
**IMPROVING THE OPERATION OF NEW
ZEALAND'S TAX AVOIDANCE LAWS**

CONTENTS

1. EXECUTIVE SUMMARY	1
The issue	2
Our recommendations	2
2. CHALLENGES POSED BY THE CONCEPT OF "TAX AVOIDANCE" AND THE GENERAL ANTI-AVOIDANCE RULE	4
What is tax avoidance and how does the GAAR work?	4
The difficulties posed by a GAAR	5
Uncertainty: a special case	9
<i>The degree of uncertainty affecting the New Zealand GAAR and its causes</i>	9
<i>The Supreme Court has declined to provide guidance in the GAAR context</i>	9
<i>Binding rulings not an adequate means of achieving certainty</i>	10
<i>Lack of general Inland Revenue guidance</i>	12
A response to those supporting the status quo	13
<i>The Crown Law Office's policy arguments in support of a GAAR with wide-ranging application</i>	13
<i>Why does certainty matter? Rule of law considerations</i>	15
<i>Why does certainty matter? Economic considerations</i>	17
3. A CASE STUDY	19
The context: personal service companies	19
Parliament's response	21
Inland Revenue applies the GAAR to personal services companies: the <i>Penny & Hooper</i> litigation	22
Where to now?	24
4. RECOMMENDATIONS ONE AND TWO: LEGISLATIVE REFORM	26
Possibility of learning from other jurisdictions	26
Two specific areas for reform	27
Recommendation one: require Inland Revenue to identify the particular tax advantage to be counteracted	27
Recommendation two: introduce statutory guidance for distinguishing tax avoidance from legitimate tax planning	29
5. RECOMMENDATIONS THREE, FOUR AND FIVE: REFORMS TO INLAND REVENUE'S PROCESSES CONCERNING THE APPLICATION OF THE GAAR	31
Overview	31
Recommendation three: publish an Interpretation Statement on the application of the GAAR	31
Recommendation four: an advisory panel to assist Inland Revenue decision-making	31
<i>Precedent for private sector input in regulatory decision-making</i>	31
<i>Panel to consider "tax avoidance" allegations in New Zealand</i>	32
Recommendation five: escalation process for when tax avoidance alleged	33
<i>Current process</i>	33
<i>Concerns with the current process</i>	34
<i>Our recommendations</i>	34
6. RECOMMENDATION SIX: CONTINUE TO ADDRESS PERCEIVED LOOPHOLES OR OTHER DEFICIENCIES IN THE TAX LAWS THROUGH LEGISLATIVE AMENDMENT	35
APPENDIX	36

FOREWORD

This report considers ways in which the operation of New Zealand's tax avoidance laws can be improved. It has been prepared by representatives of New Zealand's three leading industry bodies representing taxpayers and tax advisors: the Taxation Committee of the New Zealand Law Society, the Corporate Taxpayers Group, and the Taxation Committee of the New Zealand Institute of Chartered Accountants.¹

The report has been prepared as a basis for presenting and discussing specific recommendations with Government, and to facilitate debate among other interested parties.

The impetus for the report is a growing concern that the general anti-avoidance provision (or "GAAR") is being overused, and that in some cases its use effectively amounts to retrospective law-making to address perceived gaps in the tax laws which could have been addressed at the tax policy design stage, or by enacting remedial amendments to address an identified concern.

The report suggests measures that should result in greater certainty as to the circumstances in which the GAAR will apply. Those measures are not intended to diminish the Government's ability to combat tax avoidance, but rather to recognise that the GAAR is often a blunt and inefficient means of doing so. The report supports efforts to address tax avoidance concerns by legislative means, and suggests that this approach is in many cases fairer, more efficient, and more effective, than excessive reliance on the GAAR to plug gaps in the tax system.

¹ The views expressed in this report do not necessarily reflect the views of individual members of any of these bodies.

1. EXECUTIVE SUMMARY

The issue

- 1.1 This report is concerned with the operation of the general anti-avoidance rule ("**GAAR**") in the taxation system.² The GAAR allows Inland Revenue to override the tax consequences that would otherwise apply in a given situation, if those tax consequences are the product of tax avoidance.
- 1.2 We agree that a GAAR can perform a useful role in the New Zealand tax system, as a mechanism for combating tax-driven arrangements that are artificial and contrived to such an extent that they could not reasonably have been addressed when the relevant tax policy was being designed. But we are concerned that the New Zealand GAAR is being used (or its use is being threatened) to overturn the tax consequences of more mainstream arrangements. In some cases, the GAAR is being applied in a way that really amounts to retrospective law-making, to address situations in which Inland Revenue encounters gaps in the tax laws which could have been addressed at the outset during the tax policy design stage, or by enacting remedial amendments to the tax laws to address an identified concern.
- 1.3 A consequence of this has been that the GAAR has assumed greater significance in the operation of the tax system. A recent study confirms anecdotal evidence that the GAAR has become a major source of disputes between taxpayers and Inland Revenue and (therefore) a significant source of uncertainty. The study found that nearly 30 per cent of all reported judgments of the courts concerning questions of tax law over the past decade, have dealt with allegations of tax avoidance.³ If New Zealand is serious about having a "world class tax system"⁴ the impact of significant uncertainty arising from the GAAR cannot be ignored.

Our recommendations

- 1.4 In this report, we advocate a more principled way to deal with tax avoidance issues. Our main recommendations are:
- (a) We support legislative amendments to clarify the operation of the GAAR. In particular, we recommend:
 - (i) clarifying that in cases where the GAAR applies, it is necessary for Inland Revenue and the courts to identify the particular tax advantage resulting from tax avoidance, and that only that tax advantage would be overridden by the GAAR, not other tax consequences of the arrangement that do not result from tax avoidance. In other words, the GAAR should operate to "knock out" tax avoidance, but should not give Inland Revenue the discretion to penalise taxpayers by also knocking out other, legitimate tax consequences of the arrangement;⁵
 - (ii) reviewing international precedents to ascertain whether New Zealand's GAAR reflects international best practice. In particular,

² Currently found in sections BG 1 and GA 1 of the Income Tax Act 2007 and in section 76 of the Goods and Services Tax Act 1985.

³ Mark Keating and Kirsty Keating "Tax Avoidance in New Zealand: The Camel's Back that Refuses to Break!" (2011) 17(1) *New Zealand Journal of Taxation Law and Policy* 115 at 115-116.

⁴ Minister of Revenue Peter Dunne "NZ has chance to develop world class tax system" (press release, 1 December 2009).

⁵ There is a system of civil penalties provided for in the Tax Administration Act 1994, which makes it even more critical that the GAAR does not itself have a penal effect.

GAARs in most other jurisdictions provide some criteria (in the form of a list of factors or other indicia) for distinguishing legitimate tax planning from impermissible tax avoidance. New Zealand's GAAR, by contrast, contains no such criteria.

- (b) We support steps that would provide a greater level of assurance to taxpayers that, when applying the GAAR, Inland Revenue is acting in a principled and consistent way. In particular, we recommend:
 - (i) requiring Inland Revenue and Crown Law to publish written guidance as to its interpretation of the GAAR, including examples, and that Inland Revenue and Crown Law personnel be required to act consistently with that interpretation;
 - (ii) establishing an independent panel, which includes private sector input, to make non-binding recommendations to Inland Revenue concerning tax avoidance cases;
 - (iii) establishing a formal internal escalation process within Inland Revenue for circumstances where tax avoidance is alleged, and requiring a full disclosure of that process to the taxpayer.
- (c) We support the Government's on-going efforts to address tax avoidance concerns through legislative design and reform, and suggest that this approach is fairer, more efficient, and more effective, than relying excessively on the GAAR to plug gaps in the tax legislation.

1.5 We are not recommending the repeal of the GAAR. The GAAR does play a role in protecting the tax system against artificial schemes detached from ordinary business and commercial arrangements and which could never have been anticipated in the tax policy design. But in a well-designed and well-administered tax system, the GAAR's role should be confined to those cases, and should not extend to well known or commonplace tax saving opportunities against which Parliament could have (but has not) legislated.

2. CHALLENGES POSED BY THE CONCEPT OF TAX AVOIDANCE AND THE GENERAL ANTI-AVOIDANCE RULE

What is tax avoidance and how does the GAAR work?

2.1 It is important to identify at the outset what is meant by tax avoidance. An Australian Judge with significant experience of working with Australia's GAAR, has stated:⁶

It is a legislative feature of the anti avoidance provisions both in Australia and in New Zealand that tax is imposed through the anti avoidance provisions where tax would not otherwise be payable. The anti avoidance provisions themselves impose tax and not merely operate to make the other provisions operate. The anti avoidance provisions of Part IVA in Australia only apply where the tax benefits the Commissioner cancels are otherwise lawfully available to the taxpayer. The same effect was achieved by its predecessor provision in s 260, and is achieved in double measure through ss BG and GA of the New Zealand *Income Tax Act 2007*. In each case, tax is imposed through, or by application of, the anti avoidance provisions where tax is not otherwise imposed. The fundamental criteria chosen for this imposition is the successful purpose of avoidance. It must seem very curious to most normal people that tax would be imposed when it is lawfully not payable according to the provisions said to have been avoided, and that the very criteria of imposition could somehow be the success of its avoidance.

2.2 In a legal sense, tax avoidance must be distinguished from tax evasion. A person commits tax evasion, for example, when he or she:⁷

- (a) Knowingly does not keep the books and documents required to be kept by a tax law; or
- (b) Knowingly does not provide information (including tax returns and tax forms) to the Commissioner or any other person when required to do so by a tax law;

...

and does so—

- (f) Intending to evade the assessment or payment of tax by the person or any other person under a tax law; or
- (g) To obtain a refund or payment of tax in the knowledge that the person is not lawfully entitled to the refund or payment under a tax law; or
- (h) To enable another person to obtain a refund or payment of tax in the knowledge that the other person is not lawfully entitled to the refund or payment under tax law.

2.3 "Tax evasion" in this sense is therefore tantamount to fraud. It is a criminal offence. Further, as is to be expected in the case of a criminal offence, the legal standard for what will constitute "tax evasion" is reasonably clear.

2.4 Tax avoidance is different. Tax avoidance is not a criminal offence. It does not turn on misrepresentations being made to Inland Revenue; on the contrary, taxpayers accused of tax avoidance have commonly disclosed to Inland Revenue far more information about their affairs than they are required to by law. And finally (and critically) the legal standard for determining what is and what is not tax avoidance is far from certain.

⁶ Justice G Tony Pagone "Aspects of Tax Avoidance: Trans-Tasman Observations" (paper presented to International Fiscal Association Conference, Wellington, March 2011).

⁷ Tax Administration Act 1994, s 143B(1).

2.5 Therefore, a conclusion that a taxpayer's conduct amounts to tax avoidance may nonetheless be reached even in a case where the taxpayer:

- (a) has calculated the correct amount of tax payable according to the detailed provisions of the tax legislation, usually on the basis of professional advice;
- (b) has paid the tax, as calculated, by the due date;
- (c) has provided Inland Revenue with accurate information in the form requested by Inland Revenue;
- (d) has on any objective view acted honestly and carefully in seeking to comply with the person's tax obligations;
- (e) is nonetheless alleged to have paid too little tax because the form in which the person has organised his or her business or other affairs, or undertaken a particular transaction, is said to amount to tax avoidance.

2.6 Inland Revenue has the power to increase the amount of tax a taxpayer would otherwise have to pay by relying on the GAAR. The GAAR applies if there is an arrangement which has a more than merely incidental purpose or effect of reducing the tax a person would otherwise pay. The legal definition of "tax avoidance arrangement" (to which the GAAR applies) is as follows:

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

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

2.7 "Tax avoidance" is defined as including:

- (a) directly or indirectly altering the incidence of any income tax;
- (b) directly or indirectly relieving a person from liability to pay income tax or from a potential or prospective liability to future income tax;
- (c) directly or indirectly avoiding, postponing, or reducing any liability to income tax or any potential or prospective liability to future income tax.

The difficulties posed by a GAAR

2.8 Until three or four years ago, it was generally understood that commonplace arrangements which resulted in tax savings should not be subject to the GAAR. The basis for this understanding is best captured by the following passage in the Australian Tax Office statement summarising the principles of Australia's GAAR:⁸

When a provision is inserted into the income tax law, policy-makers may be taken to contemplate the obvious exploitation or use of the provision. The ordinary dealing or obvious case should not result in unanticipated consequences. **It is reasonable to assume that the tax opportunities of straight-forward dealing have been considered by those who design tax laws, and having been considered, if not then prevented, have in effect**

⁸ Australian Tax Office Practice Statement: "Application of General Anti-Avoidance Rules" (PS LA 2005/24) available at <http://law.ato.gov.au/atolaw/view.htm?Docid=PSR/PS200524/NAT/ATO/00001>.

been implicitly sanctioned. Moreover, from a taxpayer's perspective a provision will be seen to offer, for straightforward dealings, tax opportunities that are untainted with any notion of abuse. Doing the obvious is use, not abuse.

[Emphasis added]

- 2.9 Most tax specialists would agree that this statement no longer reflects Inland Revenue's practice in New Zealand. Nor does it reflect the approach being taken by at least some High Court and appellate court Judges. That sea-change, as it has been described,⁹ has introduced an additional and significant layer of uncertainty and complexity into the New Zealand tax system.
- 2.10 The difficulty with the deceptively straightforward language of the GAAR is that numerous commonplace arrangements can and do have a more than incidental purpose or effect of reducing a person's tax liability. Examples include:
- (a) borrowing to invest in a residential property where (as is commonly the case) tax deductible expenses exceed the taxable rental income, and any gain on the sale of the property is a capital gain and therefore tax free;
 - (b) a small business owner who decides to incorporate a company to carry on the business instead of carrying on the business in his or her own name, with the consequence that the business's profits, to the extent retained by the company, will be taxed at the lower rate than if derived by the business owner in his or her own name;
 - (c) a person with significant savings on deposit with a bank, who withdraws money from his or her call account and invests it in a managed fund established by the same bank. Money invested in the managed fund earns the same rate of interest as money invested in the call account, but because the managed fund is a portfolio investment entity (or "**PIE**") for tax purposes, the tax rate on the person's return may be lower than if the interest had remained on deposit in the call account;
 - (d) a person who purchases a high value item of jewellery for personal use, such as a bracelet or a watch. The person enters into an agreement to buy the item at a city retail store, but arranges to take delivery of the item on the airside of the customs and immigration barrier prior to departing for (say) Sydney. On this basis, the item is treated in the same way as an export for GST purposes, and no GST is payable. On return two days later, the purchaser need not declare the goods as they are classified as jewellery for personal use. The item is therefore not subject to GST, even though it was purchased for consumption in New Zealand.¹⁰
- 2.11 All of the above examples may have an effect of reducing the tax the person would otherwise pay. And in many instances, it would be hard to argue that the tax saving is "merely incidental":
- (a) In the third example the only rational reason for investing through a PIE instead of the more conventional bank deposit is to achieve the tax savings.
 - (b) In the rental property example, the tax savings will frequently be the means by which an otherwise loss-making investment can be made profitably.

⁹ Craig Elliffe and Jess Cameron "The Test for Tax Avoidance in New Zealand: A Judicial Sea-Change" (2010) 16(4) New Zealand Business Law Quarterly 178.

¹⁰ This so-called loophole was recently publicised in the news media. See Abby Gillies "Rings wing way past GST" *The New Zealand Herald* (New Zealand, 9 July 2011).

- (c) In the fourth example, the underlying transaction occurs in New Zealand, and the goods will be "consumed" in New Zealand. It has not in substance been exported, but the GST laws apply as if it had been exported, as a result of the step (undertaken solely for tax reasons) of having the retailer send the goods to the airport to be collected by the customer.

2.12 In each of these examples, it could be argued that there is an arrangement that has a more than merely incidental purpose or effect of reducing a person's liability to tax, thereby meeting the requirements of the "tax avoidance arrangement" definition. Yet there would appear to be a consensus that the examples referred to do not amount to tax avoidance.

2.13 The courts have observed on numerous occasions that the GAAR cannot be read literally. Justice McCarthy, then President of the Court of Appeal, observed that:¹¹

The [GAAR] is notoriously difficult. It cannot be given a literal interpretation, for that would, the Commissioner has always agreed, result in the avoidance of transactions which were obviously not aimed at by the section. So the Courts have had to place glosses on the statutory language in order that the bounds might be held reasonably fairly between the Inland Revenue authorities and taxpayers.

2.14 Similarly, the High Court has observed that:¹²

It is a recognised reality that most business or family transactions have tax minimisation (to use a neutral term) as one of their purposes or effects, and with a degree of significance such that it realistically cannot be termed "incidental". **Read literally [the GAAR] avoids for tax purposes the majority of business and family transactions.** Whatever else may be said, it is widely accepted that extreme outcome cannot have been intended by Parliament. The difficulty has been to ascertain the intended boundaries. The purist says this is an exercise in statutory interpretation. **The realist might say the Courts have been left to resolve the question on a policy basis.**

[Emphasis added]

2.15 If the GAAR is, as the courts have previously recognised, so broadly worded that it cannot be read literally, then on what basis should it be decided whether the GAAR applies in a given case? Some commentators have argued that the concepts of "commerciality, economic substance, contrivance and artificiality" provide the answer.¹³ We agree that those concepts are relevant and can often provide helpful guidance to taxpayers. But in other cases, they leave substantial room for uncertainty, and there is danger in them being used casually or without adequate reference to the scheme of the Act and/or Parliamentary contemplation. For example, where do those concepts leave the consumer who buys an item of jewellery from a downtown retailer, takes delivery of it at the airport (and not from the retailer directly) and does so for the sole purpose of obtaining GST-free treatment in circumstances where (in "substance") the item will not be exported but instead will be consumed in New Zealand? The concepts of commerciality, economic substance, artificiality and contrivance all tend to point to the conclusion that the person has engaged in GST avoidance; the step of taking delivery of the goods at the airport in circumstances where "in economic substance" the goods are purchased for consumption in New Zealand can only be explained as an artificially interposed step to deliver a tax advantage. Yet we are for all practical purposes certain that it has never been asserted that this fact pattern is tax avoidance to which the (GST) GAAR applies.

¹¹ *CIR v Gerard* [1974] 2 NZLR 279 at 280.

¹² *BNZ Investments Ltd v CIR* (2000) 19 NZTC 15,732 at [72].

¹³ Harry Ebersohn "Tax Avoidance and the Rule of Law" (paper presented to Legal Research Foundation Tax Avoidance Symposium, Auckland, April 2011) at [86].

- 2.16 The example demonstrates that the concepts of commerciality, economic substance, contrivance and artificiality are usually conclusory labels rather than having predictive utility. In the case of the "exported" consumer goods example, possibly the real reason we have not, so far, seen the GAAR being applied is that the practice in question is widespread, and well known, and seeking to reverse the tax benefits retrospectively (by applying the GAAR) would provoke a public backlash. That is, political, more than legal, reasons, may determine the application of the taxing power afforded by the GAAR. That is of course far from best practice as a matter of tax policy, but may be an inevitable consequence of a GAAR that is as broadly worded as New Zealand's GAAR.
- 2.17 A related difficulty caused by the absence of principled boundaries on the operation of the GAAR is that litigation becomes the main forum for working out those boundaries. In their article, Keating and Keating presented empirical evidence demonstrating that:¹⁴
- ... a disproportionate amount of time is spent by Inland Revenue, taxpayers, practitioners and the court on both the procedural and the substantive aspects of tax avoidance disputes.
- 2.18 A statutory provision which empowers Inland Revenue and the courts to override the tax consequences specifically provided for in tax legislation is of course a powerful tool from the perspective of Inland Revenue when litigating against taxpayers. As Justice Tony Pagone observed,¹⁵ "...tax is imposed through, or by application of, the anti avoidance provisions where tax is not otherwise imposed". So if the taxpayer succeeds in establishing that tax is not imposed by the specific provisions, Inland Revenue has a second chance, as it were.
- 2.19 It is hardly surprising, therefore, that those representing Inland Revenue in tax disputes should prefer to be unconstrained in framing their arguments in litigation, by Inland Revenue's Interpretation Statements or other boundaries on the GAAR's operation. But that approach is not in the interests of the tax system as a whole, because a GAAR with unrestricted operation will ultimately lead to tax policy being made in the courts and not by Parliament. In the long run, that is not in anyone's interests. In fact, courts in other jurisdictions have explicitly rejected such a role for themselves. For example, the Canadian Supreme Court has warned:¹⁶

The courts cannot search for an overriding policy of the Act that is not based on a unified, textual, contextual and purposive interpretation of the specific provisions in issue. First, such a search is incompatible with the roles of reviewing judges. The *Income Tax Act* is a compendium of highly detailed and often complex provisions. **To send the courts on the search for some overarching policy and then to use such a policy to override the wording of the provisions of the *Income Tax Act* would inappropriately place the formulation of taxation policy in the hands of the judiciary, requiring judges to perform a task to which they are unaccustomed and for which they are not equipped. Did Parliament intend judges to formulate taxation policies that are not grounded in the provisions of the Act and to apply them to override the specific provisions of the Act?** Notwithstanding the interpretative challenges that the GAAR presents, we cannot find a basis for concluding that such a marked departure from judicial and interpretative norms was Parliament's intent.

[Emphasis added]

¹⁴ Keating and Keating, above footnote 3, at 115.

¹⁵ Justice G Tony Pagone, above footnote 6, at 3.

¹⁶ *Canada Trustco Mortgage Co v Canada* (2005) SCC 54 at [41].

Uncertainty: a special case

The degree of uncertainty affecting the New Zealand GAAR and its causes

- 2.20 It is sometimes argued that the uncertainty inherent in the GAAR is unremarkable, and that the law contains numerous instances of general rules that serve as a backstop to specific detailed rules. For example, it might be argued that the offence of dangerous driving¹⁷ is analogous to the concept of tax avoidance, in that a person may be driving within the speed limit, not under the influence of alcohol or illicit drugs, and in conformity with traffic signals, road signs and markings, but may nonetheless be held to be driving dangerously. Other examples might include the prohibition on engaging, in trade, in conduct which is misleading or deceptive or likely to mislead or deceive,¹⁸ or on an arrangement having the purpose, or likely having the effect, of substantially lessening competition.¹⁹
- 2.21 Each of these examples differs from the GAAR in one critical respect however. Those other cases refer to some yardstick or standard external to the relevant statutory provision. Whether driving amounts to "dangerous driving" can be resolved as a factual matter, because whether driving is dangerous is a real world concept. So too, whether conduct is misleading or deceptive can be judged as a question of fact. And whether an arrangement substantially lessens competition can be judged by reference to (among other things) evidence of economic effects.
- 2.22 Tax avoidance is different because it is accepted that it is commonplace and legitimate for taxpayers to choose to some degree between alternative legal structures available to them to reduce the tax otherwise payable. To put the point another way, a taxpayer is not obliged to conduct his or her affairs in such a way as to maximise his or her tax liability. Further, the options open to a taxpayer enabling the taxpayer to reduce his or her tax liability are a function of the tax laws themselves. So, for example, if Parliament enacts a tax concession for investments made through a PIE, it is difficult to identify any yardstick for distinguishing "deserving" from "undeserving" PIEs, in circumstances where the concept of a PIE is purely a function of tax law. The GAAR therefore presents a unique case of uncertainty.
- 2.23 Moreover, the tax system generally operates on the basis of self-assessment, requiring taxpayers to interpret and apply the law in ascertaining their tax liability. Taxpayers may be subjected to substantial penalties to the extent Inland Revenue disagrees with their interpretation. In those circumstances there is a need for mechanisms to enable taxpayers to predict how Inland Revenue, or a court, will apply the relevant laws.

The Supreme Court has declined to provide guidance in the GAAR context

- 2.24 The present uncertainty is underscored by the difficulties even Judges encounter in interpreting the GAAR. In the leading Supreme Court decision in *Ben Nevis*²⁰ the Court acknowledged that the GAAR created uncertainty, but disclaimed any role for the courts in providing guidance that could mitigate that uncertainty. In the plurality judgment, Justice McGrath stated:²¹

...Parliament has left the general anti-avoidance provision deliberately general. That approach has been retained despite the introduction of a civil penalties regime in relation to taxpayers who take certain types of incorrect tax position.

¹⁷ Land Transport Act 1998, s 7(2).

¹⁸ Fair Trading Act 1986, s 9.

¹⁹ Commerce Act 1986, s 27.

²⁰ *Ben Nevis v CIR* [2008] NZSC 115.

²¹ *Ibid* at [112].

The courts should not strive to create greater certainty than Parliament has chosen to provide.

- 2.25 The Supreme Court's approach to the need for certainty in the GAAR context can be contrasted with the sentiment expressed in other contexts, when interpreting statutory provisions of general application. For example, when interpreting section 36 of the Commerce Act 1986 (which, as worded at the time, provided that "no person who has a dominant position in a market shall use that position for [certain purposes]"), the Court stated that:²²

It is important when addressing the statutory concept of use of market power to take an approach which gives firms and their advisers a reasonable basis for predicting in advance whether their proposed conduct falls foul of s 36 and risks a substantial financial penalty.

- 2.26 The Supreme Court's unwillingness to provide more general guidance as to the appropriate boundaries of the GAAR poses challenges for Judges at first instance. In the three decisions of the High Court in the year following the Supreme Court's decision in *Ben Nevis*, judicial opinion was divided on the question of what effect *Ben Nevis* had had on the earlier case law interpreting the GAAR. One Judge considered that the Supreme Court had affirmed the earlier approach.²³ Another considered that the Supreme Court had overruled the earlier approach.²⁴ Another was unsure, calling for "appellate clarification" to assist lower court Judges in interpreting the decision.²⁵
- 2.27 These different views as to the effect of the leading Supreme Court decision are of course of more than mere academic interest to taxpayers. For taxpayers, the consequences of Inland Revenue disagreeing with the taxpayer's approach include reversal of the tax consequences of an arrangement as the taxpayer had understood them, the imposition of interest at what may be a penal rate, and the imposition of a penalty of up to 100% of the tax in issue. For the taxpayer to contest Inland Revenue's view will generally entail entering into a costly dispute process that may take three to six years before the taxpayer has a hearing before the court - assuming the taxpayer has not given up in the meantime. If the matter does proceed to court, the taxpayer may well spend eight to 10 years in dispute with Inland Revenue before the matter is finally resolved.²⁶

Binding rulings not an adequate means of achieving certainty

- 2.28 One response the courts have offered to concerns regarding uncertainty is that a taxpayer may seek a ruling from Inland Revenue. In the Supreme Court's decision in *Glenharrow Holdings v CIR*,²⁷ the Court stated:²⁸

There will also inevitably be uncertainty whenever a taxing statute contains a general anti-avoidance provision intended to deal with and counteract such artificially favourable transactions. It is simply not possible to meet the objectives of a general anti-avoidance provision by the use, for example, of

²² *Commerce Commission v Telecom Corporation New Zealand Limited* [2010] NZSC 111 at [30].

²³ *Penny v CIR* [2009] 3 NZLR 523 at [18]. Justice Mackenzie's decision was reversed on appeal by a majority in *CIR v Penny* [2010] NZCA 231. The Supreme Court found in favour of the Commissioner in *Penny and Hooper v CIR* [2011] NZSC 95. The *Penny & Hooper* case is discussed further in section 3 of this report.

²⁴ *Westpac Banking Corporation v CIR* (2009) 24 NZTC 23,834 at [174].

²⁵ *BNZ Investments Limited v CIR* (2009) 24 NZTC 23,582 at [123].

²⁶ The *Penny and Hooper* cases, which involved relatively straightforward transactions, were first investigated by the Commissioner in April 2004. The Supreme Court issued its judgment over seven years later, in August 2011.

²⁷ *Glenharrow Holdings Limited v CIR* [2008] NZSC 116.

²⁸ *Ibid* at paragraphs [48] and [49], citations omitted.

precise definitions, as may be able to be done where an anti-avoidance provision is directed at a specified type of transaction.

[49] Transactions which are driven only by commercial imperatives are unlikely to produce tax consequences outside the purpose of the legislation and, in any isolated case in which the commercial drivers do have unusual consequences, the existence of those consequences will surely alert the parties to the possibility that the Commissioner may consider invoking the general anti-avoidance provision and may have to be persuaded that the intent of the legislation is not actually being offended. An advance ruling can be sought.

- 2.29 The Supreme Court's advice that taxpayers contemplating transactions with high value tax consequences can seek an advance ruling unfortunately represents an overly simplistic view. For one thing, the cost and timeframe involved in seeking an advance ruling are such that an advance ruling is not an option for most taxpayers.
- 2.30 Inland Revenue charges for the provision of binding rulings at an hourly rate of \$137.78 plus GST. Inland Revenue's charges on a ruling application of medium complexity would typically be around \$20,000 plus GST. And because the legal principles surrounding the GAAR are especially difficult and uncertain, taxpayers also have the cost of representation by a lawyer or tax accountant in connection with the application. That cost will typically exceed the fees payable to Inland Revenue. In total, the cost of obtaining a ruling on the application of the GAAR can easily exceed \$50,000.
- 2.31 The time taken for Inland Revenue to consider a ruling application and provide its response is (currently) around three to five months. This is a considerable improvement on earlier experience; previously, it was not uncommon for the process to take a year or longer. Nonetheless, current timeframes of three to five months remain too long for a binding ruling to be secured in advance of certain time-sensitive transactions being entered into.
- 2.32 Even where the cost and timeframes do not preclude taxpayers from seeking a ruling, the process itself involves limitations. These include:
- (a) The fact that a favourable ruling is typically subject to assumptions and conditions, which Inland Revenue may audit at a later stage. Therefore, while a binding ruling limits the scope of future disagreement with Inland Revenue, it does not eliminate that risk.
 - (b) The fact that, in recent years, there have been instances of different divisions of Inland Revenue taking different views concerning the application of the GAAR, with the consequence that a taxpayer who has received a favourable ruling from Inland Revenue's rulings unit may face attempts from a different division of Inland Revenue to overturn that ruling or to act inconsistently with it. A documented example of this phenomenon can be found in *Westpac Banking Corporation v CIR*²⁹ in which the Court of Appeal declined to hold that amended assessments issued on a basis that was arguably inconsistent with the basis on which a binding ruling had been given, were unlawful. The Court summarised the position as follows:³⁰

All in all, attempts to identify discrete legal issues on which Corporates and Rulings held diametrically opposing views were unsuccessful. This is a function of the open-textured, evaluative and fact specific exercise required by s BG 1. On the other hand, **there plainly was a difference in approach between the two business units [within Inland Revenue]**. At a broad level, Corporates staff were generally far more

²⁹ *Westpac Banking Corporation v CIR* [2009] NZCA 24.

³⁰ *Ibid* at [29].

sceptical of the repo deals than Rulings had been in relation to the First Data transaction. As well, **Corporates took a more bullish (or perhaps aggressive) approach to the application (and scope) of s BG 1.**

[Emphasis added]

Lack of general Inland Revenue guidance

- 2.33 The uncertainty as to the scope of the GAAR, and the difficulties taxpayers face in determining its scope, are underscored by Inland Revenue's unwillingness to provide meaningful guidance on when the GAAR will apply and when it will not. Guidance from Inland Revenue is important in the case of the GAAR because the statutory provision itself is so broad and open-textured as to in effect confer a discretion on the person applying it (either Inland Revenue or the court). Official guidance on Inland Revenue's position is especially important given that divisions within Inland Revenue can disagree on the scope of the GAAR.
- 2.34 Inland Revenue released a draft Interpretation Statement on its approach to applying the GAAR in September 2004. That Statement:
- (a) was approximately 80 pages long, and, although containing a useful summary of the (now potentially out-of-date) case law, did not provide examples of situations in which the GAAR would, and would not, apply;³¹
 - (b) some six and a half years after it was released in draft, has not been finalised.
- 2.35 It is also worth emphasising that the existing Policy Statement on the application of the GAAR which dates from 1990 has not been formally withdrawn, but itself is subject to a review which warns that "[u]ntil the PIB and identified TIB items are reviewed these items should be referenced with some care." When Inland Revenue has a 21 year old Policy Statement that is no longer being followed but has not been formally withdrawn, and a subsequent draft Policy Statement which is not yet official policy but seems to be more relevant to the current approach adopted by Inland Revenue, a significant level of uncertainty is generated.
- 2.36 The absence of examples in the draft Interpretation Statement is also of concern. Examples are critical in order for guidance on the application of the GAAR to be meaningful. Absent examples, it is difficult for taxpayers to know **why** Inland Revenue considers a particular arrangement to be subject to the GAAR. Further, only by including examples in respect of which the GAAR is considered not to apply will a written statement by Inland Revenue provide meaningful assurance to taxpayers that Inland Revenue will act consistently. Otherwise, taxpayers are vulnerable to the phenomenon observed in the *Westpac* case cited above, in which different divisions of Inland Revenue do not agree on the scope of the GAAR, or on the meaning of the Interpretation Statement.
- 2.37 The recent phenomenon, in which Crown Law may take a different view on aspects of tax law from the view previously held by Inland Revenue, has added to the uncertainty; even if it were possible to predict, based on Inland Revenue practice, the view Inland Revenue may take of an issue, there is now the risk that Crown Law may argue for a different view in the context of a particular tax dispute. It should be necessary for Crown Law to act consistently during the course of litigation with any Interpretation Statement issued by the Commissioner. If Crown Law remains able to advance arguments contrary to the Commissioner's publicly issued statements, then any

³¹ Inland Revenue's previous Policy Statement on the application of the GAAR (*Tax Information Bulletin*, Volume 1, No. 8 (February 1990), Appendix C) contained nine examples, some of which were, and some of which were not, regarded as subject to the GAAR.

Interpretation Statement will not serve the purpose of increasing certainty. In fact, certainty will be undermined by exposing taxpayers who place reliance on the Commissioner's Interpretation Statements to unanticipated tax risks. Considering that Crown Law has been consulted on the Interpretation Statement on applying the GAAR, it is reasonable to require Crown Law to adhere to its contents.

- 2.38 The lack of guidance on the GAAR in New Zealand can be contrasted with that in other jurisdictions which have a GAAR:
- (a) When Canada introduced its GAAR, the revenue authority issued an Information Circular (Information Circular 88-2), which contained over 20 examples and indicated whether the Canada Revenue Authority regarded those transactions as constituting tax avoidance or otherwise. A further supplement (Information Circular 88-2S1) provided additional examples.
 - (b) Australia has released a comprehensive Practice Statement on the application of the GAAR (PS LA 2005/24). The Practice Statement not only directs taxpayers to relevant public rulings, which give examples of when the GAAR will or will not apply, but also includes a list of warning signs in order to better inform taxpayers of when the GAAR is likely to apply and when it is not.
 - (c) When South Africa redrafted its GAAR in 2006, a draft Comprehensive Guide to the GAAR was released for public comment prior to finalisation. The Draft Guide contains an explanation of the provisions of the GAAR, a consideration of its role in the light of other countries' GAARs, as well as an overview of how the GAAR will be administered.

A response to those supporting the status quo

The Crown Law Office's policy arguments in support of a GAAR with wide-ranging application

- 2.39 At a Legal Research Foundation symposium in April 2011, senior lawyers from the Crown Law Office presented papers containing "A View from Crown Law" on the subject of tax avoidance, and on Crown Law's role in tax avoidance disputes.³² The views on tax avoidance were expressed as being the current views of Crown Law, and not solely the views of individual presenters.
- 2.40 Much of the Crown Law presentation involved a defence of the need for a GAAR, despite its inherent uncertainty, in order to guard against the harm caused by tax avoidance. It is unusual to see Crown Law taking a stand on a question of tax (or other) policy (such as whether there should be a general anti-avoidance provision) as distinct from opining as to what the law is. The Crown Law paper, despite coming from an agency that does not usually advocate policy positions, advances, in support of a GAAR with the broadest possible interpretation, propositions that would more often be seen in a tax policy debate in the political arena. For example:³³

- (a) At paragraph [56]:

Sir Ivor Richardson made a massive contribution to jurisprudence in New Zealand, including in the area of tax. Perhaps unfairly he is also remembered for his judgment in *Challenge*, which, correctly or incorrectly, has provided tax avoiders with a theoretical foundation to justify almost every sort of arrangement.

³² Ebersohn, above footnote 13 and Matthew S R Palmer "The Law Officers of the Crown and Departmental Lawyers" (papers presented to Legal Research Foundation Tax Avoidance Symposium, Auckland, April 2011).

³³ These examples are drawn from the paper presented by Harry Ebersohn.

(b) At paragraph [63]:

The removal of certain sections from the scope of s BG 1 means that tax planners will use those sections to obtain tax benefits. No business or self employed person would have to pay any income tax.

(c) At paragraph [22.3], describing a relatively commonplace arrangement in which a person is able to finance living expenses from capital receipts:

Uncommercial loans between associated parties with no repayment terms. The legal form requires the loan to be treated as a loan even though the borrower controls the lender and whether and when any repayment will be made. Such schemes have the added advantage for the taxpayer that he or she may be able to claim welfare benefits in the form of tax credits (i.e. working for families). Hence, the form over substance approach can make a successful business person a beneficiary.

(d) At paragraph [97]:

What some practitioners seek is the ability to reduce their client's tax obligations with more ease.

2.41 The Crown Law paper rejected the approach Justice Richardson had taken to construing the GAAR. The paper observes that "the approach [of Justice Richardson] has the advantage for tax avoiders of allowing tax driven arrangements, irrespective of the underlying economics thereof".³⁴

2.42 These warnings of dire consequences arising if Crown Law's wish for an unconstrained GAAR is not granted are, with respect, exaggerated. It is not the case that the absence of a GAAR, or the application of the decisions of Justice Richardson interpreting the GAAR, would leave the tax system defenceless against the "tax planners" and "business persons" referred to in Crown Law's paper. In particular:

(a) Many countries do not have a GAAR at all. And of those that do, most provide a greater level of certainty to taxpayers as to the scope of the GAAR, than is afforded to New Zealand taxpayers. Yet those other countries have not found themselves in the dire state suggested in the Crown Law paper.

(b) The examples Crown Law refers to (of "business persons" paying no income tax, or receiving welfare benefits) turn on choices the Government has made (or not made) in designing the tax system. For example:

(i) If capital gains are non-taxable and are not counted in determining eligibility for welfare benefits, then in some cases, business persons will not pay income tax, and may be eligible for those welfare benefits. If (as most would agree) that outcome is undesirable, the appropriate response is not more litigation on whether the situation amounts to tax avoidance, but rather a reconsideration of (for example) the eligibility criteria for the relevant welfare benefits.³⁵ Similarly, the non-inclusion of some forms of income in calculating entitlements under the Working for Families scheme enabled wider access to those entitlements than anticipated. The Government has recognised this, and has made changes to broaden the relevant meaning of income. For example, family scheme income, which is used to calculate the

³⁴ Ebersohn, above footnote 13, at [72].

³⁵ This has, for example, been recognised by the Government. See Inland Revenue and New Zealand Treasury *Social assistance integrity: defining family income - an officials' issues paper* (2010) at 9.

family scheme entitlement, now includes income from PIEs unless the PIE is a superannuation fund or a retirement savings scheme.³⁶

- (ii) If income earned by a company or trust is taxed at a lower rate than income earned by an individual, then that will incentivise self-employed taxpayers to operate through a company or trust, and for the company or trust to derive income that the individual would otherwise have derived. Again, if that is considered undesirable, the principled, efficient and effective response is not more tax avoidance disputes, but legislation either aligning the tax rates, or spelling out in what circumstances a self-employed person's income may be taxed at the company or trust rate.³⁷

2.43 In short, it is not credible to suggest, as the Crown Law paper does, that the GAAR is the peg on which the whole tax system rests. Nor is it correct to suggest that practitioners calling for greater certainty in the tax system are doing so in order to "reduce their client's tax obligations with more ease". A tax system does not need to be uncertain to be effective, efficient and fair. On the contrary, certainty is an important value which stakeholders in the tax system should strive for.

Why does certainty matter? Rule of law considerations

2.44 Reasonable certainty as to the meaning and application of the law is an important aspect of the rule of law. In general, the rule of law encompasses the view that the law should be clear, easily accessible, comprehensive, prospective rather than retrospective, and relatively stable.³⁸ Hon Murray Gleeson, then Chief Justice of the High Court of Australia, explained the importance of the ability of citizens to foresee how the law will affect them as follows:³⁹

In a liberal democracy, the idea of the rule of law is bound up with individual autonomy - the freedom to make choices. It is only if people know, in advance, the rules by which conduct is permitted or forbidden, and the rights and obligations that flow from their conduct, that they are free to set their personal goals and decide how to pursue them. That is the purpose of having law in the form of general rules, of reasonable clarity and certainty, capable of being known by people in advance of choosing to act in a certain way.

2.45 The Nobel laureate economist and political philosopher, Friedrich Hayek, similarly expressed the importance of certainty to the rule of law in this way:⁴⁰

Nothing distinguishes more clearly conditions in a free country from those in a country under arbitrary government than the observance in the former of the great principles known as the Rule of Law. Stripped of all technicalities, this means that government in all its actions is bound by rules fixed and announced beforehand - rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances and to plan one's individual affairs on the basis of this knowledge.

³⁶ Income Tax Act 2007, s MB 1(5). These changes were made in the Taxation (GST and Remedial Matters) Act 2010.

³⁷ Again, the Government recognised precisely this point, and as part of the Budget 2010 tax package aligned the top personal tax rate with the rate for trustee income, thereby going a considerable way to addressing the distortion that had arisen from the non-alignment of those tax rates from 2000 onwards.

³⁸ Joseph Raz "The Rule of Law and its Virtue" (1977) 93 Law Quarterly Review 195 at 198-202.

³⁹ Hon Murray Gleeson "A Core Value" (paper presented to the Annual Colloquium of the Judicial Conference of Australia, Canberra, October 2006).

⁴⁰ Friedrich August von Hayek *The Road to Serfdom* (1944).

- 2.46 These concerns about certainty are not just theoretical. Because the boundaries of the GAAR are so uncertain, there is a considerable chilling effect on economic transactions associated with its operation. This has two harmful consequences. The first is that people are prevented from taking action that would be permissible for fear that such actions will later be disallowed by the GAAR. Discouraging this kind of economic activity is a cost to the New Zealand economy. The second is that, given the level of uncertainty, those engaging in what should be ordinary transactions are forced to pay considerable sums of money to tax experts in order to determine the possible legal risks associated with the transaction. This increases the transaction costs associated with commercial activity, and thereby also harms New Zealand's economic wellbeing.
- 2.47 Inland Revenue has recently expressed interest in the quality of large businesses' governance arrangements in respect of tax risks. All businesses have limited resources and it is reasonable to assume that resources taken up by the need to deal with uncertain tax laws will diminish the resources available to manage and identify other risks, potentially with undesirable consequences for taxpayers and Inland Revenue. Again, this suggests that uncertainty is likely to be harmful to the tax system, and indeed the economy, as a whole.
- 2.48 Some academics have suggested that this uncertainty is not problematic, essentially on the basis that only those taxpayers who take risks have anything to fear. One commentator has argued that "[t]hose who sail too close to the wind should not complain if they get wet."⁴¹
- 2.49 There are at least three objections to this argument:
- (a) First, the way in which tax avoidance law has been developing in New Zealand is such that taxpayers are exposed to the risk that what today is regarded as perfectly acceptable - such as utilising a PIE to reduce tax - will in several years' time be regarded as objectionable.⁴² The Court of Appeal's decision in *Westpac Banking Corporation v CIR*⁴³ demonstrates that even within Inland Revenue, views can change over time; in that case, the taxpayer had obtained a binding ruling on one of its transactions from Inland Revenue's Rulings Unit, only to have the Corporates Unit (which to use the Court of Appeal's description, "were generally far more sceptical" and "took a more bullish (or perhaps aggressive) approach to the application (and scope) of s BG 1") seek to overturn the approach taken in the earlier binding ruling.
 - (b) Second, expanding the grey area of what is tax avoidance has the perverse outcome of favouring taxpayers who are willing to sail close to the wind, and take the chance that they will go undetected. The risk averse taxpayer is unlikely to enter the grey area, despite the possibility that a court may determine that tax avoidance had not occurred. In contrast, the taxpayer who is more sanguine about their chances of being detected, and, if detected, of Inland Revenue or a court disagreeing with the taxpayer, may take the risk. Those who take risks and emerge unscathed end off in a better position than those who are risk averse, which is hardly a desirable outcome.

⁴¹ Michael Littlewood "Tax Avoidance, the Rule of Law and the New Zealand Supreme Court" in Richard Ekins (ed) *Modern Challenges to the Rule of Law* (LexisNexis NZ, Wellington, 2011) 263 at 291.

⁴² To put it another way, and continue the sailing analogy, the direction of the wind can change and, when the boat's course was set some time ago, make a compliant taxpayer into a very wet sailor.

⁴³ *Westpac Banking Corporation v CIR*, above, footnote 29.

- (c) Third, uncertain laws (however laudable their objective) have significant costs. Sir Ivor Richardson, writing extra-judicially, commented that the difficulty with a freely invoked GAAR operating as a deterrent was that:⁴⁴

...too wide an area of uncertainty comes at a substantial price in terms of the effective functioning of the tax system. It may inhibit some desirable activity, damage relations between Inland Revenue and the general body of business taxpayers and tie up scarce resources while the parties skirmish.

Why does certainty matter? Economic considerations

- 2.50 In considering the importance of relatively certain and predictable tax laws it is also important to consider New Zealand's place in the world. As a small economy that remains heavily dependent on foreign money to finance both the Government and private sectors, New Zealand's viability depends on foreign investors choosing to invest here. Larger economies may be able to get away with having unusually uncertain tax laws, because investors are prepared to live with that uncertainty in order to access a large or rapidly growing market. New Zealand does not have that luxury.
- 2.51 Moreover, the Government is quite rightly supporting the development of industries which would help to diversify New Zealand's export base away from dependence on commodities, and which would attract talented individuals to New Zealand and boost local incomes. Two current examples are the film industry, and the Government's support for the development of a New Zealand funds domicile (the so-called "financial hub" initiative). Both of those examples involve (in very different contexts) the investment by foreign corporations of large sums of money in or through New Zealand and hence a high sensitivity to tax consequences. Accordingly, unless New Zealand has a reputation for certain and predictable tax laws, the perceived risk attaching to the investment of large sums in or through New Zealand may frustrate those initiatives.
- 2.52 The empirical evidence demonstrates that a significant amount of resources are being used to argue over whether an arrangement amounts to tax avoidance. It has been reported that:⁴⁵
- [o]ver the past decade, almost 20 per cent of all adjudication reports issued by Inland Revenue have involved tax avoidance as one of the grounds in dispute. Over the same period, nearly 30 per cent of all reported tax judgments have dealt with tax avoidance.
- 2.53 In this context, the most obvious conclusion to draw is that:⁴⁶
- the inherent uncertainty [of the GAAR] and the lack of judicial guidance has directly increased the administrative burden faced by both taxpayers and Inland Revenue.
- 2.54 From a purely fiscal perspective, a more certain tax system (and the advantages it will have in terms of New Zealand's international competitiveness) need not come at a cost to the Government tax-take. Our recommendations, in fact, say nothing about how much tax the Government should collect, but rather how it collects that tax. Our recommendations focus on ways in which the Government can protect the tax system against abusive practices while maintaining a tax system with a reputation for certainty

⁴⁴ "Countering Tax Avoidance" (2004) 10(4) *New Zealand Journal of Taxation Law and Policy* 301 at 304. See also Robert McLeod "An Economic Approach to Taxation Avoidance" (1996) 2(4) *New Zealand Journal of Taxation Law and Policy* 171, and "Tax Avoidance Revisited" (2000) 6(4) *New Zealand Journal of Taxation Law and Policy* 103.

⁴⁵ Keating and Keating, above footnote 3, at 115-116.

⁴⁶ *Ibid* at 138.

and predictability. The case study in the next section of this report demonstrates that the GAAR is in many respects the ambulance at the bottom of the cliff, and that cases of perceived tax avoidance can and should be addressed in a more constructive way.

3. A CASE STUDY

The context: personal service companies

- 3.1 Prior to 2000, New Zealand had a top personal tax rate, corporate tax rate, and trustee tax rate of 33%. On 1 April 2000, the top personal marginal tax rate increased to 39%. This created a six percentage point gap between the top personal tax rate and the tax rate for trustee income and for company income. In the case of company income, that differential increased to nine percentage points when the corporate income tax rate reduced to 30%, effective from the 2008/09 income year.
- 3.2 One consequence of this is the capacity for people to reduce the marginal tax rate at which income is taxed by directing income to a company or a trust rather than to an individual. In the case of a trust, this income can then be directed to the trust's beneficiaries, who are taxed at their marginal rate, which is not necessarily the top personal income tax rate. Alternatively, it can be retained as trustee income. In the case of a company, dividends can be deferred.
- 3.3 Carrying on a small business (including one that derives most of its income from the efforts of the owner) through a company is very common in the case of family-run businesses in New Zealand. And it is likewise common for individuals to hold their wealth (including businesses they operate) through a family trust. Inland Revenue has highlighted this phenomenon in the last two briefings to the incoming Minister.⁴⁷ They expressed their view that:⁴⁸

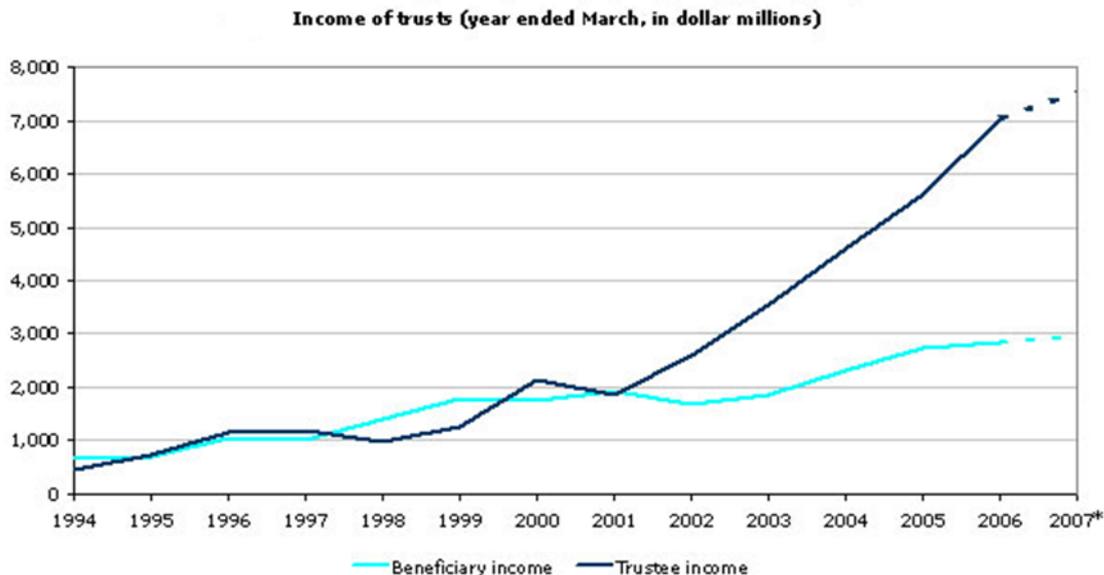
... there are considerable differences between the tax treatments of sheltered forms of income. For example, an individual can set up a company which derives business income. If the individual earns income through the company, this will be taxed at the company rate of 30 percent so long as it is retained in the company. It will be subject to a wash-up tax on distribution and taxed at the individual's marginal rate so long as shares are held directly. If the individual is on a 39 percent rate and all income is distributed, income would end up being fully taxed at the 39 percent rate. For this person there may be little tax sheltering benefit from using the company if most of the profits are distributed soon after they are earned by the company to finance personal consumption.

However, there are more tax-efficient options. If, instead, a trust is interposed between the individual and the company so the shares in the company are held by the trust in which the individual is a beneficiary, the company's profits will once more be taxed at 30 percent so long as they are retained in the company and not distributed. On distribution to the trust, however, these can be taxed as trustee income at a final tax rate of 33 percent. In this case, if all income were distributed to the trust, the company's income would end up being taxed at a 33 percent tax rate. Trusts are increasingly being used in this way not only to avoid the top marginal tax rate but also to avoid the higher effective marginal tax rates brought about by other social policy measures.

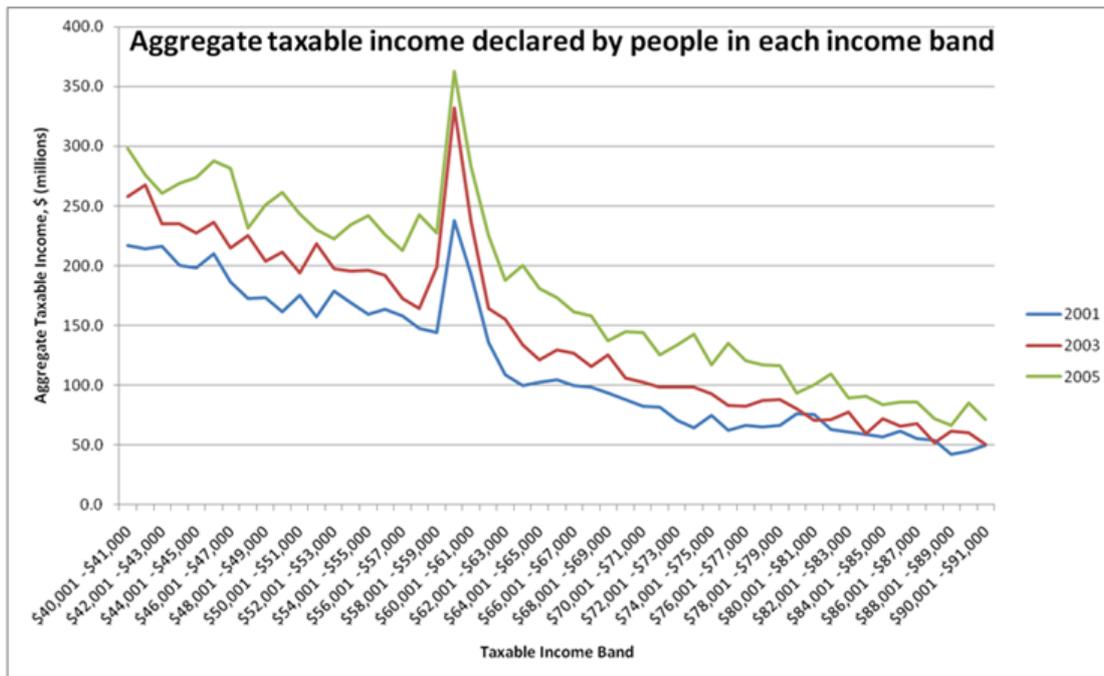
- 3.4 The widespread use of trusts in accordance with Inland Revenue's concerns is demonstrated by the graph below, which demonstrates a significant increase in the amount of trustee income, for which the tax rate from 1 April 2000 was lower than the top personal income tax rate.

⁴⁷ Inland Revenue *Briefing for the Incoming Minister of Revenue – 2008* (2008) and Inland Revenue *Briefing for the Incoming Minister of Revenue - 2005* (2005).

⁴⁸ Inland Revenue *Briefing for the Incoming Minister of Revenue - 2008* (2008) at 40.



3.5 Inland Revenue similarly warned that "with varying marginal tax rates and a company or trustee tax rate below the top personal marginal tax rate there will be incentives to split and shelter income."⁴⁹ Inland Revenue presented the data shown in the graph below, which indicated the effect the differential tax rates were having on personal income. The graph shows that from as early as 2001 (one year after the increase in personal tax rates) there was a significant spike in income earned in the income bands at the level at which the new 39% tax rate began to apply (\$60,000 at the time). Thus it was clear that the tax rate structure was driving the level of income paid to and declared by a significant number of individual taxpayers:



⁴⁹ Inland Revenue *Briefing for the Incoming Minister of Revenue - 2005* (2005) at 31.

Parliament's response

3.6 At the time that the top marginal tax rate was increased to 39 per cent, the differential between the top personal tax rate and the company rate was seen as an obvious "loophole" given the ease with which income from personal services can be derived through a company. A member of the Opposition explained the issue succinctly:⁵⁰

David Carter: It is easy to avoid paying that tax, and I will spend a minute or so advising the House - not that I claim to be a chartered accountant, I might say - and telling people just how easy it will be to dodge this tax. The first thing people can do is corporatise. ... The Institute of Chartered Accountants told Dr Cullen it will happen - and it will, mark my words. The plumber can simply form a company, and that company will then be taxed at 33c in the dollar and thus avoid paying 39c in the dollar.

Hon Dr Michael Cullen: That loophole will be closed very easily.

3.7 It is worth considering the closing of the loophole that Hon Dr Cullen was presumably referencing. The personal services attribution rules target quasi-employment relationships, where the employee interposes a company between themselves and the employer. The rules operate so as to attribute income earned by an entity to a working person where:⁵¹

- (a) a buyer purchases services from the entity, and the services are personally performed by the working person;
- (b) the working person is associated with the entity;
- (c) 80% of the entity's income from personal services is derived from the sale of services to the buyer, and those services are performed by the working person;
- (d) the working person's income, assuming attribution, would be more than \$70,000. (This coincides with the income level at which the highest marginal tax rate begins to apply; previously this amount was \$60,000); and
- (e) provided that substantial business assets are not a necessary part of the business structure used to derive the income.

3.8 For example, the rules would prohibit an information technology specialist who works for one company interposing a company between himself and his employer to reduce his marginal tax rate. No rules to target those who had income from many sources (eg many builders, plumbers or surgeons) were implemented.

3.9 It is hard to argue that arrangements involving the use of a company and a family trust were highly unusual or contrived. As indicated earlier, the Policy Advice Division of Inland Revenue has often advocated rate alignment of the top personal income tax rate, the corporate income tax rate, and the trustee tax rate in order to combat such arrangements. In the briefing to the incoming Minister of Revenue, Inland Revenue warned that companies and trusts were being used to shelter income.⁵²

The use of a trust owning a trading company has become much more common recently, in which case the 33% company tax is often effectively a final tax, even

⁵⁰ David Carter (22 December 1999) 581 NZPD 152.

⁵¹ Income Tax Act 2007, s GB 27.

⁵² Inland Revenue, above footnote 49, at 30.

though the beneficiaries of the trust may be taxed at a rate of 39%. Other assets are also frequently placed in a trust.⁵³ If the assets are income-earning (for example, as business premises can be) a 33% maximum tax rate is often achieved. Less commonly, but prevalent in some parts of rural New Zealand, trading trusts are being used for active business and achieve the same effect.

- 3.10 They issued the same warning in their next briefing to the incoming Minister:⁵⁴

Policy pressures also arise because individuals are able to shelter personal income from higher effective marginal rates using companies, trusts, portfolio investment entities (PIEs) and other savings vehicles. This can erode confidence in the fairness of the tax system and undermine voluntary compliance.

- 3.11 They have advocated this primarily because of concerns that there was widespread tax planning which enabled individuals to reduce their effective marginal tax rate.

Inland Revenue applies the GAAR to personal services companies: the *Penny and Hooper* litigation

- 3.12 Each of Mr Penny and Mr Hooper had been receiving income and having it taxed at the personal income tax rate. Mr Penny, prior to the tax changes implemented in 2000, incorporated a company, the shares of which were owned by a family trust. The company then employed Mr Penny. Mr Hooper adopted essentially the same structure, although a small fraction of the shares were retained by him and his wife.

- 3.13 Because the salary paid to each of Mr Penny and Mr Hooper was less than the total income of the company in each case, the company paid income tax on the income at the corporate tax rate, which was lower than the top marginal personal income tax rate. Fully-imputed dividends were then paid to the family trusts, and a distribution was made to beneficiaries or the dividends were retained as trustee income. This had the effect of lowering the overall tax paid on the income in comparison to how much tax could have been paid if the income had been received directly by each of Mr Penny and Mr Hooper. Inland Revenue regarded each of these arrangements as tax avoidance arrangements, and litigation between the parties ensued.

- 3.14 At first instance, Mr Penny and Mr Hooper succeeded.⁵⁵ This decision was reversed by a majority in the Court of Appeal.⁵⁶ On appeal, the Supreme Court upheld the decision of the Court of Appeal that the arrangement amounted to tax avoidance.

- 3.15 *Penny and Hooper* proceeded through the courts after the Supreme Court had set out its views on tax avoidance in *Ben Nevis*. In broad terms, the Supreme Court adopted a two-step test for tax avoidance. The first question is whether the arrangement meets the specific provisions in the income tax legislation. The second question is whether, when viewed in the light of the totality of the arrangement, the arrangement was within the contemplation of Parliament.

- 3.16 Considering that the so-called loophole was explained to Parliament during the course of debate, that Parliament failed to directly legislate against the arrangements adopted in *Penny and Hooper*, and that the incoming Minister was made well aware of what the Policy Advice Division of Inland Revenue regarded as a problem requiring a legislative solution, it seems both unfair and inconsistent that Inland Revenue invoked the GAAR to disallow the arrangement. It is also of concern that, prior to the *Penny and Hooper*

⁵³ Asset protection can also be a non-tax reason for using trusts.

⁵⁴ Inland Revenue, above footnote 48, at 36.

⁵⁵ *Penny v CIR* [2009] 3 NZLR 523.

⁵⁶ *CIR v Penny* [2010] NZCA 231.

litigation, Inland Revenue did not issue any form of policy statement suggesting that arrangements of that kind were tax avoidance arrangements. Such an approach puts many taxpayers who believe they are following the law at risk of having their legitimate expectations dashed, with consequences for taxpayer perceptions of the integrity of the tax system.

- 3.17 In the aftermath of the Court of Appeal's majority decision in *Penny and Hooper*, Inland Revenue issued a warning to all taxpayers.⁵⁷ The Revenue Alert informed taxpayers that.⁵⁸

The recent Court of Appeal decision in *CIR v Penny & Hooper* confirms that an important part of the scheme of the income tax legislation is that **income substantially generated** by the direct personal skills, experience or labour of an individual **should be subject to tax in the hands of that individual**. That tax result applies to any type of services provided by an individual to third parties.

Where a service business relies **mainly** on an individual's personal skills to generate income, that contribution to the business should be properly reflected in the income returned by that individual - either through an appropriate salary or other taxable distributions to the individual.

[Emphasis added]

- 3.18 Justice Randerson expressed concern about the consequences of finding against Mr Penny and Mr Hooper, indicating that he thought it:⁵⁹

... important to recognise, however, that this decision should not be regarded as establishing a principle that salary levels in family companies which are below the levels which could be expected in an arms-length situation, are necessarily to be regarded, without more, as evidence of a tax avoidance arrangement.

- 3.19 Considering that the Court was unwilling to accept a requirement for market salaries as a general principle, it raises the issue of when the payment of a salary below levels expected in an arms-length situation would be tax avoidance. Justice Randerson was unwilling to supply a further yardstick, (other than indicating that the case was different from a handful of examples, which his Honour presumably thought would not amount to tax avoidance), instead laying responsibility with the Commissioner, stating:⁶⁰

Where there are legitimate reasons ... for adopting a salary markedly below commercial levels, a challenge by the Commissioner may be unlikely to succeed. Nor would I expect the Commissioner to interfere in marginal circumstances.

- 3.20 Whether a particular case involves "marginal circumstances" is of course entirely subjective. If the Government were to seek to enact a statutory provision by which the extent of a person's liability for tax depended on Inland Revenue's opinion on whether a situation involved "marginal circumstances" there would be considerable opposition to such a vague law, and to a person's tax liability depending on Inland Revenue's discretion. Yet that is the consequence of the GAAR as it is currently operating. Further, for a court to caution Inland Revenue not to invoke the GAAR in "marginal circumstances" indicates a degree of discomfort on the part of the Judges regarding Inland Revenue's powers, and how those powers may be exercised.

⁵⁷ Inland Revenue, Revenue Alert 10/01.

⁵⁸ Ibid.

⁵⁹ *CIR v Penny*, above footnote 56, at [125].

⁶⁰ Ibid at [126].

3.21 In much the same way as the Court of Appeal had, the Supreme Court provided some examples of when it may be acceptable to pay a commercially unrealistic salary,⁶¹ but failed to provide or elucidate a clear test for when an arrangement was within or beyond "Parliamentary contemplation". Taxpayers are not in a clearer position as to when an arrangement will constitute tax avoidance, and it seems likely, therefore, that tax avoidance cases (including those arising from the personal services income fact scenario addressed in *Penny and Hooper*) will continue to be the subject of litigation.

3.22 Following the Supreme Court's decision, Inland Revenue released a further Revenue Alert on the issues arising in the *Penny and Hooper* cases. That Revenue Alert attempted to provide some indication of cases that Inland Revenue would regard as marginal, and not worthy of litigating, but nonetheless does not provide a principled basis for distinguishing acceptable from unacceptable tax planning in this context.⁶²

Th[e] decision confirms that income **substantially** generated by the direct personal skills, experience or labour of an individual should **generally** be subject to tax in the hands of that individual. The individual's contribution to the business should be **properly** reflected in the income returned by that individual - either through an **appropriate** salary or other taxable distributions to the individual.

[Emphasis added]

3.23 Having set out a variety of factors that Inland Revenue will assess in similar cases, the Revenue Alert then indicated that:⁶³

In certain circumstances, notwithstanding that all or most of the above factors may be present, the arrangement will still not constitute tax avoidance. This is because there are legitimate reasons both for adopting particular business structures (such as asset protection, limited liability and business continuity). Businesses can also legitimately make decisions about whether or not, or the extent to which, profits are to be retained or distributed, for example.

3.24 Looked at from the Government's perspective, the final outcome in *Penny and Hooper* is far from optimal. The circumstances in which taxpayers can derive income through a company or trust (potentially taxed at a lower rate) where the income depends substantially on the personal efforts of the individuals remains unclear. It is likely that the Government's fiscal position would have been better served by legislated rules, enacted at the time the top personal tax rate was increased in 2000, or in 2001 or 2002, by which time it was obvious that there was widespread use of companies and trusts to shelter personal services income, in response to the 2000 tax increases and consequent non-alignment of tax rates. Instead, the circumstances in which income derived from performing personal services can be taxed otherwise than at the individual tax rate will remain subject to future disputes on a case by case basis.

Where to now?

3.25 The authors of this report are concerned that we may continue to see cases reaching the courts involving allegations of tax avoidance, in circumstances where the relevant tax benefit arises from taxpayers doing no more than exercising a choice afforded by the tax laws. Many other cases will never reach the courts because taxpayers, facing a lengthy and costly dispute process, may concede the case to avoid the cost and the business and personal disruption associated with disputing Inland Revenue's position. It is not clear on what principled basis some of these cases are regarded as involving tax

⁶¹ *Penny and Hooper v CIR* [2011] NZSC 95 at [34].

⁶² Inland Revenue, Revenue Alert 11/02.

⁶³ *Ibid.*

avoidance when other examples of structuring to achieve a tax advantage (see paragraph 2.16 above) are unchallenged.

- 3.26 Examples include Inland Revenue relying on the GAAR to argue that a taxpayer who is party to a hybrid financial instrument (that is, one carrying both debt and equity characteristics) but that is debt for legal and tax purposes, should be denied the tax consequences associated with that instrument being a debt instrument, because of its hybrid features. It is submitted that the more principled way to deal with this concern is to consider the definitions of debt and equity for tax purposes, and/or the tax consequences of an instrument being a debt or equity instrument, as applicable.
- 3.27 As Judges and academics have long recognised, a given commercial transaction can often be implemented in a number of ways, and if the tax legislation provides that one way involves a lower tax burden than another way, taxpayers will naturally prefer the transaction involving the lower tax burden. That is why it is unrealistic and unworkable to expect the GAAR to fill in gaps in tax policy and tax legislation. The GAAR must be there to address artificial schemes which could never have been anticipated in the tax policy design, but not to address the mainstream.

4. RECOMMENDATIONS ONE AND TWO: LEGISLATIVE REFORM

Possibility of learning from other jurisdictions

- 4.1 Given that the Supreme Court has expressly declined to provide guidance as to the proper boundaries of the GAAR, we have considered whether legislative amendments might be a means of providing that guidance. We have considered various international precedents, and have appended to this report a summary of the GAARs used by some other jurisdictions. It will be noted that New Zealand's GAAR has not kept up with the more sophisticated provisions in force in other jurisdictions.
- 4.2 A particular shortcoming of New Zealand's GAAR is that it does not contain any indicia or other standard for distinguishing between tax planning which does not infringe the GAAR, and tax planning which does. It has accordingly been left to Inland Revenue and the courts to read glosses onto the GAAR, in order to provide some rational basis for distinguishing between cases where the GAAR does, and cases where it does not, apply. Inland Revenue's reluctance to provide examples of how the GAAR applies exacerbates this shortcoming in the statutory text of the GAAR.
- 4.3 Australian officials have themselves commented on this. A former Commissioner of the Australian Tax Office, has indicated that New Zealand's current GAAR was considered as a possible model, but not considered adequate, when Australia was considering the adoption of its current GAAR:⁶⁴

In the course of the OECD process the New Zealand experience was mentioned. In that country, there had long been a sister provision to Australia's section 260, section 108. In 1974 after a process extending over a number of years that section was replaced by a new provision, section 99. In our work on the transformation of section 260 to Part IVA we had considered the New Zealand approach and concluded that it might not adequately address the deficiencies which Australian courts had found to exist in section 260.

- 4.4 Similarly, the current Australian Tax Commissioner, Michael D'Ascenzo, has expressed the following view:⁶⁵

These reference points arguably **provide a more certain** basis than is available in other jurisdictions as to when the General Anti-Avoidance Rule (GAAR) is likely to be applied, or, in jurisdictions which do not have a GAAR, as to when the courts will intervene on the basis of judicial doctrines that have been developed in those jurisdictions to counter tax avoidance.

[Emphasis added]

- 4.5 Further, almost 20 years ago, the Valabh Committee advised in their Final Report on The Taxation of Income from Capital⁶⁶ that the GAAR required a legislative change in order to provide greater certainty. In particular, they developed a set of indicia that could be used to determine whether a particular tax arrangement was avoidance. As the Appendix to this report indicates, other countries have taken this approach, but New Zealand has not as yet done so.

⁶⁴ Trevor Boucher *Blatant, Artificial and Contrived: Tax Schemes of the 70s and 80s* (Australian Taxation Office, Canberra, 2010) at 371.

⁶⁵ Michael D'Ascenzo *A practical guide on Part IVA* (paper presented to the 15th National Convention of the Taxation Institute of Australia, Sydney, March 2001).

⁶⁶ Valabh Committee Final Report of the Consultative Committee on the Taxation of Income from Capital (October 1992) at 27.

Two specific areas for reform

- 4.6 We have identified two particular aspects of the GAAR which call for reform, which we expand on in the remainder of this section of this report:
- (a) The first is to clarify that in cases where the GAAR applies, it is necessary for Inland Revenue and the courts to identify the particular tax advantage resulting from tax avoidance, and that only that tax advantage would be overridden by the GAAR, not other tax consequences of the arrangement that do not result in tax avoidance. An amendment to this effect is remedial in nature, and should be capable of being addressed in the short term.
 - (b) The second is to conduct a review of international precedents to ascertain whether New Zealand's GAAR reflects international best practice. In particular, GAARs in most other jurisdictions provide some criteria (in the form of a list of factors or other indicia) for distinguishing legitimate tax planning from impermissible tax avoidance. This aspect of possible reform is more substantial, and represents a longer term objective.

Recommendation one: require Inland Revenue to identify the particular tax advantage to be counteracted

- 4.7 It is a particular feature of the New Zealand GAAR that the Commissioner's powers of reconstruction appear to have little or no statutory constraint. Dealing first with **what** he can adjust, the general rule enables the Commissioner to reconstruct anything "... from or under the arrangement"⁶⁷ which given the breadth of the statutory definition of "arrangement" means every part of a tax avoidance transaction.
- 4.8 In examining **how** he should apply this power, the section simply states that he has a discretionary power to adjust the arrangement "in a way the Commissioner thinks appropriate, in order to counteract a tax advantage...". The courts acknowledge that this is "a wide reconstructive power",⁶⁸ and "... it must be potentially difficult to interfere with the Commissioner's exercise of his discretion under [section GA 1(2)], for what is involved is the exercise of a discretion."⁶⁹
- 4.9 The term "tax advantage" is not defined for the purposes of sections BG 1 and GA 1. Prior to the passage of the Taxation (Core Provisions) Act 1996, which reorganised the layout and revised the drafting style of the Income Tax Act but did not intend to create any change in law,⁷⁰ the operation of the reconstruction provisions made it clear that the reconstruction allowed only the impugned tax benefit to be counteracted, and not the whole arrangement. Section BB 9 provided that:

Every arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the Commissioner for income tax purposes if **and to the extent that**, directly or indirectly,—

- (a) Its purpose or effect is tax avoidance; or
- (b) Where it has 2 or more purposes or effects, one of its purposes or effects (not being a merely incidental purpose or effect) is tax avoidance, whether or not any other or others of its purposes or

⁶⁷ Income Tax Act 2007, s GA 1(2).

⁶⁸ *Miller v CIR* [1999] 1 NZLR 275.

⁶⁹ *Peterson v CIR* (No 2) (2002) 20 NZTC 17,761 at [70] per Justice Hammond.

⁷⁰ Finance and Expenditure Select Committee "Report on the Taxation (Core Provisions) Bill" pages i - iii.

effects relate to, or are referable to, ordinary business or family dealings,—

whether or not any person affected by that arrangement is a party to it.

[Emphasis added]

4.10 And section GB 1(1) provided:

Where an arrangement is void in accordance with section BB 9, the assessable income of any person affected by that arrangement **shall be adjusted** in such manner as the Commissioner considers appropriate **so as to counteract any tax advantage** obtained by that person from or under that arrangement, and, without limiting the generality of the preceding provisions of this subsection, the Commissioner may have regard to such income as, in the Commissioner's opinion, either-

- (a) That person would have, or might be expected to have, or would in all likelihood have, derived if that arrangement had not been made or entered into; or
- (b) That person would have derived if that person had been entitled to the benefit of all income, or of such part of the income as the Commissioner considers proper, derived by any other person or persons as a result of that arrangement.

[Emphasis added]

4.11 Unfortunately, the legislation was inadvertently changed during the rewrite process, and no longer is it clear that adjustments should only be made to counteract the product of the relevant tax avoidance. A good example of the effect that this unintended legislative change has had is the reconstruction which occurred in *Westpac Banking Corporation v CIR*.⁷¹ Although the case examined many aspects of the transactions entered into by Westpac, Justice Harrison stated that:⁷²

The real issue at the heart of the tax avoidance inquiry is whether it was permissible for the bank to have paid and claimed a deduction for the GPFs

4.12 The GPFs were guarantee procurement fees. They formed the basis of the claim that tax avoidance had occurred, as indicated at [341]:

The Commissioner's specific challenge relates to the GPF's legitimacy: but for the GPF, it is unlikely he would have questioned these transactions.

4.13 On reconstruction, however, **all** deductions relating to the transactions were disallowed:

The Commissioner has elected to counteract Westpac's tax advantage by disallowing all deductions relating to a transaction – that is, the cost of funds, the swap losses and the GPF.

4.14 Justice Harrison upheld this approach on the basis that:⁷³

[The Commissioner] is not under any further duty to determine precisely what constitutes the tax avoidance or identify a particular aspect giving rise to a tax advantage. To the extent that he may be under such an obligation, the Commissioner's reassessment manifests his satisfaction that the tax

⁷¹ *Westpac Banking Corporation v CIR* (2009) 24 NZTC 23,834.

⁷² *Ibid* at [14].

⁷³ *Ibid* at [639] and [641].

advantages he counteracts are the same as those identified by Mr Mataira – the deductions for funding costs including swap losses and the GPF.

...

the Commissioner is not bound to isolate out and counteract only particular elements giving rise to a tax advantage.

- 4.15 The consequence of this approach is that the consequences for the taxpayer (in terms of disallowance of the claimed tax consequences) may be entirely disproportionate to the extent of the alleged tax avoidance. The courts have indicated that they will be reluctant to intervene to provide a remedy in such cases. This was made clear in the *Ben Nevis* decision, with the Supreme Court saying:⁷⁴

Furthermore, when taxpayers challenge an assessment based on a reconstruction adopted by the Commissioner, the onus is on them to demonstrate, not only that the reconstruction was wrong, but also by how much it was wrong. Unless the taxpayer can demonstrate with reasonable clarity what the correct reconstruction ought to be, the Commissioner's assessment based on his reconstruction must stand. This is settled law.

- 4.16 It is clear that the unintended legislative change is giving the Commissioner the power to go further than counteracting the actual tax advantage gained. The broad scope of the New Zealand Commissioner's powers to adjust taxable income "... in a way the Commissioner thinks appropriate" may be contrasted with the powers in the Canadian context, which enable the tax consequences to be determined "*as is reasonable in the circumstances*"⁷⁵ or in South Africa "... the Commissioner must make compensating adjustments that he or she is satisfied are *necessary and appropriate to ensure the consistent treatment of all parties* to the impermissible avoidance arrangement".⁷⁶
- 4.17 We recommend that section GA 1 be amended to clarify that the tax advantage to be counteracted by Inland Revenue must be commensurate with the relevant tax avoidance. Such an amendment would reinstate the law that applied prior to the inadvertent changes effected during the rewrite process, by ensuring that the tax consequences of an arrangement can be adjusted under the GAAR only to the extent of the relevant tax avoidance. Such an amendment is necessary to ensure that Inland Revenue's reconstruction power does not confer on Inland Revenue a discretion to override tax consequences not resulting from the relevant tax avoidance.

Recommendation two: review international precedents to determine whether New Zealand's GAAR reflects international best practice

- 4.18 As already noted, the New Zealand courts have long observed that the New Zealand GAAR cannot be read literally. This in itself is unsatisfactory, because it leaves the true scope of the relevant provision to be determined according to the value judgements of unelected public servants and Judges, and not through the legislative process which is the appropriate forum for balancing competing values and objectives. The particular issue is that the New Zealand GAAR, in contrast to GAARs in most comparable jurisdictions, contains no legislated criteria for distinguishing acceptable tax planning from tax avoidance to which the GAAR applies.
- 4.19 Different GAARs use different approaches to distinguishing permissible from impermissible tax planning. Many, however, rely to some extent on the notion that a GAAR's role is to target the misuse or abuse of specific provisions in the tax legislation.

⁷⁴ *Ben Nevis v CIR* [2008] NZSC 115 at [171].

⁷⁵ Income tax Act 1985 (Canada), section 245(2).

⁷⁶ Income and Tax Act 1962 (South Africa), section 80B(2).

- 4.20 Under the Canadian GAAR for example, a three-step analysis is undertaken to determine whether tax avoidance has taken place. First, there must be a tax benefit arising from the arrangement. Second, this arrangement must not be entered into "for bona fide purposes other than to obtain the tax benefit". Third, the avoidance arrangement must misuse or abuse the specific provisions when read as a whole. Such an approach targets those arrangements which misuse or abuse specific provisions, rather than those that utilise choices extended to taxpayers by Parliament that are apparent to Parliament when passing income tax legislation.
- 4.21 For example, the Canadian GAAR would provide a statutory basis for reaching the conclusion (about which there is seemingly a consensus in New Zealand) that a taxpayer who withdraws money from a call account and invests it in a managed fund that qualifies as a PIE is not committing tax avoidance. New Zealand's existing GAAR (which looks solely to the "purpose or effect" of an arrangement) is difficult to apply in cases, like the cash PIE referred to above, where entering into the arrangement can only be explained by reference to the tax benefits sought, yet where a conclusion that the GAAR would apply would seem perverse given that it must have seemed obvious that the tax advantages conferred on PIEs would cause taxpayers to substitute investment via a PIE for investment in a non-PIE form.
- 4.22 We would also note that a legislative amendment clarifying that the GAAR is intended to address cases of "misuse or abuse" of the specific provisions is not too far removed from the approach the Supreme Court has taken already in the leading decision in *Ben Nevis*. There, the Court relied in part on the notion of misuse of the specific provisions of the tax legislation (albeit using the term "deployed" rather than "used"):⁷⁷
- Parliament must have envisaged that the **way a specific provision was deployed** would, in some circumstances, cross the line and turn what might otherwise have been a permissible arrangement into a tax avoidance arrangement. Ascertaining when that will be so should be firmly grounded in the statutory language of the provisions themselves.
- [Emphasis added]
- 4.23 We do not at this stage recommend particular amendments to the GAAR to address the lack of legislative criteria for distinguishing permissible from impermissible tax planning. But we do recommend that there be a review of international precedents to ascertain whether New Zealand's GAAR reflects international best practice, and in particular, of the criteria found in GAARs in most other jurisdictions for distinguishing legitimate tax planning from impermissible tax avoidance.

⁷⁷ *Ben Nevis v CIR* [2008] NZSC 115 at [104].

5. RECOMMENDATIONS THREE, FOUR AND FIVE: REFORMS TO INLAND REVENUE'S PROCESSES CONCERNING THE APPLICATION OF THE GAAR

Overview

- 5.1 In this section we outline three additional proposals that we consider could lead to greater consistency, and less uncertainty concerning the application of the GAAR in New Zealand:
- (a) Inland Revenue should, as a matter of priority, finalise its interpretation statement on the application of the GAAR, and should provide examples illustrating when the GAAR will and will not, apply. In addition, Inland Revenue should consider publishing Adjudication Reports in redacted form.
 - (b) A panel comprising both Inland Revenue personnel and private sector representatives should be formed to make non-binding recommendations to Inland Revenue concerning tax avoidance cases.
 - (c) Introducing a formal internal escalation process within Inland Revenue where tax avoidance is alleged against a taxpayer, including a full disclosure of the process to the taxpayer so they are aware of their options.

Recommendation three: publish an Interpretation Statement on the application of the GAAR, and consider publication of Adjudication Reports in redacted form

- 5.2 Section 2 of this report has highlighted the lack of general Inland Revenue guidance concerning the GAAR. For the reasons given there, we consider that Inland Revenue, in consultation with Crown Law, should finalise its Interpretation Statement on the GAAR as a matter of urgency, and the Interpretation Statement should be adhered to by Inland Revenue and Crown Law.
- 5.3 That statement should include examples. Examples are critical in order for guidance on the application of the GAAR to be meaningful. Absent examples, it is difficult for taxpayers to know **why** Inland Revenue considers a particular arrangement to be subject to the GAAR. Further, only by including examples in respect of which the GAAR is considered not to apply will a written statement by Inland Revenue provide meaningful assurance to taxpayers that Inland Revenue will act consistently.
- 5.4 In addition, we believe a strong case can be made for publishing Adjudication Reports in a redacted form preserving anonymity of the taxpayer. While there would be some cost involved in doing so, we consider that this would be significantly outweighed by the economic benefits of greater certainty to taxpayers of understanding how Inland Revenue is likely to treat their situation.

Recommendation four: an advisory panel to assist Inland Revenue decision-making

Precedent for private sector input in regulatory decision-making

- 5.5 New Zealand currently recognises the importance of independent input into the tax system, with the Rewrite Advisory Panel being chaired by an independent person and benefiting from representation by the New Zealand Institute of Chartered Accountants and the New Zealand Law Society. In that context, the independent input provides some reassurance to taxpayers that submissions to that particular panel (which examines the desirability of remedial legislative amendments) will be considered in a principled way, and not merely from a revenue-protective viewpoint.

- 5.6 In addition, other regulatory bodies benefit from private sector expertise. For example the board of the Financial Markets Authority and the Takeovers Panel each include members who are not full time employees of the regulator, and can therefore contribute to deliberations with the benefit of current experience of developments affecting private sector market participants. Similarly, the NZ Markets Disciplinary Tribunal is made up of at least two practising barristers and solicitors, two market participants, and two company directors.

Panel to consider tax avoidance allegations in New Zealand

- 5.7 We believe that the tax system would similarly benefit from the establishment of a panel to consider cases where tax avoidance is alleged by Inland Revenue. Cases where tax avoidance is alleged often turn on the extent to which the business structure used in the impugned arrangement is consistent with commercial norms, as distinct from being artificial, contrived, and uncommercial. Private sector input should be of assistance to Inland Revenue in applying that distinction.
- 5.8 In the New Zealand context, we believe that it would be appropriate for the panel to support, and make recommendations to, Inland Revenue's Adjudication function. To the extent that tax avoidance is not alleged by Inland Revenue, then the adjudication process would operate as normal. To the extent that multiple tax issues existed, then the panel would consider only the question of tax avoidance. The remaining issues would be considered as part of the normal adjudication process.
- 5.9 As to specifics, we recommend that:
- (a) The panel should be comprised of two senior Inland Revenue officials and three independent experts. Suitable Inland Revenue personnel could include the Chief Tax Counsel and the head of the Policy Advice Division. The three independent experts could include a representative from each of NZICA and the New Zealand Law Society, and a person with more general commercial expertise (ie, not necessarily a tax specialist) appointed by the other members of the panel. We recommend that the Chair of the panel be independent from Inland Revenue.
 - (b) All arrangements that proceed through the disputes process with tax avoidance as an element at the statement of position stage would be required to be considered by the panel, unless Inland Revenue and the Chair of the panel determine that the case involves issues substantially similar to issues previously considered by the panel, or the taxpayer does not wish for the dispute to be considered by the panel.
 - (c) The panel would make its recommendation based on the statements of position submitted to the Adjudication Unit (including any exhibits, such as valuation or other expert reports) and (if the panel considers it appropriate) oral submissions supplementing the statements of position. Therefore the panel would not add to the already extensive written materials each party is required to prepare as part of the tax disputes process.
 - (d) To ensure transparency and confidence in the process, each party should be permitted to be present when the other is making its oral submissions.
 - (e) After hearing from the parties, the panel would prepare a written report to Inland Revenue. This report would not only canvass and come to a conclusion as to the application of the GAAR, but should consider the imposition of penalties where relevant. The recommendations would be non-binding.

- (f) Consideration should be given to permitting the report to be published in a form that does not identify the taxpayer. (Such an approach is presently adopted in the case of taxpayer-specific Determinations.) In addition, whether Inland Revenue accepts or rejects a recommendation should also be published.

5.10 While not binding, a recommendation by the panel should be of value to the taxpayer in question and taxpayers generally because:

- (a) the report could be referred to by the taxpayer in settlement negotiations and should be relevant at least to the question of penalties in any subsequent litigation;
- (b) although in theory Inland Revenue may reject all recommendations in favour of the taxpayer, the publication of recommendations should allow scrutiny of Inland Revenue's decision-making.

Recommendation five: escalation process for when tax avoidance alleged

Current process

5.11 The seriousness of a tax avoidance allegation is such that it is important that Inland Revenue has clear internal processes in place, which must be followed where an investigator believes that tax avoidance applies. We were concerned to discover as part of the process of preparing this report that Inland Revenue has no formal internal process in place that must be followed when tax avoidance is considered to apply. Rather, an informal "sign-off" process exists by way of the delegations that exist within Inland Revenue's organisational structure.

5.12 The current process as we understand it is:

- (a) A submission from an Inland Revenue investigator setting out the facts of the case in detail is required, along with an internal legal opinion. Usually a draft Notice of Proposed Adjustment ("**NOPA**") will be provided for consideration. This will incorporate the facts and Inland Revenue's legal analysis.
- (i) The draft NOPA will have been subjected to Inland Revenue's Core Task Assurance process (to ensure procedural matters are signed off and that the NOPA is legally consistent with Inland Revenue's view of the relevant tax issues).
- (ii) The draft NOPA will have also been reviewed by a member of the Legal and Technical Services Unit. Often in Large Enterprises disputes the review will be undertaken by one of the more experienced lawyers.
- (b) The official with delegated authority will invoke the GAAR, if they conclude that tax avoidance applies.

5.13 We anecdotally understand that for the year to 30 June 2010 a total of 44 cases involving tax avoidance were considered by Inland Revenue's Large Enterprises Unit, 33 of which were approved by a delegated authority – so approximately 25% of cases are dismissed as a result of the current internal sign-off process.

5.14 Where the above-mentioned cases involved large enterprises, we anticipate that the majority were considered under the process outlined above. Again however, there is no formal process (and we understand no records) which guarantee that this was the case.

Concerns with the current process

- 5.15 One concern related to the current process, especially among small and medium enterprises which have no in-house legal or tax team and may lack the required resources to seek legal advice, is that reference to the GAAR may be perceived as a threat, causing taxpayers to accept agreed adjustments on grounds not involving the GAAR. Disclosure of the process by Inland Revenue to the taxpayer is important for this reason. To the extent taxpayers are not aware of the process associated with a finding of tax avoidance, many may be more likely to pay up in order to avoid the cost and stress of a formal dispute. In addition, many taxpayers mistakenly believe that tax avoidance is a criminal issue, and therefore are more likely to pay up in order to avoid what they perceive to be the prospect of prosecution.

Our recommendations

- 5.16 We have outlined below our recommended changes, including introducing a formal process and making this process publicly available. In addition, we recommend that Inland Revenue be required to disclose this process, in writing, to all taxpayers before invoking the GAAR, or when indicating that the GAAR is being considered.
- 5.17 We recommend the implementation of a Standard Practice Statement ("**SPS**") that would set out a process to be followed in any situation where Inland Revenue was seeking to apply the GAAR. The process set out under the SPS would not differ between taxpayers. At a high level, we believe that the process to be followed should include the following requirements:
- (a) The investigator considering the case must gather all the relevant background information which has led them to form the view that the GAAR applies.
 - (b) The investigator must set out their reasoning and analysis as to why they believe the GAAR applies.
 - (c) A solicitor from Legal and Technical Services must consider the facts and the analysis undertaken, and confirm that they also believe that the GAAR applies.
 - (d) The analysis must then be signed off at a team-leader level.
 - (e) If all parties are in agreement that the GAAR is applicable, then a draft NOPA should be prepared, based on the analysis undertaken to date.
 - (f) The final draft NOPA must be reviewed by a solicitor from the Legal and Technical Services Unit independently from the solicitor that signed off on the original advice.
 - (g) A senior Inland Revenue official with delegated authority will consider the NOPA and provide final sign-off on the application of the GAAR.
- 5.18 Inland Revenue should be required to transparently set out the escalation process to the taxpayer. This will address the risk of the GAAR being seen by taxpayers as a threat, forcing them to agree to adjustments on other grounds.

6. RECOMMENDATION SIX: CONTINUE TO ADDRESS PERCEIVED LOOPHOLES OR OTHER DEFICIENCIES IN THE TAX LAWS THROUGH LEGISLATIVE AMENDMENT

- 6.1 There are other options for dealing with tax avoidance issues on a prospective basis. In situations where a more certain application of the GAAR may lead to tax base concerns by officials, there is the possibility of adjusting the structure of the tax system to deal with such concerns. For example, rather than using the GAAR to challenge the widespread practice of using a company structure rather than the individual to derive income, as occurred in *Penny and Hooper*, a better response would be to engage in more neutral tax design which would reduce the importance of tax planning.
- 6.2 The move towards alignment of the trustee, corporate, and personal income tax is a more sophisticated response to tax planning than stretching the GAAR to combat these arrangements. Although alignment has not yet been achieved, the lower differentials between these rates will have significantly dampened the incentives to tax plan.
- 6.3 Similarly, the Government has legislated to create a broader definition of family scheme income for Working for Families ("WFF") purposes. For the year starting 1 April 2011, for example, PIE income and fringe benefits such as motor vehicles for private use by shareholder employees, must be declared for WFF purposes. This lowers the incentives to tax plan in the first place, by preventing people contriving to earn a lower income (for WFF purposes) in order to collect tax credits.⁷⁸
- 6.4 Other examples are the changes made to depreciation rates for buildings and the replacement of the loss attributing qualifying company regime with the look-through company regime. While there may be concern that some of those changes "overreach" (given a stated objective was to address the subsidy that the tax system arguably provides to residential rental activities) most would agree that a legislative response was preferable to seeking to change behaviour by selective allegations of tax avoidance.
- 6.5 As the Committee of Experts' Report to the Treasurer and Minister of Revenue on Tax Compliance observed:⁷⁹

The most sensible way to reduce tax avoidance is to target the conditions that make tax arbitrage possible. The approach means broadening the tax base and lowering the variability of tax rates. ... An alternative response could be to rely instead on the general anti-avoidance provisions, such as section BG 1 and GB 1 of the Income Tax Act 1994 ... [but] the New Zealand approach has been to rely on the general anti-avoidance rules only as a backstop to the substantive legislation.

- 6.6 We would add that more recent experience has confirmed that the GAAR is a blunt, inefficient and often unfair means of addressing tax avoidance. The GAAR has a role, but as a backstop to sound tax policy and well-administered tax laws, not as substitute for those things.

⁷⁸ Income Tax Act 2007, ss MB 1(5) and MB 8.

⁷⁹ Committee of Experts on Tax Compliance *Tax Compliance: Report to the Treasurer and Minister of Revenue* (December 1998) at [6.32] - [6.34].

APPENDIX

1. GAARS USED BY OTHER JURISDICTIONS AND POSSIBLE LESSONS FOR NEW ZEALAND

- 1.1 The New Zealand position under section BG 1 can be contrasted to the developments which have occurred in other jurisdictions that have more recently enacted GAARs. The following analysis focuses on how some other jurisdictions assess or evaluate one of the more difficult questions in this type of legislation, "what is tax avoidance?" They do so with specific reference to the statutory rules of their GAAR. The question of how other jurisdictions deal with powers of reconstruction once tax avoidance is found to be present is discussed briefly at paragraph 4.16 above.

Australia

- 1.2 The Australian GAAR, which was enacted in 1981, requires the presence of three elements in order for Part IVA to be invoked. There needs to be a scheme, a tax benefit, and an objective conclusion (not having regard to the parties' actual intentions) that the dominant purpose of the scheme was to obtain a tax benefit. Of interest from a New Zealand perspective is that the statutory framework includes eight indicia designed to assist the taxpayer, administrator and judiciary in forming the view as to whether a scheme or any part of the scheme was entered into for the purpose of enabling a party to obtain a tax benefit (see the attached legislation - section 177D of the Income Tax Assessment Act 1936 Part IVA).

- 1.3 These key indicia include, inter alia, the manner, form and substance of the scheme, the time and timing the scheme, the resultant change in financial position (or lack thereof) of the relevant taxpayer, and the nature of the parties (and the relationship to each other) including all the participants in the scheme. The Commissioner is given discretionary power when these criteria are satisfied to determine that the GAAR applies and then reconstruct the transaction to produce the tax outcome that would have prevailed had the scheme not been entered into.

- 1.4 The interpretation of section 177D was considered in the Full Federal Court in *Consolidated Press*:⁸⁰

The section requires the decision-maker, be it the Commissioner or the Court, to have regard to each of these matters. It does not require that they be unbundled from a global consideration of purpose and slavishly ticked off. The relevant dominant purpose may be so apparent on the evidence taken as a whole that consideration of the statutory factors can be collapsed into a global assessment of purpose.

- 1.5 The High Court decisions such as *Peabody*,⁸¹ *Spotless*,⁸² and more latterly *Hart*,⁸³ have been argued by Michael D'Ascenzo (the current Australian Tax Commissioner) to

⁸⁰ *FC of T v Consolidated Press Holdings (No 1)* 99 ATC 4945 at 4971.

⁸¹ *FC of T v Peabody* (1994) 181 CLR 359.

⁸² *FC of T v Spotless Services Ltd* (1996) 186 CLR 404.

⁸³ *FC of T v Hart* (2004) ATC 4599.

provide "important consistent statement of principles".⁸⁴ This judicial guidance, together with the statutory guidance⁸⁵ in section 177D leads D'Ascenzo to conclude.⁸⁶

These reference points arguably **provide a more certain** basis than is available in other jurisdictions as to when the General Anti-Avoidance Rule (GAAR) is likely to be applied, or, in jurisdictions which do not have a GAAR, as to when the courts will intervene on the basis of judicial doctrines that have been developed in those jurisdictions to counter tax avoidance

- 1.6 Of course this is the view of a tax administrator rather the view of taxpayers or their advisers. An outsider looking at the Australian provision would however suggest that the eight indicia must be helpful guidance to all the concerned parties in a transaction which may potentially be subject to the GAAR.

Canada

- 1.7 The Canadian GAAR was introduced in 1988 and since that time has remained much the same. A three-step analysis demonstrating the application of the provision was summarised by the Supreme Court in *Canada Trustco*:⁸⁷

The first step is to determine whether there is a "tax benefit" arising from a "transaction" under s 245 (1) and (2). The second step is to determine whether the transaction is an avoidance transaction under s 245-(3), in the sense of not being "arranged primarily for *bona fide* purposes other than to obtain the tax benefit". The third step is to determine whether the avoidance transaction is abusive under s 245-(4).

- 1.8 The assessment of the primary purpose of the transaction under section 245(3) is "an objective assessment of the relative importance of the driving forces of the transaction."⁸⁸ Like the Australian provision an objective factual analysis is required and the taxpayer's motivation can be ignored. Unlike the Australian provision, but similar to the position in New Zealand, there is no further statutory guidance on the types of factors that the court should consider informing its view as to whether the purposes are "bona fide".
- 1.9 The difference between the Canadian approach and the New Zealand approach is manifested in section 245(4) of the Canadian Act. This is sometimes known as "the misuse or abuse test". In *Canada Trustco* it was held that this test involves a two-part enquiry. The first is "to interpret the provisions giving rise to the tax benefit to determine their object, spirit and purpose".⁸⁹ The second is to examine the factual context of the case in order to determine whether the avoidance arrangement defeated that purpose. The first question is one of law that is, as in all cases, ultimately the courts to decide. But the second involves a mixed question of law and fact, with the onus being on the Commissioner in respect of the factual part. Whether a transaction results in a finding of tax avoidance is determined by "conducting a unified textual, contextual and purposive analysis of the provisions giving rise to the tax benefit in order to determine why they were put in place and why the benefit was conferred."⁹⁰

⁸⁴ Michael D'Ascenzo *Part IVA and the common sense of a reasonable person* (paper presented to the Queensland Taxation Institute Convention, Surfers Paradise, May 2002).

⁸⁵ It is also part of the Tax Office's strategy to cultivate consistently sheared sensibilities on what passes the "smell test" and what does not to routinely involve external tax consultants on the Part IVA Panel.

⁸⁶ Michael D'Ascenzo *A practical guide on Part IVA (of the Income Tax Assessment Act)* (paper presented to 15th National Convention of the Taxation Institute of Australia, Sydney, March 2001).

⁸⁷ *Canada Trustco Mortgage Co v Canada* (2005) SCC 54 at [17].

⁸⁸ *Ibid* at [28].

⁸⁹ *Ibid* at [44].

⁹⁰ *Ibid* at [66].

- 1.10 The "misuse or abuse" test in section 245(4) requires the court to consider the purpose of the provision. In *Canada Trustco* when the Supreme Court considered misuse, it held that Section 245(4) requires a single, unified approach to the textual, contextual and purposive interpretation of the specific provisions of the Income Tax Act that are relied upon by the taxpayer in order to determine whether there was abusive tax avoidance. In the light of criticism of the New Zealand GAAR and the imprecise nature of the "Parliamentary contemplation" test it is interesting to note the words of warning provided by the Canadian Supreme Court justices:⁹¹

The courts cannot search for an overriding policy of the Act that is not based on a unified, textual, contextual and purposive interpretation of the specific provisions in issue. First, such a search is incompatible with the roles of reviewing judges. The *Income Tax Act* is a compendium of highly detailed and often complex provisions. **To send the courts on the search for some overarching policy and then to use such a policy to override the wording of the provisions of the *Income Tax Act* would inappropriately place the formulation of taxation policy in the hands of the judiciary, requiring judges to perform a task to which they are unaccustomed and for which they are not equipped. Did Parliament intend judges to formulate taxation policies that are not grounded in the provisions of the Act and to apply them to override the specific provisions of the Act?** Notwithstanding the interpretative challenges that the GAAR presents, we cannot find a basis for concluding that such a marked departure from judicial and interpretative norms was Parliament's intent.

- 1.11 An outsider looking at the Canadian provision would find the explicit statutory definition of the relationship of the GAAR to the rest of the Act to be of assistance in interpreting the provision.

South Africa

- 1.12 The first GAAR was introduced into South African tax legislation in 1941. The succeeding provision, section 103(1) of the Income Tax Act 1962, did not fundamentally change. A substantial amendment occurred, after public consultation, with the introduction of the new Part IIA of the Act in 2006. The GAAR, while retaining many of the same concepts from its predecessor section 103 is regarded as "an overhaul".⁹² For the GAAR to apply four requirements are necessary:

- (a) the existence of an arrangement;
- (b) existence of a tax benefit;
- (c) the sole or main purpose of the avoidance arrangement is to obtain a tax benefit;
- (d) the avoidance arrangement is characterised by the presence of any one or more of four tainted elements for arrangements in the context of business, and any one or more of three tainted elements for arrangements in the context other than business, which renders it an impermissible avoidance arrangement.

- 1.13 The tainted elements test, in a business context, includes an arrangement:

- (a) entered into or carried out by an abnormal means or manner, not used for a bona fide business purpose (the business abnormality test) other than obtaining a tax benefit;

⁹¹ Ibid at [41].

⁹² South African Revenue Service *Draft Comprehensive Guide to the General Anti-Avoidance Rule* www.SARS.gov.za.

- (b) lacking commercial substance; which consists of objective indicative tests and an object or "presumptive" test;
 - (c) creation of non-arm's length rights or obligations;
 - (d) abuse or misuse of the provisions of the Income Tax Act.
- 1.14 In the context other than business the tests are repeated with the exclusion of test (b) above.
- 1.15 As can be seen from the statutory definitions the tainted elements tests are creatures of statute. The taxpayer, where there is a tax benefit in the arrangement, is subject to a rebuttable presumption that the avoidance arrangement has been entered into for the sole or main purpose of obtaining a tax benefit (section 80G). The taxpayer must prove that, reasonably considered in the light of the relevant facts, obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement.
- 1.16 Once it is established that arrangement is an "avoidance arrangement", as defined, the next step is to determine whether such an avoidance arrangement is an "impermissible avoidance arrangement". This will be so only if any one or more of the tainted elements tests are met.
- 1.17 When the South African provision was originally enacted it simply had the abnormality test. This proved to be insufficient by itself to combat relatively blatant avoidance arrangements. The commercial substance test was added and section 80C sets out certain factors to guide the conclusion as to commercial substance. Section 80C(1) provides a general rule as to a lack of commercial substance where there is a significant tax benefit, with there being no significant impact on business or commercial risks or net cash flows. This addresses the fact that tax avoidance schemes often create a façade of substantial investments which are largely illusory, and insulate the taxpayer from economic risk contrary to the impression of the investment.
- 1.18 Section 80C(2) sets out a non-exclusive list of relevant factors that are indicative of arrangements that lack commercial substance:
- (a) the legal substance of the avoidance arrangement is inconsistent or differs significantly from the legal form of its individual steps;
 - (b) round trip financing (described in section 80D);
 - (c) an accommodating or a tax-indifferent party (described in section 80E); or
 - (d) elements that have the effect of offsetting or cancelling each other.
- 1.19 Overall, commentators have suggested that the South African provisions have gone some way to balance legitimate commercial transactions against the need to combat tax avoidance arrangements. It is suggested that "Part IIA contains many positive aspects that make it preferable to Australia's Part IVA".⁹³

Conclusion

- 1.20 The brief review above of comparative provisions in Australia, Canada and South Africa indicate that the approach taken by those jurisdictions to the design of the GAAR is different to that taken by New Zealand. In the case of Australia and South Africa

⁹³ Julie Cassidy "The Holy Grail: The Search for the Optimal GAAR" (2009) 126(4) South African Law Journal 740.

features of tax avoidance are specifically identified. In the case of Canada the legislation attempts to tie the GAAR to the purposes of the Income Tax Act itself.

- 1.21 In law, there are specific rules (such as the speed limit of 80 km/h) and more general overarching principles which may not have a safe harbour (ie you must drive in accordance with the conditions). Meeting the bright line rule may not prevent you from prosecution from driving excessively fast in dangerous conditions. The GAAR is a more principle-driven law. In considering the best way to draft it, John Braithwaite suggests:
- (a) define the overarching principle and make it binding on taxpayers;
 - (b) make the GAAR such an overarching principle so that schemes are counteracted where the dominant purpose is a tax advantage rather than a business purpose (Braithwaite is an Australian, so he applies the Part IVA terminology);
 - (c) define a set of rules to cover the complex area of tax law;
 - (d) lay down that in a contest between a rule and an overarching principle, the principle is binding and the rule is used to assist in applying the principle; and
 - (e) write specific sets of rules for the most commonly used types of transactions of business arrangements. Such rules are merely specific examples of how the principles apply.⁹⁴
- 1.22 Using Braithwaite's criteria New Zealand could sensibly consider the Australian and South African legislative framework to improve section BG 1 of the Income Tax Act 2007.

⁹⁴ John Braithwaite "Making Tax Law More Certain: A Theory" Of the Australian National University/Australian Taxation Office, Centre for Tax System Integrity, working paper number 44, December 2002.

Australia

PART IVA - SCHEMES TO REDUCE INCOME TAX

SECTION 177D

177D SCHEMES TO WHICH PART APPLIES

This Part applies to any scheme that has been or is entered into after 27 May 1981, and to any scheme that has been or is carried out or commenced to be carried out after that date (other than a scheme that was entered into on or before that date), whether the scheme has been or is entered into or carried out in Australia or outside Australia or partly in Australia and partly outside Australia, where:

- (a) a taxpayer (in this section referred to as the *relevant taxpayer*) has obtained, or would but for section 177F obtain, a tax benefit in connection with the scheme; and
- (b) having regard to:
 - (i) the manner in which the scheme was entered into or carried out;
 - (ii) the form and substance of the scheme;
 - (iii) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;
 - (iv) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;
 - (v) any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;
 - (vi) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme;
 - (vii) any other consequence for the relevant taxpayer, or for any person referred to in subparagraph (vi), of the scheme having been entered into or carried out; and
 - (viii) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in subparagraph (vi);

it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme or of enabling the relevant taxpayer and another taxpayer or other taxpayers each to obtain a tax benefit in connection with the scheme (whether or not that person who entered into or carried out the scheme or any part of the scheme is the relevant taxpayer or is the other taxpayer or one of the other taxpayers).

Canada

Income Tax Act (1985, c. 1 (5th Supp.))

245. (1) In this section,

"tax benefit"
« *avantage fiscal* »

"tax benefit" means a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act, and includes a reduction, avoidance or deferral of tax or other amount that would be payable under this Act but for a tax treaty or an increase in a refund of tax or other amount under this Act as a result of a tax treaty;

"tax consequences"
« *attribut fiscal* »

"tax consequences" to a person means the amount of income, taxable income, or taxable income earned in Canada of, tax or other amount payable by or refundable to the person under this Act, or any other amount that is relevant for the purposes of computing that amount;

"transaction"
« *opération* »

"transaction" includes an arrangement or event.

General anti-avoidance provision

(2) Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.

Avoidance transaction

(3) An avoidance transaction means any transaction

(a) that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit; or

(b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit.

Application of subsection (2)

(4) Subsection (2) applies to a transaction only if it may reasonably be considered that the transaction

(a) would, if this Act were read without reference to this section, result directly or indirectly in a misuse of the provisions of any one or more of

(i) this Act,

(ii) the *Income Tax Regulations*,

- (iii) the *Income Tax Application Rules*,
 - (iv) a tax treaty, or
 - (v) any other enactment that is relevant in computing tax or any other amount payable by or refundable to a person under this Act or in determining any amount that is relevant for the purposes of that computation; or
- (b) would result directly or indirectly in an abuse having regard to those provisions, other than this section, read as a whole.

Determination of tax consequences

- (5) Without restricting the generality of subsection (2), and notwithstanding any other enactment,
- (a) any deduction, exemption or exclusion in computing income, taxable income, taxable income earned in Canada or tax payable or any part thereof may be allowed or disallowed in whole or in part,
 - (b) any such deduction, exemption or exclusion, any income, loss or other amount or part thereof may be allocated to any person,
 - (c) the nature of any payment or other amount may be recharacterized, and
 - (d) the tax effects that would otherwise result from the application of other provisions of this Act may be ignored,
- in determining the tax consequences to a person as is reasonable in the circumstances in order to deny a tax benefit that would, but for this section, result, directly or indirectly, from an avoidance transaction.

Request for adjustments

- (6) Where with respect to a transaction
- (a) a notice of assessment, reassessment or additional assessment involving the application of subsection 245(2) with respect to the transaction has been sent to a person, or
 - (b) a notice of determination pursuant to subsection 152(1.11) has been sent to a person with respect to the transaction,
- any person (other than a person referred to in paragraph (a) or (b)) shall be entitled, within 180 days after the day of sending of the notice, to request in writing that the Minister make an assessment, reassessment or additional assessment applying subsection (2) or make a determination applying subsection 152(1.11) with respect to that transaction.

Exception

- (7) Notwithstanding any other provision of this Act, the tax consequences to any person, following the application of this section, shall only be determined through a notice of assessment, reassessment, additional

assessment or determination pursuant to subsection 152(1.11) involving the application of this section.

Duties of Minister

- (8) On receipt of a request by a person under subsection 245(6), the Minister shall, with all due dispatch, consider the request and, notwithstanding subsection 152(4), assess, reassess or make an additional assessment or determination pursuant to subsection 152(1.11) with respect to that person, except that an assessment, reassessment, additional assessment or determination may be made under this subsection only to the extent that it may reasonably be regarded as relating to the transaction referred to in subsection 245(6).

Benefit conferred on a person

- 246.** (1) Where at any time a person confers a benefit, either directly or indirectly, by any means whatever, on a taxpayer, the amount of the benefit shall, to the extent that it is not otherwise included in the taxpayer's income or taxable income earned in Canada under Part I and would be included in the taxpayer's income if the amount of the benefit were a payment made directly by the person to the taxpayer and if the taxpayer were resident in Canada, be
- (a) included in computing the taxpayer's income or taxable income earned in Canada under Part I for the taxation year that includes that time; or
 - (b) where the taxpayer is a non-resident person, deemed for the purposes of Part XIII to be a payment made at that time to the taxpayer in respect of property, services or otherwise, depending on the nature of the benefit.

Arm's length

- (2) Where it is established that a transaction was entered into by persons dealing at arm's length, *bona fide* and not pursuant to, or as part of, any other transaction and not to effect payment, in whole or in part, of an existing or future obligation, no party thereto shall be regarded, for the purpose of this section, as having conferred a benefit on a party with whom the first-mentioned party was so dealing.

South Africa

INCOME TAX ACT 1962

80A. Impermissible tax avoidance arrangements.—

An avoidance arrangement is an impermissible avoidance arrangement if its sole or main purpose was to obtain a tax benefit and—

- (a) in the context of business—
 - (i) it was entered into or carried out by means or in a manner which would not normally be employed for *bona fide* business purposes, other than obtaining a tax benefit; or
 - (ii) it lacks commercial substance, in whole or in part, taking into account the provisions of **section 80C**;
- (b) in a context other than business, it was entered into or carried out by means or in a manner which would not normally be employed for a *bona fide* purpose, other than obtaining a tax benefit; or
- (c) in any context—
 - (i) it has created rights or obligations that would not normally be created between persons dealing at arm's length; or
 - (ii) it would result directly or indirectly in the misuse or abuse of the provisions of this Act (including the provisions of this Part).

80B. Tax consequences of impermissible tax avoidance.—

- (1) The Commissioner may determine the tax consequences under this Act of any impermissible avoidance arrangement for any party by—
 - (a) disregarding, combining, or re-characterising any steps in or parts of the impermissible avoidance arrangement;
 - (b) disregarding any accommodating or tax-indifferent party or treating any accommodating or tax-indifferent party and any other party as one and the same person;
 - (c) deeming persons who are connected persons in relation to each other to be one and the same person for purposes of determining the tax treatment of any amount;
 - (d) reallocating any gross income, receipt or accrual of a capital nature, expenditure or rebate amongst the parties;
 - (e) re-characterising any gross income, receipt or accrual of a capital nature or expenditure; or
 - (f) treating the impermissible avoidance arrangement as if it had not been entered into or carried out, or in such other manner as in the circumstances of the case the Commissioner deems appropriate for the prevention or diminution of the relevant tax benefit.

- (2) Subject to the time limits imposed by **section 79, 79A(2)(a) and 81(2)(b)**, the Commissioner must make compensating adjustments that he or she is satisfied are necessary and appropriate to ensure the consistent treatment of all parties to the impermissible avoidance arrangement.

80C. Lack of commercial substance.—

- (1) For purposes of this Part, an avoidance arrangement lacks commercial substance if it would result in a significant tax benefit for a party (but for the provisions of this Part) but does not have a significant effect upon either the business risks or net cash flows of that party apart from any effect attributable to the tax benefit that would be obtained but for the provisions of this Part.
- (2) For purposes of this Part, characteristics of an avoidance arrangement that are indicative of a lack of commercial substance include but are not limited to—
- (a) the legal substance or effect of the avoidance arrangement as a whole is inconsistent with, or differs significantly from, the legal form of its individual steps; or
 - (b) the inclusion or presence of—
 - (i) round trip financing as described in section 80D; or
 - (ii) an accommodating or tax indifferent party as described in section 80E; or
 - (iii) elements that have the effect of offsetting or cancelling each other.

80D. Round trip financing.—

- (1) Round trip financing includes any avoidance arrangement in which—
- (a) funds are transferred between or among the parties (round tripped amounts); and
 - (b) the transfer of the funds would—
 - (i) result, directly or indirectly, in a tax benefit but for the provisions of this Part; and
 - (ii) significantly reduce, offset or eliminate any business risk incurred by any party in connection with the avoidance arrangement.
- (2) This section applies to any round tripped amounts without regard to—
- (a) whether or not the round tripped amounts can be traced to funds transferred to or received by any party in connection with the avoidance arrangement;
 - (b) the timing or sequence in which round tripped amounts are transferred or received; or
 - (c) the means by or manner in which round tripped amounts are transferred or received.

- (3) For the purposes of this section, the term "funds" includes any cash, cash equivalents or any right or obligation to receive or pay the same.

80E. Accommodating or tax-indifferent parties.—

- (1) A party to an avoidance arrangement is an accommodating or tax-indifferent party if—
- (a) any amount derived by the party in connection with the avoidance arrangement is either—
 - (i) not subject to normal tax; or
 - (ii) significantly offset either by any expenditure or loss incurred by the party in connection with that avoidance arrangement or any assessed loss of that party; and
 - (b) either—
 - (i) as a direct or indirect result of the participation of that party an amount that would have—
 - (aa) been included in the gross income (including the recoupment of any amount) or receipts or accruals of a capital nature of another party would be included in the gross income or receipts or accruals of a capital nature of that party; or
 - (bb) constituted a non-deductible expenditure or loss in the hands of another party would be treated as a deductible expenditure by that other party; or
 - (cc) constituted revenue in the hands of another party would be treated as capital by that other party; or
 - (dd) given rise to taxable income to another party would either not be included in gross income or be exempt from normal tax; or
 - (ii) the participation of that party directly or indirectly involves a prepayment by any other party.
- (2) A person may be an accommodating or tax-indifferent party whether or not that person is a connected person in relation to any party.
- (3) The provisions of this section do not apply if either—
- (a) the amounts derived by the party in question are cumulatively subject to income tax by one or more spheres of government of countries other than the Republic which is equal to at least two-thirds of the amount of normal tax which would have been payable in connection with those amounts had they been subject to tax under this Act; or

- (b) the party in question continues to engage directly in substantive active trading activities in connection with the avoidance arrangement for a period of at least 18 months: Provided these activities must be attributable to a place of business, place, site, agricultural land, vessel, vehicle, rolling stock or aircraft that would constitute a foreign business establishment as defined in section 9D (1) if it were located outside the Republic and the party in question were a controlled foreign company.
- (4) For the purposes of subsection (3) (a), the amount of tax imposed by another country must be determined after taking into account any applicable agreements for the prevention of double taxation and any assessed loss, credit or rebate to which the party in question may be entitled or any other right of recovery to which that party or any connected person in relation to that party may be entitled.

80F. Treatment of connected persons and accommodating or tax-indifferent parties.—

For the purposes of applying section 80C or determining whether or not a tax benefit exists for purposes of this Part, the Commissioner may—

- (a) treat parties who are connected persons in relation to each other as one and the same person; or
- (b) disregard any accommodating or tax-indifferent party or treat any accommodating or tax-indifferent party and any other party as one and the same person.

80G. Presumption of purpose.—

- (1) An avoidance arrangement is presumed to have been entered into or carried out for the sole or main purpose of obtaining a tax benefit unless and until the party obtaining a tax benefit proves that, reasonably considered in light of the relevant facts and circumstances, obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement.
- (2) The purpose of a step in or part of an avoidance arrangement may be different from a purpose attributable to the avoidance arrangement as a whole.