



CHOICE PRINCIPLE REVISIT

– A CLOSER LOOK AT PRIVY COUNCIL’S DECISION IN *PETERSON V CIR*

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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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Ivy Nixuan Chen

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Finally I would like to dedicate this dissertation to my beloved families, who are always on my side, love me, inspire me day after day. They make my normal life remarkable and an ordinary me special.

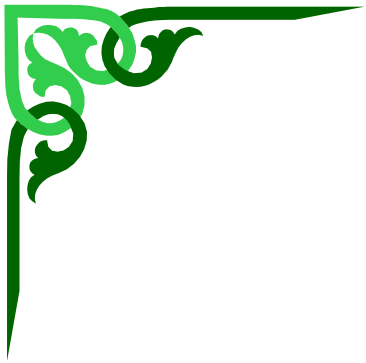
Abstract

Choice principle is a very difficult concept in the context of tax avoidance. It ultimately ousts the operation of a general anti-avoidance provision in the Income Tax Act by saying that tax benefits obtained by a taxpayer can be permitted as a matter of statutory construction. This principle was initially developed in Australian courts. It has only been considered as well established in New Zealand since the Privy Council decision in *O'Neil V C of IR*.

On 28th February 2005, the Privy Council delivered the final decision of *Peterson v C of IR*. Despite the tax avoidance arrangement in *Peterson* being highly artificial, the Privy Council upheld the taxpayer's appeal by saying that the depreciation deduction claimed was a legitimate choice.

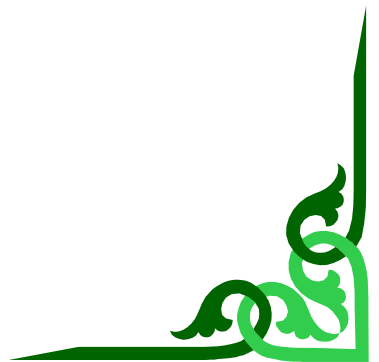
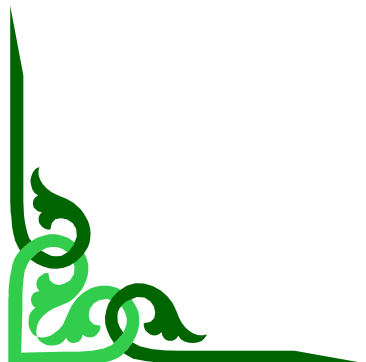
The position of choice principle, in the writer's view, has been strengthened in New Zealand tax law after the *Peterson* decision. This is inevitable as the relationship between general anti-avoidance provision and other provisions of the Income Tax Act is not clearly defined. It has even been submitted that the choice principle should replace the general anti-avoidance provision and become the essential pillar in the area of tax avoidance. However, this proposition is outside the bounds of this dissertation.

With the main purpose of revisiting choice principle from the *Peterson* decision, this dissertation also reviews concepts of "arrangement", "tax avoidance", "purpose and effect", and "commissioner's adjustment power". These concepts are recommended by the Inland Revenue Department in its Exposure Draft as important steps to consider in a tax avoidance case, before and after applying choice principle.



Chapter One

Introduction and overview



1.0 INTRODUCTION AND OVERVIEW

Tax avoidance is one of the most difficult topics in the area of tax law. Choice principle in the context of tax avoidance is even harder. It is a concept from the grey area generated by the general anti-avoidance section in the Income Tax Act. Conflicts often happen in situations where certain provision of the Act allows taxpayers to enjoy certain deductions or exemptions while the general anti-avoidance provision on the other hand wants to take those benefits away. There have been a lot of arguments about whether the general anti-avoidance provision is designed to override other provisions of the Act. On one hand, the Parliament could never have intended that the general anti-avoidance section should over-ride all other provisions of the statute so as to deprive the tax paying community of all structural choices, economic incentives and allowances provided for by the Act itself - many of which allow for the deliberate pursuit of tax advantage. On the other hand, the general anti-avoidance provision would be a dead letter if it were subordinate to all the specific provisions of the legislation.¹

Ultimately, under the choice principle the operation of a general anti-avoidance provision can only be ousted if this is permitted as a matter of statutory construction.² As there is no area in our income tax law which explains the relationship between the general anti-avoidance provisions and other sections

¹ I L Richardson "Comment: Countering Tax Avoidance" (December 2004) Volume 10:4 New Zealand Journal of Taxation Law and Policy
<http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?infobase=tax54.nfo&clientID=286389126&softpage=BROWSE_VW&modusreturnurl=http%3A%2F%2Fwww%2Ebrookersonline%2Eco%2Enz%2F&advquery=%5blevel+level+4%3a%5d+tax+avoidance&headingswithhits=on&depth=all&record={18A7}> (at 21 February 2007)

² E Trombitas "The Abracadabra Effect and Tax Avoidance – Comments on Inland Revenue's Exposure Draft INA0009: Interpretation of Section BG1 and GB1 of the Income Tax Act 2004 – Part 2" (March 2005) Volume 11:1 New Zealand Journal of Taxation Law and Policy
<http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?infobase=tax54.nfo&clientID=286389125&softpage=BROWSE_VW&modusreturnurl=http%3A%2F%2Fwww%2Ebrookersonline%2Eco%2Enz%2F&advquery=%5blevel+level+4%3a%5d+tax+avoidance&headingswithhits=on&depth=all&record={15FC}> (at 21 February 2007)

of the Act, studies of choice principle are inevitable. *Waincymer* addressed the choice principle as follows³:

The choice principle raises another particular difficulty where general anti-avoidance provisions are concerned. If a taxpayer's transaction falls foul of a specific provision, there is no need for a general anti-avoidance provision. If on the other hand their transaction is perfectly legal and acceptable under these specific provisions of the Act, why should a general anti-avoidance provision be allowed to interfere?

Trombitas was of the view that the choice principle was a statutory construction tool that could be used to determine if a general anti-avoidance provision should or should not apply. The basis of the principle was that the Income Tax Act could not, on one hand, give and yet on the other hand take away. If the choice principle applied so that there was no room for the application of a general anti-avoidance provision to a particular set of facts, this would be another way of saying that there was no tax avoidance in a general anti-avoidance provision sense or the situation involved a case of legitimate tax avoidance and the result was one contemplated by the Income Tax Act.⁴

Green believed that the choice principle was not read into the legislation but served to negate the definition of "tax avoidance" as a matter of statutory construction and upon an application of specific provisions.⁵

Ohms was of the opinion that the lack of explicit relationship established between the general avoidance rule and specific provisions that conferred tax advantages or concessions provoked the so called "doctrine of choice". The rule was initially held to be subject to certain provision in the legislation that offered tax concession regardless of whether the use of the particular provision was

³ J Waincymer "The Australian Tax Avoidance Experience and Responses: A Critical Review", in GS Cooper (ed) *Tax Avoidance and the Rule of Law*, Amsterdam, IBFD Publications in Association with the Australian Tax Research Foundation, 1997, Chapter 8 at p 251.

⁴ E Trombitas "Legitimate Tax Avoidance and the Choice Principle: Some Thoughts Following Recent Cases" (March 2002) Volume 8:1 New Zealand Journal of Taxation Law and Policy
<http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?infobase=tax54.nfo&clientID=286389135&softpage=BROWSE_VW&modusreturnurl=http%3A%2F%2Fwww%2Ebrookersonline%2Eco%2Enz%2F&advquery=%5blevel+level+4%3a%5d+tax+avoidance&headingswithhits=on&depth=all&record={3B21}> (at 21 February 2007)

⁵ R Green "Tax Avoidance: The Pendulum Returns?" (Paper presented at the 2001 ICANZ Tax Conference, Rotorua, 2001) para 3.59, 4.4

bona fide or not, and subsequently it was widened to include any situation where the taxpayer simply avoided the application of the legislation.⁶

As a matter of fact, choice principle was developed by Australian courts.⁷ As Lord Tomlin said in his famous judgement in *IRC v Duke of Westminster*.⁸

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 Commissioner of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.

Before *O'Neil v C of IR*⁹ New Zealand courts¹⁰ generally had taken the view that the predecessor to s BG 1 might override other sections of the Act.¹¹ This issue had been extensively considered by the Court of Appeal in *McKay v C of IR*¹², where the taxpayer argued that assignments of income for longer than the prescribed period would be effective for tax purpose under section 96 of *Income Tax Act 1976*. Two Australian cases were cited in support of this submission, *WP Keighery Pty Ltd v FC of T*¹³ and *FC of T v Casuarina Pty Ltd*¹⁴. The judge, by comparing the cited cases from Australia, concluded New Zealand legislation did not provide the equivalent provision and thus the assessment of the taxpayer's income was subject to the government of the anti-avoidance provision, and the submission of the taxpayer should be dismissed.¹⁵ A similar approach was taken in the Privy Council's decision in *C of IR v Challenge Corporation Ltd*¹⁶. Their Lordships' propositions were that there could be tax

⁶ C Ohms "Section 99: The General Anti-Avoidance Rule - Analysis and Reform" (December 1994)

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<http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?infobase=tax54.nfo&clientID=311677290&softpage=BROWSE_VW&modusreturnurl=http%3A%2F%2Fwww%2Ebrookersonline%2Eco%2Enz%2F&advquery=Section+99%3a+The+General+Anti-Avoidance+Rule+-+Analysis+and+Reform&headingswithhits=on&depth=all&record={6AC0}> (at 21 February 2007)

⁷ See cases *DFC of T v Purcell* [1921] 29 CLR 464, *WP Keighery Pty v FC of T* [1957] 100 CLR 66, *FC of T v Sidney Williams (Holdings) Ltd* [1957] 100 CLR 95, *FC of T v Casuarina Pty Ltd* 70 ATC 4069, *Mullens v FC of T* 76 ATC 4288, *FC of T v Gulland* 85 ATC 4765, etc

⁸ *IRC v Duke of Westminster* [1936] AC 1, 19; [1935] All ER 259, 267; 19 TC 490, 520 (HL).

⁹ [2001] 20 NZTC 17,057 (PC)

¹⁰ See cases *Mangin v C of IR* 70 ATC 6001 and [1971 NZLR 591 where s 108 of *Land and Income Tax Act 1954* was applied to disallow deductions came within S104 of the Act, *C of IR v Challenge Corporation Ltd* [1986] 8 NZLC 5,219, and *McKay v C of IR* 72 ATC 6058 and [1973] 1 NZLT 592

¹¹ New Zealand Income Tax Law and Practice para 538-000 The choice principle considered <[http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates\\$fn=default.htm](http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates$fn=default.htm)> (at 30 April 2006).

¹² [1973] 1 NZLR 592

¹³ [1957] 100 CLR 66

¹⁴ 70 ATC 4069

¹⁵ *McKay v C of IR* 72 ATC 6058, at p 6,065

¹⁶ [1986] 8 NZTC 5,219

avoidance in the manipulation of a shareholding or constitution of a company in order to obtain temporary compliance. The fact that such manipulation might also be frustrated by the operation of anti-avoidance provision did not lead to the conclusion that Parliament must have intended to permit permanent tax avoidance.¹⁷ In *Miller v CIR; Managed Fashions Ltd v CIR*¹⁸ the Court of Appeal noted that s 99¹⁹ lacks any express indicator of hierarchy between it and other sections of the Act. The Court referred to the observations of the Privy Council decision in *Challenge Corporation* on this issue. The court proceeded to reject an argument by the taxpayers to the effect that the Commissioner was precluded from applying s 99 because to do so would be inconsistent with the application of the avoidance provision of the grouping rules. The Commissioner's obligation to apply the grouping provisions does not prevent him from assessing income to another party who has received a tax advantage under the tax avoidance arrangement.²⁰

In the meantime, expressive recognitions of choice principle in New Zealand carried equal weights. As Lord *Deplock* observed in decision of the Privy Council in *Europa Oil (NZ) Ltd v C of IR*:²¹

There may be different ways of carrying out ... transactions. They will not be struck down if the method chosen for carrying them out involves the payment of less tax than would be payable if another method was followed.

The Court of Appeal's comments about the choice principle in *Challenge Corporation Ltd v C of IR*²² were also relevant as suggested by Inland Revenue Exposure Draft IN0009, although the decision was overturned by the Privy Council.²³ *Cooke J* observed that:²⁴

Where a particular section conferring tax concessions or rights has its own anti-avoidance provision (and there are other instances in the Income Tax Act) the preferable interference seems to me to be that the special provision is exhaustive in its own field. Within that field a taxpayer is entitled to assume that he has a right to

¹⁷ *C of IR v Challenge Corporation Ltd* (1986) 8 NZTC 5,219, p 5,224

¹⁸ [1998] 18 NZTC 13,961

¹⁹ S 99 is the general anti-avoidance provision of Income Tax Act 1976, equivalent to Section BG 1 of *Income Tax Act 2004*

²⁰ New Zealand Income Tax Law and Practice > para 538-100 The choice principle considered <[http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates\\$fn=default.htm](http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates$fn=default.htm)> (at 30 April 2006).

²¹ [1976] 1 NZLR 546, p 556

²² [1986] 2 NZLR 513, p541

²³ Public Rulings Unit Inland Revenue Department *Inland Revenue's Exposure Draft INA0009: Interpretation of Section BG1 and GB1 of the Income Tax Act 2004* para 4.2.15

²⁴ *Challenge Corporation Ltd v CIR* [1986] 2 NZLR 513, p 543

order his affairs to take advantage of the benefits conferred by the section, provided only that he does not fall foul of the special provision. Outside that field there may still be room for s 99 to operate.

Richardson J also pointed out that it was clear that the legislature could not have intended that a general anti-avoidance provision should override all other provisions of the Act so as to deprive the taxpaying community of structural choices, economic incentives, exemptions and incentives provided by the Act.²⁵

The choice principle seemed to be cemented into the tax law of New Zealand after the Privy Council's decision in *O'Neil*; this was effectively endorsed in the Inland Revenue's Exposure Draft IN0009,²⁶ in which Lord *Hoffmann's* decision in *O'Neil* was quoted:²⁷

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.

Trombitas suggested that the above message from *O'Neil* indicated that the choice principle had been endorsed in New Zealand. It was submitted that embedded in the above statement of principle there was recognition of the notion that there could be legitimate tax avoidance – deciding whether the taxpayer could avoid the tax legitimately, or in a permissive manner, was a matter of a statutory construction. He also respectfully submitted the notion of a general anti-avoidance provision being an essential pillar (or central pillar) given by the majority decision of *C of IR v BNZ Investments Limited*²⁸ might no longer hold true in most cases.²⁹

The last Privy Council's statement on New Zealand's anti-avoidance provision was the decision of *Peterson v CIR*³⁰. It was another controversial case in the

²⁵ Ibid, p 548

²⁶ Public Rulings Unit Inland Revenue Department *Inland Revenue's Exposure Draft INA0009: Interpretation of Section BG1 and GB1 of the Income Tax Act 2004* para 4.2.16

²⁷ *O'Neil v CIR* [2001] 20 NZTC 17,057 (PC), p 17,057

²⁸ [2001] 20 NZTC 17,103

²⁹ E Trombitas "Legitimate Tax Avoidance and the Choice Principle: Some Thoughts Following Recent Cases" (March 2002) Volume 8:1 New Zealand Journal of Taxation Law and Policy <http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?infobase=tax54.nfo&clientID=286389135&softpage=BROWSE_VW&modusreturnurl=http%3A%2F%2Fwww%2Ebrookersonline%2Eco%2Enz%2F&advquery=%5Blevel+level+4%3A%5D+tax+avoidance&headingswithhits=on&depth=all&record={3B21}> (at 21 February 2007)

³⁰ [2005] 22 NZTC 19,098

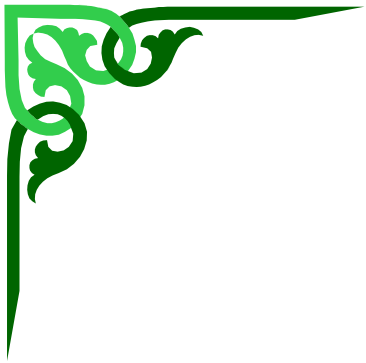
area of choice principle in New Zealand. The Privy Council, by a 3 to 2 majority decision, found in favour of the taxpayer. The taxpayer's depreciation claim on his investments in films was held not to be tax avoidance. This case was considered as a somewhat hollow taxpayer victory, as the majority indicated that the reason the investors were successful owed a great deal to their view that Inland Revenue had poorly discharged the weaponry provided by the anti-avoidance provision.³¹

Although revisiting the choice principle by studying the decision of *Peterson* is the main purpose of this dissertation, concepts of "arrangement", "tax avoidance", "purpose and effect", and the "commissioner's adjustment power" will also be discussed. These concepts are regarded as important steps by Inland Revenue Department ("IRD") when judging a tax avoidance case before and after applying choice principle.³²

In the next chapter, the general anti-avoidance provision in our income tax act and details of IRD recommended steps when judging a tax avoidance case will be discussed. Then facts and decisions of *Peterson* case from the Tax Review Authority to Privy Council, will be studied. After the *Peterson* cases overview, the steps in determining a tax avoidance case, including choice principle, will be scrutinized, and finally a conclusion will be given.

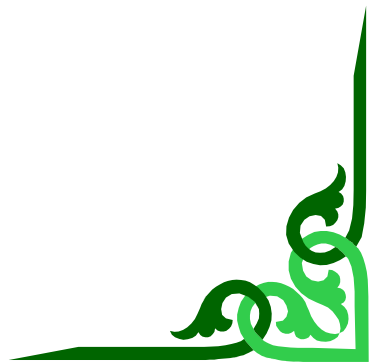
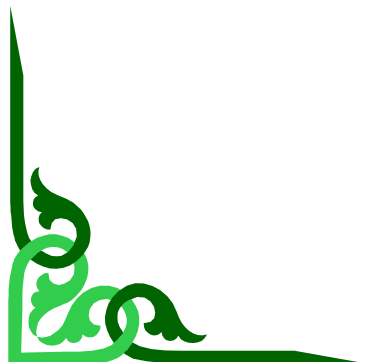
³¹ N Williams "Comment: Privy Council Delivers Final Tax Avoidance Decision: *Peterson v CIR*" (September 2005) Volume 11:3 New Zealand Journal of Taxation Law and Policy
<http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?infobase=tax54.nfo&clientID=286389113&softpage=BROWSE_VW&modusreturnurl=http%3A%2F%2Fwww%2Ebrookersonline%2Eco%2Enz%2F&advquery=%5blevel+level+4%3a%5d+tax+avoidance&headingswithhits=on&depth=all&record={EAF}> (at 21 February 2007)

³² Public Rulings Unit Inland Revenue Department *Inland Revenue's Exposure Draft INA0009: Interpretation of Section BG1 and GB1 of the Income Tax Act 2004* para 6.1



Chapter Two

Legislation and outline *of IRD procedure*



2.0 LEGISLATION AND OUTLINE OF IRD PROCEDURE

Considering choice principle or whether an arrangement frustrates Parliament's intention for the provision, regime or Act as a whole, is one of the steps in determining a tax avoidance case. One would not consider choice principle before a tax avoidance arrangement has been identified. Thus it is vital for us to know the relevant legislation and understand the procedure used by IRD in determining tax avoidance cases. After all, it is the Commissioner who has the power to challenge taxpayer's tax affairs.

2.1 RELEVANT LEGISLATION

The general anti-avoidance provisions of *Income Tax Act* 2004 are in Sections BG1 and GB1, with relevant terms defined in section OB1. The predecessors to these sections are Section BG1 and GB1 of *Income Tax Act* 1994, Section 99 of *Income Tax Act* 1976, and Section 108 of the *Land and Income Tax Act* 1954.

The sections are read as follows:

BG 1 Tax avoidance

BG 1(1) A tax avoidance arrangement is void as against the Commissioner for income tax purposes.

BG 1(2) Under Part G (Avoidance and non-market transactions), the Commissioner may counteract a tax advantage that a person has obtained from or under a tax avoidance arrangement.³³

GB 1 Agreements purporting to alter incidence of tax to be void

GB1(1) Where an arrangement is void in accordance with section BG1, the amounts of assessable income, deductions, and available net losses included in calculating the taxable income of any person affected by that arrangement may be adjusted by the Commissioner in the manner the Commissioner thinks appropriate, so as to counteract any tax advantage obtained by that person from or under that arrangement, and, without limiting the generality of this subsection, the Commissioner may have regard to –

³³ Income Tax Act 2004 Section BG1

(a) such amounts of assessable income, deductions, and available net losses as, in the Commissioner's opinion, that person would have, or might be expected to have, or would in all likelihood have, had if that arrangement had not been made or entered into; or

(b) such amounts of assessable income and deductions as, in the Commissioner's opinion, that person would have had if that person had been allowed the benefit of all amounts of assessable income, or of such part of the assessable income, as the Commissioner considers proper, derived by any other person or persons as a result of that arrangement.

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

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

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

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

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

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

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

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

GB 1(3) Without limiting the generality of subsections (1) and (2), section BG 1, or the definitions of arrangement, liability, tax avoidance, or tax avoidance arrangement in section OB 1, where, in any tax year, any person sells or otherwise disposes of any shares in any company under a tax avoidance arrangement under which that person receives, or is credited with, or there is dealt with on that person's behalf, any consideration (whether in money or money's worth) for that sale or other disposal, being consideration the whole or a part of which, in the opinion of the Commissioner, represents, or is equivalent to, or is in substitution for, any amount which, if that arrangement had not been made or entered into, that person would have derived or would derive, or might be expected to have derived or to derive, or in all likelihood would have derived or would derive, as dividends in that tax year, or in any subsequent tax year or years, whether in 1 sum in any of those years or in any other way, an amount equal to the value of that consideration, or of that part of that consideration, is deemed to be a dividend derived by that person in that first-mentioned tax year.³⁴

OB 1 Definitions

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

³⁴ Income Tax Act 2004 Section GB1

tax avoidance includes -

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

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

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

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

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

(b) has tax avoidance as 1 of its purposes or effects, whether or not any other purpose or effect is referable to ordinary business or family dealings, if the purpose or effect is not merely incidental³⁵

S BG1 is mainly saying that a tax avoidance arrangement is void *ab initio* against the Commissioner for income tax purpose, notwithstanding the Commissioner's initiative to invoke the provision to void the agreement. S BG(2) also gives the Commissioner discretion to apply s GB1. Given by the use of the words "Under Part G (Avoidance and non-market transactions), the Commissioner may counteract a tax advantage". S GB1 also indicates that tax avoidance arrangement "may be adjusted by the Commissioner in the manner the Commissioner thinks appropriate".

The important issues to be noted in s GB1 are that the Commissioner has a broad power to adjust any tax advantage obtained by a person from or under a voided arrangement. While the commissioner can make the judgement call to execute this power, he needs to ensure such adjustment must be only for the purpose of counteraction of tax advantages, and is only limited to a party to the tax avoidance arrangement or a person affected by that arrangement - and the tax advantages in this case involve an income tax benefit or a better income tax position.

These relevant sections of Legislation will be discussed in the next few chapters of this paper in more detail.

³⁵ Income Tax Act 2004 Section OB1

2.2 IRD PROCEDURE

In order for taxpayers and tax professionals to better understand the legal principles, Inland Revenue Department (IRD) published an interpretation document - Interpretation of sections BG1 and GB1 of the Income Tax Act 2004, Exposure draft for external consultation - INA0009, in September 2004 ("Exposure Draft"). This interpretation document is aimed at replacing the 1990 statement³⁶ with a more comprehensive and updated statement for guidance in what is a complex area of revenue law.

This interpretation statement examines the words of the legislation and the leading cases on tax avoidance to isolate key interpretive principles relevant to the application of section BG1 and GB1. Based on this examination and, in particular, the differing judicial approaches, the Commissioner has developed an approach that attempts to reconcile the different and sometimes conflicting objectives of the general anti-avoidance provision and other provisions of the Act.³⁷

This approach or procedure is described by the flow chart in Figure 1.³⁸ The writer considers this as the most comprehensive procedure to determine whether s BG1 and s GB1 can apply to a tax avoidance arrangement.

There are six steps involved in this procedure, they are:

Step 1 Determine whether there is an arrangement and its scope.

The word "arrangement" is interpreted as something in the nature of a relationship between two or more persons that may not legally amount to an

³⁶ A Statement issued by the Commissioner in 1990 on section 99 of Income Tax Act 1976 which was published as an appendix to the *Tax Information Bulletin*, Vol 1, No.8

³⁷ Public Rulings Unit Inland Revenue Department *Inland Revenue's Exposure Draft INA0009: Interpretation of Section BG1 and GB1 of the Income Tax Act 2004* para 1.1.2

³⁸ Public Rulings Unit Inland Revenue Department *Inland Revenue's Exposure Draft INA0009: Interpretation of Section BG1 and GB1 of the Income Tax Act 2004* para 6.2

agreement, contract, plan, or understanding, including all the transactions by which it is carried into effect. An “arrangement” also requires the parties have a consensus or meeting of minds. It is important to note that the consensus of meeting of mind involves an expectation about what is to be done, or, by each that the other will act in a particular way, and such consensus must encompass explicitly or implicitly the dimensions that actually amount to tax avoidance. While the taxpayers need to be aware of the dimensions, knowledge that the dimensions amount to tax avoidance is not necessary.³⁹

All steps and transactions by which an arrangement is brought into effect are considered in determining the scope of an arrangement. But it does not provide that part of the arrangement is itself an “arrangement”. And the definition of “arrangement” in s OB1 does not preclude any tax avoidance arrangement which form part of, or a step in, a wider series of arrangements, being considered separately from the wider series of the arrangements.⁴⁰

To conclude, the existence of an arrangement is not determined by the opinion of the Commissioner or taxpayer. Rather, whether there is a “tax avoidance arrangement” is a matter of objective fact.⁴¹

This step will be discussed further in Chapter 4 of this dissertation.

Step 2 Decide whether the arrangement involves tax avoidance?

The first limb of the definition of “tax avoidance” applies to arrangements which have the purpose or effect of altering the economic incidence of tax such that the taxpayer becomes liable to less tax after the arrangement than would have, or might have been, levied upon the taxpayer, but for it.

The second limb of the “tax avoidance” definition focuses on relieving or releasing someone from an obligation to pay income tax. The word “relieving” is

³⁹ Ibid para 6.1

⁴⁰ Income Tax Act 2004 Section OB1 “tax avoidance arrangement”

⁴¹ Public Rulings Unit Inland Revenue Department *Inland Revenue's Exposure Draft INA0009: Interpretation of Section BG1 and GB1 of the Income Tax Act 2004* para 6.1

construed as “defeating”, “evading” or “avoiding”. This limb may apply to arrangements involving tax credits.

The words “avoiding”, “postponing” or “reducing” in the third limb are construed in their ordinary sense. They mean escaping or minimizing a liability to income tax or deferring that liability to a later date.

The combined effect of the three limbs is that the taxpayer must directly or indirectly alter the economic incidence of tax; defeat, evade, or avoid liability to pay income tax; escape or minimize liability to income tax; or defer that liability to a later date.⁴²

Note that the overall net tax position of an arrangement is not taken into account at the initial stage of determining whether there is “tax avoidance”. Also in ascertaining an alteration of the incidence of income tax or a “potential” or “prospective” liability, the Commissioner considers the correct approach is to ascertain the amount of gross income, allowable deductions, or available net losses the taxpayer might reasonably have included in his/her tax income had the “tax avoidance arrangement” not been entered into or carried out.

Chapter 5 will provide more detail discussion on this step including comparison of tax avoidance and tax mitigation.

Step 3 Find out the purpose and effect of the arrangement and Step 4 Discover whether the purpose or effect is more than merely incidental

To identify whether an arrangement has a purpose or effect of tax avoidance, the arrangement is looked at with a view to determining whether it can be predicated that it was implemented in the particular way so as to avoid tax. This is done by examining the overt acts by which the arrangement is implemented. However, it is no longer possible to avoid such predication simply by claiming

⁴² Ibid para 6.1

the arrangements are capable of explanation by reference to ordinary business or family dealings.⁴³

The whole set of words “purpose or effect” denotes a concerted action to an end — the end of avoiding tax.

“Purpose” is determined objectively by reference to the arrangement itself and not subjectively in terms of motive. “Purpose” is not motive, but is the effect which the arrangement seeks to achieve. “Effect” means the result accomplished or achieved by the arrangement.

If an arrangement has a particular purpose that will be its effect. If it has a particular effect then that will be its purpose.

A “merely incidental” purpose or effect is something which follows from or is necessarily and concomitantly linked to, without any contrivance, some other purpose or effect. Such a purpose is determined objectively by reference to the arrangement itself and not subjectively in terms of motive. The proper focus is on assessing the degree of economic reality associated with a given transaction. This focus is contrasted with any artificiality, contrivance, or the relative extent to which the transaction appears to exploit the statute in direct pursuit of tax benefits.⁴⁴

Step 3 and 4 will be discussed together in Chapter 6.

Step 5 Verify whether there is a Choice, i.e. does the arrangement frustrate Parliament’s intention for the provision, regime or Act as a whole?

After having applied various elements of section BG 1 (including the relevant terms defined for the purposes of that section) to the facts of the arrangement in question, it is necessary to consider, as an additional interpretative step, whether Parliament intended the section to apply to the arrangement. Over the years the courts have adopted a number of judicial approaches to reach a view

⁴³ Ibid para 6.1

⁴⁴ Ibid para 6.1

on this issue. The choice principle and tax mitigation are the most prominent judicial approaches adopted by the courts to ascertain whether section BG 1 applies to any given arrangement.

Overall, the Commissioner considers the approach to be adopted in applying section BG 1, is first to find out whether the section applies on its terms (i.e. apply steps 1 – 4 above), and then, whether the arrangement would frustrate Parliament's intention for the provision, regime or the Act as a whole. Establishing the existence or absence of such frustration is a two-step process. These steps are to:

- Identify the legislative purpose of the provision, regime or the Act as a whole; and
- Consider whether the Parliamentary intention for the provision, regime or Act is consistent with its applying to the arrangement in the way argued for by the taxpayer or whether the arrangement would frustrate the statutory purpose. If the purpose would be frustrated, section BG 1 applies to void the arrangement.⁴⁵

Chapter 7 will focus on analyzing the choice principle and how it applies to the *Peterson* case.

Step 6 Counteract the tax benefit received directly or indirectly by the taxpayer under section GB1.

The Commissioner has been vested with a broad adjustment power, but must ensure that any adjustment is to counteract any tax advantage obtained by a person from or under a voided arrangement. The Commissioner is not constrained in the means by which the amount of an adjustment is determined.

While the Commissioner can make such adjustments as are considered necessary to counteract the tax advantage, the adjustment must be only for the purpose of the counteraction.

⁴⁵ Ibid para 6.1

The Commissioner's power to adjust is limited to a party to the arrangement and a person affected (who is not necessarily a party) where a tax advantage has been obtained from or under the arrangement.

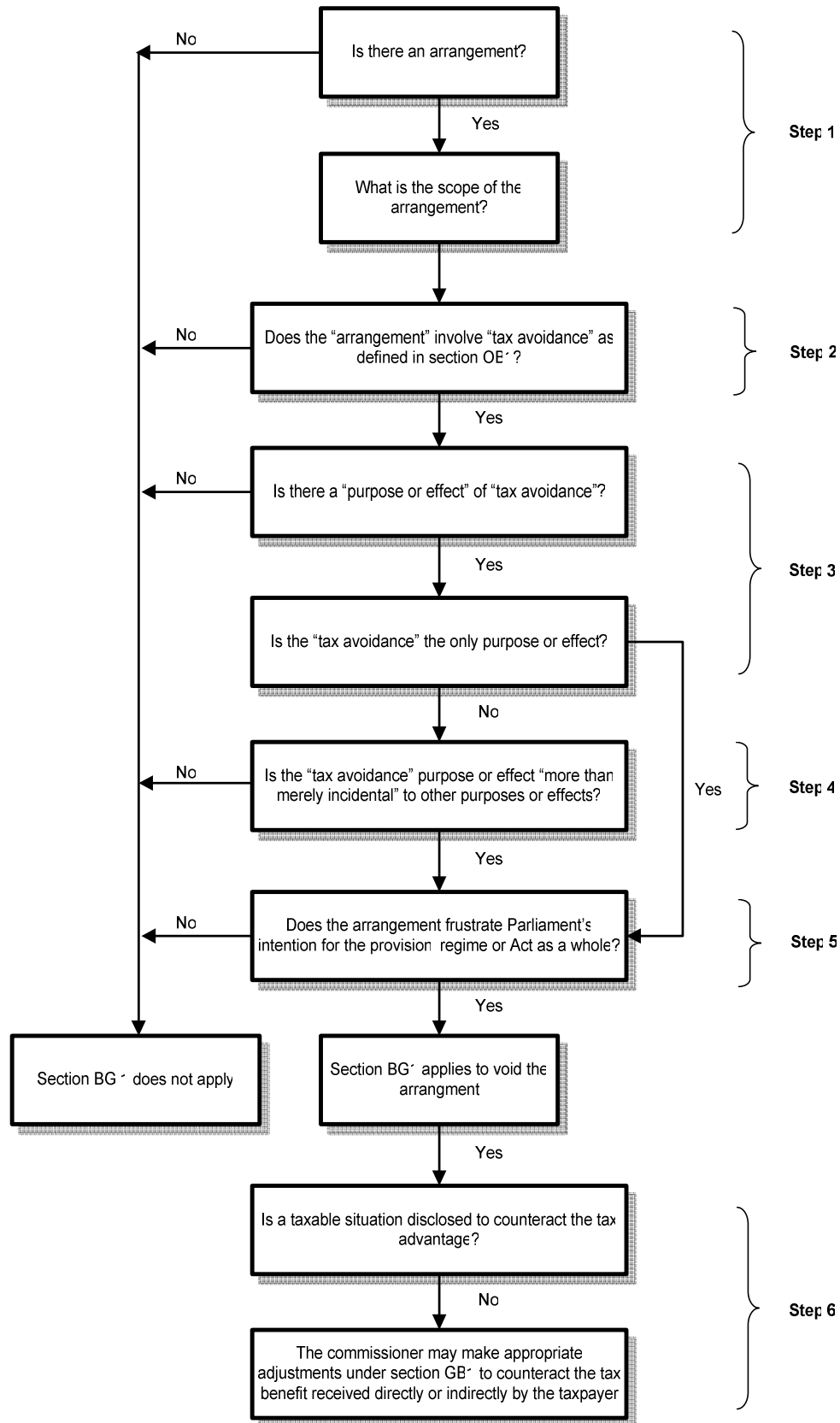
A “tax advantage” involves an income tax benefit or a better income tax position. Such a tax advantage must be obtained by way of altering the incidence of income tax; relieving any person from an existing, potential or prospective liability to pay income tax; or avoiding, reducing or postponing an existing, potential or prospective liability to pay income tax.⁴⁶

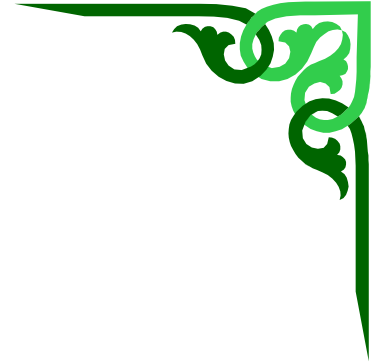
The Commissioner's power to counteract tax benefits will be considered in the Chapter 8.

It is submitted that the Exposure draft is a welcome development and a significant piece of academic work in relation to an extremely difficult topic. The break down of each component that required for the general anti-avoidance provision to apply and the detailed commentary in respect of each component will be useful to refer to when undertaking an analysis of avoidance issues.⁴⁷

⁴⁶ Ibid para 6.1

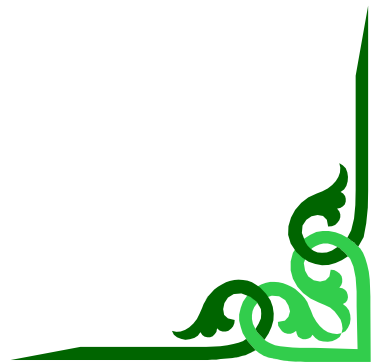
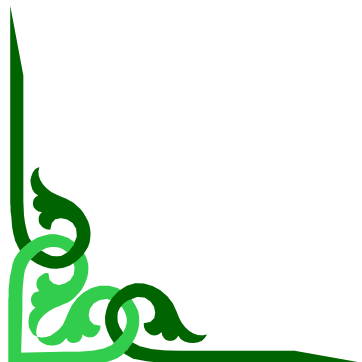
⁴⁷ E Thombitas “The Abracadabra Effect and Tax Avoidance - Comments on Inland Revenue's Exposure Draft INA0009: Interpretation of Sections BG 1 and GB 1 of the Income Tax Act 2004 - Part 1” (December 2004), Volume 10:4 New Zealand Journal of Taxation Law and Policy
<http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?infobase=tax54.nfo&clientID=286389133&softpage=BROWSE_VW&modusreturnurl=http%3A%2F%2Fwww%2Ebrookersonline%2Eco%2Enz%2F&advquery=%5blevel+level+4%3a%5d+tax+avoidance&headingswithhits=on&depth=all&record={1A39}> (21 February 2007)

Figure 1⁴⁸⁴⁸ Ibid para 6.2



Chapter Three

Peterson case overview



3.0 PETERSON CASE OVERVIEW

The Peterson case involved two films: “Utu” and the “Lie of the Land”. “Utu” has proved to be extremely successful and is still generating income, while “The Lie of the Land” has never been commercially released. The two films were discussed in separate cases when they came in front of the Tax Review Authority, the High Court and the Court of Appeal. Only when the cases were appealed to the Privy Council, the judge decided to put the two cases together due to their similarities.

3.1 TAX REVIEW AUTHORITY (TRA)

Lie of the Land

The taxpayer in this case, Mr Peterson, was one of the investors in a special partnership that was established for the purpose of making the feature film – Lie of the Land. The film was never commercially released and thus made a loss. Mr Peterson claimed a deduction of \$19,550 for his share of losses. The Commissioner only allowed the taxpayer to deduct \$6,840 for the reasons that the non-recourse loan of \$1,560,000 from Steadfold was a sham⁴⁹ and the production company Filmcraft's contribution of \$267,000 to the partnership was a sham; the Commissioner also argued the arrangement was an tax avoidance arrangement under s 99 of Income Tax Act 1976, and the Commissioner had the discretion to remove the tax benefit obtained by the taxpayer as a party affected.

⁴⁹ Sham means acts done or documents executed by parties to the sham with the common intention of creating, for third parties, the appearance or illusion of particular rights and obligations different from the actual rights and obligations (if any) which the parties intend.
Definition as per NZ Updating Master Tax Guide para 33-050
<http://library2.cch.co.nz.ezproxy.aut.ac.nz/dynaweb/ntx/numtcomm/@ebt-link;pf=;nh=1;cs=default;ts=default;pt=38?target=%25N%16_235992_START_RESTART_N%25;__next_h it__=102648;DwebQuery=sham> (at 21 February 2007)

The flowchart illustrates the financial and legal relationships between several entities in a transaction. The entities are represented by boxes: Lie of the Land Ltd & Co. Partnership, Filmcraft Ltd – the production co., South Pacific All Media Distributors Ltd, Steadfold Ltd, and Creative Arts Ltd – the supplier. The relationships are shown by arrows: solid blue arrows for legal agreements, dashed blue arrows for directorship, dashed green arrows for payments, and a dashed red arrow for a repayment. The flow is as follows:

- Subscription Deed** (diamond) connects to Lie of the Land Ltd & Co. Partnership and Filmcraft Ltd – the production co.
- Marketing agreement** (diamond) connects to Lie of the Land Ltd & Co. Partnership and Filmcraft Ltd – the production co.
- Production Deed at \$2.76m** (diamond) connects to Lie of the Land Ltd & Co. Partnership and Filmcraft Ltd – the production co.
- Loan agreement of \$1.56m/ £702k** (diamond) connects to Lie of the Land Ltd & Co. Partnership and Steadfold Ltd.
- Agreement for acting and other services at \$1.56m** (diamond) connects to Filmcraft Ltd – the production co. and Creative Arts Ltd – the supplier.
- Director of General Partner** (dashed blue arrow) connects to Lie of the Land Ltd & Co. Partnership and Steadfold Ltd.
- Director** (dashed blue arrow) connects to Filmcraft Ltd – the production co. and Creative Arts Ltd – the supplier.
- Governing director** (dashed blue arrow) connects to Creative Arts Ltd – the supplier and South Pacific All Media Distributors Ltd.
- Repayment** (dashed red arrow) connects from Creative Arts Ltd – the supplier to Steadfold Ltd, labeled "Repay \$1.56m???".
- Payments** (dashed green arrows) show \$1.56m flowing from Steadfold Ltd to Leigh Carr & Partners Trust a/c, and then from Leigh Carr & Partners Trust a/c to Creative Arts Ltd – the supplier.

The TRA commented on the two sham arguments separately. Firstly, with regards to the non-recourse loan provided by Steadfold Ltd, the judge said the non-recourse nature of the loan did not make it a sham, there is no clear evidence that Creative Arts had circulated the loan back to Steadfold, and in fact, Creative Arts had no legal obligation to repay the non-recourse loan and Mr M cannot create such an obligation merely by saying so in the telex. Filmcraft should not be expected to record the \$1.56 million loan on its account, as the loan was made between the partnership and Steadfold Ltd. His honour concluded on page 9,056:⁵⁰

⁵⁰ *Case U6* (1999) 19 NZTC 9,038, p9,056

Secondly, concerning the Commissioner's argument about Filmcraft's subscription of shares in the partnership being a sham, the TRA, by studying various documents, concluded the submission lacked factual basis.

When it came to the submission of infringing s99, the TRA found that the tax benefit obtained from the arrangement was merely an incidental outcome. Furthermore, the fact that the film made a loss was no different to a failed commercial venture and the taxpayers who seek to reduce their income tax liability from the non recourse loan remained liable to repay the money according to the terms of the loan.

Finally, the judge contented the partnership purchased a finished film for a fixed price and therefore was entitled to the depreciation. The Commissioner's submissions were thus dismissed.

Utu

The case was brought to the TRA by Mr Peterson - the taxpayer, as the Commissioner of Inland Revenue adjusted down the taxpayer's claim of deduction of his share of loss from investing in the film, from his other income in 1982 and 1983 income tax year. Mr Peterson was a member of a film partnership established to acquire the film Utu. The Commissioner found that the expenditure incurred by the partnership was less than the amount claimed and considered such increased claim was a fraud or an arrangement under s 99 of the Income Tax Act 1976. The taxpayer objected.

The TRA had carefully examined the facts of this case and various documents that formed the relationships between the parties. The writer had briefly summarized the court findings in Figure 3 below:

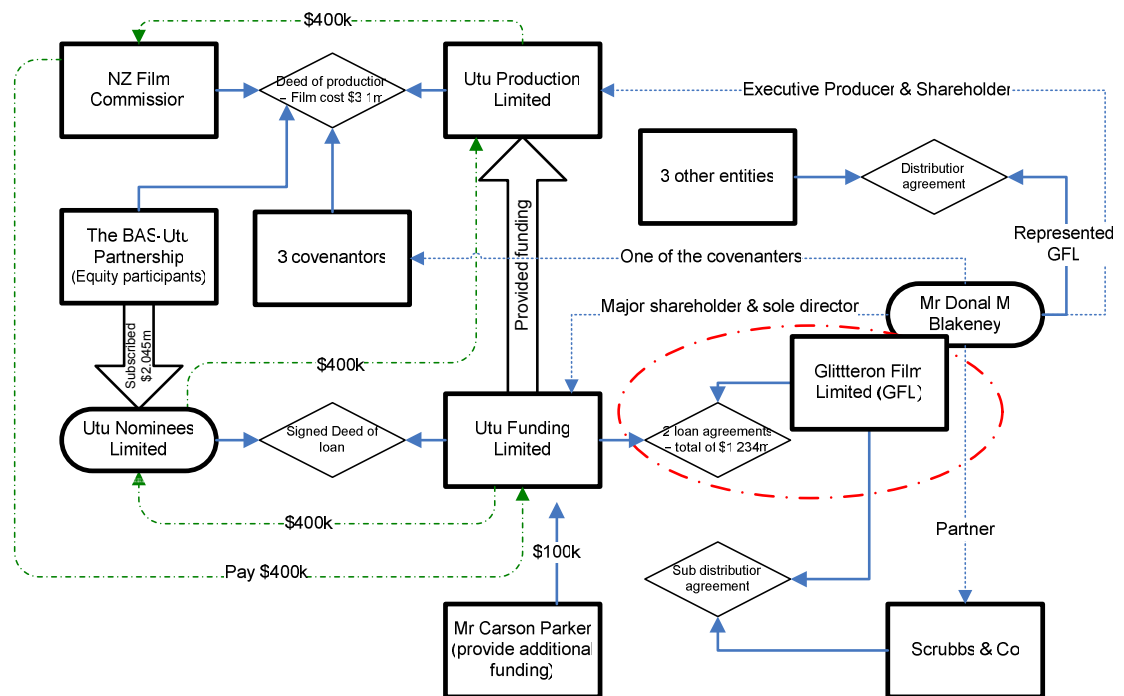


Figure 3

The TRA's decision concerned the Deed entered into by the Objector's BAS-Utu Partnership and Utu Funding Ltd which was not a fixed price contract, but represented that of a principal and agent relationship between the parties. Thus as a general proposition, a taxpayer would be assessed on the basis of the transaction which actually took place.

Secondly, the judge argued there was no evidence to prove that the loans from Glitteron Film Ltd had been made, hence the judge found in favour of the Commissioner, based on the consideration that the loan was a sham or a fraudulent claim made by the agent against its principal. S99 is therefore found not relevant.

3.2 HIGH COURT

Lie of the Land

The argument before the High Court was whether tax advantages Mr Peterson obtained from or under a tax avoidance scheme were within s 99, and could be counteracted by the Commissioner.

By considering the tax avoidance arguments, the court used the “meeting of Mind” test brought out by *CIR v BNZ Investment Limited*.⁵¹ The judge was satisfied with the evidence provided by Mr Peterson and his accountant Mr Wright that the taxpayer has no knowledge about whatever Mr McLean and Steadfold and Creative Arts were doing. His Honour also had the view that the “wilful blindness”⁵² argument was nothing but a make-weight argument, as the taxpayer had no obligation to satisfy himself where Steadfold was getting its loan money from. The Commissioner’s statement of agency relationship was also failed. The judge made it clear that the relationship between the special partners and Filmcraft was a fix price contract. The Commissioner appeal was thus dismissed.

Utu

In High Court, the taxpayer argued that investors of the film were the purchasers of a film including its copyright and not the makers of a film, and his deduction claim was about the price paid for the right to exploit the film and had nothing to do with the production expenditure actually incurred. The commissioner’s argument was that the relationship between the partnership and Utu Production Ltd was that of a joint venture conducted through the media of an agency relationship. Alternatively, although Mr Peterson did not know the

⁵¹ [2001] 20 NZTC 17,103

⁵² Wilful blindness is defined by McGechan J in *CIR v BNZ Investments Ltd* [2001] 20 NZTC 17,103 para 26 as “A taxpayer who deliberately refuses to see the obvious, but proceeds with a transaction in which the obvious occurs downstream, readily enough could be held to be part of at least an “understanding” to that effect.”

existence of Glitteron, he was a person affected by a tax avoidance arrangement and therefore subject to adjustment under s 99 of Income Tax Act 1976.

The High Court decision differed from the TRA decision as to the application of the “agency” argument. The judge found no difficulty in saying that while the Partnership had a fixed price contract with the Production Company for certain services, the Production Company also had specific authority to undertake certain designated agency functions. However, those agency functions did not of themselves alter the character of the fixed price arrangement. Therefore in the judge’s view, the cost to the partnership was the full \$3.1million.

The Count also considered the application of s 99 and found that Mr Blakeney’s arrangement to inflate the cost of film production infringed s 99. And Mr Peterson did obtain an advantage, albeit indirectly, through a share of the inflated price of the film. Thus the Commissioner’s determination and adjustment was correctly grounded.

3.3 COURT OF APPEAL

Lie of the Land

The Commissioner’s appeal to the Court of Appeal was again based on s 99. His argument was that accepting the findings that the taxpayer had no knowledge of the arrangement involving the circular movement of the “loan” moneys, still the Commissioner could counteract the tax advantage obtained by the taxpayer as a “person affected” by a tax avoidance arrangement.

By considering the facts of the case, and by referring to the *BNZ Investments Ltd* decision, the judges allowed the Commissioner’s appeal. Their Honours commented that the tax advantage obtained by the taxpayer was derived directly from the arrangement in which the loan funds were included in the cost to the partnership of the film. In addition, the taxpayer could not distance himself

from the management to the extent of not ascertaining whether the partnership loan from Steadfold was in fact repaid and simply insist he was entitled to assume that the partnership accounts from which his deductions were derived were accurate.

Utu

The taxpayer's appeal to the Court of Appeal was directed to the High Court's finding that his assessments were justified as adjustments under s 99. It was submitted that the only arrangement in which Mr Peterson participated was the fixed price contract to purchase an asset for \$3.1 million, and there was no other transaction from which he obtained a tax advantage.

The Court of Appeal found that the depreciation calculation by the partnership is to be made not on what was agreed to be paid, but on the actual cost incurred. The arrangement to falsely inflate that cost was for the purpose of increasing the loss for tax purposes. Mr Peterson as a partner claiming a share of the partnership depreciation was a persona directly affected by that arrangement and obtained a tax advantage under it.

The judge also commented on the fact that the partnership had actually paid, from the proceeds of exploitation of the film, \$207,000 in accordance with the terms of the deed of loan. He said on page 18,073, para 19:⁵³

...the fact of those payments does not make the illusory loans real. Further, it is to be noted that the payments (or at least some of them) were made not to Utu Funding Ltd, the creditor – which was dissolved in 1993, but to Mr Blakeney.

As a result, the taxpayer's appeal was dismissed.

⁵³ *Peterson v C of IR* [2003] 21 NZTC 18,069, p 18,073

3.4 PRIVY COUNCIL

Both of the cases regarding the two films were appealed to the Privy Council. In order to deal with two cases together, the Privy Council used algebraic symbols to represent monetary sums involved. The Privy Council summarized the facts as follow:

The films were expected to cost $\$x$ to make, but the investors were falsely led to believe that it would cost $\$x+y$. Accordingly they were induced to sign a production contract by which they incurred a liability to pay $\$x+y$ to the production company to make the film. The $\$x$ was funded by the investors out of their own resources and the $\$y$ was by the proceeds of a non-recourse loan from a third party lender connected with the production company. The investment was highly geared, $\$y$ represented more than half of the total investment $\$x+y$. The investor received (or treated as receiving) $\$y$ by way of loan and paid it (or treated as paying it) together with $\$x$ out of their own resources to the production company in the discharge of their contractual liability under the production contract. The production company applied $\$x$ in making the film. Unknown to the investors, however, it did not use the $\$y$ to make the film (for which it was not needed), but recycled the money to the lender immediately it was received.

The majority decision of the Privy Council was in favour of the taxpayer. The majority judges considered the depreciation deduction claimed by the taxpayer on the $\$x+y$ was entirely legitimate as it was the Parliament's intention to allow depreciation deduction on the capital cost of an asset against the taxpayer's taxable income. Although the price of making the film was inflated and there was circular movement of the $\$y$, it did not change the fact that the taxpayer suffered the economic cost of paying the $\$y$. In terms of the abnormal arrangement of the non-recourse loan, their honours indicated that borrowed money belonged to the borrower, and this is so whether the borrower incurred the liability to repay the loan or not. Depreciation allowance depended on the

taxpayer having incurred the cost of acquiring an asset, not how he came by the money to acquire the asset. Accordingly, the non-recourse loan ought ordinarily to be irrelevant.⁵⁴

The dissenting judgment carried almost the same weight as the majority judgement in this case. The dissenting judges, by considering the tax avoidance arrangement, the purpose test, came to a conclusion that if the cost of acquisition of a film is inflated for no commercial reason other than that of qualifying for a higher tax deduction then would otherwise be available, the amount of the inflation could not be regarded as the sort of cost that the statutory regime was intended to assist or encourage.

3.5 CASE SUMMARY

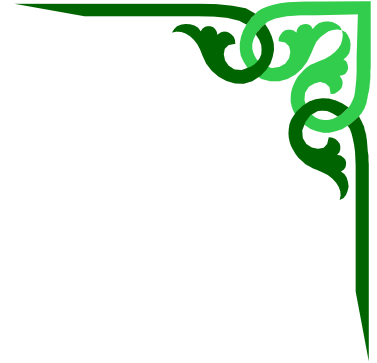
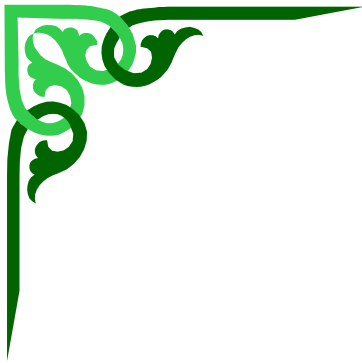
There were several arguments discussed in the decisions from TRA to Privy Council:

1. Whether the non-recourse loan involved was a sham
2. Whether the relationship between the Investor Partnership and the production company was a fixed price contract or an agency relationship.
3. Whether the investor partnership was “wilfully blind”
4. Whether the arrangement was captured by s99 of Income Tax Act 1976.
5. Whether the taxpayer, despite having no knowledge about the arrangement between the production company and the loan provider, could be attacked by s 99 as a party affected by a tax avoidance arrangement.

The “sham” and “agency” arguments were mainly discussed in the TRA and High Court. The Commissioner was mainly relying on s 99 in the Court of Appeal and Privy Council. The focus of applying s 99 was changed from the “meeting of mind” of the arrangement by the taxpayer to that of “as a party affected by the tax avoidance arrangement”.

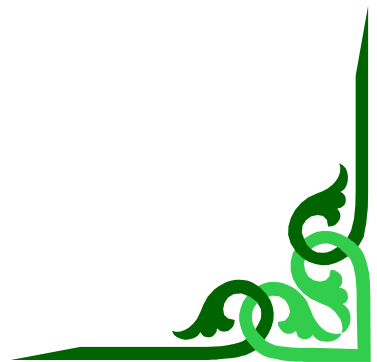
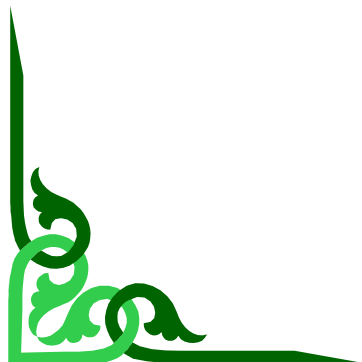
⁵⁴ *Peterson v CIR* (2005) 22 NZTV 19,098, p 19,104 para 15

It appears that the Commissioner was using his s 99 power step by step, from the beginning to the end. Surely, we do not want s 99 to override all other provisions of the Act and give the Commissioner infinite power to attack taxpayers' constructions of their tax affairs. However, the general anti-avoidance provision will be a dead letter if it subordinates to other provisions.



Chapter Four

Arrangement and its scope



4.0 ARRANGEMENT AND ITS SCOPE

In *Peterson*, the majority judges did not spend much time in determining what an “arrangement” is. Their Lordships only considered that the “arrangement” identified by the Commissioner had the purpose or effect of reducing the investors’ liability to tax and that they were affected by it, whether or not they were parties to the arrangement or the relevant part or parts of it. Their Lordships also said:⁵⁵

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* (supra).

We thus need to look at the definition of “arrangement” under legislation and case law.

4.1 ARRANGEMENT AND ITS SCOPE – LEGISLATION AND CASE LAW

“Arrangement” is defined in s OB1 as follows:⁵⁶

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

The definition was originally enacted in 1974. Before this amendment, s 108 simply provided:⁵⁷

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

⁵⁵ *Peterson v C of IR* (2005) 22 NZTV 19,098, p 19,108 – 19,109 para34

⁵⁶ Income Tax Act 2004 Section OB1

⁵⁷ Land and Income Tax Act 1954 Section 108

The same phrase “every contract, agreement or arrangement” was used in its Australian counterpart s 260 of the Australian *Income Tax Assessment Act* 1936.

The Australian High Court in *Bell v FC of T* interpreted the words “contract”, “agreement” and “arrangement” at page 573 as:⁵⁸

... the word “arrangement” is the third in a series which as regards comprehensiveness is an ascending series, and that word extends beyond contracts and agreements so as to embrace all kinds of concerted action by which persons may arrange their affairs for a particular purpose or so as to produce a particular effect.

The Privy Council in *Newton v F of CT* stated that:⁵⁹

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

It appears that these Australian decisions have been referred to in several New Zealand cases to interpret the current definition of “arrangement”.⁶⁰

In brief, the word “contract” is used in its ordinary sense as an agreement enforceable by law or transactions which involve an offer and acceptance intended to create legal obligation.⁶¹ “Agreement” can be construed as generic with “contract” involving offer and acceptance that is supported by consideration or it may be in a broader sense to denote an agreement that may or may not amount to a binding contract. It is submitted that the first meaning of “agreement” prevail.⁶² According to *Ohms*,⁶³ “Plan and understanding” may be

⁵⁸ *Bell v FC of T* [1953] 87CLR 548, p 573

⁵⁹ *Newton v F of CT* [1958] 2 All ER 759 (PC), p 763

⁶⁰ *CIR v Challenge Corporation Limited* [1986] 8 NZTC 5,001, *Europa Oil (N.Z.) Limited* (No. 2) v CIR [1974] 1 NZTC 61,169, *BNZ Investments Ltd v CIR* [2000] 19 NZTC 15,732, *Auckland Harbour Board v CIR* [1999] 19 NZTC 15,433 etc.

⁶¹ *FC of T v Newton* [1957] 96 CLR 577, 630, *C of IR v BNZ Investment Ltd* [2001] 20 NZTC 17,103, 17,116

⁶² Garth Harris et al *Income Tax in New Zealand* (Brookers Ltd, Wellington, 2004) Part E, 1070.

⁶³ *Ibid* 1073.

divided into two elements, a physical element and a mental element. The physical element includes the priori formulation of a plan or scheme, the execution of the plan in the arranged form and the ultimate end result viewed in substantive terms. The mental element relates to the expectation or awareness of the taxpayer as to the object sought by the initial plan and the willingness to be “party” to it and the steps undertaken to achieve that end result.

In summary, the definition of arrangement provides for varying degrees of enforceability from contractual situations, through agreements, plans to understandings. In other words, an arrangement is defined to encompass all kinds of concerted action by which a person may organise their affairs for a particular purpose or to produce a particular effect.⁶⁴

4.1.1 Some practical aspects of “arrangement”

The IRD in its Exposure Draft also determined some practical aspects of the “arrangement” definition.

Arrangement is between two or more persons.

This statement is firstly pointed out by the Privy Council in *Newton*:⁶⁵

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 [emphasis added].

It is supported in *BNZ Investments Limited* case, where *Richardson P* stated:⁶⁶

The definition of arrangement closely follows the meaning given to the composite expression “contract, agreement or arrangement” in *Newton* and other decisions under the former s 108 and its Australian counterpart, s 260 of the Income Tax Assessment Act 1936. In *Davis v FC of T* 89 ATC 4377; (1989) 86 ALR 195 at p 227 Hill J saw the bilaterality requirement as founded in the very nature of the words of s 260, contract, agreement or arrangement. And an arrangement cannot exist in a

⁶⁴ Public Rulings Unit Inland Revenue Department *Inland Revenue's Exposure Draft INA0009: Interpretation of Section BG1 and GB1 of the Income Tax Act 2004* para 3.2.49

⁶⁵ [1958] 2 All ER 759, p 760

⁶⁶ [2001] 20 NZTC 17,103

vacuum. As did the former s 108, s 99 bites on an “arrangement made or entered into”. It presupposes there are two or more participants who enter into a contract or agreement or plan or understanding. They arrive at an understanding. They reach a consensus.

However, the word “plan” in the “arrangement” definition is not necessarily limited to single-person situations. It is the only word in the list which could potentially be limited to one person. The IRD, in its Exposure Draft, interpreted that “plan” is not separated out of the list to indicate that it has a unique feature not shared by the other words and the inference is that arrangements have a bilateral requirement.⁶⁷

Arrangement requires a consensus or meeting of minds

The consensus or meeting of minds is required between parties involving an expectation on what is to be done, or by each that the other will act in a particular way. The consensus must encompass explicitly or implicitly the dimensions that actually amount to tax avoidance.

This is the approach upheld by *BNZ Investment Ltd (CA)*, as *Richardson J* stated:⁶⁸

In short, an arrangement involves a consensus, a meeting of minds between parties involving an expectation on the part of each that the other will act in a particular way.... The essential thread is mutuality as to content. The meeting of minds embodies an expectation as to future conduct. There is consensus as to what is to be done.

....

In order to avail the Commissioner, the consensus — the meeting of minds — necessary to constitute an arrangement under s 99 must encompass explicitly or implicitly the dimension which actually amounts to tax avoidance; albeit the taxpayer does not have to know that such dimension amounts to tax avoidance.

An arrangement involves a meeting of minds between parties involving an expectation as to future conduct. The conscious involvement of the parties must exist for there to be an arrangement. This conscious involvement consensus will be established where a significant feature of the arrangement is the obtaining (including sharing) of tax benefits. In that situation, even if a taxpayer professes

⁶⁷ Public Rulings Unit Inland Revenue Department *Inland Revenue's Exposure Draft INA0009: Interpretation of Section BG1 and GB1 of the Income Tax Act 2004* para 3.2.18

⁶⁸ [2001] 20 NZTC 17,103, para 50

no knowledge, on a commercially realistic assessment it may be assumed that the taxpayer authorised or accepted the tax avoidance mechanism. Similarly, the consensus will be established if the taxpayer was wilfully blind to what is done under an arrangement. Consensus will exist if the taxpayer authorises an agent to act on their behalf and is indifferent to whether the agent will take part in tax avoidance. On the other hand, consensus will not exist if one of the parties acts in a way that was not expected by the other party or uses a tax avoidance mechanism without the other's knowledge.

The scope of an “arrangement” is not limited to a single document or transaction.

The Commissioner is entitled, and required, to consider all the dealings or the set of circumstances between the parties, where relevant, to establish the scope of the arrangement. For example, in *Tayles v C of IR*⁶⁹, the Court looked at various individual transactions and documents, and considered the three documents executed by the appellant combined to constitute the arrangement.

In *C of IR v Europa Oil (No.1)*⁷⁰ the Privy Council considered three separate documents and had to decide whether they consisted a single interrelated complex of agreements entered into for the profits. The decision was that the separate documents represented one contractual whole, and the contractual arrangements were interdependent, one on the other.

These cases indicate that relevant documents or transactions that are sufficiently interrelated and/or interdependent can be considered together as part of the arrangement.

“Arrangement” includes all steps and transactions by which it is carried into effect.

⁶⁹ [1982] 5 NZTC 61,311 (CA)

⁷⁰ [1971] NZLR 641 (PC)

In the High Court decision of *Hadlee and Sydney Bridge Nominees Ltd v C of IR*⁷¹, *Eichelbaum* CJ considered the arrangement involved three different transactions which were the steps by which the arrangement was carried into effect. This approach was upheld by *Cooke* P in the Court of Appeal decision of *Hadlee*⁷²

Similarly, *Woodhouse* J in *Elmiger v C of IR*⁷³ considered the tax avoidance arrangement was consist of all steps taken by the taxpayer. His honour stated:⁷⁴

There usually is ... a series of transactions which have been applied in a concerted way as part of a predetermined routine... There clearly was an overall plan preceding the individual steps themselves involved first the creation of a trust which had vitality only to the extent desired or permitted by the trustees, who are the appellants; then there was a sale by them to the trust of valuable assets capable of producing a high gross income or terms which involved no money payments for purchase price by the trust; and this was followed by an agreement for hire on a basis which had the effect of cutting the appellant's assessable income in half.

As a result, *Woodhouse* J accepted the Commissioner's submission that the arrangement was a tax avoidance arrangement and should be voided in terms of s 108 of the *Land and Income Tax Act* 1954.

The definition of "arrangement" in section OB 1 of the Income Tax Act 2004 does not preclude any tax avoidance arrangement which forms part of, or a step in, a wider series of arrangements, being considered separately from the wider series of arrangements. However, various steps or transactions by which an arrangement is brought into effect should not be severed when considering an arrangement under section BG1 of the Income Tax Act 2004 or its precedent.

Also any avoidance arrangement that has a more than incidental purpose or effect of avoiding New Zealand income tax is void under section BG1 whether or not such arrangement involves steps or transactions carried out or brought into effect wholly or partly outside New Zealand.

⁷¹ [1989] 11 NZTC 6,155 (HC) p 6,171

⁷² [1991] 13 NZTC 8,116 (CA) p 8,121

⁷³ [1966] NZLR 683

⁷⁴ *Ibid* p 694

As said by *McGechan J* in *BNZ Investment Ltd* (HC):⁷⁵

What is done abroad is done abroad, but can still be part of an “arrangement” with the purpose or effect of tax avoidance in New Zealand, with s 99 applicable to elements or consequences in New Zealand accordingly.

4.2 ARRANGEMENT IN *PETERSON*

As mentioned, the majority of Judges in the Privy Council decision of this case did not spend much time identifying the arrangement. Thus it is imperative for us to look at the TRA, High Court and Court of Appeal's opinions about *Peterson's* arrangement and its scope.

Tax Review Authority

With regards to The “Lie of the Land”, the TRA concluded there was an arrangement in this case, but its purpose and effect was not caught by s 99. The tax losses claimed in this case flowed, not from any preconceived plan of deception, but from the depreciation rules then in force for such transactions and the then marginal tax rate applicable. The Judge also pointed out the Commissioner must treat the offending transaction as a whole. It was impermissible to attempt to sever parts of it and characterise them as infringing s 99. The “arrangement” in this case was the making of the film in all of its constituent parts.⁷⁶

In terms of “Utu”, the Authority found it irrelevant to refer to an arrangement caught by s 99, as all the documents relating Gliteron, Todds and the lesser matters were a sham and a fraud on the investors.⁷⁷

⁷⁵ [2000] 19 NZTC 15,732, para 123

⁷⁶ *Case U6* [1999] 19 NZTC 9,038, p9,058-9,059

⁷⁷ *Case U32* [2000] 19 NZTC 9,302, p9,321

High Court

High Court agreed that the arrangement in “The Lie of the Land” was not one which could be impugned under s 99. The Judge admitted the arrangement between lender and the production company was inappropriate, but it was one which occurred outside the knowledge of the taxpayer. The doctrine of “wilful blindness” did not apply in this case. There appeared to be no obligation on the taxpayer to satisfy himself from where the lender company was getting its loan money. There was also no relevant agency in these circumstances, as the test was contrary to the fundamental conception of a special partnership.⁷⁸

In “Utu”, the High Court agreed the arrangement infringed s 99 and allowed the Commissioner to counteract the tax benefit obtained from the tax payer as a party affected. However, the judge believed it went too far to make the blanket statement that there was somehow an overarching principle and agency relationship between the investors and the production company.⁷⁹

Court of Appeal

The Court of Appeal believed the application of s 99 to the circumstances of “Utu” was no different to the companion case relating to the film “The Lie of Land”.⁸⁰

In the case of “The Lie of the Land”, the judges found that Mr Grahame McLean, who was a director of the company, formed the special partnership, in which the taxpayer was a special partner. Their Lordships also said Mr McLean

... represented the mind of the partnership, he was a director of the general partner acting in the management of the project. He arranged the loan from Steadfold and its repayment the same day. He provided the information from which the partnership accounts were prepared. He well knew (as a signatory) that the prospectus, by which subscription for units in the partnerships were invited,

⁷⁸ *C of IR v Peterson* [2002] 20 NZTC 17,589, p17,600-17,601

⁷⁹ *Peterson v C of IR (No 2)* [2002] 20 NZTC 17,761, p 17,772 para 57

⁸⁰ *Peterson v C of IR* [2003] 21 NZTC 18,069, p 18,071 para 1

held out the tax advantages to investors on the basis of a total cost of acquisition of the film of \$2.76 million including \$1.56 million from a “limited recourse” loan.⁸¹

Their Lordships then concluded that the taxpayer could not distance himself from the management of the partnership to the extent of not ascertaining whether the partnership loan from the lender was, in fact, repaid. Nor could he simply insist he was entitled to assume that the partnership accounts from which his deductions were derived were accurate.⁸²

The arrangement to falsely inflate the film making cost was for the purpose of increasing the loss for tax purposes.

Summary

All three courts have studied the arrangement in *Peterson*, and arguments of Agency relationship and Wilfully Blind were declined. The issue remaining is the proximity between the taxpayer and the parties who made the arrangement.

4.3 DEGREE OF PROXIMITY – DECISION OF *BNZ INVESTMENT LTD*

There are arguments saying Mr Peterson, who did not know about the transactions between the producer and the lender, should not fall under s BG1 and be liable to a tax avoidance adjustment. A better view of the case is that there were in fact two different arrangements. Mr Peterson had no participation in what occurred between the producer and the lender, making that arrangement irrelevant to him except in a “but for” sense. This is consistent with the decision of *BNZ Investment Ltd*.⁸³

It is then vital to clarify the decision of *BNZ Investment Ltd*. Note that the Judges in *BNZ Investment Ltd* clearly recognized that an arrangement requires

⁸¹ *C of IR v Peterson* [2003] 21 NZTC18,060, p 18,068 para 37

⁸² *C of IR v Peterson* [2003] 21 NZTC18,060, p 18,066-18,067

⁸³ New Zealand Tax Planning Report No 5 2005 October p 5

<[http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates\\$fn=default.htm](http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates$fn=default.htm)> (at 16 October 2006)

a “consensus and meeting of mind” and an adjustment can be made to the assessable income of a person affected though not a party to the arrangement.

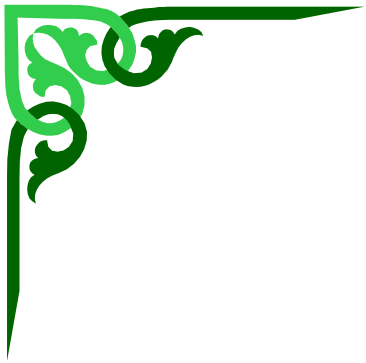
The decision of *BNZ Investment Ltd* was in favour of the taxpayer because their Lordships were satisfied that *BNZ Investment Ltd* obtained the tax advantage not from the “downstream” tax avoidance arrangement, but by another, “upstream” arrangement. There were good commercial reasons for Fay Richwhite to keep the proposed structures secret as far as and for as long as possible in order to protect their efforts from being picked up and used by competitors, including the BNZ.

In the *Peterson* case, however, the tax advantage obtained by the taxpayer was derived directly from the arrangement in which the loan funds were included in the cost to the partnership of the film.

The decision of the Court of Appeal presented a good conclusion in terms of degree of proximity in *Peterson*.⁸⁴

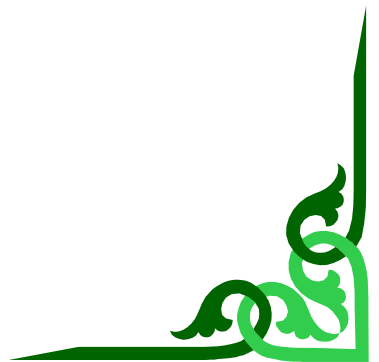
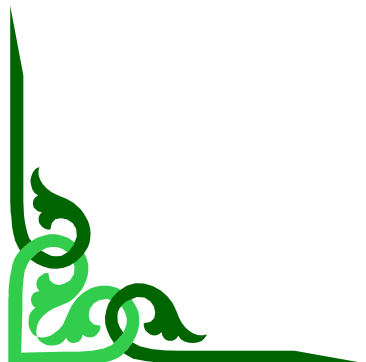
There will be circumstances in which questions will be raised as to the degree of proximity necessary to qualify as a person affected for the purpose of s 99(3). This will be another aspect of line-drawing, as it was termed in the *BNZ Investments* case, so as to distinguish between a tax advantage that may be legitimately retained and one that is vulnerable to adjustment. But we do not see the situation of the appellant in this case (despite the fact that it concerns a special partnership) as even approaching the line.

⁸⁴ *C of IR v Peterson* [2003] 21 NZTC18,060, p 18,069 para 44



Chapter Five

Tax avoidance vs Tax mitigation



5.0 TAX AVOIDANCE VS TAX MITIGATION

The second step to determine whether s BG1 can apply is to identify whether the “arrangement” involves “tax avoidance” as defined in s OB1 of *Income Tax Act 2004*.

There is no doubt that the taxpayer in *Peterson* had obtained tax advantages from the arrangement. However did such tax advantages amount to “tax avoidance” and could it be counteracted by the Commissioner under s 99? The majority judges of the Privy Council said no; their Lordships reviewed the tax mitigation-tax avoidance dichotomy developed in *C of IR v Challenge Corporation Limited*⁸⁵ and held that the tax advantages in *Peterson* were legitimate tax mitigation rather than tax avoidance because the taxpayer had suffered the economic consequences that the Parliament intended to be suffered by any taxpayer qualifying for a reduction in tax liability.

It is thus important to look at the definition of “tax avoidance” and “tax mitigation”, and the differences between them.

5.1 TAX AVOIDANCE

“Tax avoidance” as defined in s OB1 of *Income Tax Act 2004* 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.⁸⁶

⁸⁵ [1986] 8 NZTC 5,219

⁸⁶ *Income Tax Act 2004* Section OB1

First limb

The first limb provides that “tax avoidance” includes “altering the incidence of any income tax”.

The words “altering the incidence of any income tax” are interpreted by Dixon J in *de Romero v Read*⁸⁷ as follows:⁸⁸

I think the provision refers to the loss or detriment suffered as a consequence of discharging that liability and makes ineffectual attempts by agreement to place that burden, as between subject and subject, where the legislation does not mean that it shall be borne.

In the Court of Appeal, the decision of *Marx v C of IR* [1970] NZLR 182 *Turner J* stated on page 199:⁸⁹

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

Lord *Donovan* in the decision of *Mangin v CIR*⁹⁰ presented a similar view. His Lordship construed the first limb as applying when the economic incidence of tax is altered. His Lordship said on page 596:⁹¹

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

Hence, the first limb applies to an arrangement which has the purpose or effect of altering the economic incidence of tax so the taxpayer becomes liable to less

⁸⁷ [1932] 48 CLR 649

⁸⁸ *Ibid* p 660

⁸⁹ *Marx v CIR* [1970] NZLR 182

⁹⁰ [1971] NZLR 591 (PC)

⁹¹ *Ibid*

tax after the arrangement than would have, or might have been, levied upon the taxpayer, but for the arrangement.⁹²

However, there have been difficulties with interpreting the first limb that refers to “altering the incidence of tax” and the addition of “economic incidence” arguably makes this issue even harder. The reason why there are difficulties with this concept is that a person may, for example, assign his or her income, or the person may create deductions to reduce the overall income, but the incidence of the tax may not be altered. It may not be altering the incidence of tax as the statute arguably contemplates that the new owner should bear the burden of the tax, and therefore the burden of the tax falls precisely where the statute intends it to fall.⁹³ As *Turner J* held in *Marx v CIR*:⁹⁴

It seems to me that in cases where the taxpayer does not derive after the arrangement the income which he would or might have derived but for it, but derives different income, the arrangement cannot be said to be one 'altering the incidence of income tax'. What it alters is the income derived by the person concerned.

It is also important to note that tax advantage is not to be equated with economic advantage. As *McGechan J* observed in *BNZ Investments Ltd v C of IR*:⁹⁵

Reconstruction under s 99(3) can only take place if the taxpayer (BNZI) has obtained a "tax advantage". This requires a change in the base tax ... **"Tax advantage" does not mean "economic advantage". For a tax advantage to occur, there must have been an alteration in tax which otherwise would have been imposed.** There was no such alteration. ... **Any economic advantage was irrelevant.** (Emphasis added.)

Section 99(3), it is said, applies only to tax advantages. There are policy considerations supporting that view. It would be an unacceptable burden on commerce to force parties to transactions to inquire as to counterparty's tax positions and related transactions. **Section 99(3) does not allow reconstruction to eliminate economic advantages indirectly passed to the taxpayer from proceeds of avoidance by another party ...** (Emphasis added.)

⁹² Public Rulings Unit Inland Revenue Department *Inland Revenue's Exposure Draft INA0009: Interpretation of Section BG1 and GB1 of the Income Tax Act 2004* para 3.3.8

⁹³ Income Tax Act 2004 Commentary para 5.0 The scope of tax avoidance
<http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?tab=browse&softpage=BROWSE_VW&hitsperheading=on&clientID=3490588612&infobase=tax69.nfo&record=docfirst> (at 16 October 2006).

⁹⁴ *Marx v CIR* [1970] NZLR 182, p200 (CA)

⁹⁵ [2000] 19 NZTC 15,732 (HC)

The above passage demonstrates that the Courts are not prepared to equate “tax advantage” with economic advantage”.

Second limb

The second limb provides that “tax avoidance” includes “relieving any person from liability to pay income tax”.

There have also been some difficulties in applying the second limb, as *Turner J* explained in *Marx*:⁹⁶

If one avoids liability, liability never accrues. “Relief” is different. I think that one cannot have “relief” from something from which one never begins to suffer. Relief from pain follows upon first suffering it, in greater or lesser degree; avoidance of pain means never to suffer it at all. So with liability for tax. For these reasons I am of opinion that on the ordinary meaning of the words used one does not obtain relief from liability for income tax, if one so arranges matters that one never incurs liability for that tax at all. One may by taking such a step to avoid liability; one does not obtain relief from liability.

The above analysis was approved by the Privy Council in *Mangin v CIR*. Lord *Donovan* stated at page 596:⁹⁷

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.

Baragwanath J in *Miller v CIR; McDougall v C of IR*⁹⁸ put forward another explanation on the first two limbs of the tax avoidance definition. He observed that the first two limbs referred to conduct which “purports” to alter the incidence of income tax or to relieve any person from liability to pay income tax if the purpose or effect of the arrangement is tax avoidance⁹⁹. His Honour also accepted that the concept of “incidence” refers to “the falling of the tax regime

⁹⁶ *Marx v CIR* [1970] NZLR 182, p201-202 (CA)

⁹⁷ *Mangin v C of IR* [1971] NZLR 596 at p 596

⁹⁸ [1997] 18 NZTC 13,001

⁹⁹ *Miller v CIR; McDougall v CIR* [1997] 18 NZTC 13,001p 13,031

upon its affecting the income of a taxpayer being a person chargeable with income tax.”¹⁰⁰

The reference to “liability to pay income tax” in the second limb, rather than to simply be a liability to income tax means that it can apply to arrangements involving tax credits. Section BC 9 of the Act indicates that tax credits are dealt with after a person's income tax liability is calculated.

It is also noted that second and third limbs of the “tax avoidance” definition may overlap to an extent. However, they do not always have the same effect. The second limb applies if an arrangement relieves someone from an obligation to “pay income tax”, and the third limb applies if an arrangement has the effect of avoiding, postponing, or reducing “liability to income tax”.¹⁰¹

Third limb

The third limb provides that “tax avoidance” includes “avoiding, postponing, or reducing any liability to income tax”.

The Privy Council in *Newton* explained that the word “avoid” from the third limb as applying to a liability to tax that never actually fell at all upon the taxpayer but which might eventuate if the arrangement had not taken place.¹⁰²

Concise Oxford Dictionary (10th Ed. revised) defines these words as follows:

avoid•v. 1 keep away or refrain from >prevent from doing or happening. 2 Law repudiate, nullify, or render void (a decree or contract).

reduce•v. 1 make or become smaller or less in amount, degree or size.

postpone•v. arrange for (something) to take place at a time later than that first scheduled.

¹⁰⁰ Income Tax Act 2004 Commentary para 5.0 The scope of tax avoidance
<http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?tab=browse&softpage=BROWSE_VW&hitsperheading=on&clientID=3490588612&infobase=tax69.nfo&record=docfirst> (at 16 October 2006).

¹⁰¹ Public Rulings Unit Inland Revenue Department *Inland Revenue's Exposure Draft INA0009: Interpretation of Section BG1 and GB1 of the Income Tax Act 2004* para 3.3.12

¹⁰² *Newton v FC of T* [1958] 2 All ER 759

When these words are construed in their ordinary sense they mean escaping or minimising liability to income tax, or deferring that liability to a later date. The addition of the words “reducing” and “postponing” make it clear that the section operates in respect of a reduction or postponement of liability as well as a complete avoidance of liability.¹⁰³

A key factor in the third limb is the concept of taking steps to get out of the reach of a liability which is about to fall upon the taxpayer. And this concept can be instrumental to the conclusion that tax avoidance is involved. New Zealand Courts are more likely to rely on the third limb than the first two limbs in applying ss BG1/GB1.¹⁰⁴

Combined effect of the three limbs

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

In short, tax avoidance is the reduction of one's tax liability by means which are, in themselves, legal. The term covers acts and transactions by which a taxpayer arranges his or her affairs so that a prospective or potential liability to tax is avoided altogether. This concept assumes that no liability exists after the completion of the arrangement, so the taxpayer has no liability to tax which is being concealed or ignored.¹⁰⁵

In terms of functionality of the tax avoidance definition, *Trebilcock* submitted that the operational basis of the concept was to undertake an examination of the taxpayer's fiscal position, by contrasting the incidence of tax falling on the taxpayer with an arrangement deemed effectual against a hypothetical liability

¹⁰³ NZ Lawyers' Tax Companion para 71-550
<[http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates\\$fn=default.htm](http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates$fn=default.htm)> (at 16 October 2006).

¹⁰⁴ See, for instance, *CIR v Challenge Corporation Ltd* [1986] 8 NZTC 5,001, para 876 per Cooke J

¹⁰⁵ NZ Lawyers' Tax Companion para 71-550
<[http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates\\$fn=default.htm](http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates$fn=default.htm)> (at 16 October 2006).

that would have occurred but for the arrangement. While the identification of a taxpayer's liability to income tax with a particular arrangement held effective presents few problems, the assessment of the hypothetical liability that would have been obtained but for the arrangement, is less easily defined.¹⁰⁶ In fact, *Ohms* pointed out that it is almost impossible to assert that a particular liability to income tax can be regarded as inevitable. Therefore, the "benchmark" liability utilised by the tax avoidance concept is that which would have arisen without the scheme, it is only possible to postulate that a particular liability would *probably* have arisen. It then becomes a matter of policy as to what degree of certainty is required in this particular assessment.¹⁰⁷

It is also submitted by *Arieli*, to interpret the definition of "tax avoidance", one should contrast the tax liability which would attach to the taxpayer if the arrangement was found to be effectual for tax purposes, against the hypothetical liability that would have arisen had the taxpayer not entered into the transaction. The quantum of tax saved may also be a relevant factor.¹⁰⁸

5.2 TAX MITIGATION

The distinction between tax mitigation and tax avoidance was first raised in the *C of IR v Challenge*¹⁰⁹. Lord *Templeman* stated at page 5,225:

Income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to reduction in his tax liability. Section 99 does not apply to tax mitigation because the taxpayer's tax advantage is not derived from an 'arrangement' but from the reduction of income which he accepts or the expenditure which he incurs.

¹⁰⁶ MJ Trebilcock "Section 260: A Critical Examination" (1964) 38 ALJ 237 238.

¹⁰⁷ C Ohms "Section 99: The General Anti-Avoidance Rule - Analysis and Reform" (December 1994)

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<http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?infobase=tax54.nfo&clientID=311677290&softpage=BROWSE_VW&modusreturnurl=http%3A%2F%2Fwww%2Ebrookersonline%2Eco%2Enz%2F&advquery=Section+99%3a+The+General+Anti-Avoidance+Rule+-+Analysis+and+Reform&headingswithhits=on&depth=all&record={6AC0}> (at 21 February 2007)

¹⁰⁸ T N Arieli "The Law of Tax Avoidance in New Zealand" (September 2002) Volume 8:3 New Zealand Journal of Taxation Law and Policy

<http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?infobase=tax54.nfo&clientID=286389162&softpage=BROWSE_VW&modusreturnurl=http%3A%2F%2Fwww%2Ebrookersonline%2Eco%2Enz%2F&advquery=%5blevel+level+4%3a%5d+tax+avoidance&headingswithhits=on&depth=all&record={3395}> (at 21 February 2007)

¹⁰⁹ [1986] 8 NZTC 5,219

In relation to tax avoidance Lord *Templeman* said at page 5,226 that:

Section 99 does apply to tax avoidance. 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.

This distinction between tax mitigation and tax avoidance indicated that s BG 1 applied to what may be described as paper schemes. These are schemes which, for example, seek to create a loss without the taxpayer suffering any expenditure apart from the cost of implementing the scheme.

There are problems or restrictions that may arise from this distinction when applying s BG1, especially when a tax avoidance arrangement involves genuine expenditure or deduction of income. For example, an income-splitting arrangement involves disposition of income-producing assets to other parties. It would have been possible for the transferor to argue that an arrangement of this kind involves tax mitigation and not tax avoidance since a real reduction in income will be suffered even though a purpose of tax avoidance may be conceded. Or an arrangement involving a genuine commercial transaction which has inserted into it steps of tax avoidance or tax deferral. It becomes arguable that since the arrangement involves some real expenditure or a real reduction in income it should be classified as one involving tax mitigation even though it also embodies some tax-avoidance features.¹¹⁰

Thus the concept of tax mitigation was suggested not universal in some later cases. As Cooke P noted in *Hadlee and Sydney Bridge Nominees Ltd v C of IR*¹¹¹ at page 8,122:

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 problems in this field may be doubtful...

¹¹⁰ NZ Income Tax Law and Practice para 537-700

<[http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates\\$fn=default.htm](http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates$fn=default.htm)> (at 16 October 2006)

¹¹¹ [1991] 13 NZTC 8,116

Similarly, in *Miller v C of IR; McDougall v C of IR*¹¹², *Baragwanath J* observed at page 13,031 that the distinction described a conclusion rather than providing a signpost to it.

The distinction between tax mitigation and tax avoidance seems to be useless after the Privy Council decision in *O'Neil v C of IR*¹¹³. The Privy Council found the scheme in this case was a plain case of an arrangement that had the purpose or effect of tax avoidance within the meaning of s 99 of the Income Tax Act 1976 given the highly artificial nature of the scheme. The Privy Council laid to rest a distinction between tax avoidance and tax mitigation and stated at page 17,057 that the distinction between these two concepts was “unhelpful”. Their Lordships also referred to *Baragwanath J*'s statement in *Miller v C of IR; McDougall v C of IR*¹¹⁴ that the distinction “describes a conclusion rather than providing a signpost to it.” Thus, there was little merit of distinguishing tax mitigation and tax avoidance.

Also in *MacNiven v Westmoreland Investments Ltd*,¹¹⁵ the House of Lords did not regard the distinction between tax avoidance and tax mitigation as being useful. Lord Hoffmann observed as follows:¹¹⁶

... it has occasionally been said that the boundary of the *Ramsay* principle can be defined by asking whether the taxpayer's actions constituted (acceptable) **tax mitigation** or (unacceptable) **tax avoidance**. ... **But when the statutory provisions do not contain words like 'avoidance' or 'mitigation', I do not think that it helps to introduce them. The fact that steps taken for the avoidance of tax are acceptable or unacceptable is the conclusion at which one arrives by applying the statutory language to the facts of the case.** It is not a test for deciding whether it applies or not. (Emphasis added.)

Despite these comments, the commissioner considers the distinction between tax avoidance and tax mitigation can still be applied in respect to some arrangements. As the Privy Council said in the *Challenge* case,¹¹⁷ one common characteristic of tax avoidance is that the taxpayer obtains a tax advantage by

¹¹² [1997] 18 NZTC 13,001

¹¹³ [2001] NZTC 17,051

¹¹⁴ [1997] 18 NZTC 13,001 at p 13,031

¹¹⁵ *MacNiven v Westmoreland Investments Ltd* [2001] 1 All ER 865 (HL)

¹¹⁶ *Ibid* pp 883-884

¹¹⁷ *CIR v Challenge Corporation Ltd* [1986] 8 NZTC 5,219, para 22 as per Lord Templeman

reducing their liability to tax without incurring the economic consequences Parliament would have intended in the circumstances.

5.3 ECONOMIC CONSEQUENCE OF *PETERSON*

As discussed above, the line between tax mitigation and tax avoidance is drawn on whether economic consequences have been incurred.

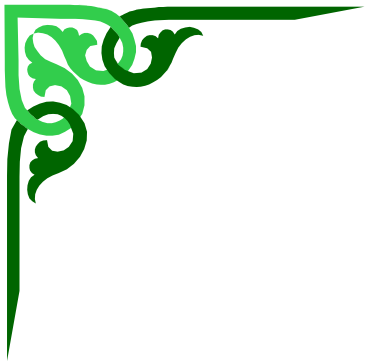
The majority decision of *Peterson* held that although the production company made a profit of \$y at the expense of the investors, it did not mean that they did not suffer the economic cost of paying it. Their Lordship continued to say:¹¹⁸

The Leverage obtained by use of a non-recourse loan meant that the investors did not sustain an economic loss after the tax deduction is taken into account. Their Lordships suspect that it is this feature of the scheme which has most exercised the Commissioner. But a moment's reflection shows that what Lord *Templeman* had in mind was expenditure or loss *before* any tax advantage is taken into account. Tax relief often makes the difference between profit and loss after tax is taken into account; and a transaction does not become tax avoidance merely because it does so. The fact that the investment was funded by a non-recourse loan did not alter the fact that the investors had suffered the economic burden of paying the full amount of \$x+y.

The writer is of the opinion that even though the production company made a secret profit on the expenses of the taxpayer and the fact that taxpayer did incur the liability to repay the loan, the nature of the arrangement could not be altered. In other words, if it is the tax avoidance arrangement with more than incidental purpose to avoid tax, any tax benefits obtained by the parties affected should be void. Tax mitigation should not be the determining point when considering whether a tax avoidance arrangement exists.

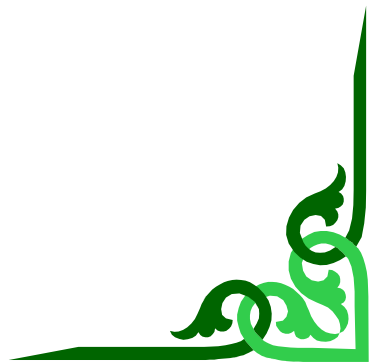
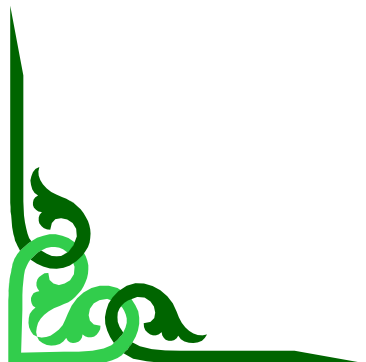
The distinction between tax avoidance and tax mitigation has been a continuing area of interest and concern since *Challenge*. The *Peterson* decision once again raised this discussion.

¹¹⁸ *Peterson v CIR* [2005] 22 NZTC 19,098, p 19,110 para 44



Chapter Six

Purpose of an arrangement



6.0 PURPOSE OF AN ARRANGEMENT

The meaning of a tax avoidance arrangement is defined in s OB 1 as:¹¹⁹

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

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

The definition of a tax avoidance arrangement brings out the concepts of “purpose or effect”. In other words, in order to be caught in a tax avoidance arrangement, there must be a purpose of avoiding tax.

According to the definition, a tax avoidance arrangement must have a single “purpose or effect” or one “purpose or effect” which is more than merely incidental of tax avoidance.

To identify whether an arrangement has a purpose or effect of tax avoidance, the arrangement is looked at with a view to determining whether it can be predicated that it was implemented in the particular way so as to avoid tax. This is done by examining the overt acts by which the arrangement is implemented.¹²⁰ However, it is no longer possible to avoid such predication simply by claiming the arrangements are capable of explanation by reference to ordinary business or family dealings.¹²¹

¹¹⁹ Income Tax Act 2004, Section OB 1

¹²⁰ *Newton v FC of T* [1958] 2 All ER 759

¹²¹ Income Tax Act 2004, Section OB 1

6.1 PURPOSE TEST IN CASE LAW

Australian and New Zealand Courts have universally adopted what has become known as the "predication test"¹²² when it comes to examining the purpose or effect of an arrangement. In the general anti-avoidance context, the word "predication" has been used to describe the process of characterizing or classifying whether a transaction involves tax avoidance or not. The courts have attempted to "predicate" from the manner in which the arrangement was entered into whether it has a purpose or effect of tax avoidance.¹²³ The "predication test" was firstly established in the Privy Council decision of *Newton v FC of T* by Lord Denning.¹²⁴ His Lordship stated on page 764:

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

In *Mangin v C of IR*,¹²⁵ the Privy Council referred to the predication test in the context of a possible application of s 108 of the *Land and Income Tax Act 1954*. The Privy Council indicated that the predication test allowed some scope for a taxpayer to adopt tax saving features when implementing a bona fide business transaction. On this topic Lord Donovan said of Lord Denning's statement in *Newton* of the predication test:¹²⁶

In their Lordships' view this passage, properly interpreted, does not mean that every transaction having as one of its ingredients some tax saving feature thereby becomes caught by a section such as s 108. If a bona fide business transaction can be carried through in two ways, one involving less liability to tax than the other, their Lordships do not think s 108 can properly be invoked to declare the transaction wholly or partly void merely because the way involving less tax is chosen. Indeed, in the case of a company, it may be the duty of the directors vis-a-vis their shareholders so to act. Again, trustees may in the interest of their beneficiaries,

¹²² See for example *Newton v FC of T* [1958] 2 All ER 759, *Mangin v C of IR* [1971] NZLR 591, *Tayles v C of IR* [1982] 5 NZTC 61,311 (CA)

¹²³ Public Rulings Unit Inland Revenue Department *Inland Revenue's Exposure Draft INA0009: Interpretation of Section BG1 and GB1 of the Income Tax Act 2004* para 3.4.11

¹²⁴ [1958] 2 All ER 759

¹²⁵ [1971] NZLR 591

¹²⁶ *Ibid* p 598

deliberately choose to invest in Government securities issued with some tax-free advantage, and to do so for the express purpose of securing it. They do not thereby fall foul of s 108. The clue to Lord Denning's meaning lies in the words 'without necessarily being labeled as a means to avoid tax'. Neither of the examples above given could justly be so labeled. Their Lordships think that what this phrase refers to is, to adopt the language of Turner J in the present case 'a scheme ... devised for the sole purpose, or at least the principal purpose, of bringing it about that this taxpayer should escape liability on tax for a substantial part of the income which, without it, he would have derived'.

In terms of the meaning of “purpose and effect”, the Privy Council in *Newton* interpreted the words to mean a concerted action to an end — the end of avoiding tax.¹²⁷

Similarly, the Court of Appeal in *Tayles v C of IR*¹²⁸ stated “Purpose” was determined objectively by reference to the arrangement itself and not subjectively in terms of motive. “Purpose” was not motive, but was the effect which the arrangement sought to achieve. “Effect” meant the result accomplished or achieved by the arrangement. *McMullin J* summarized the position in respect to s 99 *Income Tax Act 1976* as follows:¹²⁹

[Section 99] is not concerned with the motives of individuals nor their desire to avoid tax but only with the means which they employed to do it; it is the arrangement itself and not the motives of those who make it from which its purpose and effect are to be deduced ... The test is objective and the purpose of the arrangement must be determined by what the transaction effects.

Woodhouse J alleged in *Challenge*:¹³⁰

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

And *Eichelbaum CJ* in *Hadlee* was of the opinion that:¹³¹

It is well established that the approach is objective not subjective; the taxpayer's motives are irrelevant, purpose and effect being gathered from the arrangement itself; ...

¹²⁷ *Newton v FC of T* [1958] 2 All ER 759, p 763

¹²⁸ [1982] 5 NZTC 61,311 (CA)

¹²⁹ *Ibid* p 733

¹³⁰ *Challenge Corporation Ltd v CIR* [1986] 2 NZLR 513, 533

¹³¹ *Hadlee & Sydney Bridge Nominees Ltd v CIR* (1989) 11 NZTC 6,155, 6,172

In *Elmiger v C of IR*, *Woodhouse J* in the Supreme Court found that:¹³²

To the extent that the transaction included as a purpose intended benefits for the one family or the other, I consider this purpose to be entirely subsidiary to be dominant and general purpose disclosed by the whole arrangement of obtaining a disposition of income in the guise of business expense.

By considering the scope and purpose of the arrangement, *McCarthy J* in the Court of Appeal observed that the actual steps taken by the taxpayer in *Elmiger* were critical to determining the dominant purpose of the arrangement and its extent, his honour stated:¹³³

The arrangement...involved the setting up of a trust...the sales of two of their earth moving machines to that trust...and agreement to hire the two machines back... This was the essence of the arrangement though, as the Judgement of the President demonstrates, there were a number of other features which are important in ascertaining the end to which the transactions were directed.

In *Ashton & Anor v C of IR*, by referring to the dicta in *Newton*, the Privy Council said:¹³⁴

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 persona from his liability to pay income tax.

These cases demonstrate that “purpose” in the context of tax avoidance means the intended effect the arrangement seeks to achieve but not the motive, whereas “effect” means the end accomplished or achieved by the arrangement. If an arrangement has a particular purpose then that purpose is ascertained objectively and is demonstrated by the effects produced. If it has a particular effect then that means the end has been accomplished or achieved. The whole set of words denotes a concerted action to an end — the end being to avoid tax.¹³⁵

¹³² [1966] NZLR 683, p 695

¹³³ [1967] NZLR 161, p 188

¹³⁴ *Ashton & Anor v C of IR* [1975] 2 NZTC 61,030 (PC), p 61,034

¹³⁵ Public Rulings Unit Inland Revenue Department *Inland Revenue's Exposure Draft INA0009: Interpretation of Section BG1 and GB1 of the Income Tax Act 2004* para 3.4.21

Merely incidental exclusion

If there is more than one purpose, the tax avoidance purpose needs to be “more than merely incidental”.

Based on the *Concise Oxford Dictionary* (10th Ed. Revised), “incidental” has two meanings in this context. One is that a purpose or effect could be “incidental” if it is relatively minor or small compared to the other purpose or purposes. The second meaning is that a purpose or effect is “incidental” if it follows on from other relevant purposes or effects.¹³⁶

The “merely incidental” concept has been construed to point to something which is necessarily linked (and without contrivance) to some other purpose or effect so that it is a natural concomitant. The fact that a commercial transaction is accompanied by a degree of tax relief does not necessarily mean that the General Anti-Avoidance Provisions will apply; this is another way of saying that, on the facts, the General Anti-Avoidance Provisions has no scope to apply or that the “merely incidental” exclusion applies.¹³⁷

Woodhouse P discussed the meaning of “merely incidental” in his dissenting judgment in *Challenge (CA)*:¹³⁸

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

His Honour believed that the issue of whether a tax saving purpose or effect was “merely incidental” to another purpose was something to be decided “not subjectively in terms of motive but objectively by reference to the arrangement itself”. He also further stated that it was critical to determine the economic reality

¹³⁶ Ibid para 3.4.23

¹³⁷ Income Tax Act 2004 Commentary section 6.0

<http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?tab=browse&softpage=BROWSE_VW&hitsperheading=on&clientID=3490588612&infobase=tax69.nfo&record=docfirst> (at 16 October 2006).

¹³⁸ [1986] 8 NZTC 5,001 (CA), p 5,006

associated with a transaction in contrast to “artificiality or contrivance or what might be described as the extent to which it appeared to involve exploitation of the Statute while in direct pursuit of tax benefit.”¹³⁹

This approach was generally consistent with his Honour's previous judgment in the Supreme Court decision of *Elmiger*.¹⁴⁰

In *Accent Management Ltd v C of IR*¹⁴¹ (also referred to as the *Trinity* case), the High Court concluded that tax avoidance was more than incidental and was the dominant purpose of the Trinity scheme. The main reason for this was that the arrangement was seen to involve an *exploitation* of the statute, and this was determined by a scheme and purpose approach. On the evidence, *Venning J* held that the more likely scenario was that the forest investment would not achieve a positive return on capital and, in some instances would not reach the nominal return required to satisfy the premium payment. The uncertainty of the profitability of the forest venture was seen to be in stark contrast to the certainty and extent of the deductions and consequent tax advantages the scheme provided the plaintiffs, as investors.¹⁴²

The final judgment of *Trinity* was relying on the Privy Council decision in *Challenge*,¹⁴³ where Lord *Templeman* held as follows:¹⁴⁴

Tax avoidance schemes largely depend on the exploitation of one or more exemptions or reliefs or provisions or principles of tax legislation. Section 99 would be useless if a mechanical and meticulous compliance with some other section of the Act were sufficient to oust s 99.

Venning J held that the above question was ultimately determined by the scheme and purpose of the legislation. The High Court concluded that tax avoidance was more than a merely incidental purpose of the arrangement - the

¹³⁹ [1986] 8 NZTC 5,001 (CA), p 5,005-5,006

¹⁴⁰ *Elmiger v C of IR* (1966) NZLR 683 (SC)

¹⁴¹ [2005] 22 NZTC 19,027

¹⁴² *Ibid* p 19,074-19,075

¹⁴³ *CIR v Challenge Corporation Ltd* [1986] 8 NZTC 5,219

¹⁴⁴ *Ibid* para 11 as per Lord *Templeman*

High Court was effectively saying that there was "exploitation" of the provisions in the Income Tax Act.¹⁴⁵

Ascertainment of purpose

In order for s BG1 to apply to an arrangement, the purpose of the arrangement must to be ascertained and must be found to be one of tax avoidance.

The purpose of an arrangement may be ascertained either subjectively or objectively. A subjective assessment involves inferring the purpose of the arrangement from the taxpayer's testimony. However, a taxpayer's testimony in this regard would generally be viewed with a high degree of scepticism in so far as the taxpayer would be reluctant to act against his or her self-interest by admitting that the arrangement had a purpose of tax avoidance. An objective test, on the other hand, infers the purpose of an arrangement from a wide range of objective factors such as the conduct of the taxpayer concerned and the nature of the arrangement entered into.¹⁴⁶

There are some authorities saying that the motives of the taxpayer in entering into an arrangement are irrelevant.¹⁴⁷ This simply means that where it is necessary for evidence to be given as to the terms of an arrangement, evidence to the effect that some purpose other than tax avoidance was intended, appears to be irrelevant. This is confirmed by Woodhouse P in *Challenge*:¹⁴⁸

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

¹⁴⁵ Income Tax Act 2004 Commentary section 5.0

<http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?tab=browse&softpage=BROWSE_VW&hitsperheading=on&clientID=3490588612&infobase=tax69.nfo&record=docfirst> (at 16 October 2006)

¹⁴⁶ T N Arieli "The Law of Tax Avoidance in New Zealand" (September 2002) Volume 8:3 New Zealand Journal of Taxation Law and Policy

<[http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?infobase=tax54.nfo&clientID=278199956&softpage=BROWSE_VW&modusreturnurl=http%3A%2F%2Fwww%2Ebrookersonline%2Eco%2Enz%2F&advquery=%5blevel+level+4%3a%5d+tax+avoidance&headingswithhits=on&depth=all&record={3395}](http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?infobase=tax54.nfo&clientID=278199956&softpage=BROWSE_VW&modusreturnurl=http%3A%2F%2Fwww%2Ebrookersonline%2Eco%2Enz%2F&advquery=%5blevel+level+4%3a%5d+tax+avoidance&headingswithhits=on&depth=all&record={3395}>)> (at 22 February 2007)

¹⁴⁷ *Newton v FC of T* [1958] 11ATD 442, p 445; *Govan v CIR* [1968] NZLR 163, p 166; *Hooker Rex Pty v FCT* 70 ATC 4,033, p 4,043; *Hollyock v FCT* 71 ATC 4,202, p 4,205; *Loader v CIR* [1974] 1 NZTC 61,132, p 61,136

¹⁴⁸ [1986] 8 NZTC 5,001, p 5,006

Surrounding circumstances may be relevant to ascertaining the terms of an arrangement and where any part of an arrangement is not reduced to writing, evidence of its terms is properly admissible before the courts. Where it is necessary for evidence to be given as to the terms of an arrangement, evidence of the parties to the effect that some purpose other than tax avoidance was intended, appears to be irrelevant.¹⁴⁹

6.2 PURPOSE OF *PETERSON* ARRANGEMENT

The majority judges of the Privy Council did not spend enough time to identify the purpose of *Peterson's* arrangement. However, the dissenting judges spotted the purpose of the arrangement as follows:¹⁵⁰

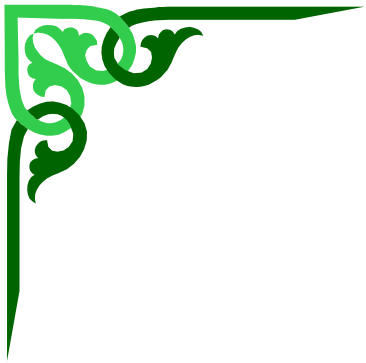
The purpose was to produce a capital sum that could, for IR52.3 purposes, be treated as part of the cost of production of the film, thereby enabling the borrower to claim tax deductions equal in amount to that capital sum.

The dissenting judges based their conclusion on the finding that the arrangement was designed to entitle the investors to get the tax deduction and such tax advantages were in fact major motivations for the investors to invest in the films. If the non-recourse loan was adopted without any valid commercial reason, but was there to boost the depreciation deduction for the taxpayer, it was difficult to believe the purpose of the arrangement is merely incidental.

More importantly, the taxpayer might not have entered into this film investment if the tax incentives were not obvious. It would be hard to argue the tax avoidance effect is merely incidental. Thus, the taxpayer, as a party affected by this tax avoidance arrangement, could not escape s 99; even though they were not parties to the arrangement.

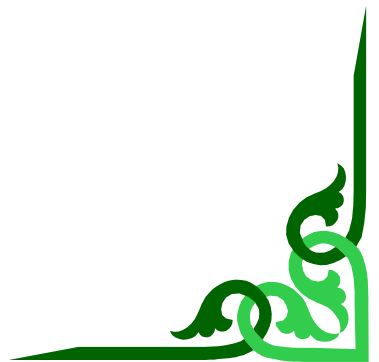
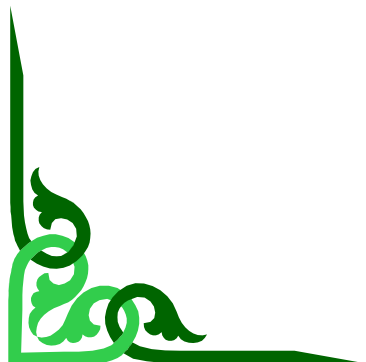
¹⁴⁹ New Zealand Income Tax Law and Practice para 537-650
<[http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates\\$fn=default.htm](http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates$fn=default.htm)> (at 16 October 2006)

¹⁵⁰ *Peterson v C of IR* [2005] 22 NZTV 19,098, p 19,120 para 88



Chapter Seven

Choice principle



7.0 CHOICE PRINCIPLE

The choice principle entails the proposition that 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 BG1. The justification for the principle is that, in light of the policies underlying the particular section, those policies would be frustrated if s BG1 could be invoked to take them away. The choice principle is one of statutory construction providing that a general provision cannot be allowed to override a specific provision.¹⁵¹

However, the application of a particular advantageous section of the Act does not automatically preclude the potential application of the general anti-avoidance provision - section BG 1 (or its precedent). Section BG 1 is not subordinate to the rest of the income tax legislation, nor will it override the specific provisions of the Act. The intended role of section BG 1 is to facilitate and promote the purpose of the legislation. Section BG 1 may also apply notwithstanding the application of a specific anti-avoidance provision within a particular section or Part of the Act.¹⁵²

7.1 CHOICE PRINCIPLE IN NZ – HISTORY AND CURRENT ESTABLISHMENT

The choice principle or choice doctrine is one developed and formally well entrenched by Australian courts.¹⁵³ Thus it is important to firstly look at the decisions of the Australian courts on the choice principle

¹⁵¹ New Zealand Income Tax Law and Practice para 538-000
<[http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates\\$fn=default.htm](http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates$fn=default.htm)> (at 16 October 2006)

¹⁵² *C of IR v Challenge Corp Ltd* (1986) 8 NZTC 5,001

¹⁵³ See cases *DFC of T v Purcell* [1921] 29 CLR 464, *WP Keighery Pty v FC of T* [1957] 100 CLR 66, *FC of T v Sidney Williams (Holdings) Ltd* [1957] 100 CLR 95, *FC of T v Casuarina Pty Ltd* 70 ATC 4069, *Mullens v FC of T* 76 ATC 4288, *FC of T v Gulland* 85 ATC 4765, etc

7.1.1 Australian decisions

The discussion of the choice principle started from the case *DFC of T v Purcell*¹⁵⁴, where the Full High Court of Australia held that the tax advantages achieved by the tax payer as a trustee of his grazing property for the benefit of himself, his wife and his daughter fell precisely where the Act intended.¹⁵⁵

It is widely recognized¹⁵⁶ that the choice principle was established in the case *WP Keighery Pty Ltd v FC of T*¹⁵⁷. In this case, the taxpayer issued redeemable preference shares so that it might be assessed as a non-private company. This had the effect that the company would not be obliged to make distributions to shareholders and it would therefore avoid liability for the additional tax imposed under Division 7 of the *Income Tax Assessment Act* 1936 (a tax somewhat analogous to excess retention tax). The Court dismissed the Commissioner's assessment and held that a taxpayer was entitled to choose on what basis it might be taxed whether as a private or public company, the Act actually provided for alternative bases of liability for income tax.

This decision was later followed in cases such as *FC of T v Sidney Williams (Holdings) Ltd*¹⁵⁸ and *FC of T v Casuarina Pty Ltd*¹⁵⁹.

The choice principle was extended in *Mullens v FC of T*¹⁶⁰. By considering whether s 260 (the general anti-avoidance section of the Australia Income Tax Act) could not apply to defeat the taxpayers' arrangements of obtaining deductions under s 77A of the Australian *Income Tax Assessment Act* in respect of moneys paid on shares in a company engaged in petroleum exploration, *Stephen J* said at p 4,303:

¹⁵⁴ [1921] 29 CLR 464

¹⁵⁵ New Zealand Income Tax Law and Practice para 538-050

<[http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates\\$fn=default.htm](http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates$fn=default.htm)> (at 22 February 2007)

¹⁵⁶ *Ibid*

¹⁵⁷ [1957] 100 CLR 66

¹⁵⁸ [1957] 100 CLR 95

¹⁵⁹ 70 ATC 4069

¹⁶⁰ 76 ATC 4288

... if no question arises of a choice between two courses of conduct but, instead, the Act offers certain tax benefits to taxpayers who adopt a particular course of conduct; the adoption of that course does not establish any purpose or effect such as is described in s. 260.

The *Mullens* decision was later on approved in *Cridland v FC of T*¹⁶¹ where the taxpayer entered into an arrangement in order to obtain the benefit of the primary producer averaging provision of the Act.

The choice principle was further widened in *Slutzkin v FC of T*¹⁶², the Full High Court said in light of the choice principle that the choice of the form of a transaction by which taxpayers obtain the benefit of their assets is a matter for them and they are quite entitled to choose that form of transaction which will not subject them to less tax than some other form of transaction might do.

The scope of the choice principle was reviewed in *FC of T v Gulland*¹⁶³ and *F & C Donebus Pty Ltd v FC of T*¹⁶⁴. Judges from both of the cases considered that despite business transactions could be brought within the literal application of one or more specific provisions of the Act, s 260 would still apply if those business transactions make no conceivable commercial sense and have a considerable tax effect.

7.1.2 New Zealand establishment

In New Zealand, before *O'Neil v C of IR*¹⁶⁵ courts generally had taken the view that the predecessor to s BG 1 might override other sections of the Act.¹⁶⁶

The first time when the choice principle was argued in New Zealand was the Court of Appeal decision in *McKay v C of IR*¹⁶⁷

¹⁶¹ 77 ATC 4538

¹⁶² 77 ATC 4076

¹⁶³ 85 ATC 4765

¹⁶⁴ 88 ATC 4582

¹⁶⁵ [2001] 20 NZTC 17,057 (PC)

¹⁶⁶ New Zealand Income Tax Law and Practice para 538-000

<[http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates\\$fn=default.htm](http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates$fn=default.htm)> (at 30 April 2006).

¹⁶⁷ 72 ATC 6058

The taxpayer in *McKay* was a partner in a legal practice, and for a period of 10 years, he assigned this income to his family trust. The Commissioner attacked this arrangement by invoking s 108 of the *Land and Income Tax Act* 1954 (now s BG1 of *Income Tax Act* 2004). Based on s 105 *Land and Income Tax Act* 1954, an assignment of income that was for a period of less than 7 years was ineffective for tax purpose and the assignor was deemed to derive the income, the taxpayer argued that because s 105 only applied to an assignment of income that was less than 7 years, assignment of income that was longer than 7 years was recognized by the legislation and came under the purpose of the Act. The *Keighery*¹⁶⁸ case and *Casuarina*¹⁶⁹ case from Australian courts were also cited in support of the taxpayer's submission.

By comparing the present case with the two cited Australian cases *Keighery* and *Casuarin*, *Turner P* concluded that:¹⁷⁰

... s 105 does not provide in any provision parallel to the Australian companies section that if the assignment is one for more than seven years the taxpayer will be entitled, relying on its provisions, to be assessed as if he had not derived the income. The section is silent as to the assessment of income assigned for a period longer than seven years. The effect of this is, simply, that the assessment of such income is left to be governed, like any other assessment, by the general provisions of the Act. ... s 105 certainly does not prevent the Commissioner, in proper case, from apply to such assignments the provisions of s 108.

In short, as *Speight J* put forward, if the assignment was not within s 105 the matter was at large and fell for decision on the same principles as any other arrangement which was tested against s 108.

In *Halliwell v C of IR*¹⁷¹, the Supreme Court considered the restructure of a dental practice partnership that achieved greater tax deductions than were available before the restructure. Although the specific deduction provision applied, the Court was still able to hold that the general Anti-avoidance provision could apply as the arrangement was found to be contrived. *Casey J* held as follows:¹⁷²

¹⁶⁸ *WP Keighery Pty Ltd v FC of T* [1957] 100 CLR 66

¹⁶⁹ *FC of T v Casuarina Pty Ltd* 70 ATC 4069

¹⁷⁰ *McKay v C of IR* 72 ATC 6058, p 6,065

¹⁷¹ [1977] 3 NZTC 61,208

¹⁷² *Halliwell v CIR* 1977] 3 NZTC 61,208, p 61,215

So long as that expenditure conforms with s 111, it cannot be attacked under s 108. But **s 108 can still apply where the need for such expenditure has been contrived** in an existing source of income, as part of an arrangement having tax avoidance as one of its main purposes, and which is not a usual business or family dealing. (Emphasis added.)

In *C of IR v Challenge Corporation Ltd*¹⁷³, the taxpayer challenge group entered into arrangement to purchase two companies with substantial accumulated losses with anticipation that considerable amount of profits were going to be achieved at the end of the income year. Relying on s 191 of the *Income Tax Act* 1976, the taxpayer used the losses carried forward to offset the group profits. It was calculated that the saving in income tax that would accrue amounted to \$.85 million - and neither of the loss companies traded after acquisition by the taxpayer. The Commissioner took the view that s 99 of the Act applied to override the treatment required by s 191. By a 2:1 majority decision, the Court of Appeal held that s 99 did not apply and the losses could be offset against the income of the Challenge group.

Cook J considered that the transactions in the *Challenge* case were so artificial, however, he said s 191 contained an anti-avoidance provision, authorising the Commissioner to disregard alterations in the proportions of the paid-up share capital if they were of a temporary nature. After remarking that s 191 should be treated as setting out its own code, he concluded:¹⁷⁴

Where a particular section conferring tax concessions or rights has its own anti-avoidance provision (and there are other instances in the Income Tax Act) the preferable inference seems to me to be that the special provision is exhaustive in its own field. Within that field a taxpayer is entitled to assume that he has a right to order his affairs to take advantage of the benefits conferred by the section, provided only that he does not fall foul of the special provision. Outside that field there may still be room for s 99 to operate.

Richardson J was of the opinion that the legislation could not have intended that s 99 should override all other provisions of the Act so as to deprive the tax-paying community of structural choices, economic incentives, exemptions and incentives provided by the Act.

¹⁷³ [1986] 8 NZTC 5,001

¹⁷⁴ *C of IR v Challenge Corporation Ltd* [1986] 8 NZTC 5,001, p 5,015

He also went on to discuss the choice principle, citing *Keighery* and *McKay*, and said:¹⁷⁵

To do no more than adopt a course which the Act specifically contemplates as effecting a tax change does not affect the taxpayer's 'liability' for income tax in the statutory sense and does not result in an alteration in the incidence of income tax contemplated by the Act.

After analysing the provisions of s 191, Richardson J concluded that the purpose of the arrangement in the *Challenge* case was to save tax for that was the purpose of every offset of a loss in one company against a profit in another, which was the only reason for the presence of s 191 in the Statute. Thus the liability for income tax that arose through the carrying out of the transaction was the liability that was contemplated by the Act.¹⁷⁶

However, when the case was appealed to the Privy Council¹⁷⁷, the Court of Appeal's decision was reversed. The Privy Council thought that Parliament may have been indifferent to or unmindful of any overlap between the general provisions of s 99 and the particular provisions of s 191 or that, in view of the well-known difficulties encountered in the formulation and enforcement of effective anti-avoidance provisions, an overlap might be useful and could not be harmful. Their Lordships concluded:¹⁷⁸

The provisions of s 99 are of general application and, in the absence of an express direction from Parliament excluding s 191 from the ambit of s 99, their Lordships consider that s 99 must be applied in the present circumstances.

It is submitted that the choice principle is endorsed in New Zealand from the Privy Council's decision in *O'Neil v C of IR*¹⁷⁹ (also reported as *Miller v CIR*¹⁸⁰). The case concerned judicial review aspects of the validity of assessments issued in relation to the scheme offered by Mr J G Russell.

¹⁷⁵ Ibid p 5,023

¹⁷⁶ Ibid p 5,025

¹⁷⁷ *C of IR v Challenge Corporation Ltd* [1986] 8 NZTC 5,219

¹⁷⁸ Ibid p 5,224

¹⁷⁹ [2001] 20 NZTC 17,051

¹⁸⁰ [2001] 3 NZLR 316

The taxpayers were shareholders in two trading companies which participated in schemes devised by an accountant - Mr Russell. The taxpayers sold the shares to a company controlled by Mr Russell with an option to repurchase at the end of the scheme. The taxpayers remained the registered shareholders as trustees for Mr Russell's company and remained directors. The companies then became part of Mr Russell's group of companies that had tax losses. The companies paid to Mr Russell the entire net profits of their companies on a yearly basis as an administrative charge using the group losses permitted under s 191 *Income Tax Act* 1976. Mr Russell 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.

The appeal was dismissed by the Privy Council. However, the court made the following useful, but obiter, comments in relation to tax avoidance:¹⁸¹

It may be more fruitful to concentrate on the nature of the concepts by reference to which tax has been imposed. In many (though by no means all) cases, the legislation will use terms such as income, loss and gain, which refer to concepts existing in a world of commercial reality, not constrained by precise legal analysis. A composite transaction like the Russell scheme, which may appear not to create any tax liability if it is analysed with due regard to the juristic autonomy of each of its parts, can be viewed in commercial terms as a unitary arrangement to enable the company's net profits to be shared between the shareholders and Mr Russell. (Compare *Macniven v Westmoreland Investments Ltd* [2001] 2 WLR 377.) Their Lordships consider this to be a paradigm of the kind of arrangement which s 99 was intended to counteract. 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.** [Emphasis added]

The highlighted passage was regarded as a clearly supporting recognition of the choice principle in New Zealand.¹⁸²

It is also submitted that the choice principle reinforced by *O'Neil* should be regarded as an essential pillar in the area of tax avoidance. The notion

¹⁸¹ *O'Neil v C of IR* [2001] 20 NZTC 17,051, para 10, per Lord Hoffmann

¹⁸² E Thombitas "Legitimate Tax Avoidance and the Choice Principle: Some Thoughts Following Recent Cases" (March 2002) Volume 8:1 New Zealand Journal of Taxation Law and Policy
<http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?infobase=tax54.nfo&clientID=286389135&softpage=BROWSE_VW&modusreturnurl=http%3A%2F%2Fwww%2Ebrookersonline%2Eco%2Enz%2F&advquery=%5blevel+level+4%3a%5d+tax+avoidance&headingswithhits=on&depth=all&record={3B21}> (at 21 February 2007)

demonstrated in the *C of IR v BNZ Investments Ltd*¹⁸³ case that a General Anti-Avoidance Provision is an essential pillar might no longer hold true in most cases.¹⁸⁴

The next Privy Council decision on choice principle in New Zealand is the *Peterson*¹⁸⁵ decision. In brief, *Peterson* further confirms the establishment of choice principle in New Zealand tax law.

7.1.3 Limitation of choice principle

Trombitas submitted that the choice principle should not be allowed to oust the operation of a general anti-avoidance provision altogether. He suggests the following reasonable limitation to be placed on the choice principle:¹⁸⁶

1. It is still necessary to consider whether there is specific anti-avoidance provision in place even if the general anti-avoidance provision does not apply due to the application of other more specific provision.
2. The choice principle may not be of any assistance to the taxpayer if an arrangement is artificial or contrived. The conclusion may be different if the tax is imposed purely by reference to a legal concept and no part of the transaction involved a liability referable to commercial concepts.
3. It is possible to structure a transaction to produce capital and not income. However, it would appear that legitimate choice making and structuring of

¹⁸³ [2001] 20 NZTC 17,103

¹⁸⁴ E Trombitas "Legitimate Tax Avoidance and the Choice Principle: Some Thoughts Following Recent Cases" (March 2002) Volume 8:1 New Zealand Journal of Taxation Law and Policy <http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?infobase=tax54.nfo&clientID=286389135&softpage=BROWSE_VW&modusreturnurl=http%3A%2F%2Fwww%2Ebrookersonline%2Eco%2Enz%2F&advquery=%5blevel+level+4%3a%5d+tax+avoidance&headingswithhits=on&depth=all&record={3B21}> (at 21 February 2007)

¹⁸⁵ *Peterson v CIR* [2005] 22 NZTC 19,098

¹⁸⁶ E Trombitas "Legitimate Tax Avoidance and the Choice Principle: Some Thoughts Following Recent Cases" (March 2002) Volume 8:1 New Zealand Journal of Taxation Law and Policy <http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?infobase=tax54.nfo&clientID=286389135&softpage=BROWSE_VW&modusreturnurl=http%3A%2F%2Fwww%2Ebrookersonline%2Eco%2Enz%2F&advquery=%5blevel+level+4%3a%5d+tax+avoidance&headingswithhits=on&depth=all&record={3B21}> (at 21 February 2007)

this nature falls within the realm of tax planning at the outset of a transaction, and it does not appear possible for income to be re-characterized into capital once it has been derived or a tax liability is about to crystallize.

4. In New Zealand, it is not possible to alter the incidence of tax by assigning the income if the income is from personal exertion. This means that as a matter of statutory construction no amount of “manufactured choice making” can provide assistance to the taxpayer because under general principles the incidence of the tax will lie with him or her as contemplated by the Act.
5. As a matter of statutory construction, the choice principle cannot produce a result which defeats the intention of Parliament and the scheme and purpose of the Act. Illustrations of this limitation have been referred to immediately above but these limitations seem to arise in limited situations.

7.2 APPLICATION OF CHOICE PRINCIPLE IN *PETERSON* – DEPRECIATION DEDUCTION

A major part of the Privy Council decision was recognizing the choice principle in New Zealand tax law. The ‘choice’ referred by the Privy Council was the depreciation provision of the Income Tax Act: A depreciation deduction is allowed permitting the capital cost of an asset with a limited life to be written off against the tax payer’s taxable income over the expected life of the asset.¹⁸⁷

The Commissioner’s ruling IR52.3 about the special treatment of film depreciation was also considered.

We will firstly look at the legislation that the majority and minority judges were relying on, and then will look at the choice principle argument in *Peterson*.

¹⁸⁷ *Peterson v CIR* [2005] 22 NZTC 19,098 para 10

7.2.1 The depreciation provision

In the majority Privy Council decision of *Peterson*, the judges pointed out that films were assets with a relatively short life and investors could write off the capital cost of acquiring or investing in such asset over their expected life under the general depreciation provisions of the taxing Acts. Thus it is important to understand the depreciation provision in our tax law and the purpose of the provision.

Basically, the concept of depreciation effectively allows a deduction for the cost of a capital asset on the basis it will require replacing. The absence of a deduction for a depreciation loss would lead to an overstatement of the year's profits. A cost in the generation of those profits will have seen a deterioration in the capital assets engaged to produce them. The deterioration will have to be made good when the asset is finally worn out and needs to be replaced. To prevent annual profits from being overstated, it is appropriate to make an annual allowance for the deterioration in and the cost of the replacement of the capital assets of a business.¹⁸⁸ The statutory object in granting a depreciation allowance is to provide a tax equivalent to the normal accounting practice of writing off against profits the capital costs of acquiring an asset to be used for the purposes of a trade.¹⁸⁹

The general depreciation provision consists of s DA1 and s EE 1 of *Income Tax Act 2004*.

In general, a depreciation loss incurred for an income year is allowed as a deduction under the general permission s DA1 to the extent that the loss is incurred in deriving assessable income or in carrying on a business for deriving assessable income despite the capital nature of the loss. The depreciation loss

¹⁸⁸ New Zealand Income Tax Law and Practice para 405-220
<[http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates\\$fn=default.htm](http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates$fn=default.htm)> (at 16 October 2006)

¹⁸⁹ *Peterson v C of IR* (2005) 22 NZTV 19,098, *Barlays Mercantile Business Finance Ltd v Mawson* (2004) 3 WLR 1383

is treated as incurred in the income year for which it is calculated. The capital limitation does not apply to prevent deduction of the depreciation loss under the general permission.

The notion of a depreciation loss incorporates a number of requirements. These requirements are set out in s EE1(2)

EE 1(2) WHEN AMOUNT OF DEPRECIATION LOSS ARISES

A person has an amount of **depreciation loss** for an item for an income year if—
 (a) the person owns an item of property, as described in sections EE 2 to EE 5; and
 (b) the item is depreciable property, as described in sections EE 6 to EE 8; and
 (c) the item is used, or is available for use, by the person in the income year; and
 (d) the amount of depreciation loss is calculated for the person, the item, and the income year under sections EE 9 to EE 11.¹⁹⁰

In short, to be entitled to depreciation loss a taxpayer firstly needs to have ownership of the property. This means the taxpayer must be the legal or beneficial owner of property if a depreciation loss for the taxpayer is to arise.¹⁹¹

Secondly, the property must be a depreciable property. Depreciable property is generally an asset of a capital nature and might reasonably be expected to decline in value whilst used to derive assessable income.¹⁹²

Thirdly the property ought to be used, or is available for use, to derive assessable income. The depreciable property must be used by the taxpayer during the income year. Alternatively, the property must be available for use during the income year. Depreciable property that is subject to a temporary repair or inspection is regarded as still available for use.¹⁹³

Lastly, the amount of the depreciation loss is calculated in the appropriate manner by application of the correct method and rate of depreciation. Most commonly, the depreciation loss is calculated under the diminishing value method as the approach conferring the greater depreciation loss in the early years of use. A second approach is the straight line method. This produces a

¹⁹⁰ Income Tax Act 2004 Section EE1(2)

¹⁹¹ New Zealand Income Tax Law and Practice para 405-220

<[http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates\\$fn=default.htm](http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates$fn=default.htm)> (at 16 October 2006)

¹⁹² Ibid para 405-220

¹⁹³ Ibid para 405-220

uniform depreciation loss over the life of the asset so that it produces the greater depreciation loss only in the later years of use. A final approach is the pool method. This is the diminishing value method applied to a collection of low value assets. Subject to the satisfaction of applicable requirements, the method to be adopted is at the taxpayer's election. The rate to be applied under the applicable method is the appropriate rate prescribed by the commissioner.¹⁹⁴

When depreciable property is disposed of, or treated as disposed of, for more than the adjusted tax value of the property, depreciation recovery income arises. The profitable sale on that calculation indicates that the total depreciation loss previously allowed for the property has been too generous so that the excess through the creation of depreciation recovery income needs to be reimbursed. A disposal for less than adjusted tax value indicates that the prior deductions for depreciation loss have been inadequate. A further depreciation loss arises except for building and petroleum exploration assets.¹⁹⁵

In the film production industry in particular, investors are allowed to capitalise and depreciate the costs of producing films at the rate of 50% over a period of two years based on the Commissioner's ruling IR52.3 published in 1952. The ruling says:¹⁹⁶

Para 52.3 FILMS COMMENCING ON OR BEFORE 5 AUGUST 1982

- The tax treatment which applies to these films is:
- No distinction is drawn between investors in films and those persons who are engaged on a full time basis in the business of producing or distributing films. Each is entitled to offset his/ her share of the costs
- of producing or marketing the film against income from the film and income from other sources.
- Deferred fees are allowed as a deduction in the year they are paid. No deduction is allowed for contingent expenditure. The deferred fees are not generally payable if a film fails.
- Non-recourse loans are treated in the same manner as normal commercial loans except that interest in respect of such loans is treated in a similar manner to deferred fees if it is subject to a provision in the documentation whereby

¹⁹⁴ Ibid para 405-220

¹⁹⁵ Ibid para 405-220

¹⁹⁶ Inland Revenue Department Technical Rulings Manual - as at September 1998 > Chapter 52 Film Production and Investment > Para 52.3 FILMS COMMENCING ON OR BEFORE 5 AUGUST 1982
<http://www.brookers.co.nz.ezproxy.auckland.ac.nz/tax/smarttax/default.asp?tab=browse&clientID=1862097052&hitsperheading=on&infobase=tax26.nfo&jump>manual%7enzl%7eird%7etrman%7e1998%7e%7ec h%2052%7etitle&softpage=BROWSE_VW#JUMPDEST_manual~nzl~ird~trman~1998~~ch%2052~title&recordswithhits=off> (17 October 2006)

interest will not be paid if no profit is derived; such interest being a contingent debt only.

- All income from the sale or other exploitation of the film is taxable.
- Costs of producing films are not deductible in the year incurred. Instead, they must be capitalised and depreciated at the rate of 50 percent on cost price.
- The first year depreciation of the cost of producing the film is allowable as a deduction is the year the film is first available for release.

This tax treatment applies irrespective of whether the money used to finance the film was invested before or after 5 August 1982.

Essentially, IR52.3 is drafted with the purpose of encouraging New Zealand film production, not to override the general provisions of depreciation regime. It emphasizes the special depreciation treatment on the costs of producing or marketing films.

7.2.2 Choice principle argument

As discussed above, the depreciation provisions are designed to allow deduction for the cost of capital assets. And IR5.3 provides special treatment to films allowing them to capitalize the costs of producing New Zealand films and to depreciate at a rate of 50%. In other words, the depreciation deduction in general or in particular, provides a tax advantage to taxpayers and this is Parliament's intention.

Disregarding the artificial feature of the non-recourse loan in *Peterson*, the cost of producing the films should not be deductible in the year incurred, but should be capitalised and depreciated at the rate of 50% on the cost price, and the cost should be written off over a period of two years.

The taxpayers were induced to invest in the films in part by the prospect of obtaining a depreciation allowance which would allow them, over a period of two years, to set off against their taxable income from other sources, the whole of their investment in the film, even if the film was never commercially released and so never generated any income at all.

Even though the artificial non-recourse loan obviously boosted the depreciation deduction, the Privy Council was of the opinion that the investors paid \$x+y to

acquire the film. They incurred the expenditure which Parliament contemplated should entitle them to the depreciation allowance which they claimed. Their honours said on page 19,104:¹⁹⁷

Borrowed money belongs to the borrower not to the lender, and this is so whether the borrower incurs a personal liability to repayment or not. Depreciation allowances depend on the taxpayer having incurred the cost of acquiring an asset, not on his liability to repay the lender. It does not matter how he came by the money to acquire the asset; he may have been given it by a friend or relative. Accordingly the fact that the cost of acquisition is funded wholly or in part by a non-recourse loan ought ordinarily to be irrelevant...

Their Lordships further emphasized that the focus was on the party who acquired the asset as they incurred the expenditure which Parliament contemplated should entitle them to the depreciation allowance. They pointed out that:¹⁹⁸

If the Commissioner had shown that the features on which he relied, singly or in combination, had the effect that the investors, while purporting to incur a liability to pay \$x+y to acquire the film, had not suffered the economic burden of such expenditure before tax which Parliament intended to qualify them for a depreciation allowance, then he could invoke s 99 to disallow the deduction.

The council considered the critical point was to consider whether the taxpayer had incurred capital expenditure in acquiring an asset (the films) for the purposes of trade. The focus should be on the party who acquired the films. It did not matter how the party who disposed of the asset dealt with the money. In other words, that the artificially inflated price of the film and the production company made a secret profit at the expense of the taxpayer, did not alter the fact that the taxpayer suffered the economic cost of paying the price.

Their honours also commented on the involvement of the non-recourse loan. They said although the investor did not sustain the economic loss by taking into account the tax deduction by using a non-recourse loan; it should not be attacked by s 99, as it was expenditure or loss before any tax advantage was taken into account. Besides, the fact that the investment was funded by a non-recourse loan did not release the taxpayer's economic burden of paying the full amount of \$x+y.

¹⁹⁷ *Peterson v CIR* (2005) 22 NZTV 19,098, p 19,104-19,105 para 15

¹⁹⁸ *Ibid* p 19,109-19,110 para 39-42

To recap, the majority judges based their judgement on the consideration that the taxpayer did incur the capital expenditure of \$x+y for the purpose of producing the films, thus he was entitled to the depreciation deduction that the Parliament intended him to have - even though, the circulation of the funds made the transaction artificial and the non-recourse loan generated a tax gain in the taxpayer's book. This decision was based on the majority's understanding of the purpose of the depreciation regime, which they stated they considered was to allow assessable income/profits to reflect what accounting concepts would recognise as profits – to allow a deduction over time for costs of capital applied in earning income.

However, the Council pointed out that if the Commissioner argued the case differently, he might already succeed in apply s 99. Firstly the Commissioner could argue the non-recourse loans were made on un-commercial terms. Secondly, he could dispute that the circulation of funds from the production company back to the lender was an agreement with the lender to lend the loan to the taxpayer. And thirdly, the Commissioner might have quarrelled that the \$x was paid to the production company to produce the films, but the \$y was for procuring the loan, so the \$y would not form part of the cost of acquiring a depreciating asset and would not qualify for the deduction claimed.

This comment of the Privy Council makes *Peterson* become the “hollow taxpayer victory”.¹⁹⁹

The dissenting judgement

The strong dissenting judgement in *Peterson* made this case distinct. The minority judges disagreed with the purpose of the depreciation regime submitted by the majority. The judges specifically referred to IR52.3 issued by

¹⁹⁹ N Williams, “Comment: Privy Council Delivers Final Tax Avoidance Decision: *Peterson v CIR*” (September 2005) Volume 11:3 New Zealand Journal of Taxation Law and Policy
<http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?infobase=tax54.nfo&clientID=286389113&softpage=BROWSE_VW&modusreturnurl=http%3A%2F%2Fwww%2Ebrookersonline%2Eco%2Enz%2F&advquery=%5blevel+level+4%3a%5d+tax+avoidance&headingswithhits=on&depth=all&record={EAF}> (at 21 February 2007)

Inland Revenue Department. There were two comments they made on the contents of IR52.3. One comment was that the Ruling had no reference to the cost of acquisition of the film, but rather the “cost of producing or marketing”. The other comment was the wording of non-recourse loans and whether they were to be treated in the same manner as normal commercial loans should depend on the terms of the non-recourse loan in question. If the non-recourse loan was granted on obviously un-commercial terms, the question of whether s 99 was applicable might well arise.

Their honours said on page 19,115:²⁰⁰

The right to depreciate the cost of producing a film and to deduct the depreciation from taxable income is undoubtedly, in ordinary language, a tax advantage. If the cost is met, or is purported to be met, by the proceeds of a non-recourse loan, is the tax advantage claimed by the borrower a tax advantage to which s 99 applies? If the approach recommended by *Richardson J* in the *Challenge* case is followed, and we think it should be, the answer to the question depends on whether the depreciation claim is within the purpose of the statutory depreciation regime. And, in particular, if it appears that the proceeds of the non-recourse loan have not in fact been used to meet the cost of production, the question will be whether the claim to depreciate the amount of the loan falls within that purpose. If it does not then, as it seems to us, s 99 should, in principle, be available for use by the Commissioner.

They further stated:²⁰¹

We cannot believe that if the cost of acquisition of a film is inflated for no commercial reason other than that of qualifying for a higher tax deduction than would otherwise be available the amount of the inflation could be regarded as the sort of cost that the statutory regime was intended to assist or encourage.

It is important at this point to note the comments of the majority judges on IR52.3; they stated that IR52.3 assimilated the treatment of persona engaged in the business of producing or distributing films with that accorded under the general rules to persona who invested capital in film production. The majority judges tended to consider the depreciation deduction based on the general depreciation provision, thus it was enough if the taxpayer could demonstrate they had paid an amount to acquire a capital asset.

²⁰⁰ *Peterson v C of IR* (2005) 22 NZTV 19,098, p 19,120-19,121 para 91

²⁰¹ *Ibid* para 91

Williams thus submitted that it is very difficult to determine whether or not a statutory provision allowing a tax benefit has been frustrated if one is not clear about which provision is being interpreted.²⁰²

7.3 FISCAL NULLITY DOCTRINE

The majority judges in *Peterson* said as long as the taxpayer could prove a capital expenditure had incurred in purchasing an income generating asset, the taxpayer should be entitled to the depreciation deduction. It did not matter how the production company dealt with the money. In other words, the artificial transaction of circulating the non-recourse loan did not void the tax benefit derived by the taxpayer under the depreciation regime. Thus it is important to look at the concept of fiscal nullity or the *Ramsay*²⁰³ approach.

The fiscal nullity doctrine was established by the House of Lords in *WT Ramsay Ltd v IRC*²⁰⁴, where the Court was confronted with a tax avoidance scheme which sought to minimise the taxpayer's exposure to capital gains tax. The Commissioner argued that the tax avoidance scheme should be treated as artificial and a fiscal nullity for tax purposes. On a substantive approach, it was evident that the gain and loss produced by the scheme were meant to be self-cancelling. Lord Wilberforce felt that the scheme was nothing more than a tax avoidance mechanism and concluded that the scheme was to be treated as fiscal nullity and that no loss was available to be offset against the realised capital gain.²⁰⁵

²⁰² N Williams, "Comment: Privy Council Delivers Final Tax Avoidance Decision: *Peterson v CIR*" (September 2005) Volume 11:3 New Zealand Journal of Taxation Law and Policy
<http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?infobase=tax54.nfo&clientID=286389113&softpage=BROWSE_VW&modusreturnurl=http%3A%2F%2Fwww%2Ebrookersonline%2Eco%2Enz%2F&advquery=%5blevel+level+4%3a%5d+tax+avoidance&headingswithhits=on&depth=all&record={EAF}> (at 21 February 2007)

²⁰³ *WT Ramsay Ltd v IRC* [1981] 1 All ER 865

²⁰⁴ [1981] 1 All ER 865

²⁰⁵ T N Arieli, "The Law of Tax Avoidance in New Zealand" (September 2002) Volume 8:3 New Zealand Journal of Taxation Law and Policy
<http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?infobase=tax54.nfo&clientID=286389162&softpage=BROWSE_VW&modusreturnurl=http%3A%2F%2Fwww%2Ebrookersonline%2Eco%2Enz%2F&advquery=%5blevel+level+4%3a%5d+tax+avoidance&headingswithhits=on&depth=all&record={3395}> (at 21 February 2007)

While the *Ramsay* case concerned circular transactions with no lasting fiscal consequences, *Furniss v Dawson*²⁰⁶ extend the scope of the fiscal nullity concept to commercial transactions which have inserted into them steps without any commercial or business purpose apart from the avoidance of tax. In such a case, the court is entitled to ignore the steps so inserted.²⁰⁷

The requirements of applying the doctrine of fiscal nullity were summarized by Lord *Oliver* at p 298 of *Craven v White*.²⁰⁸

- (1) that the series of transactions was, at the time when the intermediate transaction was entered into it, pre-ordained in order to produce a given result;
- (2) that that transaction had no other purpose than tax mitigation;
- (3) that there was at that time no practical likelihood that the pre-planned events would not take place in the order ordained, so that the intermediate transaction was not even contemplated practically as having an independent life; and
- (4) that the pre-ordained events did in fact take place.

A very good comment regarding the relationship between the fiscal nullity doctrine and the statutory language was also made in *Macniven v Westmoreland Investments Ltd.*²⁰⁹

If a transaction falls within the legal description, it makes no difference that it has no business purpose. Having a business purpose is not part of the relevant concept ... Even if a statutory expression refers to a business or economic concept, one cannot disregard a transaction which comes within the statutory language, construed in the correct commercial sense, simply on the ground that it was entered into solely for tax reasons. Business concepts have their boundaries no less than legal ones.

Therefore *Arieli* submitted that the fiscal nullity doctrine is merely a tool of statutory construction and as such operates independently of s BG1. Accordingly, once it is determined that the relevant provision is intended to operate by reference to a commercial as opposed to a legal concept, a substance approach is triggered, and s BG1 may not come into play.²¹⁰

²⁰⁶ [1984] BTC 71

²⁰⁷ New Zealand Master Tax Guide Manual para 33-070 *Ramsay* decision extended
<[http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates\\$fn=default.htm](http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates$fn=default.htm)> (at 16 October 2006)

²⁰⁸ [1988] BTC 268

²⁰⁹ [2001] 2 WLR 377, 395-396 (HL)

²¹⁰ T N Arieli, "The Law of Tax Avoidance in New Zealand" (September 2002) Volume 8:3 New Zealand Journal of Taxation Law and Policy
<http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?infobase=tax54.nfo&clientID=286389162&softpage=BROWSE_VW&modusreturnurl=http%3A%2F%2Fwww%2Ebrookersonline%2Eco%2Enz%2F&advquery=%5blevel+level+4%3a%5d+tax+avoidance&headingswithhits=on&depth=all&record={3395}>> (at 21 February 2007)

As New Zealand tax law is traditionally following a “Form” over “Substance”²¹¹ approach. It is then no surprise that the position of fiscal nullity doctrine in New Zealand tax law is still uncertain, according to *Ariel's* submission above.

Before the Privy Council decision in *C of IR v Auckland Harbour Board*²¹², the fiscal nullity approach was considered not to apply in New Zealand in the face of specific general anti-avoidance provisions.²¹³

In *BNZ Investments Ltd v C of IR*²¹⁴, the Commissioner argued that fiscal nullity could be applied in the context of s 99 of the *Income Tax Act* 1976. Justice *McGechan* did not agree. The doctrine had traditionally been applied to taxpayers who had full knowledge of the tax consequences of their transactions.

Lord *Cooke J* referred to the remarks of the *Ramsay* approach in *Mills v Dowdall*²¹⁵ where his Lordship said “I see no reason why that approach would have to be confined to tax cases”²¹⁶. *Richardson J* did not refer to *Ramsay* but his Honour stressed that analysis must proceed on the basis of legal arrangements actually entered into or carried out. They might be disregarded only where a sham was established or there was a statutory provision requiring a broader or different approach.²¹⁷

In *Miller v C of IR; McDougall v C of IR*, *Baragwanath J* noted that the English courts had introduced the concept of fiscal nullity into English law. His Honour said at p 13,036:²¹⁸

²¹¹ Meaning the courts have adopted a form approach in tax cases and have upheld a taxpayer's arrangements even if the purpose or object or those arrangements is to avoid tax. See NZ Income Tax Law and Practice para 536-300

<http://library2.cch.co.nz.ezproxy.aut.ac.nz/dynaweb/ntx/ntxcomm/@CCH__BookView;pf=;cs=default;ts=default#X> (at 22 February 2007)

²¹² [2001] 20 NZTC 17,008

²¹³ New Zealand Income Tax Law and Practice para 536-700 New Zealand view of fiscal nullity doctrine <[http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates\\$fn=default.htm](http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates$fn=default.htm)> (at 16 October 2006)

²¹⁴ [2000] 19 NZTC 15,732 at pp 15,784–15,785

²¹⁵ [1983] NZLR 154

²¹⁶ *Mills v Dowdall* [1983] NZLR 154 at p 157

²¹⁷ New Zealand Income Tax Law and Practice para 536-700 New Zealand view of fiscal nullity doctrine <[http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates\\$fn=default.htm](http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates$fn=default.htm)> (at 16 October 2006)

²¹⁸ *Miller v C of IR; McDougall v C of IR* [1998] 18 NZTC 13,001

In New Zealand it is unnecessary for the Courts to develop a concept of 'fiscal nullity' to protect the tax base. (Its application in New Zealand was disclaimed by the Commissioner in *C of IR v Challenge Corporation Ltd* (1986) 8 NZTC 5,001 (CA) at pp 5,013, 5,014; also reported as *Challenge Corporation Ltd v C of IR* [1986] 2 NZLR 513 at p 542. Compare under the former Australian legislation *John v FC of T* (1989) 166 CLR 417 at pp 434, 435). Until one comes to s [BG 1] a transaction that is not a sham is treated as effective: *Re Securitibank Ltd (No 2)* [1978] 2 NZLR 136 (CA).

That is to similar effect to the dictum in the *Europa Oil* cases. The strict legal rights approach remains the rule both of the general law and - s [BG 1] aside - of the income tax legislation.

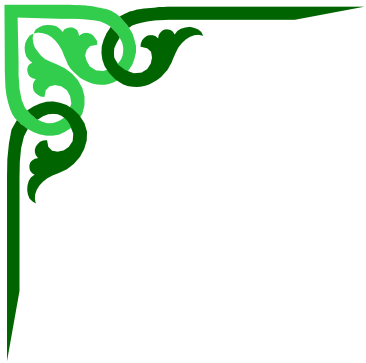
In *Auckland Harbour Board*,²¹⁹ Lord Hoffmann implied that the common law approach in *Ramsay* had assumed a more prominent role over s GB 1 in nullifying tax avoidance schemes. In view of the historical importance of the general anti-avoidance provisions in the *Income Tax Act* 1994, it is submitted that this comment is questionable. It may also be asked why, if the *Ramsay* approach truly had over-arching importance, its supremacy within New Zealand taxation law was not immediately obvious to tax practitioners and the courts.²²⁰

Unfortunately, the Commissioner's Exposure Draft INA0009 provides no comments about the *Ramsay* approach or the fiscal nullity doctrine in New Zealand tax law. This leaves the position of doctrine still unclear.

In *Peterson*, neither the majority nor the dissenting judges refer to the fiscal nullity doctrine, however it is the writer's opinion that if the doctrine is established in New Zealand, the tax avoidance arrangement in this case could be caught under the doctrine, as a step that had no commercial purpose but was artificially inserted for tax purpose – inflating the depreciation deduction, and the Court should be entitled to ignore this step.

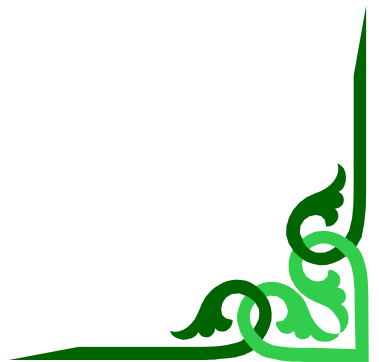
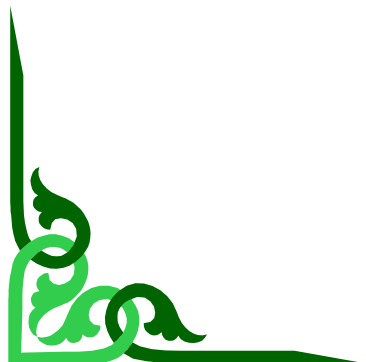
²¹⁹ *C of IR v Auckland Harbour Board* [2001] 20 NZTC 17,008

²²⁰ New Zealand Master Tax Guide Manual para 33-080 Fiscal nullity in the international context <[http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates\\$fn=default.htm](http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates$fn=default.htm)> (at 16 October 2006)



Chapter Eight

Commissioner's power to adjust income



8.0 COMMISSIONER'S POWER TO ADJUST INCOME

In the *Peterson* case, on the appeal to the TRA, the Commissioner had declared that even if the taxpayer had no knowledge about the tax avoidance arrangement the Commissioner had the power to remove the tax benefit obtained by the taxpayer as an affected party.

Once the Court has determined that an arrangement entered into by the taxpayer is void under s BG 1, the Commissioner may, under s GB 1, adjust the income of the taxpayer so as to counteract any tax advantage derived by the taxpayer from the arrangement. 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.

According to s GB1(1), the Commissioner has a broad adjustment power, but must ensure that any adjustment is to counteract any tax advantage obtained by a person from or under a voided arrangement. The Commissioner is not constrained in the means by which the amount of an adjustment is determined.

S GB1(1) states:²²¹

Where an arrangement is void in accordance with section BG1, the amounts of gross income, allowable deductions and available net losses included in calculating the taxable income of any person affected by that arrangement may be adjusted by the Commissioner in the manner the Commissioner thinks appropriate, so as to counteract any tax advantage obtained by that person from or under that arrangement, and, without limiting the generality of this subsection, the Commissioner may have regard to –

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

²²¹ Section GB1(1), *Income Tax Act 2004*

The power of reconstruction contained in s GB1(1) differed from the predecessor s 99 of the 1976 Act or s 108 of the *Land and Income Tax Act* 1954.

S 108 of *Land and Income Tax Act* 1954 indicated that an arrangement was absolutely void as against the Commissioner.²²² Lord Denning in *Newton v FC of T*²²³ said that “absolute void” was not used very precisely. It should mean that the Commissioner was entitled to completely disregard the arrangement so far as it has the purpose or effect of avoiding tax. His honor also added:²²⁴

... the ignoring of the transactions – or the annihilation of them – does not itself create a liability of tax. In order to make the taxpayers liable, the Commissioner must show that monies have come into the hands of the taxpayers which the Commissioner is entitled to treat as income derived by them.

The determination by the courts that s 108 was to be regarded purely as an annihilating provision meant that the effect of the section was limited to removing the state of affairs that existed because of the arrangement and ascertaining whether liability to income tax could arise from the situation that was left exposed. It was only if the taxpayer had in fact received an economic flow that a liability could be created by the operation of the other major provisions of the legislation by effectively assessing the taxpayer on the factual situation left after annihilation.²²⁵

S 99(2) of the *Income Tax Act* 1976 stated that an arrangement with the purpose or effect of tax avoidance was void as against the Commissioner whether or not any person affected by the arrangement is a party thereto.²²⁶ The Commissioner clarified in *Tax Information Bulletin* Vol 8, No 9, November

²²² Land and Income Tax Act 1954 Section 108

²²³ [1958] 11 ATD 442

²²⁴ [1958] 11 ATD 442, page 446

²²⁵ New Zealand Income Tax Law and Practice para 538-300 Commissioner's powers to adjust income <[http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates\\$fn=default.htm](http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates$fn=default.htm)> (at 16 October 2006)

²²⁶ Income Tax Act 1976 Section 99

1996 that the differences between these sections were not intended to change the Department's policy in relation to the general anti-avoidance provisions.²²⁷

Under s BG1 and GB1 of *Income Tax Act* 2004, the Commissioner has the power to adjust the taxable income of any person affected by the arrangement, in the manner the Commissioner thinks appropriate. However, how should this power be exercised?

In *Miller*,²²⁸ the Court of Appeal briefly discussed the ambit of the Commissioner's power under the reconstruction section, and held that:²²⁹

Section GB1 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.

Arieli submitted that s GB1 does not provide a statutory code as to 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. This is undoubtedly a major defect in this area. What the Courts have asserted, however, is that the reconstruction has to be reasonable, such that the Commissioner must have a reasonable basis for his assessment of the taxpayer's income tax liability absent the tax advantage derived from the arrangement.²³⁰

In the IRD's exposure draft INA0009, some fair comments had been made about the scope of the Commissioner's discretionary power. While the Commissioner can make such adjustments as are considered necessary to

²²⁷ Inland Revenue Department *Tax Information Bulletin* Vol 8, No 9, November 1996, Page 8
<[http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates\\$fn=default.htm](http://www.cch.co.nz.ezproxy.aut.ac.nz/nxt/gateway.dll?f=templates$fn=default.htm)> (at 16 October 2006)

²²⁸ *Miller v CIR; Managed Fashions Ltd v CIR* (1998) 18 NZTC 13,961 (CA)

²²⁹ *Ibid* p13,980

²³⁰ T N Arieli "The Law of Tax Avoidance in New Zealand" (September 2002) Volume 8:3 New Zealand Journal of Taxation Law and Policy
<http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?infobase=tax54.nfo&clientID=286389162&softpage=BROWSE_VW&modusreturnurl=http%3A%2F%2Fwww%2Ebrookersonline%2Eco%2Enz%2F&advquery=%5blevel+level+4%3a%5d+tax+avoidance&headingswithhits=on&depth=all&record={3395}>> (at 21 February 2007)

counteract the tax advantage, the adjustment must be only for the purpose of the counteraction.²³¹

The Commissioner's power to adjust is limited to a party to the arrangement and a person affected (who is not necessarily a party) where a tax advantage has been obtained from or under the arrangement.²³²

A "tax advantage" involves an income tax benefit or a better income tax position. Such a tax advantage must be obtained by way of altering the incidence of income tax; relieving any person from an existing, potential or prospective liability to pay income tax; or avoiding, reducing or postponing an existing, potential or prospective liability to pay income tax.²³³

The Court of Appeal in *Peterson* accepted the Commissioner's argument that he has the power to adjust the taxpayer's income tax liability under s 99(2) and s 99(3) even though the taxpayer was not a party to the tax avoidance arrangement. The judges distinguished the decision from *BNZ*²³⁴ by saying that in *BNZ* the taxpayer had no knowledge about the tax avoidance arrangement while in *Peterson* the taxpayer could not distance himself from the arrangement.

Unfortunately, the decision of the Court of Appeal was not followed by the Privy Council, thus how the Commissioner can exercise this power, remains indistinct.

²³¹ *Miller (No. 1) v C of IR; McDougall v C of IR* 18 NZTC 13,001 (HC)

²³² *C of IR v Peterson* (2003) 21 NZTC18,060 and *C of IR v BNZ Investments Ltd* (2001) 20 NZTC 17,103

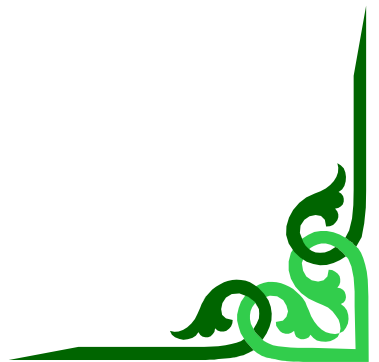
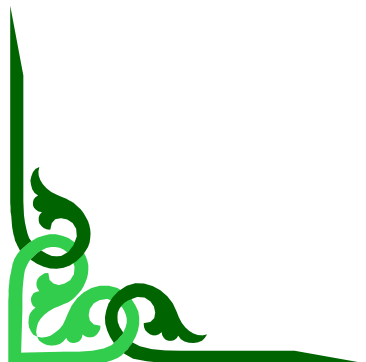
²³³ *Miller (No. 1) v C of IR; McDougall v C of IR* 18 NZTC 13,001 (HC)

²³⁴ *C of IR v BNZ Investments Limited* [2001] 20 NZTC 17,103



Chapter Nine

Conclusion



9.0 CONCLUSION

The Choice principle is a difficult concept in the context of tax avoidance. It indicates that tax benefit obtained by a taxpayer will not be caught under a general anti-avoidance provision if a tax advantage obtained is intended by the Parliament.

Choice principle will not be considered in the first place when a tax avoidance case is brought in front of courts. Base on the IRD's Exposure Draft,²³⁵ to determine whether a general anti-avoidance provision can apply, there must be firstly a tax avoidance arrangement, and tax avoidance purpose or effect of the arrangement is more than merely incidental. At this stage, if the taxpayer can not demonstrate that the tax benefit obtained is intended by the Parliament, in other words, the choice principle applies, the Commissioner can use s BG1 to void the arrangement and counteract the tax advantage achieved.

The application of choice principle comes into being as a result of the difficult position of the s BG1, the general anti-avoidance provision. Clearly the Parliament could never intend that it should over-ride all other provisions of the statute so as to deprive the taxpaying community of all structural choices, economic incentives and allowances provided for by the Act itself, many of which allow for the deliberate pursuit of tax advantage. On the other hand, the section would be a dead letter if it were subordinate to all the specific provisions of the legislation.²³⁶ The recognition of choice principle in New Zealand case law was clearly established from *O'Neil*, and in the writer's view, strengthened in *Peterson* where the majority judges allowed film depreciation deductions

²³⁵ Public Rulings Unit Inland Revenue Department *Inland Revenue's Exposure Draft INA0009: Interpretation of Section BG1 and GB1 of the Income Tax Act 2004*

²³⁶ I L Richardson "Comment: Countering Tax Avoidance" (December 2004) Volume 10:4 New Zealand Journal of Taxation Law and Policy
<http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?infobase=tax54.nfo&clientID=286389126&softpage=BROWSE_VW&modusreturnurl=http%3A%2F%2Fwww%2Ebrookersonline%2Eco%2Enz%2F&advquery=%5blevel+level+4%3a%5d+tax+avoidance&headingswithhits=on&depth=all&record={18A7}> (at 21 February 2007)

claimed by the taxpayer as tax benefits intended by the Parliament regardless that the tax avoidance arrangement entered by the taxpayer was highly artificial.

Although the application of choice principle in *Peterson* is a merit in this case, the writer is not in a position to uphold the decision of the majority judges in Privy Council, and tends to agree with the dissenting judges' submission that if the \$y had nothing to do with the cost of production of the film and nothing to do with the price that the vendor of the film wanted to extract for the rights of the film that he was selling, but was simply a means of boosting the depreciation allowance that could be claimed, it was extraordinary to rule out the application of s 99.²³⁷

The decision of *Peterson* is also considered as a hollow taxpayer victory.²³⁸ As the majority judges said if the Commissioner argued the case differently, the result may well have been different. The majority judges noted that the success of any challenge to an arrangement that may be tax avoidance depends not only on the facts and the weaponry available to the tax authorities, but also on "the marksmanship when such weaponry is discharged."²³⁹ They submitted:²⁴⁰

...the way in which the Commissioner has put his case from time to time, and the allegations and concessions which he has made. They should not be understood as deciding, had the necessary allegations been made and the necessary facts found, he might not have successfully challenged the investors' case ...

The other concern the writer wants to express is that if taxpayers are able to excuse themselves from paying tax just because they have a "lack of knowledge" of a tax avoidance arrangement, smart scheme makers can intentionally produce tax avoidance arrangements that generate considerable tax advantages for "innocent" taxpayers. Eventually s BG1 and s GB1 will be emasculated. Thus the writer is of the opinion that it is essential for the

²³⁷ *Peterson v C of IR* (2005) 22 NZTV 19,098, p 19,123, para 101

²³⁸ N Williams, "Comment: Privy Council Delivers Final Tax Avoidance Decision: *Peterson v CIR*" (September 2005) Volume 11:3 New Zealand Journal of Taxation Law and Policy

<http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?infobase=tax54.nfo&clientID=286389113&softpage=BROWSE_VW&modusreturnurl=http%3A%2F%2Fwww%2Ebrookersonline%2Eco%2Enz%2F&advquery=%5blevel+level+4%3a%5d+tax+avoidance&headingswithhits=on&depth=all&record={EAF}> (at 21 February 2007)

²³⁹ *Peterson v C of IR* (2005) 22 NZTV 19,098, p 19,102, para 2

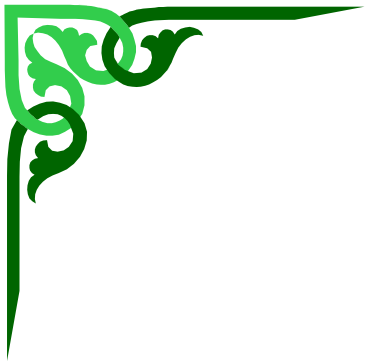
²⁴⁰ *Ibid* p 19,111, para 47

legislation to detain tax advantages gathered by a third party affected by a tax avoidance arrangement. Whether this is valid, we will have to await the decision from the Supreme Court.

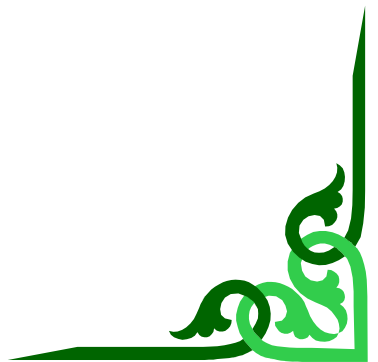
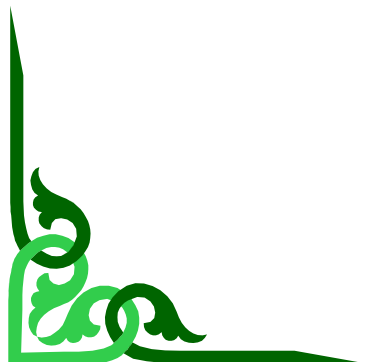
To conclude, choice principle has demonstrated more weight in New Zealand tax law in recent years. Whether it has replaced the general anti-avoidance provision and becomes the essential pillar of our tax law, remains to be further proved by case law. However, it is definitely a strong weapon for taxpayers to argue in a tax avoidance case. In the end, the writer is inclined toward the submission of *Orow*.²⁴¹

The proposition that tax avoidance is the obtaining of an unintended fiscal relief or advantage requires that in determining the scope and nature of the concept, our focus must be on the law "maker" rather than the law "breaker". In this sense the acceptability and legitimacy or otherwise of any means, conduct, or result is determined not by what the taxpayer has done or omitted to do but rather by what Parliament intended. To the extent that Parliament's purpose or intent is determinable or ascertainable, it provides the conceptual basis for deciding what tax avoidance is.

²⁴¹ N F Orow, "Towards A Conceptually Coherent Theory Of Tax Avoidance - Part 2" (December 1995) Volume 1:6, New Zealand Journal of Taxation Law and Policy
<http://www.brookers.co.nz.ezproxy.aut.ac.nz/tax/smarttax/default.asp?infobase=tax54.nfo&clientID=278203076&softpage=BROWSE_VW&modusreturnurl=http%3A%2F%2Fwww%2Ebrookersonline%2Eco%2Enz%2F&advquery=%5blevel+level+4%3a%5d+tax+avoidance&headingswithhits=on&depth=all&record={64A8}> (at 22 February 2007)



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