Revenue's position (in relation to the diverting of personal services income) has been recently confirmed by the Supreme Court's judgment in *Penny and Hooper*…

We will closely examine situations where an arrangement has the effect of diverting a substantial amount of that personal service exertion income but the benefit of those diverted funds are still enjoyed, directly or indirectly, by the individual or their family or associates. We will generally focus on the most serious and artificial cases – where the arrangement results in a substantial proportion of the income generated by the business being diverted away from the individual service providers.

In many cases, taxpayers entering into these types of arrangements are also benefiting from reduced child-support liabilities or student loan repayment obligations. In some cases taxpayers are structuring their remuneration at a level that will allow them access (or greater access) to other non-income tax benefits that rely on income calculated for tax purposes."

133. Inland Revenue states that where income is generated from the supply of services provided by individuals a combination of some or all of the following factors may result in an investigation:

(a) The controllers of a business arrange for an entity, such as a trading trust or company, to operate and own their business. The operating entity engages or employs them (or contracts for their services).

(b) Where the business has been transferred, the business operates substantially as it did before its transfer to the operating entity.

(c) The business may not in substance be operated according to the terms of the arrangements entered into. This includes examining the agreements themselves, the manner in which they are actually implemented and also whether the overall arrangement is commercial having regard to a comparison with relevant standard business practices.

(d) The degree to which the individual service providers or their families ultimately control the entity, its economic product and cash flows from the business.

(e) Whether there is a redistribution of the underlying income from the entity to the person or to family members, usually via a trust but there are other mechanisms, for example, by way of employment of the family members perhaps at inflated salaries, or related party loans or the payment of management and other service fees to associates.

(f) The extent to which, as a consequence of the arrangement, significant tax benefits are obtained e.g. where the entity and/or any beneficiaries or shareholders pay lower marginal tax rates than would have been payable by the taxpayer, but for the arrangement.

134. Inland Revenue agrees that there may be particular reasons as to why the controllers of the business may not be adequately remunerated in a particular year. Examples of this include:

- Adverse business conditions mean that the business profits are down but most of those profits are still paid out to the individual service providers.

- It is financially prudent to retain some profits in the business because it is anticipated that the business may experience financial difficulties in the future.
- The profits are set aside to acquire business assets in the next financial year.
- The business relates to a charity and the individual receives less to ensure the charity's return is maximised.

135. These examples follow the exceptions discussed by Randerson J in the Court of Appeal in *Penny and Hooper*:

> "[116] … I also accept that there may be good reasons why an employee would agree with an employer to accept a salary reduction. The reasons discussed at [98] above may all have legitimacy in different contexts."

136. The reasons discussed at [98] to which Randerson J referred were as follows:

> "[98] … there may be a variety of perfectly legitimate reasons for family companies, such as those involved in the present case, to allocate salary to their working directors at a level below that which would be appropriate if they were employed at arms length by an independent employer. Several… examples are readily distinguishable but those less readily distinguishable include situations where a company elects to pay a working director much less than a market rate because the company is in a development phase and there is a need to build up capital; where a company needs to purchase a substantial asset for the purpose of its business; where the director does not work on a full-time basis; or where the company has had a poor financial year and any profits are insufficient to pay a proper salary. (There were) further examples such as a person who wishes to donate his or her time to a company engaged in charitable purposes at a lower than market rate or even without remuneration; or, closer to the present case, the directors and shareholders of the company wish to maximise the transfer of profit from the company to trustee shareholders for their benefit."

137. Inland Revenue accepts there may be other non-tax reasons why a business may pay the individual less than an arm's length party would receive over the short term. However, in those circumstances, Inland Revenue would accordingly expect to see no significant distributions being made to entities associated with the individual.

138. The full text of the Revenue Alert RA 11/02 can be accessed at: http://www.ird.govt.nz/technical-tax/revenue-alerts/revenue-alert-ra1102.html

INLAND REVENUE DRAFT *INTERPRETATION STATEMENT*: SECTION BG 1

139. In February 1990 Inland Revenue released its Policy Statement on the predecessor to section BG 1, section 99 of the Income Tax Act 1976 ("the 1990 Policy Statement"). In September 2004 Inland Revenue released a paper entitled "Interpretation of sections BG 1 and GB 1 of the Income Tax Act 2004 – Exposure Draft for External Consultation". On 16 December 2011 Inland Revenue released its latest Draft Interpretation Statement on the application of sections BG 1 and GA 1.

140. The 1990 Policy Statement employed a four-step approach to determining whether section 99 should apply. That involved:

- Consideration of the transaction in the context of the scheme and purpose of the tax legislation.
- Evaluating the purpose of the arrangement.
- Inferring whether the tax saving is an incidental purpose or effect.
- Deciding whether the scheme and purpose of the Act has been frustrated by the arrangement.

141. The 1990 Policy Statement included a series of examples.

142. The Exposure Draft issued in 2004 was never finalised, and essentially traversed familiar ground in setting out the analysis likely to be undertaken by Inland Revenue in deciding whether or not a transaction should be attacked under section BG 1. The discussion in the 2004 Exposure Draft has been superceded by the judgments of the Supreme Court in recent years that have already referred to above.

143. On 16 December 2011 Inland Revenue issued Draft *Interpretation Statement* INS0121 *Tax Avoidance and the Interpretation of Sections BG 1 and GA 1 of the Income Tax Act 2007* with a comment deadline of 31 March 2012. Inland Revenue states:

> "3. …. This current statement now sets out the Commissioner's view of the law following the Supreme Court decision in *Ben Nevis* and other relevant cases."

144. The Commissioner takes the view that the relevance of certain previous judicial approaches is limited:

- The "scheme and purpose" approach, to the extent that it is taken to mean that compliance with specific provisions satisfies Parliament's purpose, is not the law.
- The choice principle does not provide immunity from section BG 1.
- Lord Denning's predication test in *Newton v FC of T* [1958] AC 450 has been dispensed with by legislative amendments and the decision in *Ben Nevis*.
- The 'new source" doctrine discussed by Lord Diplock in *Europa Oil (No 2) v CIR* (1976) 2 NZTC 61,066, that the anti-avoidance provision does not

apply to a new source of income, will not, of itself, apply to excluded a new source of income from the potential application of section BG 1.

- There is no place in avoidance law for any principle taken from *IRC v Duke of Westminster* [1936] AC 1 (HL) that a structure that complies with specific provisions cannot be tax avoidance.

145. The Commissioner's approach, following *Ben Nevis*, to applying sections BG 1 and GA 1 is summarised as follows.

146. *Specific provisions are applied first*: Section BG 1 is only considered after reaching a view on whether the other provisions of the Act apply or do not apply. Section BG 1 will apply to arrangements that use specific provisions and also arrangements that circumvent provisions. This applies to both general provisions, such as the general deductibility provision, and to specific detailed provisions in the Act.

147. *There must be an arrangement*: An action or transaction undertaken by one person cannot, by itself, constitute an "arrangement". Two or more documents or transactions may constitute an "arrangement" if they are sufficiently inter-related and/or interdependent. A part of an "arrangement" will be considered separately under section BG 1 only if that part, by itself, satisfies the definition of "arrangement". A taxpayer may be considered party to an arrangement even if the taxpayer did not know some of the details of the arrangement. A taxpayer who is not party to an arrangement may still be subject to the Commissioner's powers of reconstruction. Section BG 1 can apply whether or not the arrangement is carried out or brought into effect in New Zealand.

148. *The definition of "tax avoidance" is not exhaustive*: The function of the statutory definition is to confirm that certain defined circumstances are not excluded. It is quite possible, for example, for an arrangement that results in payment of more New Zealand tax than would otherwise have been paid, to be a tax avoidance arrangement.

149. *It is the objective purpose or effect of the arrangement that matters*: Motives and intentions are not relevant. Oral evidence related to the purpose of the parties is irrelevant. In almost all cases the "purpose" and "effect" of the arrangement will be the same.

150. *The Parliamentary contemplation test is then 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? Applying this test involves identifying:

- *The tax treatment claimed*: The taxpayer will assert that the provisions of the Act apply in certain ways, and it is these outcomes that are tested under section BG 1. The tax outcomes claimed by the taxpayer may relate to provisions that are used, or to provisions it is argued do not apply.

- *The commercial reality and economic effect of the arrangement*: This requires a complete understanding of the facts and a thorough grasp of the detail and workings of the arrangement as a whole. Suggested matters

to be examined closely are cash flows, changes in the parties' economic positions, rights and obligations of the parties and the risks assumed by them. Steps in the arrangement that disguise the actual consequences for the parties, particularly steps that seem artificial or that involve pretence or circularity, are ignored. Commercial reality involves such things as profitability, the viability of a transaction when tax is ignored, and whether anything is obtained in return for a payment. The economic effects concern whether the taxpayer has actually sustained the economic changes claimed. The factual matters that may be taken account of are essentially those identified by the Supreme Court in *Ben Nevis* (refer to paragraph 38(m)).

- *Parliament's purpose regarding the relevant provisions*: With some arrangements understanding what Parliament would have contemplated for particular tax provisions may not require a great deal of analysis of the Act itself. With other arrangements, for example where there are a number of parts to the transaction and a number of sections of the Act involved, there would need to be an in-depth analysis of the provisions of the Act and their inter-relationship. The form of the arrangement can be ignored and Parliament's purpose is tested against commercial reality. The test is not to establish what the actual Parliament that enacted the legislation had in mind, but to ask whether, if Parliament had foreseen transactions of this type when enacting the specific provisions used, it would have viewed them as within Parliament's

151. *The relevance of non-tax purposes is considered*: Commercial justifications will not displace the section BG 1 inquiry at the stage of considering the Parliamentary contemplation test. Commercial purposes will be relevant:

- Initially when understanding an arrangement.
- When considering whether the arrangement is within Parliamentary contemplation if they are of the nature or within the circumstances Parliament intended for the tax provisions to apply.
- When considering whether a tax avoidance purpose is merely incidental to a commercial or other non-tax purpose of the arrangement.

152. *Whether the tax avoidance purpose or effect is merely incidental*: A tax avoidance purpose will only be merely incidental if the adoption of the particular structure for the arrangement, including the detail of that structure, can be explained by a non-tax purpose and the tax avoidance purpose follows as a natural concomitant. The magnitude or significance of the tax advantage may be relevant but will not be determinative. 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, this 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. The fact that an arrangement has the effect of obtaining a tax advantage from another country may be relevant in deciding whether the New Zealand tax advantage is merely incidental.

153. *Adjustment under section GA 1*: Section GA 1 is a discretionary provision. If voiding an arrangement under section BG 1 is sufficient to negate the tax advantage, it may not be necessary to apply section GA 1. In any case, the adjustment is one the Commissioner thinks is appropriate, and the Commissioner is not under a duty to precisely describe the alternative factual basis for such an adjustment.

154. *The Commissioner is not dictating how taxpayers do business*: The Commissioner is reaching a view on the real outcomes under an arrangement so that the tax outcomes can be considered against that reality.

155. *The Commissioner's view is that certainty is neither possible nor desirable*: The Supreme Court in *Ben Nevis* said that the courts should not strive to create greater certainty than Parliament has chosen to provide. The Commissioner agrees with the statement in *Ben Nevis* that the approach outlined in that case gives as much conceptual clarity as can reasonably be achieved.

156. *There are no examples included*, as there were in the 1990 Policy Statement. A very simplistic flowchart is included as the last page. The full text of *Interpretation Statement* INS0121 can be accessed at: http://www.ird.govt.nz/resources/1/9/1995a880496fc8c3b5b3bd37e0942771/ins0121.pdf

RECONSTRUCTION

157. Section BG 1(2) allows reconstruction where there is tax avoidance and provides that:

> "Under part G… the Commissioner may counteract a tax advantage that a person has obtained from or under a tax avoidance arrangement."

158. Section GA 1 sets out the Commissioner's adjustment power if an arrangement is void under section BG 1. Section GA 1(2) sets out the Commissioner's general power of adjustment as follows:

> "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."

159. Section GA 1(3) provides the Commissioner with the specific power to disallow a tax credit of a person affected by an arrangement, or allow some other person to benefit from the tax credit.

160. Section GA 1(4) allows the Commissioner to identify the hypothetical situation which would have arisen in the absence of the arrangement. The Commissioner is allowed to adjust a person's income, deductions, tax loss and/or tax credit based on what, 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.

161. The Court has the power to vary an assessment made by the Commissioner as a result of reconstruction, under section 138P of the Tax Administration Act 1994. In *Alesco* Heath J noted that this power of the Court applies whether or not a formal reconstruction has been undertaken by the Commissioner.

162. Reconstruction was considered in *Ben Nevis*. In that case, the Commissioner disallowed the whole of the license premium as a deduction. The taxpayers argued that the Commissioner was, in effect, treating the land as if it had been acquired cost-free. The Supreme Court held that the investors had already effectively paid for the land and as the Commissioner was merely disallowing the deduction claimed, the reconstruction was within the scope of the Commissioner's powers.

163. In *Glenharrow* the Commissioner refunded only the GST fraction of the deposit and further instalments that were paid later. The Supreme Court approved the Commissioner's approach and agreed that no GST fraction was refundable on the portion of the price paid by way of the promissory note.

164. In *Krukziener* the Commissioner assessed the loans made to Mr. Krukziener as his income and the assessment was upheld by the High Court.

165. In *Penny and Hooper* the Commissioner made assessments increasing the taxpayers' taxable incomes for the relevant years by the amount equal to the difference between the salaries actually paid and what the Commissioner assessed as commercially realistic salaries for their services. The Supreme Court reached the conclusion that the taxpayers failed to show that the Commissioner had acted incorrectly.

166. In *White* there was no tax avoidance found so there was no reconstruction.

167. In *Alesco* there was a question about whether the Commissioner had based his assessment on a reconstruction of the taxpayer's affairs, or as a natural consequence of his assessment. Heath J addressed the question of reconstruction under both heads, but did not determine whether a "reconstruction had actually occurred because there was an insufficient evidential foundation to make that factual determination".

168. In *Alesco* the taxpayers questioned the approach to reconstruction adopted by the Commissioner. Heath J noted:

> "[153] The difference between the Commissioner's approach and that taken by the taxpayers is that the Commissioner contends that he has a discretion to counteract the tax advantage as he thinks fit, whereas the taxpayers contend he is obliged to apply the next best alternative to the transaction undertaken."

169. Heath J's response was as follows:

> "[154] … any challenge to the Commissioner's reconstruction falls to be considered against the advice of the Privy Council in *Miller v*

Commissioner of Inland Revenue [2001] 3 NZLR 316 (PC)…. Lord Hoffman… said:

> "…. 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 re-writing history. The reconstruction is purely hypothetical and provides a yardstick for the assessment."

170. Heath J noted that the Commissioner's decision to reconstruct is to "counteract any tax advantage":

> "[157] …. impermissible claims for interest deductions are not counteracted if the Commissioner was to treat Alesco NZ as having entered into an interest-bearing loan….
>
> [158] It is artificial for Alesco NZ to assert now that the Commissioner should pretend that an interest bearing loan was made to allow Alesco NZ to keep the benefit of the improper deductions that it claimed….
>
> [159] Further, as a matter of logic, it is not possible to counteract a tax advantage by allowing the taxpayer to obtain greater tax benefits than were actually achieved."

SHORTFALL PENALTIES

171. In *Ben Nevis* the Supreme Court addressed the question of shortfall penalties in the context of tax avoidance:

> "[174] The scheme of Pt 9 is to impose civil penalties on taxpayers who take an incorrect tax position which results in a tax shortfall. The provisions impose specified penalties, based on varying percentages of the resulting tax shortfall, which are set by the statute itself, according to the relative culpability of the taxpayer. At one end of the scale are instances where the taxpayer has not taken reasonable care where the penalty is 20%. Where the taxpayer is grossly careless, the penalty is 40%. At the other end is evasion where the penalty is 150%. In the appellants' case the penalties were imposed under s 141D (of the Tax Administration Act 1994) which applies where the taxpayer has taken an "abusive tax position". The penalty in such cases is 100% of the tax shortfall."

172. The Supreme Court considered the nature and purpose of the regime of civil penalties applicable to taxpayers:

> "[177] The penalty provisions, particularly at the higher end of the scale are onerous. This reflects Parliament's statement of the purposes of Pt 9, which are:
>
> (a) to encourage taxpayers to comply voluntarily with their tax obligations and to cooperate with the Department; and
>
> (b) to ensure that penalties for breaches of tax obligations are imposed impartially and consistently; and

(c) to sanction non-compliance with tax obligations effectively and at a level that is proportionate to the seriousness of the breach….

[178] …. (Pt 9) provides sanctions which increased in severity according to the gravity of the circumstances of what the legislation treats as inappropriate tax positions. These sanctions create strong incentives for taxpayers to meet standards of conduct in their tax affairs, in particular in relation to tax positions that may be characterised as involving tax avoidance or evasion."

173. The Supreme Court noted that there are three requirements to be met before a taxpayer will be found to have adopted an "abusive tax position":

- Firstly, a taxpayer must have taken a tax position which involves an "unacceptable interpretation of a tax law". An unacceptable interpretation is an interpretation or application of that tax law which "fails to meet the standard of being… about as likely as not to be correct" when viewed objectively. Whether an interpretation is unacceptable is determined at the time the tax position is taken by the taxpayer. In the case of positions taken in tax returns, the tax position is taken when the taxpayer provides the return.
- Secondly the tax position must be one that, viewed objectively, is taken by the taxpayer in respect, or as a consequence, of an arrangement that is entered into with a dominant purpose of avoiding tax, whether directly or indirectly. Alternatively, where there is no arrangement, the tax position itself must be taken by the taxpayer for that dominant purpose.
- Thirdly, the provision imposing a penalty for taking an abusive tax position applies only if the tax shortfall arising from the taxpayers tax position exceeds $10,000.

174. In considering whether the taxpayers had taken an "unacceptable tax position" the Supreme Court discussed whether the taxpayers' incorrect interpretation in *Ben Nevis* failed to meet the standard of, objectively, being "about as likely as not to be correct":

"[184] On its terms this standard does not require that the appellants' tax position had a 50% prospect of success but, subject to that qualification, the merits of the arguments supporting the taxpayers' interpretation must be substantial. The stipulation of an objective test means that *the taxpayers' belief that the tax position taken was correct, or not unacceptable, is irrelevant*.

[185] There is a helpful observation of Hill J concerning the statutory standard made in the context of a similar provision in Australian legislation:

> "The word 'about' indicates the need for balancing the two arguments, with the consequence that there must be room for it to be argued which of the two positions is correct so that on balance the taxpayers argument can be said to be one that while wrong could be argued on rational grounds to be right."

> Whether a taxpayer's interpretation meets the standard in any case accordingly comes down to a judgment of the weight of the arguments that support the taxpayer's position in the application of the law to the relevant facts. The Act requires that the application of all tax laws, including the general anti-avoidance provision, be taken into account in making this judgment. (Section 141B(7) of the Tax Administration Act 1994)" (emphasis added)

175. As Heath J noted in *Alesco*, under section 141B(7) of the Tax Administration Act 1994 the Court is required to have regard to all relevant tax laws and any judicial decisions interpreting them issued up to one month before the taxpayer took its tax position.

176. In both *Ben Nevis* and *Alesco*, the Courts found that the taxpayers had taken unacceptable tax positions because their interpretations failed to meet the standard of being about as likely as not to be correct if the potential application of the general anti-avoidance rule had been taken into account.

177. The taxpayers' defence in both cases centred around what is referred to as "the *Europa 2* principle" (stemming from a statement by Lord Diplock in *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue* [1976] 1 NZLR 546 (PC)) to the effect that a "legal entitlement gained under a contract from expenditure qualifies that expenditure for deductibility under a tax law" and "a general anti-avoidance provision cannot apply to bar the deduction".

178. The Supreme Court stated that the Courts have since adopted a narrow view of Lord Diplock's observations and based on subsequent cases, it was extremely unlikely that an argument based on the *Europa 2* principle could succeed. Consequently, it was more than likely that the general anti-avoidance provision could apply to deny the deductions.

179. In the Supreme Court's view, an accurate summary of the legal position was made by Baragwanath J in *Miller v Commissioner of Inland Revenue* (1997) 18 NZTC 13,001 (HC) when he said:

> "(The general anti-avoidance provision) is a section that deals with transactions altogether lawful in terms of the general law and the general provisions of the Income Tax Act but which nevertheless infringe its terms. (The general anti-avoidance provision) does concern reality and lawfulness but in a sense quite different from the general provisions. It begins to bite when their operation is complete."

180. In both *Ben Nevis* and *Alesco* the taxpayers where considered to have taken an abusive tax position because the arrangement in each case was entered into with a dominant purpose of avoiding tax.

THE BURDEN OF PROOF LIES WITH THE TAXPAYER

181. In *Ben Nevis* the Supreme Court stated:

> "[115] … On the approach we have outlined, it is necessary for the appellants (taxpayers) on whom the burden of proof lies, to persuade the Court that the arrangement is not a tax avoidance arrangement. To do that the appellants (taxpayers) must show that the steps they have taken were within the purpose and contemplation of Parliament when it enacted the specific provisions they rely on."

182. Similarly, in *Glenharrow*, in relation to the operation of section 76 of the GST Act, the Supreme Court stated:

> "[34] In order for the Commissioner to be able to invoke s 76 he must be satisfied that the arrangement which he wishes to treat as void has been "entered into between persons to defeat the intent and application" of the GST Act or of any provision of the Act. Consistent with the approach to interpretation of General Anti-Avoidance Rules (GAARs) in the income tax context… this determination requires an assessment that goes beyond the technical legality of the constituent parts of the arrangement. The onus is on the taxpayer to show that the Commissioner could not properly have been satisfied in terms of this section." (reference to section 149A(2)(b) of the Tax Administration Act 1994)

183. Section 149A(2) of the Tax Administration Act 1994 states that:

> "The onus of proof in civil proceedings–
>
> (a) Relating to evasion or similar act to which section 141E applies or to obstruction rests with the Commissioner:
>
> (b) Relating to any other matter or thing rests with the taxpayer."

184. It should be clear from the above that if the Commissioner alleges that there has been tax avoidance, it is always up to the taxpayer to convince the Commissioner otherwise. Where the Commissioner remains unconvinced, the taxpayer must either reach an agreement with Inland Revenue or will end up having to prove in Court that there has been no tax avoidance.

185. The onus is also on taxpayers to demonstrate that a reconstruction was wrong and by how much it was wrong. In *Ben Nevis* the Supreme Court noted:

> "[171] … 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 (reference made to *Buckley and Young v C of IR* (1978) 3 NZTC 61,271)"