

# Tax Avoidance: Causes and Solutions

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Master of Business

2007

The thesis submitted to Auckland University of Technology in partial fulfillment of the degree of Master of Business.

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## **Attestation of Authorship**

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

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## **Acknowledgements**

I would like to take this opportunity to thank Professor Chris Ohms who provided invaluable guidance throughout the research process, and also my family for their sacrifices, support and love.

## **Abstract**

Tax avoidance is attracting more and more attention from the public. Different people have different understanding and definitions of tax avoidance. The purpose of this thesis is to review the causes of, and solutions to tax avoidance. The thesis assesses various definitions of tax avoidance, and then discusses different options for prevention of tax avoidance. In discussing of legislative rules, the thesis reviews the various applicable sections in the New Zealand Income Tax Act 2004, taking into account of leading cases, discusses the development in other jurisdictions, and in particular examines the development of Generally Anti-avoidance Rules in three jurisdictions. The thesis recommends the key elements for design a good tax system which will help to restrict the conditions that make tax avoidance possible for the future development. The recommendations also include: establishing effective disclosure and advanced rulings system, improving specific anti-avoidance provision, reinforcing generally anti-avoidance rule and developing a purposive interpretation of the law.

## 1.0 Introduction

The purpose of this thesis is to critically review and analyse the causes and solutions of tax avoidance. The thesis reviews the relevant sections of the Income Tax Act, taking into account of leading cases, discusses the development in other jurisdictions and makes recommendation for the future development.

### 1.1 Background Overview

The original concept of taxation was raising revenue for subsequent expenditures by the ruling authority. The government financing through taxation has a fundamental influence on the standard of living of all citizens. This was recognised by New Zealand's Ross report on tax reform in 1967. Taxation to pay government to provide non-market goods and services, regulate economic and social conditions, redistribute income.<sup>1</sup>

In the modern society, to accomplish the development of political and economic structure of society has become more complex. The government responsibilities increased as well. As a consequence, taxation now serves far wider purposes. However, taxation continues rising of revenues and remains the primary source of the income required by the state to ensure the protection, social welfare and prosperity of its citizens.<sup>2</sup>

The Figure 1 below is the analysis for source of New Zealand government income in 2005. From the figure, we can see, the revenue form taxation provides over 90% total income of the New Zealand. The three key tax types are: income tax — 62% of revenue; GST — 20% of revenue; and other indirect taxes, including excise taxes on tobacco, alcohol and petrol — 10% of revenue. Taxation is still a main source of government financial and as a wide impact on the economic, social and political stability and well-being of a nation.

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<sup>1</sup> The Tax Review 2001, *Final Report*, Wellington, 2001.

<sup>2</sup> Taxation Review Committee, *Taxation in New Zealand: Report of the Taxation Review Committee*, Wellington, 1967.

**Figure 1 Crown finance<sup>3</sup>**

<b>Source of current income 2005</b>		
	\$(million)	Percentage
Income taxes	32067	62.36%
Net goods and services tax	10,686	20.78%
Other taxes	5,002	9.73%
Property income	2,179	4.24%
Other income	1,490	2.90%
Total	51,424	100.00%

### **1.2 New Zealand tax system**

Current New Zealand tax system is a result of a series of significant reformation in the past twenty years. The 1982 McCaw Report was the start point for this series of reformation, in the report McCaw concluded that the tax system needed a major overhaul. In the time of that report, New Zealand tax system was characterised by narrow bases, high tax rates, and a heavy dependency on income tax.<sup>4</sup>

The reformation introduced GST in 1986 and broadened income tax base to introduce FBT, accrual rules, international tax rules, and removal or reduction of corporate tax concessions. The reform allowed a better and more sustainable balance in the tax mix to be achieved.<sup>5</sup>

In particular, there has been a decreasing reliance on income tax, and an increased role for consumption taxes. From the time McCaw Report was released, as the income tax base has broadened, and the top marginal tax rate was reduced from 66% to 39%.<sup>6</sup>

Now, the tax base in New Zealand comprises both direct and indirect tax systems.<sup>7</sup> The Income Tax Act 1994 imposes an income tax while the Goods and Services Tax Act 1985

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<sup>3</sup> Statistics New Zealand, *New Zealand in Profile 2006*, Wellington, 2006.

<sup>4</sup> McCaw Committee, *Report of the Task Force on Tax Reform*, Wellington, 1982.

<sup>5</sup> The Tax Review 2001, *Final Report*, Wellington, 2001.

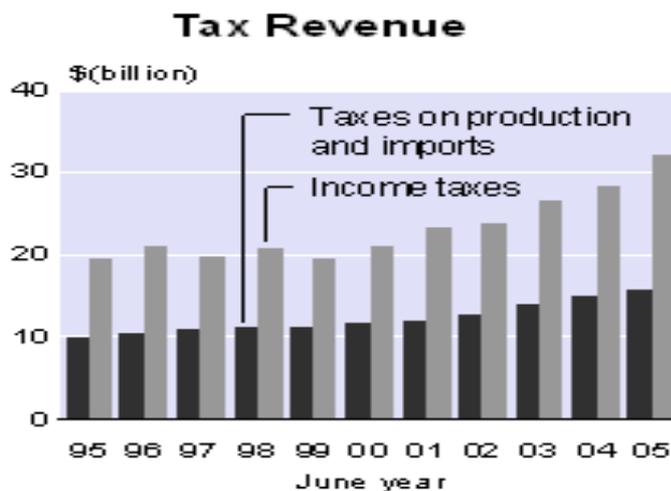
<sup>6</sup> Ibid.

<sup>7</sup> Ibid.

relates to the indirect consumption expenditure goods and services tax. Both of these taxes are integral to the revenue raising function of Government and maintenance of the tax base.<sup>8</sup> Many reform measures have been introduced over the last two decades aimed at broadening and strengthening the tax base of both the income tax and the goods and services tax. From that time, New Zealand has moved to broad bases taxes at low rate.<sup>9</sup> Current the Inland Revenue Department administers three principle acts, the Income Tax Act 2004, the Tax Administration Act 1994 and the Goods and Services Tax Act 1985.

Figure 2, is the comparison of the revenue from taxation in the last ten years. From the figure we can see the revenue from GST increased gradually for last ten years, however income taxation is still the most important component of the government tax revenue.

**Figure2. Revenue from taxation**<sup>10</sup>



Although there are still some work need to be done for the tax system, the Tax review 2001 concluded that New Zealand's current tax mix is broadly right. By having two main tax bases, overall revenue flows are relatively stable, even where one or other tax base fluctuates.<sup>11</sup>

<sup>8</sup> New Zealand Treasury, *Budget Speech and Fiscal Strategy Report 2000*, Wellington, 2000.

<sup>9</sup> Tax review 2001, *Issues Paper*, Wellington, 2001.

<sup>10</sup> Statistics New Zealand, *Crown Accounts Analysis*, Wellington, 2006.

<sup>11</sup> The Tax Review 2001, *Final Report*, IRD Wellington 2001

### **1.3 New Zealand Tax Policy**

A good taxation system should treat all people of a country equally, clearly define the tax a person should pay, be convenient for both tax payer and collector, and be cheap to pay and collect tax. Those canons of taxation: equality, certainty, convenience and efficiency, first developed by Adam Smith, in his 1776 book, *The Wealth of Nations* as a set of criteria by which to judge taxes. This was confirmed as appropriate for current government policy in the treasury reporter, Budget 2006, which stated:

“The Government is also committed to a fair distribution of the tax burden and a robust tax system where people pay their intended rates of tax.

The Government will continue to promote sound administration of the tax system and clear and effective tax rules that minimise administration and compliance costs.

The Government will give consideration to the composition of taxation to meet the government’s equity and spending objectives at lowest economic cost.

The Government will consider the use of tax exemptions and concessions only in the context of the full range of policy options and only if the benefits can be shown to outweigh the costs for New Zealand.”<sup>12</sup>

The key focus of New Zealand tax policy is to enhance the overall economic well-being of New Zealanders by seeking ways to reduce the costs of imposing taxes – or making the tax system more efficient – while promoting fairness and continuing to raise sufficient revenue.<sup>13</sup> Added to this are the goals of making the tax system as certain and simple as possible.<sup>14</sup>

### **1.4 History of New Zealand income tax**

The income tax system in New Zealand comprised of two important statutes, the *Income Tax Act 2004* and the *Tax administration Act 1994*.

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<sup>12</sup> New Zealand Government, *Budget 2006*, Wellington, 2006, P 45.

<sup>13</sup> Tax review 2001, *Issuer Paper*, Wellington, 2001

<sup>14</sup> Inland Revenue Department, *Simplifying Taxpayer Requirements*, Wellington, 1997

Direct Income tax was first imposed in New Zealand by the *Land and Income Assessment Act* 1891. The 1891 Act introduced the land tax, mortgages tax and income tax. That Act was amended and consolidated numerous times from 1900 to 1954, and various other types of tax were imposed by those Acts. In 1976, Parliament split the *Land and Income Tax Act* 1954 into two Acts. These were the *Income Tax Act* 1976 and the *Land Tax Act* 1976. In December 1994, Parliament enacted the *Income Tax Act* 1994, the *Tax Administration Act* 1994 and the *Taxation Review Authorities Act* 1994, marking the first phase in a three-step process to rewrite the *Income Tax Act* 1976. In May 2004, the *Income Tax Act* 2004 received Royal assent. The *Income Tax Act* 2004 is the latest statute and replaces the *Income Tax Act* 1994.<sup>15</sup>

### **1.5 Tax avoidance in New Zealand**

Tax avoidance is a problem facing by all the tax system, especially for a higher tax rate country, such as New Zealand. The 33% rate is well above average rates in the Asia-Pacific region and for OECD countries. The average rate in the Asia-Pacific region is 29.99% and the OECD average rate has fallen from 28.55% to 28.31%.<sup>16</sup> The purpose of taxation is to generate revenue for government. However the high tax rate may create a large incentive for enough motivations to pay less tax.

It is accepted that taxpayers can organize their affairs to minimize their taxes. In *IRC v Duke of Westminster*,<sup>17</sup> a case which is the most notable judicial approval, Lord Tomlin observed:

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

In New Zealand, tax avoidance and tax evasion are entirely different concepts. In *Peterson v C of IR*<sup>18</sup> Lord Bingham of Cornhill and Lord Scott of Foscote stated at p 19,114 (Para 60):

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<sup>15</sup> Ibid.

<sup>16</sup> KPMG, *The 2006 Corporate Tax Rate Survey*, 2006

<sup>17</sup> [1936] AC 1.

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

There are legislative rules framed by the government to prevent the possible tax avoidance. New Zealand tax legislation contains numerous anti-avoidance provisions for preventing the possible problem. These provisions can be divided into two categories: specific anti-avoidance provisions and the general anti-avoidance provision.

Specific anti-avoidance provisions are directed to particular defined situations with nature narrowly focused, whereas the general anti-avoidance provision through sBG1, of the Income Tax Act 2004, has raised a general anti-avoidance yardstick by which the line between legitimate tax planning and improper tax avoidance is to be drawn.<sup>19</sup> Section BG1 is perceived legislatively as an essential pillar of the tax system designed to protect the tax base and the general body of taxpayers from what are considered to be unacceptable tax avoidance devices.<sup>20</sup>

### **1.6 Structure of the thesis**

The structure of the thesis is organized by 8 chapters. The second part of the thesis assesses various definitions of tax avoidance. Then the current New Zealand approach is analysed in the third part. Part four discusses different options for prevention of tax avoidance, judicial rules and legislative rules. Judicial rules are reviewed in part five. Legislative rules are discussed in part six and part seven. While part six discusses specific anti-avoidance rules, part seven discusses general anti-avoidance rules. Finally, part eight offers some recommendation for the future direction.

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<sup>18</sup> (2005) 22 NZTC 19,098,

<sup>19</sup> *CIR v BNZ Investments Limited* (2001) 20 NZTC 17,103, per Richardson P.

<sup>20</sup> *Ibid.*

## 2.0 Defining tax avoidance

The definition of tax avoidance is the first concept we have to consider in order to provide the context for the discussion that follows.

The definition of OECD is that “Tax avoidance is generally used to describe the arrangement of a taxpayer's affairs that is intended to reduce his tax liability and that although the arrangement could be strictly legal it is usually in contradiction with the intent of the law it purports to follow.”<sup>21</sup>

In Australia, the Ralph Review of Business Taxation concludes “Tax avoidance may be characterized as a miss-use or abuse of the law rather than a disregard for it. It is often driven by the exploitation of structural loopholes in the law to achieve tax outcomes that were not intended by the Parliament but also includes manipulation of the law and a focus on form and legal effect rather than substance.”<sup>22</sup>

The economists Michael Brooks and John Head analyze that “in legal discussions of tax avoidance, the primary focus is clearly on contrived and artificial schemes, which do not change the substantive character of an activity or transaction but may serve nevertheless to bring the activity within some tax-exempt or more tax-favoured legal category”.<sup>23</sup>

Lord Templeman provided another definition in the Challenge Corporation case:

“Income tax is avoided and a tax advantage is derived from an arrangement when the taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that reduction. The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had”<sup>24</sup>

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<sup>21</sup> Organization for Economic Co-operation and Development, *International Tax Terms*, <[http://www.oecd.org/document/29/0,2340,en\\_2649\\_34897\\_33933853\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/29/0,2340,en_2649_34897_33933853_1_1_1_1,00.html)>, (at 10 June 2006).

<sup>22</sup> Review of Business Taxation, *A Tax System Redesigned*, Canberra, July 1999, at s. 6.2(c).

<sup>23</sup> M Brooks and J Head, *Tax Avoidance: In Economics, Law and Public Choice*, in GS Cooper (ed) *Tax Avoidance and the Rule of Law*, Amsterdam, IBFD Publications in Association with the Australian Tax Research Foundation, 1997, P71.

<sup>24</sup> *CIR v Challenge Corporation Ltd* [1987] AC 155.

In New Zealand, the concept of tax avoidance is normally associated with transaction "impropriety"<sup>25</sup>, "pretence", "Contrivance", "artificiality" and "manufactured tax advantage".<sup>26</sup>

### **2.1 Modeling tax avoidance – accounting analysis**

Tax avoidance is a term that is difficult to define, but all discussions above relate to situation which a taxpayer's tax liability is reduced and it is done consciously by taxpayer. In order to understand the concept fully under New Zealand context, it is useful to review the formula found in the Income Tax Act 2004 (ITA 2004) to see how a person's tax liability is calculated.

Section BB1 provided that income tax is imposed on taxable income, at the rate of tax fixed by an annual taxing Act, and is payable to the Crown under this Act and the Tax Administration Act 1994. Under Section BB 2(1), a person's income tax liability for a tax year must be calculated, and satisfied by the person, under subpart calculating and satisfying income tax liabilities.

The concept of gross income is described in section BD 1. This definition is supported by all of the provisions in Part C, which is a code in relation to its role of determining whether an amount arising from a transaction or event is income. Gains and profits that are not treated as income under Part C are not subject to income tax. Examples of this category are capital profits and windfall gains.<sup>27</sup> Each amount of gross income must be allocated to a specific income year in accordance with s BD3. Generally, an amount of income is allocated to the income year in which the amount is derived, unless an amount of gross income is subject to a timing regime the amount must be allocated to an income year in accordance with that regime.<sup>28</sup>

Annual total deduction is defined under section BC 3 which provides a person's annual total deduction for a tax year is the total of their deductions that are allocated to the corresponding income year.

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<sup>25</sup> Ibid.

<sup>26</sup> *Challenge Corporation v CIR* [1986] 2 NZLR 513, 562.

<sup>27</sup> *C of IR v City Motor Service Ltd* [1969] NZLR 1010.

<sup>28</sup> s BD3.

Net income is defined in s BC 4, for a tax year, if a person's annual gross income is more than their annual total deduction, the difference is their net income for the year; if a person's annual gross income equals to their annual total deduction, their net income for the year is zero; if a person's annual total deduction is more than their annual gross income, the difference is their net loss for the year, and their net income for the year is zero.

Taxable income is defined in s BC 5 as a person's taxable income for a tax year is determined by subtracting any available net losses that the person has from their net income under Part I (Treatment of net losses).

The steps to calculate income tax liability are identified under s BC 6. The unadjusted income tax liability of the taxpayer for the tax year is calculated by multiplying their taxable income for the tax year by the applicable basic tax rate. Different tax rates apply to different entities such as individuals and companies. For example, the basic tax rates for individuals are imposed at a progressive rate according to income levels. In the 2006-07 income year, individuals pay tax at 9.5 percent up to \$38,000, 33 percent with income between \$38,001 and \$60,000, and 39 percent for income greater than \$60,000. The basic rate of tax for companies is a flat 33 percent. Then the unadjusted income tax liability will become adjusted income tax liability by subtracting their allowable rebates from their unadjusted income tax liability.

Payment of income tax liability defined in s BC 9, a taxpayer's income tax liability satisfied by using credits for tax paid or tax withheld, calculated under Part L (Credits) for a tax year as far as the credits extend. If the person's income tax liability is more than the total of their credits, the difference is the person's terminal tax. The person must pay the terminal tax to complete the satisfaction of their income tax liability.<sup>29</sup>

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<sup>29</sup> s BC9 (2)

Figure 3 Calculation and satisfaction of income tax liability<sup>30</sup>

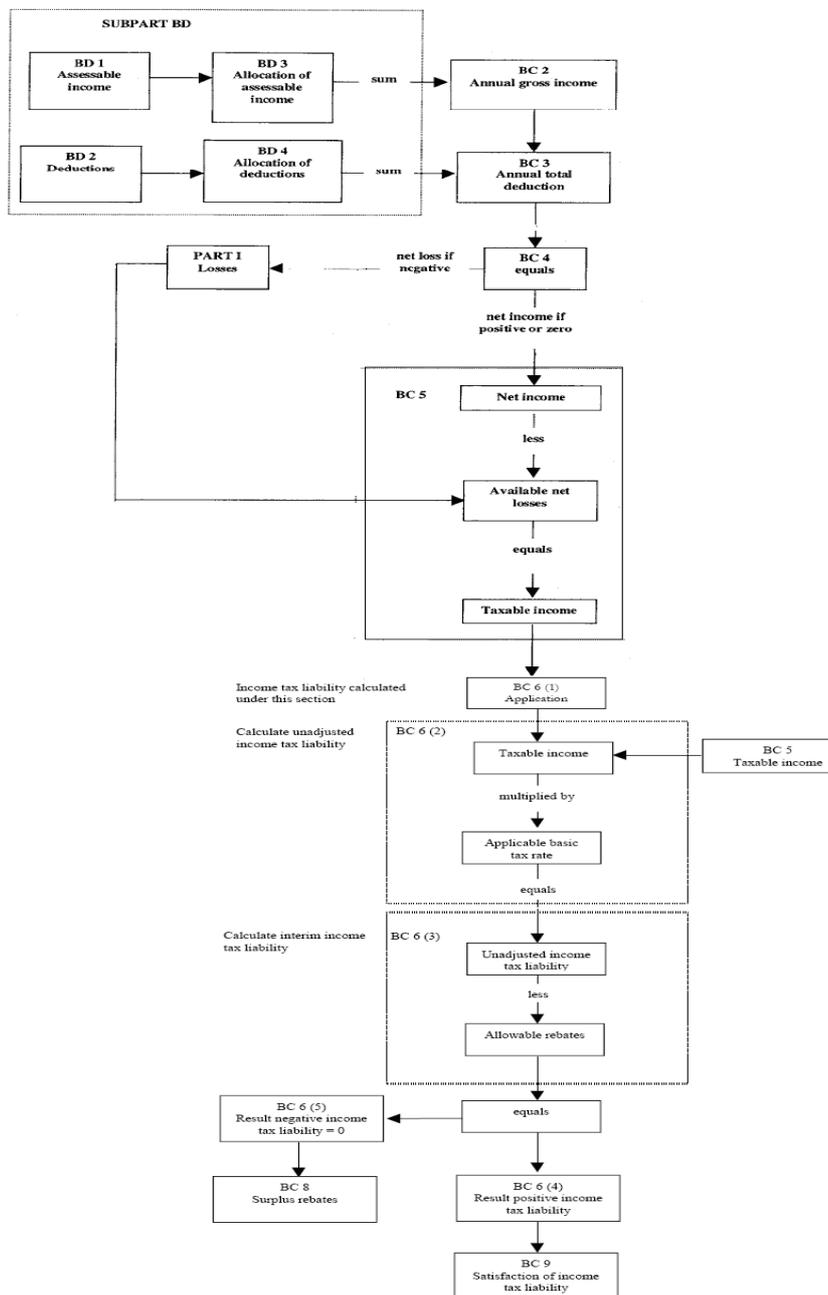


Figure 3 is the flowchart showing the process about how to calculate and satisfy income tax liabilities. The process in the Figure 3 can be summarized as follow:

Annual gross income - annual total deduction = net income (s BC4)

<sup>30</sup> *Income Tax Act 2004*

Net income - net losses = taxable income (s BC5)

Taxable income X basic tax rate = taxable income(s BC6)

Income tax liability – credits of income tax = payment of income tax liability (s BC9)

The above accounting analysis provides the basic process about how to calculate a person's income tax liable. The practical application of the way taxpayers can reduce their income tax liabilities may be separated into three main categories that emerge from the case law precedent: income splitting, conversion and deferral. In *Marx v CIR*<sup>31</sup>, Turner J discussed "income splitting" and "conversion" cases. In *Furniss v Dawson*<sup>32</sup> Lord Brightman recognized "tax deferment scheme". The income splitting case takes advantage of variable rate structure, such as rate differences applying to different entities or progressive rate scale. The conversion case arises because the tax base is less than comprehensive, for example the absence of a tax on capital gains. The deferral case exists because the current tax act gives the opportunities for taxpayer to defer existing tax liability. The following part will discuss the three categories in details.

## **2.2 Income splitting**

### **2.2.1 Description**

Income splitting is the first situation where the incidence of income tax is altered. Normally, the taxpayer will become liable to less tax after an arrangement which split the income by way of income transfer or deduction.

In *Marx v CIR*<sup>33</sup> Turner J concluded the income splitting cases "are the cases in which by virtue of the transactions the taxpayer derives less income than he would or might, but for the arrangement, have derived, others (generally relatives) emerging with larger incomes." Generally, there are two ways an income splitting can be arranged, by the way of income transfer and the way of creating deduction.

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<sup>31</sup> [1970] NZLR 182.

<sup>32</sup> [1984] AC474.

<sup>33</sup> [1970] NZLR 182.

## 2.2.2 Case law

### Income split by way of income transfer

In the case *Hadlee and Sydney Bridge Nominees Ltd v CIR*<sup>34</sup>, Mr Hadlee was a partner a national accountancy firm. The partnership agreement provided for profits to be allocated to partners proportionate to the number of “units” of partnership capital owned by them. Mr Hadlee had assigned 40 percent of his partnership units to a family trust in return for \$16,299. Mr Hadlee argued that this assignment was effective at law with the consequence being that the trust, not him, “derived” the income on these units.

In the Court of Appeal, Cooke P held<sup>35</sup>: “Without limiting the generality of that agreement, I attach particular weight to the fact that in return for a relatively minor monetary consideration, some \$16,000, most of which was actually paid out of partnership drawings, the partner at the age of 39 surrendered to his family trust 40 per cent of his future earnings in a leading accountancy practice of international stature, yet covenanted to continue diligently to attend full-time to the partnership business. The return to the trust in the first two years represented 123 per cent and 159 per cent of the monetary price.”

He endorsed Eichelbaum CJ's opinion in the High Court, that although the arrangement may have had other purposes, the significant and obvious tax benefits to be derived from entering into the arrangement pointed against the tax avoidance purpose being merely incidental. Cooke P viewed the partner as: “trying to obtain a tax advantage over other chartered accountants and professional people and other earners who pay tax on their earnings. That is contrary to the intent of the Act as a whole and s 99 in particular”.

In the *Case K52*<sup>36</sup>, an insurance agent transfers his “insurance register” to a family trust. Judge Bathgate observed that the arrangement “It directly reduced the liability of S to income tax. Before the transfer the commissions paid by the company to the trustees after the transfer, had been paid to S. Those commissions formed part of his assessable income. By transferring his insurance register to the trustees those commissions were alleged to be no longer part of his assessable income. As a result his income tax was reduced.”

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<sup>34</sup> [1991] 3 NZLR 517 (CA).

<sup>35</sup> Ibid.

<sup>36</sup> (1988) 10 NZTC 426.

In the case *W33*<sup>37</sup>, a dentist terminated his partnership and set up a company and a family trust of which the company was the trustee. The trading trust carried on the taxpayer's dentistry practice. While the taxpayer's relationship with his patients was the same as before, the trust earned the taxpayer's income and distributed the net income among the beneficiaries of the trust by book entry. Barber DCJ held "the trading trust restructuring is an "arrangement" and, prima facie, comes within the definition of "tax avoidance" and the arrangement "indirect altering of the incidence of income tax which would have been paid by the dentist, and there has been, at least, an indirect relieving of liability on him for income tax as his income has been reduced by the arrangement."

### **Income split by way of deduction**

*Peate v FC of T*<sup>38</sup> is the example how income can be split by way of transfer. In this case, a qualified medical practitioner practiced in partnership with other doctors, On 29 June 1956, a company called Westbank was formed, which derived the partnership income at the lower rate. Viscount Dilhorne found the true nature of the case that<sup>39</sup>:

"Before these arrangements were made in 1956 the appellant received fourteen percent of the net profits of the partnership and was assessed accordingly. After they were made, the doctors who had been partners treated patients in the same way as they had before but as a result of these arrangements, their incomes from the practice of their profession were reduced to the salaries received from the "family" companies, which received either by way of service fees or dividends the same percentage of the net profits of Westbank as the doctors had been entitled to under the partnership agreement. In their lordships' opinion these arrangements have the purpose and effect of avoiding a liability imposed on each doctor by the Income Tax and Social Services Contribution Assessment Act, 1936–1960."

The case *Jaques v FCT*<sup>40</sup> is an example for income split by deduction. In this case, the taxpayer claimed deduction in respect of calls paid on shares in the Kandos Cement Co Ltd and Kandos Collieries Ltd. The above two companies is the result of a reconstruction for an old company. Each of the new company purchased one of the two divisions of the old

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<sup>37</sup> (2004) 21 NZTC 11,321.

<sup>38</sup> [1967] 1 AC 308.

<sup>39</sup> Ibid.

<sup>40</sup> (1924) 34 CLR 328.

company and in return for paid up shares in the respective company. After the old company asset sold to two new companies, an arrangement arises for cash consideration. The companies issued contributing shares to the shareholders of the old company and make calls on the shareholders, which qualified as deductible expense. The High Court of Australia found that the arrangement has been carried into effect for the purpose of enabling the old company shareholders to claim a deduction and reduce their assessable income.

In recent *Case X27*<sup>41</sup>, a husband and a wife set up a trust for bakery distribution business. The husband was the settler and a family company was the trustee. They and their four children were the discretionary beneficiaries of that trust. A management contract, which set an annual management fee paid by trust to the husband and wife partnership, for distribution service was entered into between the trustee and partnership. The management fee are fixed each year at the most suitable income figure to enable the wife obtain maximum Family Support tax refunds. Barber PF held “The business structure organised by the parents and the accountant was an arrangement which, at least indirectly, had tax avoidance as an effect and, maybe, as a purpose.”<sup>42</sup>

## **2.3 Conversion**

### **2.3.1 Description**

Conversion is the second situation where the incidence of income tax is altered. Historically, conversion normally means a receipt that would have been gross income is converted into a capital or other non-taxable sum. In *Marx v CIR*<sup>43</sup>, Turner J concluded “The second class of cases in which it has been sought to set up the section are the "conversion" cases - those in which it has been sought to convert what would have been income derived by the taxpayer into a capital gain falling into his hands”.

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<sup>41</sup> (2006) 22 NZTC 12,316.

<sup>42</sup> Ibid.

<sup>43</sup> [1970] NZLR 182.

### 2.3.2 Case law

*Newton*<sup>44</sup> is a typical case of conversion. Three private companies had made large profits. At that time, under Australian law these profits would ordinarily be liable to a heavy tax. However, if the profit were distributed to the shareholders as dividends in cash or as bonus shares, the shareholders would be liable to pay tax at lower rate. The three companies entered into three different but similar arrangements, which increased the capital of the motor companies, enable the original shareholders to receive a large sum without paying tax on it.

Lord Denning Held “Looking at the whole of this arrangement, their Lordships have no doubt that it was an arrangement which is caught by s 260. The whole of the transactions show that there was concerted action to an end - and that one of the ends sought to be achieved was the avoidance of liability for tax.”

In the case *O’Neil*<sup>45</sup>, four taxpayers were shareholders in two trading companies which had participated in scheme devised by an accountant. Under this scheme, the taxpayers sold the shares to a company controlled by the accountant with an option to repurchase at the end of the scheme. The taxpayers remained the registered shareholders as trustees for the accountant's company and remained directors. The companies then became part of the accountant's group of companies that had tax losses. The companies paid to the accountant the entire net profits of their companies on a yearly basis as an administrative charge using the group losses. The accountant immediately returned to them the profits less administration fees, in the form of tax-free capital as part installment of the purchase price. The sale to the accountant's company also created a debt to the shareholders, which could be satisfied out of the profits of their companies.

Lord Hoffmann had no doubt that “the scheme by which the profits of the trading companies were to be converted into capital receipts in the hands of the shareholders” was tax avoidance caught by section 99.

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<sup>44</sup> [1958] AC 450,465.

<sup>45</sup> (2001) 20 NZTC 17,051.

## **2.3 Deferral**

### **2.3.1 Description**

In case *Furniss v Dawson*<sup>46</sup> Lord Brightman recognized “tax deferment scheme”. In this case, Lord Brightman stated, “The scheme before your Lordships is a simple and honest scheme which merely seeks to defer payment of tax until the taxpayer has received into his hands the gain which he has made.” There are two ways which have the effect of avoiding a potential liability to income tax. One is to postpone the derivation of gross income; another way is to accelerate the deductibility of expenditure.

### **2.3.2 Case law**

Case *J58*<sup>47</sup> is the type of arrangement that accelerated deductible expenses. The taxpayer was a private company providing clerical services to the public. The entire shares of this proprietary company were held by a married couple who were also the company directors. The company employed the husband as its manager. He also operated another business in his name dealing in a particular collectable item. His wife was employed as well by the company from time to time and to a lesser extent by her husband's business. The husband had set up a family partnership whereby the company's office equipment was sold at book value to the partnership. The lease of the premises was also purportedly assigned to the partnership. The office equipment and premises were rented back to the company. The rental for the premises was, however, higher than the rent the company had paid under the original lease. And the company claims a deduction for the rental payments. Judge Barber found the purported transactions involving the family partnership were a sham, so that the rent paid by the company to the partnership could not be treated as deductible because it was not a genuine expense of the company”. His honour concluded “the taxpayer had indulged in tax avoidance”.

In *Erris Promotions Ltd v C of IR*<sup>48</sup>, the six taxpayers were representatives of over 200 investors, who purchased units in the joint venture and in turn sought a tax advantage by claiming depreciation losses from the software. Judge Ronald Young J concluded “The main purpose for the joint venture arrangement was tax avoidance and this conclusion

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<sup>46</sup> [1984] AC474.

<sup>47</sup> (1987)9 NZTC 1327.

<sup>48</sup> (2003) 21 NZTC 18,330.

related to all of the six software packages purchased. Each of the purchases and subsequent claims for depreciation losses for each of the software packages were tax-avoidance schemes.”

In case *J61*<sup>49</sup>, a farmer claimed significant write downs on livestock that had been purchased and leased back to the vendor. Judge Baber found the arrangement “disclose a clear purpose of tax avoidance.” “The arrangements consisted of the said agreements entered into by the objector with the various farmers regarding stock. I find that such arrangements would not have been entered into in that particular way unless tax avoidance had been among the purposes of the objector. Further, it is clear from the evidence that tax avoidance was the main purpose.”

### **3.0 Current New Zealand approach**

#### **3.1 Overview**

How the court ascertains the legal effect of a transaction is a critical issue because the initial tax liability of a taxpayer will be determined by how the transaction is characterized. There are two possible ways used by the court to discover the true meaning of a transaction. One approach is to look for the legal nature of a transaction (i.e. the "form"), while the other approach ignores the legal position and regard is given to “the substance of the matter”. Commonly, these contrasting approaches are called “form and substance”.<sup>50</sup> The form method assesses the form or legal character of the arrangements actually entered into and carried out by the taxpayer while ignoring the economic consequences arising from the transaction. The substance method, on the other hand, looks at the real substance of the transaction, focusing on the overall economic result intended and achieved by the transaction.

The form approach was affirmed by the House of Lords in the leading case of *IRC v Duke of Westminster*.<sup>51</sup> And New Zealand Courts follow the approach in tax cases to uphold a taxpayer's arrangements even if the purpose or object of those arrangements is to avoid tax. However, there are two situations where the form approach does not apply. First, where the

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<sup>49</sup> (1987) 9 NZTC 1366.

<sup>50</sup> Inland Revenue Department, *IG9702: Form and Substance in Taxation Law*, Wellington, 1997.

<sup>51</sup> [1936] AC 1.

essential genuineness of the transaction is challenged and a sham established. Secondly, where there is a statutory provision, such as section BG 1 of the Income Tax Act 1994, which requires a broader or different approach to be adopted in assessing the transaction.<sup>52</sup>

### **3.2 Form approach**

The form approach in tax cases was established by the decision of the House of Lords in *IRC v Duke of Westminster*<sup>53</sup>. The case concerns whether the tax consequences of certain deeds the Duke entered into with several employees resulted in minimising his liability to surtax. At that time a deduction for surtax purposes was available for payments made for services by people not employed. However, if the payments were salary or wages no deduction was allowed. The majority of the House of Lords held that the payments made under the deeds were a proper deduction from the surtax assessment.

Lord Tomlin held: "...it is said that in Revenue cases there is a doctrine that the Court may ignore the legal position and regard what is called the 'substance of the matter', and that here the substance of the matter is that the annuitant was serving the Duke for something equal to his former salary or wages and that, therefore, while he is so serving, the annuity must be treated as a salary or wages. This supposed doctrine ... seems to rest its support upon a misunderstanding of language used in some earlier cases. The sooner this misunderstanding is dispelled and the supposed doctrine given its quietus the better it will be for all concerned, for the doctrine seems to involve substituting 'the uncertain and crooked cord of discretion' for 'the golden and straight mete wand of the law'.

"Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax. This so-called doctrine of 'the substance' seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable."

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<sup>52</sup> *Mills v Dowdall* [1983] NZLR 154.

<sup>53</sup> [1936] AC 1.

This approach was subsequently confirmed in New Zealand in a number of cases such as: *C of IR v Europa Oil (NZ) Ltd*<sup>54</sup>, *Re Securitibank Ltd (No 2)*<sup>55</sup>, *Buckley & Young Ltd v C of IR*<sup>56</sup> and *Mills v Dowdall*<sup>57</sup>.

Although the court will adhere to the legal form of a transaction, it has also been stated that the court will carefully ascertain the true legal nature of a transaction by considering the whole of the contractual arrangement and any surrounding circumstances the court feels appropriate. This approach is reflected in the judgment of Richardson J in *Mills v Dowdall*<sup>58</sup>:

“The true nature of the transaction can only be ascertained by careful consideration of the legal arrangements actually entered into and carried out. Not on an assessment of the broad substance of the transaction measured by the results intended and achieved; or of the overall economic consequences to the parties; or of the legal consequences which would follow from an alternative course which they could have adopted had they chosen to do so. The forms adopted cannot be dismissed as mere machinery for effecting the purposes of the parties. It is the legal character of the transaction that is actually entered into and the legal steps which are followed which are decisive.”

In applying the form approach, the whole of the contractual arrangement must be considered and if it is embodied in a number of complex or interrelated agreements, all of the agreements must be considered together and one may be read to explain the others. In both *C of IR v Europa Oil (NZ) Ltd*<sup>59</sup> and *Europa Oil (NZ) Ltd v C of IR (No 2)*<sup>60</sup> the Privy Council held that the contractual agreement entered into by the taxpayer must be considered in its entirety and, if the transaction is embodied in a series of inter-related agreements, they must be considered together and one may be read to explain the others.

The Court of Appeal in *Buckley & Young Ltd v CIR*<sup>61</sup> also held that the surrounding circumstances should be considered in assessing the transaction in order to provide an

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<sup>54</sup> ATC 6012 [1971] NZLR 641.

<sup>55</sup> [1978] 2 NZLR 136.

<sup>56</sup> (1978) 3 NZTC 61,271 [1978] 2 NZLR 485.

<sup>57</sup> [1983] NZLR 154.

<sup>58</sup> [1983] NZLR 154.

<sup>59</sup> [1971] NZLR 641;70 ATC 6,012.

<sup>60</sup> (1976) 2 NZTC 61,066 [1976] 1 NZLR 546.

<sup>61</sup> (1978) 3 NZTC 61,271.

understanding of the background in which it was made and to construe the transaction against this background. However, the Court emphasised that the factual matrix is admissible for the purpose of ascertaining the surrounding circumstances to understand the setting in which the actual agreement was made. The evidence cannot be used to contradict or deny the legal character of the written agreement entered into.

### **3.3 Shams**

Sham is first exception to the form approach. The concept of “sham” has been defined and analysed in numerous decisions both in New Zealand and elsewhere. The classic definition of a sham was given in *Snook v London & West Riding Investments Ltd*<sup>62</sup>, where Diplock LJ said:

“... that for acts or documents to be a ‘sham’, with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations which they give the appearance of creating.”

A sham is the act done or document executed that is intended to mislead. It is where the parties resort to a form of action or document which does not fit the real facts in order to deceive a third person.<sup>63</sup> A sham is not the underlying motive or intention of the parties

In *Mills v Dowdall*<sup>64</sup> Richardson J described the concept of sham as a situation in which the “essential genuineness of the transaction is challenged”. In that case Richardson J also indicated that there are two situations in which there may be a sham. First, where the documents do not reflect the true agreement between the parties; and second, where the documents are bona fide in inception but the parties have departed from their initial agreement while leaving the original documentation to stand unaltered.

A sham does not apply to transactions that are intended to take effect, and do take effect, between the parties according to their tenor, even though those transactions may have the

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<sup>62</sup> [1967] 1 All ER 518.

<sup>63</sup> *Bateman Television v Coleridge Finance Co Ltd* [1969] NZLR 794.

<sup>64</sup> [1983] NZLR 154.

effect of fraudulently preferring.<sup>65</sup> And a sham will not be found to exist simply because a taxpayer adopts one legally available form over another<sup>66</sup>.

There is no acceptance of the notion of a “halfway house” between a sham and an effective transaction. This means there is no legal principle supporting a concept where, even though the documents record the intention of parties, nevertheless the substance of the transaction can be interpreted so as to produce some different legal result<sup>67</sup>. In ascertaining the true nature of the transaction one must consider the legal character of the agreement which embodies the transaction. It is only if a challenge can be mounted on the basis of the genuineness of the agreement that it is necessary to consider the true substance of the transaction.

### **3.4 Section BG 1 Income Tax Act 2004**

The second exception for the form approach is where there is a statutory anti-avoidance provision, which requires a broader or different approach to be adopted in assessing the transaction. The statutory anti-avoidance provision can be divided into two categories: specific anti-avoidance provisions and the general anti-avoidance provision. Specific anti-avoidance provisions are directed to particular defined situations, whereas the general anti-avoidance provision is not limited to specific transactions and covers any arrangement entered into with the object of avoiding tax.

Section BG 1 is current general anti-avoidance provision of the Income Tax Act 2004. Cooke J in *Challenge Corporation Ltd v CIR*<sup>68</sup> described the ambit and effect of these provisions:

“[the provisions] nullif[y] against the Commissioner for income tax purposes any arrangement to the extent that it has a purpose ... of tax avoidance ... [W]here an arrangement is void ... the Commissioner is given power to adjust the assessable income of any person affected by it, so as to counteract any tax advantage obtained by that person.”

It was also noted by Woodhouse J in *Elmiger v CIR*<sup>69</sup> that the general provision, “is designed ... to forestall the use by individual taxpayers of ordinary legal processes for the

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<sup>65</sup> *Paintin and Nottingham Ltd v Miller Gale and Winter* [1971] NZLR 164.

<sup>66</sup> *Bateman Television v Coleridge Finance Co Ltd* [1969] NZLR 794.

<sup>67</sup> *Re Securitibank Ltd (No 2)* [1978] 2 NZLR 136.

<sup>68</sup> [1986] 2 NZLR 513, 541 (CA).

deliberate purpose of obtaining a relief from the natural burden of taxation denied generally to the same class of taxpayer”.

In *Elmiger*<sup>70</sup> case, Woodhouse J also recognised the conflict between arrangements potentially subject to section 108 and the *Duke of Westminster* principle. He was suggesting that the *Duke of Westminster* does not override the general anti-avoidance provision(s) of the Income Tax Act. Baragwanath J in *Miller*<sup>71</sup> also suggested “Section 99 is not to be construed according to the *Duke of Westminster’s* case or Rowlatt J’s dictum [that there is no equity to tax].”

## 4.0 Options for prevention of tax avoidance

The harms caused by impermissible tax avoidance are varied and pervasive. The effects include short-term revenue loss, growing disrespect for the tax system and the law, increasingly complex tax legislation, the uneconomic allocation of resources, an unfair shifting of the tax burden, and a weakening of the ability of Parliament and National Treasury to set and implement economic policy.<sup>72</sup> So the tax avoidance needs to be prevented or at least be kept it within limits. The way used to prevent tax avoidance can be judicial and legislative.

The judicial or administrative rules are developed by the courts or by the policymakers to prevent the tax avoidance. And the legislative rules are framed by the government to preventing the possible problem. These legislative rules can also be divided into two categories: specific anti-avoidance provisions and the general anti-avoidance provision. Specific anti-avoidance provisions are directed to particular defined situations, whereas the general anti-avoidance provision has raised a general anti-avoidance yardstick by which the line between legitimate tax planning and improper tax avoidance is to be drawn.<sup>73</sup>

### 4.1 Judicial/administrative rule

In most countries, the interpretation of tax law falls first into the executive branch, which will apply law and interpretation to individual cases through individual rules and decisions.

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<sup>69</sup> [1966] NZLR 683, 694.

<sup>70</sup> Ibid.

<sup>71</sup> *Miller v CIR* [1997] 18 NZTC 13,001 (HC) at p 13,032.

<sup>72</sup> Review of Business Taxation, *A Tax System Redesigned*, Canberra, 1999 at s. 6.2(c).

<sup>73</sup> *CIR v BNZ Investments Limited* (2001) 20 NZTC 17,103, per Richardson P.

Review of these rules is undertaken by independent courts<sup>74</sup>. In the normal case, courts interpret the tax law and apply it in specific disputes between the taxpayer and the tax administration. This means that the final interpretation of tax laws belongs to the judiciary.<sup>75</sup> In all Western legal systems, the courts apply a specific method of legal reasoning, based on a systematization of facts and legal rules, in order to arrive at the concrete application of the tax law in the individual case. The style of statutory interpretation differs substantially from jurisdiction to jurisdiction,<sup>76</sup> the judicial rules which developed by the court are also various.

In some country like United States, the courts have developed a variety of robust judicial doctrines to counter abusive avoidance schemes. These doctrines are closely related and work well in used by the American courts to fight with commercial realities in the tax arena<sup>77</sup>. In United Kingdom, interpretation of tax statutes used to be controlled by the form approach, which was established by the decision of the House of Lords in *IRC v Duke of Westminster*<sup>78</sup>. However, in the recent 20 years, the courts developed some different judicial anti-avoidance doctrine to put some limits on the scope for avoidance. There are also some counties such as French and China, because they are a civil law system country, they rely on largely administration rule for fight with tax avoidance.

An important doctrine found in many civil law countries is known as abuse of rights, avoidance of the law, or *fraus legis*. “Abuse of rights, in general terms, is a concept which gives a remedy to a person who is injured by another person who exercises a right but in doing so acts with malice or other improper motive.”<sup>79</sup> This concept has been applied in different ways in different countries. Application of the doctrine to tax law would prevent someone from taking advantage of the literal language of the statute. This doctrine has generally been rejected by the U.K. courts, while the attitude of American courts is much closer to that of civil law courts in this regard.<sup>80</sup>

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<sup>74</sup> International Monetary Fund, *Tax Law Design and Drafting*, 1996.

<sup>75</sup> Ibid.

<sup>76</sup> D. Neil MacCormick and Robert S. Summers, *Interpreting Statutes: A Comparative Study*, 1991.

<sup>77</sup> International Monetary Fund, *Tax Law Design and Drafting*, 1996.

<sup>78</sup> [1936] AC.

<sup>79</sup> David Ward et al., *The Business Purpose Test and Abuse of Rights*, (1985), *British Tax Review* 68, 68 n.1.

<sup>80</sup> Thuronyi, R, *Rules in OECD Countries to Prevent Avoidance of Corporate Income Tax* at s. 1.e.

## **4.2 Specific anti-avoidance rules**

Specific anti-avoidance provisions are those legislative rules which apply to a specific transaction, and the results of their application are precisely defined. In many cases, they do not focus on application or interpretation of tax law, but simply mechanically deny certain tax benefits under certain conditions. They are clear and simple solution to dealing with avoidance to against those transactions or activities which government does not wish to promote.<sup>81</sup>

Most of countries have specific anti-avoidance provisions, the country, such as the United Kingdom has continued to battle new avoidance schemes through specific anti-avoidance provisions. In the 2005 Budget, for example, three new sets of broad anti-avoidance rules were introduced targeting avoidance through arbitrage, double tax relief avoidance, and financial avoidance.<sup>82</sup>

There are several reasons why many countries have enacted specific anti-avoidance rules to counter the tax avoidance.<sup>83</sup> The first reason is the specific provisions are better suited in dealing with specific avoidance transactions. Specific anti-avoidance rules are generally narrow focus on particular types of transactions, which limited in their application. However, that narrow focus can assist tax practitioners and tax administrators to apply the law by comparison with the more generic application of the general anti-avoidance rules. The second reason is specific provisions can be utilized to close deficiencies which may arise from previous legislative enactments or judicial decisions. Moreover specific provisions have the advantage of increasing legal certainty as compared with general anti-avoidance rules, because the provisions are directed at specific situations governed by specific rules.<sup>84</sup>

The disadvantage of specific anti-avoidance provisions is potentially led to voluminous and complex legislation which may increase compliance costs. The taxpayers can exploit their precision by designing transactions that fall outside their ambit. In order to cope with the challenge, the government attempts to introduce more and more specific anti-avoidance provisions.

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<sup>81</sup> Trombitas, E, *Tax Reform Issue*, New Zealand Journal of Taxation Law and Policy Volume5:3, 1999.

<sup>82</sup> Ernst&Young, *UK budget 2005: Summary of main changes*, International Tax Alert, March 2005.

<sup>83</sup> Trombitas, E. *Tax Reform Issue*, New Zealand Journal of Taxation Law and Policy Volume5:3 1999.

<sup>84</sup> Ibid.

### **4.3 General anti-avoidance provision**

The general anti-avoidance provision is not limited to specific transactions and covers any arrangement entered into with the object of avoiding tax. If a particular transaction does not come within the framework of a specific rule, then reliance on the general anti-avoidance rules is necessary.

Richardson P has cogently explained the conceptual basis for general anti-avoidance provision (GAAP) in case *CIR v BNZ Investments*<sup>85</sup>:

“(The GAAP) is perceived legislatively as an essential pillar of the tax system designed to protect the tax base and the general body of taxpayers from what are considered to be unacceptable tax avoidance devices. By contrast with specific anti-avoidance provisions which are directed to particular defined situations, the legislature through [the GAAR] has raised a general anti-avoidance yardstick by which the line between legitimate tax planning and improper tax avoidance is to be drawn. Line drawing and the setting of limits recognise the reality that commerce is legitimately carried out through a range of entities and in a variety of ways; that tax is an important and proper factor in business decision making and family property planning; that something more than an existence of a tax benefit in one hypothetical situation compared with another is required to justify attributing a greater tax liability; that what should reasonably be struck at are artifices and other arrangements which have tax induced features outside the range of acceptable practice – as Lord Templeman put it in *Challenge* at p. 562, most tax avoidance involves a pretence; and that certainty and predictability are important but not absolute values. The function of (The GAAP) is to protect the liability for the income tax established under the other provisions of the legislation”.

Among the world, countries such as Canada, Australia and New Zealand, all have the general anti-avoidance provisions which are in similar concept to prevent possible tax avoidance transactions.

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<sup>85</sup> *CIR v BNZ Investments* [2002] 1 NZLR 450.

## 5.0 Judicial/administrative rule

### 5.1 Examples of judicial and administrative rule

#### 5.1.1 United States

Over time, the United States judiciary has long been activist in interpreting tax laws, fashioning a number of anti-avoidance doctrines to reflect the presumed intent of Congress in enacting the income tax laws. The *Gregory*<sup>86</sup> case is the starting point of the development of those anti-avoidance doctrines. In the *Gregory*<sup>87</sup> case, the court developed a doctrine allowing them to set aside certain legal constructions that do not have a “business purpose”. When a legal construction has its clear purpose of avoidance of income tax and does not at the same time involve some economic substance, it can be set aside by the courts as having no effect for tax purposes and replaced by another characterization of the underlying factual situation.

From that time, the courts have developed several judicial doctrines, such as constructive income or ownership,<sup>88</sup> continuity of business enterprise,<sup>89</sup> and the step-transaction doctrine<sup>90</sup>. The step-transaction doctrine allows a court to decompose a transaction into several distinct steps, or to take several separate transactions together, in order to ascertain whether each of the individual steps, or the overall complex transaction, meets the requirements to benefit from certain effects under the tax law.<sup>91</sup>

The application of substance over form approach, in United States tax case law, has been summarized by *Bittker & Eustice*<sup>92</sup> as following:

“One of the persistent problems of income taxation, as in other branches of law, is the extent to which legal consequences should turn on the substance of a transaction rather than on the transaction's form. It is easy to say that substance should control, but, in practice, form usually has some substantive consequences. If two transactions differ in form, they

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<sup>86</sup> *Gregory v. Helvering*, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

<sup>87</sup> *Ibid.*

<sup>88</sup> *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945).

<sup>89</sup> *Standard Realization Co. v. Commissioner*, 10 T.C. 708 (1948).

<sup>90</sup> *West Coast Marketing Corp. v. Commissioner*, 46 T.C. 32 (1966).

<sup>91</sup> *Ibid.*

<sup>92</sup> *Bittker & Eustice*, *supra* note 132, 1.05[2][b], 1.05[3][d].

probably are not identical as to substance. Even so, they may be sufficiently similar to warrant identical tax treatment. . . .

The foregoing judicial principles and statutory provisions, which often overlap in practice, are useful deterrents to tax-avoidance schemes of varying scope and ingenuity. Forcing transactions heavily freighted with tax motives to withstand judicial analysis in the context of these broad principles and provisions, vague and uncertain in application though they may be, is more salutary than uncompromising literalism in applying the statutory system for taxing corporations and shareholders”.

These doctrines are closely related and work well in used by the American courts to fight with commercial realities in the tax arena

### **5.1.2 United Kingdom**

Initially United Kingdom lacked a judicial anti-avoidance doctrine. The United Kingdom has neither a statute nor an established legal principle to counter tax avoidance in general.<sup>93</sup> Traditionally the courts in the United Kingdom have followed the *Duke of Westminster* principle (*IRC v Duke of Westminster*<sup>94</sup>) and adopted a form approach in tax cases. They have upheld a taxpayer’s arrangements even if the purpose or object of those arrangements is to avoid tax. However, in 1981, *W.T. Ramsay Ltd. v. Internal Revenue Commissioner*<sup>95</sup> was decided. This case is considered to be the starting point for the development of a “new approach” to tax avoidance schemes. In this case, the House of Lords struck down a tax-planning device on the basis that it was entitled to look at the overall result of several transactions and need not giving tax effect to every single transaction. As Lord Fraser of Tullybelton comments later<sup>96</sup> :

“[T]he fiscal consequences of a preordained series of transactions, intended to operate as such, are generally to be ascertained by considering the result of the series as a whole, and not by dissecting the scheme and considering each individual transaction separately.”

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<sup>93</sup> Revenue HM and A Customs, *General Anti-Avoidance Rule for Direct Taxes: Consultative Document*, (1998).

<sup>94</sup> [1936] AC.

<sup>95</sup> [1981] STC 174.

<sup>96</sup> *Furniss v Dawson*, [1984] 1 All E.R. 530, 532.

This doctrine was further developed in *Furniss v. Dawson*<sup>97</sup>, in which the step- transaction doctrine and the commercial purpose doctrine were formulated as follows<sup>98</sup>:

“The formulation, therefore, involves two findings of fact: first whether there was a preordained series of transactions, ie [sic] a single composite transaction; second, whether that transaction contained steps which were inserted without any commercial or business purpose apart from a tax advantage.”

That is the establishment of so called “fiscal nullity” doctrine. This decision was confirmed a few years later in *Craven v. White*,<sup>99</sup> when Lord Jauncey stated the position of the House of Lords on tax avoidance:

“I conclude my analysis of the three cases by emphasizing that the *Ramsay* principle is a principle of construction, that it does not entitle the courts to legislate at large against specific acts of tax avoidance where Parliament has not done so and that at the end of the day the question will always be whether the event or combination of events relied on amount to a chargeable transaction or give rise to allowable relief within the meaning of the relevant statutory provisions.”

The fiscal nullity doctrine try to prevent putting some limits on the scope for avoidance tax avoidance, but this approach has been rejected in most commonwealth jurisdictions even in those where UK cases are generally regarded as persuasive, such as New Zealand.

### **5.1.3 France**

France is a civil law system country, the French legality principle laid down in article 34 of the Constitution. As a consequence, tax laws are interpreted strictly. A clear text cannot be interpreted beyond the literal meaning intended by the legislator<sup>100</sup>. The French courts have developed the doctrine of “abnormal management act” under which transactions that deviate from what a prudent businessperson would do can be disregarded for tax purposes. An alternative anti-avoidance provision is art. L. 64 of the tax code, which has been interpreted to cover both simulation and abuse of right; to invoke this provision, the tax

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<sup>97</sup> [1984] STC 153.

<sup>98</sup> Ibid.

<sup>99</sup> [1988] 3 All E.R. 495.

<sup>100</sup> Demante, *Principes de l'enregistrement No. 9*, 1897, ed. trans.

administration must undergo a special procedure, and hence it is not used very often<sup>101</sup>. French courts have always recognized the authority of the tax administration to submit evidence about the real nature of the transaction, so that it should be requalified for tax purposes.

#### **5.1.4 China**

China is also a civil law system country. Under art. 67 of the Constitution of the People's Republic of China, the Standing Committee of the National People's Congress have the power to interpret the constitution and other national statutes. This means that authoritative interpretation of tax laws is in the first place the work of the legislator. However, the Chinese tax legislator has not made frequent use of this power. Article 89(18) of the constitution allows a delegation of this power to lower agencies. In this way, the constitutional provision is used to grant regulatory power to the Ministry of Finance and to the State Administration of Taxation to issue interpretive regulations of the tax laws. The legislature may achieve a similar effect by amending an existing law, with or without retroactive effect. Such action by the legislature is common when the legislature wants to reverse the effect of the interpretation of a statute by a court.<sup>102</sup>

Most of tax cases in China are an administrative case. In contrast to a judicial case, where the court makes a pronouncement on the dispute between the authorities and the taxpayer, the decision of tax officials in a tax administrative case authoritatively disposes of substantive issues without court involvement. Although it is generally known that administrative officials play a pivotal role in law making and interpretation in China, little attention has been devoted to how law has actually been used in an administrative case.<sup>103</sup>

#### **5.2 Designing rule for New Zealand**

In the 2004 Budget, the United Kingdom introduced a new obligation on promoters and users of certain tax schemes to disclose them to the UK Inland Revenue<sup>104</sup>. This is the

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<sup>101</sup> International Monetary Fund, *Tax Law Design and Drafting*, volume 1, 1996.

<sup>102</sup> Ibid.

<sup>103</sup> Jiang, Z.D, *The Administrative Use of Law in China: The Baori Gold Club Tax Case*, The Columbia Journal of Asian Law, 1999.

<sup>104</sup> The 2004 UK Budget and the Chancellor's Speech are available at, <[http://www.hm-treasury.gov.uk/budget/budget\\_04/bud\\_bud04\\_speech.cfm](http://www.hm-treasury.gov.uk/budget/budget_04/bud_bud04_speech.cfm)>.

similar approach to tax avoidance that has been launched in the United States in 2000, which requires the registration with the U.S. Revenue department of certain tax shelters.

The US rule requires that the taxpayer must disclose the shelter on the tax return. Promoters of potentially abusive tax shelters must keep a list of investors, which is available to the IRS.<sup>105</sup> A proposed legislation has been introduced in Congress to clarify and increase the penalties for failing to disclose tax shelters on returns. Under the new legislation, there will be serious penalties if a taxpayer engages in one of these transactions and does not disclose the transaction on its return.<sup>106</sup>

Introduced by Finance Act 2004 and a variety of Statutory Instruments, those disclosure rules are designed to alert the UK tax authorities to certain types of tax planning strategies at a very early stage, by requiring promoters of the arrangements to disclose details of the transactions within five working days of “selling” them to clients.<sup>107</sup> The UK provisions are more narrowly focused than their US equivalent. The scope of the UK disclosure rules is limited to certain employment and financial products and the tax advantage trigger is itself restricted to income tax, corporation tax and capital gains tax. That new disclosure approach is aimed to tackle aggressive avoidance schemes.

New Zealand had similar consideration for such pre-transaction ruling system. In the Inland Revenue issues paper, *Mass-Marketed Tax Schemes*<sup>108</sup>, one of suggested solution for mass-marketed tax schemes is:<sup>109</sup>

“Schemes that meet one of several criteria would have to register with Inland Revenue and disclose that fact in a specified format on their prospectuses or "invitations to invest””

But New Zealand didn't go any further in this suggestion, now probably is the time to reconsider the possibility to reinforce the anti-avoidance provision using similarly disclosure requirement.

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<sup>105</sup> United States Internal Revenue Code 1986. sec. 6112.

<sup>106</sup> International Monetary Fund, *Tax Law Design and Drafting*, volume 1, 1996.

<sup>107</sup> Inland Revenue (UK), *Tackling Direct Tax Avoidance — Disclosure Requirements, Draft Guidance*, London, May 2004, <<http://www.inlandrevenue.gov.uk/drafts/disclosure-draft-guidance.pdf>>.

<sup>108</sup> Inland Revenue, *Mass-Marketed Tax Schemes: an Officials' Issues Paper on Suggested Legislative Amendments*, Wellington, January 2002.

<sup>109</sup> Ibid.

## **6.0 Legislative – specific rules**

### **6.1 New Zealand**

The specific anti avoidance provision is applied in particular areas and often specified in detail the transactions targeted and the tax consequences if tax avoidance is found. In New Zealand, there are numerous specific anti-avoidance provisions that now compose a considerable part of the current Income Tax Act 2004.

Most of the specific anti avoidance provision in Tax Act 2004, apply to specific transactions, and the results of their application are precisely defined. For example, assignments of the right to income or settlements of income producing property for less than the period prescribed in s FC11 of the Act result in the income being deemed to be derived by the transferor or settler.

There is also another situation, the transaction which is impugned is specified but the application of the provisions of the section is based on discretion exercisable by the Commissioner. For example, section GD 3 stipulates that where the Commissioner is of the opinion that excessive remuneration or profits are paid to a relative employed by or in partnership with the taxpayer the Commissioner may for tax purposes allocate the remuneration or profits between the parties in such shares as the Commissioner considers reasonable.

Some key specific anti-avoidance provisions in the Income Tax Act 2004 are noted as follows:

Section CW 35 contains several qualifications and requirements of the exemption, which assists with resolving issues concerning whether a trustee is carrying on a business, controlling over the business and the gaining of a benefit or advantage from the business.

Section CD 33(11), excluding from the exemption for distributions of capital gains paid on a liquidation of a company amounts realised on the disposal of an asset to a related party. No capital gain amount is derived upon the disposal of a capital asset by a company under an arrangement with a related person.

Section FB 4 states that when trading stock is sold together with the other assets of a business, the total consideration must be apportioned to reflect the respective market values of the trading stock and the other assets.

Section FC 6(8), states that in any case where the lessee in any specified lease, at any time purchased or otherwise acquired that lease asset and sold that lease asset and the value of the consideration for that sale exceeds the value of the consideration for which the lessee purchased, an amount equal to that excess is gross income derived by the lessee in the income year in which the lease asset is sold.

Part GC contains a number of specific anti-avoidance provisions which complement specific tax regimes contained elsewhere in the Act.

Section GC 1 extends the transfer pricing rule in s GD 13 to a collateral arrangement such as a market sharing arrangement, an arrangement not to enter into a particular market, a back-to-back supply arrangement or an income-sharing arrangement.

Section GC 2 prevents the manipulation of rights attaching to shares in order to meet the terms of the net loss carry-forward rules.

Section GC 3, where there is a change in the beneficiaries of a trust under an arrangement which has a purpose or effect of defeating the intent and application of any of the continuity provisions, there is a deemed disposition by the trustee of the share or option to an unrelated third party and an immediate reacquisition.

Section GC 5 in related to entry into the qualifying company regime, is disallowed where the Commissioner believes that the shares have been subject to an arrangement for the purposes of making a company a qualifying company to defeat the intention and purpose of the qualifying company regime.

Section GC 6, sates the Commissioner may disallow any deduction for depreciation where it is considered there was an arrangement to enable additional depreciation to be claimed when it was not intended that it be available.

Section GC 9 is aimed at nullifying attempts by taxpayers to manipulate their control interests and income interests in controlled foreign companies by successive variations to those interests before and after a quarterly measurement day.

Section GC 10 permits the Commissioner to disregard, or deem to be made (as the case may be), elections for the measurement of ownership interests in controlled foreign companies or foreign investment funds, where such interests are transferred between associated persons who make, or do not make, the elections for the purposes of avoiding the application of the controlled foreign company and foreign investment fund regimes.

Section GC 11 is specific anti-avoidance rules in respect of films. Sections GC 11A and GC 11B contain provisions governing the timing of the deduction for deferred fees and other costs of acquiring and producing a film where their payment is deferred beyond the period in which they would normally have been payable, and giving the Commissioner certain powers to counteract arrangements which seek to artificially inflate the cost of producing a film or of acquiring rights in a film.

Section GC 12 allows Commissioner adjust the gross income of any person affected by an arrangement consisting of a disposal of any petroleum mining asset, the incurring of exploration expenditure or a farm-out arrangement which has the effect of, or which has been entered into for the purpose of, tax avoidance so as to counteract any tax advantage obtained by the person.

Section GC 14A is aimed at preventing non-residents from avoiding non-resident withholding tax on a redemption payment by disposing of a commercial bill to a resident immediately before its maturity.

Section GC 14B–GC 14E contains rules for the attribution of personal services income when a personal services provider has inserted an entity between himself or herself and the recipient of those services.

Section GC 14F allows the Commissioner to counteract the effect of arrangements which have an effect of avoiding the application of the restrictive covenant rule in s CHA 1(1). The commissioner may treat an amount, or part of an amount, under the arrangement as an

amount to which section CHA 1(1) applies; and a person affected by the arrangement as the person who gave the undertaking referred to in section CHA 1(1).

Section GC 15 limited exception for a benefit granted to a shareholder-employee, provided no arrangement exists between the parties to substitute employment income or avoid fringe benefit tax. The Commissioner is satisfied that the benefit is not provided or granted under an arrangement which has a purpose of providing or granting a benefit to the employee, in lieu of monetary remuneration; or Free from the application of fringe benefit tax

Section GC 16 authorises the Commissioner to determine a vehicle's cost price for fringe benefit tax (FBT) purposes where the vehicle was acquired by the employer at no cost, the vehicle was acquired at less than its current market value because of an arrangement between the employer and an associated person to defeat the intent and application of the FBT provisions, or the cost price cannot be established by the employer to the satisfaction of the Commissioner.

Section GC 17 counteracts the effect of any arrangement that has a purpose or effect of defeating the intent and application of the FBT rules. From 1 April 2006, s GC 17B allows the Commissioner to adjust any fringe benefit which a person obtains as a result of an arrangement that is void under s BG 1.

Section GC 18 provides that any agreement not to make a tax deduction, combined tax and earner premium deduction or combined tax and earner levy deduction as required by the Act is void.

Section GC 19 effectively states that the general anti-avoidance provision in s GB 1(1) is to apply to resident withholding tax.

Section GC 20 provides that an agreement not to make a tax deduction in accordance with resident withholding tax rules is void.

Section GC 22 operates to counteract the effect of credit-streaming arrangements in relation to imputation credits or dividend withholding payment credits.

Section GC 23 is the provisions of the counter "stapled stock" arrangements. This provision applies to dividends paid under arrangements to beneficiaries of trusts, where a shareholder

is a trustee in relation to any shares held; and persons associated with any such beneficiary or a shareholder.

Section GC 24 details how the specific anti-avoidance provisions in ss GC 22 and GC 23(2) apply in the case of consolidated groups.

Section GC 25, if the Commissioner considers that an arrangement has been entered into for the purpose of, or for purposes including, the avoidance of the dividend withholding payment rules, the Commissioner may deem a payment or a part of a payment to be a foreign withholding payment dividend even though the arrangement provides otherwise.

Section GC 28 is directed towards arrangements made with a view to increasing a person's entitlement to family support and family plus tax credits under subpart KD.

Part GD deals with a number of non-market transactions and sets out specific anti-avoidance rules in the area of trading stock, remuneration, superannuation and life insurance, land, and other non-market transactions.

Section GD 1 is related to the sale of trading stock disposed of for an inadequate consideration. Under s GD 1, where trading stock is disposed of without consideration, or for a consideration that is less than its market value at the date of sale, the trading stock is treated as having been sold for market value. The Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Bill, cl 82, will amend s GD 1 by adding exclusion for shares transferred back to a share supplier under a share-lending arrangement.

Section GD 2 is related to the distribution of trading stock to shareholders by companies. Under this section, the distribution is treated as a sale of the trading stock by the company to the shareholder or the associated person, and the trading stock is treated as having been sold at and realised at its market price on the date of the distribution. An amount equals to the price which under this section the trading stock is deemed to have been realised shall be treated as gross income of the company. The shareholder or the associated person shall be deemed to have purchased the trading stock at the price which under this section the trading stock is deemed to have been realised.

Section GD 3 is related to the excessive remuneration of share of profits paid to relatives. Under s GD 3, the Commissioner has broad powers to treat excessive salary or wages or

share of profits as income in the hands of the recipient and to treat certain payments as a dividend for tax purposes.

Section GD 4 is related to payments between husband and wife. Under s GD 4, no deduction is permitted for a payment of any kind made by a taxpayer to his or her spouse or civil union partner unless the Commissioner consents to that deduction before the deduction is claimed.

Section GD 5, is related to the excessive remuneration paid by a close company to a shareholder or a relative of a shareholder. Under s GD 5, when a close company pays or credits any sum as remuneration for services rendered by a shareholder, a director or one of their relatives, the Commissioner is authorised to limit the deduction available to a reasonable level of remuneration.

Section GD 6 includes within a superannuation fund's income the fringe benefit value of a low-interest loan to a scheme member.

Section GD 7 requires certain property of a life insurer to be treated as trading stock for the purposes of ss GD 1 (sale for inadequate consideration) and GD 2 (trading stock distributed to shareholders). Note that s GD 2 was repealed with effect from the beginning of the 2005/06 tax year.

Section GD 8 sets out how superannuation schemes stand in relation to the life insurance regime, eg, when the provision of a benefit by superannuation schemes to a member will be treated as if it were the provision of life insurance.

Section GD 9(1) is related to the transfer of land between associated persons where profit from sale of the land might be assessable.

Section GD 10 applies where property is leased to a relative or a related company for less than an adequate rent. It applies only to the extent that the leased property is used by the lessee in the derivation of gross income or exempt income.

Section GD 12(1) and (2) is related to artificial arrangements made in the course of producing a New Zealand film.

Section CB 13 covers the situation where one person acquires land in circumstances in which he or she would attract a liability to tax under ss CB 5–CB 12 and then he or she transfers land to an associated person.

Section GD 10 notionally increases the amount of rent received by a property owner from a relative or a related company where the rent is less than the market rate.

Section GD 11 permits the Commissioner, if he is satisfied that a financial arrangement has been issued or transferred so as to defeat the application of the financial arrangements rules, to substitute an arm's-length consideration for the consideration used by the parties.

Sections GD 12 and GD 12B are directed towards situations where parties providing goods and services used in the production of a film are not dealing on an arm's-length basis with the film investors and towards arrangements designed to attract a more favourable operation of ss DS 2, EJ 7 and EJ 8 relating to the film expenditure than would otherwise be the case.

Section GD 13 sets out the transfer pricing regime, which is directed at multi-national companies that shift profits from New Zealand to countries with low tax costs.

Section HC 1, under which losses incurred by a special partnership registered on or after 1 August 1986 cannot be used to claim deductions against other income derived by the partners.

Section MBB 6(9), which allows the Commissioner to refuse to accept a transfer from a tax pooling account to a taxpayer's account, or to reverse any such transfer, if it is considered that the request is made for the purpose or effect of tax avoidance.

Other provisions in the Income Tax Act 2004, in specifying the conditions for liability or eligibility for tax benefit, also have specific anti-avoidance rules designed to prevent an undesirable exploitation of conditions for liability or benefits expressly provided.

## ***6.2 Other jurisdictions***

In some country, the application of some specific anti-avoidance provisions depends on a finding of the taxpayer's purpose for entering into the transaction.

In the United States, for example, Code section 269 in Internal Revenue Code denies a deduction for expenses of a corporate acquisition where “the principal purpose for which such acquisition is made is evasion or avoidance of Federal income tax.” A number of provisions of the regulations issued to implement the Internal Revenue Code also refer to tax avoidance purpose. For example, under Treas. Reg. sec. 1.881, the IRS may disregard the participation of an intermediate entity in a financing arrangement, if it participates as part of a tax avoidance plan.<sup>110</sup>

The United Kingdom also has a number of specific anti-abuse provisions the application of which turns on the presence of a tax avoidance motive<sup>111</sup>. An example is sec. 703 of the Income and Corporation Taxes Act 1988:

“Where (a) in any such circumstances as are mentioned in section 704, and (b) in consequence of a transaction in securities or of the combined effect of two or more such transactions, a person is in a position to obtain, or has obtained, a tax advantage, then unless he shows that the transaction or transactions were carried out either for bona fide commercial reasons or in the ordinary course of making or managing investments, and that none of them had as their main object, or one of their main objects, to enable tax advantages to be obtained, this section shall apply to him in respect of that transaction or those transactions....”

The tax laws of most countries contain specific anti avoidance provisions, it is impossible to list all the rules in all the country. Although specific anti avoidance provisions vary from country to country; there are some provisions in comment.

Most countries have the following anti avoidance rules in the domestic area: (1) limitation of deductions for entertainment and travelling expenses; (2) rules on taxation of accrued as opposed to effectively paid interest; (3) rules on arm's-length dealing between related taxpayers, or between taxable and tax-exempt taxpayers; (4) rules against dividend stripping; (5) limitations on tax loss carryovers from one taxpayer to another and (6)

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<sup>110</sup> Treas. Reg. §1.881-3(b)(1).

<sup>111</sup> Robert W. Maas ed., *Tolley's Anti-Avoidance Provisions*, looseleaf, 2001.

limitations on loss deductions by partners and shareholders in companies not subject to corporate income tax.<sup>112</sup>

In the international context, the following rules are common: (1) rules on dealing at arm's length in international transactions; (2) rules on thin capitalization; (3) rules against the transfer abroad of income-generating assets without payment of tax; (4) rules on controlled foreign corporations; (5) rules limiting the effects of physical emigration of taxpayers; (6) rules limiting tax benefits for income sourced in tax havens; and (7) rules limiting deductions of expenses and losses in corporate headquarters or branches of foreign companies.<sup>113</sup>

## **7.0 Legislative – general anti-avoidance rule**

### **7.1 New Zealand**

Section BG1 is the current New Zealand general anti-avoidance provision of the Income Tax Act 2004. The general anti-avoidance provision through s BG1 has raised a general anti-avoidance yardstick by which the line between legitimate tax planning and improper tax avoidance is to be drawn.<sup>114</sup> Section BG1 is perceived legislatively as an essential pillar of the tax system designed to protect the tax base and the general body of taxpayers from what are considered to be unacceptable tax avoidance devices.<sup>115</sup>

#### **7.1.1 History of general anti-avoidance provisions**

The starting point was the *Land Tax Act 1878*, s 62, a section dealing exclusively with Land Tax, as to which the policy in New Zealand (comparable to the policy in the United Kingdom dealing with Landlords Property Tax) was to ensure that this tax should be borne by the owner of the land and its burden not shifted on to others (such as the tenants of the land).<sup>116</sup> Succeeding provisions were s 29 of the *Property Assessment Act 1879* and s 35 of the *Property Assessment Act 1885*.

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<sup>112</sup> International Monetary Fund, *Tax Law Design and Drafting*, volume 1, 1996.

<sup>113</sup> *Ibid.*

<sup>114</sup> *CIR v BNZ Investments Limited* (2001) 20 NZTC 17,103, per Richardson P.

<sup>115</sup> *Ibid.*

<sup>116</sup> *Mangin v CIR* [1971] NZLR 591, 601 PC per Lord Wilberforce.

Income Tax was introduced into New Zealand in 1891, the *Land and Income Tax Assessment Act 1891* was first statute dealing with income tax. Section 40 of the Land and Income Tax Assessment Act 1891 was the first general anti-avoidance provision combining land and income tax. It stated that any covenant or agreement that alter or attempt to alter the nature of the estate or interest in any land or mortgage for the purpose of defeating or evading the payment of tax, or which was contrary to the true intent of the legislation, had no effect as between the parties thereto.

Section 82 of the Land and *Income Tax Assessment Act 1900* was the succeeding sections to replace s 40. It held that contract, agreement, or arrangement made or entered into should be absolutely void in so far as, it had the purpose or effect of way altering the incidence of any tax, or relieving any person from liability to pay any tax or make any return, or defeating, evading, or avoiding income tax.

The succeeding provisions for s 82 were s 103 of the *Land and Income Tax Assessment Act 1908* and s 162 of the *Land and Income Tax Act 1916* except the reference to “avoiding” tax was omitted. Section 170 of the *Land and Income Tax Act 1923* replicated s 162. Section 108 of the *Land and Income Tax Act 1954* in the same form as in s 170 except omitted the reference to “land tax”. Then, s 16 of the *Land and Income Tax Amendment Act 1968* added that any arrangement was void “as against the Commissioner for income tax purposes” to s 108 after the word “void”.

When the 1954 Act was replaced by the *Income Tax Act 1976* the anti-avoidance provisions were located at s 99, which was enacted by s 8 of the Land and Income Tax Amendment Act (No 2) 1968 as s 108 of the Land and Income Tax Act 1954.

At the time *Income Tax Act 1994* was introduced s BB 9 was the general anti-avoidance regime in the legislation, which became with effect from the income year commencing 1 April 1997. Upon commencement of *Income Tax Act 2004*, the general anti-avoidance provisions still was located in s BG1. Since s 99, there are not significant changes took place for the general anti-avoidance provisions.

### **7.1.2 Overview of section BG1**

Section BG1 provides:

“(1) Avoidance Arrangement Void

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

(2) Reconstruction

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

There are two distinct elements under section s BG1. First element, s BG 1(1), focuses on concept of a tax avoidance arrangement and sets out the circumstances that must be satisfied for an arrangement to be void. Second element, s BG1 (2) gives the Commissioner power to adjust the accounts of a taxpayer to counteract any tax advantage obtained.

Identifying whether there is tax avoidance arrangement existing is the key to the two elements. Tax avoidance arrangement is defined in s OB 1 as:

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

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

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

These definitions bring out three of five principles to considering the application of section BG 1<sup>117</sup>. The five principles are

Step 1 - Determining the arrangement and its scope;

Step 2 - Determining "tax avoidance";

Step 3 - Determining the purpose or effect that is more than merely incidental;

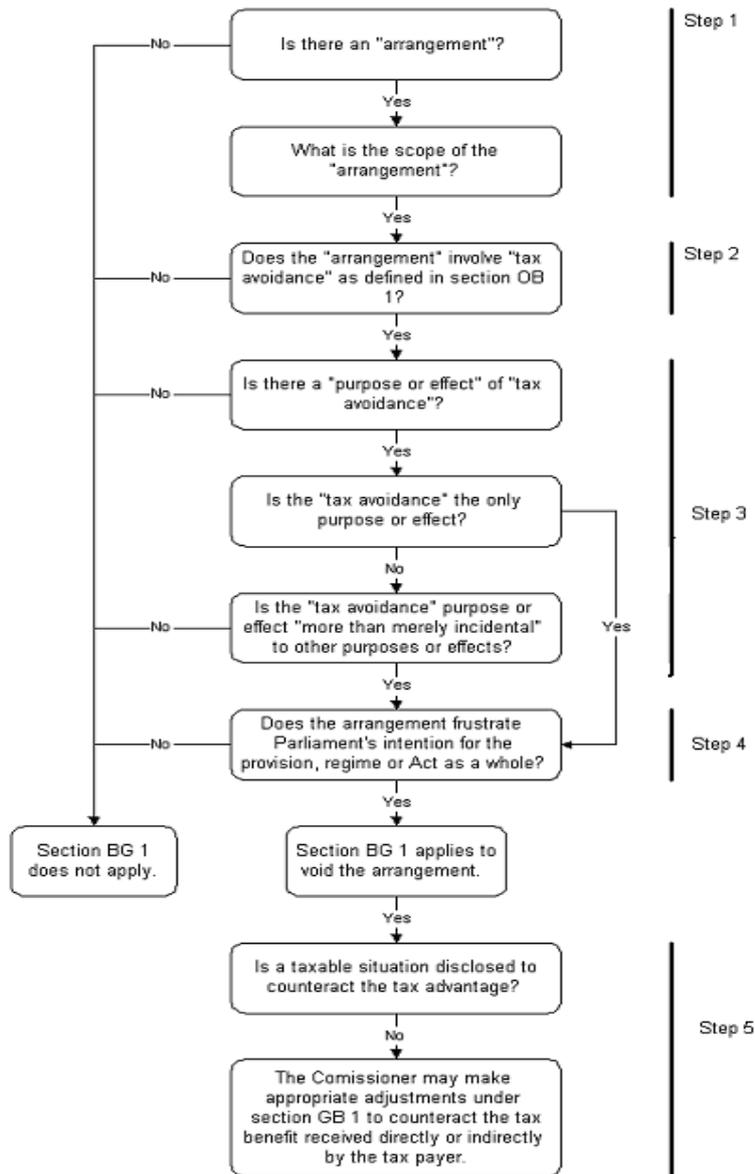
Step 4 – Judicial approaches;

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<sup>117</sup> Inland revenue Department, *INA00009 Interpretation of Sections BG 1 and GB 1 of the Income Tax Act 2004*, Wellington, 2004.

Step 5 - Adjustment of income under section GB 1;

**Figure 4 Application of Section BG1<sup>118</sup>**



<sup>118</sup> Inland revenue Department, *INA00009 Interpretation of Sections BG 1 and GB 1 of the Income Tax Act 2004*, Wellington, 2004.

Steps 1 to 3 are the three elements of s BG 1. Step 4 is an additional interpretative step which requires the consideration of whether the arrangement frustrates Parliamentary intention for the provision to give deliberate tax benefits. It is not statutory rule but adopted by the courts to identify whether s BG1 applies to any given arrangement. The most prominent judicial approach is choice doctrine approved by Lord Hoffmann in *O'Neil v CIR*<sup>119</sup>.

Step 5 is the step after the tax avoidance arrangement is found and s BG 1 applies to void the arrangement. In such case, the Commissioner has power to adjust the income of a person affected by the arrangement under s BG 1 (2). The Commissioner may make appropriate adjustments to counteract the tax benefit received directly or indirectly by the taxpayer.<sup>120</sup>

The above five steps are the reference for identifying the tax avoidance arrangement. According to Richardson P in *BNZ Investments Limited*<sup>121</sup>, the arrangement brings a tax advantages might not necessarily be a tax avoidance arrangement. The arrangement is a tax avoidance arrangement only after the necessary state of mind is proven and the choice doctrine is considered. The following section will discuss in detail about the arrangement at under s BG1 and related leading cases.

### **7.1.3 Concept of Arrangement**

*Overview: statutory definition*

The term “arrangement” is defined in section OB1:

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

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<sup>119</sup> *O'Neil v CIR* (2001) 20 NZTC 17,057.

<sup>120</sup> *CIR v BNZ Investments Limited* (2001) 20 NZTC 17,103, per Blanchard J.

<sup>121</sup> *CIR v BNZ Investments Limited* (2001) 20 NZTC 17,103, per Richardson P.

This definition closely follows the meaning given to the composite expression “contract, agreement or arrangement’ in *Newton* and other decisions under the former s 108 and its Australian counterpart, s 260 of the *Income Tax Assessment Act 1936*.<sup>122</sup>

*Newton v FCT*<sup>123</sup> is the case that leads to the definition what is an arrangement. In this case the Privy Council states:

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

The definition in *Newton* provides the basis for the current definition in s BG1.<sup>124</sup> There are also some important decisions contribute to the *Newton* approach. Isaacs J in the High Court of Australia, in *Jaques v FCT*<sup>125</sup> stated

“Arrangement is no doubt an elastic word, and in some contexts may have a larger connotation. But in this collocation it is the third in a descending series, and means an arrangement which is in the nature of a bargain but may not legally or formally amount to a contract or an agreement.”

Isaacs J interpreted the word “arrangement” as something but less formal and less restricted than a contract or an agreement.

Subsequently, the Australian High Court in *Bell*<sup>126</sup> looked at the order of the three words “contract”, “agreement”, and “arrangement” and interpreted them as becoming progressively broader. The Court said, the word "arrangement" is the third in a series which as regards comprehensiveness in an ascending series, and that word extends beyond

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<sup>122</sup> Ibid.

<sup>123</sup> (1958) AC 450,465.

<sup>124</sup> *Investments Ltd v C of IR* (2000) 19 NZTC 15,732 per McGechan J.

<sup>125</sup> (1924) 34 CLR 328 (HCA) 359.

<sup>126</sup> *Bell v FCT*(1953)87 CLR 537.

contracts and agreements so as to embrace all kinds of concerted action by which persons may arrange their affairs for a particular purpose or so as to produce a particular effect.

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

### *Contract*

In the definition of arrangement, contract is the first term. In *FCT v Newton*<sup>127</sup>, contract was considered as a technical word and implied an agreement enforceable by law.

In *BNZ Investments*<sup>128</sup> Richardson P stated contract is more formal than an agreement, and in ordinary usage is usually written.

Therefore contract refers to transactions which involve an offer, acceptance, consideration and intent to create legal obligations.

### *Agreement*

Agreement is the second term in the definition of arrangement. According to observation by Richardson P<sup>129</sup>, agreement is different with contract, which is less formal than contract. However in some case, such as *Newton*<sup>130</sup>, contract and agreement were considered as the same concept, which fundamentally different with the concept arrangement. Also in the case *Charles V Lysons*<sup>131</sup>, Hoskin J stated that:

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

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<sup>127</sup> *FCT v Newton* (1957) 96 CLR577,630.

<sup>128</sup> *CIR v BNZ Investments Limited* (2001) 20 NZTC 17,103, per Richardson P.

<sup>129</sup> *Ibid.*

<sup>130</sup> [1958] AC 450,465.

<sup>131</sup> [1922] NZLR 902.

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

#### *Plan or understanding*

The final terms in definition of an “arrangement” are: “... plan or understanding (whether enforceable or unenforceable) including all steps and transactions by which it is carried into effect.”

In the *Newton v FCT*<sup>132</sup>, the concept plan or understanding was delivered by Lord Denning as being: apt to describe something less than a binding contract or agreement, but in this section it must comprehend not only the initial plan but also all the transactions by which it is carried into effect. This expression emphasizes the point, that an arrangement does not have to be a formal contract.

#### **7.1.4 Tax avoidance**

In New Zealand, the concept of tax avoidance is defined in section OB 1 of Income Tax Act 2004:

“tax avoidance includes:

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

The definition identifies some of the characteristics of tax avoidance, which is inclusive, that means the determination of what is tax avoidance is not limited by the definition.

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<sup>132</sup> [1958] AC 450,465.

As Baragwanath J noted: “It is to be observed that the definition of ‘tax avoidance’ employs the verb ‘includes’, rather than ‘means’. A transaction may therefore entail tax avoidance even if not falling directly within any of (a), (b) or (c).”<sup>133</sup>

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

### *First limb*

The first limb states that tax avoidance includes altering the incidence of any income tax. In the Court of Appeal decision of *Marx v CIR*<sup>134</sup> Turner J stated at page 199:

“The incidence of tax is the way in which its burden falls upon those whom the Act makes liable to bear it. ... There are two different cases in which an arrangement can be said to have the purpose or effect of altering the incidence of income tax. First, a taxpayer may agree with another that the other should assume, as between the parties, but not so as to affect the Commissioner, some of the burden of the tax for which the Act makes him liable. Second, an himself and the Commissioner, that he will become liable for less tax after the arrangement taxpayer may enter into an arrangement having the effect (if it is valid), as between than would have, or might have been, levied upon him, but for it ...”

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

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

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<sup>133</sup> *Miller v CIR* [1997] 18 NZTC 13,001 (HC) at p. 13,033.

<sup>134</sup> [1970] NZLR 182.

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

### *Second limb*

The second limb states that tax avoidance includes relieving a person from liability to pay income tax. The meaning of "relief" has been addressed by Lord Donovan in *Mangin v CIR*<sup>135</sup>:

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

It can be seen that where a person relieves him from the liability to pay income tax. This will include where a person defeats, evades or avoids the incidence of income tax. The use of the term “payment of income tax” could be construed to include any action that reduced the actual amount of tax paid. Inland Revenue concludes as follows:<sup>136</sup>

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

### *Third limb*

The third limb provides tax avoidance including “avoiding, postponing, or reducing any liability to income tax” within the concept of tax avoidance. In *Newton*, Lord Denning outlined the scope of the third limb<sup>137</sup> “They are clearly of opinion that the word 'avoid' is used in its ordinary sense — in the sense in which a person is said to avoid something which is about to happen to him. He takes steps to get out of the way of it.”

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<sup>135</sup> [1971] NZLR 591 (PC).

<sup>136</sup> Inland Revenue, *Exposure Draft INA0009: Interpretation of Sections BG 1 and GB 1 of the Income Tax Act 2004*, Wellington, September 2004, p 28, para 3.3.13.

<sup>137</sup> [1958]AC 450,464.

Therefore, as suggested by Trebilcock<sup>138</sup>, the concept of avoidance envisages the targeting of arrangements which have the effect of preventing a liability from coming into an existence, where such liability would have arisen but for the arrangement.

The position in respect of the third limb was summarised by Baragwanath J in *Miller*<sup>139</sup>, where his Honour held that: “It plainly embraces the hypothetical situation of what tax the taxpayer would have had to meet had the arrangement not been made and the former regime continued.”

### *Future liabilities*

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

The income tax liability must in some respects be foreseeable based on a “reasonable expectation”<sup>140</sup> of what is likely to occur. In some transactions, it will be easy to apply the test because the alternative actions will be fairly obvious or most likely to occur in the absence of the actual transaction that did occur. The real challenge arises where there may be many alternative courses of action, of which none is more likely than the others to be implemented.

The difficulty in relation to understanding the potential application of the provision was referred to by Richardson J in *CIR v Challenge Corporation Ltd*,<sup>141</sup> where his Honour stated:

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

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<sup>138</sup> MJ Trebilcock, *Section 260: A Critical Examination*, 1964, *The Australian Law Journal*, p 237.

<sup>139</sup> (1997) 18 NZTC 13,001.

<sup>140</sup> Section 177C(1) ITAA 1936 (Cth) outlines the “reasonable expectation test” for the Australian anti-avoidance rules.

<sup>141</sup> *CIR v Challenge Corporation Ltd* [1986] 2 NZLR 513.

might have arisen but for the arrangement, and if ‘might’, probably might or ordinarily might or conceivably might?’ A complicating fact is that every financial transaction of the taxpayer may effect a tax change and it is not to be supposed that the potential or prospective liability in respect of future income to which the definition refers was intended to have that reach. ...”

This difficulty is also discussed by Inland Revenue<sup>142</sup>: “The comments of Richardson J suggest he was not willing to extend the reach of the definition to apply to every financial transaction that may effect a tax change. If this is taken to reflect the stance taken by judges generally, the practical matter remains as to whether to come within the definition of ‘liability’, the liability must be one which would have arisen, or which probably or conceivably might have arisen, but for the arrangement.”

In essence, it would appear that what is necessary is a test that recognizes an outcome that a reasonable person would expect to have occurred in the absence of the actual transaction that did occur.

### *Tax Mitigation*

The distinction between tax mitigation and tax avoidance was first introduced by the Privy Council in *Challenge*<sup>143</sup>. The Board began by citing Lord Tomlin's famous statement in the *Duke of Westminster*<sup>144</sup> that:

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

The majority subsequently recorded their view on tax mitigation in the following way<sup>145</sup>:

“Income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to reduction in his tax liability. Section [BG 1] does not apply to tax mitigation because the taxpayer's tax advantage is not derived from an ‘arrangement’ but from the reduction of income which he

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<sup>142</sup> Inland Revenue, *Exposure Draft INA0009: Interpretation of Sections BG 1 and GB 1 of the Income Tax Act 2004*, Wellington, September 2004, p 32, para 3.3.29.

<sup>143</sup> *CIR v Challenge Corporation Ltd* (1986) 8 NZTC 5,219.

<sup>144</sup> *CIR v Duke of Westminster* [1936] AC.

<sup>145</sup> *CIR v Challenge Corporation Ltd* (1986) 8 NZTC 5,219, 5,225.

incurs ... Income tax is avoided ... when the taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that reduction.”

In *Challenge*<sup>146</sup> case, the Privy Council suggested that for a taxation advantage to be enjoyed, the taxpayer should actually incur the expenditure, loss or disadvantage, that Parliament intended the taxpayer to have suffered in that situation. Tax avoidance is distinct from tax mitigation, is sometimes said to be identifiable by the presence of the “hallmarks” or “badges” of tax avoidance. Thus, tax mitigation is outside the scope of the general anti-avoidance provision where the taxpayer obtains a tax advantage by reducing his income or by incurring expenditure in circumstances in which the taxing statute affords a reduction in tax liability.

However, in case *Hadlee*<sup>147</sup>, the Court of Appeal question about the distinction, Cooke P stated that: “The distinction between tax avoidance and tax mitigation is both authoritative and convenient for some purposes, but perhaps it can be elusive on particular facts. Whether it could solve all the problems in this field may be doubtful and none of the cases collected by Lord Templeman at pp 562-3 of the report is closely in point.”

The distinction of tax avoidance and tax mitigation was further rejected by the House of Lords in *Macniven v Westmoreland Investments Ltd*<sup>148</sup> as well as in *O'Neil v CIR*,<sup>149</sup> where the Privy Council described it as unhelpful because it describes a conclusion rather than a signpost to it. Clearly, the concept tax mitigation has now been effectively nullified.

#### *The purpose test*

The next step of identifying the tax avoidance arrangement is to determine the purpose or effect of the arrangement and whether the purpose or effect of tax avoidance is not merely incidental.

In the general anti-avoidance context, the predication approach has been used by the courts to determine in which the arrangement was entered into whether it has a purpose or effect

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<sup>146</sup> Ibid.

<sup>147</sup> *Hadlee & Sydney Bridge Nominees Ltd v CIR* [1991] 3 NZLR 517 (CA).

<sup>148</sup> *Macniven v Westmoreland Investments Ltd* [2001] 2 WLR 377 (HL).

<sup>149</sup> *O'Neil v CIR* (2001) 20 NZTC 17,051 (PC).

of tax avoidance. The “predication” approach was enunciated by Lord Denning in the *Newton*<sup>150</sup> case, his Lord stated:

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

The predication approach is still used to determine or classify a purpose or effect of the arrangement as being one of tax avoidance. For example, in *Challenge*<sup>151</sup>, Woodhouse P in his dissenting judgment confirmed the applicability of the test in respect of the revised legislation.

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

The term “purpose or effect’ was discussed at *Ashton*<sup>152</sup> as:

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

It was also held in *Tayles v CIR*<sup>153</sup> that it is only the purpose of the arrangement which is of concern and the term “effect” as used in the definition is redundant. The House of Lords in *Newton v FCT*<sup>154</sup> held that “purpose” does not mean motive or intention, but the end or effect which the arrangement is intended to achieve.

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<sup>150</sup> [1958] HCA 31.

<sup>151</sup> (1985) 9 TRNZ 81,86 (CA).

<sup>152</sup> [1975] 2 NZLR 717.

<sup>153</sup> [1982] 2 NZLR 726 (CA).

<sup>154</sup> [1958] HCA 31.

If there is more than one purpose, the tax avoidance purpose must be “more than merely incidental”. The question then arises as to what is a merely incidental purpose or effect. In relation to determining what is an incidental purpose or effect, in *Hadlee and Sydney Bridge Nominees Ltd*<sup>155</sup> Eichelbaum CJ concluded:

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

The concept of incidental purpose or effect received further consideration in case *Challenge Corporation Ltd*<sup>156</sup> where Woodhouse P stated:

“... I do not think that the phrase ‘merely incidental’ does have such a limiting effect and in accord with *Newton v C of T* [1958] AC 450 I am satisfied as well that the issue as to whether or not a tax saving purpose or effect is ‘merely incidental’ to another purpose is something to be decided not subjectively in terms of motive but objectively by reference to the arrangement itself.”

“When construing section 99 and the qualifying implementations of the reference in subsec (2)(b) to ‘incidental purpose’ I think the questions which arise need to be framed in terms of the degree of economic reality associated with a given transaction in contrast to artificiality or contrivance or what may be described as the extent to which it appears to involve exploitation of the Statute while in direct pursuit of tax benefits.”

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

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<sup>155</sup> (1989) 11 NZTC 6,155, 6,175 (HC).

<sup>156</sup> *CIR v Challenge Corporation Ltd* [1986] 2 NZLR 513, 533.

recent New Zealand case<sup>157</sup>, the operation of the “merely incidental” test is clarified as follows:

“What is important for present purposes about the decision in [FCT v Hart [2004] HCA 26; (2004) 55 ATR 712; 2004 ATC 4599,] is that it expressly reinforces dicta from both the English and New Zealand Courts that tax consequences are an important consideration in any commercial activity. It is therefore legitimate, indeed necessary, to take them into account in deciding how to structure a given transaction. That, in my view, is what Parliament intends by the "merely incidental" test. It is to provide a clear distinction between arrangements which are entered into for some proven commercial purpose and have as a consequence some favourable tax outcome, and those which are entered into to secure some saving of tax.”

### **7.1.5 The Choice Doctrine**

Choice doctrine is the fourth step, which is not statutory rule but adopted by the courts to identify whether s BG1 applies to any given arrangement.

In case *Mangin*<sup>158</sup> Lord Wilberforce had some concerns about the application of GAAP:

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

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

The choice doctrine is first held by High Court of Australia in *WP Keighery Pty Ltd*<sup>159</sup>:

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<sup>157</sup> *Case XI* (2005) 22 NZTC 12,001.

<sup>158</sup> *Mangin v CIR* [1971] NZLR 591, 602 (PC).

<sup>159</sup> *WP Keighery Pty Ltd v FCT* (1957) 100 CLR 66, 92.

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

In *Casuarina Pty Ltd*<sup>160</sup> the court also approved the view that the section was not intended to deny taxpayers any right of choice between alternatives provided under the Act, and the intention of section 260 was to protect the general provisions of the Act from frustration.

The choice principle was gradually extended, in *Slutzkin*<sup>161</sup> the taxpayer had the right to choose the form of transaction which will not subject him to tax.

In *Challenge*<sup>162</sup> the appellant argued that section 99 cannot be used to defeat other provisions such as section 191 of the Income Tax Act 1976 or to prevent a result which any of them contemplate, i.e.: the choice principle. Richardson J considered the “choice principle” and stated “Clearly the Legislature could not have intended that sec 99 should override all other provisions of the Act so as to deprive the tax paying community of structural choices, economic incentives, exemptions and allowances provided for by the Act itself. .... .Again seeking and taking advantage of incentives provided through the tax system designed to encourage particular economic activities could not be rejected out of hand as contravening the section. Yet in many cases, but for the anticipated availability of the tax benefit, the taxpayer would never have entered into the activity or transaction.... It [section 99], too, is specific in the sense of being specifically directed against tax avoidance and it is inherent in the section that but for its provisions the imputed arrangements would meet all the specific requirements of the income tax legislation. In some cases, then, the section imposes an additional requirement. In others, and this is a common application of the section in cases where trusts and companies are employed for planning purposes, while

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<sup>160</sup> *Casuarina Pty Ltd v FCT* (1971) 127 CLR 62 (Full HCA).

<sup>161</sup> *Slutzkin v FCT* (1977) 140 CLR 314.

<sup>162</sup> *CIR v Challenge Corporation Ltd* (1986) 8 NZTC 5219.

the use of that machinery is regarded as perfectly legitimate and not on its own affected by sec 99, it may be only one element in a wider arrangement which is caught by the section.”

His Honour also stated that: “in the end, the legal answer must turn on an overall assessment of the respective roles of the particular provision and s 99 under the Statute and the relation between them. That is a matter of statutory construction ...”

Woodhouse P<sup>163</sup> rejected the choice principle and concluded that the answer to questions of the ambit of s 99, when in conflict with specific statutory provisions, was to be found in the use of the words “merely incidental purpose or effect”. If a tax avoidance purpose had “merely incidental purpose or effect”, it would not trigger s 99. However, the ambit of the section should be discovered as a matter of fact and degree on a case by case basis. In essence, both Judges recognised the tension between taxpayers arranging their tax affairs effectively and the need to protect the tax system from avoidance abuse.

Richardson J's statutory construction approach to the “choice doctrine” in *Challenge*<sup>164</sup> has now been supported by the decisions of the Privy Council and House of Lords. In *O'Neil*<sup>165</sup>, Lord Hoffmann stated:

“On the other hand, the adoption of a course of action which avoids tax should not fall within s 99 if the legislation, upon its true construction, was intended to give the taxpayer the choice of avoiding it in that way.”

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

### **7.1.6 Reconstruction**

Once the Court has determined that an arrangement entered into by the taxpayer is void under s BG 1 Income Tax Act 2004, the Commissioner is given an adjustment power under

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<sup>163</sup> Ibid

<sup>164</sup> Ibid

<sup>165</sup> *O'Neil v CIR* (2001) 20 NZTC 17,051 (PC).

section GB 1(1) to adjust the income of the taxpayer so as to counteract any tax advantage derived by the taxpayer from the arrangement.

Section GB1 ITA 2004 provides as follows:

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

The object of s BG 1 is to grant the Commissioner the power to adjust the taxpayer's income tax liability subject to an arrangement as if that arrangement had not been entered into or carried out. It was recognised in *Mangin*<sup>166</sup> that:

“[the section] gives rise to a number of extremely difficult problems as to what hypothetical state of affairs is to be assumed to exist after the section has annihilated the tax avoidance element in the arrangement.”

In *Miller*<sup>167</sup>, the Court of Appeal discussed the ambit of the Commissioner's power under the reconstruction section:

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

The Commissioner therefore considers section GB 1(1) allowing the exercise of a wide discretion in the adjustment of gross income, allowable deductions and net losses subject to a tax avoidance arrangement, so as to counteract any tax advantage. The adjustment can only be made where a tax advantage has been obtained and the adjustments may apply to

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<sup>166</sup> *Mangin v CIR* [1971] NZLR 591, p 602 per Lord Wilberforce (PC).

<sup>167</sup> *Miller v CIR; Managed Fashions Ltd v CIR* (1998) 18 NZTC 13,961, 13,980 (CA).

more than one person.<sup>168</sup> The concept of a “tax advantage” brings with it an expectation that the person will be in a better tax position. It is noted that the legislation provides that the Commissioner “may” adjust for the tax advantage. It is suggested that the use of the word “may” be able to indicate discretion on the part of the Commissioner.

Section GB 1 does not provide a statutory code about how the Commissioner should assess the taxpayer's income tax liability absent the arrangement. Nor have the Courts enunciated any principles which the Commissioner should have regard to in exercising his power under s GB 1. What the Courts have asserted, is that the reconstruction has to be reasonable, such that the Commissioner must have a reasonable basis for its assessment of the taxpayer's income tax liability absent the tax advantage derived from the arrangement.

In *Peabody*<sup>169</sup> the High Court of Australia noted that:

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

### **7.1.7 Recent developments**

Recently Court decisions have been somewhat mixed, for example, in case *Accent Management Ltd*<sup>170</sup>, the New Zealand High Court held that a complex forestry investment scheme constituted tax avoidance under the section BG1. By contrast, in *Peterson v CIR*<sup>171</sup>, the Privy Council, over a strong dissent by two of its members, overturned a decision by the New Zealand High Court that had applied section 99 to a film scheme. The decision of the Privy Council in *Peterson*<sup>172</sup> is very controversial, it worth to take a close look of this 3 to 2 split majority decision case.

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<sup>168</sup> Ibid.

<sup>169</sup> *FCT v Peabody* 94 ATC 4,663.

<sup>170</sup> *Accent Management Ltd & Ors v CIR* (2005) 22 NZTC 19027.

<sup>171</sup> *Peterson v CIR* (2005) 22 NZTC 19,098.

<sup>172</sup> Ibid.

### ***7.1.7.1 Peterson v CIR***

#### ***The factual background***

Mr. Peterson was a member of a syndicate formed to finance the production of a feature film in New Zealand. A special partnership was established for the purpose of making a feature film entitled “Lie of the Land Limited and Company”. Mr McLean organised the financing of production and possible marketing of the film, who was director of South Pacific Broadcasting Corporation. The special partnership was formed with this company as the general partner and the investors, including the taxpayer, as the special partners. The capital of the partnership was comprised of equity contributions (in cash) by the special partners of \$1,200,000 and a non-recourse loan of \$1,560,000 amounting to \$2,760,000.

The partnership was into a film production agreement on 13 May 1984 with Filmcraft Productions Ltd (“FPL”), under which FPL undertook to produce the film and carry out certain post production functions. The consideration payable to FPL was \$2,760,000.

This company entered into an agreement with Creative Arts Ltd. The partnership entered into a non-recourse loan agreement with Steadfold Ltd for an advance of \$1.56 million. The film was made but was not commercially released.

Then on 14 June 1984, FPL entered into an agreement with Creative Arts Limited (“CAL”) and another company called South Pacific All Media Distributors Limited for hiring the actors and obtain the other services necessary for making the film. These services valued at \$1,560,000 payable to CAL.

A company called Steadfold Limited (“SL”) agreed to advance the Partnership the sum of \$1,560,000. The lender was entitled to receive payment of the loan and interest out of the net external revenue which was to be received by the Partnership but that SL shall have no recourse against the borrower in respect of the loan or interest thereon. The loan was guaranteed by CAL pursuant to a completion guarantee dated 5 July 1984. The film was made but was not commercially released.

#### ***Tracing of argument***

In New Zealand, investors in films are entitled to depreciate their full acquisition costs.

This is so however much the film actually costs the production company to make and by whatever means the investors have obtained the funds to finance the acquisition.

The contention of the taxpayer was that the deduction was allowable whether or not the loan moneys went in a circle back to the lender.

The Commissioner's view was based on s 99 disallowance of the tax deduction claimed by the taxpayer. The commissioner argued that portion of the production costs represented by the non-recourse loan of \$1,560,000 was an artificial or contrived amount that simply was paid back to the lender and for which no "real" services were provided. The argument was that the loan only increased the deductions available to the special partners and thereby enables them individually to gain a tax benefit in the form of the write-off of the film expenditure.

### ***Majority Decision***

The majority agree with Inland Revenue that there was "an arrangement" encompassing all the aspects set out in the facts above, and that this arrangement had the purpose or effect of reducing the investor's liability to tax. However, their Lordships viewed that not every tax advantage comes within the intended scope of s 99 ITA 1976 and the question was whether or not it was an "acceptable tax advantage" or one to which s 99 ITA 1976 should be applied. Their Lordships, drawing from Lord Templeton in *Challenge*,<sup>173</sup> considered a tax advantage would be acceptable if the taxpayer's reduction in liability to tax was brought about by incurring a loss or expenditure.

The majority's view was that it was enough if the investors had paid an amount to acquire an asset which then formed the cost of the asset; that is the amount that the investors should be able to depreciate<sup>174</sup>. This view was based on the majority's understanding of the purpose of the depreciation regime, "The statutory object in granting a depreciation allowance is to provide a tax equivalent to the normal accounting practice of writing off

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<sup>173</sup> *CIR v Challenge Corporation Ltd* [1986] 2 NZLR 513.

<sup>174</sup> *Peterson v CIR* (2005) 22 NZTC 19,109, para 41.

against profits the capital costs of acquiring an asset to be used for the purposes of a trade”<sup>175</sup>

The majority held that it was irrelevant that the costs of making the film were not ever incurred by the production company, as that did not affect the cost incurred by the investors in acquiring the film.<sup>176</sup> The majority considered that the fact the loan was "recycled" to the lender almost immediately showed only that the production company did not apply it to make the film; it did not show that the investors did not pay the loan to the production company to acquire the film.<sup>177</sup> Although the production company had returned the money to the lender, the majority considered there was no evidence that this was in repayment of the loan owed by the investors to the lender.<sup>178</sup> Therefore, the majority's view was that the investors had incurred a genuine liability to repay the loan and so the tax advantage was an acceptable one. In summary, the majority's opinion is stated in the following passage<sup>179</sup>:

“... Subsequent payments through the circle of which the investors were unaware and which they could not control or prevent did not alter the fact that they had borrowed \$y and used it towards the discharge of their liability to pay \$x + \$y to the production company, thereby suffering the loss or incurring the relevant expenditure for which the depreciation allowance is granted.”

The majority appears to have widened the definition of “arrangement”, to include situations where there is no a consensus or meeting of minds. In majority's view the taxpayer needs not be a party to the arrangement and he needs not to be privy to its details either. Lord Millett stated<sup>180</sup>:

“Their Lordships do not consider that the ‘arrangement’ requires a consensus or meeting of minds; the taxpayer need not be a party to ‘the arrangement’ and in their view he need not be privy to its details either. On this point they respectfully prefer the dissenting judgment of Thomas J in *C of IR v BNZ Investments Ltd*. Moreover the investors did not merely obtain an economic advantage from the ‘arrangement’ (as in that case); they obtained a tax

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<sup>175</sup> Ibid para 39.

<sup>176</sup> Ibid para 43.

<sup>177</sup> Ibid para 44.

<sup>178</sup> Ibid para 27.

<sup>179</sup> Ibid para 45.

<sup>180</sup> Ibid para 34.

advantage, via a depreciation allowance which reduced their liability to pay tax.”

### ***Minority Decision***

The minority in their dissent disagrees with majority on the points such as: the purpose of the depreciation regime, the facts found by the Taxation Review Authority (TRA) and their significance and the definition of “arrangement”

The minority agrees that there is an arrangement and that there is a tax advantage arising from the arrangement.<sup>181</sup> Minority quote Richardson J's view in *Challenge*<sup>182</sup> that whether or not the anti-avoidance provisions apply requires a consideration of the scheme and purpose of the legislation.<sup>183</sup> The minority stated that the issue was whether depreciating the cost of producing a film when that cost is met by the proceeds of non-recourse loan which is not in fact applied to the cost of production is a depreciation claim which falls within the purpose of the depreciation regime.<sup>184</sup> The minority's answer was “no”.

The minority stated the effect of the arrangement could not be reconciled with the “statutory purpose of encouraging investment in the production of films”.<sup>185</sup> The minority commented that they could not believe that if the cost of acquisition of the film was inflated solely to qualify for a higher depreciation deduction, that this was the sort of cost that “the statutory regime was intended to assist or encourage”.<sup>186</sup> The minority’s view was that on the facts of this case, the amount of each non-recourse loan had been presented to the investors as a cost of production and as qualifying for depreciation on that basis. It was tax avoidance “of a plainly undesirable kind and of a kind that cannot, in our opinion, be reconciled with the statutory purpose of encouraging investment in the production of films.”<sup>187</sup>

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<sup>181</sup> *Ibid*, paras 87 and 88.

<sup>182</sup> *CIR v Challenge Corporation Ltd* [1986] 2 NZLR 513.

<sup>183</sup> *Ibid* para 61.

<sup>184</sup> *Peterson v CIR* (2005) 22 NZTC p 19,115, para 65.

<sup>185</sup> *Ibid* para 92.

<sup>186</sup> *Ibid* para 9.

<sup>187</sup> *Ibid* para 92.

The minority's opinion was that the depreciation regime for films required the non-recourse loans to actually be applied in the costs of production. The minority stated that the facts, which the majority relies on, do not support this conclusion. They stated<sup>188</sup>:

“We would protest that this representation of the \$y not only is not supported by, but indeed is inconsistent with, the TRA's findings of fact.”

The minority agreed with the Court of Appeal that the amount of the non-recourse loan had been returned to the lender in repayment of the loan, and stated that any other conclusion “would be shutting one's eyes to the obvious”.<sup>189</sup> The minority referred to there being no evidence that this movement of money was related to any other matter.<sup>190</sup>

While majority have widened the definition of “arrangement” to include situations where there is no consensus or meeting of the minds, the minority stuck to the approach the Court of Appeal in *BNZ Investments*<sup>191</sup>. The minority state that it is not necessary to consider the question of whether an investor who is ignorant of what is being done to achieve the tax effect is a party to the arrangement.<sup>192</sup> Because the anti-avoidance provision specifically allows adjustment of the income of “any person affected” by the arrangement, even if they are not a party to the arrangement.<sup>193</sup> The minority's approach on arrangement seems to be more appropriate in this case and follows exactly the approach in *BNZ Investments*<sup>194</sup>.

## **7.2 Other jurisdictions**

### **7.2.1 Australia**

The Australian general anti-avoidance rules can be found in Part IVA of the *Income Tax Assessment Act (ITAA) 1936*. Prior to the introduction of Part IVA on 27 May 1981, the general anti-avoidance rules were contained in s 260 of ITAA. Section 260 was very broad on its face. However, starting from the “predication test” that was formulated by Lord Denning in *Newton*<sup>195</sup>, a series of judicial decisions that acted to limit the effective

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<sup>188</sup> Ibid para 94.

<sup>189</sup> Ibid, para 78.

<sup>190</sup> Ibid, para 100.

<sup>191</sup> *CIR v BNZ Investments Ltd* [2002] 1 NZLR 450.

<sup>192</sup> *Peterson v CIR* (2005) 22 NZTC 19,109, para 42.

<sup>193</sup> Ibid, para 92.

<sup>194</sup> *CIR v BNZ Investments Ltd* [2002] 1 NZLR 450.

<sup>195</sup> *Newton v FCT* [1958] HCA 31

operation of the section in Australia. Part IVA was intended to overcome the difficulties with the prior law and to provide “an effective general measure against the tax avoidance arrangements that – inexact though the words may in legal terms be – are blatant, artificial or contrived”<sup>196</sup>.

Part IVA gives the Commissioner the discretion to cancel a ‘tax benefit’ that has been obtained, or would, but for section 177F, be obtained, by a taxpayer in connection with a scheme to which Part IVA applies. This discretion is found in subsection 177F(1).

Before the Commissioner can exercise the discretion in subsection 177F(1), there are three basic requirements of Part IVA must be satisfied. These requirements are that:

- (i) a ‘tax benefit’, as identified in section 177C, was or would, but for subsection 177F(1), have been obtained;
- (ii) the tax benefit was or would have been obtained in connection with a ‘scheme’ as defined in section 177A; and
- (iii) having regard to section 177D, the scheme is one to which Part IVA applies

#### **7.2.1.1 Scheme**

The term ‘scheme’ is defined in s 177A (1) ITAA 1936 to mean:

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

This definition is very broad. It encompasses not only a series of steps which together can be said to constitute a “scheme” or a “plan” but also the taking of but one step.<sup>197</sup> The use of the singular, narrow words, proposal, action or course of action in s177A(1)(b) in juxtaposition with, agreement or arrangement in s177A(1)(a) indicates that something done

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<sup>196</sup> *Income Tax Laws Amendment Bill (No 2) 1981: Explanatory Memorandum* (Canberra: AGPS, 1981) at p. 2.

<sup>197</sup> *Federal Commissioner of Taxation v. Hart* [2004] HCA 26 Per Gummow and Hayne JJ.

which is less than the whole of an arrangement or agreement may be capable of itself being a scheme.<sup>198</sup> This assertion is further clarified by subsection 177A(3) as the following:

“The reference in the definition of “scheme” in subsection (1) to a scheme, plan, proposal, action, course of action or course of conduct shall be read as including a reference to a unilateral scheme, plan, proposal, action, course of action or course of conduct, as the case may be.”

The definition of “scheme” clearly includes unilateral activities so the scope of the provision is not limited by the requirement for there to be two or more parties to the arrangement. And the Commissioner is also entitled to advance alternative schemes including a narrower scheme within a wider scheme in support of a Part IVA determination.<sup>199</sup>

#### **7.2.1.2 Tax Benefit**

The definition of tax benefit is in Section 177C ITAA 1936 to include:

(a) an amount not being included in the assessable income of the taxpayer of a year of income where that amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out; or

(b) a deduction being allowable to the taxpayer in relation to a year of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out;

This definition is prescriptive and covers the non-inclusion of assessable income, the availability of deductions, capital losses and foreign tax credits where it is reasonable to expect that, in the absence of the particular scheme, these tax characteristics would not have occurred. This definition also provides that the tax benefit of interest occurred “in a year of income” and this ensures that the application of the provision is not constrained by past, current or future tax benefits.

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<sup>198</sup> Ibid per Callinan J.

<sup>199</sup> *Federal Commissioner of Taxation v. Peabody* (1994) 181 CLR 359 at 382.

In Australian, requirement of the reasonable expectation test was clarified by the decision in *FCT v Peabody*<sup>200</sup> :

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

It could not be reasonably concluded that the taxpayer would have received an amount if the relevant arrangement was not entered into.<sup>201</sup> In order to form an opinion as to what may reasonably be expected to occur, in the absence of the scheme, the taxpayer’s previous actions may be relevant.

In the case *Spotless*<sup>202</sup>, the Full High Court of Australia was able to determine the reasonably expected alternative course of action in the absence of a past history of transactions and stated it as follows:

“The taxpayers were determined to place the \$40 million in short-term investment for the balance of the then current financial year. The reasonable expectation is that, in the absence of any other acceptable alternative proposal for 'off-shore' investment at interest, the taxpayers would have invested the funds, for the balance of the financial year, in Australia. The amount derived from that investment then would have been included in the assessable income of the taxpayers. ...”

### **7.2.1.3 Objective purpose**

In Australian, s 177D of ITAA 1936 provides eight tests to determine whether there is a dominant purpose to derive the tax benefit 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 time at which the scheme was entered into and the length of the period during which the scheme was carried out;

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<sup>200</sup> *Federal Commissioner of Taxation v. Peabody* (1994) 181 CLR 359 at 385.

<sup>201</sup> *Ibid.*

<sup>202</sup> *FCT v Spotless Services Ltd* [1996] HCA 34.

(v) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;

(vi) 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;

(vii) 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;

(viii) 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

(ix) 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),

Those tests apply 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, 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 taxpayer has obtained, or would but for section 177F obtain, a tax benefit in connection with the scheme.

There are eight tests to be taken into account to determine whether the requisite purpose is present. Although the Commissioner must consider all eight tests, not all of them may be applicable. In *Spotless*<sup>203</sup>, the Commissioner did not apply all the eight tests because he considered that three were inapplicable. The Court held that even if the three factors were inapplicable, the Commissioner did consider all the factors but concluded that they did not apply in that situation.

A taxpayer may have both commercial purpose and tax driven purpose, however the dominant purpose is the ruling, prevailing or most influential purpose. This issue was discussed in the *Spotless Services* case where it is stated:<sup>204</sup>

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<sup>203</sup> *FCT v Spotless Services Ltd* [1996] HCA 34.

<sup>204</sup> *Ibid.*

“A particular course of action may be, to use a phrase found in the Full Court judgments, both “tax driven” and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine the answer to the question whether, within the meaning of Pt IVA, a person entered into or carried out a ‘scheme’ for the ‘dominant purpose’ of enabling the taxpayer to obtain a ‘tax benefit’.”

“In its ordinary meaning, dominant indicates that purpose which was the ruling, prevailing, or most influential purpose. In the present case, if the taxpayers took steps which maximised their after-tax return and they did so in a manner indicating the presence of the ‘dominant purpose’ to obtain a ‘tax benefit’, then the criteria which were to be met before the Commissioner might make determinations under s 177F were satisfied.”

#### ***7.2.1.4 Step to identify schemes***

In Australian, how to identify particular scheme has been discussed by the court in various cases. For example, in *Spotless*<sup>205</sup> there was some contention in relation to the extent of the scheme identified:

“The offer and the acceptance together with the intervening acts and probably the steps commencing with the receipt by the taxpayers of the information memorandum and other documents earlier than 5 December all constitute the relevant commercial transaction and the scheme. The Commissioner selected out of the relevant series of steps only some of them and classified that isolated segment as the scheme for the purposes of Part IVA.”

In case *Hart*<sup>206</sup>, Hill J stated:

“The definition of the scheme is very important. Any tax benefit which is identified must have a relationship to the defined scheme and not some other scheme. The conclusion of dominant purpose must be made by reference to the defined scheme, not some other scheme.”

“It is, as the High Court made clear in *FCT v Peabody* 94 ATC 4663; (1993-1994) 181 CLR 359, for the Commissioner, at least initially, to determine between any narrow or broad definition of scheme and, subject to matters of unfairness, the Commissioner may

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<sup>205</sup> *FCT v Spotless Services Ltd* 32 ATR 309.

<sup>206</sup> *FCT v Hart* [2002] FCAFC 222.

change his mind. There are, perhaps, however, two qualifications to this. The first is that whatever the Commissioner may put forward as the scheme it must be such that a tax benefit has been obtained in connection with it by the taxpayer. The second, is that the Commissioner could not take a set of circumstances which constituted only part of a scheme if the circumstances are incapable of standing on their own without being ‘robbed of all practical meaning’ . . .”

The identification of the particular scheme establishes the factual parameters to determine whether a tax benefit exists. The decision in *Hart*<sup>207</sup> even clarifies further the concept and extent of an individual scheme. Gleeson CJ and McHugh J held:

“The identification of the tax benefit, and the identification of the scheme, are inter-related. The benefit was not the whole of the interest on loan account 2 (the investment part of the borrowing); it was that part of the interest which resulted from the special, or non-standard, features of the arrangements between the lender and the borrowers. Those were the features to which the respondents were invited to pay attention in deciding whether to enter into the particular transaction. Those features, which defined the 'wealth optimiser structure' and distinguished it from 'standard financing arrangements', were definitive of the scheme in connection with which the tax benefit, identified by all four members of the Federal Court, was obtained.”

Gleeson CJ and McHugh J then went on to discuss the relevant scheme<sup>208</sup>

“where the tax benefit in question is part of an allowable deduction for interest, a search for the purpose of a scheme, identified in a manner that does not include the borrowing, is not an undertaking that conforms with the requirements of the legislation. In a given case, a wider or narrower approach may be taken to the identification of a scheme, but it cannot be an approach which divorces the scheme from the tax benefit.”

In *Hart*, Gleeson CJ and McHugh J further clarified the particular scheme to which the tax benefit related<sup>209</sup>

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<sup>207</sup> *FCT v Hart* [2004] HCA 26.

<sup>208</sup> *Ibid.*

<sup>209</sup> *Ibid.*

“It was the tax benefit so obtained, and applied in reduction of the home loan, that was the wealth optimising aspect of the structure. It was the wealth optimising aspect of the structure, not divorced from the borrowing, but giving the borrowing its distinctive character, that constituted the scheme.”

The Australian Courts recognised that although schemes must be able to stand on their own, they may also attribute a dominant purpose to a scheme on the basis of the particular aspect of the scheme that gives the relevant taxpayer a tax benefit

In *Hart*<sup>210</sup>, the court also demonstrated that Part IVA of the ITAA 1936 applied to parts of schemes rather than to a scheme as a whole:

“Far from the Part requiring reference only to the purpose of those who carry out all of whatever is identified as the scheme, s 177D(b) specifically refers to it being concluded 'that the person, or one of the persons, who entered into or carried out ... any part of the scheme' did so for the purpose of enabling the relevant taxpayer (alone or with others) to obtain a tax benefit in connection with the scheme.”

#### ***7.2.1.5 Cancellation of Tax Benefit***

In Australia, s 177F ITAA 1936 gives the Commissioner power to cancel the particular tax benefit. In relation to assessable income, the Commissioner may:

(a) in the case of a tax benefit that is referable to an amount not being included in the assessable income of the taxpayer of a year of income - determine that the whole or a part of that amount shall be included in the assessable income of the taxpayer of that year of income.

Section 177F(1)(b), (c), and (d) enable the Commissioner to adjust tax benefits refer to allowable deductions, capital losses and foreign tax credits. Section 177F(3) provide that under the s 177F(1) the Commissioner has included an amount of assessable income in the income of a taxpayer who derived a tax benefit as the result of a scheme, then the same assessable income should not be included in the assessable income of another taxpayer. The consequential adjustments should adjust the tax position of other affected taxpayers.

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<sup>210</sup> Ibid.

### **7.2.1.5 Recent developments**

In December 2005, the Australian Taxation Office released the document “*Law Administration Practice Statement, PS LA 2005/24*”. This document provides further insight into how they have and will apply the general anti-avoidance rules at its disposal.

The Statement confirms that ATO officers should consider whether Part IVA may apply to an arrangement described in a ruling application, even if the taxpayer is not seeking a ruling on Part IVA. If the ATO rulings officer thinks Part IVA may apply, the officer must state in the ruling that Part IVA has not been considered but the taxpayer may seek a ruling on it. The only occasions when this statement is not necessary is when the rulings officer can see no reason to suggest Part IVA may apply<sup>211</sup>.

In this Statement, the ATO’s processes for applying Part IVA are described in detail. When the ATO is seeking to apply Part IVA, the ATO’s Tax Counsel Network (TCN) must be consulted. When the ATO is responding to a Class Ruling application, the matter will be referred to the TCN even if it is considered that Part IVA will not apply. Whenever GAAR is to be applied, it will be referred to a Deputy Chief Tax Counsel, and if it arises in the course of an audit, to the GAAR Panel. If Part IVA arises in the course of a ruling application, it will generally only be referred to the Panel at the taxpayer’s request<sup>212</sup>.

The purpose of GAAR Panel is to ensure decisions on GAARs “are objectively based and there is consistency in approach to various issues that arise from time to time in the application of the GAARs”. The Panel includes senior tax officers, tax professionals and, at present, one industry representative. Generally, any GAAR matter arising from an audit will be referred to the Panel before a final decision is made. However, the relevant ATO decision maker is not obliged to follow the advice of the Panel. A matter will generally only be referred to the Panel after the ATO has formed a ‘preliminary’ view that a GAAR applies, issued a position paper on the topic and considered the taxpayer’s response to that position paper.<sup>213</sup>

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<sup>211</sup> Australian Taxation Office, *Practice Statement Law Administration PS LA 2005/24*, December 2005.

<sup>212</sup> Ibid.

<sup>213</sup> Ibid.

## 7.2.2 Canada

Section 245 of the *Canadian Income Tax Act*<sup>214</sup> (CITA) is the current general anti-avoidance provision which was introduced in 1987 and is generally applicable with respect to transactions occurring after 1987. This provision was adopted to replace the former section 137 CITA, in response to the Supreme Court of Canada's rejection of the business purpose test in the 1984 *Stuart*<sup>215</sup> case. It was intended to enhance the form GAAR and to provide an effective statutory basis for combating abusive tax avoidance.

The application of section 245 involves three steps. 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). All three requirements must be fulfilled before the GAAR can be applied to deny a tax benefit.<sup>216</sup>

Under s 245(1) CITA, 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. A "transaction" is defined to include any "arrangement or event".<sup>217</sup>

An "avoidance transaction" is defined under s 245(3)(a) to be a transaction that would result in a tax benefit unless the primary purpose of the transaction objectively determined, was other than to obtain the tax benefit. But the definition also includes a transaction that is part of a series of transactions that would result in a tax benefit unless the primary purpose of the transaction—not the series—was other than to obtain the tax benefit, under s 245(3)(b). According to the definition, if a series of transactions results in a tax benefit, the GAAR will apply to each transaction in the series unless the transaction has a primary non-tax purpose.

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<sup>214</sup> RSC 1985, c. 1 (5th Supp.).

<sup>215</sup> *Stuart Investments Ltd. v. The Queen*, [1984] CTC 294.

<sup>216</sup> *Canadian Trustco Mortgage Co. v. Canada*, 2005 SCC 54, at para. 17.

<sup>217</sup> s 245(1) CITA.

Under section 245 (4), section 245(2) does not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole. This section provides the basis for distinguishing between legitimate tax planning and abusive tax avoidance, and it requires that distinction to be made in terms of the concepts of misuse and abuse.

In the *Canadian Trustco Mortgage Co*<sup>218</sup>, judge asserted “The heart of the analysis under s 245(4) lies in a contextual and purposive interpretation of the provisions of the Act that are relied on by the taxpayer, and the application of the properly interpreted provisions to the facts of a given case” and provided there are two requirements to determinations of misuse and abuse:

“The first task is to interpret the provisions giving rise to the tax benefit to determine their object, spirit and purpose.”<sup>219</sup> This part of the inquiry under requires the court to look beyond the mere text of the provisions and undertake a contextual and purposive approach to interpretation in order to find meaning that harmonizes the wording, object, spirit and purpose of the provisions of the Income Tax Act.<sup>220</sup>

“The second step is to examine the factual context of a case in order to determine whether the avoidance transaction defeated or frustrated the object, spirit or purpose of the provisions in issue.”<sup>221</sup> The overall inquiry thus involves a mixed question of fact and law. Thus, the GAAR will not apply to deny a tax benefit where it may reasonably be considered that the transactions were carried out in a manner consistent with the object, spirit or purpose of the provisions of the Act, as interpreted textually, contextually and purposively.<sup>222</sup> The taxpayer bears the burden to refute the elements of “tax benefit” and “avoidance transaction”<sup>223</sup>, but the Minister of National Revenue bears the burden of establishing that the avoidance is abusive<sup>224</sup>.

### ***7.2.2.1 Recent developments***

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<sup>218</sup> *Canadian Trustco Mortgage Co. v Canada*, 2005 SCC 54, at para 44.

<sup>219</sup> *Ibid.*

<sup>220</sup> *Ibid.* at para. 47.

<sup>221</sup> *Ibid.* at para. 55.

<sup>222</sup> *Ibid.* at para 62.

<sup>223</sup> *Ibid.* at para 65.

<sup>224</sup> *Ibid.* at para 69.

In the past, the court in Canada have generally refused to invoke the GAAR except where the Canadian Revenue Authority can show that the “avoidance transaction” has violated a “clear and unambiguous policy” under the relevant statutory provisions or the CITA as a whole.<sup>225</sup> Some judges even described the GAAR provision as “an extreme sanction”, a “heavy hammer”, and the “ultimate weapon”<sup>226</sup>.

On 19 October 2005, the Supreme Court of Canada, hand down two landmark income tax avoidance decisions, *Canadian Trustco Mortgage Co*<sup>227</sup> and *Mathew*<sup>228</sup>. The two very recent cases represent the first decisions by the Supreme Court of Canada interpreting section 245. In the two cases the Supreme Court of Canada tackled the hard issues and lay down some guiding principles about the tax avoidance. The approach in those two cases will help to understand the principles and jurisprudence in tax avoidance area.

## **8.0 Recommendation and Conclusion**

Tax avoidance has been a growing issue internationally. It is also an inevitable problem faced by New Zealand. New Zealand depends on legislative rules, which include specific anti-avoidance provisions and general anti-avoidance provisions, to deal with tax avoidance. Those legislative rules are helpful to limit the tax avoidance transactions in New Zealand. However, the question for consideration is how to prevent tax avoidance effectively and how existing tax-avoidance law could be improved. Here are some comments from the above discussion.

### **8.1 Tax system**

The true nature of tax avoidance transaction is to take advantage of weaknesses of tax system. So the tax system should be designed to minimize the possibility that taxpayers can find loopholes. An effective tax system is the most powerful weapon in fighting tax avoidance transactions, and is the root to reduce tax avoidance activities. To design a good tax system is the key to countering with tax avoidance. The elements for an effective tax

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<sup>225</sup> BJ Arnold, *The Long, Slow Steady Demise of the General Anti-Avoidance Rule*, 2004, Canadian Tax Journal 488.

<sup>226</sup> Ibid.

<sup>227</sup> *Canadian Trustco Mortgage Co. v Canada*, 2005 SCC 54, at para 44.

<sup>228</sup> *Mathew v R* 2005 SCC 55

system include: a broader and specified tax base, lower tax rates, effective penalty and interest systems, less incentive provisions<sup>229</sup>.

### **Tax base**

New Zealand's income tax base is relatively broad by international standards, but which is less than comprehensive because the absence of a tax on capital gains.<sup>230</sup> This absence leaves room for taxpayer to seek conversion income receipt to capital sum to reduce the possible income tax liabilities. Broadening the tax base will help reduce the tax avoidance.

### **Tax rates**

The current income tax rate structure is variable, such as rate differences applying to different entities and individual progressive rate scale. The top individual income tax rate - 39 percent creates a gap between top personal rates and the tax rate on entities such as companies and trust. This creates an opportunity for individuals to ensure income in excess of \$60,000 is earned through an entity paying 33 percent tax. Such variable tax rate structure encourages income splitting and tax avoidance. The effective way for dealing with such problem is lowering the variability of tax rates, which can reduce or eliminate the gap between the different tax rates.

### **Effective penalty and interest systems**

There are some opportunities existing in current tax legislation for taxpayer to using, such as the opportunity to defer a pre-existing tax liability. Such opportunities should be removed or limited. Developing an effective penalty and interest systems can help reduce the incentive for the taxpayer, and limit the conditions that make tax avoidance possible.

### **Tax incentives**

There is very few tax incentive provisions remain in current Income Tax Act 2004. Back to Income Tax Act 1976, there are numerous incentive provisions contained such as standard values for farmers, tax credits and tax deductions for exporters and accelerated depreciation write offs. The current tax incentive provisions are limited to specific regimes such as the

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<sup>229</sup> Sir Ivor LM Richardson, *Countering Tax Avoidance*, 2004, Vol 10:4, New Zealand Journal of Taxation Law and Policy.

<sup>230</sup> The Tax Review 2001, *Final Report*, Wellington, 2001.

taxation of petroleum, mining and forestry. Such tax incentives provide the taxpayer opportunities to take advantage of. Limit the using of tax incentives will minimize the possibility that taxpayers can find loopholes

## **8.2 Administrative rules**

An effective disclosure and advanced rulings across the entire spectrum of income tax legislation are required in the current tax system. The disclosure regimes, such as pre-transaction ruling system, will alert the tax department to certain types of tax planning strategies at a very early stage. A properly developed system of advanced rulings would assist the operation of avoidance provisions in practice. Such rulings should not overtake the role of the legislation and the Courts and so in that respect, they should only be binding on the Commissioner with respect to named parties.<sup>231</sup>

## **8.3 Legislative rules**

### **8.3.1 Specific anti-avoidance provision**

The specific anti-avoidance provisions are numerous within the *Income Tax Law 2004*. The modern trend of this type of provision is increasing hugely in number, particularly as new measures and codes are legislated. The specific anti-avoidance provisions originate from varying times, and apply to varying subject matters so the format of the various provisions are different in variety and inconsistency. The SAAPs are within all regimes without a thoroughgoing enquiry as to their need. Those concerns are expressed in the Valabh Committee report<sup>232</sup>.

The Valabh Committee<sup>233</sup> made the following recommendations in related to above concerns: within the definitional component, there should also be a two-stage analysis examining the requisite degree of tax-influence complemented by the application of a scheme and purpose saving. And similar definitional tests apply to all the SAAPs. Moreover, various SAAPs within the Act should be revised along the above lines.

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<sup>231</sup> Valabh Committee, *Final Report of the Consultative Committee on the Taxation of Income from Capital*, 1992.

<sup>232</sup> Ibid.

<sup>233</sup> Ibid.

### **8.3.2 Generally anti-avoidance rule**

In recent *Peterson*<sup>234</sup> case, five judges split into 3 to 2 and in favour of both the CIR and taxpayer. The split in the court illustrates the uncertainty created by current section BG1. Such uncertainty placed the NZ judiciary in the difficult situation of having to develop interpretative techniques to make section BG1 work. The Valabh Committee in their report<sup>235</sup> recognized the uncertainty and suggested some amendments in relation to the GAAP to improve uncertainty. The following recommendations are discussed in the Valabh Committee report.

#### **Tax liability**

The term liability is defined in section OB 1, the current definition is only an input to the definition of tax avoidance. The concept of tax liability should extend to all taxes levied under the Act, which represents an extension to the scope of the section but should restrain the proliferation of SAAPs in particular areas.<sup>236</sup> More statutory detail should be provided in relation to income tax objectives and income tax advantages. Such definition may be similar to the definition of “tax benefit” in Part IVA of Australian Income Tax Assessment Act 1936.

#### **External reference**

Section BG 1 does not contain reference to ordinary business or family dealing. The only statutory requirement is that the tax advantage must be more than an incidental purpose or effect. This creates problems with a literal interpretation which has led to the courts developing alternative tests or criteria to read down. The Newton<sup>237</sup> Predication test are followed in dealing with such problem, however the Newton approach no longer provides a taxpayer with an automatic defense. The Newton approach can be replaced with an alternative statutory test based on the taxpayers’ mental state.

#### **Internal reference**

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<sup>234</sup> *Peterson v CIR* (2005) 22 NZTC 19,109.

<sup>235</sup> Valabh Committee, Final Report of the Consultative Committee on the Taxation of Income from Capital, 1992

<sup>236</sup> *Ibid*

<sup>237</sup> [1958] AC 450,465.

The relationship of s BG1 with other provisions is not addressed in the current ITA2004. When section BG1 should apply so as to displace other provisions of the ITA is a problem to be considered. The example of such provision may be the provisions offer taxpayers incentives to modify or encourage certain types of economic activity<sup>238</sup>. The purpose approach is a judicially created technique to answer this question, but there is no legislation to answer this question. This is the primary issue making the application of section BG1 uncertain. The Canadian approach solves the problem by independently stating the relationship of the GAP to the rest of the Act, in section 245 of the CITA.

#### ***8.4 Interpreting the law***

Having an effective policy formation and implementation will help reducing the uncertainty. Appropriate interpretation of the law may not necessarily require anti-avoidance doctrines but may involve a purposive interpretation of the law. In the interests of certainty the Commissioner should express views as to how policy will be identified and how interpretation will be approached. Applicable criteria should be specified, rather than left open-ended.

One of the examples of such interpretation is “Law Administration Practice Statement, PS LA 2005/24”, which released by the Australian Taxation Office and provided information about how to apply the general anti-avoidance rules at its disposal. This type of document should also include effective detection, audit, and dispute, judicial resolution etc.

It would also make sense for the Commissioner to publish some guidance to taxpayers. The guidance can list or specify transactions that the Commissioner intends to challenge. This can alert taxpayers when they take a risk by entering into such transactions, and may deter them from doing so.

#### ***8.5 Conclusion***

This thesis discusses possible causes and solutions of tax avoidance. For different person, tax avoidance has different meaning. The various definition and understanding of tax avoidance is reviewed and analyzed. Then, the current approach using by New Zealand court to discover the true meaning of a transaction is discussed in. The harms caused by

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<sup>238</sup> Ibid

impermissible tax avoidance are varied and pervasive. The options available to prevent tax avoidance are judicial rules, which developed by the courts or by the policymakers, and legislative rules which framed by the government. These legislative rules can also be divided into two categories: specific anti-avoidance provisions and the general anti-avoidance provision. In the section of discussion of legislative rules, the thesis reviews the various applicable sections in the New Zealand Income Tax Act 2004, taking into account of leading cases, discusses the development in other jurisdictions, and particularly examines the development of generally anti-avoidance rules in three jurisdictions, as well as the impact of the general anti-avoidance provisions. The thesis recommends: designing a good tax system to include all the key elements, establishing effective disclosure and advanced rulings system, improving specific anti-avoidance provision, reinforcing generally anti-avoidance rule and developing a purposive interpretation of the law. All the recommendations aim to restrict the conditions that make tax avoidance possible for the future development.

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