

**THE ROLE OF THE NEWTON PREDICATION TEST IN
THE TAX AVOIDANCE METHODOLOGY
- THE IMPACT OF RECENT CASES**

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I. ATTESTATION OF AUTHORSHIP

I hereby declare that this submission is my own work and that, to the best of my knowledge and belief, it contains no material previously published or written by another person (except where explicitly defined in the acknowledgements), nor material which to a substantial extent has been submitted for the award of any other degree or diploma or a university or other institution of higher learning.


.....
Rakesh Datt Gosai

II. ABSTRACT

The anti-avoidance provisions of the Income Tax Act 2007 are of immense concern to tax practitioners and the Commissioner of Inland Revenue alike. This is indicated by the huge volume of litigation in this complex area of the tax law.

This dissertation endeavours to introduce the relevant legislation, considers important aspects of the law on tax avoidance, follows the common law developments in this area of the law, and studies the application of the legislation by the Commissioner and the Courts in recent tax cases in New Zealand and abroad.

The dissertation focuses on the elements of tax avoidance and draws the “purpose or effect” element of the tax avoidance legislation and analyses the application of the “*Newton* predication test” in New Zealand tax cases and how the general anti-avoidance has been dealt with in the New Zealand tax cases.

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IV. INTRODUCTION

“The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing”.¹(J. B. Colbert)

The famous quote of the author above suggests there are numerous possibilities in the legislation and administration of tax. However, the art of taxation is the ability to increase the incentives and opportunities to minimise tax through legitimate or illegitimate tax planning.

Tax avoidance is a worldwide phenomenon that is present in any taxation system. However, through robust tax legislation, judicial systems and approaches to counteract illegitimate tax planning, the tax take of a nation can be maximised and the ‘hissing of the goose’ minimised.

The taxpayers should know what taxes they are *obliged* to pay and not what they *should or should not* pay as taxes are levied through a tax system that is equal and applies to all taxpayers.

However, it is accepted that taxpayers may organise their affairs to minimise their taxes. In the famous case of *IRC v Duke of Westminster*², which has received notable judicial approval, Lord Tomlin observed:

“Everyman is entitled if he can order his affairs so that the tax attracting under the appropriate Act is less than it would otherwise be. If he succeeds in ordering them as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay the increased tax.”

In the New Zealand context, tax avoidance and tax evasion are an entirely different concept. In the recent case of *Peterson v CIR*,³ their Lords stated:

¹ < <http://www.worldofquotes.com/topic/Taxes/1/index.html>, accessed 11 September 2008 >

² [1936] AC 1

³ (2005) 22 NZTC 19,098, at para 60

“[That] the line is to be drawn between ‘tax evasion’ and ‘tax avoidance’ is clear enough. The former is criminal. The latter is not. It may be socially undesirable but it is within the letter of the law”

In New Zealand tax law, Parliament has enacted legislative rules to prevent the erosion of the tax base and to counteract possible tax avoidance. There are a number of anti-avoidance provisions including specific anti-avoidance provisions and general-anti-avoidance provisions.

It is an important area of tax legislation and of the legal system. Parliament, through consultation with policy makers, makes laws that are desirable, and its intention at the time of enactment is adhered to when applying the laws.

As far as the general anti-avoidance provisions have been enacted, it is the provision contained in s BG 1 of the Income Tax Act 2007 that is causing continuous debate due to its generality in nature. It is professed legislatively that s BG 1 is:

“...an essential pillar of the tax system designed to protect the tax base and the general body of taxpayers from what is considered to be unacceptable tax avoidance devices”⁴...

In this dissertation, the writer attempts to draw together the legislative principles and the case laws to discuss the definition of an arrangement contained in s BG 1 where that tax avoidance “arrangement” is void against the Commissioner. Essentially, the dissertation focuses on the role and application of the “*Newton*” predication test⁵ to determine the *purpose or effect* of the tax avoidance arrangements and the tax avoidance methodology applied in recent tax cases. The *Newton* predication test per Lord Denning in *Newton*⁶, stated:

“In order to bring the arrangement within the section, you must be able to predicate – by looking at the overt acts by which it was implemented - that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of

⁴ *CIR v BNZ Investments Limited* (2001)17,103 as stated by Richardson P

⁵ *Newton v FCT* [1958] AC 450,465

⁶ [1958] HCA 31

explanation by reference to ordinary business or family dealing, without necessarily being labeled as a means to avoid tax, then the arrangement does not come within the section.”

This test has long served as the practical interpretation of the “purpose”. The question to be answered in this dissertation is whether the test is still the sole test by which the purpose is to be interpreted or whether the recent *Trinity*⁷ judgment represents a fundamental shift towards a “sniff test” approach whereby more emphasis is placed on testing for artificiality and contrivance.

To understand the role and application of the *Newton* principle in recent tax cases the dissertation is structured in four broad categories:

The first part of the dissertation sets out legislative framework, the historical background of the tax avoidance legislation, introduces the concept of tax avoidance arrangements and the “purpose or effect” element of the legislation.

The second part of the dissertation discusses the interpretation techniques applied by the judiciary and the traditional methodologies adopted in determining tax avoidance.

The third part consists of discussions of tax cases that have been through the courts and the judgments reached. These cases involve discussions on the practical applications of the *Newton* principle. In this part the writer has concentrated on the judgment of the Supreme Court of New Zealand in its first ever tax case of significance in the twenty first century. This case is referred to as the “*Trinity*” case.

In the last part of the dissertation, the writer provides discussions on the trends that may follow from the *Trinity* decision. There is discussion on the developments on the application of the *Newton* principle and concludes it with the findings from the research.

⁷ *Ben Nevis Forestry Ventures Ltd and Ors v Commissioner of Inland Revenue; Accent Management Ltd and Ors v Commissioner of Inland Revenue* (2009) 24 NZTC 23,188 (SC) referred as “Trinity” or “Ben Nevis”

V. LEGISLATIVE FRAMEWORK – THE ELEMENTS FOR ESTABLISHING TAX AVOIDANCE

Section BG 1 is the current New Zealand general anti-avoidance provision of the Income Tax Act 2007. The general anti-avoidance provision, through s BG 1, has raised a general anti-avoidance yardstick by which the line between legitimate tax planning and improper tax avoidance is to be drawn.⁸

The forerunner was the *Land Tax Act 1878*, s 62, a section dealing exclusively with Land Tax. The policy in New Zealand (comparable to the policy in the United Kingdom dealing with Landlords Property Tax) was to ensure that this tax should be borne by the owner of the land and its burden not shifted on to others (such as the tenants of the land).⁹ Succeeding provisions were s 29 of the *Property Assessment Act 1879* and s 35 of the *Property Assessment Act 1885*.

It was in 1891 when Income Tax was introduced into New Zealand. The *Land and Income Tax Assessment Act 1891* was the first statute dealing with income tax. Section 40 of the *Land and Income Tax Assessment Act 1891* was the first general anti-avoidance provision combining land and income tax.

Section 82 of the *Land and Income Tax Assessment Act 1900* then replaced s 40. The succeeding provisions for s 82 were s 103 of the *Land and Income Tax Assessment Act 1908* and s 162 of the *Land and Income Tax Act 1916* except that the reference to “avoiding” tax was omitted. Section 170 of the *Land and Income Tax Act 1923* replicated s 162. Section 108 of the *Land and Income Tax Act 1954* in the same form as in s 170 except it omitted the reference to “land tax”.

Then, s 16 of the *Land and Income Tax Amendment Act 1968* added that any arrangement was void “as against the Commissioner for income tax purposes” to s 108 after the word “void”. When the Income Tax Act 1976 replaced the Income Tax Act 1954, the anti-

⁸ *CIR v BNZ Investments Limited* (2001) 20 NZTC 17,103

⁹ *Mangin v CIR* [1971] NZLR 591, 601 (PC)

avoidance provisions were located in s 99. When the *Income Tax Act 1994* was enacted, s BB 9 was the general anti-avoidance regime in the legislation, which came into effect from the income year commencing 1 April 1997.

Upon commencement of *Income Tax Act 2004*, the general anti-avoidance provisions were located in s BG 1. The *Income Tax Act 2004* was rewritten and, the current legislation is referred to as the *Income Tax Act 2007*. Since s 99, there were no significant changes in the general anti-avoidance provisions.

Section BG 1 provides¹⁰:

(1) Avoidance Arrangement Void

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

(2) Reconstruction

Under Part G (Avoidance and non-market transactions), the Commissioner may counteract a tax advantage that a person has obtained from or under a tax avoidance arrangement.

There are two distinct elements under section s BG 1. The first element, s BG 1 (1), focuses on the concept of a tax avoidance arrangement and sets out the circumstances that must be satisfied for an arrangement to be void. The second element, s BG 1 (2), gives the Commissioner power to adjust the accounts of a taxpayer to counteract any tax advantage obtained. Identifying whether there is tax avoidance arrangement that exists is the key to the two elements.

Section YA 1¹¹ defines tax avoidance arrangement as:

An arrangement, whether entered into by the person affected by the arrangement or by another person, that directly or indirectly –

- (a) has tax avoidance as its purpose or effect; or
- (b) has tax avoidance as one of its purposes or effects, whether or not any other purpose or effect is referable to ordinary business or family dealings, if the purpose or effect is not merely incidental.¹²

¹⁰ *Income Tax Act 2007*

¹¹ *Ibid*

¹² *Ibid*

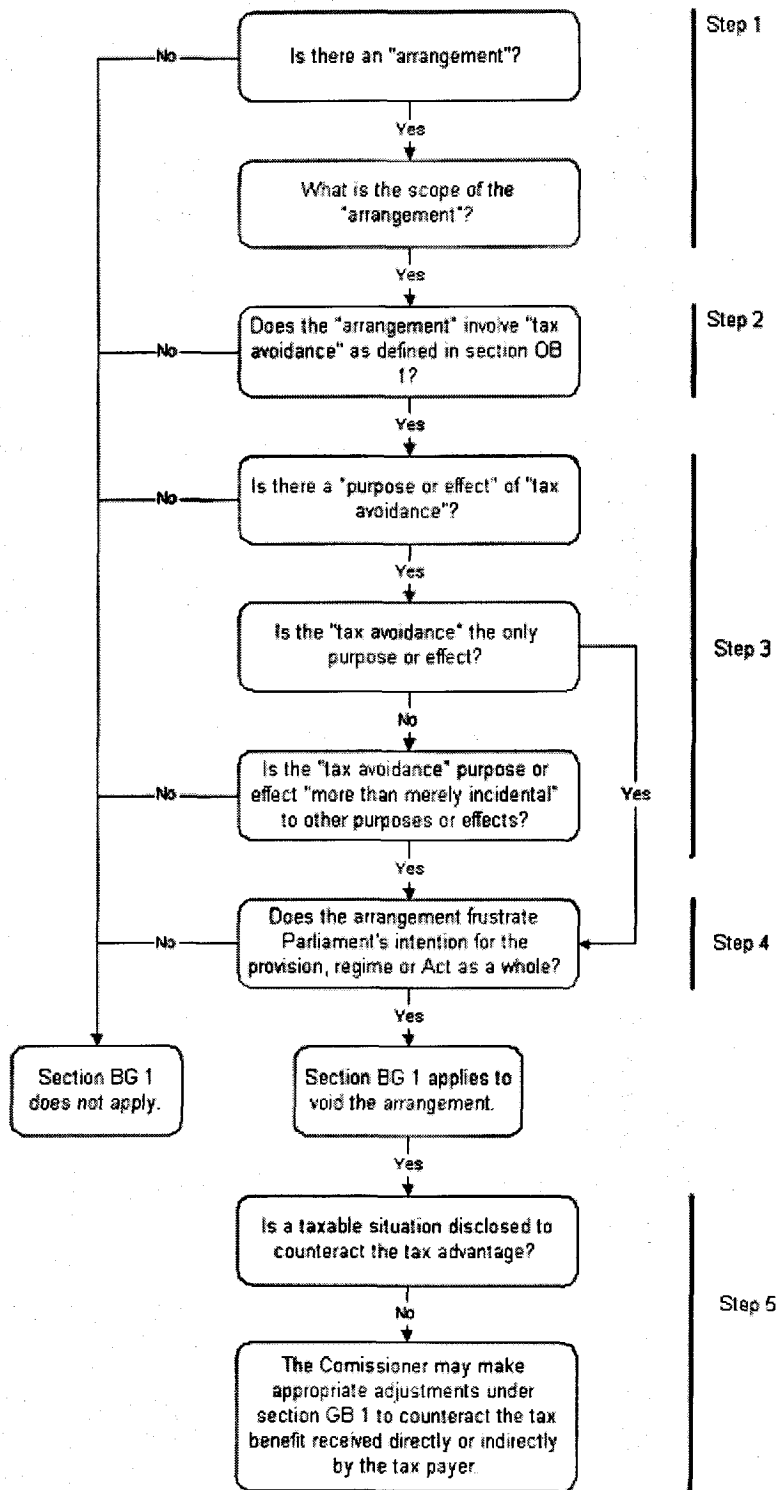
These definitions bring out three of five principles in considering the application of s BG

1.¹³ The five principles are:

- Step 1 Determining the arrangement and its scope;
- Step 2 Determining "tax avoidance";
- Step 3 Determining the purpose or effect that is more than merely incidental;
- Step 4 Judicial approaches and;
- Step 5 Adjustment of income under s GB 1. (s GA 1 of the Income Tax Act 2007).

The following flow chart illustrates the steps above:

¹³ Inland Revenue Department, *INA00009: Interpretation of Sections BG 1 and GB 1 of the Income Tax Act 2004*, (Wellington, 2004)



Steps 1 to 3 are the three elements of s BG 1. Step 4 is an additional interpretative step, which requires the consideration of whether the arrangement frustrates Parliamentary intention for the provision to give deliberate tax benefits. It is not a statutory rule but an adoption by the courts to identify whether s BG 1 applies to any given arrangement. The most prominent judicial approach is the “choice doctrine” approved by Lord Hoffmann in *O’Neil v CIR*.¹⁴

Step 5 is the step after the tax avoidance arrangement is found and s BG 1 is applied to void the arrangement. In such cases, the Commissioner has power to adjust the income of a person affected by the arrangement under s BG 1 (2). The Commissioner may make appropriate adjustments to counteract the tax benefit received directly or indirectly by the taxpayer.¹⁵

The above five steps are the reference for identifying the tax avoidance arrangement. According to Richardson P in *CIR v BNZ Investments Limited*¹⁶, the arrangement that brings tax advantages might not necessarily be a tax avoidance arrangement. The arrangement is a tax avoidance arrangement only after the necessary state of mind is proved and the choice doctrine is considered.

The following section discusses in detail the arrangement under s BG 1 and related leading cases.

¹⁴ *O’Neil v CIR* (2001) 20 NZTC 17,057

¹⁵ *CIR v BNZ Investments Limited* (2001) 20 NZTC 17,103

¹⁶ *Ibid*

A. Arrangement

Overview: statutory definition

The term “arrangement” is defined in s YA 1:

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

This definition closely follows the meaning given to the composite expression “contract, agreement or arrangement” in *Newton* and other decisions under the former s 108 and its Australian counterpart, s 260 of the *Income Tax Assessment Act 1936*.

*Newton v FCT*¹⁷ is the case that leads to the definition of what an arrangement is. In this case the Privy Council states:

“Their Lordships are of opinion that the word ‘arrangement’ is apt to describe something less than a binding contract or agreement, something in the nature of an understanding between two or more persons - a plan arranged between them which may not be enforceable at law. But it must in this section comprehend, not only the initial plan, but also all the transactions by which it is carried into effect - all the transactions, that is, which have the effect of avoiding taxation, be they conveyances, transfers or anything else. It would be useless for the commissioner to avoid the arrangement and leave the transactions still standing.”

The definition in *Newton* provides the basis for the current definition in s BG 1.¹⁸ There are also some important decisions that contribute to the *Newton* approach.

¹⁷ (1958) AC 450,465

¹⁸ *BNZ Investments Ltd v C of IR* (2000) 19 NZTC 15,732

Isaacs J in the High Court of Australia, in *Jaques v FCT*¹⁹ stated:

“Arrangement is no doubt an elastic word, and in some contexts may have a larger connotation. But in this collocation it is the third in a descending series, and means an arrangement which is in the nature of a bargain but may not legally or formally amount to a contract or an agreement. Isaacs J interpreted the word ‘arrangement’ as something but less formal and less restricted than a contract or an agreement. Subsequently, the Australian High Court in *Bell*²⁰ looked at the order of the three words ‘contract’, ‘agreement’, and ‘arrangement’ and interpreted them as becoming progressively broader. The Court said, the word ‘arrangement’ is the third in a series which as regards comprehensiveness in an ascending series, and that word extends beyond contracts and agreements so as to embrace all kinds of concerted action by which persons may arrange their affairs for a particular purpose or so as to produce a particular effect.”

In summary, according to the statutory definition, an arrangement can be any contract, agreement, plan or understanding. This definition is designed to encompass all kinds of concerted action by which persons may organize their affairs for a particular purpose or to produce a particular effect.

Contract

In the definition of arrangement, contract is the first term. In *FCT v Newton*²¹, contract was considered as a technical word and implied an agreement enforceable by law. In *BNZ Investments*,²² Richardson P stated that a “contract is more formal than an agreement, and in ordinary usage is usually written”. Therefore, contract refers to transactions that involve an offer, acceptance, consideration and intention to create legal obligations.

¹⁹ (1924) 34 CLR 328,359 (HCA)

²⁰ (1953) 5 AITR 462, at 476; 87 CLR 548, at 573

²¹ *FCT v Newton* (1957) 96 CLR 577,630

²² *CIR v BNZ Investments Limited* (2001) 20 NZTC 17,103

Agreement

Agreement is the second term in the definition of arrangement. According to observations by Richardson P²³, agreement is different to contract and is less formal than contract. However, in cases such as *Newton*²⁴, contract and agreement have been considered as the same concept, which is fundamentally different with the concept of arrangement. Also in the case *Charles v Lyson*²⁵ Hoskin J stated that:

“In our opinion a contract or agreement by which the liability of the person who is the owner, or who under the Act is to be deemed to be the owner, of the land at noon on the 31st March to pay the tax is cast upon or undertaken by some other person is a contract or agreement which purports to alter the incidence of the tax, and within s 162 of the Land and Income Tax Act, 1916, and that it is equally so if the undertaking applies only to part of the tax.”

In this case, the word “agreement” was viewed as being the same as “contract”. However, the concept of arrangement is not limited to contract or agreement.

Plan or understanding

The final terms in the definition of an “arrangement” are “... plan or understanding (whether enforceable or unenforceable) including all steps and transactions by which it is carried into effect.” In *Newton v FCT*²⁶, the concept plan or understanding was delivered by Lord Denning as being: apt to describe something less than a binding contract or agreement, but in this section it must comprehend not only the initial plan but also all the transactions by which it is carried into effect. This expression emphasises the point that the arrangement does not have to be a formal contract.

As such, there is no role for a “sub-scheme” approach when analysing the concept of arrangement. This point was confirmed in the *BNZ Investments* case, where Richardson P referred with approval to Lord Denning’s definition of arrangement in *Newton*. Richardson P noted²⁷:

²³ Ibid

²⁴ Ibid

²⁵ [1922] NZLR 902

²⁶ [1958] AC 450,465

²⁷ Ibid, at para 46

“Lord Denning [stated] that the whole set of words in the section denoted concerted action to an end; (at p 455) that ...the whole complicated series of transactions must have been the result of a concerted plan”; (at p 467) that looking at the whole of the arrangement,...the whole of the transactions show that there was concerted action to an end.”

However, the Privy Council in *Peterson*²⁸ appears to contradict this position. Lord Millet appears to suggest that an arrangement need not comprise of the whole series of transactions that result in a concerted plan. His Lordship stated²⁹:

“...Their Lordships are satisfied that the “arrangement” which the Commissioner has identified had the purpose or effect of reducing the investors’ liability to tax and that, whether or not they were parties to the arrangement or the relevant part of parts of it, they were affected by it. ...”

However, the judicial position has lately reverted to rejecting the sub-scheme approach. In *Ben Nevis Tipping, McGrath and Gault JJ* confirmed³⁰ that:

“[an] arrangement includes all steps and transactions by which it is carried out.”

²⁸ *Peterson v CIR* [2006] NZLR 433; (2005) 22 NZTC 19,098(PC)

²⁹ *Ibid*, at para 34

³⁰ *Ibid*, at para 105

B. Tax Avoidance

In New Zealand, the concept of tax avoidance is defined in s YA 1 of Income Tax Act 2007:

“Tax avoidance includes:

(a) Directly or indirectly altering the incidence of any income tax:

(b) Directly or indirectly relieving a person from liability to pay income tax or from a potential or prospective liability to future income tax:

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

The definition identifies some of the characteristics of tax avoidance, which is inclusive. That means the determination of what is tax avoidance is not limited to the definition. As Baragwanath J noted: “It is to be observed that the definition of ‘tax avoidance’ employs the verb ‘includes’, rather than ‘means’. A transaction may therefore entail tax avoidance even if not falling directly within any of (a), (b) or (c).”³¹

The first two limbs, “altering the incidence of any income tax” and “relieving any person from liability to pay income tax” were originally enacted in section 108. The third limb was inserted in 1974 to provide that “tax avoidance” include “avoiding, postponing or reducing any liability to income tax”.

First limb

The first limb states that tax avoidance includes altering the incidence of any income tax. In the Court of Appeal decision of *Marx v CIR*³²:

“The incidence of tax is the way in which its burden falls upon those whom the Act makes liable to bear it. ... There are two different cases in which an arrangement can be said to have the purpose or effect of altering the incidence of income tax. First, a taxpayer may agree with another that the other should assume, as between the parties, but not so as to affect the Commissioner, some of the burden

³¹ *Miller v CIR* [1997] 18 NZTC 13,001 (HC) at p.13,033, at p 199

³² [1970] NZLR 182

of the tax for which the Act makes him liable. Second, and himself and the Commissioner, that he will become liable for less tax after the arrangement taxpayer may enter into an arrangement having the effect (if it is valid), as between than would have, or might have been, levied upon him, but for it ...”

The first scenario concerns a situation where the taxpayer agrees with another to share some or all the burden of the taxpayer’s liability to income tax. In this situation, the agreement is between the parties and does not affect the taxpayer’s legal burden to the Commissioner.

The second scenario concerns a situation when an arrangement alters the incidence of tax between the taxpayer and the Commissioner. As a result, there is potential loss of revenue to the Commissioner. The second scenario concerns an arrangement that has an effect as between the party and the Commissioner. It is assumed that the second alternative is most likely to attract the attention of the Commissioner.

The first limb applies to an arrangement which has the purpose or effect of altering the economic incidence of tax so the taxpayer becomes liable to less tax after the arrangement than would have, or might have been, levied upon the taxpayer, but for the arrangement.

Second limb

The second limb states that tax avoidance includes relieving a person from liability to pay income tax. Lord Donovan has addressed the meaning of “relief” in *Mangin v CIR*³³ where his Lord stated:

“In the ordinary use of language one ‘secures relief from tax’ if one ‘defeats’ it or ‘evades’ it, or ‘avoids’ it; and their Lordships think that the true reason for the omission of these words from the present s 108 and its predecessors of 1916 and 1923 is probably that they were regarded as tautologous.”

It shows that where a person is relieved from the liability to pay income tax that it will include where a person defeats, evades or avoids the incidence of income tax. The use of

³³ [1971] NZLR 591 (PC)

the term “payment of income tax” could be construed to include any action that reduces the actual amount of tax paid. Inland Revenue concludes as follows:³⁴

“The reference to ‘liability to pay income tax’ in the second limb, rather than to simply a liability to income tax means that it can apply to arrangements involving tax credits.”

Third limb

The third limb provides tax avoidance including “avoiding, postponing, or reducing any liability to income tax” within the concept of tax avoidance. In *Newton*, Lord Denning outlined the scope of the third limb:³⁵

“They are clearly of opinion that the word ‘avoid’ is used in its ordinary sense — in the sense in which a person is said to avoid something which is about to happen to him. He takes steps to get out of the way of it.”

As suggested by Trebilcock³⁶, the concept of avoidance envisages the targeting of arrangements, which have the effect of preventing a liability from coming into existence, where such liability would have arisen but for the arrangement. The position in respect of the third limb was summarised by Baragwanath J in *Miller*³⁷, where his Honour held that:

“...it plainly embraces the hypothetical situation of what tax the taxpayer would have had to meet had the arrangement not been made and the former regime continued...”

In this regard, the recent High Court judgment in *Penny v CIR, Hooper v CIR*³⁸ is somewhat troubling. The case involved two orthopaedic surgeons who formed a business structure involving a company and a trust (the beneficiaries of which were the surgeons, their spouses and children). The overall effect was that significant portions of the income derived from the orthopaedic businesses were taxed at marginal tax rates that were lower than the top rate. MacKenzie J found that section BG 1 did not apply. His Honour noted³⁹:

³⁴ Inland Revenue, *Exposure Draft INA0009: Interpretation of Sections BG 1 and GB 1 of the Income Tax Act 2004*, Wellington, September 2004, p 28, para 3.3.13

³⁵ [1958]AC 450,464

³⁶ M J Trebilcock, *Section 260: A Critical Examination*, 1964, Vol 38, ALJ, p 237

³⁷ (1997) 18 NZTC 13,001

³⁸ *Penny v CIR; Hooper v CIR* (2009) 24 NZTC 23,406 (HC)

³⁹ *Ibid*, at para 75

“I have endeavored to explain why I do not discern, in the scheme of the Act, a general legislative intention to proscribe the choice of the corporate form for a personal services business.”

Although MacKenzie J does emphasise the scheme and purpose approach in other parts of the judgment, his Honour’s overall assessment is similar to the much-criticised approach taken by Barwick CJ in *Slutzkin v CIR*⁴⁰. The Chief Justice found for the taxpayer on the basis that taxpayers are entitled to choose the form of a transaction, which does not subject the taxpayers to greater tax liability instead of another form that does.

Future liabilities

Clearly, the second and third limbs of the definition recognise that tax avoidance can include relieving, avoiding, postponing or reducing “a potential or prospective liability to future income tax”. The first limb refers only to the “incidence of any income tax” and thus, it may be less likely that this concept would include a future liability to income tax. It is arguable, though, that the concept is not limited to a liability to income tax in the current year. The income tax liability in some respects must be foreseeable based on a “reasonable expectation”⁴¹ of what is likely to occur.

In some transactions, it will be easy to apply the test because the alternative actions will be obvious or most likely to occur in the absence of the actual transaction that did occur. The challenge arises where there may be many alternative courses of action is implemented.

The difficulty in relation to understanding the potential application of the provision was as referred to by Richardson J in *CIR v Challenge Corporation Ltd*,⁴² where His Honour stated:

“... ‘Liability’ is in turn defined as including a potential or prospective liability in respect of future income. That definition is still deficient. It still does not answer Lord Wilberforce’s question: ‘is it [the liability] one which must have arisen but for the arrangement, or which might have arisen but for the arrangement, and if ‘might’, probably might or ordinarily might or conceivably might?’ A

⁴⁰ (1977) 140 CLR 314

⁴¹ Section 177C (1) ITAA 1936 (Cth) outlines the “reasonable expectation test” for the Australian anti-avoidance rules

⁴² *CIR v Challenge Corporation Ltd* [1986] 2 NZLR 513

complicating fact is that every financial transaction of the taxpayer may effect a tax change and it is not to be supposed that the potential or prospective liability in respect of future income to which the definition refers was intended to have that reach. ...”

Inland Revenue discusses this difficulty in its exposure draft⁴³:

“The comments of Richardson J suggest he was not willing to extend the reach of the definition to apply to every financial transaction that may effect a tax change. If this is taken to reflect the stance taken by judges generally, the practical matter remains as to whether to come within the definition of ‘liability’, the liability must be one which would have arisen, or which probably or conceivably might have arisen, but for the arrangement.’ In essence, it would appear that what is necessary is a test that recognizes an outcome that a reasonable person would expect to have occurred in the absence of the actual transaction that did occur.”

Tax Mitigation

The Privy Council in *Challenge*⁴⁴ first introduced the distinction between tax mitigation and tax avoidance. The Board began by citing Lord Tomlin's famous statement in the *Duke of Westminster*⁴⁵ that:

“... every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Act is less than it would otherwise be.”

The majority subsequently recorded their view on tax mitigation in the following way⁴⁶:

“Income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to reduction in his tax liability. Section [BG 1] does not apply to tax mitigation because the taxpayer's tax advantage is not derived from an ‘arrangement’ but from the reduction of income which he incurs ... Income tax is avoided ... when the taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that reduction.”

In *Challenge*⁴⁷, the Privy Council suggested that for a taxation advantage to be enjoyed, the taxpayer should actually incur the expenditure, loss or disadvantage, that Parliament

⁴³ Inland Revenue, *Exposure Draft INA0009: Interpretation of Sections BG 1 and GB 1 of the Income Tax Act 2004*, Wellington, September 2004, p 32, para 3.3.29

⁴⁴ *CIR v Challenge Corporation Ltd* (1986) 8 NZTC 5,219

⁴⁵ *CIR v Duke of Westminster* [1936] AC

⁴⁶ *CIR v Challenge Corporation Ltd* (1986) 8 NZTC 5,219, 5,225

⁴⁷ *Ibid*

intended the taxpayer to have suffered in that situation. Tax avoidance is distinct from tax mitigation as it sometimes said to be identifiable by the presence of the “hallmarks” of tax avoidance. Thus, tax mitigation is outside the scope of the general anti avoidance provision where the taxpayer obtains a tax advantage by reducing his income or by incurring expenditure in circumstances in which the taxing statute affords a reduction in tax liability.

However, in *Hadlee*⁴⁸, the Court of Appeal question about the distinction, Cooke P stated that:

“The distinction between tax avoidance and tax mitigation is both authoritative and convenient for some purposes, but perhaps it can be elusive on particular facts. Whether it could solve all the problems in this field may be doubtful and none of the cases collected by Lord Templeman at pp 562-3 of the report is closely in point.”

The House of Lords in *Macniven v Westmoreland Investments Ltd*⁴⁹ and in *O'Neil v CIR*⁵⁰ further rejected the distinction of tax avoidance and tax mitigation. In these two cases, the Privy Council described it as unhelpful. This was because it describes a conclusion rather than a signpost to it. Clearly, the concept of tax mitigation has no place in New Zealand anti-avoidance.

Recently, the *Ben Nevis* case confirmed this where Tipping, McGrath and Gault JJ noted⁵¹:

“The distinction between tax mitigation and tax avoidance is now seen as conclusory and unhelpful. The underlying reasoning of the Privy Council [in *Challenge*] was later encapsulated by reference to the ‘commercial’ meaning as against the ‘juristic’ meaning of a specific provision. Whatever terminology is used, the important aspect of *Challenge Corporation* however is the underlying approach.”...

⁴⁸ *Hadlee & Sydney Bridge Nominees Ltd v CIR* [1991] 3 NZLR 517 (CA)

⁴⁹ *Macniven v Westmoreland Investments Ltd* [2001] 2 WLR 377 (HL)

⁵⁰ *O'Neil v CIR* (2001) 20 NZTC 17,051 (PC)

⁵¹ *Ibid*, para 95

C. “Purpose or Effect”

The next step of identifying the tax avoidance arrangement is to determine the purpose or effect of the arrangement and whether the purpose or effect of tax avoidance is more than merely incidental.

The predication approach, in the general anti-avoidance context, has been used by the courts to determine which arrangements are entered into and has a purpose or effect of tax avoidance. The predication approach was enunciated by Lord Denning in *Newton*⁵², where his Lord stated:

“In order to bring the arrangement within the section, you must be able to predicate - by looking at the overt acts by which it was implemented - that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labeled as a means to avoid tax, then the arrangement does not come within the section.”

The predication approach is still used to determine or classify a purpose or effect of the arrangement as being one of tax avoidance. For example, in *Challenge*⁵³, Woodhouse P in his dissenting judgment confirmed the applicability of the test in respect of the revised legislation. Where his Honour stated:

“In any case it is my opinion that the test laid down by Lord Denning in the *Newton* case continues to have application for New Zealand, for s 99 just as it did for the earlier s 108.”

The term purpose or effect was discussed in *Ashton*⁵⁴ as:

“If an arrangement has a particular purpose, then that will be its intended effect. If it has a particular effect, then that will be its purpose and oral evidence to show that it has a different purpose or different effect to that which is shown by the arrangement itself is irrelevant to the determination of the question whether the arrangement has or purports to have the purpose or

⁵² [1958] HCA 31

⁵³ (1985) 9 TRNZ 81, 86 (CA)

⁵⁴ [1975] 2 NZLR 717

effect of in any way altering the incidence of income tax or relieving any person from his liability to pay income tax.”

It was held in *Tayles v CIR*⁵⁵ that it is only the purpose of the arrangement, which is of concern and the term “effect” as used in the definition is redundant. The House of Lords in *Newton v FCT*⁵⁶ held that “purpose” does not mean motive or intention, but the end or effect which the arrangement is intended to achieve. If there is more than one purpose, the tax avoidance purpose must be “more than merely incidental”. The question then arises as to what is a merely incidental purpose or effect. In relation to determining what is an incidental purpose or effect, in *Hadlee and Sydney Bridge Nominees Ltd*⁵⁷ Eichelbaum CJ concluded:

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

The concept of incidental purpose or effect received further consideration in *Challenge*⁵⁸ where Woodhouse P stated:

“... I do not think that the phrase ‘merely incidental’ does have such a limiting effect and in accord with *Newton v C of T*⁵⁹ I am satisfied as well that the issue as to whether or not a tax saving purpose or effect is ‘merely incidental’ to another purpose is something to be decided not subjectively in terms of motive but objectively by reference to the arrangement itself.... When construing section 99 and the qualifying implementations of the reference in subsec (2) (b) to ‘incidental purpose’ I think the questions which arise need to be framed in terms of the degree of economic reality associated with a given transaction in contrast to artificiality or contrivance or what may be described as the extent to which it appears to involve exploitation of the Statute while in direct pursuit of tax benefits.”

⁵⁵ [1982] 2 NZLR 726 (CA)

⁵⁶ [1958] HCA 31

⁵⁷ (1989) 11 NZTC 6,155, 6,175 (HC)

⁵⁸ *CIR v Challenge Corporation Ltd* [1986] 2 NZLR 513, 533

⁵⁹ [1958] AC 450

From then, Woodhouse P established the “more than merely incidental” purpose or effect test. A tax avoidance purpose will be merely incidental if it is not pursued as a goal in itself. Whether tax avoidance is pursued as a goal in itself will be determined objectively (rather than subjectively) and if this is the case, then its purpose will not be merely incidental. In a New Zealand case⁶⁰, the operation of the “merely incidental” test is clarified as follows:

“What is important for present purposes about the decision in *FCT v Hart*⁶¹ is that it expressly reinforces dicta from both the English and New Zealand Courts that tax consequences are an important consideration in any commercial activity. It is therefore legitimate, indeed necessary, to take them into account in deciding how to structure a given transaction. That, in my view, is what Parliament intends by the ‘merely incidental’ test. It is to provide a clear distinction between arrangements which are entered into for some proven commercial purpose and have as a consequence some favourable tax outcome, and those which are entered into to secure some saving of tax.”

Blanchard J highlighted the importance of the purpose element and its inter-relationship with the arrangement element in the *BNZI*. As discussed elsewhere in this dissertation, the key issue in the *BNZI* case was the scope of the arrangement. Having decided that the BNZ Bank was not part of the arrangement involving the downstream transactions, his Honour also noted⁶²:

“The adjustment can be made against both a party to the arrangement and a person affected, who is not necessarily a party. But it can only be made only where a tax advantage has been obtained “under that arrangement”. The Commissioner therefore cannot make an adjustment as against someone who is not a party merely because that person has received a payment subsequent to the operation of an arrangement but outside the arrangement.”

His Honour then highlighted the importance of the purpose element and the practical difficulties associated with applying the purpose element. In finding that the purpose

⁶⁰ *Case XI* (2005) 22 NZTC 12,001

⁶¹ (2004) 55 ATR 712

⁶² *Ibid*, at para 175

element had not been satisfied in this case, his Honour appears to highlight the knowledge that BNZ had of the upstream transactions:⁶³

“The Bank was aware that Capital Markets would take the position that what it might choose to do with the money was not to be dictated by the Bank and was a commercial secret. ... Reasonable enough, I consider, secrecy in this context was not taken as indicative of the existence of an illegitimate scheme. The Bank has discharged the burden of showing that it did not believe that there would be any avoidance and that it had good reason to so believe.”

Ohms⁶⁴ notes this is indeed a problematic issue. He points out that in *BNZI*, Thomas J, was of the view that there is no *mens rea* element in s BG 1. However, the other judges (as can be seen from the statement of Blanchard J above) do not share this view.

Ohms⁶⁵ further notes that:

“[There is a] consistent application of a *mens rea* requirement by both the Australian and New Zealand courts. Indeed, the most recent Privy Council decision in *O’Neil*, Lord Hoffman specifically made mention of the point that s 99 possessed criteria by which offending arrangements were to be distinguished from those which were not caught. This implies a further consideration of the taxpayer’s state of mind, even though there is an arrangement that has a tax avoidance effect. Further, judges have also pointed out to the fact that s BG 1 could not be construed literally because it is a recognized reality that many commercial or family transactions have an effect of reducing the incidence of tax. As noted by McGechan J in *BNZI*, s BG 1 if read literally⁶⁶... avoids for tax purposes the majority of business or family transactions. Whatever else may be said, it is widely accepted that extreme outcome cannot have been intended by the parliament.”

⁶³ Ibid, para 179

⁶⁴ C Ohms et al, *Income Tax in New Zealand*, Thompson Brookers, 2004, p 1107

⁶⁵ Ibid, p 1108

⁶⁶ Ibid, at p 15,732, 15,593

D. The Choice Doctrine

The choice doctrine is the fourth step, which is not a statutory rule but has been adopted by the Courts to identify whether s BG 1 applies to any given arrangement.

In *Mangin*,⁶⁷ Lord Wilberforce had some concerns about the application of the general anti-avoidance provisions:

“[s BG 1 fails] to specify the relation between the section and other provisions in the [ITA] under which tax relief, or exemptions, may be obtained. Is it legitimate to take advantage of these so as to avoid or reduce tax?”

The issues in particular sections of the Income Tax Act present a choice of alternative courses of action and that the deliberate exercise of a choice to generate a tax advantage is not invalidated by a general provision such as s BG 1. If a taxpayer chooses to arrange his or her affairs to bring them within the terms of one of those sections, s BG 1 may not override the specific treatment that other section must be taken to have intended.

The High Court of Australia in *WP Keighery Pty Ltd* first adjudicated on the choice doctrine⁶⁸:

“Whatever difficulties there may be in interpreting s.260, one thing at least is clear: the section intends only to protect the general provisions of the Act from frustration, and not to deny to taxpayers any right of choice between alternatives which the Act itself lays open to them. It is therefore important to consider whether the result of treating the section as applying in a case such as the present would be to render ineffectual an attempt to defeat etc a liability imposed by the Act or to render ineffectual an attempt to give a company an advantage which the Act intended that it might be given.”

In *Casuarina Pty Ltd*,⁶⁹ the court also approved the view that the section was not intended to deny taxpayers any right of choice between alternatives provided under the Act, and the intention of s 260 was to protect the general provisions of the Act from frustration.

⁶⁷ *Mangin v CIR* [1971] NZLR 591, 602 (PC)

⁶⁸ *WP Keighery Pty Ltd v FCT* (1957) 100 CLR 66, 92

⁶⁹ *Casuarina Pty Ltd v FCT* (1971) 127 CLR 62 (Full HCA)

The choice principle was gradually extended. In *Slutzkin*,⁷⁰ the taxpayer had the right to choose the form of transaction that will not subject him to tax.

In *Challenge*,⁷¹ the appellant argued that s 99 could not be used to defeat other provisions such as s 191 of the Income Tax Act 1976 or to prevent a result that any of them contemplated, that is, the choice principle. Richardson J considered the “choice principle” and stated:

“Clearly the Legislature could not have intended that sec 99 should override all other provisions of the Act so as to deprive the tax paying community of structural choices, economic incentives, exemptions and allowances provided for by the Act itself. His Honour also stated that in the end, the legal answer must turn on an overall assessment of the respective roles of the particular provision and s 99 under the Statute and the relation between them. That is a matter of statutory construction ... Woodhouse P⁷² rejected the choice principle and concluded that the answer to questions of the ambit of s 99, when in conflict with specific statutory provisions, was to be found in the use of the words merely incidental purpose or effect”.

If a tax avoidance purpose had “merely incidental purpose or effect”, it would not trigger s 99. However, the ambit of the section should be discovered as a matter of fact and degree on a case-by-case basis. In essence, both Judges recognised the tension between taxpayers arranging their tax affairs effectively and the need to protect the tax system from avoidance abuse. Richardson J's statutory construction approach to the “choice doctrine” in *Challenge*⁷³ has subsequently been supported by the decisions of the Privy Council and House of Lords.

In *O'Neil*⁷⁴, Lord Hoffmann stated:

“On the other hand, the adoption of a course of action which avoids tax should not fall within s 99 if the legislation, upon its true construction, was intended to give the taxpayer the choice of avoiding it in that way. Therefore, under choice doctrine section BG 1 should not be applied to override the specific

⁷⁰ *Slutzkin v FCT* (1977) 140 CLR 314

⁷¹ *CIR v Challenge Corporation Ltd* (1986) 8 NZTC 5219

⁷² *Ibid*

⁷³ *Ibid*

⁷⁴ *O'Neil v CIR* (2001) 20 NZTC 17,051 (PC)

provisions of the Act if to do so would defeat rather than promote the statutory purpose. On the other hand, section BG 1 should not be construed subordinate to the rest of the income tax legislation as to do so would render it largely redundant and ineffective.”

Richardson P expressed similar sentiments in the *BNZI* case⁷⁵:

“The function of s 99 is to protect the liability for income tax established under other provisions of the legislation. The fundamental difficulty lies in the balancing of different and conflicting objectives. Clearly the legislature could not have intended that s 99 should over-ride all other provisions of the Act so as to deprive the taxpaying community of structural choices, economic incentives, exemptions and allowances provided by the Act itself. Equally the general anti-avoidance provision cannot be subordinated to all the specific provisions of the tax 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. The general anti-avoidance section thus represents an uneasy compromise in the income tax legislation.”

⁷⁵ *Ibid*, at para 41

E. Reconstruction

Once the Court has determined that an arrangement entered into by the taxpayer is void under s BG 1, the Commissioner is given an adjustment power under section GA 1(1)⁷⁶ to adjust the income of the taxpayer so as to counteract any tax advantage derived by the taxpayer from the arrangement.

Section GA 1 provides:

“Where an arrangement is void in accordance with section BG 1, the amounts of gross income, allowable deductions and available net losses included in calculating the taxable income of any person affected by that arrangement may be adjusted by the Commissioner in the manner the Commissioner thinks appropriate, so as to counteract any tax advantage obtained by that person from or under that arrangement, and, without limiting the generality of this subsection, the Commissioner may have regard to...”

The object of s BG 1 is to grant the Commissioner the power to adjust the taxpayer's income tax liability subject to an arrangement as if that arrangement had not been entered into or carried out. It was recognised in *Mangin*⁷⁷ that: “[the section] gives rise to a number of extremely difficult problems as to what hypothetical state of affairs is to be assumed to exist after the section has annihilated the tax avoidance element in the arrangement.”

In *Miller*⁷⁸, the Court of Appeal discussed the ambit of the Commissioner's power under the reconstruction section that:

“[It] gives the Commissioner a wide reconstructive power. He 'may' have regard to the income which the person he is assessing would have or might be expected to have or would in all likelihood have received but for the scheme, but the Commissioner is not inhibited from looking at the matter broadly and making an assessment on the basis of the benefit directly or indirectly received by the taxpayer in question.”

⁷⁶ Income Tax Act 2007

⁷⁷ *Mangin v CIR* [1971] NZLR 591, p 602 per Lord Wilberforce (PC)

⁷⁸ *Miller v CIR; Managed Fashions Ltd and Ors v CIR* (1998) 18 NZTC 13,961, 13,980 (CA)

The Commissioner therefore considers that section GA 1(1) allows the exercise of a wide discretion in the adjustment of gross income, allowable deductions and net losses subject to a tax avoidance arrangement, to counteract any tax advantage. The adjustment can only be made where a tax advantage has been obtained and the adjustments may apply to more than one person.⁷⁹ The concept of a “tax advantage” brings with it an expectation that the person will be in a better tax position. It is noted that the legislation provides that the Commissioner “may” adjust for the tax advantage.

It is suggested that the use of the word “may” be able to indicate discretion on the part of the Commissioner. Section GA 1 does not provide a statutory code about how the Commissioner should assess the taxpayer's income tax liability absent the arrangement, nor have the Courts enunciated any principles that the Commissioner should have regard to in exercising his power under s GA 1. What the Courts have asserted, is that the reconstruction has to be reasonable, such that the Commissioner must have a reasonable basis for its assessment of the taxpayer's income tax liability absent the tax advantage derived from the arrangement.

In *Peabody*⁸⁰ the High Court of Australia noted that:

“A reasonable expectation requires more than a possibility. It involves a prediction as to events which would have taken place if the relevant scheme had not been entered into or carried out and the prediction must be sufficiently reliable for it to be regarded as reasonable”.

⁷⁹ Ibid

⁸⁰ *FCT v Peabody* 94 ATC 4,663

VI. “PURPOSE OR EFFECT”

The purpose or effect, as noted above, must be present to determine the tax avoidance arrangement, which is void for tax purposes.

A. Newton Predication Test

In the *Newton*⁸¹ case, Lord Denning stated that :

“In order to bring the arrangement within the section you must be able to predicate - by looking at the overt acts by which it was implemented - that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section.”

This adopts a transactional approach to the identification of an arrangement within the provision that utilises both *actus reas* and *mens rea*. The *actus reas* requires that an arrangement exists which has the effect of tax avoidance. The *mens rea* requires that an object or purpose of arrangement must be to achieve the tax avoidance benefit. The courts have construed “purpose” as a state of mind to be equivalent to the object or reason of a course of action.

In the *Bell*⁸² case the High Court of Australia described s 260 as extending beyond contracts and agreements so as to “embrace all kinds of concerted action by which persons may arrange their affairs for a particular purpose or so as to produce a particular effect”⁸³ In the decision in *Tayles v CIR*⁸⁴ McMullin J concluded in relation to s 108, that the phrase “purpose or effect” has been typically construed synonymously to refer to the objective of the taxpayer.

B. Practical difficulties in applying the predication test

⁸¹ *Newton v C of T* [1958] AC 450 at page 466

⁸² *Bell v FCT* (1953) 87 CLR 548, 578

⁸³ (1953) 87 CLR 548, 578

⁸⁴ [1982] 2 NZLR, 726, 734 CA

The tax avoidance arrangement definition refers to arrangements that have a purpose or effect of avoiding tax. However, it is recognised that the reference to “effect” is redundant and the focus is on the “purpose” of an arrangement. If the effect were the only criterion, it would apply to otherwise bona fide arrangements and transactions that incidentally resulted in a tax benefit regardless of the reason as to why the arrangement took place. In terms of *Newton*, purpose is taken to mean the end or objective of the taxpayer in undertaking the subject arrangement.

In the next part, the writer examines cases, which confer the practical problems associated with applying the predication test.

1. Early Australian High Court decision – *Jaques*

*Jaques v FCT*⁸⁵ is a significant case for one reason – it is one of the earliest Australian High Court decisions on anti-avoidance.

This case was about the tax consequences involving the restructuring of a company (“the old company”). It was placed into voluntary liquidation and the liquidator divided the operations of the company into two divisions and subsequently entered into agreements with two new companies under which each company purchased one division. The next step was an arrangement whereby the liquidator sold the assets of the old company to the two new companies for a cash consideration. The two new companies issued contributing shares to the shareholders of the old company. Subsequently calls were made on the shareholders in respect of these shares. The amounts of the calls were equal to the amount of consideration payable for the assets of the old company. Technically, this arrangement qualified as a deductible expense.

The High Court found for the Commissioner on the basis that the arrangement fell within the ambit of the third limb of s 260. Specifically, that it displayed an effect of tax avoidance by enabling the shareholders to reduce their assessable income by, in effect, “manufacturing” a deduction for tax purposes. The Court was heavily swayed by the fact

⁸⁵ *Jaques v FCT* (1924) 34 CLR 328

that what was done via the “arrangement” was to create deduction which prior to the arrangement was not available.

In *Jaques v FCT*⁸⁶, Knox CJ said that the transactions were complained of what they were:

“... to enable the members of the old company to escape wholly or in part from their liability to pay income tax on their true taxable income by obtaining a deduction under s 18(1)(i) of the Income Tax Assessment Act to which they were not on the real facts entitled. These transactions, on which the appellant's claim to a deduction is rested, constitute in my opinion an arrangement having the purpose of relieving the appellant, in common with other members of the old company, from liability to pay income tax which on the true facts he was liable to pay, and so fall within s 53 of the Income Tax Assessment Act 1915-1918” (the emphasis is mine).

His Honour's view was supported by Isaacs J who stated that:

“...the transactions in no way altered the income of the taxpayer”.⁸⁷

The *Jaques* judgment, in the writer's view, appears to be a very “clinical” type analysis, that is, the judges did a “before and after” analysis of the tax consequences arising from the arrangement. In this case, a deduction had been after the arrangement and that was enough for their Honours to find that the anti-avoidance legislation had been breached. A consideration was given to the commercial analysis. (For example, whether this type of re-structuring was common-place at that time).

⁸⁶ Ibid, at page 355

⁸⁷ Ibid, at page 360

2. BNZI – per Blanchard J

In *BNZI*, Blanchard J highlighted the importance of the correlation between the purpose elements and the arrangement elements. The discussion, earlier in this dissertation, which concerned the *BNZI* case was in relation to the scope of the arrangement. An important aspect of Justice Blanchard's judgment was that his Honour applied the purpose element by reference to the commercial factors surrounding the transactions involving the redeemable preference shares⁸⁸:

“The tax advantage which the Bank sought from the redeemable preference shares appeared to be achievable legitimately. Redeemable preference share transactions, structured as this one was in the upstream transaction, were relatively common-place. So far as the Bank was concerned, the structure consisted of and went no further than the subscription for the preference shares, the put option and the securities.”

From the above statement by Blanchard J in finding for the taxpayer, it can be concluded that His Honour placed a heavy reliance on commercial considerations. This judgment was in stark contrast to the “clinical” approach in *Jaques*.

3. Penny and Hooper

As noted earlier, the *Penny and Hooper* decision is respectfully, in the writer's view, considered incorrect on the basis that it did not correctly apply the purpose element. However, even if His Honour had applied the test correctly (and probably found for the Commissioner), there would still arise significant conceptual problems with that decision.

Consider an example involving two orthopaedic surgeons who set up a business structure identical to that set up in the *Penny and Hooper* case.

The first surgeon set up his structure in 1992, when the top marginal tax rates were identical. Therefore, there were little or no tax advantages associated with the structure. As such, the sole purpose was commercial or family. It would be difficult to hold that once the

⁸⁸ *Ibid*, at para 179

top tax rates were changed (and tax benefits started arising from that structure) that it constituted a tax avoidance arrangement. It would be unfair to the taxpayer and even against the scheme and purpose of the income tax legislation.

The second surgeon sets his structure in 2002, when there is a 6% difference in the top tax rates. Clearly, tax avoidance was a significant purpose in setting up the structure. Therefore, if the Commissioner invokes s BG 1 against this surgeon (and the Courts uphold the Commissioner's contentions), then the situation is where two surgeons in the exact situation are taxed differently. Clearly this would be against one of the most fundamental aims of any taxing system, viz. to have equity between two taxpayers in the same situation.

The writer considers that this conundrum is perhaps impossible to resolve under the current anti-avoidance framework. A possible reform option is outlined later in this dissertation.

C. Confusion with the choice doctrine and tax mitigation

The concept of choice doctrine and tax mitigation has been discussed earlier in the dissertation. The confusion in these concepts often arises when considering the relationships between s BG 1, the anti-avoidance provision of the Act and the other provisions that determine the tax liabilities of the taxpayers. It is from these issues that the choice doctrine has arisen. This principle deals with the issue of whether s BG 1 applies absolutely to override other provisions of the Income Tax Act.

Parsons⁸⁹ delineates the choice doctrine as:

“...A doctrine that precluded the operation of [general anti-avoidance provision such as [BG 1] if the tax consequences of the arrangement in question were consequences that the policy of the relevant provisions of the Act would approve.”(Emphasis added)

⁸⁹ R W Parsons, *Income Taxation in Australia: Principles of income, deductibility and tax accounting*, (1985), Law Book Co., Sydney, at para 16.29

While the above principle is not difficult to comprehend at the theoretical level, its practical application is problematic. In essence, the difficulty arises in delineating the exact ambit of the choice doctrine – the circumstances in which it applies. Moreover, it can be said that a choice *is* offered by the Act.

The choice doctrine originated from the Court of Appeal decision of *Challenge Corporation Ltd v CIR*⁹⁰ where Lord Templeman described tax avoidance as a situation where:

“The taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that reduction.”

Tax mitigation, on the other hand occurs where:⁹¹

“A taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to reduction in his tax liability. Section 99 [BG 1] does not apply to tax mitigation because the taxpayer’s tax advantage is not derived from an “arrangement” but from reduction in income which he accepts or the expenditure which he incurs.”

If one has regard to the factual setting of the Privy Council decision in *Mangin*⁹² where the taxpayer transferred part of his farm and income to a family trust, this would be on the one hand tax mitigation on the test developed by the Board in *Challenge*⁹³ because a real reduction in income had been experienced. On the other hand, it would be tax avoidance within the meaning of *Newton* as that concept was applied by the Board in *Mangin*⁹⁴.

⁹⁰ [1986] 2 NZLR 513,550 (CA); (1986) 8 NZTC 5,001; (1985) 9 TRNZ 81 (CA)

⁹¹ *Ibid*

⁹² G Harley, *The Europa Oil (NZ) Case*, points to features of the case which emphasise the fact that s.108 was properly applied, and the third limb of s.99 would apply equally

⁹³ [1986] 2 NZLR 513,550 (CA); (1986) 8 NZTC 5,001; (1985) 9 TRNZ 81 (CA)

⁹⁴ [1971] NZLR591,598 (PC)

VII. WHAT LEGISLATIVE AND INTERPRETATION TECHNIQUES ARE REQUIRED IN ANY AVOIDANCE ANALYSIS?

A. Rules of Statutory Interpretation

Traditionally the Courts have developed three approaches that are used to interpret legislation. These are:⁹⁵

1. The literal rule: the intention of parliament to impose taxation was to be determined according to plain, ordinary meaning of language used by the legislature.
2. The mischief rule: states that Courts must have regard to the common law, the mischief and defects that common law did not provide and the remedy the statute provided to alleviate the defects. The court must construe the legislation so as to suppress the mischief and advance the remedy.
3. The golden rule: the courts would depart from the literal rule if the application of the literal meaning to the words of the statute would lead to results that were not the intention of the Parliament.

However, the current favoured approach to statutory interpretation in New Zealand is the “purposive approach”. The purposive approach is approved by section 5(1) of the Interpretation Act 1999, which states that:

“The meaning of an enactment must be determined from its text in the light of its purpose”

In *CIR v Alcan NZ Ltd*,⁹⁶ the Court of Appeal made the following comments about the principles of statutory interpretation⁹⁷:

⁹⁵ C Ohms, et al, *Income Tax In New Zealand*, Thomson Brookers, p 64

⁹⁶ [1994] 3 NZLR 439 (CA)

⁹⁷ C Alley et al. , *New Zealand Taxation 2005 – Principles Cases and Questions*, Thomson Brookers, p 28

1. It is fundamental to all statutory interpretation that words are to be given their ordinary meaning;
2. Where words are capable of more than one meaning and the object of the legislation is clear, the word must be given such a fair, large, and liberal construction as will best ensure the attainment of the object of the Act;
3. Where words are unclear, or are reasonably capable of more than one meaning the one which accords with the evident purpose; and
4. The true meaning must be consonant with the words used, having regard to their context in the Act as a whole, and to the purpose of the legislation to the extent that this is discernible.

In New Zealand, Parliament is the supreme lawmaker and the tax laws in New Zealand are made by Parliament. This is traditionally taken to mean that the Courts cannot declare its legislation invalid. It is very often said that the task of the interpreter, be it a Judge or anyone else, is to give effect to the intention of parliament. A judge or an interpreter is not entitled to legislate, or to go beyond the text and impose solutions simply because they seem fair and just⁹⁸.

The purposive approach is where the words of the legislation are read to their fullest context, and with a view to giving effect to the purpose of the legislation.

Next, the rules in relation to doctrine of legal precedent is considered and discussed.

⁹⁸ J F Burrows , *Statute Law in New Zealand*, Butterworths, Second Edition, p 108

B. The Doctrine of Legal Precedent

The doctrine of legal precedent is known as *stare decisis*. The doctrine based on the notion of consistency. It is one of the key foundations in the development of case law and relies on the Court hierarchy⁹⁹.

The doctrine states that the lower court is obliged to follow the precedents established by a higher court, and is not obliged to follow a decision of a lower court. Since New Zealand has a Supreme Court as its final appellant court, the Court of Appeal may be more restricted from departing from its earlier decisions¹⁰⁰.

Not every statement made by the higher court is binding on the lower court. The doctrine of precedent only applies to statements of law, not to statements about particular facts of a case. There are two types of statements of law:

1. **Ratio decidendi** – this is the statement of law that is an essential step in deciding the case before the court. This is binding on the future courts that are lower in the hierarchy.
2. **Obiter dictum** – in reaching a decision, a judge may refer to examples of principles of law, which are not essential for the particular decision but tend to demonstrate the legal reasoning being used (a statement made by the way).

A precedent case is only binding if the case to be decided by the court has substantially the same **material facts**.

⁹⁹ Ibid, at p 32

¹⁰⁰ McDowell M, Webb D, *The New Zealand Legal System – Structure and Process*, Lexis Nexis, Fourth Edition p 334, 336

C. The Literal Approach

Fiscal legislation was traditionally construed in accordance with the presumption of strict or literal interpretation. In applying the presumption, it was considered that the intention of Parliament to impose taxation was to be determined according to the plain, ordinary meaning, of the language used by the legislature. The presumption of strict interpretation was explained by Lord Cairns in *Partington v AG*¹⁰¹ when he said:

“... as I understand the principle of all fiscal legislation, it is this: If the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible, in any statute, what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you simply adhere to the words of the statute.”

In applying the presumption, any ambiguities in the charging provisions of a tax statute were resolved in favour of the taxpayer¹⁰². Conversely, for the taxpayer to gain the benefit of any specific exemptions or deductions, required that the facts fall clearly within the provision and any doubt was resolved in favour of the Crown¹⁰³.

In *Trinity*, the Court of Appeal, while providing an over overview of the inconsistency between general anti-avoidance provisions and specific tax rules¹⁰⁴ noted that the *Trinity* scheme “Under the specific tax rules relied on by the taxpayers, they are entitled to deductions for the licence and insurance premiums”. The Supreme Court confirmed this decision.¹⁰⁵

On the other hand, if the *Trinity* scheme was a tax avoidance arrangement as the Commissioner contended, it would have fallen foul of the relevant general anti-avoidance provisions. There is not much difficulty in concluding that a literal reading of the general

¹⁰¹ (1869) LR 4 (HL) 100, 122

¹⁰² *Naranjee v CIT (East Africa)* [1964] AC 1238

¹⁰³ *WA Sheaffer Pen Co Ltd v MNR* [1953] Ex Cr 25

¹⁰⁴ *Ibid*, at para 109

¹⁰⁵ *Ibid*, at para 156

anti-avoidance provisions catches the *Trinity* scheme. The case raises what is now a reasonably familiar problem: which part of the Act takes priority, the general anti-avoidance provisions relied on by the Commissioner or the specific tax rules relied on by the taxpayers.

D. Scheme and Purpose Approach

It is generally recognised that there has been a move towards the use of the "purpose" or the "plain meaning" approach which involves giving effect to the grammatical and ordinary meaning of the words used by the legislation, in the context of the overall objective purpose which the legislation as a whole is intended to achieve.¹⁰⁶

The scope of the purpose approach was explained by the New Zealand Court of Appeal in *Donselaar v Donselaar*¹⁰⁷ where Somers J said:

“The function of the Court in relation to a statute is to discover the intention of the legislature. That intent is to be ascertained from the words it has used. ... In modern legal parlance that is called a ‘purposive’ construction. But it has still to be stressed that the inquiry is not what the legislature meant to say but as to what it means by what it has in fact said in the framework of the Act as a whole.”

E. Acts Interpretation Act 1999 Section 5

It is noted that the above approach was also established by the former Acts Interpretation Act 1924, s 5 (j) that stated:

“Every Act, and every provision or enactment thereof, shall be deemed remedial ... and shall accordingly receive such fair, large and liberal construction and interpretation as will best ensure the attainment of the object of the Act and of such provision or enactment according to its true intent, meaning, and spirit.”

The Interpretation Act 1999 has replaced the Acts Interpretation Act 1924. Section 5(1) is the key provision and serves the same function as the former s 5 (j). It states:

¹⁰⁶ *Challenge Corp Ltd v CIR* [1986] 2 NZLR 511, 549 (CA)

¹⁰⁷ [1982] 1 NZLR 97, 114

“The meaning of an enactment must be ascertained from its text and in the light of its purpose.”

The New Zealand Courts have now, at least, clearly recognised that the purpose approach was mandated by s 5 (j). In *Challenge Corp Ltd v CIR*¹⁰⁸ the purpose approach was approved and supported by reference to s 5 (j). Richardson J noted:

“That is a matter of statutory construction and the twin pillars on which the approach to Statutes mandated by sec 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.”

Whilst some doubt exists as to whether the approach under the former s.5 (j) is directly applicable to the new s.5 (1), the leading academic commentator Professor Burrows expressed the following view:¹⁰⁹

“Overall, however, it is not believed that the new [section] ... 5 (1) will benefit from refined linguistic analysis. It is basically just a re-enactment of s 5 (j) in plainer and more economical terms.”

Dunbar, in his article,¹¹⁰ considered the objective of Parliament stating that when s BG 1 was enacted, Parliament intentionally left the section broad, due to the fact that Parliament was not able to anticipate taxpayers’ each and every action and legislate on the matter. Parliament has left it to the New Zealand Courts to develop interpretative techniques to read down the open-ended definition of tax avoidance arrangement.

In *Miller v CIR; McDougall v CIR*¹¹¹ case Baragwanath J noted that Parliament has deliberately left [s BG 1] open textured.

¹⁰⁸ [1986] 2 NZLR 513, 549 (CA)

¹⁰⁹ Ibid, at p 141

¹¹⁰ D G Dunbar, “A statutory solution to the problem of tax avoidance: the New Zealand experience” Paper submitted to the British Tax Review (as at 31 July 2006) p3

¹¹¹ (1997) 18 NZTC 13,001

In *Challenge Corporation v CIR*¹¹², Woodhouse J commented on the breadth of the general anti-avoidance rule noting that:

“...the Parliament had taken the deliberate decision that because the problem of definition in this elusive field cannot be met by expressly spelling out the series of detailed specifications in the statute itself, the interstices must be left for the attention by the judges.”

From the above, it can be concluded that the Parliament’s objective was to allow the New Zealand Courts to interpret the application of s BG 1 in a purposive manner.

However, in the judgment of *Trinity*, the Court of Appeal has not referred to this and has not analysed the purpose or objective, in that, when construing specific tax rules and looking for their scheme and purpose of s BG 1 should be kept in mind as intended by the Parliament.

This raises an important issue: what intention are we talking about when Parliamentary intention is being ascertained? Is it the actual intention of the Members of Parliament sitting in the House at the time the relevant Act was passed? Harley¹¹³ notes this conundrum when discussing the amendments to the general anti-avoidance provision in the Land & Income Tax Bill (No 2) 1974. Specifically, he noted the significant challenges faced in *Mangin* and the legislative changes that flowed from it:

“On the basis of a “pass/fail” yardstick, and if measured against the serious problems that the section had posed before the Courts and as listed by Lord Wilberforce, the overall question to be answered in the words of Sir Frank Kitto was whether the drafter had taken the trouble to analyse and define his or her intentions before putting pen to paper.”

This highlights the fact that the actual intentions of the Members of Parliament passing the tax bill may not be what we are after. Certainly, the speeches made in Parliament by the Ministers of Finance and Revenue during the passage of tax bills may be relevant in

¹¹² (1986) 8 NZTC 5001

¹¹³ G Harley, *Section BG 1 is in need for a Rewrite: Part I Historical Developments*, Sawyer A (ed), *Taxation Issues in the Twenty First Century* (The Centre for Commercial and Corporate Law Inc (2006), University of Canterbury, p 112

ascertaining the Parliamentary intention. However, the speeches in turn are likely to have been derived from policy documents prepared by Inland Revenue (and to a lesser extent the Treasury). The writer believes that this highlights the importance of policy objectives being outlined by officials prior to tax bills being introduced.

F. Methods of Legal Reasoning

Legal reasoning is the hallmark of jurisprudence. The case discussion that follows demonstrates the importance of legal reasoning and the methodology applied. The *Hallstroms*¹¹⁴ case concerned a company that manufactured and sold household refrigerators. There was a competition from different and better kind of refrigerators so the company suffered a decline in business. The company went into some other form of business that included quite new constructions and differed methods of production of these. The purpose of expending the money upon the opposition proceedings was to enable the taxpayer company to compete and carry into effect plans for manufacturing a very different type of refrigerator.

Thus, while a transition was being effected from the one form of the product to the other as the subject of the company's business, a question arose whether a legal restriction was to be extended. The expenditure was directed to ensuring that there should be no renewal of the restriction. The issue before the courts was whether the expenditure was deductible or of a capital nature. In this case, Dixon J concluded that:

“...this appears to me to go to the character and organization of the profit-earning business and not to be an incident in the operations by which it is carried on. I think it is an affair of capital”

Regent Oil was one of a trilogy of cases decided in 1965 which considered whether trade tie payments to petroleum retailers were capital or revenue in nature.¹¹⁵

Regent Oil was in the business of importing oil and selling it to garages and service stations and faced intense competition during the 1950s. As a consequence of this competition, oil

¹¹⁴ *Hallstroms Proprietary Ltd v The Federal Commissioner of Tax* (1946) 634 (HC)

¹¹⁵ The judgments in *Regent Oil*, *Mobil Oil Australia Ltd v CoT* [1966] AC275 and *BP Australia v CoT* [1966] AC 224 were delivered by virtually the same judges within days of each other

companies such as *Regent Oil* sought to tie retailers into long term exclusive supply arrangements. There were a number of alternative ways in which to structure a trade tie arrangement, and *Regent Oil* chose to utilise a leaseback structure.

The leaseback structure was chosen because of the prevailing view at the time that the premium would be a capital receipt in the hands of the retailer. The view taken by *Regent Oil*, subsequently challenged by the Inland Revenue, was that the premium would also be deductible on the basis that it was in reality a rebate, or alternatively, a necessary marketing expense.

The question before the House of Lords was whether the premium paid for the lease was revenue or capital in nature, that is, whether the payment was deductible to *Regent Oil*. The House held unanimously that the payment was not deductible because it was capital in nature but proffered different reasons in support of this conclusion.

The majority, adopting the strict legal rights approach, concluded that the consideration for the payment was a lease, which on the relevant authorities was a capital asset. As the payment takes its character from the nature of the advantage obtained (the lease) the premium was capital in nature.

Lord Wilberforce, constituting the minority in the case, considered that the approach of the majority was too narrow because when one examined the commercial realities of the case, one could not ignore the fact that the commercial advantage sought and obtained by *Regent Oil* was not the lease, but the trade tie:

“I do not wish to rest on this narrow ground; indeed, I do not think it is sound reasoning to do so. [If] one considers the business reality here, or, in the words of Dixon J, what the expenditure is calculated to effect from a practical and business point of view, the payments were made for rights (reinforced by the lease-sublease method) of exclusive supply of petrol to certain filling stations...[It] is the durability of this complex right which has to be considered, and we must squarely face the question whether such an advantage is sufficiently enduring in the context of Regent's trade to qualify as a capital asset...”

For Lord Wilberforce, the trade tie was a capital advantage because it afforded significant security to *Regent Oil*, was secured by lump sum payment, and most importantly, it endured for a substantial period (21 years). The expenditure referred to in the legal documentation as the “premium” was therefore capital in nature as it secured a capital asset, namely a trade tie.

There are two significant points to be drawn from the different approaches taken in *Regent Oil*. First, it was only a coincidence that the same conclusion was reached by the majority and minority. It is not difficult to alter the facts slightly so the trade tie becomes a revenue advantage (as prevailed in *BP Australia Limited v Commissioner of Taxation*)¹¹⁶, expenditure on which would be revenue in nature on Lord Wilberforce’s analysis.

However, even on the altered facts, the majority would still find that the “premium” is expenditure of a capital nature because the lease would remain a capital asset. It may be argued that the lease ceases to be a capital asset when the lease term is minimal, for example two years. However, such an argument has to be rejected because of the insuperable proposition that, at common law, a premium paid to secure a lease is capital in nature (assuming the taxpayer is not dealing in leases or buying for resale).

This was recognised by Lord Nolan in *CIR v Wattie*¹¹⁷ where his Lordship stated that:

“A premium has always been recognised, in the law of New Zealand as in the law of the United Kingdom, as capital rather than revenue.”

This was indeed the approach of the majority in *Regent Oil*. None of their Lordships considered the length of the lease term a matter relevant to the decision, and once the expenditure was properly characterised as a genuine lease premium it was a simple step to conclude the expenditure was capital in nature unless the taxpayer is dealing in leases.

Secondly, Lord Wilberforce's analysis is consistent with the legal rights created between the parties because the promise to purchase exclusively from *Regent Oil*, which in Lord

¹¹⁶ [1966] AC 224

¹¹⁷ (1998) 18 NZTC 13,991, 13,999 (PC)

Wilberforce's view was the relevant advantage, was a legally enforceable right vested in *Regent Oil* pursuant to the sub-lease. It is important to note that the reason Lord Wilberforce considered the advantage was the trade tie was not because it was a legally enforceable right, but because this was the advantage secured as a matter of commercial reality.

VIII. TRADITIONAL METHODOLOGY ADOPTED FOR ASCERTAINING THE PURPOSE OR EFFECT

A. Newton Predication Test

In the general anti-avoidance context, the word “predication” has been used to describe the process of characterising or classifying whether a transaction involves tax avoidance or not. The courts have attempted to “predicate” from the manner in which the arrangement was entered into whether it has a purpose or effect of tax avoidance.

The *Concise Oxford Dictionary* (10th ed. revised) defines “predicate” as follows; the second definition being the relevant one:

Predicate ... v 1 Grammar & Logic state, affirm, or assert (something) about the subject of a sentence or an argument of proposition. 2 (predicate something on/upon) found or base something on.”

In *Newton*¹¹⁸ the predication test, per Lord Denning, is expressed as:

“In order to bring the arrangement within the section you must be able to predicate — by looking at the overt acts by which it was implemented — that it was implemented in that particular way so as to avoid tax. If you cannot predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section.”

In order for s BG 1 to apply to an arrangement the purpose of the arrangement must be ascertained, and must be found to be one of tax avoidance. The purpose of an arrangement is ascertained by reference to its terms whether oral or in writing¹¹⁹. In *Newton* the Privy Council set out what has become known as the predication test which has been universally adopted by Australian and New Zealand courts as the proper approach to determining the purpose of an arrangement.

¹¹⁸ *Newton v C of T of the Commonwealth of Australia* (1958) 11 ATD 442, 445, (PC) [1958] 2 ALL ER 759, 764

¹¹⁹ *Ashton v C of IR* (1975) 2 NZTC 61,030 at p 61,033

In *Mangin*¹²⁰, the Privy Council referred to the predication test in the context of a possible application of s 108 of the *Land and Income Tax Act 1954*. The Privy Council indicated that the predication test allowed some scope for a taxpayer to adopt tax saving features when implementing a bona fide business transaction.

There are many authorities saying that the motives of the taxpayer in entering into an arrangement are irrelevant¹²¹. This simply means that where it is necessary for evidence to be given as to the terms of an arrangement, evidence to the effect that some purpose other than tax avoidance was intended appears to be irrelevant.

In relation to s 99, the Court of Appeal in *C of IR v Challenge*¹²² confirmed that this test was still relevant. Woodhouse P stated:

“Purpose is something to be decided not subjectively in terms of motive but objectively by reference to the arrangement itself.”

The taxpayer in *Tayles v C of IR*¹²³ relied on *Ashton's*¹²⁴ case to contend that the Court was wrong to place reliance on the way in which the impugned arrangement had in fact worked out in subsequent income years. The taxpayer said that the purpose or effect of the arrangement must be determined only by reference to the arrangement and not by reference to the parties' subsequent conduct. In rejecting this contention, McMullin J said that:

“To note that the provisions of an agreement, plain enough in themselves, have operated in a significant way in a particular year is not to act in breach of that rule of construction in that it is the deed, not the words of the parties, which is speaking. To note the effect of an arrangement on the incomes of the parties to it is to do no more than note the way in which its provisions have been projected into reality”

The general legal principles to be applied in ascertaining the “purpose or effect” of an arrangement can be summarised as follows:

¹²⁰ *Mangin v C of IR* [1971] NZLR 591; 70 ATC 6001

¹²¹ *Newton v FC of T* (1958) 11 ATD 442 (PC) at p 445

¹²² (1986) 8 NZTC 5,001

¹²³ (1982) 5 NZTC 61,311

¹²⁴ *Ashton v CIR* (1975) 2 NZTC 61,030

1. To identify whether an arrangement has a purpose or effect of tax avoidance, the arrangement is looked at with a view to determining whether it can be predicated that it was implemented in the particular way to avoid tax. This is done by examining the overt acts by which the arrangement is implemented. Merely because an arrangement is capable of explanation by reference to ordinary business or family dealings will not necessarily mean that there was no purpose or effect of tax avoidance;
2. The whole set of words “purpose or effect” denotes a concerted action to an end – the end of avoiding tax;
3. “Purpose” is determined objectively by reference to the arrangement itself and not subjectively in terms of motive. “Purpose” is the effect which the arrangement seeks to achieve. “Effect” means the result accomplished or achieved by the arrangement and;
4. If an arrangement has a particular purpose that will be its intended effect. If it has a particular effect then that will be its purpose.

B. Challenge

The majority of the Privy Council, in its judgment delivered in October 1986, ended one of the most significant sagas in recent New Zealand taxation law. The litigation between the Commissioner and *Challenge* was over the potential for application of s 99 of the Income Tax Act 1976 to the acquisition by the company of an existing tax loss company and the subsequent grouping of the tax losses.

There appears to be some degree of confusion after the *Challenge* decision concerning the third limb of the definition of arrangement where, in essence, the effect that must result from the arrangement under this limb is that the taxpayer decreases the tax liability.

Of the two decisions of the Privy Council in relation to the application of s 99, very different approaches have emerged on this issue. In *Challenge*, Lord Templeman seemed to depart from the traditional approach that originated in *Newton*. Later, in *O’Neil*¹²⁵, Lord

¹²⁵ *O’Neil v CIR* (2001) 20 NZTC 17,051

Hoffman seemingly rejected the method of the previous Law Lord and returned to the *Newton* model.

The *Challenge* judgment was in favour of the Commissioner with the majority of the Privy Council overturning the judgment of the New Zealand Court of Appeal and holding that s 99 was applicable to the outlined arrangement¹²⁶.

Challenge entered into a transaction involving the acquisition of an unrelated shell company, with substantial income tax losses, prior to the end of the relevant income tax year. It also involved the grouping of those losses against the assessable income of the *Challenge* group.

The judgment of the Court of Appeal held that s 99 did not apply to the arrangements. Cooke J placed emphasis on the fact that the tax loss grouping provisions, s 191 of the Income Tax Act 1976, in themselves had specific anti-avoidance provisions and conferred tax rights, and that Parliament must have intended those provisions to be operative to allow the obtaining of tax benefits despite s 99.

Richardson J emphasised on the fact that the tax loss grouping provisions inevitably allow the avoidance of tax and the transactions in question merely achieved the taxation consequences contemplated by the Act, with s 99 accordingly not being applicable.

In *Challenge*, Lord Templeman concluded that:

“A clearer case for the application of sec 99 cannot be imagined. If such an arrangement were not caught by sec 99 ... income tax would only be collected from those profitable companies which fail to come to terms with loss-making companies”¹²⁷.

His Lordship then considered the three arguments raised by *Challenge*. The first, and arguably the most significant, was that s 99 did not apply to situations where the specific requirements of the tax loss grouping provisions are met.

¹²⁶ (1986) 8 NZTC 5,219 (PC)

¹²⁷ *Ibid*, at p 5,223

On this argument, his Lordship stated:

“That argument cannot be correct. Tax avoidance schemes largely depend upon the exploitation of one or more exemptions or reliefs or provisions or principals of tax legislation. Section 99 would be useless if mechanical and meticulous compliance with some other section of the Act were sufficient to oust sec 99”¹²⁸.

The second argument of *Challenge* referred to by his Lordship was that as the tax loss grouping provisions contain their own particular tax avoidance provisions, by necessary implication this excludes the general anti-tax avoidance provision of s 99.

His Lordship as expressed the third argument of *Challenge* as:

“...the threat that if their chosen method of tax avoidance is not rendered effective by the Courts, any commercial transaction or family arrangement will be fraught with uncertain, capricious or harsh fiscal consequences and will be vulnerable to action by the Commissioner under sec 99...”

The approach of Lord Templeman appeared to focus on the degree of economic reality associated with a particular arrangement. On the basis contemplated, the third limb would apply if there was an actual deprivation of income or incurrence of expenditure as a result of the arrangement. Such an interpretation was certainly at odds with the concept developed in *Newton* which simply examined the taxation situation of the taxpayer with the arrangement deemed effectual against that which would, in all likelihood, have arisen to ascertain whether a tax saving had been effected.

In *Challenge*, perhaps the most significant statements made by the Privy Council relate to the distinction drawn between “tax mitigation” and “tax avoidance”. In essence, the principal distinction between the conclusions of the majority of the Court of Appeal and those of the majority of the Privy Council relate to whether it must be predicated from compliance with the specific provisions of the tax loss grouping sections that Parliament intended that the claimed tax benefits should result. The issue certainly is not a new one as

¹²⁸ Ibid

Lord Wilberforce in *Mangin v CIR*¹²⁹ noted that the predecessor to s 99 gave rise to a number of areas of uncertainty.

C. Elmiger

Although *Elmiger v CIR*¹³⁰ is primarily a case about the arrangement element, there are nevertheless useful comments made in relation to purpose. In this case, two brothers carried on an agricultural contracting business in order to reduce the high incidence of taxation applicable to their partnership. They restructured their business by selling their assets to a newly formed trust then leasing it back. The net effect sought was to transfer the income of the partnership to the trust, by way of lease payments, and subsequently into the hands of the beneficiaries via trust distributions.

Woodhouse J summarized the application of the “purpose” test as follows¹³¹:

“...On the principles laid down by the Privy Council, therefore, and taking into account the Australian decisions, it seems that the application of s. 108 will depend first upon a decision as to whether an income tax advantage was one of the actuating purposes of the transaction under review; or whether it is “capable of explanation by reference to ordinary business or family dealing, without necessarily being labeled as means for obtaining such a tax advantage. (See Newton’s case [1958] A.C. 450,466). And this decision is to be made objectively by looking at the overt acts done in pursuance of the whole arrangement (ibid. 465). The section is not designed to prevent ordinary commercial, or family, or charitable dispositions. Nevertheless, this is a general provision aimed at otherwise legal methods of tax avoidance. It is designed, as I stated earlier, to forestall the use by individual taxpayers of ordinary legal processes for the deliberate purpose of obtaining a relief from the natural burden of taxation denied generally to the same class of taxpayer. Accordingly, it is my opinion that family or business dealings will be caught by s. 108 despite their characterization as such, if there is associated with them the additional purpose or effect of tax relief (in the sense contemplated by the section) pursued as a goal in itself and not arising as a natural incident of some other purpose, if this were not so I suppose an appropriate legal window dressing could still be devised to defeat the general objects of the section”

¹²⁹ [1971] NZLR 591

¹³⁰ *Elmiger v CIR* [1966] NZLR 683 (HC)

¹³¹ *Ibid.*, at p 695

IX. LATEST DEVELOPMENTS ON PRACTICAL INTERPRETATION OF PURPOSE

A. BNZI

The concept of arrangement requires a mental element of a taxpayer for an arrangement to exist. The mental element relates to the expectation or awareness of the taxpayer as to the object sought to the initial plan and the willingness to be *party* to it and importantly *the steps taken to achieve the end result*.

The decision of the court of Appeal in *CIR v BNZI Investments*¹³² was delivered in 2001. The taxpayer, BNZ Investments Limited (“*BNZI*”), made a series of redeemable preference share investments (“RPS”) in entities provided by Capital Markets Limited (“CML”), a member of the Fay Richwhite Group. This funded the share capital of BNZI taken up by its parents from outside borrowings.

CML used four varieties of transactions that made up the nine transactions. These were:

- a. The funds were deposited with prime overseas banks by BNZI using RPS;
- b. The repatriation of interest earned to BNZI as exempt income;
- c. BNZI and CML negotiated rates of dividends so as to share the tax advantages; and
- d. In future, as intended, the RPS were redeemed.

The structure used consisted two elements, which were referred to as the “upstream” and “downstream” transactions.

The upstream transactions involved borrowing of funds by *BNZI* and included the formation of and capitalization of *BNZI*, and investing the funds borrowed in RPS in entities provided by CML. The RPS carried with it appropriate indemnities and securities.

¹³² *CIR v BNZ Investments Limited*. (2001) 20 NZTC 17,013

The downstream transactions involved the passing through of the funds by the entities that issued the RPS to *BNZI*, then to the down stream entities and the ultimate deposit of the funds with prime overseas banks. The downstream entities were New Zealand, Hong Kong and Cook Islands residents.

The argument put forward by the *BNZI* was that it was not a party to the larger arrangement, including the downstream elements, because it never had knowledge of the wider structure or of the tax avoidance aspect. It contended that it was simply entering into a normal commercial bank lending transaction, which is a common practice.

The Commissioner formed the view that the RPS investments by *BNZI* were caught under s 99 [s BG 1] and that the taxpayer had entered into arrangement that consisted both the upstream and downstream elements.

On this issue it was concluded in the High Court by McGechan J that all elements found in the definition of arrangement had one essential common factor inherent in the term “arrangement”, that is *a consensus involvement by the taxpayer*.¹³³

In applying the leading decision in *Newton v FCT*¹³⁴ McGechan J was of the opinion that Parliament in enacting the definition of arrangement confined itself to consensual activity towards an end and that the intention should be respected¹³⁵.

On appeal to the Court of Appeal, the majority decided in favour of *BNZI*. In the Court of Appeal the majority clearly supported the view that *BNZI* had a *common purpose* of gaining tax advantage with the other parties to the arrangement. Richardson P delivered the leading majority decision that was consistent with that described earlier and seen in *Newton*¹³⁶.

The issue in *BNZI* was whether it was a party to the downstream arrangement. In this regard, if it could be shown that *BNZI* had a common purpose of gaining a tax advantage

¹³³ *BNZ Investments Limited v CIR* (2000) 19 NZTC, p. 15,791

¹³⁴ *Newton v FCT* [1958] AC 450

¹³⁵ *Ibid*, p 15,789

¹³⁶ *FCT v Newton* (1957) 96 CLR 577

with the participators, then the Courts would infer that the taxpayer was a party to the downstream arrangement.

As the evidence stood, *BNZI* entered into an arrangement, that is, issue of RPS, which carried certain tax benefits. However, this by itself was not the arrangement that the Commissioner sought to argue. The downstream arrangement was found to be separate by *McGechan J* and *BNZI* had no *purpose* in relation to that arrangement.

It is considered that the “purpose” of the arrangement has to be determined if tax avoidance is to be alleged. If the taxpayer believes on reasonable grounds that a particular and legitimate tax saving mechanism was to be used by the other party, whereas in fact the taxpayer used a mechanism amounting to tax avoidance, it would be difficult to conclude that the taxpayer had entered into an arrangement for the purpose and effect of tax avoidance.

It is submitted that it would always depend on the facts of a particular case as to the extent of the arrangement entered into by the taxpayer.

B. Peterson

These were cases¹³⁷ taken by the taxpayer in relation to two film investments made in the 1980s. The films were “Lie of the Land” and “Utu”. In both cases the Commissioner concluded that the expenses of the films were inflated by means of non-recourse loans and circular funding. This increased the depreciation deduction apparently available to the taxpayer but for which there was no actual liability as the circular funding had already repaid the loans. The Commissioner disallowed the depreciation deduction to the extent of the inflated expenses.

The taxpayer objected and the cases were heard at the Taxation Review Authority (“TRA”). The taxpayer won one (Lie of the Land) and the Commissioner the other. Both TRA decisions were appealed to the High Court where the taxpayer won one again and the

¹³⁷ [2006] 3 NZLR 433; (2005) 22 NZTC 19,098

Commissioner the other¹³⁸. Both decisions were appealed to the Court of Appeal where the Commissioner won both¹³⁹.

The taxpayer appealed to the Privy Council. The main issue was the proper application of s 99 of the Income Tax Act 1976 to the taxpayer. The taxpayer argued that there was no tax avoidance by him and as he was not part of the “*meeting of minds*” necessary for an arrangement under s 99 (the test from *BNZI*¹⁴⁰). As a result, s 99 could not be applied to him. Further, it was argued that the taxpayer entered a fixed price contract and this was the cost to him of the investment regardless of what consequently occurred outside his knowledge.

The Commissioner argued that s 99 could be applied to the taxpayer as there was a tax avoidance arrangement which also met the *BNZI* test even though the taxpayer was not one of those involved in the necessary “meeting of minds” and he was a “person affected by that arrangement”. The Commissioner also placed weight upon the phrase “whether or not any person affected by that arrangement is a party thereto”

The issue before the Privy Council was whether the Commissioner was correct to adjust the taxpayer’s assessments relying upon s 99.

In a split decision, the taxpayer was successful. This was a 3:2 majority decision. The majority accepted the existence of an arrangement in this case and considered it was entirely at the Commissioner’s option to identify the whole or any part of a composite scheme as the arrangement.

The majority did not accept the taxpayer’s argument that he needed to be a party or participant to an arrangement to be effected by it:

“Their Lordships are satisfied that the ‘arrangement’ which the Commissioner has identified had the purpose or effect of reducing the investors’ liability to tax and that, whether or not they were parties to the arrangement or the relevant part or parts of it, they were affected by it. **Their Lordships do**

¹³⁸ See (2002) 20 NZTC 17,583 and 17,761

¹³⁹ See (2003) 21 NZTC 18,060 and 18,069

¹⁴⁰ [2002] 1 NZLR 450

not consider that the ‘arrangement’ requires a consensus or meeting of minds; the taxpayer need not be a party to ‘the arrangement’ and in their view he need not be privy to its details either.”¹⁴¹ [Emphasis added]

However, the critical question identified by the majority was whether the tax advantage was obtained by tax avoidance and thus within s 99.

The majority considered that the taxpayers are entitled to depreciate the full acquisition costs regardless of how much the film actually cost to make, as the Commissioner did not challenge the apparent acquisition cost of the film plus the non-recourse lending. The focus is on the cost to the person acquiring the asset rather than the person disposing of it and what they did with the purchase price (in this case repay the non-recourse lending but not discharge the investors apparent liability under the loan)¹⁴².

The majority then pointed to a factor that may have enabled the Commissioner to be successful, if there had been a finding of fact at the TRA that the lending was un-commercial¹⁴³. It was also suggested that had the Commissioner argued that to the extent of the non recourse lending was being repaid by the production company, the taxpayer did not purchase a film but paid for the acquisition of a loan. This would not have been deductible as part of the cost of acquiring a film.¹⁴⁴

The minority considered that this was a tax avoidance arrangement. While accepting the “meeting of minds” test found in *BNZI*, the minority recognised:¹⁴⁵

“The investors were not part of the consensus underlying the ‘plan’ or ‘arrangement’ as described; they were not parties to it... We would accept, on the findings of the courts below, that that is so. But sub-section (2) says, in terms, that the arrangement “shall be absolutely void as against the Commissioner ... whether or not any person affected by the arrangement is a party thereto”. The fact that the investors were not parties to the arrangement cannot be enough to allow them to escape section 99”. [Emphasis added]

¹⁴¹ (2005) 22 NZTC 19,098(PC), para 34

¹⁴² Ibid at para 42,43

¹⁴³ Ibid at para 45

¹⁴⁴ Ibid at para 49-51

¹⁴⁵ Ibid, para 89

The minority focused on, and endorsed, the twin pillars of statutory interpretation: statutory scheme and purpose, as found in the *Challenge* case.

Applying the scheme and purpose approach to the facts of the case the minority concluded:

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“...The statutory right to depreciate an item of cost and to deduct the amount of the depreciation from assessable income is plainly a tax advantage. Whether it is a tax advantage vulnerable to attack under section 99 depends, in our opinion, on whether it is within the purpose of the statutory regime. We cannot believe that if the cost of acquisition of a film is inflated for no commercial reason other than that of qualifying for a higher tax deduction than would otherwise be available the amount of the inflation could be regarded as the sort of cost that the statutory regime was intended to assist or encourage...”

The minority also took issue with the majority’s conclusion that there was no evidential basis to say the loans were not genuine. In a lengthy postscript, the minority went to the transcript to highlight proof that the taxpayer had incurred no real liability on the loans.

The writer agrees with comments made by *Williams*¹⁴⁷ that “*this illustrates that the crux of an avoidance case is the interpretation of the provision under which the taxpayer is seeking the tax advantage.*”

Furthermore, Prebble explains in his article¹⁴⁸ that the requirement to have the meeting of minds comes from the fact that the High Court and the Court of Appeal have followed the so-called “legal benefit” in *Cecil Bros Pty Ltd v Federal Commissioner of Taxation*¹⁴⁹. That case says that when a taxpayer incurs an expense you look only at what the taxpayer is legally entitled to get for his money, and calculate fiscal results from there. *Cecil Bros* itself was a footwear retailer. It paid higher than the market price for some of its trading stock by inter-posing a related entity (Breckler Pty Ltd) into the transaction. Breckler was

¹⁴⁶ Ibid, para 101

¹⁴⁷ N, *Williams Privy Council Delivers Final Tax Avoidance Decision: Peterson v CIR*, *New Zealand Journal of Taxation Law and Policy*, September 2005, Vol 11, p 288

¹⁴⁸ J Prebble, *The Peterson Case and its Impact on the rules in BNZ Investments Ltd and Cecil Bros*, in Sawyer A (ed) *Taxation Issues in the Twenty First Century* (The Centre for Commercial and Corporate Law Inc (2006), University of Canterbury, p 21

¹⁴⁹ *Cecil Bros Pty Ltd v Federal Commissioner of Taxation*(1964) 111 CLR 430 (FC)

on a lower tax regime than *Cecil Bros*. Prebble summarises the application of the legal benefit test to this case as follows¹⁵⁰:

“Legally speaking, the transactions netted Cecil Bros only trading stock; the economic benefit to Breckler [i.e. the artificial loss generated] and its shareholders should be ignored: so Cecil Bros could deduct the whole price, inflated though it was”.

While a supposedly a disappointing result for the Commissioner, the Privy Council opinion do offer one helpful point with their unanimous conclusion that a taxpayer need not be a party to or participant in the consensus or meeting of minds necessary for finding a person affected by the arrangement committed tax avoidance.

¹⁵⁰ Ibid, at p 121

X. TRINITY

A. Facts

The appellants were investors in a syndicate that has been involved in the development of a Douglas fir forest project as part of what is known as the *Trinity* scheme. The forest was planted in Southland, and is due to be harvested by 2048.

The land on which the forest was planted was purchased and held by Trinity Foundation (Services No 3) Limited ("Trinity 3"), which was a subsidiary of Trinity Foundation Limited, which in turn was owned by the Trinity Foundation Charitable Trust. The investors did not at any stage acquire ownership of the land.

Investors in Trinity 3 became members of a syndicate, called Southern Lakes Joint Venture, which then formed a company, Southern Lakes Forestry Limited, to act as the joint venture's agent. That company entered into various contracts on behalf of the joint venture, which constituted the scheme.

Investors in the *Trinity* scheme were granted a fifty-year licence to use land in Southland to plant pine trees. The licence gave investors the right to receive proceeds from the sale of the pine trees at harvest. Investors issued a promissory note to pay a fixed fee for the licence in 50 years time. The licence greatly exceeded the value of the land at the time the investment was entered into.

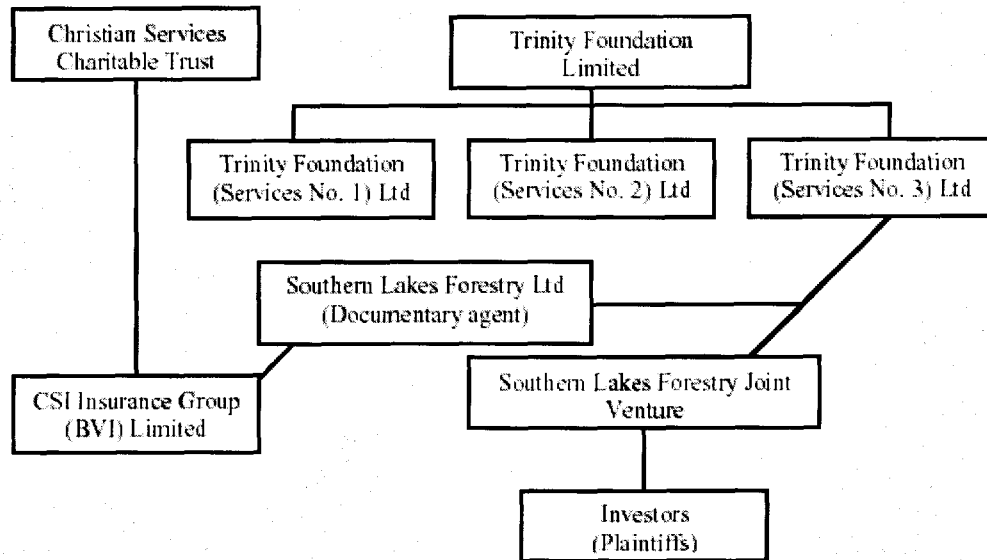
Investors were also required to enter into an insurance arrangement under which an insurer assumed risk for the decrease in the value of the forest at the time of harvest below an amount equal to the fee payable for the licence in 50 years. A small premium was payable upfront but payment of the majority of the premium was deferred until harvest. The investors issued a promissory note to the insurer to secure payment of the deferred premium at harvest.

The result of the scheme was that the investors claimed over 99% of the total expenditure and 87% of the expenditure claimed in the first year was deferred for 50 years. The investors claimed a deduction for tax purposes for the insurance premium in the first year on the basis that the premium had been incurred for tax purposes in that year. Investors treated the cost of the licence fees as “depreciable intangible property” (which includes a “right to use land”) and sought to amortise the cost of the licence over the term of the investment.

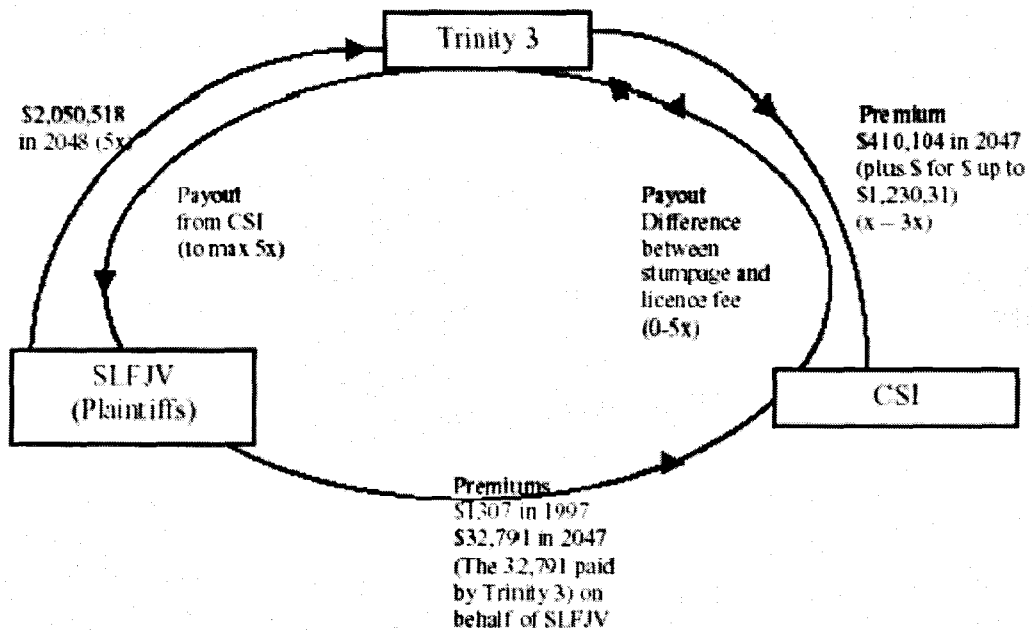
A total of \$3.7 billion of tax revenue was at risk if the scheme had run to maturity. A draft business plan prepared for the insurer stated that *“the real benefits of the deal are tax concessions that can be obtained now by the investors.... The actual outcome of the deal in fifty years is not considered material”*.¹⁵¹

The schematics that follow show the business structure and the flow of funds.

¹⁵¹<http://www.bellgully.com/resources/resource.01415.asp>: Bell Gully update. *The Trinity Case: Tax Avoidance or No More Than the Law Intended*, Aug 2007, last accessed on 15 October 2008



Source: High Court judgment



Source: High Court Judgment

B. Judgment of the Courts

1. High Court

The High Court was to deliberate on whether the *Trinity*¹⁵² scheme was a tax avoidance arrangement. The court had to consider, in particular, whether the Commissioner could disallow the deductions claimed by the taxpayers pursuant to the Income Tax Acts for the reasons that:

1. The forestry investment was not a commercially viable investment;
2. The insurance premium was not deductible, and;
3. The amortised licence premium was not deductible as depreciable property

Interestingly, the Commissioner's challenge was on the basis of the commerciality of the investment. The argument raised by the Commissioner was that the deductions in relation to the licence and insurance premiums were not deductible under the specific statutory provisions relating to deductibility of such expenses as they do not meet the statutory criteria.

The judgment delivered by Venning J in *Trinity* was considered to be a *two step* process. The issues relating to insurance premiums and use of land right premiums when construed, the Court will look at the legal arrangements between the parties and give legal effects of the transactions as set out in the contracts. The Courts would not usually explore the commerciality and the economic substance of the transactions when interpreting statutes. Venning J suggested that these two issues were at the heart of the analysis of tax avoidance¹⁵³.

The High Court judgment advanced around the commerciality of the scheme. The lack of commerciality was an important factor in applying the scheme and purpose approach. Venning J reached the conclusion that the *Trinity* scheme was a tax avoidance scheme.

¹⁵² *Accent Management Ltd v CIR* (2005) 22 NZTC 19,027(HC)

¹⁵³ *Ibid*, para 185

The issue of tax avoidance in *Trinity*, according to Venning J required consideration of the scheme and purpose of the Act, taking into account the specific and general provisions of the Act. The judge had to consider whether there was an arrangement, inter alia, an arrangement that:

1. directly or indirectly alters the incidence of tax avoidance;
2. directly or indirectly relieves any person from the liability to pay income tax; or
3. directly or indirectly avoids, reduces or postpones any liability to income tax.

In reaching its decision the High Court also considered the issue of whether the arrangement was a tax avoidance arrangement, in that, it had tax avoidance as its *purpose or effect* and that if it existed was more than merely incidental.

Not only did the court find that the “purpose or effect” of the *Trinity* scheme was more than merely incidental but a dominant purpose of the *Trinity* scheme. Venning J went on to conclude that:

“The purpose is to ascertained on and objective basis¹⁵⁴”.

This conclusion was consistent with the approach taken by Lord Denning in *Newton*.

2. Court of Appeal

The key findings and the judgment of the Court of Appeal¹⁵⁵ were:

1. While the insurance arrangements were “highly artificial and indeed contrived”,¹⁵⁶ they were not shams, albeit this was decided by a “narrow margin”,¹⁵⁷

¹⁵⁴ *Accent Management Ltd v CIR* (2005) 22 NZTC 19,027(HC), p 301

¹⁵⁵ E Trombitas, *Trinity Exposed: Does the Emperor Really Have No Clothes or is He Wearing an Unusual Silver Rugby Jersey? – The Latest News from the GAAR Front*, New Zealand Journal of Taxation Law and Policy, Vol.13, December 2007

¹⁵⁶ *Accent Management Ltd v CIR* [2007] NZCA 230; (2007) 23 NZTC 21,323, para 57

¹⁵⁷ *Ibid*, para 58

2. The investors' payment of the insurance premium was accrual expenditure under s EF 1 of Income Tax Act 1994 and the resulting deduction should be spread accordingly (although this was academic in light of the overall avoidance conclusion);
3. The licence is a right to use land for the purposes of the Income Tax Act 1994. Due to the existence of the promissory note, the structure of the transaction is that *Trinity* is paid for conferring on the taxpayers that right to use land and the monetary outlay to be made in 2048 is therefore made for that right. The payment is "the cost" of the relevant "right to use land". This meant that there was depreciable intangible property prima facie resulting in depreciation deductions (leaving aside the GAAR ("General Anti-Avoidance Rules"));
4. Notwithstanding the above findings on the "black letter" law arguments, the Commissioner disallowed all deductions correctly on the grounds of avoidance and;
5. The Commissioner could impose penalties of 100 percent of the tax shortfalls arising from the denied deductions because the investors had taken an abusive tax position.

While the Court acknowledged that the deductions under the scheme were technically allowable, it concluded that the end results were not "material" and that the "real benefits" and thus the purpose of the arrangements, was achieving the "tax concessions"¹⁵⁸.

The Court specifically held that the ability to depreciate depends on capital assets being acquired for a business purpose. The licence fee payable was seen as not being a cost of the kind contemplated by the depreciation provisions relied on¹⁵⁹.

The Court also held that there was no business purpose, simply a purpose of generating deductions, and in this respect the taxpayers have not met what Parliament must have contemplated as a precondition of deductibility¹⁶⁰.

¹⁵⁸ Ibid, paras 142 and 143

¹⁵⁹ Ibid, para 144

As noted above, a document authored by the designer (promoter) of the scheme, which recorded that the real advantage of the arrangement were the tax benefits and that the “actual outcome in fifty years time [was] not considered material”, did not help the taxpayers’ case. In the overall scheme of the evidence relating to this case and the Court’s impression of the business plan extract, this evidence was fatal. But, should it have been?

Taxpayer motives are irrelevant in tax cases. In other words, a person can say “I really want to avoid tax at all cost”, but the arrangement (or transaction) might still comply with the law and its spirit so as not to be avoidance. Similarly, the same person can say “I don’t want to avoid tax no matter what” but the transaction can still be found to be avoidance.

The avoidance analysis is an *objective* assessment of the arrangement tested against the legislative background. The real question is whether the policy that underpins the law (that is, the legislative scheme) intends the tax effect despite the technical or literal outcome achieved or contended for by the taxpayer.

The Court acknowledged that when looking at the specific tax rules in the context of the scheme and purpose of taxing statutes, it was necessary to keep the GAAR in mind¹⁶¹.

The implications of the Court’s decision is one where warning messages have been sent to taxpayers that the Commissioner will take a tough stance on purported arrangements which he considers to be tax avoidance.

It is submitted, respectfully, that the Court’s decision has not been comprehensive as it could have been or should have been. The *Trinity* Court of Appeal decision so far has done little, if anything, to clarify the scope and application of the general anti-avoidance provisions, as the court has mainly advocated the “line” test where it has contemplated that a line is to be drawn between proper and improper avoidance.

¹⁶⁰ Ibid, para 144

¹⁶¹ Ibid, para 126

The Court of Appeal decision does not further clarify *how* the distinction was to be made where it is acknowledged that the transaction entered into is otherwise commercial and within the black letter of the law.

Following the Court of Appeal decision, the taxpayers' appealed to the Supreme Court, the highest jurisdiction in the New Zealand legal system. The outcome and analysis of the decision is set out in the preceding section of the dissertation.

3. Supreme Court

The key findings and the judgment of the Supreme Court were as follows:

The long waited decision of the *Trinity*¹⁶² [*Ben Nevis*] case was delivered in the Supreme Court on 19 December 2008. The Supreme Court upheld the Court of Appeal's decision in favour of the Commissioner, in that, the arrangements entered into by the taxpayers' was tax avoidance.

The majority of the Supreme Court delivered by Tipping, McGrath and Gault JJ, found that, although the deductions claimed by the taxpayers complied with the specific provisions that the taxpayers relied on, the taxpayers' use of those provisions was not within Parliament's purpose and contemplation when it authorised deductions of the kinds in question. It found the *Trinity* scheme to be a tax avoidance arrangement that was void against the Commissioner and therefore, disallowed the claims for deductions.

In a separate judgment, the minority judgment delivered by Elias CJ and Anderson J agreed with the majority that there was a tax avoidance arrangement. Therefore, the deductions should be disallowed. In essence, however, the minority did not agree with the majority on the question of how specific statutory allowances interact with the general anti-avoidance provision. Whereas the majority judges accepted that the deductions claimed by the taxpayers satisfied the ordinary meaning of the specific provisions in the Act, Elias CJ and Anderson J did not accept that.

¹⁶² Ibid

The minority seems to be saying that, in determining whether a specific tax provision applies, the courts should take a substance-based (non-literal) approach in determining whether the relevant specific provision “upon its true construction” applies to the facts.

The minority does not agree with the majority that, “when considering the application of a specific tax provision, and before considering the question of avoidance, the Court is concerned primarily with the legal structures and obligations created by the parties and not with the economic substance of what they do”. The minority says this depends on the context.

By contrast, the majority acknowledges that frequently in commerce there are different means of producing the same economic outcome that have different tax consequences. The question arises as to what role the general anti-avoidance provision has (other than a reconstructive mechanism) under the minority’s approach.

The minority conclude that¹⁶³:

“As s BG 1 makes it clear, arrangement tips into tax avoidance if the fiscal affect intended is more than ‘merely incidental’ to the business or family purpose. The fiscal implications of an arrangement that is ‘merely incidental’ to a business purpose may in some cases be substantial and still within the statutory scheme and purpose. ‘Merely incidental’ may properly be contrasted with the end view, the ‘purpose or effect’...”

It follows the fact that one of the purposes of the arrangement may be explainable by reference to a normal business or family per se is to be ignored when establishing purposes under s BG 1. In *Tayles v CIR*¹⁶⁴ Cooke J also observed that s 99(2) applied regardless of whether it could be explained as an ordinary business or family dealing.

Perhaps the most significant aspect of the *Trinity* decision is that their Honours appear to have reinforced the *Newton* predication test as the cornerstone for interpreting the purpose test. What the judgment suggests is that the prediction test is still “well and truly”

¹⁶³ Ibid, at p 23,197

¹⁶⁴ [1982] 2 NZLR726,733 (CA)

applicable in assisting the judges to determine the purpose or effect of the arrangement in question.

C. Legal Methodology taken by the Courts

1. The Court's decision

The Court of Appeal acknowledged that the scheme was clever but commented that:

“...this cleverness should not be allowed to obscure the reality that this particular emperor has no clothes”¹⁶⁵

The Court held that the arrangement was a tax avoidance arrangement void for tax purposes because the real purpose of the investment was to obtain what it described as “spectacular tax benefits” and not to profit from a forestry business.

It upheld the imposition of penalties equal to 100% of the tax benefit claimed by investors on the basis that the position adopted by the investors was "abusive" from a tax perspective.

The Supreme Court upheld the decision of the Court of Appeal.

2. Approaches to tax avoidance

a) Inland Revenue's ("IRD") Traditional Approach

The traditional IRD approach to the application of the general anti-avoidance rules is outlined in a Policy Statement¹⁶⁶ released in 1990. The approach has been to analyse:

1. the underlying scheme and purpose of the Income Tax Act as a whole and the specific regime and/or provision(s) under review;

¹⁶⁵ *Accent Management Ltd v CIR* [2007] NZCA 230; (2007) 23 NZTC 21,323, paras 140-141

¹⁶⁶ Policy Statement on section 99, Tax Information Bulletin Vol 1, No 8, p 3 and Appendix C

2. the arrangement, to ascertain its purpose or effect; and
3. whether a fair and reasonable inference can be drawn that tax avoidance is a more than merely incidental purpose of the arrangement.

Only after this analysis does the IRD consider whether it can be inferred that the arrangement in question frustrates the underlying scheme and purpose of the legislation.

The IRD's Exposure Draft¹⁶⁷ on the interpretation of the general anti-avoidance provisions released in 2004 confirms its view that it is first necessary to determine whether the anti-avoidance rules apply on their terms and then to assess whether the arrangement frustrates the underlying intention of the applicable provisions or the Income Tax Act as a whole.

b) The Court's Approach

i) Court of Appeal

In *Trinity* case, the Court of Appeal treated the consideration of whether or not the arrangement frustrated the scheme and purpose of the Act as the first and most fundamental step in the application of the general anti-avoidance rules. The decision confirms the view held by many tax practitioners that the Commissioner has been conducting its analysis of tax avoidance in the wrong order.

The Court's approach is best summarised in this statement:

“Obviously, there is a need to recognise that in some instances the legislature must have intended to encourage particular types of behaviour. Behaviour of that type (being the sort of behaviour which was within the contemplation of the legislature) cannot be within the general anti-avoidance provisions because the overall legislative purpose is that such behaviour should attract the tax consequences provided for by Parliament. Likewise, it may sometimes be obvious that the specific tax rules relied on were not intended to confer the tax benefits in issue. Such a case, however, is

¹⁶⁷ Inland Revenue Department, *Interpretation of Section BG1 and GB 1 of the Income Tax Act 2004*, INA0009 Exposure Draft for External Consultation, Policy Advice Division

likely to be decided simply by construing the relevant specific tax rules so as to accord with the legislative intent and without any need to resort to the general anti-avoidance provisions.”¹⁶⁸

Adopting this approach may cause taxpayers and the Commissioner to examine the underlying purpose or object of applicable provisions and tax regimes to assess whether the tax outcome of an arrangement is consistent with that “purpose” or objective before analysing whether the tax advantages of the arrangement were a more than merely incidental purpose or effect of the arrangement.

In cases where tax avoidance is alleged by the Commissioner it should not be necessary to “step-through” the individual requirements of the general anti-avoidance rules if it can be demonstrated that the underlying scheme and purpose of the legislation has not been frustrated.

In the *Trinity* decision the Court of Appeal recognised that:

“Legislation necessarily creates both incentives and disincentives and it would be perverse to hold that rational and intended taxpayer responses to those incentives (or disincentives) are caught by anti-avoidance provisions”

This approach is not dissimilar to the so-called “*choice principle*” developed in Australia which, in summary, states that anti-avoidance rules should not apply to a transaction which is structured in a way that minimises tax if the legislation, upon its true construction, is intended to give the taxpayer the choice of minimising tax in that way.

At a more practical level, the Court of Appeal stated that in determining whether the general anti-avoidance rules apply it is important to recognise:

1. the reality that commerce is legitimately carried out through a range of entities and in a variety of ways;
2. that tax is an important and proper factor in business decision making and family property planning;

¹⁶⁸ Ibid, para 125

3. that something more than the existence of a tax benefit in one hypothetical situation compared to another is required to justify attributing a greater tax liability; and
4. that what should reasonably be struck at are artifices and other arrangements which have tax induced features outside the range of acceptable practice.

While the Court of Appeal did not have any difficulty deciding that the *Trinity* scheme was a tax avoidance arrangement, the Court's approach to that issue was positive for taxpayers. That approach will compel the Commissioner to first consider whether a tax advantage claimed under an arrangement is in fact an advantage intended to be conferred upon the taxpayer despite the fact that the taxpayer may have entered into the arrangement with a view to obtaining that advantage.

So, what is wrong with this approach? It is submitted that this almost takes a global approach to anti-avoidance. This is problematic as it ignores the basic framework of the general anti-avoidance framework as highlighted earlier in the dissertation.

What then is the role of "artificiality and contrivance"? At least no one disputes that generally the *purpose* element *will* be satisfied if there is no "commercial reality" to the arrangement. This commercial reality is really just another manifestation of the *Newton* predication test. In the normal circumstances this would be enough.

But what then is the role of artificiality and contrivance. Is this required in all cases in order for the Commissioner to prove his case under general anti-avoidance rules? Or is it the case wherever there is no commercial reality, there is automatically artificiality and contrivance? The writer submits that it is not, because a lack of commercial reality appears to have a lesser evidential burden on the Commissioner. Is the Commissioner then required to go a further step and prove artificiality and contrivance?

With respect, it is not clear what the contrived and pretence elements add to the analysis. The concept of artificiality has also been referred to in this context before. Artificiality in a tax avoidance context should be measured by reference to the words in the statute. That is,

the yardstick for artificiality is the statute and only the statute - it is not a test based on a 'gut response' or a subjective 'smell test'.

The writer tends to look at the concepts of artificiality, contrivance or pretence as labels only, but what they really extend to is something that produces unnatural consequences, or a result that is not mandated or contemplated, under the statute. It is ultimately a question of construction as there is no presumption in favour of or against avoidance.

ii) Supreme Court

In the first part of its judgment in the Supreme Court their Honours were not in agreement over whether the taxpayers were properly entitled to claim the license fee and insurance premium deductions under the *black letter* of the law.

The minority, Elias CJ and Tipping J, adopted an unconventional approach that appeared to elevate the economic substance of the arrangement over its legal form. Relying upon principles of interpretation arising from the English cases generally referred to as "fiscal nullity", the minority found the taxpayers were not properly entitled to the deductions under the specific provisions, and therefore the Commissioner did not have to rely upon the general anti-avoidance provision. Their Honours stated:

"... recourse to the general anti-avoidance provision is not necessary ... If the use of the specific provision falls outside its intended scope of the scheme of the Act, the use is not authorised within the meaning of the specific provision¹⁶⁹. ..."

"The first question is whether the claimed allowance or deduction falls within the meaning of the specific provision, purposively construed. If it does not, the Commissioner can disallow the claim. ... We think it doubtful that the claim fell within the scope of the relevant statutory provisions, properly construed¹⁷⁰."

This approach has not previously been applied in New Zealand. Traditionally the economic substance of the arrangement is only considered during the application of the general anti-

¹⁶⁹ Ibid, at para 2

¹⁷⁰ Ibid, at para 3

avoidance provision, not when interpreting the scope and application of the black letter of the law, as explained by the Court of Appeal in the leading case of *Mills v Dowdall*¹⁷¹. If this approach was taken by the majority, it would have blurred the established approach to the interpretation of revenue statutes.

By contrast, the majority, Tipping, McGrath and Gault JJ, found that “despite what can be said about the ... arrangements for avoidance purposes,”¹⁷² the deductions would have been permitted. In taking a conventional form-over-substance analysis, the majority determined that the deductions would have been allowed under the black letter of the law, which was largely confirmed by the reasoning of the High Court and the Court of Appeal that:

1. the license fee was paid for the right to use land and was therefore fixed life intangible property that was depreciable on a straight line basis over the 50 years of the arrangement, under then Part EG of the Act¹⁷³, and
2. the insurance premium was not a sham and therefore was deductible, although it also arguably had to be spread over the 50 years as part of a financial arrangement, under Part EH of the Act¹⁷⁴.

In reaching this decision the majority expressly questioned the application of the English case law to the interpretation of New Zealand's general anti-avoidance provision:

“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. Care must, therefore, be taken when applying English cases in the different New Zealand context”¹⁷⁵.

¹⁷¹ [1983] NZLR 154

¹⁷² Ibid, at para 3

¹⁷³ Part EE, *Income Tax Act 2007*

¹⁷⁴ Part EW, *Income Tax Act 2007*

¹⁷⁵ Ibid, at para 110

The *Trinity* scheme contained a number of artificial or uncommercial features which the Supreme Court concluded could not be explained by reference to business or family dealings. These included:

1. the lack of any realistic expectation of profit from the arrangement;
2. the discrepancy between the underlying value of the forestry land and the license fees payable to *Trinity*;
3. the calculation of the license fee by Dr Muir based on tax considerations, thereby ensuring the only benefits from the scheme were the ongoing tax deductions;
4. the "artificial and contrived" insurance structure;
5. the "payment" of both license fee and insurance premium using a promissory note from each taxpayer, to be satisfied in 50 years time, and;
6. the length of the arrangement itself, which made any future payment obligation so remote as to lack reality.

All these features combined to give taxpayers a significant timing advantage by permitting immediate deductions greatly in excess of their actual economic costs, while the scheme itself offered little prospect of a commercial return. Accordingly, the Court was unanimous that the *Trinity* arrangement was "both artificial and contrived"¹⁷⁶ and therefore was "clearly a tax avoidance arrangement"¹⁷⁷.

The majority noted that, on general principles that concerns the applications of s BG 1¹⁷⁸ that

"... the highly contrived nature of the whole arrangement, in conjunction with the mismatch of timing between when deductions were claimed and payments were to be made, always meant this arrangement was highly likely to be set aside."

The minority agreed that the scheme, including the licence fee and insurance premium, constituted tax avoidance. This conclusion was supported by a document obtained by the

¹⁷⁶ Ibid, at para 148

¹⁷⁷ Ibid, at para 182

¹⁷⁸ Ibid, at para 205

Serious Fraud Office, apparently co-written by Dr Muir, stating the “*real benefits of the deal are the tax concessions*” and “*the actual outcome of the deal in fifty years time is not considered material*”.

As a result, the majority concluded that

“the appellants altered the incidence of income tax by means of a tax avoidance arrangement which the Commissioner correctly treated as void. ...”¹⁷⁹

The minority agreed with this conclusion, noting:

“In application of the general anti-avoidance provision contained in s BG 1 we agree with the reasons why Tipping, McGrath, and Gault JJ conclude that the scheme, including the licence fee component and the insurance premium, constituted tax avoidance. We consider it plainly established that fiscal advantage was the purpose or effect of the arrangement. Nor was this object merely incidental to a business purpose. It was a principal object in itself.”¹⁸⁰

One of the other significant aspects of the *Trinity* judgment is the disagreement between the majority and the minority over whether there is potential for conflicts between the general anti-avoidance provisions and specific provisions.

The majority answered this question in the affirmative. Therefore, one of the key aims of any anti-avoidance analysis is to reconcile the anti-avoidance outcome with Parliament’s intention. The desired outcome of this reconciliation is, of course, to give supremacy to Parliament’s intention. The majority noted that to some extent this reconciliation involves the so-called *scheme and purpose* approach adopted by the Court of Appeal in the *Challenge* decision.

However, the majority decision is very important for one particular point about the reconciliation process. The majority clearly advocated a much wider reconciliation analysis than the *scheme and purpose* approach. As such, the majority endorsed the

¹⁷⁹ Ibid, at para 156

¹⁸⁰ Ibid, at para 8

approach taken by the Privy Council in *CIR v Auckland Harbour Board*¹⁸¹, where the Privy Council emphasised a more realistic approach to the construction of taxing acts and suggested that a general anti-avoidance provision is a form of longstop for the Commissioner. The majority in *Ben Nevis*¹⁸² commented on *Auckland Harbour Board* as follows:

“There has, however, also been a recent judgment of the Privy Council in a tax avoidance case 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 in *Challenge Corporation* ...”

At first glance, the majority in *Ben Nevis* appears to not only be watering down the importance of the *Challenge* decision, but also rejecting the traditional approach laid out in cases such as *Tayles v CIR*¹⁸³, where Cooke J noted:

“... s 108 is not concerned with the motives of individuals nor their desire to avoid tax but only with the means which they employed to do it; it is the arrangement itself and the motives of those who make it from which its purpose and effect are to be deduced - *Newton v Commissioner of Taxation* ..”

In effect, Cooke J is re-stating the *Newton* predication test. Similarly, in *Ashton v CIR*¹⁸⁴, where Viscount Dilhorne (PC) in delivering the judgment said that:

“...if an arrangement has a particular purpose, then that will be its intended effect. If it has a particular effect, then that will be its purpose ...”

“Whatever difference of meaning there may be in dictionary terms between the words ‘purpose’ or ‘effect’, posed as they seem to be as alternatives in s 108, they usually have been looked on in the cases as a composite term. ... The word ‘purpose’ means not motive but the effect which it is sought to achieve - the end in view. The word ‘effect’ means accomplished or achieved. The whole set of words denotes concerted action to an end - the end of avoiding tax.’ *Newton v FCT* at p 465...”

¹⁸¹ Ibid

¹⁸² Ibid

¹⁸³ *Tayles v CIR* [1982] 2 NZLR 726, 733-734

¹⁸⁴ Ibid, at p 61,034

In the writer's view, the majority in *Ben Nevis* and the Privy Council in *Auckland Harbour Board* did not reject the *Newton* predication test. However, what they did do was to downplay the pre-eminent status that Lord Denning's predication test used to have in any anti-avoidance analysis.

Dunbar, in his chapter on tax avoidance¹⁸⁵, states the following relation to the current applicability of the *Newton* predication test:

“[the test] has been explicitly repealed via the definition of tax avoidance arrangement in s BG 1(1) (b) [in the Income tax Amendment Act 1974]. What this means is that if one of the purposes of the arrangement is explainable by reference to ordinary business or family dealing s BG 1 will still apply if the family or business dealing is not merely an incidental purpose or effect.”

The writer agrees that reference to ordinary business or family dealings is now irrelevant in considering the purpose of an arrangement. However, it must be noted that the predication test is much wider than the mere reference to business or family dealings. The core of the test is, after all, that the purpose is to be predicated by examining *why* an arrangement was structured in the way it was. This part of the test is not revolutionary - Lord Denning is merely highlighting the objective nature of the test and the importance of the arrangement itself. As such, the test reflects the very words of section BG 1 itself.

As such, the writer concludes that the first part of the predication test is, and should, remain the starting point of any analysis of whether section BG 1 applies. It sets the boundaries of the analysis in that it serves as a reminder that the *motives* of the persons behind the arrangement are irrelevant to the analysis.

The opponents of the predication test would argue that the nature of the inquiry is now much wider. Specifically, they would argue that there is now a “sniff test” that applies, pursuant to which the line of inquiry is much wider into the surrounding circumstances of the case (as appears to be the case in *Ben Nevis*). Be that as it may, the wider inquiry still needs to be objective. It is the predication test that serves as the bulwark against the slow drift into subjective elements creeping into the purpose element.

¹⁸⁵ C Alley et al., *New Zealand Taxation: Principles, Cases and Questions* (2008), Thompson Brookers, Ch 21.9.5, p 990

The wider-but-still-objective approach is evident in the majority decision in *Ben Nevis*, where the following was noted:¹⁸⁶

“We differ from them [the majority] in being of the view that the specific statutory allowances under the Income Tax Act are not in potential conflict with the general anti-avoidance provision and that the two do not need reconciliation. Rather, both are to be purposively and contextually interpreted, as is required by s 5 of the Interpretation Act 1999 and s AA 3 of the Income Tax Act. Recourse to the general anti-avoidance provision is not necessary to prevent uses of the specific provisions which fall outside their intended scope in the overall scheme of the Act. If the use of a specific provision falls outside its intended scope in the scheme of the Act, the use is not authorized within the meaning of the specific provision. This approach is in our view required by settled principles of statutory construction. It avoids the distortion of overuse and unnecessary expansiveness in application of general anti-avoidance provision. On this view, we do not think that there are stark differences between the general approach to statutory interpretation of specific provisions in New Zealand and in the United Kingdom...”

In the writer's view, the position taken by the majority appears to be the better one. With respect, the minority view ignores the fact that the general anti-avoidance rules (“GAAR”) can sometimes be a crude instrument, especially in dealing with cases where Parliament approves of “legitimate tax avoidance”. A good example is the loss attributing qualifying companies regime - it clearly offers tax advantages to those using it, but clearly Parliament did not intend for such advantages to be struck down by GAAR. Clearly there can (and often will be) conflicts between specific provisions and GAAR.

One thing is clear, in writer's view, from the above analysis is that any *proper* anti-avoidance cannot be strictly limited to applying the elements. In the next part, the writer examines some of the judicial techniques employed by judges in this analysis.

¹⁸⁶ Ibid, at para 2

**D. Line- Drawing and the Threshold Question –
is it correct from a methodology perspective?**

As noted above, mere reference to and application of the three elements (including the *Newton* predication test is no longer sufficient in anti-avoidance analysis. A much broader line of inquiry is needed. In this part, the writer discusses two discusses judicial techniques that have evolved as part of this broader analysis – ‘line drawing’ and the ‘threshold question’.

In *Challenge*¹⁸⁷, Lord Templeman drew distinction between tax avoidance and tax mitigation. In his judgment according to his Lordship, the then s 99 applied to the arrangements involving tax avoidance but not to the arrangements involving tax mitigation. His Lordship went on to confirm that “line drawing” from the tax mitigation perspective is not unhelpful in this instance by referring to Cooke P in *Challenge*¹⁸⁸. He stated:

“The distinction between tax avoidance and tax mitigation is both authoritative and convenient for some purposes, but perhaps it can be elusive on particular facts. Whether it can solve all problems in this field may be doubtful...”

In the *Trinity* Court of Appeal decision, it was settled that the general anti-avoidance provisions reign supreme over the specific provisions. The Court sees that schemes that come within the specific deductibility rules by means of contrivance or pretence as candidates for tax avoidance. The Court quoted the judgment of Richardson P in *BNZI*, and highlighted three elements of line drawing in the context of general anti-avoidance rule in New Zealand:

1. there must be an arrangement coming within the section line drawing process;
2. the arrangement must have a more than merely incidental purpose or effect of tax avoidance; and

¹⁸⁷ *Challenge Corporation v CIR* [1986] 2 NZLR513

¹⁸⁸ *Ibid*

3. when the above two ingredients are present, the assessable income of any person affected by the arrangement is adjusted to counteract any tax advantage obtained by that person from or under the arrangement.

The Court of Appeal dealt with the threshold issue and in doing so came up with some positive developments. In acceptance of the “threshold question” William Young P held that:¹⁸⁹

“It is very much on the basis of Richardson J’s *Challenge* judgment and Peterson that the taxpayers, through Mr Carruthers, advanced their “threshold question” argument. On their contention, unless it could be shown that the deductions lay outside the scheme and purpose of the provisions of the Act which were invoked by the taxpayers, the Commissioner’s case failed. We accept that this proposition of law is well-supported by the current authority and that we should apply it. But how it should be applied is not altogether easy.”

Due to the complexity of the area of tax avoidance, this gives some solidity in this area. The *threshold question* is grounded in the *scheme and purpose* approach and is essential to achieve a greater certainty in this area.

The same thing happened in *Challenge* at the Privy Council level (albeit more extremely) where their lordships ignored the specific elements and came up with their own theory (tax mitigation) which has been much criticized.

It appears that there is no presumption in favour of or against tax avoidance and the answer would be found by applying a consistent and principled approach on case-by-case basis.

As far as the legal methodology is concerned, the *threshold question* highlights the critical relationship between statutory interpretation and tax avoidance.

Parliament has stipulated certain elements that the Commissioner must satisfy in order to prove his case under s BG 1. Respectfully, judges seem to be ignoring the specific elements

¹⁸⁹ *Accent Management Limited v CIR* (2007) 23 NZTC 21,323 (CA) at para 113

and instead arriving at an overall assessment of whether there is or there is not tax avoidance. This is manifestly wrong, as it is not applying the law properly.

The author agrees with the comments made by Trombitas¹⁹⁰, who suggests that:

“The practical problem in the dynamic field of taxation is that this [Government’s intention as to the desired tax base] is impossible to achieve, which gives rise to tax avoidance dimension, that is, gaps between expression and discernible policy.”

It is submitted that as tax avoidance is a difficult area of tax law, the legal methodology that is to be applied is the established principles of statutory construction together with the true intention of the Parliament and the correct interpretation of the words of the statute when ascertaining whether the anti-avoidance provisions applies in a particular case.

In *Trinity*, the Court of Appeal is right on the outcome but, respectfully, erroneous on the process used to arrive at the answer. The challenge for the Supreme Court in *Trinity* was to get both process and outcome right.

In *Trinity*, the Supreme Court, their Honours had to consider whether the general anti-avoidance provisions applied to the arrangement, which necessitated consideration of the interrelationship between the general anti-avoidance provision with specific provisions and the reconciliations of different legislative policies.

In doing so, their Honours had to deal with the question of whether the taxpayers gained the benefits of the specific provisions in an artificial and contrived way.

On this issue, their Honours have delivered that the correct approach is to consider the application of specific provisions. The first inquiry concerns the application of those provisions and its intended scope. However, they went on to say that, the general anti-avoidance provision does not confine the Courts as to the matters that may be taken into account when considering whether an arrangement exists.

¹⁹⁰ Ibid, at p 593

Therefore, the Commissioner and the Courts may address a number of relevant factors. Its significance will depend on the particular facts. A classic indicator is the structuring of an arrangement that is outside the Parliamentary contemplation to gain the benefit of the specific provision in a 'artificial and contrived' way and that it is not within in the Parliaments' purpose for specific provisions to be used in that manner.

It is submitted that the Supreme Court has applied the *scheme and purpose* approach in arriving at the tax avoidance conclusion and did not address the *threshold question* any further. However, the Supreme Court appears to have endorsed the 'artificiality and contrivance' principle, as did the Court of Appeal.

E. Compare to the correct methodology identified above

As laid down in the schematics earlier in this dissertation, it is agreed that that the correct methodology for applying s BG 1 can be summarised as taking the following five steps:

1. Verify if the specific provision allows the transaction in question. This is essentially the fiscal nullity concept. If yes, then only does the question of anti- avoidance arise and the next step is to be applied.
2. Apply the three elements of BG 1 (in accordance to the legislative requirement and statutory interpretation rules discussed above) in the order of: 'is there an arrangement' and;
3. 'Is there 'tax avoidance' and;
4. Is one of the purposes of the arrangement, which is more than merely incidental, tax avoidance?
5. If the answer to all three elements above is yes then apply the choice principle.

The accuracy of this legal approach is based on the principles introduced in *Elmiger* and *Newton* concerning the application of the three elements of s BG 1. The basis of these principles is grounded in the statutory interpretation rules and the law of legal precedent.

It is important that the judges use the legal methodology correctly when applying s BG 1. This is because the judges do not make the law as the law is created by Parliament. The function of the Courts is to interpret and apply the legislation to the best of the Judges' ability. The Judges have guidelines and are bound by the law of legal precedent and the statutory interpretation rules when applying legislation.

Correctly understanding the statutory interpretation rule provides guidance towards the legal approach that *must* be used to interpret and apply s BG 1. This, in turn, reduces the uncertainty attached to the avoidance tax law and allows taxpayers to conduct their affairs with the requisite degree of certainty. In the ideal world, the expression in a statute would clearly record the Parliaments' intention.

Unfortunately, this is not practical if GAAR is to aptly protect the tax base. Hence, the judges rely on the guiding principles found in the statutory interpretation rules and the law of legal precedent as discussed earlier in the dissertation.

In *Trinity*, the Supreme Court has applied the correct legal methodology and the established legal principles. Although the reasoning of the minority differed from that of the majority, the methodology and the result in the writer's view are correct.

On the purpose or effect element of the arrangement in *Trinity*, the Supreme Court has confirmed, at least of the reasoning of the minority, that the *Newton* prediction test is still applied in the New Zealand context.

F. Where to from here?

The Supreme Court decision fires a warning shot across the bows of all taxpayers. It indicates clearly that the Commissioner will take a tough stance on arrangements that amount to avoidance. One commentator¹⁹¹ suggests that:

“The avoidance analysis in the decision is not as comprehensive as it could or should have been. As a practical matter, the case has done very little, if anything, to clarify the scope and application of the general anti-avoidance provision. The Court advocates the ‘line’ test. That is, the Court endorses the principle that a line is to be drawn between proper and improper avoidance. However, it did not elaborate on how this distinction was to be made where it is accepted that a transaction is otherwise commercial and complies with the tax law.”

The Supreme Court has some practical consequences of how the taxpayers and the IRD should approach the application of the general anti-avoidance provision. In an article¹⁹² the authors suggest the following principles, which the writer agrees with, emerge from the decision:

1. The decision puts an end to speculation that the new Supreme Court would jettison the existing case law concerning the provision and the start with clean slate.
2. The principal judgment, consistently with unanimous decision of the Court of Appeal, has recognised the reality that the taxpayer’s enter into many transactions which have been structured ... in order to reduce tax.”, and that this fact, on its own, does not result in s BG 1 applying.
3. In deciding whether a particular tax benefit is within Parliaments’ purpose and contemplation, it is necessary to view the arrangement in a commercially and economically realistic way.

¹⁹¹ <http://www.pwc.com/en_NZ/nz/tax-tips/taxtips13_2008.pdf, last accessed on 27 January 2008>

¹⁹² S Connolly and R Scoular, *Trinity: The Supreme Court’s First Foray into s BG 1*, *Taxation Today*, March 2009, Thompson Brookers, p 20

The Supreme Court has not deviated from the established case law and legislative principles in the area of tax avoidance. The appellants had not sought to rely on the “merely incidental” concept, so the importance of whether tax avoidance purpose or effect was “merely incidental” was noted but not an issue in this matter.

In a recent development, McKenzie J in the High Court delivered a decision in the *Penny and Hooper v CIR*¹⁹³ case on alleged tax avoidance. This decision has put a possible new spin on the application of the tax avoidance provisions. The case although heard before the judgment of the *Trinity* Supreme Court decision, applied the legal principles set out in *Trinity*.

The issue in this case was whether the arrangements in respect of the private practice of each of Mr Penny and Mr Hooper constituted tax avoidance arrangements for the purposes of s BG 1 of the Income Tax Act 1994.

Since the hearing, the judgments of *Trinity*¹⁹⁴ and *Glenharrow*¹⁹⁵ have been released. McKenzie J therefore considered it appropriate to apply what he considered to be the restated principles established by the Supreme Court. His Honour then saw the Supreme Court’s decision as endorsing a scheme and purpose approach. He resolved to consider each step of the arrangement against the specific provisions in relation to those steps in order to have regard to the arrangement “as a whole.”

His Honour agreed that it was common ground that in *Penny and Hooper* a genuine and substantial business existed with the principal source of income being from the surgeons. It was also agreed that the services provided were personal. Only some extra resources other than taxpayer services were required. His Honour agreed that in the plain words of the statute, the transfer of the practice altered the incidence of tax.

However, his Honour also found that the relevant inquiry was to investigate whether the incidence of income tax that necessarily resulted from the earning of income by the

¹⁹³ Ibid

¹⁹⁴ Ibid

¹⁹⁵ *Glenharrow Holdings Ltd v CIR* (2008) (2008) 23 NZTC 21,663

company instead of the individual was consistent with the scheme and purpose of the Income Tax Act. His Honour then noted that the Act assigns different tax consequences to different categories of person. McKenzie J then considered what he saw as the true *purpose* for adopting the company structure and whether the tax change effect was more than merely incidental to some other purposes.

McKenzie J confirmed that the fundamental established from company law was that the formation of a company was a valid choice of business structure.

McKenzie J did not agree with the submission by the Commissioner that in the case of personal exertion the scheme and purpose of the Act is not indifferent as to whether or not the income was derived from an individual whose exertions was involved or by a company under the control of that individual. Nor did his Honour accept that a graduated rate structure that applied to individuals but not to corporate taxpayers indicated a statutory purpose that would be frustrated if the individual did not derive income so that the effect of the graduated tax scale was avoided. *Hadlee*¹⁹⁶ was seen as different from the present case.

In case there was any doubt, McKenzie J then considered the “purpose” of the transfer of the business to the company. His Honour referred to the examples set out in *Trinity*¹⁹⁷ to establish the objective purpose for the arrangement and noted the distinction between *purpose* and *motive*.

In applying the distinction (motive may give guidance as to purpose but is not purpose in itself), His Honour found that the purpose of the choice to form the company structure was to “conduct the business through a corporate form.” His Honour viewed the adoption of the corporate form as an orthodox commercial decision. McKenzie J saw no artifice or contrivance in conducting the practice through a company. His Honour also noted that he accepted that the protection of assets from client claims was a genuine motive for making the choice to move to a company structure.

¹⁹⁶ *Hadlee v CIR* [1993] 2 NZLR 385

¹⁹⁷ *Ibid*, at para 8,73

The *Penny and Hooper* case, in essence, does not strictly accept the objective nature of the purpose element (as highlighted in the principles established in the *Newton* case) to arrive at the decision. Specifically, it appears that in the analysis undertaken by McKenzie J, the predication test has little in modern anti-avoidance jurisprudence. Moreover, his Honour's analysis bears a lot of resemblance to the flawed analysis undertaken by Barwick CJ in the *Shutzkin* case, where the Chief Justice found for the taxpayer on the basis that the taxpayer is free to choose the "form" of the transactions it undertakes.

As such, the *Penny and Hooper* High Court judgment is treading on dangerous grounds. After all, one must not forget that under Chief Justice Barwick's leadership of the Australian High Court, the general anti-avoidance rules had been nullified to the point that it had no practical application. Surely, it is highly undesirable for the same to occur in New Zealand. As noted elsewhere in this dissertation, the Commissioner will appeal the *Penny and Hooper* decision to the Court of Appeal. The writer anticipates that, irrespective of the outcome, the analysis of the Court of Appeal will not follow the flawed analysis of Barwick CJ.

XI. AUSTRALIAN DEVELOPMENTS ON PREDICATION TEST

A. General Anti-Avoidance Provisions

In Australia, the general income tax anti-avoidance provisions is enacted in the Income Tax Assessment Act 36 Part IVA ("Pt IVA"). Sections 177A to 177F are the core sections of this provision. This provision is considered to be applied as a "last resort", so it does not apply if the taxpayer's claim is allowable. Pt IVA was introduced so that the apparent deficiencies could be remedied in the previous general anti-avoidance provision in s 260 of the Act, which was seen as failing in its primary purpose of preventing tax avoidance.

Section 260 was considered very broad on its appearance. However, in the *Newton* case, Lord Denning who formulated the "predication test" followed a series of judicial decisions that acted to limit the effective operation of the general anti-avoidance provisions in Australia. In *Newton*, his Lordship stated the principle as follows:¹⁹⁸

"I order to bring the arrangement within the section, you must be able to predicate – by looking at the overt acts by which it was implemented – that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labeled as means to avoid tax, then the arrangement does not come within the section"

His Lordship suggests that if there was a commercial or family reason for obtaining the advantage then it could not be said that it was for the purpose of avoidance of tax. It was only if there was no commercial purpose for which the transaction otherwise be explained, tax avoidance purpose could be determined. The support was given to this approach in a Sir Garfield Barwick led High Court in Australia encouraged the Australian Government to introduce Pt IVA.

It is understood that Pt IVA was intended to overcome the difficulties with the previous law and to provide "an effective general measure against the tax avoidance arrangement that's - inexact though the words in legal terms be - are blatant, artificial or contrived"¹⁹⁹.

¹⁹⁸ *Newton v FCT* (1958) CLR1 ALJR 187, p 764

¹⁹⁹ *The Explanatory Memorandum to Income Tax Laws Amendment Bill (No 2) 1981 (Cth)*, p 2

In cases where Pt IVA applies, the Commissioner cancels the relevant tax benefit also considers the imposition of penalty tax.

Section 177D has the central role of defining tax avoidance. Section 177D provides that Pt IVA applies to any scheme defined under section 177A (1) that states:

- (a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceeding; and
- (b) any scheme, plan, proposal, action, course of action or course of conduct.

It is submitted that Pt IV provides the Commissioner with the discretion to cancel the “tax benefit” that has been obtained, or would, but for s 177F, be obtained, by a taxpayer in connection with a scheme to which Pt IV applies. This discretion is contained in ss 177F (1).

There are three basic requirements of Pt IVA that must be satisfied before the Commissioner can exercise the discretion under ss 177F (1). These are:

- (i) a “tax benefit”, as identified in s 177C, was or would but for ss 177F (1), have been obtained;
- (ii) the tax benefit was or would have been obtained in connection with a scheme in defined in s 177A; and
- (iii) having regard to s 177D, is one to which Pt IVA applies.

The questions that are to be answered when considering whether Pt IVA applies to a given set of facts are:

1. Is there a scheme?
2. Was a tax benefit obtained?
3. Would it be concluded that there was a sole purpose of obtaining a tax benefit?

In cases where the answers to the above questions are “yes”, then the general provisions of Pt IVA may apply and the Commissioner has power to determine that the whole or part of the tax benefit is disallowed and additional penalties be imposed.

B. Recent Developments in General Anti - Avoidance Rules

There is a certain conundrum involved in designing a general anti-avoidance rule. The function of a general anti-avoidance rule is to limit the opportunities that may be available to taxpayers to reduce tax. That is all it does. However, a general anti-avoidance provision will necessarily appear in the context of a statute, many of whose other provisions exist to *offer* opportunities to reduce tax. This contradiction has to be reconciled. It cannot be reconciled by saying that the anti-avoidance applies if your main purpose in doing something is to reduce tax because there are provisions in the Act framed on the assumption that taxpayers will act to reduce tax²⁰⁰.

The status by taxpayers of an actual purpose of reducing tax in the ordinary course of business is taken as given by tax policy makers. However, one cannot say that a general anti-avoidance rule will *not* apply merely because the Act otherwise provides an opportunity to reduce tax. The opportunity itself may be unintended, and even if it is intended, it may still be abused in unintended ways. Therefore, there is a requirement for some sort of touchstone, some criteria to distinguish the permissible exploitation of opportunities to reduce tax from abusive exploitation of those same opportunities.

Section 260 had the effect of making void as against the Commissioner any arrangement so far as it had the purpose or effect of avoiding tax, very broadly defined²⁰¹. Consider the range of transactions that have the effect of changing the incidence of income tax. The formation of a company by, say, a grocer who had formerly traded on his own account, to carry on his grocery business, can have that effect. Any business re-organization or re-

²⁰⁰ Apart from the obvious case of tax concessions intended to encourage certain behaviour, many transactions have the effect of reducing tax, for example, expenditure incurred in carrying on a business is generally deductible

²⁰¹ Specifically, altering the incidence of any income tax; relieving any person from any liability to pay income tax or make any return; defeating, evading, or avoiding any duty or liability imposed on any person by the Act; or preventing the operation of the Act in any respect.

arrangement of one's affairs will most likely alter the incidence of income tax, as can, indeed, mere trading. As Knox CJ pointed at in *DFC of T v Purcell*:

“The section, if construed literally, would extend to every transaction whether voluntary or for value which had the effect of reducing the income of any taxpayer”²⁰².

Lord Denning articulated an approach for determining whether an arrangement had a tax avoidance character to which s 260 and a rule like Pt IVA should apply²⁰³.

“But, said Sir Garfield, if such a wide interpretation is given to the words, where is the section to stop? Does it enable the Commissioner to avoid all transactions by which a man seeks to escape a liability to tax which is about to fall upon him? The answer to the problem seems to their Lordships to lie in the opening words of the section. They show that the section is not concerned with the motives of individuals. It is not concerned with their desire to avoid tax, but only with the means by which they employ to do it. It affects every ... arrangement ... which has the purpose or effect of avoiding tax”.

In applying the section you must, by the very words of it, look at the arrangement *itself* and see which is its *effect* - what it does, irrespective of the motives of the persons who made it. Williams J put it well when he said:

“If you cannot so predicate, but that have to acknowledge that the transactions are capable of explanation by reference to ordinary business and family dealing, without necessarily being labelled a means to avoid tax, then the arrangement does not come within the section”

The *Newton* case was referred to in the *Explanatory Memorandum* accompanying the Bill introducing Pt IVA.

“Some writers on the subject suggest that tax avoidance involves conduct entered into for the sole or dominant purpose of obtaining a particular tax advantage. That description could be expected to cover the types of tax avoidance that, again using the language of social or political debate, are blatant, artificial or contrived, and which are indeed intended to be covered by this Bill. But it is also apt to describe other arrangements, including some family arrangements, which are beyond the

²⁰² (1921) 29 CLR 464 (HCA)

²⁰³ *FC of T v Newton* (1958) 98 CLR 1 at p 8

appropriate scope of general anti-avoidance measures and ought, if need be, to be dealt with by specific measures. ...”

The test for the application of the new provision is intended to have the effect that arrangements of a normal business or family kind, including those of a tax planning nature, will be beyond the scope of the Pt IVA.

In this respect, Pt IVA may be seen as effectuating a position akin to that which appears to emerge from the decision in *Newton*. The essence of the views expressed in that case was that a tax avoidance situation covered by s 260 exists only if it can be predicated from looking at an arrangement that it was implemented *in that particular way* so as to avoid tax.

If the tax avoidance purpose of a scheme has to be deduced from the overt acts by which it was implemented, it will only be possible to infer such purpose from schemes that differ in some relevant way from the character of usual business or family planning. Within the field of ordinary dealing, a taxpayer would be free to take up the opportunities to reduce tax offered to them by the other provisions of the Act. Therefore, the scope for tax planning would be limited, but the limit would not prevent or foreclose any normal dealing or transaction.

On the other hand, an arrangement that exhibited contrivance or artifice would show its tax avoidance purpose on its face, and could fall within the provision. A taxpayer would therefore not be free to take up opportunities to reduce tax that required artifice or contrivance to achieve.

Such an approach makes good sense. When a provision is inserted into the income tax law, policy-makers may be taken to contemplate the obvious exploitation or use of the provision. The ordinary dealing or obvious case should not result in unanticipated consequences. It is reasonable to assume that the tax opportunities of straightforward dealing have been considered by those who design tax laws, and having been considered, if not then prevented, have in effect been implicitly sanctioned. Moreover, from a taxpayer's perspective a provision will be seen to offer, for straightforward dealings, tax opportunities that are untainted with any notion of abuse. Doing the obvious is use, not abuse.

The same cannot be said of contrivance and artifice. This, to generalise, is precisely what is not contemplated by those who design tax laws, and when they do contemplate it, they generally put something in the law to try to prevent it. Some people say that we should be used to it by now and surely, some of the dodges ought to be obvious. However, the product of human ingenuity when it is wasted on tax avoidance is not as easy to predict as you might think, but anyway, this is not the point.

The point is that there is a very big difference between what flows naturally from the Act, and what can be extracted from its provisions by contrivance and artifice. In the first case, it may be said that the opportunity to reduce tax was given by Parliament through the design of the tax laws; the second, it can only be said that it was taken. What one wants is a rule that allows tax reduction opportunities to be given by policy-makers, but prevents them from being taken unilaterally by taxpayers where that was not intended.²⁰⁴ That, in a nutshell, is what s 260 meant to achieve, and indeed, it is what Pt IVA is meant to achieve.

Take the example of the case of *FCT v Hart*²⁰⁵, where the High Court of Australia found against the taxpayer under Pt IVA in relation to a split loan facility arrangement. It was held, based on the facts of the case that the structure evolved around obtaining tax benefits from the arrangements entered into. In this arrangement, the taxpayer had the ability to repay the loan relating to the residence first before she had any obligations to repay the loan relating to the investment property. The interest accrued from the arrangement, if worked would give rise to higher deductions. According to the High Court, there was no explanation other than the arrangement's fiscal consequences. The mere fact that a taxpayer pays less tax, if one form of transaction rather than another is made, does not demonstrate that Pt IVA applies. Simply to show that a taxpayer has obtained a tax benefit does not show that Pt IVA applies. With these considerations in mind, it is sometimes said that it is necessary to read Pt IVA in a way that will not bring "ordinary" transactions to tax.

²⁰⁴ As Lockhart J. said in *Pettigrew v FC of T* 90 ATC 4124 at p 4126; 20 ATR 1833 at p 1836: "If in all the circumstances the use of the specific or particular provision of the Act warrants the description of an 'abuse' of it ... sec. 260 will apply"

²⁰⁵ [2004] 217 CLR 216; 55 ATR 712 (HCA)

XII. REFORM MECHANISMS

If it is intended that the general provision should be subject to the other specific provisions of the legislation, such as incentives and concessions, it is desirable to establish the relationship by resorting to a test that relies on the scheme and purpose of the legislation²⁰⁶.

Ultimately, the writer submits that an adequate general anti-avoidance provision can be drafted that satisfies the accepted criteria of optimal tax reform. As discussed in the earlier part of the dissertation a more suitable form of the general anti-avoidance provision will, in the words of *Explanatory Memorandum*²⁰⁷ to Pt IVA, give or effect a position similar to that emerged in the *Newton* decision.

This is of course subject to any appropriate modifications to the form of the general anti-avoidance, that was considered in *Newton*, that were implicit in the approach of the Privy Council as submitted by Ohms²⁰⁸. The writer is in agreement with the approach contemplated in the submission.

In recent developments, the first issue to consider is whether changes to the legislation are required. It may not be a bad idea, especially if we can legislate for the *Newton* predication test, but otherwise no changes are needed.

The basic problem is that the judges, respectfully, are still not getting what the methodology is about. It is submitted that the Commissioner's counsel, at subsequent cases, keep driving this point to the judges strongly and in future case decisions all that is needed is one Supreme Court decision that specifically identifies and applies the elements to prove tax avoidance.

The *Trinity* Supreme Court decision is a good decision and the *Penny and Hooper* decision is, hopefully a temporary blip, and that the Commissioner will challenge the decision.

²⁰⁶ *Challenge Corp Ltd v CIR* [1986] 2 NZLR 513, p 548,549 (CA)

²⁰⁷ *Ibid*

²⁰⁸ C Ohms, *General Income Tax Anti-Avoidance Provision: Analysis and Reform*, (PhD Thesis, University of Auckland, Unpublished, 1994) p 23

The *Penny and Hooper* decision does, however, show significant conceptual problems with the current framework. Referring to the example involving two surgeons discussed earlier, it can be seen that if s BG 1 applies to neither surgeons, then horizontal equity is achieved because both surgeons in the same situation are taxed the same. However, this leads to vertical inequity. Consider the situation of a third surgeon that does exactly the same work but is instead employed by a hospital. All three surgeons derived exactly the same gross remuneration. Here the two surgeons will be able to obtain the benefits of tax avoidance but the third one cannot.

There are no easy answers for achieving a GAAR framework that is completely coherent in conceptual terms. However, in the writer's view, a reform option that may be adopted is outline below:

Earlier in this dissertation, the writer has discussed how the "purpose" test evolved from a very clinical "before and after" approach (*Jaques*) to where commercial considerations are more important than the avoidance provisions themselves (*Ben Nevis*, Supreme Court). The writer submits that a further evolution is needed to incorporate a *mens rea* type requirement in GAAR whereby it is necessary to consider the taxpayer's state of mind vis-à-vis why the arrangement was entered into. This test should be determined on a year-to-year basis. As such, our three surgeons would be taxed if they *intend* to avoid tax.

Ohms' analysis of recent avoidance cases indicates that this may already be part of New Zealand. He states, for example, that in *O'Neil*:

"...Lord Hoffman specifically made mention of the point that s 99 possessed criteria by which offending arrangements were to be distinguished from those which were not caught. This implies a further a further consideration of the taxpayer's state of mind, even though there is an arrangement that has a tax avoidance effect."

The writer contemplates that consideration should be given as to whether the mental element should be incorporated into law.

This proposal does not necessarily mean that the evidentiary onus would have to shift to the Commissioner. The current land tax provision, for example, considers the treatment of tax profits on land that was purchased for the intention of re-sale. The onus is on the taxpayer to prove its intention at the time of purchase. The legislation appears to be working fine.

The Valabh Committee made a similar recommendation by suggesting that taxpayer-specific factors should be considered. It recommended²⁰⁹:

“Arguably, a more acceptable approach is to look to the degree of tax-influence on the taxpayer, measured by a comparison of the tax influences with the non-tax influences that are present. This is a slight variation on *Newton* but does not suffer from the above criticisms. A strong economic argument can also be advanced in support of this approach. In order to have neutral impact on resource allocation, taxation should apply evenly to all project economic income. Significant tax-influence in commercial decision-making is unlikely to be conducive to economic efficiency because it contributes to a disparate treatment of economic income.”

Trans-Tasman Harmonization

The issue of trans-Tasman GAAR harmonization is a very important one. New Zealand and Australia have had a Closer Economic Relations (CER) agreement since 1983. However, the laws of the two countries have not been harmonised despite numerous calls.

In an anti-avoidance context, harmonizing the GAAR laws of New Zealand and Australia will be beneficial. Since the inception of CER, trans-tasman trading has proliferated, such that transactions can have a tax impact in both countries. Harmonizing the GAAR rules will remove the scope for taxpayers to “tax arbitrage” whereby they structure their transactions to take advantage of the GAAR rules applicable in the more lenient country.

The next issue that needs consideration is to consider the differences between the New Zealand and Australia GAARs and then to consider how the differences should be resolved.

²⁰⁹A Valabh et al. , *Final Report of the Consultative Committee on the Taxation of Income from Capital*, The Valabh Committee, October 1992, p 22

The key difference relates to the “purpose” element. The New Zealand GAAR states that this element will be satisfied if tax avoidance is a purpose (as long as it is not a merely incidental purpose). However, the test is more stringent under Part IVA Income Tax Assessment Act 1936 because it requires a “dominant” purpose. The writer considers that a dominant purpose test is preferable, for the following reason:

Assume that it is possible to mathematically assign percentages to purposes. In a particular avoidance case, the commercial purpose is 80% and the tax avoidance purpose is 20%. In this case, it may still be possible for the purpose test to be satisfied in New Zealand since 20% is small but not incidental. However, the writer submits that from a policy perspective this is not an acceptable outcome.

Under the Australian dominant purpose test, it is highly unlikely that a 20% avoidance purpose would suffice.

There is a further anomaly in the New Zealand GAAR legislation. As noted above, the GAAR itself does not require a dominant purpose. However, a dominant purpose is required when the Commissioner seeks to impose a shortfall penalty for an abusive tax Position under 141D of the Tax Administration Act 1994.

It is submitted that the policy makers and the academics alike continue to work in this area, which in future, will continue be streamlined given that New Zealand is a net capital importing country and the structures and arrangements that reduce or avoid tax and erode the New Zealand tax base needs to be protected.

XIII. CONCLUSION

The anti-avoidance journey has been a long one and it continues to develop where it started in *Newton*. At its core are the three elements – arrangement, purpose and tax avoidance. The predication test represents the objective approach to anti-avoidance in its purest form in the sense that focus of the inquiry is on the overt acts of the arrangement itself.

The application of these elements forms the correct legal methodology that should be applied in **all** cases where avoidance is considered. This methodology has generally been applied correctly in the early New Zealand and Australian cases. The approach hit its lowest point in Justice Richardson's decision in the *Challenge* case. This was also the general pattern in Australia, although it hit a few bumps in the Australian High Court during Chief Justice Barwick's era.

Justice Barwick said that there was a fourth element – the so called 'choice principle'. Barwick's version of the choice principle arose from his literalist approach to statutory construction. Despite the fact that this outcome was wrong, Justice Barwick at least got the methodology correct. In *Trinity* and other recent cases, this has not happened. In writer's view, the Courts have applied only one criterion, that is, the threshold question but came to the right answer. The threshold question is clearly a much wider concept than the *Newton* predication test. Under the new approach, currently preferred by New Zealand Supreme Court judges, it appears that a 'sniff test' is being developed whereby the wider range of factual matters can now be examined to ascertain the purpose of an arrangement. As such, the inquiry is not limited to the arrangement itself, but may include the surrounding circumstances as well.

In the writer's view, with respect, the Supreme Court in *Trinity* follows the right methodology in its analysis, but perhaps could have been more forthright in stating that there are at least three or may be four elements to be proved to bring an arrangement to be a tax avoidance arrangement within the 'purpose' of the Income Tax legislation.

The minority focused on the principles of proving the “purpose or effect” element that had been established in *Newton*. What this shows is that although there is often confusion in its application, the *Newton* predication test is applied by the New Zealand Courts to assist in the determination of an arrangement in a particular case.

This may not be a major issue, but it is, if one considers the implications of the most recent decision in *Penny and Hooper*. In the writer’s view, respectfully, the decision in *Penny and Hooper* had an incorrect outcome. As noted in the dissertation elsewhere, the *Penny and Hooper* judgment referred to the *Trinity* Supreme Court decision but came to a different outcome.

The *Trinity* Supreme Court decision is a step in the right direction but the questions still is - are we there yet? In future, the Judges, with respect, need to be clear that each element must be applied on its own. The *Penny and Hooper* appeal is important to the Commissioner, which would clarify the methodology the judiciary applies to arrive at a tax avoidance conclusion in a particular case.

It is also concluded, from the analysis in the dissertation, that a further evolution is needed, may be, to incorporate the *mens rea* type of requirement in GAAR whereby it is necessary to consider the taxpayer’s state of mind, that is, the question - why the arrangement was entered into?

Furthermore, due to the CER with Australia, consideration should be given to alignment of the GAAR between New Zealand and Australia to reduce potential tax arbitrage. The writer submits that the favourable Australian ‘dominant purpose’ approach could be adopted.

Finally, in reference to the quote in the opening paragraph of this dissertation, it is concluded that the question remains as to the extent the tax legislation and litigation decisions in the “grey” area of tax avoidance can ever really reduce the *feathers being plucked* and thereby increasing the amount of *hissing by the goose*.

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