Inland Revenue
Te Tari Taake

26OIA1668

1 December 2025

[redacted]

Dear [redacted]

Thank you for your request made under the Official Information Act 1982 (OIA), received on 22 November 2025. You requested the following:

> *...I am researching and writing on s BG 1.*
>
> *I need urgently a copy of the former Exposure Draft on s 99/s BG 1 INA0009 as mentioned in TIB Vol 16 No 9 October 2004.*

Information publicly available

Your request for the following document would normally be refused under section 18(d) of the OIA, as the information is publicly available. However, in the spirit of the OIA, a copy of the document is provided alongside this response.

Item	Date	Document	Website address
1.	24/09/2004	INA0009 Interpretation of sections BG 1 and GB 1 of the Income Tax Act 2004	https://www.wolterskluwer.com/en-nz/solutions/cch-iknowconnect

For clarity, please note that the provided document was an exposure draft issued for external consultation. Our current view of BG1 is contained in *IS 23/01 "Tax avoidance and the interpretation of the general anti-avoidance provisions sections BG 1 and GA 1 of the Income Tax Act 2007"* which is publicly available on Inland Revenue's Tax Technical website (taxtechnical.ird.govt.nz).

Right of review

If you disagree with my decision on your OIA request, you have the right to ask the Ombudsman to investigate and review my decision under section 28(3) of the OIA. You can contact the office of the Ombudsman by email at: info@ombudsman.parliament.nz.

Publishing of OIA response

We intend to publish our response to your request on Inland Revenue's website (ird.govt.nz) as this information may be of interest to other members of the public. This letter, with your personal details removed, may be published in its entirety. Publishing responses increases the availability of information to the public and is consistent with the OIA's purpose of enabling more effective

participation in the making and administration of laws and policies and promoting the accountability of officials.

Thank you again for your request.

Yours sincerely

Josh Green
Domain Lead, Ministerial Services

Inland Revenue
Te Tari Taake

Interpretation of Sections BG 1 and GB 1 of the Income Tax Act 2004

Exposure Draft for External Consultation

Public Rulings Unit
Adjudication and Rulings
Inland Revenue Department

Exposure Draft

Inland Revenue's Public Rulings Unit is responsible for developing and publishing public rulings and interpretation statements on aspects of tax law. Exposure drafts on public rulings and interpretation statements are circulated to interested parties for their comment before the rulings or interpretation statements are issued in their final form.

This exposure draft concerns the interpretation of sections BG 1 and GB 1 of the Income Tax Act 2004 and will replace the Commissioner's statement on section 99 of the Income Tax Act 1976 (Appendix C to the *Tax Information Bulletin*, Vol 1, No 8, February 1990). This statement is based on the Income Tax 2004. As there are only minor changes from the wording of sections BG 1 and GB 1 of the Income Tax Act 1994, and no intention to change the meaning of those sections in enacting the 2004 Act, the Commissioner considers that the analysis and conclusions also apply to sections BG 1 and GB 1 of the Income Tax Act 1994. The case law on other previous forms of the legislation is still applicable in some instances, as discussed in this statement.

This exposure draft provides an overview of the general principles applicable to sections BG 1 and GB 1 rather than a comprehensive analysis of all of the various legal issues that may be encountered in any fact situation. It is with this aim in mind that a summary of legal principles and a flow chart are provided at the end of the statement. The Commissioner is aware there are different views between tax experts inside and outside Inland Revenue on this subject, and that future judicial developments are also possible. Accordingly, this exposure draft is subject to future refinement and development before finalisation and publication, and therefore the draft should not be taken as representing the Commissioner's concluded view.

The Commissioner may issue additional statements in the future on matters of detail relating to sections BG 1 and GB 1 not dealt with in this statement, if the need arises.

This exposure draft does not consider any possible application in New Zealand of the general legal principles discussed in *WT Ramsay Ltd v IRC* [1981] 1 All ER 865 (HL), and the subsequent cases following from that decision.

Status of Draft Items

Draft items, including this exposure draft, represent the preliminary, though considered, views of the Commissioner of Inland Revenue. In draft form these items may not be relied on by taxation officers, taxpayers, or practitioners. Only finalised items are authoritative statements by Inland Revenue of its stance on the particular issues covered.

Submissions

Inland Revenue welcomes your written comments on any of the technical or practical issues raised in this paper. Please send them to:

Manager Field Liaison and Communication
Adjudication and Rulings
Inland Revenue Department
National Office
PO Box 2198
WELLINGTON

Fax 04-474 7153
E-mail rulings@ird.govt.nz

Please quote reference: INA0009
Public Rulings Unit

Issued for public consultation on 24 September 2004, with a comment deadline of 17 December 2004

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TABLE OF CASES

This table refers only to substantial discussions in the text herein.

CASES

1 INTRODUCTION

Purpose and Scope

1.1.1 In February 1990 the Commissioner issued a statement on section 99 of the Income Tax Act 1976 which was published as an appendix to the *Tax Information Bulletin*, Vol. 1, No. 8. That statement was not intended to be a detailed textual analysis of the provision, rather, the statement set out the Commissioner's view on the function of the section, the relevance of case law, and the process the Commissioner would follow when considering invoking the section and several illustrative examples. Since then, there have been some significant judicial developments in the area of tax avoidance in New Zealand and overseas. Accordingly, the Commissioner considers it appropriate to replace the 1990 statement with a more comprehensive and updated statement for guidance in what is a complex area of revenue law.

1.1.2 This statement examines the words of the legislation and the leading cases on tax avoidance to isolate key interpretative principles relevant to the application of sections BG 1 and GB 1. Based on this examination and, in particular, the differing judicial approaches, the Commissioner has developed an approach that attempts to reconcile the different and sometimes conflicting objectives of the general anti-avoidance provision and other provisions of the Act. In short, this will be achieved, if the requirements for these other sections are met, by assessing whether the arrangement under review facilitates, rather than frustrates, Parliament's intended operation of the Act.

1.1.3 In this statement the analysis is set out under the following headings, which flow from the requirements of the legislation:

- "Arrangement" and its scope:
  - Unilateral arrangements;
  - Consensus or "meeting of minds";
  - Unenforceable arrangements;
  - Combined effect of transactions or documents;
  - Steps by which an arrangement is carried into effect;
  - Severing parts of an arrangement;
  - Extraterritorial limitations.
- "Tax avoidance":
  - The three limbs of tax avoidance;
  - Future liabilities;
  - New source;

- Whether tax is avoided on a wide or narrow consideration of the overall net tax effect.

- "Tax avoidance arrangement":

  - How to determine whether tax avoidance is a purpose or effect of an arrangement (predication);
  - Purpose or effect;
  - More than merely incidental.

- Judicial approaches in deciding whether the general anti-avoidance provision(s) should apply:

  - The choice principle;
  - Tax mitigation;
  - Relevance of the *Duke of Westminster* principle in the context of sections BG 1 and GB 1;
  - The Commissioner's approach.

- Adjustment of income under section GB 1:

  - Any person affected;
  - Any tax advantage;
  - Commissioner's power to adjust income;
  - How should the Commissioner's power under section GB 1 be exercised?

1.1.4 A summary of legal principles and a flow chart are provided at the end of the statement.

1.1.5 This statement is limited to the interpretation of the specific anti-avoidance provisions. It does not consider any possible application in New Zealand of the general legal principles discussed in *WT Ramsay Ltd v IRC* [1981] 1 All ER 865 (HL), and the subsequent cases following from that decision.

1.1.6 This statement replaces the Commissioner's 1990 statement on tax avoidance in *Tax Information Bulletin*, Vol. 1, No. 8.

2 LEGISLATION

2.1 Introduction

2.1.1 The general anti-avoidance provisions of the Income Tax Act 2004 are in sections BG 1 and GB 1, with relevant terms defined in section OB 1.

2.1.2 Many cases on tax avoidance refer to the predecessor(s) to sections BG 1 and GB 1 – sections BG 1 and GB 1 of the Income Tax Act 1994, section 99 of the Income Tax Act 1976, and section 108 of the Land and Income Tax Act 1954.

2.1.3 In many important respects, the relevance of those cases to the current provisions depends on the words used in the corresponding repealed provisions. In some situations, however, the relevant wording is the same or similar and the cases remain authoritative.

2.2 Legislation

2.2.1 The general anti-avoidance provisions of the Income Tax Act 2004 are as follows:

> **BB 3 Overriding effect of certain matters**
>
> **BB 3(1)** Under Part G (Avoidance and non-market transactions), the Commissioner may counteract a tax advantage from a tax avoidance arrangement.
>
> **BG 1 Tax avoidance**
>
> **BG 1(1)** A tax avoidance arrangement is void as against the Commissioner for income tax purposes.
>
> **BG 1(2)** Under Part G (Avoidance and non-market transactions), the Commissioner may counteract a tax advantage that a person has obtained from or under a tax avoidance arrangement.
>
> **GB 1 Agreements purporting to alter incidence of tax to be void**
>
> **GB 1(1)** Where an arrangement is void in accordance with section BG 1, the amounts of assessable income, 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—
>
> (a) such amounts of assessable income, deductions, and available net losses as, in the Commissioner's opinion, that person would have, or might be expected to have, or would in all likelihood have, had if that arrangement had not been made or entered into; or
>
> (b) such amounts of assessable income and deductions as, in the Commissioner's opinion, that person would have had if that person had been allowed the benefit of all amounts of assessable income, or of such part of the assessable income, as the Commissioner considers proper, derived by any other person or persons as a result of that arrangement.

GB 1(2) Where any amount of assessable income or deduction is included in the calculation of taxable income of any person under subsection (1), then, for the purposes of this Act, that amount is not included in the calculation of the taxable income of any other person.

GB 1(2A) Without limiting the generality of the preceding subsections, if an arrangement is void in accordance with section BG 1 because, whether wholly or partially, the arrangement directly or indirectly relieves a person from liability to pay income tax by claiming a credit of tax, the Commissioner may, in addition to any other action taken under this section,—

(a) disallow the credit in whole or in part; and

(b) allow in whole or in part the benefit of the credit of tax for any other taxpayer.

GB 1(2B) For the purposes of subsection (2A), the Commissioner may have regard to the credits of tax which the taxpayer or another taxpayer would have had, or might have been expected to have had, if the arrangement had not been made or entered into.

GB 1(2C) In this section, credit of tax means the reduction or offsetting of the amount of tax a person must pay because—

(a) credit has been allowed for a payment of any kind, whether of tax or otherwise, made by a person; or

(b) of a credit, benefit, entitlement, or state of affairs.

GB 1(3) Without limiting the generality of subsections (1) and (2), section BG 1, or the definitions of arrangement, liability, tax avoidance, or tax avoidance arrangement in section OB 1, where, in any tax year, any person sells or otherwise disposes of any shares in any company under a tax avoidance arrangement under which that person receives, or is credited with, or there is dealt with on that person's behalf, any consideration (whether in money or money's worth) for that sale or other disposal, being consideration the whole or a part of which, in the opinion of the Commissioner, represents, or is equivalent to, or is in substitution for, any amount which, if that arrangement had not been made or entered into, that person would have derived or would derive, or might be expected to have derived or to derive, or in all likelihood would have derived or would derive, as dividends in that tax year, or in any subsequent tax year or years, whether in 1 sum in any of those years or in any other way, an amount equal to the value of that consideration, or of that part of that consideration, is deemed to be a dividend derived by that person in that first-mentioned tax year.

OB 1 Definitions

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

tax avoidance includes—

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

> (b) directly or indirectly relieving a person from liability to pay income tax or from a potential or prospective liability to future income tax:
>
> (c) directly or indirectly avoiding, postponing, or reducing any liability to income tax or any potential or prospective liability to future income tax
>
> **tax avoidance arrangement** means an arrangement, whether entered into by the person affected by the arrangement or by another person, that directly or indirectly—
>
> (a) has tax avoidance as its purpose or effect; or
>
> (b) has tax avoidance as 1 of its purposes or effects, whether or not any other purpose or effect is referable to ordinary business or family dealings, if the purpose or effect is not merely incidental

3 SECTION BG 1

3.1 Effect of the application of section BG 1

3.1.1 Under section BG 1 a tax avoidance arrangement is void against the Commissioner for income tax purposes. The section applies to an arrangement which has a tax avoidance purpose or effect, or has tax avoidance as one of its purposes or effects that is more than merely incidental, whether or not that purpose or effect is referable to ordinary business or family dealings. Where an arrangement is void under section BG 1, section GB 1 may operate to allow the Commissioner to counteract the tax advantage that would otherwise have been obtained through the voided arrangement.

3.1.2 Referring to the operation of section 108 (a predecessor to section BG 1), Haslam J in *Wisheart, Macnab and Kidd v CIR* [1972] NZLR 319 (CA) made the following comments at page 337, which were subsequently approved by McCarthy P in *CIR v Gerard* (1974) 1 NZTC 61,151 (CA), at page 61,157:

> In effect therefore, s 108 annihilates but cannot create; it nullifies but does not revest. Unless the income can be left in the taxpayer's hands by the avoiding process and his accounting to another in pursuance of the "arrangement" be rendered **void *ab initio* at that point**, so as to strip away retrospectively his fiduciary functions, s 108 cannot bring the income back into his hands to be eligible for tax purposes. [emphasis added].

3.1.3 While these cases were decided under section 108, the principle that an arrangement is void *ab initio* equally applies to sections BG 1 and GB 1. To this effect section BG 1(1) expressly provides:

> **BG 1(1) [Avoidance arrangement void]** A tax avoidance arrangement is void as against the Commissioner for income tax purposes.

3.1.4 The plain meaning of these words indicates that a "tax avoidance arrangement" is void *ab initio* (at the time the arrangement is entered into) against the Commissioner, notwithstanding the Commissioner's initiative to invoke the provision to void the arrangement.

3.1.5 In the Commissioner's opinion, voiding an arrangement under section BG 1 may have the effect, for some arrangements, of negating the tax advantage. In such a case, there is no need to apply section GB 1 to counteract the tax advantage. But the Commissioner has discretion to apply section GB 1, given by the use of the words "Under Part G (Avoidance and non-market transactions), the Commissioner *may* counteract a tax advantage" in section BG 1(2) and "*may* be adjusted by the Commissioner" in section GB 1.

3.1.6 Case law is consistent with this view. In *Newton v FCT* [1958] 2 All ER 759 (PC), where there was no equivalent to section GB 1 under the Income Tax Assessment Act, 1936 - 1951, the Privy Council found that the Commissioner had correctly assessed the taxpayers on the basis of the arrangement being void. The Privy Council agreed with the opinion of the Full High Court in *Bell* v *FCT* (1953) 87 CLR 548. In *Bell*, speaking of the Australian anti-avoidance provision, the Court said that the section was (at p 476):

> … an annihilating provision only. It has no further or other operation than to eliminate from consideration for tax purposes such contracts, agreements and arrangements as fall within the descriptions it contains. It assists the Commissioner, in a case like the present, only if, when all contracts, agreements and arrangements having such a purpose or effect as the section mentions are obliterated, the facts which remain justify the Commissioner's assessment.

3.1.7 Richardson J made the same point in relation to the New Zealand provision in *CIR v Challenge Corporation* (1986) 8 NZTC 5,001 (CA). Professor Trebilcock also took this view in *Section 260: A Critical Examination* 38 ALJ p 237 at p 239 (referred to by Baragwanath J in *Miller & Ors v CIR; McDougall & Anor v CIR (No.1)* (1997) 18 NZTC 13,001 (HC)).

3.2 Arrangement and its scope

Background

3.2.1 The term "arrangement" is defined in section OB 1 as follows:

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

3.2.2 This definition was originally enacted in 1974. Before the amendment, section 108 simply referred to "every contract, agreement, or arrangement" without any specific definition. Section 108 then provided:

> Every contract, agreement, or arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void in so far as, directly or indirectly, it has or purports to have the purpose or effect of in any way altering the incidence of income tax, or relieving any person from his liability to pay income tax.

3.2.3 The same phrase "every contract, agreement or arrangement" was used in section 260 of the Australian Income Tax Assessment Act 1936. Isaacs J in the High Court of Australia, in *Jaques v FCT* (1924) 34 CLR 328 (HCA) said at page 359:

> "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.

3.2.4 Isaacs J interpreted the word "arrangement" as something in the nature of a bargain, broader in its scope but less formal and less restricted than a contract or an agreement.

3.2.5 Dr I.C.F Spry in his book *Section 260 of the Income Tax Assessment Act* (Sweet & Maxwell (NZ) Ltd, 1978) commented at page 12:

> Perhaps in using the term "descending series" Isaac J was referring, not to the comprehensiveness of the material words, but rather to their definiteness or to their effectiveness to vary legal rights or to some such other characteristic. But his meaning was not entirely clear.

3.2.6 Subsequently, the Australian High Court in *Bell* looked at the order of the three words "contract", "agreement", and "arrangement" and interpreted them as becoming progressively broader. The Court said at page 573:

> It must be remembered, however, that the section is concerned only with contracts, agreements and arrangements which have an effect in law and accordingly are capable of statutory avoidance. With this in mind, it may be said that the word "arrangement" is the third in a series which as regards comprehensiveness is 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.

3.2.7 Some elements of the current definition, as enacted in 1974, stem from the observations of Lord Denning in *Newton* (PC). In that case the Privy Council stated at page 763:

> Their Lordships are of the 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 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.

3.2.8 These cases, although concerned with the Australian general anti-avoidance provision, have been referred to in several New Zealand decisions. In *CIR v BNZ Investments Ltd* (2001) 20 NZTC 17,103 (CA) Richardson P stated at page 17,116 that "the words contract, agreement, plan and understanding appear to be in descending order of formality". His Honour concluded, at page 17,117, the descending order of the terms suggests descending degrees of enforceability. So a contract is ordinarily but not necessarily legally enforceable, as is perhaps an agreement, while a plan or understanding may not be legally enforceable. The order of these words has changed to be listed alphabetically in the 2004 Act, but the same observation can be made that the terms encompass a range of arrangements, including those not intended to be legally enforceable.

3.2.9 In summary, the definition of "arrangement" provides for varying degrees of enforceability from contractual situations, through agreements, plans to understandings. In other words, an arrangement is defined to encompass all kinds of concerted action by which persons may organise their affairs for a particular purpose or to produce a particular effect.

3.2.10 There are some practical aspects of the definition that merit comment. In particular:

- Does the definition include unilateral arrangements?
- The relevance of consensus between parties;
- The inclusion of unenforceable arrangements;
- The scope of an arrangement may encompass several transactions or documents;

- The inclusion of steps by which an arrangement is carried into effect;
- The ability to sever parts of an arrangement; and
- Extraterritorial limitations.

Unilateral arrangements

3.2.11 The words "agreement", "contract", and "understanding" in the definition of "arrangement" indicate the requirement for there to be two or more parties to an arrangement. The primary authority is *Newton*, where at page 763 the Privy Council said:

> [T]he 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 [emphasis added].

3.2.12 This interpretation is supported by the decision in *BNZ Investments Ltd* (CA). Richardson P said at para. 43:

> The definition of arrangement 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. In *Davis v FC of T* 89 ATC 4377; (1989) 86 ALR 195 at p 227 Hill J saw the bilaterality requirement as founded in the very nature of the words of s 260, contract, agreement or arrangement. And an arrangement cannot exist in a vacuum. As did the former s 108, s 99 bites on an "arrangement made or entered into". It presupposes there are two or more participants who enter into a contract or agreement or plan or understanding. They arrive at an understanding. They reach a consensus.

3.2.13 In *Case G43* (1985) 7 NZTC 1,163 (TRA) Sheppard DJ took the view that "plan" in the definition of arrangement might apply to a course of action involving only one person. The case concerned whether a payment of interest on a mortgage loan which was not due could be taken into account for rebate purposes under section 48B(1) of the Income Tax Act 1976, and whether the relevant arrangement was a "tax avoidance arrangement" under section 99 of the Act. Sheppard DJ made the following *obiter* comments at page 1,168:

> [T]he definition of "arrangement" supplied by sec 99(1) expressly gives a meaning which includes "any … plan". Although the other meanings (contract, agreement, understanding) imply participation by two or more persons, "plan" does not. The relevant meaning given to the word "plan" in the *Shorter Oxford Dictionary* (3rd edition) is:

> "A scheme of action [...] the way in which it is proposed to carry out some proceeding".
>
> However, what the objector did in this case was not only done by him alone without the participation of any other person, it was scarcely a scheme of action or the way in which it was proposed to carry out some proceeding; it did not involve any number of steps or transactions.

3.2.14 On appeal to the High Court (cited as *CIR v Cockburn* (1987) 9 NZTC 6,163) Quilliam J commented that he ought not to say anything about the application of section 99, and decided the case on the relevant specific legislative provision in issue.

3.2.15 But the word "plan" is not necessarily limited to single-person situations. It is quite possible for two or more parties to think about, bring into existence and agree on a "plan". Notably, in *Newton* the Privy Council used the word "plan" when describing something in the nature of an understanding between two or more persons. When the word "plan" is construed for the arrangement definition, it is to be read alongside the words "agreement", "contract", and "understanding" – terms used to describe something like a dealing between two or more persons. The word "plan" comes in this list of words which all involve two or more parties. It is the only word in the list which could potentially be limited to one person, but it is not separated out of the list to indicate that it has a unique feature not shared by the other words – that it may include unilateral arrangements. The inference is that arrangements have a bilateral requirement.

3.2.16 Two other features of the term "arrangement" support the view that Parliament's intention was that an "arrangement" includes two or more people. One is that the definition of "arrangement" in section OB 1 applies whether or not the arrangement is "enforceable or unenforceable". These words can only sensibly apply if an arrangement involves more than one person. Secondly, the definition of "tax avoidance arrangement" in section OB 1 provides that the arrangement must be "entered into" by the person affected by the arrangement or by another person". An arrangement "entered into" suggests something done with another person.

3.2.17 If Parliament had intended that unilateral arrangements would come within the section, it seems likely that it would have stated this more explicitly (as, for example, in the Australian Act, where sections 221AX and 221YHAAA(1) define the word "arrangement" to include unilateral actions or a course of conduct).

3.2.18 Therefore, it is considered the legislative reference to "plan" is to some detailed proposal for doing or achieving something between two or

more persons. This interpretation is supported by Richardson P's comments in *BNZ Investments Ltd* (CA).

3.2.19 Accordingly, in the Commissioner's view the term "arrangement" in section BG 1 means any agreement, contract, plan or understanding entered into between two or more persons.

Consensus or "meeting of minds"

3.2.20 In *BNZ Investments Ltd v CIR* (2000) 19 NZTC 15,732 the High Court construed the definition of "arrangement" in section 99 as requiring a "conscious involvement" of the parties to the arrangement. This approach was upheld, upon appeal, by the majority in the Court of Appeal. The majority considered an arrangement cannot exist in a vacuum and it presupposes there are two or more participants who arrive at an understanding. An "arrangement" (as defined) requires a meeting of minds between parties involving an expectation by each that the other will act in a particular way. Richardson P stated at para 50:

> In short, an arrangement involves a consensus, a meeting of minds between parties involving an expectation on the part of each that the other will act in a particular way. … The essential thread is mutuality as to content. The meeting of minds embodies an expectation as to future conduct. There is consensus as to what is to be done.
> ….
>
> In order to avail the Commissioner, the consensus – the meeting of minds – necessary to constitute an arrangement under s 99 must encompass explicitly or implicitly the dimension which actually amounts to tax avoidance; albeit the taxpayer does not have to know that such dimension amounts to tax avoidance.

3.2.21 In adopting this view the Court required a consensus or meeting of minds between the parties. This involved an expectation on what is to be done, or, by each that the other will act in a particular way. Further, the consensus must encompass explicitly or implicitly the dimensions that actually amount to tax avoidance. However, it is noteworthy that while the taxpayer needs to be aware of the dimensions, knowledge that the dimensions amount to tax avoidance is not necessary.

3.2.22 Richardson P commented on the extent of the knowledge required at para 44:

> The crucial issue in this case is the extent of the understanding: how much knowledge is required and how and where the line is to be drawn when it is contended that A has left downstream matters to the decision of B.

3.2.23 In assessing whether the requisite consensus or meeting of minds is present the majority of the Court of Appeal set out a number of factors, as follows:

Each party can assume the other party to the arrangement will act consistently with the justified expectation of the first party:

> One is the assumption which each party may be entitled to make, other things being equal, that the other will act consistently with the justified expectations of the first, in relation to the way their common purpose is to be achieved. An unexpected departure from those expectations should not, without more, be regarded as part of the meeting of minds and hence as part of the arrangement [per Richardson P, at para 53].

Consensus to be assessed on a commercially realistic approach:

> On the other hand, a commercially realistic approach should be adopted when assessing the extent of the meeting of minds, particularly in cases where a significant feature of the arrangement is the obtaining, and sometimes the sharing, of tax benefits. Where that feature is present, a court is unlikely to find persuasive the stance of a taxpayer who professes to have had no knowledge or expectation of the mechanism by which the benefit was to be delivered. In such a situation the taxpayer may well appropriately be regarded as having authorised or accepted whatever mechanism was actually used. In such circumstances a consensus could properly be found in respect of the use of that mechanism [per Richardson P, at para 54].

Consensus present where wilfully blind:

> Whether there has been a meeting of minds as to what is subsequently done in a particular respect by one party to an arrangement, and whether in answering that question the concept of wilful blindness (discussed by McGechan J — see para [26] above) may provide guidance, will depend on the particular facts [per Richardson P, at para 52]; and
>
> > While to suspect, or to have grounds for suspicion, and even to know, do not in themselves predicate involvement in a "contract, agreement, plan or understanding", it does not take very much more to move a situation onward to a point where tacit involvement may be found ... The situation in that way could move past mere suspicion, or even knowledge, to one of "mutuality", albeit tacit. The same will follow, of course, in Nelsonian cases of wilful blindness. A taxpayer who deliberately refuses to see the obvious, but proceeds with a transaction in which the obvious occurs downstream, readily enough could be held to be part of at least an "understanding" to that effect. A taxpayer who actually knows all the details, and proceeds nevertheless, is of

> course at equal or greater risk [McGechan J at para 64 quoted by Richardson at para 26].

No consensus if the taxpayer reasonably believes that a legitimate tax saving mechanism is to be used and another party uses a tax avoidance mechanism:

> By contrast, if the taxpayer believes on reasonable grounds that the particular and legitimate tax saving mechanism is to be used by the other party, whereas in fact the other party uses a mechanism amounting to tax avoidance, it would be difficult to conclude that the taxpayer had entered into an arrangement extending that far. In such circumstances there would ordinarily be no consensus in respect of the dimension which constituted the tax avoidance. But as we have emphasised the extent of the arrangement entered into by the taxpayer will always depend on the facts of the particular case [per Richardson P, at para 55].

Consensus is satisfied where another is authorised:

> Where a taxpayer does not know how a tax advantage will be produced but expressly chooses, or must be taken to have chosen, to authorise someone acting on behalf of the taxpayer to procure such an advantage, being indifferent to whether or not what is to occur will involve tax avoidance, that other person is the taxpayer's agent and the agency will encompass the avoidance mechanisms. The taxpayer is thus a party to the avoidance arrangements and is caught by s99 [per Blanchard J, at para 170].

Consensus determined before purpose or effect:

> That inquiry, of course, precedes consideration of its purpose or effect under s99(2) [per Richardson P, at para 55].

3.2.24 An arrangement involves a meeting of minds between parties involving an expectation as to future conduct. The conscious involvement of the parties must exist for there to be an arrangement. This conscious involvement or consensus will be established where a significant feature of the arrangement is the obtaining (including sharing) of tax benefits. In that situation, even if a taxpayer professes no knowledge, on a commercially realistic assessment it may be assumed that the taxpayer authorised or accepted the tax avoidance mechanism. Similarly, the consensus will be established if the taxpayer was wilfully blind to what is done under an arrangement. Consensus will exist if the taxpayer authorises an agent to act on their behalf and is indifferent to whether the agent will take part in tax avoidance. On the other hand, consensus will not exist if one of the parties acts in a way that was not expected by the other party or uses a tax avoidance mechanism without the other's knowledge.

3.2.25 Conscious involvement is required to establish that an arrangement exists. However, it should be noted that in *CIR v Peterson* (2003) 21

NZTC 18,060 (CA) , the Court of Appeal confirmed that if there is a tax avoidance arrangement, the Commissioner is entitled to adjust the income of a person affected, to counteract the tax advantage obtained, who is not a party to the arrangement and has no knowledge of it.

Unenforceable arrangements

3.2.26 Section OB 1 defines "arrangement" to mean:

> an agreement, contract, plan or understanding **(whether enforceable or unenforceable)** including all steps and transactions by which it is carried into effect [emphasis added].

3.2.27 An arrangement includes agreements, contracts, plans or understandings that are not intended to be legally binding, and arrangements that are unenforceable at law, e.g. contracts unenforceable due to reasons of public policy, contractual incapacity, or illegality. Such arrangements may still be subject to section BG 1.

Combined effect of transactions or documents

3.2.28 The scope of an "arrangement" is not limited to a single document or transaction. Rather, the Commissioner is entitled, and required, to consider all of the dealings or the set of circumstances between the parties, where relevant, to establish the scope of the arrangement. For example, in *Tayles v CIR* (1982) 5 NZTC 61,311 (CA) the appellant farmer executed three documents – a deed of trust, a deed of partnership, and an agreement for the bailment of stock. McMullin J stated at page 61,318:

> It follows that before that section [section 108] can be said to have application to a particular case there must be an enquiry as to whether there has been an arrangement at all and, if so, what is its nature or purpose. It has never been the case for the taxpayers that the three documents executed by each did not amount to an arrangement.

3.2.29 In effect, the three documents combined constituted the arrangement. The Court looked at the various individual transactions and documents in ascertaining the scope of the arrangement.

3.2.30 The test will often be whether the relevant documents or transactions are sufficiently interrelated and/or interdependent to be considered together as part of the arrangement. For example, in *CIR v Europa Oil (No. 1)* [1971] NZLR 641 (PC) the Privy Council was concerned with three separate documents and had to decide whether the three documents should be considered as a single interrelated complex of agreements entered into for a consideration consisting partly of the supply of gasoline and partly of the advantage sought – i.e., the profits.

3.2.31 The Privy Council stated at page 651:

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

3.2.32 Thus, this case is illustrative of the fact there may be instances where the degree of interrelation or the interdependence of separate documents may be sufficient to regard those documents as the means by which the arrangement was carried into effect and hence represent a single arrangement.

3.2.33 Therefore, where any two or more documents or transactions are sufficiently interrelated or interdependent, they can be considered as part of one arrangement under section BG 1.

Steps by which an arrangement is carried into effect

3.2.34 The definition of "arrangement" explicitly includes all steps and transactions by which it is carried into effect. "Arrangement" is defined to mean:

> an agreement, contract, plan, or understanding (whether enforceable or unenforceable), **including all steps and transactions** by which it is carried into effect [emphasis added].

3.2.35 In *Hadlee and Sydney Bridge Nominees Ltd v CIR* (1989) 11 NZTC 6,155 (HC) Eichelbaum CJ considered the arrangement involved three different transactions which were the steps by which the arrangement was carried into effect. His Honour stated at page 6,171:

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

3.2.36 This approach was approved by Cooke P in the Court of Appeal: *Hadlee and Sydney Bridge Nominees Ltd v CIR* (1991) 13 NZTC 8,116. Cooke P said at page 8,121:

> Eichelbaum CJ held that the section applied, in the part of his judgment reported in (1989) 11 NZTC at pp 6,171–6,175; [1989] 2 NZLR at pp 465 – 70. I agree with and adopt everything that he there says.

3.2.37 The Court of Appeal in *BNZ Investments Ltd* also made the point the words "including all steps and transactions by which it is carried into effect" are concerned with the implementation of the established "contract, agreement, plan or understanding". The word "it" in "by which it is carried into effect" refers back to the applicable "arrangement" and does not extend it.

Severing parts of an arrangement

3.2.38 One issue that arises with an arrangement, consisting of several smaller transactions, is whether a constituent transaction can, of itself, be an arrangement. This can be an important distinction in practice, as there may often be large transactions which are themselves commercially driven, but where one component could be seen (if viewed by itself) to be structured to secure a tax advantage.

3.2.39 This issue has been considered by the courts in Australia and England, in the context of anti-avoidance legislation that refers to the term "scheme", rather than "arrangement" as in the New Zealand context. The Australian courts have generally been unwilling to apply a sub-scheme approach in the application of the Australian general anti-avoidance provisions under Part IVA of the Australian Income Tax Assessment Act 1936.

3.2.40 In *FCT v Peabody* 94 ATC 4,663 (HCA) one of the issues was whether it was possible to take a scheme and isolate one step and apply Part IV to that step. The High Court rejected the use of a sub-scheme approach and would not accept that a scheme within the meaning of Part IVA could be divided into separate parts to apply the dominant purpose test as required under their legislation. It stated at page 4,670:

> But Pt IVA does not provide that a scheme includes part of a scheme and it is possible, despite the very wide definition of a scheme, to conceive of a set of circumstances which constitutes only part of a scheme and not a scheme in itself.

3.2.41 The High Court was influenced, in part, by an earlier decision of the House of Lords in *IRC v Brebner* [1967] 2 AC 18 (HL) where a sub-scheme concept in the context of section 28 of the Finance Act 1960 (UK) was also rejected.

3.2.42 In *Brebner*, their Lordships declined to accept the argument that an entire scheme coming within the section could be divided into separate

sub-schemes and thought the section, which utilised a dominant object test, would be deprived of all practical meaning if one had to isolate one part of the arrangement from the object of the whole arrangement. Lord Pearce stated at page 27:

> And it would be quite unrealistic and not in accordance with the subsection to suppose that their object has to be ascertained in isolation at each step in the arrangement.

3.2.43 The Australian High Court in *FCT v Hart & Anor* 2004 ATC 4,599 (HCA) took the opportunity to highlight a misunderstanding following what the Court had said in *Peabody*. The Court in *Hart* emphasised that the reference to circumstances being "robbed of all practical meaning" was not a criterion to be applied in deciding whether there was a scheme to which Part IVA applied. Rather a scheme must meet the definition of "scheme" set out in the relevant Act. Accordingly, while a scheme does not include part of a scheme, an action or course of action undertaken in the course of, or as part of a transaction or series of transactions, is not the same as part of a scheme. Something done which is less that the whole of an arrangement or agreement may be capable of itself being a scheme.

3.2.44 The Court in *Hart* also confirmed the point made in *Peabody* that the discretion given to the Commissioner by Part IVA to identify a scheme does not depend upon the formation of an opinion; it depends upon objective facts. Similarly, in the New Zealand context, the existence of a tax avoidance arrangement is not determined by the opinion of the Commissioner – or of the taxpayer(s). Rather, whether or not there is a "tax avoidance arrangement", as that expression is defined in the legislation, is a matter of objective fact.

3.2.45 Although the word "scheme" is not included in the definition of "arrangement" in section OB 1, the Commissioner considers the judicial rejection of a "sub-scheme" approach also applies to an arrangement. The definition of "arrangement" in section OB 1 explicitly requires that all steps and transactions by which an arrangement is carried into effect be considered as part of that arrangement. But it does not provide that part of an arrangement is itself an "arrangement".

3.2.46 Therefore, various steps or transactions by which an arrangement is brought into effect should not be severed when considering an arrangement under section BG 1. Similarly a series of transactions which form part of a "wider" arrangement should not be severed when considering the wider arrangement for section BG 1. However, the definition of "arrangement" in section OB 1 does not preclude any tax avoidance arrangement which forms part of, or a step in, a wider series

of arrangements, being considered separately from the wider series of arrangements.

Extraterritorial limitations

3.2.47 Sometimes arrangements involve steps or transactions carried out or brought into effect wholly or partly outside New Zealand. This raises a question about whether section BG 1 applies to such arrangements. In the Commissioner's view any arrangement that has a more than incidental purpose or effect of avoiding New Zealand income tax is void under section BG 1 irrespective of where it is entered into or carried out. To this effect, McGechan J in *BNZ Investments Ltd* (HC) stated at para. 123:

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

3.2.48 Accordingly, it is the Commissioner's view that section BG 1 applies to a tax avoidance arrangement whether or not the arrangement is carried out or brought into effect in New Zealand.

Summary of legal principles

3.2.49 The principles which are relevant when considering an "arrangement" for the purposes of section BG 1 are as follows:

- A tax avoidance arrangement is void against the Commissioner at the time it is entered into by virtue of the operation of section BG 1.

- The word "arrangement" is interpreted to mean something in the nature of a relationship between two or more persons that may not legally amount to an agreement, contract, plan, or understanding, including all the transactions by which it is carried into effect. In other words, it means all kinds of concerted action by which persons may arrange their affairs for a particular purpose or to produce a particular effect (*Jaques, Bell, Newton, BNZ Investments Ltd (CA*)).

- The term "arrangement" means any agreement, contract, plan or understanding made or entered into between two or more persons (*Newton, the definition of "arrangement" in section OB 1, BNZ Investments Ltd (CA)*).

- An "arrangement" requires two or more participants who arrive at an understanding: a consensus or meeting of minds. This consensus involves an expectation about what is to be done, or, by each that the other will act in a particular way. The consensus must encompass explicitly or implicitly the dimensions that actually amount to tax avoidance. While the taxpayers need to be aware of the dimensions, knowledge that the dimensions amount to tax avoidance is not necessary.

- Consensus will be established on a commercially realistic assessment, particularly in cases where a significant feature of the arrangement is the obtaining, and sometimes the sharing, of tax benefits.

- Consensus will exist if the taxpayer authorises an agent to act on their behalf and is indifferent to whether the agent will take part in tax avoidance. Consensus may exist if the taxpayer was wilfully blind to what is done under an arrangement. Consensus will not exist if one of the parties acts in a way that was not expected by the other party or uses a tax avoidance mechanism without the other's knowledge (*BNZ Investments Ltd (CA)*).

- "Arrangement" under section BG 1 can include agreements, contracts, plans, or understandings unenforceable at law (*the definition of "arrangement" in section OB 1*).

- Where any two or more documents or transactions are sufficiently interrelated and/or interdependent, they may be considered one arrangement for the purposes of section BG 1 (*Tayles, Europa (No.1*).

- All steps and transactions by which an arrangement is brought into effect are considered in determining the scope of an arrangement. The word "it" in "by which it is carried into effect" refers back to the applicable "arrangement" and does not extend it (*Hadlee* (*CA)*, *Newton, BNZ Investments Ltd (CA)*, *the definition of "arrangement" in section OB 1*).

- The existence of an arrangement is not determined by the opinion of the Commissioner or taxpayer. Rather, whether there is a "tax avoidance arrangement" is a matter of objective fact.

- The definition of arrangement requires that all steps and transactions by which the arrangement is carried into effect be considered as part of the arrangement. But it does not provide that part of an arrangement is itself an "arrangement" (*Brebner, Peabody, Hart*).

- The definition of "arrangement" in section OB 1 does not preclude any tax avoidance arrangement which forms part of, or a step in, a wider series of arrangements, being considered separately from the wider series of the arrangements (*the meaning of "tax avoidance arrangement" in section OB 1*).

- Section BG 1 applies to a tax avoidance arrangement whether or not the arrangement is carried out or brought into effect in New Zealand (*BNZ Investments Ltd (HC)*).

3.3 Tax avoidance

Background

3.3.1 Section OB 1 defines the term "tax avoidance" to include:

> (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

3.3.2 It is noteworthy the term "tax avoidance" is defined inclusively. As Baragwanath J noted in *Miller (No.1)* (HC) at page 13,033:

> 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).

3.3.3 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" includes "avoiding, postponing or reducing any liability to income tax".

The three limbs of "tax avoidance"

First limb

3.3.4 The first limb provides that "tax avoidance" includes "altering the incidence of any income tax". In the Court of Appeal decision of *Marx v CIR* [1970] NZLR 182 Turner J stated at page 199:

> The incidence of tax is the way in which its burden falls upon those whom the Act makes liable to bear it. So the phrase was understood by Rich J in *De Romero v. Read* (1932) 48 C.L.R. 649 on page 657, and by Dixon J. in the same case at page 660; and so

> I understand it. The inquiry must therefore be: is the arrangement before us one having the purpose or effect of altering the way in which the burden of income tax laid by the Act upon the taxpayers concerned in these appeals falls upon them? 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 of the tax for which the Act makes him liable. Second, a taxpayer may enter into an arrangement having the effect (if it is valid), as between himself and the Commissioner, that he will become liable for less tax after the arrangement than would have, or might have been, levied upon him, but for it. The first of these two possibilities was the one explored in this Court in *Charles v. Lysons and Others* [1922] NZLR 902. That was a land tax case, and it was there held, at least with regard to land tax, that any arrangement by which the liability of the owner of land to pay land tax was cast upon or undertaken by some other person was one which purported to alter the incidence of the tax. I have no reason to think – but it is unnecessary here to decide – that a different result would follow upon an agreement to share the burden of income tax, or at least would have followed as the section stood at the time material to these proceedings.
>
> But it is the second of the two possibilities to which I have referred, with which we are now concerned.

3.3.5 The first scenario illustrates a situation whereby a taxpayer agrees with another that the other will assume some 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.

3.3.6 The second scenario looks at a situation whereby a taxpayer enters into an arrangement having the effect, as between the taxpayer and the Commissioner, of becoming liable for less tax after the arrangement than would have, or might have been, levied upon the taxpayer, but for the arrangement.

3.3.7 It is the second scenario the Commissioner adopts in construing the first limb. The first scenario concerns an arrangement between parties whereby one party assumes some of the burden of tax imposed on the other party. However, such an arrangement does not affect the other party's liability to the Commissioner. The second scenario does concern an arrangement that has an effect as between the party and the Commissioner. Support for this view is found in the majority judgment delivered by Lord Donovan in *Mangin v CIR* [1971] NZLR 591 (PC), in which his Lordship construed the first limb as applying when the economic incidence of tax is altered. His Lordship said at page 596:

> The taxpayer, considering the provisions of fiscal legislation, may discern that by entering into some arrangement he can so distribute the legal incidence of tax upon his income that he

> himself will pay less. In other words the economic incidence is altered. In their Lordships' view this is what is contemplated by s 108.

3.3.8 Hence, 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

3.3.9 The second limb provides that "tax avoidance" includes "relieving any person from liability to pay income tax". In *Mangin* (PC) Lord Donovan stated at page 596:

> 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.

3.3.10 His Lordship referred to the words "defeat", "evade" and "avoid" to explain the ordinary meaning of the phrase from" liability to pay income tax. The *Concise Oxford Dictionary* (10th Ed. revised) explains the ordinary meaning of the words "defeat", "evade" or "avoid" as follows:

> **defeat**•v. **1** win a victory over. **2** prevent (an aim) from being achieved: *this defeats the object of the exercise.* ➤thwart or frustrate. ➤Law render null and void. •n. an instance of defeating or being defeated.
>
> **evade**•v. **1** escape or avoid, especially by guile or trickery. ➤avoid giving a direct answer to (a question). **2** escape paying (tax or duty), especially by illegitimate presentation of one's finances. ➤defeat the intention of (a law or rule), especially while complying with its letter.
>
> **avoid**•v. **1** keep away or refrain from ➤prevent from doing or happening. **2** Law repudiate, nullify, or render void (a decree or contract).

3.3.11 It is arguable the second limb may overlap with the third limb as "relieving" in the second limb could potentially have the same legal effect as "avoiding" in the third limb. Support for this is found in *Mangin* where Lord Donovan, as indicated above, thought one "secures relief from tax" if one "avoids" it.

3.3.12 Although the second and third limbs of the "tax avoidance" definition may overlap to an extent, they do not always have the same effect. The second limb applies if an arrangement relieves someone from an

obligation to "pay income tax", and the third limb applies if an arrangement has the effect of avoiding, postponing, or reducing "liability to income tax".

3.3.13 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. Section BC 9 of the Act indicates that tax credits are dealt with after a person's income tax liability is calculated. The Commissioner's ability to counteract arrangements involving tax credits is specifically provided for in subsections GB 1 (2A)-(2C).

Third limb

3.3.14 The third limb provides that "tax avoidance" includes "avoiding, postponing, or reducing any liability to income tax". The words "reducing" or "postponing" first appeared in the 1974 amendments to section 108.

3.3.15 Without any judicial authority on this limb, reference is made to the ordinary meanings of these words as defined in the *Concise Oxford Dictionary* (10th Ed. revised), as follows:

> **avoid•v**. **1** keep away or refrain from ➢prevent from doing or happening. **2** Law repudiate, nullify, or render void (a decree or contract).
>
> **reduce •v**. **1** make or become smaller or less in amount, degree or size.
>
> **postpone •v**. arrange for (something) to take place at a time later than that first scheduled.

3.3.16 When these words are construed in their ordinary sense they mean escaping or minimising liability to income tax, or deferring that liability to a later date. The addition of the words "reducing" and "postponing" make it clear that the section operates in respect of a reduction or postponement of liability as well as a complete avoidance of liability (a point also noted by R L Congreve in "Land and Income Tax Amendment Act (No 2) 1974" (1975) 6 NZULR 310 at 311).

Combined effect of the three limbs

3.3.17 The combined effect of the three limbs is that tax avoidance is present where the taxpayer directly or indirectly alters the economic incidence of tax; defeats, evades, or avoids liability to pay income tax; or either escapes or minimises liability to income tax or defers that liability to a later date.

Future liabilities

Background

3.3.18 As set out above, section OB 1 defines the term "tax avoidance" to include:

> (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

3.3.19 In construing the three limbs of the definition of "tax avoidance" the courts have, in the past, applied those limbs either to existing, or to potential or prospective, liabilities. Paragraphs (b) and (c) have since been amended to specifically include potential and prospective liabilities.

Does paragraph (a) include future liabilities?

3.3.20 Paragraph (a) was not amended to include the words "potential" and "prospective". However, that is not to say that paragraph (a) may not include a future incidence of income tax. North P in the Court of Appeal in *Marx* (CA) did not accept the argument that the phrases "altering the incidence of income tax or relieving any person from his liability to pay income tax" did not apply to tax in respect of future income. His Honour held that by diverting a future source of income tax the arrangement in question had altered the incidence of income tax.

3.3.21 In *Mangin* the Privy Council accepted that the words "altering the incidence of tax" include a future liability to tax. The Privy Council stated:

> The taxpayer, considering the provisions of fiscal legislation, may discern that by entering into some arrangement he can so distribute the legal incidence of tax upon his income that he himself will pay less. In other words the economic incidence is altered. In their Lordship's view this is what is contemplated by s 108.

3.3.22 Baragwanath J in *Miller (No 1)* (HC) noted that paragraph (a) of the definition of tax avoidance involves a comparison between the tax paid under the arrangement and a hypothetical situation:

> 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.

Issues relating to future liabilities

3.3.23 In the context of tax avoidance arrangements, two issues arise which relate to future liabilities, namely:

- the degree of certainty necessary for a liability to be regarded as:
  - an incidence of tax which has been altered or
  - a "potential or prospective" liability; and

- the degree to which income from new sources can be the subject of "tax avoidance".

How likely must the hypothetical liability be under paragraph (a)?

3.3.24 The definition of "tax avoidance" does not set out how to identify the incidence of tax altered. Note that in this discussion, paragraphs (b) and (c), which specifically include potential and prospective liabilities, will be discussed separately from paragraph (a).

3.3.25 The Privy Council in *Mangin* accepted that a future incidence of tax would be within the section, and gave no indication that such an incidence had to be one which would definitely have otherwise arisen.

3.3.26 In the quotation referred to above of Baragwanath J in *Miller (No 1)*, his Honour said that paragraph (a) "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 using the words "would have had to meet", it could be argued that his Honour considered that the section requires an identification of a tax liability which definitely would have otherwise arisen. The taxpayer argued that if the arrangement had not been entered into, the company would have retained its profits. The Commissioner argued that the company profits would have been distributed to shareholders. Baragwanath J held that it was "quite unlikely" on the facts that the company would have distributed all of the profits, and that therefore paragraph (a) would not apply. His Honour's view was that paragraph (a) cannot apply if the incidence of tax altered is "quite unlikely". His Honour did not go further, however, and state that the incidence of tax must be likely to have arisen. In any event, Baragwanath J found that paragraph (c) would apply to such an unlikely liability. He said:

> There is no a priori reason to read s 99 down, or otherwise than in accordance with the principles of s 5(j) of the Acts Interpretation Act 1924: *C of IR v Alcan New Zealand Limited* (1994) 16 NZTC 11,175; [1994] 3 NZLR 439 (CA). It is the income derived which every taxpayer must return, pursuant to s 9. It is the concept of derivation of income which is specifically referred to in s 99(3)(a) and (b) and may be seen as contemplated generally by the first part of subs (3). The cashflow in

> question here involves moneys which if paid direct to the taxpayers as shareholders of Company A would have been taxable in their hands. While it is likely that much of that cashflow would have remained in Company A rather than been passed on to the plaintiffs had the arrangement not been made, it is consistent with the purpose of s 99 to ascribe to Parliament an intent to fix tax liability on the very cashflow which has moved from the business to its proprietors as a result of the arrangement which has permitted such direct receipt by the plaintiffs without liability for and therefore avoiding income tax.

How likely must the hypothetical liability be under paragraphs (b) and (c)?

3.3.27 Paragraphs (b) and (c) include potential and prospective liabilities. The *Concise Oxford Dictionary* (10th Ed. revised) defines the words "potential" and "prospective" as follows:

> **Potential** •***adj.*** having the capacity to develop into something in the future.
>
> **Prospective** •***adj.*** expected or likely to happen or be in the future.

The ordinary meanings of "potential" and "prospective" both suggest the liability to future income tax should be foreseeable to some degree at the time of entering into the arrangement. "Potential" suggests a lower threshold of likelihood than "prospective". A potential liability is one which has the capacity to arise (i.e., one which is at least possible), compared with a prospective liability which is expected or likely to arise.

3.3.28 It is implicit in the words "potential" and "prospective" that a comparison is required between the tax liability relieved, avoided, postponed or reduced, and a hypothetical tax liability which might have otherwise arisen. Richardson J made the following observation in relation to "potential" and "prospective" in *Challenge* (CA). His Honour said at page 5,021:

> "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 [in *Mangin v CIR* [1971] NZLR 591 (PC)]:
>
> > "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 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.

3.3.29 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.

3.3.30 In some instances, the relevant liability that is relieved, avoided, postponed or reduced, will be obvious. It will be that amount which must have arisen but for the arrangement. In other instances, it may be difficult to establish what possible other course of action the taxpayer might have taken if the tax avoidance arrangement had not been entered into. This is the question raised by Lord Wilberforce in *Mangin* referred to above. There is conceptually a range of degrees of likelihood from one which is inevitable to one which may conceivably happen. In the Commissioner's opinion, the test under which a hypothetical liability is identified cannot be one at the end of the spectrum that requires identification of a liability that would have inevitably arisen. As Professor Trebilcock has commented, in the article referred to earlier, the hypothetical comparison **cannot** be one that is **inevitable,** because a future and at present non-existent liability will almost never be inevitable.

3.3.31 A taxpayer might argue in some situations that as there is insufficient certainty about what they would have done if they had not entered into the tax avoidance arrangement, as a consequence, the section cannot apply. In the Commissioner's opinion, this view cannot be sustained in terms of the statutory scheme. It seems highly unlikely that Parliament would have enacted an anti-avoidance provision that could never apply in such situations. To give effect to the section, the Commissioner has to identify a possible comparative tax liability. The meanings of "potential" and "prospective", and particularly "potential", indicate that the intention was to include liabilities which merely have the capacity to arise. It follows that the liability is not required to be one which is inevitable or one which in all likelihood would have arisen but for the arrangement.

3.3.32 This conclusion is also consistent with section GB 1. When section GB 1 applies, as is discussed later, the Commissioner is required to counteract the **tax advantage obtained** from or under the arrangement. In counteracting the tax advantage the Commissioner must identify the tax to be payable if the tax avoidance arrangement had not been entered into. The Commissioner is given very broad power under the section to counteract the tax advantage derived by any other person or persons as a result of that arrangement "in the manner the Commissioner thinks appropriate".

3.3.33 Further, in applying section GB 1, the Commissioner may consider paragraphs (a) and (b) of section GB 1, which are stated to apply "without limiting the generality of this subsection". Paragraph (a) states that the Commissioner may have regard to the amounts of assessable income, deductions, and available net losses the person would have, or might be expected to have, or would in all likelihood have had if the tax avoidance arrangement had not been entered into. The Commissioner **may** have regard to the factors in paragraph (a), but it is notable that the Commissioner is **not required to** refer to or apply them. Accepting the argument that the Commissioner has to identify a liability which was inevitable or the most likely to have otherwise arisen under section BG 1, would lead to the incongruous result that there is a different and lower standard when the Commissioner is counteracting the advantage under section GB 1, when it would be logical to expect these provisions to operate at the same level. Applying that argument would mean that effect could not be given to the broad legislative scope given to counteract a tax advantage under section GB 1. For all of the foregoing interpretative and policy reasons, the Commissioner considers that the argument cannot be correct.

3.3.34 In the Australian case of *FCT v Spotless Services Ltd* 96 ATC 5201 the High Court rejected an argument that the anti-avoidance provision could not apply because, it was not possible to identify an alternative course of action they might have taken but for the tax avoidance arrangement. The taxpayers had invested amounts in the Cook Islands and claimed that the interest was exempt from income tax. The Court held that the arrangement was subject to the Australian anti-avoidance provision. The argument put forward by the taxpayers was outlined at page 5,211:

> The taxpayers submit that the Full Court erred in holding that, if the scheme had not been entered into or carried out, an amount of income from the use of the sum on deposit would have been, or could reasonably be expected to have been, included in the assessable incomes of the taxpayers for the year of income. They submit that there is no possible way of knowing whether the amount actually derived from the investment, or any other particular amount, would have been included in the assessable income of the taxpayer had they chosen not to make the investment that they did. It is said that, if the taxpayers had not entered into the scheme, there would have been no interest and no amount would have been included in assessable income with the result that the definition of "tax benefit" set out above makes no sense in the context of the present case.

3.3.35 The anti-avoidance provision operated when a tax benefit was identified in paragraph (a) of section 177C of the Income Tax Assessment Act 1936 as an amount not included in the taxpayer's assessable income. The taxpayer's submission turned upon the use in

paragraph (a) of section 177C(1) of the expression "an amount not being included". In short, the taxpayer submitted that without the scheme there would have been no investment and the relevant amount would not have existed, and paragraph (a) of section 177C(1) would have had no subject matter upon which to operate.

3.3.36 In response to this argument the Court stated at page 5,211:

> In our view, the amount to which para (a) refers as not being included in the assessable income of the taxpayer is identified more generally than the taxpayers would have it. The paragraph speaks of the amount produced from a particular source or activity. In the present case, this was the investment of $40 million and its employment to generate a return to the taxpayers. **It is sufficient that at least the amount in question might reasonably have been included in the assessable income had the scheme not been entered into or carried out** [emphasis added].

3.3.37 The Commissioner considers there is merit in the approach taken by the Australian High Court in the *Spotless* decision. While the focus in the *Spotless* decision was on "an amount" not being included in the taxpayer's assessable income, for section BG 1 the same reasoning can be applied to a potential or prospective liability. The Commissioner considers that faced with a taxpayer's proposition that, but for the arrangement, there is no way of knowing what the liability for future income tax would have been had they not chosen the arrangement they did, a New Zealand Court would most likely apply a similar approach.

3.3.38 In identifying the hypothetical liability relieved, avoided, postponed or reduced, there will be instances where there is only one possible course of action which could have been taken if the arrangement had not been entered into (in comparison to the facts in *Spotless*). In such a case that will be the hypothetical situation to which the Commissioner should refer. Otherwise, however, the Commissioner may have regard to the income tax liability which conceivably might have arisen but for the arrangement. However, this hypothetical comparative tax liability should be based on some **reasonable** expectation. To use the language of the Australian High Court in *Spotless*, it is sufficient if the liability in question might reasonably have been included in the assessable income had the arrangement not been entered into or carried out.

3.3.39 In relation to paragraph (a) of the definition of "tax avoidance", as noted above, there is no judicial guidance on how likely the hypothetical incidence of tax altered needs to be. Nevertheless, as with paragraphs (b) and (c), under paragraph (a) it is the Commissioner's view that he is <u>not</u> required by the paragraph to identify an altered incidence of tax that otherwise inevitably would have arisen or that in all likelihood would have arisen. In many situations, there will be more than one possible courses of action (and differing incidence of

tax), and it is considered that Parliament did not intend that the anti-avoidance provision would never be able to be applied in such situations. Therefore, the Commissioner considers that the approach of ascertaining the amount of gross income, allowable deductions and available net losses the taxpayer **might reasonably have included** in its income had the arrangement not been entered into or carried out is also applicable to paragraph (a).

Conclusion on ascertaining a future liability or incidence of tax

3.3.40 Therefore, the Commissioner considers that in ascertaining an altered incidence of tax or a "potential" or "prospective" liability, the correct approach is to ascertain the amount of gross income, allowable deductions and available net losses the taxpayer **might reasonably have included** in its taxable income had the "tax avoidance arrangement" not been entered into or carried out.

New source

3.3.41 In the past there have been contrasting judicial comments on the possible application of the general anti-avoidance provisions to income from new sources.

3.3.42 Lord Diplock in *Europa Oil (No. 2)* v CIR (1976) 2 NZTC 61,066 (PC) considered that section 108 did not strike at arrangements dealing with new sources of income. His Lordship stated at page 61,074:

> Secondly, the description of the contracts, agreements and arrangements which are liable to avoidance presupposes the continued receipt by the taxpayer of income from an existing source in respect of which his liability to pay tax would be altered or relieved if legal effect were given to the contract, agreement, or arrangement sought to be avoided as against the Commissioner. The section does not strike at new sources of income or restrict the right of the taxpayer to arrange his affairs in relation to income from a new source in such a way as to attract the least possible liability to tax. Nor does it prevent the taxpayer from parting with a source of income.

3.3.43 This passage was referred to, but found not to apply on the facts, by Casey J in *Halliwell v CIR* (1977) 3 NZTC 61,208 (SC). There, a dentist, upon the dissolution of a partnership carried on with his father, formed a trust to which he sold and leased back plant and equipment for use by him in carrying on the practice as a sole practitioner. It was contended the implementation of the arrangement occurred on the very day the taxpayer assumed sole proprietorship of the dental practice.

3.3.44 In the Supreme Court, Casey J rejected the argument there was a new source of income on the ground that even before his takeover of the practice, the taxpayer was substantially in control of the practice due to

his father's poor health during the previous five years. The change in the quality of ownership was not sufficient to justify the conclusion the taxpayer was succeeding to a new source of income.

3.3.45 His Honour stated at page 61,215:

> Mr. Sorensen [for the Commissioner] argued that Lord Diplock was speaking of "income spreading" in the passage cited, and not of "deduction" cases. I can see no indication that this was so; indeed, he was dealing principally with a deduction situation, although the receipt by the taxpayer of tax-free dividends did come up for consideration. I confess to some difficulty in deciding what is meant by an "existing source" of income in this context, Mr. Halliwell carried on the practice of dentistry both before and after his father's retirement, and in a physical sense continued to receive income from the same source. […]
>
> One can envisage a number of situations where it would be against reason to hold there had been a change in the source of income of continuing partners in a large professional practice e.g. on the retirement of only one member, of the admission of a junior, or even an alteration in the partners' interests. I think the answer to the question of whether there is an existing or a new source of income (to which the arrangement under attack relates) depends on a common-sense appraisal of the physical source itself, as well as of the taxpayer's interest in it, and of any other relevant circumstances. The onus is on the taxpayer, and I have no evidence of Mr. Halliwell's interest in the partnership before his father's retirement [….] I am not satisfied there was such a change to justify the view Mr. Halliwell acquired a new source of income for which these arrangements were made.

3.3.46 Although Casey J did not dissent from Lord Diplock's proposition, he thought that the question of whether income is from an existing or a new source depends on a common-sense appraisal of the physical source itself, as well as of the taxpayer's interest in it, and of any other relevant circumstances. His Honour indicated the onus of proving the income was from a new source was on the taxpayer.

3.3.47 The general anti-avoidance provision was substantially amended in 1974, to make the provision more effective than the section under consideration by Lord Diplock. That this was so was acknowledged by the Privy Council in *CIR v Challenge Corporation Ltd* (1986) 8 NZTC 5,219 (PC) where their Lordships stated at page 5,224:

> The provisions of section 99 [equivalent to section 108 as amended] are of general application and, in the absence of any express direction by Parliament excluding section 191 from the ambit of section 99, their Lordships consider that section 99 must be applied in the present circumstances.
>
> This conclusion is supported by the legislative history of sections 99 and 191 [….] In the words of Richardson J in the present case

> "the old section 108 was found to be both unreasonably restrictive and too broad in its application" [….] Section 108 was amended and replaced by a more extensive general anti-avoidance measure in 1974.

3.3.48 Because of this background, it seems anomalous to contend that section BG 1 automatically, and without exception, was intended to be ineffective against arrangements involving new sources of income. The Commissioner considers the application of section BG 1 cannot be circumvented merely because a new source of income is involved.

3.3.49 More recently, in *BNZ Investments Ltd* the High Court expressed the view the "new source" rule as enunciated by Lord Diplock in *Europa Oil (No.2)* (PC) is outdated and obsolete. McGechan J stated at page 15,803:

> I regard the "new source" doctrine as obsolete. Observations made in *Europa Oil (NZ) Limited v CIR (No. 2)* [1976] 1 NZLR 546 (PC) [also reported as *Europa Oil (NZ) Ltd v C of IR (No 2*); *C of IR v Europa Oil (No 2)* (1976) 2 NZTC 61,661] were based on former s 108 which pivoted on "alteration of incidence". Section 99, in the expanded definition of "tax avoidance" contained in s 99(1) now extends beyond "alteration of incidence" to include even "directly or indirectly avoiding" liability. While there were obvious logical difficulties in regarding creation of a new source of income as "altering incidence", that does not apply in relation to "avoiding", and even less so in relation to "indirectly avoiding".

3.3.50 Accordingly, the Commissioner considers the presence of a "new source" of income will not, of itself, exclude the potential application of section BG 1.

Is tax avoidance determined on a wide or narrow consideration of the net tax effect of the arrangement?

3.3.51 This part of this statement considers whether tax avoidance is to be tested from the position of a single person who is a party to, or affected by, the arrangement, or whether the overall tax position of the arrangement is relevant to determine whether there is tax avoidance.

3.3.52 For example, it is possible that a financing arrangement may result in, overall, the same or increased net New Zealand tax. However, one party to the arrangement may suffer a reduction in tax payable that, in isolation, would lead to a conclusion of tax avoidance, while another party endures an increased liability, to the same or a greater extent. The question arises as to whether a "tax avoidance arrangement" can be said to exist when, overall, the arrangement arguably does not result in a reduced net amount of New Zealand tax.

Single taxpayer basis

3.3.53 In the Commissioner's view, the definition of "tax avoidance" requires the single taxpayer approach. Paragraph (b) clearly applies on a single taxpayer basis as it refers to relieving "any person" from a liability to pay income tax. The words "any person" can only be interpreted as applying to a single taxpayer in isolation.

3.3.54 Paragraph (c) is also arguably framed with only a single taxpayer in mind, on the basis that only single taxpayers will suffer a **liability** to income tax, and therefore the tax avoidance is the alteration of that single taxpayer's liability.

3.3.55 Accordingly, the wording of both paragraphs (b) and (c) are strongly counter to any argument that it is the overall tax consequences of an arrangement that are relevant in determining whether there is, as an initial question, tax avoidance. Rather, they require a consideration of the effect of the arrangement on the tax position of any person.

3.3.56 Paragraph (a) is less certain as it refers to "directly or indirectly altering the incidence of any income tax". However, in the Commissioner's view, the paragraph can be applied on the basis of whether the arrangement alters the way in which the burden of tax falls upon the person in question.

3.3.57 It is also noted that section GB 1, in giving a discretion to counteract any tax advantage, requires the Commissioner to exercise the discretion in relation to the taxable income of "any person affected" by the arrangement so as to counteract any tax advantage obtained **by that person** from or under the arrangement.

Possible relevance of an overall net tax gain

3.3.58 As noted above, it is the Commissioner's view that the "tax avoidance" test is applied to individual taxpayers, and that the overall tax effect of a transaction does not circumvent or modify this approach.

3.3.59 This is not an absurd, or even a particularly surprising, result. As with the design and operation of other general anti-avoidance provisions (such as those in the accrual rules), it is the Commissioner's view that section BG 1 casts a wide net at the stage of determining whether there is "tax avoidance". Therefore, in terms of the scheme of the legislation, the overall net tax position of an arrangement is not taken into account so as to exclude the operation of section BG 1 at the initial stage of determining whether there is "tax avoidance". However, the overall net tax position may potentially be relevant in any subsequent consideration whether tax avoidance is "merely incidental" or whether the arrangement "frustrates" the legislative purpose. (The concepts of

"merely incidental" and "frustration" are discussed in more detail later.)

Summary of legal principles

3.3.60 The relevant principles under the definition of "tax avoidance" are as follows:

- 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 paragraphs (a), (b) or (c) of the definition of "tax avoidance" (*Miller (No.1) (HC)*).

- The first limb applies to arrangements which have the purpose or effect of altering the economic incidence of tax such that the taxpayer becomes liable to less tax after the arrangement than would have, or might have been, levied upon the taxpayer, but for it (*Marx, Mangin*).

- The second limb focuses on relieving or releasing someone from an obligation to pay income tax. The word "relieving" is construed as "defeating", "evading" or "avoiding" (*Mangin*; *dictionary meanings*). This limb may apply to arrangements involving tax credits.

- The words "avoiding", "postponing" or "reducing" in the third limb are construed in their ordinary sense. They mean escaping or minimising a liability to income tax or deferring that liability to a later date (*dictionary meanings*).

- The combined effect of the three limbs is that the taxpayer must directly or indirectly alter the economic incidence of tax; defeat, evade, or avoid liability to pay income tax; escape or minimise liability to income tax; or defer that liability to a later date (*Newton*, *Marx*, *Mangin*).

- In ascertaining an alteration of the incidence of income tax or a "potential" or "prospective" liability, the Commissioner considers the correct approach is to ascertain the amount of gross income, allowable deductions, or available net losses the taxpayer **might reasonably have** included in its tax income had the "tax avoidance arrangement" not been entered into or carried out (*statutory construction, dictionary meanings, Spotless).*

- The existence of a "new source" of income will not, of itself, exclude the potential application of section BG 1 (*the definition of "tax avoidance" in section OB 1, BNZ Investments Ltd (HC)*).

- The overall net tax position of an arrangement is not taken into account at the initial stage of determining whether there is "tax avoidance".

3.4 Tax avoidance arrangement

Background

3.4.1 The definition of "tax avoidance arrangement" in section OB 1 states:

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

3.4.2 Three fundamental questions arise out of the above definition:

- How to determine whether tax avoidance is a purpose or effect of an arrangement;
- What is the meaning of "purpose or effect"; and
- What is the meaning of "merely incidental"?

3.4.3 In the context of the equivalent Australian provision, section 260 of the Australian Income Tax Assessment Act 1936, the Privy Council held in *Newton* that transactions that are capable of explanation by reference to ordinary business or family dealings, without necessarily being labelled as a means to avoid tax, did not come within the section. However, that view is no longer directly relevant following amendments to section 108 in 1974 to incorporate arrangements that have a more than merely incidental purpose or effect of tax avoidance, whether or not such a purpose or effect is "referable to ordinary business or family dealings".

3.4.4 Before the 1974 amendment the word "purpose" had been variously interpreted as "an actuating purpose", a "sole purpose", or "the principal purpose" of the arrangement. For example, in *Elmiger v CIR* [1967] NZLR 161 (CA) North P said at page 167:

> The alteration of incidence or relieving from liability need not be the sole purpose of the arrangement: *Newton's* case (supra) 467. It was only the second of the purposes that clearly involves a tax

> avoidance purpose. Relating this holding of the Privy Council in *Newton*'s case to s. 108 the use of the words "in so far as" in our section compels the same conclusion. It is clear there must be a purpose of tax avoidance, it is not sufficient if tax avoidance is an incidental consequence only. **To emphasise that there must be a purpose and not just an incidental consequence, Woodhouse J. used the expression "actuating" purpose.** "Actuating" is taken from Fullagar J. in *Newton's* case (supra). *Purdie's* case (supra) 609 supports Woodhouse J. so long as "substantial" is regarded as a synonym for "real" or "actuating" [emphasis added].

3.4.5 The Court found there was a purpose of tax avoidance, which was not just an incident of some other non-tax purpose, and the arrangement was subject to the anti-avoidance provisions.

3.4.6 But an alternative view – a sole or principal purpose approach – was subsequently favoured by the Privy Council in *Mangin,* where Lord Donovan said, at page 598:

> Their Lordships think that what this phrase ["without necessarily being labelled as a means to avoid tax"] refers to is, to adopt the language of Turner J in the present case "a scheme … devised for **the sole purpose, or at least the principal purpose**, of bringing it about that this taxpayer should escape liability on tax for a substantial part of the income which, without it, he would have derived" [emphasis added].

3.4.7 The 1974 amendment was intended, among other things, to return the law to the *Elmiger v CIR* [1966] NZLR 683 (SC) position to include arrangements having a purpose or effect of tax avoidance that is less than a sole or principal purpose. The amended definition of "tax avoidance arrangement" provides:

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

3.4.8 During the second reading of the Bill (which was later enacted as the Land and Income Tax Amendment Act (No. 2) 1974), Hon Dr A M Finlay (then Minister of Justice) discussed the new clause and referred to the decision of Woodhouse J in *Elmiger* (SC). This was reported at page 4192 of the *New Zealand Parliamentary Debates* (Vol. 393, 2 Aug-3 Sept 1994):

> That [*Elmiger*] is a decision which I, for my part, regard as a landmark in our legal and social history, and typical of the

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

3.4.9 The Minister continued by citing the decision of *Hollyock v FCT* 2 ATR 601 (HCA) where the Court rejected the *Mangin* "sole or principal purpose" test. He concluded at page 4194:

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

3.4.10 The Minister's comments make it clear that Parliament's intention in introducing the "more than merely incidental" threshold was to restore the law to that of the *Elmiger* (SC) position.

How to determine whether tax avoidance is a purpose or effect of an arrangement - predication

3.4.11 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.

3.4.12 The "predication" approach was enunciated by Lord Denning in the Privy Council in the *Newton* case. In considering section 260 of the Australian Income Tax Assessment Act 1936, his Lordship stated at page 764:

> 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.

3.4.13 The *Concise Oxford Dictionary* (10th Ed. revised) defines "predicate" as follows; the second definition being the relevant one:

> **Predicate** •**n. 1** *Grammar* the part of a sentence or clause containing a verb and stating something about the subject (e.g. *went home* in *John went home*). **2** *Logic* something which is affirmed or denied concerning an argument of a proposition. •**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.

3.4.14 This approach was routinely applied to section 108 before its amendment in 1974. Amongst other things, the section was amended to include, within the definition of tax avoidance arrangement, arrangements whether they are referable to ordinary business or family dealings. The inclusion of these words makes it clear that Lord Denning's reference in *Newton* to transactions being "capable of explanation by reference to ordinary business or family dealings" is no longer authoritative.

3.4.15 Nevertheless, it is still necessary under the section to "predicate" (in the sense of positively determining or classifying) a purpose or effect of the arrangement as being one of tax avoidance. For example, in *Challenge* (CA) Woodhouse P in his dissenting judgment (later upheld by the Privy Council) confirmed the applicability of the test in respect of the revised legislation. He stated at page 5,011:

> In Australia the *Newton* predication principle appears to have received little judicial attention in the cases during the 1970s while use of the choice principle seems to have had the effect of putting such wide-ranging limits upon the anti-tax avoidance provisions of the Australian Act as to virtually stultify it. It would be unfortunate if such a thing were to happen here and then it was thought necessary by Parliament to arm the Commissioner of Inland Revenue with significant discretionary powers as a more effective weapon. **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.** [Emphasis added]

3.4.16 Therefore, the *Newton* approach is still relevant because it is necessary to predicate tax avoidance in the ordinary sense of positively determining the purpose or effect of tax avoidance, but not in so far as limiting the inquiry to overt acts which fall outside the scope of "ordinary business or family dealings".

Purpose or effect

3.4.17 The definition of "tax avoidance arrangement" provides that any arrangement that has a "purpose or effect" that is more than merely incidental will amount to a tax avoidance arrangement, whether tax avoidance is the sole or dominant purpose of that arrangement.

3.4.18 The leading cases have held that the "purpose or effect" requirement is determined objectively. The motive of the parties is irrelevant. Lord Denning said in the *Newton* case at page 763:

> The word "purpose" means, not motive, but the effect which it is sought to achieve – the end in view. The word "effect" means the end accomplished or achieved. The whole set of words denotes concerted action to an end - the end of avoiding tax.

3.4.19 In *Ashton & Anor v CIR* (1975) 2 NZTC 61,030 (PC), where the taxpayers did not dispute that one of the purposes or effects of the arrangement was to avoid the incidence of tax, the Privy Council referred to the dicta in *Newton*. Referring to a concession made for the taxpayers that one purpose or effect of the arrangement was to avoid the incidence of tax, the Judicial Committee said at page 61,034:

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

3.4.20 In the Court of Appeal decision of *Tayles,* McMullin J stated at page 61,318:

> The issue before the Board of Review, the High Court and this court involved an enquiry into the purpose or effect of the arrangement admittedly made. Whatever difference of meaning there may be in dictionary terms between the words "purpose" or "effect", posed as they seem to be as alternatives in sec. 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. F.C. of T.* at p. 465. And "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 [....]" *Ashton v. C. of I.R.* at p. 61,034.

3.4.21 These cases demonstrate that "purpose" in the context of tax avoidance means the intended effect the arrangement seeks to achieve but not the

motive, whereas "effect" means the end accomplished or achieved by the arrangement. If an arrangement has a particular purpose then that purpose is ascertained objectively and is demonstrated by the effects produced. If it has a particular effect then that means the end accomplished or achieved. The whole set of words denotes a concerted action to an end – the end of avoiding tax.

More than merely incidental

3.4.22 If there is more than one purpose, the tax avoidance purpose must be "more than merely incidental". The word "incidental" is defined in the *Concise Oxford Dictionary* (10th Ed. revised) to mean:

> **incidental** •***adj.*** **1** occurring as a minor accompaniment. ➤occurring by chance in connection with something else. **2** (**incidental to**) liable to happen as a consequence of. •**n** an incidental detail, expense, event, etc.

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

3.4.24 A possible example of the first meaning can be found in the High Court decision of *Hadlee* (HC) (which was approved by Cooke P at the Court of Appeal level), where Eichelbaum CJ concluded at page 6,175:

> 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.

3.4.25 However, it is the second approach which has the greater authoritative and legislative support. In *Challenge* (CA) Woodhouse P, in his dissenting judgment, discussed the meaning of "merely incidental" (at page 5,006) as follows:

> Clearly enough para (b) [section 99(2)(b)] is designed to catch an arrangement whenever it has a tax avoidance purpose (or effect) even if it has another and real purpose which is not tax avoidance. But the bracketed words [ie, not being a merely incidental purpose or effect] enable a "merely incidental" tax avoidance purpose to be disregarded. So the meaning of that qualifying phrase is important. Does it have the rather exiguous meaning and effect of excusing only "the casual" or "the minor" or "the inconsequential"

> tax avoidance purposes? If so, many "ordinary" dealings would probably be caught by section 99 because inevitably the associated tax purpose could seem stronger than that.

3.4.26 Woodhouse P continued at page 5,006:

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

3.4.27 This suggests that a "merely incidental" tax avoidance purpose or effect is something which naturally follows from or is necessarily linked (without contrivance) to some other purpose or effect, so that, objectively, it can be regarded as a natural concomitant, or accompanying thing.

3.4.28 The President went on to say at pages 5,005-5,006:

> I do not think that the phrase "merely incidental" does have such a limiting effect and in accordance with *Newton v C of T* [1958] AC 450 I am satisfied as well that **the issue as to whether or not a tax saving purpose or effect is "merely incidental" to another purpose is something to be decided not subjectively in terms of motive but objectively by reference to the arrangement itself** [emphasis added].
> ….
>
> **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.** To put the matter in another way, there is all the difference in the world, I think, between the prudent attention on the one hand that can always be given sensibly and quite properly to the tax implications likely to arise from a course of action when deciding whether or not to pursue it and its pursuit on the other hand simply to achieve a manufactured tax advantage [emphasis added].

3.4.29 This is generally consistent with his Honour's previous judgment in the Supreme Court decision of *Elmiger* (SC). In that case, Woodhouse J (as he then was) stated at page 694 that family or business dealings come within the section:

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

3.4.30 It is clear from the *Hansard* comments noted at paragraphs 3.4.8 and 3.4.9 that Parliament's intention in redrafting the provision in 1974 was to amend the law, among other things, so that it was consistent with the views of Woodhouse J in *Elmiger* (SC).

3.4.31 In some subsequent TRA decisions the Authority has also adopted the Woodhouse approach. For example, in *Case M72* (1990) 12 NZTC 2,419 (TRA) Barber DCJ stated at page 2,424:

> The words "merely incidental" were considered in detail by Woodhouse P in the *Challenge* decision at p 5,006. In the Privy Council, this matter was not referred to by their Lordships, but there seems to be implicit support for the judgment of Woodhouse P.
> ….
>
> I respectfully agree with Woodhouse P that an objective approach must be taken.

3.4.32 Similarly in *Case S95* (1996) 17 NZTC 7,593 (TRA) Willy DJ stated at page 7,602:

> Where the arrangement has none that are purpose or effect (*sic*) then the taxpayer must show that saving tax was "merely incidental" to some other purpose or effect. That is to be decided applying an objective test *C of IR v Challenge Corporation Limited* (1986) 8 NZTC 5,001 (CA) at p 5,005 (Woodhouse P).

3.4.33 From these cases and the Hansard comments noted above the preferred test for establishing a "more than merely incidental" purpose or effect is the test adopted by Woodhouse P in *Challenge* (CA). That is, to ascertain whether the "merely incidental" purpose or effect follows from or is necessarily and concomitantly linked to, without any contrivance, some other purpose or effect. According to his Honour, such a purpose has to be determined by framing questions 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 pursuance of tax benefits. It must be decided not subjectively in terms of motive but objectively by reference to the arrangement itself.

Summary of legal principles

3.4.34 The relevant principles to be applied in ascertaining the purpose or effect of an arrangement are as follows:

- 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 so as to avoid tax. This is done by examining the overt acts by which the arrangement is implemented. However, it is no longer possible to avoid such predication simply by claiming the arrangements are capable of explanation by reference to ordinary business or family dealings (*Newton, the definition of "tax avoidance arrangement" in section OB 1*).

- The whole set of words "purpose or effect" denotes a concerted action to an end – the end of avoiding tax (*Newton*).

- "Purpose" is determined objectively by reference to the arrangement itself and not subjectively in terms of motive. "Purpose" is not motive, but is the effect which the arrangement seeks to achieve. "Effect" means the result accomplished or achieved by the arrangement (*Newton, Tayles*).

- If an arrangement has a particular purpose that will be its effect. If it has a particular effect then that will be its purpose (*Ashton*).

- A "merely incidental" purpose or effect is something which follows from or is necessarily and concomitantly linked to, without any contrivance, some other purpose or effect. Such a purpose is determined objectively by reference to the arrangement itself and not subjectively in terms of motive. The proper focus is on assessing the degree of economic reality associated with a given transaction. This focus is contrasted with any artificiality, contrivance, or the relative extent to which the transaction appears to exploit the statute in direct pursuit of tax benefits (*Elmiger* (SC) per Woodhouse J, *Challenge* (CA), per Woodhouse P).

4 JUDICIAL APPROACHES APPLICABLE TO SECTION BG 1

4.1 Application of judicial approaches

4.1.1 Even if section BG 1 potentially applies, because the arrangement may have a more than merely incidental purpose or effect of tax avoidance, a question arises about whether its application is **intended** by Parliament. There is inevitably a tension between the different and possibly conflicting objectives of specific legislative provisions and the general anti-avoidance provisions (sections BG 1 and GB 1 of the Income Tax Act). This was succinctly observed by Richardson J (as he then was) in *Challenge* (CA), at page 5,019:

> The fundamental difficulty lies in the reconciliation of different and conflicting objectives.

> 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.
> ….
>
> On the other hand, sec 99 would be a dead letter if it were subordinate to all the specific provisions of the legislation.
> ….
>
> Section 99 thus lives in an uneasy compromise with other specific provisions of the income tax legislation.

4.1.2 For example, if section BG 1 is read literally the section potentially voids, for tax purposes, a very large number of accepted commercial and family arrangements where the taxation impact is financially significant. Hence, in recognition of different and conflicting objectives, the courts have adopted some approaches designed to ascertain whether Parliament intended section BG 1 to apply to given arrangements. The most prominent judicial approaches adopted are the "choice principle" and the concept of "tax mitigation". These two approaches will be examined to determine what assistance they provide in determining whether the section applies.

4.1.3 The application of the *Duke of Westminster* principle in the context of sections BG 1 and GB 1 is also considered.

4.1.4 The Commissioner is also aware of a further test, an "impropriety test", developed by Baragwanath J in *Miller (No 1*) (HC) where, at pages 13,028 – 13,030, he referred to the terms "proper" and "improper" tax avoidance, as those terms had been used by Lord Wilberforce in *Mangin* (PC) at page 600. However, in the Commissioner's opinion, there is no place in interpreting the words of section BG 1 for a judgment on whether a particular "business technique" (to use Baragwanath J's words) is proper or not. Lord Hoffmann also rejected the notion of an impropriety test in *O'Neil v CIR* (2001) 20 NZTC 17,051 (PC). His Lordship stated at page 17,057 that he considered the concept of "impropriety" to be inappropriate since it suggested a moral judgment that, he stated, had been repudiated by the Privy Council and the Court of Appeal in New Zealand in relation to anti-avoidance provisions. Therefore, the impropriety test is not applicable law in New Zealand.

4.2 The Choice Principle

4.2.1 The expression "choice principle" in a statutory tax avoidance context refers to a proposition that alternative courses of action provided for under specific provisions in the income tax legislation are not necessarily to be treated as invalidated by a general anti-avoidance

provision such as section BG 1. The taxpayer is argued to have simply exercised a choice expressly made available by Parliament

4.2.2 One of the leading Australian cases on this principle is *WP Keighery Pty Ltd v FCT* (1957) 100 CLR 66 (HCA). In that case, Dixon CJ, Kitto and Taylor JJ in their joint judgment said at pages 92, and 93-94:

> 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.
> ….
>
> The very purpose or policy of Div. 7 is to present the choice to a company between incurring the liability it provides and taking measures to enlarge the number capable of controlling its affairs. To choose the latter course cannot be to defeat, evade or avoid a liability imposed on any person by the Act or to prevent the operation of the Act.

4.2.3 In summary, the Court held the section was not intended to deny taxpayers any right of choice between alternatives provided under the Act, and the intention of section 260 was to protect the general provisions of the Act from frustration. This view was approved and applied in *Casuarina Pty Ltd v FCT* (1971) 127 CLR 62 (Full HCA).

4.2.4 This principle was subsequently expanded by the Australian High Court in *Mullens & Ors v FCT* 76 ATC 4,288 (HCA). In that case it was found the taxpayer entered into an arrangement in order to obtain a deduction under section 77A of the Australian Income Tax Assessment Act 1936 in respect of moneys paid on shares in a company engaged in petroleum exploration. Barwick CJ stated at page 4,292:

> The Court has made it quite plain in several decisions that a taxpayer is entitled to create a situation to which the Act attaches taxation advantages for the taxpayer. Equally, the taxpayer may cast a transaction into which he intends to enter in a form which is financially advantageous to him under the Act. *Keighery v F.C. of T* (1957) 100 C.L.R. 66 and the *F.C. of T v Casuarina* 71 ATC 4068; (1971) 127 C.L.R 62, amply demonstrate this and are, in my opinion, very relevant to the resolution of this case.

4.2.5 In the same case, Stephen J was more adamant in his proposition the *Keighery* choice principle equally applies to situations where a taxpayer quite deliberately enters into an arrangement for the purposes of obtaining a tax advantage. His Honour stated at page 4,303:

> The principle in *W P Keighery Pty v F.C. of Taxation* (1957) 100 C.L.R. 66 is not to be confined to cases where the Act offers to the taxpayer a choice of alternative tax consequences either of which he is free to choose; it was there held that merely because the taxpayer chose, quite deliberately, the alternative most advantageous to it from a tax standpoint it did not thereby attract sec 260. So, too, if no question arises of a choice between two courses of conduct but, instead, the Act offers certain tax benefits to taxpayers who adopt a particular course of conduct, the adoption of that course does not establish any purpose or effect such as described in section 260.

4.2.6 Thus, the Australian High Court held that there was no relevant alteration of the incidence of tax for the purposes of section 260 where the actual transaction between the parties conforms to and satisfies a specific provision of the Act. This approach was later followed and applied by the Australian High Court in *Slutzkin v FCT* 7 ATR 166 (HCA) and *Cridland v FCT* 8 ATR 169 (HCA).

4.2.7 The New Zealand courts have not adopted the expanded choice principle developed in the *Mullens*, *Slutzkin,* and *Cridland* cases. In *Challenge* (CA) the appellant argued that section 99 cannot be used to defeat other provisions such as section 191 of the Income Tax Act 1976 (which dealt with the utilisation of tax losses within a corporate group) or to prevent a result which any of them contemplate, i.e.: the choice principle. Richardson J considered the "choice principle" and stated at page 5,019-5,020 (in a passage referred to earlier):

> 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. …. Again seeking and taking advantage of incentives provided through the tax system designed to encourage particular economic activities could not be rejected out of hand as contravening the section. Yet in many cases, but for the anticipated availability of the tax benefit, the taxpayer would never have entered into the activity or transaction.
>
> ….
>
> It [section 99], 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 imputed arrangements would meet all the specific requirements of the income tax legislation. In some cases, then, the section imposes an additional requirement. In others, and this is a common application of the section in cases where trusts and companies are employed for planning purposes, while the use of that machinery is regarded as perfectly legitimate and not on its own affected by sec 99, it may be only one element in a wider arrangement which is caught by the section.

4.2.8 Richardson J went on to consider the various Australian authorities which relied on the choice principle and stated at page 5,023:

> However, I do not find it helpful to consider particular applications in another jurisdiction of that approach to statutory construction. It is the principle which is important and *Keighery* provides powerful support for the proposition that to do no more than adopt a course which the Act specifically contemplates as effecting a tax change does not affect the taxpayer's "liability" for income tax in the statutory sense and does not result in an alteration in the incidence of income tax contemplated by the Act.

4.2.9 So, it would seem that Richardson J was willing to adopt the (more restricted) "choice principle" applied in *Keighery* on the basis the approach sought to determine whether the general avoidance provision should or should not counter the effect of specific provisions by reference to Parliament's purpose in enacting those provisions.

4.2.10 In apparent contrast to Richardson J, Woodhouse P (dissenting) was not willing to embrace the *Keighery* choice principle "in its bare form". His Honour said at page 5,011:

> It may be that in some cases an opportunity open to a taxpayer to take one route rather than another will provide useful assistance in deciding whether an arrangement has a sec 99 tax avoidance purpose or whether it does not. But for my part I am satisfied that in its bare form at least the *Keighery* choice principle is not in accord with the purpose and effect intended by Parliament for sec 99 of the New Zealand Income Tax Act in its general statutory setting and should not be adopted for this country. I would add that in any event I do not think myself that the situation under review is one involving a simple choice of the kind discussed in *Keighery* or of taking a particular course of action legally open rather than another.

4.2.11 However, when the learned President's judgment is carefully considered, it becomes apparent that his reservations about the *Keighery* case and its principle were primarily that he did not wish to establish a simplistic rule that automatically excluded the operation of the general anti-avoidance provision by viewing application of every section of the Act (other than the anti-avoidance provision) as a choice provided by the legislature.

4.2.12 Consequently, it can be seen the views of Richardson J and Woodhouse P in *Challenge* (CA) are not diametrically opposed, but rather that Woodhouse P is warning against adopting any black-and-white exclusionary rule. Both Judges fully recognised the need to balance the potential application of specific provisions with the operation of a general anti-avoidance provision for the reasons referred to earlier in this statement.

4.2.13 In summary, Richardson J expressed the view that section 99 should not 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. Woodhouse P suggested that there can be opportunities open to a taxpayer to take one route rather than another. These observations can provide useful assistance in deciding whether an arrangement has a section 99 tax avoidance purpose or effect.

4.2.14 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.

4.2.15 While the *Challenge* (CA) decision was overturned by the Privy Council, their Lordships did not comment upon the *Keighery* "choice principle". Thus, the Court of Appeal comments are still relevant in determining the scope of the application of this principle in New Zealand.

4.2.16 This position on the choice principle is supported by the comments of Lord Hoffmann in *O'Neil v CIR* (2001) 20 NZTC 17,057 (PC) where he said, at page 17,057:

> 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.

4.2.17 Therefore, under this approach section BG 1 should not be applied to override the specific 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.

4.2.18 If taxpayers avail themselves of a choice and in such a way as to accord with Parliament's intent, then it would be contrary to the scheme and intent of the legislation for a general anti-avoidance provision to counter the operation of that specific provision. On the other hand where a taxpayer takes steps to attract the operation of such a provision, in circumstances where Parliament's purpose would be frustrated, it is quite appropriate for the general anti-avoidance provision to apply so as to prevent such an effective "misuse" of the specific provision. The purpose of section BG 1 is not to defeat the purpose of the legislation, but to protect the legislation from frustration. These concepts will be referred to again later in this statement.

4.2.19 In the Commissioner's view, the reliance on a particular advantageous section of the Act does not automatically rule out the application of the general anti-avoidance provision – section BG 1. Nor does the "choice principle" apply in New Zealand in the form of a rigid rule such that

taxpayers availing themselves of a specific provision will exclude the operation of section BG 1. The Commissioner considers the correct approach is to determine whether, having regard to the scheme, purpose, and language of the legislation, Parliament intends the specific provision, regime or the Act to apply to the arrangement (unhindered by the general anti-avoidance provision) or whether the arrangement frustrates rather than facilitates Parliament's intention.

4.3 Tax Mitigation

4.3.1 The distinction between tax mitigation and tax avoidance was first introduced by the Privy Council in *Challenge*. Lord Templeman drew a distinction between the two concepts in the following way (at page 5,225):

> The material distinction in the present case is between tax mitigation and tax avoidance. A taxpayer has always been free to mitigate his liability to tax. In the oft quoted words of Lord Tomlin in *CIR v Duke of Westminster* [1936] AC 1:
>
> > …"every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Act is less than it otherwise would be".
>
> In that case, however, the distinction between tax mitigation and tax avoidance was neither considered nor applied.
>
> 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 99 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 accepts or the expenditure which he incurs.

4.3.2 His Lordship went on to give examples of tax mitigation which highlighted that the tax advantage obtained by a taxpayer must result from a "corresponding" reduction in income or an actual expenditure that is incurred.

4.3.3 In *Challenge* the Privy Council found that it was a case of tax avoidance, as there was no reduction in income or expenditure incurred in circumstances where the Act provides for a reduction in liability. Lord Templeman stated at pages 5,226 – 5,227:

> Section 99 does not apply to tax mitigation 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.
>
> Section 99 does apply to tax avoidance. Income tax is avoided and a tax advantage derived from an arrangement when the

> taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that reduction. The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had.
> ….
>
> It is true that Challenge expended $10,000 in purchasing the shares in Perth, but this purchase price is not deductible against Challenge's assessable income. Apart from the risk of losing $10,000, the Challenge group never risked anything, never lost anything and never spent anything but now claim to deduct the loss of $5.8 million. Challenge have practised tax avoidance to which sec 99 applies. [....] The tax advantage stems from the arrangement with Merbank and not from any loss sustained by Challenge or the Challenge group.
> ….
>
> In an arrangement of tax avoidance the financial position of the taxpayer is unaffected (save for the costs of devising and implementing the arrangement) and by the arrangement the taxpayer seeks to obtain a tax advantage without suffering that reduction in income, loss or expenditure which other taxpayers suffer and which Parliament intended to be suffered by any taxpayer qualifying for a reduction in his liability to tax.
> ….
>
> Most tax avoidance involves a pretence [....] In the present case Challenge and their taxpayer subsidiaries pretend that they suffered a loss when in truth the loss was sustained by Perth and suffered by Merbank. [….] Section 99 also applies where, as in this case, the taxpayer alleges that he has achieved the magic result of creating a tax loss by purchasing the tax loss of another taxpayer.

4.3.4 There is a strong consistency of approach between Lord Templeman's opening words in the passage cited above and the previous discussion about the circumstances when Parliament should be taken to have intended an advantageous tax treatment to apply. In essence, the Privy Council in *Challenge* suggested that for a taxation advantage to be enjoyed, the taxpayer should actually incur the expenditure, loss or disadvantage (or otherwise satisfy the factual circumstances), that Parliament intended the taxpayer to have suffered in that situation.

4.3.5 Undertaking this assessment, the Privy Council examined the financial position of the taxpayer before and after the implementation of the arrangement (as well as recognising the possibility of there existing more than one purpose). At page 5,227 Lord Templeman said:

> If Perth had assets, no doubt the purchase price paid by Challenge would have been higher than the 10,000 dollar minimum payable pursuant to the agreement. In that event the agreement would have had two purposes, the disposition of the assets and tax avoidance. Section 99 would have required the Commissioner to

> eliminate the tax advantage claimed. If Perth had debts, the tax avoidance arrangement would have been difficult if not impossible without the agreement of the creditors. But sec 99 would still require the elimination of the tax advantage. Whatever the circumstances or complications, if a taxpayer asserts a reduction in assessable income, or if a taxpayer seeks tax relief without suffering the expenditure which qualifies for such relief, then tax avoidance is involved and the Commissioner is entitled and bound by s 99 to adjust the assessable income of the taxpayer so as to eliminate the tax advantage sought to be obtained.

4.3.6 From their Lordships' view, 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.

4.3.7 Tax avoidance, as distinct from tax mitigation, is sometimes said to be identifiable by the presence of the "hallmarks" or "badges" of tax avoidance. For example, in *Challenge* (PC) Lord Templeman said at page 5,227:

> Most tax avoidance involves a pretence [….] Section 99 also applies where, as in this case, the taxpayer alleges that he has achieved the magic result of creating a tax loss by purchasing the tax loss of another taxpayer.

4.3.8 Similarly, in distinguishing the hallmarks of tax avoidance and the hallmarks of tax mitigation, in an English context Lord Nolan in *IRC v Willoughby* [1997] STC 995 (HL) said at page 1,003:

> The hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be suffered by any taxpayer qualifying for such reduction in his tax liability. The hallmark of tax mitigation, on the other hand, is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation, and genuinely suffers the economic consequences that Parliament intended to be suffered by the taking of the option.

4.3.9 However, reservations have been expressed on whether the distinction between tax mitigation and tax avoidance is a complete answer to all problems that may arise in the context of "tax avoidance". In *Hadlee* (CA) Cooke P said at page 8,122:

> The only difficulty in this part of the case arises from the part of the judgment of the majority of the Judicial Committee of the Privy Council in *Challenge Corporation Ltd v Commissioner of Inland Revenue* (1986) 8 NZTC, 5219 at pp 5,223-5,225: [1986] 2 NZLR 556 at pp 560-563, which distinguishes between tax mitigation and tax avoidance and on which the appellant seeks to rely. The judgment does not mention any of the earlier Privy Council decisions just cited and I cannot think that it was intended

> to overrule them. 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.

4.3.10 In *Miller (No.1)* (HC), Baragwanath J referred to the issue of tax mitigation and said, at page 13,031:

> I am nevertheless of the respectful view that […] the distinction between tax mitigation and tax avoidance, […] describes a conclusion rather than providing a signpost to it.

4.3.11 More recently Lord Hoffmann in the Privy Council decision in *O'Neil* concurred with this opinion. Lord Hoffmann stated at page 17,057:

> There are, however, two points in the thoughtful analysis of Baragwanath J. which require comment. The first is that [their Lordships] are in complete agreement with his observation that the distinction between tax mitigation and tax avoidance is unhelpful: as the judge pithily said, it "describes a conclusion rather than providing a signpost to it" …

4.3.12 Despite these comments, the Commissioner considers the distinction between tax avoidance and tax mitigation can still be usefully applied in respect of some arrangements, to ascertain whether Parliament intended section BG 1 to apply. As Cooke P said in *Hadlee*, the distinction may be authoritative and convenient for some purposes. The comments made by Baragwanath J in *Miller (No.1)* were made in the context of attempting to discern the proper process to adopt in forming a decision about whether section BG 1 applies. In that context, the distinction between tax mitigation and tax avoidance describes a conclusion. But, in the Commissioner's opinion, the distinction can still be convenient in considering whether Parliament intended the particular provision to apply in the way argued for by the taxpayer.

4.3.13 As the Privy Council said in *Challenge*, one common characteristic of tax avoidance is that the taxpayer obtains a tax advantage by reducing their liability to tax without incurring the economic consequences Parliament would have envisaged ordinarily being suffered by taxpayers in general to qualify for such a reduction in tax liability. If this characteristic is present, or if an arrangement otherwise has the hallmarks of tax avoidance, such as a circular flow of funds or creates a "magic" result involving tax losses, those features may indicate that the provision, regime, or the Act was not being applied in the way Parliament intended. Therefore, the tax mitigation distinction is still useful in determining whether a taxpayer is obtaining a tax advantage

without incurring the real economic consequences Parliament would have intended in the circumstances.

4.4 Application of the *Duke of Westminster* in the context of sections BG 1 and GB 1

4.4.1 It is also useful to consider the possible application of what has become known as the *Duke of Westminster* principle in the context of sections BG 1 and GB 1, as it is often referred to in tax avoidance cases.

4.4.2 *IRC v Duke of Westminster* [1936] AC 1 (HL) stands for the proposition that taxpayers are entitled to order their affairs so the tax attaching is less than it otherwise would be. The often quoted passage comes from the judgment of Lord Tomlin in that case, at pages 19-20:

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

4.4.3 This general proposition has been reaffirmed by the Privy Council and the Court of Appeal on several occasions. However, the general application of the *Duke of Westminster* principle in the context of tax avoidance sections has been the subject of judicial comments in New Zealand, Australia and the United Kingdom.

4.4.4 Woodhouse J in the Supreme Court decision of *Elmiger* recognised the conflict between arrangements potentially subject to section 108 and the *Duke of Westminster* principle. His Honour stated at pages 686-687:

> Nevertheless, since the House of Lords was obliged to consider the highly beneficial arrangements which were able to be made in 1930 on behalf of the *Duke of Westminster*, there has been a growing awareness by the Legislature and the Courts alike that ingenious legal devices contrived to enable individual taxpayers to minimise or avoid their tax liabilities are often not merely sterile or unproductive in themselves (except perhaps in respect of their tax advantages for the taxpayer concerned), but that they have social consequences which are contrary to the general public interest. There is the problem, too, that the Legislature usually is lagging several steps behind the ever-developing arrangements worked out by experts in this field on behalf of their taxpayer clients.
>
> I think these provisions [section 108 and the equivalent Australian section] are intended to forestall deliberate attempts by individuals to obtain tax advantages denied generally to the same class of taxpayer.

4.4.5 Woodhouse J was suggesting in this passage that the *Duke of Westminster* does not override the general anti-avoidance provision(s) of the Income Tax Act. While it can still be said that (consistent with the *Duke of Westminster* principle) a taxpayer is required to pay no more than the correct statutorily imposed quantum of tax, it is also the case that under the Income Tax Act a taxpayer is not entitled to alter that proper statutory impost by entering into a tax avoidance arrangement.

4.4.6 More recently, Baragwanath J in the High Court decision of *Miller (No. 1)* (HC) said at page 13,032:

> Section 99 is not to be construed according to the *Duke of Westminster's* case or Rowlatt J's dictum [that there is no equity to tax].

4.4.7 The Australian High Court in *Spotless* also cautioned against a universal application of the words used by Lord Tomlin in the *Duke of Westminster* (HL) in relation to the Australian anti-avoidance provision. The Court said at page 5,205:

> In this Court, counsel for the taxpayers referred to the repetition by the Privy Council in *Commissioner of Inland Revenue v Challenge Corporation* of the statement by Lord Tomlin in *Inland Revenue Commissioners v Duke of Westminster* that "[e]very man is entitled if he can order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be." Lord Tomlin spoke in the course of rejecting a submission that in assessing surtax under the Income Tax Act 1918 (UK) the Revenue might disregard legal form in favour of "the substance of the matter". His remarks have no significance for the present appeal. Part IVA is as much a part of the statute under which a liability to income tax is assessed as any other provision thereof.

4.4.8 Even in the absence of a specific legislative anti-avoidance measure, the House of Lords has had to reconsider the application of *Duke of Westminster* in avoidance cases. For example, Lord Diplock in *IRC v Burmah Oil Co Ltd* [1982] STC 30 (HL) stated at page 32:

> It does not necessitate the overruling of any earlier decisions of this House; but it does involve recognising that Lord Tomlin's oft-quoted dictum in *IRC v Duke of Westminster* [1936] AC 1 at 19, 19 TC 490 at 520, 'Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be', tells us little or nothing as to what methods of ordering one's affairs will be recognised by the courts as effective to lessen the tax that would attach to them if business transactions were conducted in a straight-forward way. The *Duke of Westminster's* case was about a simple transaction entered into between two real persons each with a mind of his own, the Duke and his gardener, even though in the nineteen-thirties and at a time of high unemployment there might be reason to expect that the mind of the gardener would manifest some degree of subservience

> to that of the Duke. The kinds of tax-avoidance schemes that have occupied the attention of the courts in recent years, however, involve inter-connected transactions between artificial persons, limited companies, without minds of their own but directed by a single master-mind.

4.4.9 In *IRC v McGuckian* [1997] 3 All ER 817 (HL) Lord Steyn noted the shift away, in the United Kingdom, from literalist to purposive methods of construction. Further, as an aid to the interpretation of taxing statutes, he considered that the dictum in the *Duke of Westminster* emanated from an era when statutory interpretation was based on a literal approach and that literalist compliance protected the taxpayer regardless of the purpose of the provision. His Lordship agreed with the modern approach to statutory interpretation where the correct approach was said not to be literal, but to consider the clear words of the section in the context and scheme of the Act as a whole. This, he considered, was a broad purposive approach giving effect to the intention of Parliament. Lord Steyn said the *Duke of Westminster* principle is no longer canonical in situations where tax avoidance is involved (p 825):

> While Lord Tomlin's observations in the *Duke of Westminster's* case still point to a material consideration, namely the general liberty of the citizen to arrange his financial affairs as he thinks fits, **they have ceased to be canonical as to the consequence of a tax avoidance scheme.** [emphasis added].

4.4.10 In summary, the Commissioner considers that the *Duke of Westminster* principle does not apply in tax avoidance situations, as the purpose of section BG 1 is to counteract such tax avoidance. The Commissioner considers section BG 1 must, in terms of its function of dealing with arrangements that apply the letter of a provision but frustrate the statutory intention, effectively limit the scope of the *Duke of Westminster* principle where tax avoidance exists.

4.5 The Commissioner's approach following from judicial decisions and statements

4.5.1 A fundamental difficulty with tax avoidance lies in the reconciliation of different and, at times, conflicting objectives within the Act. As Baragwanath J said in *Miller (No.1)* (HC) (page 13,027):

> In the light of that decision [*Challenge Corporation*] and for the reasons that follow I am satisfied that s 99 is not at all on the same hierarchical level as sections such as 104, 188 and, as will appear, s 191. It is a section that deals with transactions altogether lawful in terms of the general law and the general provisions of the Income Tax Act but which nevertheless infringe its terms. Section 99 does concern reality and lawfulness, but in a sense quite different from the general provisions. It begins to bite when their operation is complete.

4.5.2 This view goes to the heart of the operation of section BG 1, in the sense that the provision operates at a different level from the rest of the Income Tax Act, while remaining part of that Act. As Richardson J (as he was then) said in *Challenge* (CA), at page 5,019:

> Its [section 99] function is to protect the liability for income tax established under other provisions of the legislation.

4.5.3 It is inevitable from the role and function of section BG 1 that there will be uncertainty in deciding whether Parliament would intend it to apply to a particular arrangement that satisfied the wording of another, operative section of the Act. Historically the courts, aware of this issue, developed the approaches discussed above to assist in achieving an appropriate outcome in particular cases. It is the Commissioner's view that underpinning these judicial "glosses" to the general anti-avoidance provision is the need to give effect to Parliament's intention notwithstanding the existence, in an avoidance situation, of potentially conflicting statutory objectives. In such situations the courts have attempted, over time, to adopt an approach that ensures the anti-avoidance provisions are construed so that they can achieve their objective in a balanced but effective way.

4.5.4 The Commissioner considers the function of the general anti-avoidance provision is to protect the tax legislation and the integrity of the tax system from frustration. This approach accords with the joint judgment of Dixon CJ, Kitto and Taylor JJ in the leading Australian case of *Keighery*, where, as quoted above, the Court said:

> 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.

4.5.5 Richardson J in the Court of Appeal in *Challenge* approved the approach in *Keighery* in this respect. The approach is also consistent with the Commissioner's previously expressed view on section 99 in TIB Vol 1, No 8.

4.5.6 Accordingly, when considering whether section BG 1 is to be applied to an arrangement it is important to identify Parliament's intention. Is the legislative purpose satisfied by permitting the arrangement to be effective from a taxation point of view? Put another way, does the arrangement facilitate the statutory purpose and therefore meet Parliament's intention, or alternatively, does the arrangement frustrate the statutory purpose of a provision, a regime or the Act as a whole? It is considered that this is consistent with the tenor of the judicial

approaches outlined above and encapsulates in a meaningful way the aim behind them.

4.5.7 Establishing whether an arrangement frustrates the statutory purpose of a relevant provision, regime or the Act is an exercise in statutory construction, in that it requires an appreciation of the legislative purpose of a provision, regime or the Act as a whole. It is important, however, to distinguish this exercise from the more frequently encountered issue of determining the legislative intention where, for example, the words used in the Act are ambiguous. In the Commissioner's opinion, the relevant enquiry in the anti-avoidance context is whether Parliament intended the specific provision, regime or the Act as a whole to apply to the arrangement unhindered by the general anti-avoidance provision. In other words, in an avoidance context the goal is to discover the underlying legislative intention of the relevant operative provision, regime or the Act, and then to consider whether Parliament intended the legislation to apply in the way contended for by the taxpayer, or whether to do so would amount to frustrating Parliament's intention. This view is consistent with the Privy Council's analysis in *O'Neil* and was recently applied by the Court of Appeal in *Dandelion Investments Ltd v CIR* (2003) 20 NZTC 18,101 (CA).

4.5.8 In some situations, the frustration of a provision, regime or the Act will be blatant and a court will find it straightforward to find that the statutory purpose has been frustrated. For example, in *Dandelion*, the taxpayer claimed an interest deduction on a loan used to fund the acquisition by a subsidiary of shares in an overseas company. The funds were further applied in various offshore transactions with the ultimate effect that they were returned to the taxpayer to enable the loan to be repaid. The receipt of the loan funds was in the form of a tax free dividend and the taxpayer claimed the deduction for the interest expense. The Court of Appeal decided that in reality there was no true business purpose to be achieved by the taxpayer in entering the transaction other than to obtain the deduction for the interest expense. The transaction was circular in its inception and unwinding. The Court was unable to discover any element of business dealing other than tax avoidance as a purpose of the arrangement. It was an artifice involving a pretence. The Court considered the legislative purpose behind the operative provision, and asked whether the concessional treatment of interest expenses under section 106(1)(h)(ii) of the 1976 Act for borrowings to acquire shares in what would be a group company was intended to give the taxpayer a deduction in this way. The Court did not think so. The Court considered that in enacting section 106(1)(h)(ii), Parliament did not intend to give a taxpayer the opportunity of obtaining a deduction in the way argued for by the taxpayer. An interest deduction in the circumstances would frustrate Parliament's intention.

4.5.9 This approach to section BG 1 has elements in common with the approach that is applicable in Canada. The Canadian general anti-avoidance provision is differently worded to section BG 1. Section 245(4) of the Income Tax Act, SC 1988 requires the courts to determine whether a particular provision constitutes a "misuse of the provisions" of the Act or an "abuse having regard to the provisions" of the Act. Despite this difference in wording, the Commissioner considers the analysis required parallels that which must be done under section BG 1 in resolving the conflicting objectives of a particular provision and section BG 1. In *OSFC Holding Ltd v R* 2001 DTC 5471, the majority of the Canadian Federal Court of Appeal set out the preferred approach to determine misuse and abuse. The Court considered a convenient way to deal with each test was to adopt the view of Professor Krishna, in Tax Avoidance: *The General Anti-Avoidance Rule*, (Toronto: Canada, 1990) who states at page 51:

> What constitutes a 'misuse" of the Act depends upon the object and spirit of the particular provision under scrutiny. What constitutes an "abuse" of the Act, as a whole is a wider question and requires an examination of the inter-relationship of the relevant statutory provisions in context

4.5.10 The Court in *OSFC Holdings* recognised that ascertaining Parliament's intention through interpreting legislation is a difficult exercise when the arrangement in question conforms to the letter of the Act. In weighing up whether the anti-avoidance provision applies when an arrangement conforms with a strictly literal interpretation of an operative provision or provisions, the aim is to determine whether the arrangement accords with Parliament's intention – as found in an assessment of the provisions or the Act as a whole.

4.5.11 In applying section BG 1, it is first necessary to find whether the section prima facie applies on its terms, and then, whether the arrangement would frustrate Parliament's intention for a provision, a regime or the Act as a whole. Establishing the existence or absence of such frustration is itself a two-step process. Firstly, the legislative purpose of a provision, regime or the Act as a whole must be identified. The second step involves considering whether the Parliamentary intention for the provision, regime or Act is consistent with its applying to the arrangement in the way argued for by the taxpayer or whether the arrangement would frustrate the statutory purpose. If the purpose would be frustrated, section BG 1 applies to void the arrangement.

Summary of legal principles

4.5.12 The relevant principles extracted from the cases discussed above are as follows:

- The Choice Principle: The application of a particular advantageous section of the Act does not automatically preclude the potential application of the general anti-avoidance provision – section BG 1 (*Challenge (CA)*; *O'Neil (PC)*). Section BG 1 is not subordinate to the rest of the income tax legislation, but nor will it override the specific provisions of the Act. The intended role of section BG 1 is to facilitate and promote the purpose of the legislation (*Challenge (CA)*). Section BG 1 may also apply notwithstanding the application of a specific anti-avoidance provision within a particular section or Part of the Act (*Challenge (CA)*).

- Tax Mitigation: The distinction between tax avoidance and tax mitigation can be useful in determining whether a taxpayer is obtaining a tax advantage without incurring the real economic consequences Parliament would have intended in the circumstances (*Challenge (PC)*).

- The *Duke of Westminster* Principle: The *Duke of Westminster* case does not override the operation of sections BG 1 and GB 1.

4.5.13 The Commissioner's approach to these principles and to applying section BG 1 is as follows. Firstly, does the section apply on its terms, such that it can be predicated that a purpose or effect of an arrangement is tax avoidance, and that the purpose or effect is "more than merely incidental"? If so, is it the case that to permit any tax advantage accruing under that arrangement would frustrate or facilitate Parliament's intention for the provision, regime or the Act as a whole? In answering this second question, after identifying the relevant legislative purpose, the arrangement is tested to assess whether it frustrates the statutory purpose.

5 SECTION GB 1

5.1 Background

5.1.1 Section GB 1(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—

> (a) Such amounts of gross income, allowable deductions and available net losses as, in the Commissioner's opinion, that person would have, or might be expected to have, or would in all likelihood have, had if that arrangement had not been made or entered into; or
>
> (b) Such amounts of gross income and allowable deductions as, in the Commissioner's opinion, that person would have had if that person had been allowed the benefit of all amounts of gross income, or of such part of the gross income as the Commissioner considers proper, derived by any other person or persons as a result of that arrangement.

5.1.2 As already discussed, the Commissioner's view is that section BG 1 does not, of itself, create any tax liability. The effect of section BG 1 is that it is a "destructive" provision. In *Challenge* (CA), Richardson J said at page 5,019:

> Section 99 is not an independent charging provision. It does not itself create a liability for income tax.

5.1.3 As a result, where an appropriate taxable situation is disclosed the other provisions of the Act apply to determine the taxation outcome following the voiding of the tax avoidance arrangement. While this may be sufficient to negate any "tax advantage" in some situations, it is also possible that another reconstruction or adjustment is necessary or more appropriate. To assist the Commissioner, section GB 1 allows adjustments to be made to "the amounts of gross income, allowable deductions and available net losses included in calculating the taxable income of any person affected by that [tax avoidance] arrangement" to counteract any taxation advantage.

5.1.4 Four important issues arise in respect of section GB 1:

- Does the Commissioner's power to adjust the amount of gross income, allowable deductions and available net losses extend to all persons affected by the arrangement, irrespective of whether they are parties to the arrangement?

- What is the meaning of "tax advantage" under the provision?

- Does the Commissioner's power to adjust the amount of gross income, allowable deductions and available net losses subject to a tax avoidance arrangement under section GB 1 amount to an obligation or a discretion?

- How is the Commissioner's power to adjust the amount of gross income, allowable deductions and available net

losses subject to a tax avoidance arrangement to be exercised?

5.2 Any person affected

5.2.1 Section GB 1(1) provides that the Commissioner may adjust the amounts of gross income, allowable deductions and available net losses included in calculating the taxable income of "any person affected" by a tax avoidance arrangement, so as to counter any tax advantage obtained "by that person" from or under that arrangement.

5.2.2 An adjustment under section GB 1 can therefore be made in respect of "any person affected by that arrangement" (as distinct from a person who is a party to it). The ordinary meaning of "affect" is defined in the *Concise Oxford English Dictionary* (10th Ed. revised):

> **affect**[1] **•v** have an effect on; make a difference to. ➤ touch the feelings of.
>
> **affect**[2] **•v** pretend to have or feel. ➤ use, wear, or assume pretentiously or so as to impress.

5.2.3 In the context of section GB 1, the first meaning is the relevant one. The use of the term "any person affected" indicates that Parliament intended the section can also apply to persons who are not a party to the arrangement. For example, the adjustment of the income of a trust could "affect" the beneficiaries of the trust to counteract the tax advantage obtained, although the beneficiaries may not be parties to the tax avoidance arrangement.

5.2.4 In *BNZ Investments Ltd* (CA), Blanchard J expressed the view that "any person affected" under section 99(3) includes any person who has obtained a tax advantage under the arrangement, although that person is not necessarily a party to the arrangement. His Honour stated at page 17,142:

> As the principal judgment records at para [42], there are three successive inquiries. The first is as to the extent of the arrangement; the second is as to whether it has the purpose or effect of tax avoidance and the third, which arises only where the second is answered affirmatively, is as to the adjustment to be made to counteract the tax advantage. **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 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 [emphasis added].

5.2.5 Subsequently, in *CIR v Peterson* the Court of Appeal explicitly confirmed that "any person affected" under section 99(3) includes any person who has obtained a tax advantage under the arrangement, although that person is not necessarily a party to the arrangement. The effect is therefore that section GB 1 can be applied to parties and persons affected by an arrangement.

5.2.6 Section GB 1 states that the Commissioner can adjust the amounts of gross income, allowable deductions and available net losses of "any" person affected by the tax avoidance arrangement. This suggests that it is contemplated that there may be more than one person "affected by" the arrangement (and therefore subject to adjustment). In *O'Neil* (PC) Lord Hoffmann said, at paragraph 31, in response to an argument by counsel for the taxpayer that only one person can obtain a tax advantage from the arrangement:

> … Section 99(3) says that the Commissioner shall adjust the assessable income of any person affected by the arrangement to counteract any tax advantage that person has obtained. **There is no reason why an arrangement should not confer tax advantages upon more than one person** and, as their Lordships have already explained, this one plainly did. There were different tax advantages in relation to different payments. Mr Russell's company obtained the advantage of using group relief on income received from the trading company; the trading company obtained the advantage of deducting the administration and consultancy charges and the shareholders received the advantage of receiving payments as capital when they would otherwise have been income. **There was no reason why the Commissioner should not adjust the assessable income of each or any of these persons.** Of course his assessments would have to be consistent with each other. He could not maintain an assessment on Mr Russell's company on the basis that it had received the whole trading profit but was not entitled to group relief and at the same time assess the shareholders on the basis that they had received the trading profit in the form of remuneration. But provided that he was not using inconsistent hypotheses for his reconstructions, he was in their Lordships' opinion entitled to assess any party who had obtained a tax advantage. *[Emphasis added.]*

5.2.7 Therefore, in counteracting a tax advantage under section GB 1, the Commissioner may adjust the income of "any person affected" under the arrangement.

5.3 Any tax advantage

5.3.1 Under section GB 1 the Commissioner is empowered to adjust the gross income, allowable deductions and available net losses included in calculating the taxable income of any person affected by the arrangement "in the manner the Commissioner thinks appropriate". The adjustment can only be made "so as to counteract any tax advantage obtained by that person from or under the arrangement".

5.3.2 The term "tax advantage" is not defined in the Act in relation to section GB 1. However, the term "tax" is defined as "income tax", which in turn means "income tax imposed under the Income Tax Act". Thus, the "tax advantage" must be an income tax advantage.

5.3.3 The term "advantage" is defined in the *Concise Oxford Dictionary* (10th Ed. revised) as:

> **advantage•n 1** a condition or circumstance that puts one in a favourable position. ➤ benefit; profit.

5.3.4 In *Miller (No. 1)* (HC), Baragwanath J considered English cases that looked at the term "tax advantage". His Honour noted at page 13,035:

> The advantage to the plaintiffs of receiving tax-free the bulk of the business' trading is, in my view, clearly a "tax advantage".
>
> While there is no definition of the term, its sense must include the benefit of the tax avoidance which (but for s 99) the Commissioner was entitled to conclude the plaintiffs have achieved.

5.3.5 Therefore, a "tax advantage" involves an income tax benefit or a better income tax position. Such a tax advantage must be obtained by way of altering the incidence of income tax; relieving any person from liability to pay income tax; or avoiding, or reducing or postponing the burden of a liability to income tax; whether the liability is an existing, potential or prospective liability to pay income tax, and as such will generally correlate with the tax avoidance identified pursuant to section BG 1 as arising under the tax avoidance arrangement. This is consistent with the words of section BG 1(2) which states "the Commissioner, in accordance with Part G, may counteract a tax advantage obtained by a person from or under a tax avoidance arrangement".

5.4 Commissioner's power to adjust income

5.4.1 The Commissioner's power to adjust amounts of gross income, allowable deductions and available net losses, so as to counteract the advantage of a tax avoidance arrangement, is given by section GB 1 and confirmed by section BG 1(2). Section BG 1(2) provides:

> The Commissioner, in accordance with Part G (Avoidance and Non-Market Transactions), may counteract a tax advantage obtained by a person from or under a tax avoidance arrangement.

5.4.2 To counteract such an advantage, the Commissioner is given an adjustment power under section GB 1(1). It 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 — [emphasis added]

5.4.3 Previously, section 99(3) (and the "pre-core provisions" initial enactment of section GB 1) provided the assessable income of a person affected by the tax avoidance arrangement "**shall** be adjusted" by the Commissioner. Following the amendment of section GB 1 by the Taxation (Core Provisions) Act 1996, section GB 1(1) now provides that any amount of gross income, allowable deductions and available net losses included in calculating the taxable income of any person affected by the arrangement "**may** be adjusted" by the Commissioner.

5.4.4 The Commissioner does not consider that this change (from "shall" to "may") results in any substantive alteration to the manner in which section GB 1(1) is intended to be applied. Rather, the change more accurately recognises the complementary operation and effect of sections GB 1 and BG 1, as summarised in paragraphs 5.1.2 and 5.1.3.

5.4.5 Prior to the enactment of a reconstructive provision (now section GB 1, previously section 99(3)), section 108 of the 1954 Act and initially section 99 only provided for the *ab initio* voiding of the tax avoidance arrangement. As noted by Richardson J (as he then was) in *Challenge* (CA), referring to those earlier provisions:

> … the section was a destructive provision not allowing any reconstruction and it assisted the Commissioner only if following annihilation of the arrangements voided by the section a taxable situation was disclosed …

5.4.6 Thus, it was held that as section 108 voided the tax avoidance arrangement, the Commissioner had no power to "reconstruct" the assessment of any income arising from such an arrangement. The legislative solution was to enact what became section 99(3) of the Income Tax 1976, and subsequently section GB 1(1), to provide the Commissioner with the ability to adjust the income, deductions, or losses of any person affected by the tax avoidance arrangement in order to counteract the tax avoidance arrangement.

5.4.7 In the Commissioner's view, the adoption of the word "may" by the core provisions amendments can be seen as recognising that there will be circumstances when an adjustment by the Commissioner will be necessary, and other times when it will not (as the tax advantage will

have been appropriately counteracted by the operation of section BG 1 and the application of other provisions of the Act).

5.4.8 Giving the words of section GB 1 their plain ordinary meaning, the Commissioner has a **discretion** to adjust. Therefore, the Commissioner will have the ability to adjust if, taking into account the scheme of the Act, such an adjustment is necessary to counteract a tax advantage following the voiding of an arrangement.

5.5 How should the Commissioner's power under section GB 1 be exercised?

5.1.1 Where a tax advantage is obtained from or under a tax avoidance arrangement, section GB 1(1) allows the Commissioner to adjust the taxable income of any person affected by the arrangement, in the manner the Commissioner thinks appropriate. The wording of the provision is that:

> 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—
>
> (a) Such amounts of gross income, allowable deductions and available net losses as, in the Commissioner's opinion, that person would have, or might be expected to have, or would in all likelihood have, had if that arrangement had not been made or entered into; or
>
> (b) Such amounts of gross income and allowable deductions as, in the Commissioner's opinion, that person would have had if that person had been allowed the benefit of all amounts of gross income, or of such part of the gross income as the Commissioner considers proper, derived by any other person or persons as a result of that arrangement.

The breadth of the discretion

5.1.2 The power to adjust is discretionary. As Hammond J said in *Peterson v CIR (No 2)* 20 NZTC 17,761 (HC) at paragraph 70:

> "… it must be particularly difficult to interfere with the Commissioner's exercise of his discretion under s 99(3), for what is involved *is* the exercise of a discretion. …"

5.1.3 Further, the adjustment may be made in the manner the Commissioner "thinks appropriate" to counteract any tax advantage.

5.1.4 In the High Court, and when referring to section 99(3), Baragwanath J in *Miller (No. 1)*, stated at page 13,036 (paragraph 236):

> … subs (3) requires the Commissioner to counteract any tax advantage. At that point he is not constrained by the rule in *Salomon v Salomon & Co* but he is empowered to make adjustment
>
> > "in such a manner as [he] considers appropriate so as to counteract [the] tax advantage…"

5.1.5 His Honour added at paragraph 241:

> … there can be no reason in principle for the Court to restrain the exercise of the Commissioner's power under subs (3) more than Parliament itself has done in settling the limits of that provision.

5.1.6 The breadth of the discretion was confirmed by the Court of Appeal in *Dandelion*. McGrath J made the following observations in respect of the adjustment made by the Commissioner under section 99(3):

> … But in any event the Commissioner was entitled in the exercise of the discretion under s 99(3) to disallow the appellant's claim for deduction and as long as the Commissioner was of the opinion it was a proper adjustment to make under s 99(3) it cannot be attacked on the basis that the Commissioner has not simultaneously amended an inconsistent assessment of another taxpayer: *Miller v CIR* [1999] 1 NZLR 275, 289, 292 CA.
>
> …
>
> 88 In applying s 99 the Commissioner adjusted the appellant's income by disallowing the deduction of interest paid under the arrangement. As the Authority said this adjustment was "simple and appropriate" as well as being "the most effective and fair way of counteracting the tax advantage". (pp 9,134 to 9,135) It was a proper treatment of a taxpayer who had obtained a tax advantage and it met the requirements of s 99(3).

5.1.7 However, the Commissioner's discretion in making an adjustment is not completely unfettered. While the Commissioner is broadly able to make such adjustments as are considered necessary to counteract a tax advantage, the adjustment must be only for the purpose of countering the tax advantage.

Are paragraphs (a) and (b) mandatory?

5.1.8 Section GB 1 does not dictate the manner in which the Commissioner is to counteract the tax advantage. Under paragraphs (a) and (b) of subsection GB 1(1), the Commissioner may have regard to a hypothetical state of affairs that "would have", "might have been expected to have", or "would in all likelihood have" existed but for the

arrangement. This can then be used as a basis for the assessment. This was recognised by Lord Hoffmann in *O'Neil* (PC), where he said at page 9:

> … The Commissioner's duty is to make an assessment with regard to what in his opinion was likely to have happened if there had been no scheme. But that does not mean that he is actually rewriting history. The reconstruction is purely hypothetical and provides a yardstick for the assessment.

5.1.9 However, the Commissioner does not consider that he is limited to making adjustments consistent with paragraphs (a) and (b) of subsection (1). This proposition clearly follows from the legislative wording. The subsection specifies that certain amounts included in calculating taxable income "may be adjusted by the Commissioner in the manner the Commissioner thinks appropriate". Further, in providing guidance the section sets out what the Commissioner "may have regard to" in paragraphs (a) and (b). But such power is to be exercised "without limiting the generality" of the subsection.

5.1.10 The proposition is also authoritatively recognised in *Miller v CIR* (1998) 18 NZTC 13,961 (CA), where Blanchard J stated, at page 13,980:

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

5.1.11 The assessment made by the Commissioner in *Miller* was upheld in the Court of Appeal, and the Court of Appeal's decision was upheld by the Privy Council in *O'Neil*. It will be noted that Blanchard J, in stressing the word "may", explicitly contrasted the wording of the paragraphs with the Commissioner being able to look at the matter broadly, supporting the view that the Commissioner has a wide discretion in how he determines the amount of adjusted income.

5.1.12 A similar conclusion was accepted by the Court of Appeal in *Peterson* and more recently by the Taxation Review Authority in *Case W33* (2004) 21 NZTC 11,321 (TRA). In the latter, Barber DCJ said, at 11,330, referring to the Commissioner:

> He is not required to second-guess what the taxpayer might have done if given another chance. He is to ensure that no tax advantage is obtained from the arrangement.

5.1.13 The Commissioner considers that the use of the words "in the manner the Commissioner thinks appropriate", "without limiting the generality of this subsection", "may" and "have regard to" all indicate that the Commissioner is not required to have resort to paragraphs (a) and/or (b) in the making of an adjustment under section GB 1(1).

5.1.14 The Commissioner therefore considers section GB 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, so as to counteract any tax advantage. The Commissioner may, but is not required to, have regard to the matters noted in paragraphs (a) and (b) of the subsection. As such, the Commissioner is not inhibited from looking at the matter broadly and may make **appropriate** adjustments to counteract the tax benefit received, directly or indirectly, by the taxpayer. However, the Commissioner must ensure that any adjustment is to counteract any tax advantage obtained by a person from or under the voided arrangement.

"have regard to"

5.1.15 The words "have regard to" precede paragraphs (a) and (b) of subsection GB 1(1). In *New Zealand Co-operative Dairy Company Limited v Commerce Commission* [1992] 1 NZLR 601, the High Court considered section 26 of the Commerce Act 1986 which provided that:

> … the Commission **shall have regard to** the economic policies of the Government as transmitted in writing from time to time to the Commission by the Minister [emphasis added]."

5.1.16 The judgment accepted that the effect of the word "shall" was that the Commission was required to "have regard to" the relevant economic policies, so, in contrast to section GB 1, no element of discretion was involved. However, the Court made the following relevant comments about the requirement to "have regard to":

> "We do not think there is any magic in the words 'have regard to'. They mean no more than they say. The tribunal may not ignore the statement. It must be given genuine attention and thought, and such weight as the tribunal considers appropriate. But having done that the tribunal is entitled to conclude it is not of sufficient significance either alone or together with other matters to outweigh other contrary considerations which it must take into account in accordance with its statutory function:"

5.1.17 As has been discussed, the combination of the words "without limiting the generality of the subsection", "may" and "have regard to" means the Commissioner has a discretion as to whether he takes into account the matters specified in paragraphs (a) and (b). If the Commissioner exercises the discretion in favour of having regard to those matters, they must then be "given genuine attention and thought, and such

weight as [the Commissioner] considers appropriate". However, having done so it is within the scope of the broad discretion available to the Commissioner to conclude that those matters are "not of sufficient significance either alone or together with other matters to outweigh other contrary considerations which it must take into account in accordance with [the Commissioner's] statutory function" to make such appropriate adjustments as are necessary to counteract the tax advantage.

Summary of legal principles

5.1.18 The relevant principles for applying section GB 1 to counteracting a tax advantage are as follows:

- The Commissioner has been vested with a broad adjustment power, but must ensure that any adjustment is to counteract any tax advantage obtained by a person from or under a voided arrangement. The Commissioner is not constrained in the means by which the amount of an adjustment is determined (*Miller (No.1) (HC)*, *Miller (CA)*, *Dandelion Investments (CA)*).

- While the Commissioner can make such adjustments as are considered necessary to counteract the tax advantage, the adjustment must be only for the purpose of the counteraction (*Miller (No 1)*).

- The Commissioner's power to adjust is limited to a party to the arrangement and a person affected (who is not necessarily a party) where a tax advantage has been obtained from or under the arrangement (*Peterson* (CA) and *BNZ Investments Ltd (CA) per Blanchard J*).

- A "tax advantage" involves an income tax benefit or a better income tax position. Such a tax advantage must be obtained by way of altering the incidence of income tax; relieving any person from an existing, potential or prospective liability to pay income tax; or avoiding, reducing or postponing an existing, potential or prospective liability to pay income tax (*Miller No. 1*).

6 SUMMARY OF LEGAL PRINCIPLES AND FLOWCHART

The following pages contain a summary of legal principles and a flow-chart intended to provide a reference guide to the steps and principles involved in considering the application of sections BG 1 and GB 1.

6.1 Summary of legal principles

Step 1 – Determining the arrangement and its scope

- A tax avoidance arrangement is void against the Commissioner at the time it is entered into by virtue of the operation of section BG 1.

- The word "arrangement" is interpreted to mean something in the nature of a relationship between two or more persons that may not legally amount to an agreement, contract, plan, or understanding, including all the transactions by which it is carried into effect. In other words, it means all kinds of concerted action by which persons may arrange their affairs for a particular purpose or to produce a particular effect (*Jaques, Bell, Newton, BNZ Investments Ltd (CA*)).

- The term "arrangement" means any agreement, contract, plan or understanding made or entered into between two or more persons (*Newton, the definition of "arrangement" in section OB 1, BNZ Investments Ltd (CA)*).

- An "arrangement" requires two or more participants who arrive at an understanding: a consensus or meeting of minds. This consensus involves an expectation about what is to be done, or, by each that the other will act in a particular way. The consensus must encompass explicitly or implicitly the dimensions that actually amount to tax avoidance. While the taxpayers need to be aware of the dimensions, knowledge that the dimensions amount to tax avoidance is not necessary.

- Consensus will be established on a commercially realistic assessment, particularly in cases where a significant feature of the arrangement is the obtaining, and sometimes the sharing, of tax benefits.

- Consensus will exist if the taxpayer authorises an agent to act on their behalf and is indifferent to whether the agent will take part in tax avoidance. Consensus may exist if the taxpayer was wilfully blind to what is done under an arrangement. Consensus will not

exist if one of the parties acts in a way that was not expected by the other party or uses a tax avoidance mechanism without the other's knowledge (*BNZ Investments Ltd (CA)*).

- "Arrangement" under section BG 1 can include agreements, contracts, plans, or understandings unenforceable at law (*the definition of "arrangement" in section OB 1*).

- Where any two or more documents or transactions are sufficiently interrelated and/or interdependent, they may be considered one arrangement for the purposes of section BG 1 (*Tayles, Europa (No.1*).

- All steps and transactions by which an arrangement is brought into effect are considered in determining the scope of an arrangement. The word "it" in "by which it is carried into effect" refers back to the applicable "arrangement" and does not extend it (*Hadlee* (*CA)*, *Newton, BNZ Investments Ltd (CA)*, *the definition of "arrangement" in section OB 1*).

- The existence of an arrangement is not determined by the opinion of the Commissioner or taxpayer. Rather, whether there is a "tax avoidance arrangement" is a matter of objective fact.

- The definition of arrangement requires that all steps and transactions by which the arrangement is carried into effect be considered as part of the arrangement. But it does not provide that part of an arrangement is itself an "arrangement" (*Brebner, Peabody, Hart*).

- The definition of "arrangement" in section OB 1 does not preclude any tax avoidance arrangement which forms part of, or a step in, a wider series of arrangements, being considered separately from the wider series of the arrangements (*the meaning of "tax avoidance arrangement" in section OB 1*).

- Section BG 1 applies to a tax avoidance arrangement whether or not the arrangement is carried out or brought into effect in New Zealand (*BNZ Investments Ltd (HC)*).

Step 2 – Determining "tax avoidance"

- 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 paragraphs (a), (b) or (c) of the definition of "tax avoidance" (*Miller (No.1*) *(HC)*).

- The first limb applies to arrangements which have the purpose or effect of altering the economic incidence of tax such that the taxpayer becomes liable to less tax after the arrangement than would have, or might have been, levied upon the taxpayer, but for it (*Marx, Mangin*).

- The second limb focuses on relieving or releasing someone from an obligation to pay income tax. The word "relieving" is construed as "defeating", "evading" or "avoiding" (*Mangin*; *dictionary meanings*). This limb may apply to arrangements involving tax credits.

- The words "avoiding", "postponing" or "reducing" in the third limb are construed in their ordinary sense. They mean escaping or minimising a liability to income tax or deferring that liability to a later date (*dictionary meanings*).

- The combined effect of the three limbs is that the taxpayer must directly or indirectly alter the economic incidence of tax; defeat, evade, or avoid liability to pay income tax; escape or minimise liability to income tax; or defer that liability to a later date (*Newton*, *Marx*, *Mangin*).

- In ascertaining an alteration of the incidence of income tax or a "potential" or "prospective" liability, the Commissioner considers the correct approach is to ascertain the amount of gross income, allowable deductions, or available net losses the taxpayer **might reasonably have** included in its tax income had the "tax avoidance arrangement" not been entered into or carried out (*statutory construction, dictionary meanings, Spotless).*

- The existence of a "new source" of income will not, of itself, exclude the potential application of section BG 1 (*the definition of "tax avoidance" in section OB 1, BNZ Investments Ltd (HC)*).

- The overall net tax position of an arrangement is not taken into account at the initial stage of determining whether there is "tax avoidance".

Step 3 – Determining the purpose or effect of the arrangement

- 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 so as to avoid tax. This is done by examining the overt acts by which the arrangement is implemented. However, it is no longer possible to avoid such predication simply by claiming

the arrangements are capable of explanation by reference to ordinary business or family dealings (*Newton, the definition of "tax avoidance arrangement" in section OB 1*).

- The whole set of words "purpose or effect" denotes a concerted action to an end – the end of avoiding tax (*Newton*).

- "Purpose" is determined objectively by reference to the arrangement itself and not subjectively in terms of motive. "Purpose" is not motive, but is the effect which the arrangement seeks to achieve. "Effect" means the result accomplished or achieved by the arrangement (*Newton, Tayles*).

- If an arrangement has a particular purpose that will be its effect. If it has a particular effect then that will be its purpose (*Ashton*).

Step 4 – Determining a purpose or effect that is more than merely incidental

- A "merely incidental" purpose or effect is something which follows from or is necessarily and concomitantly linked to, without any contrivance, some other purpose or effect. Such a purpose is determined objectively by reference to the arrangement itself and not subjectively in terms of motive. The proper focus is on assessing the degree of economic reality associated with a given transaction. This focus is contrasted with any artificiality, contrivance, or the relative extent to which the transaction appears to exploit the statute in direct pursuit of tax benefits (*Elmiger* (SC) per Woodhouse J, *Challenge* (CA), per Woodhouse P).

Step 5 – Judicial approaches

- After having applied the various elements of section BG 1 (including the relevant terms defined for the purposes of that section) to the facts of the arrangement in question, it is necessary to consider, as an additional interpretative step, whether Parliament intended the section to apply to the arrangement. Over the years the courts have adopted a number of judicial approaches to reach a view on this issue. The choice principle and tax mitigation are the most prominent judicial approaches adopted by the courts to ascertain whether section BG 1 applies to any given arrangement.

- Overall, the Commissioner considers the approach to be adopted in applying section BG 1, is first to find out whether the section applies on its terms (i.e. apply steps 1 – 4 above), and then, whether the arrangement would frustrate Parliament's intention for the

provision, regime or the Act as a whole. Establishing the existence or absence of such frustration is a two-step process. These steps are to:

- identify the legislative purpose of the provision, regime or the Act as a whole; and

- consider whether the Parliamentary intention for the provision, regime or Act is consistent with its applying to the arrangement in the way argued for by the taxpayer or whether the arrangement would frustrate the statutory purpose. If the purpose would be frustrated, section BG 1 applies to void the arrangement.

Step 6 – Adjustment of income under section GB 1

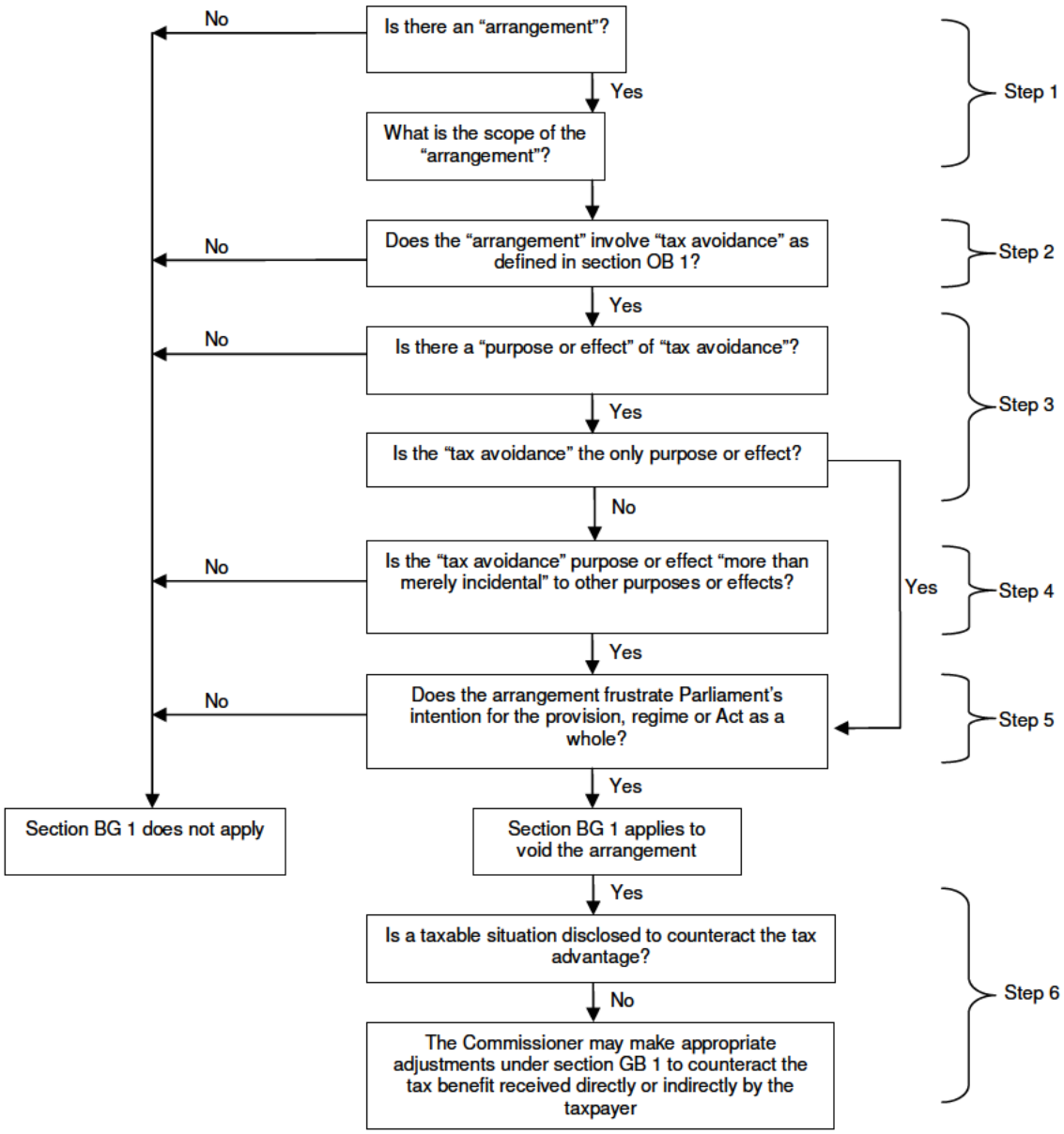
- The Commissioner has been vested with a broad adjustment power, but must ensure that any adjustment is to counteract any tax advantage obtained by a person from or under a voided arrangement. The Commissioner is not constrained in the means by which the amount of an adjustment is determined (*Miller (No.1) (HC)*, *Miller (CA)*, *Dandelion Investments (CA)*).

- While the Commissioner can make such adjustments as are considered necessary to counteract the tax advantage, the adjustment must be only for the purpose of the counteraction (*Miller (No 1)*).

- The Commissioner's power to adjust is limited to a party to the arrangement and a person affected (who is not necessarily a party) where a tax advantage has been obtained from or under the arrangement (*Peterson* (CA) and *BNZ Investments Ltd (CA) per Blanchard J*).

- A "tax advantage" involves an income tax benefit or a better income tax position. Such a tax advantage must be obtained by way of altering the incidence of income tax; relieving any person from an existing, potential or prospective liability to pay income tax; or avoiding, reducing or postponing an existing, potential or prospective liability to pay income tax (*Miller No. 1*).

6.2 Flow chart



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